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

CPA Ontario Public Sector Accounting Symposium
Wednesday, June 20, 2018

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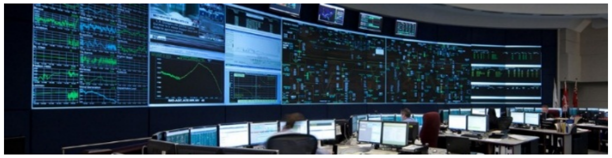
Auditor General of Ontario

2018-07-11

Overview

- About the Office of the Auditor General
- 2017 Annual Report
- Audit of the Public Accounts of the Province
- Overview of The Fair Hydro Plan
- Pre-Election Report
- Questions?



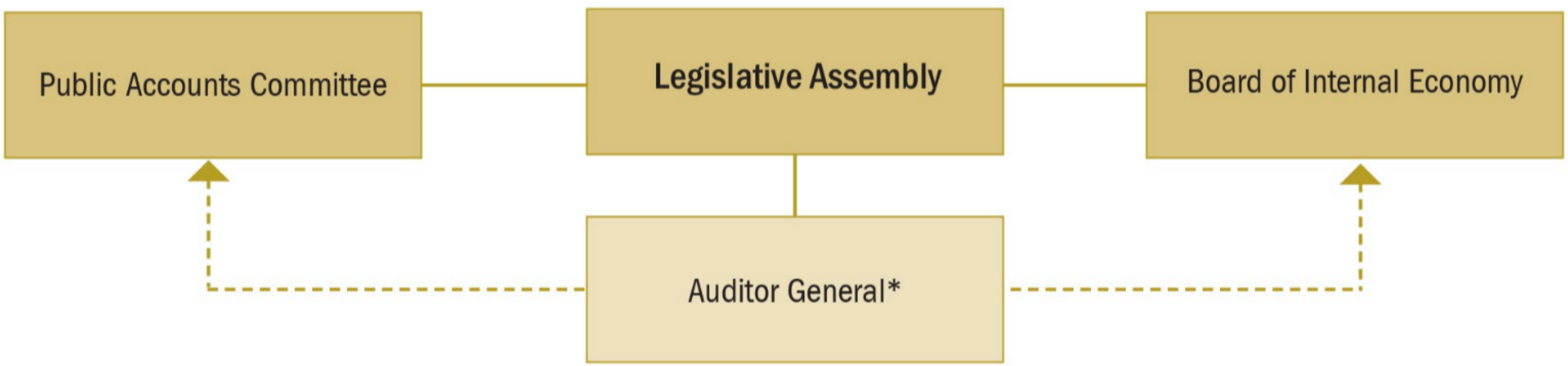
Role of the Auditor General

- Appointed under the *Auditor General Act, 1990.*
- The Auditor General has a 10 year non-renewable term.
- We provide information to the Legislature to help ensure taxpayer funds are prudently spent and government administrators follow sound business practices.
- We encourage improvements in the way the government delivers public services by reviewing their economy, efficiency, and effectiveness.
- We provide assurance that financial accounts are fairly presented (traditional auditor role) – Auditor General provides an opinion on whether the Consolidated Financial Statements are fairly prepared and presented in accordance with **Canadian Public Sector Accounting Standards**

Role of the Auditor General

- As an Officer of the Assembly, the Auditor General is independent from the government. Our key stakeholder is the Legislative Assembly.

Reporting Structure



* Member of the following Associations: Chartered Professional Accountants of Canada (CPA), Canadian Council of Legislative Auditors (CCOLA), and Canadian Audit and Accountability Foundation (CAAF)

Our Work

- **Value-for-Money audits** are conducted annually – mandate extends to ministries, crown agencies, school boards, long-term care homes, hospitals, universities, colleges, etc.

- **Follow-up reports** on value-for-money audits are conducted every two years to determine the status of implementation of recommendations.
  - We have also introduced a new process to follow-up on all recommendations after the two-year follow-up until each recommendation is fully implemented.

- **Financial statement audits** are conducted on the province's Public Accounts, as well as numerous provincial Crown agencies such as the Liquor Control Board of Ontario, TVOntario, and the Ontario Securities Commission.

