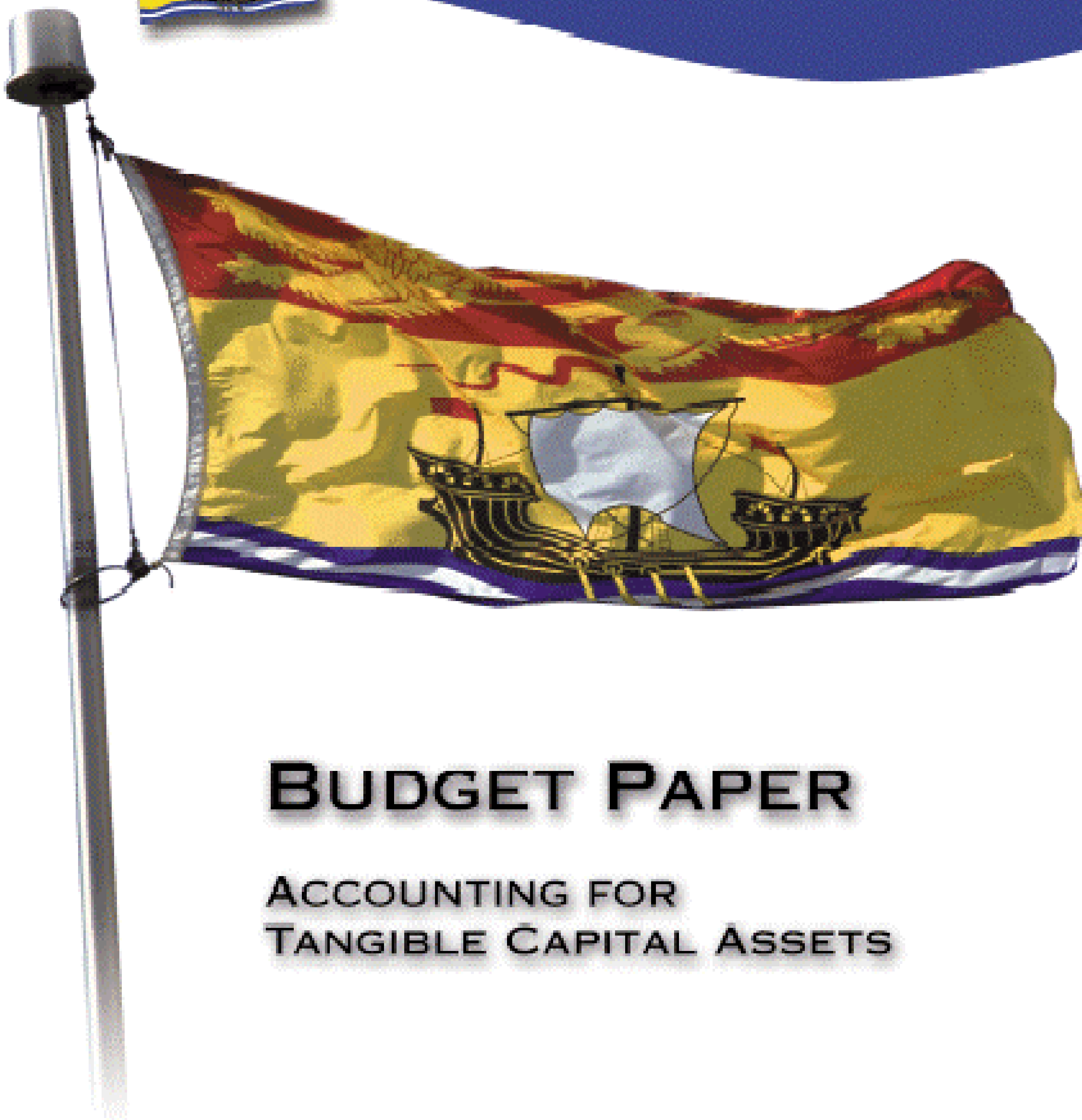

Budget Paper

Accounting for Tangible Capital Assets

New Nouveau Brunswick
CANADA

Accounting for Tangible Capital Assets

Introduction

The Province of New Brunswick is moving toward a major change in its accounting procedures that will enhance accountability to taxpayers.

In making this important accounting change, the government is following the recommendations of the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants (CICA), which released a new model for government reporting.

Under the new policy, the government will account for its fixed assets as prescribed by PSAB. Fixed assets are government-owned buildings such as schools and hospitals, roads, bridges, vehicles, large pieces of machinery or equipment, etc. These items, which have a 'shelf life' and an economic value, are used to deliver services to the public for many years. Accountants refer to these items as tangible capital assets (TCA).

