



## **2005 Memorandum on Recent Municipal Accounting and Audit Issues**

### *Audit Issues*

Auditors have been deluged with a number of expanded requirements over the past few years. This has put considerable upward pressure on audit fees for municipalities which have shown a trend of increase well in excess of cost of living increases in recent years. The requirements of auditors looks to continue to increase over the immediate future before (hopefully) leveling off.

In 2004 and 2005 the new fraud standards introduced through CICA Handbook S. 5135, required an increase in audit focus and procedures specifically in the area of fraud.

For 2006 there are two new Handbook sections that will affect all audits; S. 5141, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" and S. 5143, "The Auditor's Procedures in Response to Assessed Risks". These two new sections together increase the detail to which auditors must understand the risks that affect all of your accounting systems and both the manual and computer supported internal controls that are in place to mitigate those risks. Although auditors have always investigated and documented your accounting systems in the past, these new regulations go far beyond what was traditionally required and will thus require a significant amount of work during the audit, particularly in the first year of implementation.

In order to comply with these two new sections, all accounting systems must be documented and tested, even if there are more efficient methods to audit the transactions within those systems.

### *An Example*

An example is property taxation receivable. Because this receivable is secured by the tax folios, this can be audited by (1) ensuring that the taxes are calculated properly (easy to do because a bylaw approves the tax rates and the assessment roll is prepared by a third party (BCAA)) and (2) ensuring that when payments are made they are credited to the correct folio (which can be tested by tracing receipts through the cash receipts process). With the new requirements auditors would now have to go beyond this to also document and test the programmed controls in the accounting system and test transactions through the computer not just the resulting documents.

In order to continue to provide the most efficient and effective audit possible, BDO has taken the opportunity provided by these two new sections of the Handbook to re-evaluate our audit methodology. In the past, we have typically relied on "substantive" audit procedures whenever they were more efficient. ("Substantive" procedures involve examining samples of invoices and other evidence to support transactions, with limited reliance on internal control testing.) As we will now be required to document and test all accounting systems in complete detail on all audit engagements, we have altered our audit methodology to take advantage of the assurance that will be produced by this work, thus reducing the amount of "substantive" audit evidence that we rely on and increasing the amount of evidence produced by testing your accounting systems. We believe that this change in methodology will produce the most efficient method of implementing these new standards.



You will note that these standards do not have to affect your audit until 2006 (although earlier adoption is encouraged). For most of our municipal engagements, our plan is to select one of your accounting systems during the 2005 audit on which to implement the new standards. We will be doing the same for other of our municipal clients, with a different accounting system being selected for each client. This will allow us to spread the “learning curve” among all of our clients, thus preventing anyone from being the “guinea pig” for the new process. This will allow us to determine what sort of problems we will encounter and what sort of efficiencies that we can capitalize on when we implement the new standards on your entire audit in 2006. We feel that this process will allow us to minimize any fee increase for the implementation of these standards.

### *Accounting Issues*

Accounting standards for municipalities and other public sector accounting entities are continuing to evolve in the Public Sector Accounting Board (“PSAB”) standards. In 2005, PSAB Section PS 3200 Liabilities, PS 3300 Contingent Liabilities and PS 3390 Contractual Obligations came into effect. PS 1150 Generally accepted accounting principles, and PS 2130 Measurement uncertainty were issued. Government reporting entity PS 1300 was issued in 2004.

We have previously discussed PS 3200, PS3300 and PS 3390 with you but wanted to remind government entities of the effective date and provide some examples of its affect. As well, we wish to inform you of the new sections released in 2004 and 2005 their affect and their effective date.

Finally we wanted to advise you of upcoming projects in PSAB.

### *Sections in Effect in 2005:*

#### **PS 3200 Liabilities**

This new section establishes recognition and disclosure standards for a government’s liabilities.

It defines liabilities as present obligations of a government to others, arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefit.



It states that liabilities can arise from contracts and agreements, another government's legislation (for example required environmental clean up), a government's own legislation, constructive obligations (those that can be inferred from the facts in a particular situation) and equitable obligations (those based on ethical or moral considerations). In the case of constructive and equitable obligations the government must accept responsibility and a clear communication of the decision to act to the other party is required (not just one politician's promise) before they would be accrued.

