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CIVIC AFFAIRS

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An independent fact-finding organization reporting to the public on civic affairs.

July 20, 1951

A DISCUSSION OF T.T.C. FINANCING FOR THE CITIZEN

Fellow Citizens:

Street car and bus transportation in Toronto has been provided entirely by a publicly-owned system since 1921. The year before, a special Act of the Ontario legislature was passed enabling the City to buy out the Toronto Railway Company and assume full control over public transportation services. There were two ways in which civic management could have been set up: a) directly within a City department, as in the case of the waterworks system; or b) under a separated commission, as had been done with the hydro-electric system. The legislation has followed the second alternative and provided for a three-man Commission, appointed by the City Council for a three-year term, and responsible for setting fares and adopting policies that would maintain operations on a paying basis.

Most citizens will agree that the T.T.C.'s record over the years is a very creditable one. Efficient transportation has been provided at reasonable cost; the original debenture debt has been practically wiped out; earnings turned back into the system have gone to improve the rolling stock and other capital equipment; the Gray Coach Lines, a wholly-owned subsidiary, has been developed as a profitable inter-city and special bus service; and construction of a rapid transit route from the Union Station to Eglinton Avenue is well under way. Indeed, the T.T.C. is quite properly held up to outsiders as a notable instance of successful public management.

By and large, Toronto citizens today take it for granted that the T.T.C.'s management is capable and its financial position strong. This is not to say that the T.T.C.'s operations and policies are flawless or that the Commission entirely escapes public criticism. On the other hand, the Commissioners and their officials have done much to build confidence in the soundness of their operations through an active public relations programme.

The latest financial report of the T.T.C. has just been released. Although, the Commission in recent years has materially improved the form of its financial statements, yet there are aspects of its accounting practice which make it difficult to gain a precise understanding of its affairs. In particular, its practices with regard to depreciation and amortization and its treatment of reserves makes the annual balance sheet and the yearly statement of income difficult to appraise. This fault, which is a common one in financial reporting, is more disturbing where a corporation is publicly-owned and not just responsible to a small group of shareholders who are in close touch with the company's business.

Revenues and Expenditures

The financial results of T.T.C. operations since its inception, as reported by the Commission, are shown in the accompanying chart. Current revenues have been plotted alongside expenditures; deficits and surpluses show up in the years in which they occurred. As well as immediate operating expenses, the expenditures for each year include (a) interest on borrowed money, (b) depreciation and amortization provided in the year on capital assets - buildings, equipment, rolling stock - represented by debt retirement and any additional depreciation regarded as necessary, and (c) any provisions made for anticipated liabilities such, for example, as uncashed street car tickets in the hands of the public. The amounts to be charged to operating costs for depreciation and for anticipated liabilities have of course to be estimated each year by the T.T.C.

Since 1922, the T.T.C. has had both lean and fat years. The T.T.C. legislation requires it to pay its way from fares and so the operating costs have had to be met from this source, with deficits when they occur being made up out of the surpluses of earlier years. Deficits have never been turned back on the taxpayer.

Tax and Franchise Privileges

The policy under which the T.T.C. is expected to pay its own way has not fully taken into account two important factors.

First, while the City in buying out the private railway interests on behalf of the Commission had to pay in excess of the value of physical assets, the T.T.C. has never been asked to meet a continuing charge for its franchise to operate along the public streets as its predecessor was made to do. The agreement with the Toronto Railway Company, which imposed both a mileage and a revenue franchise also required the City to maintain the roadbed along the right of way. The T.T.C. now maintains its own right of way but the Commission pays nothing further for its exclusive rights to furnish bus and transportation services.

Secondly, the Toronto Transportation Commission from the beginning has also enjoyed partial exemption from municipal taxes. Since 1942, payments have been made in lieu of real property and business taxes roughly equal to full taxation other than on the Commission's tracks, poles and wiring along the streets which continue tax-free. Payments now stand at approximately $100,000 a year plus free transportation for amputation cases and blind persons --estimated to cost them some $40,000 annually. Gray Coach Lines has paid full municipal taxes from the beginning.

