Attachment 3

Independent Electricity System Operator

Special Audit of the Financial Statements for the Year Ended December 31, 2017

Management Letter as of April 6, 2018

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1. INAPPROPRIATE ACCOUNTING POLICIES

Fair Hydro Plan Transactions and Variance Accounts, Smart Meters and PSAB Transition Item and Market Accounts

The IESO has recognized rate regulated and market account assets and liabilities. IESO is considered an "other government organization" under Canadian public sector accounting standards. Rate regulated accounting is not permitted in an "other government organization" under Canadian public sector accounting standards and therefore, the regulated assets recognized by the IESO should not be recognized. The market accounts track mainly buy and sell transactions between electricity market participants (electricity power generators and power distributors). These market accounts, as recorded on the financial statements are not assets and liabilities of the IESO. Under the current Market Rules, the IESO has no access or discretion to use the market account assets for their own benefit, nor does the IESO have an obligation to settle the market account liabilities in the event of default by market participants.

Beginning in July 2017, as part of its legislated role in the Fair Hydro Plan Act, 2017, the IESO incurs a shortfall from the difference between the amounts it collects from power distributors and it pays to contracted power generators. The electricity price ceiling imposed by the Fair Hydro Plan Act exposes the IESO to financial risk such that it is now responsible for obtaining financing to cover the shortfall in market settlement. To fund this shortfall, the IESO receives advances from Fair Hydro Trust, a related party. At the same time, IESO records the sale of rate regulated and market accounts assets and liabilities to the Fair Hydro Trust in an amount equal to the shortfall, thereby removing the impact of the shortfall on the annual surplus and eliminating the obligation to the Fair Hydro Trust. This approach constitutes a departure from Canadian public sector accounting standards, as these are not assets and liabilities of IESO. As a result, a loan of $1.179 billion and the remaining shortfall of $199 million has not been recorded in Total Liabilities with corresponding losses on the statement of operations totalling $1.378 million.

The use of the market accounts on the statement of financial position allows IESO to not have the shortfall impact the statement of operations.

Effect on Statement of Operations and Accumulated Surplus

If the IESO had correctly excluded the regulated assets and market accounts, the effect on the statement of operations for the years ended December 31, 2017 and 2016 would have been as follows:

	2017 ($ thousand)	2016 ($ thousand)
Surplus/(deficit) as presented	**(3,146)**	**234**
Effect of removal of regulated assets	25,535	23,138
Effect of recognizing shortfall related to Fair Hydro Plan	(1,378,475)	-

Surplus/(deficit) in accordance with Canadian public sector accounting standards	**(1,356,086)**	**23,372**

Effect on Statement of Financial Position

If the IESO had correctly excluded the regulated assets and market accounts, the effect on the statement of operations for the years ended December 31, 2017 and 2016 would have been as follows:

	2017 ($ thousand)	2016 ($ thousand)
Total Financial Assets as stated	**2,195,615**	**1,862,279**
Effect of removal of regulated assets	(39,529)	(65,064)
Effect of removal of market accounts - assets	(2,005,167)	(1,692,752)
Total Financial Assets in accordance with Canadian public sector accounting standards	**150,919**	**104,463**

	2017 ($ thousand)	2016 ($ thousand)
Total Liabilities as stated	**2,289,298**	**1,959,452**
Effect of recognizing financing from Fair Hydro Trust	1,179,000	-
Effect of recognizing liability for shortfall in Fair Hydro Plan	199,475	-
Effect of removal of market accounts - liabilities	(2,005,167)	(1,692,752)
Total Liabilities in accordance with Canadian public sector accounting standards	**1,662,606**	**266,700**

	2017 ($ thousand)	2016 ($ thousand)
Net Debt as stated	**(93,683)**	**(97,173)**
Effect of removal of regulated assets	(39,529)	(65,064)
Effect of recognizing liability for shortfall in Fair Hydro Plan	(199,475)	-
Effect of recognizing financing from Fair Hydro Trust	(1,179,000)	-
Net Debt in accordance with Canadian public sector accounting standards	**(1,511,687)**	**(162,237)**

