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UNDERSTANDING CANADIAN PUBLIC SECTOR FINANCIAL STATEMENTS

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TABLE OF CONTENTS

WHO WILL FIND THIS GUIDE HELPFUL

All Canadian public sector entities – federal, provincial and local governments, as well as most organizations controlled by them – prepare financial statements. The majority of those statements are prepared according to public sector accounting standards adopted across Canada.

Public sector financial statements are read and used by a broad group of readers such as elected legislators and councillors, board members, credit rating agencies, and other interested members of the public. As a result, public sector financial statements must meet the needs of a broad range of users.

The purpose of this guide is to help all these readers – and specifically those who are not familiar with public sector financial statements – improve their ability to review and interpret government financial reports. The guide describes the unique aspects of financial performance and accountability that one can find when the financial statements are prepared in accordance with the *CPA Canada Public Sector Accounting (PSA) Handbook*. After reading this guide you should have a general understanding of the following:

- What is included in a set of public sector financial statements;
- The key measures of public sector financial position and performance;
- Why reading the notes to the financial statements is important;
- How financial statement discussion and analysis from management supplements the audited financial statements; and
- Why the independent auditor's report should be read before using the financial statements.

You may find it useful to have this guidance at hand when reviewing a set of public sector financial statements.

We have also provided in each section questions you should consider asking when reviewing a set of financial statements. This does not include all possible questions but provides a starting point for questions to ask.

Why does the public sector have different accounting standards than the private sector? To find out, see Appendix A.

How has the standard-setting process in Canada resulted in high-quality public sector accounting standards? To find out, see Appendix B.

SCOPE OF THE GUIDE

This guide describes the financial statements of public sector entities that prepare their financial statements using the *CPA Canada Public Sector Accounting Handbook* issued by the Public Sector Accounting Board.

The guide does not cover the financial reporting requirements of: government business enterprises,[1] organizations that have opted to apply the standards applicable for business enterprises, or government not-for-profit organizations that have opted to follow the not-for-profit standards set out in the *Public Sector Accounting Handbook*.

This guide reflects Canadian public sector accounting standards at the date of publication; however, accounting standards change frequently. The guidance provided here is a basic summary of Canadian public sector financial reporting and should not be relied on as accounting advice.

1 *The Public Sector Accounting Handbook* directs government business enterprises to adopt the accounting standards for publicly accountable enterprises in Part I of the *CPA Canada Public Sector Handbook – Accounting* (2014). The standards contained in Part 1 are the International Financial Reporting Standards (IFRS) set globally by the International Federation of Accountants.

WHAT A SET OF PUBLIC SECTOR FINANCIAL STATEMENTS INCLUDES

CANADA'S PUBLIC SECTOR ACCOUNTING standards aim to ensure that a public entity's financial statements:

- account for the full **nature and extent of the financial affairs and resources** that the entity controls;
- show the entity's **financial position at the end of the fiscal period,** so the entity's ability to finance its activities and provide future services can be evaluated;
- describe the entity's **change in financial position during the fiscal period;** and
- demonstrate the entity's **accountability** for the management of the resources, obligations and financial affairs for which it is responsible.

This means that financial statements should provide readers with a clear understanding of the assets, liabilities, revenues and expenses of the entity in question. Public sector financial statements are prepared using the accrual basis of accounting. This method records transactions and their effect when they occur, which is often in a different period than when the associated cash exchanges to settle the transaction.

FIVE SEPARATE STATEMENTS MAKE UP A FULL SET OF FINANCIAL STATEMENTS

The five separate financial statements, shown in Exhibit 1, are described briefly below and in more detail in the pages that follow.

1. **Statement of Financial Position** – This is the overarching statement that summarizes an entity's financial position at a point in time. Changes in the financial position of the entity are summarized in the following four statements.
2. **Statement of Operations** – This statement explains the change in the overall financial position of the entity during the accounting period except for those changes reported separately in the Statement of Remeasurement Gains and Losses.
3. **Statement of Remeasurement Gains and Losses** This statement explains the change in the overall financial position of the entity during the accounting period due to remeasurements related to unrealized gains and losses on specific financial assets and liabilities recorded at fair value, and unrealized foreign exchange gains and losses.[2]
4. **Statement of Cash Flow** – This statement explains the change in cash and cash equivalents from the prior year and provides important information about the entity's ability to generate cash to meet its cash requirements.
5. **Statement of Change in Net Debt** – This statement reconciles the change in net debt for the current and prior year. Net debt is a financial performance measure unique to public sector financial reporting and is explained in the next section.

2 Governments are not required to present this statement until fiscal periods beginning on or after April 1, 2016. Some government organizations are now required to report remeasurement gains and losses; however, as many do not have such transactions to report this statement is often not included.

Exhibit 1: How the Statement of Financial Position links to the other financial statements

Statement of Financial Position

PUBLIC SECTOR ENTITY
Statement of Financial Position - As at March 31, 2014

	2014	2013
Financial Assets		
Cash and cash equivalents	XXX	XXX
Accounts receivable	XXX	XXX
Total Financial Assets	XXX	XXX
Liabilities		
Accounts payable and acrued liabilities	XXX	XXX
Debt	XXX	XXX
Total Liabilities	XXX	XXX
Net financial assets (debt)	XXX	XXX
Non-Financial Assets		
Tangible capital assets	XXX	XXX
Inventories of supplies	XXX	XXX
Total Non-financial Assets	XXX	XXX
Accumulated surplus (deficit)	XXX	XXX
Accumulated surplus (deficit) is comprised of:		
Accumulated operating surplus (deficit)	XXX	XXX
Accumulated remeasurement gains (losses)	XXX	XXX

Statements Explaining Changes in Financial Position

PUBLIC SECTOR ENTITY
Statement of Cash Flow - For the year ended March 31, 2014

	2014	2013
Operating Transactions	XXX	XXX
Capital Transactions	XXX	XXX
Investing Transactions	XXX	XXX
Financing Transactions	XXX	XXX
Increase in cash and cash equivalents	XXX	XXX
Cash and cash equivalents at beginning of year	**XXX**	**XXX**
Cash and cash equivalents at end of year	**XXX**	**XXX**

PUBLIC SECTOR ENTITY
Statement of Net Debt - For the year ended March 31, 2014

	Budget 2014	Actual 2014	Actual 2013
Annual operating surplus	XXX	XXX	XXX
Acquisition of tangible capital assets	(XXX)	(XXX)	(XXX)
Amortization of tangible capital assets	XXX	XXX	XXX
Changes in other non financial assets	XXX	XXX	XXX
(Increase)/decrease in net debt	**XXX**	**XXX**	**XXX**
Net debt at beginning of year	**XXX**	**XXX**	**XXX**
Net debt at end of year	XXX	XXX	XXX

PUBLIC SECTOR ENTITY
Statement of Operations - For the year ended March 31, 2014

	Budget 2014	Actual 2014	Actual 2013
REVENUES	XXX	XXX	XXX
EXPENSES	XXX	XXX	XXX
Operating Surplus (Deficit)	XXX	XXX	XXX
Accumulated operating surplus (deficit) at beginning of year	XXX	XXX	XXX
Accumulated operating surplus (deficit) at end of year	**XXX**	**XXX**	**XXX**

PUBLIC SECTOR ENTITY
Statement of Remeasurement Gains and Losses - For the year ended March 31, 2014

	2014	2013
Accumulated remeasurement gains (losses) at beginning of year	XXX	XXX
Net remeasurement gains (losses)	XXX	XXX
Accumulated remeasurement gains (losses) at end of year	XXX	XXX

Note: these are simplified statements for illustration and do not include all the categories required by the public sector accounting standards.

