

FW: Globe & Mail Story re FHP Accounting

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From: Kwamena, Boafoa (CAB)
Sent: Saturday, April 21, 2018 9:42:23 AM (UTC-05:00) Eastern Time (US & Canada)
To: Orsini, Steve (CAB); Bromm, William (CAB)
Cc: Betzner, Lynn (CAB); Farrow, Alicia (CAB)
Subject: Re: Globe & Mail Story re FHP Accounting

[Issue note attached.](#)

[Sent from my BlackBerry 10 smartphone on the Rogers network.](#)

From: Kwamena, Boafoa (CAB)
Sent: Saturday, April 21, 2018 9:40 AM
To: Orsini, Steve (CAB); Bromm, William (CAB)
Subject: Globe & Mail Story re FHP Accounting

[See highlights. A number of civil servants are named.](#)

There's also a [video](#) on the Globe website that describes the accounting structure

Bad books: How Ontario's new hydro accounting could cost taxpayers billions; As Ontarians head to the polls in June, voters have to make sense of two competing versions of their province's bottom line: The Auditor-General's and the Kathleen Wynne government's. Matthew McClearn investigates how creative accounting in hydro revenue made their math so different

theglobeandmail.com
Sat Apr 21 2018, 8:25am ET
Section: National
Byline: Matthew McClearn

In March last year, Kim Marshall called and left a message for Bonnie Lysyk, Ontario's Auditor-General. Ms. Marshall was the chief financial officer of the Independent Electricity System Operator (IESO), the agency that manages the province's electrical system and acts as an intermediary between power generators and consumers. The IESO had just made a big change to its accounting practices, and Ms. Marshall said she wanted to give the Auditor-General a "heads up."

Ms. Lysyk was already well aware of the change. She and her staff had found the IESO's latest financial statements

online. Poring over them in their downtown Toronto office, they found a terse footnote describing the new accounting policy.

"And my staff go, 'What the heck is this?' " Ms. Lysyk told **The Globe and Mail**. "You're not supposed to do this."

Ms. Lysyk believed the IESO's new practice - a method known as rate-regulated accounting - violated government accounting standards. What she didn't know was that it represented a radical departure in how the government of Premier Kathleen Wynne - not just the IESO - planned to disclose its future borrowing activities to the public.

Earlier that month, the government had announced significant reductions in electricity rates, what it dubbed the Fair Hydro Plan. A decade of investing in greener power sources, such as wind and solar, and the shuttering of cheaper but dirtier coal-fired power plants had resulted in soaring hydro bills - a serious political liability for Ms. Wynne, who had accepted personal responsibility for fixing the problem.

But charging Ontarians less for electricity than it cost to produce meant the province would have to borrow billions of dollars to cover the shortfall.

"In order for that to not show up on the bottom line, they created creative accounting to take it off the government's statements," Ms. Lysyk said.

Using that new accounting, the government declared it had balanced the province's books for the fiscal year ended Mar. 31, 2018, just months before a general election. But Ms. Lysyk said that was not true. And the Financial Accountability Office, the body responsible for providing the legislative assembly with independent analysis and advice on Ontario's finances, agreed: In December, it forecast that the province would actually rack up a deficit of \$4-billion - a discrepancy that will grow markedly as the government's off-balance-sheet borrowing continues.

Ms. Lysyk said she's worried that the Wynne government's success in concealing its borrowing will encourage more aggressive bookkeeping, both in Ontario and in other provinces.

"If you get away with doing something that's inappropriate accounting, the next time you'll do it again and you'll do it again," she said. "Pretty soon they won't have any numbers that will have any integrity behind them."

Ontario had been racking up large deficits every year since the 2008-09 recession and already owed more than \$300-billion - almost \$22,000 for every person in the province. Bond rating agencies had downgraded its credit rating. That, too, had become a serious political liability.

Even before Ms. Wynne became Premier in 2013, Ontario's Liberals promised a return to balanced budgets. In his April, 2017, budget speech, Finance Minister Charles Sousa boasted that her government had finally done it. "And next year and the year after we're projecting it to be balanced, too," he declared. "And the people of Ontario can count on it."

