PUBLIC SECTOR ACCOUNTING BOARD

20 Questions About Government Financial Reporting

Federal, Provincial and Territorial Governments

PSAB Public Sector Accounting Board
Conseil sur la comptabilité dans le secteur public CCSP

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

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Foreword

WHO SHOULD READ THIS PUBLICATION?

Elected officials of Canada's federal, provincial and territorial governments will find this guide a useful summary of the basic fundamentals of government financial reporting in the context of newly released reporting standards.

Media reporting on government finances will also find the guide useful for understanding the financial information published by governments.

Any taxpayers wishing to learn more about government finances should find this guide a good introduction.

WHY SHOULD YOU READ THIS GUIDE?

Government spending is responsible for almost half of the country's gross domestic product and governments affect the lives of all Canadians. So, understanding government finances is fundamental to your job as an elected official or reporter of government finances, and most importantly, your role as a Canadian taxpayer. But government is complex and so are its finances, particularly for those without specialized expertise in financial reporting. Even those with some background in private sector accounting and financial reporting can find government financial statements confusing. To clear up some of this confusion, this guide provides a section that contrasts and explains the accounting and reporting done by a business and that done by a government.

The objective of this guide is to make government financial statements more understandable — and less intimidating. It provides enough information so you can ask probing questions about your government's finances and understand the answers. And, it explains some of the features of the new reporting model for federal, provincial and territorial governments.

WHAT WILL THIS GUIDE TELL YOU?

This guide will help you:

- Enhance your understanding of government financial statements.
- Find out why you need to look beyond the government's annual surplus or deficit.
- Discover why net debt is still an extremely significant number.
- Understand what a government's key financial measures are and what they say about government finances.
- Learn why the government's measure of annual results has changed and the implications of this change.
- Learn why comparisons of budgeted and actual performance are crucial for government accountability.
- Understand why governments need to report their capital assets.
- Learn why governments don't report like businesses.
- Find out what rules govern financial reporting.
- Ask good questions about government finances — and understand the answers.

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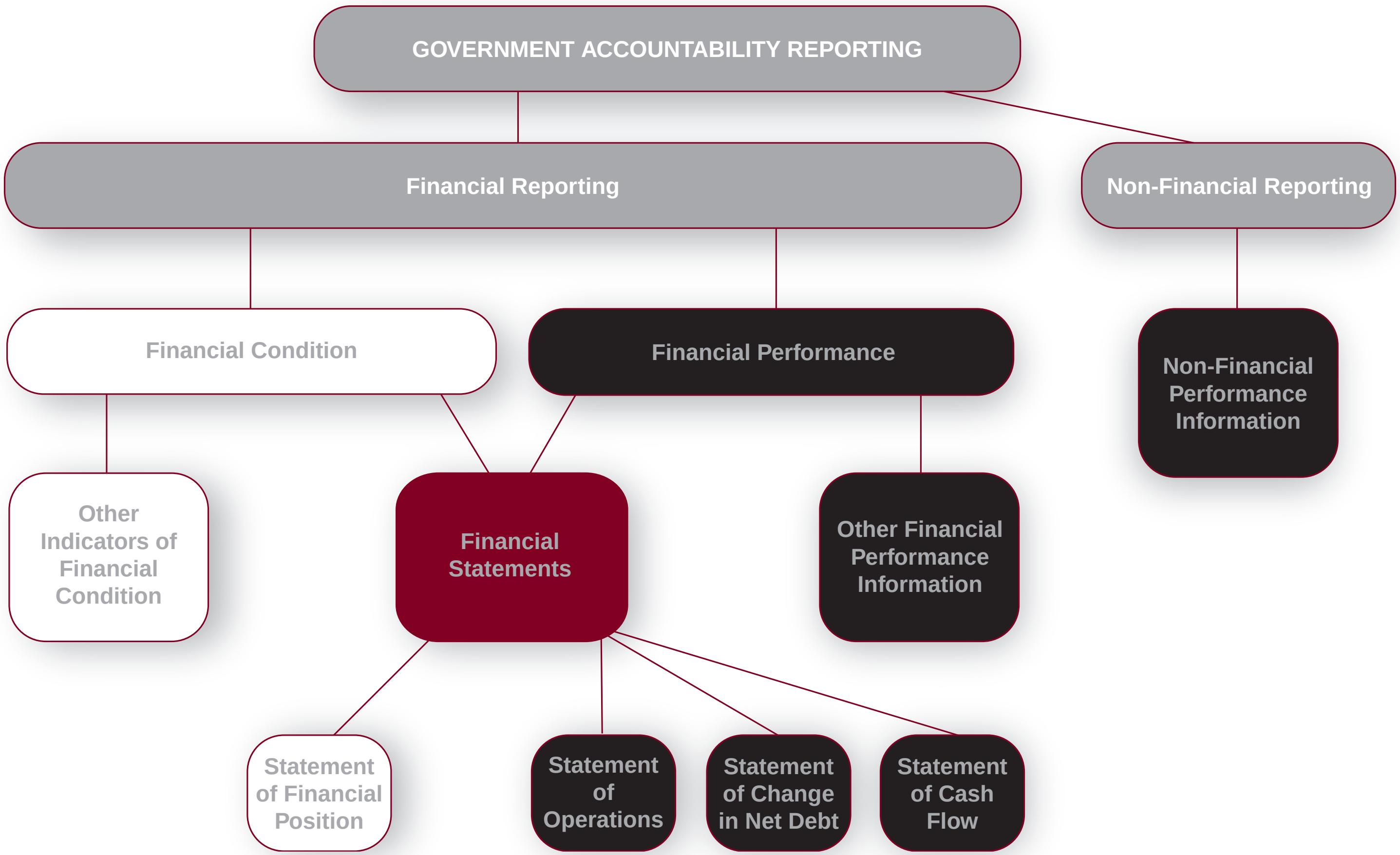
Government Reporting



1 *What is financial reporting?*

Governments prepare many types of reports to provide accountability to taxpayers. Those reports use both financial and non-financial information. Financial reporting involves reporting on a government's financial condition and its financial performance. Non-financial performance reporting reports the outcomes of government actions and programs. Examples of such outcomes might be the health or literacy level of the population or the condition of the environment or the crime rate in a jurisdiction.

Financial condition[1] is a broad, complex concept, with both short- and long-term implications, that describes a government's financial health in the context of the overall economic and financial environment. Financial performance considers both the changes in the government's financial position in the year (including its results of operations) and other additional financial performance information such as cost per kilometre of road, the total cost of services outsourced, the cost of individual services provided per capita or financial ratio and trend information.

Financial reporting is essentially a process of communication of financial information. Financial reporting is a key source of the information elected officials need to make informed choices about how to use their government's limited resources to best serve the interests of taxpayers. It also provides accountability about government finances and how governments have used the resources taxpayers have entrusted to them.

Government financial statements are a fundamental component of government financial reporting *(as illustrated in figure 1 on the facing page)*.

Government financial statements traditionally report a government's financial position at the end of the year and its results of operations for that year.

The government's financial position is a snap-shot of where it stands financially in terms of the resources it holds and the debts it owes at a particular point in time, such as the year end. Financial position as measured in the financial statements is only one factor in determining a government's financial condition. Financial condition is a broader concept than financial position. Nevertheless, financial statements provide information that is essential to evaluating a government's financial condition, and they form the cornerstone of a government financial report.

The changes in a government's financial position in a year describe the results of its activities in that year. There are three components to the changes in a government's financial position: its annual surplus or deficit (results of operations), its change in net debt and its change in cash. All three and their relationship to each other are discussed later in this guide. The changes in the government's financial position presented in the financial statements are essential — but not the sole factors in assessing a government's financial performance in an accounting period. Additional financial performance information that draws on data external to the financial statements supplements and adds further depth to the picture of financial performance shown in the financial statements.