	2017 ($ thousand)	2016 ($ thousand)
Accumulated Surplus as stated	**13,920**	**14,488**
Effect of removal of regulated assets	25,535	23,138
Accumulated impact of regulated assets	(65,064)	(88,202)
Effect of recognizing shortfall related to Fair Hydro Plan	(1,378,475)	-

Accumulated surplus in accordance with Canadian public sector accounting standards	**(1,404,084)**	**(50,576)**

Recommendation

OAGO recommends the IESO adjust its December 31, 2017 financial statements and the comparative period to remove the effects of adopting rate-regulated accounting. In addition, the IESO should recognize a liability and a corresponding loss for the shortfall and the financing received as at December 31, 2017.

OAGO recommends the IESO remove the market accounts from its December 31, 2017 financial statements and the comparative period.

Management Response

The IESO disagrees with the Auditor General's statement that PSAS does not permit rate-regulated accounting. Rather, PSAS is silent with respect to rate-regulated accounting. In absence of a clear position on this issue, standard accounting practice dictates that an entity is entitled to consult another accounting standard. As a result, the IESO consulted US GAAP, the only accounting framework in North America that provides guidance on rate regulated operations.

After extensive discussions with external auditors, the IESO Audit Committee of the Board, as well as the Board of Directors, the IESO adopted aspects of the US GAAP accounting framework allowing the IESO to recognize a regulatory asset on its financial statements. This change brings the IESO in line with (6 of 8) other independent system operators across North America, and is supported by the IESO's external auditors as well as the Office of the Provincial Controller.

In its role as the electricity market administrator, the IESO operates and settles approximately $17 billion through the electricity market transactions, where money is constantly flowing to and from market participants, such as consumers and generators. This role requires the IESO to temporarily hold and transfer money between market participants (like Local Distribution Companies and Generators), including recovering costs associated with Global Adjustment.

The change to include market account assets and liabilities on our financial statements provides increased transparency around the value of transactions that flow through Ontario's electricity market, and the IESO feels the public reporting of market accounts is relevant to the needs of its financial statement users.

These changes in no way affect the IESO's operational costs, or the financial impact on electricity ratepayers.

Auditor General's Response

Our understanding is that IESO's consultations were with KPMG LLP and the Office of the Provincial Controller Division.

None of the six independent system operators (ISOs), which IESO indicated they were comparable to, follow Canadian public sector accounting standards (PSAS).

Five of these six ISOs operate in the United States and follow U.S. accounting standards. Furthermore, all five of these ISOs act as a “central counterparty” in their respective real-time electricity markets pursuant to an order issued by the Federal Energy Regulatory Commission, the United States federal agency that regulates the transmission and wholesale sale of electricity. Central counterparties act as the buyers to every seller, and the seller to every buyer. This means that the five ISOs are direct parties to the market transactions. This contrasts with the Market Rules for the Ontario Electricity Market, which state that, “The IESO shall not be a counter-party to any trade transacted through the real-time markets” (Chapter 9, Section 6.9.2).

The remaining ISO is the Alberta Electric System Operator (AESO). Unlike the IESO, the AESO follows International Financial Reporting Standards. IFRS contains a restricted exemption for the recognition of “regulatory deferral accounts”, which is not available to IESO under Canadian PSAS.

PS 1000.30 indicates that an entity preparing financial statements in accordance with Canadian PSAS should be comparable to other entities preparing financial statements in accordance with Canadian PSAS. Given the key differences between IESO and its North American peers outlined above, we do not believe that an entity preparing financial statements in accordance with Canadian PSAS should be aligned with private sector entities, especially those preparing financial statements in accordance with different financial reporting frameworks.

The accounting treatment used by the IESO understates the operating costs of the IESO and the ultimate financial impact on electricity rate payers.

Value of Plan Assets for IESO Pension Plan

The IESO's accounting policy for determining its retirement benefit liability and expense does not comply with public sector accounting standards. The IESO shows the funded status of its pension plan on a market value basis, while using a market-related value of plan assets to determine the expected return on plan assets.

