Chapter 2

Public Accounts of the Province

Introduction

Ontario's Public Accounts for the fiscal year ending March 31, 2014, were prepared under the direction of the Minister of Finance, as required by the *Financial Administration Act* (Act). The Public Accounts consist of the province's annual report, including the province's consolidated financial statements, and three supplementary volumes of additional financial information.

The government is responsible for preparing the consolidated financial statements and ensuring that this information, including 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 authorize transactions, safeguard assets and maintain proper records.

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

The province's 2013/14 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, 2014, including some details of the government's accomplishments in the fiscal year. Providing such information enhances the fiscal accountability of the government to both the Legislative Assembly and the public.

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

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

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 2013/14 Annual Report and Consolidated Financial Statements, along with the three Public Accounts supplementary volumes, on September 22, 2014, meeting the legislated deadline.

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

Summary

We have focused this year on Ontario's growing debt burden, and the critical implications this has for the province's finances. Increases in the debt are attributable to continued government borrowing to finance deficits and infrastructure spending.

The government has been able to rely on historically low interest rates to keep its debt-servicing costs relatively stable, but the debt itself continues to grow regardless of which measure—total debt, net debt or accumulated deficit—is used to assess it.

The negative consequences of a large debt load include:

- debt-servicing costs diverting funding away from other government programs;
- a greater vulnerability to any interest-rate increases; and
- potential credit-rating downgrades and changes in investor sentiment, which could make it more expensive to borrow.

We take the view that the government should provide legislators and the public with long-term targets for addressing the province's current and projected debt, and we recommend that the government develop a long-term debt-reduction plan.

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

It is our view that PSAB standards are the most appropriate for the province to use in preparing its consolidated financial statements. This ensures that information provided by the government about the deficit and surplus is fair, consistent and comparable to data from previous years, allowing legislators and citizens to assess the government's management of the public purse.

We note the ongoing challenges facing PSAB in reaching a consensus on what accounting standards are most appropriate for the public sector, and we discuss a number of significant accounting issues that will need to be addressed for future years. In this respect, we also outline PSAB initiatives in the development of new standards that might impact the preparation of the province's consolidated financial statements in future.

Ontario has introduced legislation on a number of occasions to establish specific accounting practices that are not, in some cases, consistent with PSAB. This has not at this time had a material impact on the province's consolidated financial statements. However, if the government introduces further legislated accounting treatments in future, this could become a greater concern to my Office. Standard-setters, governments and auditors must work together if we are to resolve financial reporting issues faced by governments and public-sector entities in the public interest.

The Province's 2013/14 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. We are pleased to note that the Independent Auditor's Report to the Legislative Assembly on the province's consolidated financial statements for the year ended on March 31, 2014, 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, 2014, 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, 2014, and the consolidated results of its operations, change in its net debt, change in its accumulated deficit, and its cash flows for the year then ended in accordance with Canadian public sector accounting standards.

	[signed]
Toronto, Ontario	Bonnie Lysyk, MBA, CPA, CA, LPA
August 19, 2014	Auditor General

The above audit opinion is without any reservation, indicating that the consolidated financial statements fairly present the province's fiscal results for the 2013/14 fiscal year and its financial position at March 31, 2014. This "clean" audit opinion means that, based on our audit work, we have concluded that the province's consolidated financial statements were prepared in accordance with accounting standards recommended for governments by the Chartered Professional Accountants of Canada (CPA Canada). We are also communicating to users that the province's consolidated financial statements do not have any material or significant errors and provide a fair reflection of what has actually transpired during the year.

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

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

To help make this assessment, we determine a materiality threshold. This year, as in past years and consistent with most other provincial jurisdictions, we set the threshold at 0.5% of the greater of government expenses or revenue for the year. If misstated items individually or collectively exceed the threshold, and management is not willing to make appropriate adjustments, a reservation in our Independent Auditor's Report would be required.

As a final comment, it is notable that in the past 21 years, all Ontario governments, regardless of the political party in power, have complied in all material respects with approved accounting standards. Accordingly, our Office has been able to issue "clean" audit opinions on the province's consolidated financial statements every year since the province adopted PSAB accounting standards in the 1993/94 fiscal year.

Ontario's Debt Burden

In our past three Annual Reports, we have commented on Ontario's growing debt burden. Our commentary has highlighted the consequences for the province of carrying a large debt load, including:

- debt-servicing costs reducing the availability of funds for other programs;
- greater vulnerability to the impact of interest rate increases; and
- potential credit-rating downgrades, which would likely increase borrowing costs.

Our commentary on Ontario's increasing debt has attracted little public attention. We believe one reason for this is primarily because of the focus placed on first eliminating Ontario's annual deficit.

Ultimately, the question of how much debt the province should carry and the strategies that would be used by the government to pay down its debt is one of government policy. However, this should not prevent the government from providing information that promotes further understanding of the issue and clarifies the choices it is making or will make to address it.

Financial Performance at March 31, 2014

The province projected an $11.7 billion deficit for 2013/14 in its 2013 Ontario Budget. The actual deficit was $10.4 billion, or about $1.3 billion less than the projection, because expenses were significantly lower than forecast while revenues dropped only slightly. Specifically:

- Expenses were $2.2 billion less than forecast, as follows:
  - $1 billion saved by not using the budget reserve;
  - $600 million less in education expenses due to lower than expected school board expenses;
  - $300 million in lower children and social services sector expenses; and
  - $300 million in reduced spending across all other ministries.
- Revenue was $900 million lower than forecast, as follows:
  - Taxation revenue was $2.0 billon lower than forecast due to a $1.4-billion decrease in Harmonized Sales Tax (HST) revenue resulting primarily from a downward revision to the federal estimate of Ontario's HST entitlement, as well as a $600-million decrease in personal income tax revenue due to lower than expected growth in labour compensation in 2013.
  - Government of Canada transfers to Ontario were $200 million below the budget forecast, owing primarily to revisions to what the federal government estimated it owed the province.
  - The above lower-than-forecast differences were offset by a $900-million increase in income from the government's business enterprises, mainly from Ontario Power Generation Inc. and Hydro One Inc., and $400 million more in other non-tax revenue.

Projected Financial Performance—The 2014 Budget

Given that the government plans to eliminate its annual deficit by 2017/18, as illustrated in **Figure 1**, and given that the cost of carrying debt is expected to rise from the current historic lows, we believe the time is now for the government, its legislators and the public to start a conversation about paying down the province's total debt.