1 "The financial condition of a government is its financial health as measured by sustainability, vulnerability and flexibility, looked at in the context of the overall economic and financial environment." *"Indicators of Government Financial Condition,"* Research Report. Toronto: CICA, 1997.

Financial reporting involves reporting on a government's financial condition and its financial performance.

2 *What is a financial reporting model and why is it important?*

WHAT IS A FINANCIAL REPORTING MODEL?

The term **"financial reporting model"** is a misnomer as financial reporting is broader than just financial statements. But traditionally, the term "financial reporting model" is used to describe the set of rules, parameters and content requirements that prescribe what must be presented in financial statements.

At a minimum, a financial reporting model prescribes the number, type and format of the financial statements, what information those financial statements should report, when it should be reported and how, as well as the notes required to explain what has been reported in the financial statements.

A financial reporting model dictates the basis of accounting used in compiling a government's accounting records because the accounting system must be able to generate the financial information needed to meet the requirements of the model. The basis of accounting is the prescribed method of accounting (such as cash or accrual) that specifies when revenues, expenses, assets and liabilities should be recognised in the financial statements.

The new reporting model prescribes five indicators or "messages" that should be included in government financial statements: net debt; accumulated surplus/deficit; annual surplus/deficit; change in net debt in the year; and the cash position and the cash flow in the year. Each is needed to help readers understand how well a government has managed its finances in a year and where it stands in terms of resources held and debts owed at the end of that year. The new model also prescribes the full accrual basis of accounting, which means that it incorporates information about the stock and use of a government's capital assets. Accrual accounting is explained on *pages 18-19* of this guide.

WHY IS A FINANCIAL REPORTING MODEL IMPORTANT?

A financial reporting model is important because it provides a framework within which governments can assess their transactions and results and account for and report them on a consistent basis — from year to year and from jurisdiction to jurisdiction.

A reporting model describes the basic information needed for fair presentation of government finances. The criteria accountants use to determine whether financial statements are fairly presented are known as generally accepted accounting principles (GAAP). The nature of GAAP is described on *pages 12-13*.

The term "financial reporting model" is used to describe the set of rules, parameters and content requirements that prescribe what must be presented in financial statements.

3 *What is PSAB?*

"PSAB" is the acronym for the **Public Sector Accounting Board** of the Canadian Institute of Chartered Accountants (CICA). PSAB has the authority to set accounting standards for the public sector. That authority means that PSAB sets generally accepted accounting principles (GAAP) for governments. GAAP is explained on *pages 12-13* of this guide.

Detailed information about PSAB, such as its Terms of Reference, is provided on its web page at **www.cica.ca/PublicSector**. PSAB follows a "due process" in developing standards. A detailed description of this process is described on the PSAB web page too.

PSAB has a chair and a maximum of 11 members. Members of PSAB or its task forces are not appointed by other organizations. PSAB recruits individuals, and all PSAB Board and task force volunteers serve as individuals and not as representatives of their governments or organizations — a policy which allows for a full and open debate on issues.

Members are recruited based on:

- their commitment to PSAB objectives;
- their technical knowledge; and
- their ability to consider the practical aspects of issues being debated and influence the adoption of standards and the building of consensus on the Board's positions.

PSAB's Board and task force members are drawn primarily from the ranks of senior government, including Deputy and Assistant Deputy Ministers of Finance and Municipal Affairs, comptrollers, legislative auditors, budget directors, and municipal treasurers and auditors, but also include academics, bond-raters and other experts in government accounting and auditing. Current members of PSAB are listed in **PSAB Who's Who** on PSAB's web page.

The objectives of PSAB are:

- To issue recommendations and guidance that enhance the usefulness of public sector financial statement information.
- To issue recommendations that enhance the usefulness of public sector financial and non-financial performance information.
- To engage interest and debate by improving stakeholders' understanding of public finances.
- To effectively coordinate activities with other accounting standard-setters and other public sector related organizations.
- To provide PSAB's program of standard-setting and communications effectively, efficiently and economically.

In meeting its objectives, PSAB:

- Is committed to serve the public interest.
- Follows due process and respects and encourages input from all of its stakeholders.
- Brings objectivity to the consideration of issues.
- Respects stakeholders' ability to change.
- Recognizes the need for timely responses to stakeholders' needs.

"PSAB" is the acronym for the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants (CICA).

4 What is "GAAP"?

"GAAP" stands for "**generally accepted accounting principles.**" For governments, the standards set out in the *CICA Public Sector Accounting (CICA PSA) Handbook* are the primary source of GAAP.

Generally accepted accounting principles (GAAP) encompass broad principles and conventions of general application together with rules and procedures that determine accepted accounting practices at a particular time. Establishing generally accepted accounting principles for any sector is an evolutionary process. GAAP evolves and adapts to changes in economic or social conditions.

For senior governments in Canada, these standards are "generally accepted" in the true sense of that phrase. The federal, provincial and territorial governments are sovereign governments. They can't be forced to follow the standards. Yet, there is a very high voluntary compliance with the standards in the *CICA PSA Handbook*.

GAAP for governments have concentrated mainly on the summary financial statements — a set of financial statements tailored to meet the basic financial information needs of a broad range of potential users, such as taxpayers, the media and special interest groups. GAAP govern the format and contents of these multi-purpose financial statements.

Summary financial statements include the financial position and results of all the organizations a government controls. Because they are summary documents, they cannot be expected to fulfill all of the users' needs served by a government's financial reporting system. To do that, governments produce many kinds of other financial reports in addition to the financial statements. For example, individual entities prepare reports to comply with certain legislation; there are reports to measure and report on the performance of individual programs and activities; and there are special purpose reports designed to meet particular needs of specific users. In addition, governments set out their fiscal plan in budgets and estimates of expenses or expenditures. Certain information is better provided, or can only be provided, by financial reports other than summary financial statements.

Nevertheless, summary financial statements are a central feature of government financial reporting. Governments use them to account for their administration of public financial affairs and resources. These financial statements are a primary way to communicate financial information to those not involved in the government's financial administration. They present information that can be integrated with other government financial statements, schedules and reports. They are "general purpose financial statements." Government financial statements prepared according to GAAP are comparable across the country.

"GAAP" stands for "generally accepted accounting principles."

WHAT YOU SHOULD LOOK FOR:

- A “clean” audit report on the financial statements. This means that an external auditor has expressed no reservations or concerns about the information reported in the financial statements, how the information is reported or whether any information appears to be missing.
- A note to the financial statements (generally Note 1) outlines the accounting policies a government has used in preparing the statements. This note may also tell you if a government’s financial statements are prepared in accordance with GAAP.

5 *Why should governments follow GAAP?*

In the public sector, a fundamental principle of accountability requires governments to report "credible" financial information to their legislatures and stakeholders.

For financial statements to be credible, readers need to have confidence that the statements follow accepted and identifiable standards established by an arm's length standard-setting body. Standards should not be chosen according to the preferences of individual financial statement preparers or auditors. Accounting principles that are subject to either changes in laws or the needs of special interest groups result in inconsistencies in both the principles and their application. Further, bias can occur when accounting principles are selected with the interest of a particular user, economic or political objective(s) in mind.

When all senior governments follow the same rules in preparing their statements, a reader can compare and contrast the financial statements of one government with another, or of the same government over time, even if the statements have been prepared by different governments. If individual governments of the day follow independently set standards, readers can have confidence that the financial statements are consistent or comparable over time. Without such confidence, the credibility of all government financial statements is compromised.

