Chapter 2

Public Accounts of the Province

Introduction

Ontario's Public Accounts for each fiscal year ending on March 31 are prepared under the direction of the Minister of Finance, as required by the *Financial Administration Act* (Act). The Public Accounts comprise the province's annual report, including the province's consolidated financial statements, and three supplementary volumes of additional financial information.

The government's responsibility for preparing the consolidated financial statements involves ensuring that the information, including the many amounts based on estimates and judgment, is presented fairly. The government is also responsible for ensuring that an effective system of control, with supporting procedures, is in place to ensure that transactions are authorized, assets are safeguarded, and proper records are maintained.

Our Office audits these consolidated financial statements. The objective of our audit is to obtain reasonable assurance that the statements are free of material misstatement—that is, free of significant errors or omissions. The consolidated financial statements, along with our Independent Auditor's Report, are included in the province's annual report.

The province's 2012/13 annual report also contains a Financial Statement Discussion and Analysis section that provides additional information regarding the province's financial condition and fiscal results for the year ended March 31, 2013, including some details of what the government accomplished in the fiscal year. Providing such information enhances the fiscal accountability of the government to both the Legislative Assembly and the public.

The three supplementary volumes of the Public Accounts consist of the following:

- Volume 1—statements from all ministries and a number of schedules providing details of the province's revenue and expenses, its debts and other liabilities, its loans and investments, and other financial information;
- Volume 2—audited financial statements of significant provincial corporations, boards and commissions whose activities are included in the province's consolidated financial statements, as well as other miscellaneous audited financial statements; and
- Volume 3—detailed schedules of ministry payments to vendors and transfer-payment recipients.

Our Office reviews the information in the province's annual report and in Volumes 1 and 2 of the Public Accounts for consistency with the information presented in the province's consolidated financial statements.

The Act requires that, except in extraordinary circumstances, the government deliver its annual report to the Lieutenant Governor in Council within 180 days of the end of the fiscal year. The three supplementary volumes must be submitted to the Lieutenant Governor in Council within 240 days of the end of the fiscal year. Upon receiving these documents, the Lieutenant Governor in Council must lay them before the Legislative Assembly or, if the Assembly is not in session, make the information public and then lay it before the Assembly within 10 days of the time it resumes sitting.

This year, the government released the province's 2012/13 Annual Report and Consolidated Financial Statements, along with the three Public Accounts supplementary volumes, on September 10, 2013, meeting the legislated deadline.

In conducting our annual audit of the Public Accounts we work closely with the Ministry of Finance (Ministry) and particularly with the Office of the Provincial Controller. While we might not always agree on financial reporting issues, our working relationship has always been professional and constructive.

Summary

It is important to acknowledge that the province's consolidated financial statements, in all material respects, have consistently complied with the standards of the Public Sector Accounting Board (PSAB). Successive governments have been diligent in their continued efforts to improve the clarity and completeness of the province's consolidated financial statements and annual reports.

My predecessor has publicly stated that PSAB standards are the most appropriate for use by the province in preparing its consolidated financial statements. I also firmly hold this view. It is critically important that Ontario continue to prepare its financial statements in accordance with independent standards such as PSAB's so that legislators and the public can rely on the reported annual surplus or deficit as being a fair, consistent and comparable reflection of what has actually transpired with respect to the government's management of the public purse. This same principle should be applied to the province's public-sector entities in preparing their individual financial statements.

Accounting standards need to facilitate clear and consistent understanding and interpretation by stakeholders to ensure they contribute to credible and consistent financial reporting. PSAB has ongoing challenges in this regard and in reaching consensus on what accounting standards are most appropriate for the public sector. Ontario has introduced legislation on a number of occasions to establish specific accounting practices that in some cases are consistent with PSAB and Accounting Standards Board (AcSB) standards and in other cases are not, but at this time doing so has not had any material impact on the province's consolidated financial statements. However, if in the future the government introduces further legislated accounting treatments, it could become a greater concern to my Office.

Standard-setters, governments and auditors must work together if we are to resolve financial reporting issues faced by governments and public-sector entities in the public interest. The task force set up to review PSAB's conceptual framework is a good starting point for developing a consensus on the most appropriate public-sector accounting standards. These standards must meet user needs if PSAB is to reduce the risk that governments will establish their own.

These issues are discussed in more detail later in this chapter.

The Province's 2012/13 Consolidated Financial Statements

The *Auditor General Act* requires that we report annually on the results of our examination of the province's consolidated financial statements. I am pleased to report that the Independent Auditor's

Report to the Legislative Assembly on the province's consolidated financial statements for the year ended on March 31, 2013, is free of reservations. It reads as follows:

Independent Auditor's Report

To the Legislative Assembly of the Province of Ontario

I have audited the accompanying consolidated financial statements of the Province of Ontario, which comprise the consolidated statement of financial position as at March 31, 2013, and the consolidated statements of operations, change in net debt, change in accumulated deficit, and cash flow for the year then ended and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements
The Government of Ontario is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian public sector accounting standards, and for such internal control as the Government determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
My responsibility is to express an opinion on these consolidated financial statements based on my audit. I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Government, as well as evaluating the overall presentation of the consolidated financial statements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

Opinion
In my opinion, these consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Province of Ontario as at March 31, 2013 and the consolidated results of its operations, change in its net debt, change in its accumulated deficit, and its cash flows for the year then ended in accordance with Canadian public sector accounting standards.

[signed]

Toronto, Ontario — Gary Peall, CPA, CA, LPA
August 14, 2013 — Acting Auditor General

The above audit opinion is without any reservation, which indicates that the consolidated financial statements fairly present the province's fiscal results for the 2012/13 fiscal year and its financial position at March 31, 2013. This "clean" audit opinion means that, based on our audit work, we can reasonably conclude that the province's consolidated financial statements have been prepared in accordance with accounting standards recommended for governments by the Chartered Professional Accountants of Canada. (CPA Canada was created January 1, 2013, by the merger of the Canadian Institute of Chartered Accountants [CICA] and Certified Management Accountants Canada [CMA].) We are also communicating to users that the province's consolidated financial statements do not have any material or significant errors and provide a fair reflection of what has actually transpired during the year.

If we were to have significant concerns with the government's compliance with CPA Canada's recommended PSAB accounting standards, we would be required to issue an audit opinion with a reservation. An audit opinion with a reservation means significant financial transactions have not been recorded, have not been recorded properly or have not been disclosed properly in the notes to the province's consolidated financial statements.

In determining whether a reservation is needed, we consider the materiality or significance of the unrecorded, misstated or improperly disclosed item in relation to the overall consolidated financial statements. An assessment of what is material (significant) and immaterial (insignificant) is based primarily on our professional judgment. Essentially, we ask the question "Is this error, misstatement or omission significant enough that it could affect decisions made by users of the province's consolidated financial statements?" If the answer is yes, then we consider the error, misstatement or omission material.

To assist in this assessment, we calculate a materiality threshold. This year, as in past years and consistent with most other provincial jurisdictions, we set this threshold at 0.5% of the greater of government expenses or revenue for the year. If misstated items individually or collectively exceed the threshold, and management is not willing to make the required adjustments, a reservation in our Independent Auditor's Report would normally be required. However, no such reservation was required this year.

We have been working closely with the Office of the Provincial Controller over the years to enhance the usefulness, readability and transparency of Ontario's Annual Report and Consolidated Financial Statements, so we were most pleased to see a February 2013 commentary from the C.D. Howe Institute on federal and provincial reporting practices that recognized these enhancements:

> The federal government and the governments of Ontario and New Brunswick are leading the way in presenting clear public accounts documents and making an effort to compare and explain deviations from budgeted and year-end revenues and spending figures.

As a final comment, we wish to point out that it is notable that in the past 20 years, all Ontario governments, regardless of the political party in power, have complied in all material respects with approved accounting standards. Accordingly, we have been able to issue "clean" audit opinions on the province's consolidated financial statements since the province moved to adopt PSAB accounting standards in the 1993/94 fiscal year.

The Province's Financial Condition

In our past two Annual Reports, we commented on Ontario's debt burden. In our *2011 Annual Report* we discussed the different measures of government debt—total debt, net debt and accumulated deficit. We noted that the province's growing debt burden was attributable to continued government borrowing to finance large deficits and infrastructure spending. We compared Ontario's net-debt-to-GDP ratio to other Canadian and international jurisdictions, and highlighted the negative consequences of carrying a large debt load, including:

- debt-servicing costs crowding out funding needed for other programs;
- greater vulnerability to interest rate increases; and
- potential credit-rating downgrades, which would likely increase borrowing costs.

In our *2012 Annual Report* we noted that two credit-rating agencies had updated their assessment of the province's credit rating shortly after the government released its 2012 Ontario Budget, with Standard and Poor's (S&P) giving Ontario's AA- credit rating a negative outlook and Moody's Investors Service lowering Ontario's credit rating from Aa1 to Aa2. DBRS, a third credit-rating agency, had maintained the province's rating of AA (low). We explained that a credit rating is an assessment of a borrower's creditworthiness with respect to specified debt obligations and that investors use these credit ratings to assess the returns they require to offset the risk of holding these debt securities, thus affecting the cost of future government borrowing. We had noted that despite these developments there was as yet no evidence that rating changes have had a significant impact on Ontario's borrowing costs. Investor demand for Ontario debt had remained strong, helping to contain borrowing costs.

Shortly after the release of the 2013 Ontario Budget, all three rating agencies confirmed their existing ratings. S&P noted that while Ontario continues to have a large and well-diversified economy, it still faces large deficits over the next few years. It projected that there was a one-in-three chance that it would lower the province's long-term credit rating within the next year, citing the province's high debt levels and its doubts regarding the achievability of the province's aggressive plans to contain costs. However, it did indicate that it could revise this outlook upward if the province is able to meet or exceed its budget deficit targets.

