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

Independent Electricity System Operator

Audit Findings Report to the Audit Committee

For the Year Ended December 31, 2017

Auditing and professional standards require that the auditor communicate to the Audit Committee ("those charged with oversight") certain information regarding the scope and results of the audit that may assist those charged with oversight in fulfilling its responsibilities to:

- review the financial statements for the year ended December 31, 2017; and
- recommend that the Board of Directors approve the financial statements.

However, as this report is a by-product of the audit it does not necessarily identify all matters that may be of interest to those charged with oversight in fulfilling its responsibilities. The required communications are summarized below by area.

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Auditors' Responsibilities Under Canadian Generally Accepted Auditing Standards (GAAS) Our audit was designed in accordance with Canadian GAAS to provide reasonable, but not absolute, assurance that the financial statements are free of material misstatement.	We completed our audit of the Independent Electricity System Operator's (IESO) December 31, 2017 financial statements in accordance with Canadian GAAS, as outlined in our Audit Planning Report to those charged with oversight dated January 11, 2018 with the exception of the following items: • *Receipt of a signed representation letter by management dated on March 8, 2018 (the Board's approval of the financial statements);* • *Actuary report using sensitivity analysis for discount rate used for the unfunded plans;* • *Completion of our audit work on the collateral pledged;* • *Written responses to our standard fraud questions; and* • *Acknowledgment of management and those charged with governance of their roles and responsibilities.* We will be issuing a disclaimer of opinion on the financial statements. We are providing a disclaimer of opinion, as required by Canadian Auditing Standards, due to the refusal of management and those charged with governance to acknowledge their roles and responsibilities in our audit and failure to sign a management representation letter addressed to us. We are unable to withdraw from the audit due to our responsibilities under the Auditor General Act and the significance of the transactions of IESO to the consolidated financial statements of the Province of Ontario. Our audit opinion on the financial statements will be dated March 8, 2018, the date of approval of the

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	financial statements by the Board of Directors. **See Appendix B for copy of the audit opinion.** Despite our requests, we were not informed of the date of the Audit Committee meeting to recommend approval of the financial statements or the Board of Directors meeting to approve the financial statements until after such meetings had taken place. The IESO informed us that the Board approved the financial statements on March 8, 2018. Although we have requested a copy of the minutes indicating the board approval, we have not yet received it.
Auditors' Independence Auditors are required to report annually on their independence to those charged with oversight.	We are objective and are not aware of any relationship with the IESO that would impair our independence for the purpose of expressing an opinion on the financial statements. Our independence and compliance with ethical standards was discussed in detail in our Audit Planning Report to those charged with oversight dated January 11, 2018.
Significant Accounting Policies Management is responsible for selecting the appropriate financial reporting and selecting accounting policies in accordance with this framework. Significant accounting policies, as well as changes to those policies or to their application, and any new accounting and reporting standards introduced during the year, must be disclosed.	The significant accounting policies used by the IESO have been applied in accordance with the Canadian public sector accounting standards (PSAS) and have been adequately disclosed in the notes to the financial statements except for the regulated assets and market accounts, which are not permitted under PSAS. Significant changes to the financial statements from the previous year (December 31, 2016): • Statement of operations – added new section “Other government programs” • Note 3 – Regulated Assets (prior year Note 3 was new accounting policies for regulated assets and market accounts) • Note 5 – Market Accounts – includes the details of the Fair Hydro Plan transactions, Market Debt and Related Party Transactions with the market • Note 9 – Post-Employment Benefits Plans • Note 12 – Segment Expenses – discloses the nature of expenses for Core operations, Other Government Programs, Smart Metering and

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	Market Sanctions (previously included in statement of operations). • A number of notes were expanded to make reference to regulatory assets and market accounts resulting from the Fair Hydro Plan designed accounting.
Management Judgments and Accounting Estimates Preparing financial statements usually requires the use of accounting estimates. Certain estimates are particularly sensitive because of their significance to the financial statements and the possibility that future events may differ significantly from management's expectations.	The significant accounting estimates used in preparing the financial statements were the carrying value of tangible capital assets, accrued pension liability and accrual for employee future benefits other than pensions. We concluded on the basis of the best information available at the time that the estimates used by management were reasonable and were disclosed adequately in the notes to the financial statements except for the discount rates used to determine the non-registered pension plan and the other post-employment benefits which are discussed below in the Financial Reporting Errors section.
Results of Work Performed and Key Findings Our audit approach to significant financial statement areas was communicated in our Audit Planning Report dated January 11, 2018. Significant financial statement areas were identified as: • Management override of controls • Revenue recognition and market participant rebates • Market accounts and regulatory assets	In each of the significant financial statement areas (except for market accounts and regulatory assets), the results of testing were satisfactory and the work performed was based on the procedures identified in our Audit Planning Report dated January 11, 2018. The exceptions to the satisfactory results were market accounts and regulatory assets, which are discussed below in the Significant Matters Discussed with Management section.
Other Information in Documents Containing Audited Financial Statements Management is responsible for providing us with the annual report or any other publication that will contain the audited financial statements, with sufficient lead time for us to review it prior to printing.	We will review any such documents provided to us to ensure that the audited financial statements have been accurately reproduced and that other financial information in the document is consistent with the audited statements. We will report any unresolved matters resulting from our review to those charged with oversight. As detailed in our Audit Planning Report dated January 11, 2018, the IESO is required to submit an annual report to Minister of Energy within 90 days of fiscal year-end. The IESO is also responsible for