Financial statement preparers or their auditors may have their own ideas as to what accounting standards should say. They might prefer that a particular standard be different, and there may be good theoretical arguments for alternative viewpoints. That is why PSAB's processes for developing accounting standards provide ample opportunity to express individual points of view. Once the standards are established, however, individual preferences must be set aside and the standards followed. That is why PSAB is at arm's length from government financial statement preparers and auditors.

Accounting principles that are subject to either changes in laws or the needs of special interest groups result in inconsistencies in both the principles and their application.

6 *Why should governments use a different reporting model than businesses?*

Governments are inherently different from businesses. And, the unique characteristics of government have implications for what a government needs to report in its financial statements.

The objectives of financial reporting for governments and businesses are not the same. For example, government's goal is to provide services and redistribute resources, not make a profit. The *tables on the following two pages, 16-17* summarize this and other unique characteristics of government and their reporting implications. The accounting standards established for business do not require the presentation and disclosure of all of the financial information needed for government accountability and useful for decision-making by the users of government financial statements.

As a result, government financial statements do not look exactly like those of a business. For example, while both report assets and liabilities in describing financial position, government financial statements also require that two indicators of financial position be reported — "net debt" and "the accumulated surplus/deficit." The financial statements of a business do not show net debt — only accumulated surplus/deficit (equity).

One of the reasons government financial statements show net debt as an indicator of financial position and then add non-financial assets (including capital assets) to it to calculate the the accumulated surplus/deficit number is because government capital assets are different from those of a business. They can't be used to pay off liabilities unless they are sold. Because of the unique characteristics of government, making government financial statements look like those of a business might be misleading.

A government's goal is to provide services and redistribute resources, not make a profit.

Unique Characteristics of Government

	UNIQUE CHARACTERISTIC	EXPLANATION	REPORTING IMPLICATIONS
1	Government's goal is to provide services and redistribute resources, not make a profit.	Government accountability is primarily for the level, quality and cost of services provided. Governments redistribute resources through grants, concessionary loans and other transfers, in accordance with government objectives. In fact, most resource redistribution involves service provision by one level of government or another, except for welfare and other monetary assistance programs. The ability of a government to afford existing services and meet the need for new services is also key information.	**Net cost of services** and affordability of services should be reported. The **net economic resources (accumulated surplus/deficit)** available to use in providing future services should be reported.
2	Most government tangible capital assets are different in nature from those held by a business.	Most government tangible capital assets represent service capability, rather than future cash inflows to the government. They, and other non-financial assets, represent the portion of the government's financial position that is unexpired service potential. The distinction between a government's financial and non-financial assets is the degree of choice in application associated with them. Financial assets can be used to discharge liabilities or provide services, while non-financial assets are normally used only for service provision, unless they are sold and thus converted back into financial assets.	**Financial assets** and **non-financial assets** should be reported separately on the statement of financial position. The **net financial resources/net debt** and the **net economic resources (accumulated surplus/deficit)** measures should both be reported on the statement of financial position as they represent different perspectives of the government's financial position.
3	Government capital spending may not focus on maximizing financial return because government objectives are broader.	A business is interested in what acquired capital will produce — the end product and the related net cash inflows. For government, the end product might not always be financial. Sometimes, it is the process of building capital that achieves a government objective (for example, providing employment or regional development).	**Capital spending and its effect on net debt** must be highlighted in the financial statements.
4	The principal source of revenue for governments is taxation.	The payment of taxes is obligatory — not part of an exchange transaction nor a voluntary contribution or investment. The bulk of government revenues do not arise from the direct sale of goods and services.	Ability to tax = ability to spend. So **net debt** needs to be reported because it represents the government's future revenue requirements based on past transactions and events (such as spending) to be met from future taxes and is an indication, therefore, of the affordability of additional spending.
5	Governments hold assets acquired in right of the Crown.	For many governments, the value and use of these items far outweigh the value and use of recognized assets. A business does not have access to these types of assets unless they are paid for.	Practical issues regarding the measurement and valuation of these assets prevent their financial statement recognition; however, disclosure of the existence of these assets is key to understanding the government's total economic resources.

	UNIQUE CHARACTERISTIC	EXPLANATION	REPORTING IMPLICATIONS
6	Governments operate in a non-competitive environment.[2]	No competitive market for most government outputs means that there is no independent indication of their value. And many of the services provided by government are unlikely to be provided by anyone else, such as welfare and defence. The benefits of government services cannot be measured solely by a bottom line that shows net revenues or expenses.	**Net cost of services** and affordability of services are the financial measures required, but these are not enough to show the efficiency and effectiveness of government services. Performance measurement information is needed, too. There is no one measure of government performance. Non-financial performance measures are also needed.
7	A government's budget portrays public policy, establishes estimates of revenue, expense, expenditure and financing requirements and is an important part of the government accountability cycle.	The budget includes financing requirements for operating and capital spending. It sets tax rates and decides on borrowing requirements. A comparison of actual-to-budget amounts demonstrates public accountability for government finances.	**Actual-to-budget comparisons** should be provided in the financial statements.
8	Senior governments have debt capacities unparalleled by most other organizations in Canada.	Senior governments' only limits on their borrowing are the ability of their tax base to bear the debt burden and the financial community's assessment of that ability. Businesses are normally reined in sooner than governments. The federal government can control the money supply and has access to international agreements that no other organizations have recourse to. Both factors are taken into account in any assessment of its ability to service its debt load. High debt levels affect the flexibility of governments in providing programs and services, especially in times of economic downturns.	It is essential that **debt** and **net debt** be highlighted in government financial statements.
9	Governments are held to a higher standard of accountability than a business or a not-for-profit organization.	A broader public accountability must be demonstrated in government financial statements because the nature of a democratically elected government requires a greater degree of transparency in financial reporting than most private sector reports provide. Governments are accountable to taxpayers on many levels, in contrast to the more limited accountability a company has for return on investment to a limited group of investors.	The "captive" nature of taxpayers as contributors to government finances requires that they be given simple yet robust information about what has been done with their money — that is, complete information about the government's financial position and results is needed and each financial statement should convey clear, key messages about government finances.

2 Some government business enterprises operate in competitive environments. For the purposes of their own financial statements, government business enterprises follow the standards for profit-oriented enterprises in the *CICA Handbook – Accounting*.

7 *What is accrual accounting?*

The **"accrual basis of accounting"** recognizes the financial effects of transactions in the period(s) in which they occur, irrespective of whether cash has been received or paid. For example, revenue would be recognized for all taxes assessed on income earned by taxpayers in the year even if the cash payment of those taxes is received from taxpayers in a future year. Accrual accounting provides information about assets, liabilities, revenues and expenses, as well as changes in them, that cannot be obtained by accounting only for cash receipts and payments.

In contrast, the **"cash basis of accounting"** recognizes the financial effects of transactions only when cash has been received or paid. For example, cash payments of taxes received in the current year that are related to taxes assessed on income earned by taxpayers in the prior year would be recorded as revenue in the current year, because that is when the cash was received. Cash information on its own provides insufficient information for decision-making and accountability. It is inadequate for assessing or identifying the assets government controls, the liabilities it is obliged to meet and the revenues and expenses resulting from increases or decreases in those assets and liabilities.

Accrual accounting is part of the new reporting model for the senior governments. That model requires governments to capture information on an accrual basis in their accounting systems and then also tells them how to present this information in their financial reports in a way that provides information for decision-making and accountability.

Back in 1992, when PSAB began to consider how to include capital assets in government financial statements, Canada's senior governments already used a form of accrual accounting. This "modified accrual accounting" concentrated on spending. Under modified accrual accounting, the full purchase price of a capital asset is shown as an expenditure item in the year of purchase and, therefore, the purchase has an immediate effect on the annual results. Modified accrual accounting deducts from the annual results the cost of all resources a government has **acquired** in the year of acquisition. It provides more information than just cash flows, but does not provide information about a government's inventory of capital assets or the cost of using them to provide services. Modified accrual accounting provides information about financial assets only, but requires a government to book and report all of its liabilities.