If an estimate of the liability cannot be made, information about the nature of the liability should be disclosed in the notes together with the reason(s) why a reasonable estimate cannot be made of the amount involved.

We anticipate that this section will require additional liabilities to be accrued and that additional work will be needed by finance and auditors to ensure all liabilities are captured.

For audit purposes, we will be asking you how Finance has ensured that all liabilities have been recorded. So to this end, please prepare a memo on how you have determined that all liabilities have been captured and have available during our audit visit.

### **PS 3300 Contingent Liabilities**

This new section establishes recognition and disclosure standards for government's contingent liabilities.

The section defines contingent liabilities as possible obligations that may result in the future sacrifice of economic benefit arising from existing conditions or situations involving uncertainty.

This section requires:

- A government to accrue a contingent liability when the expected future confirming event is likely to occur and the amount can be reasonably estimated (the previous section required disclosure only).
- That an accrued contingent liability be derecognized when it is settled or otherwise extinguished or when the future confirming event is unlikely.
- A government to disclose the existence of a contingent liability when the occurrence of the confirming future event is likely but the amount cannot be reasonably estimated; the occurrence of the confirming future event is likely and an accrual has been made, but there exists an exposure to liability in excess of the amount accrued; or the occurrence of the confirming future event is not determinable.

Government entities must disclose the nature, the dollar amount (except when disclosure would have an adverse effect on the outcome (for example in the case of a lawsuit)), the reason for non-disclosure of the amount if applicable and when an estimate of the amount has been made, the basis for that estimate.



Retroactive legislation that is passed after the financial statement date cannot create an existing condition or situation at the financial statement date therefore if a condition or situation did not exist at the date of the financial statements, there is no contingent liability.

For audit purposes, please prepare a memo for BDO documenting how you have determined that all contingent liabilities have been captured.

### **PS 3390 Contractual Obligations**

This new section establishes disclosure standards for contractual obligations in government statements.

The section defines contractual obligations as obligations of a government to others that will become liabilities when the terms of those contracts or agreements are met.

This section also requires a government to disclose information about the nature, extent and expected timing of the related expenditures.

We recommend that procedures be put into place to ensure Finance receives copies of all material contracts so that proper disclosure can be made and they can be audited efficiently. For audit purposes, please prepare a memo for BDO documenting how you determined that all significant contractual obligations have been disclosed in the notes to the financial statements.

Also note that PSAB staff members have suggested that Union agreements guaranteeing certain levels of staffing or other payments should be disclosed as a contractual obligation.

#### *An Example*

A standard example of the above sections in practice would be a construction contract. If a local government signed a \$20 million contract for an overpass and at fiscal year end \$2 million of the work had been performed, then at year end a liability for \$2 million would need to be accrued and the additional \$18 million would need to be disclosed as a contractual obligation. If the full project value was \$30 million (that is, there is a further \$10 million of anticipated cost for work not yet contracted for) then this other \$10 million is not a contractual obligation requiring disclosure. (It may however be good disclosure to discuss the project and its budget, but the disclosure must make a clear distinction between the portion that is committed to and the portion that is just planned.)

To continue the example, if a car accident happened at the construction site and those involved were suing the local government and your lawyer advised that it is likely the municipality will have to pay a settlement of between \$50,000 and \$100,000 – then you would have to accrue your best estimate of the liability (perhaps it is \$75,000) and note disclose the contingency, the range of outcomes, and the amount accrued.

*Sections Coming into Effect in 2006:*

**PS 1150 Generally Accepted Accounting Principles**

This new Section formalizes the status of PSAB Handbook and Guidelines as the primary source of Canadian generally accepted accounting principles (“GAAP”) for public sector organizations that met the criteria in the PSAB Handbook reporting entity PS 1150. It also states that both italicized and non-italicized paragraphs in the handbook have equal weight.

When the primary source of GAAP is silent, the public sector entity should adopt accounting principles that are consistent with the primary source of GAAP and consistent with the conceptual framework and determined using professional judgment. Identification of some other sources that an entity might consult is listed in the section but there is no longer any ranking of the alternatives. In other words, the CICA Handbook for commercial entities does not take precedence over other sources of GAAP when the PSAB rules are silent on an issue. It is more important that the accounting principles used are consistent with the PSAB conceptual framework.