The release of the province's March 31, 2013, Annual Report and Consolidated Financial Statements marks the fourth consecutive year that Ontario has reported a deficit lower than forecast. However, with declining but still significant deficits forecast in the 2013 Ontario Budget (and substantially unchanged in the *Ontario Economic Outlook and Fiscal Review 2013*), we believe an update on the province's "financial health" indicators, last examined in our *2010 Annual Report*, is warranted.

FINANCIAL PERFORMANCE AT MARCH 31, 2013

The province projected a $14.8 billion deficit for 2012/13 in its 2012 Ontario Budget. The actual deficit was $9.2 billion or some $5.6 billion less. There are several reasons for this improvement:

- Revenue was $0.8 billion higher than forecast. Taxation revenue was $0.3 billion higher due to an unexpected $1.3 billion increase in corporation tax revenue related to tax assessment revisions for prior years. This was partially offset by $1 billion in poorer results from the other sources of taxation, including a $0.5 billion decrease in personal income tax revenue due to slower-than-expected economic growth. There was also a $0.4 billion increase in income from government business enterprises and a $0.2 billion improvement in other revenue, partially offset by $0.1 billion in lower transfers from the federal government.
- Expenses were $4.8 billion lower than forecast. There was a $2.2 billion decrease in education-sector expenses primarily due to one-time savings of $1.3 billion from the elimination of banked sick days for teachers, and from reducing retirement gratuities and other school board expenses; $1.3 billion from reduced spending across all other ministries, particularly health and general government; $0.3 billion in lower interest expenses reflecting lower-than-forecast interest rates and lower borrowing because of the lower

deficit; and $1 billion saved by not using the budget reserve.

Primarily because of the annual deficit and infrastructure investments, the province's total debt rose to $281.1 billion and net debt to $252.1 billion at March 31, 2013.

PROJECTED FINANCIAL PERFORMANCE—THE 2013 BUDGET PLAN

The government is projecting deficits for the next four years before being able to balance its books in 2017/18, as illustrated in Figure 1.

While annual deficits are projected to decrease, the province must still increase its borrowing to finance these deficits, replace maturing debt and fund investments in infrastructure. Figure 2 provides details on the province's debt levels for the past six fiscal years, along with projections over the next three fiscal years. By 2015/16, with one more year of a deficit forecast remaining, Ontario's total debt will have increased by an additional $42 billion, or over 15%. Over the same three-year period Ontario's net debt will have increased by $52 billion, or over 20%. The government will need to continuously monitor and take action to manage its debt in a sustainable manner.

Ultimately, the question of what Ontario's budget surplus or deficit should be or how much debt the government should incur is one of government policy. This analysis is presented solely to help the government, legislators and the public better understand the current state of the province's finances. It is they who must make the decisions required to protect and preserve the province's financial condition, and consider the impact and sustainability of the level of debt on current and future generations.

ONTARIO'S FINANCIAL CONDITION INDICATORS

The March 31, 2013, consolidated financial statements provide a snapshot of the province's financial position at that time and its financial results for the 2012/13 fiscal year. To provide legislators and the public with a more complete picture, we assessed the government's financial health using several PSAB-recommended financial indicators: sustainability, flexibility and vulnerability.

Our analysis indicates that Ontario's financial condition has not improved significantly since the global economic downturn in 2008/09, and although it is projected to remain relatively stable over the next few years, it remains challenging. Over the next few years, the province's debt will become less sustainable and the government will have less flexibility to respond to changing economic circumstances. Its finances will also be more

Figure 1: Ontario Revenue and Expenses, 2008/09–2017/18 ($ billion)

Sources of data: 2012/13 Province of Ontario Consolidated Financial Statements and 2013 Ontario Budget

	Actual					Plan Medium-term Outlook			Extended Outlook	
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Total Revenue	**97.5**	**96.3**	**107.2**	**109.8**	**113.4**	**116.9**	**120.5**	**124.9**	**130.1**	**134.4**
Expense										
Program expense	95.3	106.9	111.7	112.7	112.3	117.0	118.3	118.8	118.8	118.0
Interest on debt	8.6	8.7	9.5	10.1	10.3	10.6	11.1	12.2	13.4	14.5
Total Expense	**103.9**	**115.6**	**121.2**	**122.8**	**122.6**	**127.6**	**129.5**	**131.0**	**132.1**	**132.4**
Reserve	–	–	–	–	–	1.0	1.2	1.2	1.5	1.5
Surplus/(Deficit)	**(6.4)**	**(19.3)**	**(14.0)**	**(12.9)**	**(9.2)**	**(11.7)**	**(10.1)**	**(7.2)**	**(3.5)**	**0.5**

Note: Numbers may not add up due to rounding.

Figure 2: Total Debt,[1] Net Debt[2] and Accumulated Deficit,[3] 2007/08–2015/16 ($ million)

Sources of data: 2012/13 Province of Ontario Consolidated Financial Statements and 2013 Ontario Budget

	Actual						Estimate		
	2007/08[a]	2008/09[a]	2009/10[a]	2010/11[a]	2011/12[a]	2012/13[b]	2013/14[a]	2014/15[a]	2015/16[a]
Total debt	162,217	176,915	212,122	236,629	257,278	281,065	290,853	308,100	323,800
Net debt	156,616	169,585	193,589	214,511	235,582	252,088	272,810	290,100	303,900
Accumulated deficit	105,617	113,238	130,957	144,573	158,410	167,132	179,935	190,100	197,300

1. *Total debt* represents the total amount of money the government owes to outsiders and consists of bonds issued in public capital markets, non-public debt, T-bills and U.S. commercial paper.
2. *Net debt* is the difference between the government's total liabilities and its financial assets.
3. *Accumulated deficit* represents the sum of all past government annual deficits and surpluses. It is derived by taking net debt and deducting the value of the government's non-financial assets, such as its tangible capital assets.

a. 2013 Ontario Budget
b. 2012/13 Province of Ontario Consolidated Financial Statements

vulnerable to decisions of the federal government. The province's debt burden and interest costs will continue to rise, acting as a constraint on future program delivery.

We elaborate on our analysis in the following sections.

Sustainability

Sustainability as defined by PSAB is the degree to which a government can maintain its existing financial obligations—its service commitments to the public and its financial commitments to creditors, employees and others—without increasing the debt or tax burden relative to the economy in which it operates. Sustainability provides insight into the government's ability to manage its financial and program commitments and debt burden.

There are two key sustainability indicators: ratio of net debt to GDP, and ratio of net debt to total annual revenue.

Ratio of Net Debt to GDP

Net debt is the difference between a government's total liabilities and its financial assets. Liabilities consist of all amounts a government owes to external parties, including debt, accounts payable, pensions and transfer payment obligations. Financial assets include cash, accounts receivable, temporary investments and investments in government business enterprises.

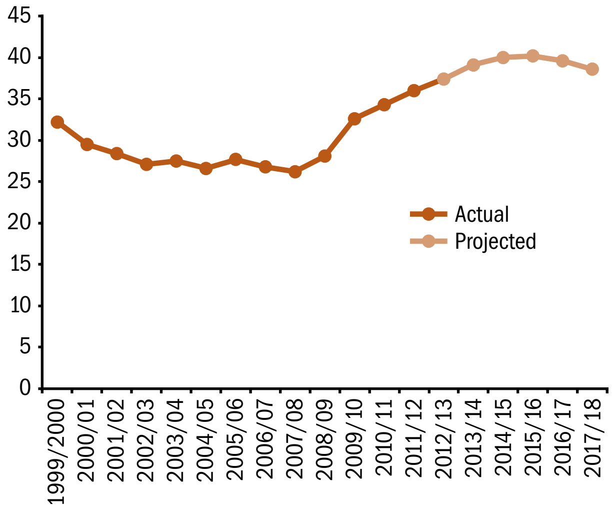
Net debt is an important measure of a government's financial position as it provides insight into the affordability of continuing to provide public services. Essentially, net debt reflects the amount of future provincial revenue that will be required to pay down a government's liabilities. A large net-debt position reduces a government's ability to devote future financial resources to existing programs and public services.

Gross domestic product (GDP) is a measure of the total value of all goods and services produced by an economy. It is also equal to the sum of all income earned in the economy. The ratio of net debt to GDP is an indicator of the burden of debt on the economy. If the amount of debt that must be repaid relative to the value of the output of an economy is rising—in other words the ratio is rising—it means a government's debts are becoming an increasing burden.

Figure 3 shows that the province's net-debt-to-GDP ratio gradually fell since 1999/2000, from a high of 32.2%, to 26.2% in 2007/08. However, it has been trending upward since then, reflecting the impact of the 2008 global economic downturn on the provincial economy. Tax revenue fell abruptly, and the government has increased its borrowing significantly to fund annual deficits and infrastructure stimulus spending since that time. Ontario

Figure 3: Ratio of Net Debt to Gross Domestic Product (GDP), 1999/2000–2017/18 (%)

Sources of data: March 31, 2013 Province of Ontario Consolidated Financial Statements and 2013 Ontario Budget



Note: Net debt includes broader-public-sector net debt starting in 2005/06.