Our Work

- Review/approve **Government Advertising**
- Review and report on reasonableness of the **Pre-Election Report on Ontario's Finances – PSAS Standards**
- Conduct **special audits** when requested by the Legislature, the Premier, the Standing Committee on Public Accounts or a Minister
- Work closely with and assist the **Standing Committee on Public Accounts**
- The *Auditor General Act* requires that the results of our audits be tabled in an **Annual Report**

Our Team

- **11 Audit Portfolios**
  - **Public Accounts**
  - **Agency Financial Statements (2)**
  - Education and Training
  - Health
  - Health & Energy
  - Infrastructure & Environment
  - Social Services & Finance
  - Justice & Government Services
  - IT Services
  - Cross Ministry & Recommendation Follow-up

- Approximately 117 staff
- Staff are assigned based on their interests and skills, and the office's needs
- Some pooling and sharing of staff for Public Accounts, Agency Financial Statements and special audits
- Teams may also acquire subject matter experts if require

The Standing Committee on Public Accounts

- PAC holds formal hearings on selected contents of our Annual Report at which senior ministry and agency officials are questioned about the matters under review.
- After each hearing, PAC usually issues a formal report to the Assembly on the ministry program or entity that was being reviewed.
- PAC's report often reinforces the Auditor General's recommendations and usually goes even further with additional recommendations.

The Auditor General's Panel of Senior Advisors

- **Tim Beauchamp**
  - Former Director, Public Sector Accounting Board

- **Deborah Deller**
  - Former Clerk of the Legislative Assembly of Ontario

The Auditor General's Panel of Senior Advisors

- **Burkard Eberlein**
  - Associate Professor, Public Policy at the Schulich School of Business

- **Sheila Fraser**
  - Former Auditor General of Canada

The Auditor General's Panel of Senior Advisors

- **David Marshall**
  - Former President, Workplace Safety and Insurance Board

- **Bill Robson**
  - President and CEO, C.D. Howe Institute

The Auditor General’s Panel of Senior Advisors

- **Carmen Rossiter**
  - Program Director, Centre for Governance Risk Management and Control at Schulich

- **Wayne Strelioff**
  - Former Auditor General of British Columbia and Former Provincial Auditor of Saskatchewan

The Auditor General's Panel of Senior Advisors

- **Christopher Wirth**
  - Partner, Keel Cottrelle LLP

2017 Reports

Special Report

- **The Fair Hydro Plan: Concerns About Fiscal Transparency, Accountability and Value for Money**

2017 Annual Report

- **Chapter 2 - Public Accounts of the Province**
- 14 Reports on Value-for-Money Audits
- **Toward Better Accountability – Quality of Annual Reporting**
- Review of Government Advertising
- 15 Follow-Up Reports on 2015 Value-for-Money Audits
- 7 Public Accounts Committee Follow-Up Reports
- 1 Follow-Up Report on Special Report (CCACs)
- Follow-Up on Audit Recommendations from 2012 to 2016

Overall Themes in 2017 Annual Report

- Apart from specific findings, we noted several themes common to many of our audits in areas where the Province can do better:
  - Ministries do not always have all of the information needed to make the most appropriate decisions.
  - Some government services could be delivered in a timelier way.
  - Performance benchmarks are not always met (or sometimes are not set).
  - Spending controls and operational oversight need to be improved.
  - The level of services the public receives may vary depending upon where you live in Ontario.
  - Opportunities exist to eliminate duplicate services.

- The one overarching theme this year that was common in varying degrees to almost all of the audits:
  - The need to improve planning that supports timely and informed decision-making and oversight.

Audit of the Public Accounts of the Province

The Public Accounts Audit

- Our Office is responsible for providing an audit opinion to the Legislative Assembly of the Province of Ontario.

- The consolidated financial statements are comprised of the Consolidated Revenue Fund (Ministries) and over 300 provincially controlled entities:
  - 5 Government Business Enterprises (LCBO, OLGC, OPG, Hydro One, Brampton Distribution Holdco Inc.)
  - 40 Other Government Organizations (IESO, Metrolinx, OEFC, Legal Aid Ontario, etc.)
  - 256 Broader Public Sector Organizations (146 Public hospitals, 14 LHINs, 72 School Boards, 10 School Authorities and 24 Colleges)

- Government Business Enterprises are consolidated using modified equity accounting in the province’s consolidated financial statements.

- Other government organizations are line-by-line consolidated into the province’s consolidated financial statements.

Significant Components and Requirement of CAS 600

- **Canadian Auditing Standard 600** – Special Considerations – Audits of Group Financial Statements require the Auditor General, the group auditor, to take full responsibility for the audit report of the province's consolidated financial statements.