New Brunswick Auditor General Daryl C. Wilson is the current chair of PSAB. In that role, he has been quoted as saying: *"This new model allows us to look at a government's debt and the sources and uses of its cash in addition to its annual results. This will serve to enhance government accountability to taxpayers."*

Five provincial jurisdictions and the federal government implemented the new accounting model by the end of fiscal 2002-2003. The remaining jurisdictions have indicated that they plan to implement it by fiscal 2005-2006.

The change in New Brunswick reflects the government's commitment to financial accountability. It will have an impact on the government's main financial documents and its internal reports. As a result, the public will see more relevant, appropriate and timely information about the government's tangible capital assets.

New Brunswickers will see the new format beginning with the Main Estimates book that will accompany the 2004-2005 Budget in the spring. This short paper outlines what will be different, why and what it means.

What are tangible capital assets?

Tangible capital assets are non-financial assets that are physical in nature such as highways, bridges, dams, reservoirs, schools, hospitals, community colleges, ferries, vehicles, major pieces of equipment, etc.

To be considered a capital asset, an asset must be used in the delivery of a government service. It must also have an expected life or usage beyond one year.

Capital assets are vital to the delivery of government programs and services. The delivery of health care and education would not be possible without capital investment in hospitals and schools. The economy would not be able to function effectively without ongoing investment in transportation infrastructure, including highways and bridges.

Governments have a significant investment in capital assets and must manage the growing demands to fund new capital initiatives (e.g., highway twinning) with the ongoing requirements to maintain existing capital infrastructure.

What are the accounting practices for tangible capital assets?

The long-standing practice of the Province of New Brunswick is to expense the full cost of a capital asset in the year in which it is acquired. This is quite different from the way the private sector would handle the same transaction.

For example, if the government bought a building for $1 million in 2003-2004, it would record the entire $1 million as an expense in its financial statements in 2003-2004.

On the other hand, if a local business bought a building for $1 million at the same time, the $1 million would be expensed over a much longer period. The business would not see the purchase as a one-time event. It would see the building as useful for at least 40 years. It would therefore amortize – or, spread out - the cost over time, recording only $25,000 per year for 40 years as an expense on its books.

Here is another example to explain how the government now handles such situations.

The full cost of a new courthouse is expensed as it is constructed, although the courthouse will serve the public for many years. This means that the full cost of a capital asset affects the Province's bottom line surplus or deficit in the year in which it is acquired or constructed.

> ***Example:***
>
> The Province builds a new courthouse over a three-year period. The cost of the new courthouse is $5 million in Year 1, $10 million in Year 2 and $10 million in Year 3. The courthouse will open at the beginning of Year 4. It is expected to serve the public and last for 40 years.
>
> Under current accounting practice, the Province would expense $5 million in Year 1, $10 million in Year 2 and $10 million in Year 3. There would be no expense related to the construction of the courthouse following Year 3, although the courthouse will be used to provide services during the next 40 years. The Province would have to fund these annual costs out of new or existing revenues so as not to run a deficit.

How does the current accounting practice for capital assets affect the net debt of the Province?

This approach to the treatment of capital assets is consistent with the 'net debt model' that historically has been considered the most appropriate reporting model for governments.

When a government's liabilities are bigger than its financial assets, the government is in a net debt position. Financial assets are either cash or assets that will produce a flow of cash in the future.

At the end of 2002-2003, the Province of New Brunswick's net debt stood at $6.7 billion.

What are the new accounting standards for tangible capital assets?

The new accounting standards will move governments closer to a 'private-sector model' in accounting for capital assets. There will no longer be a fundamental mismatch between the accounting treatment and the life of a capital asset.

Under the new model, the government would expense the $1 million building. It would not be a one-time cost, but it would be spread it out over many years. It would do the same thing as the local business did in our earlier example.

Using tangible capital asset accounting, the expensing of the new courthouse will look different. Government accountants will set it up as an asset because it has long-lasting service potential to the public.

Over 40 years, as the courthouse is used, the government will report a 'usage' or 'depreciation' expense. This means that the full cost of the capital asset affects the government's bottom line surplus or deficit over time as the asset is used.

Let's look at the courthouse example again, using the new accounting model.

Example:

The Province builds a new courthouse over a three-year period. The cost of the new courthouse is $5 million in Year 1, $10 million in Year 2 and $10 million in Year 3. The courthouse will open at the beginning of Year 4. It is expected to last for 40 years.

Under the new model, there would be no expense associated with the courthouse in Years 1 to 3. The cost of the courthouse would be expensed over 40 years (1/40th per year)[1] beginning when it opens in Year 4. The expense would be recorded at $625,000 per year ($25 million divided by 40 years) as the courthouse is used.

