Chapter 2

Public Accounts of the Province

1.0 Summary

This year, the audit opinion on the Province's consolidated financial statements is qualified. Based on our audit work, we have concluded that the Province's consolidated financial statements for 2016/17 are fairly presented except for the two items disclosed in the basis-for-qualified-opinion paragraph. The two items are:

- The government overstated the net pension asset relating to the Ontario Teachers' Pension Plan (OTPP) and the Ontario Public Service Employees' Union Pension Plan (OPSEUPP).
- The government inappropriately recognized and consolidated the market account assets and liabilities relating to transactions between power generators and distributors managed by the Independent Electricity System Operator (IESO).

The issuance of a qualified audit opinion should not be taken lightly. In reaching this opinion, the Office of the Auditor General supplemented its own extensive work with external advice.

The government did not record a valuation allowance against the net pension asset relating to the OTPP and the OPSEUPP in its consolidated statement of financial position. As a result, the Province's net debt and accumulated deficit at March 31, 2017, is understated by $12.429 billion (March 31, 2016 – $10.985 billion) and the 2016/17 annual deficit is understated by $1.444 billion (2015/16 – $1.831 billion). The government inappropriately recorded the market account assets and liabilities of the IESO in its consolidated financial statements, resulting in an overstatement of Other Assets and Other Liabilities at March 31, 2017, by $1.652 billion (March 31, 2016 – $1.443 billion) with no effect on the 2016/17 and 2015/16 annual deficits.

We also include an Other Matter paragraph in the auditor's report referencing the fact that the Province's March 31, 2017, consolidated financial statements recognized rate-regulated assets, which is not permitted when applying Canadian Public Sector Accounting Standards (PSAS) to government financial statements. The Other Matter paragraph notes that although the adoption of rate-regulated accounting at the consolidated provincial level did not result in material misstatement in the Province's 2016/17 consolidated financial statements, the statements may become materially misstated in future periods as a result of the legislated accounting prescribed under the *Ontario Fair Hydro Plan Act, 2017*. In our audit opinion, "legislated accounting" refers to the government creating an asset through legislation.

Canadian PSAS are the most appropriate accounting standards for the Province to use in preparing its consolidated financial statements because they ensure that information provided by the government about the surplus and the deficit is fair, consistent and comparable to data from previous years and from peer governments. This allows all legislators and the public to better assess government management of the public purse. Therefore, the receipt of audit qualifications from the Auditor General for the past two years is a serious matter that should concern legislators and the public.

Annually, we have raised the issue of the government having introduced legislation on a number of occasions to facilitate their establishment of specific accounting practices that may not be consistent with Canadian PSAS. Until now, such actions have not resulted in a material impact on the Province's consolidated financial statements. However, the use of legislated accounting treatments by the government, such as that used to support the accounting/financing design prescribed under the *Ontario Fair Hydro Plan Act, 2017*, could have a material impact on the annual results and become a significant concern to our Office as early as next year. More discussion of this issue can be found in our Special Report titled *The Fair Hydro Plan: Concerns About Fiscal Transparency, Accountability and Value for Money*, tabled in the Legislative Assembly on October 17, 2017.

Additional Issues

The Government's Use of Consultants

We noted the government engaged external advisers to help design the complex accounting/financing structure of the Fair Hydro Plan rate reduction, and sought advice from accounting firms on parts of the transaction. However, despite the recommendation made in our *2016 Annual Report* that any advice obtained from or work performed by external advisers in formulating an accounting position be shared with our Office, the government did not inform us of their advisers' work until we became aware that significant discussions were being held on matters related to the Fair Hydro Plan, and we specifically requested information.

Moving forward, the interests of the Office of the Treasury Board and the Office of the Auditor General will be best served when the work of external advisers, impacting not only the current year's consolidated financial statements of the Province, but those of future years as well, is brought to our attention and discussed on a timely basis.

The Auditor General's Reliance on Component Auditors

As the auditor of the Province's consolidated financial statements, we regard as important the work done by private-sector component auditors, who audit the entities that are consolidated into the government's financial statements. Every year, we issue instructions to specific component auditors in order to obtain information about the audit of their component. We use this information to support our audit opinion on the Province's consolidated financial statements. To promote timeliness, we set deadlines for the responses, and emphasize that any significant or unusual events are to be reported to us as early as possible.

During this year's audit, we experienced significant delays in receiving timely communication from the component auditor of the Independent Electricity System Operator (IESO). This is concerning because we disagreed with changes made to the IESO's accounting policies that are significant not only to the Province's 2016/17 consolidated financial statements, but also to future reporting. Our October 17, 2017, Special Report titled *The Fair Hydro Plan: Concerns About Fiscal Transparency, Accountability and Value for Money* highlight that these changes were integral to the accounting/financing structure being designed under the Fair Hydro Plan to ensure that the Province's consolidated financial statements would not show the financial impact of the rate reduction in its annual results and net debt.

The transparency and timeliness of communication between the Office of the Auditor General and component auditors must be preserved as the interests of all parties are best served when there is full and open disclosure of significant matters affecting the consolidated financial statements.

The Increasing Debt Burden of the Province of Ontario

The Province's growing debt burden also remains a concern this year, as it has been since we first raised the issue in 2011. This year, as in the past, we focus on the critical implications of the growing debt for the Province's finances. We maintain the view that the government should provide legislators and the public with long-term targets for addressing Ontario's current and projected debt, and we reaffirm our recommendation that the government develop a long-term debt-reduction plan.

Reduction of the Unfunded Liability of the Workplace Safety Insurance Board

Our *2009 Annual Report* discussed the risk posed at the time to the financial viability of the Workplace Safety Insurance Board (WSIB) by its unfunded liability, which is the difference between the value of the WSIB's assets and its estimated financial obligations to pay benefits to injured workers. In 2009, we also urged the government to reconsider the exclusion of the WSIB's financial results from the Province's consolidated financial statements, particularly if there were any risks that the Province might have to provide funding to ensure the WSIB remained viable.

In response to our concerns and to the recommendations of the report, the government passed a Regulation under the *Workplace Safety and Insurance Act, 1997* in June 2012 that was effective January 1, 2013, requiring the WSIB to ensure it meets a funding ratio by specified dates. As of December 31, 2016, the WSIB reported a Sufficiency Ratio of 87.4%. This means the WSIB has already achieved its December 31, 2022, funding requirement. As a result of commitments by the government and the WSIB to address the unfunded liability and the progress the WSIB has made so far, we support the exclusion of WSIB's unfunded liability from the Province's liabilities.

Ontario Pre-Election Report Mandate

The *Fiscal Transparency and Accountability Act, 2004* (Act) states, among other things, that in such circumstance as may be prescribed by regulation, the Ministry of Finance shall release a report on Ontario's finances and shall do so before the deadline established by regulation. The purpose of this report is to provide the public with detailed information to enhance its understanding of the Province's estimated future revenues, expenses, and projected surpluses or deficits for the next three fiscal years. According to the *Election Act*, Ontario's next provincial general election will be held on June 7, 2018. Under the *Fiscal Transparency and Accountability Act, 2004* the Auditor General must review the report to determine whether it is reasonable, and release an independent report describing the results of her review. We will work closely with the Ministry of Finance and Treasury Board Secretariat as we prepare for and undertake our review in order to issue our report sufficiently ahead of the June 7, 2018, general election.

This chapter contains 10 recommendations, consisting of 14 actions, to address our observations.

2.0 Background

Ontario's Public Accounts for the fiscal year ending March 31, 2017, were prepared under the direction of the Minister of Finance, as required by the *Financial Administration Act*, and the President of the Treasury Board. The Public Accounts consist of the Province's Annual Report, including the Province's consolidated financial statements, and three supplementary volumes of additional financial information.

The government is responsible for preparing the consolidated financial statements for the Province of Ontario and ensuring that this information, including many amounts based on estimates and judgment, is presented fairly. The government is also responsible for ensuring that an effective system of internal controls, with supporting procedures, is in place to authorize transactions, safeguard assets and maintain proper records.

Our Office, under the *Auditor General Act*, is responsible for the annual audit of these consolidated financial statements. The objective of our audit is to obtain reasonable assurance that the statements are free of material misstatements—that is, free of significant errors or omissions. The consolidated financial statements, along with the Auditor General's Independent Auditor's Report, are included in the Province's Annual Report.

The Province's 2016/17 Annual Report also contains a Financial Statement Discussion and Analysis section that provides additional information regarding the Province's financial condition and fiscal results for the year ended March 31, 2017. Providing such information is intended to enhance the fiscal accountability of the government to both the Legislative Assembly and the public.

The three supplementary volumes of the Public Accounts consist of the following:

- **Volume 1**—unaudited statements from all ministries and a number of schedules providing details of the Province's revenue and expenses, its debts and other liabilities, its loans and investments, and other financial information;
- **Volume 2**—audited financial statements of significant provincial corporations, boards and commissions whose activities are included in the Province's consolidated financial statements, as well as other miscellaneous audited financial statements; and
- **Volume 3**—detailed unaudited schedules of ministry payments to vendors and transfer-payment recipients.

Our Office reviews the information in the Province's Annual Report, and in Volumes 1 and 2 of the Public Accounts, for consistency with the information presented in the Province's consolidated financial statements.

The *Financial Administration Act* requires that, except in extraordinary circumstances, the government deliver its Annual Report to the Lieutenant Governor in Council within 180 days of the end of the fiscal year. The deadline for this year was September 27, 2017. The three supplementary volumes must be submitted to the Lieutenant Governor in Council within 240 days of the end of the fiscal year. Upon receiving these documents, the Lieutenant Governor in Council must lay them before the Legislative Assembly or, if the Assembly is not in session, make the information public and then lay it before the Assembly within 10 days of the time it resumes sitting.

This year, the government released the Province's 2016/17 Annual Report and Consolidated Financial Statements, along with the three Public Accounts supplementary volumes on September 7, 2017, meeting the legislated deadline.

The Auditor General's audit opinion on the Province's consolidated financial statements was qualified for two accounting treatments that did not conform to Canadian PSAS.

The first qualification relates to the government's accounting for its calculated net pension asset of $12.429 billion for two pension funds it co-sponsors, the Ontario Teachers' Pension Plan and the Ontario Public Service Employees' Union Pension Plan. As a result, the annual deficit is understated by $1.444 billion for 2016/17 ($1.831 billion in 2015/16) and the net debt and accumulated deficit are understated by $12.429 billion for 2016/17 ($10.985 billion in 2015/16).

The second qualification relates to the government inappropriately recording the market account assets and liabilities relating to transactions between power generators and distributors managed by the Independent Electricity System Operator, in its consolidated financial statements. As a result, Other Assets and Other Liabilities are overstated by $1.652 billion ($1.443 billion in 2015/16).

A qualified opinion in the public sector should be considered just as serious as a qualified audit opinion received by a publicly traded corporation.

The qualified audit opinion on the Province's consolidated financial statements is discussed in **Section 3.0**.

3.0 The Province's 2016/17 Consolidated Financial Statements

3.1 Auditor's Responsibilities

As the Legislature's independent auditor of the Province's consolidated financial statements, the Auditor General's objective is to express an opinion on whether the financial statements are free of material misstatements and are prepared in accordance with Canadian PSAS so that they give a true and fair view of the financial position and results of the Province. It is this independence, combined with the professional obligation to comply with established Canadian Auditing Standards and relevant ethical requirements, which allows the Auditor General to issue an opinion that provides users with confidence in the Province's consolidated financial statements.

To enable the Auditor General to form her opinion, our Office collects sufficient appropriate audit evidence and evaluates it to determine whether the financial statements are free of material misstatements. This includes assessing the government's preferred accounting treatment over certain transactions and analyzing the appropriateness of those treatments under Canadian PSAS.

An assessment of what is material (significant) and immaterial (insignificant) is based primarily on our professional judgment. In making this assessment, we seek to answer the following question: "Is this error, misstatement or omission significant enough that it could affect decisions made by users of the Province's consolidated financial statements?" If the answer is yes, then we consider the error, misstatement or omission as material.

To help us make this assessment, we determine a materiality threshold. This year, as in past years, and consistent with most other auditors in provincial jurisdictions, we set our threshold at 0.5% of the greater of government expenses or revenue for the year.

Our audit is conducted on the premise that management has acknowledged certain responsibilities that are essential to the conduct of the audit in accordance with Canadian Auditing Standards. These responsibilities are discussed below.

3.2 Management's Responsibilities

The auditor's report distinguishes between the responsibilities of management and of the auditor with respect to a financial statement audit. Management is responsible for the preparation of the financial statements in accordance with Canadian PSAS. The auditor examines the financial statements in order to express an opinion as to whether the financial statements have been prepared in accordance with Canadian PSAS. The division of responsibility between management and the auditor is fundamental and preserves the auditor's independence, a cornerstone of the auditor's report.

In addition to the preparation of the financial statements and having the relevant internal controls, management is also required to provide the auditor with all information relevant to the preparation of the financial statements, additional information that the auditor may request, and unrestricted access to individuals within the entity who the auditor determines are necessary to obtain audit evidence. Canadian Auditing Standards are clear on these requirements, and the fulfilment of these is formally communicated to the auditor in the form of a signed management representation letter at the end of the audit.

When a transaction occurs, it is management's responsibility to identify the applicable accounting standards, determine the implications of the standards on the transaction, decide on an accounting policy and ensure that the financial statements present the transaction in accordance with the applicable financial reporting framework (e.g., Canadian PSAS for governments). The auditor must also be proficient in the applicable financial reporting framework in order to form an independent opinion on the financial statements, and may perform similar procedures in identifying the applicable standards and understanding the implications of the standards on the accounting transaction. However, unlike management, the auditor does not select an accounting policy or the bookkeeping entries for the organization. These decisions are in the hands of management—in Ontario's case, Treasury Board Secretariat and the Ministry of Finance, both with support from the Office of the Provincial Controller Division.

When there are disagreements between an auditor and management on the application or adequacy of accounting policies, the auditor must assess the materiality or significance of the issue to the overall financial statements in forming the audit opinion. If the issue is material, it would result in a qualified opinion in which the auditor concludes that the financial statements are fairly presented except for the items described in the basis for the qualification. Again, this distinguishes the role of management and auditor such that the auditor examines the financial statements to express an opinion, whereas management prepares the financial statements.

The Office of the Auditor General may make suggestions about the consolidated financial statements but this does not change management's responsibility for the financial statements. Similarly, the government may seek external advice on accounting treatments of certain transactions. In such situations, the government still has the ultimate responsibility for the decisions made, and the use of external advisers does not diminish, change or substitute the government's accountability as the preparer of the Province's consolidated financial statements.

3.3 The Independent Auditor's Report

The auditor's report, which is issued at the conclusion of an audit engagement, is comprised of:

- an introductory paragraph that identifies the financial statements audited;
- a description of the responsibility of management for the proper preparation of the financial statements in accordance with the applicable financial reporting framework;
- a description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit; and
- an opinion paragraph containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements.

The auditor's report may further include:

- an Emphasis of Matter paragraph that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements; and
- an Other Matter paragraph that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to user's understanding of the audit, the auditor's responsibilities or the auditor's report.

3.4 The Significance of a Qualified Audit Opinion

The independent auditor's report is the way the auditor communicates their opinion to the users of the financial statements as to whether the financial statements of an entity are presented fairly. After the audit of the financial statements is completed, the auditor can sign one of four possible opinions:

- **Unqualified, or clean, opinion:** The financial statements present fairly, in all material respects, the financial position and results of the entity.

- **Qualified opinion:** The statements contain one or more material misstatements or omissions.
- **Adverse opinion:** The statements do not fairly present the financial position, results of operations and changes in financial position, as per generally accepted accounting principles.
- **No opinion:** It is not possible to give an opinion on the statements because, for example, key records of the entity were destroyed and thus unavailable for examination.

An *unqualified* audit opinion indicates financial statements are reliable. When an auditor issues a *qualified* opinion, he or she is expressing concern about the entity's compliance with the accounting standards issued by the standard setter (e.g., the Public Sector Accounting Board), or about the auditor's ability to obtain sufficient and appropriate information on the financial statements.

An audit qualification is generally a rare occurrence. In fact, the audit opinions on the consolidated financial statements of the Province were not qualified for 22 years. The audit opinion on the Province's March 31, 2017, consolidated financial statements is qualified because the Province's consolidated financial statements do not comply with Canadian PSAS, reflecting the Auditor General's concern about the fair presentation of the Province's consolidated financial statements.

3.5 The 2016/17 Audit Opinion

The *Auditor General Act* requires that we report annually on the results of our examination of the Province's consolidated financial statements. The Independent Auditor's Report to the Legislative Assembly on the Province's Consolidated Financial Statements for the year ended March 31, 2017, is reproduced on the following pages.

3.6 The Reasons for the Qualified Audit Opinion

This year, the audit opinion on the Province's consolidated financial statements is qualified.

Based on our audit work, we have concluded that the Province's consolidated financial statements for 2016/17 are fairly presented except for the two items disclosed in the basis-for-qualified-opinion paragraph. The two items are:

- The government overstated the net pension asset relating to the Ontario Teachers' Pension Plan (OTPP) and the Ontario Public Service Employees' Union Pension Plan (OPSEUPP).
- The government inappropriately recognized and consolidated the market account assets and liabilities relating to transactions between power generators and distributors managed by the Independent Electricity System Operator (IESO).

