The Corporation of the City of Markham

Audit Findings Report
for the year ended December 31, 2021

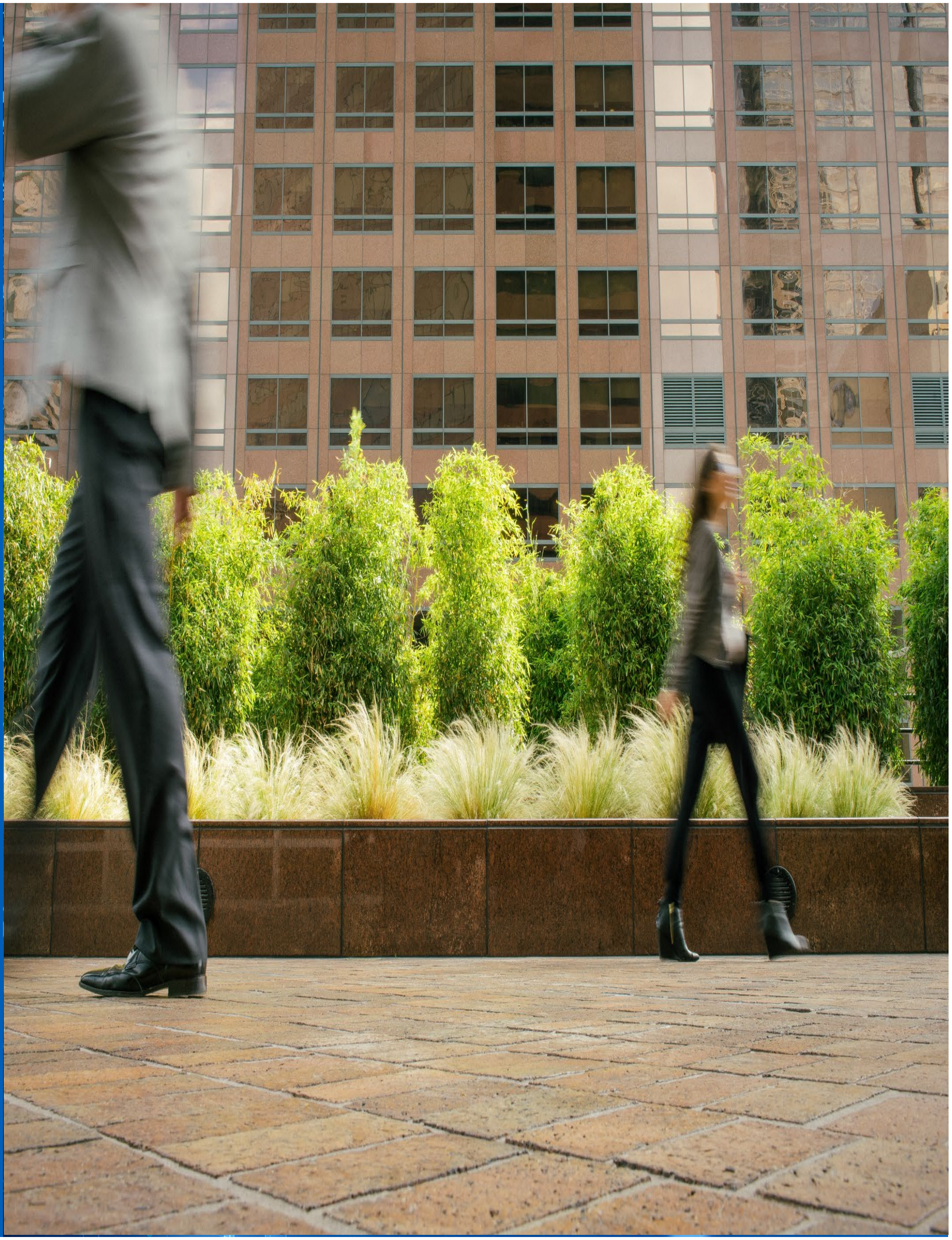
KPMG LLP

Licensed Public Accountants

Prepared on April 5, 2022 for

Presentation on April 19, 2022

kpmg.ca/audit



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Our refreshed Values

What we believe

Integrity

We do what is right.

Excellence

We never stop learning and improving.

Courage

We think and act boldly.

Together

We respect each other and draw strength from our differences.

For Better

We do what matters.