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	posting the annual report on a provincial agency or government website within 30 days of tabling in the legislature. We noted that the annual report for the year ended December 31, 2016 was submitted to the Ministry of Energy before the deadline. As well, we noted that the annual report was published online within the allotted time frame. We will continue to monitor the IESO's progress in meeting these requirements on a timely basis.
Dealing with Management and Those Charged with Governance We must report matters such as our inability to obtain essential information, significant delays in receiving information, or receiving unreliable information.	While IESO management and those charged with governance have agreed to comply and fully cooperate with our audit of IESO's December 31, 2017 financial statements, the following are examples where management has interfered with the audit: • IESO management designated an individual to be an IESO audit coordinator to attend all meetings between IESO staff and our auditors to record conversations, comments, and all audit requests. • We observed one instance where the IESO audit coordinator emailed an IESO employee during a meeting with our auditor asking for details because she was unable to attend the meeting. • In a discussion with another IESO employee, we became aware that staff could not send audit requests directly to our auditors. The IESO employee stated that this was the protocol established by IESO management. • One of our auditors verbally requested documentation from the Finance Manager, which she agreed was not an issue. The IESO audit coordinator subsequently sent our auditor an email requesting him to make all audit requests through email. • The audit coordinator's position is Advisor, Government Affairs.

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	• Management has refused to sign the acknowledgment of roles and responsibilities and the management representation letter. • The Chairs of the Board and Audit Committee engaged us in a litany of letters with the message that they would cooperate, while still stating that they would not sign the documents needed for us to complete our audit in accordance with Canadian Auditing Standards (e.g., audit planning report and letter of representation). As well, we did not receive written responses to our standard fraud questions. Their actions, at the end of the day, did not demonstrate full cooperation. • Despite numerous requests for the date of the Board meeting to approve the financial statements, management claimed that they did not know when the meeting would be held and upon subsequent requests did not provide responses. Management did not inform us of the date until after the Board meeting had taken place. The above examples demonstrate that the “tone at the top” at the IESO is not one of complete openness and transparency.
Significant Matters Discussed with Management We must report matters such as management’s consultations with other accountants on accounting principles and other financial reporting matters, business strategies that may affect the risk of material misstatement and any disagreements with management on accounting and financial reporting matters.	We reviewed all materials provided to us on the rate regulated accounting and market accounts policies and that our conclusions were based on our review of this material, our own analysis and support obtained from the recently retired Director of the Public Sector Accounting Standards Board, the other Auditors General in Canada, a former Auditor General, and major external private sector accounting and auditing firms. **Fair Hydro Plan – Summary of Unadjusted Differences (SUD) #1** Starting in 2017, under the Fair Hydro Plan, the IESO continues to settle the market and recover Global Adjustment from customers, but as a result of the fair adjustment applicable to specified consumers, the IESO collects less than the full amount of the Global Adjustment. The shortfall, costs of financing the shortfall, the carrying costs of the Fair Hydro Trust, and certain other amounts relating to the Fair Hydro Plan are recorded in a new Deferred Global Adjustment Variance account. The cumulative

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	amount recorded in this variance account to the end of December 2017 was $1.378 billion. The IESO has chosen to apply the guidance set out in United States Generally Accepted Accounting Principles (US GAAP) Topic 980, Regulated Operations, in recognizing this variance account as a regulated asset in its market accounts. This is not permitted under Canadian public sector accounting standards (PSAS). PSAS does not allow an “other government organization” to use rate-regulated accounting as it does not comply with the definitions of assets and liabilities set out in PS 1000, Financial statement concepts. On December 21, 2017, the IESO received $1.179 billion from the Fair Hydro Trust. The IESO characterizes this transaction as a sale of a regulated asset. However, as it is inappropriate for the IESO to recognize regulated assets, the IESO has essentially financed the shortfall through the Fair Hydro Trust. As a result, the IESO should account for this as a financing transaction by recognizing a $1.179 billion note payable to the Fair Hydro Trust on its statement of financial position with a corresponding loss in its statement of operations. The loss represents the shortfall that the IESO was previously recognizing as a regulated asset in the variance account. As at December 31, 2017, the balance of the variance account was $0.199 billion. As such, the IESO should recognize a liability on its statement of financial position and a corresponding loss on the statement of operations in this amount for the year ended December 31, 2017. In total, the loss should be $1.378 billion. **Rate Regulation – SUD #2** As at January 1, 2016, the IESO changed its accounting policy regarding the recognition of assets and liabilities subject to rate regulation. The IESO retroactively applied this change, which resulted in the recognition of previously unrecorded regulatory assets of five years prior for its unrecovered smart metering expenses ($40.849 million) and unrecovered PSAB transition items ($47.353 million), and a decrease in the amounts previously reported for accumulated deficit ($88.202 million). In 2017, the IESO increased smart metering charges and system fees by $21.623 million (2016 – $19.226

