Auditor General's Audit Findings Report, April 2018
Key Messages and Q&As

April 10, 2018

KEY MESSAGES

- The IESO welcomes the report of the Auditor General and values her review. As an organization, the IESO works every day to manage the province's electricity system with transparency, accountability and prudence. We are already hard at work to implement most of the recommendations included in the audit report.

- Over the past few months, the IESO has worked cooperatively with the Auditor General in support of her special audit. To be clear, the IESO acted throughout the process in a manner that is entirely consistent with its responsibilities as a public sector organization that already had a contractual audit relationship with independent auditors.

- As a public sector organization, the IESO uses principles-based accounting standards which require some discretion and professional judgment when being applied. It is very common to have more than one acceptable approach when applying accounting standards.

- With respect to changes made in 2017, specifically, the recognition of rate regulated assets and market accounts, it is important to note that these changes were made after extensive discussions and deliberations with external professional advisors and the IESO Board of Directors.

- After extensive review, the Board of Directors and management of the IESO continue to believe that the policies that the IESO adopted in 2017 are appropriate and in accordance with Canadian Public Sector Accounting Standards.

Q&As – COOPERATION

How does IESO characterize its cooperation with the Auditor General?

The IESO has fully cooperated with the Office of the Auditor General of Ontario with respect to their special audit of the IESO. The IESO recognizes the Auditor General's statutory role and authority to perform an audit of the IESO and has cooperated fully throughout the special audit process.

Over the twelve-week period, IESO staff met with OAGO staff on over 40 occasions and responded to over 225 information requests. The IESO also arranged for working accommodations for seven OAGO staff on IESO premises, complete with access to a private meeting room for their sole use, as well as direct access to IESO employees. Further, the IESO designated a staff member to assist in coordinating meeting and information requests to ensure they were done in a timely manner.

In addition to the meetings held with IESO staff, the IESO also complied with numerous requests from the Auditor General to attend meetings of the IESO's Audit Committee and the full IESO Board of Directors.

This spirit of cooperation is one that the IESO has followed in all of its previous engagements with the OAGO.

Why did the IESO not sign the management representation letter, or the audit planning report, as requested by the Auditor General?

The management representation letter and signed audit planning report were signed with KPMG, the IESO's independent third-party auditor. KPMG was engaged by the IESO Board to conduct its 2017 financial statement audit. As the Auditor General's Office was not formally engaged to perform this audit, it would be inappropriate and bad governance practice for the IESO to sign two sets of the aforementioned documents.

Although the Auditor General was not engaged as the IESO's auditor, any information that was shared with KPMG, along with all other information relevant to the 2017 financial statements, was also shared with the OAGO. In recognition of the Auditor General's work, a copy of the management representation letter between the IESO and KPMG was provided to her office.

Why did the IESO not invite the Auditor General to attend the Board meeting to approve the financial statements?

As a Crown controlled corporation with independent auditors, the responsibility for the preparation and approval of the financial statement rests with IESO management and its Board. A draft copy of the IESO's financial statements was provided to the Auditor General in advance of being approved by IESO's Board.

Over the course of the audit, the IESO complied with numerous requests from the Auditor General to attend meetings of the IESO's Audit Committee and the full Board of Directors. This includes her request to attend the in-person Audit Committee meeting on February 27, 2018 to witness KPMG's overview of their findings report.

At the request of the auditor General, the IESO postponed the approval of its financial statements from February 27 to the week of March 5. The timing of the approval was postponed in order to accommodate a technical discussion between KPMG and the OAGO that .

The IESO Board and management approved the 2017 financial statements after it received and reviewed the draft audit report from the Auditor General in late February.

Why did the IESO reissue its financial statements, and why did the IESO not inform the Auditor General of this?

The IESO reissued its financial statements to adopt the Auditor General's recommendation to include disclose the Security Agreement and pledging of market receivables as collatoral.

The IESO Board and management had previously considered and approved the 2017 financial statements on March 8, 2018 after receiving a draft audit report from the Auditor General in late February. Following approval of the 2017 financial statements, the IESO received an updated draft audit report from the Auditor General, on March 20, with a new recommendation to disclose the Security Agreement and the pledging of market receivables as collateral.

The IESO considered the new recommendation and believed the disclosure would enhance the IESO's financial statements. The revisions to the disclosure notes are not material, but reflect the decision of the Board and management to improve the transparency of the financial statements.

Is the IESO satisfied that KPMG has communicated fairly and transparently with the Auditor General's office?

Yes. It is our understanding that KPMG has responded to all requests from the Auditor General and her office. We also understand that KPMG met with the OAGO on a number of occasions to discuss the relevant account issues, and to share relevant correspondence and documentation.