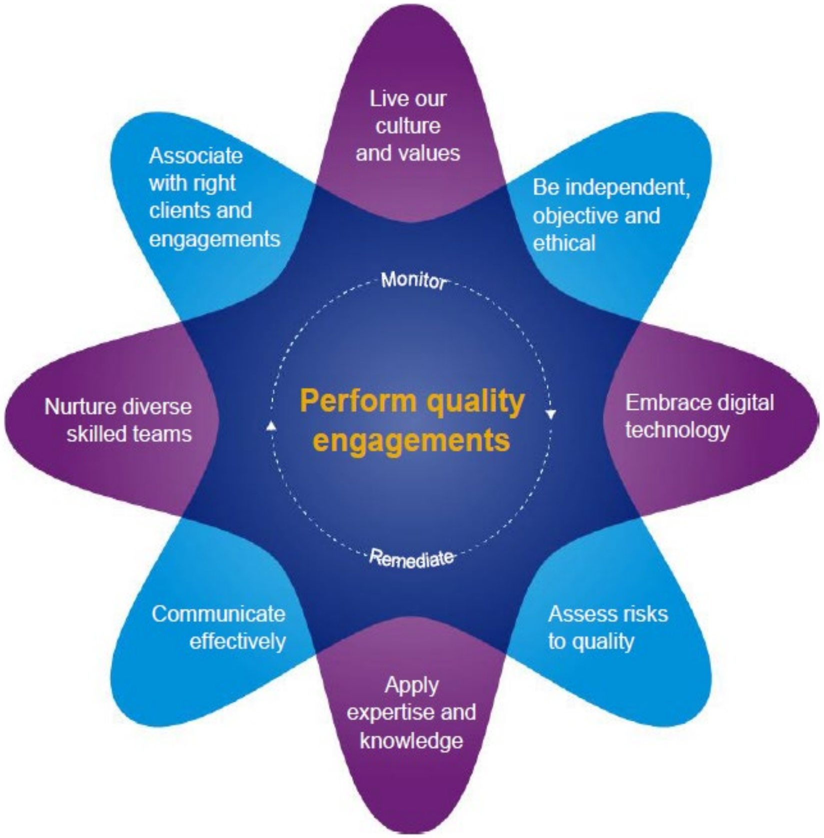
Audit Quality: How do we deliver audit quality?

Transparency report

Quality essentially means doing the right thing and remains our highest priority. Our **Global Quality Framework** outlines how we deliver quality and how every partner and staff member contributes to its delivery.

'**Perform quality engagements**' sits at the core along with our commitment to continually monitor and remediate to fulfil on our quality drivers.

Our **quality value drivers** are the cornerstones to our approach underpinned by the **supporting drivers** and give clear direction to encourage the right behaviours in delivering audit quality.



We define '**audit quality**' as being the outcome when:

- audits are **executed consistently**, in line with the requirements and intent of **applicable professional standards** within a strong **system of quality controls;** and
- all of our related activities are undertaken in an environment of the utmost level of **objectivity, independence, ethics,** and **integrity.**

Visit our **Resources** page for more information.

Doing the right thing. Always.

Executive summary

Purpose of this report[1]

The purpose of this report is to assist you, as a member of General Committee (the "Committee") in your review of the results of our audit of the consolidated financial statements ("financial statements") of the Corporation of the City of Markham, (the "Entity") as at and for the year ended December 31, 2021.

Finalizing the audit

As of the date of this report, we have completed the audit of the financial statements, with the exception of certain remaining procedures, which include amongst others:

- Completing our discussions with the Committee;
- Obtaining evidence of Council's approval of the financial statements; and,
- Receipt of signed management representation letter (to be signed upon approval of the financial statements).

We will update you on significant matters, if any, arising from the completion of the audit, including the completion of the above procedures.

Our auditors' report will be dated upon the completion of any remaining procedures.

Significant changes from the audit plan

There were no significant changes to our audit plan which was originally communicated to management.

Control deficiencies

We did not identify any control deficiencies that we determined to be significant deficiencies in internal control over financial reporting.

Significant accounting policies and practices

There have been no initial selections of, or changes to, significant accounting policies and practices to bring to your attention.

Independence

We are independent with respect to the Entity, within the meaning of the relevant rules and related interpretations prescribed by the relevant professional bodies in Canada and any other standards or applicable legislation or regulation.

Accounting estimates

Overall, we are satisfied with the reasonability of accounting estimates.

The critical areas of estimates relate to amortization of tangible capital assets, valuation of employee future benefits and contingent liabilities.

See pages 11 and 12

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[1] This report is intended solely for the information and use of the Council, General Committee, and Management, and should not be used for any other purpose or any other party. KPMG shall have no responsibility or liability for loss or damages or claims, if any, to or by any third party as this 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.

Audit risks and results

Professional requirements	Why is it significant?
Fraud risk from management override of controls	• This is a presumed risk of material misstatement due to fraud. • Although the level of risk of management override of controls will vary from entity to entity, professional standards presume the risk of management override of controls is nevertheless present in all entities and requires the performance of specific procedures to address this presumed risk.

Our response

- As this risk is not rebuttable, our audit methodology incorporated the required procedures in professional standards to address this risk.
- These procedures included the testing of journal entries and other adjustments, performing a retrospective review of estimates and evaluating the business rationale of significant unusual transaction.
- We did not identify any issues or concerns regarding management override of controls.

Audit risks and results (continued)

Professional requirements	Why is it significant?
Risk of material misstatement due to fraud resulting from fraudulent revenue recognition.	• This is a presumed risk of material misstatement due to fraud. • Audit standards require us to assume there are generally pressures/incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition. This can be perpetrated through revenue cut-off or manual journal entries and other adjustments related to revenue recognition of deferred revenue obligatory reserve.

Our response

- Our audit methodology incorporated the required procedures in professional standards to address this risk.
- Our audit approach consisted of evaluating the design and implementation of selected relevant controls. We tested journal entries that meet specific criteria. This criteria was designed during the planning phase of the audit and is based on areas and accounts that are susceptible to manipulation through management override. We also designed search filters that allowed us to identify any unusual journal entries.
- As part of our audit approach to address the inherent risk of error in revenue recognition, we substantively tested revenues (both recognized and amounts held as deferred at year end).
- We did not identify any issues related to fraud risk associated with revenue recognition.