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	million) and $3.912 million (2016 - $3.912 million) in order to account for the amortization of deferred expenses realized in the fiscal year. As at December 31, 2017, the IESO had fully recovered the smart metering expenses, which resulted in a $nil balance in the regulated asset account. There is still a $39.529 million balance for the unrecovered PSAB transition items. As an "other government organization" that applies public sector accounting standards, the IESO cannot apply the guidance set out in United States Generally Accepted Accounting Principles (US GAAP) Topic 980, Regulated Operations. Therefore, the IESO should not recognize regulated assets for the unrecovered smart metering expenses and unrecovered PSAB transition items. In addition, the deferral of any transition costs related to retirement benefits and other post-employment benefits is not permitted under PS 2125 (First-time adoption), specifically PS 2125.05 and .07. In order to comply with public sector accounting standards, the IESO should perform the following adjustments to its December 31, 2017 financial statements: • In the comparative period, opening accumulated deficit should be increased by $88.202 million, smart metering charges and system fees should have increased by $19.226 million and $3.912 million respectively, and ending accumulated deficit should have decreased to $65.064 million. • In the current period, opening accumulated deficit should increase by $65.064 million, smart metering charges and system fees should increase by $25.535 million, $21.623 million and $3.912 million respectively, and ending accumulated deficit should decrease to $39.529 million. **Market Accounts – SUD #3** As at January 1, 2016, the IESO changed its accounting policy regarding the recognition of market accounts assets and liabilities on the statement of financial position. The IESO retroactively applied this change, which resulted in an increase of $1.443 billion to both financial assets and liabilities. There was no impact to opening and ending accumulated deficit, or to the annual deficit as the market accounts will always settle to a $nil balance in accordance with

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	market rules. As at December 31, 2016, the IESO recorded balances in financial assets and liabilities of $1.667 billion. These market accounts are not assets and liabilities of the IESO. 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. As a result, financial assets and liabilities are both overstated by $2.005 billion (2016 – $1.667 billion) as at December 31, 2017. There is no effect on the statement of operations.
Financial Reporting Errors Errors, both intentional and unintentional, include calculation/input mistakes, improper application of accounting principles, and inadequate disclosure. Material accounting and disclosure errors are those that are likely to change or influence the decisions of persons relying on the financial statements and must therefore be corrected. We are required to report all financial reporting errors, other than those that are clearly trivial. For the purposes of our audit, trivial errors are defined as errors that are inconsequential, both individually and in the aggregate.	Based on materiality of $3,000,000, we have set a threshold of $2,250,000 that we used in determining whether misstatements that were accumulated during the audit require adjustment. We noted the following financial reporting errors: Seven misstatements that in the aggregate overstates reported income by $1.353 billion, overstates total financial assets by $2.046 billion, overstates total liabilities by $0.628 billion and overstates accumulated surplus by $0.065 billion. Additional adjustments will be necessary once we receive the actuary report providing a sensitivity analysis for the impact of discount rate changes required under Canadian PSAS for the unfunded plans. **All non-trivial financial reporting errors are provided in Appendix A**. Canadian GAAS require us to discuss any non-trivial errors with management and request that management correct all such errors identified during the course of our audit. Management agreed to correct three misstatements, which were a correction of a 2016 error between cash and accounts receivable, a correction for vacation entitlement accrual (and offsetting adjustment to rebates due to market participants) and a correction to security deposits. Management decided not to correct remaining errors that in the aggregate overstates reported income by $1.353 billion, overstates total financial assets by $2.045 billion, overstates total liabilities by $0.627 billion and overstates accumulated surplus by $0.065 billion. Management believes that the items related to rate regulated accounting and market accounts are

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	correct, and we disagree with their assessment that rate regulated accounting and market accounts are allowable under PSAS. Management also believes that items related to their unfunded pension and retirement benefit plans are correct. We disagree with their assessment. SUD entry #4 in **Appendix A** relates to IESO using a discount rate based on the expected return on plan assets in valuing its supplemental executive retirement plan (SERP) and other post-employment benefit (OPEB) obligations. PS 3250 requires IESO to use a discount rate based on the cost of borrowing for unfunded plans (such as the SERP and OPEB). We have requested IESO to have their actuary calculate the adjustment. As such, we are unable to determine the impact of the error at this time. The expected impact will be material (e.g., greater than $3.0 million) and should be adjusted in the current year and prior years. Based on a preliminary calculation made by IESO's actuary, the impact of a 100 to 200 basis point reduction in the discount rate results in an increase of $25 million to $55 million, respectively, to the non-RPP and OPEB total defined benefit plan obligations as at December 31, 2017. **Disclosure Deficiencies** *Disclosures for Defined Benefit Pension Plan* The IESO provides aggregated disclosure for both its registered and non-registered defined benefit pension plans. On a market-value basis (and market-related value basis), the registered plan is in a funded status whereas the non-registered plan is in a net unfunded status (i.e., the benefit obligation is in excess of plan assets). Therefore, the IESO should disclose the non-registered plan separately from the registered plan. Also, while the IESO discloses the expected return on plan assets, it does not disclose the actual return on plan assets during the period as required under PS 3250.084(s). *Disclosure Deficiency Regarding the Use of Comparative Figures Note* We draw attention to the corrected error in **Appendix A** showing an error correction of $5.909 million between cash and accounts receivable in the comparative period (2016). As part of correcting this