*An Example*

The PSAB Handbook does not currently have recommendations set out in respect of accounting for property, plant and equipment by local governments. The commercial CICA Handbook (the “blue book”) has well defined rules for property, plant and equipment requiring capitalization at cost and amortization over useful life. These rules are not brought into local government accounting because they are inconsistent with the current PSAB model of expenditure based accounting. (Note thought that PSAB accounting rules for property, plant and equipment are expected to change in about 2008 as discussed below).

The Section is effective for fiscal years beginning on or after April 1, 2005.

**PS 1300 Government Reporting Entity**

The recommendations of this section apply for all fiscal years beginning on or after April 1, 2005. The government reporting entity should comprise the organizations that are controlled by the government (in past the criteria for including as part of the government reporting entity was one of direct ownership or accountability). Control is defined as the power to govern the financial and operating policies of another organization with expected benefits or the risk of loss to the government from the other organization’s activities. Indicators of control are listed in 1300.18.

Government financial statements should consolidate the financial statements of organizations comprising the government reporting entity, except for government business enterprises which are accounted for by the modified equity method. Government business enterprises are defined in PS 1300.28.



This section has been amended in the year to add transitional provisions that allow a government, in limited cases to choose to defer consolidating certain government organizations until fiscal years beginning on or after April 1, 2008. For the transitional period, government organizations that have not been included in the reporting entity in the previous fiscal year and that have specific characteristics may be accounted for on a modified equity basis rather than being fully consolidated. These are defined in PS 1300.49. For fiscal years beginning on or after April 1, 2008, all government organizations, except government business enterprises, would be fully consolidated.

Government financial statements should disclose, in notes or schedules, a listing of the major organizations comprising the reporting entity, separately identifying those that are consolidated and those that are accounted for by the modified equity method.

We recommend that all municipalities and regional districts should identify organizations that are associated with their entity, determine if the organizations is controlled, not controlled or a government business enterprise and document the conclusions for each. In general, these new rules will result in a greater number of entities being included in the government reporting entity.

### **PS 2130 Measurement uncertainty**

This section applies to *both recognized and disclosed* amounts presented in the financial statements. When a material change in an amount that is recognized or disclosed is reasonably possible in the period of one year from the date of the financial statements, the notes to the financial statements need to provide information about the nature and extent of the uncertainty. The amount of the item subject to measurement uncertainty should be disclosed, except when disclosure of the amount would have a significant adverse effect on the entity. When the amount is not disclosed, the notes should indicate the reason(s) for non-disclosure.

This section is required to be implemented for fiscal years beginning on or after April 1, 2005. Early adoption is encouraged.

## ***Projects Underway***

### **Financial Instruments**

Commercial financial instruments standards were approved in January 2005 and are proving to be one of the most significant changes to accounting standards in recent years. Fortunately for local governments, PSAB has yet to issue standards in this area. Note however that government reporting units may be impacted by these new standards as many governmental organizations adhere to commercial accounting standards.



A PSAB task force has been established to develop accounting standards for the recognition, de-recognition, measurement, presentation and disclosure of financial instruments. The task force is dealing with the commercial standard and its applicability to the public sector and, at the same time, attempting to limit the GAAP differences between the commercial and public sector handbook so that consolidating the government reporting entity will not be more complex than necessary.

A financial instrument is any contract that gives rise to a financial asset of one party and a financial liability or equity instrument of another party. The commercial standard deals extensively with derivatives which are financial instruments or contracts with the following characteristics:

- Its value changes in response to a change in a specified rate or index;
- No initial net investments, or a net investment smaller than other types of contracts that would have a similar response to changes in market factors, and
- It is settled at a future date.

Examples of financial instruments include: bank balances, investments, loans and receivables, accounts payable and long-term debt.

As financial instrument derivatives are very complex, a primary objective is to develop standards that will make reporting of the use of financial instrument derivatives as transparent and understandable as possible.

