Ministry of Education
Financial Analysis and
Accountability Branch

21st Floor, Mowat Block
900 Bay Street
Toronto, Ontario M7A 1L2
Tel.: (416) 327-9356
Fax: (416) 325-2007
Email: Andrew.Davis@Ontario.ca

Ministère de l'Éducation
Direction de l'analyse et de la
responsabilité financières

21e étage, édifice Mowat
900, rue Bay
Toronto, Ontario M7A 1L2
Tél. : (416) 327-9356
Téléc.: (416) 325-2007
Courriel: Andrew.Davis@Ontario.ca

Ontario

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MEMORANDUM TO: Superintendents of Business and Finance

FROM: Andrew Davis
Director
Financial Analysis and Accountability Branch

DATE: March 04, 2010

SUBJECT: Update on Changes to Financial Accountability, Budgeting and Reporting

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Over the past two years, the Ministry of Education has been consulting with the education sector on changes to modernize the financial accountability sections of the *Education Act*. I am writing to you today to advise you of the changes that are being made to financial compliance and reporting to improve transparency and consistency.

Most significant among these changes are:

- **I.** Updating Budget Compliance to Public Sector Accounting Standards (PSAB);
- **II.** Expense Exceptions to PSAB Compliance;
- **III.** Accounting Treatment for Capital Funding which will be treated as Deferred Capital Contributions (DCC);
- **IV.** Wrap-up of the Capital Funding Model (mainly New Pupil Places Grants);
- **V.** Treatment of Capital Debt and Reserves

I. Updating Budget Compliance to PSAB

Since 2003-04, school boards have been using PSAB standards for their audited financial statements, however, compliance was on a modified cash basis. This inconsistency in reporting is being eliminated through amendments to the Financial Accountability sections of the *Education Act* which received Royal Assent in December 2009, as part of the Ministry of Finance's Bill 218. This legislation, which comes into effect on September 1, 2010, is key to modernizing financial reporting and updating budget compliance to conform to PSAB standards used by the Province.

It should be noted that the important accountability and financial management levers that boards had available to them in the past will remain, although in some cases, the terminology will change:

- Reserves will either be included in the Accumulated Surplus (which is the summation of prior year surpluses), or treated as deferred revenue (revenues with an external restriction);
- The Accumulated Surplus can be internally restricted and tracked by the board, just as reserves were in the past.

Under the old compliance model when a board drew on reserves to balance its budget, this action masked the fact that it had an underlying deficit. With the introduction of PSAB compliance, it will be transparent that such a board has a deficit.

School boards are still required to pass a balanced budget, although there are circumstances where an in-year deficit is permissible if there is an accumulated surplus. The draw on the accumulated surplus is limited to ensure that this action does not place the board at undue financial risk. To ensure deficit management practices are sustainable, in-year deficits cannot exceed the lesser of:

i. The board's Accumulated Surplus for the preceding year, and
ii. One per cent of the board's operating revenue.

Carrying a deficit larger than this amount will require approval of the Minister of Education.

The amendments in Bill 218 also introduce a new standard for school board financial accountability that will require the adoption and implementation of financial recovery plans to monitor the return of boards to financial health in the event the above mentioned requirements are not met at Estimates or at any other reporting cycle.

II. Expense Exceptions to PSAB Compliance

Benefits

PSAB expense for benefits includes a benefit component for cash costs that will be incurred in the future for both current and retired employees. Currently, the demographic profile of the education sector is such that the cash costs for benefits are less than the PSAB expense. There is a $3 billion unfunded future employee benefit liability in the sector that is growing, which means that benefits provided to employees are in excess of anticipated funding. This liability is impacted by the economy and demographics, but also by plan changes.

The PSAB budget compliance definition will exclude the gap between the cash cost and the PSAB expense, with the exception of any changes resulting from net enhancements to benefits. This definition will be in place for 2010-11 and 2011-12, consistent with the labour framework agreements that call for benefit levels to remain unchanged, with the

exception of the introduction of a $33 million enhancement. A longer term solution will be developed addressing funding and compliance in connection with future labour and benefit discussions.

In making benefit decisions, boards are reminded to keep in mind the financial implications of the proposed new PSAB compliance requirements. For example, as previously announced, the education sector will be receiving $33 million for sector-wide improvements to benefits and other working conditions. When determining the impact of these improvements on board finances, it is important to cost out the PSAB expense not just the cash requirements. If the PSAB expense is higher than the enhancement funding, boards will have to fund this pressure from other sources.

Interest and vacation accrual

Current compliance is based on excluding interest and vacation accruals. This approach was implemented to assist with the transition to PSAB financial statements. The new legislative compliance model will continue to exclude interest accrual on approved debt from compliance, to recognize the difference in timing where interest expense is accrued in one year, but not funded until the following year.