It was made possible by a team led by the Ministry of Energy that also included senior officials from the Ministry of Finance, Treasury Board Secretariat, the Provincial Controller, Ontario Power Generation and the IESO. Between December, 2016, and May, 2017, they devised a novel approach that would allow the government to have its cake and eat it, too.

'The government is making up its own accounting rules'

As with most businesses, utilities record consumers' outstanding balances as assets, typically as "accounts receivable." **The IESO's new practice, rate-regulated accounting, is akin to accounts receivable on steroids.** The underlying idea is that heavily regulated industries, such as power generation, which are unable to set their own prices, should have a means of deferring costs, such as building a new power plant. Rate-regulated accounting allows utilities to place such costs in special accounts to carry them forward into future years, provided their regulator gives them the right to recover those costs through future bills. Such rights can be recorded as assets - even though no electricity has been generated, used or billed for.

The main criticism of the practice is that it can produce books bearing little resemblance to reality. When BC Hydro

adopted it, that province's auditor-general objected strongly, warning in a special report that "if overused, rate-regulated deferrals can mask the true costs of doing business, distort the financial condition of an enterprise and place undue burdens on future taxpayers."

And what happens if the utility can't collect? "On a number of occasions," explained Michael Ferguson, the Auditor-General of Canada, "there has [later] come a realization that, in fact, the organization will not be able to charge those rates. And, therefore, there have been fairly large amounts of some regulatory assets that have been written off."

Recording expenses as assets is perfectly legal in certain contexts, but the practice has been controversial in the private sector. In their book *Easy Prey* Investors, forensic accountants Al Rosen and Mark Rosen write that recording "fake assets" on corporate balance sheets is one of the "most common financial scams of the past 50 years."

If the accounting concept is elusive, the IESO's motives for adopting it are even murkier.

In fact, the IESO decided against adopting rate-regulated accounting when it was formed in 2015 - a decision supported by its auditor, KPMG. And earlier this year, Ms. Marshall told the province's public accounts committee that in February, 2017, she presented financial statements prepared in the usual way to her audit committee.

The following month, though, she produced a fresh set of financial statements using rate-regulated accounting.

The official explanation is that in mid-January, 2017, at one of the earliest meetings to discuss the Fair Hydro Plan, Ontario Controller Cindy Veinot ordered Ms. Marshall to "take a closer look" at adopting rate-regulated accounting because she didn't think the IESO's existing policies were appropriate.

The government has repeatedly stated that Ms. Veinot's request was completely unrelated to the Fair Hydro Plan. Deputy energy minister Serge Imbrogno asserted that "the important thing is that the changes that the IESO made reflected its existing business" and not the Fair Hydro Plan, which had not been announced yet. Peter Gregg, who was appointed IESO president and CEO in April, 2017, said the management team simply asked itself: "Is this the right thing to do?"

Since Canada's public sector accounting standards make no mention of rate-regulated accounting, the IESO turned to private-sector standards in the United States known as generally accepted accounting principles, which permit the practice.

The official story overlooks two crucial details. First, while the IESO was changing its accounting policy, Mr. Imbrogno, Ms. Marshall, Ms. Veinot and other senior officials were already part of the team devising the Fair Hydro Plan. Enacted last June, the Fair Hydro Plan Act put IESO's new policy to immediate use, instructing the IESO to create a "regulatory asset" on its books. This "asset" reflected the agency's right to recover the costs it was about to incur paying for hydro discounts from future consumers, over a 30-year period.

Tim Beauchamp, a member of the auditor-general's advisory panel and a former director of the Public Sector Accounting Board, said the entire accounting structure of the Fair Hydro Plan depended on the IESO's ability to call this right an asset. "Without [the IESO], it doesn't work," he said.

The second detail is that, as an agency of the Province of Ontario, the IESO's finances are consolidated into the province's public accounts. With the provincial controller's encouragement, the agency's management had effectively adopted a new accounting policy on behalf of the entire province.

