

# Public Accounts of the Province

## Introduction

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

The consolidated financial statements of the province are the responsibility of the government of Ontario. This responsibility encompasses ensuring that the information in the consolidated financial statements, including the many amounts based on estimates and judgment, is presented fairly. The government is also responsible for ensuring that a system of control, with supporting procedures, is in place to provide assurance that transactions are authorized, assets are safeguarded, and proper records are maintained.

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

The province's annual report contains, in addition to the province's consolidated financial statements and our Auditor's Report on them, a Financial Statement Discussion and Analysis section that provides additional information regarding the province's financial condition and fiscal results for the year ending March 31, 2008, including some details of what the government accomplished in the 2007/08 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, which contains the ministry statements and a number of schedules providing details of the province's revenues and expenses, its debts and other liabilities, its loans and investments, and other financial information.
- Volume 2, which contains the 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 financial statements.
- Volume 3, which contains 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 on or before the 180th day after the end of the fiscal year. The three supplementary volumes must be submitted to the Lieutenant Governor in Council before the 240th day after the end of the fiscal year. Upon receiving these documents, the Lieutenant Governor in Council must lay them before the Legislative Assembly or, if it is not in session, make the information public and then, when the Legislative Assembly resumes sitting, lay it before the Legislative Assembly on or before the 10th day of that session.

This year, the government released the province's 2007/08 Annual Report and Consolidated Financial Statements, along with the three Public Accounts supplementary volumes, on August 25, 2008.

## The Province's 2007/08 Consolidated Financial Statements

The *Auditor General Act* requires that I report annually on the results of my examination of the province's consolidated financial statements. I am pleased to report that my Auditor's Report to the Legislative Assembly on the province's consolidated financial statements for the year ended March 31, 2008, is clear of any qualifications or reservations and reads as follows:

To the Legislative Assembly of the Province of Ontario

I have audited the consolidated statement of financial position of the Province of Ontario as at March 31, 2008, and the consolidated statements of operations, change in net

debt, change in accumulated deficit, and cash flow for the year then ended. These financial statements are the responsibility of the Government of Ontario. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. The audit also includes assessing the accounting principles used and significant estimates made by the Government, as well as evaluating the overall financial statement presentation.

In my opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Province as at March 31, 2008, and the results of its operations, the changes in its net debt, the changes in its accumulated deficit, and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

[signed]

Toronto, Ontario August 1, 2008  
 Jim McCarter, CA  
 Auditor General  
 Licensed Public Accountant

## Objective Accounting Standards—Key to Credible Government Financial Statements

### INTRODUCTION

The financial reporting environment is changing rapidly for both the private and the public sectors. The Accounting Standards Board (AcSB) of the Canadian Institute of Chartered Accountants (CICA), the national organization responsible for establishing accounting and reporting standards, has announced changes to the method of financial reporting used by some entities, including all publicly traded companies. By 2011, the current Canadian generally accepted accounting principles used to prepare the financial statements of publicly accountable, profit-oriented enterprises will be replaced by the accounting framework set out in International Financial Reporting Standards (IFRS). The AcSB of the CICA is also reviewing and updating the accounting standards applicable to not-for-profit organizations.

With respect to government financial statements, the CICA's Public Sector Accounting Standards Board (PSAB) has the authority to set accounting standards for the public sector. PSAB is working to address a number of complex financial accounting and reporting issues, including accounting for government transfers, financial instruments, foreign exchange, and how the adoption of IFRS by government business enterprises and government business-type organizations should be accounted for in a government's financial statements.

These changes reflect the ongoing globalization of financial markets and the movement toward worldwide standards in several areas of business and government. This movement includes not only accounting standards, but also auditing standards and securities regulation.

### PUBLIC SECTOR ACCOUNTING BOARD (PSAB)—THE INDEPENDENT ACCOUNTING STANDARD SETTER

The CICA established the Public Sector Accounting Board (PSAB) in 1981 to develop public sector accounting and reporting standards. PSAB has grown in influence since that time, and in our view has served the public interest very well as an independent standard setter. Its standards now represent generally accepted accounting principles (GAAP) for governments in Canada. While its recommendations are not mandatory given the sovereignty of governments, they reflect best practices in government accounting. Their adoption demonstrates a government's commitment to transparency, credibility, consistency, and comparability in accounting and financial reporting. PSAB's success in achieving stakeholder consensus with its accounting and reporting standards is clearly demonstrated by the fact that, with very few exceptions, the consolidated financial statements of the federal and all provincial/territorial governments are now prepared in accordance with its standards.

### Improvements in the Last 15 Years

Governments, including the province of Ontario, have introduced a number of major improvements in their accounting and financial reporting practices over the last 15 years. The key accounting and financial reporting milestones noted below are the result of moves by successive Ontario governments toward compliance with PSAB's evolving accounting standards:

- In 1993/94, the province's financial statements changed from being prepared on a modified cash basis of accounting, where revenues and expenditures were essentially recognized as monies were received or paid out in cash, to being prepared on the accrual basis of accounting, whereby revenues are recognized as they are earned and expenses are recognized as they are incurred.

- Also in 1993/94, the province's financial statements moved from a central revenue fund model, which generally included only the transactions affecting government ministries, to a consolidated model, which included the activities of agencies that were accountable to the Ontario Legislature and were owned or controlled by the government.
- In 1995/96, the Ontario Budget was for the first time prepared on a consolidated and accrual basis—that is, on the same basis as the province's financial statements—allowing for a true comparison of actual results against budget.
- In 1995/96, the province significantly enhanced its disclosure of financial instruments and derivatives.
- In 2002/03, the province introduced new policies to account for its investments in land, buildings, and transportation infrastructure. The province now accounts for such capital expenditures as long-term investments and amortizes the cost of these investments over the assets' estimated useful lives. This is consistent with how capital assets are accounted for in the private sector. Previously, the government's capital expenditures were charged to current year expenses as incurred.
- Commencing with the 2002/03 Annual Report, the province included an expanded discussion and analysis of its consolidated financial statements to provide a better understanding of its financial results.
- In 2003/04, the appropriations and estimates of the government, which set out the amounts the government requests of the Legislature annually and, once approved, reflect the government's legal spending authority, were for the first time also prepared on an accrual basis.
- In 2005/06, hospitals, school boards, and colleges were for the first time consolidated into the province's financial statements.
- In 2007/08, the province enhanced the transparency of its financial statements by provid-

ing segmented information on the major categories of its revenues and expenses.

## PSAB's Standard-setting Process

Accounting standards are authoritative standards for financial accounting and reporting developed through an organized standard-setting process and issued by a recognized standard-setting body (the Public Sector Accounting Board) (PSAB). Accounting standards specify how transactions and other events are to be recognized, measured, presented and disclosed in government financial statements. The objective of such standards is to meet the needs of users of financial statements by providing the information needed for accountability and decision making.

—CICA, "About PSAB"

PSAB consists of a maximum of 12 board members and a chair. To help ensure that PSAB standards are appropriate for governments, under its term of reference, two-thirds of PSAB board members are normally individuals involved with government financial reporting and auditing.

PSAB uses a consultative "task force" approach for developing standards and other guidance. After its members approve a project, PSAB usually appoints a task force consisting of individuals who have a particular expertise or interest in the subject area to research, develop, and draft the proposed new standard. PSAB ensures that the task force is provided with the necessary background information and research materials. The task force in turn makes its recommendations to PSAB.

PSAB emphasizes due process in order to ensure that both it and the task force raise and consider a wide range of views and issues. Developing an accounting standard typically follows a five-step process:

- basic research;
- approval of a project proposal;
- a statement of principles sent to a designated group of associates for initial feedback;
- one or more public exposure drafts which are issued for public comment by any interested individual or organization; and
- a final approved standard.

Another element in the accounting-standard-setting process is the requirement that any new standard be consistent with the CICA's overall conceptual framework. The CICA's conceptual framework consists of interrelated objectives and fundamentals that support the development of consistent accounting standards. As new accounting and financial-reporting issues arise, accounting-standard-setting bodies such as PSAB use this framework to ensure that any proposed standard is consistent with the CICA's overall financial reporting model.

Any final standard requires the approval of two-thirds of all members of PSAB.