Different Measures of Government Debt

Government debt can be measured in a number of ways. **Figure 2** shows the province's debt levels over the past five fiscal years, along with projections for the next four fiscal years:

Figure 1: Ontario Revenue and Expenses, 2009/10–2017/18 ($ billion)

Sources of data: March 31, 2014 Province of Ontario Consolidated Financial Statements, 2014 Ontario Budget and Ministry of Finance

	Actual					Plan	Medium-term Outlook		Extended Outlook
	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Total Revenue	**96.3**	**107.2**	**109.8**	**113.4**	**115.9**	**118.4**	**124.2**	**129.0**	**134.5**
Expense									
Program expense	106.9	111.7	112.7	112.3	115.8	119.4	120.1	120.2	119.4
Interest on debt	8.7	9.5	10.1	10.3	10.6	10.8	11.8	12.9	13.9
Total Expense	**115.6**	**121.2**	**122.8**	**122.6**	**126.4**	**130.2**	**131.9**	**133.1**	**133.3**
Reserve	–	–	–	–	–	0.7	1.2	1.2	1.2
Surplus/ (Deficit)	**(19.3)**	**(14.0)**	**(13.0)**	**(9.2)**	**(10.5)**	**(12.5)**	**(8.9)**	**(5.3)**	**0.0**

Figure 2: Total Debt, Net Debt and Accumulated Deficit, 2009/10–2017/18 ($ million)

Sources of data: March 31, 2014 Province of Ontario Consolidated Financial Statements, 2014 Ontario Budget and the Office of the Auditor General of Ontario

	Actual					Estimate			
	2009/10[1]	2010/11[1]	2011/12[1]	2012/13[1]	2013/14[2]	2014/15[1]	2015/16[1]	2016/17[1]	2017/18[3]
Total debt	212,122	236,629	257,278	281,065	295,758	310,549	326,600	337,800	345,600
Net debt	193,589	214,511	235,582	252,088	267,190	289,251	305,300	317,200	325,000
Accumulated deficit	130,957	144,573	158,410	167,132	176,634	189,765	198,600	204,000	204,000

1. 2014 Ontario Budget
2. March 31, 2014 Province of Ontario Consolidated Financial Statements
3. Office of the Auditor General of Ontario

- **Total debt** is the total amount of borrowed money the government owes to external parties. It consists of bonds issued in public capital markets, non-public debt, T-bills and U.S. commercial paper. It provides the broadest measure of a government's debt load.
- **Net debt** is the difference between the government's total liabilities and its financial assets. Liabilities consist of all amounts the government owes to external parties, including total debt, accounts payable, pension and retirement obligations, and transfer payment obligations. Financial assets are those that theoretically can be used to pay off liabilities or finance future operations, and include cash, accounts receivable, temporary investments and investments in government business enterprises. Net debt provides a measure of the amount of future revenues required to pay for past government transactions and events.
- **Accumulated deficit** represents the sum of all past government annual deficits and surpluses. It can also be derived by deducting the value of the government's non-financial assets, such as its tangible capital assets, from its net debt.

Total debt will eventually need to be paid off or refinanced. It becomes a particularly relevant measure when global capital markets tighten and credit is not readily available.

Net debt is a useful indicator of a government's financial position because it provides insight into the affordability of continuing to provide public services. Essentially, net debt reflects the amount of future provincial revenues that will be required to pay down a government's liabilities. A large net debt position reduces a government's ability to devote future financial resources to existing programs and public services, and as such is important in assessing a government's fiscal capacity.

The Ontario government considers the accumulated deficit to be a key measure for evaluating its financial position and its capacity to deliver future services because the accumulated deficit takes into account the acquisition of non-financial assets, such as tangible capital assets. Under the *Fiscal Transparency and Accountability Act, 2004* (FTAA) the government is required to maintain a prudent ratio of provincial debt (defined in the FTAA as the accumulated deficit) to Ontario's gross domestic product (GDP), which is discussed in more detail in the next section.

Main Contributors to Net Debt Growth

The province's growing net debt since the end of the 2008/09 fiscal year is attributable to its large deficits in recent years, along with its investments in capital assets such as buildings, other infrastructure and equipment acquired directly or through public-private partnerships for the government or its consolidated organizations, such as public hospitals, as illustrated in **Figure 3**.

Figure 3: Net Debt Growth Factors, 2008/09–2017/18 ($ million)

Sources of data: March 31, 2014 Province of Ontario Consolidated Financial Statements, 2014 Ontario Budget and the Office of the Auditor General of Ontario

	Net Debt Beginning of Year	Deficit/ (Surplus)	Net Investment in Tangible Capital Assets[1]	Miscellaneous Adjustments[2]	Net Debt End of Year	Increase/ (Decrease)
Actual						
2008/09	156,616	6,409	5,348	1,212	169,585	12,969
2009/10	169,585	19,262	6,285	(1,543)	193,589	24,004
2010/11	193,589	14,011	7,306	(395)	214,511	20,922
2011/12	214,511	12,969	7,234	868	235,582	21,071
2012/13	235,582	9,220	7,784	(498)	252,088	16,506
2013/14	252,088	10,453	5,600	(951)	267,190	15,102
Estimated						
2014/15	267,190	12,500	9,561		289,251	22,061
2015/16	289,251	8,900	7,149		305,300	16,049
2016/17	305,300	5,300	6,600		317,200	11,900
2017/18	317,200	–	7,800		325,000	7800
Total over 10 years	**–**	**99,024**	**70,667**	**(1,307)**	**–**	**168,384**

1. Includes investments in government-owned and broader public sector land, buildings, machinery and equipment, and infrastructure assets capitalized during the year less annual amortization and net gains reported on sale of government-owned and broader public sector tangible capital assets.
2. Unrealized Fair Value Losses/(Gains) on the funds held by Ontario Power Generation Inc. under the Ontario Nuclear Funds Agreement (ONFA), and accounting changes.

While annual deficits are projected to decline, the province is still increasing its borrowings annually to finance these deficits, replace maturing debt and to fund infrastructure. In fact, the net debt is projected to continue growing in absolute terms even after the province starts to run annual budget surpluses. This important fact should not go unnoticed by our legislators and the public. The province can begin paying down its debt only when such future surpluses provide cash flows over and above the amounts required to fund government operations and its net investments in tangible capital assets.

By the time the government projects it will have eliminated the deficit in 2017/18, Ontario's net debt will have doubled over a 10-year period, from $156.6 billion in 2007/08 to over $325 billion by 2017/18. We estimate total debt will exceed $340 billion by 2017/18.

To put this debt in perspective, the amount of net debt owed by each resident of Ontario on behalf of the government will increase from about $12,000 per person in 2008 to about $23,000 per person in 2018. In other words, to eliminate Ontario's net debt, each Ontarian would need to contribute $23,000 to the provincial coffers.

Ontario's Ratio of Net Debt to GDP

A key indicator of the government's ability to carry its debt is the level of debt relative to the size of the economy. This ratio of debt to the market value of goods and services produced by an economy (the gross domestic product, or GDP) measures the relationship between a government's obligations and its capacity to raise the funds needed to meet them. It is an indicator of the burden of government debt on the economy. If the amount of debt that must be repaid relative to the value of the output of an economy is rising—in other words, the ratio is rising—it means that the government's net debt is growing

faster than the provincial economy and becoming an increasing burden.

Figure 4 shows that the province's net-debt-to-GDP ratio gradually fell over a period of eight years from a high of 32.2% in 1999/2000 to 26.2% in 2007/08. However, it has been trending upward since then, reflecting among other things, the impact of the 2008 global economic downturn on the provincial economy. Tax revenues fell abruptly and the government has increased its borrowings significantly since that time to fund annual deficits and infrastructure stimulus spending.