Figure 4: Net Debt and the Net-debt-to-GDP Ratios of Canadian Jurisdictions, 2012/13

Sources of data: 2012/13 Province of Ontario Annual Report and Consolidated Financial Statements; 2013 Federal Budget; budget updates and 2013 budgets of provincial jurisdictions; and Office of the Auditor General of Ontario

	Net Debt/ (Net Assets) ($ million)	Net Debt to GDP (%)
AB	(14,604)	(4.7)
SK	5,109	6.6
BC	38,136	17.0
MB	15,893	26.8
NB	11,054	33.9
PEI	1,971	35.8
NS	13,954	36.7
Federal	671,363	36.9
ON	**252,100**	**37.4**
QC	176,575	49.4

expects to continue to incur large deficits and a growing debt. In fact, Ontario's net debt will have almost doubled from $157 billion in 2007/08 to over $303 billion by 2015/16.

The net debt-to-GDP ratio is projected to reach a high of 40.2% in 2015/16. After this peak, the government then expects it to begin falling. Thus, provincial net debt growth will be less sustainable over the next three years, and will improve only if longer-term projections are met. Many experts contend that a jurisdiction's fiscal health is at risk and is vulnerable to unexpected economic shocks when the net-debt-to-GDP ratio rises above 60%.

A useful exercise in assessing Ontario's ratio of net debt to GDP is to compare it with other Canadian jurisdictions. The net debt of most provinces and the federal government, along with their respective ratios of net debt to GDP, is illustrated in Figure 4. Generally, the western provinces have a significantly lower net-debt-to-GDP ratio than Ontario, while the Maritime provinces and the federal government are roughly similar to Ontario, and Quebec has a significantly higher ratio than Ontario.

In his February 2012 report of the *Commission on the Reform of Ontario Public Services*, Don Drummond noted that while Ontario's debt is relatively small compared to that of many international jurisdictions, and the province is "a very long way from the dreadful fiscal condition of countries that have dominated the news over the past two years," he warned, "so, however, were many of [these countries] at one time and, in some cases, surprisingly recently." For example, he wrote, "…nations whose net debt was once similar to Ontario's current 35% of GDP include Britain (2004), the United States (2001), Japan (1997) and France (1993)…Today, debt burdens have reached 73% in Britain and the United States, 131% in Japan, and 81% in France."

Drummond added: "We do not mean to be alarmist in noting the province's debt picture, only to point out that government debt burdens can rise quickly if they are not headed off early with appropriate action."

In its 2013 Budget, the government committed to eliminating the annual deficit by 2017/18 and then reducing the net debt-to-GDP ratio to the pre-recession level of 27%.

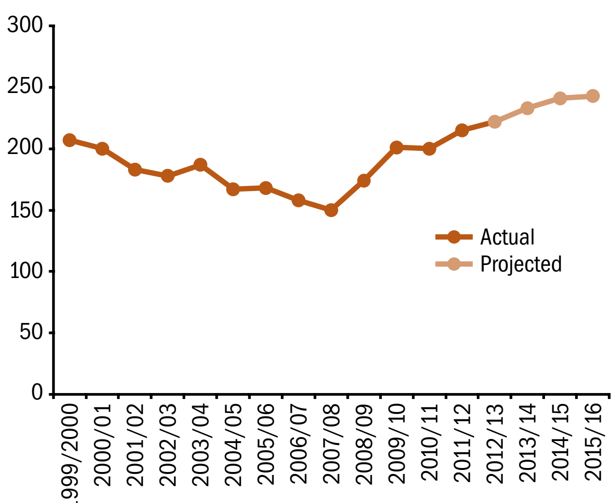
Ratio of Net Debt to Total Annual Revenue

The ratio of net debt to total annual revenue is an indicator of how much time would be needed to eliminate the province's debt if all revenue could be devoted to it. For instance, a ratio of 250% indicates that it would take two and a half years to eliminate the provincial debt if all revenue was devoted to it. As shown in Figure 5, this ratio declined from about 200% in 1999/2000 to about 150% in 2007/08, reflecting the fact that, while the province's net debt remained essentially the same, annual provincial revenue was increasing. However, the ratio has increased steadily since 2007/08 and is expected to top 240% by 2015/16. This increasing ratio of net debt to total annual revenue also indicates the province's net debt has less revenue to support it.

Of interest are S&P's May 2013 review comments published after the government tabled its 2013 Ontario Budget. The agency noted that if it were to downgrade Ontario's rating next year (thereby increasing its cost of borrowing), it would be because of "Ontario's growing debt burden trending materially above [its] base-case scenario projection of a tax-supported burden of around 250% of consolidated operating revenues by the end of fiscal 2015." S&P further noted that either economic or fiscal pressures arising from lower-than-projected economic growth or the government's inability to rein in spending could trigger this unplanned debt growth.

Figure 5: Ratio of Net Debt as Percentage of Total Annual Revenue, 1999/2000–2015/16 (%)

Sources of data: March 31, 2013 Province of Ontario Consolidated Financial Statements; 2008, 2009, 2013 Ontario Budgets



Flexibility

Flexibility is the degree to which a government can change its debt or tax burden to meet existing financial obligations. Current borrowing reduces the government's future ability to respond to changing economic circumstances. Similarly, increasing taxes or government fees reduces the government's ability to levy these measures in future as it approaches the limits that the public is willing and the economy is able to bear.

In the following section, we examine two flexibility indicators to help assess how well the government is managing its finances.

Ratio of Interest Expense to Revenue

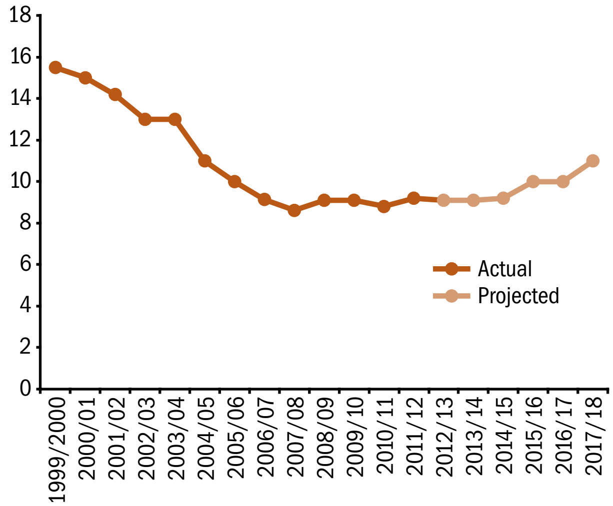
Increases in the cost of servicing total debt, or interest expense, can directly affect the quantity and quality of programs and services that government can provide. The higher the proportion of government revenue needed to pay interest costs arising from past borrowing, the less will be available for program spending.

The interest-expense-to-revenue ratio illustrates the extent to which servicing past borrowing takes a greater or lesser share of total revenue.

As Figure 6 shows, the province's interest-expense-to-total-revenue ratio decreased steadily in the decade ending in 2007/08. This is mainly due to a lower interest rate–environment. Because rates have been at historic lows since the early part of this decade, both the actual and projected interestexpense-to-total-revenue ratio have held and are expected to hold steady at approximately 9% from 2009/10 to 2014/15, even as the province's total borrowing is expected to increase by $96 billion, or 45%, from $212 billion to over $308 billion.

Figure 6: Ratio of Interest Expense to Revenue, 1999/2000–2017/18 (%)

Sources of data: March 31, 2013 Province of Ontario Consolidated Financial Statements; 2008, 2009, 2013 Ontario Budgets



Based on the government's latest projections, the ratio is expected to gradually increase to 10% by 2015/16 and further to 11% by 2017/18, when total debt is expected to be around $340 billion. This means that by 2017/18 the government expects to have to spend nearly one out of every nine dollars of revenue collected on servicing its debt. In 2007/08, only one out of every 12 dollars of revenue collected was required to service the province's debt.

The province's debt also exposes it to significant interest-rate risk. As discussed above, interest rates are currently at record low levels, enabling the government to keep its annual interest expense relatively steady even as its total borrowing has increased significantly. However, if interest rates rise, the government will have considerably less flexibility in using its revenue to provide public services because a higher proportion will be required to pay interest on the province's outstanding debt.

The expected increasing ratio of interest expense to revenue beginning in 2015/16 indicates the government will have less flexibility to respond to changing economic circumstances. Past government borrowing decisions mean a growing portion of revenue will not be available for current and future government programs.

Ratio of Own-source Revenue to GDP

The ratio of own-source revenue—primarily tax and fee revenue—to GDP shows the extent to which a government is taking revenue out of the economy through taxation, user charges or other sources. If the ratio is rising, the government may have less flexibility in future to raise taxes or increase fees. From the 2005/06 fiscal year to 2012/13, the government's own-source revenue as a percentage of GDP has ranged from 13% to 14.6% and is expected remain in that range.

Vulnerability

Vulnerability refers to the degree to which a government becomes dependent on outside revenue sources or is exposed to other risks that could impair its ability to meet existing service commitments to the public and financial commitments to creditors, employees and others. Vulnerability measures provide insight into a government's reliance on funding sources that are beyond its control, such as transfers from other levels of government. The higher the reliance on outside revenue sources, the less control the government has over its finances and the more vulnerable it becomes to the decisions of others.