WHAT THE FINANCIAL STATEMENTS REVEAL ABOUT FINANCIAL PERFORMANCE AND ACCOUNTABILITY

The financial statements tell the financial performance story for the current and prior fiscal periods. Exhibit 2 summarizes the financial performance measures, or indicators, presented on each financial statement.

Exhibit 2: Performance and accountability measures by financial statement

Financial performance & accountability measures	Statement of Financial Position	Statement of Operations	Statement of Remeasurement Gains and Losses[3]	Statement of Cash Flow	Statement of Change in Net Debt
Net financial assets or debt	✓				✓
Accumulated surplus or deficit	✓				
Budget to actual comparisons		✓			✓
Annual operating surplus or deficit		✓			
Net remeasurement gains or losses			✓		
Cash flow by activity				✓	

THE IMPORTANCE OF THE NOTES TO FINANCIAL STATEMENTS

Supporting the five financial statements are the explanatory notes that go along with them. These notes (referenced on each applicable statement) provide expanded disclosures on the reported amounts. An entity's reported financial results cannot be fully understood without reading the notes to the financial statements.

3 Governments are not required to present this statement until fiscal periods beginning on or after April 1, 2016. Some government organizations are now required to report remeasurement gains and losses; however, as many do not have such transactions to report this statement is often not included.

QUALITATIVE CHARACTERISTICS OF PUBLIC SECTOR FINANCIAL STATEMENTS

To effectively communicate financial information, financial statements must go beyond the numbers. To do this, financial statements must also meet the following qualitative characteristics:

- **Timely** – For the information to be useful, the financial statements should be published as soon as possible after the annual reporting period. The value of the information for decision making or accountability purposes decreases over time.
- **Comparable** – Financial statements must show results on a consistent basis to enable readers to compare the current and prior periods and make assessments on whether the entity's financial position is improving or deteriorating.
- **Reliable** – The information presented in financial statements must be accurate and complete if it is to be seen as reliable. In the public sector, financial statements are normally audited by an independent auditor to provide assurance for readers that the information is reliable. The last section of this guide discusses the information communicated by an auditor's report.
- **Understandable** – The information in the financial statements must be clearly presented and explained so that readers with a reasonable interest in interpreting what the information means can understand it.

The Statement of Financial Position presents an entity's financial assets and liabilities at a point in time. The statement layout provides two key performance measures of the entity's ability to finance its operations and provide future services.

The main sections of this statement are described below along with an explanation of how the unique presentation of assets within the statement generates the two financial position performance measures. Exhibit 3 is a sample statement of financial position for your reference as you read this section.

Statement of Financial Position: financial statement elements

- assets (financial and non-financial)
- liabilities

Financial accountability and performance measures

- net debt or net financial assets
- accumulated surplus or deficit

FINANCIAL ASSETS

Financial assets are the financial resources an entity controls and can use to pay what it owes to others. These assets include cash, accounts receivable, investments, and assets that are convertible to cash or that generate cash so that the entity can pay its liabilities as they come due.

Information about the liquidity of an entity's financial assets is not presented on the Statement of Financial Position. (*Liquidity* means how quickly assets can be used to pay bills.) However, the notes to the financial statements include disclosures on the liquidity of an entity's financial assets.

LIABILITIES

Liabilities are existing financial obligations to outside parties at the date of the financial statements. They result from past transactions and events and will lead to the future sacrifice of economic benefits (e.g., financial assets).

Common liabilities are accounts payable, debt, employee pension obligations, and unearned revenue. Users should also read the notes to the financial statements to better understand the nature of an entity's liabilities and when liabilities are due.

FINANCIAL PERFORMANCE MEASURE: NET DEBT OR NET FINANCIAL ASSETS

Net debt is a term unique to public sector financial reporting. It is the difference between an entity's financial assets and liabilities at a point in time. This performance measure provides readers with important information regarding the entity's requirement to generate future revenues to fund past services and transactions.

Financial assets are the resources available to settle an entity's liabilities to external parties. When liabilities exceed financial assets, an entity is in a net debt position. Entities in a net debt position must generate future revenues to cover the cost of past transactions and events. The reverse is true when an entity is in a net financial asset position (financial assets exceed liabilities). Entities in a net financial asset position have sufficient financial assets to settle existing liabilities.

To understand how an entity's net debt (or net financial asset) position has changed, users should read the statement of change in net debt.

NON-FINANCIAL ASSETS

Non-financial assets are assets that an entity will use up when providing future services to the public. These assets are not normally used by an entity to settle its liabilities with external parties. As a result, they are shown separately in the Statement of Financial Position.

Often, the most significant group of assets within this category are tangible capital assets, like buildings or roads, which are acquired to provide services over many years. As entities deliver services, the estimated portion of the assets used is recorded as an expense in the Statement of Operations. The balance presented represents the remaining service potential of the non-financial assets.

Crown lands and natural resources inherited in right of crown and all intangible assets are not recognized as assets in public sector financial statements. When these assets are important to an entity's ability to generate revenues or deliver services, additional information should be included in either the notes to the financial statements or in the financial statement discussion and analysis accompanying the financial statements.

FINANCIAL PERFORMANCE MEASURE: ACCUMULATED SURPLUS OR DEFICIT

The accumulated surplus or deficit represents the net recognized economic resources (all assets and liabilities) of the entity at the date of the financial statements. This measure provides the net economic position of the entity from all years operations at a point in time.

The accumulated surplus or deficit is comprised of all of the past :

- operating surpluses or deficits; and
- remeasurement gains and losses.

When total assets exceed total liabilities, the entity is in an accumulated surplus position. An accumulated surplus position means that the entity has net positive resources that, subject to direction of the government or governing board, could be used to provide future services. However, when an entity is in an accumulated deficit position (total liabilities exceed total assets), the entity must fund past transactions and events from future revenues. An accumulated operating deficit position means the entity has borrowed to finance annual operating deficits.

As noted in Exhibit 1, the statement of operations and statement of remeasurement gains and losses provides information explaining the change in the accumulated surplus or deficit position of the entity over the past two fiscal years.

Exhibit 3: Sample Statement of Financial Position

PUBLIC SECTOR ENTITY
Statement of Financial Position
As at March 31, 2014

	Note	2014	2013
FINANCIAL ASSETS			
Cash and cash equivalents	2	1,908	1,573
Accounts receivable	3	1,864	1,708
Portfolio investments	4	2,254	1,331
Derivatives	5	35	-
Loans	6	4,909	5,659
Inventories for resale	7	109	135
Total Financial Assets		**11,079**	**10,406**
LIABILITIES			
Accounts payable and accrued liabilities	8	2,383	2,644
Derivatives	9	10	105
Debt	10	9,398	9,796
Pension obligation	11	4,813	4,890
Other accrued liabilities	12	1,395	1,510
Deferred revenue	13	308	331
Total Liabililies		**18,307**	**19,276**
Net financial assets (debt)	14	(7,228)	(8,870)
NON-FINANCIAL ASSETS			
Tangible capital assets	15	7,218	7,215
Inventories of supplies	16	112	222
Prepaid expenses	17	30	20
Total Non-financial Assets		**7,360**	**7,457**
Accumulated surplus (deficit)	18	132	(1,413)
Accumulated surplus (deficit) is comprised of :			
Accumulated operating surplus (deficit)		10	(1,366)
Accumulated remeasurement gains (losses)		122	(47)
		132	(1,413)

The accompanying notes are an integral part of these financial statements.