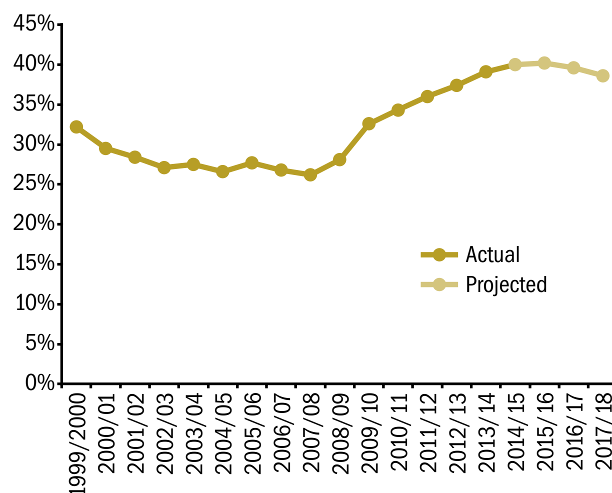
The net-debt-to-GDP ratio is projected to reach a high of 40.5% in 2015/16. After this peak, the government then expects the ratio to begin falling. Thus, provincial net debt growth will be less sustainable over the next two years, and will improve only if these longer-term projections are met. The Conference Board of Canada recently noted that this is by no means assured, given the Conference Board's less-than-optimistic revenue forecasts and the government's difficult-to-achieve expense forecasts, which are highly optimistic given the rate of growth in expenditures over the last decade. As we noted in our *2013 Annual Report*, many experts contend that a jurisdiction's fiscal health is at risk and is vulnerable to unexpected economic shocks when its net-debt-to-GDP ratio rises above 60%.

We caution it is somewhat of an oversimplification to rely on one measure to assess a government's borrowing capacity because it cannot take into account the province's share of both federal and municipal debts. If the province's share of federal and municipal debts were included in Ontario's indebtedness calculations, Ontarians' net debt would be much higher. However, consistent with the debt measurement methodologies used by most jurisdictions, we have focused on only the provincial government's net debt throughout our analysis.

An interesting exercise in assessing Ontario's ratio of net debt to GDP is to compare it with other Canadian jurisdictions. **Figure 5** shows the net debt of most provinces and the federal government, along with their respective ratios of net debt to GDP. Generally, the western provinces have a significantly lower net-debt-to-GDP ratio than Ontario and the Atlantic provinces, and Quebec has a significantly higher ratio than Ontario.

Figure 4: Ratio of Net Debt to Gross Domestic Product (GDP), 1999/2000–2017/18

Sources of data: March 31, 2014 Province of Ontario Consolidated Financial Statements and 2014 Ontario Budget



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

Figure 5: Net Debt and the Net-debt-to-GDP Ratios of Canadian Jurisdictions, 2013/14

Sources of data: Province of Ontario Annual Report and Consolidated Financial Statements; Annual Report and Consolidated Financial Statements of other provincial jurisdictions; Federal Budgets and budget updates, budgets of provincial jurisdictions; and the Office of the Auditor General of Ontario

	Net Debt ($ million)	Net Debt to GDP (%)
AB	(13,032)	(2.9)
SK	4,615	5.6
BC	38,777	17.2
NL	9,084	24.6
MB	17,344	28.8
NB	11,641	36.7
PEI	2,120	37.3
NS	14,762	37.8
Federal	682,300	36.3
ON	267,190	38.6
QC	181,965	49.9

Ratio of Net Debt to Total Annual Revenue

Another useful measure of government debt is the ratio of net debt to total annual revenues, an indicator of how much time it would take to eliminate the debt if the province spent all of its revenues on nothing but debt repayment. For instance, a ratio of 250% indicates that it would take 2½ years to eliminate the provincial debt if all revenues were devoted to it. As shown in **Figure 6**, this ratio declined from about 200% in 1999/2000 to about 150% in 2007/08, reflecting the fact that, while the province's net debt remained essentially the same, annual provincial revenue was increasing. However, the ratio has increased steadily since 2007/08 and is expected to top 245% by 2017/18. This increasing ratio of net debt to total annual revenue indicates the province's net debt has less revenue to support it.

Ratio of Interest Expense to Revenue

Increases in the cost of servicing total debt, or interest expense, can directly affect the quantity and quality of programs and services that government can provide: the higher the proportion of government revenues going to pay interest costs on past borrowings, the lower the proportion available for program spending in other areas.

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

As **Figure 7** shows, the province's interest-expense-to-total-revenues ratio decreased steadily in the decade ending in 2007/08, due mainly to a lower interest-rate environment. Because rates have been at historic lows since the beginning of this decade, both the actual and projected interest-expense-to-total revenues ratio have held, and are expected to hold steady at approximately 9.0% from 2009/10 to 2014/15 even as the province's total borrowings are expected to increase by approximately $98.0 billion, or 46%, from $212 billion to over $310 billion.

Based on the government's latest projections, the ratio is expected to gradually increase to 10% by 2015/16 and to 11% by 2017/18, when total debt is expected to be around $340 billion.

The province's debt also exposes it to further risks, the most significant being interest-rate risk. As discussed above, interest rates are currently at

Figure 6: Ratio of Net Debt as Percentage of Total Annual Revenues, 1999/2000–2017/18

Source of data: March 31, 2014 Province of Ontario Consolidated Financial Statements, 2014, 2009, 2008 Ontario Budgets, Office of the Auditor General of Ontario

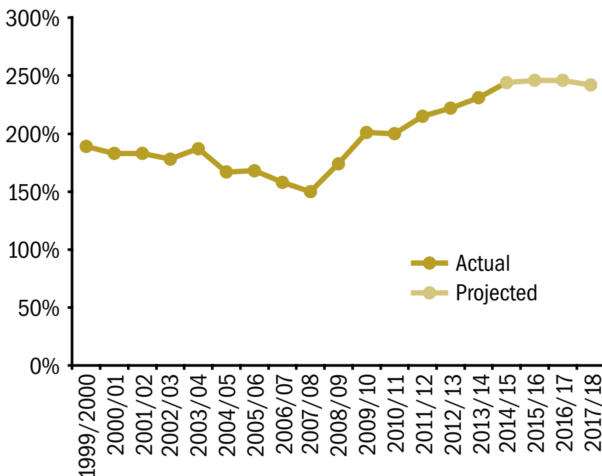
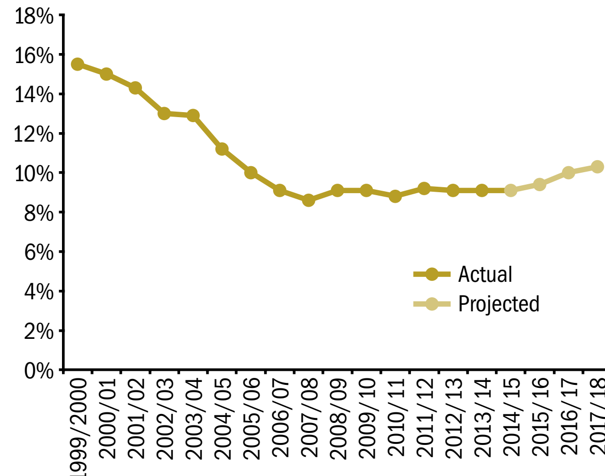


Figure 7: Ratio of Interest Expense to Revenues, 1999/2000–2017/18

Source of data: March 31, 2014 Province of Ontario Consolidated Financial Statements, 2014, 2009, 2008 Ontario Budgets, Office of the Auditor General of Ontario



record low levels, enabling the government to keep its annual interest expense relatively steady even as its total borrowing has increased significantly. However, if interest rates rise, the government will have considerably less flexibility to provide public services because a higher proportion of its revenues will be required to pay interest on the province's outstanding debt.