As the IESO uses a market-related value of plan assets to determine the expected return on plan assets (a component of retirement benefit expense), it must use that same basis in determining actuarial gains and losses. The IESO determines the market-related value of plan assets using the average value of assets over three years as at the measurement date of September 30. As at December 31, 2017, the market value of plan assets was $545.400 million (2016 – 523.756 million) and the market-related value of plan assets was $537.587 million (2016 – $506.791 million).

In order to estimate the adjustment to the retirement benefit liability and expense, we require an actuarial re-valuation for accounting purposes for 2018.

Recommendation

OAGO recommends the IESO apply its basis of valuation for plan assets consistently when determining both its retirement benefit liability and expense. The IESO should also consult its actuary, AON Hewitt, to determine the amount of any necessary adjustment to retirement benefit liability and expense in its December 31, 2018 financial statements.

Management Response

The IESO will consult its actuary to determine appropriateness of adjustment in its December 31, 2018 financial statements.

The IESO uses a market-related value of assets for the purposes of determining pension expense and accrued pension liability, per Section PS 3250, Paragraph 35. If IESO disclosed the funded status of the pension plan using the market-related value of assets rather than the market value of assets, there would be no impact on either the pension expense or the accrued pension asset and liability.

Auditor General's Response

Using a market-related value of plan assets rather than market value of assets will result in an impact to future pension expense and liability through the amortization of actuarial gains/losses.

Discount Rate Selected for Non-Registered Defined Benefit Plan and Other Post Employment Benefits

The IESO currently uses the same discount rate for its employee registered pension plan (RPP), the non-registered pension plan (non-RPP) and other post employment benefit plan (OPEB). Unlike the RPP, which is funded through employee and employer contributions, the non-RPP and OPEB plans are unfunded and benefits are paid by IESO as they fall due.

The most significant assumption used in the actuarial calculations of a pension or OPEB plan is the discount rate. In determining the discount rate, Canadian PSAS allows financial statement preparers to base their assumptions on either an expected rate of return on *plan* assets currently held in the fund or the *entity's* cost of borrowing. In determining the discount rate for its funded RPP, the IESO uses a discount rate based on an expected rate of return on the plan assets held in trust by the RPP. This is appropriate under Canadian PSAS. In determining the discount rate for its unfunded non-RPP and unfunded OPEB plans, the IESO elected to use the same rate of return based on the plan assets held in trust by the RPP. Since these plans are unfunded and the RPP assets are not available to the plans, it is inappropriate to use this discount rate for these plans.

The generally accepted practice among entities reporting under Canadian PSAS is to use a discount rate based on the entity's cost of borrowing for unfunded plans and a discount rate based on expected plan asset returns for partially or fully funded plans.

The expected impact of using a discount rate based on the cost of borrowing in valuing the unfunded non-RPP and OPEB plans is material and should be adjusted in the current and prior years. We requested IESO to have their actuary estimate the adjustment using a discount rate 200 basis points lower than management's expected return on plan assets for the last two fiscal years. This 200 basis point decrease changes the discount rate to be consistent with the discount rates that we observe for unfunded benefit plans in other government organizations consolidated by the Province.

Based on the calculation made by IESO's actuary, the impact of a 200 basis point reduction in the discount rate for the SERP and OPEB results in the following:

- an increase of $55.0 million and $41.2 million to total accrued liability for employee future benefits other than pension as at December 31, 2017 and 2016, respectively; and
- an increase of $1.9 million and $1.6 million to total benefit costs for other plans for the year ended December 31, 2017 and 2016, respectively.

Recommendation

OAGO recommends the IESO select a discount rate for the non-RPP and OPEB plans based on IESO's cost of borrowing and management's best estimate of expected long-term experience and short-term forecast. Using this rate, IESO should adjust its December 31, 2016 and 2017 financial statements for the correction of this error.

