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REPORT TO THE GOVERNANCE AND FINANCE COMMITTEE
MEETING OF WEDNESDAY, MAY 1, 2019

SUBJECT **Capital Regional District 2018 Audit Findings Report and Statement of Financial Information**

ISSUE

To approve the Capital Regional District (CRD) 2018 Statement of Financial Information (SoFI) and receive the 2018 Audit Findings Report for information.

BACKGROUND

The *Local Government Act* and the *Community Charter* require local governments to prepare financial statements each calendar year. The financial statements must be prepared in accordance with Generally Accepted Accounting Principles for Local Government (Canadian Public Sector Accounting Board (PSAB) Standards) and independently audited by a qualified auditor. These statements, along with the annual filing of the Local Government Data Entry (LGDE) form, must be submitted to the Inspector of Municipalities by May 15 each year. The audited financial statements must also be available for public viewing at this time. The financial statements must also be included in both the Statement of Financial Information and the annual municipal report. The Statement of Financial Information and the annual municipal report must be completed by June 30 each year.

The 2018 Audited Financial Statements have been prepared by management in accordance with Canadian Public Sector Accounting Board (PSAB) Standards. Under PSAB regulations, governments are required to present five statements with explanatory notes:

1. Statement of Financial Position
2. Statement of Operations
3. Statement of Change in Net Debt
4. Statement of Remeasurement Gains and Losses
5. Statement of Cash Flows

In addition to the required statements listed above, the 2018 Consolidated Statements of Financial Information (Appendix 1) include:

6. Schedules of Long Term Debt
7. Schedule of Guarantee and Indemnity Agreements
8. Schedule of Supplies of Goods and Services
9. Schedule of Remuneration and Expenses – Directors
10. Schedule of Remuneration and Expenses – Employees
11. Statement of Severance

Also included in the package are unaudited statements (Appendix 2) that present financial information by service, a whitepaper on rating Canadian Municipal Governments (Appendix 3) which describes DBRS's credit rating methodology, additional financial analysis (Appendix 4) that provides financial indicators on 2018 financial results, and the 2018 Audit Findings Report (Appendix 5).

KPMG LLP has audited the 2018 CRD financial statements and is now submitting their Audit Findings Report for review and discussion. This is the final step to finalize the audit and obtain an unqualified opinion on the financial statements; meaning they are free from material misstatements. The audit findings report highlights that the audit did not identify any uncorrected differences and also did not identify any significant control deficiencies. The report also confirms that there were no significant changes in audit approach for financial reporting risks identified in the Audit Planning Report (presented to the CRD Board on January 9, 2019).

ALTERNATIVES

Alternative 1

That the Governance and Finance Committee recommend to the Capital Regional District Board:

That the Capital Regional District 2018 Audit Findings Report be received and the Capital Regional District 2018 Statement of Financial Information be approved.

Alternative 2

That the Finance Committee refer this report back to staff for additional information.

DISCUSSION

Audit Findings Report

The Audit Findings Report includes results for all areas of focus identified in their audit plan. Highlights of the report include:

Regional Housing First Program (RHFP) – Treanor Avenue Purchase
On January 25, 2019, the CRD purchased Millstream Ridge for $42.3 million. The CRD entered into a 60-year lease and 35 year operating agreement with CRHC for this project. As this transaction occurred subsequent to fiscal year end, a financial statement note disclosure was required per PSAB standards. The audit approach around this disclosure was designed to assess the accuracy of the nature of the disclosure. KPMG inspected relating information, including the RHFP project details, purchase contract, lease agreement and the BC Housing financing commitment letter, which resulted in KPMG concurring with CRD's assessment and disclosure of the transaction.

Core Area Wastewater Treatment Project (CAWTP)
The audit approach was designed specifically to ensure the completeness, existence, and accuracy of tangible capital assets for the CRD, including assets acquired and constructed by the CAWTP. Audit procedures and findings highlighted are:

- A walkthrough of the procurement processes related to the CAWTP and related controls over expenditures did not reveal any significant deficiencies.
- Substantive audit procedures over a sample of capital additions, agreeing samples to source documentation without error.
- Review of management's analysis over impairment resulting in concurrence with management's assessment that no impairment is required.

Costs capitalized for the CAWTP as at December 31, 2018, total $250.9 million, including $129.7 million in capital additions during 2018.