Source: Adapted from the *CPA Canada Public Sector Accounting Handbook*

POTENTIAL QUESTIONS TO ASK WHEN REVIEWING A STATEMENT OF FINANCIAL POSITION – AND HOW TO FIND THE ANSWERS

1. Is the net debt or net financial asset position of the entity increasing or decreasing?

This performance measure shows the extent to which sufficient financial assets exist to discharge liabilities. When assessing trends in the net debt or net financial asset position, readers should look to the Statement of Change in Net Debt to identify the key components of the current trends. Increases or decreases may indicate that:

- significant tangible capital assets have been added (net debt increasing), or the entity has not fully replaced consumed tangible capital assets (net debt decreasing); or
- debt financing is being used to fund operations (net debt increasing), or current year revenues exceed operating expenses (net debt decreasing).

The strength of the net financial asset position (or weakness of the net debt position) is determined by the ratio of financial assets to liabilities. When financial assets significantly exceed liabilities the entity will be in a strong net financial asset position. However, when liabilities significantly exceed financial assets the entity will be in a weak financial position. A trend of increasing net debt or decreasing net financial assets may indicate that current operations are unsustainable.

The ratio of financial assets to liabilities is one of the sustainability indicators published by the Public Sector Accounting Board (PSAB) in *Statement of Recommended Practice (SORP) 4 – indicators of financial condition.* SORP 4 provides guidance to entity's when reporting supplementary information on the financial condition of the entity including possible sustainability, flexibility and vulnerability indicators.

2. Is the accumulated surplus or deficit of the entity increasing or decreasing, and how strong is the overall financial position of the entity?

It is important to understand the balance between the entity's historic revenue generation and its service delivery. This means looking at current trends to see whether the financial position (the accumulated surplus or deficit) is increasing or decreasing, as well as the overall strength of the financial position in which these results occurred. An entity in a strong accumulated surplus position may be able to incur annual deficits for a longer period of time than an entity in a weaker financial position (i.e., accumulated deficit position). The strength or weakness of the accumulated surplus or deficit position is determined by the ratio of assets (financial and non-financial) to liabilities. The ratio of assets to liabilities is one of the sustainability financial condition indicators recommended in SORP 4.

3. What investment has the entity made in tangible capital assets for providing future services?

The type of services a public sector entity provides determines the extent to which it must invest in and maintain tangible capital assets. Some services depend heavily on long-life tangible capital assets such as sewer and water infrastructure; other services do not. It is important to first understand the nature of what services an entity provides before conclusions can be drawn on an entity's investment in tangible capital assets.

Considerations when looking at an entity's tangible capital assets include:

- What type and mix of tangible capital assets has the entity acquired (this information is disclosed in the notes)?
- Is the entity acquiring sufficient assets (purchases) to replace those that have been consumed in service delivery (amortization expense)?
- What level of resources is the entity spending on maintaining capital assets? (this may be disclosed in the notes)
- To what extent is the entity securing the use of capital assets through operating leases or other arrangements to supplement the capital asset stock acquired by the entity? (this information is disclosed in the notes)

The financial statements can not provide all of the information necessary for making assessments on the effective management of tangible capital assets. However, the financial statements do provide basic information on tangible capital asset purchases, disposals, estimated service potential and current period usage through amortization, as well as resources the entity has expended for maintenance of the tangible capital asset stock.

PSAB has also developed a statement of recommended practice (*SORP – 3 Assessment of tangible capital assets*) to assist public sector entities with reporting more detailed information on tangible capital assets to supplement the basic information contained in the financial statements. This includes information on the nature and extent of tangible capital assets, the condition of assets and the estimated remaining useful life.

The Statement of Operations is one of the financial statements prepared to explain the changes in the overall financial position of the entity during the accounting period. This statement explains the change in the accumulated surplus or deficit from the prior year except changes due to remeasurement gains or losses. Exhibit 4 shows a sample Statement of Operations for your reference as you read this section.

The financial elements in the Statement of Operations include revenues and expenses. The performance and accountability measures are the annual surplus or deficit and the comparison of budgeted to actual results.

Statement of Operations: financial statement elements

- revenues
- expenses

Financial performance and accountability measures

- annual operating surplus or deficit
- budget to actual results

REVENUES

Revenues are increases in economic resources that result from the entity's operations, transactions and events during the accounting period. Revenues result from decreases in liabilities or increases in assets. Common revenues include:

- taxation revenue, such as income or property tax;
- transfers from governments, such as federal equalization payments to the provinces and contributions from a provincial government to service delivery organizations such as hospitals;
- investment income; and
- revenues from the sale of goods and services.

EXPENSES

Expenses are decreases in economic resources that result from the entity's operations, transactions and events during the accounting period. Expenses result from decreases to assets or increases in liabilities.

The Statement of Operations presents expenses by function or program, such as health or education. This presentation conveys the entity's financial resource allocation decisions. The notes to the financial statements contain additional information on the classification of expenses by type. For example, amortization expense represents the portion of tangible capital assets consumed during the year and is disclosed in the notes.

FINANCIAL PERFORMANCE MEASURE: ANNUAL OPERATING SURPLUS OR DEFICIT

The annual operating surplus or deficit shows whether the revenues raised in the year were sufficient to cover the year's operating expenses and consequently, whether the financial position improved, was unchanged or declined during the year. This measure explains the overall change in financial position for entities that do not prepare a Statement of Remeasurement Gains and Losses.

The impact of an entity's annual operating surplus or deficit must be viewed in the context of the entity's overall financial position. An entity in a strong financial position is better positioned to absorb the impact of annual operating deficits than an entity in a weak financial position. This makes it important to look at the annual operating surplus or deficit trends over time.

FINANCIAL ACCOUNTABILITY – BUDGET TO ACTUAL RESULTS

Annual budgets approved by elected officials and boards convey the financial policy and resource decisions for the entity in question. As a result, a key component of financial accountability in the public sector is comparing the actual financial results with the originally planned results in the budget.

To achieve this reporting objective, the Statement of Operations includes an entity's original approved annual budget. This is a unique requirement of public sector financial statements. By reporting the budget, you can see how the entity's revenues and expenses compared against the original plan.

Exhibit 4: Sample Statement of Operations

PUBLIC SECTOR ENTITY
Statement of Operations
For the year ended March 31, 2014

	Budget 2014	Actual 2014	Actual 2013
REVENUE (Note 19)			
Personal income tax	5,392	5,969	5,655
Corporate taxes	2,642	2,659	3,848
Sales and other taxes	2,080	2,296	2,431
Health and insurance premiums	641	680	652
Fees, permits, licenses and fines	581	651	669
Other revenue	1,237	2,122	1,669
Investment income	409	610	747
Canada health and social transfer	940	970	903
Other transfers	355	365	280
	14,277	**16,322**	**16,854**
EXPENSE (Note 20)			
Education	4,329	4,287	4,168
Health	4,541	4,626	4,457
Agriculture, environment, development	1,706	1,856	1,740
Social services	1,654	1,701	1,709
Transportation and utilites	626	823	807
Recreation and culture	281	272	217
General government	551	627	560
Justice	468	487	462
Interest expense	93	267	183
	14,249	**14,946**	**14,303**
Operating Surplus (Deficit)	28	1,376	2,551
Accumulated operating surplus (deficit) at beginning of year	(1,366)	(1,366)	(3,917)
Accumulated operating surplus (deficit) at end of year	**(1,338)**	**10**	**(1,366)**

Source: Adapted from the *CPA Canada Public Sector Accounting Handbook*

POTENTIAL QUESTIONS TO ASK WHEN REVIEWING A STATEMENT OF OPERATIONS – AND HOW TO FIND THE ANSWERS

1. How did the entity's actual results for revenues and expenses compare with its approved financial plan and prior year results?

Comparing planned results with actual results is useful for assessing whether or not the entity met the financial objectives set at the beginning of the year. Significant variances between planned and actual results may be indicators of:

- changes to program offerings or program delivery;
- delayed or accelerated program implementation; or
- unplanned funding contributions or events.