Management Response

The IESO will review and consider adopting a new discount rate methodology in future years. The IESO is aware that the Public Sector Accounting Board recently issued an invitation to *comment on how the discount rate under PSAB is determined, and will continue to monitor the process.*

Section PS 3250 does not recommend a specific methodology for determining the discount rates to measure the liability of benefit programs; however, two examples are identified in the standard as reference points for determining an acceptable discount rate. The two examples include the expected return on plan assets and the organization's cost of borrowing. Further, the IESO believes that an inconsistency in valuation of overall pension benefit would be created if different discount rates were used for the registered pension plan and the other plans.

Given this, the IESO believes that its discount rate assumptions for the other plans are within the bounds of reasonableness and will maintain the current discount rates for the pension and OPEB plans in its 2017 financial statements.

Auditor General's Response

We reviewed other government organization financial statements consolidated into the province of Ontario's financial statements. We found that when there are no plan assets, these government organizations use a discount rate based on a cost of borrowing. Similarly, this is also the policy used in the preparation of the province of Ontario's consolidated financial statements.

Disclosure Deficiency Regarding the Collateral Pledged Pursuant to the Security Agreement between IESO and the Fair Hydro Trust

Pursuant to a Security Agreement between the IESO and the Fair Hydro Trust dated December 21, 2017, the IESO has pledged the market receivables from local distribution companies (LDCs) as collateral for the statutory obligation of the IESO to pay the carrying costs of the Fair Hydro Trust under Regulation 206/17 of the *Ontario Fair Hydro Plan Act, 2017*. The pledge under the Security Agreement subordinates the claims of power generators in favour of the claims of the Fair Hydro Trust, a related party to IESO. Effectively, this means that if IESO defaults on its payments to the Fair Hydro Trust, the money received from ratepayers (through LDCs) must be used to pay the Trust before power generators can be paid. The notes to the financial statements of IESO do not disclose existence or the terms of the Security Agreement.

Recommendation

OAGO recommends the IESO disclose the Security Agreement and the pledging of market receivables as collateral in the notes to the financial statements.

Management Response

The IESO has included a disclosure relating to the security agreement. Specifically, the IESO has provided security for the IESO's currently monthly obligation to pay carrying costs to the Fair Hydro Trust monthly during the period beginning on December 1, 2017 and ending on July 31, 2021.

Auditor General's Response

We acknowledge that the IESO revised their financial statements on March 27, 2018 (subsequent to their provision to us of their original financial statements, which were approved on March 8, 2018) to include note disclosure for the security agreement. As well, we acknowledge that KPMG LLP revised their Auditors' Report dated March 8, 2018 with a new Auditors' Report dated March 27, 2018.

2. INTERNAL CONTROL DEFICIENCIES

Bank Reconciliations Not Properly Prepared for 2016 and 2017

The cash clearing account ("AP-Payment Clearing Account") had a balance of $8.111 million (2016 - $7.152 million) as at December 31, 2017 and was not regularly reconciled or reviewed by management. As a result, there was an unexplained difference between the cash accounts recorded in the general ledger and the December 31 bank statements. Although the cash accounts agreed with bank records, the package did not provide a reconciliation for the "AP-Payment Clearing Account" recorded as part of cash on the statement of financial position. This account incorporates all the differences between the cash balances in the G/L and the bank statements, which are the items to be reconciled in the bank reconciliation process.

This issue was not identified by management or raised by IESO's auditor during the 2016 audit. Subsequent to us bringing this issue to management's attention, management discussed this with KPMG.

In response to our request, IESO's finance and accounting department investigated the difference and determined that it primarily comprised of two items: 1) Outstanding cheques in the TD bank account ($2.026 million) and 2) four invoices from 2016, which were not cleared as they were paid outside of normal processes ($5.909 million). In the latter case, the four invoices were market-related payments that were part of Conservation programs. Management corrected these errors.

Recommendation

We recommend that the IESO prepare a proof of balance of the A/P clearing account, which incorporates all the differences between the general ledger and the bank balances, on a monthly basis. The proof of balance should research and explain differences between the aggregated bank balances and the total cash balance on the statement of financial position on an itemized basis. The IESO should assign this responsibility to an employee who does not have access to cash and who does not record cash receipts, cash disbursements, or general journal entries. Lastly, a supervisor should review the monthly proof of balance and authorize any correcting entries.

