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.

My 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 my Independent Auditor's Report, are included in the province's annual report.

The province's 2011/12 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, 2012, 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 revenues 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.

My 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 2011/12 Annual Report and Consolidated Financial Statements, along with the three Public Accounts supplementary volumes, on September 13, 2012, meeting the 180-day 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.

The Province's 2011/12 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 Independent Auditor's Report to the Legislative Assembly on the province's consolidated financial statements for the year ended on March 31, 2012, 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, 2012, 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, 2012 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]

Jim McCarter, FCA
Auditor General
Licensed Public Accountant

Toronto, Ontario
September 6, 2012

The above audit opinion is without any reservation, which indicates that the consolidated financial statements fairly present the province's fiscal results for the 2011/12 fiscal year and its financial position at March 31, 2012. This "clean" audit opinion means that based on our audit work, I can reasonably conclude that the province's consolidated financial statements have been prepared in accordance with accounting standards the Canadian Institute of Chartered Accountants (CICA) recommends for governments when preparing their financial statements. In other words, I am 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 I were to have significant concerns with the government's compliance with the CICA accounting standards, I would be required to issue an audit opinion with a reservation. An audit opinion with a reservation means significant financial transactions have either not been recorded or not been recorded properly in the province's consolidated financial statements.

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

To make this assessment I calculate a materiality threshold. Historically, this threshold has been set at around 0.5% of total government expenses or revenues for the year. If the misstated items individually or collectively exceed the threshold, and management was not willing to make the required adjustments, a reservation in my audit opinion would normally be required. However, no such reservation was required this year.

As a final comment, I wish to point out that it is a notable achievement that in the past 19 years, all Ontario governments, regardless of the political party in power, have complied in all material respects with the CICA standards. Accordingly, my predecessor and I have been able to issue "clean" audit opinions on the province's consolidated financial statements since the province moved to adopt the CICA's Public Sector Accounting Board standards in the 1993/94 fiscal year.

Update 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 government borrowing to finance recent large deficits and increased infrastructure spending. We compared Ontario's ratio of net debt-to-GDP to other Canadian and international jurisdictions, and highlighted the consequences to the province of carrying a large debt load.

In updating our debt analysis this year, we observe that the province's debt, whether measured by total debt, net debt, or accumulated deficit continues to increase, as illustrated in Figure 1.

While the government has not provided details on its projected debt beyond the 2014/15 fiscal year, we estimate that if the government balances its books as it projects in 2017/18, Ontario's total debt, which represents the total amount of money the government owes to outsiders in the form of bonds issued in the public capital markets, non-public debt, T-bills and U.S. commercial paper, will still total more than $340 billion or double what the outstanding debt was at the end of 2007/08. Net debt, which is the difference between the government's total liabilities and its financial assets, will likely surpass $320 billion, and the accumulated deficit, which represents the sum of all past annual deficits and surpluses, will stand at around $210 billion by 2017/18.

ONTARIO'S NET DEBT

We noted last year that net debt is often considered the best measure of a government's fiscal situation. While it is important to examine whether net debt is increasing or decreasing over time, the level of debt relative to the size of the economy—that is, net debt to gross domestic product (GDP)—is generally considered to be a good indicator of a government's ability to manage its debt load. When this ratio is rising, it means the government's net debt is growing at a faster rate than the provincial economy.

Ontario's net debt-to-GDP ratio has risen steadily from a low of 26.8% in 2007/08 to 36.9% in the 2011/12 fiscal year, as illustrated in Figure 2. The projected growth in this ratio indicates that government debt will continue to grow at a faster rate than the provincial economy until 2015/16, when the expected growth rate of government debt will fall below the expected growth rate of the provincial economy.

Another useful tool for assessing Ontario's debt load is to compare it with other Canadian jurisdictions. Figure 3 illustrates the net debt of the federal government and the provinces, along with their respective ratios of net debt to GDP, and the amount of debt owed by each resident of the jurisdiction. As of March 31, 2012, with the exception of the province of Quebec and the federal government, Ontario has the highest net debt-to-GDP ratio

Figure 1: Total Debt, Net Debt, and Accumulated Deficit, 2007/08–2014/15 ($ million)

Source of data: 2012 Ontario Budget, 2011/12 Province of Ontario Annual Report and Consolidated Financial Statements, 2012 Ontario Economic Outlook and Fiscal Review, and the Office of the Auditor General of Ontario

	Actual					Estimate		
	2007/08[a]	2008/09[a]	2009/10[a]	2010/11[a]	2011/12[b]	2012/13[c]	2013/14	2014/15
Total debt	162,217	176,915	212,122	236,629	257,278	278,000	297,500[a]	314,100[a]
Net debt	156,616	169,585	193,589	214,511	235,582	257,600	277,600[c]	293,300[c]
Accumulated deficit	105,617	113,238	130,957	144,573	158,410	172,800	185,600[c]	195,700[c]

a. 2012 Ontario Budget
b. 2011/12 Province of Ontario Consolidated Financial Statements
c. 2012 Ontario Economic Outlook and Fiscal Review

and the highest amount of debt owed by residents of a jurisdiction.