A reporting model recommended by PSAB in 1997 was a compromise that represented the only consensus the government community could reach at that time. But the model was complex and confusing. It retained the modified accrual measure of net debt as the indicator of financial position and the modified accrual indicator of the change in net debt as the measure of annual results but allowed one of two reporting formats for the statement of annual results and reported capital asset inventories and the cost of using those assets on a separate statement. Many governments did not use this compromise model and in 2000, PSAB went back to the drawing board to develop a government reporting model that more fully and simply incorporated capital asset information into the financial statements.

The "accrual basis of accounting" recognizes the financial effects of transactions in the period(s) in which they occur, irrespective of whether cash has been received or paid.

The new reporting model issued by PSAB in January 2003 asks governments to move to what is called "full accrual accounting." Under full accrual accounting, the annual cost of owning and using a capital asset (estimated depreciation or amortization) is deducted from annual results. That is, a part of the cost of the asset is recognized in annual results in each of the periods of its useful life. So, full accrual accounting charges annual results with the cost of the government resources **used** in the year. A full accrual model provides more information for governments and financial statement readers about a government's financial position and results. In particular, it provides more information about capital assets.

In fact, the main distinction between the old 1992 and the new 2003 reporting models relates to how capital assets are accounted for and reported. An example illustrates the effect of the change in standards:

EXAMPLE: A GOVERNMENT BUYS A NEW BUILDING

Under modified accrual accounting:

- The building is not reported as part of the government's assets on its statement of financial position. Other things being equal, the accumulated surplus decreases (accumulated deficit increases) by the amount of cash used (or debt incurred) to acquire the building in the year the government takes ownership, without any recognition that this cash has purchased an asset that will be used for several years.
- After the year of acquisition, the only part of the annual cost related to the building that is recorded is the annual spending to operate and maintain the building.

Under full accrual accounting:

- The building is included as part of the government's assets. The cash is reduced (or debt is increased) and a new building is included as an asset instead.
- The annual cost of using the building [the depreciation in the reported value of the building] is recognized as an expense as is the annual spending to operate and maintain the building.

WHAT YOU SHOULD LOOK FOR:

- A note to the financial statements (generally Note 1), which describes the significant accounting policies the government used to prepare the financial statements. The basis of accounting a government uses is a fundamental policy that affects the choice of and underlies the accounting policies for specific items reported in the financial statements such as capital assets.
- When the basis of accounting description says, for example, that "these financial statements have been prepared using an accrual basis of accounting, except for…," it may be important to seek the reasoning behind the noted exceptions in order to fully understand the policies used in preparing the financial statements. For example, the accounting policy stated for revenue recognition might state that personal and corporate income taxes are recognized on a cash basis (when collected) because of difficulties in measuring such revenues on an accrual basis.

8 *Why was a new government reporting model needed?*

PSAB's goal is better information for decision-making and accountability. The new requirement to use full accrual accounting, and the approval of a new model that provides a comprehensive set of indicators that describe a government's financial position and results, are significant improvements in government financial reporting.

In 1992 PSAB set out to develop a new reporting model because governments had little or no information about their capital assets, resulting in incomplete information for decision-making and providing accountability to taxpayers.

The standards to date had concentrated on making sure that the government's financial assets and liabilities were all reported, and reported appropriately. But, government accounting had reached a point in its development where it became imperative for PSAB, as the standard setter, to look at how capital assets were reflected in government financial statements.

Many in the government community were concerned that the existing modified accrual or "expenditure" model was creating a bias against spending on capital assets — a bias that was contributing to the "infrastructure deficit" in Canada. Governments needing to balance their budgets found that putting off capital spending was an easy way to meet this objective. The phrase "infrastructure deficit" describes the fact that the infrastructure — such as highways, bridges and canal systems — that supports Canada's economy has been deteriorating over the years. Many argue that this problem is a direct result of the old reporting rules that required governments to charge annual results with the full cost of a capital asset when it was acquired. Many governments were reluctant to spend what was needed to keep assets in good shape because large charges to the bottom line did not make them look good. Capital spending was the easiest thing to put on hold when times got tight and people didn't really notice anything until the infrastructure started falling apart.

The other problem was that the costs of using government capital assets were not considered when key decisions were made, such as the allocation of resources, the setting of user fees and other prices, outsourcing of services, etc. Often, once assets were acquired, they were out of sight, out of mind and did not figure prominently in government decision-making processes in the years subsequent to acquisition.

As well, some people were concerned that showing a statement of a government's financial position without identifying its capital resources was misleading. Even though a government's capital assets are different from its financial assets — capital assets can be used almost solely for providing services and can't be used to discharge liabilities — capital assets are still government resources that will help meet the service needs of taxpayers.

In fact, many governments did not really know what capital assets they had. When PSAB started looking at the reporting model, many governments did not even have an inventory of their assets. And, without such an inventory, it is very difficult to plan for maintenance and replacement of capital assets in a cost-effective way. Governments also had insufficient information to adequately meet their responsibility for the stewardship of the assets entrusted to them by taxpayers.

PSAB's goal is better information for decision-making and accountability.

9 *What are the key features of the new government reporting model?*

Just as earnings-per-share figures do not provide enough information about the financial health of a business, one annual results number is insufficient to explain whether a government has had a good year. Financial statements prepared using the new reporting model give readers five messages about the state of a government's finances:

1. **The government's net debt position** is often called its "future revenue requirements" because this indicator provides a measure of the future revenues required to pay for past transactions and events. Net debt is calculated as the difference between financial assets and liabilities. It provides an indication of the affordability of additional spending. *See statement 1 on page 22.*
2. **The government's accumulated surplus/deficit position** represents the government's net economic resources. An accumulated surplus is that amount by which all assets (financial and non-financial), exceed all liabilities. An accumulated surplus indicates that a government has net resources (financial and physical) that can be used to provide future services. An accumulated deficit means that liabilities are greater than assets and that the government has been financing annual operating deficits by borrowing. The extent of a government's accumulated surplus/deficit is an indication of its ability to provide future services. *See statement 1 on page 22.*
3. **The government's annual surplus/deficit** measures, in money terms, whether a government has maintained its net assets in a year. For example, if a government's revenues equal its expenses in the year such that its annual results are $0, the government is said to have maintained its net assets in the year. The annual surplus or deficit shows whether the revenues raised in the year were sufficient to cover the year's costs. The costs of the year include the cost of using existing and new capital assets to provide services. *See statement 2 on page 22.*
4. **The government's change in net debt in the year** is a measure of whether the revenues raised were sufficient to cover government spending. The spending in the year would include any capital spending to acquire new capital assets. An increase in net debt means that more future revenues will be needed to pay for past transactions and events. And, if a government is spending on capital assets, the statement of change in net debt will highlight the actual level of capital spending in the year and compare it to planned capital spending. *See statement 3 on page 23.*
5. **The government's cash flows in the year** are reported on the Statement of Cash Flow, which shows the change in cash in the year as well as highlights the sources and uses of cash. Capital activities, including the use of cash to acquire capital assets, are highlighted on this statement. *See statements 4a and 4b on page 23*, which illustrate the two allowed formats for this statement. The difference between the two formats relates solely to how the cash flows from operating activities are presented — directly, or indirectly by reconciling from the annual surplus or deficit.

More detail about each of these messages is provided later in this guide.

One further essential feature of the new reporting model is the requirement to report both budget and actual numbers on the Statement of Operations and on the Statement of Change in Net Debt. This provides important accountability to readers of the financial statements. *See "Why are budget and prior year numbers reported in the financial statements?"* later in this guide.

