HALIFAX

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Item No.
Audit & Finance Standing Committee
March 21, 2018

TO:	Chair and Members of Audit & Finance Standing Committee
SUBMITTED BY:	Original Signed ______________________________________ Jerry Blackwood, Acting Director, Finance & Asset Management/CFO
DATE:	February 27, 2018
SUBJECT:	Audit of the Consolidated Financial Statements of HRM

ORIGIN

This report is originated by staff in preparation for the 2018 year end audit of the consolidated financial statements, General Rate Surplus statements, and Miscellaneous Trust Funds statements of HRM.

LEGISLATIVE AUTHORITY

Section 46 of the Halifax Regional Municipality Charter outlines the responsibilities of the Municipal Auditor including issuance of an Auditor's Report.

RECOMMENDATION

It is recommended that the Audit & Finance Standing Committee approve the attached Audit Planning report for the year end audit of HRM's consolidated financial statements, General Rate Surplus statements, and Miscellaneous Trust Funds statements as prepared by the Municipal Auditor (KPMG).

BACKGROUND

Each year the Municipal Auditor is required to prepare an Audit Planning Report to be approved by the Audit & Finance Standing Committee.

DISCUSSION

KPMG has prepared the attached Audit Planning Report for review and approval by the Audit & Finance Standing Committee.

FINANCIAL IMPLICATIONS

The fees for the year end audit, as described in the Audit Planning Report are $81,343 net tax, consistent with the amount in the tender and are budgeted for.

RISK CONSIDERATION

There are no significant risks associated with the recommendation in this report.

COMMUNITY ENGAGEMENT

N/A

ENVIRONMENTAL IMPLICATIONS

N/A

ALTERNATIVES

The Audit & Finance Standing Committee through discussion with our Municipal Auditor, may request additional services or audit procedures. These services or audit procedures would likely be a separate engagement and would result in increased costs to HRM.

ATTACHMENTS

1. KPMG's Audit Planning Report for the March 31, 2018 year end audit of the consolidated financial statements of HRM
2. KPMG's Public Sector Accounting Update for November 2017
3. KPMG's Public Sector Accounting Update for February 2018

A copy of this report can be obtained online at http://www.halifax.ca/boardscom/SCfinance/index.php then choose the appropriate meeting date, or by contacting the Office of the Municipal Clerk at (902) 490-4210, or Fax (902) 490-4208.

Report Prepared by: Dave Harley, Senior Financial Consultant, Finance and Asset Management, 902.490.4260

ATTACHMENT 1

Halifax Regional Municipality

Audit Planning Report

For the year ended March 31, 2018

February •2018

kpmg.ca/audit

The contacts at KPMG in connection with this report are:

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At KPMG, we are **passionate** about earning your **trust**. We take deep **personal accountability**, individually and as a team, to deliver **exceptional service and value** in all our dealings with you.

At the end of the day, we measure our success from the **only perspective that matters – yours**.

Executive summary

Audit and business risk

Our audit is risk-focused. In planning our audit we have taken into account key areas of focus for financial reporting.

See pages 6-8

KPMG team

The KPMG team will be led by Carey Blair. Subject matter experts will be involved to ensure our approach is appropriate and robust.

Effective communication

We are committed to transparent and thorough reporting of issues to Jerry Blackwood, Acting CFO and Louis de Montbrun, Manger Financial Reporting and the Audit and Finance Standing Committee.

Audit Materiality

Materiality has been determined based on expected total expenses. We have reviewed the scope of work across the group. We have determined group materiality to be $13.5 million for the year ending March 31, 2018.

See page 4

Independence

We are independent and have extensive quality control and conflict checking processes in place.

Current developments

Please refer to Appendix 7 for relevant accounting changes.

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This Audit Planning Report should not be used for any other purpose or by anyone other than the Audit and Finance Standing Committee. KPMG shall have no responsibility or liability for loss or damages or claims, if any, to or by any third party as this Audit Planning Report has not been prepared for, and is not intended for, and should not be used by, any third party or for any other purpose.

Materiality

The determination of materiality requires professional judgment and is based on a combination of quantitative and qualitative assessments including the nature of account balances and financial statement disclosures.

The first step is the determination of the amounts used for planning purposes as follows:

Materiality determination	Comments		Amount
Metrics	Relevant metrics included assets, revenue, and total expenses.		
Benchmark	Based on an estimate of total expenses. This benchmark is consistent with the prior year.		$927 million
Materiality	Determined to plan and perform the audit and to evaluate the effects of identified misstatements on the audit and of any uncorrected misstatements on the financial statements. The corresponding amount for the prior year's audit was $14.4 million		$13.9 million
% of Benchmark	The corresponding percentage for the prior year's audit was 1.5%		1.5%
Performance materiality	Used 75% of materiality, and used primarily to determine the nature, timing and extent of audit procedures. The corresponding amount for the prior year's audit was 75%		$10.4 million
Audit Misstatement Posting Threshold (AMPT)	Threshold used to accumulate misstatements identified during the audit. The corresponding amount for the previous year's audit was 720,000 Different threshold used to accumulated reclassification misstatements.		$695 thousand $2.8 million
	HRM – Non-consolidated	Halifax Regional Water Commission	
Component Materiality	$12.5 million	$5.0 million	

Professional standards require us to re-assess materiality at the completion of our audit based on period-end results or new information in order to confirm whether the amount determined for planning purposes remains appropriate. Our assessment of misstatements, if any, in amounts or disclosures at the completion of our audit will include the consideration of both quantitative and qualitative factors.

Audit scope

Professional standards require that we obtain an understanding of the Company's organizational structure, including its components and their environments that is sufficient to identify those components that are financially significant or that contain specific risks that must be addressed during our audit.