### **Auditor General Act**

We noted previously that the *Auditor General Act* requires the Auditor General to report annually on the results of the Auditor General's examination of the province's consolidated financial statements.

More specifically, subsection 12 (3) of the *Auditor General Act* requires that the Auditor General provide an opinion 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." Our view is that generally accepted accounting principles for governments are those recommended by the PSAB of the CICA.

### **Canadian Council of Legislative Auditors**

My Office is not alone among legislative audit offices across Canada in supporting PSAB. This past year, the Canadian Council of Legislative Auditors

(CCOLA), comprising the Auditor General of Canada and the Auditor General or Provincial Auditor of every Canadian province, wrote to the Chair of the CICA Accounting Standards Oversight Council (Council) expressing its full support for PSAB as the appropriate independent standard-setter for government financial accounting and reporting. In its letter, CCOLA emphasized the importance of the "due process" described earlier in helping to ensure that accounting standards consider the views of all stakeholders while maintaining the objectivity of the accounting standard-setting process.

On June 13, 2008, the Auditor General of Canada and I met with the Council to express the full support of Canada's legislative auditors for PSAB standards. Interestingly, there was considerable discussion of the *Investing in Ontario Act, 2008* that the Ontario Legislature recently passed. As discussed in the next section, this Act mandates that certain transactions be accounted for in the financial statements of the province in a manner that, depending on how the transaction is structured, may not be in accordance with generally accepted accounting principles.

### **MINISTRY RESPONSE**

The province's consolidated financial statements are prepared in compliance with legislation and in accordance with generally accepted accounting principles for governments in Canada. The Auditor General expressed a clean opinion in his Auditor's Report, concurring that the province's financial statements for the year ended March 31, 2008, were prepared in accordance with Canadian generally accepted accounting principles.

Ontario and all other federal, provincial, and territorial governments in Canada have been part of a Joint Working Group with the Public Sector Accounting Board (PSAB) for more than a year to address a number of major concerns with the direction of the recent development of accounting standards for governments in Canada. The major areas of concern include:

- the consistency of PSAB's conceptual accounting framework with sound public policy decision-making, fiscal accountability, and public understanding of government financial information;
- the nature of PSAB's governance structure and its standard-setting process with respect to the breadth of representation of public-sector interests and the need for improvement in its standard-setting process; and
- the direction of proposed changes in accounting standards for financial instruments, government transfers, government business enterprises, and broader-public-sector organizations.

The recommendations of the Joint Working Group are expected to be submitted to the Accounting Standards Oversight Council and PSAB later this year. They are overwhelmingly supported by senior governments across Canada.

## ***INVESTING IN ONTARIO ACT, 2008***

### **Introduction**

In March 2008, the government introduced Bill 35, the proposed *Investing in Ontario Act, 2008* (Act). The Act was passed by the Legislature and received Royal Assent on May 14, 2008. Under the Act and related regulations, the government can apply a portion of any unplanned surplus for the fiscal year to reduce the accumulated deficit, and also allocate a portion of the unplanned surplus to “eligible recipients” in order to address priority public needs as determined by the government in any given year. The portion of the unplanned surplus that would go to eligible recipients and toward reducing the accumulated deficit would be set out by regulation.

### ***Accounting for Transfers under the Investing in Ontario Act, 2008***

In 2007/08, under the Act and related regulations, of the total 2007/08 preliminary surplus of \$1.7 billion, the government provided additional transfers to municipalities of \$1.1 billion and allocated the final \$600 million surplus to reducing the province's accumulated deficit. The transfers were provided after the tabling of the 2007/08 Public Accounts.

In assessing these transactions, we concluded that accounting for these transfers as an expense of the 2007/08 fiscal year was appropriate, as the PSAB criteria for expense recognition had been met. Specifically, we agreed that a liability had been established by the government prior to March 31, 2008, by its announcement of these transfers to municipalities in the 2008 Ontario Budget, and by the government's communication to municipalities of their entitlement to these funds once the audit of the province's financial statements for the year had been completed and the final surplus amount was determined. In addition, the government received appropriation approval prior to year-end.

### ***Our Concern with Respect to Certain Clauses Contained in the Investing in Ontario Act, 2008***

Although we accepted the government's accounting with respect to the year-end investments made under the Act, we do have a serious concern relating to certain sections in the Act that amend the *Fiscal Transparency and Accountability Act, 2004* (FTAA) and the *Ministry of Treasury and Economics Act* (MTEA).

Section 4 of the Act amends the FTAA by specifying that government transactions under the Act “shall be considered to be an expense of the Government of Ontario for that fiscal year.” Subsection 5(2) of the Act amends the MTEA by further specifying that these amounts “shall be recorded as an expense of the Government of Ontario for that

fiscal year in the summary financial statements as set out in the Public Accounts.”

Our concern is that through this legislation the government has, for the first time that we are aware of, taken upon itself to decree how transactions will be accounted for rather than applying generally accepted accounting standards. The only possible purpose of these provisions is to enable the government to record such transactions as expenses under the Act, even though future transactions, depending how they are structured, might not be considered expenses under generally accepted accounting principles as established by PSAB. As noted previously, the PSAB of the CICA is recognized throughout Canada as the appropriate body for establishing accounting standards for the public sector. We support PSAB standards and believe that the method of accounting for government transactions should not be established by the government itself through legislation.

To elaborate on our concern, we believe that the CICA is well established as the Canadian accounting profession’s independent standard-setting body, and the accounting standards it develops through its public-sector board (PSAB) provide governments with an objective and appropriate basis for accounting and reporting on transactions.

There are a number of PSAB accounting standards already in place that provide guidance to governments in recognizing and measuring expenses, including a distinct section on accounting for government grants, the subject of the Act.

Our concern with section 4 and subsection 5(2) of the Act is that they raise an obvious “what if” question as to how to account for transactions made under the Act that did not qualify as expenses under PSAB standards but were required to be expensed by the terms of the Act.

To illustrate by way of an example, one of the key principles in PSAB standards is that transfer recipients must have met the eligibility criteria for receiving grants before the government providing them can recognize such grants as an expense. Many of Ontario’s social assistance programs are

delivered at the municipal level, with municipalities entitled to receive transfers on a cost-shared basis, as they directly provide social assistance to eligible recipients. The Ontario government could provide advance payments to a municipality under the Act over and above those required to fund its share of the municipality’s social assistance payments for that year, because it had excess funds available at year-end. These payments could be made under the proviso that the province would withhold payments in the next year until the municipality’s “credits” under these cost-sharing programs had been exhausted. The government would then presumably treat these transfers as an expense of the current fiscal year. However, these payments would likely not meet PSAB criteria for expense recognition, as the municipality had not yet made the payments to its social assistance recipients relating to the advanced funds and thus had not yet “earned” these monies. If this were the case, under PSAB standards, the amounts provided should be treated as advances or as assets in the government’s financial statements rather than expenses of the current year, and would be expensed in future periods as the eligibility criteria were met (that is, as the municipality made the social assistance payments to individual recipients).

Depending on the amounts involved, the annual fiscal results of the province could be significantly misstated if these legislative provisions were to be used in future to override PSAB standards. For instance, the government set aside up to \$2 billion this year under the Act, and actually expended \$1.1 billion of this allocation. These are significant amounts, so we believe our concern is more than just an academic one.

At the time of the introduction of Bill 35, I communicated my concerns in writing to the Deputy Minister of Finance and Secretary of Treasury Board on April 24, 2008, with a copy to the Minister of Finance, urging the Ministry of Finance to delete section 4 and subsection 5(2) of the Bill to avoid the potential for conflicting requirements in how transactions should be accounted for in the

province's consolidated financial statements. I had hoped that this timely intervention by my Office would permit our concerns to be addressed by the government.

I also wrote on April 25, 2008, to the Chair of the Standing Committee on Finance and Economic Affairs, which was responsible for the clause-by-clause review of Bill 35, to express my concerns and offered to appear before the Committee to discuss my concerns more fully. Although a motion to permit the Auditor General, an Officer of the Legislative Assembly, to appear was put forward, it was voted down by the government majority on the committee and Bill 35 was approved a short time later without any amendments.