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

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

Drummond added: "We do not mean to be alarmist in noting the province's debt picture, only to point out that government debt burdens can rise quickly if they are not headed off early with appropriate action." These comments are particularly important for the Ontario government, its legislators and the public to heed because of the stark reality that debt becomes more difficult to control and rein in the larger it becomes.

Ontario accounts for almost half of all provincial net debt in Canada and almost 40% of Canada's population. The province's high debt load could be viewed as a national concern.

Consequences of High Indebtedness

High levels of indebtedness have consequences for governments, including the following:

- **Debt-Servicing Costs Take Funding Away from Other Government Programs:** As indebtedness grows, so does the amount of cash needed to pay the interest costs to service it. As higher interest costs consume a greater proportion of government resources, they limit the amount the government can spend on other things. To put this "crowding-out" effect into perspective, the government now spends more on debt interest than it does on post-secondary education, and these interest costs are growing. In fact, interest on debt is projected to be the fastest-rising cost for the government over the next four years, increasing by 7.1% per year from 2013/14 onward, although the government plans to hold other program spending increases to 0.8% over this period. Interest on debt represents almost half of the government's planned growth in expenses over the next four years, with interest costs increasing by $3.3 billion while program spending will increase by only $3.6 billion over the same period. The government's debt-servicing cost in 2008/09 was $8.6 billion and rose to $10.6 billion in 2013/14 during a period of declining and relatively low interest rates. It is projected to rise to $13.9 billion by the time the province plans to balance its books in 2017/18. As noted earlier, based on the government's latest projections, the proportion of its revenues needed to pay the cost of servicing total debt (the interest expense ratio) is expected to gradually increase to 10% of total expenditures by 2015/16 and further to 11% by 2017/18, when total debt is expected to be around $340 billion. This means that by 2017/18 the government expects to have to spend nearly one out of every nine dollars of revenue collected on servicing its debt. In 2007/08, only one of every 12 dollars of revenue collected was required to service debt.

- **Greater Vulnerability to a Rise in Interest Rates:** Over the past few years, governments generally have been able to benefit from record-low interest rates to finance higher debt loads. The province has been able to keep its annual interest expense relatively steady even as its total borrowing has increased significantly. For example, Ontario was paying an average effective interest rate of about 8% in 1999/2000, but that has dropped to around 4% for 2013/14. However, if interest rates rise, the government will have considerably less flexibility in using its revenue to provide public services because a much higher proportion will be required to pay the interest on the province's much larger outstanding debt. For example, in its 2014 budget, the Ontario government noted that, at its current debt level, a 1% increase in rates would add an additional $400 million to its annual interest costs. Higher debt levels increase the province's sensitivity to such rate increases.
- **Potential Credit-rating Downgrades and Changes in Investor Sentiment:** We will address these issues in the following section.

Ontario's Credit Rating

Another analytical tool for assessing the province's debt burden and the risk it poses to the province's economic viability is its 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 generate revenue to service its debts, and they consider such factors as that government's economic resources and prospects, industrial and institutional strengths, financial health, and susceptibility to major risks. Investors in government debt use this credit rating to assess the likelihood the government will be able to pay its debt obligations.

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. A rating downgrade can also result in a reduction of the potential market for a government's debt, because 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. An outlook is not necessarily a precursor of 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. When determining a rating outlook, the agency considers any changes in economic, financial or business conditions.

After the provincial budget was tabled again in July 2014, all three rating agencies reaffirmed their existing ratings for Ontario: Aa2 from Moody's, AA- from S&P, and AA (low) from DBRS. However, they

have indicated that a downgrade will be almost inevitable eventually unless the province implements measures to address its high debt levels.

In July 2014, Moody's changed its outlook for Ontario from stable to negative and warned of a possible downgrade, saying the change reflected risks surrounding the province's ability to meet its medium-term fiscal targets. After several years of weak to moderate economic growth and higher-than-projected deficits, Moody's noted, the province was facing greater challenges returning to a balanced budget than anticipated. The rating agency added that the required revenue growth in an environment of slower-than-average economic growth and the necessity of imposing significant operating-expense controls to achieve fiscal targets would require a considerable government shift. It also noted that capital borrowing will place additional pressures on the province. Moody's concluded that Ontario's debt rating could be downgraded if the province fails to provide clear signals of its ability and willingness to implement the required operating-expense control measures to redress the current fiscal pressures.

Also in July 2014, Standard & Poor's affirmed its AA- rating with a negative outlook, citing the province's strong economy, strong financial management, budgetary flexibility, revenue support from the federal government, low contingent liabilities and high debt burden. However, the rating agency cautioned that it could lower Ontario's rating next year if the province does not materially exceed its fiscal targets, but noted that it could also revise the outlook to stable if the province achieves fiscal balance before 2017/18 and its total debt begins to decline from its 2016/17 expected peak of 270% of consolidated operating revenue. Echoing the comments of the other rating agency, S&P said the government's plan to balance the books "may not be achievable unless the province implements additional measures or takes more aggressive cost-containment initiatives in the next three years."

And in that same month, DBRS confirmed its provincial rating of AA (low) with a stable outlook supported by five consecutive years of lower-than-expected deficits, which "helped limit erosion in the credit profile" since the government introduced its 2010 plan to eliminate the deficit. However, similar to Moody's assessment, DBRS noted that the province's medium-term outlook has weakened due to slightly lower revenues and higher program spending projections, raising doubts about whether "the government will have the fortitude to make the difficult decisions required to adhere to its original targets."

Figure 8 shows Ontario's credit ratings relative to those of the other provinces and the federal government.

Chapter 2

Figure 8: Target Date for Return to Balance and Credit Rating by Province

Source of data: Moody's Investor Services (Moody's), Standard and Poor's (S&P) and DBRS

	Moody's Investors Service	DBRS	Standard & Poor's	Target Date for Return to Balanced Budget
BC	Aaa	AA (high)	AAA	n/a (in surplus)
AB	Aaa	AAA	AAA	n/a (in surplus)
SK	Aaa	AA	AAA	n/a (in surplus)
MB	Aa1	A (high)	AA	2016/17
ON	Aa2	AA (low)	AA–	2017/18
QC	Aa2	A (high)	A+	2015/16
NB	Aa2	A (high)	A+	2017/18
NS	Aa2	A (high)	A+	not stated
PEI	Aa2	A (low)	A	2015/16
NL	Aa2	A	A+	2015/16
Federal	Aaa	AAA	AAA	2015/16

Impact of Lower Credit Rating/ Revised Outlook

While downgrades and poorer outlooks for the credit ratings theoretically increase future borrowing costs, there is no evidence yet suggesting Ontario's latest ratings have had a significant impact on its borrowing costs. For example, Ontario's interest costs on its bonds have remained relatively unchanged since the ratings were updated, indicating investors are still confident in the province's ability to meet its debt obligations. Ontario bonds remain relatively attractive because many other jurisdictions around the world were affected by the 2008 global financial downturn to a greater extent than Canada, and investors cannot improve their risk and return by switching their investments into these jurisdictions.

Foreign investors are interested in Canadian provincial bonds because the government of Canada is one of the few remaining jurisdictions in the world that has retained its Aaa/AAA credit rating, the highest that can be assigned. Investors associate Ontario debt with the perceived creditworthiness of the federal government, so Ontario benefits from the relative strength of investor faith in government of Canada debt. This means demand for Canadian government debt, both federal and provincial, has remained high, especially among investors looking for relatively low-risk investments.