Financial statements prepared using the new reporting model give readers five messages about the state of a government's finances.

10 What do the new statements look like?

The new reporting model requires that a government's financial statements comprise four statements:

1. a Statement of Financial Position;
2. a Statement of Operations (or annual results);
3. a Statement of Change in Net Debt; and
4. a Statement of Cash Flow (two possible formats allowed).

The following are examples of what the new statements look like:

statement 1

Government of X
Consolidated Statement of Financial Position
as at March 31, 20X4

	20X4	*20X3*
	(in $000,000's)	
Financial assets		
Cash and cash equivalents	1,577	1,366
Accounts receivable	1,864	1,708
Portfolio investments	2,122	1,273
Commercial enterprises equity	331	207
Loans	4,909	5,659
Inventories for resale	109	135
Total Financial Assets	10,912	10,348
Liabilities		
Accounts payable and accrued liabilities	2,383	2,644
Issued debt	9,363	9,796
Pension obligations	4,813	4,890
Other accrued liabilities	1,395	1,510
Deferred revenue	308	331
Total Liabilities	18,262	19,171
Net debt	(7,350)	(8,823)
Non-financial assets		
Tangible capital assets	7,218	7,215
Inventories of supplies	112	222
Prepaid assets	30	20
Total Non-financial Assets	7,360	7,457
Accumulated surplus/(deficit)	10	(1,366)

statement 2

Government of X
Consolidated Statement of Operations
for the year ended March 31, 20X4

	20X4	*20X4*	*20X3*
		(in $000,000's)	
	Budget	*Actual*	*Actual*
Revenues			
Personal income tax	5,392	5,969	5,655
Corporate taxes	2,642	2,659	3,848
Sales tax	1,265	1,408	1,543
Fuel tax	470	547	558
Tobacco tax	345	341	330
Lottery revenues	660	770	705
Health insurance premiums	641	680	652
Fees, permits, licenses and fines	581	651	669
Liquor commission	427	485	465
Income from enterprises	50	525	97
Miscellaneous revenues	100	342	402
Investment income	409	610	747
Canada Health and Social Transfer	940	970	903
Other transfers	355	365	280
	14,277	16,322	16,854
Expenses			
Education	4,329	4,287	4,168
Health	4,541	4,626	4,457
Agriculture, environment, development	1,706	1,856	1,740
Social services	1,654	1,701	1,709
Transportation and utilities	626	823	807
Recreation and culture	281	272	217
General government	551	627	560
Justice	468	487	462
Interest expense	93	267	183
	14,249	14,946	14,303
Annual surplus	28	1,376	2,551
Accumulated deficit at beginning of year	(1,366)	(1,366)	(3,917)
Accumulated surplus/(deficit) at end of year	(1,338)	10	(1,366)

The cost of using capital assets in the year to provide services is reflected in these expenses. In accrual accounting, a government allocates the purchase cost of the asset to each of the periods in which the asset is used to provide services.

statement 3

Government of X
Consolidated Statement of Change in Net Debt
for the year ended March 31, 20X4

		20X4	*20X4*	*20X3*
			(in $000,000's)	
		Budget	*Actual*	*Actual*
	Annual surplus	28	1,376	2,551
Purchase of new capital assets	Acquisition of tangible capital assets	(294)	(294)	(250)
Sale of old capital assets	Proceeds on sale of tangible capital assets	0	46	72
Reversal of accrual accounting entries	Amortization of tangible capital assets (depreciation)	226	226	230
	(Gain)/loss on sale of tangible capital assets	0	(5)	(19)
	Write-downs of tangible capital assets	0	24	44
		(68)	(3)	77
Spending to acquire non-financial assets	Acquisition of supplies inventories	0	0	(324)
	Acquisition of prepaid asset	0	(30)	(20)
Reversal of accrual accounting entries	Use of supplies inventories	0	110	102
	Use of prepaid asset	0	20	0
		0	100	(242)
	(Increase)/decrease in net debt	(40)	1,473	2,386
	Net debt at beginning of year	(8,823)	(8,823)	(11,209)
	Net debt at end of year	(8,863)	(7,350)	(8,823)

The change in net debt indicator relates to government spending. A change in net debt reflects the spending to acquire new capital assets in the year less the sale of any old capital assets in the year. The annual surplus/(deficit) is an accrual accounting number. Accrual accounting allocates some of the cost of a capital asset to each of the periods in which the capital asset is used.

The Statement of Change in Net Debt backs out these accrual accounting allocations as well as any gains or losses on sale of capital assets or any write-downs of capital assets.

statement 4a

Government of X
Consolidated Statement of Cash Flow — Indirect Method
for the year ended March 31, 20X4

	20X4	*20X3*
	(in $000,000's)	
Operating transactions		
Annual surplus	1,376	2,551
Non-cash items included in annual surplus/(deficit)	504	522
Prepaid expenses	(30)	(20)
Change in deferred revenue	(23)	16
Other	(708)	77
Cash provided by operating transactions	1,119	3,146
Capital transactions		
Acquisition of tangible capital assets	(294)	(250)
Sale of tangible capital assets	46	72
Cash applied to capital transactions	(248)	(178)
Investing transactions		
Proceeds from disposals and redemptions of portfolio investments	262	2,997
Repayment of loans and advances	768	1,129
Portfolio investments	(594)	(4,089)
Loans and advances	(290)	(280)
Other	(17)	(15)
Cash provided by (applied to) investing transactions	129	(258)
Financing transactions		
Public debt issues	13,970	3,694
Public debt retirement	(14,759)	(6,175)
Cash applied to financing transactions	(789)	(2,481)
Increase in cash and cash equivalents	211	229
Cash and cash equivalents at beginning of year	1,366	1,137
Cash and cash equivalents at end of year	1,577	1,366

statement 4b

Government of X
Consolidated Statement of Cash Flow — Direct Method
for the year ended March 31, 20X4

	20X4	*20X3*
	(in $000,000's)	
Operating transactions		
Cash received from:		
Taxes	8,239	7,267
Transfers	1,541	1,943
Non-renewable resources	2,118	3,808
Fees, permits, licenses and fines	1,581	1,291
Enterprises	1,401	983
Investments	1,564	1,675
Other	1,676	1,516
	18,120	18,483
Cash paid for:		
Salaries, wages, employment contracts and benefits	1,345	1,276
Material and supplies	3,192	2,936
Grants and other transfers	12,074	10,290
Financing charges	282	733
Travel and communication	108	102
	17,001	15,337
Cash provided by operating transactions	1,119	3,146
Capital transactions		
Acquisition of tangible capital assets	(294)	(250)
Sale of tangible capital assets	46	72
Cash applied to capital transactions	(248)	(178)
Investing transactions		
Proceeds from disposals and redemptions of portfolio investments	262	2,997
Repayment of loans and advances	768	1,129
Portfolio investments	(594)	(4,089)
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Cash provided by (applied to) investing transactions	129	(258)
Financing transactions		
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Increase in cash and cash equivalents	211	229
Cash and cash equivalents at beginning of year	1,366	1,137
Cash and cash equivalents at end of year	1,577	1,366

11 *What is the difference between gross debt, total liabilities and net debt?*

"Gross debt" describes the total debt a government owes to outsiders (i.e., "issued debt"), usually through debentures or bonds. Gross debt represents only a part of a government's total liabilities. It is just one item reported on the Statement of Financial Position (*see statement 1 on page 22*).

A government's **"total liabilities"** represent all of the amounts it owes to external parties, including government employees. They include accounts payable, issued debt, employee pension and other retirement obligations, as well as other amounts owing to individuals and organizations outside of the government.

In contrast, **"net debt"** describes one indicator of government financial position. This indicator takes into account the value of many items reported on the Statement of Financial Position. It is calculated as the difference between the sum of all of a government's financial assets[3] and the sum of all of its liabilities and is explained further in the next section of the guide.