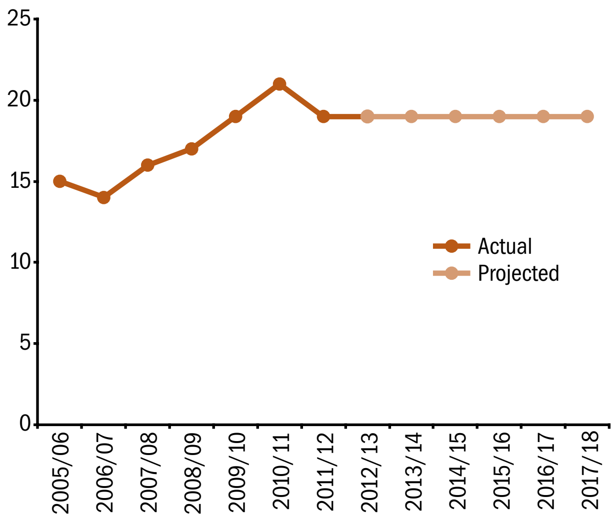
There is one key indicator for Ontario's vulnerability:

Ratio of Federal Government Transfers to Total Revenue

As shown in Figure 7, the ratio of federal government transfers to revenue rose in Ontario since 2005/06, when it was 14.7%, to a peak of 22.2% in 2010/11, largely as the result of a drop in own-source revenue and federal–provincial stimulus funding to address the 2008 global economic downturn. This funding ended in 2010/11, and the proportion of revenue that the Ontario government

Figure 7: Ratio of Federal Government Transfers to Total Revenue, 2005/06–2017/18 (%)

Sources of data: March 31, 2013 Province of Ontario Consolidated Financial Statements; 2008, 2009, 2013 Ontario Budgets



Note: The ratios of federal government transfers to total revenue are assumed to be flat-lined at 19% after 2013/14.

received from the government of Canada has since decreased to 19%. While the province expects it to remain at this rate, the federal government is facing a number of its own fiscal challenges, and any unforeseen reductions in future federal transfers could result in the province having to issue more debt or raise taxes or fees if it wishes to maintain its projected spending plans. Even if federal transfers remain the same, any drop in own-source revenue will increase this ratio again, indicating greater dependence on federal transfers to fund program spending. Conversely, any increase in own-source revenue will decrease this ratio and reduce dependence on federal transfers to fund programs.

LOOKING AHEAD

Long-term fiscal sustainability refers to the capacity of a government to finance its debt obligations without placing an excessive burden on successive generations—in other words, a government's ability to meet service delivery and financial commitments both now and in the future. In a May 2013 discussion paper, New Zealand's Controller and Auditor General noted that to fully understand whether the government is able to sustain itself financially requires "an increasing focus on understanding the underlying social, environmental and economic drivers of public spending, and the connections between them." Our review of Ontario's indicators of financial condition is just a first step in performing such a complex review.

The government plans to balance its books by 2017/18 by restraining spending while revenue rises with economic growth. Specifically, it plans to hold program spending increases to 4.2% in 2013/14, 1.1% in 2014/15 and 0.4% in 2015/16. Program spending is forecast to remain at the 2015/16 level for the 2016/17 and 2017/18 fiscal years. The province's financial condition will deteriorate further if these government restraint targets cannot be achieved. This is a significant risk given that program spending has already been restrained in recent years.

MINISTRY RESPONSE

In the wake of the global recession, governments around the world took steps to maintain programs and stimulate the economy. Ontario has been successful in controlling costs and managing down its net-debt-to-GDP trajectory relative to its 2010 plan. The 2012/13 fiscal year was the second year in a row for which year-over-year growth in program spending was held to less than 1%. In addition, in 2012/13, reported total spending and program spending fell from the previous year for the first time in more than a decade.

Since the last time the Office of the Auditor General reviewed these statistics in its *2010 Annual Report*, Ontario's financial condition indicators have generally improved relative to its 2010 plan. For example, the net-debt-to-GDP ratio for 2012/13 as reported in 2010 was projected to be 41%. In fact, Ontario's net-debt-to-GDP ratio in 2012/13 was actually 37.4%. The improvement in Ontario's net-debt-to-GDP trajectory is a direct result of bettering its deficit targets in each of the past four years and avoiding $22.2 billion in debt. Similarly, the trajectories of the net-debt-to-revenue and interest-expense-to-revenue ratios have also improved, while the federal-transfers-to-revenue ratio is essentially unchanged.

Update on the Workplace Safety and Insurance Board

The Workplace Safety and Insurance Board (WSIB) is a statutory corporation created by the *Workplace Safety and Insurance Act, 1997* (Act). Its primary purpose is to provide income support and medical assistance to workers injured on the job. The WSIB receives no funding from government; it is financed through premiums on employer payrolls.

Over the past decade, we have raised a number of concerns about the significant growth in the WSIB's unfunded liability, which is the difference between the value of the WSIB's assets and its estimated financial obligations to pay benefits to injured workers. In our *2009 Annual Report* we discussed the risk that the growth and magnitude of the unfunded liability posed to the WSIB's financial viability, including the ultimate risk of the WSIB being unable to meet its existing and future commitments to provide worker benefits.

We also urged the government to reconsider the exclusion of the WSIB's financial results from the province's consolidated financial statements, particularly if there was any risk that the province might have to provide funding to ensure the WSIB remained viable. Excluding its financial results was based on the WSIB's classification as a "trust"; however, given its significant unfunded liability and various other factors, we questioned whether the WSIB was operating like a true trust. Including the WSIB in the government's financial reporting would have a significant impact on the government's fiscal performance.

In September 2010, the WSIB announced an independent funding review to provide advice on how to best ensure the long-term financial viability of Ontario's workplace safety and insurance system. The May 2012 report by Professor Harry Arthurs contained a number of recommendations, in particular calling for a new funding strategy for the WSIB with the following key elements:

- realistic assumptions, including a discount rate based on the best actuarial advice;
- moving the WSIB as quickly as feasible beyond a "tipping point" of a 60% funding ratio (tipping point being defined as a crisis in which the WSIB could not within a reasonable time frame and by reasonable measures generate sufficient funds to pay workers' benefits); and
- putting the WSIB on course to achieve a 90%–110% funding ratio within 20 years.

In response to our concerns and to the recommendations of the Arthurs report, in June 2012 the government made a new regulation under the Act. Effective January 1, 2013, it required the WSIB to ensure it meets the following funding sufficiency ratios by specified dates:

- 60% on or before December 31, 2017;
- 80% on or before December 31, 2022; and
- 100% on or before December 31, 2027.

The regulation also required the WSIB to submit a plan to the Minister of Labour by June 30, 2013, outlining the measures it will take to achieve these targets. The WSIB has to date complied with the requirements of the regulation by issuing a sufficiency plan to the Minister. It has also approved a new funding policy and provided stakeholders with a 2012 sufficiency report. The Ministry asked our Office to confirm whether the June 30, 2013, funding sufficiency plan is consistent with our interpretation of the new regulation, and we did so.

The WSIB consulted with our Office and the Ministry of Labour to clarify its interpretation of the regulation as to the accounting policies to be followed in measuring progress against the plan. The

WSIB has proposed to the Ministry that a regulatory amendment be made with respect to the valuation of the assets. Our Office concurs with this suggested amendment. The Ministry of Labour was still considering the WSIB's request at the time of writing.

During the 2012 calendar year, the WSIB achieved strong financial and operational performance, as illustrated in Figure 8, which provides a summary of the WSIB's operating results and unfunded liability since 2010, the year following our 2009 review.

The $2 billion growth in the unfunded liability from 2010 to 2011 arose primarily from a significant reduction in the discount rate used to value its obligations, reflecting the changed interest-rate environment and investment climate. The decrease of almost $1 billion from 2011 to 2012 was the result of the WSIB's continued efforts to increase revenue and reduce operating and claims costs. For the first time since 1997, the WSIB's premiums not only covered current costs, but were able to contribute $300 million to its investment fund, due to higher premiums and investment returns, combined with improved recovery and return-to-work outcomes and a drop in new claims.

The WSIB's funding ratio—the percentage of assets to liabilities—increased to 56.9 % as of December 31, 2012, from 52.1% as of December 31, 2011, a significant improvement.

However, the WSIB's ability to achieve the prescribed funding sufficiency ratios will continue to be subject to considerable uncertainty. For example, the WSIB reports its financial results based on International Financial Reporting Standards (IFRS). A new standard under IFRS effective January 1, 2013, will necessitate an increase in the unfunded liability by $585 million to reflect the net amount of unamortized losses in the WSIB's pension plan currently being amortized into income over several years.

As a result of the government's and the WSIB's commitments to and progress to date in addressing its unfunded liability, we support the continued classification of the WSIB as a trust for the 2012/13 fiscal year, and therefore the exclusion of its unfunded liability from the province's liabilities. However, we will continue to monitor the progress being made toward meeting the required funding sufficiency ratios and re-evaluate our position as necessary.

Figure 8: Workplace Safety and Insurance Board Operating Results and Unfunded Liability, 2010–2012* ($ billion)

Sources of data: WSIB Financial Statements and Fourth Quarter 2012 Report to Stakeholders

	2010	2011	2012
Revenue			
Premiums	3,507	3,876	4,061
Net investment income	1,207	296	1,459
	4,714	**4,172**	**5,520**
Expenses			
Benefit costs	4,509	5,260	3,773
Loss of Retirement Income Fund contributions	73	70	67
Administration and other expenses	291	324	328
Legislated obligations and commitments	227	228	231
	5,100	**5,882**	**4,399**
Comprehensive Income (Loss) for the Year	**(386)**	**(1,710)**	**1,121**
Unfunded Liability	**12,438**	**14,222**	**13,299**

* As of December 31.

Update on the Pension Benefit Guarantee Fund

The Pension Benefit Guarantee Fund (PBGF) guarantees the payment of certain pension benefits when eligible defined-benefit plans are terminated under conditions specified in the *Pension Benefits Act* (Act). The PBGF is funded through annual assessments paid by sponsors of pension plans with covered benefits. The PBGF is intended to be self-financing, with funding based on per-member and risk-related fees.