Debt Reduction Plan

A government's debt has been described as a burden placed on future generations. This is especially so for debt used to finance operating deficits. Debt used to finance infrastructure investments is more likely to leave behind tangible capital assets that would benefit future generations.

It is important to note that while the government has presented a plan to eliminate its annual deficit in 2017/18 by restraining spending and is committed to then reducing Ontario's net-debt-to-GDP ratio to the pre-recession level of 27%, no clear strategy has been articulated for paying down its existing and future debt.

Regardless of what strategy is being contemplated, we believe the government should provide legislators and the public with long-term targets for its plans to address the current and projected debt burden.

RECOMMENDATION

In order to address the province's growing total debt burden, the government should work toward the development of a long-term total debt reduction plan.

MINISTRY RESPONSE

Since the last time the Office of the Auditor General reviewed these statistics in its *2013 Annual Report*, the province's net debt-to-GDP ratio has improved from 39.1% to 38.6% for 2013/14 and remained relatively unchanged for 2014/15 at 40.1%. This improvement is a direct result of better than forecast deficits, although the ratio for the out years has been impacted, primarily by decreases in the GDP forecast.

With regard to debt management, the government's support for and commitment to economic growth will maintain debt at sustainable levels and achieve its target of reducing the net debt-to-GDP ratio to the pre-recession level of 27%.

The province has consistently beaten its annual deficit targets over the last five years resulting in borrowings and accumulated deficits that are $25 billion lower than they would otherwise have been. A major contributor toward beating annual deficit targets has been the focus on annual expenditure management limiting the growth in program spending to an average of 1.5% from 2010/11 to 2013/14. The government has also addressed Ontario's infrastructure deficit through targeted capital investments.

OFFICE OF THE AUDITOR GENERAL RESPONSE

With regard to debt management, we believe that the government should also look at developing a long-term debt reduction plan that is linked to its target of reducing its net debt-to-GDP ratio to its pre-recession level of 27%.

Update on the Workplace Safety and Insurance Board

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

Over the past decade, we have raised a number of concerns about 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* discussed the risk that the growth and magnitude of the unfunded liability posed to the WSIB's financial viability, including the ultimate risk of the WSIB being unable to meet its existing and future commitments to provide worker benefits.

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

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

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

In response to our concerns and to the recommendations of the Arthurs report, in June 2012 the government passed Regulation 141/12 under the Act. Effective January 1, 2013, it required the WSIB to ensure it meets the following funding Sufficiency Ratios by specified dates:

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

The regulation also required the WSIB to submit a plan describing the measures it would take to improve its funding Sufficiency Ratio. On August 8, 2013, the Minister of Labour formally accepted the WSIB's sufficiency plan.

The government also passed Ontario Regulation 338/13 in 2013. It came into force January 1, 2014, and changed the way the WSIB calculates the funding Sufficiency Ratio by changing the method used to value its assets. Our office concurred with this amendment.

The WSIB issues quarterly sufficiency reports and an audited sufficiency report to stakeholders annually. As at December 31, 2013, under Regulation 141/12, the WSIB reported a Sufficiency Ratio

of 66%. Had the methodology of the new Regulation been retrospectively applied, the sufficiency ratio would have been 63.0%.

The WSIB's operational and financial performance was strong in 2013, as illustrated in **Figure 9**, which provides a summary of its operating results and unfunded liability compared to 2012.

The strong performance in 2013 was due to growth in premium revenues and improved return-to-work outcomes, better-than-expected investment returns (12.7% versus the target of 6.0%), and a one-time increase in the employee pension liability discount rate used to value the WSIB's employee benefits liabilities.

However, the WSIB's ability to achieve the prescribed funding Sufficiency Ratios and continue its strong financial performance remains subject to considerable uncertainty. For example, the WSIB notes that 57% of its comprehensive income is considered unusual and non-recurring in nature, and caution must be exercised in projecting current financial results into the future.

As a result of the government's and the WSIB's commitments to and progress in addressing the unfunded liability, we supported the continued classification of the WSIB as a trust for the 2013/14 fiscal year, and therefore the exclusion of the unfunded liability from the province's liabilities. However, we will continue to monitor its progress on meeting the required funding sufficiency ratios and re-evaluate our position as necessary.

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 under the *Energy Competition Act, 1998*, with the 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 or OPG.

OEFC inherited $38.1 billion in total debt and other liabilities from Ontario Hydro when the

Figure 9: Workplace Safety and Insurance Board Operating Results and Unfunded Liability, 2012–2013 ($ million)
Source of data: WSIB Financial Statements and WSIB Fourth Quarter 2013 Report to Stakeholders

	2012	2013
Revenue		
Premiums	4,106	4,387
Net investment income	1,459	2,042
	5,565	**6,429**
Expenses		
Benefit costs	3,782	2,873
Loss of Retirement Income Fund contributions	67	62
Administration and other expenses	333	361
Legislated obligations and commitments	276	286
Remeasurement of employee defined benefit plans	163	(840)
	4,621	**2,742**
Comprehensive Income (Loss)	**944**	**3,687**
Unfunded Liability	**14,061**	**10,638**

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 included dedicating revenue streams to OEFC to help pay down this debt:

- Future revenue streams from payments in lieu of taxes made by the electricity-sector companies (OPG, Hydro One and the municipal electrical utilities), and 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, which were estimated at a present value of $13.1 billion.
- 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 dual structure was intended to eliminate the stranded debt in a prudent manner while sharing 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 approximately $950 million a year in DRC revenue. As of March 31, 2014, approximately $11.5 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 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 in our *2011 Annual Report*, the Minister had made no such public determination of the outstanding amount of the residual stranded debt, since April 1, 1999. 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 reducing 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*.

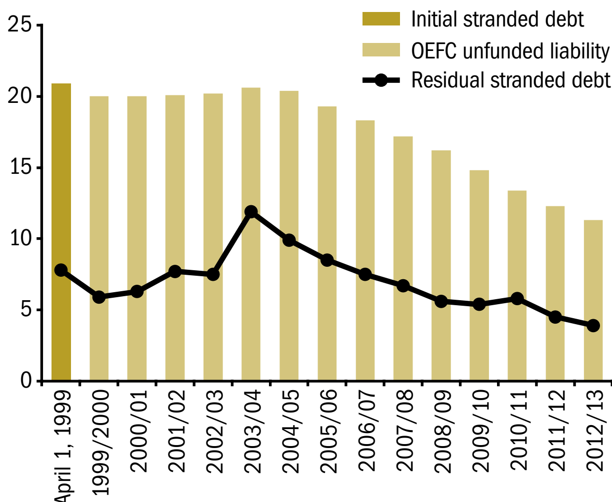
Commencing with the 2012 Ontario Budget, the government has provided annual updates of the residual stranded debt. The most recent update

in the 2013 Ontario Economic Outlook and Fiscal Review repeated in the 2014 Ontario Budget presented the Exhibit, illustrated in **Figure 10**, reflecting annual residual stranded debt estimates from April 1, 1999, to March 31, 2013.

