TBS

Office of the Provincial Controller

Financial Reporting Risks

November 15, 2016

Briefing to Secretary of Cabinet

Purpose

- To highlight immediate and longer-term fiscal/financial reporting issues

- Options and recommendations to address immediate high risk items
  - Pension Asset Accounting
  - OPG/H1 reporting

Background

- The Provincial Budget and Public Accounts will be impacted by new and future changes to public and private sector accounting standards as well as the resolution of disagreements with the Auditor General
- Potential risks:
  - Outcome of Pension Asset Expert Advisory Panel and AG acceptance of the Panel's recommendations
  - Consistency between results reported by OPG and H1 vs. Public Accounts
  - Various current year transactions (e.g. cap & trade, Metrolinx transaction with City of Toronto)
  - Future standard setting projects (e.g. financial instruments, rate-regulated accounting)
- As a sovereign government, the Province is not bound by PSAB. Legislation is in place to allow for a regulatory solution to mitigate risks (under FAA).
- The government regulated accounting for pension assets for the 2015/16 Public Accounts using a time-limited regulation (only for 2015-16).
- Under the AG Act, the audit opinion for the Public Accounts is based on the AG's judgment of 'appropriate GAAP'. The AG is opposed to legislated accounting.

Key Challenges

Near Term

1. Pension Asset Accounting
2. Consolidation reporting basis for H1 and OPG (US GAAP vs. IFRS)
3. Specific transactions (transfer payments similar to GIF, Metrolinx)
4. Cap and Trade accounting (accounting for proceeds from auction and expenses)
5. Expected reduction in AG materiality used for Public Accounts
6. Consolidation (presentation – e.g. BPS and what is consolidated – e.g. CASs)
7. Increased AG focus on governance and accounting re: contaminated sites
8. Other GBE transactions (Hydro One sale, recognition of unrealized gains/losses)
9. Implementation of Related Party disclosures – new accounting standard
10. Implementation of Hyperion Financial Management (parallel run)
11. Timing for release of 2016/17 Public Accounts – goal of an earlier release date (July 31)

Future:

1. Accounting for Financial Instruments – standard under review
2. PSAB -- new standards on asset retirement obligations, revenues, public-private partnerships
3. Finalization of PSAB Conceptual Framework
4. Timing and frequency of internal and external financial reporting
5. Basis for accounting for balanced budget legislation (budget and actuals)

Pension Assets – High Risk

- In preparing the 2015-16 Public Accounts, the Province and the Auditor General's Office engaged in discussions regarding the appropriate application of Public Sector Accounting Board's (PSAB) standards, specifically in relation to pension accounting for the province's jointly sponsored pension plans.
- A time-limited regulation was passed for the 2015-16 Public Accounts to reflect a full valuation allowance against the pension assets. The AG provided her opinion that the 2015-16 results were fairly stated but qualified her opinion for lack of restatement of the 2014-15 results.
- A report from the Pension Asset Expert Advisory Panel, including recommendations on the interpretation of PSAS for the Province’s defined benefit plans is expected to be delivered by the end of December.
- It is uncertain whether the Auditor General will accept the recommendations of the Panel.
- Work plan underway – see Appendix A

Accounting for GBEs – High Risk

Government Business Enterprises (GBEs)

- **OLG and LCBO** --
  - OLG and LCBO have been consolidated on International Financial Reporting standards (IFRS) since 2011/12
  - Results may be impacted by future changes to IFRS standards
  - No issues raised by AG

- **OPG and Hydro One** –
  - Private sector accounting standards for rate regulated entities changed effective January 1, 2015. PSAB requires that GBEs follow IFRS.
  - OPG and Hydro One are consolidated using US GAAP in the Province's consolidated financial statements which is the same basis that they report to securities regulators and the Ontario Energy Board.
  - The AG treats the difference between IFRS and US GAAP based results for OPG and Hydro One as errors on her Schedule of Unadjusted Differences (SUDs) listing. The largest impact relates to the discount rate on the nuclear asset retirement obligation. This difference is expected to be material in fiscal 2016-17.

