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FINANCIAL PLANNING AND BUDGETING - CAPITAL EXPENDITURES

BACKGROUND

4.1 *New process* - The Province changed its accounting policy for recording the purchase and use of tangible capital assets (Exhibit 4.1) in 1999-2000 to comply with generally accepted accounting principles. This resulted in capital expenditures being recorded as assets on the Province's consolidated statement of financial position, and an amount for amortization based upon the useful life of the asset being included in the consolidated statement of operations. Prior to this change in accounting policy, capital expenditures were wholly expensed during the year in which they were incurred. This represented a dramatic shift in accounting for capital assets and required government departments and agencies to develop an inventory and values for all capital assets. One year later, this shift brought about a change in the way the government plans and budgets for expenditures on capital assets.

4.2 In October 2000, a discussion paper entitled *Prioritization of Tangible Capital Assets* was released by the Department of Finance. The purpose of the paper was to establish a process which government departments would follow in obtaining funding for tangible capital assets (TCAs) through the annual Estimates process.

4.3 The new planning and budgeting process included the establishment of a Tangible Capital Asset Prioritization Committee comprised of senior management staff from various departments. Total funding for TCAs is established by Executive Council each year. Departments submit funding requests to the Committee. The Committee is responsible for the review and recommendation of departmental requests for final approval by Executive Council. Recommended total capital spending cannot be greater than the allocation approved by Executive Council. The Committee ensures departments follow established formats and time lines for requesting funding, and that requests are properly categorized in accordance with process guidelines. After funding decisions are finalized, the Committee calculates amortization costs applicable to newly approved and existing TCAs for inclusion in the Estimates.

4.4 Funding for hospital construction and renovations is not reviewed by the Committee. Hospital capital projects are funded by way of grants from the Department of Health to District Health Authorities. Grants are treated as operating expenditures of the Department of Health and, as such, are reviewed by others during deliberations on the Department's operating budget.

4.5 *Process implementation* - The discussion paper was used to communicate and implement the new process for planning and budgeting for capital assets. Drafts of the discussion paper were sent for comment on several occasions to the members of the Senior Financial Executive Forum who are the senior financial managers responsible for accounting for departmental spending. In addition, officials of Treasury and Policy Board and the Department of Finance held meetings with senior staff of the major departments to explain the new accounting policy and budgeting process. Interpretations were provided in response to questions asked, and various amendments and guidelines were issued to respond to concerns expressed.

4.6 To assist in ensuring the new process is properly followed, the discussion paper outlines various knowledge requirements for members of the Tangible Capital Asset Prioritization

Committee. These include: knowledge of policy issues and the business planning process; knowledge of finance and accounting; and experience and operational knowledge related to public works (e.g., construction and repair of buildings and roads). The discussion paper also recommends representation from central agencies such as Treasury and Policy Board and the Department of Finance, and that members be fair and unbiased and make decisions from a corporate perspective. As a further measure to ensure correct implementation of the new process, the Provincial Controller was appointed Chair of the Committee.

4.7 Provincial accounting policies set cost thresholds (Exhibit 4.2 on page 79), below which an expenditure would be considered an operating expenditure, not a capital expenditure. Requests for capital funding which meet or exceed the thresholds are to be submitted to the Committee and are to contain specific information to enable the Committee to evaluate submissions using predefined criteria. No presentations are to be made to the Committee; rather, decisions to fund a project are to be based upon the information submitted. We were told that if submissions are lacking information or are otherwise unclear, additional information or clarification of the submission will be sought. The Committee reviews each proposal and ranks them as either critical, important, desirable, or not recommended.

4.8 *2001-02 funding decisions* - Based upon requests received for the 2001-02 fiscal year (including projects approved by Executive Council prior to this new process being established), and on the high priority classification assigned to so many of them, the Committee concluded that insufficient funding was available to address all critical needs. The Committee requested Executive Council to approve additional TCA funding. Approximately \$10 million in additional funds were approved, bringing total funding for new TCAs in the 2001-02 Estimates to approximately \$187 million. A little over \$102 million was provided for amortization (Exhibit 4.3 on page 80). The amounts approved for each department were included in the 2001-02 Estimates presented to the House of Assembly for debate.