In 2005, PSAB issued a Draft Guideline for comment addressing the reporting by a government of organizations and partnerships included within its reporting entity that base their accounting on the CICA Handbook – Accounting and have implemented the financial instruments standards.

PSAB expects that the Guideline will be approved before the end of 2005. They plan on implementing this section in a staged approach with two statements of principles being planned for November 2005 and 2006 and standard adoption tentatively scheduled for 2008.

### **Government Transfers**

This major issue involved in this project are: when should operating and capital grants be recognized by the payer and recipient and, clarifying the nature and extent of the authorization needed to be in place for a transfer to be recognized.



Of key concern is addressing the appropriate accounting for capital transfers received. This is complicated by the expected change of capitalizing and amortizing property, plant and equipment (see below) rather than the current expenditure model that involves expensing property, plant and equipment when purchased. The three alternatives being examined are deferral (showing as deferred revenue and amortizing this to income over the life of the asset), using the restricted method (showing as revenue in a restricted fund) or immediate recognition.

The original expected date of issuance of the standard was November 2006 with an effective date of April 1, 2007 but due to the above complications it will likely not be issued on schedule.

### **Property, Plant and Equipment (Tangible Capital Assets)**

As previously discussed, PSAB is looking at creating standards for Local Governments that require them to capitalize and amortize their tangible capital assets. It is expected that standards in this area will be issued in 2006 with implementation to be in 2008 (or perhaps as late as 2010).

When the requirements come into force, they will have to be applied on a retroactive basis. This means that municipalities must be starting very soon in developing the information they will need about the historical cost, lifespan and age of existing assets. It is also expected that PSAB will require disclosure in 2006 of whether a municipality has the information available to meet the rules that will be coming in. If not, then they will need to disclose the plan of how they will obtain compliance.

The reasoning behind this move to amortizing tangible capital assets is that tangible capital assets represent a significant investment to local government and information about the dollar amount invested and use of these assets is vital for stewardship, accountability and a development of management plans for ongoing maintenance and replacement.

This section is expected to define tangible capital assets as non financial assets that are held for use, for rental to others, for administrative or maintenance of other acquired constructed or developed economic useful lives not intended for sale. They will include betterments and contributed infrastructure such as roads, bridges, water and sewer systems. This clear definition is expected to improve consistency in local government reporting. PSAB is looking at PS 3150 Tangible Capital Assets which is currently applicable to senior government only to determine if it can be used as a starting point for the local government model. They are hoping to have Senior and Local government rules very similar if at all possible.

As has been discussed with you in past, a significant amount of time will be required by each local government to determine a complete listing of their capital assets and the value of those assets. Most local governments have not kept complete records in this area. We are pleased to report that several municipalities have staff and software programs in place and are starting the arduous task of completing an accurate listing of tangible capital assets.

PSAB and auditors are encouraging local governments to start collecting data as early as possible. The suggested steps are:

- Set a capitalization policy – you will need to consider the cost/benefit threshold which may mean different thresholds for different areas.
- Start with a small department which will give you some experience and acquaint you with some of the pitfalls.
- Identify your existing inventory of tangible capital assets. There has been some talk about whether you need to value all components of a system or just the system in total (i.e. water and sewer). See PS Section 3150.14.
- Document when the capital item was purchased.
- If possible use historical cost for capital. Obtain invoice copy to prove cost.
- If no historical cost is available it is expected that a deflated amortized replacement cost will be used. Determine a replacement cost at today price by using a specialist – perhaps an independent engineer or a quantity surveyor. Determine when the asset was purchased/built. Deflate the replacement cost number to when the asset was purchased. Retain documentation of how cost was calculated. Amortize to today. PSAB recognizes that this will not be a precise number but rather the best estimate.
- Determine an estimate of the remaining useful life.
- Determine amortization rates. (We are expecting that the Ministry of Community Services will set standard rates for British Columbia.) Local government will need to consider these rates and assess whether the rates are accurate for them given their unique weather conditions, maintenance programs and any other factors which affect the useful life of local government assets. It appears that the maximum amortization period may be 40 years unless an argument can be made that clearly demonstrates that the useful life of the asset is expected to exceed 40 years.
- Consider purchasing software programs to assist you in managing and amortizing your tangible capital assets.
- Keep accurate records of tangible capital assets purchased from this point on. There have been some concerns regarding what costs are considered betterments and what should be expensed. See PS Section 3150.18 to .20.
- Assess the condition of the Asset. Is the asset impaired?



