Independent Electricity System Operator

Audit Findings Report

For the year ended
December 31, 2017

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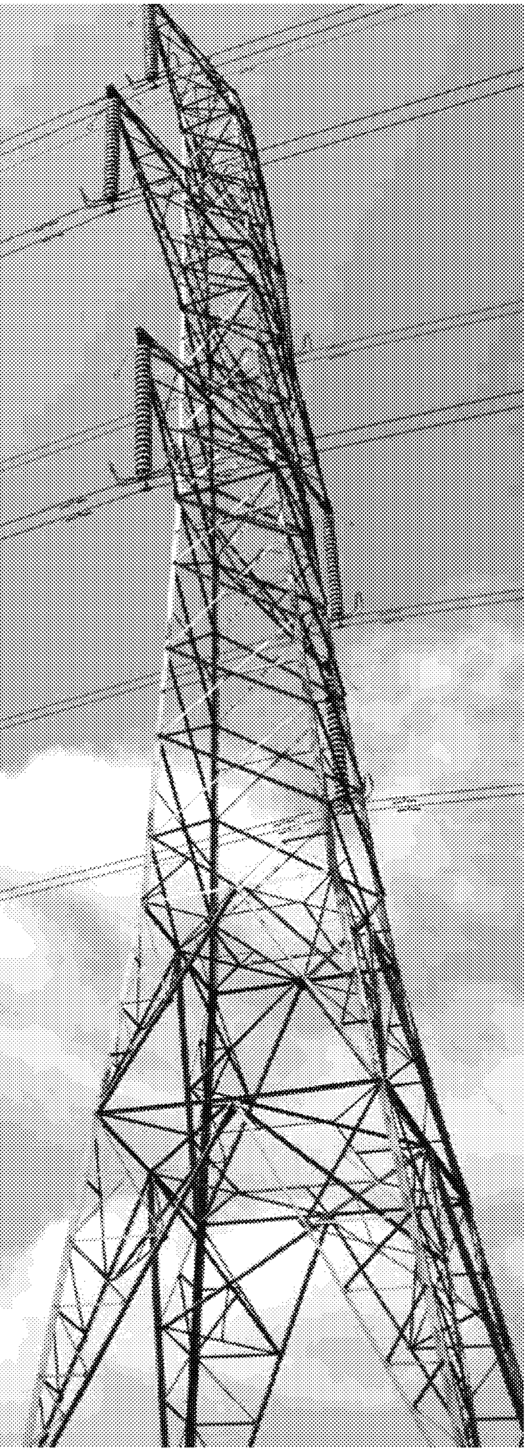

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At KPMG, we are **passionate** about earning your **trust**. We take deep **personal accountability**, individually and as a team, to deliver **exceptional service and value** in all our dealings with you.

At the end of the day, we measure our success from the **only perspective that matters – yours**.

Executive summary

Purpose of this report*

The purpose of this Audit Findings Report is to assist you, as a member of the audit committee, in your review of the results of our audit of the financial statements of the Independent Electricity System Operator (IESO) as at and for the year ended December 31, 2017.

This Audit Findings Report builds on the Audit Plan we presented to the Audit Committee in October 2017.

Finalizing the audit

As of February 16, 2018, we have completed the audit of the financial statements, with the exception of certain remaining procedures, which include amongst others:

- Receipt of signed management representation letter;
- Receipt of legal inquiry letters
- completing our discussions with the Audit Committee;
- Obtaining evidence of the Board's approval of the financial statements.

We will update the Audit Committee, and not solely the Chair (as required by professional standards), on significant matters, if any, arising from the completion of the audit, including the completion of the above procedures. Our auditors' report will be dated upon the completion of any remaining procedures.

Changes from the Audit Plan

There have been no significant changes regarding our audit from the Audit Planning Report previously presented to you.

Materiality for planning purposes was set at $4,000,000. We have not changed this determination at the conclusion of the audit.

Audit risks and results

We discussed with you at the start of the audit a number of **significant financial reporting matters**.