With those new rules in place, the Fair Hydro Plan could proceed. Here's how it works:

Ontario Power Generation, which operates the province's fleet of nuclear and hydroelectric stations, has assigned four of its employees to manage the Fair Hydro Trust, a special-purpose entity created in December. OPG's financial results will actually get a boost because it will earn interest and management fees from the trust. And OPG doesn't need to worry if the trust blows up financially, because the trust "is structured to be bankruptcy remote and ring fenced from OPG."

Even so, OPG appears to be the only arm of government that has expressed reservations about its role in the Fair Hydro Plan. "OPG's reputation could potentially be adversely impacted through its involvement as the Financial Services Manager under the Fair Hydro Act," the company warned in its 2017 annual report.

The Fair Hydro Plan's complexity comes at a cost. Had the province borrowed directly, the interest costs likely would total tens of billions of dollars over the plan's duration. But using information and assumptions supplied by the government, the Financial Accountability Office (FAO) calculated the additional interest costs at \$4-billion over 30 years. Said Ms. Lysyk: "We're talking \$4-billion more than needed, to get an accounting result."

Alexandre Laurin, the C.D. Howe Institute's research director, said he'd never before encountered such a convoluted arrangement in the public sphere. To him, the use of related party transactions between multiple entities resembles tax-avoidance schemes in the private sector.

"The same accountants that are advising the government are advising the private sector to build other types of complex accounting structures," he told The Globe. "How crazy is this, really?"

FAO officials had immediate concerns. "It looked like there was at least a very novel new approach being taken to a large amount of planned borrowing and repayment," chief financial analyst Jeffrey Novak said.

Meanwhile, the auditor-general's office scrambled to find out what had happened. Ms. Lysyk demanded tens of thousands of pages of briefings and e-mails created by the Fair Hydro Plan's architects. She began meeting with the senior officials responsible and their advisers, including KPMG.

Months later, she concluded that the IESO's accounting change was no mere coincidence: The government had instructed the Fair Hydro Plan's architects that the rate reductions must not cause a reported increase in the province's deficit and net debt. Other options were rejected on that basis.

Energy Minister Glenn Thibeault categorically denied accusations that the Fair Hydro Plan was an election ploy. And he justified the new accounting practice that made it possible by telling the provinces's estimates committee last October that because electricity ratepayers, not taxpayers, would be required to repay the debt and interest costs associated with the Fair Hydro Plan, the associated costs did not belong on the province's books.

In order to weigh the Auditor-General's allegations against the government's position, The Globe sought the same documents Ms. Lysyk used in preparing her reports. Her office is not subject to the province's Freedom of Information and Protection of Privacy Act, so The Globe requested them from the departments that originally produced them.

In responses to the requests, all the departments anticipated that large volumes of records would fall under exemptions in the act. The Treasury Board Secretariat, for example, said that of the 1,500 or so relevant pages in the possession of its deputy minister, just 169 would be released. Citing the large number of records involved, the Ministry of Energy estimated The Globe would be charged \$112,000 in fees, half of that up front.

So The Globe issued narrower requests and also asked that the Information and Privacy Commission mediate some of them. At publication time, The Globe had received no documents.

'Don't tell the Auditor-General what we're doing'

What is clear is that, in devising the Fair Hydro Plan, the government relied heavily on consultants, including three of the world's "Big Four" accounting firms: KPMG, Deloitte and Ernst & Young. It also hired Blakes, a law firm. According to the Auditor-General, the government paid these advisers a total of \$2-million for their services. In a statement, the Treasury Board Secretariat emphasized that work was part of the government's efforts to "ensure due diligence was completed."

Their opinions and advice carried the day. Sophie Kiwala, a Liberal MPP and member of the estimates committee, said on Oct. 24: "Our plan has been approved by the peers of the Auditor-General at some of Canada's top accounting firms, including Ernst & Young, KPMG and Deloitte."

KPMG's team, composed of more than half a dozen of the firm's partners, was led by Michel Picard. In one 32-page

document(www.theglobeandmail.com)) provided to The Globe by the government, KPMG itemized and refuted the Auditor-General's objections to the new accounting practice. "The concerns expressed by the AGO result from a difference of opinion in the application of professional judgment," KPMG spokesperson Lisa Papas told The Globe in a statement. As the auditor of IESO's books, the firm also signed off on the application of these new accounting standards, just as it had under the IESO's previous accounting methods. "We would like to emphasize that the standards provide a choice," the firm said in a statement. "There has always been the ability to choose between two alternatives."