Management Response

The IESO is committed to preparing more frequent reconciliations of general ledger accounts and conducting proof of balances throughout each fiscal year.

The IESO agrees that the noted issue was not appropriately adjusted in a timely manner. This was an isolated event related to the merger of the former IESO and OPA. The identified issue does not have any impact on the IESO's net surplus or deficit. A repeated event has not occurred.

Auditor General's Response

At the time of our audit, IESO was not preparing regular bank reconciliations. We are pleased to see that IESO acknowledges that they will now be conducting reconciliations. The merger of the former IESO and OPA occurred on January 1, 2015.

Security Deposits Not Fully Tracked and Reconciled to General Ledger

IESO obtains security deposits on certain contracts and procurement applications. The balance per the general ledger is $16.800 million (2016 - $17.538 million). When the OAGO requested a detailed breakdown of the account balance, management informed the OAGO that they do not regularly review the detailed balances.

Upon investigation of the balance by the program area, the security deposit balance was comprised of two items: 1) deposits for contracts for $14.700 million and 2) procurement applications for $0.800 million.

There is an unexplained balance of $1.279 million. Management corrected these errors.

Without performing a detailed breakdown or reconciliation, IESO does not track the cash flows on an individual basis and management does not know who is owed a refund on security deposits.

Recommendation

OAGO recommends the IESO prepare reconciliations for each of its significant general ledger accounts on a monthly basis. The IESO should assign this responsibility to an employee who does not record cash receipt, cash disbursement, or journal entry transactions. Lastly, a supervisor should review the monthly reconciliation and authorize any correcting entries.

Management Response

The IESO agrees that the noted issue was not appropriately adjusted in a timely manner. The IESO is committed to preparing more frequent reconciliations of general ledger accounts and conducting proof of balances.

Manual Override of Controls by Human Resources and Review of Manual Changes Made to Payroll Systems

During testing of payroll, the OAGO identified two control weaknesses – 1) Manual override of controls by Human Resources and 2) Review of manual changes made to payroll systems.

OAGO observed instances where an HR associate bypassed the normal process and manually entered an employee's compensation change in the HR Management System. OAGO requested and received evidence that supported the compensation change, but there was no evidence of review and approval. This manual bypass resulted in an underpayment of salary and management corrected after the issue was brought to their attention.

Given these observed instances of manual override, there is a risk that employees who received compensation changes did not receive retroactive payments for the week in which the change became effective. There is also a potential risk of error and/or fraud as nobody is responsible for reviewing manual entries in the HR Management System.

OAGO noted that HR Management System automatically interfaces most compensation changes to the Payroll System on a daily basis. However, payroll must enter some payroll changes, such as severance payments, retroactive payments, and certain dates manually into the Payroll System. Furthermore, payroll has the ability to override certain information.

In discussions with payroll, OAGO determined that payroll associates are responsible for both making manual entries in the Payroll System and reviewing those changes for completeness and accuracy. OAGO observed evidence that payroll associates reviewed payroll registers, but there was no evidence of supervisor review or sign-off. As a result, there is a lack in segregation of duties between the preparer of payroll information and the reviewer. OAGO also noted that payroll could not provide a report summarizing all payroll changes for each pay period. The Payroll System does not appear to have this functionality readily available.

While OAGO did not note any errors in its testing relating to these control gaps, the lack of controls could lead to incorrect payments to employees or unnoticed fraudulent transactions.

Recommendation

OAGO recommends the IESO prevent HR associates from overriding controls when entering compensation changes in HR Management System. Alternatively, the IESO should determine whether it is possible for HR Management System to generate exception reports. A supervisor should review and approve exceptions against supporting documentation on a timely basis.