These included:

- Revenue recognition and market participant rebate accrual,
- Post-employment benefits,
- Asset capitalization policies
- Rate regulated accounting policies
- Market accounts balances

These risks have been addressed in our audit.

Adjustments and differences

We did not identify differences that remain uncorrected.

* This Audit Findings Report should not be used for any other purpose or by anyone other than the audit committee. KPMG shall have no responsibility or liability for loss or damages or claims, if any, to or by any third party as this Audit Findings Report has not been prepared for, and is not intended for, and should not be used by, any third party or for any other purpose.

Executive summary

Critical accounting estimates

Overall, we are satisfied with the reasonableness of critical accounting estimates.

Independence

We have included a copy of our independence letter, which notes that we are independent with respect to the Company (and its related entities), within the meaning of the relevant rules and related interpretations prescribed by the relevant professional bodies in Canada and any other standards or applicable legislation or regulation. Fees for non-assurance services and the nature of the services themselves have been summarized in our annual independence letter (see appendices).

Significant accounting policies and practices

There have been no initial selections of, or changes to, significant accounting policies and practices to bring to your attention.

Audit risks and results

Inherent risk of material misstatement is the susceptibility of a balance or assertion to misstatement which could be material, individually or when aggregated with other misstatements, assuming that there are no related controls.

We highlight our significant findings in respect of significant financial reporting risks as identified in our discussion with you in the Audit Plan, as well as any additional significant risks identified.

Significant financial reporting risks	Why	Our response and significant findings
Fraud risk from revenue recognition	This is a presumed fraud risk.	The audit team rebutted this presumption, as presented in the audit planning report, for the following reasons: • The presumed fraud risk is ordinarily associated with profit oriented enterprises; • The majority of revenue is calculated based on market accounts data and is not subject to complexity or judgement at the corporate level; and • KPMG does not believe that the use of inappropriate cut-off or "channel" stuffing would be utilized to perpetrate fraud.
Fraud risk from management override of controls	This is a presumed fraud risk. We have not identified any specific additional risks of management override relating to this audit.	This fraud risk is not rebuttable. Our audit methodology includes procedures required in professional standards to address this risk. Through the performance of the following required procedures, no instances of management override of controls were noted. Procedures performed to address management override of controls: • Journal entry testing • Performance of retrospective reviews of estimates; and • Evaluation of business rational of significant unusual transactions.

Audit risks and results (continued)

We identified other areas of focus for our audit in our discussion with you in the Audit Plan.

Significant findings from the audit regarding other areas of focus are as follows:

Other areas of focus	Why	Our response and significant findings
Pensions and other post employment benefits	• Significance of the account balance • Estimates and judgements used by management • Complexity of accounting guidance • Regulatory scrutiny	The pension and other post-employment benefits calculations were performed by IESO's independent actuary, AON Hewitt. In accordance with professional standards, we: • Communicated directly with AON and confirmed their calculations • We assessed the reasonableness of the assumptions used by AON, as instructed by management, and discussed these assumptions with AON • Tested the appropriateness of the underlying data • We confirmed the values of the investments held in the Pension Plan No errors or adjustments were identified as a result of our work.
Revenue recognition and market participant rebates	• Judgements used in determining the amount of the regulatory deferral account • Stakeholder impact of the rebate and its impact on the rate setting process	For 2017, system fees were earned by the IESO based on a dual usage rates fee, one for domestic customers and one for export customers, according to the OEB's Decision and Order October 31, 2017. The rates were effective for the entire 2017 fiscal year. As per our audit plan, we • Tested the amounts received from market accounts • Tested the controls around recording of revenues • Performed independent analysis of system fees based on usage trends • Assessed the reasonableness of the year-end market participant rebate accrual No errors or adjustments were identified as a result of our work. **Other matters** Historically, IESO has retained a regulatory surplus account of $10 million ($5.0 million for each of the former IESO and OPA). In 2017, the OEB required that the surplus be reduced to $6.0 million. Furthermore, IESO was required to refund $4.0M of the previously held surplus, which occurred in the fall of 2017.