In the past three years, KPMG earned between \$86,000 and \$92,000 in annual fees for auditing IESO's books. Last year, it earned \$652,000 for its advice on the new accounting policy.

Did KPMG's dual role as auditor and consultant represent a conflict of interest? "You might say that their ability to be impartial and effective auditors had become compromised," said Randy Hillier, a Conservative MPP who sits on the public accounts committee. "Why would you not [sign off] when you're getting such a significant bundle of cash?"

Ms. Lysyk told the same committee that firms should not be advocating for particular accounting treatments on a client's behalf while auditing the client's books.

Forensic accountant Al Rosen said that, generally speaking, it's not difficult to hire consultants to provide favourable accounting opinions in Canada, in part because standards are so elastic. "You can go to any of the public accounting firms and get them to render an opinion on whatever you want," he said. "The ethics have gone all to hell."

KPMG and the IESO denied any impropriety. "It is very common for auditors to provide advisory services to help their clients understand the application of complex accounting matters," KPMG said in a statement.

Should the Auditor-General have been consulted?

On Jan. 11, 2017, as Ms. Lysyk's office prepared to audit Ontario's public accounts, it sent a letter to KPMG asking if there would be any accounting policy changes at the IESO. KPMG did not respond. There was a follow-up phone call, but KPMG did not call back. In Ms. Lysyk's opinion, KPMG had a professional obligation to respond.

She also felt that the Ministry of Finance and the Treasury Board should have told her earlier. "You do assume when you're the external auditor for anybody that you're kept in the loop," she said. "That's the relationship, it should be open and transparent."

She said the e-mails reviewed by her office confirm that the architects of the Fair Hydro Plan expected her office to object to the IESO's proposed accounting changes - and that their silence had been deliberate. "All the stuff said, 'Don't tell the Auditor-General what we're doing.'"

Helen Angus, the deputy minister of the Treasury Board Secretariat, resisted that allegation before the public accounts committee. "I don't think we second-guessed the Auditor-General on her opinion," she said.

KPMG agreed that it had a professional obligation to respond to the Auditor-General's requests, but it said it discharged that duty by answering her inquiries in the months after the publication of the IESO's statements.

And the IESO's senior management saw no need whatsoever to consult the Auditor-General. Mr. Gregg, the CEO, said his obligation was to satisfy his own board of directors and its audit committee. And Ms. Marshall told MPPs in February: "We would speak to the Auditor-General once we had come to a conclusion on our own."

So what did those "approvals" from the big accounting firms actually mean? In a statement to The Globe, KPMG emphasized it had no formal role in selecting or approving Ontario's accounting policies. Nor did Deloitte. Ernst & Young declined to answer questions about its work.

The Auditor General's office, on the other hand, is the only body responsible by law for opining on whether the province's financial statements have been prepared according to appropriate accounting standards. And if the

government did not stand down, Ms. Lysyk warned, she would issue a qualified opinion on Ontario's books.

Other auditors-general confirmed that is not something they do lightly.

"It's one of the most serious things we can do ... to say we don't believe this set of financial statements has been fairly stated," said Mr. Ferguson, Canada's Auditor-General.

Ms. Lysyk said she received letters from all the other auditors-general in Canada supporting her position. Although she declined to release those letters to The Globe, Mr. Ferguson confirmed that wrote such a letter.

So did Carol Bellringer, B.C.'s Auditor-General. "It's inconsistent with the framework that is in place for the public sector," she said. "If British Columbia decided to set up a regulatory account within its provincial accounts, we would say, 'No, you can't do that.' "

Others also rallied to Ms. Lysyk's defence. In a report(www.fao-on.org)) published in December, the FAO adopted her recommended accounting policy and warned that the government's approach "reduced the transparency and reliability of Ontario's fiscal plan."