In summary, we hold the view that in the public sector, a fundamental principle of government accountability to its citizens is that it produce financial information in such a way that the Legislature and the public can rely on its credibility. For government financial statements to be credible, we further believe that users should have confidence that the statements adhere to generally accepted and identifiable standards that are established by an independent, arm's length standard-setting body.

As noted earlier, all governments over the past 15 years have made significant progress in enhancing the accountability, credibility, and usefulness of their financial statements. However, we are concerned that attempting to establish accounting principles through legislation may well be taking a step backward from the substantial progress made to date.

## MINISTRY RESPONSE

The *Investing in Ontario Act* (Act) provides the government the option of allocating a portion of any unanticipated year-end surplus to priority provincial needs as well as to the reduction of the province's accumulated deficit. In the absence of this Act, all year-end surpluses would go to the reduction of the province's accumulated deficit.

Under this Act and related regulations, the province allocated \$1.1 billion to municipalities for the year ended March 31, 2008, to help address their priority capital needs. This significant provincial investment will help address the municipal infrastructure deficit and is important for the province in these challenging economic times. This investment is expected to create 11,000 full-time jobs during the period of construction of these projects.

It is important that accounting policies support sound public policy. The Act provides assurance that governments will have a choice on the use of unanticipated year-end surpluses to meet priority public needs. The importance of accounting standards supporting sound public policy is a critical point that the inter-jurisdictional Joint Working Group is emphasizing to PSAB in its development of accounting standards for governments in Canada.

The Auditor General concurs that the \$1.1 billion year-end investment in municipal infrastructure under the Act is a 2007/08 expense consistent with current PSAB standards. Unless accounting standards change, year-end one-time investments under the Act should continue to be accounted for under the legislation on a basis consistent with PSAB accounting standards. In future years, the Auditor General, as part of his audit of the Public Accounts, will continue to review any allocations under the Act to determine whether, in his opinion, they are compliant with the legislation and in accordance with appropriate generally accepted accounting principles.

## Potential Change in Auditor's Standard Opinion

### BACKGROUND

As part of its strategy to harmonize Canadian standards with international standards, the CICA's Auditing and Assurance Standards Board (AASB) is adopting International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB). Currently, the IAASB is working to redraft all its existing international standards and has indicated that the redrafted standards may be available for adoption as of December 15, 2009. The AASB plans to incorporate these redrafted international standards into its Canadian auditing standards as they are completed.

In adopting the international standards issued by the IAASB, the AASB also plans to adopt, with appropriate Canadian modifications, standards which deal with the form and content of an auditor's standard opinion. Under existing Canadian standards, except in very limited circumstances, audit opinions must indicate whether the financial statements being audited are presented fairly in accordance with Canadian generally accepted accounting principles (GAAP). The CICA has established standard wording for an auditor's report to ensure that its meaning is clear to knowledgeable users of financial statements.

The IAASB is proposing an expansion of the possible acceptable financial reporting frameworks for general-purpose financial statements. Specifically, it proposes that acceptable reporting frameworks will not only include financial reporting standards of an established standard-setting organization such as the CICA or PSAB, but also standards established by law or regulation, or standards established by authorized industry organizations.

### THE PRIVATE SECTOR

Under the proposed new audit-reporting standard, in most cases the applicable financial reporting framework for profit-oriented entities will be Canadian GAAP, which will converge to IFRS in 2011. For example, under the *Canada Business Corporations Act*, all federally chartered public companies are required to prepare their financial statements in accordance with GAAP as established by the AcSB of the CICA. Canadian securities regulators also require GAAP-based financial statements.

These private-sector entities are required to adhere to GAAP for one main reason—to ensure that the reported fiscal and financial results in the financial statements are credible. For example, GAAP accounting helps ensure that private-sector entities that want to issue debt or sell securities in the capital markets not be able to distort their financial results by devising accounting policies that hide losses or inflate gains.

### THE GOVERNMENT SECTOR

While it appears that the private sector will be required to follow generally accepted accounting standards established by the CICA in their general-purpose financial statements, this may not be the case for governments. Specifically, the new proposals raise the risk that a government could pass legislation establishing accounting policies that result in its financial statements not being fairly presented. While we are not implying that this will happen, the new reporting standard opens the door for this possibility.

My fellow legislative auditors and I share this concern. In February 2008, the Auditor General of Canada and the Auditors General or Provincial Auditors of all the Canadian provinces jointly wrote to the Chair of the AASB expressing our concerns. We noted that Canadian governments are sovereign and not required to use generally accepted accounting principles to prepare their general-purpose financial statements. We further noted that under

the proposed standards an auditor would be required to state without reservation that the financial statements had been prepared in accordance with the prescribed financial reporting framework, regardless of whether he or she considered the framework used to be appropriate.

We also expressed concern that the proposed audit-reporting model would allow an entity to use disclosure as a substitute for appropriate accounting. Specifically, one provision in the proposed standards provides that when an *“unacceptable financial reporting framework is prescribed by law,”* the auditor must still issue an unqualified audit as long as the entity provides additional disclosures in its financial statements describing the matters that have not been appropriately accounted for in the financial statements. We do acknowledge that a Canadian modification to these standards is being proposed that would call for the auditor to highlight in his or her audit report that the entity has not used GAAP in preparing the financial statements and to explain the difference that makes to the statements. However, it is our view that accepting disclosure as a substitute for proper accounting is not appropriate.

In the concluding paragraph of our letter to the AASB, we highlighted the fact that Canadian public-sector accounting principles are highly respected internationally, and that it has taken many years for these principles to reach the point where they are generally accepted by our governments. However, the proposed audit-reporting model would appear to give permission to governments to return to earlier days when public-sector general-purpose financial statements were prepared on a basis of accounting chosen by the government rather than in accordance with independently established generally accepted accounting principles.

## MINISTRY RESPONSE

It is important that the Auditor General respect both laws and generally accepted accounting principles in expressing his audit opinion on whether the province’s consolidated financial statements present fairly its financial results.

## Public Accounts Issues in 2007/08

My Office and the Ministry of Finance have had differing views on the most appropriate accounting treatment of a variety of issues over the years. This is certainly not uncommon, and typically we have been able to work together to resolve our differences. As a result, my predecessor and I have been able to issue an unreserved or “clean” opinion on the annual consolidated financial statements of the government since the province first adopted PSAB standards in the 1993/94 fiscal year—a period of 14 years. In my view, this demonstrates the commitment of both the government and my Office to produce consolidated financial statements in accordance with PSAB standards.

During this year’s audit of the government’s consolidated financial statements, we dealt with a number of accounting issues, most of which were satisfactorily resolved. There were two issues, however, where we still have a difference of opinion with the Ministry. Given the size of the Ontario government and the dollar value of its transactions, these issues did not affect my opinion on the consolidated financial statements’ overall fairness. These issues included accounting for certain transfers provided to the province by other levels of government for investments in provincial infrastructure, and accounting for the rate-regulated assets and liabilities recorded by the Ontario Power Authority (OPA). As these two issues remain unresolved, they are discussed in the next two sections.

## ACCOUNTING FOR CAPITAL TRANSFERS

In our view, the government is not accounting for all capital transfers it receives from other levels of government in accordance with PSAB standards. These capital grants are received from two sources. First, the province receives federal capital grants under a cost-sharing arrangement whereby the

federal government contributes to the cost of construction of provincial highways. PSAB accounting standards require transfers under such cost-sharing agreements to be recognized as revenue when the recipient of the grant incurs the expenditures that make it eligible for the grant. As at March 31, 2008, the province had received significant amounts, accumulated over several years, that should have been recognized as revenue, as the government had incurred the construction expenditures making it eligible for the grants. Instead, the recognition of the revenues has been deferred with the intention of recording these revenues over the useful lives of the related assets.

Similarly, the province, through the Greater Toronto Transit Authority (GTTA), an Ontario government agency whose activities are consolidated with those of the province in the government's consolidated financial statements, receives capital transfers from both the federal and municipal governments for public transit infrastructure-capital-related projects. PSAB accounting standards require such transfers to be recognized as revenue in a government's financial statements as the resources provided are used for the purposes specified. As at March 31, 2008, the GTTA had received significant amounts, again accumulated over several years, that had been spent on public transit infrastructure-capital-related projects and accordingly should have been recorded as revenue, but the recognition of these revenues has also been deferred.