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	material prior year error, management added Note 17 (Comparative Figures) indicating that this is a reclassification to conform to current year presentation. This note mischaracterizes this adjustment to the presentation of the 2016 balance sheet in response to a 2017 reclassification. In fact, this adjustment is to correct a 2016 error that flows through the cash and accounts receivable balances in 2017. *Disclosure Deficiency Regarding the Collateral and Security Agreement for the Fair Hydro Trust* Pursuant to a Security Agreement, the IESO has pledged the receivables from local distribution companies (LDCs), which it reports under "Market accounts – assets" in the financial statements, as collateral for the payment of carrying costs due from the IESO to the Fair Hydro Trust under Regulation 206/17 made under the Ontario Fair Hydro Plan Act, 2017. This pledge of security subordinates the claims of power generators against the market accounts for electricity supplied under contract to the IESO administered market in favour of the now senior claims of the Fair Hydro Trust. The notes to the financial statements have no disclosure of the Security Agreement or the pledging of the market accounts as collateral. Trivial financial reporting errors, which are those that were less than $150,000, were not reported.
Significant Deficiencies in Internal Control Management is responsible for establishing a system of internal controls that enables the preparation of financial statements that are free from material misstatement, whether due to fraud or error. A significant deficiency is a control deficiency, or a combination of control deficiencies, that can lead to a material misstatement of the financial statements or loss of assets that would not be prevented, or detected and corrected, on a timely basis.	The purpose of our audit is to express an opinion on the financial statements, not the systems of internal control. However, during the course of our audit, we may note significant control deficiencies relevant to the financial statements in order to design appropriate audit procedures to address the risks identified. We noted the following significant deficiencies in internal control: **Bank Reconciliations Not Properly Prepared for 2016 and 2017** As part of our control-based audit procedures, we requested the IESO finance and accounting department to provide bank reconciliations for each of its bank accounts in the general ledger. We received a package prepared by the Treasury department that

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	included a tie-out of the cash accounts on the general ledger to 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. As a result, there was an unexplained difference of \$8.111 million (2016 - \$7.152 million) between the cash accounts recorded in the general ledger and the December 31 bank statements. We requested the IESO finance and accounting department to provide a proof of balance for the A/P clearing account. 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. Subsequent to us bringing this issue to management's attention, management discussed it with KPMG. **Recommendation** We recommend 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 prepares timely and appropriate bank reconciliations, and has sufficient internal controls over bank transactions.*

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	The IESO agrees that the noted issue was not appropriately adjusted in a timely manner, but notes that 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 and a repeated event has not occurred. *In the future the IESO commits to preparing timely reconciliations of general ledger accounts and conducting proof of balances throughout each fiscal year, in order to continue to ensure that a repeated event does not occur.* **Manual Override of Controls by Human Resources without Proper Approvals** Based on our understanding of internal controls, we expected payroll to review and approve all compensation changes entered as a workflow by HR associates. During testing, we observed one instance where an HR associate manually entered an employee's compensation change in HR Success Factors (i.e., there was no workflow). We requested and received evidence that supported the compensation change, but there was no evidence of review and approval by payroll. Based on our subsequent discussion with payroll, the HR associate did not communicate this compensation change to payroll. This resulted in $114 underpayment to the affected employee for the week in which the retroactive payment should have been paid. Per our discussion with payroll, the employee received this payment in January 2018. We observed another instance where an HR associate manually entered compensation changes into HR Success Factors. The HR associate was unable to provide any evidence of communication to payroll for review and approval. Given these observed instances of manual override, there is a risk that employees that 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 no one is responsible for reviewing manual entries in the HR Success Factors system.

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	Recommendation We recommend the IESO restrict HR associates from being able to override controls when entering compensation changes in HR Success Factors. Alternatively, the IESO should determine whether it is possible for HR Success Factors to generate exception reports. A supervisor should review and approve exceptions against supporting documentation on a timely basis. **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.* **Manual Changes Made to Payroll without Proper Approvals** We noted that HR Success Factors automatically interfaces most compensation changes to Ceridian Insync on a daily basis. However, payroll must enter some payroll changes, such as severance payments, retroactive payments, and certain dates manually into Ceridian Insync. Furthermore, payroll has the ability to override certain information. In discussions with payroll, we determined that payroll associates are responsible for both making manual entries in Ceridian Insync and reviewing those changes for completeness and accuracy. We 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

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	payroll information and the reviewer. We also noted that payroll could not provide a report summarizing all payroll changes for each pay period. The Ceridian Insync system does not appear to have this functionality readily available. While we did not note any errors in its substantive testing relating to these control gaps, the lack of controls could lead to incorrect payments to employees or unnoticed fraudulent transactions. **Recommendation** We recommend the IESO to ensure that an individual that is not responsible for entering information into the system reviews changes to Ceridian Insync data against supporting documentation each pay period. In addition, in order to facilitate this review, the Ceridian Insync 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 is in the process of upgrading its payroll system. Automation is a key focus of this project and it is IESO's intent to reduce the need for manual entries. This project is expected to be completed by Q3, 2018.* *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.* **Security Deposits not Fully Tracked and Reconciled to General Ledger** We requested the IESO finance and accounting department to provide a proof of balance of its security deposit accounts.

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	In response to our request, IESO's contract management area investigated the balance and determined that it primarily comprised of two items: 1) deposits for contracts for $14.700 million and 2) procurement applications for $0.800 million. There is a remaining unexplained difference of $1.279 million between the amount that is in the general ledger and the listing provided by the program area. Management corrected these errors. Management does not regulary review the security deposit balance or prepare proofs of balance. Without performing a proof of balance, IESO does not track the cash flows on an individual customer basis and management cannot identify who is owed a refund on security deposits on a financial reporting date. **Recommendation** We recommend the IESO prepare reconciliations for each of its significant general ledger accounts that do not have an automated subledger 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 commits to preparing timely reconciliations of general ledger accounts and conducting proof of balances throughout each fiscal year.* The matters being reported are limited to those deficiencies that we have identified and concluded are of sufficient importance to merit being reported to those charged with oversight.
Compliance with Provincial Requirements Regarding Expense Claims The external auditors of Ontario's agencies, boards, and commissions are expected to examine internal controls designed to ensure compliance with provincial policies and legislation regarding expense claims by employees and contract staff. This work can also be carried out by or in conjunction with Ontario Internal Audit.	We reviewed the controls established by management and the Board to ensure compliance with provincial policies and legislation regarding expense claims by employees and contract staff, and examined a sample of claims to check that the controls were operating effectively during 2017. We did not find any weaknesses in the compliance controls and did not find any serious instances of non-compliance in the sample we tested.