When significant variances between planned and actual results occur, the notes may provide some information. However, readers should find the rationale for significant variances in the unaudited financial statement discussion and analysis from management, attached to the financial statements.

Similar variances and trends may also be observed between current and prior period results.

2. Did the entity raise sufficient annual revenues to cover annual operating expenses?

One of the primary financial performance measures is the annual operating surplus or deficit. An entity's overall financial position improves with annual surpluses and declines with annual deficits.

Readers should first consider the trend of the current and prior year results within the context of the accumulated surplus or deficit presented in the Statement of Financial Position. Then they should assess whether the position is improving or deteriorating. Questions to ask include:

- Is the entity consistently generating annual surpluses or deficits?
- How significant are the annual surpluses or deficits incurred?
- Is the overall financial position (i.e., accumulated surplus or deficit) improving or deteriorating over time?

3. How dependent is the entity on transfers from other governments or organizations to meet its operating costs?

An entity may be highly dependent on transfers of resources from governments or other entities in order to deliver services. Readers should consider how effectively the entity could respond if those transfers were reduced. Would the entity be able to:

- raise additional revenues from its own revenue generating activities such as taxation or fees?
- obtain debt financing to finance unexpected annual deficits?
- reduce operating expenses to match potential revenue reductions?

The financial statement notes will provide some detail on the fixed future expenses and payments the entity cannot avoid, such as debt payments, and contractual obligations.

4. How is the entity allocating resources to the functions or programs it is accountable for?

The entity conveys its financial priorities through the planned and actual service costs presented in the Statement of Operations. Based on their policy decisions, entities will allocate more or fewer resources to a specific function or purpose. By analyzing this information, readers can identify changes in financial priorities. This information can also be a starting point for asking if the entity is allocating the right amount of resources to specific functions or programs.

5. Was the annual operating surplus or deficit impacted by unusual or non-recurring transactions?

When assessing the financial performance of an entity, it is important to understand the impact of non-recurring events or non-routine transactions on the financial results presented. These transactions do not create ongoing revenues or expenses for the entity. Therefore, in analyzing the entity's performance, a reader must consider the impact of these transactions.

For example, an entity might sell a significant tangible capital asset and realize a large gain (revenue) in the current year. This is a one-time revenue source that will not occur in future periods. The reader should therefore assess what the annual surplus or deficit would have been had this transaction not occurred. If the revenue from this sale was necessary for an annual operating surplus to occur, the entity may need to generate new revenue sources to cover future operating expenses.

PSAB APPROVED NEW ACCOUNTING standards in 2011[4] that introduced the new statement of remeasurement gains and losses for public sector financial reporting[5]. When entities apply the new standards, the change in the accumulated surplus or deficit of the entity may be explained by two financial statements (the statement of operations and the statement of remeasurement gains and losses). Entities will only prepare this statement when the entity's operations require the reporting of remeasurement gains and losses.

Exhibit 5 shows a sample statement of remeasurement gains and losses for your reference.

WHAT ARE REMEASUREMENT GAINS AND LOSSES?

Remeasurement gains and losses result from the following:

- Fair value measurement

  Public sector accounting standards now require that the recognized value of specific financial assets and liabilities be updated annually using the current fair value. These include certain derivative financial instruments and investments in publicly traded equity instruments. Entities may also elect to value other financial assets and liabilities using fair value when they are evaluated and managed on a fair value basis. The annual change in the fair value of these assets and liabilities are reported in the statement of remeasurement gains and losses until the assets are sold or liabilities are settled.

- Foreign currency exchange rate fluctuations

  When an entity holds foreign currency such as US dollars, the value of the US dollar cash is subject to changes in foreign exchange rates. To prepare the financial statements preparers must convert these monetary financial assets and liabilities to Canadian dollars. The annual fluctuations that result from changes in exchange rates are reported in the Statement of Remeasurement Gains and Losses until the monetary assets or liabilities are used or settled.

Changes in the reported value of assets and liabilities due to fair value measurement or changes in exchange rates are only included in the Statement of Remeasurement

4 The new standards are 1201 Financial Statement Presentation and Disclosure, 2601 Foreign Currency Translation and 3450 Financial Instruments. All three accounting standards must be adopted concurrently.

5 The new accounting standard for financial statement presentation and disclosure must be applied for fiscal periods beginning on or after April 1, 2016. Entities that transitioned from the *CICA Handbook* to the *PSA Handbook* (most government organizations) were required to apply the new standards for fiscal periods beginning on or after April 1, 2012.

Gains and Losses until the asset or liability is disposed of or settled. When this occurs, previously reported unrealized gains and losses are transferred from accumulated remeasurement gains and losses and the entire gain or loss (relative to cost) is recognized in the statement of operations.

WHAT THE STATEMENT PRESENTS

This statement provides a reconciliation of the opening and closing remeasurement gains and losses. To do this the statement is structured with four main sections:

1. The opening remeasurement gain or loss position;
2. Current year changes in the remeasurement gains or losses by type;
3. Gains or losses realized in the year and transferred to the statement of operations; and
4. The ending remeasurement gain or loss position.

WHY ARE REMEASUREMENT GAINS AND LOSSES NOT REPORTED IN THE STATEMENT OF OPERATIONS?

Entities cannot anticipate with any certainty how the market values of assets or foreign exchange rates will change. Therefore, the statement of remeasurement gains and losses was introduced to separately report the financial impact of these unrealized fluctuations on the financial position of the entity.

By excluding these changes from the statement of operations, the budget to actual comparisons presented for accountability purposes in that statement continues to reflect the operations that the entity can traditionally plan for.

WILL ALL PUBLIC SECTOR ENTITIES PREPARE THIS STATEMENT?

Unlike the other financial statements explained in this document, this statement may not be prepared by all entities. The statement mainly captures the financial changes resulting from the use of fair values and holding foreign currency monetary assets and liabilities. An entity will only prepare the statement when it applies to their circumstances.

Exhibit 5: Sample Statement of Remeasurement Gains and Losses

PUBLIC SECTOR ENTITY
Statement of Remeasurement Gains and Losses
For the year ended March 31, 2014

	2014	2013
Accumulated remeasurement gains (losses) at the beginning of the year	(47)	0
Unrealized gains (losses) attributable to:		
Foreign exchange	(35)	-
Derivatives	130	(105)
Portfolio investments	54	108
Amounts reclassified to statement of operations		
Portfolio investments	20	(50)
Net remeasurement gains (losses) for the year	169	(47)
Accumulated remeasurement gains (losses) at end of year	122	(47)

Source: Adapted from the *CPA Canada Public Sector Accounting Handbook*

POTENTIAL QUESTIONS TO ASK WHEN REVIEWING THE FINANCIAL STATEMENTS– AND HOW TO FIND THE ANSWERS

1. Why do the entity's published financial statements not include a Statement of Remeasurement Gains and Losses?

Entities generally only include this statement when there are remeasurement gains or losses to report. Therefore, the inclusion of this statement will depend on the circumstance of the entity. In addition, governments and some government organizations are not required to adopt the accounting standards that require the reporting of remeasurement gains and losses until fiscal periods beginning on or after April 1, 2016. The accounting policy note should explain if these standards have been applied.

When portfolio investments are valued using cost, any changes to the fair value of the investments will be recorded only when the investment is sold or if there is a permanent impairment in value. To assist readers with understanding the value of an entity's investments when the cost basis is used, the notes provide information on the market value of specific investments.

2. What is the potential exposure of the entity to future fair value and foreign currency exchange rate changes?

The notes to the financial statements should provide you with information to determine which financial assets and liabilities result in remeasurement gains and losses along with the potential impact to financial results from changes in risk factors.