The 2013 Ontario Economic Outlook and Fiscal Review reported $3.9 billion of residual stranded debt as at March 31, 2013, and estimated the residual stranded debt would likely be retired between 2015 and 2018. On April 23, 2014, the government announced its intention to remove the DRC from residential users' electricity bills after December 31, 2015. The proportion of the residential rate class contribution to the DRC is approximately one-third, with commercial, industrial and institutional users contributing the remaining two-thirds. The charge would remain on all other electricity users' bills until the residual stranded debt is retired; the government estimated this will occur by the end of 2018, as per the 2014 Ontario Budget, in line with the previous estimate.

Figure 10: Residual Stranded Debt and OEFC Unfunded Liability for Each Fiscal Year Since 1999 ($ billion)

Source of data: 2014 Ontario Budget



MINISTRY RESPONSE

As the Ministry of Finance noted in its response to the Auditor's General's *2011 Annual Report*, the Ministry began moving forward in 2011 with a regulation under the *Electricity Act, 1998* (Act), on the requirement for an annual determination by the Minister of Finance of the residual stranded debt. An annual determination of residual stranded debt has been provided since then, starting with the determination as at March 31, 2011, which was provided in a news release on May 15, 2012. The Auditor General reports in 2012 and 2013 noted that the Auditor General was pleased to see increased transparency with respect to public reporting on the residual stranded debt.

The residual stranded debt has been reduced by an estimated $8 billion, from an estimated peak of $11.9 billion as at March 31, 2004, to $3.9 billion as at March 31, 2013, as published in the 2013 Ontario Economic Outlook and Fiscal Review. The Minister of Finance will continue to report annually on the residual stranded debt.

The Ministry of Finance also concurred with the Auditor General's 2011 report with respect to the Ontario Electricity Financial Corporation (OEFC) being in compliance with the Act in the use of Debt Retirement Charge (DRC) revenues. DRC revenues are used by the OEFC to perform its objectives under the Act, including servicing and retiring its debt and other liabilities. The OEFC's expenses included interest payments of about $1.45 billion in the 2013/14 fiscal year. On April 23, 2014, the government announced that it is proposing to remove the DRC cost from residential users' electricity bills after December 31, 2015, once the Ontario Clean Energy Benefit ends.

The DRC is to remain on all other electricity users' bills until the residual stranded debt is retired, and the 2014 Ontario Budget provided an estimate that this would occur by the end of 2018. The estimated timing for residual stranded debt retirement is subject to uncertainty in forecasting future OEFC results and dedicated revenues to OEFC, which depend on the financial performance of Ontario Power Generation, Hydro One and municipal electricity utilities, as well as other factors such as future tax rates, interest rates and electricity consumption.

Update on the Pension Benefits Guarantee Fund

As discussed in our *2013 Annual Report*, the government has taken a number of steps over the past few years to place the Pension Benefits Guarantee Fund (PBGF) on a more stable footing. We commented that while the build-up of reserves in the PBGF was encouraging, considerable risk remained, given the PBGF's history of requiring government financial assistance and the precarious state of many of the defined-benefit plans in the province. However, we noted that the risk was mitigated by amendments made to the *Pension Benefits Act* in 2009 that specified that the PBGF's liabilities are limited to its assets. In 2010, the Ontario government provided the PBGF with a $500-million grant in order to stabilize the PBGF's financial position and pay its claims. Even though the 2009 legislation limits the province's responsibility to fund PBGF liabilities, it continued to provide assistance for the PBGF to cover its claims.

This year our Office conducted a value-for-money audit on the Financial Services Commission of Ontario—Pension Plan and Financial Service Regulatory Oversight. The audit comments on the PBGF can be found in Section 3.03 of this report.

Use of Legislated Accounting Standards

As discussed in our *2013 Annual Report*, some Canadian governments have begun to legislate specific accounting treatments in certain circumstances rather than applying independently established accounting standards. This includes the Ontario government, which several times in recent years has passed legislation or amended regulations to enable it to prescribe accounting policies for its public-sector entities.

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

- The *Investing in Ontario Act, 2008* (Act) and related regulations allowed the government to provide additional transfers to eligible recipients from unplanned surpluses reported in its consolidated financial statements. Any transfers made under 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. The *Education Act* amendments specified that the government could prescribe accounting standards for Ontario school boards to use in preparing financial statements. The *Financial Administration Act* amendments allow the government to specify accounting standards to be used by any public or non-public entity whose financial statements are included in the province's consolidated financial statements.
- In 2011, a regulation under the *Financial Administration Act* directed Hydro One, a fully owned Ontario government business enterprise, to prepare its financial statements in accordance with U.S. generally accepted accounting principles effective January 1, 2012. The government has since provided the same direction to Ontario Power Generation Inc. (OPG), another fully owned government business enterprise. American accounting rules allow rate-regulated entities such as Hydro One and OPG to defer current expenses

for recognition in future years; the government's direction to adopt these U.S. rules came in anticipation of the planned Canadian adoption of International Financial Reporting Standards (IFRS), which currently do not allow for such deferrals.

- Ontario government regulations now require transfers for capital acquisitions and transfers of tangible capital assets to be accounted for by transfer recipients as deferred contributions. The deferred amounts are to be brought into revenue by transfer recipients at the same rate as they recognize amortization expense on the related assets. We have historically supported this accounting because we believe that it best reflects the economic reality of the underlying transactions and it complies with generally accepted accounting principles. However, PSAB standards in this area are being interpreted differently by many stakeholders.
- The *Strong Action for Ontario Act (Budget Measures), 2012*, further amended the *Financial Administration Act*. These amendments provided the government with full authority to make regulations regarding the accounting policies and practices used to prepare its consolidated financial statements.

To maintain its financial credibility, we believe it is critical that Ontario continue to prepare its financial statements in accordance with generally accepted accounting standards, specifically those set by PSAB, as most other governments in Canada do.

As the auditor of these 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 the government's reported deficit or surplus under legislated accounting standards is materially different than what it would be under generally accepted accounting principles, I will have no choice but to include a reservation in my audit opinion. My Office has been able to issue "clean" opinions on the government's financial statements for the past 21 consecutive years. I am hopeful that this will continue to be the case. We will continue to raise this matter in our Annual Reports.

Significant Accounting Issues

There are five significant accounting issues relating to our audit of the province's consolidated financial statements that we wish to bring to the Legislature's attention. Three of these are driven by accounting standard changes that will impact the way the province accounts for financial instruments, rate-regulated expenditure deferrals and liabilities for contaminated sites. The other two—retirement benefits expenses and corporation tax revenues estimates—relate to complex transactions materially affecting the province's fiscal results that present unique auditing challenges. We discuss these five areas in the following.

Financial Instruments

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

In March 2011, PSAB approved a new public-sector accounting standard on financial instruments, effective for fiscal periods beginning on or after April 1, 2015. The new standard provides guidance on the recognition, measurement, presentation and disclosure of government financial instruments, and is similar to comparable private-sector standards.

One of its main requirements is for certain financial instruments, including derivatives, to be recorded at fair value, with any unrealized gains or losses on these instruments recorded annually in a new financial statement of remeasurement gains and losses.

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

In response to governments' concerns, PSAB committed to reviewing the new financial instruments standard by December 2013. PSAB completed its review of Section PS 2601, *Foreign Currency Translation*, and Section PS 3450, *Financial Instruments*, and in February 2014 confirmed the soundness of the principles underlying the new standard. In short, PSAB does not intend to change the standard, despite the governments' concerns. However, it did defer the effective date for these new standards to fiscal years beginning on or after April 1, 2016.