- **This means the Office of the Auditor General must:**
  - have an understanding of the group, its components and their environment;
  - develop an overall audit strategy and audit plan that takes into account the audit risks of the significant components including determining the component materiality;
  - have an understanding of the component auditor (ethical requirements, independence requirement, professional competence, group engagement team involvement in the work of component auditor to the extent necessary to obtain sufficient appropriate audit evidence);
  - direct and evaluate the work of significant components where necessary;
  - have an understanding of the consolidation process; and,
  - ensure sufficient and appropriate audit evidence is obtained.

Significant Components and Requirement of CAS 600

- The nature, timing and extent of the group auditor’s involvement is affected by the group engagement team’s relationship with the component auditor and at a minimum shall include:
  - Discussing with the component auditor or component management those of the component’s business activities that are significant to the group;
  - Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error; and
  - Reviewing the component auditor’s documentation of identified significant risks of material misstatement of the group financial statements.

Timelines for the Audit of the Public Accounts

- Public Accounts planning begins in October.
- Letters to component auditors are sent out in October for School Boards and in December/January for all other entities.
- Communication happens throughout the audit.
- Review of component auditors work happens between May and July when most financial statements have been finalized.
- Province of Ontario's consolidated financial statement audit sign off is usually mid-August (August 15, 2018 for the fiscal 2017/18).

The Fair Hydro Plan: Concerns About Fiscal Transparency, Accountability & Value for Money

Background

- Sound fiscal transparency and accountability require that the costs of any government policy decision be fairly reported to the Legislature and the people of Ontario.
- Value for money requires that the government consider the optimal use of resources to implement its policy decisions.
- When governments pass legislation to make their own accounting rules that serve to obfuscate the impact of their financial decisions, their financial statements become unreliable.
- The complex accounting/financing design of the Ontario Fair Hydro Act, 2017 was designed to remove transparency and accountability, and unnecessarily cost Ontarians billions of dollars.

Globe and Mail Video on “Bad Books”

The government made a critical decision early in the process of setting out the details of the Fair Hydro Plan: the accounting treatment for the 16% rate reduction should not “affect the fiscal plan”— that is, it should not show any deficit incurred from this required borrowing, nor should it add to the amount the government would report as Ontario’s net debt.

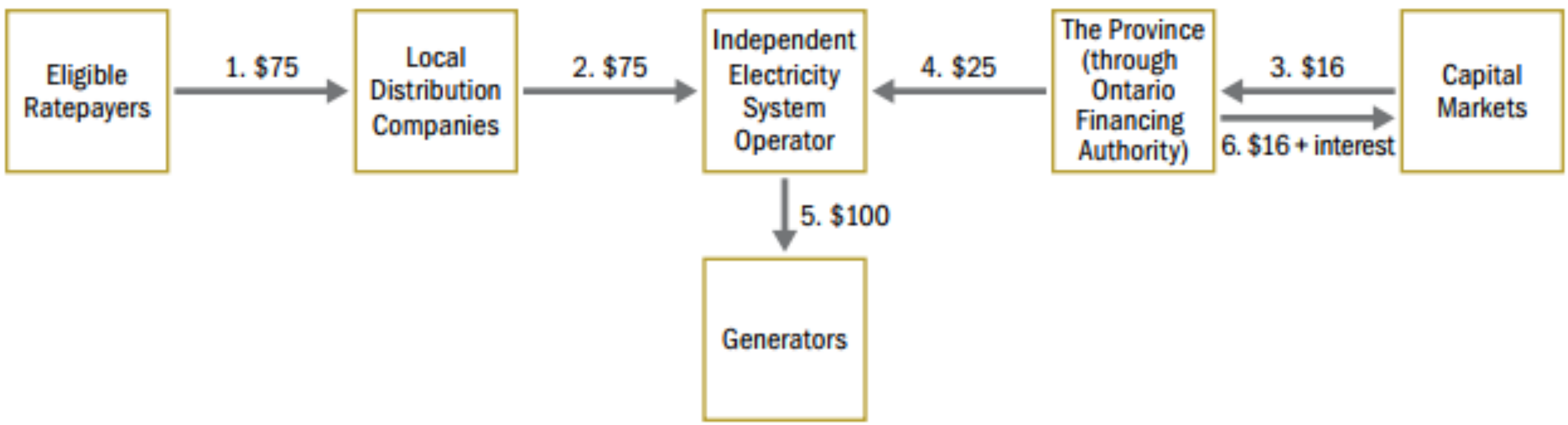
Link:

https://www.theglobeandmail.com/canada/investigations/article-bad-books-how-ontarios-new-hydro-accounting-could-cost-taxpayers/