For example, an entity that issues debt in US dollars is impacted by foreign currency risk. The value of the liability increases or decreases as exchange rates change (this change is reported in the Statement of Remeasurement Gains and Losses). The notes should also provide you with information on the organization's exposure to this risk and how it is being managed.

The Statement of Cash Flow explains the change in cash and cash equivalents from the prior year and provides readers with important information about how the entity generated cash to meet its requirements. Exhibit 6 is a sample Statement of Cash Flow for your reference as you read this section.

FOUR CATEGORIES OF CASH FLOW

The layout of the statement is designed to show how the entity financed its activities during the current and prior year. The statement presents cash flow in four categories. How the cash is generated and used is shown separately in each case:

1. **Operating activities:** Cash flow from operating activities demonstrates the extent to which an entity generates sufficient cash flow from revenues to cover the cost of programs, purchase capital assets and repay debts.
2. **Capital activities:** This category of activities, unique to the public sector, reflects how the public and private sectors use tangible capital assets differently. The public sector normally purchases capital assets to provide services.

   Cash flow related to purchasing capital assets, therefore, reflects the decision to use resources to acquire future service potential. Businesses acquire tangible capital assets to generate future cash flow from the sale of goods and services. Therefore, businesses include transactions related to capital assets within investing activities.
3. **Investing activities:** Cash flow from investing activities relates to the purchase and disposal of investments similar to a business. This category includes investments such as marketable securities and investments in government-controlled business enterprises.
4. **Financing activities:** Cash flow from financing activities includes the issuance and payment of debt obligations by the entity. This category also includes cash transactions associated with tangible capital assets acquired through a capital lease.

DIRECT OR INDIRECT METHOD OF PREPARATION

The statement of cash flows can be prepared using either the direct or indirect method. The indirect method is more commonly used in practice, however, the *PSA Handbook* describes the direct method as the preferred method.

The difference between the two methods relates to the presentation of operating activity information. The indirect method is a reconciliation that adjusts the annual surplus or deficit for non-cash items such as tangible capital asset amortization. The direct method provides cash inflows and outflows for each major source of operating activities such as cash inflows from taxation and cash outflows from employee compensation. The additional information provided by the direct method is useful for estimating future cash flows from operating activities. This information is not available when the statement is prepared using the indirect method.

Cash equivalents

Short-term, highly liquid investments that are readily convertible to known cash amounts.

Unique Public Sector Cash Flow Category

Capital activities for cash flows associated with investments in non-financial assets

Exhibit 6: Sample Statement of Cash Flow (Direct Method)

PUBLIC SECTOR ENTITY
Statement of Cash Flow
For the year ended March 31, 2014

	2014	2013
OPERATING TRANSACTIONS		
Cash received from:		
Taxes	8,239	7,267
Transfers	1,541	1,943
Non-renewable resources	2,118	3,808
Fees, permites, licenses and fines	1,581	1,291
Investments	1,564	1,675
Other	3,201	2,706
	18,244	18,690
Cash paid for:		
Salaries, wages, employment	1,345	1,276
Material and supplies	3,192	2,936
Grants and other transfers	12,074	10,290
Financing charge	282	733
Travel and communication	108	102
	17,001	15,337
Cash provided by operating transactions	1,243	3,353
CAPITAL TRANSACTIONS		
Proceeds on sale of tangible capital assets	46	72
Cash used to acquire tangible	(294)	(250)
Cash applied to capital transactions	(248)	(178)
INVESTING TRANSACTIONS		
Proceeds from disposals and redemptions of portfolio investments	262	2,997
Repayment of loans and advances	768	1,129
Portolio investments	(594)	(4,089)
Loans and advances	(290)	(280)
Other	(17)	(15)
Cash provided by (applied to) investing	129	(258)
FINANCING TRANSACTIONS		
Public debt issues	13,970	3,694
Public debt retirement	(14,759)	(6,175)
Cash applied to financing transactions	(789)	(2,481)
Increase in cash and cash equivalents	335	436
Cash and cash equivalents at beginning of year	1,573	1,137
Cash and cash equivalents at end of year	1,908	1,573

Source: Adapted from the *CPA Canada Public Sector Accounting Handbook*

POTENTIAL QUESTIONS TO ASK WHEN REVIEWING A STATEMENT OF CASH FLOW – AND HOW TO FIND THE ANSWERS

1. Did the entity use the direct or indirect method to prepare the Statement of Cash Flow?

If the entity used the direct method, the reader will have additional information with which to compare the amounts recognized in the Statement of Operations with the related cash settlement amounts.

2. Did the entity generate sufficient cash flow from operations to cover the cash requirements during the period?

Public sector entities use the cash generated from operations to: fund the acquisition of tangible capital assets; purchase investments; and repay debt financing. Insufficient cash flow from operating activities may require the entity to sell investments or obtain additional debt financing. Readers should assess the extent to which the entity is reliant on obtaining cash flow from non-operating sources to meet cash requirements.

3. Does the entity have excess cash that could be used to pay down debt?

Entities need to manage their financial resources to ensure that sufficient cash is on hand to pay liabilities as they come due. As part of good cash flow management, entities should therefore look for ways to use excess cash resources to pay down debts to reduce interest costs or generate additional investment returns.

THE STATEMENT OF CHANGE IN NET DEBT (FINANCIAL ASSETS)

As discussed for the Statement of Financial Position, the net debt or net financial asset position of a public sector entity is a key indicator of its financial position. The Statement of Change in Net Debt reconciles the change in net debt for the current and the prior year. This information helps readers understand why the net debt position of the entity changed. A sample Statement of Change in Net Debt is provided in Exhibit 7.

EXPENDITURES

In the public sector, the accounting standards distinguish between expenses and expenditures. *Expenses* are the cost of goods and services consumed during the period. *Expenditures* are the costs of goods and services acquired during the period.

The Statement of Change in Net Debt provides information on the extent to which the expenditures of the fiscal period were met by the revenues recognized in the Statement of Operations.[6] An increase in net debt means that more future revenues will be needed to pay for past transactions and events.

RECONCILIATION OF THE CHANGE IN NET DEBT

To explain how the expenditures of the period were met by revenues, the statement reconciles the annual operating surplus or deficit shown in the Statement of Operations (which includes revenues and expenses) to the change in net debt.

The common items that explain the difference between the annual surplus or deficit and the change in net debt are:

- the acquisition and disposal of tangible capital assets;
- the current year amortization expense for tangible capital assets (expense for current year consumption); and
- the acquisition and disposal of other non-financial assets.

FINANCIAL ACCOUNTABILITY – BUDGET TO ACTUAL RESULTS

As the Statement of Operations does, the Statement of Change in Net Debt also compares the current period results with the entity's original spending plans. This presentation provides key accountability information about the entity's performance in achieving its spending objectives.

The incremental budget information in the statement generally relates to the planned spending to acquire tangible capital assets and other non-financial assets.

6 For entities that have adopted PS 1201, the statement also shows the extent to which expenditures were met by revenues recognized in the Statement of Remeasurement Gains and Losses.

