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Office of the Provincial Controller Division

2016 Annual Report – Chapter 2 Public Accounts of Ontario

November 2016

Background

- Chapter 2 of the Auditor General's Annual Report summarizes:
  - Findings related to the audit of the Province's consolidated financial statements and Public Accounts, and
  - Comments on accounting, accountability and financial reporting matters.

Areas of Commentary – Chapter 2

- The Province's 2015-16 Consolidated Financial Statements
- Office of the Provincial Controller Division
- Government's Use of External Advisors
- Use of Legislated Accounting Standards
- Update on Ontario's Debt Burden
- Significant Accounting and Reporting Issues
- Liability for Contaminated Sites
- Financial Statement Presentation and Disclosure
- Annual Report Financial Statement Discussion and Analysis
- Significant Other Matters
- Financial Reporting Frameworks and Canadian Auditing Standards
- Update on the WSIB Unfunded Liability
- Ontario Retirement Pension Plan Initiative
- Reporting under Fiscal Transparency and Accountability Act
- Ongoing Accounting Matters
- Public Sector Accounting Board Initiatives
- Statutory Matters

2015-16 Consolidated Financial Statements

- The Auditor General expressed a qualified opinion on the Province's 2015-16 Consolidated Financial Statements on the basis that the 2014-15 comparative results were not restated to address her interpretation of pension accounting standards.
- She noted the delayed release of the Public Accounts beyond the legislative deadline, and commented that it was not the result if extraordinary circumstances.
- She also expressed her disappointment on the government's decision to release unaudited Consolidated Financial Statements.
- She states that the government's position on accounting for pension assets was finally revealed to her on October 6th when the unaudited financial statements were released.

2015-16 Consolidated Financial Statements (cont'd)

- ***Treasury Board Response:***
  - To inform the Province's accounting treatment for pension plans, the government has established an Expert Advisory Panel (the 'Panel') that will provide advice on the interpretation of PSAS to the Province's net pension assets.
  - The Panel's recommendations will inform the Province's final position paper on accounting for net pension assets which will be shared with the Office of the Auditor General.

Office of the Provincial Controller Division (OPCD)

- The Auditor General described the essential role that OPCD plays in preparation of the Province`s Consolidated Financial Statements and observed the significant workload pressures on OPCD staff.
- The Auditor General notes increasing pressures on OPCD to address new and changing reporting requirements and need to provide accurate and timely advice to internal stakeholders in addition to supporting the annual Public Accounts audit.

- ***Treasury Board Response:***
    - As part of the audit planning process for the 2016/17 Public Accounts, OPCD will work with the OAG to ensure a common understanding of all issues.

Government’s Use of External Advisors

- The Auditor General notes that the government engages external advisors throughout the year in various capacities. She calls for the full disclosure on the intent and use of external advisors to her Office including any work performed by external advisors in formulating an accounting position as part of the audit of the consolidated financial statements.

- ***Treasury Board Response:***
  - We will ensure that information required to be provided under professional standards is shared with the Office of the Auditor General.

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Legislated Accounting Standards

- As disclosed in the AG's recent Annual Reports, the AG comments on actions taken by several governments, including Ontario, to legislate specific accounting treatments in certain circumstances rather than applying independently established generally accounting standards. The AG notes Ontario's past legislation or regulations which prescribe accounting policies for its public sector entities.
- Specific examples of Ontario's legislated accounting are noted, including:
  - Investing in Ontario Act
  - Amendment to Education Act and FAA allowing governments to specify accounting standards to be used
  - Regulation directing Hydro One and OPG to use US GAAP
  - Regulation directing accounting for capital transfers
  - Strong Action for Ontario Act (Budget Measures), 2012
  - Regulation directing pension accounting
- The AG advises that recent legislative changes in respect of pension accounting, if applied retroactively would have had a material impact on the Province's comparative pension numbers for 2014-15 and for that reason her Office has issued a "qualified" opinion on the government's financial statements for 2015-16.

Legislated Accounting Standards

- ***Treasury Board Response:***
  - *The Province is committed to provide high-quality financial reports that support transparency and accountability in reporting to the public, the legislature and other users.*
  - *For the 2015-16 Public Accounts, the government passed a time-limited regulation prescribing the accounting treatment for net pension assets in order to allow Treasury Board Secretariat and Ministry of Finance officials to sign off on Public Accounts.*
  - *The recommendations of the Expert Advisory Panel on Pension Assets will help to inform the government's decision on future accounting for pension assets under public sector accounting standards.*

Ontario's Debt Burden

- The section on Ontario's Debt Burden has now become a recurring theme in the Auditor General's (AG) Annual Report.
- She comments on the fact that although the Province's debt servicing costs have stayed relatively stable, primarily due historically low interest rates, the debt itself continue to grow.
- She lists the main contributors to the rising debt as being the large deficits incurred in recent years and investments in capital assets and infrastructure.
- She notes that the Province can only begin to pay down debt if future surpluses yield cash flows over and above the amounts required to fund government operations and net investments in tangible capital assets.
- She states that by the time the Province plans to balance its books in 2017-18, Ontario's net debt will have doubled over a 10-year period from $156.6 billion in 2007-08 to over $316.9 billion by 2017-18 .