Group auditors are required to be involved in the component auditors' risk assessment in order to identify significant risks to the group financial statements. If such significant risks are identified, the group auditor is required to evaluate the appropriateness of the audit procedures to be performed to respond to the identified risk.

The components over which we plan to perform audit procedures are as follows:

Components	Why	Our audit approach
Halifax Regional Municipality KPMG, Halifax	Individually financially significant	Audit of component financial information KPMG Halifax will be performing the work as part of the consolidated audit.
Halifax Regional Water Commission Grant Thornton, Halifax	Individually financially significant	Statutory audit of component financial statements KPMG will provide direction to Grant Thornton through group audit instructions and determine, based on findings for the current year the extent of additional file review required of the Grant Thornton's working papers to ensure work appropriately completes for significant equity accounted component.
Various sport, recreation, and key facilities [1] KPMG, Halifax	Non-significant component; however, necessary to issue group audit opinion	Review of component financial information

1 These venues include: Scotia Bank Centre, Dartmouth Sportsplex, Halifax Regional Library, Cole Harbour Place, Halifax Forum, Centennial Arena, St. Margaret's Arena Assoc., Canada Games Centre, BMO Centre and Dartmouth 4Pad

Audit approach

Inherent risk is the susceptibility of an assertion related to a significant account or disclosure to a misstatement which could be material, individually or when aggregated with other misstatements, assuming that there are no related controls.

Our assessment of inherent risk is based on various factors, including the size of the balance, its inherent complexity, the level of uncertainty in measurements, as well as significant external market factors or those particular to the internal environment of the entity.

Significant financial reporting risks	Why	Our audit approach
We have not identified any significant risks		

Audit approach

Professional standards presume the risk of fraudulent revenue recognition and the risk of management override of controls exist in all companies.

The risk of fraudulent revenue recognition can be rebutted, but the risk of management override of control cannot, since management is typically in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

Professional requirements	Why	Our audit approach
Fraud risk from revenue recognition	This is a presumed fraud risk. Fraud risk has been rebutted as the Halifax Regional Municipality ("HRM") prepares consolidated financial statements using Public Sector Accounting Standards. Key decisions such as tax rates and service fees are based on guidance in the Nova Scotia Municipal Government Act. There are no incentives or bias to report higher or lower revenue.	Not applicable
Fraud risk from management override of controls	This is a presumed fraud risk. We have not identified any specific additional risks of management override relating to this audit.	As the risk is not rebuttable, our audit methodology incorporates the required procedures in professional standards to address this risk. These procedures include testing of journal entries and other adjustments, performing a retrospective review of estimates and evaluating the business rationale of significant unusual transactions.

Audit approach

Other areas of focus	Why	Our audit approach
Taxation Revenues - Halifax Regional Municipality ("HRM")	Most significant sources of revenue to fund annual operations and capital expenditures.	Evaluating the design and implementation of controls and complete substantive analytical procedures over the completeness, existence and accuracy of additions to revenue based on assessed property values.
Capital Assets - HRM	HRM is engaged in significant capital projects annually.	Evaluating the design and implementation and operating effectiveness of controls over procurement. Complete substantive procedures over the completeness, existence and accuracy of additions to capital assets.
Change in investment in Halifax Regional Water Commission – HRWC	HRWC is a significant investment accounted for on the Modified Equity basis.	Direct, review and communicate with Component auditor and have them report findings to KPMG. Review key areas of the component auditor's work directly.
User fees and charges – HRM and various sport, recreation, and other facilities	significant source of revenue for the HRM	Evaluating the design and implementation of controls and complete substantive analytical procedures over the completeness, existence and accuracy of revenue. Review of revenue at various sport, recreation, and other key facilities operated by boards and commissions.
Payroll expenditures – HRM and various sport, recreation and other facilities	Payroll is a significant expense across all functions.	Evaluating the design and implementation and operating effectiveness of controls over payroll. Perform substantive procedures including substantive analytical procedures over the completeness, existence and accuracy of payroll expense. Review of payroll expenses at various sport, recreation, and other key facilities operated by boards and commissions.
Routine expenses - HRM	Procurement is a significant function of the HRM supporting all functions.	Evaluating the design and implementation and operating effectiveness of controls over procurement. Perform substantive procedures including substantive analytical procedures over the completeness, existence and accuracy of routine expenditures.
Treasury	Cash and borrowings are significant to the financial position.	Evaluating the design and implementation of controls and complete substantive procedure through external confirmation over cash and debt balances.

Data & analytics in the audit

We will be integrating Data & Analytics (D&A) procedures into our planned audit approach. Use of innovative D&A allows us to analyze greater quantities of data, dig deeper and deliver more value from our audit.

We believe that D&A will improve both the quality and effectiveness of our audit by allowing us to analyze large volumes of financial information quickly, enhancing our understanding of your business as well as enabling us to design procedures that better target risks.

Area(s) of focus	Planned D&A routines
Journal entry testing	– Utilizing KPMG application software (IDEA) to evaluate the completeness of the journal entry population through a roll-forward of all accounts – Utilizing KPMG application software (IDEA) to analyze journal entries and apply certain criteria to identify potential high-risk journal entries for further testing
Taxation revenue	– Utilizing KPMG application software (IDEA) to evaluate the completeness of the property tax assessments in the Hanson system used to generate property tax billings as compared to external data received from Property Tax Assessment Services – Unitizing KPMG application software (IDEA) to calculate the expected property tax revenue used in the substantive analytic procedures based on assessment values from the Hanson system that has been verified for completeness and accuracy.

Detailed results and summary insights gained from D&A will be shared with management and presented in our Audit Findings Report.

How we deliver audit quality

Value for fees

In determining the fees for our services, we have considered the nature, extent and timing of our planned audit procedures as described above. Our fee analysis has been reviewed with and agreed upon by management.