The Bureau would not advocate that the T.T.C. should be asked to forego what is quite a normal benefit of municipal ownership in enjoying a free operating franchise. Again, while the Bureau favours full taxation of public utilities, it recognizes that the T.T.C. has made considerable progress towards this goal. The Bureau does say, however, that tax and franchise privileges should be noted in reviewing T.T.C. finances over the years and particularly in comparing the position under public or private ownership. How much operating costs have been reduced as a result cannot readily be calculated. To the extent that costs have been reduced, the taxpayers have been helping the transportation commission to keep its fares low.

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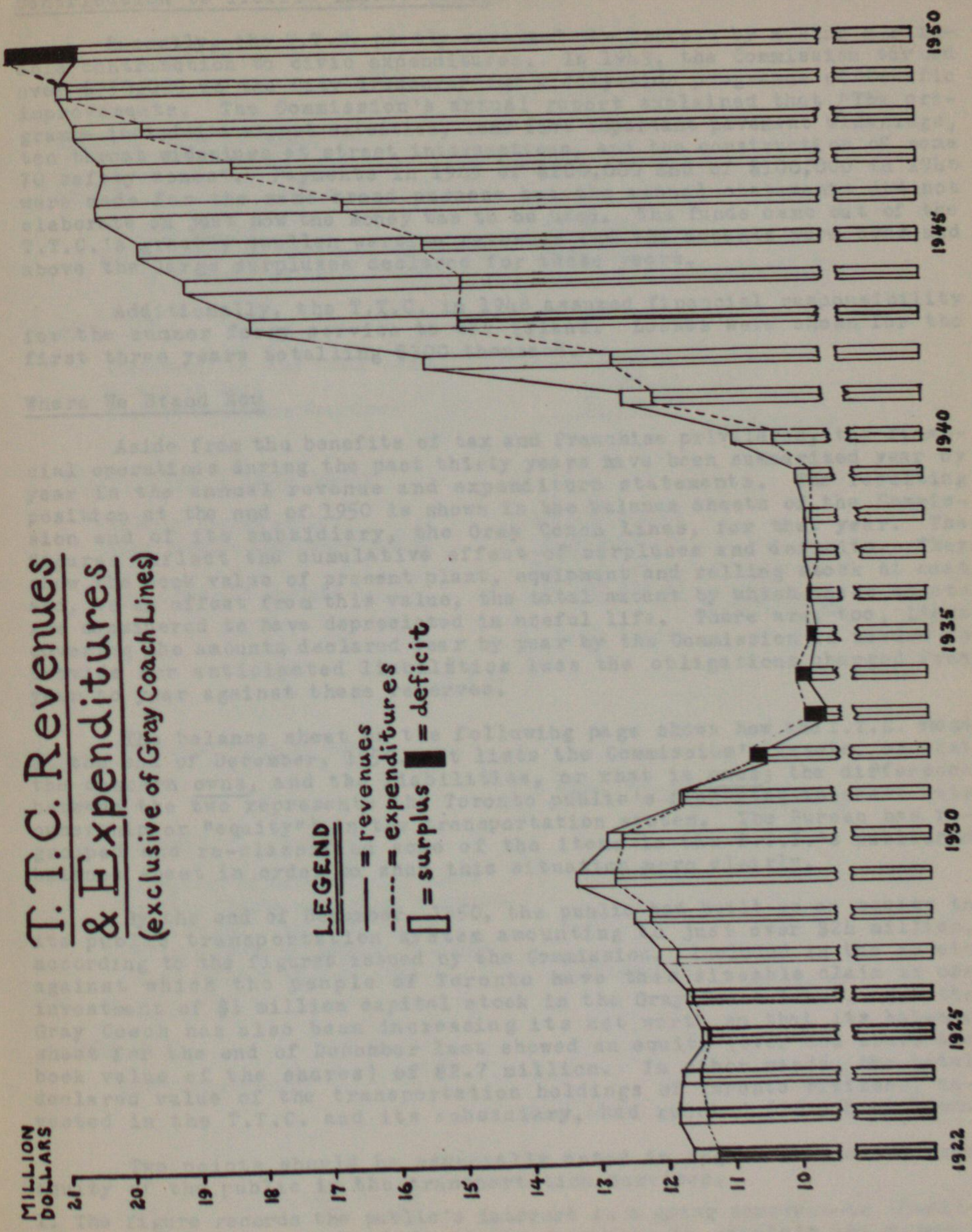