3 A government's financial assets are assets that are cash or cash equivalents and other assets that are expected to contribute cash inflows to the government. That is, they are assets that could be used to discharge existing liabilities or finance future operations and are not for consumption in the normal course of operations. Capital assets, except for those identified for and capable of sale in the near term, are not financial assets. Capital assets are used to provide services, not finance future operations or pay liabilities unless they are sold and thereby converted into financial assets.

A government's total liabilities represent all of the amounts it owes to external parties, including government employees.

12 *Why is net debt still an extremely significant indicator?*

Net debt was the focus of the old reporting model. Net debt was the measure of financial position and the change in net debt was the measure of the government's results for the year — its "annual surplus/deficit."

Net debt is a number that results from government spending — it arises over time when a government's spending for the year consistently exceeds the amount of revenues that it raises in the year. Government spending represents almost half of Canada's gross domestic product (GDP)[4]. So, net debt has a direct relationship to the economy.

A government's net debt burden is a measure that focuses on accountability for spending decisions when they are made. The net debt burden also gives some indication of the affordability of future government spending because it represents a lien on the ability to provide future services. There is no "right" level of net debt — what is right for a particular jurisdiction will vary according to its financial condition (financial condition was explained on *page 9* of the guide).

Net debt is often called a government's "future revenue requirements" because it indicates the amount of future revenues that will be required to pay for past transactions and events. If the difference between financial assets and liabilities is positive, putting the government into a "net financial asset position," this indicator means that the government has net financial resources it can use to finance future operations.

Even though the reporting model has changed, net debt is still an extremely significant indicator because it provides information about the affordability of future services. Having to report it may, therefore, act as a check on a government spending beyond its means. The extent of a government's net debt and its financial ability to service residual liabilities that cannot be met through the use of existing financial assets is an important test of that government's sustainability.

WHAT YOU SHOULD LOOK FOR:

- Whether the government's net debt is increasing or decreasing.
- Whether the government's net debt has increased in a year when an annual surplus was reported.

The government's Statement of Change in Net Debt *(discussed later in this publication)* should highlight some of the reasons for the increase or decrease in net debt. This statement should also explain the difference between the government's annual results (surplus or deficit) and the change in net debt.

Net debt has a direct relationship to the economy.

4 The Canadian gross domestic product or GDP is the market value of all goods and services produced in Canada in a calendar year. The gross domestic product includes only final goods and services, not goods and services used to make another product. Changes in gross domestic product are an indication of economic output. It is the standard measure of the overall size of the economy. Looking at the government's spending in relation to GDP provides a measure of the size of government in relation to the economy.

13 *Why do governments need to report capital assets?*

Governments use their capital assets to deliver services over the course of many years. With the new reporting model, governments will no longer show the full cost of an asset as a one-time charge against annual results. In many instances, this meant that capital costs were often not considered in the years after the purchase. Instead, governments will now keep track of their capital property as assets and charge annual results with the cost of using the assets over many years.

Capital assets are not reported as part of a government's financial position because they reduce the government's indebtedness. Government capital assets are generally used to provide services and do not normally generate cash flows that can be used to discharge liabilities. The principal reason for governments recording capital assets is to get a better appreciation of the stock and the cost of using these assets, which should lead to an improved decision-making process regarding their management. But reporting this capital asset information also provides accountability to taxpayers regarding the capital resources acquired, used and managed by governments. Accounting for and reporting the stock and use of capital assets helps:

- provide a context for debating maintenance, renewals, replacement, funding, financing and rate-setting decisions;
- establish a common basis of measurement, allowing for enhanced comparability;
- provide a starting point for evaluating the condition of infrastructure and other assets on a regular basis and for highlighting changes in their condition over time;
- identify the government's flexibility in responding to a community's changing service demands because the government would have a better awareness of its fixed costs and the mix of labour and capital that it can thus employ.

It also helps:

- government provide accountability for the stewardship of the capital resources entrusted to it;
- decision-makers assess current program costs and the need for future infrastructure replacement or improvements.

Having capital asset information prompts decision-makers to consider things such as:

- selling idle assets and using the proceeds to reduce debts, or employ them elsewhere;
- the compounding effect of the cost of infrastructure debt[5] that can result in increased future costs and funding requirements;
- changing plans for infrastructure and other asset growth;
- entering into service agreements with other public or private sector partners;
- removing the assets from service; and
- replacing existing assets, including infrastructure.

WHAT TO LOOK FOR:

- A description of the capital assets a government owns.
- The extent of the cost of maintenance and replacement of capital assets in a year.
- The effect of capital asset purchases in the year on the level of net debt.

The principal reason for governments recording capital assets is to get a better appreciation of the stock and the cost of using these assets, which should lead to an improved decision-making process regarding their management.

5 "Infrastructure debt" is a term used to describe the situation where maintenance is deferred and infrastructure is allowed to deteriorate or be used up beyond the point where its rehabilitation through maintenance alone is possible. In such circumstances, major replacement or refurbishment of components of the system, or the system as a whole is required.

14 *What does the accumulated surplus/deficit number mean?*

The accumulated surplus/deficit and the net debt indicator discussed on *page 21* are the two indicators of government financial position.

Under the previous accounting standard — modified accrual accounting — net debt was the sole measure of a government's financial position. Under the new full accrual reporting model, with the inclusion of non-financial assets, the net debt indicator describes only one dimension of a government's financial position — its future revenue requirements, calculated as the difference between its financial assets and liabilities. The accumulated surplus/deficit number then provides a complete picture of the government's net economic resources as it is calculated by adding its non-financial assets (the majority are capital assets) to its net debt.

The accumulated surplus/deficit number represents the government's "reported net economic resources." Each of the words in this phrase has a distinct meaning.

Economic resources are resources useful for carrying out economic activities, such as consumption, production and exchange.

Some economic resources are not **reported** in government financial statements. Natural resources and Crown lands inherited by the government in right of the Crown, rather than having been purchased, are economic resources that are not recognized in government financial statements because the economic value of such items can't be reasonably quantified. And, there are currently no appropriate public sector recognition and measurement criteria for intangibles, such as air and sea rights. So all intangibles, including those that have been purchased, developed, constructed or inherited in right of the Crown, are not recognized in government financial statements.

The word **"net"** means that the accumulated surplus/deficit number represents the residual that remains when the government's total liabilities are deducted from its total assets.

WHAT DOES THE NUMBER TELL YOU?

- The accumulated surplus/deficit or "accumulated surplus/deficit" indicator tells you the net resources a government has to provide future services.
- An accumulated surplus represents that amount by which all assets (financial and non-financial), exceed all liabilities. An accumulated surplus indicates that a government has net resources (financial and physical) that can be used to provide future services. An accumulated deficit means that total liabilities are greater than total assets and that the government has been financing annual operating deficits by borrowing.
- A government's accumulated surplus/deficit is also the sum of its net financial performance — good and bad — since Day 1. What that means is that it represents the sum of all of the annual surpluses and deficits ever reported by that government.

The accumulated surplus/deficit number represents the government's "reported net economic resources."