The PBGF is classified as a trust in the province's consolidated financial statements. This means its assets, liabilities and operating results are excluded from the accounts of the province. However, its financial position is summarized in notes to the province's consolidated financial statements, and a five-year summary of its results is shown in Figure 9. In our *2011 Annual Report* we noted that corporate insolvencies and bankruptcies arising primarily from the economic downturn in 2008 had led to increased claims on the PBGF. As a result, the PBGF reported unfunded liabilities of $102 million as of March 31, 2008, and $47 million as of March 31, 2009. These unfunded liabilities existed despite a $330-million interest-free loan from the province in 2003/04 that is being repaid in $11-million annual instalments over 30 years.

In 2009, the government amended the Act to clarify that the PBGF is intended to be self-sustaining and independent of the government. The amendments allow, but do not require, the government to provide grants or loans to the PBGF. The amendments specify that the PBGF's liabilities are limited to its assets.

In March 2010, the government approved a $500-million grant to the PBGF to help stabilize its financial position and cover the costs of a number of plan windups. However, as of March 31, 2011, notwithstanding this $500-million cash infusion, the PBGF was back in a $6-million unfunded liability position because annual expenses, primarily claims, exceeded revenue by $109 million. In essence, the government's $500-million funding infusion in 2009/10 was fully depleted within a year because of a few large claims, of which the Nortel pension plans were the most significant.

An independent actuary appointed by the government to review the PBGF's stability and financial status noted in June 2010 that in the absence of increased assessments, the fund would require between $680 million and $1.023 billion from the government to cover expected future claims. The actuary estimated that in order for the PBGF to be self-sufficient over the long term and continue to fund benefits at the current maximum coverage level of $1,000 per month per employee, the PBGF would need to increase its annual assessment rates by an estimated 450%.

To mitigate the risks to the PBGF and enhance the PBGF's sustainability, the government announced in August 2010 that it would do the following:

- build reserves through the $500-million grant provided in March 2010;

Figure 9: Pension Benefit Guarantee Fund Financial Position, 2007/08–2012/13 ($ million)
Source of data: Pension Benefit Guarantee Fund

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Revenue	75,169	123,974	555,806	67,105	122,318	201,346
Claims and other expenses	64,546	69,107	406,641	176,671	40,049	21,309
Recoveries	–	–	(1,529)	(42)	(40)	–
Excess/(Deficiency) of Revenue over Expenses	**10,623**	**54,867**	**150,694**	**(109,524)**	**82,309**	**180,037**
Fund Surplus/(Deficit)–Beginning of Year	(112,841)	(102,218)	(47,351)	103,343	(6,181)	76,128
Fund Surplus/(Deficit)–End of Year	**(102,218)**	**(47,351)**	**103,343**	**(6,181)**	**76,128**	**256,165**

- raise future PBGF revenue by increasing assessments in 2012;
- extend the eligibility period for covering new plans and benefit improvements from three to five years; and
- strengthen pension-funding rules.

Although the government had taken steps to place the PBGF on a more stable financial footing, we believed that the PBGF still did not meet the criteria to retain its “trust” status, given a history of government funding and the likelihood that this dependency would continue. In our opinion, if the government must step in periodically to provide financial resources to an organization, it cannot be considered a “trust” for accounting purposes, as the intent of the accounting standard is to allow only financially independent trusts to be excluded from a government’s financial statements.

Accordingly, we concluded that the PBGF’s financial position and fiscal results should be included in the province’s consolidated financial statements. However, we also concluded that the impact of excluding the PBGF from the consolidated financial statements was not enough to cause those statements to be materially misstated.

The government’s strategy to enhance the PBGF was implemented with the passage of Regulation 466/11 effective January 1, 2012, which did the following:

- raised the base annual fee per Ontario plan beneficiary (active members, retired members and other beneficiaries) from $1 to $5;
- raised the maximum annual fee per Ontario plan beneficiary in unfunded pension plans from $100 to $300;
- eliminated the $4 million assessment cap for unfunded pension plans;
- introduced a minimum annual assessment of $250 for every pension plan covered; and
- eliminated the exemption for small pension plans.

Given these changes, the PBGF is better positioned to cover its claims without requiring further government assistance. As of March 31, 2013, the PBGF reported a surplus of over $250 million. This improved financial condition is more consistent with the PBGF’s designation as a trust for accounting purposes. The risk that the province will have to fund a deficit in the PBGF, as it has historically done, has been reduced as a result of the measures taken and fewer claims. Accordingly, we accept the exclusion of the PBGF from the province’s consolidated financial statements at this time, and will continue to monitor its affairs.

While this build-up of reserves is encouraging, considerable risk remains given the PBGF’s history and the precarious state of many of the defined benefit plans in the province. Another economic downturn could threaten its sustainability once again, although, as mentioned earlier, the PBGF’s liabilities are limited to its assets under the Act.

Use of Legislated Accounting Standards

As discussed in our *2012 Annual Report*, some Canadian governments have begun to legislate specific accounting treatments in certain circumstances rather than applying independently established accounting standards. This includes the Ontario government, which several times in recent years has passed legislation or amended regulations to enable it to prescribe accounting policies for its public-sector entities.

We raised concerns about this practice in our *2008 Annual Report*, warning that it was a troubling precedent to adopt accounting practices through legislation rather than through an independent, consultative process such as that followed by the Public Sector Accounting Board (PSAB). Although these legislated accounting treatments have not yet resulted in the province’s consolidated financial statements materially departing from PSAB standards, the risk of such a material misstatement in future has increased. The following is a chronological synopsis of these developments:

- The *Investing in Ontario Act, 2008,* and related regulations allowed the government to provide additional transfers to eligible recipients from unplanned surpluses reported in its consolidated financial statements. Any transfers made under this act would be recorded as an expense of the government for that fiscal year irrespective of PSAB accounting standards.
- In the 2009/10 fiscal year, the *Education Act* was amended to allow the government to prescribe accounting standards for Ontario school boards to use in preparing their financial statements.
- In the 2010/11 fiscal year, the *Financial Administration Act* was amended to allow the government to specify accounting standards to be used by any public or non-public entity whose financial statements are included in the province's consolidated financial statements.
- In 2011, a regulation under the *Financial Administration Act* directed Hydro One, a fully owned Ontario government business enterprise, to prepare its financial statements in accordance with U.S. generally accepted accounting principles effective January 1, 2012. The government has since provided the same direction to another fully owned government business enterprise, Ontario Power Generation Inc. (OPG). American accounting rules allow rate-regulated entities such as Hydro One and OPG to defer current expenses for recognition in future years; the government's direction to adopt these U.S. rules came in anticipation of the planned Canadian adoption of International Financial Reporting Standards (IFRS), which do not allow for such deferrals.
- Ontario government regulations now require transfers for capital acquisitions and transfers of tangible capital assets to be accounted for by transfer recipients as deferred contributions. The deferred amounts are to be brought into revenue by transfer recipients at the same rate as they recognize amortization expense on the related assets. We have historically supported this accounting as we believe that it best reflects the economic reality of the underlying transactions and in most instances complies with generally accepted accounting principles. However, many stakeholders are interpreting PSAB standards differently in this area, so the government felt it prudent to regulate and require this treatment.
- The authority to dictate accounting standards was further supported in the *Strong Action for Ontario Act (Budget Measures), 2012*, amending the *Financial Administration Act* again. These amendments provided the government with full authority to make regulations regarding the accounting policies and practices used to prepare its consolidated financial statements.

To maintain its financial credibility, we believe it is crucial that Ontario continue to prepare its financial statements in accordance with generally accepted accounting standards, specifically those recommended by PSAB.

As the auditor of these statements, the Auditor General is required to opine on "whether the consolidated financial statements of Ontario, as reported in the Public Accounts, present fairly information in accordance with appropriate generally accepted accounting principles (GAAP)." If the government's reported deficit or surplus under legislated accounting standards is materially different than what it would be under GAAP, we will have no choice but to include a reservation in the Auditor General's audit opinion. Our Office has been able to issue "clean" opinions on the government's financial statements for the past 20 years. I sincerely hope that this will continue to be the case.

Financial Reporting Frameworks and Canadian Auditing Standards

CPA Canada's Auditing and Assurance Standards Board (AASB) has recently worked to harmonize Canadian auditing standards with international standards issued by the International Auditing and Assurance Standards Board (IAASB). New Canadian auditing standards reflecting this harmonization were issued effective for audits of financial statements for periods ending on or after December 14, 2010.

Through these recent standards, the AASB adopted, with appropriate Canadian modifications, standards that address the form and content of an independent auditor's report. Under the former Canadian standards, most auditor's reports indicated whether financial statements were presented fairly in accordance with Canadian generally accepted accounting principles. This standard wording helped ensure that the report's meaning was clear to knowledgeable users of financial statements.

However, the new Canadian auditing standards provide a number of different acceptable frameworks for the preparation of financial statements. As described in Figure 10, a financial reporting framework now may be general purpose or special purpose, and reflect either a fair presentation or a compliance presentation.

The standards do not specify a particular framework as being acceptable for general-purpose financial statements. Acceptable reporting frameworks not only include financial reporting standards of an established standard-setting organization such as the Public Sector Accounting Board (PSAB) or the Accounting Standards Board (AcSB) of CPA Canada but also accounting standards established by law or regulation, or standards established by industry organizations.

In our *2008 Annual Report* we alerted readers to this expansion in acceptable reporting frameworks, warning that it would provide governments with a mechanism for establishing accounting policies that could result in financial statements that were not fairly presented. We also noted that the province and its public-sector entities could follow legislated accounting policies to prepare their general-purpose financial statements that were not in accordance with generally accepted accounting standards and still obtain an independent auditor's report without reservations.