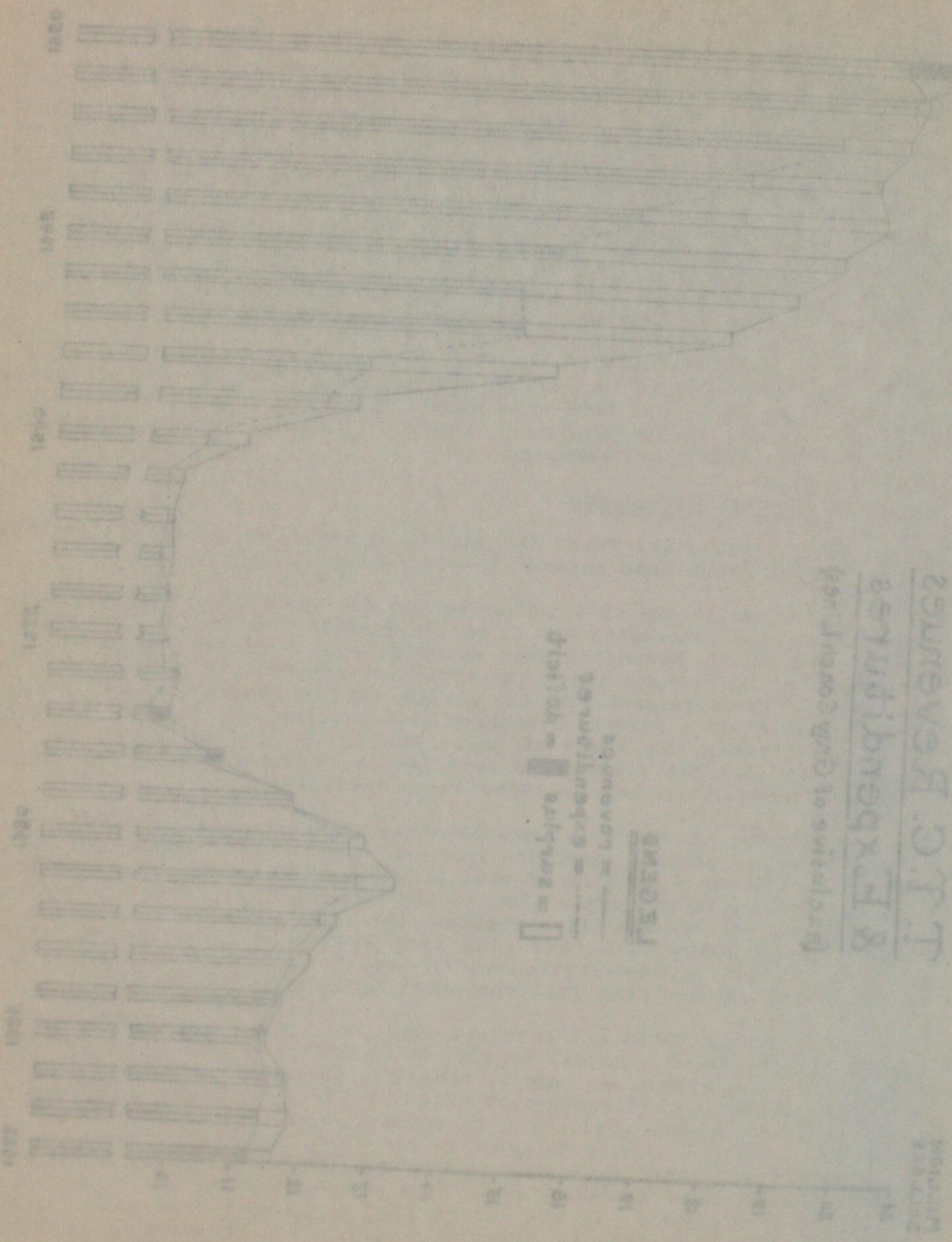

Contribution to Traffic Improvements

Recently, the T.T.C. partly reversed the process by making a sizeable contribution to civic expenditures. In 1943, the Commission turned over $750,000 to the City Treasurer for a city-wide programme of traffic improvements. The Commission's annual report explained that "The programme included a street extension, some five important pavement widenings, ten throat widenings at street intersections, and the construction of some 70 safety zones". Payments in 1945 of $200,000 and of $100,000 in 1946 were made for the same broad purpose but the annual statements did not elaborate on just how the money was to be used. The funds came out of the T.T.C.'s greatly swollen wartime revenues and the amounts were over and above the large surpluses declared for these years.

Additionally, the T.T.C. in 1948 assumed financial responsibility for the summer ferry service to the island. Losses were shown for the first three years totalling $300 thousand.

Where We Stand Now

Aside from the benefits of tax and franchise privileges, the financial operations during the past thirty years have been summarized year by year in the annual revenue and expenditure statements. The resulting position at the end of 1950 is shown in the balance sheets of the Commission and of its subsidiary, the Gray Coach Lines, for that year. The figures reflect the cumulative effect of surpluses and deficits. They show the book value of present plant, equipment and rolling stock at cost and, as an offset from this value, the total amount by which these assets are considered to have depreciated in useful life. There are, too, items covering the amounts declared year by year by the Commission as needed to provide for anticipated liabilities less the obligations charged from year to year against these reserves.

The balance sheet on the following page shows how the T.T.C. stood at the end of December, 1950. It lists the Commission's assets, or what the concern owns, and the liabilities, or what it owes; the difference between the two represents the Toronto public's financial interest (its ownership or "equity") in the transportation system. The Bureau has regrouped and re-classified some of the items in the T.T.T.'s published balance sheet in order to show this situation more clearly.