We fully expect the Ontario government will account for its financial instruments in accordance with the new PSAB standards in 2016, and have requested the Treasury Board Secretariat to keep us informed of any significant issues identified as it works to implement them. We have recommended that the Treasury Board Secretariat assess the province's current accounting practices against the new standards in order to identify areas where the accounting practices may need to change and the potential impact of such change. We have also recommended early and continuous dialogue between our respective Offices to review areas where there may be possible differences in interpretation to ensure all matters are resolved before implementation of the new standards is required.

MINISTRY RESPONSE

The province made a submission to PSAB detailing the impact of PS 2601 and PS 3450 on its current accounting practices and fiscal results. The submission has been shared with the Office of the Auditor General and indicates that upon implementation both PS 2601 and PS 3450 will materially impact the province's fiscal results as well as the year-to-year volatility in both interest on debt and net debt.

The province notes that the International Accounting Standards Board issued IFRS 9, its standard on accounting for derivative instruments. The standard allows for the implementation of hedge accounting, which together with the other provisions in the standard appear to address the majority of the issues raised by the province. As such, we would welcome an effort by PSAB to review both PS 2601, Foreign Currency Translation, and PS 3450, *Financial Instruments*, with an objective of ensuring a closer alignment with IFRS 9. The Treasury Board Secretariat will work with the Office of the Auditor General as it continues to bring its concerns forward to PSAB.

Rate-regulated Accounting

Over the past few years, we have raised concerns about the appropriateness of recognizing rate-regulated assets and liabilities in the province's consolidated financial statements. Rate-regulated

accounting practices were developed to recognize the unique nature of regulated entities such as electricity generators, transmitters and distributors.

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

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

PSAB standards allow OPG and Hydro One, which are defined as government business enterprises, to be included in the province's consolidated financial statements without adjusting their accounting policies to remove the impact of rate-regulated accounting. The impact of this allowance is significant; for example, OPG recognized $2.1 billion in net rate-regulated assets as of March 31, 2014. We have accepted this accounting treatment as allowable under Canadian generally accepted accounting principles, even though on principle we question whether rate-regulated assets should be considered *bona fide* assets for the purposes of the government's consolidated financial statements.

In recent Annual Reports we have commented that the era of rate-regulated accounting appeared to be ending for jurisdictions such as Canada that were converting to International Financial Reporting Standards (IFRS). Our comments were based on the fact that, in January 2012, Canada's AcSB reaffirmed that all government business enterprises should prepare their financial statements in accordance with IFRS for fiscal years beginning on or after January 1, 2012. At that time no standard specifically addressed rate-regulated activities, and by default therefore IFRS standards did not permit rate-regulated accounting.

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

In May 2013, the AcSB issued an exposure draft proposing to incorporate a new standard on regulatory deferral accounts based on a recently issued IASB exposure draft. The exposure draft proposed an interim standard for use by first-time adopters of IFRS with activities subject to rate regulation until the IASB completes its comprehensive rate-regulated activities project, which could take several years. In September 2013, the mandatory IFRS changeover date for entities with qualifying rate-regulated activities was extended once again, to January 1, 2015.

In January 2014, the IASB issued an interim standard, IFRS 14, *Regulatory Deferral Accounts*. This eased the adoption of IFRS by a rate-regulated entity by allowing it to continue to apply existing policies for its regulatory deferral account balances upon adoption of IFRS starting on January 1, 2015. Essentially, the interim standard provides a first-time adopter of IFRS with relief from having to derecognize their rate-regulated assets and liabilities until the IASB completes its comprehensive project on accounting for such assets and liabilities. However, the standard does require a rate-regulated entity to provide financial statements that present the results as if it were not applying rate-regulated accounting, with one-line adjustments at the bottom of the balance sheet and income statement showing the net effect of rate-regulated accounting. The

AcSB has confirmed that Canadian rate-regulated entities must adopt IFRS for fiscal periods beginning on or after January, 1 2015.

With the uncertainty regarding rate-regulated accounting, the Ontario government passed a regulation in 2011 allowing for and subsequently directing both Hydro One and OPG to prepare their financial statements in accordance with U.S. accounting standards. These standards specifically require rate-regulated entities to use rate-regulated accounting. However, as noted previously, Hydro One and OPG are recorded in the province's consolidated financial statements using Canadian generally accepted accounting principles that include rate-regulated accounting standards recommended by PSAB and AcSB.

Rate-regulated accounting would have an impact on the government's financial statements. Future reporting under IFRS that does not accommodate rate-regulated accounting may increase the volatility of Hydro One and OPG's annual operating results, which in turn could result in volatility of the Province's annual deficit (surplus), and this could impact the government's revenue and spending decisions.

Since the government controls both the regulator and the regulated entities in question, it has significant influence on which electricity costs the regulated entities will recognize in any given year, which could ultimately impact electricity rates and the annual deficit or surplus reported in the province's consolidated financial statements.

If the government continues to direct OPG and Hydro One to use U.S. generally accepted accounting principles in preparing their financial statements, and continues to use Canadian generally accepted accounting principles to prepare the province's consolidated financial statements, we will need to assess the differences that result from the government not following the accounting standards espoused by PSAB and AcSB. These differences will need to be quantified, and if material we would most likely treat them as errors in the consolidated financial statements.

My Office will work with the Office of the Provincial Controller to plan for any changes related to the consolidation of Hydro One and OPG as a result of changes in accounting standards.

Liability for Contaminated Sites

Contamination is the introduction into air, soil, water or sediment of a chemical, organic or radioactive material or live organism that exceeds an environmental standard. Contamination can come from many different sources, including commercial or industrial activity, waste disposal, improper chemical or fuel storage, and spills or leaks. Areas of land or water that are affected by hazardous waste or pollution in concentrations that exceed the maximum acceptable amounts under an environmental standard are referred to as contaminated sites. In many cases these sites were contaminated by prior activities whose environmental impacts were not understood or considered at the time.

Remediating a contaminated site refers to the actions taken to reverse or stop the damage being caused to the environment and human health. The actions may range from removing the hazardous material to managing the problem by restricting access, for instance by building a fence around it. The ultimate objectives of remediation are to remove the contaminant, minimize its risks to the environment and to the public, and allow for future use of the site.

PSAB issued a new standard, PS 3260, *Liability for Contaminated Sites*, for accounting for and reporting liabilities associated with site remediation. The new standard is effective for fiscal years beginning on or after April 1, 2014. The province plans to recognize these liabilities in the province's March 31, 2015, consolidated financial statements. We concur with the Secretariat's proposal to implement this standard retroactively with no restatement of prior periods, and agree it is supported by Section PS 2120, *Accounting Changes*.

A liability for remediation of contaminated sites must be recognized when, as of the financial reporting date, all of the following criteria are satisfied:

- an environmental standard exists;
- contamination exceeds the environmental standard;
- the government or government organization is directly responsible or accepts responsibility;
- it is expected that future economic benefits will be given up; and
- a reasonable estimate of the amount can be made.