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	We also noted that IESO's expense policies are generally consistent with those established for the OPS.
Fraud and Illegal Acts In planning our audit, we ask those charged with oversight and management to confirm their respective responsibilities regarding the prevention and detection of fraud or illegal acts, and whether they had any knowledge of fraud, suspected fraud, or illegal acts and if so, what action was taken. Also, in the course of our audit we may find evidence that suggests that a material misstatement may have been the result of a fraud or illegal act.	Both those charged with oversight and management advised us verbally that they were not aware of any fraud, suspected fraud, or illegal acts. In the course of our audit, we did not find any evidence indicating material misstatements resulting from fraud or illegal acts. We again request written responses to the standard fraud questions.
Written Representations Management is required to provide us with a written statement that management has fulfilled its responsibility for the preparation of the financial statements. Management must also represent that it has provided us with full access and all relevant information and has recorded and reflected all transactions in the financial statements.	We again request that management provide us with a signed representation letter dated March 8, 2018. These representations would appear in substantially the same form as those listed in **Appendix A**. Management and those charged with governance have indicated that a written representation will not be addressed to us. As a result, under Canadian Auditing Standards, we are required to provide a disclaimer of opinion as outlined in **Appendix B**.
Related-party Transactions Parties are related if one party has the ability to exercise, directly or indirectly, control, joint control, or significant influence over the other. Two or more parties are related when they are subject to common control, joint control or common significant influence. Common examples of related parties are: management, directors, their immediate families, and public-sector entities controlled by the provincial government.	Our review of related-party transactions found that the majority of these transactions were properly identified and measured. However, additional disclosures are required related to the related party transactions for the Fair Hydro Plan. Although we disagree with the IESO including market accounts and rate regulated accounting in the financial statements, should the IESO continue to disclose the Fair Hydro Plan transactions with the recording of market accounts and rate regulated assets, disclosures would be incomplete without an economic dependence disclosure. As well, the statement of cash flows currently shows no impact from the Fair Hydro Plan.

Other Matters

Those charged with oversight should consider the following additional matters when recommending the financial statements for approval by the Board:

Process Descriptions and Control Narratives Not Available

We 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 us to acquire this documentation from its auditor, KPMG LLP.

We subsequently obtained and reviewed the documentation from KPMG LLP, but determined that it was insufficiently detailed for the purposes of carrying out our audit of IESO's December 31, 2017 financial statements. As a result, we 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 represents a business risk to IESO. As indicated, management is responsible for the documentation of processes and controls.

After we left the field and during final reporting, we were provided with process narratives. However, we noted some of the narratives have not been updated since 2008 (e.g., Kronos and payroll).

Recommendation
We recommend the IESO update and maintain process descriptions and/or narratives of its internal controls related to financial reporting.

Management Response
The IESO will continue to review and update its process descriptions and control narratives related to financial reporting, as appropriate. However, the IESO disagrees with the assertion that it lacks process descriptions and control narratives related to financial reporting, and believes the current documents are accurate and effective.

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	CSAE 3416 Report on Market Settlement Operations Systems Needed with Annual Coverage 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. We 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 to 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, we recommend 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.*

Appendix A — Management Representation Letter

March 8, 2018

Ms. Bonnie Lysyk, MBA, FCPA, FCA, LPA
Auditor General
Office of the Auditor General of Ontario
20 Dundas Street West, Suite 1530
Toronto, Ontario
M5G 2C2

Dear Ms. Lysyk:

We are providing this representation letter in connection with your special audit of the accounts and transactions forming the financial statements of the Independent Electricity System Operator (IESO) for the year ended December 31, 2017, for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations and cash flows in accordance with Canadian public sector accounting standards. We are providing representation until March 8, 2018, which is the date the financial statements were approved by our Board of Directors and the date of your audit opinion.

We acknowledge that we are responsible for the fair presentation of the financial statements in accordance with Canadian public sector accounting standards and for the design and implementation of internal control to prevent and detect fraud and error. We acknowledge that your examination was planned and conducted in accordance with Canadian generally accepted auditing standards so as to enable you to express an opinion on the financial statements. We understand that while your work includes an examination of the accounting system, internal control, and related data to the extent you considered necessary in the circumstances, it is not designed to identify, nor can it be expected to disclose, fraud, shortages, errors, and other irregularities, should any exist.

Certain representations in this letter are described as being limited to matters that are material. An item is considered material, regardless of its monetary value, if it is probable that its omission from or misstatement in the financial statements would influence the decision of a reasonable person relying on the financial statements.

We confirm, to the best of our knowledge and belief, as of March 8, 2018, the following representations made to you during your audit.

Financial Statements

1. The financial statements referred to above present fairly, in all material respects, the financial position of the IESO as at December 31, 2017, and the results of its operations and its cash flows for the year then ended in accordance with Canadian public sector accounting standards.

Completeness of Information

2. Proper books of account have been kept, and the financial statements at the statement of financial position date are in agreement with them.

3. We have provided you with:

    - Access to all information of which we are aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters;

    - Additional information that you have requested from us for the purpose of the audit, including minutes of meetings of directors of committees of directors held throughout the period and up to the date of your auditor’s report.

    - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.

4. All accounts and transactions have been appropriately described and properly recorded or disclosed in the financial statements and in the accounting records underlying the financial statements.

Fraud and Error

5. We have assessed the risk that the financial statements may be materially misstated as a result of fraud and have determined such risk to be low.