3.6.1 Net Pension Asset Overstated

Net Pension Asset and the Consolidated Financial Statements

As at March 31, 2017, the government reported net pension assets from the OTPP of $11.511 billion (2015/16 – $10.147 billion) and from the OPSEUPP of $0.918 billion (2015/16 – $0.838 billion), for a total of $12.429 billion (2015/16 – $10.985 billion). However, a full valuation allowance against the pension assets should have been recorded in order to comply with Canadian PSAS. Recording a full valuation allowance would require the net pension asset reported on the consolidated statement of financial position to be reduced by $12.429 billion (2015/16 – $10.985 billion), resulting in a net pension liability of $1.396 billion (2015/16 – $1.673 billion) being reported. This is illustrated in **Figure 1**.

The effect on the consolidated statement of operations of recording the full valuation allowance against the net pension asset for the OTPP and the OPSEUPP would increase the Province's reported annual deficit by $1.444 billion (2015/16 – $1.831 billion).

Office of the Auditor General of Ontario
Bureau de la vérificatrice générale de l'Ontario

INDEPENDENT AUDITOR'S REPORT

To the Legislative Assembly of the Province of Ontario

I have audited the accompanying consolidated financial statements of the Province of Ontario, which comprise the consolidated statement of financial position as at March 31, 2017, and the consolidated statements of operations, change in net debt, change in accumulated deficit and cash flow for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

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

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 the Government, as well as evaluating the overall presentation of the consolidated financial statements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified audit opinion.

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Basis for Qualified Opinion

Net Pension Asset Overstated, Annual Deficit Understated, Net Debt Understated and Accumulated Deficit Understated

As described in Note 16a to these consolidated financial statements, a net pension asset is recorded on the Consolidated Statement of Financial Position relating to the Ontario Teachers' Pension Plan and the Ontario Public Service Employees' Union Pension Plan. However, the Government does not have the unilateral legal right to use this asset because its ability to reduce future minimum contributions or withdraw any pension plan surplus is subject to agreement with the respective pension plans' joint sponsors. Canadian public sector accounting standards require the Government to record a valuation allowance against this asset.

The Government did not record a valuation allowance for this net pension asset at March 31, 2017. The Government also retroactively restated the March 31, 2016 comparative figures to exclude the valuation allowance previously included in the prior year's consolidated financial statements. This departure from Canadian public sector accounting standards has led me to express a qualified opinion on the consolidated financial statements for the year ended March 31, 2017 and on the March 31, 2016 comparative figures.

The recommendations of the Government's appointed Pension Asset Advisory Panel are not an authoritative source on the application of Canadian public sector accounting standards as implied in Note 16a to these consolidated financial statements.

Effect on Consolidated Statement of Operations

If the Government had correctly recorded the valuation allowance against the net pension asset for the Ontario Teachers' Pension Plan and the Ontario Public Service Employees' Union Pension Plan, the effect on the consolidated statement of operations for the years ended March 31, 2017 and 2016 would have been as follows:

	2017 ($ million)	2016 ($ million)
Annual deficit as presented	(991)	(3,515)
Effect of valuation allowance on:		
• Education expense	(1,364)	(1,480)
• General Government and Other expense	(80)	(351)
Annual deficit in accordance with Canadian public sector accounting standards	**(2,435)**	**(5,346)**

Effect on Consolidated Statement of Financial Position

If the Government had correctly recorded the valuation allowance against the net pension asset for the Ontario Teachers' Pension Plan and the Ontario Pubic Service Employees' Union Pension Plan, the effect on the consolidated statement of financial position as at March 31, 2017 and 2016 would have been as follows:

	2017 ($ million)	2016 ($ million)
Net pension asset as presented	11,033	9,312
Effect of valuation allowance	(12,429)	(10,985)
Net pension liability in accordance with Canadian public sector accounting standards	**(1,396)**	**(1,673)**

	2017 ($ million)	2016 ($ million)
Net debt as presented	(301,648)	(295,372)
Effect of valuation allowance	(12,429)	(10,985)
Net debt in accordance with Canadian public sector accounting standards	**(314,077)**	**(306,357)**

	2017 ($ million)	2016 ($ million)
Accumulated deficit as presented	(193,510)	(192,029)
Effect of valuation allowance	(12,429)	(10,985)
Accumulated deficit in accordance with Canadian public sector accounting standards	**(205,939)**	**(203,014)**

Inappropriate Consolidation of Independent Electricity System Operator (IESO) Market Accounts

As described in Note 16c to these consolidated financial statements, the IESO changed its accounting policy and applied it retroactively to recognize market account assets and liabilities. The market accounts track mainly buy and sell transactions between market participants (electricity power generators and power distributors). These market accounts, as recorded on the Province of Ontario's consolidated financial statements are not assets and liabilities of the Province of Ontario. The Government has no access or discretion to use the market account assets for their own benefit, nor does the Government have an obligation to settle the market account liabilities in the event of default by market participants. As a result, Other Assets and Other Liabilities are both overstated by $1.652 billion (2016 – $1.443 billion). There is no effect on the Consolidated Statement of Operations.

Qualified Opinion

In my opinion, except for the effects of the matters described in the Basis for Qualified Opinion paragraphs, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Province of Ontario as at March 31, 2017, and the consolidated results of its operations, change in its net debt, change in its accumulated deficit and its cash flows for the year then ended in accordance with Canadian public sector accounting standards.

Other Matters

Use of Rate-regulated Accounting May Cause a Material Misstatement on the Consolidated Financial Statements of the Province of Ontario

I draw attention to Note 16c to these consolidated financial statements, which describes the Independent Electricity System Operator's retroactive adoption of rate-regulated accounting during the year. The recognition of rate regulated assets on the consolidated financial statements of the Province of Ontario is not permitted when applying Canadian public sector accounting standards. This departure does not have a material impact on the Province of Ontario's consolidated financial statements for the year ended March 31, 2017 and my opinion is not modified in respect of this matter. However, the consolidated financial statements may become materially misstated in future periods, as a result of the legislated accounting prescribed under the *Ontario Fair Hydro Plan Act, 2017* (Fair Hydro Plan) and its related regulations as it is not in accordance with Canadian public sector accounting standards.

Financial Statement Discussion and Analysis

I draw attention to the Province of Ontario's Financial Statement Discussion and Analysis that discusses the Province of Ontario's financial results without properly reflecting the valuation allowance required in respect of the net pension asset and the recognition of market accounts, as discussed in the Basis for Qualified Opinion paragraphs above.

Toronto, Ontario
August 18, 2017

Bonnie Lysyk, MBA, CPA, CA, LPA
Auditor General

Figure 1: Pension Asset (Liability) as at March 31, 2017

Sources of data: March 31, 2017, Province of Ontario Consolidated Financial Statements and Office of the Auditor General of Ontario

	2017 Pensions ($ million)	2016 Pensions ($ million)
Obligation for benefits	124,700	118,448
Less: plan fund assets	(149,851)	(140,834)
Obligation over/(under) plan assets	**(25,151)**	**(22,386)**
Unamortized actuarial gains	14,104	13,074
Accrued pension asset	**11,047**	**9,312**
Valuation allowance	(14)	–
Net pension asset (liability)[1]	**11,033**	**9,312**
Additional valuation allowance[2]	(12,429)	(10,985)
Net pension asset (liability)[3]	**(1,396)**	**(1,673)**

1. As presented in the March 31, 2017, Province of Ontario consolidated financial statements.
2. Valuation allowance recorded against the accrued pension asset of the Ontario Teachers' Pension Plan $11.511 billion (2015/16, $10.147 billion) and Ontario Public Service Employees Union Pension Plan $0.918 billion (2015/16, $0.838 billion).
3. In accordance with Canadian Public Sector Accounting Standards.

Discussion of the Accounting Treatment of a Pension Asset under Canadian PSAS

A net pension asset generally arises when the government's total contributions to a plan (plus interest earned thereon) are greater than the pension expense recognized for employee service since the plan's inception.

Canadian PSAS limit the carrying amount of the pension asset. The limit requires a government to record a valuation allowance for any excess of the pension asset over the government's "expected future benefit." In other words, the limit calculation caps the pension asset at an amount equal to the government's expected future benefit. Subsequent changes in a valuation allowance are recorded in the consolidated statement of operations in the period in which the change occurs.

A government's expected future benefit is the benefit a government expects to realize from a pension plan's surplus. The benefit can be in the form of reductions in future required contributions or cash withdrawal of the surplus.

Canadian PSAS provide guidance on the factors to consider in determining whether a benefit should be included in the calculation of a government's expected future benefit. The expected future benefit excludes any surplus withdrawals to which the government is not currently entitled, such as those subject to the approval of employees, an appropriate regulatory authority, or, where no such approval has been granted, a court of law.

The standards specifically state that a government may not anticipate obtaining a legally enforceable right to withdraw a portion of a plan surplus to which it is not currently entitled, whether on the basis of precedent or otherwise. The same concepts are applicable when determining the government's ability to reduce its future minimum contributions.

After reviewing the agreements governing the jointly sponsored pension plans in 2015/16, we, along with our expert advisers, determined that the government does not have the unilateral right to reduce contributions without reaching a formal agreement with the plans' other joint sponsors. As a result, we concluded that the government did not have a legally enforceable right to benefit from the pension assets because agreement from the other joint sponsors was not obtained in 2015/16. We arrived at the same conclusion in 2016/17.

For greater certainty, we also examined whether the pension assets met the definition of an asset laid out in the financial statement concepts that underpin all Canadian PSAS. This guidance defines assets as economic resources controlled by a government as a result of past transactions or events, and from which it expects to obtain future economic benefits.

The three essential characteristics of assets are:

- They must embody future economic benefits that involve a capacity, singly or in combination with other assets, to provide goods and services, to provide future cash inflows, or to reduce cash outflows.
- The government can control the economic resource and access to the future economic benefits.
- The transaction or event giving rise to the government's control has already occurred.

The first characteristic could potentially be met as the pension asset offers the potential for either future cash inflows in the form of approved surplus withdrawals or reduced cash outflows in the form of reductions in future contributions. A further option is that benefits could be increased to members, but in this case, the benefit would flow to the plan members, not the government.

However, the second characteristic is not met, because the government does not control access to the benefits of the plan surplus, including taking any unilateral actions to change its contribution amounts, taking contribution holidays, or withdrawing surplus. Under both plan agreements, these actions require negotiation and agreement between the two joint sponsors. No transaction or event has occurred to give the government this legally enforceable right and, as a result, the government has neither control nor access to the assets. As a result, the third characteristic also is not met.

Therefore, we, along with our expert advisers, concluded that the net pension asset reported by the Province relating to the OTPP and the OPSEUPP was overstated as at March 31, 2017, and March 31, 2016. In other words, because the government cannot access these pension plans' surpluses (as it has not obtained the agreement from the plans' other joint sponsors to use these surpluses), the recognition of a net pension asset relating to these plans without a valuation allowance contravenes Canadian PSAS.

Applying Canadian PSAS requires an adjustment to recognize a valuation allowance against the total amount of pension assets reported by the OTPP and the OPSEUPP to reflect the expected future benefit. The expected benefit, in this case, is the reduction of future contributions related to the annual costs of the plans. Specifically, according to PSAS section PS 3250.056:

> A government determines its expected future benefit as the sum of:
>
> (a) the present value of its expected future accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the government is required to make regardless of any surplus; and
>
> (b) the amount of the plan surplus that can be withdrawn in accordance with the existing plan and any applicable laws and regulations.

This is also consistent with the application of the fundamental concepts in Canadian PSAS for the recognition of assets in general.

The government appointed a pension asset advisory panel that provided the government advice on the interpretation of Canadian PSAS regarding the pension assets. We disagree with the panel's conclusion that the government could record a pension asset for the two pension funds it co-sponsors, the OTPP and the OPSEUPP, without recording a valuation allowance. We further note that this government-appointed panel is not an authoritative source on the application of Canadian PSAS.

In order to remove the audit qualification relating to the net pension asset recorded in the Province's consolidated financial statements, we would need a signed negotiated agreement from the other joint sponsors of those plans as evidence that the government has a pension asset that it can benefit from today. The government did not record a valuation allowance as required under Canadian PSAS to reduce the net pension asset it reported on its consolidated statement of financial position.

RECOMMENDATION 1

We recommend the government record valuation allowances to offset the net pension assets it has recorded from the Ontario Teachers' Pension Plan and the Ontario Public Sector Employees' Union Pension Plan until such time as it obtains formal written authorization from their pension plan co-sponsors that they are able to lower minimum contributions or withdraw surpluses from the pension funds within the next 12 months.

TREASURY BOARD SECRETARIAT RESPONSE

Treasury Board Secretariat does not agree with the recommendation.

3.6.2 Inappropriate Consolidation of the IESO's Market Accounts

We also qualified our 2016/17 audit opinion on the Province's consolidated financial statements as the Province inappropriately recorded market accounts (that are not assets and liabilities of the Independent Electricity System Operator (IESO) or the Province) through the consolidation of the financial results of the IESO without first conforming the IESO's results to be in accordance with Canadian PSAS.

The IESO is classified as an Other Government Organization (OGO) under the provisions of Canadian PSAS, which state that the financial results of an OGO must be conformed to Canadian PSAS prior to consolidation in the government's consolidated financial statements. The market accounts recorded on the IESO's financial statements do not meet the definitions of an asset or liability within Canadian PSAS from the perspective of the Province's consolidated financial statements.

The IESO, an Ontario provincial government organization, is responsible for operating the electricity market and contracting with independent electricity generators to supplement the electricity provided by Ontario Power Generation Inc. (OPG). Generators and importers supply power into the bulk electricity system to be available to consumers and exporters, including private and municipal distributors such as Power Stream Inc. and the Toronto Hydro-Electric System Ltd. The distributors monitor consumption of electricity by metering their customers' consumption.

Generators generally do not know who is consuming the power they supply to the grid, and distributors generally do not know who they are purchasing their supply from, because they simply access the electricity supply from the grid. The IESO performs the function of a facilitator for settling transactions between electricity market participants such as power generators and electricity distributors, rather than having market participants settle transactions directly with each other. The buyers are the local distribution companies, exporters and large, directly-connected consumers, and the sellers are the power generators and importers.

Market Rules for the Ontario Electricity Market (Market Rules) provide a framework for the operation of the market and the determination of charges payable or receivable from market participants. The IESO's role, as per Ontario Regulation 288/14, is to operate the IESO-administered markets to promote the purposes of the *Ontario Electricity Act, 1998* (Act) and engage in activities related to settlements and payments under contracts entered into under the authority of the Act and payments provided for under the Act or the *Ontario Energy Board Act, 1998*.

To facilitate the flow of cash from the distributors to the generators, the IESO established a number of accounts called Market Accounts, which represent the amounts due from the distributors, and the amounts owing to the generators. The Market Accounts presented in the IESO financial statements are the point-in-time balances (assets and liabilities) which result from the settlement process between the distributors and the generators. The Market Account assets and liabilities consist of cash restricted for the market activities, a revolving line of credit, interest receivable/payable, due to/from market participants' accounts, and HST receivable.

Based on the Market Rules, the IESO has no role in promoting the interests of one party over another, is not specifically engaged as an agent in economic terms on behalf of any party, and does not have an economic interest in the ultimate consummation of any transaction. The IESO indicates in its public communications that it is the independent administrator of the market. The IESO's Market Rules contain terms that specify its relationship to market participants, and the IESO is not considered a counter-party to the transactions between market participants.

Furthermore, the IESO's Market Rules contain terms that specify the IESO's relationship to market participants and its exposure to financial risks within the Market Accounts.

Specifically, Chapter 9, Section 6.9.2, of the Market Rules states: "The IESO shall not be a counter-party to any trade transacted through the real-time markets." In this term, "trade" is not specifically defined, but is meant to be generic to refer to transactions within the real time market between market participants that are facilitated by the IESO.

Chapter 9, Section 6.16.2, states that subject to the provisions of Section 6.14, "the IESO shall not be liable to make payments in excess of the amount it receives for transactions in the real-time markets."

Section 6.14 addresses remedies of default of a market participant. In summary, the IESO has recovery mechanisms for a default of payment by a market participant, and if those recoveries cannot be made by the specific defaulting market participant, then the funds owed to creditors will be collected from the remaining market participants on a pro-rata basis.

The IESO has no responsibility to settle the market account liabilities in the event of default by market participants, nor does it have any inventory risk related to distributing the electricity to the LDCs or ratepayers.

Canadian PSAS outline the definition and characteristics of an asset in Section PS 3210:

> ".03 Assets are economic resources controlled by a public sector entity as a result of past transactions or events and from which future economic benefits are expected to be obtained.
>
> .04 Assets have three essential characteristics:
>
> (a) They embody future economic benefits that involve a capacity, singly or in combination with other assets, to provide goods and services, to provide future cash inflows, or to reduce cash outflows.
>
> (b) The public sector entity can control the economic resource and access to the future economic benefits.
>
> (c) The transaction or event giving rise to the public sector entity's control has already occurred.
>
> .05 Economic resources are not assets unless they meet the three characteristics of assets."