Exhibit 7: Sample Statement of Change in Net Debt

PUBLIC SECTOR ENTITY
Statement of Change in Net Debt
For the year ended March 31, 2014

	Budget 2014	Actual 2014	Actual 2013
Operating Surplus	28	1,376	2,551
Acquisition of tangible capital assets	(294)	(294)	(250)
Amortization of tangible capital assets	226	226	230
(Gain) loss on sale of tangible capital assets	-	(5)	(19)
Proceeds on sale of tangible capital assets	-	46	72
Write-downs of tangible capital assets	-	24	44
	(68)	(3)	77
Acquisition of supplies inventory	-	-	(324)
Acquisition of prepaid expenses	-	(30)	(20)
Use of supplies inventory	-	110	102
Use of prepaid expenses	-	20	-
	-	100	(242)
	(40)	1,473	2,386
Net remeasurement gains (losses)		169	(47)
(Increase) decrease in net debt	(40)	1,642	2,339
Net debt at beginning of year	(8,870)	(8,870)	(11,209)
Net debt at end of year	(8,910)	(7,228)	(8,870)

Source: Adapted from the *CPA Canada Public Sector Accounting Handbook*

POTENTIAL QUESTIONS TO ASK WHEN REVIEWING A STATEMENT OF CHANGE IN NET DEBT – AND HOW TO FIND THE ANSWERS

1. How did actual spending on capital assets compare with the original plan?

As the Statement of Operations does, the Statement of Change in Net Debt also provides accountability information on how actual results compared with previously communicated plans. Readers should assess whether actual spending on capital assets exceeded, met, or fell below planned acquisitions.

Readers should also seek additional information on the entity's investing decisions in the Financial Statement Discussion and Analysis (FSD&A), including explanations for significant variances between planned and actual results.

2. How were expenditures for the current and prior period financed?

The Statement of Change in Net Debt highlights how entity expenditures were financed. Readers should assess whether the entity raised sufficient operating revenues to finance reported expenditures.

Net debt increases when insufficient operating revenues are raised to finance expenditures. Therefore, when operating revenues are insufficient to finance expenditures, readers should assess what expenditures the entity was required to finance with increased liabilities.

Entities commonly finance the purchase of long-lived tangible capital assets with debt. When the purchase of tangible capital assets exceeds the current year consumption of tangible capital assets in operations, the net debt of the entity will increase. Therefore, net debt may increase significantly in periods when the entity makes significant investments in tangible capital assets. And the reverse can occur: net debt may decrease significantly in periods when an entity makes limited tangible capital asset investments.

THE NOTES AND SCHEDULES are an integral part of the financial statements and form the majority of pages in a set of financial statements. The note disclosures must be read to fully understanding the results presented in the financial statements.

Note disclosures provide you with a variety of information on the entity's current and future financial performance including:

- the basis on which the financial statements were prepared – what is recognized, when it is recognized and what amount is recognized;
- expanded details on items recognized in the financial statements – the financial statements present highly summarized information. The notes provide more detailed information of what is included in the financial statements;
- items not recognized in the financial statements – what is not recognized can be as important as what is recognized when assessing the financial results; and
- details for future transactions of the entity – the notes provide information on future liabilities and transactions of the entity that result from existing transactions.

While all disclosures required by the *Public Sector Accounting Handbook* are essential for fairly presenting an entity's financial results, specific attention should be paid to those summarized in the table below:

Note disclosure	Why the disclosure is important
The reporting entity	The financial statements should include the financial position and results of all activities that the entity controls. Governments and government organizations may establish separate legal entities to administer specific programs or policies. The financial position and results of all controlled entities should be consolidated.[7] The notes to the financial statements describe all entities consolidated and how the results are consolidated. The schedules to the financial statements provide summarized financial statements for all government business enterprises.
Significant accounting policies	All financial reporting frameworks require preparers to exercise professional judgement when applying accounting principles. The significant accounting policies describe the recognition and measurement policies applied when preparing the financial statements. Where the accounting standards provide preparers with options, the significant accounting policies should describe which option the entity selected for preparing the financial statements.

7 Government business enterprises and government business partnerships are consolidated using the modified equity method. The accounting policies for these entities are not conformed to those of the parent organization for consolidation purposes and the financial results are not consolidated on a line-by-line basis.

Note disclosure	Why the disclosure is important
Estimates and measurement uncertainty	To produce timely information for readers, preparers must make estimates for some transactions that will settle at future dates. Preparers must use all available information at the date of the financial statements to support their estimates. When it is reasonably possible that an estimate recorded could change by a material amount within the next year, management should disclose information for the reader to understand the nature of the uncertainty and the range of amounts. Common disclosures for measurement uncertainty relate to taxation revenues, and pension benefit liabilities.
Alternative presentation of expenses	The Statement of Operations presents expenses by function or program, such as health or education services. The notes include supplementary reporting on the resources used to deliver those services (e.g., employee salaries and benefits, transfers to individuals or organizations, building rent, maintenance expenses). This disclosure provides critical information about how an entity delivers services.
Subsequent events	The financial statements present the financial position and results at a specific point in time. However, transactions or events after that date but before the release of the financial statements can change the reported performance or significantly affect future performance results. The notes to the financial statements should disclose information on material subsequent events so that readers can assess the impact of those events on reported performance or the potential future performance of the entity.
Contractual obligations	Contractual obligations are future liabilities that will be recorded when the terms of agreements or contracts in place at the financial statement date are met. Contractual obligation note disclosure provides readers with key information about an entity's future financial flexibility for program delivery.
Contingencies	Contingencies exist when it is unclear whether the entity has an obligation to an external party or is entitled to receive assets. The uncertainty is resolved when a future event confirms the obligation or entitlement. A common example of a contingent liability is a lawsuit against an entity. Whether a liability exists is confirmed by a court ruling on the external party claim. Contingent liabilities may or may not be recorded in the financial statements. Contingent assets are not recorded in the financial statements until the confirming event occurs. The notes to the financial statements provide information explaining the impact of contingencies on the reported amounts and the potential impact of contingencies to future financial performance.

Note disclosure	Why the disclosure is important
Accounting for pension plans and other employee future benefits	Accounting for employee pension plans and other employee future benefits is a complex area of accounting in both the public and private sector. Liabilities associated with these plans are not always recognized in an entity's financial statements when applying PSA standards. When liabilities are recognized, the amounts recognized are usually complex estimates prepared in consultation with actuaries. The notes provide extensive disclosure on the accounting for these benefits. These disclosures must be read carefully to fully understand how the accounting for these benefits impacts the financial results presented.
Debt	Governments frequently finance a portion of their expenditures with debt. The notes provide extensive information on the terms of an entity's borrowings and the financial risks associated with those borrowings. Common information contained in the notes includes: ◆ The total principal borrowed and the repayment timing; ◆ The interest expense associated with the borrowings; ◆ Funds the entity is required to set aside under the borrowing terms to finance future debt principal repayments; and ◆ Assets the entity pledged as collateral for the amounts borrowed. Additional information on financial risks associated with debt will also be included in the notes.
Financial instrument risk disclosures[8]	Financial instrument disclosures required by the accounting standards provide readers with an understanding of the nature and extent of risks that arise from financial instruments held by a public sector entity supplemented with how the entity manages those risks. Common risks from financial instruments include credit risk, liquidity risk, interest rate risk, price risk and foreign currency risk. The accounting standards also allow for these disclosures to be included in the unaudited financial statement discussion and analysis (FSD&A) attached to the financial statements instead of the notes.

8 Government and some government organizations do not have to adopt the accounting standards requiring risk disclosures until fiscal periods beginning on or after April 1, 2016.

POTENTIAL QUESTIONS TO ASK WHEN REVIEWING NOTES TO FINANCIAL STATEMENTS – AND HOW TO FIND THE ANSWERS IN THEM

1. What is the entity's potential exposure to contingent liabilities?

Entities record contingent liabilities when it is likely that a future event will confirm that a liability existed. However, in many cases entities are unable to determine what the likely outcome will be. When the outcome cannot be determined there are no amounts recorded in the financial statements. As a result of this uncertainty, the notes provide readers with information on contingencies to broadly understand how the resolution could impact the financial results of the entity.

2. What future goods or services has the entity secured through contractual arrangements?

It is common to secure the purchase of goods or service in advance through leasing or other agreements. The notes to the financial statements provide details on the obligations the entity will be required to pay when suppliers meet the terms of the agreements.