Generally, if a financial reporting framework established by a law or regulation does not conflict with the standards established by an independent standard-setting organization, then that framework will not affect the independent auditor's report provided on financial statements prepared under that framework. However, if the legislated financial reporting framework departs from generally accepted accounting standards, a number of issues arise. We believe users of government and

Figure 10: Financial Reporting Frameworks Under Canadian Auditing Standards

Source of data: CPA Canada Auditing and Assurance Standards Board

	General Purpose	Special Purpose
Fair presentation	• Meets the common needs of a wide range of users • Complies with an accounting framework (GAAP—full compliance with PSAB)	• Meets the needs of specific users • Complies with a special-purpose framework (GAAP or non-GAAP) • Explicit deviation from an accounting framework to achieve fair presentation of financial statements
Compliance presentation	• Meets the common needs of a wide range of users • Complies with a non-GAAP accounting framework (i.e., requirements of legislation and/or regulation)	• Meets the needs of specific users • Complies with a special-purpose framework (i.e., internal guideline)

public-sector-entity financial statements need to be aware of these issues.

Until the 2010/11 fiscal year, all public-sector entities in Ontario used a reporting framework that was in accordance with Canadian generally accepted accounting principles (GAAP). However, Ontario's school boards now prepare their financial statements using a legislative accounting framework rather than a GAAP framework and receive an auditor's report indicating whether the statements comply with the legislated framework. There is no longer a statement in the auditor's report that the financial statements are "fairly presented." Two of Ontario's electricity-sector entities—Hydro One and OPG—also now prepare their financial statements under legislation that requires them to use U.S. rather than Canadian GAAP. Their auditors provided them with an auditor's report without reservation, as allowed under Canadian Auditing Standards.

To date, these departures from PSAB and CPA Canada AcSB standards for preparing Ontario public-sector-entity financial statements have not had a material impact on the province's deficit, its net debt or its accumulated deficit. Accordingly, they have not affected our report on the province's consolidated financial statements.

However, users of public-sector financial statements may not even realize when public-sector entities are not complying with Canadian accounting standards, because audit reporting standards do not require this to be specifically disclosed. Instead, users must now carefully review the wording of auditor's reports and examine the notes to any public-sector entity financial statements to understand the accounting basis on which the financial statements have been prepared.

We believe that accounting standards recommended by Canadian independent standard-setters should form the basis for the preparation of not only the province's consolidated financial statements, but the financial statements of all other public-sector organizations. Financial statements prepared on such a basis are credible, consistent and comparable, enhancing their usefulness. Allowing preparers to choose to adopt their own accounting standards could undermine these attributes. It could also negatively affect the transparency, credibility and, accordingly, usefulness of the resulting financial statements.

For that reason, most Canadian governments use PSAB standards in preparing their annual budgets, printed estimates, economic updates and year-end consolidated financial statements. When governments use the same set of accounting standards to prepare key financial reports, the public can evaluate expected financial performance against actual results and against the results of other jurisdictions. PSAB standards are intended to help governments publicly demonstrate stewardship over the resources they manage, and thereby strengthen accountability to taxpayers.

MINISTRY RESPONSE

The government agrees that the choice of appropriate accounting standards is important to ensure that consistent and transparent financial reporting and fiscal accountability is sustained throughout Ontario's public sector. In 2010, in response to PSAB's changes to accounting standards applicable to public-sector entities, Ontario undertook an extensive stakeholdering exercise in collaboration with the Office of the Auditor General, ministries, and their respective agencies and sectors to facilitate entity-level decisions on their appropriate basis of accounting. As a result, the government believes that financial reporting by Ontario's public sector is now more consistent and comparable and better supports transparency and accountability in public-sector reporting.

At that time, significant uncertainty existed regarding PSAB's direction for government transfer accounting standards. In response, the government provided direction to school boards and other consolidated entities on the implementation of capital transfer accounting in order to preserve consistency and comparability with the province's accounting policies and practices. This direction, together with the PSAB standard, has significantly enhanced consistency and transparency in public reporting.

The government's direction to Hydro One and OPG to adopt U.S. GAAP effectively reflects the economic substance of rate-regulated activities on a basis consistent with Canadian GAAP and helped to avoid inconsistencies in reporting by the province's energy utilities that would have resulted if IFRS had been adopted as originally directed by PSAB. The AcSB has since deferred the mandatory adoption date for rate-regulated entities to implement IFRS while standard setters address rate-regulated accounting.

Future Accounting Standards

Accounting standards specify how and when transactions and other events are to be recognized, measured and disclosed in financial statements. To be objective and credible, accounting standards are best established by an independent, recognized professional body using a comprehensive, open and transparent standard-setting process. The Public Sector Accounting Board (PSAB) is responsible for establishing accounting standards for the public sector. PSAB standards represent generally accepted accounting principles for governments in Canada and are the primary source of guidance for public-sector accounting.

PSAB emphasizes due process in the development of accounting standards and attempts to ensure that the views of all interested parties are heard and considered. This helps maintain the objectivity of the standard-setting process. In developing or revising an accounting standard, PSAB generally follows seven steps:

- agenda setting;
- project planning;
- task force recruitment (optional);
- development and publication of a statement of principles or other similar document (optional);
- review of responses to the statement of principles or other similar document, and development and publication of an exposure draft supported by an issues analysis;
- review of responses to the exposure draft, and development and publication of a standard supported by a basis for conclusions document; and
- procedures after standards are issued.

PSAB also strives to ensure that all new accounting standards are consistent with its conceptual framework. A financial reporting conceptual framework is a coherent set of interrelated objectives and fundamentals that can support the development of standards that appropriately prescribe the nature, function and limits of financial accounting and reporting. The conceptual framework is the foundation on which generally accepted accounting standards are established by standard-setting bodies such as PSAB. It sets out the concepts that underlie the preparation and presentation of financial statements.

THREE SIGNIFICANT ACCOUNTING ISSUES

Canada is generally regarded as a world leader with respect to the consistent application of public-sector accounting standards. However, maintaining this leadership role will not be without challenges. In recent years, some Canadian governments, including Ontario, have raised concerns over a number of PSAB's accounting and financial reporting proposals.

In the next section, we discuss three areas—financial instruments, rate-regulated accounting and government transfers—where these concerns have been raised.

Financial Instruments

PSAB's project to develop a new standard for reporting financial instruments began in 2005. Financial instruments include debt and derivatives such as currency swaps and foreign-exchange forward contracts. A key financial instrument issue is whether changes in the fair value of derivative contracts held by a government should be reflected in its financial statements and, in particular, whether such changes should affect the government's annual surplus or deficit.

In March 2011, PSAB approved a new standard on financial statements effective for governments for fiscal periods beginning on or after April 1, 2015, and effective for most other public-sector entities for fiscal periods beginning on or after April 1, 2012. The standard provides guidance on the recognition, measurement, presentation and disclosure of government financial instruments, and is similar to existing private-sector standards. One of its main requirements is for certain financial instruments, including derivatives, to be recorded at fair value, with any unrealized gains or losses recorded annually in a new financial statement.

Some Canadian governments, including Ontario's, do not support the introduction of these fair-value remeasurements and the recognition of unrealized gains and losses on derivative holdings. Ontario's view is that it uses derivatives solely to manage foreign currency and interest-rate risks related to its long-term-debt holdings and that it has both the intention and ability to hold its derivatives until the debts associated with them mature. Accordingly, remeasurement gains and losses would offset each other over the period that any derivative is held and therefore would have no real economic impact on the government's long-term resource inflows or outflows. The government argues that recording paper gains and losses each year would force the province to inappropriately report the very volatility the derivatives were acquired to avoid in the first place. This, in its view, would not reflect the economic substance of government financing transactions and does not meet the public's needs for transparent information on government finances.

The government was also concerned that entities included in the province's consolidated financial statements were required to adopt the standards before the province was. However, PSAB's 2013 decision to allow all first-time adopters to delay implementing the new standard until April 1, 2015, addressed that concern. Nevertheless, some public-sector entities whose results do form part of the consolidated financial statements of the province did adopt the standard.

PSAB has committed to reviewing this standard later this year, noting that it may need revision to address issues identified in its Concepts Underlying Financial Performance project.

MINISTRY RESPONSE

Ontario and other senior Canadian governments continue to be concerned with the potential negative impacts of PSAB's new standards on foreign currency translation and financial instruments. As a result, PSAB has been requested to extend the implementation date for these standards to allow governments to fully assess and prepare for the associated requirements. Such an extension will also allow PSAB an opportunity to address outstanding issues with the standards and to take into account the results of its work on its Concepts Underlying Financial Performance project.

Rate-regulated Accounting

Over the past few years, we have raised concerns about the appropriateness of recognizing rate-regulated assets and liabilities in the government's consolidated financial statements. Rate-regulated accounting practices were developed to recognize the unique nature of regulated entities such as electricity generators, transmitters and distributors.

Under rate-regulated accounting, a government-established regulator, such as the Ontario Energy Board, approves the prices that a regulated entity may charge customers, and often allows regulated entities to defer for accounting purposes certain costs for recovery in future periods. Such deferred costs are typically set up as assets on the entity's statement of financial position. Under normal generally accepted accounting principles, these significant costs would be expensed in the year incurred.

Ontario's electricity sector includes two significant provincially owned organizations—OPG and Hydro One—that use rate-regulated accounting. The use of rate-regulated accounting by certain rate-regulated entities, while still allowed under Canadian generally accepted accounting principles, is now under review by the Accounting Standards Board (AcSB).

PSAB standards allow OPG and Hydro One, which are defined as government business enterprises, to be included in the province's consolidated financial statements without adjusting their accounting policies to remove the impact of rate-regulated accounting. And the numbers are significant—for example, OPG recognized $1.9 billion in rate-regulated assets and $36 million in rate-regulated liabilities (according to Canadian generally accepted accounting prinicples) as of March 31, 2013. We have accepted this accounting treatment even though we question whether rate-regulated assets and liabilities meet the definition of *bona fide* assets or liabilities for the purposes of the government's consolidated financial statements.