6. We have no knowledge of fraud or suspected fraud that affects the entity and involves:

    - Management;

    - Employees who have significant roles in internal control; or

    - Others where the fraud could have a material effect on the financial statements.

7. We have no knowledge of any allegations of fraud or suspected fraud affecting the IESO’s financial statements communicated by employees, former employees, regulators, or others.

8. All actions taken by the IESO have been within its corporate powers. We are unaware of any violations or suspected or possible violations of laws or regulations, the effects of which should be considered for disclosure in the financial statements or as the basis for recording a contingent loss.

9. We have no knowledge of any illegal acts committed by the IESO’s directors, officers, or employees acting on the IESO’s behalf, the consequences of which could result in a significant misstatement of the financial statements.

10. We acknowledge that we have received a copy of the schedule of unadjusted errors and have attached it to this representation letter. We disagree with the unadjusted items listed as errors relating to market accounts, regulated assets and discount rates used for the non-registered pension plans and other post-employment benefits.

11. We have reviewed and approved all the following matters arising from your audit:

- journal entries your auditor prepared or changed;
- account codes your auditor determined or changed;
- transactions classified by your auditor; and
- accounting records your auditor prepared or changed.

Recognition, Measurement, and Disclosure

12. The IESO has satisfactory title to all owned assets, and such assets have been fairly stated and recorded in the accounts. Where the value of any asset has been impaired, an appropriate provision has been made in the account. There are no liens or encumbrances on such assets, nor has any asset been pledged.

13. The IESO has granted a security interest to the Fair Hydro Trust for the amounts collected and receivable from licensed distribution companies and other electricity vendors between December 21, 2017 and June 30, 2021. This pledge of collateral serves as a general and continuing security for the IESO's statutory obligation to pay the carrying costs of the Fair Hydro Trust from April 1, 2017 and June 30, 2021.

14. We have identified to you, and appropriately measured and disclosed in the financial statements, all known related parties and related-party transactions, including guarantees, non-monetary transactions, and transactions for no consideration, in accordance with the requirements of Canadian public sector accounting standards.

15. We assume responsibility for the findings of our expert in evaluating rate regulated accounting and market accounts and have adequately considered the qualifications of the experts in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give or cause any instructions to be given to experts with respect to the values or amounts derived in an attempt to bias their work, and we are not otherwise aware of any matters that have had an impact on the independence or objectivity of the experts.

16. There are no off-balance-sheet financial instruments.

17. All information regarding terms and conditions, interest-rate risk, credit risk, and fair value of financial instruments has been properly disclosed.

18. We have included budgetary data in our financial statements, which is relevant to the users of financial statements and consistent with that originally planned and approved by the Minister of Energy. Planned results and amounts were presented for the same scope of activities and on a basis consistent with that used for actual results.

19. We have disclosed to you and properly identified in the accounting records all the IESO's bank accounts, as well as any funds held on behalf of the IESO by other parties.

20. The receivables shown in the statement of financial position represent bona fide claims against debtors for charges arising on or before the statement date. These receivables do not include any amounts that are collectible after one year. The amount recorded for doubtful accounts and allowances is sufficient to provide for losses that may be sustained on realization of the receivables.

21. The estimated useful lives of tangible capital assets, as disclosed in the financial statements, are a reasonable basis for amortization.

22. We have disclosed to you all significant estimates and fair value measurements. We believe that:
    a. the measurement methods used are in accordance with Canadian public sector accounting standards and are appropriate in the circumstances and consistently applied;
    b. the underlying assumptions reflect management's best estimates, are reasonable and consistently applied; and
    c. significant estimates and measurement uncertainties known to management that are required to be disclosed in accordance with *PS 2130, Measurement Uncertainty* have been appropriately disclosed.

23. We have disclosed to you, and the IESO has complied with, all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance.

24. All arrangements, whether formal or informal, explicit or implied, to provide retirement income and other post-retirement benefits to employees after they cease employment have been disclosed to you.

25. Employee future benefit obligations, costs and assets have been determined, accounted for and disclosed in accordance with the requirements of *PS 3250, Retirement Benefits* and *PS 3255, Post-employment Benefits, Compensated Absences and Termination Benefits.*

    In particular:
    a. The significant accounting policies that IESO has adopted in applying *PS 3250, Retirement Benefits and PS 3255, Post-employment Benefits, Compensated Absences and Termination Benefits* are accurately and completely disclosed in the notes to the financial statements.
    b. Each of the best estimate assumptions used reflects management's judgment of the most likely outcomes of future events.
    c. The best estimate assumptions used are, as a whole, internally consistent, and consistent with the asset valuation method adopted.
    d. The discount rate used to determine the accrued benefit obligation was determined by reference to the IESO's borrowing rate rates at the measurement date on high-quality debt instruments with cash flows that match the timing and amount of expected benefit payments; or inherent in the amount at which the accrued benefit obligation could be settled.
    e. The assumptions included in the actuarial valuation are those that management instructed Aon Hewitt to use in computing amounts to be used by management in determining pension costs and obligations and in making required disclosures in the above-named financial statements, in accordance with *PS 3250*.
    f. In arriving at these assumptions, management has obtained the advice of Aon Hewitt, but has retained the final responsibility for them.
    g. The source data and plan provisions provided to the actuary for preparation of the actuarial valuation are accurate and complete.
    h. All changes to plan provisions or events occurring subsequent to the date of the actuarial valuation and up to the date of this letter have been considered in the determination of pension costs and obligations and as such have been communicated to you as well as to the actuary.
    i. The extrapolations are accurate and properly reflect the effects of changes and events that occurred subsequent to the most recent valuation and that had a material effect on the extrapolation.

j. We agree with the findings of Aon Hewitt as management's expert in evaluating the valuation of employee future benefits and have adequately considered the qualifications of the expert in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give or cause any instructions to be given to specialists with respect to the values or amounts derived in an attempt to bias their work, and we are not otherwise aware of any matters that have had an impact on the independence or objectivity of the specialists.