As demonstrated above, there is no economic benefit that accrues to IESO.

Similarly, Section PS 3200 outlines the definition and characteristics of a liability under Canadian PSAS:

> .05 Liabilities are present obligations of a government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits. Liabilities have three essential characteristics:

(a) they embody a duty or responsibility to others, leaving a government little or no discretion to avoid settlement of the obligation;

(b) the duty or responsibility to others entails settlement by future transfer or use of assets, provision of goods or services, or other form of economic settlement at a specified or determinable date, on occurrence of a specified event, or on demand; and

(c) the transactions or events obligating the government have already occurred.

.06 Obligations are not liabilities unless they meet the three characteristics of liabilities.

As demonstrated above, the IESO is not liable for any shortfall in cash flows occurring in the period.

Similar to the IESO, the Province has no access/discretion to use the Market Account assets for its own benefit; nor does the Province have an obligation to settle the Market Account liabilities in the event of default by market participants. As such, the Market Accounts do not meet the criteria for recognition as assets and liabilities in the Province's consolidated financial statements.

RECOMMENDATION 2

We recommend that the government remove the Independent Electricity System Operator's Market Accounts from the Province's consolidated financial statements.

TREASURY BOARD SECRETARIAT RESPONSE

Treasury Board Secretariat does not agree with the recommendation.

3.7 The Reasons for the Other Matter Paragraph

In addition to the two qualifications to our 2016/17 audit opinion on the Province's consolidated financial statements, we outlined in an Other Matter paragraph that the Province had inappropriately adopted rate-regulated accounting as set out by the U.S. Financial Accounting Standards Board (FASB) in its Accounting Standards Codification 980, Regulatory Operations (ACS 980) under Canadian PSAS.

We arrived at this conclusion because:

- Canadian PSAS is silent on the application of rate-regulated accounting concepts to an OGO or to a government. Canadian PSAS, like other international public-sector standard-setters, must give permission to use rate-regulated accounting. Within PSAS there is no such permission.
- All other accounting standard-setters, including those in the United States, allow for the use of rate-regulated accounting by specifically indicating its use is permitted. That permission usually restricts the adoption of rate-regulated accounting to specific types of government business entities, such as public electric utilities.
- Rate-regulated accounting is not consistent with the primary sources of Canadian generally accepted accounting principles (GAAP) or the concepts set out in Canadian PSAS as required by Section PS 1150, *Generally Accepted Accounting Principles*.
- The IESO and the provincial government are neither government business enterprises nor governmental electric utilities. In Canada, only governmental electric utilities that are considered government business enterprises can use rate-regulated accounting.
- Organizations cannot select individual accounting policies from secondary sources of GAAP without considering the overall environment for which the underlying standards were created.

- The terms and conditions of the contracts entered into by the IESO that are subject to the *Ontario Fair Hydro Plan Act, 2017* were not subject to rate-regulation by the Ontario Energy Board, the Province's regulator. The recovery of IESO's costs of operating the real-time market is not a rate-regulated activity; rather, the Ontario Energy Board determines the fees to be added to the electricity price to allow the IESO to recover its administration costs.

The IESO is classified as an OGO under provisions of Canadian PSAS which state that the financial results of an OGO must be conformed to Canadian PSAS prior to consolidation into the government's financial statements. By consolidating rate-regulated balances recorded in the IESO's financial results without conforming to Canadian PSAS, the government is implying that accounting provisions for rate-regulated accounting found in the FASB ASC 980 can be applied to the Province's consolidated financial statements.

In general, the most widely adopted government accounting standards do not allow governments to create assets and liabilities in their financial statements through the application of rate-regulated accounting. The use of rate-regulated accounting derived from legislation in financial statements prepared using Canadian PSAS would allow governments to manipulate their bottom line to disclose whatever financial result they desire, and would render public reporting of government financial results useless.

The IESO pointed to the GAAP hierarchy outlined in Canadian PSAS Section PS 1150 in adopting the accounting provisions in FASB ASC 980 in its December 31, 2016, financial statements. FASB issues the GAAP that are followed by private-sector entities in the United States.

As the Ontario Government said in a technical briefing on October 17, 2017, regarding the IESO adopting the provisions of U.S. GAAP ASC 980, Section PS 1150.07 of Canadian PSAS states:

> .07 No rule of general application can be phrased to suit all circumstances or combinations of circumstances that may arise. As a result, matters may arise that are not specifically addressed in the primary sources of GAAP. It is necessary to refer to other sources when the primary sources do not deal with the accounting and reporting in financial statements of transactions or events that a public sector reporting entity encounters, or when additional guidance is needed to apply a primary source to specific circumstances.

However, Section PS 1150 also notes that a public-sector reporting entity should adopt accounting policies and disclosures that are consistent with the primary sources of GAAP and the PSAS Conceptual Framework. Canadian PSAS Section PS 1150 goes on to describe and name other sources of GAAP, and outlines the concept that the government reporting entity should look to the most relevant secondary sources of GAAP when applying the GAAP Hierarchy.

3.7.1 Canadian PSAS Do Not Permit Rate-Regulated Accounting

Canadian PSAS do not explicitly state that rate-regulated accounting is not allowed; however, the concepts of rate-regulated accounting are not in line with other primary sources of GAAP or the PSAS Conceptual Framework. The silence of Canadian PSAS on rate-regulated accounting means that rate-regulated accounting is not permitted. All other standard-setters for government that allow the use of rate-regulated accounting explicitly permit the use of rate-regulated accounting for certain types of entities.

However, Canadian PSAS allows government business enterprises, such as Ontario Power Generation (OPG) who are more like private-sector businesses in that they sell goods and services and are self-sustaining from the revenue they receive from those sales, to use rate-regulated accounting. In this case, PSAB specifically exempts OPG from applying Canadian PSAS, and requires it to apply International Financial Reporting Standards (IFRS). This is a specified exemption from applying Canadian PSAS.

Further, some not-for-profit organizations such as universities, colleges and hospitals are specifically permitted by Canadian PSAS—but not required—to apply other standards that may or may not be consistent with the accounting concepts and principles under Canadian PSAS. This is another example of a specified exemption under Canadian PSAS. Given this exemption, a not-for-profit organization's financial statements can still be said to be prepared in accordance with Canadian PSAS.

For governments and government organizations applying Canadian PSAS, there is no specific permission or exemption to use rate-regulated accounting. The only time such permission is given by Canadian PSAS is when a government organization, by exemption, has chosen to prepare its financial statements in accordance with IFRS, and the specific criteria for applying rate-regulated accounting are met under those standards.

It is our view that rate-regulated accounting is not permitted when a government or a government-controlled organization presents its financial statements in accordance with Canadian PSAS.

This view is and has been supported by many public-sector accounting experts in Canada, including Auditors General across Canada, private accounting firms, and others, such as the recently retired Director of the Public Sector Accounting Standards Board, who have extensive experience in developing and applying Canadian PSAS.

The international public-sector standard-setters share the same view that a government's inherent ability to raise revenue in the future is not an asset today. The International Public Sector Accounting Standards Board (IPSASB) Conceptual Framework, BC5.18, states: "A government's power to establish a right to levy a tax or fee, for example, often begins a sequence of events that ultimately results in the flow of economic benefits to the government." In particular, the IPSASB concluded that "a government's inherent powers do not give rise to assets until these powers are exercised and the rights exist to receive service potential or economic benefits."

In the context of accounting for public-sector entities, this view is even supported in the United States the jurisdiction cited by the IESO.

The Federal Accounting Standards Advisory Board (FASAB), which issues accounting standards for the federal government, states in its Statement of Federal Financial Accounting Concepts 5 (SFFAC 5) *Elements*, paragraph 34:

> The government's intent or ability to acquire a resource in the future does not create an asset. For the resource to qualify as an asset, the government already must have acquired the resource or otherwise obtained access to the economic benefits or services it embodies to the exclusion of other entities. For example, the mere existence of the government's power to tax is not an asset because, until the government has exercised that power by imposing a tax and has access to benefits by virtue of completion of a taxable event, no event has occurred to generate resources and there are no resulting economic benefits that the government can control and use in providing programs and services.

The Governmental Accounting Standards Board (GASB), which issues standards for U.S. state and local governments, states in its Concept Statement no. 4 – *Elements of Financial Statements*, paragraph 11:

> The power to tax is a distinguishing characteristic of government. Because governments are formed to provide services, frequently irrespective of the ability of specific individuals to pay for those services, governments are often established with the power to tax. That power, while

central to the function of many governments, does not constitute an asset of those governments with that power. A government's power to tax may be considered one of the government's most important resources (that is, a means that can be drawn on), but it is not an asset of the government because the power to tax does not have present service capacity. The power to tax produces an asset for accounting and financial reporting purposes only when the power to tax is exercised and an enforceable tax levy or a taxable transaction occurred, as applicable, has resulted in a resource with present service capacity—taxes receivable.

In 2002, the former Canadian Institute of Chartered Accountants (now CPA Canada) published a research report titled *Financial Reporting by Rate-Regulated Enterprises* that had been jointly commissioned by the Canadian Accounting Standards Board (AcSB) and the Public Sector Accounting Board (PSAB). The report study group was comprised of representatives from the private sector and the public sector, including the then Provincial Controller of Ontario and a representative from the Ontario Energy Board.

Chapter 8 of this 2002 report specifically addressed whether rate-regulated accounting could be applied to the public sector. With respect to the public sector, the research report noted that rate-regulated accounting should only be applied to Government Business Enterprises (GBEs). The report stated: "By inference, although it is not specifically stated in the Public Sector Accounting Handbook, except for GBEs, rate-regulation does not apply to the public sector."

The study group concluded that the scope of public-sector activities that may be considered "rate-regulated" for financial-reporting purposes should be limited to government business enterprises that meet the criteria for qualifying as a rate-regulated enterprise. In our view, the conclusions of the report still apply today.

It has been asserted that rate-regulated accounting is a generally accepted practice. Clearly, there are a number of private and public utilities that use this accounting. However, for the purposes of the Canadian public sector, the use of rate-regulated accounting can only be applied when the organization is a government business enterprise such as Ontario Power Generation, or if the organization chooses to adopt IFRS in preparing its financial statements. Rate-regulated accounting under Canadian PSAS is only permitted when the organization is directed to IFRS, or the organization has chosen to adopt IFRS (where permitted), for the purposes of its own financial statements. The Province does not apply IFRS and, for non-government business enterprise organizations that do, any difference arising between IFRS and PSAS must be adjusted when the Province consolidates such organizations.

3.7.2 U.S. Government Generally Accepted Accounting Standards Permit Rate-Regulated Accounting Only for Government Business Enterprises

The Ontario government pointed out in its technical briefing to media on October 17, 2017, that, whereas the provisions of Canadian accounting standards are principles-based, the provisions of U.S. GAAP are rules-based. The provisions of U.S. GAAP are generally prescriptive in nature. When referring to U.S. GAAP for guidance in developing accounting policies under the hierarchy outlined in Canadian PSAS Section PS 1150, the Province cannot choose which U.S. GAAP rules it wishes to follow, while ignoring other pertinent rules.

As noted above, the Financial Accounting Standards Board (FASB) issues private-sector accounting standards in the U.S. When determining whether a government or government entity can adopt the provisions of U.S. GAAP for rate-regulated accounting (FASB's ASC 980), the most relevant sources of GAAP are the public-sector accounting boards of the United States, including the Federal Accounting Standards Advisory Board (FASAB) and the Governmental Accounting Standards Board (GASB). FASB's accounting standards cannot be read in isolation of the application of the FASAB or GASB accounting standards.

Both FASAB and GASB restrict the use of FASB's rate-regulated accounting standards to government business enterprises (GBEs). Neither FASAB nor GASB permit the U.S. federal government, state or local governments, or other governmental organizations (other than GBEs) to adopt rate-regulated accounting.

When looking to other international government accounting standard setters, the accounting provisions issued by the International Public Sector Accounting Standards Board (IPSASB) are the most relevant. While the IPSASB permits certain organizations to adopt IFRS, which contain provisions for applying rate-regulated accounting, the effects are removed for the purposes of a government issuing its own financial statements.

3.7.3 Rate-Regulated Accounting Provisions Require an Independent Regulator in Most Cases, Including under Ontario's Regulatory Framework

When issuing a new accounting standard, standard-setters often publish a companion document referred to as the "basis of conclusions." This document provides a more detailed background of discussions that went into setting the new standard and, in some cases, further interpretation of the accounting provisions within that new standard.

In the basis of conclusions for ASC 980 (paragraph 64), FASB notes that ASC 980 does not preclude a governmental utility from adopting the provisions of ASC 980. However, the Province of Ontario is not a governmental utility, and neither is the IESO. Although ASC 980 does not preclude U.S. governmental utilities from adopting rate-regulated accounting, the permission for a governmental utility to adopt these provisions in the U.S. comes from FASAB or GASB (that is, the governmental utility must be a GBE).

Even with the permission to adopt the provisions of ASC 980, a governmental utility must still meet the required criteria for adoption set out in those provisions. These criteria include the requirement for regulated activities to be approved by an independent third-party regulator, except when an entity has been given statutory or contractual authority to establish rates that bind customers. Ontario does not have any governmental utilities that have the statutory or contractual authority to establish rates that bind its customers. The Ontario Energy Board regulates the majority of OPG's electricity generation operations and all of Hydro One's transmission and distribution operations.

Under ASC 980, in a rate-setting model where a regulator sets the electricity rates (as is the case in Ontario with the OEB), that regulator must be independent from the regulated entity in order to apply rate-regulated accounting. As outlined in the basis of conclusions for ASC 980, paragraph 62, "the first criterion is the existence of third-party regulation."

At the Province of Ontario consolidated level, the IESO and OEB are related parties through common control by the Province. As such, the third-party independent relationship required in order to adopt the provisions of ASC 980 does not exist. Therefore, although we believe that the IESO should not record rate-regulated balances, any rate-regulated balance that would be included in the IESO's financial results would have to be eliminated prior to consolidation into the Province's financial statements.

3.7.4 The Contracts to be Smoothed under the Ontario Fair Hydro Plan Are Specifically Excluded from Applying Rate-Regulated Accounting Provisions

The Other Matter paragraph in our Auditor's Report noted that although the adoption of rate-regulated accounting at the provincial level did not result in material misstatement in the Province's 2016/17 consolidated financial statements, the amounts may become materially misstated in future periods as a result of the *Ontario Fair Hydro Plan Act, 2017* (Act). This statement was based on the estimated annual borrowing required to fund the cash shortfall from applying the rate discount outlined in the Fair Hydro Plan, and the fact that the provisions of U.S. GAAP ASC 980 do not apply to the contracts that are being considered in the Global Adjustment account smoothing plan, not only at the provincial consolidated-financial-statement level but also at the IESO financial-statement level.

The Act refers to the Global Adjustment costs that are to be smoothed under the Fair Hydro Plan as a "clean energy benefit." The renaming of these costs to be smoothed to a "clean energy benefit" does not change their underlying nature. These costs relate to electricity to be purchased according to contracts with third-party generators. The terms and conditions of these contracts were not subject to rate regulation by the OEB; rather, they were negotiated and agreed to by third-party generators and the IESO (or the former Ontario Power Authority). U.S. GAAP ASC 980 specifically states that its provisions do not apply to contracts whose terms and conditions are not subject to rate regulation.

3.7.5 Rate-Regulated Accounting Provisions Can Only Be Applied to an Entity's Own Rate Regulated Operations

In addition to the other compelling arguments that rate-regulated accounting should not impact the Province's consolidated financial statements, it should be noted that the provisions of ASC 980 apply to an entity's own rate-regulated operations. The asset that is being established by the Act—the right to recover amounts from future ratepayers—does not relate to the IESO's own operations. As outlined previously in **Section 3.6.2**, the Market Rules state that the IESO is not a party to the transactions of the market.

3.7.6 In Absence of Rate-Regulated Accounting, the Asset Created under the Fair Hydro Plan Would Be Classified as an Intangible Asset and Not Be Recognized under Canadian PSAS

OPG, in its analysis regarding the asset (i.e., the shortfall from paying generators more than what is collected from distributors) that OPG Trust will be purchasing from the IESO, correctly pointed out that the OPG Trust cannot classify this asset as a rate-regulated asset because this asset does not relate to the activities of OPG Trust. OPG's analysis went on to note that this asset will be classified as an intangible asset.

From the IESO perspective, this right to collect future revenues does not meet the definition of an accounts receivable because the specific ratepayers who will owe this amount in the future cannot be determined until those ratepayers consume electricity in future years at the higher rates reflecting the recovery of the Fair Hydro Plan reduction.

The IESO cannot record the asset as a rate-regulated balance for the many reasons outlined above; nor can the IESO record this balance as an accounts receivable. As such, the right to future recovery of the shortfall of cash received from ratepayers versus the amount due to generators would be classified as an intangible asset under Canadian PSAS, similar to the classification of the asset by the OPG Trust following IFRS.