In recent Annual Reports we have commented that the era of rate-regulated accounting appeared to be ending for jurisdictions such as Canada that were converting to International Financial Reporting Standards (IFRS). Our comments were based on the fact that, in January 2012, Canada's AcSB reaffirmed that all government business enterprises should prepare their financial statements in accordance with IFRS for fiscal years beginning on or after January 1, 2012. IFRS standards do not currently permit rate-regulated accounting.

However, the landscape has continued to change. The United States has not adopted IFRS and therefore continues to allow rate-regulated accounting. Partly in an effort to reconcile U.S. generally accepted accounting principles with IFRS, in March 2012 Canada's AcSB granted a one-year extension, to January 1, 2013, to the mandatory IFRS changeover date for entities with qualifying rate-regulated activities. In September 2012, it granted an additional one-year extension, to January 1, 2014.

At the time of drafting this Annual Report, the deferral of the mandatory IFRS changeover date for entities with qualifying rate-regulated activities had been extended again to January 1, 2015. In May 2013, the AcSB issued an exposure draft proposing to incorporate a new standard on regulatory deferral accounts based on a recently issued International Accounting Standards Board (IASB) exposure draft. The exposure draft proposes an interim standard for use by first-time adopters of IFRS with activities subject to rate regulation until the IASB completes its comprehensive rate-regulated activities project, which could take several years.

Ontario's Ministry of Finance (Ministry) contends that rate-regulated accounting has an impact on the government's fiscal policy decisions. The Ministry also contends that the province's rate-regulated assets and liabilities might meet PSAB standards without reference to any of the rate-regulated provisions from Canada's AcSB. As the Ministry is aware, we do not agree with this position. Since the government controls both the regulator and the regulated entities in question, it has significant influence on which electricity costs the regulated entities will recognize in any given year, which could ultimately impact electricity rates and the government's annual deficit or surplus.

With the uncertainty regarding rate-regulated accounting, the government passed a regulation in 2011 allowing for and subsequently directing both Hydro One and OPG to prepare their financial statements in accordance with U.S. generally accepted accounting principles, which allow for rate-regulated accounting, as discussed above. We are concerned about the possible effect of the inclusion of these financial statements on the province's March 31, 2015, and subsequent consolidated financial statements, as it is unclear what the AcSB will have decided at that time regarding rate-regulated accounting in Canada.

MINISTRY RESPONSE

The province accounts for rate-regulated electricity costs reported by Hydro One and OPG in accordance with PSAB standards in preparing its consolidated financial statements. Given the original direction from PSAB for government business enterprises such as Hydro One and OPG to follow IFRS, rate-regulated accounting would not have been possible. In response, the government directed Hydro One and OPG to follow U.S. GAAP to allow the entities to account for their rate-regulated assets and liabilities on a basis consistent with historical Canadian GAAP. With the standard-setters' subsequent deferral of this issue, the province's decision was consistent with actions taken by both the Canadian Securities Administrators and the Ontario Securities Commission, which enabled rate-regulated utilities to submit their financial statements on a U.S. GAAP basis until 2014. The government continues to look forward to standard-setters appropriately resolving this issue.

Transfer Payments

PSAB's Government Transfers project began a number of years ago to address several accounting issues related to monetary transfers from one level of government to another, including the following:

- appropriately accounting for multi-year funding provided by one government to another;
- clarifying the authorization needed for transfers to be recognized by both the transferor and transferee;
- clarifying the degree to which stipulations imposed by a transferring government affect the timing of transfer recognition in the accounts of both the transferring and recipient governments; and
- appropriately accounting for transfers that are to be used to acquire or construct tangible capital assets.

After substantial discussion, the issuing of several documents for comments and consideration of respondents' views, PSAB approved a new standard on government transfers in December 2010, effective for fiscal years beginning on or after April 1, 2012.

One of the most difficult areas PSAB had to address in developing the standard was how recipients should account for multi-year transfers. If the federal government makes a lump-sum transfer near the end of a fiscal year to a province to fund services over several years, the question arises as to whether the province should immediately recognize the full amount of the grant as revenue or whether it should recognize the revenue over the years it funds provincial services. A similar issue arises with respect to capital transfers from the province to other entities such as school boards and hospitals. A number of stakeholders held the view that capital transfers should be recognized as revenue when the recipient government incurs the expenditures making it eligible to receive the grant. However, other stakeholders held that such transfers should be brought into revenue over time as the tangible capital asset acquired or constructed with the transferred funds is used to provide public services.

The new standard generally recommends that recipients should recognize a government transfer as revenue when it has been authorized and the recipient has met all eligibility criteria. However, this requirement does not apply when the transferring government creates a liability for the recipient government by imposing stipulations on the use of the transfer, or specifies actions the recipient needs to take to keep the transfer. The standard also specifies that actions and communications by the recipient that restrict the use of transferred funds for a specific purpose can create a liability. To meet PSAB's liability definition, there must be no discretion to avoid it, there must be a future outflow of economic resources to settle it, and it must be the result of past transactions and events. Whether the facts and circumstances surrounding a particular transfer support the recognition of a liability is a matter of professional judgment. If a transfer is deemed to create a liability for the recipient government, the transfer is deferred and recognized as revenue as the liability is settled over time.

Rather than enhancing consistency and comparability in accounting for government transfers, the new standard appears to be creating confusion. Its requirements are very broad and open to interpretation, resulting in significant differences in its application. This is a significant concern, because transfers are usually a significant government activity and can have a great impact on reported results. In the 2012/13 fiscal year, Ontario recorded transfer-payment expenses in excess of $50 billion and transfer revenue from the federal government of over $21 billion.

Many stakeholders have asked PSAB to consider amending the transfers standard because of inconsistencies in interpretation and application. This includes a request signed by all members of the Canadian Council of Legislative Auditors in 2013. PSAB discussed the matter and is of the view that more empirical evidence is needed before it will consider amending the standard.

One significant area where consensus has been difficult to reach is accounting for transfers received to fund the acquisition or construction of tangible capital assets. Depending on the circumstances, such transfers might be recognized as revenue when received, when the asset has been acquired or constructed, or over the service life of the asset.

While we acknowledge the controversy over this new standard, we believe that it supports initially accounting for both 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. As such, we agreed with $5.6 billion in deferred capital contributions being recorded in the province's March 31, 2013, consolidated financial statements ($5.1 billion in 2011/12).

Public Sector Accounting Board Initiatives

This section outlines some additional items the Public Sector Accounting Board (PSAB) has been studying over the last year that may impact the preparation of the province's consolidated financial statements in the future.

CONCEPTS UNDERLYING FINANCIAL PERFORMANCE

PSAB's existing conceptual framework is a set of interrelated objectives and fundamental principles that support the development of consistent accounting standards. Its purpose is to instill discipline into the standard-setting process to ensure that accounting standards are developed in an objective, credible and consistent manner. PSAB formed the Conceptual Framework Task Force (Task Force) in April 2011 in response to concerns raised by several governments regarding current revenue and expense definitions, which they contend result in volatility in reported results and distort budget-to-actual comparisons. The Task Force's objective is to review the appropriateness of the concepts and principles in the existing conceptual framework for the public sector.

The Task Force issued its first consultation paper in August 2011 to seek input from stakeholders on the key characteristics of public-sector entities and their accounting and reporting implications. Respondents to the exposure draft were in general agreement with its key proposals. In October 2012, the Task Force issued a second consultation paper focused on measuring financial performance in public-sector financial statements. It sought input on the following:

- the objective and context of public-sector financial reporting;
- who public-sector entities are accountable to, and what they are accountable for;
- how the provision of information in financial statements can help to demonstrate those accountabilities; and
- alternative models of measuring financial performance.

Input received from the two consultation papers will be considered in drafting a statement of principles that PSAB intends to issue in March 2014.

IMPROVEMENTS TO NOT-FOR-PROFIT STANDARDS

The AcSB and PSAB recently initiated a project to improve accounting standards for not-for-profit organizations, including government not-for-profit organizations. These standards are followed by many organizations funded by the Ontario government. In April 2013, the Joint Not-for-Profit Task Force established to lead this project issued a statement of principles containing 15 proposed principles, the most significant of which were the following:

- contributions received would be immediately recognized as revenue, unless the terms of the contribution give rise to an obligation meeting the definition of a liability;
- financial statement presentation for government not-for-profit organizations would follow the same standards as for governments and other government organizations. This would require the presentation of net-debt indicators, a statement of net debt and enhanced budget information; and
- government not-for-profit organizations would adopt public-sector standards for capitalizing, amortizing, writing down and disposing of tangible capital assets.

The task force is seeking comments by December 15, 2013. The next step in this project is expected to be the release of an exposure draft for public comment.

RELATED-PARTY TRANSACTIONS

PSAB's Related-Party Transaction project is aimed at issuing a new accounting standard that defines related parties in the context of the public sector and describes their measurement and disclosure requirements. Such disclosures allow users to assess the effect that related-party transactions have on a reporting entity's financial position and financial performance. An exposure draft issued in September 2012 proposed the following:

- Related parties would include entities that control or are controlled by a reporting entity, entities under common control, and entities with shared control over or subject to shared control of a reporting entity.
- Individuals who are members of key management personnel and close members of their family are included as related parties; however, disclosure of management compensation arrangements, expense allowances and other similar routine payments would not be not required.
- Disclosure would be required only when transactions and events between related parties have or could have a material effect on the financial statements.
- Related-party transactions other than contributed goods and services would be recognized by both parties. Contributed goods and services may be recognized or disclosed by the reporting entity.
- Related-party transactions would be recorded at the exchange amount, which could be the carrying amount, the consideration paid or received, or fair value. If the exchange amount differs from the carrying amount, the gain or loss would be recognized.