Audit procedures were also specifically designed to ensure completeness of liabilities for the CRD, including those related to the CAWTP. To obtain the necessary evidence to support this assertion, KPMG reviewed the CAWTP Board minutes and updated the audit plan as necessary, and verified the completeness of liabilities and contingent liabilities related to the CAWTP through legal confirmations and accounts payable cut-off procedures.

Hartland Landfill Closure and Post-closure Costs
As at December 31, 2018, the recorded liability for Hartland landfill closure and post-closure costs is estimated at $10.1 million. Closure and post-closure costs are a significant estimate recognized in the CRD's financial statements. Measurement involves a number of estimates including capacity available and used, future costs, discount rates and inflation rates, among others. Audit procedures over the estimated liability resulted in KPMG concluding the CRD's estimate to be reasonable.

A summary of the audit adjustments identified during the audit are summarized on page 22 of the Audit Findings Report.

FINANCIAL STATEMENTS

The Consolidated Statement of Financial Position and the Consolidated Statement of Operations form the basis of the audited financial statements and are similar to the Balance Sheet and Income Statement, respectively, in private organizations. As the CRD is in the public sector, the consolidated financial statements are prepared and presented in accordance with PSAB.

The Capital Region Housing Corporation (CRHC) financials are consolidated in the CRD's financial statements, as required by PSAB. The CRHC audited financial statements were presented and approved by the CRHC Board on April 10, 2019, and will be published on the CRD website.

HIGHLIGHTS

1. Consolidated Statement of Financial Position

The Statement of Financial Position highlights the following four key figures that together describe the financial position of the organization:

a. The cash resources.
b. The net debt position calculated as the difference between financial assets and financial liabilities.
c. The non-financial assets that are normally held for service provision such as tangible capital assets.
d. The accumulated surplus that can be thought of as equity instead of surplus and represents the net recognized economic resources of a government organization remaining after subtraction of liabilities from assets.

Assets are items that provide future economic benefits. Under PSAB, assets are divided between Financial assets (which have value based on a contractual claim) and Non-Financial assets (which have physical value, such as tangible capital assets).

Financial Assets

Financial assets are non-physical assets whose value is derived from a contractual claim. CRD financial assets are made up of cash, short and long term investments and debt. These assets are used to pay vendors and employees.

Cash and Cash Equivalents
Cash and cash equivalents includes cash on hand, bank deposits and cashable investments. The cash and cash equivalent balance increased in 2018 to $70.1 million, an increase of $38.0 million. The net increase is attributable to the higher annual surplus which was primarily driven by grant revenue collected for capital projects. Further detail on changes in cash are discussed below in section 5, Consolidated Statement of Cash Flows.

Investments
Investments consist of term deposits of $106.7 million, investments in the MFA bond fund of $40.1 million and investments in the MFA intermediate fund of $21.4 million. The MFA bond fund is invested in fixed income and money market securities with maturities up to seven years. The MFA intermediate fund is invested in fixed income and money market securities with maturities of up to two years. Term deposits consist of guaranteed investment certificates (GIC) in a number of financial institutions, with maturities ranging from six months to three years. Investments increased over 2017 by $5.6 million, primarily in GIC term deposits.
Accounts Receivable
Amounts due through the normal course of business are net of doubtful account allowances. The balance at December 31, 2018, comprises tipping fees due from commercial solid waste haulers, development cost charge (DCC) income, and payments due from member municipalities for bulk water sales. There was a $0.7 million increase from prior year to $25.0 million in accounts receivable due primarily to grants receivable.

Member Municipality Debt and Municipal Finance Authority (MFA) Debt Reserve Fund
Regional districts in British Columbia are required to borrow through the MFA, both for their own borrowings and for all member municipality borrowings. On the financial statements, debt recoverable from member municipalities is a receivable related to the total MFA debt service obligations for member municipalities. As this receivable is fully offset by the debt obligation under long term debt it has no direct impact on the Net Debt on the Statement of Financial Position. Both the Debt recoverable and the long term debt obligation from and for member municipalities has decreased by $11.0 million in 2018 to $150.8 million at December 31, 2018.

The MFA debt reserve fund represents the amount required, under agreement with the MFA, as security for debt service obligations related to MFA debentures issued to the District and its member municipalities. These amounts reside with MFA and are refundable, with interest, upon debenture maturity. Cash deposits of $3.2 million (excluding member municipalities) are presented as a receivable on the financial statements. This balance fluctuates upward with new debt issues and downward as issues mature.