But Ms. Wynne's government seemed untroubled by Ms. Lysyk's warnings. She had already issued a qualified opinion on a separate issue - the government's accounting for the assets of two pension funds, a matter of billions of dollars - but the government shrugged that off, too.

Deputy finance minister Scott Thompson signed the statement of responsibility on last year's public accounts, with which the government accepts responsibility for the statements' integrity and avows that they conform with public sector accounting standards. So did Ms. Veinot, the controller, and Ms. Angus, deputy minister of the Treasury Board. In theory, these signatures conferred substantial obligations upon these officials - even as the Auditor-General was warning them that the province was using improper accounting. (None of them granted The Globe an interview.)

The last line of defence was the legislature. The public accounts committee is charged with reviewing the Auditor-General's reports and making recommendations to the Legislative Assembly. When it convened in February to discuss the Auditor-General's concerns, Mr. Hillier, the Tory MPP, flagged the issue as unusual. "This committee has a track record of being non-partisan to a large extent," he said - suggesting, though, that neutrality might be difficult when it came to the politically charged Fair Hydro Plan.

Indeed, the committee's questioning split along party lines. Mr. Hillier and NDP MPP John Vanthof hammered the officials involved in creating the financial and accounting structure, demanding justification for the additional interest costs.

Liberal MPP Liz Sandals, by contrast, asked no questions about the Fair Hydro Plan. Instead, she voiced her support for rate-regulated accounting and defended the IESO's decision to not consult the Auditor-General. She used much of her allotted time to ask Mr. Thompson to comment on the balanced budget. He responded that the government was "in a very solid position to balance this fiscal year."

An era of bad books?

Last month, the government published the 2018 Pre-Election Report on the state of the province's finances. The requirement to produce that report was first introduced in 2004, by the government of Dalton McGuinty. Published in the lead-up to the 2007 election, then-finance minister Greg Sorbara presented it as an antidote to the Conservatives' alleged accounting shenanigans.

"The previous government's approach to balancing the budget was to count on phantom revenues like asset sales which they knew would not materialize," Mr. Sorbara said in a statement. "It is essential that the real state of the province's finances be known before and not after an election."

With Ontarians heading to the polls on June 7, they are confronted by two conflicting accounts about the state of their province's current and future indebtedness.

At press time, the Auditor-General's office was rushing to prepare her opinion on the Pre-Election Report. She is likely to issue another qualified opinion.

The Fair Hydro Plan triggered a breakdown of trust. Previously, the Auditor-General relied on KPMG to audit the IESO's books. Not any more: This year, she conducted her own special audit. "We couldn't risk that something else is going to pop up on this," Ms. Lysyk said.

It did not go well. Ms. Lysyk said she was "professionally unable" to provide an audit opinion because management refused to sign certain documents.

"They basically treated, I think, my audit team like we were subservient to KPMG," she told the public accounts committee. "When a board or management in any other province recognizes that an AG's office has issues with their accounting, they would have handled it differently."

Both the IESO and KPMG said they co-operated fully at all times.

Ms. Marshall will step down as the IESO's CFO at the end of this month. (No replacement has been named.) But the battle over the integrity of Ontario's financial statements rages on. In March, Ms. Lysyk warned the public accounts committee that the government risked receiving its first-ever "adverse" opinion - essentially a disclaimer that the financial statements should not be trusted.

One year after the unveiling of the Fair Hydro Plan, the irony is that the alleged raison d'être for the accounting practice that made it possible has suddenly vanished: Mr. Sousa, the finance minister, has revealed that Ontarians can no longer count on balanced budgets; he has forecast deficits of more than \$6-billion for each of the following three years as the government ramps up spending on health care, child care, social assistance and postsecondary education.

The government now forecasts its next balanced budget won't arrive until 2024-25. In a recent report examining Ontario's finances, the C.D. Howe Institute concluded: "While the government may claim to have balanced the budget for 2017/18, the medium- and long-term fiscal outlook for Ontario is dire."

Follow this link to view this story on globeandmail.com: Bad books: How Ontario's new hydro accounting could cost taxpayers billions(www.theglobeandmail.com))

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