Audit risks and results (continued)

We identified other areas of focus for our audit in our discussion with you in the Audit Plan.

Significant findings from the audit regarding other areas of focus are as follows:

Other areas of focus	Why	Our response and significant findings
Asset capitalization policies	• Significance of account balance • Stakeholder impact of the rebate and its impact on the rate setting process	• Discussed with management capitalization policies and their application • Statistical sample testing was performed on additions to capital assets to ensure existence and accuracy • Tested a sample of items transferred from construction in progress to assets in service. • Tested items recorded as repairs & maintenance or other similar accounts to ensure completeness of capital additions
Cash Clearing Account	• Amendment to prior period accounts	• During the audit it was identified that certain balances in the cash clearing account required adjustment. The adjustment is an increase to cash and decrease to accounts receivable, with no impact on annual surplus or ending net liabilities or accumulated surplus. • The cash clearing account is effectively the holding place for cheques that are awaiting clearance in the bank account. • At December 31, 2017 approximately $5.9M in transactions had cleared the bank account but were not adjusted out. The corresponding entry is an amount due from the Market, as these are market transactions that were processed through the corporate ledger. • As such, both the current and prior year figures have been updated for the change. • KPMG recommends that a process put implemented to periodically reconcile and clear transactions from the cash clearing account.

Audit risks and results (continued)

We identified other areas of focus for our audit in our discussion with you in the Audit Plan.

Significant findings from the audit regarding other areas of focus are as follows:

Other areas of focus	Why	Our response and significant findings
Market accounts assets and liabilities	• Significance of account balance • Judgements used in determining accounting policies	• Gained an understanding of the various components of market accounts assets and liabilities, including cash, investments, line of credit, amounts receivable and payable from and to market participants, and accrued liabilities • Confirmed cash and investment balances and line of credit balances with 3rd parties • Examined reconciling items where significant • Tested a sample subsequent cash receipts and payments in January 2018 based on market participant invoices • Reviewed accounting policy and other disclosures in the financial statements
Regulatory assets	• Significance of account balance • Judgements used in determining accounting policies	• Reviewed management's assessment of regulatory assets • Obtained evidence of regulatory ability to recover the assets based on future billings to customers, either by specific order/legislation (SME Charge) or precedent (Pension and OPEB transition costs) • Reviewed the calculations to changes to assets, revenues, and accumulated surplus in the current year • During 2017, the SME recovered the balance of its regulatory asset. It has now recorded an accumulated surplus of $939K. Based on submissions with the OEB, IESO has applied to retain an accumulated surplus of up to $2.5 million for the SME. As such, no regulatory liability has been recorded. Should accumulated surpluses exist in future years in excess of the $2.5, a market participant rebate accrual will be recorded, similar to system fees. • Reviewed accounting policy and other disclosures in the financial statements

For both market accounts assets and liabilities and regulatory assets, we also considered evidence and analysis provided to KPMG and IESO from the Office of the Auditor General of Ontario and discussions held between KPMG and OAGO staff.

Critical accounting estimates

Under PSAB, management is required to disclose information in the financial statements about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to carrying amounts of assets and liabilities within the next financial year. Generally, these are considered to be "critical accounting estimates."

We have summarized our assessment of the subjective areas.

