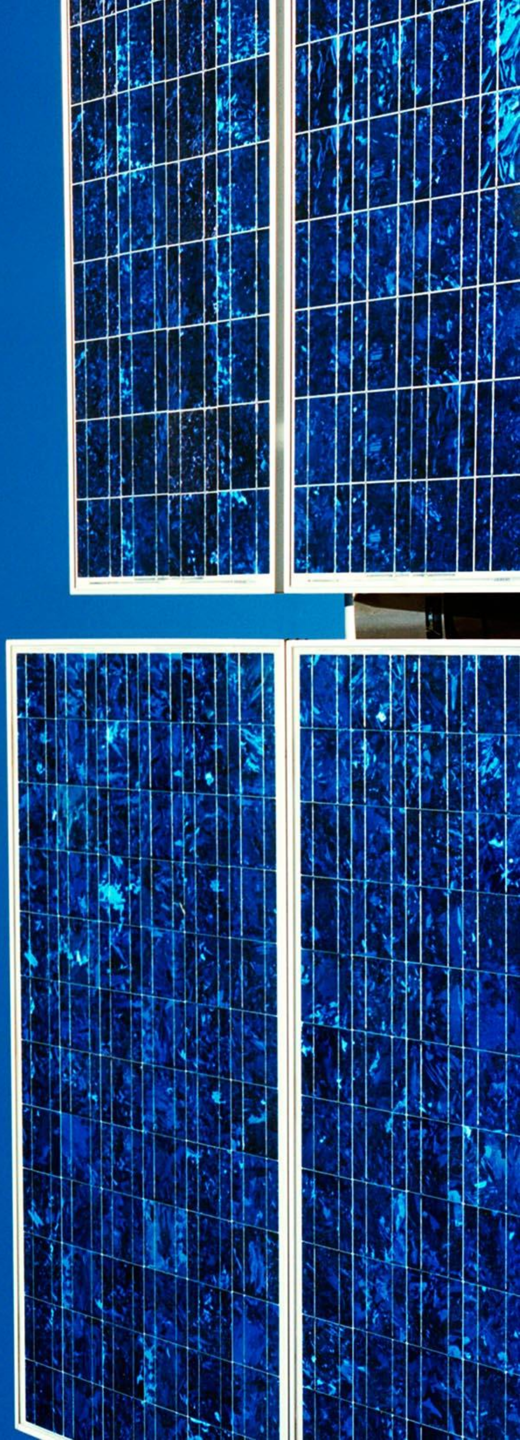
Public Sector Accounting Minute



November 2017

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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

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.***

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.**

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.***

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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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

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.***

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.

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.

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.***

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.***

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.***

Questions?

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