26. There were no direct or contingent liabilities, contractual obligations, or substantial commitments, whether written or oral, other than those incurred in the ordinary course of business, that would materially affect the financial statements and would require disclosure in the financial statements.

27. There are no outstanding legal actions or possible legal claims that existed at the statement date and up to the date of your auditor’s report, whether or not they have been discussed with legal counsel, that would require disclosure in the financial statements.

28. The financial statements do not report any known or contingent liabilities arising from environmental matters because there are none to report.

29. No events have occurred subsequent to the statement date and up to the date of your auditor’s report that Canadian public sector accounting standards would require adjustment to or disclosure in the financial statements.

30. No significant matters, other than those disclosed in the financial statements, have arisen that would require a restatement of the comparative figures presented in the financial statements.

Sincerely,

Peter Gregg, CEO

Kim Marshall, CFO

Appendix A

Summary of Adjusted and Unadjusted Differences - IESO
December 31, 2017
(in thousands)

Item	Proposed Correcting Entry	Description of Error	Income Effect Current Period	Current Assets	Current Liabilities	Non-Current Liabilities	Equity
			$	$	$	$	$
Summary of Adjusted Difference							
1	DR Cash CR Accounts Receivable	To correct an accounting error from 2016 - 5,909 increase in cash and decrease in A/R		5,909 (5,909)			
2	DR Accounts payable CR Accounts receivable	To record the balance of the security deposits to actual		(1,279)	1,279		
3a	DR Salary expense CR Accounts Payable	To correct vacation entitlement accrual	885		(885)		
3b	DR Rebates Due to Market Participants CR Revenue	To record offsetting entry for adjustment to market participants	(885)		885		
Summary Unadjusted Differences – Fair Hydro Plan							
1	DR Core operations expenses CR A/P CR Debt	Recognition of the Cumulative Deferred Global Adjustment Variance and the financing of the shortfall by Fair Hydro Trust	1,378,475		(199,475)	(1,179,000)	
2	DR Surplus CR Regulated assets CR Smart Meter Charges CR System Fees	To derecognize the effects of rate regulatory accounting	(25,535)	(39,529)			65,064
3	DR Market accounts - liabilities CR Market accounts - assets	To derecognize the market accounts		(2,005,167)	2,005,167		
Summary Unadjusted Differences – Other than Fair Hydro Plan							
4	DR Pension Expense CR Pension Liability	IESO using a discount rate based on expected return on assets in unfunded plans	X,XXX*			(XX,XXX)*	(XX,XXX)*
Aggregate of unadjusted differences			**1,352,940 + SUD #4**	**(2,044,696)**	**1,805,692**	**(1,179,000) + SUD #4**	**65,064 + SUD #4**
Aggregate of all audit differences			**1,352,940 + SUD #4**	**(2,045,975)**	**1,806,971**	**(1,179,000) + SUD #4**	**65,064 + SUD #4**

*Note: To be updated for revised accounting valuation from IESO's actuary.

Disclosure Deficiencies

Disclosures for Defined Benefit Pension Plan

The IESO provides aggregated disclosure for both its registered and non-registered defined benefit pension plans. On a market-value basis (and market-related value basis), the registered plan is in a funded status whereas the non-registered plan is in an unfunded status (i.e., the benefit obligation is in excess of plan assets). Therefore, the IESO should disclose the non-registered plan separately from the registered plan. While the IESO discloses the expected return on plan assets, it does not disclose the actual return on plan assets during the period as required under PS 3250.084(s).

Disclosure Deficiency Regarding the Use of Comparative Figures Note

We draw attention to the corrected error in the table above showing an error correction of $5.909 million between cash and accounts receivable in the comparative period (2016). As part of correcting this material prior year error, management added Note 17 (Comparative Figures) indicating that this is a reclassification to conform to current year presentation. This note mischaracterizes this adjustment to the presentation of the 2016 balance sheet in response to a 2017 reclassification. In fact, this adjustment is to correct a 2016 error that flows through the cash and accounts receivable balances in 2017.

Disclosure Deficiency Regarding the Collateral and Security Agreement for the Fair Hydro Trust

Pursuant to a Security Agreement, the IESO has pledged the receivables from local distribution companies (LDCs), which it reports as market accounts – assets in the financial statements, as collateral for the payment of carrying costs due from the IESO to the Fair Hydro Trust under Regulation 206/17 made under the Ontario Fair Hydro Plan Act, 2017. This pledge of security subordinates the claims of power generators against the market accounts for electricity supplied under contract to the IESO administered market in favour of the now senior claims of the Fair Hydro Trust. The notes to the financial statements have no disclosure of the Security Agreement or the pledging of the market accounts as collateral.

