Office of the Provincial Controller

Financial Reporting Risks

November 14, 2016

Briefing to Associate Deputy Minister

Purpose

- To highlight immediate and longer-term financial reporting issues
  - Accounting for GBEs (Hydro One and OPG)
  - Pension Accounting
  - Changes in PSAB standards
  - Specific transactions (transfer payments, Metrolinx)
  - Timing and frequency of financial reports
  - Audit risks (contaminated sites, system changes)

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

- Proposed Implementation Plans

Background

- The Provincial Budget and Public Accounts will be impacted by new and future changes to public and private sector accounting standards
- Potential risks:
  - Consistency between the Province’s Budgets and Public Accounts
  - Consistency between results reported by OPG and H1 vs. Public Accounts
  - Outcome of Pension Asset Expert Advisory Panel and AG acceptance
  - PSAB’s conceptual framework project and financial instruments standard review
  - Outcome of IASB’s rate regulated project
  - Volatility in the Province’s annual surplus/deficit (e.g. path to balance)
  - Impact on key financial indicators (net debt, net debt to GDP)
  - Reduced transparency and accountability
- As a sovereign government, the Province is not bound by PSAB. Legislation is in place to allow for a regulatory solution to mitigate risks.
- The government regulated accounting for pension assets for the 2015/16 Public Accounts.
- Under the AG Act, Ontario’s Auditor General’s 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 (2016/17)
3. Specific transactions (transfer payments, Metrolinx)
4. Cap and Trade accounting
5. AG Materiality for Public Accounts
6. Implementation of Hyperion Financial Management (parallel run)
7. Presentation (consolidation of BPS, CASs)
8. AG review of Contaminated Sites
9. Additional sale of Hydro One
10. Implementation of Related Party disclosures

Future:

1. Accounting for Financial Instruments
2. PSAB Conceptual Framework
3. Basis for accounting for balanced budget legislation (budget and actuals)
4. PSAB standard changes on AROs, assets, revenues, pensions
5. Timing and frequency of internal and external financial reporting
6. Timing for release of 2016/17 Public Accounts

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.

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
- **OPG and Hydro One** –
  - Both OPG and H1 were consolidated in the past on Canadian GAAP (until 2014/15)
  - 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 on 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 SUDs listing. The largest impact relates to the discount rate on the Nuclear asset retirement obligation. This difference is expected to be material.
  - Despite an interim IFRS standard which grandfathers rate regulated accounting, there is <u>no certainty</u> that the IASB's project will retain rate regulated accounting in the future.
  - If in the future PSAB eliminates modified equity accounting for GBEs, the Province would consolidate GBEs on a line by line basis. Assets, liabilities/debt, revenues and expenses would be reported on a line by line basis without rate regulated accounting vs. one line accounting for investment in GBEs and reporting revenue from GBEs.

Risks Related to GBE Reporting (H1&OPG)

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

- Significant volatility under IFRS-based reporting for OPG/H1, especially due to the discount rate for OPG's Asset Retirement Obligation (see **Appendix A**)
- A decline in the relevance and usefulness of PSAS as basis for Budgeting may cause a change to new basis of budgeting, resulting in 2 versions of the budget and 2 sets of actual results.
- Inconsistency between results reported by OPG/H1 on US GAAP vs. IFRS based results in the CFS.
- Potential future changes in IFRS standards (e.g. rate regulated accounting, leases, pensions, etc.) may increase volatility in the CFS and cause further divergence from audited US GAAP-based reports issued by OPG and H1.
- Potential line by line consolidation of GBEs (Net Debt increase, elimination of rate regulated balances and intangibles which are not reflected under PSAS).
- Continued disagreement with AG on date for reporting of accounting for changes in standards applicable to GBEs with December 31st year ends (i.e. report as of April 1st of subsequent period).

Rate Regulated Accounting – High Risk (Future IASB decisions)

- Canadian accounting standards and US GAAP reflect regulated accounting which allow entities to defer and amortize rate-regulated assets of the periods in which the related revenues are reflected in rates, thus matching costs and revenues.
- Under PSAB, all GBEs are required to adopt International Financial Reporting Standards (IFRS).
- There is no certainty that rate regulated accounting will be introduced into IFRS, despite the existence of an interim (temporary) standard which grandfathers existing rate regulated accounting for first time IFRS adopters. If OPG and Hydro One were consolidated on an IFRS basis and rate regulated accounting was subsequently discontinued, the Province's Net Debt would increase by at least $3B and significant volatility would be introduced into the Province's annual surplus/deficit.
- Reflecting OPG and H1 results on an IFRS basis in the Public Accounts will result in two different balance sheets and actual results being reported for each of the entities (OPG and H1 issue US GAAP f/s, while for Public Accounts results and balances would be reflected on an IFRS basis). Differences between the two sets of reports will be most significantly impacted by differences in accounting for Asset Retirement Obligations and the potential outcome of the IASB's rate regulated accounting project.
- In February, 2015 TBS requested that PSAB consider acknowledging US GAAP reporting for purposes of GBE consolidation, but a negative response was received.