Audit risks and results (continued)

Other areas of focus	Why are we focusing here?
Markham Enterprises Corporation (“MEC”) Investment	• Accounting for the City’s investment in Markham Enterprises Corporation (“MEC”)

Our response and significant findings

- The City recognizes its investment in MEC using the modified equity method.
- We reviewed the criteria per PS 3070 – *Investment in Government Business Enterprises* and noted the City’s investment in MEC continues to meet the criteria of the section and therefore it is appropriate to continue to record the investment in MEC using the modified equity method of accounting.
- We reviewed the MEC modified equity method calculation. We noted that there are two major components to the calculation i.e. MEC’s current year net income / other comprehensive income and MEC’s dividend declared and paid to the City. These transactions are disclosed in Note 6 of the financial statements.
- Included in the annual surplus for the City for the year is $20.1M (2020 - $15.5M), which represents 100% of the net income of MEC for the year.
- During the year, MEC paid the City dividends of $8.8M (2020 – $10.3M), which are treated as a reduction to the investment under the modified equity method.
- There was a return of capital to the City of $1.5M (2020 – $1.7M), which is also treated as a reduction of the investment.

Audit risks and results (continued)

Other areas of focus	Why are we focusing here?
Tangible Capital Assets	• Risk of material misstatement related to existence and accuracy of tangible capital assets and accuracy of timing of revenue recognition, particularly related to funds intended for tangible capital asset additions, deferred capital contributions, and contributed assets.

Our response and significant findings

- During our substantive testing, we performed audit procedures on the total additions to tangible capital assets of $479.3M (2020 - $127.6M) by picking a sample of addition items and vouching to supporting documentation. We obtained assurance related to the accuracy and existence of these additions and also assessed if these additions met the criteria for capitalization. As part of this testing we noted that there were $124.4M (2020 - $58.9M) of tangible capital assets that were capitalized from assets under construction. We performed procedures to assess if the assets transferred from assets under construction to completed tangible capital assets met the requirements of being classified as tangible capital assets.
- We reviewed on a sample basis the additions to tangible capital assets and noted that management has appropriately capitalized the additions from work in progress to capital assets and developer contributions land acquisitions.
- In our testing, we reviewed the contributions from developers and others recognized of $364.2M (2020 - $50.8M) on the statement of operations and accumulated surplus.
- Refer to the management representation letter for the adjustment identified, and subsequently corrected by management.
- There were no other significant findings as a result of our audit procedures for tangible capital assets. The amounts reported for tangible capital assets are reasonable and disclosures in the financial statements are in accordance with the Public Sector Accounting Standards.

Audit risks and results (continued)

Other areas of focus	Why are we focusing here?
Deferred Revenue Earned	• Recognition of revenue relating to amounts previously deferred as a result of legislation or contractual agreements

Our response and significant findings

- During our substantive testing, we noted that the City recognized $40.1M (2020 - $14.4M) of deferred revenue earned.
- We obtained the deferred revenue continuity schedule and selected samples for testing to determine if the selected amounts had been recognized in the current year in accordance with the appropriate legislation or agreements that the revenues pertain to.
- No exceptions were noted during testing.

Audit risks and results (continued)

Other areas of focus	Why are we focusing here?
2021 COVID-19 Recovery Funding for Municipalities program (formerly known as the Safe Restart Funding)	• Recognition of revenue relating to amounts previously deferred as a result of funding agreement with the Provincial Government of Ontario

Our response and significant findings
– During the year, the City recognized $11.8M of grant revenue (where $2.8M was received in 2020 in relation to Phase 2 Safe Restart funding and an additional $9M was received in 2021 in relation to the new program) which was provided by the Provincial Government of Ontario as a response to the COVID-19 pandemic. – We obtained the COVID-19 Recovery Funding for Municipalities program and Safe Restart funding letters, agreed amounts recorded to the funding agreements and vouched to supporting documentation of receipt of payment. – No exceptions were noted during testing.

Audit risks and results - Estimates

Management is required to disclose information in the consolidated financial statements about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a risk of resulting in a material adjustment to carrying amounts of assets and liabilities within the next financial year.

We believe management's process for identifying estimates with significant risk is considered adequate. We have summarized our assessment of the subjective areas.

Liability	Amount ($'000s)
Employee future benefits obligation	$34,433 (2020 – $34,305)
KPMG Comment	
– We reviewed actuarial reports regarding estimates related to employee future benefits – We conducted tests of detail to assess the reliability of the underlying data used within the reports. – We recalculated the accruals based on the information noted above. – No exceptions were noted during testing.	

Audit risks and results - Estimates (continued)

Expense / Liability	Amount ($'000s)
Contingent liabilities	See discussion below

KPMG Comment

- The Chartered Professional Accountants Handbook PS3300 Contingent Liabilities requires that the City recognize a liability when "…it is likely that a future event will confirm that a liability has been incurred at the date of the financial statements; and the amount can be reasonably estimated."
- At any point in time, the City is subject to a number of matters which could potentially result in the determination of a contingent liability as defined above, including, but not limited to matters such as legal claims, contract settlement accruals etc.
- We reviewed the City's assessments of contingent liabilities and the process employed to develop and record the estimated liabilities. Where applicable, we met with the individuals responsible for the process and are satisfied that the methodology used is consistent with the approach taken in prior years and has been appropriately reviewed.
- As these items are resolved, it is possible that the final amounts recorded for these liabilities may change, however the amounts currently recorded represent management's best estimates of exposure given the information presently available.
- We did not note any issues in the City's assessment of contingent liabilities and amount of related liabilities for the year-ended December 31, 2021.

Financial statement presentation and disclosure

Misstatements, including omissions, if any, related to presentation and disclosure items are in the management representation letter.

