ACCOUNTING FOR OPG AND HYDRO ONE IN THE PUBLIC ACCOUNTS

ISSUE

How are Hydro One and OPG being accounted for in the Province’s 2015-16 Public Accounts?

KEY FACTS

- Canadian accounting standards related to rate regulated entities (e.g. OPG and Hydro One) changed January 1, 2015 and would require that these entities follow International Financial Reporting Standards (with an option to follow a transitionary standard IFRS 14 which grandfathers rate regulated accounting).
- The Introduction to PSAB standards, states that government business enterprieses should adopt accounting standards applicable to publicly accountable enterprises (holding public debt or equirty) as per Part 1 of the Handbook which references International Financial Reporting Standards (IFRS). PSAB standards for consolidation of GBEs would required that OPG and H1 be consolidated on a modified equity basis of accounting which would refrelect their results based on US GAAP which is the basis of reporting that they both use, as permitted by securities regulators and the OEB.
- Results under IFRS could differ materially from results that would otherwise be reported under US GAAP, both under IFRS 14 and moreso under pure IFRS if the International Accounting Standards Board decides not to adopt rate regulated accounting in its standards.
- If the results for OPG and Hydro One were reflected on the Province's books an an IFRS basis, costs associated with OPG's asset retirement obligation (related to nuclear plants) would be significantly different under IFRS than under US GAAP reporting. This variance is due to a difference in the discount rate methodology when present valuing the obligation.
- In addition to the discount rate impact noted above, there is a risk that rate regulated accounting may be removed from IFRS standards which could result in even greater volatility on the Province's future results. In the meantime, IFRS 14 is intended to temporarily grandfather rate regulated acocuntign for first time adopters of IFRS.
- It is the Province's position that reporting the results of OPG and H1 on a US GAAP basis is the only option to 'fairly' present the results of the government since it is the same basis upon which the entities themselves report and that their rates are set on. Both the Ontario Energy Board and securities regulators accept US GAAP based financial statements from OPG and H1.
- The AG has stated that for purposes of her audit she expects the government to adhere to PSAB's standards which would require the results of the entities to be reflected on IFRS basis of accounting.
- For the 2015-16 Public Accounts, the AG required that both H1 and OPG undertake a detailed analysis of the differences between USGAAP and IFRS, and that their analysis be subject to independent audit. The level of materiality required by the AG for this exercise was not consistent with the level of materiality applied by the AG in the past for consolidated results of OPG and Hydro One.

- For the 2015-16 Public Accounts, the results for OPG and Hydro One have been reflected on a US GAAP basis. For purposes of the AG's Error Summary, the Auditor required that OPG's original discount rate methodology intreoduced during last year's Public Accounts process, despite the fact that OPCD advised the AG of a preferred alternative approach that the entity had identified that they would want to use if they were to transition to IFRS.

- Under the methodology used by the AG to compute the US GAAP vs. IFRS error for audit purposes, it is anticipated that the difference will be significant to the Province's Public Accounts in 2016/17 and could result in a qualified audit opinion.

- In early 2016, TBS reached out to the Public Sector Accountign Standards Board to seek clarification on the conflict between PSAB's Introduction to the Handbook which would require that the results of OPG and H1 be reflected on an IFRS basis compared to authoritative PSAB standards which would require modified equity accounting. Despite discussion at both its March and June Board meetings, the Board advised TBS that they would not be considering any future changes to the Introduction to address this matter.

BACKGROUND

- As a matter of policy, Ontario's Budget, Estimates and Public Accounts are all prepared on a consistent set of standards set by the on Public Sector Accounting Board (PSAB).

- As a sovereign government, the Province is not bound by PSAB. A key objective of financial reporting is to ensure that the province's reports reflect the economic substance of the government's activities and supports sound fiscal policy decisions.

- Under PSAB GBEs are expected to use standards applicable to 'publicly accountable enterprises' (defined as entities with public debt or equity). Despite the fact that US GAAP is used by numerous publicly accountable enterprise (e.g. TransCanada Pipelines, Enbridge Gas and Fortis), PSAB has not been updated to reflect this fact and continues to only reference IFRS as the basis for GBE reporting.

- OPG and H1 report based on US GAAP accounting standards and have received unqualified audited opinions on their statements which are accepted by the SEC, OSC and the OEB.

- Effective January 1, 2015 rate regulated GBEs are directed by the accounting standard setters to transition to IFRS. OPG and Hydro One will continue to report on US GAAP which best meet the needs of the users of their financial statements (e.g. the OEB, public, credit rating agencies). Since PSAB continues to refer only to IFRS, under PSAB the results of OPG and H1 would have to be reported on the Province's books on an IFRS basis for the 2015/16 Public Accounts.

- Based on a preliminary analysis of information provided by OPG and Hydro One, the financial impact of reflecting the results for OPG and Hydro One on an IFRS basis are anticipated to be materially different than under US GAAP, impacting the fiscal outlook in respect to the government's path to balance and beyond. For example, a change in discount rate for nuclear related liabilities could result in a $1 billion negative impact in 2016/17.

- In addition, there is uncertainty regarding the future of rate regulated accounting under IFRS. If rate regulated accounting is removed from IFRS in the future, the Province's annual results and net debt would be subject to even <u>greater</u> volatility.

- Reflecting the results of OPG and Hydro One in the Public Accounts on an IFRS basis would:

    - Introduce inconsistency with the audited US GAAP based results reported by OPG and H1.
    - Cause confusion for users if rate regulated accounting is removed from IFRS in the future (as to which costs have to be covered by taxpayers vs. rate payers).
    - Introduce volatility in the Province's annual surplus/deficit and net debt over the path to balance and beyond.
    - Pose communication challenges in presenting the Province's performance in addressing the deficit over the path to balance.
    - Additional time, cost and effort to produce and obtain audit assurance on a second set of IFRS based results purely for CFS purposes.

- In order to **fairly** present the financial results of the Province, it may be necessary to deviate from PSAB in the Province's Public Accounts by adopting US GAAP as the basis for consolidation of OPG and Hydro One.

- The Province's financial statements are subject to independent by the Auditor General who under the AG Act is required to express her opinion as to whether the consolidated financial statements of Ontario present fairly information in accordance with **appropriate** generally accepted accounting policies.

- Depending on the results of ongoing stakeholdering efforts, the government may consider regulating accounting policies related to consolidation of its government business enterprises to ensure that the Province's financial reports reflect the same basis of reporting used by the entities for external reporting.

- Pending any regulatory changes, the government will also consider whether amendments to the AG Act may desirable to better reflect the basis upon which the government reports and to more closely align the AG's financial audit mandate with other Senior Governments in Canada, including the Federal government.

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Date: **September 28, 2016**