This information can be a starting point for discussions about the financial management of the entity. Considerations would include: is the entity securing the right resources in advance? Is the entity securing the right amounts and an appropriate price, and how do the contractual obligations impact the flexibility of the entity to respond to potential changes in financial circumstances?

3. Does the entity participate in a multi-employer defined benefit plans such as a pension or long term disability plan?

Governments frequently establish employee benefit plans that multiple government organizations participate in. When the benefit plan liabilities are not segregated by entity the statement of financial position does not report their share of the liabilities (or assets) of the plan. The contributions employers make to these plans are recorded as an expense in the statement of operations.

As a result of the above, the notes provide information on the overall funded position of the plan (assets available for benefits and accrued benefit obligations). This information can be an indicator of potential increases or decreases to contribution rates that would impact the entity's future expenses.

AUDITED FINANCIAL STATEMENTS prepared in accordance with public sector accounting standards are the most common form of public sector financial accountability in Canada. However, financial statements alone do not provide readers with all the information necessary to assess an entity's financial performance.

This guide has presented some common questions a reader should keep in mind when reviewing a set of financial statements. However, fully answering many of these questions requires additional information from an entity's management.

A common method used to disclose such information to readers is to supplement the audited financial statements with a *financial statement discussion and analysis* (FSD&A) from management. This supplementary financial reporting gives the entity's management a means of explaining the financial statement results to all readers in a consistent manner. The FSD&A attached to the financial statements is unaudited.

Readers of public sector financial statements should expect that the financial reporting of the entity include a FSD&A to supplement the audited financial statements.

GUIDANCE FOR PREPARING A FINANCIAL STATEMENT DISCUSSION AND ANALYSIS

As part of its mandate, PSAB developed a statement of recommended practice[9] to assist public sector entities with the development of FSD&A reporting. The statement of recommended practice provides a general framework for determining the most relevant information to report. A high level summary of the guidance is provided in Exhibit 8. This exhibit should assist legislators and councillors, board members and other stakeholders with understanding what management should be reporting to readers when explaining the financial statements.

The statement of recommended practice provides management with more detailed guidance for specific financial statement elements.

9 Statement of recommended practice SORP – 1 financial statement discussion and analysis

Exhibit 8: Summary of SORP 1: Financial statement discussion and analysis recommended practice

Financial report components

- The entity's financial report should include an FSD&A along with the audited financial statements. The FSD&A should be cross-referenced to the audited financial statements.
- The entity should include a statement acknowledging its responsibility for preparing the FSD&A.

Qualitative characteristics

The FSD&A is meant to enhance readers' understanding of the entity's financial position and changes in financial position. To do this, the report must have the following qualitative characteristics:

- information must be presented in a way that is understandable to a general audience;
- information presented must be relevant for decision-making or assessing accountability;
- information presented must be consistent with the financial results contained in the audited financial statements; and
- the current and historical information presented throughout the report must be prepared on the same basis to enable comparability.

Key components of a FSD&A

The FSD&A should provide the following supplementary reporting to enhance readers' understanding of the financial statements:

- a summary of the significant events affecting the financial statements;
- analysis that explains the reasons for significant variances between planned and current year actual results;
- analysis that explains the reasons for significant variances between current and prior year results;
- analysis of significant trends (multi-year analysis) for specific financial statement elements; and
- information on known significant risks to, and uncertainties associated with, the entity's financial position and changes to financial position, along with a discussion of the entity's approach to managing the identified risks.

THE IMPORTANCE OF THE INDEPENDENT AUDITOR'S REPORT ON THE STATEMENTS

An entity's financial statements contain management's representations of the entity's financial performance, in accordance with Canadian public sector accounting standards. For those financial statements to be relevant, the information must be reliable. A financial statement audit by an independent auditor provides readers with assurance on whether the financial statements prepared by management are free of material misstatement.

The auditor provides this assurance by expressing an opinion on whether or not the financial statements have been prepared in accordance with Canadian public sector accounting standards. A sample of an unqualified independent auditor's report is provided in Exhibit 9.

INFORMATION COMMUNICATED IN AN INDEPENDENT AUDITOR'S REPORT

The independent auditor's report on a set of financial statements explains:

- the scope of the audit – Every financial statement opinion identifies the specific financial statements and other information subject to audit. The auditor does not provide assurance on the FSD&A that accompanies the financial statements.
- the responsibilities of management and the auditor – The auditor's report:
  - identifies that the financial statements are the responsibility of management and the financial reporting framework management used to prepare the financial statements;
  - identifies the standards followed by the auditor to provide the opinion, and gives a high-level overview of how the audit was conducted; and
  - describes the level of assurance provided by the auditor (audits provide a high level of assurance that the financial statements are free of material misstatement – an error or omission that would influence or change the decisions of readers when using the information).
- The auditor's opinion – The auditor provides his or her opinion on the financial statements based on the results of the audit. When the auditor does not issue an unqualified opinion, the report will explain the reasons within the report. The types of opinions are summarized below.

Opinion type	Opinion paragraphs	
Unqualified opinion	The report includes one opinion section: ◆ Opinion	The financial statements present fairly[10], in all material respects, the financial position and results of the entity.
Qualified opinion	The report includes two opinion sections: ◆ Basis for qualified opinion ◆ Qualified Opinion	In the auditor's opinion, the financial statements contain material misstatements or omissions. The different opinions reflect the pervasiveness of the misstatement on the financial statements. Financial statement readers should regard the statements with caution when the auditor has not issued an unqualified opinion.
Adverse opinion	The report includes two opinion sections: ◆ Basis for adverse opinion ◆ Adverse opinion	
Disclaimer of opinion	The report includes two opinion sections: ◆ Basis of disclaimer of opinion ◆ Disclaimer of opinion	

- "Emphasis of matter" or "other matter" paragraphs – The use of these paragraphs is rare. However, when auditors use them, it is to report significant information that, in the auditors' opinion, is fundamental to the reader's understanding of the financial statements. When the auditor includes these paragraphs, it is critical that readers understand what the auditor is conveying.
- Other legal and regulatory requirements – It is common in the public sector that auditors provide opinions on legal or regulatory requirements such as compliance with financial legislation. The auditor's report presents these requirements separately from the auditor's opinion on the financial statements.

QUESTIONS TO ASK WHEN REVIEWING AN INDEPENDENT AUDITOR'S REPORT

1. Were the financial statements prepared in accordance with Canadian public sector accounting standards?

Readers should expect most public sector entities to prepare general purpose financial statements in accordance with Canadian public sector accounting standards.[11] However, governments may direct organizations through legislation to prepare their financial statements using an accounting framework other than a framework for general purpose financial statements. When this occurs, the independent auditor's report will bring this to the reader's attention through an emphasis of matter paragraph. The emphasis of matter directs the reader to the note disclosure that describes the difference between the reporting framework used and generally accepted financial reporting frameworks in Canada. Furthermore, the entity's financial statements will not be comparable to other financial statements prepared in accordance with Canadian public sector accounting standards.

10 The audit opinion will not use the phrase "present fairly" when the financial statements are prepared in accordance with a legislative accounting framework that differs from generally accepted accounting frameworks for preparing general purpose financial statements.

11 When applying the *PSA Handbook*, government organizations may elect to use International Financial Reporting Standards (IFRS) as the financial reporting framework for preparing financial statements.

2. Did the independent auditor issue an unqualified opinion on the financial statements?

Readers should expect the financial statements prepared by management to be free of material error and to fairly present the financial position and performance of the entity in accordance with Canadian public sector accounting standards. An unqualified opinion provides readers with this assurance.

All material errors identified during the external audit process should be corrected by management prior to the issuance of the financial statements. A material error is an omission or error that in the opinion of the auditor would impact a reader's decision when using the financial statements.