Liabilities

Liabilities are obligations or debt that will be settled by using assets like cash. Liabilities represent the costs for goods and services consumed and owed by the CRD. The liabilities are used to finance operations and large capital construction or acquisitions.

Accounts Payable and Other Liabilities
Collectively, accounts payable, deferred revenue and other liabilities increased by $31.4 million, which is mainly due to a $28.4 million increase in accounts payable related to CAWTP holdbacks. They are comprised mainly of:

- Amounts owing to suppliers for goods received and services rendered
- Deferred revenue, system development cost charges as an example
- Contaminated sites, Post-employment benefits and other benefits payable

Landfill Closure and Post-Closure Liability
The estimated liability increased by $0.6 million, representing another year of capacity usage. The total liability represents the present value of the estimated future costs for closure and post closure activities. Changes in the estimated costs, the useful life of the landfill, the discount rate and the capacity estimates can have significant impacts on the liability. An external review of the assumptions and calculations is scheduled in 2019. Upon completion, the review will be used to reassess the reasonability of the current estimates.

Debt
Debt increased by $28.3 million to $384.5 million in 2018. Debt includes debt for CRD, CRHC and member municipalities. While member municipality debt decreased by $11.0 million, CRD and CRHC debt increased by a combined $39.3 million in 2018. This is predominately due to $32.0 million borrowed from the MFA for CAWTP.

Non-Financial Assets

Non-financial assets are resources that are normally held for service provision over one or more future periods. They include tangible capital assets, inventories of supplies that will be used in operations, the prepaid portion of land leases on housing properties, and prepaid expenses for items such as insurance. Due to the primarily service nature of non-financial assets, they are essential in achieving CRD objectives. Non-financial assets increased by $155.8 million to $1.3 billion in 2018, due mainly to an increase in engineering structures for the CAWTP.

Accumulated Surplus

The accumulated surplus or net book value of equity for the CRD is $1.18 billion. This is comprised of $1.75 billion in purchases, less $0.50 billion in accumulated depreciation. Net the accumulated surplus shows that the organization has assets (Financial and Non-Financial) of greater value than what it owes (Liabilities). The $1.18 billion can be broken down into the following distinguishable categories:

Accumulated Surplus Categories:	**$ in Millions**
Equity Invested in Tangible Capital Assets	1,027.3
Capital and Operating Reserves	134.0
Accumulated Surplus Net of TCA Equity and Reserves	16.2
2018 Accumulated Surplus	1,177.5

The 2018 CRD operating surplus of $16.2 million represents 1% of total accumulated surplus. The remaining accumulated surplus is predominantly tied to capital assets and the associated funding through restricted capital reserves.

2. Consolidated Statement of Operations

The Statement of Operations identifies the results of the organization's financial activities for the year by presenting revenues less expenses, resulting in the organization's annual surplus/deficit on an accrual basis. Under accrual accounting and the matching principle, the CRD records economic events regardless of when cash is actually received or used, with a view to matching the revenues for the period with the costs incurred to generate them.

The budget per bylaw is included on the Statement of Operations and has been adjusted to exclude reserve transfers and principal repayment, items not classified as expenses under PSAB standards. Other differences from budget exist but have not been adjusted as these did not form part of the original budget bylaw. Other differences include grant revenue, deferred revenue, donations and amortization expense.

Notable explanations pertaining to the Consolidated Statement of Operations are as follows:

Revenues
Revenue in 2018 increased by $60.8 million from prior year to a total of $294.1 million. This was primarily due to a $50.2 million increase in government transfers, $5.7 million increase in sale of services, $2.5 million increase in developer contributions, and $1.3 million increase in interest earnings.

The increase in Government transfers of $50.2 million primarily was driven by an increase of $48.0 million from federal government transfers for federal grants to fund CAWTP.

The increase in Sale of Services of $5.7 million was driven primarily by a $4.4 million increase in water sales. This can be attributed to an approximate 4% increase in water consumption due to a warmer, dryer spring and summer, a growing number of households in the region and an increase in the water billing rates.

Developer contributions increased as a direct result of the increase in development projects in the region. In particular, the West Shore (Colwood, Langford and Sooke) has had an increase in commercial and residential property development from prior year, contributing to the overall increase of $2.5M.

The increase in interest earnings is partially due to more cash on hand with increased capital activity, partially due to the Bank of Canada increasing the benchmark interest rate by 75 basis points over the year, and partially due to a more active investment strategy improving returns.