4.9 Departments are informed by letter from the Department of Finance of projects or classes of projects which will be funded. The letter states that any changes to projects must be reviewed by the Committee and approved by Executive Council. Should a project cost less than the approved funding level, departments do not have authority to spend the savings. The Committee decides, based upon project priorities, how and where the savings will be allocated. Savings will not necessarily be allocated to fund assets of the department that received the original funding. Conversely, if a project costs more than originally approved, departments are informed that the Committee may be unable to recommend the additional funds required. Departments must find alternative funding, such as reallocation of funds from other capital projects, or delay the project's completion until future years' funding is available.

4.10 *Monitoring of spending* - Once TCA requests have been approved, departments do not have the authority to divert the funding to a project that was not submitted for approval or to bolster the funds available for another approved project. A contingency amount is established to fund critical situations arising during the year that were unforeseen when initial requests for TCAs were approved. For 2001-02, this amount is \$5 million and is included in the Estimates of the Department of Transportation and Public Works.

4.11 Once the House of Assembly has debated and voted on the annual Estimates, there is a monitoring process to ensure capital funds are being spent for the purposes for which they were appropriated. This responsibility has been assigned to Treasury and Policy Board. The Board reviews department spending and there is regular interaction between Board and senior departmental staff. Monthly forecasts of spending by departments also assist Board staff in monitoring capital spending against approved amounts. Explanations are obtained for variances from spending authority. If departmental capital spending exceeds approved funding, the Board may require

departments to stop a project or fund overspending from another capital project, unless Executive Council approves a recommendation from the Tangible Capital Asset Prioritization Committee for additional capital funds. However, if the project is considered critical and all other avenues of funding have been unsuccessful (including the TCA contingency fund), then the department will have to seek Executive Council approval for the spending through an additional appropriation.

RESULTS IN BRIEF

4.12 The following are our principal observations from this audit.

- The new capital asset planning and budgeting process was well communicated to the individuals required to comply with its requirements.
- Information used to make decisions on the funding of tangible capital assets was not documented in all cases examined.
- Certain departments were allocated blocks of capital funding to be spent as the department decided, which we believe to be inconsistent with the requirements or intent of the new TCA planning and budgeting process, and inconsistent with the handling of requests for capital spending from other departments.
- The process used to set amortization rates was reasonable, and the calculation of amortization costs for the 2001-02 Estimates was accurate.
- Procedures for monitoring departmental spending to ensure consistency with capital asset funding approvals appear to be reasonable.

AUDIT SCOPE

4.13 The objective of this assignment was to assess government's systems and controls for planning and budgeting for tangible capital assets. This audit was completed in October 2001 and conducted under the authority of Section 8 of the Auditor General Act. The assignment was performed in accordance with auditing standards established by the Canadian Institute of Chartered Accountants, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

PRINCIPAL FINDINGS

4.14 We found that the new capital asset planning and budgeting process was well communicated to the individuals who would have to comply with its requirements. We reviewed the membership of the Tangible Capital Asset Prioritization Committee and concluded that, based upon their position responsibilities within the various departments which they represent, the skill requirements for Committee members appear to have been met.

4.15 We selected a sample of ten capital asset funding submissions approved for the 2001-02 budget and examined them to determine if the Committee's information requirements were adhered to. We found submissions relating to school buses and health-oriented information systems did not contain all of the required information. We were informed that the Committee asked for additional information to support the requests, or were otherwise aware of the details supporting the requests, but this additional information was not documented. We recommended that all required information be submitted for future funding requests, and that requests for additional information and responses be documented and kept on file.

4.16 We also observed that the Committee does not prioritize school construction projects. School construction projects are reviewed by the School Capital Construction Committee which reports recommendations to Executive Council. A member of the Tangible Capital Asset Prioritization Committee sits on the school committee. After the school committee's report is approved by Executive Council, the approved school construction projects are presented to the TCA Prioritization Committee for inclusion in the Estimates. We recommended that the tangible capital asset prioritization process be revised to reflect the approval process for school construction projects.

4.17 The Tangible Capital Asset Prioritization Committee could not recommend all funding requests due to the magnitude of the funds required. In the case of school improvements, road construction and road rehabilitation, the Committee negotiated with departments on the level of funding to be provided and allocated a block of funding without specifying the projects to be pursued. The Committee was aware of the types of projects for which funding was needed, but it was left to the departments to decide how the funds would be spent on capital projects so that they would have the needed flexibility to deal with changing priorities, construction delays, program changes, etc. Recommending blocks of funding without specifying how it is to be spent does not appear to be consistent with the requirements or intent of the new TCA planning and budgeting process, and also is inconsistent with how requests for capital spending of other departments are handled. If this process is determined to be the best means of allocating TCA funding for such needs, the documented procedures for TCA prioritization should be updated to better describe and guide the process.