We also highlight the following:

Financial statement presentation - form, arrangement, and content	The form, arrangement and content of the financial statements is adequate.
Significant qualitative aspects of financial statement presentation and disclosure	We did not note any material disclosure omissions in the financial statements.

Uncorrected differences and corrected adjustments

Differences and adjustments include disclosure and presentation differences and adjustments.

Professional standards require that we request of management that all identified differences be corrected. We have already made this request of management.

Uncorrected differences

We did not identify misstatements that remain uncorrected.

Corrected adjustments

The management representation letter includes all misstatements identified as a result of the audit, communicated to management and subsequently corrected in the financial statements.

Appendices

Content

Appendix 1: Other required communications

Auditor’s Report	Representations of management
The conclusion of our audit is set out in our draft auditors’ report attached to the draft financial statements.	A copy of the management representation letter.

Audit Quality in Canada	
The reports available through the following links were published by the Canadian Public Accountability Board to inform audit committees and other stakeholders about the results of quality inspections conducted over the past year: • CPAB Audit Quality Insights Report: 2021 Interim Inspections Results • CPAB Audit Quality Insights Report: 2020 Annual Inspections Results	

Appendix 2: Current developments

Title	Details	Link
Public Sector Update – connection series	Public Sector Accounting Standards are evolving – Get a comprehensive update on the latest developments from our PSAB professionals. Learn about current changes to the standards, active projects and exposure drafts, and other items.	Contact your KPMG team representative to sign up for these webinars. Public Sector Minute Link

The following are upcoming changes that will be effective in future periods as they pertain to Public Sector Accounting Standards. We have provided an overview of what these standards are and what they mean to your financial reporting so that you may evaluate any impact to your future financial statements.

Standards	Summary and implications
Asset Retirement Obligations	– The new standard is effective for fiscal years beginning on or after April 1, 2022. – The new standard addresses the recognition, measurement, presentation and disclosure of legal obligations associated with retirement of tangible capital assets in productive use. Retirement costs will be recognized as an integral cost of owning and operating tangible capital assets. PSAB currently contains no specific guidance in this area. – The ARO standard will require the public sector entity to record a liability related to future costs of any legal obligations to be incurred upon retirement of any controlled tangible capital assets ("TCA"). The amount of the initial liability will be added to the historical cost of the asset and amortized over its useful life. – As a result of the new standard, the public sector entity will have to: • Consider how the additional liability will impact net debt, as a new liability will be recognized with no corresponding increase in a financial asset; • Carefully review legal agreements, senior government directives and legislation in relation to all controlled TCA to determine if any legal obligations exist with respect to asset retirements; • Begin considering the potential effects on the organization as soon as possible to coordinate with resources outside the finance department to identify AROs and obtain information to estimate the value of potential AROs to avoid unexpected issues.
Financial Instruments and Foreign Currency Translation	– The accounting standards, PS3450 *Financial Instruments*, PS2601 *Foreign Currency Translation*, PS1201 *Financial Statement Presentation* and PS3041 *Portfolio Investments* are effective for fiscal years commencing on or after April 1, 2022. – Equity instruments quoted in an active market and free-standing derivatives are to be carried at fair value. All other financial instruments, including bonds, can be carried at cost or fair value depending on the public sector entity's choice and this choice must be made on initial recognition of the financial instrument and is irrevocable. – Hedge accounting is not permitted.

	– A new statement, the Statement of Remeasurement Gains and Losses, will be included in the financial statements. Unrealized gains and losses incurred on fair value accounted financial instruments will be presented in this statement. Realized gains and losses will continue to be presented in the statement of operations. – In July 2020, PSAB approved federal government narrow-scope amendments to PS3450 *Financial Instruments* which will be included in the Handbook in the fall of 2020. Based on stakeholder feedback, PSAB is considering other narrow-scope amendments related to the presentation and foreign currency requirements in PS3450 *Financial Instruments*. The exposure drafts were released in summer 2020.
Revenue	– The new standard is effective for fiscal years beginning on or after April 1, 2023. – The new standard establishes a single framework to categorize revenues to enhance the consistency of revenue recognition and its measurement. – The standard notes that in the case of revenues arising from an exchange transaction, a public sector entity must ensure the recognition of revenue aligns with the satisfaction of related performance obligations. – The standard notes that unilateral revenues arise when no performance obligations are present, and recognition occurs when there is authority to record the revenue and an event has happened that gives the public sector entity the right to the revenue.
Public Private Partnerships ("P3")	– PSAB has introduced Section PS3160, which includes new requirements for the recognition, measurement and classification of infrastructure procured through a public private partnership. The standard has an effective date of April 1, 2023, and may be applied retroactively or prospectively. – The standard notes that recognition of infrastructure by the public sector entity would occur when it controls the purpose and use of the infrastructure, when it controls access and the price, if any, charged for use, and it controls any significant interest accumulated in the infrastructure when the P3 ends. – The public sector entity recognizes a liability when it needs to pay cash or non-cash consideration to the private sector partner for the infrastructure. – The infrastructure would be valued at cost, which represents fair value at the date of recognition with a liability of the same amount if one exists. Cost would be measured in reference to the public private partnership process and agreement, or by discounting the expected cash flows by a discount rate that reflects the time value of money and risks specific to the project.
Purchased Intangibles	– In October 2019, PSAB approved a proposal to allow public sector entities to recognize intangibles purchased through an exchange transaction. Practitioners are expected to use the definition of an asset, the general recognition criteria and the GAAP hierarchy to account for purchased intangibles. – PSAB has approved Public Sector Guideline 8 which allows recognition of intangibles purchased through an exchange transaction. Narrow-scope amendments were made to Section PS 1000 Financial statement concepts to remove prohibition on recognition of intangibles purchased through exchange transactions and PS 1201 Financial statement presentation to remove the requirement to disclose that purchased intangibles are not recognized. – The effective date is April 1, 2023 with early adoption permitted. Application may be retroactive or prospective.