THE GLOBE AND MAIL

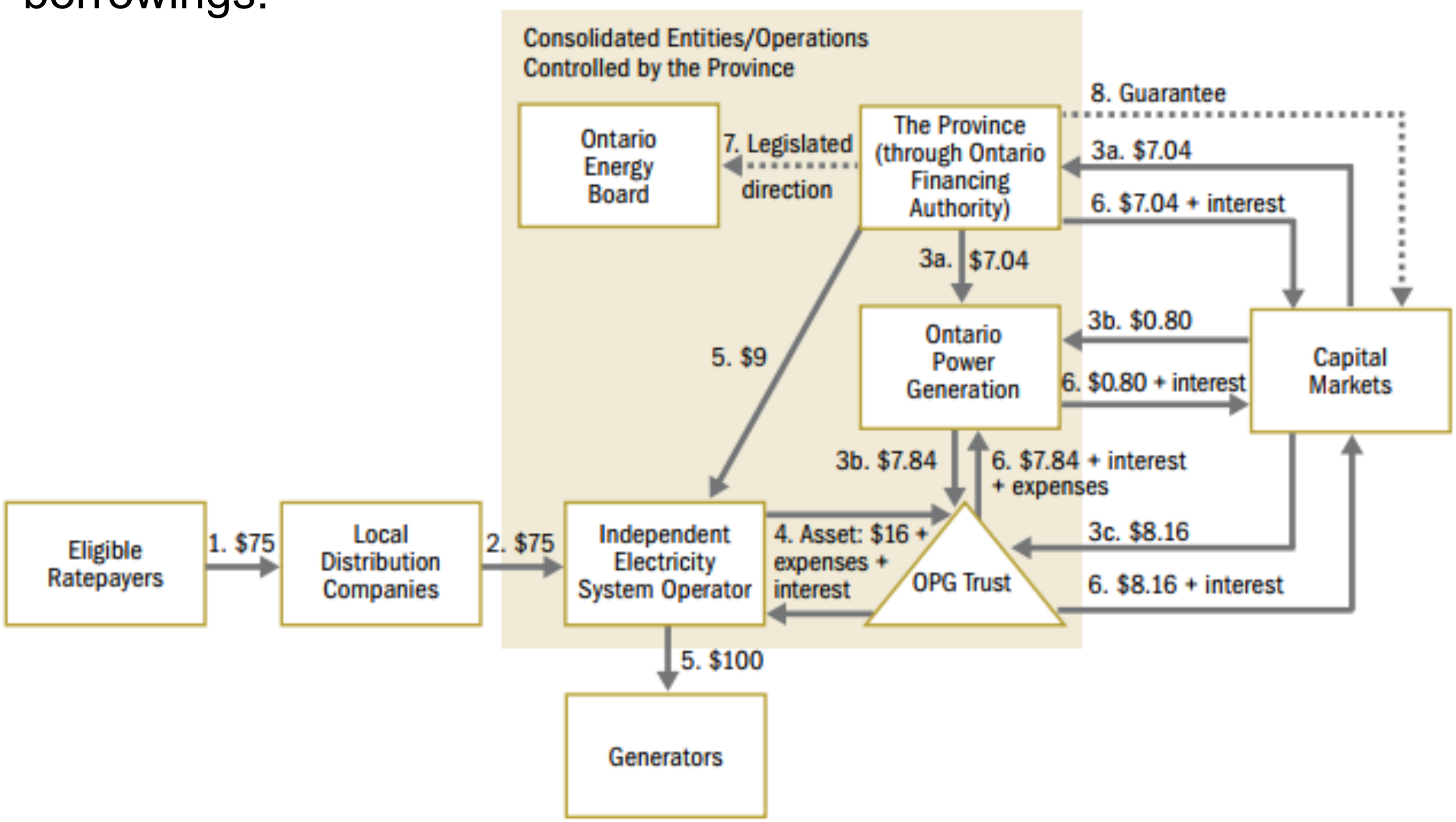
The Substance of the Accounting/Financing Transactions

- The accounting substance of the Policy Decision, shown below, is straightforward and transparent when the required transactions are recorded in the budget and the Province's consolidated financial statements in accordance with Canadian Public Sector Accounting Standards (PSAS).