Expenses

Expenses in 2018 increased by $2.1 million (1.3%) from prior year to a total of $164.7 million. The increase in expenses was primarily due to a $3.2 million (5.5%) increase in salaries, wages, and benefits. On August 14, 2018, a memorandum of settlement was signed between the CRD and CUPE Local 1978, which included a 2% general wage increase for union employees for 2018. Additionally, there was a 7% increase in cost to provide extended health and dental benefits to employees.

Offsetting the increase in salaries, wages, and benefits was a $1.1 million decrease in interest on debt. In 2017, there was an overall net decrease in debt of $12.1 million. Therefore, at the beginning of 2018, the CRD had less debt to pay interest on than it did comparatively at the beginning of 2017. The interest impact of the net debt increase in 2018 will be in 2019. All CRD debt is financed through the MFA. As part of the MFA long term debt program, twice a year (generally in the Spring and Fall) the MFA will fund the loan requests of clients. In April 2018, the CRD borrowed $12 million from the MFA and another $17.3 million in September. An additional $32 million was borrowed in short term loans specifically for CAWTP, which were spread out in five payments throughout 2018. Management expects in 2019 to see a net increase in interest on debt due to the net increase in borrowing in 2018.

2018 Annual Surplus

The 2018 annual surplus is $129.4 million, which identifies the change in accumulated surplus in the current year and can be categorized into the following increases in operating, capital and reserves:

Surplus Reconciliation	**$ in Millions**
Operating surplus (final budget)	0.4
Add: Increase in Cap Equity	106.9
Add: Capital and Operating Reserve Equity	13.9
Add: Net Revenues from CRHC	3.3
All Other PSAB Entries (including CRHC)	4.9
2018 Annual Surplus	129.4

Financial surpluses generated from operations are accumulated in surplus and carried forward to be used to reduce service revenue requirements and funding requirements to maintain existing infrastructure. In 2018, the operating surplus, excluding that invested in capital and transferred to reserve, is $17.6 million and represents 6% of revenue and 2% of the opening accumulated surplus.

The $106.9 million and $13.9 million above are revenues and transfers to equity, restricted to funding current and future asset construction and acquisitions. As such, they are unavailable to moderate future requisitions.

3. Consolidated Statement of Change in Net Debt

The Statement of Change in Net Debt reconciles the change in net debt for the current and the prior year. This information helps readers of the financial statements to understand why the net debt position for the CRD has changed in the current fiscal year. Items included on the Statement of Change in Net Debt are expenditures that could be acquired in the year but not consumed during the period; these include items such as tangible capital assets, inventory, prepaid expenses, and unrealized remeasurement losses on portfolio investments.

Overall, the net debt position increased by $26.8 million, in which $187.5 million of the increase was a result of acquired and contributed capital assets. This was offset by an annual surplus of $129.4 million and amortization of $31.2 million. Amortization of tangible capital assets is added back on the Statement of Change in Net Debt because it is not a true cash related expense that would result in any change in debt.

4. Consolidated Statement of Remeasurement Gains and Losses

Investments are carried at fair value and result in remeasurement gains or losses in the Financial Statements annually. Additionally, the Consolidated Statement of Remeasurement Gains and Losses has been added as a required statement with explanatory notes. In 2018, the CRD experienced an unrealized remeasurement loss of $0.4 million due to a decrease in market value of investments held in MFA Intermediate Fund and Bond Fund. This amount is not a true or realized remeasurement loss unless market conditions are similar at time of divestiture. Any loss on investment at maturity or divestiture will become realized through the Statement of Operations as a loss in the reporting period.

5. Consolidated Statement of Cash Flows

The Statement of Cash Flows reports the sources and uses of cash during the period. The positive cash flow is from operating activities, which means that core operations is generating enough cash to buy new assets and to cover future loan payments. The Statement of Cash Flows also provides information about capital, investing and financing activities during the period. Capital and investing activities resulted in negative cash flow, while financing activities had a positive cash flow. Overall, the CRD’s cash position increased in 2018 by $38.0 million

The increase in cash was primarily due to the annual surplus of $129.4 million, which contributed to a $180.4 million change in cash from operating activities. Also supporting a further increase in cash was the increase from financing activities of $43.6 million. Offsetting cash outflows were for capital and investment activity, $180.3 million and $6 million respectively.