CONSEQUENCES OF HIGH INDEBTEDNESS

In our *2011 Annual Report*, we highlighted that the province's escalating indebtedness has a number of negative consequences. These include:

- debt-servicing costs taking away funding needed for other programs;
- greater vulnerability to increases in interest rates; and
- potential credit-rating downgrades and changes in investor sentiment.

At that time, some analysts saw little evidence to suggest that Ontario's credit rating needed to be downgraded, although some noted that Ontario's large borrowing requirements, along with its growing reliance on foreign lenders, would increase this risk. However, there have been a number of developments in this regard since our *2011 Annual Report*.

ONTARIO'S CREDIT RATING

A credit rating is an assessment of a borrower's creditworthiness with respect to specified debt obligations. It indicates the capacity and willingness of a borrower to pay the interest and principal on these obligations in a timely manner. The province requires ratings from recognized credit-rating agencies to issue debt in capital markets. The three main credit-rating agencies are Moody's Investors Service (Moody's), Standard and Poor's (S&P), and DBRS.

Credit-rating agencies assess a government's creditworthiness largely based on its capacity to manage its debts, and they consider such factors as that government's economic resources and prospects, institutional strengths, financial health, and susceptibility to major risks. Investors use this credit rating when making investment decisions.

Credit ratings influence borrowing conditions by affecting both the cost and the availability of credit. A credit rating has an impact on the cost of future government borrowing because a lower rating indicates that the agency believes the risk of the government defaulting on its debt is higher, and investors will accordingly demand a greater risk premium in the form of a higher interest rate before they will lend to that jurisdiction. A rating downgrade can also result in a reduction of the potential market for a government's debt, as some investors are unable (due to contractual or institutional constraints) or unwilling to hold debt below a certain rating.

Credit-rating agencies use letter designations to rate a jurisdiction's debt. For example, Moody's assigns credit ratings of Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C, WR (withdrawn) and NR (not rated). Obligations rated Aaa are judged to be of the highest quality and subject to the lowest level of credit risk, whereas obligations rated C are the lowest rated and are often in default, with little prospect for recovery of principal or interest. S&P and DBRS assign similar credit ratings ranging from AAA to D.

In addition to a credit rating, the agency may issue a credit outlook that indicates the potential direction of a rating over the intermediate term, typically six months to two years. When determining a rating outlook, the agency considers any changes in economic or fundamental business conditions. An outlook is not necessarily a precursor of

Figure 2: Ontario Net Debt-to-GDP Ratio, 2005/06–2017/18 (%)

Source of data: 2012 Ontario Economic Outlook and Fiscal Review

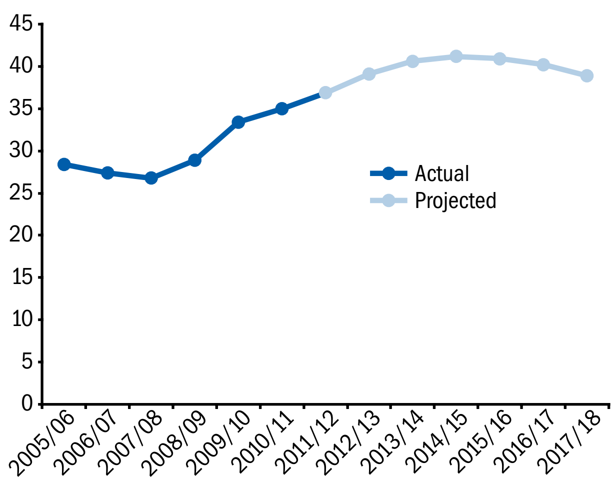


Figure 3: Net Debt ($), Net Debt to GDP (%) and Net Debt Per Capita ($) of Canadian Jurisdictions, 2011/12 and 2010/11

Source of data: 2011/12 Province of Ontario Annual Report and Consolidated Financial Statements, 2012 Federal Budget and budget updates, 2011/12 Annual Report and Consolidated Financial Statements of other provinces, 2012 provincial budgets, Statistics Canada, and the Office of the Auditor General of Ontario

	2011/12			2010/11		
	Net Debt (Net Asset) ($ million)	Net Debt (Net Asset) to GDP (%)	Net Debt (Net Asset) Per Capita ($)	Net Debt (Net Asset) ($ million)	Net Debt (Net Asset) to GDP (%)	Net Debt (Net Asset) Per Capita ($)
BC	35,973	17.0	7,815	30,637	15.2	6,728
AB	(18,991)	(6.6)	(4,901)	(21,653)	(7.4)	(5,784)
SK	3,560	6.3	3,343	3,783	6.2	3,600
MB	14,511	25.5	11,814	12,837	24.0	10,322
ON	235,582	36.9	17,647	214,511	35.0	16,134
QC	170,887	51.2	21,436	158,955	50.1	20,021
NB	10,046	32.6	13,311	9,480	33.2	12,565
NS	13,243	35.0	14,049	12,837	35.7	13,549
PEI	1,737	35.1	15,094	1,695	34.9	15,866
NL	7,769	23.5	12,037	8,129	28.8	11,723
Federal	650,135	37.8	18,796	616,900	38.0	17,987

a rating change but rather informs investors about the agency's view of the potential evolution of a rating—either up or down. A positive outlook means that a rating might be raised. A negative outlook means that a rating might be lowered, and a stable outlook means that a rating is not likely to change in the short term.