The Form of the Planned Accounting/Financing Transactions

- Figure 2 below shows that the government decided on a very complex form, where the transactions are driven by the mandate to avoid recording an annual deficit and an annual increase in net debt from borrowings.



Government Legislated an Accounting/ Financing Structure

- In the emails and other documents we reviewed, senior officials and staff expressed views such as:
  - The emerging design will result in higher costs for Ontarians.
  - It is doubtful that Canadian Public Sector Accounting Standards (PSAS) will allow an accounting treatment that keeps the required borrowing from showing as a deficit, along with no impact on net debt. It will therefore be necessary to legislate a solution.
  - The Office of the Auditor General will likely disagree with the accounting treatment and may well publicly state as part of its value-for-money mandate its concern about the additional cost being incurred.

- Ultimately, the Fair Hydro Plan would need to contain **many legislated details** to effect the accounting in the IESO, OPG and a new entity OPG would create, referred to in plans as OPG Trust.

Historical Ontario Precedent in Proper Accounting For Electricity Costs Not Yet Being Billed to Ratepayers

- In 1999, the government of the day made a policy decision to restructure the Province’s electricity sector, which resulted in the government becoming responsible for the former Ontario Hydro’s net debt of $19.4 billion.
- Starting in 2002, ratepayers began paying down the stranded debt through a “debt retirement charge” (DRC) on their bills.
- The collection of the DRC and the Fair Hydro future reduction recovery are similar - both stem from policy decisions and did not result from an independent regulatory process.
- However, in the 1999/2000 fiscal year, the government followed Canadian PSAS properly, and included the debt and the expenses related to it in the Province’s consolidated financial statements.
- The same accounting should be applied to the Fair Hydro Plan rate reduction: include the debt being accumulated through the 10 years of the reduction as Provincial debt, and record interest expense on this debt as an expense in the Province’s consolidated financial statements.

Inappropriate Legislated Accounting Not Allowed Under Canadian Public Sector Accounting Standards

- Canadian PSAS enshrine a no-nonsense approach to accounting that follows the principle of "substance over form."
- Following this principle of "substance over form":
  - When a government spends more than it takes in, it incurs a deficit.
  - When a government needs to borrow to cover that deficit, net debt increases, and it incurs interest expense.
  - Interest expense adds to the annual deficit and the net debt.
  - A promise or commitment to raise revenue in the future is not an asset today.
- The complex accounting design of the Fair Hydro Plan fails the above substance test under Canadian PSAS.
- Whether the Province borrows all the money directly or directs organizations that it controls to do so on its behalf, in substance, it is still the Province requiring money to be borrowed. That borrowed money must be reflected in the net debt balance of the Province's consolidated financial statements under Canadian PSAS.

The Complex Accounting Design Fails Because Legislation is Used to Inappropriately Create an Asset

- The “asset” being legislated into existence does not meet the accounting requirements for an asset on the Province’s consolidated financial statements under Canadian PSAS.
- The asset that the Fair Hydro Act creates is referred to as a “regulatory” or “rate-regulated” asset.
- In reviewing emails and correspondence, senior officials and their advisers looked to U.S. accounting standards for private enterprises as a means to justify moving to regulatory accounting for Ontario’s consolidated financial statements.
- One of the requirements for recording a regulatory asset in the U.S. is that the entity’s rates for regulated services or products provided to its customers are established by or subject to approval by an independent, third-party regulator.
- However, the regulator of the electricity sector in Ontario is the Ontario Energy Board (OEB), but they have been legislated in the Fair Hydro Act to follow a course of action, and therefore lack independence.

Proper Accounting for the Policy Decision As Designed

- Recording the Fair Hydro Act's rate reduction in accordance with Canadian PSAS entails the following:
  - All related debt, including that of OPG and OPG Trust, would become debt on the Province's financial statements.
  - All interest expense would become an expense of the Province.
  - The annual shortfall between the amount paid to generators and the amount collected from local distribution companies would be recorded as an expense of the Province.
  - The amount collected in the future through the clean energy adjustment to pay down the accumulated principal and interest and other expenses of $39.4 billion would be recorded in the future as revenue of the Province when future electricity is used by Ontarians.

Recommendations to Government of Ontario

- The Office of the Auditor General recommends that the government:
  a) record the true financial impact of the Fair Hydro Plan's electricity rate reduction on the Province's budgets and consolidated financial statements; and
  b) use a financing structure to fund the rate reduction that is least costly for Ontarians.