Ontario's Debt Burden (cont'd)

- The Auditor General (AG) provides an update on key indicators of the government's ability to carry its debt, specifically noting the following key measures:

  - Net Debt to GDP – illustrates the relationship between a government's obligations and its capacity to raise funds needed to meet them. A rising ratio means that net debt is growing faster than the economy. The ratio has trended steadily upward since 2008, and the net debt to GDP ration for 2015-16 is 40.9% which is 1% higher than what was projected for 2015-16 in the prior year. The increase is primarily attributable to change in accounting treatment for public sector pension asset reported in financial statements. A ratio of 60% generally means that the province's fiscal health is at risk.
  - Net Debt to Revenue – indicates the amount of time it would take the province to repay its debt if all of its revenues were dedicated to debt repayment. The ratio has been increasing steadily since 2008 and expected to top 236% by 2016-17.
  - Interest Expense to Revenue – illustrates the portion of annual revenues required to service debt. This ratio is expected to hold steady at about 9% mainly due to the historically low interest rates (regardless of the fact that debt is increasing) It is expected to be close to 10% by 2017-18.

Ontario's Debt Burden (cont'd)

- The AG highlights the consequences for the Province of carrying a large debt load including:
  - Debt servicing costs reducing the availability of funds for other programs;
  - Greater vulnerability to the impact of interest rate increases; and
  - Potential credit-rating downgrades, which would likely increase borrowing costs.
- Due to lower interest rates, the Auditor General expects that the level of interest expense to total revenue will hold steady at approximately 9% from 2009-10 to 2014-15, despite an expected increase in total borrowings by 46% or $98 billion from $212 billion to $310 billion.
- The Auditor General recommends that the government should work towards the development of a long-term total debt reduction plan to address the Province's growing total debt burden with the target of reducing the net-debt-to-GDP ratio to a pre-recession level of 27%. This is consistent with the Auditor General's recommendation made in the 2014 Annual Report.

Ontario's Debt Burden (cont'd)

- ***Treasury Board Response***
  - *The Government plans to invest about $160 billion in capital over 12 years which will, in addition to addressing much needed infrastructure requirements, improve the economic growth of the province. A September 2015 report by the Centre for Spatial Economics found that, on average, investing $1 in public infrastructure in Canada raises GDP by $1.43 in the short term and up to $3.83 in the long term.*

  - *Once balance is achieved in 2017-18, increases to net debt will be limited to the difference between the cash investment to build the assets and the amortization which is a non-cash amount. The balanced budget and the Government's continued focus on capital investment will add to economic growth, resulting in GDP growing more quickly than debt, and lowering the net debt-to-GDP ratio to the government's 27% target.*

Liability for Contaminated Sites

- In this section the AG provides some background on the new accounting standard for liabilities for contaminated sites, which was implemented by the province in fiscal 2014-15.
- She acknowledges that Office of the Provincial Controller Division (OPCD) was charged with the responsibility of leading the implementation of this standard on behalf of the province.
- She further highlighted the complexities of the standard and the difficulty in estimating environmental liabilities, and the need to rely on specialists to assess the extent of a site's contamination.
- Overall she agreed that the Office of the Provincial Controller Division implemented the standard effectively, in accordance with the PSAB standard, and that the estimated liability recorded was reasonable.

Liability for Contaminated Sites

- ***Treasury Board Response:***
  - *We are pleased that the Auditor General was satisfied with the completeness of the ministries' efforts to identify all high-risk sites and to provide a reasonable estimate of the liability reported under PSAB standards. Treasury Board Secretariat will continue to work with line ministries to support effective reporting in accordance with Public Sector Accounting Standards.*