LT 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 between results reported by OPG/H1 (US GAAP) and Public Accounts (IFRS) may be material.
   - Additional time, cost and effort would be involved in preparing a second set of IFRS based budgets and financial reports for Budget & CFS purposes, as well as time and cost associated with audit of second set of IFRS-based numbers. Cost are not expected to be recoverable through rates.
   - IFRS accounting introduces greater volatility on the Province's books , compared to US GAAP
   - Risk continues regarding potential elimination of rate regulated accounting under IFRS, as well as risks associated with other changes to IFRS
   - AG disagreement on effective reporting date for changes in standards for OPG/H1 would continue.
2) **Regulate Consistent Accounting for GBEs**
   - Confirm 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

Recommendations

OPCD recommends that Treasury Board Secretariat work with its partners to draft appropriate regulation to address accounting for GBEs on the Province's consolidated financial reports, retroactive to April 1, 2016 (*not to prior year*):

1. ***GBEs would be consolidated on a modified equity basis, on the same basis of GAAP that the entity uses for reporting (i.e. US GAAP/IFRS).***
2. ***Results for GBEs would be modified to conform with the Province's accounting policies with regards to elimination of unrealized gains and losses.***
3. ***Confirm subsequent period implementation of changes to accounting standards/policies for GBEs with different reporting periods (December 31 year-ends).***

OPCD also recommends a comparison of Ontario's *Auditor General Act* against other senior governments' AG Acts. A change should acknowledge the fact that governments are sovereign and that CFS can reflect legislated accounting as well as PSAB. As such, consider removing the reference to 'appropriate GAAP' for purposes of issuing an independent audit opinion of the Province's Public Accounts. Note that references to legislated accounting were reflected in the AG Mandate prior to 2004 (per Legal Services Branch). Any changes in the AG Act should be retroactive to April 1, 2016 to align with introduction of legislated accounting for GBEs.

Implementation Plan (GBE Acctg)

	Step	Actions
November December 2016	1. Internal Briefings re: risks and potential solutions (acctg. reg)	Brief TBS, MOF, OEFC, MOE on issues and recommendation to proceed with accounting regulation
	2. Confirm policy direction	Confirm policy direction (through TB)
	3. Finalize draft of acctg. regulation	Legal Services Branch to work with MAG
	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 included in Budget Bill or Spring Billl	OPCD
Feb 2017	7. Support review of Auditor General Act and Comms products for Budget Document/Spring Bill	OPCD (TBS) to work with TBS, MOF, MAG on possible changes
Spring 2017	8. Changes to Audit General Act could be reflected in Budget document or Spring Bill (TBD)	TBS & MOF Legal

Implementation Plan (Pensions)

TBS

	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 Document	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 OAG 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
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)

Appendix B

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.

Appendix B

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

- 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).

Appendix D
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 project underway to review its asset definition.
- The final standard 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

- Consultation Paper (#3) presented problematic suggestions which would reduce the integrity and relevance of the Statement of Operations (the key financial statement for fiscal accountability and transparency purposes)
- The proposals threatened to lead to a divergence between the basis upon which the Province's budget is prepared and the basis of reporting actual results. Proposals may lead to 2 different versions of budgets and actual results.
- PSAB has since confirmed that it be planning to retain historical cost as the basis for measurement.

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.

Appendix D

Audit - 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.

Areas of Focus -- 2016-17 Public Accounts

TBS

High risk

1. Pension assets and pension economic assumptions
2. OPG and H1 – use of US GAAP to consolidate operations
   - AG accepted US GAAP on the basis of materiality in 2015-16, but required disclosure of differences using a methodology for OPG's asset retirement obligation that is inconsistent with OPG's view of a preferred accounting policy; AG has stated she will continue to require the same methodology in 2016-17 (expected deficit impact of $1B – increase to deficit)
3. Accounting for transfer payments made at year-end – AG rejected guidance agreed to by previous AG that had been used for year-end transfers – impact on accounting for current year 4th quarter investments
4. Materiality– expecting AG to reduce materiality re: path to balance goals (2015-16 materiality = $660M)

- Compiled from planning memo, draft audit findings report for 2015-16, and SUDs listing

Areas of Focus -- 2016-17 Public Accounts

TBS

Medium risk

6. Liabilities for contaminated sites
   - Follow up on prior year audit on adoption of standard – will need to focus on both updating estimates and ensuring new liabilities are captured
7. Additional sale of Hydro One
   - Sale to OPG (related party) and transactions with Chiefs of Ontario/First Nations
8. Accounting for Cap & Trade proceeds – new transaction stream
9. Consolidation – what is consolidated and how
   - Universities – AG will review analysis at university level
   - Children's Aid Societies -- AG believes these should be consolidated
   - Monitoring of WSIB and MVAC
   - Consolidation principles used by BPS – income statement expense presented net of 3rd party revenues -- AG recommends line by line consolidation
10. Non-Ontario Nuclear Funds Agreement unrealized gains/losses – AG recommends they should be recorded in statement of revenues and expenses – not recognized currently

- Compiled from planning memo, draft audit findings report for 2015-16, and SUDs listing