2018 Pre-Election Report on Ontario's Finances

Background on Pre-Election Report

- The government released its *2018 Pre-Election Report on Ontario's Finances* (Pre-Election Report) on March 28, 2018, as required by the *Fiscal Transparency and Accountability Act, 2004* (Act) and Ontario Regulation 41/18.

- Under the Act, I am responsible for reviewing this report to determine whether it is reasonable and for providing a statement describing the results of my Office's work. In this report I fulfill this responsibility.

- Key financial items the government must report on include economic forecasts and assumptions used to project revenues, expenses (including interest on debt), the reserves, the Province's surpluses or deficits and the ratio of provincial debt to Ontario's gross domestic product (GDP).

Overall Conclusions

- We concluded that the Pre-Election Report is not a reasonable presentation of Ontario's finances insofar as its expense estimates are understated for two items, resulting in understated annual deficits.

- The two understated expense items are:
  - The government did not properly record **the true financial impact of the Fair Hydro Plan's electricity rate reduction** in the Pre-Election Report.
    - Neither the expenses to pay the power generators nor the interest on the funds borrowed to pay power generators have been included in the expense estimates in the Pre-Election Report. As a result, the combined other program and interest expenses are understated by $2.4 billion in 2018/19, $2.6 billion in 2019/20 and $2.8 billion in 2020/21.
  - The government recorded pension revenue from the Ontario Teachers' Pension Plan and insufficient pension expense from the Ontario Public Service Employees' Union Pension Plan, both of which reduce **the overall pension expense.**
    - It should not have done this because it does not have the unilateral legal right to reduce its future contributions to these plans or to withdraw any surplus from these plans without first reaching a formal agreement with the plans' other joint sponsors. The result of the incorrect recording of pension revenues and expenses is an understatement of other program expenses in the Pre-Election Report of $2.6 billion in 2018/19, $3.0 billion in 2019/20 and $3.2 billion in 2020/21.

Overall Conclusions

- After adjusting for these items, the **annual deficit would be $11.7 billion for 2018/19** (or 75% more than the reported $6.7 billion), **$12.2 billion for 2019/20** (or 85% more than the reported $6.6 billion) and **$12.5 billion for 2020/21** (or almost double the reported $6.5 billion).
- When expenses are understated, the perception is created that government has more money available than it actually does. Government decision-makers might therefore budget more money to be spent on initiatives and programs, when that money is actually needed to pay for expenses the government has failed to reflect properly.
- Aside from the two significant items, the government based its estimates of revenues, program expenses and interest on debt on cautious assumptions, as required by the Act. The government showed prudence by including a reserve amount in its fiscal plan (although it is lower than in previous years), and the assumptions used to prepare the Pre-Election Report are consistent with the plans of the government of Ontario (as reflected in the 2018 Ontario Budget).

Other Risks

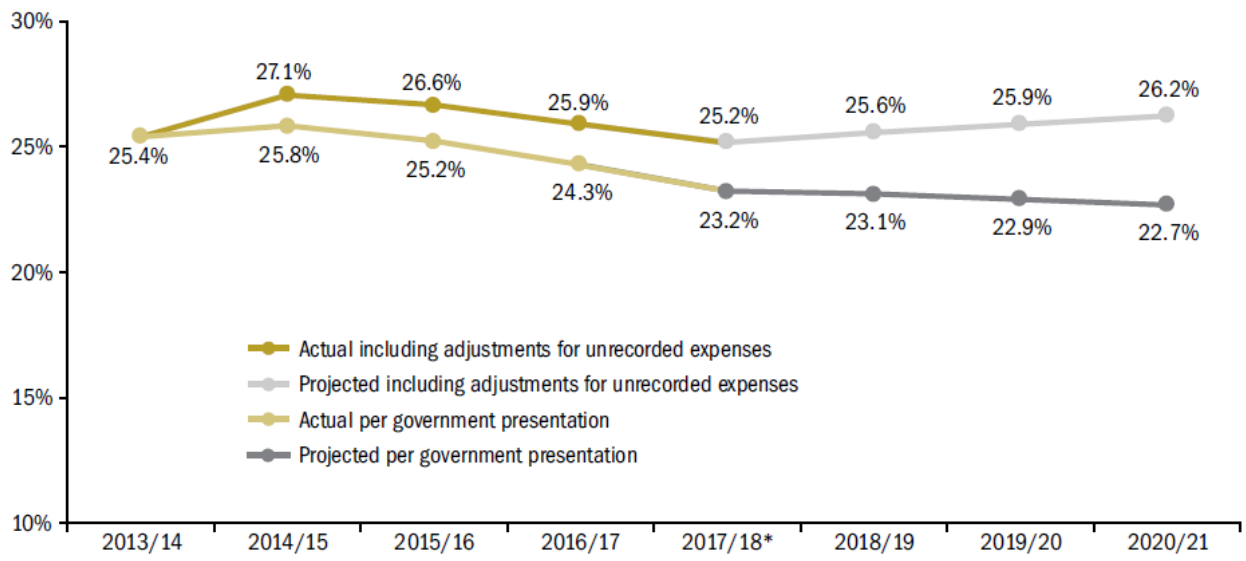
- We identified two areas where the risk of future uncertainty is high and could result in significant differences between estimated and actual spending:
  - Actual compensation costs may differ significantly from estimates due to the undetermined results of future contract negotiations.
  - The costs of increased spending on new programs as announced by the government may differ significantly from estimates because there is no program history to inform the estimates.
- As well, we noted one risk relating to the forecasted income from Government Business Enterprises. In its December 31, 2017, annual report, Hydro One Limited disclosed a potential one-time decrease in net income as a result of a rate decision by the Ontario Energy Board (OEB) that is currently under review by the OEB.
  - If Hydro One's Motion to Review to the OEB is unsuccessful, the one-time decrease would be approximately $420 million to the forecasted revenues in the Pre-Election Report, potentially for 2018/19 (based on the estimated Provincial ownership percentage of Hydro One Limited).