Our fees are estimated as follows:

	Current period (budget)	Prior period (actual)
Audit of the annual consolidated financial statements	$78,000	$82,750

Matters that could impact our fee

The proposed fees outlined above are based on the assumptions described in the engagement letter.
The critical assumptions, and factors that cause a change in our fees, include:

- Significant changes in the nature or size of the operations of the Company beyond those contemplated in our planning processes;
- Changes in professional standards or requirements arising as a result of changes in professional standards or the interpretation thereof;
- Changes in the time of our work.

Appendices

Appendix 1: Audit quality and risk management

KPMG maintains a system of quality control designed to reflect our drive and determination to deliver independent, unbiased advice and opinions, and also meet the requirements of Canadian professional standards.

Quality control is fundamental to our business and is the responsibility of every partner and employee. The following diagram summarises the six key elements of our quality control systems.

Visit our Audit Quality Resources page for more information including access to our audit quality report, Audit quality: Our hands-on process.

- Other controls include:
  - Before the firm issues its audit report, Engagement Quality Control Reviewer reviews the appropriateness of key elements of publicly listed client audits.
  - Technical department and specialist resources provide real-time support to audit teams in the field.
- We conduct regular reviews of engagements and partners. Review teams are independent and the work of every audit partner is reviewed at least once every three years.
- We have policies and guidance to ensure that work performed by engagement personnel meets applicable professional standards, regulatory requirements and the firm's standards of quality.

- All KPMG partners and staff are required to act with integrity and objectivity and comply with applicable laws, regulations and professional standards at all times.
- We do not offer services that would impair our independence.
- The processes we employ to help retain and develop people include:
  - Assignment based on skills and experience;
  - Rotation of partners;
  - Performance evaluation;
  - Development and training; and
  - Appropriate supervision and coaching.
- We have policies and procedures for deciding whether to accept or continue a client relationship or to perform a specific engagement for that client.
- Existing audit relationships are reviewed annually and evaluated to identify instances where we should discontinue our professional association with the client.

Appendix 2: KPMG's audit approach and methodology

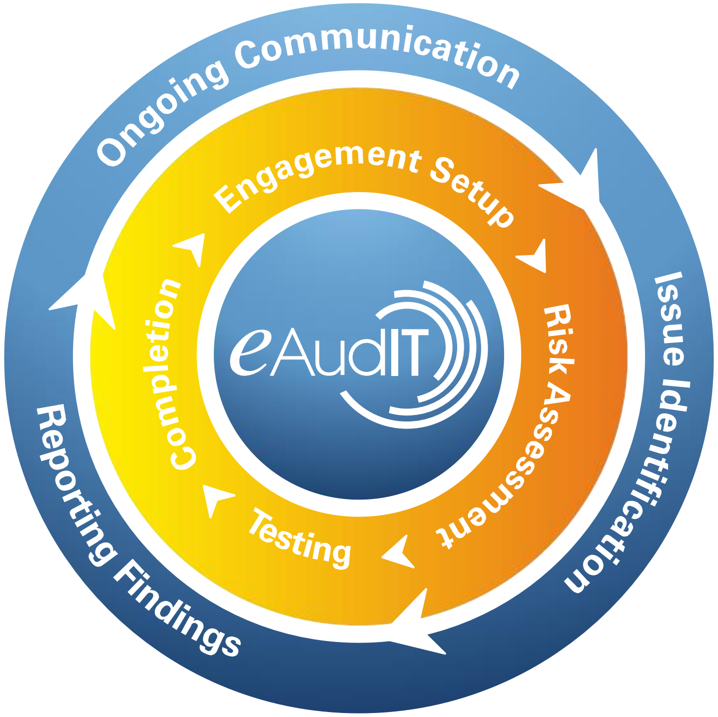
Technology-enabled audit workflow (eAudIT)

Engagement Setup

- Tailor the eAudIT workflow to your circumstances
- Access global knowledge specific to your industry
- Team selection and timetable

Completion

- Tailor the eAudIT workflow to your circumstances
- Update risk assessment
- Perform completion procedures and overall evaluation of results and financial statements
- Form and issue audit opinion on financial statements
- Obtain written representation from management
- Required Audit Committee communications
- Debrief audit process



Risk Assessment

- Tailor the eAudIT workflow to your circumstances
- Understand your business and financial processes
- Identify significant risks
- Plan the use of KPMG specialists and others including auditor's external experts, management experts, internal auditors, service organizations auditors and component auditors
- Determine audit approach
- Evaluate design and implementation of internal controls (as required or considered necessary)

Testing

- Tailor the eAudIT workflow to your circumstances
- Perform tests of operating effectiveness of internal controls (as required or considered necessary)
- Perform substantive tests

Appendix 3: Required communications

In accordance with professional standards, there are a number of communications that are required during the course of and upon completion of our audit. These include:

- **Engagement letter** – the objectives of the audit, our responsibilities in carrying out our audit, as well as management's responsibilities, are set out in the engagement letter and any subsequent amendment letters as provided by management.
- Audit planning report – as attached
- **Required inquiries** – professional standards require that during the planning of our audit we obtain your views on risk of fraud and other matters. We make similar inquiries to management as part of our planning process; responses to these will assist us in planning our overall audit strategy and audit approach accordingly

Management representation letter – we will obtain from management certain representations at the completion of the annual audit. In accordance with professional standards, copies of the representation letter will be provided to the Audit and Finance Standing Committee

- **Audit findings report** – at the completion of our audit, we will provide a report to the Audit and Finance Standing Committee

Appendix 4: Lean in Audit™

An innovative approach leading to enhanced value and quality

Our new innovative audit approach, Lean in Audit, further improves audit value and productivity to help deliver real insight to you. Lean in Audit is process-oriented, directly engaging organizational stakeholders and employing hands-on tools, such as walkthroughs and flowcharts of actual financial processes.