Starting in 2011-12, the vacation accrual will no longer be excluded from compliance. Vacation accruals, unlike the interest accruals noted above, are determined by the board's vacation policy. The Ministry will be providing boards with additional details on how this change will be implemented and when it will come into effect. Boards are encouraged to start looking at options to address this expense.

III. Accounting Treatment for Capital Funding - Deferred Capital Contributions

PSAB currently requires that boards recognize the value of their Tangible Capital Assets (TCA) and report on the use of their TCA, that is, the amortization of the assets which will appear as an operating expense.

With the new accounting treatment for capital assets, the Province wants to ensure that capital does not distort how the board's financial position is presented. Specifically, deficits or surpluses should not be created from building a school that is fully funded. The Province will require boards to follow a policy of Deferred Capital Contributions (DCC) for capital grants. This policy will ensure that financial reporting is more transparent and will help avoid large swings between surpluses and deficits caused by a misalignment of capital grants and the amortization expense. For example, in the absence of a DCC policy, if the Province provides $10 million for a school, this revenue would be recorded in year one, creating a surplus of about $10 million, followed by 39 years of deficits related to the amortization expense. DCC will eliminate distortions to school boards' financial positions.

IV. Wrap-up of the Capital Funding Model (mainly New Pupil Places Grants)

The New Pupil Places grant, for the most part, is a debt support grant. For a small number of boards it still generates some funding for new construction. Since a significant portion of this grant varies with enrolment, boards are left with the risk that if enrolment were to come in below forecast, there wouldn't be sufficient revenue for an asset that is already built. Similar to the DCC rationale whereby the Ministry does not want to distort the financial position of the board, we want to avoid similar distortions created by grants that flow over 25 years where the amortization expense will be quite different.

Based on the evaluation of the current capital funding approach, the NPP model will be wrapped-up and replaced with a debt support grant that does not fluctuate with enrolment. The Ministry intends to propose amendments to the 2009-10 grant regulations and introduce necessary provisions in the 2010-11 grant regulations to wind up the NPP model. Starting in 2010-11 the Ministry will recognize capital grant entitlements on all existing capital programs (NPP, Good Places to Learn, Capital priorities etc.) based on the eligible capital expenditures. The Province will recognize and support all the debt of school boards on approved expenditures that were previously supported by these grants.

The wrap-up will be implemented through a one-time grant that recognizes all the existing capital debt as of August 31, 2010, that is being supported by existing capital programs. This grant will be cash flowed to boards over the remaining term of their existing capital debt instruments. This means that school boards will record a receivable from the Province, and these revenues will be part of the DCC balance. In the absence of ineligible expenditures, the DCC balance will equal the TCA balance, which means that board books will not be distorted by how capital is now being funded.

Boards will continue to long term finance capital expenditures related to these prior capital programs through the Ontario Financing Authority (OFA), and will receive a cash flow from the Ministry to meet their annual debt repayments. This means that a board's cash flow will be different than the revenue recorded (a timing difference only).

Some capital funding is being protected for a small number of boards that still have funding room under the NPP program sufficient to build at least one new school. This entitlement room, estimated at $272M, will be converted into a four year capital program for eligible boards.

V. Capital Debt and Reserves

To help implement these changes, the Ministry will use the capital liquidity templates and develop specified procedures to support a one-time accountant report that validates debt balances, non-permanently financed capital spending and pupil accommodation reserves. The Ministry will provide further details on implementation through a separate memorandum.

Given that the Province will recognize, for funding purposes, the supported debt on existing capital programs, pupil accommodation reserves as of August 31, 2010 will be recovered through offsets against amounts owing for future capital grant entitlement or against cash payable to school boards for supported debt servicing costs, or a combination of the two. This action is necessary to ensure that the debt from approved capital expenditures is not funded twice, once through funding allocated for capital purposes but not spent, and a second time, by covering the cost of the same capital asset through the one time grant. Any transfers from these reserves from the date of this memorandum to August 31, 2010 must be for debt servicing costs only, unless a transfer was supported by a specific board motion dated prior to February 25, 2010 and approved by the ministry. Transfer approvals will continue as per 2009:SB:32, *Introduction of New Accountability Measures for Capital Projects based on Preliminary Findings of the Expert Panel*.

The Ministry has scheduled training sessions in March 2010 to present the changes for the 2010-11 Estimates EFIS forms, which will incorporate the new reporting model and new budget compliance model as well as the implementation of Deferred Capital Contributions.

We look forward to working with you in implementing these important improvements.

If you have any questions, feel free to contact me or:

- Elizabeth Sulkovsky at (416) 325-8527 or Elizabeth.Sulkovsky@ontario.ca
- Marie Li at (416) 326-0201 or Marie.Li@ontario.ca

Andrew Davis
Director
Financial Analysis and Accountability Branch

cc: Directors of Education
DSB External Auditors