Ontario's Ratio of Accumulated Deficit to GDP

- **Figure 6** compares the Pre-Election Report's forecast of the accumulated-deficit-to-GDP ratios with the ratios corrected to include all combined other program and interest expenses for the Fair Hydro Plan and all pension expenses.

Figure 6: Accumulated Deficit to Gross Domestic Product (GDP), 2013/14–2020/21

Sources of data: March 31, 2016 Province of Ontario Annual Report, March 31, 2017 Province of Ontario Annual Report and 2018 Ontario Budget



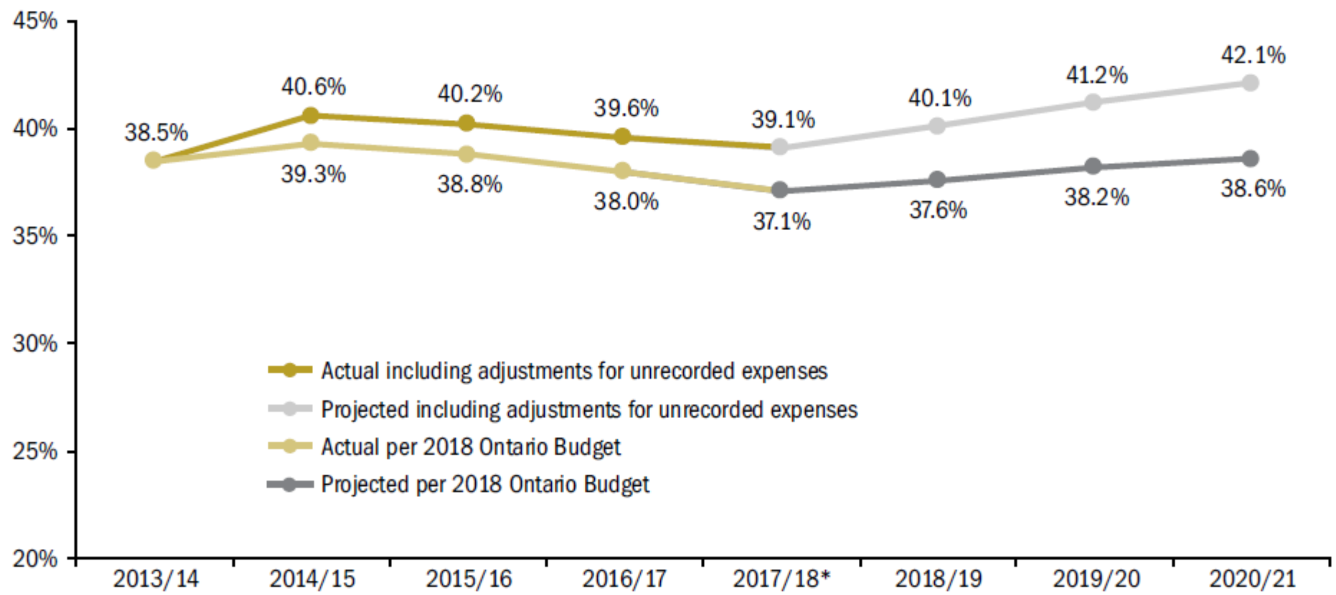
* Unaudited.