All three credit-rating agencies updated their assessment of the province's credit rating shortly after the government released its 2012 budget. Moody's had put the province on a credit watch in December 2011, and in April 2012 it downgraded Ontario's credit rating from Aa1 to Aa2. On the other hand, in April 2012 S&P revised its outlook on Ontario to "negative" from "stable" and maintained the province's current AA– rating, which it had downgraded in 2009. DBRS has not changed Ontario's rating since downgrading it to AA (low) in the fall of 2009. It may well be that Moody's downgrade is a catch-up to the S&P and DBRS downgrades in late 2009. Ontario's rating relative to other Canadian senior governments is shown in Figure 4.

IMPACT OF LOWER CREDIT RATING/ REVISED OUTLOOK

While downgrades and poorer outlooks for the provinces' credit ratings theoretically increase a government's future borrowing costs, there is no evidence yet suggesting these latest ratings have had a significant impact on Ontario's borrowing costs. Ontario's bond interest costs have remained relatively unchanged since the ratings were revised, which indicates investors still want to hold Ontario debt.

Ontario bonds remain relatively attractive because many other jurisdictions around the world have been affected by the 2008 global financial downturn to a greater extent, and investors are therefore reluctant to invest in these jurisdictions. The credit-rating agencies also believe that Ontario has the necessary fiscal flexibility to improve its financial position over the medium term, so have indicated they expect no more rating adjustments in the near future.

Figure 4: Credit Rating by Province and Balanced Budget Target Date

Source of data: Provincial and federal budget documents, and Laurentian Provincial Monitor, as of April 26, 2012

	Moody's Investors Service	DBRS	Standard & Poor's	Target Date for Return to Balanced Budget
BC	Aaa	AA (high)	AAA	2013/14
AB	Aaa	AAA	AAA	2013/14
SK	Aa1	AA	AAA	n/a (in surplus)
MB	Aa1	A (high)	AA	2014/15
ON	Aa2	AA (low)	AA–	2017/18
QC	Aa2	A (high)	A+	2013/14
NB	Aa2	A (high)	AA–	2014/15
NS	Aa2	A	A+	2013/14
PEI	Aa2	A (low)	A	2014/15
NL	Aa2	A	A+	2014/15
Federal	Aaa	AAA	AAA	2015/16

The government of Canada is also one of the few remaining jurisdictions in the world that has retained its Aaa/AAA credit rating—the highest that can be assigned. This means demand for Canadian government debt, both federal and provincial, is high, especially among investors looking for relatively risk-free investments. This demand works to push down interest rates. And, because investors associate Ontario debt with the perceived creditworthiness of the federal government, Ontario benefits from the relative strength of investor faith in federal government debt.

Even with its most recent downgrade, Ontario has the same credit rating as Quebec and the Maritime provinces, with a Moody's credit rating of Aa2. Only the federal government and the Western provinces have higher ratings.

CONCLUSION

In our *2011 Annual Report* we concluded that while the government had presented a plan to eliminate its annual deficits by the 2017/18 fiscal year, no strategy had been presented for paying down its existing and future debt. We indicated at the time that once deficits have been tackled, one strategy for paying down debt would be to hold the line on any future debt increases and use additional revenues generated by a growing economy to start reducing the debt. We went on to say that the government should consider providing legislators and the public with long-term targets and a strategy for how to address the current and projected debt burden. These comments continue to be appropriate.

MINISTRY RESPONSE

In order to meet the Province's fiscal targets, the government is managing spending. Last year, growth in program spending was less than 1%—the second-lowest rate of growth in Ontario in a decade. For the fourth year in a row, Ontario is ahead of its targets in lowering the deficit. The Province's deficit for the 2012/13 fiscal year is projected to be $14.4 billion, an improvement of $0.4 billion from the 2012 Budget forecast.

The Province's debt-to-GDP ratios are expected to increase due to the projected deficits and investments in capital. The ratios will stabilize and begin to decline as the deficit is eliminated. The net debt-to-GDP ratio is expected to peak in 2014/15 at 41.2%, which is below the 41.3% forecast in the 2012 Budget. The accumulated deficit-to-GDP ratio is expected to peak at 27.5% in 2014/15.

Update on the Unfunded Liability of 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, our annual reports have made a number of references to our 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. Our *2009 Annual Report* included a separate section that discussed our review of the WSIB's unfunded liability. In that section we expressed our concern that the growth and magnitude of the unfunded liability posed a risk to the system's financial viability and ultimately could result in 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 financial statements. Excluding these financial results is 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.