By embedding Lean techniques into our core audit delivery process, our teams are able to enhance their understanding of the business processes and control environment within your organization – allowing us to provide actionable quality and productivity improvement observations.

Any insights gathered through the course of the audit will be available to both engagement teams and yourselves. For example, we may identify control gaps and potential process improvement areas, while companies have the opportunity to apply such insights to streamline processes, inform business decisions, improve compliance, lower costs, increase productivity, strengthen customer service and satisfaction and drive overall performance.

How it works

Lean in Audit employs three key Lean techniques:

1. Lean training

- Provide basic Lean training and equip our teams with a new Lean mind-set to improve quality, value and productivity.

2. Interactive workshops

- Perform interactive workshops to conduct walkthroughs of selected financial processes providing end to end transparency and understanding of process and control quality and effectiveness.

3. Insight reporting

- Quick and pragmatic insight report including your team's immediate quick win actions and prioritized opportunities to realize benefit.

Appendix 5: New Auditor Reporting

In response to investors demanding more than a binary pass/fail opinion from the auditors' report, the new and revised auditor reporting standards have introduced significant changes to the traditional auditors' report we provide.

In April 2017, the Auditing and Assurance Standards Board (AASB) in Canada approved the new and revised auditor reporting standards as Canadian Auditing Standards (CASs).

What's new?

Highlights of the new auditors' report include:

Change	Applicability
Re-ordering of the auditors' report including moving opinion to the first section	Listed and non-listed entities
Expanded descriptions of management's, those charged with governance and auditors' responsibilities	Listed and non-listed entities
Disclosure of name of the engagement partner	Listed entities
Description of key audit matters (KAMs)	Applicable only when required by law or regulation or when the auditors is engaged to do so

When are the new requirements effective?

The new and revised standards in Canada will be effective for audits of financial statements for periods ending on or after December 15, 2018 with early application permitted.

Appendix 6: KPMG's Cyber Security Protocol

This summary is intended to provide management and Audit and Finance Standing Committee members with some insight into KPMG's strategies and procedures regarding our cyber defence.

KPMG Global

KPMG Global provides managed security services for member firms which includes 24x7 monitoring and alerting services to identify potential attacks on our environment. We use a series of centrally managed firewalls among our network of member firms to identify and address potential attacks to member firms and to prevent attacks from spreading between member firms. This approach was in place during the Wanna Cry outbreak and was a critical element in our successful defence against that incident.

KPMG Global has also implemented enhanced email protection to address malware and attacks through email and we have implemented automated vulnerability detection services. This service scans equipment that is exposed to the Internet and identifies known vulnerabilities on a real-time basis. "Good housekeeping" is a central tenet of our approach and we continue to focus on known vulnerabilities and patching.

KPMG Global believes the cloud represents a secure environment when appropriately configured and monitored as a platform to deliver services. Our approach to secure the cloud includes deploying full-time, dedicated security and privacy resources, integrating the cloud platform into our managed security services to promote "good housekeeping," and deploying a continuous monitoring plan for each of the cloud platforms that we deploy to member firms and to our clients.

KPMG Global has invested heavily in enhancing the security of our environment, evidenced by the introduction of our Global Security Operations Centre, managed services and other enhancements to our cyber defence.

KPMG Canada Approach

- KPMG Canada does not currently use Office 365 or Cloud based email.
- Cloud environments provide robust security when properly configured, with proper password management.
- The Canadian firm's email servers are hosted in Canada and controlled and managed by KPMG Canada.
- In compliance with our global security controls, we enforce strong passwords that need to be renewed at regular intervals.
- We also maintain a specific IT security platform for the maintenance and management of privileged accounts.
- KPMG's Information Security Program is built on a comprehensive framework of policies, standards, and processes based on ISO 27001:2013.
- KPMG's security requirements are set out in Global Information Security Policies and Standards (GISP).
- The Canadian firm undergoes an internal audit every year to ensure compliance to key security controls in the GISP.
- Every three years, the Canadian firm goes through a Compliance Review conducted by a team from non-Canadian member firms.

Appendix 7: Current developments

Please see the attached Public Sector Accounting Minute issues for February 2018 and November 2017

kpmg.ca/audit

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KPMG member firms around the world have 174,000 professionals, in 155 countries.

The independent member firms of the KPMG network are affiliated with KPMG International, a Swiss entity. Each KPMG firm is a legally distinct and separate entity, and describes itself as such.

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ATTACHMENT 2

KPMG

Public Sector Accounting Minute

November 2017

Disclaimer

The contents of this presentation do not represent the official views of KPMG, CPA Canada, the Public Sector Accounting Board, or the Public Sector Accounting Discussion Group. This presentation represents my personal views and opinions. KPMG accepts no responsibility to anyone for the information contained in this presentation.