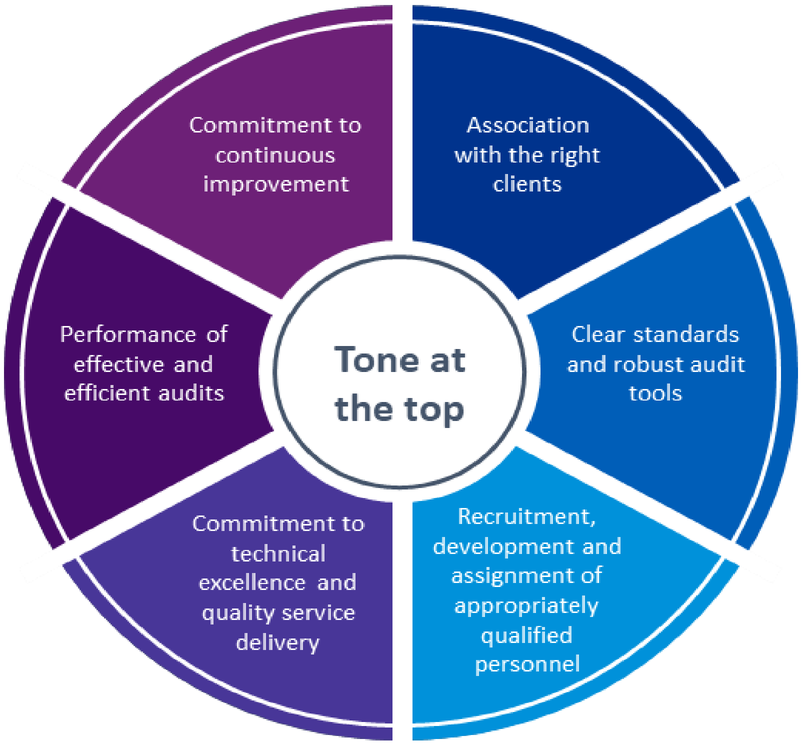
Appendix 3: Upcoming changes to auditing standards

The following changes to auditing standards applicable to our 2022 audit are listed below.

Standard	Key observations
Revised CAS 315, *Identifying and Assessing the Risks of Material Misstatement*	Revised CAS 315, *Identifying and Assessing the Risks of Material Misstatement* has been released and is effective for audits of financial statements for periods beginning on or after December 15, 2021. The standard has been significantly revised, reorganized and enhanced to require a more robust risk identification and assessment in order to promote better responses to the identified risks. Key changes include: – Enhanced requirements relating to exercising professional skepticism – Distinguishing the nature of, and clarifying the extent of, work needed for indirect and direct controls – Clarification of which controls need to be identified for the purpose of evaluating the design and implementation of controls – Introduction of scalability – Incorporation of considerations for using automated tools and techniques – New and revised concepts and definitions related to identification and assessment of risk – Strengthened documentation requirements CPA Canada plans to publish a Client Briefing document in early 2022 to help you better understand the changes you can expect on your 2022 audit.

Appendix 4: KPMG's System of Quality Control

Quality control is fundamental to our business and is the responsibility of every partner and employee. To help all audit professionals concentrate on the fundamental skills and behaviors required to deliver a quality audit, KPMG has developed the Audit Quality Framework shown below. These are the cornerstones of how we execute our responsibilities.



What do we mean by audit quality?

Audit Quality (AQ) is at the core of everything we do at KPMG.

We believe that it is not just about reaching the right opinion, but how we reach that opinion.

We define 'audit quality' as being the outcome when audits are executed consistently, in line with the requirements and intent of applicable professional standards within a strong system of quality controls.

All of our related activities are undertaken in an environment of the utmost level of **objectivity, independence, ethics,** and **integrity**.

Visit our Audit Quality Resources page for more information including access to our Transparency report.

Appendix 5: Audit and assurance insights

Our latest thinking on the issues that matter most to audit committees, Boards and Management.

Consideration	Key observations	Links
Audit & Assurance Insights	Curated thought leadership, research and insights from subject matter experts across KPMG in Canada	**Learn more**
Momentum	A quarterly Canadian newsletter which provides a snapshot of KPMG's latest thought leadership, audit and assurance insights and information on upcoming and past audit events – keeping management and board members abreast on current issues and emerging challenges within audit.	**Sign-up now**
COVID-19 Financial Reporting Resource Centre	Resource centre on the financial reporting impacts of coronavirus	**Learn more**
Return to the Workplace	As all levels of government begin to take steps toward re-opening the country and restarting our economy, planning for the return to a physical workplace is quickly becoming a top priority for many organizations. With the guidelines for the pandemic continuing to evolve daily, there are many considerations, stages and factors employers need to assess in order to properly develop a robust action plan which can ensure the health and safety of their workforce.	**Learn more**
Hybrid Workplace Guide	In this eBook, you'll discover: The business case for building a hybrid workplace: What are the benefits of a hybrid work model? From employee attraction and retention to achieving enterprise-wide cost efficiencies. The flexibility imperative: How do you create a successful hybrid workplace model that balances employees and organizations' needs and wants? From remote work to safely supporting more face to face interactions. The building blocks of a hybrid workplace: We address human, organizational, regulatory, digital and physical considerations, and aspects such as how do you manage digital and cybersecurity when working from home in a hybrid workplace model? How can management lead by motivation and results for better employee engagement? Returning to the physical workplace: How do you ensure a safe workplace when employees return to the office space in a hybrid workplace model? How can you emphasize safety to instill confidence in your employees?	**Learn more**