Despite efforts taken by management to improve the operations of the insurance fund, the WSIB's unfunded liability has continued to grow, principally due to a significant change to the discount rate introduced in 2011 that added $2 billion to the liability. Absent the impact of this change, the WSIB would have showed its first surplus in 10 years. As of December 31, 2011, the unfunded liability totalled $14.2 billion, an increase of $2 billion from its December 31, 2010, balance of $12.4 billion. The WSIB's funding ratio—the percentage of assets to liabilities—was 52.2% as of December 31, 2011. (As of December 31, 2010, it had been 54.7%.)

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 was comprehensive and contained a series of recommendations to ensure the WSIB remains financially stable and sufficiently funded.

In particular, the report recommended a new funding strategy for the WSIB, including 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 filed Regulation 141/12 under the Act, which, effective January 1, 2013, will require 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
- 100% on or before December 31, 2027

The regulation also requires the WSIB to submit a plan to the Minister of Labour by June 30, 2013, outlining the measures it will take to achieve these goals by the prescribed dates. As reported in our *2011 Annual Report* follow-up section, the WSIB continues to take actions that have recently improved its operating results and financial position. For example, during 2011, the WSIB reported its first operational surplus in 10 years (excluding the change in the discount rate discussed below). Increased premium revenue, fewer new lost-time claims, more workers returning to work sooner, and fewer workers suffering permanent impairment have not only contributed to these financial improvements but have demonstrated the WSIB's focus on getting injured workers back to work as quickly as possible.

However, the WSIB's ability to achieve the funding sufficiency ratios prescribed in the regulation will be affected by changes to certain actuarial assumptions and proposed new accounting standards.

- The discount rate is the interest rate used to calculate future benefit obligations in current dollars. In layman's terms, it is often perceived as the expected rate of return an insurance company or pension fund can earn on its investments. During 2011 a discount rate reduction from 7.0% to 5.5% resulted in an almost $2 billion increase in the unfunded liability. WSIB management have concluded that subject to any changes in accounting standards (as discussed below), it would be appropriate to retain this 5.5% discount rate for the period 2012–2015 and increase it to 6.0% thereafter. For example, reducing the discount rate by one percentage point would add approximately $2.1 billion to the benefits obligation.
- The WSIB reports its financial results based on International Financial Reporting Standards (IFRS). A proposed new standard for valuing insurance liabilities is expected to take effect as of the end of fiscal 2016. If approved in its current form, it could increase the unfunded liability significantly because it would require a further reduction in the discount rate WSIB uses to calculate its benefits obligation. Based on current market interest rates, this could increase the actuarial estimate of WSIB's benefit obligations by an estimated $3 billion. The new standard also proposes that a new risk margin be included in the benefits obligation that could increase the benefits obligation by a further $1 billion. (This new risk margin is similar to the actuarial provision for adverse deviations, which is a reserve for the likely difference between the actual result of a calculation and the corresponding result using best estimate assumptions.) Without any compensating increases in the WSIB's premiums rate, its investment performance or further success in reducing lost-time claims to reduce costs, the combined $4 billion impact of this proposed standard could significantly impair the WSIB's ability to meet its 2017 legislated funding ratio of 60%.

As a result of the government's commitments to address its unfunded liability, we support the continued classification of the WSIB as a trust for the 2011/12 fiscal year and therefore the exclusion of the unfunded liability from the province's liabilities. However, we will continue to monitor the progress being made toward meeting the funding sufficiency ratios prescribed by the regulation. Should we feel enough progress is not being achieved, we will re-evaluate our position.

WSIB RESPONSE

The proposed new IFRS standard for valuing insurance liabilities will have the effect of valuing liabilities using the market rates prevailing at discrete points in time. This introduces volatility as well as one-time changes of a very large magnitude, both positive and negative, depending on whether interest rates are rising or falling.

WSIB is following IFRS standards in preparing its financial statements. However, for purposes of complying with the funding sufficiency ratios prescribed by regulation, we believe that IFRS standards are not well suited to funding a going concern insurance fund such as the WSIB's. Consequently, the WSIB will consult with the government on the merits of adopting a "going-concern basis" to value the benefits liabilities of the insurance fund, for funding purposes. This will have the effect of using a long-term expected rate-of-investment return with which to value liabilities. This method will avoid potentially large multibillion-dollar swings in the valuation of liabilities from year to year and the consequent instability for employers who must fund the system and the workers who must rely on it.

Update on the Electricity Sector Stranded Debt

In Section 3.04 of our *2011 Annual Report*, we commented on the stranded debt of the electricity sector and the Debt Retirement Charge (DRC), a component of nearly every Ontario ratepayer's electricity bill.

The stranded debt arose with the passage of the *Energy Competition Act, 1998*, which resulted in a major restructuring of the electricity industry, including the breakup of the old Ontario Hydro into three main successor companies: Hydro One, Ontario Power Generation (OPG) and the Ontario Electricity Financial Corporation (OEFC). OEFC was given the responsibility to manage the legacy debt of the old Ontario Hydro and certain other liabilities not transferred to Hydro One and OPG.

OEFC inherited $38.1 billion in total debt and other liabilities from Ontario Hydro when the electricity market was restructured on April 1, 1999. Only a portion of the $38.1 billion was supported by the value of the assets of Hydro One, OPG and the Independent Electricity System Operator, leaving $20.9 billion of stranded debt not supported by assets.