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Agenda

- **Hot Topics**
  - Asset retirement obligations
  - Public private partnerships
  - Employee benefits

- **PSA Discussion Group Highlights– November 17th 2017**
  - Compliance-type Audit Reports – Implications for Public Sector GAAP
  - Green Infrastructure
  - Restructuring Transactions – Recipient Adjustments
  - Social Impact Bonds – Government Funder Perspective
  - Consolidation of Entities using IFRS Standards: Lessee Accounting for Operating Leases

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Hot Topics

Asset Retirement Obligations

- PSAB's exposure draft on ARO's closed for comment June 15, 2017. The proposed standard would apply to fiscal years beginning on or after April 1, 2021.
- At the CPA Canada Public Sector Accounting Conference October 23rd and 24th, certain members of PSAB's ARO task force presented an overview of stakeholder feedback on the exposure draft.
- Asset retirement obligations related to **asbestos** received significant feedback, with stakeholders questioning when or if future economic benefits would actually be given up by a public sector entity for a building with asbestos.
- The task force expressed the view that the obligation to remove the asbestos arises from existing regulations, and hence formed a current obligation regardless of timing for the sacrifice of future economic benefits. The deferral of the removal until an unspecified future period was not thought to alleviate the current obligation of public sector entity.
- ***Baileys View - I think we will hear a lot more about asbestos before this standard is approved and implemented. Existing provincial regulations focus on obligations arising when asbestos is disturbed, such as through a building demolition. Including asbestos in scope for the ARO standard assumes that public sector entities will sacrifice future economic resources for the removal of the asbestos, or through a reduced future market value for the building (if sold before demolition). Measurement of the retirement obligation will require substantial judgement, and may vary considerably across jurisdictions.***

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Asset Retirement Obligations

- Stakeholders also commented on the focus of the exposure draft on legal obligations for asset retirement, and questioned whether the scope should be broadened to address other constructive and equitable obligations. The task force commented that, by including obligations from promissory estoppel, the intent was to broaden the scope of potential obligations.
- Stakeholder feedback was also received on impairment of tangible capital assets – do the capitalized retirement obligation costs represent future economic value to the public sector entity? The task force noted that this would be considered in PSAB's broader impairment of non financial assets project.
- ***Bailey's View – The exercise of professional judgment regarding tangible capital asset impairment will be essential, and there will likely be significant preparer-auditor debate on the judgement applied. Entities should be prepared to demonstrate how the capitalized retirement costs meet the definition of an asset. Auditability will be key.***
- **A formal accounting standard is expected to be brought to the Public Sector Accounting Board for approval in March 2018. The 2021 implementation date remains under consideration.**

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Public Private Partnerships

- PSAB's Statement of Principles on accounting for public private partnerships closed for comment in October 2017.
- The Statement of Principles outlines principles regarding the recognition of public private partnership infrastructure by public sector entities. New estimates and judgments will be required to account for these arrangements.
- The scope of the Statement of Principles defines a public private partnership as "*An alternative finance and procurement model available to public sector entities to build, acquire, improve or refurbish infrastructure. They include arrangements:*

a) between a public sector entity and a private sector entity for infrastructure-project delivery;

b) with an allocation of responsibilities for, and risks of, the infrastructure; and

c) with private capital at risk"

- ***Bailey's View – Public sector entities should review arrangements which may fall under the scope of this future standard to determine potential impact, and consider whether the arrangements are accounted for in a manner consistent with these principles.***

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Public Private Partnerships

- The recognition criteria for public private partnership infrastructure by public sector entities is based on the existing asset recognition criteria outlined in the Public Sector Accounting Standards.
- A public sector entity's liability is Initially measured at the same amount as the infrastructure, less any consideration previously transferred.
- A public sector entity can have a liability related to either (a) cash payments due to the private sector entity (financial liability), or (b) from granting the private sector entity the right to earn revenue from third-party users or from another revenue-generating asset (right to use).
- Under the right to use model, revenue should be recognized by the public sector entity and the liability reduced according to the economic substance of the public private partnership
- ***Bailey's View – The Statement of Principles is balance sheet focused, with particular attention on how assets and liabilities under public private partnerships are recognized and measured. Significant judgement will need to be applied to account for arrangements under the right to use model. I expect that the right to use model accounting may differ the most from how public private partnerships are presently reported.***
- **Based on the feedback received on the Statement of Principles, an Exposure Draft will be presented to the Board for their approval and issued for comment. Targeted date is Fall 2018, with a final standard to follow in 2019.**

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Employee Benefits

- PSAB has approved a project to review Section PS 3250, Retirement Benefits, and Section PS 3255, Post-employment Benefits, Compensated Absences and Termination Benefits. As noted on PSAB's project page, "*Since the issuance of these Sections decades ago, new types of pension plans have been introduced and there have been changes in the related accounting concepts.*
- *This project will involve looking at issues such as deferral of experience gains and losses, discount rates, how to account for shared risk plans, multi-employer defined benefit plans and vested sick leave benefits. Other improvements to existing guidance will also be considered*."
- Phase 1 of this project is addressing issues related to deferral provisions and discount rates. The first invitation to comment document was issued by PSAB regarding deferral provisions in November 2016. The second invitation to comment on discount rates is expected later in 2017.
- Phase 2 of the project will address non-traditional and multi-employer defined benefit plans, others issues and improvements.
- ***Bailey's View – Employee benefit obligations and related expenses are often significant for most public sector entities. Future changes to PS 3250 and PS 3255 could materially impact your future financial reporting. Watch these discussions closely.***

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KPMG

PSA Discussion Group Highlights- November 17th 2017

Topics of Focus

- Compliance-type Audit Reports – Implications for Public Sector GAAP
- Green Infrastructure
- Restructuring Transactions – Recipient Adjustments
- Social Impact Bonds – Government Funder Perspective
- Consolidation of Entities using IFRS Standards: Lessee Accounting for Operating Leases

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Compliance Type Audit Reports

Issue

- Consider the implications of compliance-type audit reports on general purpose financial statements that are not in adherence with public sector GAAP in Canada