Significant Accounting and Reporting Issues

- In January 2014, the IASB issued an interim International Financial Reporting Standard (IFRS) standard to allow rate-regulated entities to continue to apply existing policies for its regulatory deferral account balances upon adoption of IFRS starting on January 1, 2015.
- Canadian rate-regulated entities must adopt IFRS for fiscal periods beginning on or after January 1, 2015.
- Ontario had passed a regulation in 2011 allowing for and directing both OPG and Hydro One to use U.S. GAAP. The AG noted that if Ontario continues to direct both GBE's to use U.S. GAAP, and Ontario does not consolidate their results on an IFRS basis, the AG will need to assess the differences and if material, treat them as errors.
- The effect of OPG and Hydro One not adopting IFRS was determined to be immaterial to Ontario's March 31, 2016 consolidated financial statements and disclosed in note# 12 to the CFS
- The AG and OPCD will work together to plan for any changes related to the consolidation of Hydro One and OPG as a result of changes in accounting standards.
- The AG notes that she will continue to track the differences in IFRS vs. USGAAP until the government adopts the IFRS for the purpose of consolidating OPG and H1. She also anticipates the difference could be material as soon as the 2016-17 fiscal year.

Financial Statement Presentation and Disclosure (cont'd)

Treasury Board Response:

- *Treasury Board Secretariat will continue to work with the Public Sector Accounting Standards Board and the Office of the Auditor General to ensure that the Province's financial reports support transparency and accountability to the public and other users.*

Financial Statement Presentation and Disclosure

- The Office of the Auditor General undertook a review of Ontario's disclosures to assess whether further improvements were needed. They used the 2014-15 Consolidated Financial Statements as the basis for their analysis and undertook a jurisdictional review of Canada's senior governments' financial statements to support their analysis.
- The result of the jurisdictional review showed that the application of the disclosure requirements established by PSAB varied in depth and quality.
- The Auditor General notes that Ontario was more detailed than some of the other provinces in providing disclosure in certain areas, while also having less detailed disclosures in other areas. She notes that while Ontario's disclosures are in compliance with PSAB, when compared to some of the disclosures in other jurisdictions, there is still room for improvement in pension and revenue disclosure.

Financial Statement Presentation and Disclosure

Treasury Board Response

- *The Office of the Provincial Controller Division will review this recommendation and work with the Office of the Auditor General in the upcoming year.*

Annual Report Financial Statement Discussion and Analysis

- ***The Auditor General noted that the government implemented the following changes to address her recommendation from last year.***
  - Expand the comparison of the current year's results to those of the prior year and include analysis of the trends over a five-year period as related to several financial items, including an expanded discussion on balance sheet items;
  - Provide a description of the Province's capital assets, reflecting their importance in service delivery and their impact on the Province's financial condition; and
  - Include a discussion of key risks that could impact the Province's financial results.
- ***The Auditor General notes that the government's decision not to restate the prior year (2014-15) comparatives on a consistent basis as the consolidated financial statements for 2015-16 is not compliant with PSAB standards. She notes that the lack of restatement raises issues with the financial highlights, variance analysis and trend analysis which do not reflect restated financial results as would be required by PSAB standards for correction of an error.***

Significant Other Matters

- ***Sale of Hydro One Inc. and Hydro One Brampton Networks Inc.***
  - The AG discusses the Hydro One IPO and references the Building Ontario Up Act passed in June 2015 that enables the sale of up to 60% of Hydro One Inc.
  - The Auditor General details the partial sale of Hydro One including the special dividend, departure tax and the overall net gain from the sale of the shares.
  - On March 24, 2016, the government announced a tentative share sale agreement with three municipally-owned local hydro distribution companies for the province's shares of Hydro One Brampton at a price of $607 million, subject to closing conditions including approval by the Ontario Energy Board (OEB).
  - As part of next year's audit of Public Accounts, the Auditor General will examine the sale of the shares of Brampton Hydro One and the related accounting gain when the transaction is completed in late 2016.

Significant Other Matters (cont'd)

- ***Ontario Trillium Trust***
  - The Auditor General outlines the creation of the Ontario Trillium Trust and the Trillium Trust Act, 2014 noting it was created to track the prescribed amounts of financial benefits to Ontario from the sale of qualifying assets under the Act.
  - The Auditor General notes that a report on the financial activities of the Trillium Trust is included in Volume 1 of Public Accounts. She also notes that her Office reviews Volume 1 and does not audit it.
  - Going forward, the Auditor General intends to perform a detailed review on the transactions recorded in the Trillium Trust for compliance with the Trillium Trust Act, 2014.