The government's long-term plan to service and retire the $20.9 billion in stranded debt involved dividing it into two components:

- An estimated $13.1 billion was to be supported through future revenue streams from payments in lieu of taxes made by the electricity-sector companies (OPG, Hydro One and the municipal electrical utilities), and from the cumulative annual combined profits of OPG and Hydro One in excess of the government's $520-million annual interest cost of its investment in the two companies.
- The remaining $7.8 billion, called the residual stranded debt, was the estimated portion of the stranded debt that could not be supported by the expected dedicated revenue streams from the electricity companies. The *Electricity Act, 1998* authorized a new Debt Retirement Charge (DRC), to be paid by electricity ratepayers, until the residual stranded debt was retired.

This structure was intended to eliminate the stranded debt in a prudent manner while distributing the debt repayment burden between electricity consumers and the electricity sector.

Collection of the DRC began on May 1, 2002. The rate was established at 0.7 cents per kilowatt hour (kWh) of electricity and remains the same today. Currently, the OEFC collects more than $940 million a year in DRC revenue. As of March 31, 2012, approximately $9.7 billion in DRC revenue had been collected.

Our *2011 Annual Report* focused on providing details about how much DRC revenue has been collected, the progress in eliminating the residual stranded debt, and when electricity ratepayers might expect to see the DRC eliminated.

Section 85 of the *Electricity Act, 1998* (Act) entitled "The Residual Stranded Debt and the Debt Retirement Charge" gave the government the authority to implement the DRC, and this same section specifies when it is to end. The key observations from our *2011 Annual Report* were based on our interpretations of the provisions of section 85 of the Act and assessing whether these provisions had been complied with in both spirit and form. Specifically, section 85 requires that the Minister of Finance determine the residual stranded debt "from time to time" and to make these determinations public. When the Minister determines that the residual stranded debt has been retired, collection of the DRC must cease.

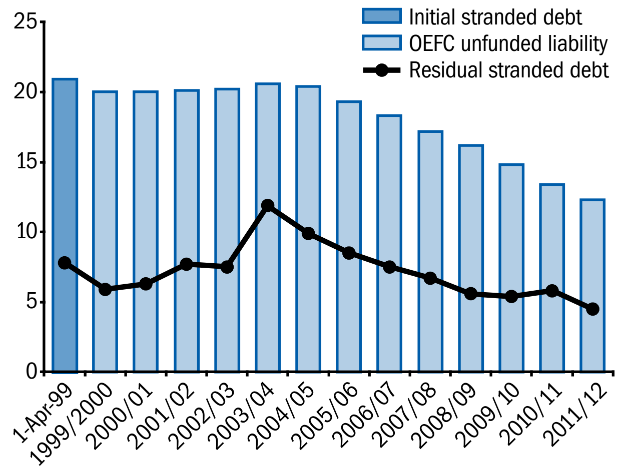
While the Act did not specify precisely how the determination of the residual stranded debt was to be done, it does allow the government, by regulation, to establish what is to be included in its calculation. We also observed that the term "from time to time" was not formally defined, and could be left solely up to the government of the day to determine. Since the passage of the Act more than a decade ago, we noted the Minister had made no such public determination of the outstanding amount of the residual stranded debt. Our view was that the intent of section 85 was that Ministers had an obligation to provide a periodic update to ratepayers on what progress their payments were having on paying down the residual stranded debt. We concluded that a decade was long enough, and suggested the Minister should provide ratepayers with an update.

In response to these observations, the government introduced Regulation 89/12 under the Act on May 15, 2012, to provide transparency and meet reporting requirements on the outstanding amount of residual stranded debt. The new regulation formally establishes how the residual stranded debt is to be calculated, and requires annual reporting of the amount in *The Ontario Gazette*.

We were pleased to see this increased level of transparency was also reflected in the 2012 budget, which contained a residual stranded debt estimate of $5.8 billion as of March 31, 2011, and a projected estimate of $4.5 billion as of March 31, 2012. Prior to the 2012 budget, there had been no public update provided on the estimated residual stranded debt since the $7.8 billion estimate on April 1, 1999. The update in the 2012 Ontario Economic Outlook and Fiscal Review also contained the chart, illustrated in Figure 5, reflecting annual residual stranded debt estimates back to April 1, 1999, and amounts going up to March 31, 2012.

Figure 5: Residual Stranded Debt and OEFC Unfunded Liability for Each Fiscal Year Since 1999 ($ billion)

Source of data: 2012 Ontario Economic Outlook and Fiscal Review



Use of Legislation to Override Accounting Standards

One significant recent development in Canadian public accounting is that some governments have legislated specific accounting treatments that would apply in certain circumstances rather than relying on established generally accepted accounting principles to prescribe how transactions would be recorded. On several occasions in recent years the Ontario government has done this by passing legislation or regulations that give it the authority to prescribe specific accounting policies for its public sector entities.