However, where OPG Trust may be able record an intangible asset under IFRS, the Province cannot record an intangible asset under Canadian PSAS PS 1000.58, which states: "In the absence of appropriate public sector recognition and measurement criteria for intangibles, all intangibles, including those that have been purchased, developed, constructed or inherited in right of the Crown, are not recognized as assets in government financial statements."

3.7.7 Historical Accounting Precedent – The Electricity Consumer Price Protection Fund

There is precedent in previous government accounting for the electricity rate freeze for the period from May 2002 to March 2004 is similar to our recommended accounting for the proposed transactions under the Fair Hydro Plan.

In May 2002, electricity consumers were introduced to market-based prices. During the summer of 2002, the market price of electricity in Ontario rose to unanticipated levels due to such unforeseen circumstances as warmer-than-seasonal weather. As a result, electricity bills were significantly higher than in 2001. In response, the government enacted the *Electricity Pricing, Conservation and Supply Act, 2002* (Act), which established a single, fixed price for electricity.

The Act, which received Royal Assent on December 9, 2002, aimed to protect electricity consumers by lowering and freezing the price of electricity at 4.3 cents per kilowatt hour (kWh) for families, small businesses and farmers. With passage of the Act, the government fixed the electricity price at 4.3 cents per kWh until 2006, retroactive to May 1, 2002.

Under this program, power generators would receive the market price as set in the electricity market administered by the Independent Market Operator (IMO, now the IESO). The program would be administered through the Electricity Consumer Price Protection Fund (ECPPF), managed by the Ontario Electricity Financial Corporation (OEFC).

As manager, OEFC was required to pay to or receive from the IMO any difference between the current market price (spot price) and the fixed 4.3 cents/kWh charged to consumers under the Act.

When spot prices were higher than 4.3 cents/kWh, OEFC would make a payment to the IMO equal to the difference between the spot price and 4.3 cents/kWh, based on the quantity of electricity consumed. When spot prices were lower than 4.3 cents/kWh, OEFC would receive a payment from the IMO equal to the difference between the spot price and 4.3 cents/kWh, based on the quantity consumed. The ECPPF was to receive a large portion of its funding from the piece of the Market Power Mitigation Agreement rebate paid by Ontario Power Generation (OPG) that was attributable to the low volume and designated consumers.

For the 2002/03 fiscal year, the program resulted in $665 million in additional costs recorded as an expense in OEFC, reflecting the fact the average price of electricity was greater than the fixed rate of 4.3 cents/kWh. Specifically, expenditures from the ECPPF that amounted to $1.461 billion in 2002/03 were reduced by a portion of the rebate paid by OPG under the Market Power Mitigation Agreement totaling $796 million, leaving a net cost in OEFC of $665 million. In 2003/04, expenditures from the ECPPF during the year amounted to $643 million, reduced by a portion of the rebate provided by OPG under the Market Power Mitigation Agreement totaling $390 million, leaving a net cost in OEFC of $253 million.

On December 18, 2003, the passage of the *Ontario Energy Board Amendment Act, 2003* (Pricing Act), removed the 4.3 cents/kWh price freeze effective April 1, 2004, in favour of another pricing structure. This interim pricing structure was introduced on April 1, 2004, with an expectation that the net cost for the ECPPF would be eliminated in 2004/05. Upon passage of the Pricing Act and its related regulations, the responsibility for managing the ECPPF, that had reported a surplus of $704 million for the period from April 1, 2004, to March 31, 2005, was transferred to the Ontario Power Authority (OPA) on January 1, 2005. Accordingly, $176 million of the fiscal 2005 surplus was transferred to the OPA, representing the payments required to be made for the first quarter of 2005. The remaining surplus of $528 million was reflected as a liability on the balance sheet and would be returned to electricity consumers in a subsequent period.

During the ECPPF's life, 2002/03 and 2003/04 funding program shortfalls that were recovered from electricity ratepayers were recorded as an expense in OEFC's financial statements, and in the

Province's consolidated financial statements, both of which were prepared using Canadian PSAS. The 2004/05 funding program surpluses that were to be returned to electricity ratepayers were recorded as a liability. The accounting policies used for the ECPPF in OEFC's financial statements and in the Province's consolidated financial statements in prior years are consistent with our Office's accounting recommendations for recording the Fair Hydro Plan rate reduction.

RECOMMENDATION 3

We recommend the government follow the accounting standards established by the Public Sector Accounting Board and the Province's historical accounting precedent, and implement the recommendations in the Special Report issued by our Office and tabled in the legislature on October 17, 2017, titled *The Fair Hydro Plan: Concerns About Fiscal Transparency, Accountability and Value for Money*, as follows:

- record the true financial impact of the Fair Hydro Plan's electricity rate reduction on the Province's budgets and consolidated financial statements; and
- use a financing structure to fund the rate reduction that is least costly for Ontarians.

TREASURY BOARD SECRETARIAT RESPONSE

Treasury Board Secretariat does not agree with the recommendation.

4.0 The Government's Use of External Consultants

In our *2016 Annual Report*, we reported on the government's use of external advisers. The government engages external advisers in various capacities that include providing accounting analysis, advice and interpretation. We highlighted that the interests of the Treasury Board Secretariat, the Ministry of Finance and the Office of the Auditor General are best served when there is full disclosure on the use of external advisers. For this reason, any work performed by external advisers in formulating an accounting position should be shared with the Office of the Auditor General as soon as possible, as part of the audit of the Province's consolidated financial statements. We recommended that the government provide our Office with copies of all contracts with external advisers so that we are aware of the scope of their work performed and can assess its impact on the annual audit. We also recommended that Treasury Board Secretariat incorporate in its contracts with external advisers a provision to notify our Office of their engagement with the Province.

We noted that in 2016/17, as the government designed the accounting/financing structure for the Fair Hydro Plan rate reduction, they engaged external advisers to achieve the desired accounting treatment, and sought advice from private accounting firms on various elements of the transaction at an individual entity level. Despite the recommendation made in our *2016 Annual Report*, the government did not inform our Office of its external engagements until we became aware that significant discussions were being held on matters related to the Fair Hydro Plan that would have an impact on our audit. We requested a formal briefing in early March 2017, but it was not until April 2017 that we received a high-level briefing on the Fair Hydro Plan. The accounting/financing structure was not presented at that briefing. Further, the contracts that the government had with the external advisers on the accounting/financing transaction of the Fair Hydro Plan were not provided to us until we made a specific, formal request for them.

The Office of the Auditor General is mandated under law to be the auditor of the consolidated financial statements of the Province of Ontario. However, our position on the proper accounting for the Fair Hydro Plan rate reduction was not sought despite the fact that on numerous occasions, ministry staff advised the government that we may not agree with the accounting determined by the ministry staff and therefore the government was acutely aware of the risk that we would take issue with the accounting/financing structure being designed to avoid recording the impact of the rate reduction on the annual deficits and net debt of the Province's consolidated financial statements.

It is important that timely information is provided to our Office and that the accounting for proposed major transactions is transparently discussed with our Office early in the planning stage. The government did not implement our recommendations from last year's Annual Report related to the use of external advisers, and we repeat these recommendations this year.

RECOMMENDATION 4

The Office of the Auditor General is appointed under the *Auditor General Act* as the auditor for the consolidated financial statements of the Province of Ontario. We recommend that the Treasury Board Secretariat:

- proactively supply copies to the Auditor General of all contracts it enters into for accounting advice and opinions in order to ensure that our Office is aware of the work the advisers are performing, can assess significant issues in a timely manner, and can determine their impact on the Province's consolidated financial statements and our annual audit; and
- build into its contracts with external advisers the requirement that the advisers engaged to provide accounting advice and opinions that affect the consolidated financial statements notify our the Office of their engagement as required under the Code of Professional Conduct of the Chartered Professional Accountants of Ontario.

TREASURY BOARD SECRETARIAT RESPONSE

Treasury Board Secretariat's use of external expertise for accounting and financial reporting matters supplements its own resources on complex or emerging accounting and reporting matters. External advisers are generally engaged to provide advice and guidance to supplement internal analysis.

Treasury Board is committed to working with the Office of the Auditor General to discuss issues, once the professional staff has completed its analysis of the issue.

5.0 The Roles of the Group Auditor and the Component Auditor

5.1 Introduction

Paragraph 12(2)(f) of the *Auditor General Act* provides for our Office to bring to the attention of the Legislative Assembly any matter relating to the audit of Crown-controlled corporations.

5.1.1 Responsibilities

As noted earlier, the Auditor General is responsible under law to provide an audit opinion on the Province's consolidated financial statements. The consolidated financial statements are comprised of ministries and provincial organizations controlled by the government and include the following:

- four government business enterprises (GBEs): Hydro One, Liquor Control Board of Ontario, Ontario Lottery and Gaming Corporation, and Ontario Power Generation;
- more than 40 other government organizations (OGOs), including the Independent Electricity System Operator, Legal Aid Ontario, Metrolinx, and Ontario Electricity Financial Corporation;

- 14 Local Health Integration Networks (LHINs); and
- more than 250 broader-public-sector organizations (BPS) such as hospitals, colleges and school boards.

Under the Canadian Assurance Standards (CAS), the audit of the consolidated financial statements of the Province of Ontario is determined to be a "group audit." CAS 600 *Special Considerations – Audits of Group Financial Statements* (CAS 600) includes the requirements for audits under this classification.

A group audit is the audit of financial statements comprised of the financial statement information of more than one component, which is an entity or business activity for which financial information is prepared, and should be included in the consolidated financial statements.

In the Province of Ontario, each of the more than 300 entities grouped above are components. For the requirements of CAS 600 to be met, it is important to have transparent and timely information provided to our Office by the private-sector auditors of the components. As auditor of the group financial statements, we have the ultimate responsibility to ensure that sufficient and appropriate audit evidence is obtained to support the audit opinion on the Province's consolidated financial statements.

5.1.2 Chronology

Every year, we issue instructions to specific component auditors that include the work to be performed at the component level, the intended use of that work and professionally required communication on matters relevant to our conclusions on the audit of the consolidated financial statements. To promote timeliness, we set deadlines for responses, and emphasize that any significant or unusual events are to be reported to us as early as possible.

Our instructions require a response from the component auditor as it completes key phases of the audit process as outlined in our letter, specifically the pre-engagement, planning and post-engagement phases.

This year, in the case of the IESO component audit, our letter to the IESO private-sector component auditor was dated January 11, 2017. We requested a reply by February 17, 2017, on the first two phases and by June 16, 2017, for the last phase.

We followed up with a phone call to the IESO component auditor in mid-February for a response, but did not receive one. Subsequently we learned that there was an Audit Committee meeting on February 28, 2017, to review a draft of the December 31, 2016, financial statements. During the meeting, management, the IESO component auditor, and an adviser from the same firm discussed with the Audit Committee new accounting policies related to the recording of the market account assets and liabilities on the IESO's financial statements and the adoption of rate-regulated accounting for the preparation of its financial statements.

As part of the work done by our Office on the Special Report titled *The Fair Hydro Plan: Concerns About Fiscal Transparency, Accountability and Value for Money*, we now know that management and the IESO auditor were aware that there was a risk that our Office would not accept the proposed rate-regulated accounting policy change on the Province's consolidated financial statements. The Audit Committee initially asked management to discuss these accounting policies with the Auditor General, but we were never contacted.

Although CAS 600 does not include specific requirements for the component auditors to comply with our letter of instructions, professional responsibilities would dictate that the IESO auditor contact us without delay to inform us when significant or unusual items had occurred. As well, Subsection 9(3) of the *Auditor General Act* requires the person or persons performing the audit of a Crown-controlled corporation to comply with our letter of instructions.

On March 14, 2017, we sent a follow-up email to the IESO component auditor as their response was overdue, and we did not receive a reply. We now know that on March 15, 2017, there was a special meeting of the IESO Audit Committee to discuss changes in their accounting policies. Following the discussion, the IESO Audit Committee resolved that the accounting policies of the IESO be amended to record market accounts assets and liabilities on the IESO's balance sheet and to adopt rate-regulated accounting. These were significant accounting policy changes.

We received a response from the IESO component auditor on March 21, 2017, on the first two phases requested in our letter of instructions, but there was no mention of any accounting policy changes. The timing of these responses did not give us the opportunity to properly engage in the discussions at the component level, given that the IESO's revised and final financial statements (including restated comparatives) to December 31, 2016, were approved by the Audit Committee and the component auditor provided its audit opinion dated March 22, 2017.

We obtained a copy of the IESO's financial statements from its website shortly after this date. We expressed our disagreement with these changes to the senior management and board members of the IESO. We formally recommended that they correct their financial statements for the policy changes they made, remove the market accounts from their financial statements, and remove rate-regulated accounting. As an "Other Government Organization," the IESO follows Canadian PSAS in preparing its financial statements and is not permitted to use rate-regulated accounting. We expressed these same concerns to the component auditor and the adviser from the same firm that significantly contributed to designing the complex accounting/financing structure for the rate reduction under the Fair Hydro Plan.

Ultimately, the government's decision to rely on the changes to the IESO's accounting policies in preparing the Province's March 31, 2017, consolidated financial statements resulted in a basis-for-qualification paragraph and an Other Matter paragraph in the Auditor General's audit opinion on the Province's 2016/17 consolidated financial statements.

5.1.3 Our Concern

The delay in receiving timely communication is concerning. The changes to the accounting policies made by the IESO resulted in a significant change in their December 31, 2016, financial statements that resulted in a restatement of five years of their prior financial results. However, we were never informed by the IESO component auditor despite earlier requests sent to them requesting that they inform us of items of this nature as soon as possible.

We disagreed with the changes made to the Province's 2016/17 consolidated financial statements resulting from the accounting policy changes made by the IESO. On consolidation, accounting policies of other government organizations have to be conformed on a uniform basis of accounting applicable at the Province's consolidated financial statement level. At the consolidated level, the recognition of the market account assets and liabilities, as well as the use of rate-regulated accounting in the public sector (other than a GBE), is not appropriate, but the government chose not to make these adjustments.

The changes to the IESO's accounting policies are significant, not only to the Province's 2016/17 consolidated financial statements but also to future reporting. As described in our October 17, 2017, Special Report titled *The Fair Hydro Plan: Concerns About Fiscal Transparency, Accountability and Value for Money*, these changes were integral to the accounting/financing structure being designed under the Fair Hydro Plan to ensure that the Province's consolidated financial statements do not show the financial impact of the rate reduction on the Province's annual results and net debt.

5.1.4 Moving Forward

Following the completion of the audit of the Province's 2016/17 consolidated financial statements, I along with senior staff from my Office held an information session with senior audit partners from the major accounting firms. The purpose of the meeting was to introduce our Office and explain our role under the *Auditor General Act*.

At the same time, I also emphasized that as the auditor of the Province's consolidated financial statements, which include the results of hundreds of entities, I regard the work done by the component auditors as important. The transparency and timeliness of communication between my Office and component auditors must be preserved as the interests of all parties are best served when there is full disclosure and open dialogue on significant matters affecting the financial statements of government agencies, Crown-controlled corporations and, ultimately, the consolidated financial statements for the Province of Ontario.

RECOMMENDATION 5

We recommend that the Independent Electricity System Operator (IESO), an "other government organization," use the Canadian Public Sector Accounting Standards (PSAS) in the preparation of its financial statements. Specifically, it should:

- remove market accounts recorded on its financial statements; and
- discontinue the inappropriate use of rate-regulated accounting in the preparation of its financial statements.

To ensure that the members of the Legislative Assembly receive financial information on the operations of the IESO prepared in accordance with Canadian PSAS, the Office of the Auditor General will conduct an attest audit of the December 31, 2017, financial statements of the IESO as permitted under the *Electricity Act*, Subsection 25.2(2), which states: "The Auditor General may audit the accounts and transactions of the IESO. 2014, c. 7, Sched. 7, s. 3 (1)."

TREASURY BOARD SECRETARIAT RESPONSE

Treasury Board Secretariat does not agree with the recommendation.

6.0 Legislated Accounting Standards

Canadian PSAS have been widely adopted by Canadian federal, provincial, territorial and local governments as the basis for the preparation of their financial statements.

Over time, standards develop to address increasingly complex transactions and emerging financial issues. When changes to standards have a significant impact on the accounting for and measurement of transactions affecting annual deficit/surplus or net debt, governments may be reluctant to adopt them to the extent they generate potential volatility in annual reported results.

As discussed in our *2016 Annual Report*, the government passed legislation in 2008, 2009, 2011 and 2012 giving it the ability to make regulations for specific accounting treatments rather than the wholesale application of independently established accounting standards. In recent years, Ontario has passed legislation or amended regulations to enable it to prescribe accounting policies for its public-sector entities as follows:

- The *Investing in Ontario Act, 2008* (Act) and related regulations allow the government to provide additional transfers to eligible recipients from unplanned surpluses reported in its consolidated financial statements. Any transfers made under the Act would be recorded as an expense of the government for that fiscal year, regardless of the treatment prescribed under Canadian PSAS. Transfers under this Act have occurred only once, in 2007/08. We concluded the accounting for these transfers as an expense was appropriate under Canadian PSAS.
- In 2009, the *Education Act* and the *Financial Administration Act* were amended. The *Education Act* amendments specify that the government could prescribe accounting standards for Ontario school boards to use in

preparing financial statements. The *Financial Administration Act* amendments allow the government to prescribe accounting standards for any public or non-public entity whose financial statements are included in the Province's consolidated financial statements. For example, the Ministry of Education prescribed one accounting treatment to school boards on the adoption the new PSAS standard PS 3410, Government Transfers, which was not consistent with Canadian PSAS. We ensured that the prescribed accounting treatment was corrected when the financial statements of the school boards were consolidated into the Province's financial statements.

