

Financial Forecasting in the Budget Preparation Process

The original recommended practice was developed by the Government Finance Officers Association (GFOA). Some aspects of the practice have been revised by the Financial Management Capacity Building Committee (FMCBC) for use by Nova Scotia municipal governments. The original GFOA recommended practice is *Financial Forecasting in the Budget Preparation Process*, approved by the Committee on Canadian Issues in 2001.

Recommendation

The GFOA recommends that governments at all levels forecast major revenues and expenditures. Following the GFOA's recommendation, the FMCBC recommends that as part of the budget process local governments forecast all major revenue and expense items.

Purpose

Forecasting of major revenue and expense items allows municipalities to predict the impacts (both short and long term) of current and proposed policies. The ability to predict impacts allows a government to plan for those events.

The forecast, along with its underlying assumptions and methodology, should be clearly stated and made available to participants in the budget process and stated in the final budget document.

Background

Municipalities should have a financial planning process that assesses long-term financial implications of current and proposed policies, programs, and assumptions. Municipalities should develop appropriate strategies to achieve their goals. A key component in determining future options, potential problems, and opportunities is the forecast of revenues and expenditures. Revenue and expenditure forecasting can provide the following benefits:

- Provides an understanding of potential funding available;
- Evaluates financial risk;
- Assesses the likelihood that services can be sustained;
- Assesses the level at which capital investments can be made;
- Identifies future commitments and resource demands; and
- Identifies the key variables that cause change in the level of revenue.

Considerations in Policy Development

Forecasting is an estimate of future demands and needs of the municipality and the revenue required to meet those demands. If the demand for services is exceeding the expected revenue that will be collected, elected officials have the ability to either generate new revenue or rationalize services. For a more in-depth discussion of forecasting revenues and expenditures see *Appendix I*.

Forecasters should make assumptions about future events based on past experience, interpretation of citizen's demands, and the strategic plan of the municipality. It is highly recommended that a municipality have a strategic plan in place to assist with the forecasting process. A strategic plan outlines the future plans of council; the forecast should reflect those plans. Forecasting helps a council to focus on the financial issues that have an impact on what it wants to accomplish.

The forecast should extend at least three to five years beyond the budget period and should be regularly monitored and periodically updated. Forecasts are not static documents; in order to be effective the forecast must be monitored to allow for corrections to assumptions as they occur. To improve future forecasting, the variances between previous forecasts and actual amounts should be analysed. Variance analysis should identify the factors that influence revenue collections, expenditure levels, and forecast assumptions.

Appendices

Appendix I: Considerations in Policy Development

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1) Forecasting Revenues and Expenditures

When forecasting major revenues and expenditures it is recommended that the following categories be used:

<i>Major Revenues</i>	<i>Major Expenditures</i>
<ul style="list-style-type: none"> - Taxes - Grant in lieu of taxes - Services provided to other governments - Sales of services - Other revenue from own sources - Unconditional transfers from other governments - Conditional transfers from other governments - Other transfers, collections from other governments 	<ul style="list-style-type: none"> - General government services - Protective services - Transportation services - Environmental health services - Public health and welfare services - Environmental development services - Recreation and cultural services - Fiscal services

Revenues and expenditures should be presented as gross figures. Gross figures show the total cost of providing the services. This is a practice that is recommended by both the *Municipal Accounting and Reporting Manual* as well as the *Public Sector Accounting Board*. Net figures may also be presented, but the gross format is considered to be the minimum requirement.

2) Forecasting Non-Financial Items

Forecasting Expenditure Drivers

When forecasting, municipalities should identify the major cost drivers for each service or program delivered. These items should then be forecasted along with the financial items to create a more complete picture of the future.

Example:

A municipality has forecasted that in five years the cost of their tennis program is going to be \$50,000. Currently the tennis program costs the municipality \$40,000, and there are 300 people enrolled, each paying \$100. The municipality feels that an increase of \$10,000 in the cost of providing the service is reasonable. However, what about the number of people enrolled in the program? Unless the number of people enrolled in the program increases, along with the cost, the municipality is going to pay more for the tennis program.