When the auditor issues a modified (qualified, adverse or disclaimer) opinion the reader needs to consider the information contained in the paragraphs explaining the opinion when using the financial statements.

Exhibit 9: Sample unqualified independent auditor's report

Independent Auditor's Report

To the Board of [Public Sector Entity]

Report on the Financial Statements

We have audited the accompanying financial statements of [Public Sector Entity], which comprise the Statement of Financial Position as at December 31, 20XX, and the Statements of Operations, Remeasurement Gains and Losses, Cash Flow and Change in Net Debt for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian public sector accounting standards and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of [Public Sector Entity] as at December 31, 20XX, and its financial performance and its cash flows for the year then ended in accordance with Canadian public sector accounting standards.

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

Auditor's Signature
Date of Auditor's Report
[**Auditor's address**]

Source: Adapted from the *CPA Canada Handbook - Assurance*

APPENDIX A: WHY THE PUBLIC SECTOR HAS DIFFERENT ACCOUNTING STANDARDS THAN THE PRIVATE SECTOR

Governments and government organizations exist for different purposes than private businesses do. In general:

- Governments and government organizations raise revenues to deliver services on behalf of the citizens they represent.
- Businesses exist to generate value for shareholders or owners by earning a profit.

The unique characteristics of public sector entities are summarized in Exhibit A1 (left column). The implications of these characteristics for financial reporting and accounting standards are summarized in the table's right column.[12]

Because financial statements alone can't fully meet all financial accountability needs, various other means are also often used to demonstrate accountability. These are noted in the table's right column as well.

Together these characteristics explain why public sector entities prepare their financial reporting using an accounting framework, standards and guidance designed specifically for the public sector.

The special case of business-like government entities

Some government organizations are set up with unique mandates that allow them to operate like a business. Examples include tolling authorities, utility authorities, and gaming corporations. Because they were set up to be self-sustaining, they have some characteristics of a business. This makes the public sector accounting standards less appropriate for measuring performance.

The Public Sector Accounting Handbook directs these types of organizations to prepare their financial statements using world-wide private sector standards called International Financial Reporting Standards (IFRS). Other government organizations may also elect to prepare their financial statements using IFRS when the standards are more appropriate for their operating circumstances.

12 Most of these public sector characteristics apply to the federal and provincial governments. The characteristics that apply to local governments and government organizations vary by the nature of the entity.

Exhibit A1: Public sector characteristics, and the effect of each on financial reporting

Characteristic[13]	Effect of characteristic on financial reporting by public sector entities
Accountability Public sector entities are held to a higher standard of accountability than private organizations are. They use funds raised from taxpayers to provide public services, and the public expects the use of those funds to be transparent. The stakeholder community for governments and their organizations is therefore significantly broader than for businesses.	Financial statements must be designed to meet the information needs of a broad range of readers. Public sector entities need to supplement their financial statements with other performance information to meet all accountability information needs of stakeholders[14]. Additional guidance is provided to public sector entities for the development of supplemental financial and performance reporting.
Entity objectives Public sector entities provide services to the public and redistribute wealth based on government policies. Businesses, however, generate wealth and profits for shareholders through the sale of goods and services.	Readers need information about: ◆ The cost of providing current services; and ◆ The resources available to provide future services.
Budgets Public sector entities communicate public policies through approved annual budgets for revenues, expenses, and financing requirements.	Readers need accountability information to assess how actual financial performance compares with communicated plans. Financial statements must therefore include a comparison of budgeted with actual results.
Revenue sources Governments generate revenues mainly through taxation. Payment of taxes is mandatory. Taxpayers therefore demand that governments and the organizations to which they distribute the funds spend those revenues wisely and be transparent about their use.	Because the taxes that citizens pay are not usually directly linked to the goods or services they receive, financial statements must clearly account for how government has used the funds raised through taxation.
Non-exchange transactions Public sector entities require taxpayers to provide resources without direct entitlement to specific services, and distribute resources without any expectation of receiving goods or services in return. Businesses, however, provide goods and services to customers in exchange for agreed amounts. Thus, while the transactions of businesses are generally on an exchange basis, a large portion of public sector transactions are one sided or occur on a non-exchange basis.	Public sector accounting standards address a range of non-exchange transactions that accounting standards for the private sector do not specifically address.
Tangible capital assets Public sector entities acquire a variety of assets – such as schools, hospitals, roads and other infrastructure – to deliver services. These "tangible capital assets" represent future potential to provide services. Businesses, on the other hand, use tangible capital assets to generate revenues.	In public sector financial reporting, financial assets (like cash and investments) are shown separately from tangible capital assets because they are for separate purposes.
Operation in a non-competitive environment Public sector entities generally do not provide goods and services in a competitive environment. They and their organizations must therefore demonstrate to the public their effective and efficient use and stewardship of the resources entrusted to them.	Public sector entities like the private sector cannot show they are efficient and effective solely through published financial statements. Additional accountability reporting is needed. PSAB issued SORP 2 – Public performance reporting to provide entities with guidance in this area.
Source: Adapted from the *CPA Canada Public Sector Accounting Handbook*	

13 The majority of public sector characteristics will apply to the federal and provincial governments. The characteristics applicable to local governments and government organizations will depend on the nature of the entity.

14 PSAS developed four statements of recommended practice (SORP) outlining information that should be reported in addition to the financial statements in order to provide a complete picture of performance. One of these SORPs provides guidance on preparing a financial statement discussion and analysis and is discussed earlier in this document.

WHO IS RESPONSIBLE FOR SETTING ACCOUNTING STANDARDS IN CANADA?

The Accounting Standards Oversight Council established by CPA Canada oversees the development of accounting standards for financial reporting in Canada. Responsibility for determining accounting standards is divided between two boards. The Public Sector Accounting Board (PSAB) sets accounting standards for public sector entities. The Accounting Standards Board sets accounting standards for private sector and all other entities. This segregation reflects the differing accountabilities and measurement of financial performance between the public and private sectors.

How the standard-setting process results in high-quality public sector accounting standards?

To ensure the financial reporting standards and guidance developed result in high-quality information for accountability and decision-making purposes, PSAB follows a rigorous due diligence process. Key elements include:

- *An open and transparent process* – General acceptance of an accounting framework requires users and preparers to agree on the overall objectives that drive accounting standards and other financial reporting guidance. PSAB members represent users, preparers and auditors from all levels of government. PSAB's due process invites comments from all interested parties (users, preparers and auditors) at all development stages. Therefore, the standard-setting process considers all expressed views on the overall framework and resulting standards and guidance.

  Consistent with being open to all stakeholder groups, PSAB is transparent about the standard-setting process and publishes key information on the process as it progresses. This information is publicly available.

- *Consultation occurs at multiple points* – The standard-setting process follows a set development process. PSAB receives and considers comments from stakeholders at each stage of the process. This ensures stakeholders have multiple opportunities to provide feedback on the direction of new or revised standards as they are developed.

- *International standard setting developments considered* – PSAB participates in the international standard-setting process and considers developments in international public sector standard-setting when developing Canadian standards.

The intended result of PSAB's standard-setting process is a financial framework, standards and guidance that all public sector stakeholders agree produces relevant financial information for accountability and decision-making purposes. When entities prepare their financial statements using common accounting standards, users can also compare the financial performance of similar public sector entities, such as provinces or municipal governments.

PSAB Mission Statement

The Public Sector Accounting Board (PSAB) serves the public interest by establishing standards and other guidance for financial reporting by all Canadian entities in the public sector and by contributing to the development of internationally accepted public sector financial reporting standards. The mission of the PSAB shall be to contribute to supporting informed decision-making and accountability by maintaining a framework that provides a basis for high-quality information about organizational performance reported by Canadian public sector entities.

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