Risks Related to GBE Reporting (H1&OPG)

Risks of adopting IFRS for H1&OPG consolidation in the CFS:

1. Lack of transparency between stand-alone statements and results consolidated with the Province
2. Volatility under IFRS-based reporting for H1&OPG, especially due to the discount rate for OPG's Asset Retirement Obligation in fiscal 2016-17
   - Potential future changes in IFRS standards and US GAAP standards may cause further divergence from audited US GAAP-based reports issued by H1&OPG
3. Future of rate-regulated accounting under IFRS
   - IFRS currently has an interim standard on rate-regulated accounting and has a project underway evaluating whether a permanent standard supporting rate-regulated accounting will be issued
   - If H1&OPG were consolidated on an IFRS basis and rate regulated accounting was subsequently discontinued, more than $8 Billion of regulatory assets on the books of H1 & OPG would have to be analyzed to determine what amount would continue to be recorded (write-off would increase Province's Net Debt); additional volatility would be introduced into the Province's annual surplus/deficit.

Options to Mitigate GBE Risks

1) **Adopt IFRS for consolidation of OPG/H1**
   - OPG/H1 results would be based on IFRS for Public Accounts. A material impact can be expected in 2016/17 when the ONFA plan is updated (due to a change in the discount rate associated with the asset retirement liability).
   - Differences in results reported by OPG/H1 (US GAAP) and the Province (IFRS) may be material.
   - Additional time, cost and effort would be involved in preparing and auditing a second set of IFRS based budgets and financial reports for Budget & Public Accounts purposes.
   - Risk continues regarding potential elimination of rate regulated accounting under IFRS
2) **Work to support the use of US GAAP with AG until the IFRS decision on rate-regulated accounting is complete**
   - IASB (International Accounting Standards Board), expects to issue a discussion paper on this project in calendar 2017. Given the widespread use of rate regulated accounting in Canada, the AcSB may determine the need for a Canadian solution. It would be inefficient to move to IFRS now and reconsider that move in the future.
3) **Regulate Consistent Accounting for GBEs** (see Appendix A re: proposed work plan)
   - Regulate Province's accounting for GBEs on modified equity basis of consolidation using the same GAAP as used by the entity itself (IFRS/US GAAP), with adjustments to confirm to the Province's accounting for unrealized gains/losses, and effective date for in-year changes to accounting policies for GBEs with different year-ends.
   - Regulation should be retroactively effective as at April 1, 2016 which was the first day that OPG and Hydro One were reported on a US GAAP basis in the Province's books. (for 2016/17)
   - No time-restriction, but may be reconsidered by the government at any time in the future.
   - Other considerations: Potential change to the AG Act, timing

DRAFT Implementation Plan (Pensions)

		Step	Actions
November December 2016	1.	Initiate Panel and support deliberations	Members announced November 10. Materials compiled, including position paper.
	2.	Engage external writer	Exemption from procurement policy to be approved
	3.	Run additional analysis/models as required	External actuary engaged
	4.	Complete analysis for additional plans	TBS with assistance from external advisors
	5.	Receive final report and summary	Share final report with AG and solicit agreement. Prepare summary document for public release.
January 2017	6.	Confirm accounting policy direction and valuation for Budget and Public Accounts	TBS & MOF
	7.	Draft communications products and briefing materials for Report from Panel	OPCD with TBS Communications (and MOF Comms)
Feb 2017	8.	Support impact analysis for Budget Document/Spring Bill	OPCD (TBS) to work with TBS, MOF on possible changes
	9.	Obtain AG acceptance of accounting	OPCD (TBS) to work with AG on concurrence
Spring 2017	10.	Any necessary changes to O.Reg. 395/11 or the Audit General Act could be reflected in Budget document or Spring Bill (TBD)	TBS & MOF Legal

Appendix A

DRAFT Implementation Plan (GBE Acctg)

	Step	Actions
November December 2016	1. Internal Briefings re: risks and potential solutions (acctg. reg)	Brief TBS, MOF, OEFC, MOE
	2. Confirm policy direction	Confirm policy direction (through TB)
	3. Consider draft of acctg. regulation	Review status of AcSB activities
	4. Consider review of AG Act	TBS & MOF Legal (use same process as for changes to AG Act w.r.t. H1 IPO)
January 2017	5. Draft communications products and briefing materials for Document	OPCD with TBS & MOF Comms
	6. Accounting Regulation to be considered for Budget Bill or Spring Billl	OPCD
	7. Consider implications of changes to Auditor General Act and Comms products for Budget Document/Spring Bill	OPCD (TBS) to work with TBS, MOF, MAG on possible changes and implications
Spring 2017	8. Potential changes to Audit General Act could be reflected in Budget document or Spring Bill (TBD)	TBS & MOF Legal

IFRS vs. US GAAP Impacts (OPG/H1)