- In 2011, a regulation under the *Financial Administration Act* directed Hydro One, at the time wholly owned by the Ontario government, to prepare its financial statements in accordance with U.S. generally accepted accounting principles (GAAP), effective January 1, 2012. Subsequently, changes were made to the *Financial Administration Act* such that this regulation no longer applied to Hydro One following its initial public offering on the Toronto Stock Exchange in 2015. The government also required another wholly owned government business enterprise, Ontario Power Generation (OPG), to prepare its financial statements in accordance with U.S. GAAP. When the government chose to use U.S. GAAP to record the results of Hydro One and OPG in the Province's consolidated financial statements rather than International Financial Reporting Standards (IFRS), we examined the differences between IFRS and U.S. GAAP, and concluded these differences had no material effect on the Province's annual deficit. The government adopted IFRS for the purposes of recording the results of OPG and Hydro One in the Province's March 31, 2017, consolidated financial statements as required by Canadian PSAS.
- Ontario government regulations require transfers for capital acquisitions and transfers of tangible capital assets to be accounted by recipients as "deferred contributions." The deferred amounts are to be brought into revenue by transfer recipients at the same rate as they recognize amortization expense on the related assets. This prescribed accounting treatment is in accordance with PSAS.
- The 2012 Budget further amended the *Financial Administration Act* to provide the government with full authority to make regulations regarding the accounting policies and practices used to prepare its consolidated financial statements. This legislated provision was used in connection with the preparation of the 2015/16 consolidated financial statements. A time-limited regulation was passed requiring a full valuation allowance to be recorded for jointly sponsored pension plans, which was in accordance with Canadian PSAS, while in effect.
- Most recently, as noted in our Special Report titled *The Fair Hydro Plan: Concerns about Fiscal Transparency, Accountability and Value for Money*, we expressed concerns about the government legislating a complex accounting/financing structure to improperly avoid showing annual deficit and increases in net debt. The "legislated accounting" refers to the government creating a regulatory asset through legislation. This asset represents the difference between what electricity generators are owed and the lesser amount being collected from electricity ratepayers as a result of the electricity rate reduction. Without the legislated accounting, the difference would be recorded as an expense rather than as an asset in the Province's consolidated financial statements.

We have raised the issue of the risk of the government's potential use of legislated accounting treatment on a number of occasions in our previous annual reports. This year, it was used to support inappropriate accounting in the Province's consolidated financial statements. It is critical that Ontario continue to prepare its financial statements in accordance with generally accepted accounting standards, specifically those of Canadian PSAS, in order to maintain its financial reporting credibility, accountability and transparency.

If the government reports a deficit or surplus under legislated accounting standards that is materially different than what it would be using Canadian PSAS, the Auditor General is compelled to include a qualification in her audit opinion.

RECOMMENDATION 6

We recommend the government follow the accounting standards established by the Public Sector Accounting Board, rather than using legislation and regulations to prescribe accounting treatments.

TREASURY BOARD SECRETARIAT RESPONSE

Treasury Board Secretariat does not agree that it does not follow the accounting standards established by the Public Sector Accounting Board.

7.0 Ontario's Debt Burden

In previous annual reports, we have commented on Ontario's growing debt burden, attributable to its large deficits in recent years and its investments in capital assets such as infrastructure. We do so again this year.

In reporting on Ontario's debt burden, we have updated the government's publicly reported debt figures to be in accordance with Canadian PSAS for two issues: properly accounting for the net pension assets of the OTPP and the OPSEUPP, and accounting for the projected costs of the Fair Hydro Plan. Without these adjustments, the improper accounting treatment of these two items understates net debt and the accumulated deficit.

We noted that the Province has relied on historically low interest rates to keep its debt-servicing costs relatively stable, but the debt itself, whether measured as total debt, net debt or accumulated deficit, continues to grow. **Figure 2** shows that the Province's debt levels continue to rise. The three measures of debt are defined below:

- *Total debt* is the total amount of borrowed money the government owes to external parties. It consists of bonds issued in public capital markets, non-public debt, T-bills and U.S. commercial paper. Total debt provides the broadest measure of a government's debt load.
- *Net debt* is the difference between the government's total liabilities and its financial assets. Liabilities consist of all amounts the government owes to external parties, including total debt, accounts payable, pension and retirement obligations, and transfer-payment obligations. Financial assets are those that theoretically can be used to pay off liabilities or finance future operations, and include cash, accounts receivable, temporary investments and investments in government business enterprises. Net debt provides a measure of the amount of future revenues required to pay for past government transactions and events.
- *Accumulated deficit* represents the sum of all past annual deficits and surpluses of the government. It can also be derived by deducting the value of the government's non-financial assets, such as its tangible capital assets, from its net debt.

7.1 Main Contributors to Net Debt

The Province's growing net debt is attributable to its large deficits in previous years, along with its investments in capital assets such as buildings and other infrastructure and equipment acquired directly or through public-private partnerships for the government or its consolidated organizations, such as public hospitals, as illustrated in **Figure 3**.

Figure 2: Total Debt, Net Debt and Accumulated Deficit, 2011/12–2019/20

Sources of data: March 31, 2017, Province of Ontario Consolidated Financial Statements, 2017 Ontario Budget and Office of the Auditor General of Ontario

	Actual ($ million)						Estimate ($ million)		
	2011/12[1]	**2012/13[1]**	**2013/14[1]**	**2014/15[1]**	**2015/16[2]**	**2016/17[2]**	**2017/18[1]**	**2018/19[1]**	**2019/20[1]**
Total debt as reported by government	257,278	281,065	295,758	314,960	327,413	333,102	341,058	351,300	362,400
Increase for:									
Fair Hydro Plan[3]	–	–	–	–	–	–	2,500	5,000	7,500
Revised total debt per Office of the Auditor General	**257,278**	**281,065**	**295,758**	**314,960**	**327,413**	**333,102**	**343,558**	**356,300**	**369,900**
Net debt as reported by government	235,582	252,088	267,190	284,576	295,372	301,648	311,921	323,300	335,900
Increase for:									
Net pension asset adjustment[4]	–	–	–	9,154	10,985	12,429	14,472	16,841	19,590
Fair Hydro Plan[3]	–	–	–	–	–	–	2,500	5,000	7,500
Revised net debt per Office of the Auditor General	**235,582**	**252,088**	**267,190**	**293,730**	**306,357**	**314,077**	**328,893**	**345,141**	**362,990**
Accumulated deficit as reported by government	158,410	167,132	176,634	187,511	192,029	193,510	193,544	193,500	193,500
Increase for:									
Net pension asset adjustment[4]	–	–	–	9,154	10,985	12,429	14,472	16,841	19,590
Fair Hydro Plan[3]	–	–	–	–	–	–	2,500	5,000	7,500
Revised accumulated deficit per Office of the Auditor General	**158,410**	**167,132**	**176,634**	**196,665**	**203,014**	**205,939**	**210,516**	**215,341**	**220,590**

1. 2017 Ontario Budget.
2. March 31, 2017, Province of Ontario Consolidated Financial Statements.
3. Office of the Auditor General Special Report: *The Fair Hydro Plan: Concerns About Fiscal Transparency, Accountability and Value for Money.*
4. Assumed growth rate based on past growth rates.

Figure 3: Net Debt Growth Factors, 2010/11–2019/20 ($ million)

Sources of data: March 31, 2017, Province of Ontario Consolidated Financial Statements, 2017 Ontario Budget and Office of the Auditor General of Ontario

	Net Debt Beginning of Year	Deficit/ (Surplus)	Net Investment in Tangible Capital Assets[1]	Miscellaneous Adjustments[2]	Net Debt End of Year	Increase/ (Decrease)
Actual						
2010/11	193,589	14,011	7,306	(395)	214,511	20,922
2011/12	214,511	12,969	7,234	868	235,582	21,071
2012/13	235,582	9,220	7,784	(498)	252,088	16,506
2013/14	252,088	10,453	5,600	(951)	267,190	15,102
2014/15	267,190	10,315	6,509	9,716	293,730	26,540
2015/16	293,730	5,346	5,450	1,831	306,357	12,627
2016/17	306,357	2,435	4,795	490	314,077	7,720
Estimated						
2017/18	314,077	4,543	13,100	(2,827)	328,893	14,816
2018/19	328,893	4,869	15,400	(4,021)	345,141	16,249
2019/20	345,141	5,249	17,100	(4,500)	362,990	17,849
Total over 10 years	**—**	**79,409**	**90,278**	**(287)**	**—**	**169,401**

1. Includes investments in government-owned and broader-public-sector land, buildings, machinery and equipment, and infrastructure assets capitalized during the year less annual amortization and net gains reported on sale of government-owned and broader-public-sector tangible capital assets.
2. Unrealized Fair Value Losses/(Gains) on the Ontario Nuclear Funds Agreement (ONFA) Funds held by Ontario Power Generation Inc. and accounting changes. In 2014/15, a valuation allowance of $9.154 billion was correctly made to the net pension asset.

After properly accounting for the net pension assets of the OTPP and the OPSEUPP and the expected costs of the Fair Hydro Plan, the Province will continue to have annual deficits over the next three years, and net debt will continue to increase as the government borrows to finance its operations.

In fact, Ontario's net debt will have increased by 88% over a 10-year period, from $193.6 billion in 2010/11 to approximately $363.0 billion by 2019/20. We estimate total debt will almost total $370 billion by 2019/20.

To put this in perspective, the amount of net debt owed by each resident of Ontario on behalf of the government will increase from about $15,000 per person in 2010 to about $23,000 per person in 2020. In other words, it would cost every Ontarian $23,000 to eliminate the Province's net debt.

7.2 Ontario's Ratio of Net Debt to GDP

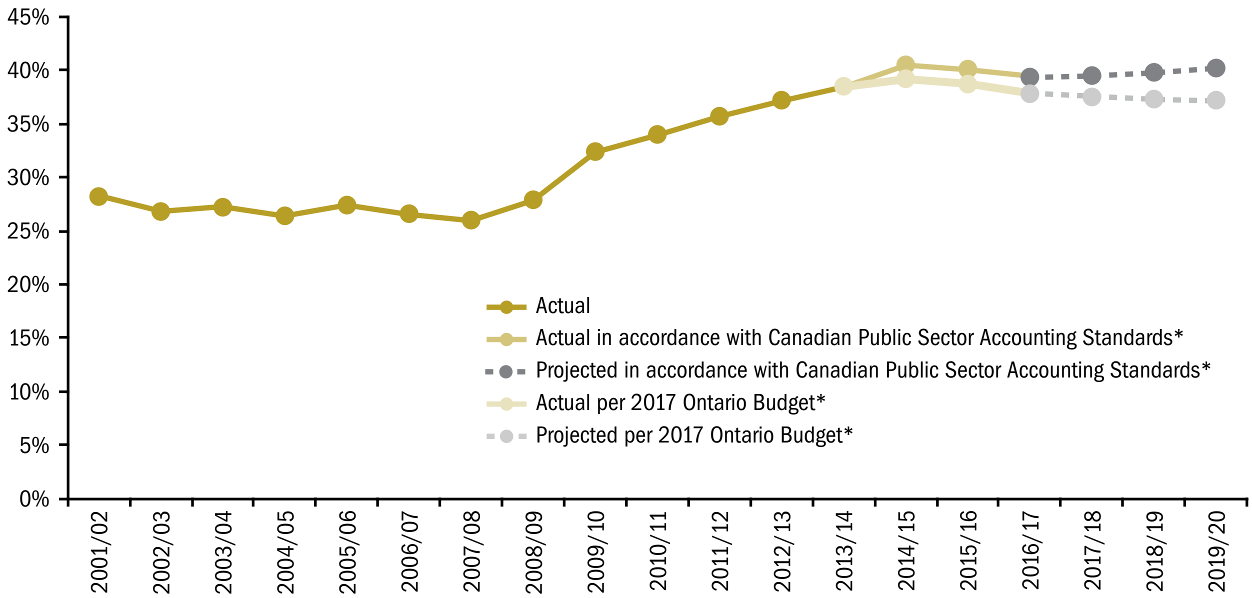
A key indicator of the government's ability to carry its debt is the level of debt relative to the size of the economy. The ratio of net debt to the market value of goods and services produced by an economy (the gross domestic product, or GDP) measures the relationship between a government's obligations and its capacity to raise the funds needed to meet them. It is an indicator of the burden of government debt on the economy.

If the amount of debt that must be repaid relative to the value of the GDP is rising—in other words, the ratio is rising—it means the government's net debt is growing faster than the provincial economy, and becoming an increasing burden.

Figure 4 shows that the Province's net-debt-to-GDP ratio gradually fell over a period of eight years, from a high of 29.3% in 2000/2001 to 26.0% in 2007/08. However, it has been trending upward since then, reflecting factors such as significantly

Figure 4: Ratio of Net Debt to Gross Domestic Product (GDP), 2001/02–2019/20

Source of data: March 31, 2016, and March 31, 2017, Province of Ontario Annual Reports—Financial Statement Discussion and Analysis, 2017 Ontario Budget, and 2017 Ontario Economic Outlook and Fiscal Review



* Beginning in 2014/15, the Office of the Auditor General has made an adjustment to the net pension asset in accordance with Canadian Public Sector Accounting Standards. This adjustment was not made in the government's presentation of the Province's consolidated financial statements.

increased borrowing to fund annual deficits and infrastructure spending. As well, there was the significant jump in the ratio in 2014/15 after properly accounting for the net pension assets of the OTPP and the OPSEUPP. Ontario's net-debt-to-GDP rose from approximately 26% prior to the 2008/09 recession to approximately 39.6% in 2016/17. We project Ontario's net debt will increase by $49 billion over the next three years to approximately $363 billion in 2019/20, resulting in the net-debt-to-GDP ratio rising to 40.0%. In contrast, the government's 2017 Fall Economic Statement projected a small decline in the net-debt-to-GDP ratio, to 37.0% by 2019/20, because that estimate does not reflect the net pension asset and Fair Hydro Plan adjustments.

We noted in our previous annual reports that many experts believe when a jurisdiction's net-debt-to-GDP ratio rises above 60%, that jurisdiction's fiscal health is at risk and is vulnerable to unexpected economic shocks. Of significance, the Financial Accountability Office in its report on the Long-term Budget Outlook 2017, released October 19, 2017, projected Ontario's net-debt-to-GDP ratio would rise to 63% by 2050/51, significantly above today's ratio of 39.6%.

We also noted it is somewhat of an oversimplification to rely on just one measure to assess a government's borrowing capacity, because that measure does not take into account Ontario's share of federal and municipal debts. If the Province's share of those debts was included in its indebtedness calculations, the net debt would be much higher. However, consistent with debt-measurement methodologies used by most jurisdictions, throughout our analysis we have focused only on the provincial government's direct net debt.

Figure 5 shows the net debt of Ontario compared to other provinces and the federal government, along with their respective ratios of net debt to GDP. Generally, the western provinces have a significantly lower net-debt-to-GDP ratio than Ontario and the Atlantic provinces, and Quebec has a significantly higher ratio than Ontario.

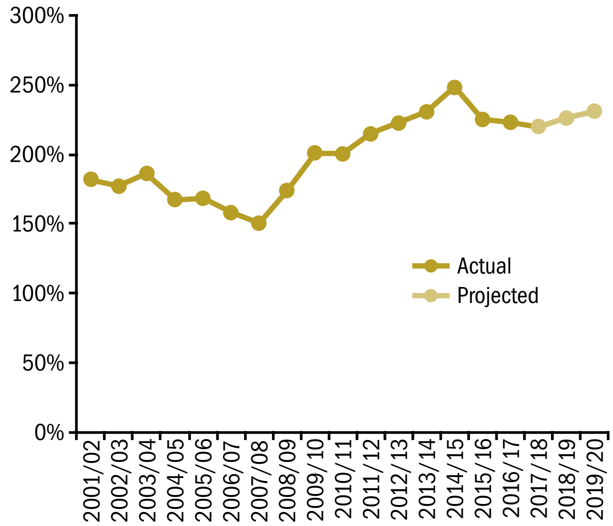
Figure 5: Net Debt and the Net-Debt-to-GDP Ratios of Canadian Jurisdictions, 2016/17

Sources of data: Province of Ontario Annual Report and Consolidated Financial Statements; Annual Reports and Consolidated Financial Statements of other provincial jurisdictions; Federal Budgets and budget updates; budgets of provincial jurisdictions; and the Office of the Auditor General of Ontario

	Net Debt ($ million)	Net Debt to GDP (%)
AB	8,901	2.9
SK	10,192	13.3
BC	37,795	14.4
Federal	631,899	31.2
MB	22,693	33.7
PEI	2,172	34.0
NS	14,955	36.4
ON	314,077	39.6
NB	13,827	41.1
NL	13,598	44.6
QC	185,214	47.2

Figure 6: Ratio of Net Debt as Percentage of Total Annual Revenue, 2001/02–2019/20

Sources of data: March 31, 2017, Province of Ontario Consolidated Financial Statements; 2017, 2016, 2015, 2009 and 2008 Ontario Budgets; 2017 Ontario Economic Outlook and Fiscal Review; and Office of the Auditor General of Ontario



Ontario's government committed to reducing net-debt-to-GDP ratio to its pre-recession level of 27% by 2029/30. However, the government's commitment does not take into account the overstatement of the pension assets of the OTPP and the OPSEUPP and the accounting for the projected costs of the Fair Hydro Plan.