We recognize that the accounting used by the Ministry of Finance is consistent with its stated accounting policy for tangible capital assets. However, we believe, and have expressed this belief to the Ministry for several years, that this policy is inconsistent with PSAB standards. Accordingly, the accumulation of these deferred balances has been of increasing concern to our Office. The annual impact of this non-compliance on the province's annual surplus/deficit, while not yet material to their overall fair presentation, is also of concern, especially given the new *Investment in Ontario Act* and its provisions calling for payments to transfer-

payment recipients to be based on the preliminary surplus as recorded in the province's consolidated financial statements.

The Ministry of Finance believes that a different interpretation of PSAB standards is possible. It further believes that a better matching of costs to revenues is achieved if such capital grants are brought into revenue to offset the annual amortization expense of the related capital assets. We acknowledge that the Ministry's position has some theoretical merit and has been adopted by several other Canadian jurisdictions, but we do not agree that it is in accordance with PSAB accounting standards. As well, we question whether it is consistent with the CICA's conceptual framework and the movement in the profession both internationally and in Canada to eliminate deferred charges and liabilities and allow only assets and liabilities that meet strict definitional tests to be recorded on an entity's statement of financial position.

A PSAB task force has been revisiting this issue as part of a project aimed at revising its standards for government transfers. In fact, the re-exposure draft issued by this task force included recommendations that could permit a recipient government to defer capital transfers and recognize them over the period specified by the transferring government as the assets acquired are used to provide services to the public. However, this amortization option would require that funding agreements between the two governments contain specific stipulations as to use of the assets, but these are not set out in the existing agreements, and government officials have indicated that they would not support their inclusion in future agreements. It is unlikely, therefore, that this option, even if adopted by PSAB, would be applicable to Ontario's situation.

We expect PSAB to finalize its position on government transfers in late 2008 or early 2009. If the position taken by the Ministry is not supported by PSAB, we strongly recommend that the Ministry revise its current accounting policy relating to capital transfers for the 2008/09 fiscal year.

## MINISTRY RESPONSE

The province's accounting treatment for capital transfers is consistent with the accounting practices of many other governments in Canada, including Quebec, British Columbia, the Northwest Territories, Nunavut, Prince Edward Island, and New Brunswick. Senior governments in Canada, through the Joint Working Group, strongly support the accounting practice for capital transfers currently followed by Ontario.

It is the position of the Ministry of Finance that the accounting treatment currently being followed by the province for capital transfers is appropriate, consistent with the practices of other governments in Canada, and in accordance with generally accepted accounting principles.

## RATE-REGULATED ASSETS AND LIABILITIES

Rate regulation refers to an arrangement whereby a government-established regulatory authority approves the prices that a regulated entity can charge its customers for its products or services. Regulators often prohibit regulated entities from immediately recovering all of their current costs in their current rates, ordering rather that such costs be "deferred" (and recorded as an asset) for recovery from customers in future periods. Rate-regulated accounting practices were developed to recognize the unique nature of regulated entities and these types of transactions.

Rate-regulated accounting is used extensively in Ontario's electricity sector and has accordingly found its way into the accounts of the Ontario government, because the government owns and controls Ontario Power Generation Inc. and Hydro One Inc. Under PSAB accounting standards, government business enterprises like these are consolidated into the government's statements via the modified equity method of accounting, which requires

that the assets and liabilities of the enterprise be included in the government's consolidated financial statements without making any adjustments to conform its accounting policies to those of the government.

However, commencing in the 2005/06 fiscal year, the government began including rate-regulated assets and liabilities of the Ontario Power Authority (OPA), a government organization, in its consolidated financial statements. In contrast to its standards for government business enterprises, PSAB requires that the accounting policies of government organizations such as the OPA be harmonized with those of the government itself upon consolidation. Accordingly, prior to 2005/06, regulatory assets and liabilities of government organizations were written off as part of the consolidation process.

We question whether this expansion of the government's use of rate-regulated accounting is in accordance with PSAB standards. PSAB's revenue-recognition principles are based on the concept that revenues are to be recorded in the period they are earned. This means that anticipated future revenues cannot be recognized. This contrasts with rate-regulated accounting whereby expected future revenues can be used to offset current costs as if they have already been earned, under the theory that the monopoly powers of the regulated entity provide assurance that such costs can be recovered from future rates. The position of the Ministry of Finance is that this provides sufficient certainty for these assets and liabilities to be recognized under PSAB's asset and liability definitions without reference to the rate-regulation provisions found in the CICA Handbook. We do not agree with this position.

The government clearly has monopoly powers over many aspects of the provincial economy, but PSAB does not make allowance for any recognition of future revenues in any of these other spheres of activity. For example, PSAB does not allow governments to record as an asset or defer costs relating to the collection of any future tax revenues, future

liquor profits, or future lottery or casino profits, even though future profits in these sectors may be just as “assured” as those in the electricity sector. The legacy of Ontario’s electricity industry also does not instill confidence that it is the one government sector for which such accounting is appropriate—the former Ontario Hydro, which had a mandate to fully recover its costs of producing and distributing electricity, used rate-regulated accounting extensively and left a \$19.4 billion legacy of stranded debt when it was disbanded in 1999. This stranded debt was recognized as an Ontario government liability for the first time in the province’s March 31, 2000, consolidated financial statements. The government argued at that time that this stranded debt should simply be considered another rate-regulated asset that should be set up as a deferred-charge asset on the province’s statement of financial position because, once again, its recovery was fully assured under the new electricity regime. After much debate, this position was rejected, and the province’s accumulated deficit that year increased by the largest single amount in Ontario’s history. Eight years later, most of this stranded debt remains on Ontario’s books.

As is further discussed in the next section, we are uncomfortable with the inclusion of any rate-regulated assets and liabilities in the province’s consolidated financial statements, but, as PSAB specifically allows government business enterprises to be consolidated without adjustment of their accounting policies, we have accepted their inclusion. However, we are not in agreement with the government’s accounting practice that essentially allows the recognition of all rate-regulated assets or liabilities, whether they are in government business enterprises or not, as we do not believe they meet the definition of bona fide assets or liabilities under generally accepted accounting principles. While the amounts are not significant enough to be material to the province’s financial results, they could be in future years, and accordingly we urge the province to reconsider its position on this issue.

## Should Rate-regulated Assets and Liabilities Be Recorded in the Accounts of the Province?

Rate-regulated accounting has a long history, and it may well have merit at the rate-regulated entity level of accounting. We hold no position on standards that apply at that level. Rather, our concern is with the government’s consolidated financial statements. PSAB has never issued an accounting standard on rate-regulated accounting. A task force established by the CICA a number of years ago to study the continued relevance of “specialized” accounting for rate-regulated entities was unable to reach a consensus in its deliberations, and its work was discontinued before a standard could be developed from its findings. The group did publish a research study, but it expressed both a majority viewpoint and a dissenting viewpoint, a rare occurrence in CICA literature. The dissenter questioned the appropriateness of rate-regulated accounting for public-sector entities because of the lack of independence of the regulator from the organization being regulated and from the government. In our view, if independence of the regulator is a concern at the level of the regulated entity’s financial statements, it is even more so when considered at the level of the government’s own consolidated financial statements.

The government of Ontario has established and controls the electricity sector’s rate regulator, the Ontario Energy Board, and the major electricity sector entities that are subject to regulation by it. These controlled entities are all instruments of the Ontario government’s energy policy. From the perspective of the government as a whole, we would argue that accounting transactions resulting from rate-regulation decisions should be considered as simply inter-company transactions—that is, transactions between entities inside the government reporting entity. In the case of the establishment of a regulatory asset, a government-controlled regulator is ordering a government-controlled regulated entity not to pass on certain current costs to electricity consumers but rather to recover these costs

in future years. In the case of a regulatory liability, the regulator is ordering the regulated entity to return to its customers in future years the “excess” revenues it has received over the costs it has incurred. It does so by ordering the deferral of what in the absence of rate-regulated accounting and under “normal” GAAP would either be a current expense or a current revenue transaction. From the perspective of the government’s consolidated financial statements, it seems questionable that these regulatory deferrals should be considered bona fide arm’s-length transactions that generate legitimate gains or losses to the province, when no transaction has as yet occurred outside the government with any third party.