	US GAAP	IFRS
Asset Retirement Obligations (Bruce Power portion buffered by rate reg)	• Constant discount rate, except for incremental changes (smoothing for prescribed facilities) • Lifecycle costs capitalized and smoothed over remaining asset life • Matches cost of service definition for regulatory purposes	• Strict IFRS would require annual update to discount rate (volatility) • Lifecycle costs treated as variable (used fuel bundles)
Decommissioning Costs	• Similar to CGAAP	• Greater impact in years of decommissioning when variables costs will hit P&L (e.g. Pickering 2020)
Rate Regulated Accounting	• No plans to remove rate regulated accounting • US GAAP consistent with basis up on which OPG and H! report, and are regulated (cost of service)	• IFRS14 is only a temporary standard • Uncertainty remains regarding potential introduction of rate regulated accounting under IFRS • If RRA g is removed, then RRA/RRL would be removed from OPG/H1 results and volatility introduced in annual surplus/deficit • Costs recoverable through rates would be reported as costs to be covered by taxpayers
Pension/OPEB Accounting	• No significant difference	• Less ability to smooth past service costs (volatility risk for future plan amendments)
Capitalization of Indirect Overhead	• Allows for capitalization of indirect overhead,.	• Indirect overhead cannot be capitalized. If rate regulated accounting is not permanently introduced into IFRS, volatility will be introduced into CFS. (approx. 300M/year)
Lease Accounting	• Standard changing but maintaining the concept of operating versus capital leases	• Moving to a single approach to recognize all leases on the balance sheet (as capital), which would result in recognition of liability and amortization
Revenue Accounting	• US standard largely converged with IFRS	• Similar to US GAAP (Converged)

AG Mandate Summary

ON	(3) In the annual report in respect of each fiscal year, the Auditor General shall express his or her opinion as to whether the consolidated financial statements of Ontario, as reported in the Public Accounts, present fairly information in accordance with appropriate generally accepted accounting principles and the Auditor General shall set out any reservations he or she may have. 2004, c. 17, s. 14 (8).
BC	11 (1) The Auditor General must report each year, in accordance with generally accepted auditing and assurance standards, to the Legislative Assembly on the financial statements of the government reporting entity. (2) The report under subsection (1) must state whether these financial statements arepresented fairly in accordance with generally accepted accounting principles. (3) The auditor in accordance with section 10 (3) must report each year on the financial statements of the government organizations and of the trust funds, in accordance with generally accepted auditing and assurance standards, to (a) the boards of management of the government organizations and the trustees of the trust funds to which the appointment is made, and (b) the minister responsible.
AB	(2) A report of the Auditor General under subsection (1) shall (a) include a statement as to whether, in the Auditor General's opinion, the financial statements present fairly the financial position, results of operations and changes in financial position of the Crown in accordance with the disclosed accounting principles,
SK	11. (3) For the purposes of this section, where an auditor, including an appointed auditor, is required to examine accounts and render an opinion on those accounts, he shall do so in accordance with generally accepted auditing standards as prescribed from time to time by the Canadian Institute of Chartered Accountants.
MB	9(4) The Auditor General must express an opinion as to whether the financial statements included in the Public Accounts fairly present information in accordance with the accounting policies of the government stated in the Public Accounts and on a basis consistent with that of the preceding year, and must set out any reservations the Auditor General might have.
NB	[.10]The Auditor General shall examine the several financial statements required by section 48 of the Financial Administration Act to be included in the Public Accounts and shall express his opinion as to whether they fairly present information in accordance with stated accounting policies of the Province and on a basis consistent with that of the preceding year, together with any reservations he may have.

AG Mandate Summary

NS	Auditor General Act	19 (1) The Auditor General shall audit the annual consolidated financial statements of the Government that are included in the public accounts required under the Finance Act. (2) The Auditor General shall submit a report to the House of Assembly, which must be included in the public accounts and which must provide an opinion, prepared in accordance with generally accepted auditing standards, as to the fair presentation of the consolidated financial statements. 2010, c. 33, s. 19.
NL	Auditor General Act	[.11] The auditor general shall examine the several financial statements required by the Financial Administration Act to be included in the public accounts of the province, and any other statement that is required to be audited by the auditor general under that Act or another statement that the Minister of Finance may present for audit and shall express his or her opinion as to whether the financial statements present fairly the financial position, results of operations and changes in the financial position of the province in accordance with the disclosed accounting policies of the provincial government and on a basis consistent with that of the preceding year, together with reservations the auditor general may have.
GOC	Auditor General Act	6. The Auditor General shall examine the several financial statements required by section 64 of the Financial Administration Act to be included in the Public Accounts, and any other statement that the President of the Treasury Board or the Minister of Finance may present for audit and shall express his opinion as to whether they present fairly information in accordance with stated accounting policies of the federal government and on a basis consistent with that of the preceding year together with any reservations he may have.
QC	Auditor General Act	38. In his report on the annual financial statements of the Government, the Auditor General (1) shall indicate whether, in his opinion, these statements present fairly the financial position of the Government, the results of its operations and the changes in its financial position in accordance with the accounting principles or policies stated in the financial statements and whether these principles or policies have been applied on a basis consistent with that of the preceding fiscal year;