	Legal considerations of a hybrid work model: What could the tax implications be for companies if they implement a hybrid workplace model? Considerations to help you navigate the risks of hybrid work, including changing policies, approaches for new vs. existing employees, and security and privacy.	
Board Leadership Centre	Leading insights to help board members maximize boardroom opportunities.	**Learn more**
Going digital, faster in Canada	Pre-COVID-19, private and public organizations were moving towards a digital business model, travelling at varying speeds. But the pandemic forced a dramatic acceleration, both in the speed of change and the required investment to digitally transform. According to Canadian insights from KPMG's recent global survey, organizations are investing heavily in technology to address immediate concerns, ranging from falling revenue and interrupted supply chains to building longer-term competitiveness and operational resilience.	**Learn more**
The ESG journey: Lessons from the boardroom and C-suite	To build on our work in ESG, strategy and the long view, the Board Leadership Center interviewed directors and officers of major corporations, including Morgan Stanley, Tyson Foods, Ford Motor, Microsoft, Mars, and Whirlpool, among others.	**Learn more**
ESG, strategy, and the long view	To help boards understand and shape the total impact of the company's strategy and operations externally—on the environment, the company's consumers and employees, the communities in which it operates, and other stakeholders—and internally, on the company's performance, this paper presents a five-part framework.	**Learn more**
Inclusion and diversity practices	Getting started on the inclusion and diversity journey. Unique inclusion and diversity considerations for boards.	**Learn more**

Appendix 6: Why audit committees should know about asset retirement obligations

(See attachment below)

Why Audit Committees should know about Asset Retirement Obligations

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KPMG

Municipalities have evolved significantly over the last two decades and this evolution has escalated over the last two years due to the huge push towards digital transformation. Municipalities have come to a refreshed realization about the dynamic change it needs from their citizens resulting in a push towards a citizen-centric approach to defining their goals and objectives.

With all this change, the citizens are looking for new and improved ways to obtain information from the municipalities and public sector entities generally. They are looking for information that is timely, accurate and accessible. For instance, more and more municipalities are moving towards quarterly financial reporting to provide more timely information to stakeholders.

The finance function within municipalities tend to focus a large portion of their resources on their budget-setting process each year, relative to financial reporting. This budget sets out the municipality's operating and capital spending plan for the next year, leading to the determination of the necessary tax levy to support the planned spend. It is necessarily a cash-based document, which leads to difficulty in comparing it to a municipality's financial results, which are prepared on a basis prescribed by the Chartered Professional Accountants Canada. The annual financial statements are presented on an accrual basis in accordance with Public Sector Accounting Standards (PSAS). This disconnect between the cash basis and accrual basis often makes it difficult for 'Those Charged With Governance' (TCWG) to fully understand the actual financial results since relatively more resources are deployed towards the creation of the budget than the presentation of the financial results. While there are quite a few intersections between the budget-based reporting and PSAS reporting, there are many differences that can come in the way of effective municipal financial management and oversight.

Please note that the discussion in this paper is relevant for all public sector entities that report their financial results in accordance with PSAS. While the specific examples in this paper focus on municipalities, the same implications can be applied to other entities with slight modification to incorporate the differences in operations in the various types of public sector entities.

With that in mind, let's talk about a new reporting standard which is required to be implemented by public sector entities for years ending on or after April 1, 2022 and why it is important for TCWG to understand the implications of this new standard. This standard pertains to Asset Retirement Obligations (ARO) and requires public sector entities to set up a liability related to the legal obligation for retiring a tangible capital asset. The assets that fall into this standard are the ones that are controlled by the public sector entity and includes leased assets. This standard has far-reaching impacts for municipalities and requires proper attention from TCWG, in order to exercise appropriate oversight over the financial reporting process. We have highlighted some key items here:

(a) Completeness of liabilities
(b) Legal obligations
(c) Completeness of assets
(d) Technical expertise
(e) Financing repercussions
(f) Environmental Social Governance (ESG) implications

Let's talk about these one by one!

a. Completeness of liabilities

In many cases, the liability associated with AROs has not been recorded within the financial records of the public sector entities which means that these entities are underreporting their obligations. It is possible that certain public sector entities might have some of these obligations included within their legal obligations however it is unclear how these are being tracked and whether the process used to determine the magnitude of these legal obligations is accurate.

Not only is it important to have accurate and complete information for the measurement and recognition of these liabilities for financial reporting purposes, but the same information is also equally important for financial planning and for effective financial management of the municipalities.