Financial Indicators

DBRS is Canada’s largest and the world’s fourth largest credit rating agency, respected for its independent, third-party evaluation of credit quality. They publish research whitepapers describing their methodology of rating Canadian municipal governments (Appendix 3). Their methodology includes analyzing the economic environment within which the government operates, and assessing fiscal management by looking at revenue generation, program responsibilities and fiscal discipline, as well as at the coherence and appropriateness of the strategies, policies and processes governing the planning and allocation of public funds. Other critical rating factors include financial management in terms of debt and liquidity, and relations with senior governments.

Although the final rating is a blend of both operating risk and financial risk considerations in their entirety, key ratios can provide a quick measure in assessing the government's financial strength—its ability to make timely payments on outstanding obligations (whether principal, interest, or other expenditures) with respect to the terms of the obligation. A sample of these critical ratios (Appendix 4) include:

1. Net tax-supported debt per capita
2. Net tax-supported debt as a percentage of taxable assessment
3. Interest costs as a percentage of total revenue
4. Net post-capex surplus (deficit) as a share of total revenue

The four ratings, from exceptional to adequate credit quality, are:
'AAA' – The capacity for the payment of financial obligations is exceptionally high and unlikely to be adversely affected by future events.

'AA' – The capacity for the payment of financial obligations is considered high. Differs from AAA only to a small degree. Unlikely to be significantly vulnerable to future events.

'A' – The capacity for the payment of financial obligations is substantial. May be vulnerable to future events, but considered manageable.

'BBB' – Adequate credit quality. The capacity for the payment of financial obligations is considered acceptable. May be vulnerable to future events.

For illustrative purposes, applying the 2018 financial results through the DBRS rating methodology with regard to the four critical ratios identified above, the CRD would result in a AA rating for 'interest costs as a percentage of total revenues', while achieving a AAA rating for 'net tax-supported debt per capita', 'net tax-supported debt as % of assessment' and for 'net post-capex surplus (deficit) as a share of total revenue'.

Appendix 4 discusses additional financial indicators of trends and performance:

5. Debt service costs as a percentage of total revenue
6. Principal and interest as proportion of debt service costs
7. Current ratio
8. Contributions to reserves as a percentage of total reserve
9. Total debt
10. Tangible capital assets
11. Capital investment versus amortization

FINANCIAL IMPLICATIONS

The 2018 financial statements are a statutory requirement prepared in accordance to specific accounting principles. The statements have been audited by KPMG and no misrepresentations and no control deficiencies were identified. Overall the 2018 statements reflect an increase in the CRD accumulated surplus of $129.4 million. The CRD continues to invest in its infrastructure through a net increase in tangible capital assets of $156.3 million. The financial performance of the organization is illustrated in the financial indicators (Appendix 4). These indicators demonstrate a consistent, healthy financial position based on current operational needs, existing market conditions and debt servicing costs. Although the overall net debt has increased by $26.8 million in 2018, our debt ratios using the DBRS rating methodology illustrate that the CRD is able to meet its obligations and is unlikely to be adversely affected by future events. The debt increases are directly related to significant capital projects in the capital region that are in progress. These include, but are not limited to, construction of E&N rail trail, the wastewater treatment program, a unified emergency call centre, and sewer system rehabilitation. The overall 2018 revenue has increased by $60.8 million, demonstrating an expanded scope of CRD service delivery.

CONCLUSION

Board approval of the CRD 2018 Statement of Financial Information is required under the *Local Government Act*, *Community Charter*, and *Financial Information Act*. As noted in the Audit Findings Report, it is the auditors' opinion that these financial statements present fairly the consolidated financial position of the CRD as of December 31, 2018, and the results of financial activities for the year then ended in accordance with Canadian Public Sector Accounting Standards.

RECOMMENDATION

That the Governance and Finance Committee recommend to the Capital Regional District Board:

That the Capital Regional District 2018 Audit Findings Report be received for information and the Capital Regional District 2018 Statement of Financial Information be approved.

Submitted by:	Rianna Lachance, BCom, CPA, CA, Senior Manager, Financial Services
Concurrence:	Nelson Chan, MBA, CPA, CMA, Chief Financial Officer
Concurrence:	Robert Lapham, MCIP, RPP, Chief Administrative Officer

RL:nm

Attachments: Appendix 1 – 2018 Statement of Financial Information
Appendix 2 – 2018 Unaudited Statements
Appendix 3 – DBRS Rating Methodology
Appendix 4 – 2018 Additional Financial Analysis
Appendix 5 – 2018 Audit Findings Report