7.3 Other Measures to Assess Government Debt Levels

7.3.1 Ratio of Net Debt to Total Annual Revenues

Another useful measure of government debt is the ratio of net debt to total annual revenues, an indicator of how much time it would take to eliminate the debt if the Province spent all of its revenues on nothing but debt repayment. For instance, a ratio of 250% indicates that it would take 2.5 years to eliminate the provincial debt if all revenues were devoted exclusively to it.

As shown in **Figure 6**, this ratio declined from about 183% in 2000/2001 to about 150% in 2007/08, reflecting the fact that the Province's net debt grew at a slower pace than annual provincial revenue. However, the ratio has increased steadily since 2007/08, and expected to reach 229.5% by 2019/20 before beginning to fall. This increasing ratio of net debt to total annual revenue indicates the Province's net debt has relatively less revenue to support the debt burden.

7.3.2 Ratio of Interest Expense to Revenue

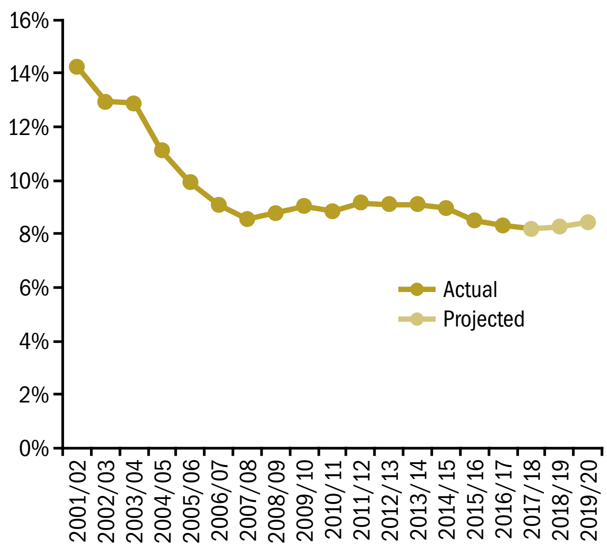
Increases in the cost of servicing total debt, or interest expense, can directly affect the quantity and quality of programs and services that government can provide; the higher the proportion of government revenues going to pay interest costs on past borrowings, the lower the proportion available for spending in other areas.

The interest-expense-to-revenue ratio illustrates the extent to which servicing past borrowings takes a greater or lesser share of total revenues.

As **Figure 7** shows, rates have been at historic lows since the beginning of this decade, and the actual interest-expense-to-total revenues ratio

Figure 7: Ratio of Interest Expense to Revenue, 2001/02–2019/20

Sources of data: March 31, 2017, Province of Ontario Consolidated Financial Statements; 2017, 2016, 2015, 2009 and 2008 Ontario Budgets; 2017 Ontario Economic Outlook and Fiscal Review; and Office of the Auditor General of Ontario



held steady at around 9.0% from 2010/11 to 2014/15. In 2016/17, the government consolidated the broader public sector on a line-by-line basis, which increased both interest expense and revenue reported in the Province's consolidated financial statements beginning in 2015/16. By including the broader public sector, the ratio has decreased to 8.5% in 2015/16. The ratio stood at 8.3% in 2016/17 and is projected to be 8.3% in 2019/20. This means approximately 8.3 cents of every dollar in revenue that the government collects will go toward paying interest on debt by 2019/20.

The Province's debt also exposes it to further risks, the most significant being interest-rate risk. As noted above, interest rates are currently at record low levels, enabling the government to keep its annual interest expense relatively steady even as its total borrowing has increased significantly. However, interest rates began to rise this year and there is an increasing risk that the government will have considerably less flexibility to provide public services such as health care and education, because a higher proportion of its revenues will be required to pay interest on the Province's outstanding debt.

As was noted in last year's annual report, the government has mitigated its interest-rate risk to some extent by increasing the weighted average term of its annual borrowings in order to take advantage of the current low rates. However, the Bank of Canada raised its key lending rate twice in 2017. When the government refinances debt at a higher interest rate than the rate paid on the maturing debt, then the average interest expense on the government's debt will go up. This means more money will go towards interest expense and therefore will increase the annual deficit.

The ratio of interest-expense-to-revenue is expected to continue to increase in the near future as more interest will be paid on the accumulation of debt issued to fund the Fair Hydro Plan transactions, indicating the government will have less flexibility to respond to changing economic circumstances. Past governments' borrowing and debt-servicing decisions mean a growing portion of revenues will not be available for other current and future government programs.

7.4 Consequences of High Indebtedness

Our commentary last year highlighted the consequences for the Province of carrying a large debt load—and the same observations continue to be relevant this year. They include the following:

Debt-servicing costs cut into funding for other programs: As debt grows, so do interest costs. As interest costs consume a greater proportion of government resources, there is less to spend on other things. To put this "crowding-out" effect into perspective, the government currently spends more on debt interest than on post-secondary education.

Greater vulnerability to interest-rate increases: Ontario has been able to keep its annual interest expense relatively steady, even as its total borrowing has increased significantly. For example, it was paying an average effective interest rate of about 8.4% in 1999/2000, but that dropped to 3.5% in 2016/17. However, if interest rates start to rise again, the government will have considerably less flexibility to provide public services as it will have to devote a higher proportion of its revenue to interest payments.

Potential credit-rating downgrades could lead to higher borrowing costs: Prepared by specialized agencies, credit ratings assess a government's creditworthiness largely based on its capacity to generate revenue to service its debt. They consider such factors as a government's economic resources and prospects, industrial and institutional strengths, financial health, and susceptibility to major risks. A credit rating affects the cost of future government borrowing, with a lower rating indicating that an agency believes there is a relatively higher risk that a government will default on its debt. Accordingly, investors will lend to that government only in return for a greater risk premium, in the form of higher interest rates. A rating downgrade could also shrink the potential market for a government's debt, because some investors will not hold debt below a certain rating.

7.5 Final Thoughts on Ontario's Debt Burden

We recognize that, ultimately, decisions about how much debt the Province should carry, and the strategies to pay down that debt, are questions of government policy. However, as we observed last year, this should not prevent the government from providing information to promote a greater understanding of the issue and clarify the choices it makes around provincial debt.

We noted that government debt has been described as a burden on future generations, especially debt used to finance operating deficits (debt used to finance infrastructure is more likely to leave behind tangible capital assets that benefit future generations). In the 2017 Budget, the government set an interim net debt-to-GDP ratio target of 35% by 2023/24, and restated its commitment to reduce the net debt-to-GDP ratio to its pre-recession level of 27% by 2029/30. Meeting its 2029/30 commitment is based on the three key assumptions:

- ongoing balanced budgets, on average, over the next 12 years;
- future capital spending as laid out in the long-term infrastructure plan; and
- the continuation of strong economic growth.

The Financial Accountability Office of Ontario's September 6, 2017, Commentary, titled *Ontario's Debt Reduction Based on Unlikely Assumption*, noted that "if any of these relatively optimistic assumptions fall short of expectations, the government's 27% net debt-to-GDP target would not be achieved." The commitment does not take into account the effects of the proper accounting treatment of the OTPP and the OPSEUPP assets and accounting for the costs of the Fair Hydro Plan. If the government were to account for these items as recommended by our Office, balanced budgets are unlikely over the next few years, and the fulfilment of the government's net-debt-to-GDP reduction commitment is even more unlikely.

We offer one final observation: despite the government's commitment to reduce the net debt-to-GDP ratio, there is as yet no discussion around the repayment of debt.

RECOMMENDATION 7

We recommend that in order to address the Province's growing total debt burden, the government work toward the development of a long-term total-debt reduction plan linked to its target of reducing the net debt-to-GDP ratio to its pre-recession level of 27% as measured using proper accounting for net pension assets and the projected costs of the Fair Hydro Plan. The government should also discuss publicly how it plans to pay down the debt.

MINISTRY OF FINANCE RESPONSE

The 2017 Budget and the 2017 Fall Economic Statement stated that the government continues to maintain a target of reducing the net debt-to-GDP ratio to its pre-recession level of 27%, currently projected for 2029/30, together with an interim target of 35% by 2023/24. From 2017/18 onwards, the balanced budget environment will limit increases in debt to the difference between annual investments in infrastructure improvements and the amortization of such investments.

The government's long-term infrastructure plan to invest about $190 billion over 13 years, starting in 2014/15, will contribute to the growth of the economy. The Centre for Spatial Economics found that for every $1 spent on public infrastructure, GDP increases by $6, on average, in the long term.

Therefore, while overall debt will rise to fund these infrastructure investments, measurements of relative debt such as the net debt-to-GDP ratio, a recommended indicator by the Public Sector Accounting Board, will gradually diminish due to the Province's GDP increasing at a faster rate than net debt. This will allow the Government to continue to move towards its 27% net debt-to-GDP target.

8.0 Other Significant Accounting and Audit Issues

8.1 Earlier Finalization of the Province's Consolidated Financial Statements

Historically, the Public Accounts have been released in either late August or September of each year. However, the government has indicated it would like to have an earlier release date for the Public Accounts in the future. We support a more timely publication of the Province's financial results. However, our ability to support this initiative depends on the Province's ability to provide us with sufficient and appropriate audit evidence such that we can assess the reasonability of the consolidated financial statements.

Canadian PSAS recognize that there is often a trade-off between the timeliness of producing financial statements to provide relevant information, and the reliability of the information reported in the financial statements. A significant change to the timing of the release of Public Accounts requires management to set the groundwork and apply sufficient resources for it to succeed in ensuring that appropriate schedules and other documentation are available for audit. An earlier preparation and audit timeline requires co-ordination between the preparer and auditor of the financial statements.

For example, the need for reasonable corporations tax and personal income tax estimates at an earlier date is an audit concern that the Province will need to address in order for our audit opinion to be issued sooner. Corporations tax and personal income tax revenues combined make up approximately 50% of the Province's total tax revenues, and 33% of total revenues. Both corporations tax and personal income tax revenues are based on, among other factors, an estimate of current-year tax assessments. These estimates are based on tax-filing data provided by the federal government to the Province. This data has historically not been available before July. Without this data, there is a significant challenge to accurately estimating (and auditing) corporations tax and personal income tax revenue. The Ministry of Finance needs an alternative to the current tax revenue estimation process it uses in order to prepare the Province's consolidated financial statements earlier in the year.

RECOMMENDATION 8

We recommend that the Office of the Provincial Controller undertake thorough planning involving all stakeholders, including Treasury Board Secretariat, ministries and provincial government agencies, to identify the barriers and key areas to be addressed to achieve earlier finalization of the Province's consolidated financial statements, including the estimation risks associated with corporations tax and personal income tax revenues.

TREASURY BOARD SECRETARIAT RESPONSE

Treasury Board Secretariat and the Ministry of Finance are supportive of the timely delivery of the Public Accounts.

The Office of the Provincial Controller will work closely with the Office of the Auditor General to identify audit issues early and to ensure that stakeholders are engaged in discussions regarding risks and resolution. The Office of the Provincial Controller will collaborate with the Office of the Auditor General to support the timely delivery of the Public Accounts.

The Province will work with the Canada Revenue Agency on this recommendation, as reporting Personal and Corporate taxation revenues is highly dependent on information it provides.

8.2 The Restatements in the 2016/17 Consolidated Financial Statements

8.2.1 Introduction

In preparing the Province's 2016/17 consolidated financial statements, the government also restated the prior year comparative figures for 2015/16. Financial restatements can result from a number of factors such as the retroactive application of a new accounting standard, correction of an error due to a misapplied accounting policy, or a reclassification of comparative figures to conform to the current year presentation. Note 16 to the Province's 2016/17 consolidated financial statements describe the four areas impacted by the restatements.

Restatements of previously issued financial statements typically occur for the preparation of financial statements that give a true and fair view in accordance with the financial reporting framework. However, in the Province's 2016/17 consolidated financial statements, the government made a number of restatements that further departed from Canadian PSAS. We found that the magnitude of the misstatements and the departures from the standards established by the Public Sector Accounting Board could influence decisions made by the users of the Province's consolidated financial statements, and this led to the qualified audit opinion on the 2016/17 consolidated financial statements.

8.2.2 Accounting for Net Pension Assets of Jointly Sponsored Pension Plans

In the previously issued 2015/16 consolidated financial statements, the government had correctly recorded an adjustment to recognize a valuation allowance against the pension asset it had recorded for the Ontario Teachers' Pension Plan (OTPP) and the Ontario Public Service Employees' Union Pension Plan (OPSEUPP). We agreed with this accounting treatment as the government has neither unilateral control, nor access to the surplus assets of these jointly sponsored pension plans until an agreement is in place with the joint sponsor to allow the government to unilaterally reduce minimum contributions or withdraw plan surpluses. To date, no such agreement exists.

However, the government did not record the same adjustment in the 2014/15 comparative figures on the 2015/16 financial statements, and this led to the qualified audit opinion on the Province's March 31, 2016, consolidated financial statements. In addition to the magnitude of the financial impact, we were concerned that by not restating the 2014/15 comparative figures, the government demonstrated a lack of transparency on the nature of the adjustment of the pension assets as a correction of an error in prior periods.

Subsequent to the publication of the 2015/16 Public Accounts, the government decided to change its accounting policy and recognize pension assets in the Province's 2016/17 consolidated financial statements without properly reducing them by way of a full valuation allowance. The valuation allowance that had been recorded to reduce pension assets in 2015/16 was reversed, resulting in the 2015/16 comparative pension assets balances being restated for the 2016/17 consolidated financial statements. The originally published 2015/16 amounts were correct. The change made resulted in a significant error to the restated 2015/16 comparative figures.

An essential characteristic of an asset, as defined by Canadian PSAS, is that the government must have unilateral control to access the pension assets. It does not have this control. Therefore, a net pension asset related to the OTPP and the OPSEUPP should not be reported in the Province's consolidated financial statements. **Section 3.6.1** in this chapter discusses the accounting in more detail and our recommendations on the proper accounting treatment of the OTPP and the OPSEUPP pension assets in the Province's consolidated financial statements in accordance with PSAS.

8.2.3 Consolidation of the Broader Public Sector, Accounting for Ontario Power Generation and Hydro One

The consolidated financial statements include the financial results of all the ministries and organizations controlled by the government. Whether a government controls an organization from an accounting perspective is a question of judgment that must be determined by reference to the definition established by the Canadian PSAS. Schedule 8 of the consolidated financial statements lists the government business enterprises (GBEs), other government organizations (OGOs) and broader public sector (BPS) organizations controlled by the Province and included in the consolidated financial statements.

Canadian PSAS established two accounting methods for recording the results of the organizations that form part of the government reporting entity in the Province's consolidated financial statements, depending on the nature of an organization. This section discusses the broader public sector, Ontario Power Generation and Hydro One, and in particular, the conditions that resulted in the revised presentation.

Broader Public Sector Properly Consolidated on a Line-by-Line Basis

The Broader Public Sector (BPS) organizations include hospitals, school boards and colleges. Prior to 2016/17, the assets and liabilities of the BPS organizations were consolidated with those of the Province on a line-by-line basis on the consolidated statement of financial position. However, the Province did not apply the same line-by-line consolidation method to the consolidated statement of operations. Instead, the revenues and expenses of the BPS sector were netted against the respective sectors' expenses (for example, Health, Education, etc.).

In the past, we have communicated that in order to comply with Canadian PSAS, all the accounts of the BPS organizations are required to be consolidated on a line-by-line basis.

We noted that the Province decided to fully apply the line-by-line consolidation of the BPS organizations in the Province's 2016/17 consolidated financial statements. As a result of this change, both the 2015/16 comparative period figures and the 2016/17 Budget amounts were appropriately restated.

Proper Recording of OPG and Hydro One's Financial Results Using IFRS

Canadian PSAS include guidelines that define the nature of a government business enterprise (GBE). Fundamentally, a GBE has autonomy and business-oriented objectives. In the normal course of its operations, a GBE should be able to maintain its operations, meet its liabilities and repay its gross debt from revenues received from sources outside of the government reporting entity. GBEs are consolidated under Canadian PSAS using the modified equity approach, and this method reflects the nature of the independently-managed business enterprise.

Both OPG and Hydro One are deemed to be GBEs. Given that a GBE carries on a business, Canadian PSAS prescribe that GBE financial statements should be prepared on the same basis as the private sector, which is International Financial Reporting Standards (IFRS). In accordance with Canadian PSAS, the financial results of OPG and Hydro One, should be reflected in the Province's consolidated financial statements based on IFRS.