Analysis

- Since the issuance of CAS 210 and 700, there has been an increasing trend of governments using legislation to modify the accounting frameworks of their government organizations, and requesting that a compliance-type audit report be issued. The potential for an increase in these non-GAAP legislated accounting frameworks by sovereign governments or their controlled entities was a key concern of the discussion.
- Compliance-type audit reports provide an opinion as to whether the general-purpose financial statements were prepared “in accordance with” the legislated accounting framework, where the audit report on GAAP FS provides an opinion as to whether the statements were “presented fairly” in accordance with GAAP.
- The Discussion Group discussed issues arising from clean compliance-type audit opinions provided on legislated accounting frameworks that are not in accordance with PSAB, as the typical users of the financial statements would be unaware of the magnitude of these differences.
- The Discussion Group considered whether the description of the compliance framework, typically outlined in the financial statement notes, provided sufficient information around the changes in framework and whether the users of the financial statements would refer to this note for additional information
- The Discussion Group expressed the view that while such legislative frameworks may be adopted through a public, democratic process, if governments choose to legislate accounting, the financial statements and audit reports on them should clearly identify and quantify the impact of the departure from GAAP.
- ***Bailey’s View – Look for more discussion on this matter at both PSAB and the Auditing and Assurance Standards Board.***

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Green Infrastructure

Issue

- Consider to which extent the PSA Handbook allows green infrastructure to be recognized in public sector general-purpose financial statements.

Analysis

- The Discussion Group reflected on the importance of this issue as environmental initiatives become more prevalent within the public sector.
- It was noted that Federal and Provincial governments provide public sector entities with funding for infrastructure which is typically recorded as capital assets. However, the PSA Handbook currently does not specifically address accounting for green infrastructure, leaving entities to reference first principles in other accounting standards. An unintended consequence is that more entities may pursue "grey infrastructure" initiatives, as the accounting is clearer regarding the capitalization of these assets, and the funding may therefore be easier to obtain.
- The Discussion Group believed that PSAB should consider clarifying that existing guidance in PSAB could apply to green infrastructure, in situations where expenditures have been incurred to purchase, develop or improve. It was also discussed that if green infrastructure is not recorded as a capital asset, additional information regarding green infrastructure may be disclosed, if it provided useful information to the reader.
- The valuation of these green infrastructure assets remains a key concern as the measurement of service potential and control of the future economic benefit are unclear.

Bailey's View – As the Discussion Group noted, accounting should not drive business decisions of an entity. Further consideration will hopefully be given to taking this on as a future accounting standards project.

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Restructuring Transactions

Issue

- Consider the adjustments a recipient might make in recognizing assets received in a restructuring that are immaterial to the transferor and recorded at a nominal value, but material to the recipient.

Analysis

- The Discussion Group considered what steps are appropriate for a recipient to follow in recognizing a transferred asset based on the transferor's carrying value. Where the asset is immaterial to the transferor, it could be recorded at a nominal carrying value which does not reflect its future economic benefit.
- On one hand, PS3430 Restructuring Transactions directs recipients to recognize individual assets and liabilities received in a restructuring transaction at their carrying amount of the transferor. On the other hand, PS3150, Tangible Capital Assets, requires contributed capital assets received to be recognized at fair value on receipt.

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Restructuring Transactions… cont'd

Analysis (continued)

- PS3430 does permit the recipient to make adjustments at the restructuring date to comply with PSA standards; to align with accounting policies, methods and assumptions to be adopted by the recipient; and to reflect the circumstances of the recipient.
- The Discussion Group debated whether carrying value is always the most appropriate basis for measurement for assets transferred in a restructuring transaction, and circumstances where adjustments to carrying value would be appropriate by the recipient. The Discussion Group commented that an estimate of the transferor's carrying value should be made - as if the transferor had not been allowed to choose a nominal amount on the basis of the assets being immaterial.
- ***Bailey's View – Where recipients make adjustments to the carrying value of a transferred asset, auditability will become a key concern. Regardless of the circumstances giving rise to the adjustment under PS3430, entities should be prepared to demonstrate to their auditors why the adjustments better reflect the future economic benefit of that asset to their organization.***

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Social Impact Bonds

Issue

- Consider how social impact bonds should be accounted for in the financial statements of a government funder.

Analysis

- The Discussion Group focused its debate on the underlying economic substance of a social impact bond. Members believed that the bond was a liability instrument and not an equity instrument, and that contingent liability standard may provide the best current accounting guidance. Many similarities to public private partnership arrangements were observed, which might suggest that P3 accounting concepts could be applied to certain social impact bonds.
- In assessing the underlying economic substance, the Discussion Group noted that the transfer of risk (i.e.: who takes risk and how they are rewarded) was an essential element.
- The nature and timing of the obligating event for liability recognition was also discussed, and it was noted that payment would be primarily dependent on progress indicators and a defined payment schedule (i.e. when a payment is earned)**.** A contingent liability model may be appropriate.
- The application of contingent liability accounting was noted to assist public sector entities in assessing the likelihood of future payments under a social impact bond. However, existing contingent liability accounting guidance may not be robust enough to address the unique elements of a social impact bond in assessing likelihood.
- ***Bailey's View – I wouldn't be surprised to see a future PSAB project analyze this issue in more depth particular if the federal government moves to encourage more social impact financing vehicles. The current work of the PPP accounting task force will be useful as as many of the accounting issues are similar from the government perspective.***

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Consolidation of Entities using IFRS Standards

Issue

- Consider whether it is permissible on consolidation for a controlling entity to not conform the accounting for the operating leases of a consolidated entity (usually an Other Government Organization from IFRS 16 to the accounting requirements of PSG-2.