Critical accounting estimates

Asset / liability	Balance ($'000s)	KPMG comment
Pensions and other post-employment benefits	Pension: $29.2m Other post-employment benefits: $96.2m	Management uses an expert, AON Hewitt, to value their pension and post-employment benefit obligations. Management provides membership data, as well as an estimate of expected long-term and short-term forecasts to help support the expected return on plan assets for the valuations. We communicate directly with the actuary, AON Hewitt, to confirm the valuation has been performed under the appropriate accounting standards, that there are no subsequent events which would impact the report provided, the assumptions used are appropriate for the purposes of the valuation, an appropriate materiality has been applied and that the report has been prepared in accordance accepted actuarial practices in Canada. We also assess the assumptions used by management's expert to ensure that the assumptions used are reasonable for the purposes of the valuation. No adjustments or deficiencies were noted during our assessment of pension and other post-employment benefit obligations.
Revenue recognition and market participant rebates	Market participant rebate: $2.3m	The current regulatory balance was approved in 2017 and is set at $6.0 million. The market participant rebate is based on the opening regulatory deferral account, plus core operations annual surplus before rebates, less amortization of PSAB transition amounts, less the allowable regulatory deferral account balance. As noted in the audit risks and results section, we have performed procedures over revenue accounts relating to core operations. We have also performed sampling procedures over expenditures to provide us with assurance over core operations annual surplus before rebates. We were able to re-calculate the rebate accrual without exception. No adjustments or deficiencies were noted during our assessment of the market participant rebate.

We believe management's process for identifying critical accounting estimates is considered adequate.

Data & Analytics in the audit

As previously communicated in our Audit Planning Report, we have utilized Data & Analytics (D&A) in order to enhance the quality and effectiveness of the audit.

We have summarized areas of the audit where D&A tools and routines were used.

Area(s) of focus	D&A tools and routines	Our results
Journal entry testing	• Utilized KPMG application software (IDEA) to evaluate the completeness of the journal entry population through a roll-forward of high-risk criteria accounts. • We assessed the high-risk criteria of journal entries and tested all entries matching the high-risk criteria.	No issues were noted with the journal entries. No entries tested were indicative of error or fraud.

Financial statement presentation and disclosure

The presentation and disclosure of the financial statements are, in all material respects, in accordance with the Company's relevant financial reporting framework. Misstatements, including omissions, if any, related to disclosure or presentation items are in the management representation letter included in the Appendices.

We also highlight the following:

Form, arrangement, and content of the financial statements	— Appropriate under the accounting framework. It is noted that the PSAB framework was used. The PSAB framework is the preferred framework of the Province of Ontario.
Application of accounting pronouncements issued but not yet effective	— No concerns at this time regarding future implementation.
Critical accounting policies or practices	— Critical accounting policies and practices comprise a subset of the Entity's significant accounting policies and practices. The reason why certain significant accounting policies and practices are considered critical is that they are *both*: • the most important to the portrayal of the Company's financial position and financial performance, and • require management's most difficult, subjective, or complex judgments. — The following are the critical accounting policies and practices identified this period: • Recording of regulatory assets and adoption of regulatory accounting • Recording of the market accounts balances on the statement of financial position — We would like to discuss the following matters: • How current and anticipated future events might affect the determination of whether a significant accounting policy and practice is considered critical. • Management's disclosures in the financial statements related to critical accounting policies and practices
Changes to accounting policies	— There were no changes to accounting policies in the fiscal 2017 financial statements.

Adjustments and differences

Adjustments and differences identified during the audit have been categorized as "Corrected adjustments" or "Uncorrected differences". These include disclosure adjustments and differences.

Professional standards require that we request of management and the audit committee that all identified differences be corrected. We have already made this request of management.

Corrected adjustments

We did not identify differences that were corrected.

Uncorrected differences

We did not identify differences that remain uncorrected.

Appendices

Appendix 1: Required communications

In accordance with professional standards, there are a number of communications that are required during the course of and upon completion of our audit. These include:

- **Auditors' report** – the conclusion of our audit is set out in our draft auditors' report
- **Management representation letter** –In accordance with professional standards, a copy of the management representation letter is attached.
- **CPAB Big Four Firm Public Report (November 2017)** – Please refer to http://www.cpab-ccrc.ca/Documents/Annual%20Reports/CPAB_2017_Big_Four_Inspections_Report_EN.pdf
- **CPAB 2017 Big Four Public Report: Highlights for Audit Committees** – Please refer to http://www.cpab-ccrc.ca/Documents/Annual Reports/CPAB_2017_Big_Four_Highlights_EN.pdf

Appendix 2: Independence

KPMG maintains a system of quality control designed to reflect our drive and determination to deliver independent, unbiased advice and opinions, and also meet the requirements of Canadian professional standards.