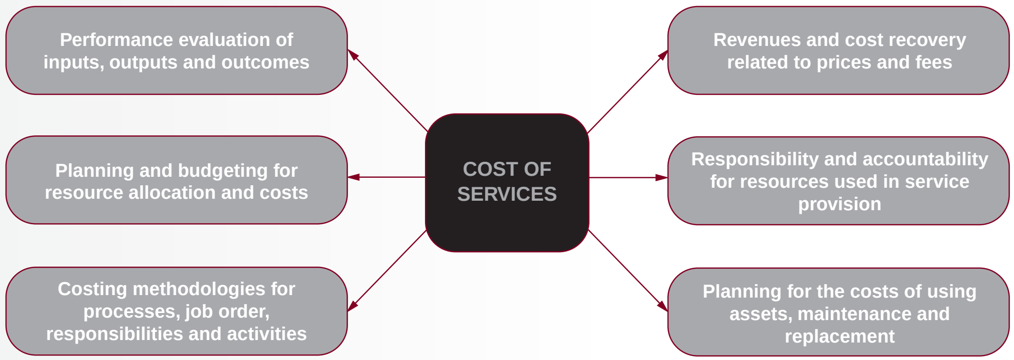
15 *Why is reporting the cost of services important?*

The new reporting model calls for reporting the cost of services or "expenses" in determining a government's annual surplus or deficit. The costs of services must be reported by function (like health, education, transportation) in the financial statements.

Reporting this high-level cost information is important because it:

- provides accountability for the total costs of services for each major government function;
- allows financial statement readers to compare the costs of each government function to its total costs and thus obtain information about the government's priorities; for example, the percentage of government revenues used for education costs could be compared to the amount used for interest costs;
- allows readers to compare costs with those incurred in the prior year and with those budgeted.

The reporting and auditing of high-level cost information also adds credibility to the more detailed costs that underlie the reported numbers. Although the benefits of costs of services information are not realized to any great extent at the financial statement level, real benefits do arise at the program level. The following illustrates the need for cost of services information for planning, budgeting and cost management.



Reporting costs assists management in:

- understanding costs;
- choosing among various service delivery options;
- assisting in cost reduction initiatives;
- establishing charges and fees;
- serving as a basis for transfer payments and subsidies;
- establishing budgets and analyzing variances;
- benchmarking activities and assessing performance;
- improving accountability for allocation and use of resources.

The reporting and auditing of high-level cost information adds credibility to the more detailed costs that underlie the reported numbers.

16 Does an annual surplus mean that a government has money to spend?

The new model moves governments away from a one-dimensional focus on the bottom line and challenges elected officials, the media and taxpayers to make sure that a government is accountable for a slate of key indicators of financial position and results. And, although the new model changes how a government measures its annual results, and the change may mean that a government generates a surplus or reduces a deficit, it would not mean that the government now has extra profits or cash to spend. A change in how a government measures its annual results does not generate cash or open up spending room. The landscape has remained the same, but the picture is being taken from a different perspective.

To get a more complete picture, you need to look at a government's gross and net debt positions and the sources and uses of its cash, in addition to its annual results. Only then can you truly get a sense of whether the government is doing a good job in managing the resources taxpayers have entrusted to it or whether their future is being mortgaged to support the present.

The main distinction between the old and the new reporting models relates to how capital assets are accounted for and reported. So, whether the change in accounting will have a significant impact on the measure of annual results depends primarily on two factors:

1. How significant capital assets are in financial terms for that particular government.
2. The magnitude of the difference between the cost of using capital in the year (the "depreciation amount") and the cost of acquiring new capital in the year.

Municipal governments are very capital intensive. That means their capital assets form a big part of their total resources, hence a change in accounting for capital could have a significant impact on annual results[6]. In contrast, the federal government is considerably less capital intensive. Federal capital assets do not form as large a portion of total resources. So, a change in how it accounts for capital assets would have less of an impact on annual results. The provinces and territories generally fall somewhere in between municipal governments and the federal government in terms of the financial significance of their capital assets.

Regarding the second factor, there are three main scenarios:

1. If a jurisdiction is in a steady state, so that the cost of using capital assets in a year (the depreciation expense for using those capital assets) is approximately equal to the cost of acquiring new/replacement capital assets (the spending to acquire new capital assets), the impact on the measurement of the annual surplus/deficit because of a change in the accounting for capital assets will not be significant.
2. In contrast, if a jurisdiction has capital assets that are fully used up (depreciated), the cost of acquiring new capital assets would be higher than the cost of using existing and new capital assets in the period because many of the old assets would be fully depreciated. In such circumstances, all other things being equal, a government could end up with an annual surplus or a reduction in its annual deficit merely because of a change in how it accounts for capital assets. That is because, under the new model, the larger cost of acquiring new capital assets would not be charged

Although the new model changes how a government measures its annual results, and the change may mean that a government generates a surplus or reduces a deficit, it would not mean that the government now has extra profits or cash to spend.

6 The new reporting model standards apply only to the federal, provincial and territorial governments in Canada. PSAB has started a project to look at local government financial reporting and capital assets accounting.

to annual results. Instead, only the smaller depreciation amount would be charged. Annual results would look better even though only the accounting policy had changed. Of course, this "improved picture" of annual results should not be looked at in isolation. In many instances, debt is incurred for spending on new capital assets and the debt would show up as a liability right away, perhaps impairing the affordability of future services.

3. If a government has primarily new capital assets in a given year, it may find that the depreciation charge for using the assets in the year is much bigger than the cost of acquiring new capital assets would be. In such circumstances, the change in the accounting for capital assets would make a government's annual surplus/deficit look worse.

WHAT YOU SHOULD LOOK FOR:

- The primary reasons for an annual surplus — e.g., operations, or one-time asset sales, or other unusual items.
- The primary reasons for an annual deficit — e.g., operations, or unusual items (natural disaster, health emergency).
- An increase in debt when the government has generated an annual surplus.
- The size of the government's capital asset position in comparison to its accumulated surplus/deficit position.
- Any disclosures on deferred maintenance or capital asset condition in the notes or schedules to the financial statements.
- The capital spending to acquire new capital assets in the period (as shown on the Statement of Change in Net Debt) in comparison to the total depreciation expense charged against annual results in the period related to both old and new capital assets (see the note to the financial statements that details "expenses by object" or the capital asset continuity schedule provided in the notes and schedules to the financial statements).

17 *What is the purpose of the change in net debt statement?*

The Statement of Change in Net Debt is primarily designed to explain the difference between a government's annual surplus or deficit reported on the Statement of Operations and the change in net debt. This statement is important because net debt is still considered to be an extremely significant indicator of government financial position and the affordability of future services.

The statement is also crucial because one of the items that explain the difference between the annual surplus/deficit and the change in net debt is the government's capital spending for the year. The biggest difference in the calculation of the change in net debt and the calculation of the annual surplus/deficit relates to the treatment of capital assets *(see statement 3 on page 23):*

- When calculating the annual surplus/deficit, a government recognizes the costs of using capital assets over the lives of the assets. The full cost is not charged in the period of acquisition, but is spread over future periods, — that is, a portion of the cost of the asset is charged as depreciation cost in each year until the asset is considered to be fully used up.
- When calculating the change in net debt, a government recognizes the whole cost of purchasing an asset at the time the asset is purchased.

The new standards require the Statement of Change in Net Debt to report budgeted numbers as well as actual numbers. So, the budgeted capital spending for the year is also reported in comparison to the capital spending that actually occurred. This reporting gives readers of the financial statements information about whether the government is spending more or less on capital than planned. All other things being equal, increasing net debt through overspending on capital may impair the affordability of future government services; spending less on capital assets than planned may, over time, run down the government's capital assets.

One of the concerns about moving to a calculation of the annual surplus/deficit that does not include capital spending was that a government might feel that it could invest in a lot of new capital assets and the cost of those assets would be spread over future years, with a minimal effect on the annual results in the year of acquisition. So, budgeted and actual capital spending are highlighted on the Statement of Change in Net Debt. The cash flows related to capital acquisition are also highlighted in the new Statement of Cash Flow. Both pieces of information give financial statement readers enough information about capital spending to ask questions if government spending on capital appears to be getting out of hand.