On the basis of the above analysis, our view is that rate-regulated balances should be removed upon consolidation like all other inter-organizational gains and losses that, under PSAB standards, must be removed upon consolidation to arrive at a presentation of the government’s transactions with third parties. From this perspective, removal of rate-regulated balances would appear appropriate whether those assets or liabilities are reported in a government business enterprise’s financial statement or in that of a government organization.

Ministry of Finance officials contend that rate-regulated assets and liabilities meet PSAB’s standards without reference to any of the rate-regulated provisions in the CICA Handbook. We do not agree with this position. For example, PSAB 1000.36 sets out the three essential characteristics of a government asset:

- it embodies a future benefit that involves a capacity, singly or in combination with other assets, to provide future net cash flows, or to provide goods and services;
- the government can control access to the benefits; and
- the transaction or event giving rise to the government’s control of the benefit has already occurred.

In our view, rate-regulated assets are suspect under the second characteristic and fail to meet the test of the third characteristic.

With regard to the second characteristic, we simply point again to the legacy of the former Ontario Hydro and its stranded debt. This in our view provides concrete evidence that even in monopoly situations governments do not have sufficient assurance that an enterprise will generate enough profits in future years to recover all of its past costs. With regard to the third characteristic, we do not believe that a rate-regulation decision can be considered a transaction or event giving rise to an asset or obligation because, as stated above, from the level of the government’s consolidated financial statements such a decision is an internal event between two government-controlled entities. An equivalent analysis for rate-regulated liabilities leads to the same conclusion. PSAB standards preclude the inclusion of both gains and losses from such inter-company transactions. Therefore, our contention is that, at the consolidated financial statement level, rate-regulated assets and liabilities have no place and should be removed upon consolidation of the government’s controlled entities.

We further believe that the Ministry of Finance should reconsider its support for rate-regulated accounting for another reason. As discussed previously, the CICA is adopting international accounting standards as part of its strategic move to harmonize Canada’s accounting practices with those found around the world. These new international standards do not contain provisions supporting rate-regulated accounting, and the CICA’s Accounting Standards Board has indicated that it does not intend to amend these standards to make any provision for it. Rather, all assets and liabilities will have to meet the CICA’s conceptual framework definitions to be included in financial statements in future. These definitions are essentially equivalent to the definitions already found in the PSAB Handbook discussed above.

Because of the government’s expanded use of rate-regulated accounting, we have suggested

to PSAB that it consider a review of this practice and consider issuing guidance on rate-regulated accounting for governments.

## MINISTRY RESPONSE

These balances result from the rulings of the Ontario Energy Board related to the Regulated Price Plan (RPP) and represent amounts to be recovered from, or refunded to, retail electricity customers under the RPP in accordance with the *Electricity Act, 1998*. The province's accounting is consistent with the legislation and rulings of the Ontario Energy Board. Under Canadian generally accepted accounting principles for commercial organizations, accounting for rate-regulated balances as assets and liabilities is the commonly accepted practice. In the absence of PSAB providing guidance in this area, these commercial standards and other authoritative resources are referenced for determining appropriate generally accepted accounting principles. Ontario Power Authority's external auditor has issued a clean audit opinion, concurring that these balances are valid rate-regulated assets and liabilities.

It is the position of the Ministry of Finance that these rate-regulated balances should be reported as assets and liabilities in the province's consolidated financial statements as it better reflects the underlying economic substance of these transactions in accordance with generally accepted accounting principles.

## Asset-backed Commercial Paper

As at March 31, 2008, the province had liquid reserves comprising cash and temporary investments totalling approximately \$8.1 billion. The province also holds asset-backed commercial paper (ABCP) with an original cost of \$636.9 million.

Commercial paper consists of short-term promissory notes with a fixed maturity date, usually less than a year, issued by a financial institution or large corporation. While commercial paper is normally secured only by the reputation of the issuer, ABCP is commercial paper that is backed by other assets such as mortgage or car loans, derivatives, or other assets pooled in conduits or trusts.

In Canada, a number of ABCP trusts have been established by banks and other financial institutions. ABCP issued by trusts established by the banks is referred to as bank-sponsored ABCP, while ABCP issued by trusts established by non-bank financial institutions is referred to as non-bank-sponsored ABCP. As of June 2007, the market value of Canadian bank-sponsored ABCP was approximately \$80 billion and the market value of non-bank-sponsored ABCP was approximately \$35 billion.

The assets in the trusts underlying the ABCP typically have a longer maturity than the commercial paper itself. Therefore, ABCP trusts raise funds by issuing new ABCP as the earlier issues fall due. As well, most of these ABCP trusts have fallback liquidity agreements whereby one or more liquidity provider, such as Canadian and international banks and other financial institutions, would lend them cash to ensure that the trusts could make appropriate payments to investors as the commercial paper fell due if there was a "market disruption" and new ABCP could not be issued.

In spring and summer 2007, many investors in Canadian ABCP became concerned with the quality of the assets underlying this commercial paper. Some of the underlying assets included United States residential mortgages, and this sector was undergoing significant financial difficulty. By August 2007, a number of non-bank-sponsored trusts were unable to find investors to purchase new commercial paper to fund maturing commercial paper, as investors were no longer willing to buy the new issues because of concerns about the underlying assets. In response, the majority of these non-bank-sponsored trusts called upon their

liquidity providers for support. However, in many cases these liquidity providers did not provide the funds requested, as, according to the terms of the liquidity agreements, support had to be provided only in times of general “market disruption,” and these providers contended that no such disruption had occurred. As a result, investors in ABCP, including the province of Ontario, were unable to recoup their investments in non-bank-sponsored ABCP.

To deal with this illiquidity, a number of investors and other market participants formed a pan-Canadian investors’ committee in September 2007 to develop a plan to restructure the ABCP debt issued by non-bank-sponsored trusts. The restructuring plan essentially called for investors holding this ABCP to exchange their holdings for long-term notes with maturities matching those of the underlying assets.

The restructuring plan was approved by the majority of investors on April 25, 2008, and sanctioned by the Ontario Superior Court of Justice on June 5, 2008. Some investors who did not support the plan appealed this decision to the Supreme Court of Canada on September 20, 2008, but the Supreme Court of Canada upheld the Ontario Superior Court of Justice ruling. Accordingly, investors, including the province, will be able to convert their existing ABCP into long-term notes.

At the time we finalized our audit of the province’s March 31, 2008, consolidated financial statements, the above appeal process was outstanding. Under PSAB accounting standards, the province is required to reduce the book value of its investments by any impairment in value that is deemed to be “other than temporary.” Accordingly, the government conducted a valuation exercise that assessed both the likelihood of success of the restructuring and the attributes of each class of notes the province would hold under the restructuring plan. On the basis of this work, the government’s best estimate of the net recoverable value of its ABCP investments was \$530.1 million as at March 31, 2008. Accordingly, a valuation adjustment of

approximately \$106.8 million was recognized as an expense for the 2007/08 fiscal year.

Owing to the complexity of valuing ABCP, we contracted the services of a major chartered accounting firm that had already assisted two other provincial jurisdictions in their assessments of their ABCP holdings. The firm reported to us that the province’s valuation methodology seemed appropriate and consistent with the CICA’s guidance on ABCP valuations. On the basis of this and our own work, we concluded that the province’s valuation process and the resulting adjustment were reasonable.

The *Financial Administration Act, 1990* sets out the types of investments the province may invest in, and these provisions allow the province to invest in commercial paper. The government has also established a number of investment policies that, for example, set out dollar limits on the amounts that may be invested in particular instruments. While its ABCP investments were within those limits at the time they were made, the government’s experience with ABCP has led to changes in its investment policies. For example, commercial paper issuers must now be rated by at least two credit rating agencies before the province can consider investing in their offerings. This is a noteworthy change in policy, as at the time the province purchased its ABCP, there was only one credit rating firm that rated the Canadian ABCP market. Although this rating agency had given its highest rating to non-bank-sponsored ABCP, major international credit rating firms were unwilling to provide a rating. For example, in June 2006, one of these firms publicly stated that “conduits with this type of liquidity backup likely would not receive an investment-grade rating” from the firm. The province has also revised certain other policies to provide for additional oversight of liquid reserves in an effort to identify and address any potential liquidity problems at an early stage.