The following summarizes the professional services rendered by us to the IESO during the 2017 fiscal year:

Description of professional services	Fees paid or payable
Audit of the annual 2017 financial statements	$86,500
French translation services for financial statements and the Executive Compensation Section (2016 financial statements, completed in 2017)	$10,600
Compilation of 2016 Corporate Tax Returns	$1,400
Audit of the 2016 Pension Plan financial statements	$16,500
Assistance with indirect tax matters, concerning both corporate and market activities	$27,165
Accounting advisory assistance in connection with the Fair Hydro Plan	$572,391
IT Governance Advisory	$13,311

We have prepared the following comments to facilitate our discussion with you regarding independence matters.

Professional standards require that we communicate the related safeguards that have been applied to eliminate identified threats to independence or to reduce them to an acceptable level. Although we have policies and procedures to ensure that we did not provide any prohibited services and to ensure that we have not audited our own work, we have applied the following safeguards related to the threats to independence listed above:

- We instituted policies and procedures to prohibit us from making management decisions or assuming responsibility for such decisions
- We obtained pre-approval of non-audit services, and during this pre-approval process we discussed the nature of the engagement and other independence issues related to the services
- We obtained management's acknowledgement of responsibility for the results of the work performed by us regarding non-audit services, and we have not made any management decisions or assumed responsibility for such decisions

Appendix 3: Audit Quality and Risk Management

KPMG maintains a system of quality control designed to reflect our drive and determination to deliver independent, unbiased advice and opinions, and also meet the requirements of Canadian professional standards.

Quality control is fundamental to our business and is the responsibility of every partner and employee. The following diagram summarises the six key elements of our quality control systems.

Visit our Audit Quality Resources page for more information including access to our audit quality report, Audit quality: Our hands-on process.

- Other controls include:
  - Before the firm issues its audit report, the Engagement Quality Control Reviewer reviews the appropriateness of key elements of publicly listed client audits.
  - Technical department and specialist resources provide real-time support to audit teams in the field.
- We conduct regular reviews of engagements and partners. Review teams are independent and the work of every audit partner is reviewed at least once every three years.
- We have policies and guidance to ensure that work performed by engagement personnel meets applicable professional standards, regulatory requirements and the firm's standards of quality.
- All KPMG partners and staff are required to act with integrity and objectivity and comply with applicable laws, regulations and professional standards at all times.

- We do not offer services that would impair our independence.
- The processes we employ to help retain and develop people include:
  - Assignment based on skills and experience;
  - Rotation of partners;
  - Performance evaluation;
  - Development and training; and
  - Appropriate supervision and coaching.
- We have policies and procedures for deciding whether to accept or continue a client relationship or to perform a specific engagement for that client.
- Existing audit relationships are reviewed annually and evaluated to identify instances where we should discontinue our professional association with the client.

Appendix 4: Background and professional standards

Internal control over financial reporting

As your auditors, we are required to obtain an understanding of internal control over financial reporting (ICFR) relevant to the preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on internal control. Accordingly, we do not express an opinion on the effectiveness of internal control.

Our understanding of ICFR was for the limited purpose described above and was not designed to identify all control deficiencies that might be significant deficiencies and therefore, there can be no assurance that all significant deficiencies and other control deficiencies have been identified. Our awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors.

The control deficiencies communicated to you are limited to those control deficiencies that we identified during the audit.

Documents containing or referring to the audited financial statements

We are required by our professional standards to read only documents containing or referring to audited financial statements and our related auditors' report that are available through to the date of our auditors' report. The objective of reading these documents through to the date of our auditors' report is to identify material inconsistencies, if any, between the audited financial statements and the other information. We also have certain responsibilities, if on reading the other information for the purpose of identifying material inconsistencies, we become aware of an apparent material misstatement of fact.

We are also required by our professional standards when the financial statements are translated into another language to consider whether each version, available through to the date of our auditors' report, contains the same information and carries the same meaning.

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