The IESO had asked KPMG to deliver their audit report to the Auditor General's Office and make available their working papers in respect of the audit, in line with their obligation under the Auditor General's Act.

Q&As – AUDIT FINDINGS

What is the IESO's view on the findings included in the Auditor General's report?

The IESO welcomes the report of the Auditor General and values her review. As an organization, the IESO works every day to manage the province's electricity system with transparency, accountability and prudence. We are already hard at work to implement most of the recommendations included in the audit report.

Are there any items where the IESO disagrees with the Auditor General? If so, which ones and why?

The IESO has accepted most of the recommendations included in the Auditor General's recent report, and has already begun to implement some changes. As an example, the IESO recently included a new disclosure on the security agreement in our financial statement notes, as recommended by the Auditor General.

The IESO may have a difference in professional judgement with the Auditor General in respect to the recommendation related to Fair Hydro Plan transactions and variance accounts, smart meters, and PSAB transition item and market accounts. However, we have and will continue to fully cooperate with the Office of the Auditor General of Ontario.

Another area in which we have not immediately implemented a recommendation by the AG is around the discount rate the IESO uses for its pension plans. The reason the IESO has opted not to adopt this recommendation is because this issue is currently up for debate with the Public Sector Accounting Board. If or when changes are made, the IESO will review and consider adopting a new discount rate methodology.

See IESO's management responses in the appendix for full details.

Q&As – CHANGES IN ACCOUNTING POLICIES (2017)

The AG has stated her disapproval with the IESO's accounting change, saying that the IESO would be the only government organization in Canada to have recorded regulatory assets on its PSAS-based financial statements. How do you respond to this?

The IESO is not aware of any other Canadian entities recognizing regulatory accounting, under PSAS. However, using rate regulated accounting brings the IESO in line with (6 of 8) other independent system operators across North America.

The AG claims the IESO cannot adopt regulatory accounting under US GAAP, because the OEB is not an independent regulator.

The IESO is rate-regulated by the OEB in accordance with the Electricity Act, 1998 (the Electricity Act") and the Ontario Energy Board ("OEB") Act, 1998 (the "OEB Act"). The IESO activities subject to rate regulation by the OEB include the following:

- (a) IESO's expenditure, revenue requirements and fees;
- (b) Smart metering activities; and
- (c) A subset of market accounts.

How did the IESO come to the conclusion that it was acceptable to look to US GAAP for guidance on rate regulated activities? Is there a clause or section of PSAS that permits the use of GAAP in a given scenario?

The IESO follows Public Sector Accounting Standards (PSAS) for its accounting. PSAS neither explicitly permits, nor prohibits, the recognition, measurement, presentation or disclosure of rate-regulated activities.

In absence of a clear position on an issue, standard accounting practice dictates that an entity is entitled to consult another accounting standard. In this case, the IESO consulted US GAAP, the only accounting framework in North America that provides guidance on rate regulated operations. The IESO has since adopted aspects of the US GAAP accounting framework allowing the IESO to recognize a regulatory asset.

This decision was supported by an accounting opinion from our external auditors at KPMG and aligns the IESO with six of the eight other independent system operators in North America. In fact, more than one of the big-four accounting firms agree with our decision on this matter.

The AG has raised concerns about the fact that KPMG provided advisory services concerning the Fair Hydro Plan while also auditing IESO's financial statements. What is IESO's response?

When the IESO began to review its accounting policies early in 2017, it engaged KPMG to provide accounting advisory services related to the understanding and application of Public Sector Accounting Standards.

In late April, the IESO engaged KPMG to provide accounting advisory services, this time in relation to the application of PSAS to the consolidation of a trust and to the recognition and de-recognition of a variance account in relation to the proposed Ontario Fair Hydro Plan.

Engaging KPMG to conduct analysis on the application of Public Sector Accounting Standards does not preclude KPMG from acting as the external auditor under applicable rules of professional conduct in Canada. KPMG's work related to the Fair Hydro Plan took place well after the IESO's 2016 financial statement audit was complete.

Was the IESO asked to change its accounting policies by the government?

The IESO reviews its accounting policies from time-to-time to ensure our financial reporting best represents our operations and the substance of the accounts we oversee. In early 2017, an internal review of our accounting policies was initiated after a conversation with the Office of the Provincial Controller about the IESO's financial reporting of market accounts, but the IESO was not directed to change its accounting policy by government.