Analysis

- Entities following PSAS currently use PSG-2, Leases Tangible Capital Assets for guidance on the accounting for leases. PSG-2 classifies leases based on criteria concerning whether a lease transfers substantially all of the benefits and risks to the lessee. IFRS 16 looks at economic substance and will result in more leases being capitalized than under PSG-2 or its predecessor IFRS standard.
- The Discussion Group considered whether a reporting entity following PSAS would be required to make adjustments to an OGO's accounting upon consolidation if it follows IFRS 16 and therefore records substantially all leases "on balance sheet".
- The Discussion Group generally expressed the view that, under PSAS, a government, as the controlling entity, should adjust the accounting of the OGO to conform with its existing accounting policies, which are in compliance with PSG-2, not IFRS 16.
- ***Bailey's View – The adjustment of an OGO's accounting for leases from IFRS 16 to PSG-2 will require significant attention by governments. These adjustments will effectively result in fewer leases being "on balance sheet", and could significantly change an OGO's reported financial results. I expect these adjustments will be subject to significant scrutiny from an audit perspective.***

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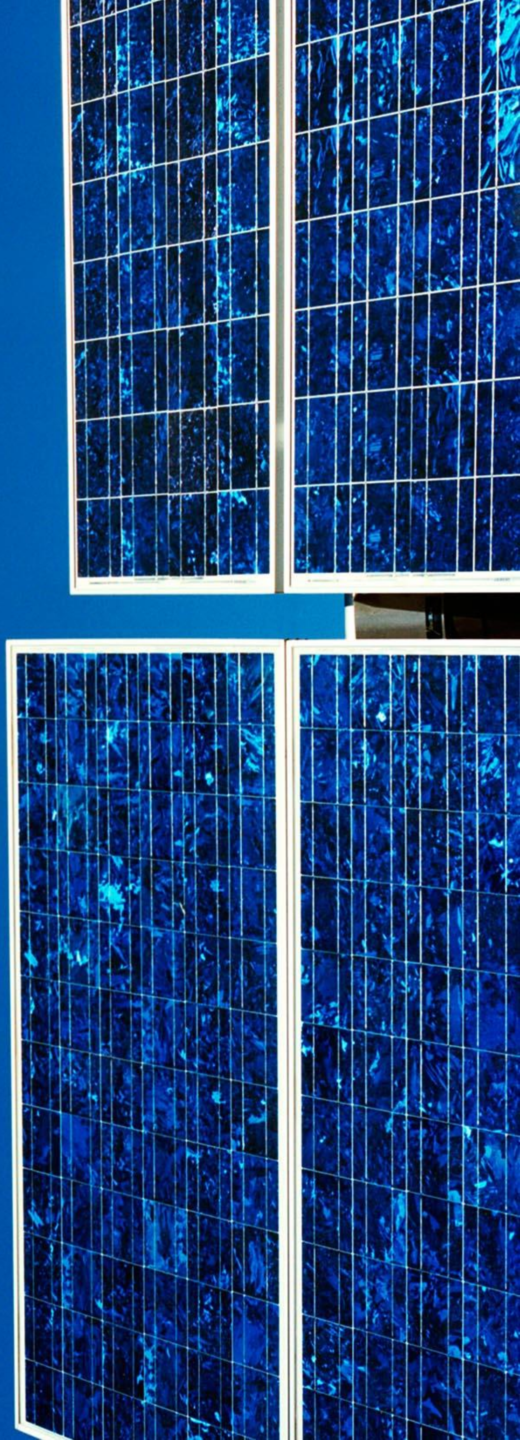
ATTACHMENT 3

Public Sector Accounting Minute



February 2018

Disclaimer

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Agenda

- **Public Sector Accounting Board December 2017 Session**
  - Session Highlights

- **Employee Benefits Discount Rates Invitation to Comment**

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Public Sector Accounting Board December 2017 Meeting

December Board Highlights

PSAB discussed a number of core topics at the December Board that will influence the foundation of public sector financial reporting for many years to come. Following this meeting, a number of documents will be issued by PSAB throughout Spring/ Summer 2018 for stakeholder input into the standard setting process. Some key topics you should be aware of:

- The Statement of Concepts, "A Revised Conceptual Framework for the Canadian Public Sector" and the Statement of Principles, "A Revised Reporting Model for the Canadian Public Sector" both received Board approval in December, and are expected to be issued in the Spring of 2018. These documents will revisit the concepts and principles currently outlined in existing Sections PS 1000 — PS 1300, including financial statement objectives and elements, and the qualitative characteristics of public sector financial statements.
- ***Baileys View - These two documents will be critical to the landscape of public sector financial reporting for many years to come. Watch for them and make sure you respond. The revised reporting model will be particularly impactful, as PSAB proposes moving away from the net debt Statement of Financial Position model to an asset, liability, and accumulated surplus/ net asset model. It is expected that the Financial Statement presentation standard for not-for-profit organizations will also be replaced by this new model.***
- The Board considered comments received from stakeholders on the Exposure Draft, "Asset Retirement Obligations, Proposed Section PS 3280". A final standard goes to the Board for approval at the March 2018 session.
- ***Baileys View - I anticipate that the final standard which will be issued by PSAB in later spring 2018 will be very similar in substance to the exposure draft. While some clarifications might be added to the standard or the accompanying Basis of Conclusions based on stakeholder feedback, don't expect any major changes in the requirements of the standard.***

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December Board Highlights

- An appropriate internal methodology to be used by PSAB for developing discount rate guidance was discussed by the Board. The goal of this guidance is to better ensure a consistent approach for all new standards with respect to discount rate, by considering elements such as measurement objectives; the materiality of discounting to measurement; and whether the benefits outweigh the costs of developing robust discount rate guidance.
- ***Baileys View - A consistent, internal methodology goes a long way to providing more consistency in discount rate guidance in future PSAB standards. While discount rate guidance in existing PSAB sections will not be impacted at the current time, this will ensure common factors influence discount rate going forward.***
- On the Financial Instruments – Subsequent Issues project, PSAB received an overview of the key concerns voiced by stakeholders during consultations and recent discussions about the International Public Sector Accounting Standards Board's Exposure Draft 62, "Financial Instruments." Based on the Board's direction, PSAB staff are developing options for addressing issues raised which will be presented to the Board at its March session.
- ***Baileys View - The inability to access hedge accounting in PSAB's current financial instruments standard remains a major concern of stakeholders. IPSAS's exposure draft on financial instruments has some conceptual consistency with IFRS 9 on elements like basis of measurement, and the recognition of expected credit losses. IPSAS has also considered hedge accounting in exposure draft 62. This will be interesting both from the perspective of PSAB's financial instruments guidance, and as an indicator of what the Board's international strategy might look like in the future.***