Appendix B — Auditor's Report

DRAFT

INDEPENDENT AUDITOR'S REPORT

To the Independent Electricity System Operator and
The Standing Committee on Public Accounts of Ontario

Report on the Financial Statements

I have audited the accompanying financial statements of the Independent Electricity System Operator (IESO), which comprise the statement of financial position as at December 31, 2017, and the statements of operations and accumulated surplus, remeasurement gains and losses, changes in net debt, and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian public sector accounting standards, and for such internal control as management determines is necessary to enable the preparation of 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 financial statements based on conducting the audit in accordance with Canadian generally accepted auditing standards. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

Management and those charged with governance refused to acknowledge their roles and responsibilities in my audit and they have failed to sign a management representation letter addressed to me to confirm that management has fulfilled their responsibilities for the financial statements. As a result of this refusal, I am unable to obtain assurance over the accuracy and completeness of information provided by and representations made to me by management and those charged with governance.

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion, I have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, I do not express an opinion on the financial statements.

Other Matter

The financial statements of the IESO for the year ended December 31, 2016 were audited by another auditor who expressed an unqualified opinion on those financial statements on March 22, 2017.

Report on Matters Arising from Special Audit

Auditor General Act

As the Auditor General, I have a responsibility under the Auditor General Act (Act) to report on matters that are significant to the consolidated financial statements of the Province of Ontario. When something of the magnitude, described below, affects the consolidated financial statements of the Province of Ontario, I am also responsible under the Act to take additional steps to understand and investigate the transactions.

Inappropriate Inclusion of Rate Regulated Assets and Market Accounts

As described in Notes 2d, 2e, 3, 5, 7 and 14c to these financial statements, 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 recognized 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 its 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 arising 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 legislated shortfall, the IESO receives advances from Fair Hydro Trust, a related party. At the same time, the IESO records the sale of a rate regulated asset 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.

These departures will impact the Province's consolidated financial statements for the year ended March 31, 2018 unless corrected by the Province. Based on the transactions for the period up to December 31, 2017, the estimated impact on the Province's consolidated financial statements is as follows:

- Understatement of Annual Deficit by $1.353 billion
- Overstatement of Total Financial Assets by $2.045 billion
- Overstatement of Total Liabilities by $0.627 billion
- Understatement of Provincial Net Debt by $1.418 billion
- Understatement of Accumulated Deficit by $1.418 billion

Inappropriate Discount Rate Used on Unfunded Retirement Benefit Plans

As described in Note 2i to these financial statements, the IESO uses an expected return on plan assets as the discount rate to value all of its pension and other post-employment plan liabilities. IESO provides certain non-registered defined benefit pensions and other employee future benefits through two unfunded non-registered benefit plans. As these unfunded plans have no plan assets, it is inappropriate to use an expected rate of return on plan assets for the discount rate. In accordance with PSAS, the IESO should use a discount rate based on their cost of borrowing for these unfunded plans. The impact of using an inappropriate discount rate is likely to be material to the IESO with a reportable difference on the Province's consolidated financial statements.

Disclosure Deficiency Regarding Collateral and Security Agreement for 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 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. The notes to the financial statements of IESO do not disclose the existence or the terms of the Security Agreement. This disclosure is material to the IESO and a reportable difference on the Province's consolidated financial statements. Under the current Market Rules, the IESO has no access or discretion to use the market account assets for its own benefit.

Toronto, Ontario
March 8, 2018

Bonnie Lysyk, MBA, FCPA, FCA, LPA
Auditor General

Appendix C — Management Letter

Ms. Kimberly Marshall
Vice President, Corporate Services and Chief Financial Officer
Independent Electricity System Operator
1600-120 Adelaide Street West
Toronto, ON
M5H 1T1

Dear Ms. Marshall,

During our audit of the Independent Electricity System Operator's (IESO) December 31, 2017 financial statements, certain matters came to our attention on which we would like to comment.

Our responsibility is to plan and perform an audit to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement. An audit is not designed to provide absolute assurance that there are no misstatements in the financial statements resulting from fraud, irregularities or errors. The responsibility for the prevention and detection of errors rests with management.

Since our examination did not include a complete review of all accounting procedures, systems of internal control and compliance matters, the following comments may not necessarily identify all weaknesses that may be present.

If you have any further questions with respect to these or any other matters, please don't hesitate to call me at 416-550-1680.

Sincerely,

Bonnie Lysyk
Auditor General

CC: Carole Workman, Chair of the Audit Committee

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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

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.

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 has opted to use 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. Based on a calculation made by IESO's actuary, the impact of a 100 to 200 basis point reduction in the discount rate results in an increase of $25 million to $55 million, respectively, to the non-RPP and OPEB total defined benefit plan obligations as at December 31, 2017.

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 is aware that the Public Sector Accounting Board recently issued an invitation to comment on how the discount rate under PSAB is determined. When changes are made, the IESO will review and consider adopting a new discount rate methodology, if appropriate.

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. More specifically the discount rate on the registered pension plan is determined with reference to the expected return on plan assets and the discount rates assumptions for the other plans are determined with reference to the discount rate on the registered pension plan.

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

As of March 20, 2018, no response has been received from management.

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 prepares timely and appropriate bank reconciliations, and has sufficient internal controls over bank transactions.

The IESO agrees that the noted issue was not appropriately adjusted in a timely manner, but notes that 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 and a repeated event has not occurred.

In the future the IESO commits to preparing timely reconciliations of general ledger accounts and conducting proof of balances throughout each fiscal year, in order to continue to ensure that a repeated event does not occur.

Auditor General's Response

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 commits to preparing timely reconciliations of general ledger accounts and conducting proof of balances throughout each fiscal year.

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 is in the process of upgrading its payroll system. Automation is a key focus of this project and it is IESO's intent to reduce the need for manual entries. This project is expected to be completed by Q3, 2018.

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 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. However, the IESO disagrees with the assertion that it lacks 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.