Significant Other Matters (cont'd)

- ***Ontario Greenhouse Gas Reduction Account***

  - Under the proposed Climate Change Mitigation and Low Carbon Economy Act, all proceeds from Ontario's cap-and-trade program would be deposited in the consolidated revenue fund and the amounts would be recorded in the new Greenhouse Gas Reduction Account.
  - It is anticipated that the government will begin to collect and deposit proceeds into the consolidated revenue fund from cap-and-trade auctions in March 2017.
  - The Auditor General notes in the Report that her Office will audit the receipts and disbursements recorded in the Greenhouse Gas Accounts for compliance with the Climate Change Mitigation and Low Carbon Economy Act and regulations during the regular Public Accounts audit.

Significant Other Matters (cont'd)

- ***Pension Economic Assumptions***
  - On an annual basis, the Auditor General evaluates the key pension economic assumptions, including the discount rate, inflation rate, and salary-escalation rates.
  - This year, the Auditor General engaged an external expert advisor to assist with reviewing these economic assumptions. Based on the review this year, the Auditor General is generally satisfied that these rates were reasonable. However, she does note that in 2015-15 fiscal year, the discount rates are edging towards the high end of reasonable range.

Significant Other Matters (cont'd)

- ***Treasury Board Response:***
  - *The 2016/17 pension economic assumptions will be reviewed as part of the process for setting the assumptions for 2017/18. Assumptions from prior years are reviewed based on long-term trends, actual experience and future expectations over the previous year. Decisions are made at that time whether any changes are warranted.*

Financial Reporting Frameworks and Canadian Auditing Standards

- The Auditor General notes that users of government and public sector-entity financial statements need to be aware when legislated financial reporting framework depart from generally accepted accounting standards.
- The report notes that two of Ontario's electricity-sector entities, Hydro One and OPG prepare their financial statements using U.S. generally accepted accounting principles as determined by the securities regulators and not PSAB standards.
- The Auditor General believes that accounting standards recommended by Canadian independent standard-setters should form the basis for the preparation not only of the province's consolidated financial statements but the financial statements of the all other public-sector organizations.

Update on the WSIB Unfunded Liability

- The Auditor General outlines concerns her Office has previously raised regarding the significant growth in the WSIB's unfunded liability and her recommendation to reconsider the exclusion of the WSIB's financial results from the Province's consolidated financial statements.
- Mention is made to Regulation 141/12 (effective January 2013) which stipulates that the WSIB must achieve certain target sufficiency ratios by specified dates, and for which the Board submitted a plan to the Minister outlining measures the Board will take to achieve those sufficiency ratios by the prescribed dates.
- The Auditor General makes reference to Regulation 338/13 (effective January 2014) which changed the way the WSIB calculates the funding Sufficiency Ratio by changing the method used to value its assets.
- The Auditor General concludes that the continued classification of the WSIB as a Trust is appropriate; however, she is committed to continuing to monitor progress on meeting the required sufficiency ratios.

Ontario Retirement Pension Plan Initiative

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- The Auditor General noted that the Ministry of Finance requested that her office undertake a special assignment to provide an attest opinion the accuracy and completeness of the cost estimates for the Ontario Retirement Pension Plan (ORPP) initiative as presented in the summary of ORPP costs.
- The schedule of costs for the ORPP, on an accrual basis, covers the costs incurred by the Corporation, Secretariat and other Ministry of Finance expenditures. The expenditures for the ORPP initiative were $55.4 million plus provisions for the contingent expenditures of $15 million.
- The Auditor General expressed an unqualified auditor opinion on the full cost schedule.

Reporting under Fiscal Transparency and Accountability Act

- The Auditor General notes that to ensure compliance with financial disclosure requirements under the Fiscal Transparency and Accountability Act, 2004, the Ministry of Finance should ensure that:
  - The Third Quarter Finances report is prepared and publicly released on a timely basis;
  - When there are delays in issuing Ontario's Long Term Report on the Economy and a letter is tabled to that effect, the letter includes the reasons for the delay and;
  - Delayed information is tabled as soon as it is available

Reporting under Fiscal Transparency and Accountability Act

- ***Treasury Board Response***
  - *The Ministry of Finance will ensure that financial disclosures are released on a timely basis and when they are not available, an explanation is provided in accordance with legislation.*

Ongoing Accounting Matters: Financial Instruments

- PSAB's new accounting standard on financial instruments main requirement is for certain financial instruments, such as derivatives, be reported at fair value and that the resulting unrealized gain or loss from fair value remeasurement be recorded in a new Statement of Remeasurement Gains or Losses.
- The Auditor General describes that the view of Ontario and some other senior Canadian governments that introducing fair market value concepts in the government's financial statements (resulting in volatility) is not desirable.
- The Auditor General recommends that: OPCD continue to communicate with the Auditor General on this item and to review areas of common concern as PSAB develops this standard for implementation on April 1, 2019.