How does the new accounting practice for capital assets affect the net debt of the Province?

The new accounting treatment for capital assets will not alter the way in which 'net debt' is calculated.

Using the courthouse example again, net debt will increase if governments cannot fund the cost of the capital asset (i.e., $5 million in Year 1, $10 million in Year 2 and $10 million in Year 3) with new or existing revenues, similar to the current treatment.

However, the new accounting model introduces an additional financial measure for governments that is referred to as the 'accumulated deficit' or 'provincial debt.' The provincial debt can be defined as net debt minus non-financial (tangible) assets.

With this model, net debt is divided into two components: the portion that relates to investment in capital infrastructure and the portion that relates to past operating deficits.

How is the government getting ready for this change?

As indicated in the finance minister's Main Estimates speech in April 2002, the Province has proactively reviewed the new accounting method and its implications. New Brunswick has decided to adopt the new standards in 2004-2005, one year earlier than required by PSAB.

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[1] *The actual expense in Year 4 would be $312,500 because only one-half year of depreciation is expensed in the first year of the capital asset's life, regardless of which month during the year it was actually acquired.*

It is a big challenge to revamp the processes and materials to comply with the new PSAB standards. The Office of the Comptroller is providing leadership, guidance and educational material for financial staff across government. The comptroller's office is also finalizing a comprehensive policy to guide staff.

The Department of Finance will also have to revise financial documents such as the Main Estimates because changes will be required in 2004-2005 to conform to PSAB's new reporting model.

The audited financial statements in the Province's Public Accounts will also look different than in the past.

What kinds of changes are required to the government's financial documents?

The new reporting model will result in a number of financial statement changes. Further details will be available when the Main Estimates for 2004-2005 are issued.

However, here are some hypothetical examples, using a statement of financial position to show provincial debt, a statement of operations to show surplus or deficit, and a statement of change in net debt to show net debt.

In this way, one can compare the presentation under the current accounting model with the presentation required under the new reporting model. (These examples are for illustrative purposes only and are not based upon New Brunswick data.)

Statement of Financial Position

	Current Model	**New Model**
Financial Assets	1,500.0	1,500.0
Liabilities	(8,500.0)	(8,500.0)
Net Debt	(7,000.0)	(7,000.0)
Capital Assets (Net book value)	N/a	3,000.0
Provincial Debt *	N/a	**(4,000.0)**

* *Also referred to as Accumulated Deficit.*

Statement of Operations

	Current Model	New Model
Revenue	5,000.0	5,000.0
Expenditures (excluding capital & depreciation)	(4,700.0)	(4,700.0)
Sub-total	300.0	300.0
Net Capital Expenditures	(250.0)	N/a
Depreciation	N/a	(200.0)
Surplus / (Deficit)	**50.0**	**100.0**

Statement of Change in Net Debt

	Current Model	New Model
Opening Net Debt	(7,050.0)	(7,050.0)
Surplus (Deficit)	50.0	100.0
Sub-total	(7,000.0)	(6,950.0)
Net Capital Expenditures	N/a	(250.0)
Depreciation	N/a	200.0
Ending Net Debt	**(7,000.0)**	**(7,000.0)**

Conclusion

PSAB's new accounting principles represent a major change in how the government will report government-owned capital assets.

The Province welcomes this important change in accounting standards for tangible capital assets and will be ready for implementation with the 2004-2005 Main Estimates.

By showing tangible capital assets in the financial statements, the government will provide a better measure of its financial condition and of the resources available to it in delivering services. It is a better measure because it shows that a government has assets that still have value and service potential.

By including capital assets and depreciation in its financial statements, the government will focus even more on effective long-term capital and maintenance plans. Capital costs will not be out of sight or mind after the acquisition of the asset. The government can gain a much better understanding of the nature and extent of its capital assets and can plan for ongoing maintenance and eventual replacement.

It is also expected that the inclusion of an annual usage or depreciation expense in the government's financial statements will present a sharper picture of the cost of government programs. Transparency and accountability are watchwords for this government, and having a much clearer picture will be good for taxpayers who want to see how and where hard-earned tax dollars are spent.

Government capital assets will be reported on a basis that is more comparable with the private sector. Because the model used for many years by business is more the norm in our province, it will be more readily understandable by the public who are familiar with the concept of assets being expensed over their useful life.

Net debt will continue to be reported, and it will continue to be one measure of the financial condition of the government. However, the provincial debt will serve to better explain the different components of net debt.

Overall, the new accounting standards will maintain the government's commitment to improving financial accountability to all New Brunswickers.