By the end of December, 1950, the public had built up an equity in its public transportation system amounting to just over $24 million, according to the figures issued by the Commission. Included in the assets against which the people of Toronto have this sizeable claim is one investment of $1 million capital stock in the Gray Coach Lines. But the Gray Coach has also been increasing its net worth so that its balance sheet for the end of December last showed an equity (over and above the book value of the shares) of $2.7 million. In other words, the total declared value of the transportation holdings of Toronto citizens, invested in the T.T.C. and its subsidiary, had reached $26 3/4 million.

Two points should be especially noted in regard to the declared equity of the public in the transportation services.

1. The figure records the public's interest in a going concern--an investment that needs to be left in the business to maintain the present standard of service.

BALANCE SHEET
as at December 31, 1950

TORONTO TRANSPORTATION COMMISSION
(Excluding Gray Coach Lines)

ASSETS - "What it Owns"			
Current			
Working Assets	$ 4,824,626.35		
Money Remaining from Bond Borrowing (to be spent on Rapid Transit)	9,159,015.55	$13,983,641.90	
Long Term			
Investment in Gray Coach Lines	$ 1,000,000.00		
Mortgages Held	43,986.55		
Cost of Debenture Borrowing	371,829.24		
		1,415,815.79	
Rolling Stock & Fixed Assets			
Present System at Cost	$66,116,502.44		
Less Reserve for Depreciation	46,000,417.90		
	$20,116,084.54		
Rapid Transit Project	14,085,225.86	34,201,310.40	
Total Assets			$49,600,768.09
L E S S			
LIABILITIES - "What it Owes"			
Current	$ 4,948,961.78	$ 4,948,961.78	
Anticipated			
Redemption of Outstanding Tickets	$ 420,120.03		
Possible Claims re Workmen's Compensation and Public Liability	1,527,293.92		
Possible Costs of Redeeming Debentures Payable in U.S. Funds	1,880,850.86		
		3,828,264.81	
Long Term			
Bonds Outstanding		16,751,416.66	
Total Liabilities			$25,528,643.25
E Q U A L S			
PUBLIC EQUITY IN THE SYSTEM			$24,072,124.84