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December Board Highlights

- PSAB received an update from the Accounting Standards Board Chair on ongoing research regarding rate-regulated accounting activities to support the International Accounting Standards Board's standard-setting project. PSAB continues to watch developments regarding rate regulated accounting closely.
- PSAB also reviewed a draft consultation paper regarding its strategy with respect to International Public Sector Accounting Standards, which outlined various options including full Canadian adoption of IPSAS; adoption and customization of certain IPSAS guidance; and no migration towards IPSAS (status quo). The Board expects to approve the consultation paper at its March 2018 meeting.
- ***Baileys View - This consultation paper is very timely. Consistency with IPSAS is already a consideration for PSAB's financial instruments project, and the public private partnerships project. The direction the Board goes with these two projects will be an interesting measure of stakeholder willingness to consider IPSAS migration.***

- PSAB also received a summary of responses to the Exposure Draft, "Revenue, Proposed Section PS 3400." Feedback was provided to the task force, and an additional status update is expected in March 2018.

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Employee Benefits Discount Rate Guidance Invitation to Comment

Invitation to Comment Overview

PSAB's invitation to comment ("ITC") on employee benefits discount rate guidance in PS3250, Retirement Benefits is open for stakeholder comments until March 9th 2018. Here is an executive summary, and I encourage you to respond.

- PS 3250 does not currently provide specific guidance on which discount rate should be used to estimate an accrued benefit obligation. The standard currently notes that actuarial assumptions should be based on the government's best estimates of expected long-term experience and short-term forecast. Examples provided in the section reference rate of return on plan asset earnings, and the entity's cost of borrowing as a basis for determining discount rate. The evolution of guidance issued by other standard setters have suggested other approaches to determining discount rate which may be appropriate.
- While expected return on plan assets is often used to determine the present value of the accrued benefit obligation of benefit plans that are fully or partially funded, the entity's cost of borrowing is usually used to determine the present value of the accrued benefit obligation of benefit plans that are unfunded.

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Invitation to Comment Overview

Expected outcomes of PSAB's review of discount rate guidance include: (a) updating the examples provided in the section; (b) identifying factors to consider in selecting discount rates; (c) setting out principles and/or criteria for selecting discount rates; and/or (d) prescribing an approach or approaches to determine discount rates.

- The ITC notes that the appropriate discount rate for accounting purpose should be determined based on the financial reporting concepts set out in the conceptual framework.
- The ITC requests feedback on 14 questions including the need for review of discount rates; current accounting practices; alternative discount rates; and alternative discount rate application.
- PSAB has not yet considered how actuarial gains and losses should be recognized, nor whether unamortized actuarial gains and losses should remain a component of the net benefit liability/asset. This is still to come.

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Invitation to Comment Overview

The ITC discusses a number of market participant perspectives which may be incorporated in present value techniques used to estimate fair value, including (a) estimates of future cash flows; (b) possible variations in the estimated amount and timing of future cash flows caused by the uncertainty inherent in the cash flows; (c) the time value of money; (d) the price for bearing the uncertainty inherent in the cash flows (i.e., a risk premium); (e) the possibility that the entity may fail to fulfill the liability (i.e., own credit risk or non-performance risk); and (f) other factors, such as liquidity, that market participants would take into account in the circumstances.

The ITC expresses a view, based on recent accounting guidance that the discount rate used in present value measurement would consist of a risk-free interest rate and adjustments for risks that reflect the characteristics of the liability being measured.

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Invitation to Comment Overview

The ITC discusses views on alternative discount rates, including:

- market yields of high-quality debt instruments (including corporate and government bonds) that have a deep and liquid market at the reporting date;
- effective settlement rate at the reporting date;
- average historical rate for marketable treasury securities; and
- expected return on plan investments.

While the first two discount rate bases reflect a projected view, the last four discount rate bases may reflect a current, an average or a projected view of an entity’s obligation.

It was noted that any one of these alternative rates could generally represent the different objectives of estimating accrued benefit obligations at the reporting date. Some debate is noted with respect to whether the same discount rate should be used for funding and accounting purposes, to enhance user understanding.

The ITC discusses prospective application of alternative discount rates in certain scenarios: (a) Apply the same discount rate bases/views to the entire benefit obligation of a benefit plan regardless of its funding level, similar to the guidance in most equivalent standards. (b) Apply different discount rate bases/views based on a benefit plan’s funding policy, similar to the Canadian public sector practice. (c) Apply different discount rate bases/views based on a benefit plan’s funding level, similar to the U.S. Governmental Accounting Standards Board (GASB) guidance.

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Invitation to Comment Overview

- ***Bailey's View – Its great to see the complex topic of discount rates getting attention through this ITC, and the separate internal methodology developed by PSAB to guide discount rate guidance (discussed earlier). In January 2018 CPA Canada also published a great article, "Employment benefits discount rate: Any case for a current rate?" that you should read.***
- ***It will be interesting to see how PSAB develops guidance that addresses two major challenges: (i) allowing appropriate discretion for public sector entities to develop discount rates that better match the underlying economic substance of employee benefit plans; and (ii) the need for a robust framework around discount rates that will support an appropriate and healthy preparer / auditor debate. This is no easy challenge. Hats off to the employee benefits task force and PSAB for taking this on!***

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