One of the tools used by municipalities in order to perform long term financial planning is through reserves and reserve funds to ensure they have sufficient funds set aside for future needs. If a municipality does not have a clear understanding of their ARO liability, it would hinder their ability to assess the adequacy of their reserve funds. Cash flow management would also be impacted due to the potential unplanned outflow in any given year.

b. Legal obligations

Next, let's talk about legal obligations. It is important to understand that the obligation related to the ARO is a legal obligation. However, unlike some of the traditional legal obligations, where there might be uncertainty around the outcome of the legal item, there is no uncertainty related to the existence of the future obligation related to an ARO. This means that the future settlement is guaranteed for an ARO and the uncertainty in this situation is limited to the quantification or the amount of the future settlement.

Not getting a good handle on the ARO liability also increases the risk of negative legal implications for the municipality in the future. As an example, if there is a contaminated site that requires a municipality to perform clean up to ensure the safety of the residents, but this contamination is not rectified in a timely and reasonable manner as required by environmental regulations. This could result in severe legal implications for the municipality due to the hazardous nature of these materials and potential negative health impact on the residents.

The new ARO reporting standard also includes the concept of promissory estoppel as part of the legal liability assessment. For your convenience, we have included the definition of promissory estoppel in the glossary at the end of this document.

The key point that is important to emphasize is that it would be important to engage a legal expert as part of the ARO implementation team as this assessment might be outside the expertise of the core finance team members.

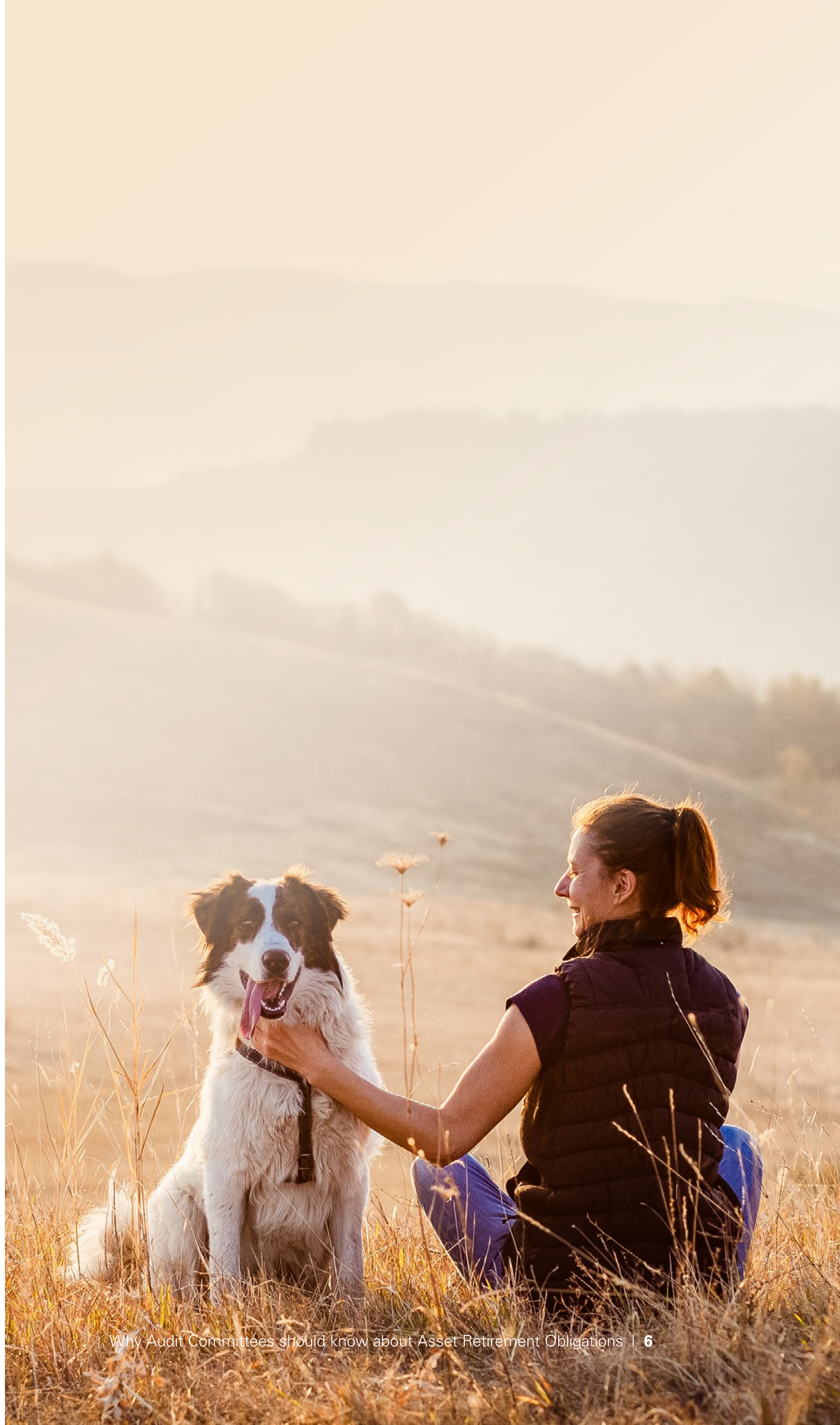
c. Completeness of assets

When Canadian municipalities first began reporting their tangible capital assets as a component of their balance sheets back in 1999, it was apparent that many municipalities did not have good historical data on the assets that they owned at that time and consequently many still do not have a complete listing of owned assets. A comprehensive approach to asset management brings numerous benefits to local and regional governments and assists them in being able to demonstrate that taxpayers get good value from each capital asset they fund, in part or in whole.