2. The size of the public equity is greatly affected by the estimated allowances by the T.T.C. for depreciation and to a lesser extent by the amounts they have set up for anticipated liabilities.

Reserves

In the T.T.C.'s balance sheet presentation, the allowances made for depreciation and the amounts set up for anticipated liabilities are described as "reserves". To a person without accounting training, the significance of various "reserves" is not always clear.

What the T.T.C. calls "reserves for depreciation and amortization of capital assets" represents the amounts by which present plant, equipment and rolling stock have been written down in value in recognition of the fact that their useful lifetime is steadily running out. Amounts set up for this purpose are commonly called "capital reserves".

The reserves for anticipated liabilities are set up in readiness for expenses of doing business which are apt to be encountered in the course of operations in future years. The three such reserves which the T.T.C. carries are listed in the attached balance sheet. These provisions for anticipated liabilities are described as "operating reserves".

Suitable provision for both capital and operating reserves represents a recognized expense of doing business--a cost that has to be calculated before the annual profit or loss can be arrived at from the year's operations. Because such reserves have been set up it does not mean that equivalent amounts have been accumulated and retained in the business in liquid funds or cash. They may have been reinvested and have found their way largely into fixed assets.

Anticipated Liabilities

On the balance sheet given, T.T.C. reserves for anticipated liabilities are shown totalling $3,828 thousand. Similar reserves were carried by the Gray Coach Lines of $465 thousand.

In its 1943 financial statements, the T.T.C. quoted opinions secured from an independent firm of chartered accountants on the suitability of its reserves at the end of 1942. At that time, the T.T.C. reserve for outstanding tickets was $260 thousand. The Clarkson report stated: "The amount appears to be reasonable and, as it is not substantial, we have accepted it without question". Since then, the reserve for the same purpose has been augmented, without explanation, by more than 60 percent although the number of revenue passengers has increased by less than 30 percent. On the other hand, while the reserves for workmen's compensation and public liability which were described in 1942 as "liberal" have been more than doubled, they have not been expanded in proportion to the heavier claims made upon them in recent years.

The usual accounting practice on operating reserves for exchange is to provide for conversion of the principal only, at the rate prevailing on the year-end. The rate at that time of $1.06 1/8 called for a reserve of $997 thousand. This contrasts with the $1,881 thousand actually set up which was to provide exchange on interest as well as principal repayment over the term of the bond issues based on an 8 per cent rate. While recognizing that in 1950 a substantial premium was obtained through

marketing debentures in the United States, it appears that only $997 thousand was a required operating reserve and the balance represents a separate reserve for future contingencies in exchange fluctuation and could have been credited to surplus.

Is Depreciation Over-Estimated?

Whether or not there should be adjustments between anticipated liabilities and the balance sheet surplus, the amounts involved are relatively small, but when it comes to depreciation and amortization reserves the sums are much larger.

In December 1922, the fixed assets of the T.T.C., after deducting depreciation and amortization, were carried at a value of $31.7 million. But the figure was tentative pending a final settlement of the purchase price of Toronto Railway Company assets. At the end of 1924, the position had been clarified: Real assets were listed totalling $37.3 million and, adding in the cost of intangible assets, the total for fixed assets including rolling stock stood at $43.5 million; the depreciation taken on both real and intangible assets brought the value down to $39.3 million.

What was the depreciated book value of the system at the close of 1950? Aside from the expenditures on rapid transit, value at cost was given as $66 million and the depreciated book value as $20 million. Rapid transit expenditures on December 31st, 1950, were shown separately at over $14 million.