OAGO recommends the IESO ensure that an individual that is not responsible for entering information into the system reviews changes to the Payroll System data against supporting documentation each pay period. In addition, in order to facilitate this review, the Payroll System system should be able to generate a summary of all changes and/or exceptions each pay period. Alternatively, IESO should focus on automating the process and reducing the need for manual entries.

Management Response

The IESO agrees that there is an opportunity to enhance the internal controls with respect to HR Success Factors.

Due to a system limitation, manual entries for compensation changes may be required in unique instances. Manual entries are only made if supporting evidence is provided.

Additionally, compensating controls exist when manual processes are used. Specifically, manual data changes made in the HR Success Factors system are reviewed and approved by the Supervisor, Compensation & Benefits.

Although supporting evidence is provided and compensating controls exist, there is an opportunity to enhance the internal controls. This need was previously identified by the IESO and will be addressed as part of the HR Success Factors system enhancement, scheduled to be implemented in Q3 2018.

The IESO agrees that there is an opportunity to reduce the need for manual entries, and is in the process of upgrading its payroll system. Automation is a key focus of this project, which is expected to be completed by Q3, 2018.

In the meantime, any changes to payroll system data are reviewed and signed-off by an employee's supervisor. Specifically, if a payroll change is made by a payroll associate, it is captured in an employee's timesheet that then requires approval by the employee's supervisor.

In addition to timesheet sign-off, the IESO has other compensating controls in place. Specifically, the IESO uses three-way payroll reconciliations to compare payroll data to timesheet data and the payment file from the bank. These reconciliations are prepared by a Financial Analyst and reviewed by the Manager, Accounting and Finance.

3. OTHER MATTERS

Process Descriptions and Control Narratives Not Available

OAGO requested the IESO to provide descriptions and/or narratives of the entity's internal controls related to financial reporting. The IESO stated that it did not have any process descriptions or narratives, and instead asked the OAGO to acquire this documentation from its auditor, KPMG LLP.

OAGO subsequently obtained and reviewed the documentation from KPMG LLP, but determined that it was not sufficiently detailed for OAGO purposes of carrying out the audit of IESO's December 31, 2017 financial statements. As a result, the OAGO had to carry out detailed walkthroughs and interviews to gain an understanding of the IESO's key processes and internal controls that related to financial reporting.

The lack of process descriptions and control narratives is a business risk to IESO. Management is responsible for ensuring sufficient internal documentation of processes and internal controls exists. These documents should be updated and retained by management.

After we left the field and during final reporting, we were provided process narratives. However, we noted some of the narratives have not been updated since 2008. For example, IESO's payroll narrative has not been updated to reflect the new Human Resources information system that tracks employee hires, promotions, and terminations.

Recommendation

OAGO recommends the IESO to update and maintain process descriptions and/or narratives of its internal controls related to financial reporting. OAGO is will provide the updated narratives under a separate cover to the CFO that IESO can build from and maintain.

Management Response

The IESO will continue to review and update its process descriptions and control narratives related to financial reporting, as appropriate. For clarity, the IESO produces its own process descriptions and control narratives related to financial reporting, and believes the current documents are accurate and effective.

Auditor General's Response

At the time of our audit this was not the case.

CSAE 3416 Report on Market Settlement Operations System

The IESO engages Ernst & Young to perform an audit of the IESO's description of its settlement operations system for processing user entities' transactions and the suitability of the design and operating effectiveness of key controls over these processes. According to the most recent CSAE 3416 report, the audit covers the period from January 1, 2017 to June 30, 2017.

OAGO noted that the IESO obtains this CSAE 3416 report on a bi-annual basis, in accordance with the Market Rules.

As the design and operating effectiveness of controls over the settlement operations is key the audit of IESO's financial statements, it would be cost-effective for the IESO to request EY to perform the audit engagement on an annual basis.

Recommendation

As a best practice, OAGO recommends the IESO to engage an auditor to perform the CSAE 3416 audit on an annual basis with a full year of coverage over operating effectiveness.

Management Response

The IESO will consider this recommendation in future years. As an immediate next step, the IESO will be extending its next CSAE 3416 audit report coverage to a 12-month period.