We first raised concerns about this practice in our *2008 Annual Report*, where we warned that it was a troubling precedent to establish accounting principles through legislation rather than through an independent, consultative process such as that followed by the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants (CICA). Although this and subsequent developments have not yet resulted in the province's consolidated financial statements containing a material departure from PSAB standards, the risk of such departures in future financial statements has increased. Here is a chronological synopsis of these developments since 2008:

- The *Investing in Ontario Act, 2008* (Act) and related regulations allowed the government to reduce its accumulated deficit and provide additional transfers to eligible recipients from unplanned surpluses reported in its consolidated financial statements. Any transfers made under the 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* and the *Financial Administration Act* were amended. Amendments under the *Education Act* specified that the government can prescribe the accounting standards that school boards use in preparing financial statements. Amendments under the *Financial Administration Act* allow the government to specify the accounting standards to be used by any public or non-public entity whose financial statements are included in the province's consolidated financial statements. School boards and certain other government organizations are affected by both these legislative amendments.
- In 2011, a regulation under the *Financial Administration Act* directed Hydro One 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 OPG. American accounting rules allow for rate-regulated entities to defer expenses to future years; the government's direction to follow U.S. rules came in anticipation of the planned Canadian adoption of International Financial Reporting Standards, which do not provide for the use of rate-regulated accounting.
- Ontario government regulations now require capital transfers and transfers of tangible capital assets to be accounted for by transfer recipients as deferred capital contributions. The amounts transferred are to be brought into revenue at the same rate as amortization expense is recognized on the related assets. We have historically supported this accounting as we believe that in most instances it complies with generally accepted accounting principles. However, PSAB standards are open to interpretation in this respect, so to ensure consistency the government considered it necessary to introduce a regulation requiring this treatment.
- The direction taken by the province beginning in 2008 to legislate accounting standards was further supported in the *Strong Action for Ontario Act (Budget Measures), 2012*, the latest amendments to the *Financial Administration Act*. These amendments provide the government with full authority to make regulations regarding the accounting policies and practices used to prepare its consolidated financial statements.

We believe it is critical that Ontario continue to prepare its financial statements in accordance with generally accepted PSAB standards.

As the auditor of the province's consolidated financial statements, I am required by the *Auditor General Act* to 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." If I conclude that the government's reported deficit or surplus under legislated accounting standards is significantly different than what it would be under generally accepted accounting standards, I will need to include a reservation in my audit opinion. However, based on the past 19 consecutive years of "clean" audit opinions, I am hopeful that this situation will not arise.

Future Public Accounts Issues

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 their key financial reports, the public can evaluate the government's 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.

ACCOUNTING STANDARDS FOR GOVERNMENTS

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 should be established by an independent, recognized professional body using a comprehensive, open and transparent standard-setting process.

The Public Sector Accounting Board of the Canadian Institute of Chartered Accountants 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.

The PSAB emphasizes due process to ensure that the views of all interested parties are heard and considered, thereby maintaining the objectivity of the standard-setting process. In developing or revising an accounting standard, the PSAB generally follows these five steps:

- basic research;
- approval of a project proposal;
- issuing a statement of principles to a designated group of accountants and non-accountants for feedback;
- issuing one or more public exposure drafts and soliciting comments from all interested individuals and organizations; and
- approving and publishing a final standard.

Canada is generally regarded as a public sector world leader with respect to the consistent application of generally accepted accounting standards at all three levels of government. However, maintaining this leadership role will not be without challenges. For instance, in the past few years, Canadian governments, including Ontario, have become concerned with several of the PSAB's accounting and financial reporting proposals. In the next section, we discuss two areas—financial instruments and rate-regulated accounting—where they have questioned whether proposed standards adequately reflect the unique environment in which governments operate when making decisions on financial reporting, budgeting and fiscal policy.

Financial Instruments

The PSAB's project to develop a new standard for the reporting of financial instruments began in January 2005 with the creation of a PSAB task force. Examples of financial instruments include debt, and derivatives such as currency swaps and foreign-exchange forward contracts. One of the key issues the task force had to address was 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, the PSAB approved a new standard effective for fiscal periods beginning on or after April 1, 2015. The new public-sector accounting standard—PS 3450 "Financial Instruments"—provides guidance on the recognition, measurement, presentation and disclosure of government financial instruments, and is similar to the standards applicable to the private sector. One of its main requirements is that certain financial instruments, including derivatives, are to be recorded at fair value, and any unrealized gains or losses must be recorded annually in a new statement of remeasurement gains and losses.

Ontario, along with certain other Canadian governments, did not endorse the introduction of fair-value remeasurements and the recognition of unrealized gains and losses on its derivative holdings. Ontario's view is that derivatives are used solely to mitigate 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 associated debt matures. Accordingly, remeasurement gains and losses would net out to zero over the period to maturity and therefore have no long-term economic impact on annual government resource inflows or outflows. The government argues that recording paper gains and losses each year would reintroduce the very volatility the derivatives were acquired to avoid in the first place.

Therefore, its view is that the inclusion of fair-value gains and losses in a government's financial reports, even if reported outside the statement of operations, does not reflect the economic substance of government financing transactions and does not meet the public's needs for transparent information on government finances.