4.18 As part of its mandate, the Committee calculated the amortization costs to be included in the 2001-02 Estimates. The amortization rates were established through a review of rates used by other provinces and discussions with experts on the useful life of specific assets. We concluded that a reasonable process was used to set the rates. We also found that the rates used by the Committee in calculating amortization for the 2001-02 Estimates agreed to Provincial accounting policies. Amortization calculations were accurate and the amounts calculated agreed to amortization recorded in the Estimates.

4.19 However, there appears to be inconsistency in some of the thresholds used to determine whether or not a purchase is to be considered a tangible capital asset (Exhibit 4.2 - page 79). For example, buildings have a threshold of \$250,000 while portable classrooms have a limit of \$50,000, though both serve a similar purpose. Similarly, ferries and boats have a threshold of \$250,000 whereas motor vehicles have a limit of only \$15,000. Computer hardware has a threshold of \$25,000, but computer software has a threshold of \$250,000. We recommended a review of the thresholds to determine if there is benefit in such inconsistencies.

4.20 We wanted to review the Committee's work and specific decisions made in its consideration of funding submissions. However, the Committee did not document its deliberations (through minutes, for example) and thus we were unable to determine the nature of the consideration given to each funding request and the rationale for decisions made. However, we were able to determine that each request was reviewed and in certain cases rejected as not meeting the threshold amount or definition of a capital asset. We recommended that the Committee document future deliberations.

4.21 Procedures for monitoring departmental spending to ensure it is consistent with capital asset funding approvals appear to be reasonable. Adequate systems are in place to reallocate any approved funding which is not required for the projects for which funding was originally provided.

CONCLUDING REMARKS

4.22 In our opinion, the systems and controls for planning and budgeting for tangible capital assets are reasonable. The calculation of amortization costs for the 2001-02 Estimates was accurate. However, the approval process for school construction and the provision of block funding to certain departments appear to be inconsistent with the process described in government guidelines for capital asset budgeting. Also, because of a lack of documentation of certain capital asset funding requests and the deliberations of the Tangible Capital Asset Prioritization Committee, we cannot express an opinion on whether the prioritization of capital spending and the recommendation of capital spending to Executive Council were reasonable and consistent with government guidelines.

*Exhibit 4.1***TANGIBLE CAPITAL ASSETS
DEFINITION**

Provincial accounting policies define a tangible capital asset as:

a non-financial asset that is purchased, constructed or developed and:

- is held for use in the production or supply of goods and services, for rental to others, for administration purposes or for development, construction, maintenance or repair of other capital assets;
- requires operating and maintenance expenditures and may need to be replaced in the future;
- has a useful life extending beyond an accounting period and is intended to be used on a continuing basis; and
- is not intended for sale in the ordinary course of operations.

Tangible capital assets do not include:

- intangibles;
- land and other assets acquired by right;
- works of art and historical treasures; and
- natural resources such as forests, water and mineral resources.

Exhibit 4.2

TANGIBLE CAPITAL ASSETS COST THRESHOLDS	
Land	\$ 250,000
Buildings	250,000
Schools	250,000
Portable classrooms	50,000
Leasehold improvements	250,000
Wharf	250,000
Major equipment	50,000
Ferries and boats	250,000
Computer hardware	25,000
Computer software	250,000
Customized software	250,000
Motor vehicles	15,000
Roads, bridges and highways - substructure, pavement, bridges	500,000
Roads and highways - repaving	500,000

Exhibit 4.3

TANGIBLE CAPITAL ASSETS 2001-02 ESTIMATES		
	Capital Purchases	Amortization
Agriculture and Fisheries	\$ 500,000	\$ 103,000
Community Services	—	35,000
Economic Development	—	4,000
Education	90,558,000	35,068,000
Environment and Labour	25,000	35,000
Finance	—	2,346,000
Health	13,243,000	6,490,000
Justice	—	1,314,000
Natural Resources	400,000	410,000
Public Services	150,000	36,000
Service Nova Scotia and Municipal Relations	650,000	1,587,000
Tourism and Culture	—	23,000
Transportation and Public Works	<u>81,434,000</u>	<u>54,775,000</u>
	<u>\$ 186,960,000</u>	<u>\$ 102,226,000</u>