We have commented in the past that the Ontario government chose to use U.S. generally accepted accounting standards (which is not accepted for consolidation in a government's financial statements prepared using Canadian PSAS) and not IFRS as the basis for recording the financial results of OPG and Hydro One. In **Chapter 2** of our *2016 Annual Report*, we indicated that we anticipated that differences between the U.S. generally accepted accounting standards and IFRS could become material in the future. We recommended then that the Province include the financial results for OPG and Hydro One in the Province's consolidated financial statements determined based on the IFRS framework. We noted that the Province decided to change its accounting policy to comply with Canadian PSAS and record the financial results of Ontario Power Generation and Hydro One using IFRS in the Province's 2016/17 consolidated financial statements.

8.2.4 Improper Recognition of Market Accounts

In the 2016/17 consolidated financial statements, the Province changed its accounting policies to recognize market accounts and rate-regulated assets, which also resulted in the restatement of the Province's 2015/16 comparative financial results.

The market accounts principally track buy and sell transactions between electricity power generators and power distributors. As we outlined in **Section 3.6.2** of this chapter, we disagree with the restatement to record the market accounts on a gross basis, because the government has no access or discretion to use the market account assets for their own benefit; nor does it have an obligation to settle the market account liabilities in the event of default by market participants. The nature of the market accounts do not meet the characteristics of an asset or liability established by Canadian PSAS and the recognition of these accounts on the consolidated financial statements is a basis for the qualified audit opinion.

8.2.5 Inappropriate Recording of Impact of Rate-Regulated Accounting

In the Province's 2016/17 consolidated financial statements, the Province recognized the rate-regulated assets from an "other government organization," the Independent Electric System Operator (IESO), in its consolidated financial statements, and restated the 2015/16 comparative amounts for this accounting change. We disagree with this restatement. As we outline in **Section 3.7** of this chapter, although it is not specifically stated in the Canadian PSAS, rate-regulated accounting is not permitted for use in financial statements prepared under Canadian PSAS (except for GBEs that report using the IFRS Framework that are included in a government's consolidated financial statements).

8.3 The Affordability Fund Trust

The timing as to when expenses are recorded in the Province's consolidated financial statements is important, and the criteria used to determine when these amounts should be recognized is based on Canadian PSAS.

The Province of Ontario consolidates into its financial statements the financial results of over 300 organizations controlled by the Province. The amounts reflected in the Province's consolidated financial statements for the activities of a controlled organization are net of inter-organizational balances and transactions. This means, for example, that if a ministry transfers funds to an organization that the government controls, the ministry records an expense (decrease in economic resources) while the organization records a revenue (gain in economic resources). These amounts cancel out on consolidation such that no net revenue or expense is recognized in the consolidated financial statements because the Province, as a whole, has not experienced a change in its overall level of economic resources.

In contrast, if funds are transferred to a non-controlled entity (i.e., independent, third-party) an expense is then recorded in the consolidated financial statements (assuming the eligibility criteria attached to the funds were met by the non-controlled entity).

On March 23, 2017, the Province established an arm's-length trust, the Affordability Fund Trust (Affordability Fund), in consultation with Hydro One and in conjunction with all other Local Distribution Companies (LDCs), as part of the Fair Hydro Plan. The Affordability Fund was formed to provide direct funding to individual electricity customers in need to reduce their future electricity bills up to December 31, 2019. On the same day, the Province transferred $100 million to the Affordability Fund and recognized this expense in full in the Province's 2016/17 consolidated financial statements.

If the Affordability Fund were determined to be controlled by the Province, the expense would have only been able to be recognized when the actual funds were provided to the specific beneficiaries (that is, the individual electricity customers under Canadian PSAS). As at March 31, 2017, there were no transfers made to beneficiaries. However, the Affordability Fund was set up as an arm's length trust in order to not to be controlled by the Province, and therefore able to record the expense of $100 million in the Province's 2016/17 consolidated financial statements.

In order to record the expense, the government accepted the trade-off of then giving up control over the spending of $100 million provided to the Affordability Fund.

Although we acknowledge that accounting for such transfers of funds to non-controlled trusts is an acceptable way under Canadian PSAS to enable the recording of an expense before money is spent, the government has given up control over the management of these funds before funds are provided to the intended beneficiaries. In the case of the Affordability Fund, it may be years before funds are fully distributed to intended grant recipients.

RECOMMENDATION 9

We recommend that the government avoid establishing arm's length trusts in order to record an expense in its consolidated financial statements before it is necessary, given that it loses the ability to ensure that funds are ultimately provided to the appropriate beneficiaries.

TREASURY BOARD SECRETARIAT RESPONSE

The response received from the Treasury Board Secretariat did not address the recommendation.

9.0 Auditor General Review of the 2018 Pre-Election Report on Ontario's Finances

One of the most significant initiatives to improve the transparency of government financial reporting is the requirement that the government release a report on Ontario's finances in advance of a provincial election.

The *Fiscal Transparency and Accountability Act, 2004* (Act) states, among other things, that in such circumstances as may be prescribed by regulation, the Ministry of Finance shall release a report on Ontario's finances and shall do so before the deadline established by regulation. The purpose of this report is to provide the public with detailed information to enhance its understanding of the Province's estimated future revenues, expenses, and projected surplus or deficit for the next three fiscal years. Ontario election law says the next provincial general election will be held on June 7, 2018.

As required by the Act, the government's Pre-Election Report will provide information on:

- the macroeconomic forecasts and assumptions used to prepare the government's fiscal plan;
- Ontario's estimated revenues and expenses, including estimates of the major components of the revenues and expenses;
- details of the budget reserve; and,
- the ratio of provincial debt to Ontario's gross domestic product.

As required under the Act, the Auditor General must review the report to determine whether it is reasonable, and release an independent report describing the results of her review. Two things must occur before this review can take place:

- The government must prepare a Pre-Election Report covering a defined period of time.
- As per the Act, in such circumstances as may be prescribed by regulation, the Ministry of Finance shall release a report on Ontario's finances and shall do so before the deadline established by regulation.

As of November 7, 2017, a regulation prescribed by Lieutenant Governor in Council has not yet been issued. This regulation is important because it provides our Office with information on when the pre-election report will be available to us for review. The sooner our Office is made aware of the form and timing of issuance of the pre-election report, the better our ability to complete a review prior to the pre-election report deadline.

The Act was created when the fixed general election date was set for the fall of every fourth year. As such, pre-election reports issued by the Ministry of Finance used the budgeted revenue and expense estimates contained within the spring budget of the election year. Now, with the change of the fixed general election date to June of every fourth year, if the pre-election report is based on the same spring budget, this could pose time constraints for us to complete our work.

If the government establishes a regulation under subsection 10(1) of the Act to release a Pre-Election Report, and if the Minister does not release information required by this Act on or before the deadline it sets in a regulation, the Minister shall release a statement on or before that deadline to explain why the required information was not so released.

We will work closely with the Ministry of Finance and Treasury Board Secretariat in order to allow us to complete the review and issue our report in sufficient time in advance of the June 7, 2018, general election.

RECOMMENDATION 10

We recommend that the government publicly communicate if and when it will file a regulation as outlined under subsection 10(1) of the *Fiscal Transparency and Accountability Act, 2004* confirming that the government will release a Pre-Election Report and the timelines for release of the Report that will be subject to our review under the Act.

TREASURY BOARD SECRETARIAT RESPONSE

Under the *Fiscal Transparency and Accountability Act, 2004*, the government may file a regulation that would require it to release a Pre-Election Report on Ontario's Finances. Should the government file such a regulation, the Auditor General would be required to issue a Statement based on a review following the release of such a Pre-Election Report.

The government remains committed to meeting the legislative requirements of the Act and working constructively with the Office of the Auditor General.

OFFICE OF THE AUDITOR GENERAL RESPONSE

Our concern at the time we went to print with our *2017 Annual Report* was that we may be put in a situation where the government does not allow us sufficient time, as required by Canadian generally accepted auditing standards, to perform the work required to issue a statement on the results of our review of the Pre-Election Report.

10.0 Update on WSIB

The Workplace Safety and Insurance Board (WSIB) is a statutory corporation created by the *Workplace Safety and Insurance Act, 1997* (Act). Its primary purpose is to provide income support and medical assistance to workers injured on the job. The WSIB receives no funding from government; it is financed through premiums on employer payrolls.

Our *2009 Annual Report* discussed the risk that the growth and magnitude of the unfunded liability (the difference between the value of the WSIB's assets and its estimated financial obligations to pay benefits to injured workers) at that time posed to the WSIB's financial viability, including the ultimate risk of the WSIB being unable to meet its existing and future commitments to provide worker benefits.

At the time, we also urged the government to reconsider the exclusion of the WSIB's financial results from the Province's consolidated financial statements, particularly if there were any risks that the Province might have to provide funding to ensure the WSIB remained viable. The government excludes WSIB's financial results because it is classified as a "trust." However, given the WSIB's significant unfunded liability and various other factors, we questioned whether the WSIB operates like a true trust. Including the WSIB in the government's consolidated financial statements would have a significant impact on the government's fiscal performance.

As of June 30, 2010, the WSIB's unfunded liability had grown to almost $13 billion. In September 2010, the WSIB announced an independent funding review to obtain advice on how to best ensure the long-term financial viability of Ontario's workplace safety and insurance system. The May 2012 report contained a number of recommendations, in particular calling for a new funding strategy for the WSIB with the following key elements:

- realistic assumptions, including a discount rate based on the best actuarial advice;
- moving the WSIB as quickly as feasible beyond a "tipping point" of a 60% funding Sufficiency Ratio (a tipping point is a crisis in which the WSIB could not generate sufficient funds to pay workers' benefits within a reasonable time frame and by reasonable measures); and
- putting the WSIB on course to achieve a 90%–110% funding Sufficiency Ratio within 20 years.

In response to our concerns and to the recommendations of the report, the government passed Regulation 141/12 under the Act in June 2012. Effective January 1, 2013, it required the WSIB to ensure it meets the following funding Sufficiency Ratios by specified dates:

- 60% on or before December 31, 2017;
- 80% on or before December 31, 2022; and
- 100% on or before December 31, 2027.

The government also passed Ontario Regulation 338/13 in 2013. It came into force January 1, 2014, and changed the way the WSIB calculates the funding Sufficiency Ratio by changing the method used to value its assets and liabilities. Our Office concurred with this amendment.

The WSIB issues quarterly Sufficiency Reports and an audited Sufficiency Report to stakeholders annually. As of December 31, 2016, under Regulation 141/12 as amended by Regulation 338/13, the WSIB reported a Sufficiency Ratio of 87.4% (in 2015, the Sufficiency Ratio was 77.9%). This means the WSIB has already achieved its December 31, 2022 funding requirement.

The WSIB now incorporates its annual update of the Sufficiency Plan within the economic statement, in which it describes the measures taken to improve its funding Sufficiency Ratio. The most recent plan was announced at WSIB's Annual General Meeting held on September 20, 2017, and is also available on the WSIB website.

The WSIB's operational and financial performance was strong in 2016, as illustrated in **Figure 8**, which provides a summary of the WSIB's operating results and unfunded liability compared to 2015.

Figure 8: Workplace Safety and Insurance Board Operating Results and Unfunded Liability, 2016 and 2015
Source of data: WSIB Financial Statements

	2016 ($ million)	2015 ($ million)
Revenue		
Premiums	4,862	4,684
Net investment income	1,497	1,199
	6,359	**5,883**
Expenses		
Benefit costs	2,747	3,760
Loss of Retirement Income Fund contributions	56	56
Administration and other expenses	431	406
Legislated obligations and commitments	244	263
Remeasurement of employee defined benefit plans	35	(45)
	3,513	**4,440**
Total Comprehensive Income	**2,846**	**1,443**
Less: Non-Controlling Interests	(172)	(152)
Total Comprehensive Income Attributable to WSIB Stakeholders	**2,674**	**1,291**
Unfunded Liability	**3,925**	**6,599**

The WSIB's continued strong operating performance in 2016 resulted from growth in premium revenues, improved return-to-work outcomes and better-than-expected investment returns (6.3% versus the target of 5.25%).

As a result of commitments by the government and the WSIB to address the unfunded liability and the progress the WSIB has made so far, we support the continued classification of the WSIB as a trust for the 2016/17 fiscal year and, therefore, the exclusion of the unfunded liability from the Province's liabilities.

11.0 Ongoing Accounting Standards Matters

Canadian PSAS are the most appropriate for the Province to use in preparing its consolidated financial statements. This ensures that information provided by the government about its surplus or the deficit is fair, consistent and comparable to data from previous years, allowing legislators and the public to assess the government's management of the public purse. It is worth noting that Ontario's provincial budget is also prepared on the same basis as its consolidated financial statements.

However, the Public Sector Accounting Board (PSAB) faces challenges in reaching a consensus among its various stakeholders, including financial statement preparers and auditors, during the development and update of standards for the public sector.

We discuss two significant accounting issues: Financial Instruments and Rate-Regulated Accounting in government business enterprises that have posed a significant challenge to PSAB over the past few years. Their final accounting-standard determination may affect the way the Province accounts for these items, and may have a significant impact on the Province's reported financial results.

11.1 Financial Instruments

Financial instruments include provincial debt and derivatives such as currency swaps and foreign-exchange forward contracts. PSAB's project to develop a new standard for reporting financial instruments began in 2005, with a key issue being whether changes in the fair value of derivative contracts held by governments should be reflected in their financial statements and, in particular, whether such changes should affect a government's annual surplus or deficit.

In March 2011, PSAB approved a new public-sector accounting standard on financial instruments, effective for fiscal periods beginning on or after April 1, 2015. The new standard provides guidance on the treatment of government financial instruments, and is similar to comparable private-sector standards.

One of its main requirements is for certain financial instruments, including derivatives, to be recorded at fair value, with any unrealized gains or losses on these instruments recorded annually in a new financial statement of re-measurement of gains and losses.

Some Canadian jurisdiction preparers, including Ontario, do not support the introduction of these fair-value re-measurements and the recognition of unrealized gains and losses. Ontario's view is that it uses derivatives solely to manage foreign currency and interest-rate risks related to its long-term-debt holdings, and that it has both the intention and ability to hold these derivatives until the debts associated with them mature.

Accordingly, re-measurement gains and losses on the derivatives and their underlying debt would offset each other over the total period that such derivatives are held, and therefore would have no real economic impact on the government.

The government argues that recording paper gains and losses each year would force the Province to inappropriately report the very volatility that the derivatives were acquired to avoid. This, in its view, would not reflect the economic substance of government financing transactions and would not provide the public with transparent information on government finances.

In response to governments' concerns, PSAB committed to reviewing the new financial instruments standard by December 2013. PSAB completed its review of *Section PS 2601, Foreign Currency Translation*, and *Section PS 3450, Financial Instruments*, and in February 2014 confirmed the soundness of the principles underlying the new standard.

PSAB deferred the effective date for these new standards to fiscal years beginning on or after April 1, 2016. In 2015, however, PSAB further extended the effective date for the new standard to April 1, 2019, for senior governments, to allow further study of reporting options for these complex financial instruments.

Since February 2016, staff with PSAB have been consulting with the government and not-for-profit stakeholders on implementation issues of the financial instruments standard. The senior government community has communicated the need for a hedge accounting option during these consultations. PSAB noted that its staff, in collaboration with stakeholders, has identified certain timing issues in the new financial-instruments standard that may impact a government's annual surplus or deficit in a manner that is unrepresentative of the underlying transactions. PSAB observed that the International Public Sector Accounting Standards Board (IPSASB) has released a Financial Instruments Exposure Draft that builds upon the private sector's best practices in accounting for financial instruments under International Financial Reporting Standards. PSAB has been following the work of IPSASB whose proposed financial instrument standard includes a hedging option. PSAB noted it is considering using this standard. PSAB also noted some stakeholders expressed concerns about the volatility of net debt of governments on recording derivative instruments at fair value. PSAB noted that while this matter is not within the scope of investigating the hedge accounting option, if PSAB's stakeholders are in favour of the IPSASB proposal, PSAB would consider the implications for net debt in finalizing the hedge accounting requirements.

We continue to recommend ongoing dialogue between our Office and the Office of the Provincial Controller to review areas of common concern as the PSAB reassesses the standard in preparation for implementing it on April 1, 2019.

11.2 Rate-Regulated Accounting

Rate-regulated accounting was developed to recognize the unique nature of entities, such as electric utilities, whose rates are regulated by an independent regulator in most regulatory frameworks. In general, it allows the deferral of revenue and expenses to future years. The regulator often allows the entity to recover certain current-year costs from the ratepayer in future years, and these deferred costs are typically set up under rate-regulated accounting as assets on the entity's statement of financial position. Under normal accounting principles, these costs would be expensed in the year incurred. We have concerns about the appropriateness of recognizing rate-regulated assets and liabilities, including those of government business enterprises in the Province's consolidated financial statements. However, the absence of rate-regulated accounting would have considerable impact on those entities that have followed it for many years where it is still permitted under Canadian PSAS.