It should be noted that the PSAB is committed to reviewing these standards on or before December 31, 2013, and has noted that its Concepts Underlying Financial Performance project might identify issues that need to be addressed within the financial instrument standard.

MINISTRY RESPONSE

Ontario supports public-sector accounting standards that promote transparency and accountability in reporting on how taxpayer dollars are spent, and that support sound fiscal-policy decisions. Concerns with the introduction of fair-value accounting concepts into government financial reports are based on the fact that they will cause significant fluctuations in the recorded value of derivatives on a year-over-year basis as a result of movements in interest and exchange rates. Such results would, in turn, introduce difficult-to-explain fluctuations in the province's net debt, a key measure upon which both investors and credit-rating agencies rely when assessing the financial health of the province.

Rate-regulated Accounting

Over the past four 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 regulator established under legislation, such as the Ontario Energy Board, approves the prices that a regulated entity may charge customers, and often allows regulated entities to defer certain costs for recovery in future periods. Such costs are typically set up as assets that, under normal generally accepted accounting principles, would be expensed in the year incurred.

Ontario's electricity sector has three major provincially owned organizations—OPG, Hydro One and the OPA—that use rate-regulated accounting and whose financial position and operating results are included in the government's consolidated financial statements. The use of rate-regulated accounting by certain rate-regulated entities, while still allowed under Canada's generally accepted accounting principles, could be disallowed in the near future. PSAB standards currently allow OPG and Hydro One, which are defined as government business enterprises, to be included in the province's consolidated financial statements without their accounting policies being adjusted to remove the impact of rate-regulated accounting. Given the PSAB's position, we accepted this accounting treatment even though we questioned whether rate-regulated assets and liabilities met the definition of *bona fide* assets or liabilities for the purposes of the government's consolidated financial statements.

However, the OPA does not meet the PSAB criteria of being a government business enterprise, so the impact of rate-regulated accounting on its results should have been removed before the OPA was included in the consolidated statements. (This did not have a material impact on the province's reported results and therefore did not affect our audit opinion).

Last year we reported that the era of rate-regulated accounting appeared to be ending for jurisdictions such as Canada that were converting to International Financial Reporting Standards. In January 2012, Canada's Accounting Standards Board 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, which would mean that accounting for rate-regulated balances would no longer be allowed under Canadian accounting standards.

However, since that time, the rate-regulated landscape has changed again. The accounting standard-setter in the United States, the Financial Accounting Standards Board, 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 Accounting Standards Board 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. Therefore, PSAB accounting standards will continue to allow OPG and Hydro One to use rate-regulated accounting for inclusion in the province's consolidated financial statements until that time. Most recently, in late September 2012, the International Accounting Standards Board (IASB) decided to restart its project on rate-regulated accounting to consider the use of this accounting method under IFRS.

Ontario's Ministry of Finance 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 Accounting Standards Board. As the Ministry is aware, we do not agree with this position. In its March 31, 2012, Annual Report and Consolidated Financial Statements, the government commented specifically on rate-regulated accounting, noting that:

> Under these practices, a regulated entity may defer certain costs that are expected to be recovered in future, creating an asset on its balance sheet. Without rate-regulated accounting, these costs would be expensed in the year they were incurred, which could result in significant fluctuations in consumer electricity rates.

The government recently passed a regulation allowing for and subsequently directing both Hydro One and OPG to prepare their future financial statements in accordance with U.S. generally accepted accounting principles, which allow for rate-regulated accounting. In the government's view, these regulations are required because the IASB has not yet completed its deliberations on the future of rate-regulated accounting. We are not the auditors of Hydro One or OPG, and so our concern is not the impact of this regulation on their individual financial statements. However, with the deferral of the issue to January 1, 2014, it is the effect their accounting policies might have on the province's consolidated financial statement of March 31, 2014, and subsequent statements, that is our concern.

MINISTRY RESPONSE

The Ministry recognizes the ongoing challenges in the accounting-standards-setting environment to achieve consensus on the required approach for rate-regulated accounting. Given the deferral by the standards-setters to resolve this issue, the government had directed Hydro One and OPG to follow U.S. GAAP to allow the entities to continue to account for their rate-regulated assets and liabilities consistent with historical Canadian GAAP. This decision was consistent with actions by both the Canadian Securities Administrators and the Ontario Securities Commission that have enabled rate-regulated utilities to submit their financial statements on a U.S. GAAP basis until 2014. This also helped to ensure consistency in reporting among the province's rate-regulated entities until outstanding issues are resolved.

In late September 2012, the International Accounting Standards Board decided to restart its project on rate-regulated accounting. The government looks forward to the standards-setters undertaking this review and, ultimately, to resolution of the outstanding certainty regarding the future of rate-regulated accounting.

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 detailed 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 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. For a more in-depth discussion of the legislative estimates review process, see section 3.07 of this Annual Report.

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, 2012*, which pertained to the fiscal year ended March 31, 2012, received Royal Assent on April 24, 2012.