Ontario's Ratio of Net Debt to GDP

- **Figure 7** compares the 2018 Budget's forecast of the net-debt-to-GDP ratios with the ratios corrected to include all combined other program and interest expenses for the Fair Hydro Plan and all pension expenses.

Figure 7: Ratio of Net Debt to Gross Domestic Product (GDP), 2012/13–2020/21

Sources of data: March 31, 2016 Province of Ontario Annual Report, March 31, 2017 Province of Ontario Annual Report and 2018 Ontario Budget



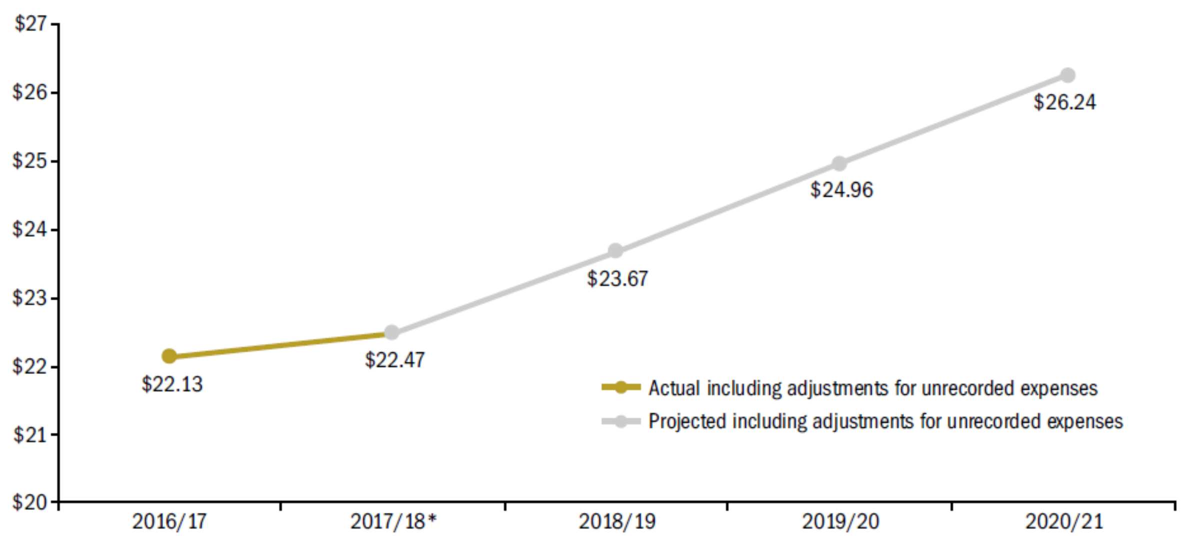
* Unaudited.

Net Debt Per Ontario Resident

- Ontario's net debt will have increased by 26% over a five-year period, from $314 billion in 2016/17 to $393 billion by 2020/21. To put this in perspective, the amount of net debt owed by each resident of Ontario on behalf of the government will increase from about $22,000 per person in 2016 to about $26,000 per person in 2021.

Figure 8: Net Debt per Ontario Resident, 2016/17–2020/21 ($ 000)

Sources of data: March 31, 2016 Province of Ontario Annual Report, March 31, 2017 Province of Ontario Annual Report, 2018 Ontario Budget and Statistics Canad



* Unaudited.

PSAS Conceptual Framework Learnings

- Important to have independently established and defendable accounting standards for the Canadian Public Sector
- In making changes to PSAS, important not to forget the importance of federal and provincial financial statements to all Canadian stakeholders
  - The importance of Net Debt – the long-term perspective – reflective of a government's future revenue requirement
  - The emphasis by governments on the annual bottom line – the short-term perspective – reflective of short-term promises
  - The importance of budgeting and actual reporting to be on the same basis
- Concepts and standards applicable for First Nation governance
- Important to ensure that PSAS does not encourage or enable inappropriate governance choices/decisions
- Important for the Public Sector Accounting Standards Board not to forget about federal, provincial and First Nations governance financial reporting when trying to address not-for-profit entities needs
- Important to continue to educate elected officials and the public on the importance of PSAS in Canada

Thank you!

Any questions?