## Accounting for Alternative Financing and Procurement Projects

An Alternative Financing and Procurement (AFP) project can be described as an arrangement between public-sector and private-sector entities to design, construct, acquire, or manage a public-sector asset such as a highway, a hospital, or a jail. The use of AFP arrangements has been growing in recent years as governments seek new ways to finance and manage large-scale infrastructure projects. AFPs can take many different forms and can vary significantly in the degree of private-sector involvement in the project and the extent to which the economic risks and benefits of the project are shared between the partners. The province of Ontario is actively engaged in a number of AFP projects.

Infrastructure Ontario, the provincial government agency responsible for delivering public infrastructure projects for the province, has a mandate to look for private-sector financing to rebuild public infrastructure, while ensuring public ownership and control over these assets. Infrastructure Ontario also provides Ontario municipalities and universities with loans to build and renew their own infrastructure.

Infrastructure Ontario is currently overseeing more than 40 AFP projects, with work on more than two dozen projects underway that will cost an estimated \$7.5 billion. The majority of these are hospital projects.

Accounting for these various AFPs can be complex. We are interested in this accounting because the financial results of hospitals are consolidated in the province's financial statements. At present, there is little guidance available either from the CICA or internationally on how these arrangements are to be accounted for. We have noted that the International Public Sector Accounting Standards Board issued a paper focusing on the accounting

and financial reporting issues related to what it defined as a "Service Concession Arrangement," which has many of the attributes of the province's AFP arrangements. The consultation paper discusses how to determine whether a public-sector entity should report the underlying property as an asset in its financial statements and the circumstances involved in making that determination.

Given that AFP arrangements are complex and may take myriad forms, we believe that the Ministry of Finance, in the absence of specific guidance in Canadian accounting standards, should provide direction to the public-sector entities in Ontario that are undertaking these AFP projects on how they should be accounting for them. This would contribute to ensuring that AFP projects are being accounted for consistently throughout the province. We understand that the Ministry has been providing informal guidance and is in the process of finalizing an AFP accounting policy.

## Status of Certain Issues Raised in Prior Years

### ACCOUNTABILITY RELATING TO YEAR-END SPENDING

In my annual reports of prior years and in last year's *2007 Pre-Election Report on Ontario's Finances* and review of the Ministry of Citizenship and Immigration's year-end grants, I expressed concerns regarding the government's loosening of the normal accountability controls over year-end spending.

In those reports, I noted that while nearly all of the transfer payments I examined were made to recipients with which the province had long-standing relationships, such as municipalities, in the majority of cases normal accountability and control provisions were weakened or eliminated to ensure that the transfers qualified for immediate expense recognition prior to the March 31 fiscal year-end.

As a result of my concerns in this area, I wrote to the Deputy Minister of Finance in August 2007 recommending that the government's approach to its year-end investments be reassessed. Specifically, I indicated that I believed it possible for the government to set out certain conditions and accountability provisions for year-end transfers and still meet the accounting criteria for immediate expense recognition of these transfers.

Over the fall of 2007, we worked with the Ministry of Finance on this issue and were able to come to an agreement as to the types of accountability and control provisions that could be included in year-end transfers without compromising their immediate expense recognition. These provisions were incorporated into this year's year-end reinvestment process. I believe that the Ministry of Finance's new approach has improved the government's accountability for its year-end transfers.

### REPORTING HEALTH TRANSFER PAYMENT EXPENDITURES IN THE 2007/08 ESTIMATES

Local Health Integration Networks (LHINs) are statutory not-for-profit corporations and Crown agencies under the *Local Health System Integration Act, 2006* (Act). There are 14 LHINs across the province responsible for planning, integrating, and funding local health services within their geographic areas. Additional LHIN responsibilities and performance expectations are set out in memoranda of understanding and accountability agreements that they enter into with the Ministry of Health and Long-Term Care.

In last year's Annual Report, I raised a concern based on my understanding that, beginning in the 2007/08 fiscal year, the government expenditure estimates setting out the details of the government's operating and capital plans for the year would report as expenditures only the amounts transferred to each of the LHINs, and would no longer provide details of these expenditures. I was concerned about the potential loss of information

as to how much of the approximately \$19 billion in public-health-care money provided through the LHINs was being allocated to each of the major health-care sectors, such as to public hospitals, Community Care Access Centres, long-term-care facilities, mental-health or addiction agencies, and other health-care and community support organizations.

At that time, the government indicated that since the respective LHINs were responsible for deciding how best to allocate the funds provided to them, the general funding envelope provided to the LHINs best reflected this flexibility. Accordingly, as an alternative, we recommended that at year-end, once the actual allocations had been made and were known, the financial reporting should disclose LHIN expenditures by these individual health-care components.

I was pleased to note that in Volume 1 of the 2007/08 Public Accounts, the Ministry of Health and Long-Term Care expenditures provided the level of detail we had suggested by reporting, by major health-care sector, how each LHIN allocated the government funds it had received.

## The Government Reporting Entity

### SCHOOL BOARD SECTOR—USE OF SPECIFIC REVIEW PROCEDURES

I noted in last year's Annual Report that consolidating Ontario's school boards sector into the province's consolidated financial statements presented two unique challenges. First, school boards have a fiscal year-end of August 31, which does not coincide with the province's March 31 fiscal year-end. As well, school boards do not yet record the value of their tangible capital assets in their financial statements. To address both of these issues, the government annually requests school boards to submit financial information for the

same fiscal period as the province, and to provide sufficient information on their capital expenditures and assets to allow the government to include school board capital transactions and balances in the province's consolidated financial statements. The auditors of each school board perform specific review procedures on this additional submitted information, and we rely upon these procedures in conducting our audit. We have encouraged the continued use of these additional review procedures, as they provide a timely and cost-effective method of obtaining assurance on amounts reported by the school boards for which there is no alternative source of information. I would like to acknowledge that the Ministry of Education has indicated that it will continue to require school boards to have their auditors undertake these additional review procedures that we support.

## FULL LINE-BY-LINE CONSOLIDATION OF THE BROADER PUBLIC SECTOR

Under PSAB's new reporting entity standard, governments are permitted to consolidate broader-public-sector (BPS) organizations on a modified equity basis of accounting until the 2008/09 fiscal year. Under modified equity accounting, BPS organization net assets are included as a single line on the province's Consolidated Statement of Financial Position, and each sector's annual surplus or deficit is included as a single line on the province's Consolidated Statement of Operations.

For all fiscal years that commence on or after April 1, 2008, PSAB will require BPS organizations to be fully consolidated. Full consolidation requires the accounts of BPS organizations to be included using the same accounting policies as the province, and each revenue and expense item, as well as each asset and liability item, to be combined with the corresponding item in the province's consolidated financial statements. One key consequence of this line-by-line approach would be that the \$29.7 billion in BPS tangible capital assets and \$12.6 billion in net debt would then be included in and reported

as being part of the province's capital assets and net debt, respectively.

The Ministry of Finance does not support line-by-line consolidation, and holds the view that equity accounting with a "one-line" approach to consolidation better reflects both the overall financial impact of the BPS on the province's financial statements and the greater autonomy that BPS organizations have than the other organizations that the province controls and fully consolidates. The Ministry has indicated that it is consulting with PSAB on this matter.

We are currently working with the Ministry of Finance on what additional information would be required to make line-by-line consolidation possible, how conformity with the province's accounting policies can be ensured, how a number of presentation and disclosure issues associated with this change should be dealt with, and what the impact on the consolidated financial statements would be if full consolidation is not adopted.

## Accounting for Capital Assets

### GOVERNMENT CAPITAL ASSETS

In January 2003, PSAB revised a 1997 standard setting out rules for the recognition, measurement, amortization, and presentation of capital assets in a government's financial statements. The standard recommends that governments, in a manner similar to the approach taken in the private sector, record acquired or constructed capital items as assets and amortize their cost to operations over their estimated useful lives.