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—but ministry programs require interim spending authority prior to its passage. For the 2011/2012 fiscal year, the Legislature authorized these payments by passing two acts allowing interim appropriations: the *Interim Appropriation for 2011-2012 Act, 2010*; and the *Supplementary Interim Appropriation Act, 2011*. These two acts received Royal Assent on December 8, 2010, and May 12, 2011, respectively, and authorized the government to incur up to $114.5 billion in public service expenditures, $3.5 billion in investments, and $193.5 million in legislative offices expenditures. Both acts were made effective as of April 1, 2011.

The two interim acts provided the government with sufficient temporary appropriations to allow it to incur expenditures from April 1, 2011, to when the *Supply Act, 2012* received Royal Assent on April 24, 2012. As the legal spending authority under the interim acts was intended to be temporary, they were repealed under the *Supply Act, 2012*, and the authority to incur expenditures provided under them was subsumed into the authority provided under the *Supply Act, 2012*, which increased total authorized legislative offices expenditures from $193.5 million to $197 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, 2012.

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 books of the government 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 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 and 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 Treasury Board, subject to limitations and requirements that the Treasury Board may specify. This delegation will continue to be in effect until replaced by a new delegation. For the fiscal year ended March 31, 2012, the Treasury Board delegated its authority to ministers for issuing Treasury Board Orders to make transfers between programs within their ministries, and to the Chair of the Treasury Board for making transfers in programs 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 6 summarizes the total value of Treasury Board Orders issued for the past five fiscal years.

Figure 7 summarizes Treasury Board Orders for the fiscal year ended March 31, 2012, 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 2011/12 fiscal year are expected to be published in *The Ontario Gazette* in the near future. A detailed listing of 2011/12 Treasury Board Orders, showing the amounts authorized and expended, is included as Exhibit 3 of this report.

Figure 6: Total Value of Treasury Board Orders, 2007/08–2011/12 ($ million)

Source of data: Treasury Board

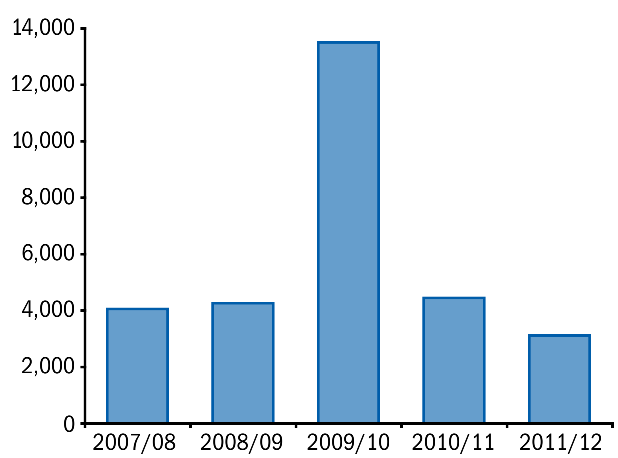


Figure 7: Total Value of Treasury Board Orders by Month Relating to the 2011/12 Fiscal Year

Source of data: Treasury Board

Month of Issue	#	Authorized ($ million)
April 2011–February 2012	81	2,544
March 2012	31	329
April 2012	8	54
August 2012	1	190
Total	**121**	**3,117**

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 8 shows the transfers made within Vote 201 with respect to the 2011/12 Estimates.

Figure 8: Authorized Transfers Relating to the Office of the Assembly, 2011/12 Fiscal Year ($)

Source of data: Board of Internal Economy

From:		
Item 2	Office of the Clerk	(9,900)
Item 3	Legislative Services	(9,200)
Item 6	Sergeant at Arms and Precinct Properties	(41,800)
Item 8	Caucus Support Services	(109,900)
Item 9	Members' Compensation and Travel	(1,366,100)
To:		
Item 4	Information and Technology Services	51,100
Item 5	Administrative Services	7,300
Item 10	Members' Office Support Services	1,476,000
Item 12	Lieutenant Governor's Suite	2,500

UNCOLLECTIBLE ACCOUNTS

Under section 5 of the *Financial Administration Act*, the Lieutenant Governor in Council, on the recommendation of the Minister of Finance, may 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 2011/12 fiscal year, receivables of $816.4 million due to the Crown from individuals and non-government organizations were written off. (The comparable amount in 2010/11 was $432.1 million.) The writeoffs in the 2011/12 fiscal year related to the following:

- $382.2 million for uncollectible retail sales tax ($71.9 million in 2010/11);
- $155.8 million for uncollectible corporate tax ($65.1 million in 2010/11);
- $114.1 million for uncollectible receivables under the Student Support Program ($145.2 million in 2010/11);
- $86.3 million for uncollectible receivables under the Ontario Disability Support Program ($118.8 million in 2010/11);
- $48.9 million for uncollectible employer health tax ($6.4 million in 2010/11); and
- $29.1 million for other tax and non-tax receivables ($24.7 million in 2010/11).

Volume 2 of the 2011/12 Public Accounts summarizes the writeoffs by ministry. Under the accounting policies followed in the preparation of the consolidated financial statements of the province, a provision for doubtful accounts is recorded 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.