Forecasting Service Levels

Another key non-financial item to forecast is service levels. When forecasting, the

costs of new, improved, or changed services should be incorporated. Adding a new service is the most obvious example. The costs of the new service are included in the forecast. Sometimes though, a municipality may change the level of service being offered, and this changes the cost of that service.

Example

If the town office is planning on increasing the size of staff over the next three years, the additional costs should be included in the forecast. Likewise, if the water utility is going to start adding a new beneficial chemical into the water next year, then the additional costs of that chemical must be added to the forecast, as well as any user fee increases.

3) Forecast Assumptions

The assumptions of a forecast are those factors that must be taken into consideration before a forecast can be projected. You cannot produce an accurate dollar forecast of revenues and expenditures without accounting for inflation, and you cannot accurately predict what your taxation revenue is going to be without providing for growth in assessment values.

The following are some common assumptions used in forecasting:

- Consumer Price Index (CPI)/Inflation–(Nova Scotia, Annual Average, Jan.–Dec.)
- Uniform assessment
- Interest rates
- Assessment growth

Other assumptions that can be used including the following:

- Municipal property tax rate increases
- Residential and commercial expansion
- Fuel and oil prices
- General economic conditions

Another important assumption, which was discussed earlier, is service levels. A municipality needs to decide what levels of services are going to be provided before the forecast can be completed. This assumption can be as simple as assuming that service levels are going to remain unchanged, or it can become as complicated as detailing all anticipated changes in service levels, as provided by a strategic plan, and incorporating these changes into the forecast.

4) Municipal Indicators

Municipal Indicators are a set of financial, community, governance, and performance indicators to be used to understand the challenges facing municipalities in Nova Scotia. The entire list of indicators can be located on the Service Nova Scotia and

Municipal Relations website (<http://www.gov.ns.ca/snsmr/muns/indicators/>).

The indicators can be used to augment the assumptions that were presented in the previous section of this document. Calculating these indicators can show municipalities where the danger areas are, and these issues can be worked into the forecast.

Example

A municipality calculates that their transfer from other governments' indicator is at 15%, when the average is 7%. This makes the municipality aware that they are too dependent on transfers and must diversify their revenues.

5) Monitoring the Forecast

The forecast should be monitored on a regular basis to ensure that deviations will be noticed early and corrections made. The current year's forecast should be monitored more closely than future years. Over time many of the assumptions will vary and so it would not be prudent to be monitoring five years into the future in as much detail as a one to two year forecast.

Monitoring consists of verifying the assumptions, comparing the forecasted amounts to the actual amounts as they occur, and identifying any external or internal events that could affect the results of the forecast.

One component of monitoring the forecast should be a variance analysis between the forecasted revenues, expenditures, and non-financial items and the actual results. A municipality should decide what constitutes a significant variance, or deviation from the forecast. A percentage or absolute dollar value should be set as the maximum variation allowed. Any variance greater than the maximum will be investigated and may lead to a change in future forecasts.

6) Communicating the Forecast

An important issue to consider after completing a multi-year forecast is how to disseminate the information to the end-users. The ultimate users of a forecast are generally municipal managers and the council, but they can also include engaged citizens. The forecast can be included in the budget as either a component of the document or as a reference. The forecast can also be posted on the website, separate from the budget, so that the public can access it at any time. Placing the forecast on the municipal website is also a way to gain public interest in the affairs of the municipality (see FMCBC's recommended practice *Using a Website to Disclose Financial Information*).

7) The Forecast Document

If a municipality is creating a formal forecast the following categories are suggested:

- Preamble
- Overview
- Identifying Key Issues
- Assumptions
- Forecast
- Analysis

References

Financial Management Capacity Building Committee. Using a Website to Disclose Financial Information, Approved August 2003.

Government Finance Officers Association. Financial Forecasting in the Budget Preparation Process, Approved 2003.
<http://www.gfoa.org/downloads/rpCCIfinancialforecastingbudgetpreparationprocess2001.pdf>.

Public Sector Accounting Board, The Canadian Institute of Chartered Accountants. CICA Public Sector Accounting Handbook.

Service Nova Scotia and Municipal Relations. Municipal Indicators.
<http://www.gov.ns.ca/snsmr/muns/indicators/public/default.asp>.