The government's approach, which we supported, was to phase in these PSAB recommendations over time. In the 2002/03 fiscal year, it valued and capitalized the province's land holdings, buildings, and transportation infrastructure and accordingly recognized, for the first time, over \$13 billion of its net capital investments in its

financial statements. By 2007/08, the province's net investments in these capital assets had grown to \$19 billion.

The government has advised us that it intends to complete the capitalization project for its remaining tangible capital assets, such as its computer systems, vehicles, and equipment, for the 2009/10 fiscal year. We have held a number of meetings over the past year with Ministry of Finance officials on this issue to address the scope of this project and the methodologies that will be used with respect to the valuation of these assets.

## PSAB Initiatives

This section briefly outlines some of the more significant issues that PSAB has been dealing with over the last year that may affect the province's consolidated financial statements in future years.

### STANDARDS

#### Financial Instruments

The province uses financial instruments or derivatives such as foreign-exchange forward contracts, swaps, futures, or options primarily to manage (or "hedge against") risks related to debt it has issued in foreign currencies and/or at variable interest rates. Currently, PSAB guidance on accounting for derivatives is limited to their application in hedging foreign-currency items, such as managing the foreign-currency risk associated with holding a debt repayable in U.S. dollars. Governments, including the Ontario government, also use derivative financial instruments to manage interest-rate risk. For instance, the province may issue debt at a variable interest rate and, through the subsequent use of derivative financial instruments, effectively convert this variable-interest-rate debt into fixed-interest-rate debt, thereby limiting the province's exposure to future interest rate fluctuations.

In January 2005, the CICA Accounting Standards Board approved three new Handbook sections relating to such activities: "Financial Instruments," "Comprehensive Income," and "Hedges." Although these Handbook sections were written for use by the private sector, and governments were not required to apply these sections, they underscored the need to address these issues from a public-sector perspective.

Accordingly, PSAB created a task force to consider how governments should account for financial instruments. The main issue to be addressed is whether changes in the fair market value of derivative contracts (like equities and bonds, their fair market value fluctuates) should be recognized in an organization's financial statements. Secondly, if such changes are to be recognized, should they affect the determination of the annual surplus or deficit?

The main argument for recognizing changes in the fair market value of financial instruments is to ensure that all assets and liabilities of an organization are recognized at their current value rather than historical value at the end of each fiscal period. However, such changes could have a significant impact on the organization's annual surplus or deficit, even though any unrealized losses could well be recovered in future years and any unrealized gains could well be wiped out by offsetting changes in the market value of these instruments. Accordingly, this treatment increases the potential for volatility in an entity's statement of operations.

The task force developed a statement of principles on financial instruments that was issued in June 2007, setting out suggested principles for the recognition and measurement of financial instruments, including derivatives and hedges, in a government's financial statements. PSAB received a number of responses from governments and others to this statement of principles and has been reviewing them.

A key issue that PSAB is attempting to address is whether derivatives should be measured at fair value consistent with the direction provided in the

CICA private-sector standard. PSAB also recognizes that these revaluations increase the potential for volatility in reported annual results. Accordingly, it is considering provisions that would allow for the annual surplus or deficit impact of such revaluations to be offset in some cases by recognizing the fair-value impact of transactions entered into to hedge against such risks, and in other cases by recording the fair-value impact directly to the accumulated deficit rather than through the annual operating statement.

PSAB expects to release an exposure draft on these matters in March 2009.

## FOREIGN-CURRENCY TRANSLATION

At present, PSAB accounting standards include recommendations allowing gains and losses on foreign-currency-denominated items to be deferred and amortized to operations over time. However, PSAB has indicated that as part of its plan to address financial instruments it will need to revisit these recommendations. Specifically, it is expected that the current deferral provisions will be replaced with the requirement that such gains and losses be immediately recognized in the determination of the annual surplus or deficit. These changes are expected to be included in an exposure draft to be released at the same time as the exposure draft on financial instruments, in March 2009.

## GOVERNMENT TRANSFERS

PSAB is working on amending its standard on government transfers to address a number of issues raised by the government community with regard to application and interpretation. The major issues that need to be addressed include the following: the need to resolve an ongoing debate over the appropriate accounting for multi-year funding provided by governments; clarification of the nature and extent of the authorization needed for transfers to be recognized as an expense; clarification of the degree to which stipulations imposed

by a transferring government should affect the timing of expense recognition by the transferor or revenue recognition by the recipient government; and the appropriate accounting for capital transfers received. Given the billions of dollars in government transfers made annually, the revised standard has the potential to significantly affect a government's financial results.

A variety of views have been expressed on these issues, and PSAB has faced challenges in obtaining a consensus on the revisions to be made to the existing standard. One of the key challenges is PSAB's desire for any revised standard to be consistent with CICA's conceptual framework, which focuses on assets and liabilities, unlike a government's key fiscal focus, which is on the annual surplus or deficit.

PSAB issued an exposure draft for comment in June 2006 that called for the immediate recognition as an expense (for the transferor) and revenue (for the recipient) of all transfers, provided the transfer had been authorized and any eligibility criteria had been met by the recipient. After reviewing comments received on this exposure draft, PSAB issued a re-exposure draft in April 2007 proposing certain changes whereby under certain conditions a recipient government could defer recognition of a transfer it had received. PSAB is reviewing the comments received on this draft, and has indicated that it intends to issue a second re-exposure draft in late 2008.

## ENVIRONMENTAL LIABILITIES

Canadian accounting standards do not specifically address environmental liabilities. In recognition of the need to do so, PSAB approved a project to develop accounting standards specific to environmental liabilities. It is expected that a statement of principles on this issue will be released in the near future.

In the absence of an accounting standard, the governments of Ontario and most other Canadian jurisdictions have not developed any accounting policies specifically addressing environmental

liabilities. However, the Ontario government's practice is to record environmental liabilities when it determines that it has little or no discretion to avoid future costs or payments resulting from its environmental responsibilities, and when the amounts of these liabilities can be reasonably estimated.

## Guidance

PSAB issues Statements of Recommended Practices (SORPs) for reporting supplementary information beyond that presented in the financial statements. SORPs do not form part of PSAB accounting standards and are designed to provide general guidance to a government that chooses to provide this supplementary information.

### ASSESSMENT OF TANGIBLE CAPITAL ASSETS

PSAB is developing a statement of recommended practice to assist governments in reporting on major government assets and to improve the comparability and reliability of financial and non-financial information about such assets. These improvements would assist governments in evaluating their financial condition and their financial and non-financial performance.

Existing guidance on reporting financial and other information about tangible capital assets is limited. Appropriate information about the use and condition of a government's tangible capital asset infrastructure assists users in understanding the ongoing maintenance, renewal, and replacement costs associated with this infrastructure. It is therefore a major factor in determining a government's financial ability to maintain existing levels of services.

PSAB approved a statement of principles for this project in March 2007 and a draft statement of recommended practice in March 2008. PSAB expects the final statement of recommended practice to be approved in late 2008.

### INDICATORS OF GOVERNMENT FINANCIAL CONDITION

Governments are complex organizations, and it is important that they provide clear information to citizens about what they plan to achieve and what they have achieved with the resources entrusted to them. Performance reporting is one means of providing this information.

In June 2006, PSAB completed its first project on performance indicators and approved *Public Performance Reporting*, a statement of recommended practice that promotes consistency and comparability in reporting outside of a government's financial statements. It sets out recommended practices for reporting performance information in a public-performance report, addresses non-financial performance information and its linkage to financial performance information, and encourages governments to provide information about governance practices.

The main objective of reporting on a government's financial condition is to provide an expanded discussion of the information contained in government financial statements that is not limited to financial position and changes in financial position, but also examines the context of the government's overall economic and fiscal environment. Governments may choose to provide this information in special reports or in the annual report that accompanies the government financial statements. In September 2008, PSAB issued a draft Statement of Recommended Practice regarding indicators of government financial condition, and plans to produce a final statement of recommended practice in the near future.

### Internal Audit Financial Assurance Program

The Ministry of Finance is funding the implementation of a new Financial Assurance Program whereby

the government's internal audit division will assess the internal control procedures relating to the government's financial management processes for operating and capital expenditures, revenues, and asset/liability management. As the financial information produced by these processes are used to prepare the financial statements of ministries (Volume 1) and the province's consolidated financial statements, our Office welcomes this initiative.