This is a contributing factor as to why there are regulatory requirements for good asset management practices. For example, the Federal Gas Tax Agreement requires municipalities to demonstrate a strong asset management system. In absence of a well-thought-out asset management plan, local municipalities could put at risk the operational effectiveness of their assets, public health and safety and overall public confidence in the local government. A solid asset management approach helps to ensure reliability of the services offered by a local government and thus instill more confidence from the public.

Asset management itself is quite a broad topic of discussion for municipalities, perhaps the above description provides an understanding of why there is so much emphasis placed on good asset management. As important as it already was to have a complete listing of tangible capital assets in order to develop a reasonable asset management plan, it has become even more so with the implementation of financial reporting standards for AROs. This due to the fact that AROs are based on identifiable tangible capital assets controlled by the Entity. If the asset listing is not complete or not up to date, any obligations relating to assets not being reported would also not be captured. If items are missed in the scoping and measurement of AROs, this results in a significant risk for the municipalities where the corresponding liabilities will be incomplete. There might be other consequences of missing these liabilities for municipalities depending on the nature and extent of error such as cash-flow management, environmental and social implications.

The ARO standard does not require entities to assess their overall asset management approach for reasonableness. The ARO standard also does not require entities to undertake an asset management exercise to make sure they have a complete inventory of all of their assets. However, it is quite clear that the entities who have an accurate and complete listing of their assets through a well-thought-out asset management plan are the ones who will be in the best position to ensure completeness of their AROs.



d. Technical expertise

Another matter to consider and assess is the quality of the information that the entity has regarding their assets. How well does the entity understand its assets including the nature and components of its assets? For the finance team to scope and measure the ARO associated with different assets, they would need clear guidance from subject matter experts that understand the technical aspect of this determination.

Finance teams would likely have the requisite expertise relating to the cost and fair value of these assets but may not be as aware of the legal, environmental, and / or other obligations attached to these assets. The knowledge of subject matter experts will be to assist the finance team in this area.

In addition to legal experts, other experts on which the exercise may depend upon include individuals from the operations team, mechanical and engineering teams, etc.

It would be important to have a discussion with the finance team to identify which subject matter experts are considered necessary based on their initial assessment in order to make optimal resource allocations. It would also be important to note that these needs could change as the implementation project matures.

e. Financing repercussions

Even though not directly related to ARO, financing repercussions should also be front of mind with overall asset management, particularly when planning for asset replacement / remediation / maintenance. In different provinces in Canada, there are restrictions on the amount of borrowing for local municipalities. In Ontario, for instance, long-term borrowing is restricted to capital investments and is also subject to a prescribed maximum level based on a preset formula.

Local municipalities use debt to help finance large capital projects. Local municipalities conduct long-term financial planning through the adoption of a multi-year capital plan and a long-term fiscal plan that would typically consider the amount and timing of debt necessary to support the planned expenditures over the term of Council. It also becomes important to understand the useful life of the asset in order to match the cost to the period over which the benefits are received. This provides more affordable financing by matching the repayment term to the economic useful life of the project, instead of funding the entire cost from current revenues.

In recent years, we have noted the trend of the issuance of green bonds, with the province of Ontario reaching a whopping $10.75 billion in green bonds in 2021. Other local municipalities are following suit and this move is expected to continue. It would be important to have a good grasp on the asset management plans before these green bonds are attached to environmentally friendly infrastructure capital projects. Talking about green bonds, let's move into other ESG considerations.

f. ESG Implications

It is quite interesting that the concept of ARO touches all three aspects of the ESG spectrum i.e., environmental, social and governance. Physical contamination caused by hazardous materials such as asbestos or the toxins and leachate from landfills are all contributors towards damaging the environment.

Inappropriate or sub-optimal treatment of these hazardous materials can have significant health detriments which becomes a social responsibility issue whereby the expectation is that public sector entities, especially municipalities would ensure appropriate level of remediation for these hazardous items. The heightened fiduciary responsibility in the public sector environment especially with the elected officials with the municipalities creates a huge need for an appropriate level of governance in place.

The ESG implications for ARO have gained a lot of traction in recent years. These discussions have become more important now as public sector entities work towards the implementation of this new standard. While it is important to embrace ESG into our strategic planning, it will be critical to ensure that this planning is comprehensive and well thought out. As daunting as this task can seem, the key is to have a structured approach to map out what is relevant for the organization and to design a plan to tackle these implications.

In conclusion, while the ARO standard implementation may seem like any other accounting standard implementation, it has far reaching implications from a municipal operational and governance perspective requiring consideration and input from the organization as a whole, not just its finance team. It is therefore critical to take the time to understand these implications and design a plan to address them in a meaningful manner.

We would be more than happy to continue this discussion with you. We are currently running customized sessions for different entities to help them understand these various implications of AROs and how to best address them.

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Glossary

Public Sector

Public sector refers to governments, government components, government organizations and partnerships. Each of these entities is a "public sector entity". A government component is an integral part of government, such as a department, ministry or fund. It is not a separate entity with the power to contract in its own name and that can sue and be sued. A government organization is any organization controlled by a government that is a separate entity with the power to contract in its own name and that can sue and be sued. Public sector organizations have a higher accountability to the taxpayer – above and beyond the traditional fiduciary duty.

Promissory estoppel

The elements of a promissory estoppel claim are "(1) a promise clear and unambiguous in its terms; (2) reliance by the party to whom the promise is made; (3) [the] reliance must be both reasonable and foreseeable; and (4) the party asserting the estoppel must be injured by his reliance."

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