Due to concerns raised in the responses to this exposure draft, PSAB issued a re-exposure draft in June 2013 with significant revisions:

- Entities may be related when management of the reporting entity or their close family members also manage another entity.
- Related-party transactions would be measured at the carrying amount, unless:
  - they are in the normal course of operations; or
  - a recipient's future economic benefits or service potential is expected to change significantly as the result of the transaction.

  In these cases, the transaction would be measured at the exchange amount.
- Preparers could apply the proposed standard retroactively or prospectively.

PSAB requested comments to the re-exposure draft by September 4, 2013.

REVENUE

Revenue recognition is fundamental to government financial reporting as it has a direct impact on the surplus or deficit it reports. Current public-sector accounting standards provide general guidance on revenue recognition and disclosure, with specific standards that address taxes and government transfers. PSAB has recognized the need for guidance applicable to a broader range of types of revenue common in the public sector, such as fines and penalties, royalties, licence fees and other fees, and sales and rental income. It issued a statement of principles on revenue for public comment in August 2013 and is seeking comments by February 3, 2014.

Statutory Matters

Under section 12 of the *Auditor General Act*, I am required to report on any Special Warrants and Treasury Board Orders issued during the year. In addition, section 91 of the *Legislative Assembly Act* requires that I report on any transfers of money between items within the same vote in the Estimates of the Office of the Assembly.

LEGISLATIVE APPROVAL OF EXPENDITURES

Shortly after presenting its budget, the government tables expenditure estimates in the Legislative Assembly outlining, on a program-by-program basis, each ministry's spending proposals. The Standing Committee on Estimates (Committee) reviews selected ministry estimates and presents a report on this review to the Legislature. The estimates of those ministries that are not reviewed are deemed to be passed by the Committee and are so reported to the Legislature. Orders for Concurrence for each of the estimates reported on by the Committee are then debated in the Legislature for a maximum of two hours before being voted on.

After the Orders for Concurrence are approved, the Legislature still needs to provide the government with legal spending authority by approving a *Supply Act*, which stipulates the amounts that can be spent by ministry programs, typically those detailed in the estimates. Once the *Supply Act* is approved, the individual program expenditures are considered to be Voted Appropriations. The *Supply Act, 2013*, which pertained to the fiscal year ended March 31, 2013, received Royal Assent on April 23, 2013.

The *Supply Act* does not typically receive Royal Assent until after the start of the fiscal year—and sometimes even after the related fiscal year is over—so the government usually requires interim spending authority prior to its passage. For the 2012/13 fiscal year, the Legislature passed the *Interim Appropriation for 2012-2013 Act, 2012* (Interim Act). The Interim Act received Royal Assent on June 20, 2012, and authorized the government to incur up to $114.8 billion in public service expenditures, $4.3 billion in investments, and $197 million in legislative office expenditures. The Interim Act was made effective as of April 1, 2012.

The Interim Act provided the government with sufficient authority to allow it to incur expenditures from April 1, 2012, to when the *Supply Act, 2013,* received Royal Assent on April 23, 2013. The spending authority provided under the Interim Act was intended to be temporary, and it was repealed when the *Supply Act, 2013,* received Royal Assent. The *Supply Act, 2013,* also increased total authorized expenditures of the legislative offices from $197 million to $199.6 million.

SPECIAL WARRANTS

If the Legislature is not in session, section 1.0.7 of the *Financial Administration Act* allows for the issuance of Special Warrants authorizing the incurring of expenditures for which there is no appropriation by the Legislature or for which the appropriation is insufficient. Special Warrants are authorized by Orders-in-Council and approved by the Lieutenant Governor on the recommendation of the government.

No Special Warrants were issued for the fiscal year ended March 31, 2013.

TREASURY BOARD ORDERS

Section 1.0.8 of the *Financial Administration Act* allows the Treasury Board to make an order authorizing expenditures to supplement the amount of any voted appropriation that is expected to be insufficient to carry out the purpose for which it was made. The order may be made only if the amount of the increase is offset by a corresponding reduction of expenditures to be incurred from other voted appropriations not fully spent in the fiscal year. The order may be made at any time before the government books for the fiscal year are closed. The government considers the books to be closed when any final adjustments arising from our audit have been made and the Public Accounts have been published and tabled in the Legislature.

Even though the *Treasury Board Act, 1991*, was repealed and re-enacted within the *Financial Administration Act* in December 2009, subsection 5(4) of the repealed act was retained. This provision allows the Treasury Board to delegate any of its duties or functions to any member of the Executive Council or to any public servant employed under the *Public Service of Ontario Act, 2006*. Such delegations continue to be in effect until replaced by a new delegation. Since 2006, the Treasury Board has delegated its authority for issuing Treasury Board Orders to ministers to make transfers between programs within their ministries, and to the Chair of the Treasury Board for making program transfers between ministries and making supplementary appropriations from contingency funds. Supplementary appropriations are Treasury Board Orders in which the amount of an appropriation is offset by a reduction to the amount available under the government's centrally controlled contingency fund.

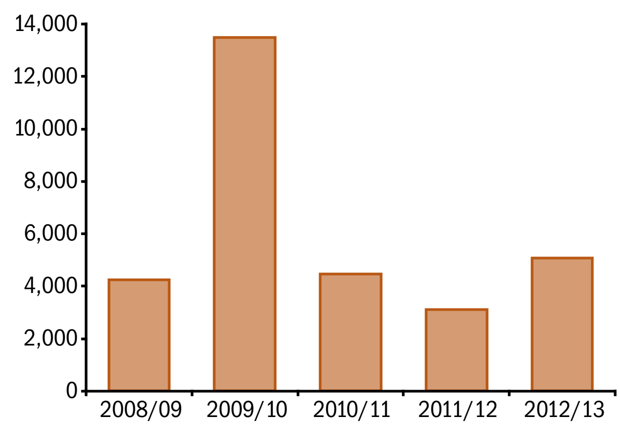
Figure 11 summarizes the total value of Treasury Board Orders issued for the past five fiscal years.

Figure 12 summarizes Treasury Board Orders for the fiscal year ended March 31, 2013, by month of issue.

According to the Standing Orders of the Legislative Assembly, Treasury Board Orders are to be printed in *The Ontario Gazette*, together with explanatory information. Orders issued for the 2012/13 fiscal year are expected to be published in *The Ontario Gazette* in December 2013. A detailed listing of 2012/13 Treasury Board Orders, showing

Figure 11: Total Value of Treasury Board Orders, 2008/09–2012/13 ($ million)

Source of data: Treasury Board



Chapter 2

the amounts authorized and expended, is included as Exhibit 4 of this report.

TRANSFERS AUTHORIZED BY THE BOARD OF INTERNAL ECONOMY

When the Board of Internal Economy authorizes the transfer of money from one item of the Estimates of the Office of the Assembly to another item within the same vote, section 91 of the *Legislative Assembly Act* requires that we make special mention of the transfer(s) in our Annual Report.

Accordingly, Figure 13 shows the transfers made within Vote 201 with respect to the 2012/13 Estimates.

UNCOLLECTIBLE ACCOUNTS

Under section 5 of the *Financial Administration Act*, the Lieutenant Governor in Council, on the recommendation of the Minister of Finance, may authorize an Order-in-Council to delete from the accounts any amounts due to the Crown that are the subject of a settlement or deemed uncollectible. The amounts deleted from the accounts during any fiscal year are to be reported in the Public Accounts.

In the 2012/13 fiscal year, receivables of $395.8 million due to the Crown from individuals and non-government organizations were written off. (The comparable amount in 2011/12 was $816.4 million.) The writeoffs in the 2012/13 fiscal year related to the following:

- $92.1 million for uncollectible retail sales tax ($382.2 million in 2011/12);
- $86.5 million for uncollectible receivables under the Student Support Program ($114.1 million in 2011/12);
- $60.4 million for uncollectible corporate tax ($155.8 million in 2011/12);
- $48 million for uncollectible receivables under the Ontario Disability Support Program ($86.3 million in 2011/12);
- $44.7 million for uncollectible loans from pulp and paper companies ($0 in 2011/12);
- $15.1 million for uncollectible employer health tax ($48.9 million in 2011/12);
- $13.2 million for uncollectible forestry royalties ($0 in 2011/12); and
- $35.8 million for other tax and non-tax receivables ($29.1 million in 2011/12).

Volume 2 of the 2012/13 Public Accounts summarizes the writeoffs by ministry.

Under the accounting policies followed in the preparation of the province's consolidated financial statements, a provision for doubtful accounts is recorded annually against accounts receivable balances. Accordingly, most of the writeoffs had already been expensed in the government's consolidated financial statements. However, the actual writeoff in the accounts required Order-in-Council approval.

Figure 12: Total Value of Treasury Board Orders by Month Relating to the 2012/13 Fiscal Year

Source of data: Treasury Board

Month of Issue	#	Authorized ($ million)
April 2012–February 2013	72	2,428
March 2013	36	1,969
April 2013	12	421
July 2013	2	270
Total	**122**	**5,088**

Figure 13: Authorized Transfers Relating to the Office of the Assembly, 2012/13 Fiscal Year ($)

Source of data: Board of Internal Economy

From:		
Item 3	Legislative Services	(26,400)
Item 4	Information and Technology Services	(18,200)
To:		
Item 2	Office of the Clerk	9,900
Item 5	Administrative Services	21,900
Item 6	Sergeant at Arms and Precinct Properties	12,800