WHAT YOU SHOULD LOOK FOR:

- The primary reasons for a government's change in net debt.
- An increase in net debt when the government has generated an annual surplus.
- Whether the actual capital spending is the same as what was budgeted.
- Explanations for why budgeted and actual capital spending are different [this information is unlikely to be in the financial statements themselves but may be highlighted or addressed in other government documents].

The Statement of Change in Net Debt is primarily designed to explain the difference between a government's annual surplus or deficit reported on the Statement of Operations and the change in net debt.

18 *Why are budget and prior year numbers reported in the financial statements?*

Legislators, investors and other users need information that helps them assess a government's results in the management of its resources and financial affairs. A comparison of the actual results with those originally forecast in the budget, and with those of the prior period, is necessary to identify significant differences. To facilitate meaningful comparisons, planned and prior period results need to be reported using the same accounting policies and must be based on a scope[7] consistent with that used to report the actual results of the current period in the financial statements.

The financial statements provide a measure of a government's financial performance in the achievement of its objectives. Financial statements that include a comparison of the government's actual and planned financial results in a year, provide important accountability information about the budget decisions of the current period.

Unlike the continuity and relatively focused direction provided by a company's board of directors, a government's organizational objectives tend to be very broad, are continuously redefined in each annual budget and are often completely revamped whenever there is a change of government. The budget plays a dominant role in portraying public policy. It establishes estimates of revenues and expenses or expenditures. The budget includes financing requirements for both operating and capital spending. It is used to set tax rates and determine borrowing requirements. A government's budget is a crucial element in the accountability cycle and the standard against which subsequent performance is judged. Governments are thus held publicly accountable for the choices they have made, for their programs, the cost of services and the financial position of their jurisdiction.

Two comparisons of actual and budgeted results, on the Statement of Operations and on the Statement of Change in Net Debt, provide the key accountability information integral to evaluating a government's performance in achieving its operational and spending plans.

Including budget figures on the Statement of Change in Net Debt (in addition to the Statement of Operations) enhances accountability. This stems from the availability of information on actual and budgeted spending on capital assets, the display of the actual and budgeted extent to which expenditures of the period were met by revenues and the inclusion of actual and budgeted opening and closing net debt numbers.

If a budget is prepared on a different basis or for a different scope than the financial statements, the government needs to provide a link to the financial statements so that the legislature understands how the results for the period compare to the results planned and the amounts the legislature authorized to accomplish those plans. When neither the budgeted scope nor the basis of accounting used in the budget is consistent with that used for reporting actual results, the financial statements need to provide a reconciliation of the planned information included in the financial statements with that originally budgeted.

In addition to budget numbers, each of the Statement of Operations, the Statement of Change in Net Debt and the Statement of Cash Flow will include comparative numbers for the prior year that can be compared with current year numbers. Changes in performance from the prior year will be apparent. The Statement of Financial Position also provides

7 The scope of the financial statements refers to a government's "reporting entity," which comprises all of the organizations controlled by that government.

A comparison of the actual results with those originally forecast in the budget, and with those of the prior period, is necessary to identify significant differences.

prior year comparative balances. This prior year information highlights areas where the mix of assets and liabilities in the government's financial position has changed from the prior year.

WHAT YOU SHOULD LOOK FOR:

- The accounting policies used in the budget in comparison to those used in the financial statements.
- The organizations included in the government's budget in comparison to those included in the financial statements.
- Any large differences between the current and prior year reported numbers.
- Any changes in accounting policy from the policies used in the prior year [this may be explained in the note that explains the accounting policies used in preparing the financial statements, which is generally Note 1, and/or may be explained in a note that explains why prior year numbers have been restated from how they were reported in last year's official published financial statements].
- Explanations of large differences between the current and prior year numbers [these may be provided in documents other than the financial statements].
- Any large differences between the current year actual and budgeted numbers.
- Explanations of large differences between the current year actual and budget numbers [these may be provided in documents other than the financial statements]. In particular, explanations for large differences on the Statement of Operations or a big difference between actual and budgeted capital spending (on the Statement of Change in Net Debt) would be informative.

19 *What information does the cash flow statement provide?*

The Statement of Cash Flow reports the change in cash and cash equivalents in an accounting period, and shows how a government financed its activities and met its cash requirements in that period.

Information about a government's cash flows helps users of its financial statements assess its capacity to generate cash and cash equivalents and its needs for cash resources. A government generates cash to finance its activities and meet its obligations by raising revenue, converting other financial assets into cash and cash equivalents and by external borrowing. Cash flow information helps in evaluating a government's liquidity and assessing its future cash requirements as well as providing accountability for its use of cash resources. Historical cash flow information may be useful as an indicator of the amount, timing and certainty of future cash flows.

The change in a government's cash resources can be explained and must be reported in the context of four major activities — **operations, capital, investing** and **financing**.

The amount of cash flows arising from operating activities is a key measure of the extent to which a government has generated sufficient cash flows to maintain its programs and services, invest in new capital assets, repay loans and make new investments without recourse to external sources of financing. Cash flows from operating activities are primarily derived from the government's principal revenue-raising activities. Therefore, they are generally derived from the transactions and other events that enter into the determination of the results of an accounting period.

Unlike the cash flow statement of a business, a government cash flow statement reports cash flow related to capital acquisitions in the capital activities category. Unlike the capital assets of a business, there are no future cash inflows associated with most government assets. Government capital assets embody "future service potential" because they are used almost solely in service provision. So, there is no return on investment associated with these capital investments as there is for a business. Investing is a term that can only be applied to government financial assets. In addition, this highlighting of the cash flows related to capital acquisitions, when considered along with the capital spending information provided on the Statement of Change in Net Debt, gives financial statements readers the information they need to ask questions if they feel that the level of the government's capital spending is not appropriate.

Cash flow information related to investing would include investments made and realized during an accounting period. Cash flow information related to financing would include both domestic and foreign debt issued and repaid during that period.

WHAT YOU SHOULD LOOK FOR:

- The primary sources of cash — operating or financing?
- The cash outflows to acquire capital assets in the year in comparison to the cash flows from operating activities and the cash flows received from borrowings in the year.

The Statement of Cash Flow reports the change in cash and cash equivalents in an accounting period, and shows how a government financed its activities and met its cash requirements in that period.

20 *What is the purpose of the notes to the financial statements?*

Without explanation, many items reported in the financial statements could be misunderstood. Therefore, generally accepted accounting principles (GAAP) require that the four government financial statements be supplemented with a number of additional disclosures or explanations, known collectively as the "notes to the financial statements" or the "notes and schedules to the financial statements." The notes to the financial statements provide some of the most important data in the financial report and can alert readers to the effects of transactions and events they might otherwise overlook.

In fact, fair note disclosure is not separable from fair presentation of financial statements because classification and presentation within the statements of financial position, operations, change in net debt and cash flow provide the basis for fair disclosure, which is augmented and supported by the accompanying notes. When there are transactions, circumstances or events of such size or nature that their disclosure is necessary to understand a government's finances, a government must provide sufficient information about those events to allow readers to understand their effect on the financial statements. This information would include the significant terms and conditions of such transactions, as well as the nature of such circumstances or events and their financial effects.

WHAT YOU SHOULD LOOK FOR:

- Disclosure and explanation of significant transactions and events in the accounting period.
- Obligations disclosed in the notes but not recognized in the financial statements themselves.
- Resources disclosed in the notes but not recognized in the financial statements themselves.
- Contingencies note disclosure.
- Commitments note disclosure.
- Disclosure regarding operating leases.

The notes to the financial statements provide some of the most important data in the financial report and can alert readers to the effects of transactions and events they might otherwise overlook.

20 Questions

About Government Financial Reporting

Federal, Provincial and Territorial Governments

FEEDBACK

Let us know how we can improve this guide.

Contact PSAB at **www.cica.ca/PublicSector**

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