Rate-regulated accounting is used by two of the Province's government-controlled business enterprises, Ontario Power Generation (OPG) and Hydro One whose rates to customers are approved by the Ontario Energy Board, a government-established regulator. Rate-regulated accounting treatment is currently allowable under Canadian generally accepted accounting principles for government business enterprises. Rate-regulated accounting provisions outline the need for an independent, third-party regulator to set rates. We note that since the Ontario government controls both the regulator and the major regulated entities, it has significant influence on which costs Hydro One and OPG will recognize in a given year. This could ultimately affect both electricity rates and the annual deficit or surplus reported by the government.

In our previous annual reports, we outlined that the era of rate-regulated accounting appeared to be ending for jurisdictions like Canada as they were converting to International Financial Reporting Standards (IFRS), developed by the International Accounting Standards Board (IASB), in 2012. Our comments were based on the fact that in January 2012 Canada's Accounting Standards Board (AcSB) reaffirmed that all government business enterprises should prepare their financial statements in accordance with IFRS for fiscal years beginning on or after January 1, 2012. At that time, IFRS standards did not include accounting provisions that addressed rate-regulated activities and so, by default, IFRS standards did not permit rate-regulated accounting.

However, the rate-regulated accounting landscape has continued to evolve since then. Efforts to harmonize U.S. generally accepted accounting policies (U.S. GAAP) and IFRS were in place as Canada converted to IFRS in 2012. At that time, U.S. GAAP allowed for, and continues to allow for, rate-regulated accounting. The appropriateness of rate-regulated accounting has been discussed as part of the efforts to harmonize U.S. GAAP and IFRS. As these discussions were taking place, Canada's AcSB granted a one-year extension in March 2012 to the mandatory IFRS changeover date for entities with qualifying rate-regulated activities. Multiple one-year extensions to defer adoption of IFRS by these entities followed over the next few years.

An interim IFRS standard was issued in January 2014 in an attempt to ease the adoption of IFRS for rate-regulated entities by allowing them to continue to apply existing policies for their deferred rate-regulated balances upon adoption of IFRS starting on January 1, 2015. Essentially, the interim standard provides a first-time adopter of IFRS with relief from having to de-recognize their rate-regulated assets and liabilities until the comprehensive review on accounting for such assets and liabilities is completed by the IASB. The result of this review and the determination of whether rate-regulated accounting will be allowed, for example, in government business enterprises on an ongoing basis as opposed to an interim basis, is uncertain at this time.

In 2017, the Auditor General of British Columbia qualified the Province of British Columbia's consolidated financial statements because the government has directly impacted the setting of electricity rates by not allowing BC Hydro to recover its costs of service. The Office of the Auditor General of British Columbia's September 2017 report titled *Understanding Our Audit Opinion on BC's 2016/17 Financial Statements* states: "Even though B.C. has an independent third-party regulator, government has issued a number of directions that the regulator must follow in the rate setting process. In effect, because government brings the accounting results of BC Hydro into its Summary Financial Statements (SFS), government's directions are impacting its own bottom line."

We will continue to monitor developments impacting the use of rate-regulated accounting in government business enterprises going forward to assess its impact on Ontario's consolidated financial statements.

12.0 Public Sector Accounting Board Initiatives

This section outlines some additional items that PSAB has been studying over the past year that might affect the preparation of the Province's consolidated financial statements in the future.

12.1 Concepts Underlying Financial Performance

PSAB's existing conceptual framework is a set of interrelated objectives and fundamental principles that support the development of consistent accounting standards. Its purpose is to instill discipline into the standard-setting process to ensure that accounting standards are developed in an objective, credible and consistent manner that serves the public interest.

In 2011, PSAB formed the Conceptual Framework Task Force in response to concerns raised by several governments regarding current and proposed standards which they contend cause volatility in reported results and distort budget-to-actual comparisons. The task force's objective was to review the appropriateness of the concepts and principles in the existing conceptual framework for the public sector.

The task force's first step was to seek input from stakeholders on the building blocks of the conceptual framework; these will form the basis for evaluating the existing concepts underlying the measurement of financial performance. To this end, the task force issued two consultation papers: *Characteristics of Public Sector Entities* and *Measuring Financial Performance in Public Sector Financial Statements*.

In March 2015, the task force issued a third consultation paper that proposed a new reporting model and draft principles on public-sector characteristics, financial statement objectives, qualitative characteristics, elements, recognition, measurement and presentation. The comment period ended in August 2015.

The task force is currently developing a statement of principles that will take into account input received from the three Consultation Papers, and will propose a revised conceptual framework and reporting model for public-sector entities. PSAB expects to issue a statement of principles in 2018.

12.2 Asset Retirement Obligations

The objective of this project is to develop a standard that addresses the reporting of legal obligations associated with the retirement of long-lived tangible capital assets currently in productive use. For example, there may be obligations associated with decommissioning an electricity generating facility.

In August 2014, PSAB issued a statement of principles that proposed a new section on retirement obligations associated with tangible capital assets controlled by a public-sector entity. The comment period ended in November 2014; based on the feedback received, PSAB issued an exposure draft in March 2017. The main features of the Exposure Draft are:

- A retirement obligation should be recognized when there is a legal obligation to incur retirement costs in relation to a tangible capital asset and a reasonable estimate can be made.
- The recognition of an asset retirement obligation will increase the net debt reported by a public-sector entity.
- Upon initial recognition, the entity would increase the carrying amount of the related tangible capital asset by the same amount as the liability. However, if the related asset is no longer in productive use, or if the related asset is not recognized for accounting purposes, these costs would be recorded as an expense.
- The cost included in the carrying amount of the tangible capital asset should be allocated to expense in a rational and systematic manner. This could include amortization over the remaining useful life of the related tangible capital asset, or a component thereof.
- The estimate of a liability for retirement obligation should include costs directly attributable to retirement activities, including post-retirement operation, maintenance and monitoring.
- A present value technique is often the best method with which to estimate the liability.
- The carrying amount of the liability for a retirement obligation should be reviewed at each financial reporting date.
- Subsequent re-measurement of the liability can result in either a change in the carrying amount of the related tangible capital asset or an expense.

PSAB accepted feedback on these proposals until June 15, 2017.

12.3 Revenue

Two major sources of government revenue—government transfers and tax revenue—are addressed in the sections *PS 3410, Government Transfers* and *PS 3510, Tax Revenues* of the Canadian PSAS. However, PSAS do not specifically address other revenues.

In September 2011, PSAB approved an amended project proposal on revenues to address the limited guidance on revenues that are common in the public sector. PSAB did not initiate the project to review the existing revenue standards; rather, it aimed to put in place overarching guidance to address questions about when revenues are recognized, and how they are measured and presented in the financial statements.

The purpose of the project is to expose a new section on revenues that would apply to public-sector entities that follow PSAS.

Following the publication of a statement of principles in 2013, PSAB issued an exposure draft for public comment earlier this year.

The exposure draft:

- focuses on two main areas of revenue:
  - exchange transactions; and
  - unilateral (non-exchange) transactions
- notes the presence of performance obligations for the public-sector entity as the distinguishing feature of an exchange transaction;
- defines performance obligations as enforceable promises to provide goods or services to a payor;
- specifies that revenue from an exchange transaction is recognized as or when the public-sector entity's satisfies the performance obligation;
- recognizes that performance obligations may be satisfied at a point in time or a over a period of time, depending on which method best depicts the transfer or goods or services to the payor; and
- sets out the requirement that public sector entities recognize unilateral revenues when there is the authority and a past event that gives rise to a claim of economic resources.

PSAB asked stakeholders to submit comments on the exposure draft by August 15, 2017.

12.4 Employment Benefits

In December 2014, PSAB approved an Employment Benefits project to improve the existing PSAS sections by taking into account changes in the related accounting concepts and new types of pension plans that were developed since the existing sections were issued decades ago. The project aims to review the existing sections, *PS 3250 Retirement Benefits* and *PS 3255 Postemployment Benefits, Compensated Absences and Termination Benefits*. The first phase of the project will focus on measurement issues such as the deferral of experience gains and losses and discount rates. The second phase will address non-traditional pension plans such as shared-risk plans as well as other important topics such as multi-employer defined-benefit plans and vested sick-leave benefits.

In December 2016, PSAB began the first phase of the project by issuing an invitation to comment on the deferral of actuarial gains and losses. Governments and other public sector entities need to make significant assumptions when valuing pension plan obligations and plan assets. Actuarial gains and losses measure the differences between these assumptions and the plans' experience, plus any updates to the assumptions. In the past, it was common accounting practice in Canada to defer such gains and losses over an extended period of time. However, over the past decade, other accounting frameworks in Canada have moved towards an immediate recognition approach. The invitation to comment seeks input from stakeholders as to whether deferral is still an appropriate choice in the public sector. Proponents of deferrals point to the fact that this approach avoids creating volatility in the reported results and facilitates budget-to-actual comparison. Proponents of the immediate recognition approach believe that it promotes accountability by providing users of the financial statements with the most relevant information.

The next step in the process is an invitation to comment on discount rates is expected to be approved by the end of 2017.

13.0 Statutory Matters

Under section 12 of the *Auditor General Act*, the Auditor General is required to report on any Special Warrants and Treasury Board Orders issued during the year. In addition, section 91 of the *Legislative Assembly Act* requires that the Auditor General report on any transfers of money between items within the same vote in the Estimates of the Office of the Assembly.

13.1 Legislative Approval of Expenditures

Shortly after presenting its budget, the government tables detailed Expenditure Estimates in the Legislative Assembly outlining, on a program-by-program basis, each ministry's planned spending. The Standing Committee on Estimates (Committee) reviews selected ministry estimates and presents a report on this review to the Legislature. Orders for Concurrence for each of the estimates selected by the Committee, following a report by the Committee, are debated in the Legislature for a maximum of two hours before being voted on. The estimates of those ministries that are not selected are deemed to be passed by the Committee, reported to the Legislature, and approved by the Legislature.

After the Orders for Concurrence are approved, the Legislature still needs to provide its final approval for legal spending authority by approving a *Supply Act*, which stipulates the amounts that can be spent by ministries and legislative offices, as detailed in the estimates. Once the *Supply Act* is approved, the expenditures it authorizes are considered to be Voted Appropriations. The *Supply Act, 2017*, which pertained to the fiscal year ended March 31, 2017, received Royal Assent on March 30, 2017.

The *Supply Act* does not receive Royal Assent until after the start of the fiscal year—and sometimes even after the related fiscal year is over—so the government usually requires interim spending authority prior to its passage. For the 2016/17 fiscal year, the Legislature passed two acts allowing interim appropriations—the *Interim Appropriation for 2016–2017 Act, 2015* (Interim Act) and the *Supplementary Interim Appropriation for 2016–2017 Act, 2016* (Supplementary Act). These two Acts received Royal Assent on December 10, 2015, and December 8, 2016, respectively, and authorized the government to incur up to $127.1 billion in public-service expenditures, $4.4 billion in investments, and $219.5 million in legislative office expenditures. Both acts were made effective as of April 1, 2016, and provided the government with sufficient authority to allow it to incur expenditures from April 1, 2016, to when the *Supply Act, 2017* received Royal Assent on March 30, 2017.

Because the legal spending authority under the Interim Act and the Supplementary Act was intended to be temporary, both were repealed when the *Supply Act, 2017*, received Royal Assent. The *Supply Act, 2017*, also decreased total authorized expenditures in investments from $4.4 billion to $4.3 billion, and increased total authorized expenditures of the legislative offices from $219.5 million to $225.4 million.

13.2 Special Warrants

If the Legislature is not in session, Section 1.0.7 of the *Financial Administration Act* allows for the issuance of Special Warrants authorizing the incurring of expenditures for which there is no appropriation by the Legislature or for which the appropriation is insufficient. Special Warrants are authorized by Orders-in-Council and approved by the Lieutenant Governor on the recommendation of the government.

No Special Warrants were issued for the fiscal year ended March 31, 2017.

13.3 Treasury Board Orders

Section 1.0.8 of the *Financial Administration Act* allows the Treasury Board to make an order authorizing expenditures to supplement the amount of any voted appropriation that is expected to be insufficient to carry out the purpose for which it was made. The order may be made only if the amount of the increase is offset by a corresponding reduction of expenditures to be incurred from other voted appropriations not fully spent in the fiscal year. The order may be made at any time before the government closes the books for the fiscal year. The government considers the books to be closed when any final adjustments arising from our audit have been made and the Public Accounts have been published and tabled in the Legislature.

Even though the *Treasury Board Act, 1991* was repealed and re-enacted within the *Financial Administration Act* in December 2009, subsection 5(4) of the repealed act was retained. This provision allows the Treasury Board to delegate any of its duties or functions to any member of the Executive Council or to any public servant employed under the *Public Service of Ontario Act, 2006*. Such delegations continue to be in effect until replaced by a new delegation. Since 2006, the Treasury Board has delegated its authority for issuing Treasury Board Orders to ministers to make transfers between programs within their ministries, and to the Chair of the Treasury Board for making program transfers between ministries and making supplementary appropriations from contingency funds. Supplementary appropriations are Treasury Board Orders in which the amount of an appropriation is offset by a reduction to the amount available under the government's centrally controlled contingency fund.

Figure 9 summarizes the total value of Treasury Board Orders issued for the past five fiscal years.

Figure 10 summarizes Treasury Board Orders for the fiscal year ended March 31, 2017, by month of issue.

According to the Standing Orders of the Legislative Assembly, Treasury Board Orders are to be

Figure 9: Total Value of Treasury Board Orders, 2012/13–2016/17 ($ million)

Source of data: Treasury Board

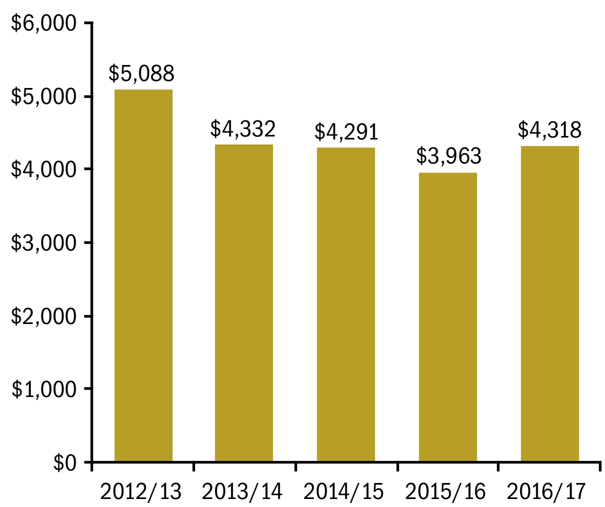


Figure 10: Total Value of Treasury Board Orders by Month Relating to the 2016/17 Fiscal Year

Source of data: Treasury Board

Month of Issue	#	Authorized ($ million)
April 2016–February 2017	92	1,800
March 2017	60	2,136
April 2017	5	189
May 2017–August 2017	4	193
Total	**161**	**4,318**

printed in The Ontario Gazette, together with explanatory information. Orders issued for the 2016/17 fiscal year are expected to be published in The Ontario Gazette in December 2017. A detailed listing of 2016/17 Treasury Board Orders, showing the amounts authorized and expended, is included in **Exhibit 4** of this report.

13.4 Transfers Authorized by the Board of Internal Economy

When the Board of Internal Economy authorizes the transfer of money from one item of the Estimates of the Office of the Assembly to another item within the same vote, Section 91 of the *Legislative Assembly Act* requires that we make special mention of the transfer(s) in our Annual Report.

Accordingly, **Figure 11** shows the transfers made within Vote 201 with respect to the 2016/17 Estimates.

13.5 Uncollectible Accounts

Under Section 5 of the *Financial Administration Act*, the Lieutenant Governor in Council, on the recommendation of the Minister of Finance and the President of the Treasury Board, may authorize an Order-in-Council to delete from the accounts any amounts due to the Crown that are the subject of a settlement or deemed uncollectible. The amounts deleted from the accounts during any fiscal year are to be reported in the Public Accounts.

In the 2016/17 fiscal year, receivables of $267 million due to the Crown from individuals and non-government organizations were written off. (The comparable amount in 2015/16 was $396 million.) The write-offs in the 2016/17 fiscal year related to the following:

- $64.4 million for uncollectible corporations tax ($98.9 million in 2015/16);
- $49.9 million for uncollectible receivables under the Student Support Program ($50.9 million in 2015/16);
- $45.9 million for uncollectible receivables under the Ontario Disability Support Program ($65.3 million in 2015/16);
- $40.3 million for uncollectible retail sales tax ($124.2 million in 2015/16);

Figure 11: Authorized Transfers Relating to the Office of the Assembly, 2016/17 Fiscal Year

Source of data: Board of Internal Economy

From:	$
Item 6 Sergeant at Arms and Precinct Properties	(95,500)
To:	
Item 2 Office of the Clerk	95,500

- $27.3 million for uncollectible employer health tax ($20.3 million in 2015/16); and
- $39.2 million for other tax and non-tax receivables ($36.4 million in 2015/16).

Volume 2 of the 2016/17 Public Accounts summarizes the write-offs by ministry. Under the accounting policies followed in the preparation of the Province's consolidated financial statements, a provision for doubtful accounts is recorded against accounts receivable balances. Most of the write-offs had already been expensed in the government's consolidated financial statements. However, the actual write-off in the accounts required Order-in-Council approval.