Draft Regulation (GBE Accounting)

TBS

- Ontario Regulation 395/11 is amended by adding the following section:
- **Clarity on the accounting policies and practices to be followed to prepare the consolidated financial statements of the Province**
  - 3. (1) The modified equity basis of consolidation required by Public Sector Accounting Standard PS 1300.35 (Government reporting entity), issued by the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants as issued in June 1996 shall be the basis for consolidating government business enterprises and government business partnerships.
  - (2) For purposes of preparing the Province's consolidated financial reports, the basis of **GAAP** used by government business enterprises (GBE) in preparing their entity-level financial statements, including any regulated requirements, will be applied in conjunction with the basis of consolidation in section 3(1) above.
  - (3) Where a GBE's financial reporting year-end differs from the Province's reporting period ending March 31st, the Province's consolidated financial reports will reflect the GBE's accounting policies in place as at April 1st of the Province's reporting period.
- *As long as Hydro One, OPG, LCBO and OLG are controlled by the province they will be consolidated on the modified equity basis (no reference to GBEs).

PSAB Standards Specific Items

- Financial Instruments

(Financial Instruments and Foreign Currency Translation)

- The effective date for PSAB’s new standard has been deferred to April 1, 2019
- The new standard, as currently written, would introduce fair value accounting into government financial reporting. The volatility could not be budgeted for, resulting in variances from plan.
- The new standard would impact the province’s annual surplus/deficit results due to the elimination of hedge accounting, and also impact the province’s net debt position due to reflection of unrealized gains and losses..
- A new financial statement, the Statement of Remeasurement Gains and Losses would be introduced to reflect unrealized gains and losses.
- PSAB has initiated a review of their current standard and has met with the OFA and OPCD.
- There is no certainty that PSAB will introduce hedge accounting which would address most stakeholder concerns with the new standard. Hedge accounting is also commonly reflected in FI standards around the world.
- In addition, uncertainty remains regarding the ability to retain the province’s current accounting treatment for ONFA under the new standard. Once the new standard is known, OFA and OPCD will consult with the AG regarding interpretation and impact on ONFA reporting.

PSAB Standards Specific Items

Related Party Transactions

- PSAB's final standard will impact disclosures starting with the 2017/18 Public Accounts.
- The main requirements of the standard relate to government transactions with private sector entities where key government management and political personnel, or close family members are related to a private sector entity or their key management or owners.

Revenue Standard

- PSAB has a project underway to revisit revenue recognition standards.
- The new Exposure Draft is expected to be released in the third quarter of 2016

Assets Standard

- PSAB has issued revised standards that will require additional disclosures.

PSAB Standards Specific Items

Asset Retirement Obligations

- PSAB is expected to issue an Exposure Draft on Asset Retirement Obligations in the near future

PSAB Conceptual Framework Task Force

- PSAB is working through a revised conceptual framework – could have implications on presentation and disclosure; unlikely to have any impact on deficit or surplus

Employee Future Benefits

- PSAB has initiated a project to review how pension plans are reported by the public sector.
- ON is hopeful that PSAB may be able to include certain issues with PS 3250 which are resulting in disagreements on interpretation and application between the Auditor General and TBS.

CONFIDENTIAL - Draft For Discussion Only

Other - Specific Items

Tax Revenue Accrual Methodology

- OEP, OPCD and the OAG continue to monitor and assess potential enhancements to the current methodology used to accrue tax revenues for Public Accounts purposes.

Expectation for Quarterly External Reports

- Implementation of CHIRP will allow for consideration of in-year external reporting. Quarterly reporting already a feature for many other senior Canadian governments.

Potential for Earlier Release Date for Public Accounts

- Implementation of CHIRP, supplemented by modified reporting requirements by ministries and consolidated orgs and change in OAG's audit approach will increase feasibility of earlier release.
- During the 2016/17 Public Accounts, OPCD will be undertaking a parallel run using the new Hyperion Financial Management system.