Twenty years ago, the T.T.C.'s percentage depreciation overall amounted to just 30.6 percent of the value of fixed assets at cost, exclusive of Gray Coach Lines. In the intervening years, the system has been substantially modernized and intangible asset valuation entirely written off the books. Yet in the latest balance sheet statement, the T.T.C.'s fixed assets and rolling stock are depreciated a fraction under 70 percent from cost (excluding the rapid transit system on which no depreciation has yet been taken). The depreciation against total Gray Coach assets at the end of 1950 was nearly as heavy and stood at 64.2 percent.

A check on the depreciation figures of the T.T.C. and the Gray Coach Lines would require a thorough appraisal of each of their assets, beginning with the purchase price and considering the loss in useful life through age, wear and tear and obsolescence. Such a detailed check is not a normal responsibility of the firm which is retained to conduct the annual audits. The responsibility rests with the owners of the system to question the size of the depreciation figures if they are concerned that the amounts may be too large.

Why are Surpluses Desirable?

Important differences exist between the conditions which govern the operations of publicly-owned utilities and those under private management. The publicly-owned utility has only two sources of capital for its operations - a) funds secured through debenture borrowing, and b) earnings which are held in the system for capital purposes. Additionally, the privately-owned utility has share capital on which dividends are paid only as profits permit. By contrast, all the capital of the publicly-owned utility, aside from retained earnings, creates a burden of fixed charges for bond interest and repayment of principal regardless of current income.

In the case of publicly-owned enterprises, the arguments in favour of ploughing back earnings in the system are particularly strong. Such a policy enables rates or fares to be held fairly steady for long periods despite the large fixed charges on debenture debt. In the long run, however, fares must reflect operating experience, although fares can be brought down and held lower once a substantial public equity has been accumulated. For this reason, the T.T.C. has been able until now to hold to its 6½ cent fare in spite of higher operating costs. Today, the trend of costs is unmistakable and in continuing prudent budgeting, based on a long-term viewpoint, the fare increase which has been announced seems amply justified.

Major adjustments to meet new operating conditions are also made easier by the accumulation of past earnings. The observance of this policy has enabled the Commission to develop a modern system and a strong financial position as the prelude to launching the expensive rapid transit project. Under less favourable conditions the T.T.C. might have failed to gain public support for its subway.

Under the circumstances, it is not surprising that public utilities wish to hold annual profits in the business as capital. To do so, they must resist demands for immediate reductions in rates or fares and, alternatively, requests that the surplus be turned over in whole or in part to the public treasury.

In the light of the T.T.C.'s experience, it would appear short-sighted to quarrel with their policy of retaining earnings. But because there is seldom a close check on the amount of depreciation taken on fixed assets, public utilities in order to retain net earnings without declaring them as such sometimes provide depreciation and amortization reserves that are higher than they need to be. For instance, the Toronto Hydro, in its latest published balance sheet (December 31, 1949) shows depreciation and amortization reserves that actually exceed the total value of fixed assets by more than a million dollars. This is double depreciation with a vengeance!

Another method of making the extent of accumulated earnings less obvious in the balance sheet presentation is to classify most of the public equity (the balance sheet surplus) as reserves held for one purpose or another--to stabilize fares, for example. Unless money has actually been set aside in a reserve fund, this method of classifying surplus is no more than a statement of intentions. The T.T.C. "reserve of $13.4 million for modernization and expansion of the system" is not even that; for the money has already been used for the purpose and so aknnowledged in the balance sheet heading under which the amount is listed. Consequently, there would seem to be little reason why this reserve should not now be included in the ordinary surplus.

The adequacy or otherwise of these reserve amounts which are charged each year as operating expense of course affects the amounts shown as surplus on the year's operation. To that extent, the annual surplus or deficit may be overstated or understated and the public equity at each year-end likewise. For this reason the Bureau suggests that independent opinion be sought to clarify any existing doubt on this score.

President

Director