### **Local Government Reporting Model**

With the suggested change to Tangible Capital Asset Reporting, PSAB is also looking at changing the local government reporting model to mimic the senior government reporting model (which is already set out in the PSAB Handbook) in order to increase consistency in government reporting. It is expected that this will be issued and come into implementation at the same time as Tangible Capital Assets.

PSAB is recommending/discussing the following:

- The Statement of Financial Position to include the categories of Financial Assets, Liabilities, Net Debt, Non Financial Assets and Net Assets. This will be the most important financial statement and the key indicators of financial position will include Cash and cash equivalents, Net Debt Position, Non-financial assets, and Accumulated Surplus/deficit (Net Debt and Non Financial Assets).
- The Statement of Operations will be revenues less expenses (which will include amortization and consumption of inventories/prepays) which will equal the change in Net Assets.
- There will be a Statement of Changes in Net Debt which will explain the change in net Debt.
- The Cash Flow statement will be prepared using either the indirect or direct method; however the direct method will be encouraged. It will have four categories: operating, capital, investing and financing.
- Individual fund balances will not be disclosed on the Statement of Financial Position but will be disclosed in the Notes to the Financial Statements.
- Budget to actual comparisons will be on the Statement of Operations and the Statement of Changes in Net Debt.

### **Segment Disclosures**

The new definition of the reporting entity in PS1350 (effective April 1, 2005) will result in more organizations being consolidated into local government financial statements. Thus this project has been undertaken due to concerns about the level of aggregation of government summary financial statements. This section will provide guidance about the relevant segment disclosures required.

The objective of requiring disclosures on governmental segments is to help users of financial statements better understand the different types of activities that government engage in. There is a feeling that users may be losing important information by consolidating, and that there is a need to bring comparability and consistency to financial reporting.



Issues that will be addressed include defining segments, guidance on identifying bases of segments and identifying specific disclosures. It has been suggested that the basis of segmentation could be on:

- functional,
- service lines distinguished by outputs or achievements
- or on accountability and control relationships.

One of the task force's biggest concerns is that no onerous burden be placed on government to prepare the information but rather to define segments in such a way that allow government to gather the information easily from existing reporting structures.

It is important to note that the standard is calling for disclosures and not full financial statements. In addition only revenues and expense information is required with assets and liability information encouraged but not required. The standard will also include a variety of examples demonstrating what needs to be disclosed and the presentation of the material and a requirement that the method of allocation be disclosed.

Implementation date is expected for April 1, 2006 with the standard being issued in December 2005.

### **Performance Reporting**

This project will result in a new statement of Recommended Practice ("SORP") that will provide a general framework for public performance reporting. SORP's are not part of generally accepted accounting principles but serve as guidelines for best practices.

The key objectives are to:

- provide consistency in performance reporting:
- enhance the usefulness of public sector financial and non-financial performance information to meet user needs:
- improve accountability and measurement of performance:
- and increase transparency.

The SORP is to provide a framework for performance reporting which will include but not be limited to:

- Reporting Results (strategic direction, planned results, actual results and difference between the two, lessons learned)
- Key Factors that Influence Performance (risk, capacity and other critical factors)
- Critical Factors (identify those that impacted performance, the nature of the impact and how they will be addressed)

The SORP is expected to be approved in March 2006.



## **Revenue**

This project is in its initial stages and has been undertaken to fill a gap in Government GAAP as PSAB Handbook does not currently include a definition of revenue.

The project will define government revenue, clarify revenue recognition criteria for all government revenue types and develop specific recognition principles for government exchange and non-exchange revenues.

These issues will be addressed by leveraging the work of the international public sector accounting standards board (IPSASB) revenues project which is running concurrently. The handbook section is tentatively scheduled for release in November 2006.

## ***On the Horizon***

- Revising the Introduction to the Public Sector Accounting Handbook
- Project priorities review process

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