The IESO worked with KPMG on the review and determined that there were reporting options for market accounts and regulatory assets and that a choice was required as to whether or not to report these in the IESO financial statements. By analyzing the nature of the accounts, IESO's economic relationship to them, legislative requirements and market rules it was concluded that an appropriate position for either treatment was acceptable. Draft white papers on the reporting options from KPMG were provided to the Provincial Controller on February 21, 2017.

Ultimately, the IESO felt the public reporting of market accounts was relevant to the needs of its financial statement users and enabled greater transparency into the market transactions it oversees, which amounted to over $17 billion last year. The IESO also determined that recognizing regulatory assets would provide more transparency into the substance of certain accounts that we oversee.

APPENDIX: Management Responses to AG Audit Report

The IESO has fully cooperated with the Office of the Auditor General of Ontario (OAGO) with respect to the special audit of the IESO. The IESO recognizes the Auditor General's statutory role and authority to perform an audit of the IESO and has cooperated fully throughout the special audit process.

Over the ten week audit period, IESO staff met with OAGO staff on over 40 occasions and responded to over 225 information requests. The IESO also arranged for working accommodations for seven OAGO staff on IESO premises, complete with access to a private meeting room for their use, as well as direct access to IESO employees. Further, the IESO designated a staff member to assist in coordinating meeting and information requests to ensure it was done in a timely manner. The IESO received positive feedback from OAGO staff on this coordinating role, who noted the helpfulness and convenience of having a single point of contact throughout the audit process.

This spirit of cooperation is one that the IESO has followed in all of its engagements with the OAGO. In addition to the meetings held with IESO staff, the IESO also complied with numerous requests from the OAGO to attend meetings of the IESO's Audit Committee and the full Board of Directors.

Prior to the request from the Auditor General to conduct an attest audit of the IESO's 2017 financial statements, the IESO Board of Directors appointed KPMG as the financial statement auditor, in line with the Board's obligation under s. 25.2 of the *Electricity Act*, 1998. Given that the Board had already retained KPMG to conduct the annual financial statement audit, it is not appropriate for the IESO to sign a management representation letter addressed to the Auditor General, nor can the IESO acknowledge and sign the roles and responsibilities as set out in the Auditor General's proposed engagement letter and audit planning report.

However, in recognition of the OAGO's work, the IESO instructed its auditor, KPMG, to deliver their audit report to the Auditor General and make available their working papers in respect of the OAGO's audit. A copy of the management representation letter provided by the IESO to KPMG will also be shared with the OAGO.

Bank Reconciliations Not Properly Prepared for 2016 and 2017

The IESO is committed to preparing more frequent reconciliations of general ledger accounts and conducting proof of balances throughout each fiscal year.

The IESO agrees that the noted issue was not appropriately adjusted in a timely manner. This issue was an isolated event related to the merger of the former IESO and OPA and does not have any impact on the IESO's net surplus or deficit. A repeated event has not occurred.

Manual Override of Controls by Human Resources without Proper Approvals

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 Systems without Proper Approvals

The IESO agrees that there is an opportunity to reduce the need for manual entries, and is in the process of upgrading its payroll system. Automation is a key focus of this project, which is expected to be completed by Q3, 2018.

In the meantime, 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 Deposit Not Fully Tracked and Reconciled to General Ledger

The IESO agrees that the noted issue was not appropriately adjusted in a timely manner. The IESO is committed to preparing more frequent reconciliations of general ledger accounts and conducting proof of balances throughout each fiscal year.

Process Descriptions and Control Narratives Not Available

The IESO will continue to review and update its process descriptions and control narratives related to financial reporting, as appropriate. For clarity, the IESO produces its own process descriptions and control narratives related to financial reporting, and believes the current documents are accurate and effective.

CSAE 3416 Report on Market Settlement Operations System

The IESO will consider this recommendation in future years. As an immediate next step, the IESO will be extending its next CSAE 3416 audit report coverage to a 12-month period.

Fair Hydro Plan Transactions and Variance Accounts, Smart Meters and PSAB Transition Item and Market Accounts

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.

Value of Plan Assets for IESO Pension Plan

The IESO will consult its actuary to determine appropriateness of adjustment in its December 31, 2018 financial statements.

The IESO uses a market-related value of assets for the purposes of determining pension expense and accrued pension liability, allowed under 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.

Discount Rate Selected for Non-Registered Defined Benefit Plan and Other Post-Employment Benefits

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.

Disclosure Deficiency Regarding the Collateral Pledged Pursuant to the Security Agreement between IESO and the Fair Hydro Trust

The IESO has included a disclosure relating to the security agreement. Specifically, the IESO has provided security for the IESO's currently monthly obligation to pay carrying costs to the Fair Hydro Trust monthly during the period beginning on December 1, 2017 and ending on July 31, 2021.