## Other Matter

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 Legislative Assembly.

### LEGISLATIVE APPROVAL OF GOVERNMENT EXPENDITURES

Shortly after presenting its Budget, the government tables in the Legislature detailed Expenditure Estimates 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 them to the Legislature. The estimates of those ministries that are not selected for review 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 debated in the Legislature for a maximum of two hours and then voted on.

Once the Orders for Concurrence are approved, the Legislature provides the government with legal spending authority by approving a *Supply Act*, which stipulates the amounts that can be spent by ministry programs, typically those set out in the estimates. Once the *Supply Act* is approved, the

individual program expenditures are considered to be Voted Appropriations. The *Supply Act* pertaining to the fiscal year ended March 31, 2008, received Royal Assent on March 31, 2008.

The *Supply Act* is typically not passed until after the start of the fiscal year, but ministry programs require interim funding approval prior to its passage. The Legislature authorizes these payments by means of motions for interim supply. For the fiscal year ending March 31, 2008, the time periods covered by the motions for interim supply and the dates that the motions were agreed to by the Legislature were as follows:

- April 1, 2007, to June 30, 2007—passed December 4, 2006; and
- February 1, 2008, to March 31, 2008—passed December 6, 2007.

### *Interim Appropriation Act, 2007*

This year, for the first time, the government also passed an act allowing interim appropriations. As a result of the October 2007 provincial election, the Legislature was dissolved on September 10, 2007, before it had passed the *Supply Act*. The *Interim Appropriation Act, 2007* (Act) ensured that during the period before and after the general election, the existing government had sufficient legal spending authority until the new government was formed. The Act allowed the government to incur up to \$50 billion in public service expenditures, \$1.2 billion in investments in capital assets, and \$170 million in legislative office expenditures.

An interim supply motion passed on December 4, 2006, provided the government with temporary approval to incur expenditures from April 1, 2007, until the Act received Royal Assent on May 17, 2007. The Act was made effective as of April 1, 2007, and replaced the interim supply motion.

A second interim supply motion passed on December 6, 2007, provided the government with temporary approval to incur expenditures from February 1, 2008 (when spending authority under the Act and the special warrant discussed below

was expected to become insufficient) until the enactment of the *Supply Act, 2008*.

Since the legal spending authority under the Act was intended to be temporary, it was repealed under the *Supply Act, 2008*, and the authority to incur expenditures provided under the Act was subsumed in the authority provided under the *Supply Act, 2008*.

## SPECIAL WARRANTS

If motions for interim supply cannot be approved because, for instance, the Legislature is not in session, section 7(1) of the *Treasury Board Act, 1991* 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 approved by the Lieutenant Governor on the recommendation of the government.

For the fiscal year ended March 31, 2008, one special warrant totalling \$24,624,839,200 was approved by an Order-in-Council dated October 25, 2007. This special warrant was required because the authority to incur expenditures provided under the *Interim Appropriation Act, 2007* was not sufficient to allow the government to continue operating after October 31, 2007. As a result, the special warrant allowed the government to incur expenditures from November 1, 2007, until the new Legislature began its first session.

## TREASURY BOARD ORDERS

Subsection 8(1) of the *Treasury Board Act, 1991* 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 books of the government of Ontario for the fiscal year are closed.

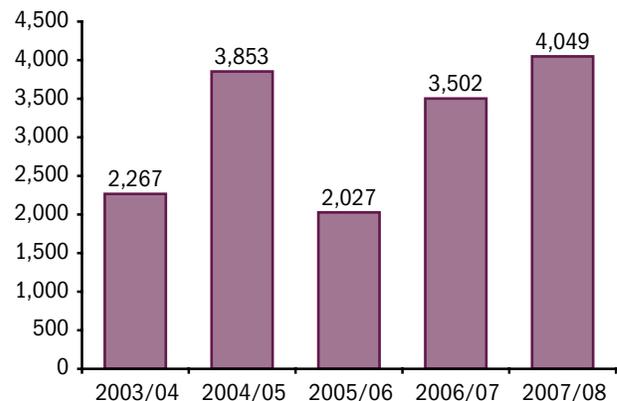
Subsection 5(4) of the *Treasury Board Act, 1991* allows the Treasury Board to delegate to any member of the Executive Council or to any public servant employed under the *Public Service of Ontario Act, 2006* any power, duty, or function of the Board, subject to limitations and requirements that the Board may specify. In the fiscal year ended March 31, 2008, the Treasury Board delegated its authority for issuing Treasury Board orders to ministers for making transfers between programs within their ministry, and to the Chair of the Treasury Board for making transfers between programs in different ministries and making supplementary appropriations from contingency funds. Supplementary appropriations are Treasury Board orders whereby the amount of an appropriation is offset by reducing the amount available under the government's centrally controlled contingency fund.

Figure 1 summarizes the total value of Treasury Board orders issued for the past five fiscal years. Figure 2 summarizes Treasury Board orders for the fiscal year ended March 31, 2008, by month of issue. The last Treasury Board order for the fiscal year ended March 31, 2008, was issued on August 19, 2008.

According to the Standing Orders of the Legislative Assembly, Treasury Board orders are to

**Figure 1: Total Value of Treasury Board Orders Issued, 2003/04–2007/08 (\$ million)**

Source of data: Treasury Board



**Figure 2: Treasury Board Orders by Month of Issue, 2007/08 (\$)**

Source of data: Treasury Board

Month of Issue	#	Authorized (\$)
April 2007–February 2008	111	1,970,603,200
March 2008	62	1,915,890,300
April 2008	7	108,744,400
August 2008	3	53,760,100
<b>Total</b>	<b>183</b>	<b>4,048,998,000</b>

be printed in *The Ontario Gazette*, together with explanatory information. Orders issued for the 2007/08 fiscal year are expected to be published in *The Ontario Gazette* in December 2008. A detailed listing of 2007/08 Treasury Board orders, showing the amounts authorized and expended, is included as Exhibit 3 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 I make special mention of the transfer(s) in my Annual Report.

Accordingly, with respect to the 2007/08 estimates, the following transfers were made within Vote 201 and Vote 202, respectively:

From:	Item 3	Legislative Services	\$ 1,400
To:	Item 2	Office of the Clerk	\$ 1,400
From:	Item 3	Office of the Integrity Commissioner	\$116,800
To:	Item 1	Environmental Commissioner	\$ 27,300
	Item 4	Office of the Provincial Advocate for Children and Youth	\$ 89,500

## UNCOLLECTIBLE ACCOUNTS

Under section 5 of the *Financial Administration Act*, the Lieutenant Governor in Council, on the recommendation of the Minister of Finance, may author-

ize an Order-in-Council to delete from the accounts any amount due to the Crown that is deemed uncollectible. The amounts deleted from the accounts during any fiscal year are to be reported in the Public Accounts.

In the 2007/08 fiscal year, receivables of \$200 million due to the Crown from individuals and non-government organizations were written off (in 2006/07, the comparable amount was \$174 million). The major portion of the write-offs related to the following:

- \$92.4 million for uncollectible retail sales tax (2006/07 – \$53.7 million);
- \$59.8 million for uncollectible corporate tax (2006/07 – \$76.5 million);
- \$10.4 million for uncollectible employer health tax (2006/07 – \$9.5 million);
- \$9.9 million for uncollectible receivables under the Student Support Program (2006/07 – \$6.7 million);
- \$7.3 million for uncollectible Criminal Code fines (2006/07 – \$0.1 million);
- \$5.6 million for uncollectible receivables under the Ontario Disability Support Program (2006/07 – \$10.8 million); and
- \$5.1 million for uncollectible receivables under the Motor Vehicle Accident Claims Fund (2006/07 – \$6.3 million).

Volume 2 of the 2007/08 Public Accounts summarizes these write-offs by ministry. Under the accounting policies followed in the audited consolidated financial statements of the province, a provision for doubtful accounts is recorded against accounts receivable balances. Accordingly, most of the write-offs had already been previously provided for in the audited financial statements. However, the actual deletion from the accounts required Order-in-Council approval.