Ongoing Accounting Matters: Rate-Regulated Accounting (cont'd)

- In January 2014, the IASB issued an interim IFRS standard to allow rate-regulated entities to continue to apply existing policies for its regulatory deferral account balances upon adoption of IFRS starting on January 1, 2015.
- Ontario had passed a regulation in 2011 allowing for and directing both OPG and Hydro One to use U.S. GAAP. The AG noted that if Ontario continues to direct both GBE's to use U.S. GAAP, and Ontario continues to use non-IFRS GAAP to prepare the Public Accounts, the AG will need to assess the differences and if material, treat them as errors.
- The Auditor General notes that rate-regulated accounting has a significant impact on the government's financial statements. For example, OPG recognized $5.6 billion in net rate-regulated assets as of March 31, 2016. Future reporting under IFRS that does not accommodate rate-regulated accounting would increase the volatility in the province's annual deficit or surplus and may impact the government's revenue and spending decisions.
- The Auditor General will continue to monitor developments impacting the use of rate regulated accounting going forward to assess its impact on the Province's consolidated financial statements.

Ongoing Accounting Matters: Transfer Payments(cont'd)

- The Auditor General provides a background on *PS3410, Government Transfers which was effective* on April 1, 2012.
- She notes that the new standard requirements are broad and open to interpretation, which are resulting in significant differences in application. She notes that many stakeholders had asked PSAB to consider amending the standard.
- The Auditor General acknowledges the controversy over this new standard and supports the initial accounting of government transfers and external contributions as deferred capital contributions, with both being recorded as revenue over the useful life of the related tangible capital assets based on transfer stipulations and recipient actions and communications.
- The Auditor General agreed with $6.9 billion in deferred capital contributions being recorded in 2015/16 in the Province's March 31, 2106, consolidated financial statements.
- The Auditor General concludes that Ontario's accounting for deferred capital contribution is consistent with PS3410, Government Transfers.

Public Sector Accounting Board Initiatives

- **Concepts Underlying Financial Performance**
  - PSAB is revisiting the conceptual framework, which establishes the fundamental principles for development of standards used for financial reporting by governments.
  - In March 2015, the third consultation paper proposed a new reporting model and draft principles on public-sector characteristics, financial statement objectives, qualitative characteristics, elements, recognition, measurement and presentation.
  - The task force is currently developing a Statement of Principles that will take into account input from the three Consultation Papers and will propose a revised conceptual framework and reporting model for public sector entities. PSAB expects to approve the Statement of Principles in 2017.

Public Sector Accounting Board Initiatives (cont'd)

- **Asset Retirement Obligations**
  - AG outlined the August 2014 SOP addressing the reporting of legal obligations associated with retirement of long-lived tangible capital assets currently in productive use.
  - PSAB accepted feedback on the proposals until September 2014. Respondents were in general agreement with the key proposals. The next step in the project is an exposure draft to be issued in the first quarter of 2017.

- **Revenue**
  - AG outlines the August 2013, SOP that will impact the reporting of a broad range of revenues that focuses on two main areas of revenue, exchange transactions and unilateral non exchange transactions. The exposure draft to be issued in the first quarter of 2017.

Public Sector Accounting Board Initiatives (cont'd)

- **Employment Benefits**
  - In December 2014, PSAB approved an Employment Benefits to review of *PS3250 Retirement Benefits* and of *PS 3255 Post-employment Benefits, Compensated Absences and Termination Benefits*.
  - PSAB will focus on deferral of experience gains and losses, discount rate, share risk plans, multi-employer defined benefit plans and sick-leave benefits. The second stage will focus on account for the new types of pension plans.
  - Invitation to comment is currently being developed. PSAB expects to issue the invitation by the end of 2016. A separate invitation to comment on discount rates is planned for 2017.
- **Public-Private Partnerships**
  - The Auditor General notes that public-private partnerships are increasingly common in the public sector as a way to deliver large public infrastructure projects.
  - In December 2015, PSAB approved a project to develop a standard that addresses recognition, measurement and disclosure matters and provides guidance on how to account for public-private partnerships.
  - PSAB expects to issue a Statement of Principle in the first quarter of 2017.

Statutory Matters

- Under Section 12 of the AG Act, the AG is required to report on any Special Warrants and Treasury Board Orders issued during the year.
- The AG also produces two charts: a summary of the total value of Treasury Board Orders issued over the last 5 years, and the total value of Treasury Board Orders issued by month during 2015-16.
- In addition, the AG notes the transfers authorized within the votes of the Office of the Assembly by the Board of Internal Economy.
- Lastly, the AG listed significant annual uncollected amounts that were written off in 2015-16.