The new standard may significantly increase the amount of liabilities that will be recorded in the province's March 31, 2015, consolidated financial statements. The Office of the Provincial Controller Division (OPCD) of the Secretariat has the lead responsibility for implementing the new standard, and in December 2013 it outlined for us the approach it plans to use to identify and manage contaminated sites. It has been working closely with the five key ministries that own government land: the Ministry of Environment and Climate Change, Ministry of Economic Development, Employment and Infrastructure, Ministry of Natural Resources and Forestry, Ministry of Northern Development and Mines, and Ministry of Transportation. This co-ordinated approach should help in the identification of contaminated sites and in encouraging that funding for remediation is first directed at those sites with the greatest risk to the environment and public safety.

The standard will not be easy to implement because it may require the considerable use of site assessors, engineers and other specialists to determine if and how badly a site is contaminated. It will take time to establish the government's inventory of sites, and even more time to populate it with information sufficient to allow the government to reasonably estimate its future remediation costs. We expect the number of sites to be significant and the potential liabilities to be large. Therefore, our Office will work closely with OPCD over the coming year to assess whether the standard is implemented effectively and to ensure the estimated liability is appropriate.

Public Service Non-pension Retirement Benefits

In the latter part of the 2013/14 fiscal year, the government announced changes to its non-pension retirement benefits for Ontario public servants who receive a pension from the Public Service Pension Plan or Ontario Public Service Employees Union Pension Plan.

Under these changes, the government will transition to a benefits cost-sharing model from a full-cost model for employees retiring on or after January 1, 2017. The new model requires these retirees to pay 50% of their premiums for health, life and dental benefits; the government currently pays 100% of these premiums. The eligibility period for these benefits will also increase from 10 years to 20 for employees hired on or after January 1, 2017.

The government introduced these changes as part of its measures to manage compensation costs in order to achieve its annual deficit targets and balance Ontario's budget by 2017/18. The government also said these changes would bring public service retirement benefits more in line with practices in the private sector and other jurisdictions.

In accordance with PSAB standards, the province has accounted for the changes to retiree benefits as a plan amendment. Accordingly, the estimated actuarial gain of $1.1 billion arising from these changes reduced the future obligations to pay these benefits. For accounting purposes, this gain was recorded as a reduction in benefit expenses in the province's March 31, 2014, consolidated financial statements and was fully offset by unamortized experience losses of $1.1 billion; therefore, it had no fiscal impact on the 2013/14 deficit. The province's decision to make changes to retiree benefits will however reduce benefit expenses in future years.

We considered the evaluation of and accounting for this transaction could have a high audit risk due

to the potential impact of the gain on the province's annual deficit. Accordingly, we engaged our own actuary expert to review the plan's report, the underlying assumptions and the benefit obligation calculations to confirm that the actuary estimates used in the plan were reasonable and met the standards of the Canadian Institute of Actuaries. This was in addition to the standard audit procedures we perform each year to assess the reasonableness of the retiree benefits obligation and expense calculations the government uses in preparing the province's consolidated financial statements and to confirm, among other things, that the projected benefit obligation calculations were prepared in accordance with PSAB accounting standards.

Based on our audit work, we were satisfied that the government has accounted for the changes to public service non-pension retiree benefits in accordance with PSAB accounting standards and that the estimated gain amount was determined appropriately.

Corporations Tax Revenue Estimate

Corporations carrying on business through a permanent establishment in Ontario must pay both federal and Ontario corporate taxes. Provincial corporations tax revenue is a significant source of total provincial revenues, as shown in **Figure 11**.

The federal government has administered Ontario's corporations tax since January 1, 2009. This single administration of corporate tax was introduced to streamline the tax system for businesses and reduce the compliance burden on Ontario corporations. Previously, corporations filed taxes with both Ontario's Ministry of Finance and the federal government's Canada Revenue Agency (CRA). Under single administration, Ontario corporations file only one tax return for both federal and provincial taxes with the CRA, which in turn assesses the taxes and remits Ontario's portion to the province. Ontario still retains administrative responsibility for two minor components of corporate tax: insurance premiums tax, paid primarily by insurance companies, and corporations' tax assessed in the current year for tax years 2008 and prior. The latter of these two amounts will eventually disappear.

Figure 11: Corporations Tax Revenue and Total Revenues, 2009/10–2013/14 ($ million)

Source of data: Province of Ontario Consolidated Financial Statements

Fiscal Year	Corporations Tax Revenue	Total Revenues
2013/14	11,423	115,911
2012/13	12,093	113,369
2011/12	9,944	109,773
2010/11	9,067	107,175
2009/10	6,135	96,313

The federally administered Ontario corporate tax represents a significant component of corporations tax revenue in Ontario. It is paid in instalments throughout the year based on the federal government's estimate of amounts owing to the province. The province has relied solely on the payments it receives from the federal government to record this component of corporations tax revenue in the province's consolidated financial statements. Because the federal government estimate is being made before the completion of the tax year, the federal government adjusts its earlier corporate tax revenue estimate. Final amounts assessed for the current tax year are not known until tax returns are processed in the following calendar year and finalized subsequent to that calendar year. A final adjustment payment for the tax year is made after this.

Since the federal government began administering Ontario's corporate taxes in 2009, corporations tax revenue reported in the province's consolidated financial statements has been lower than the amount that is ultimately earned by the province (owed by corporations) in three of the past four years, as shown in **Figure 12**. The differences are driven entirely by the difference in the estimates made by the federal government and the final entitlement amounts it determines at a later date.

Figure 12: Additional Federal Government Payments (Deductions) by Fiscal Year—Corporation Tax Revenue ($ million)

Source of data: Province of Ontario Consolidated Financial Statements and Office of the Auditor General of Ontario

Fiscal Year	Under (Over) Catch-up Payment (Deduction)
2010/11	682
2011/12	1,135
2012/13	1,998
2013/14	(6)

These corporate tax catch-up payments (deductions) for prior year underpayments (overpayments) are recorded in the province's consolidated financial statements in the fiscal year the payments are received or deducted. This accounting treatment is in accordance with PSAB standards on accounting for changes in an estimate; corporations tax revenue is such an accounting estimate.

A number of factors contribute to the difficulty in making a more accurate corporations tax revenue estimate. The estimation methodology is quite complex and requires input from all provinces and territories whose taxes are administered federally, the federal Department of Finance and the Canada Revenue Agency. In general, the federal government determines provincial and territorial entitlements based on its estimation of Canada-wide taxable income, provincial shares of corporate taxable income, jurisdictional tax rates and projected corporate profit growth. It then pays instalments to the provinces and territories based on these estimates. A small estimation difference in any of these factors can have a significant impact to the corporations tax revenue estimate calculated for Ontario due to its size and its corporations' financial profile.

The final amount Ontario is entitled to receive for a particular tax year is typically known about 18 months after the end of the tax year in question and after that year's corporations tax is recorded in the province's consolidated financial statements. Once the final tax assessments have been processed, a catch-up payment is made or a recovery payment is requested to close off a particular tax year. For example, in the 2013/14 Public Accounts, the federal government is predicting the actual final corporation tax assessments for the 2013 tax year 18 months before the actual figures are available, and pays the provinces and territories accordingly on the basis of that estimate.

Clearly, there is significant uncertainty with this estimate, given historical variances, but the Ministry of Finance does not believe it has at present a more accurate and reliable basis for estimating its corporations tax revenue entitlement. As well, because the province does not have direct access to the information the federal government uses to estimate Ontario corporations tax revenue, both the Ministry of Finance and our Office face significant challenges in assessing whether the corporations tax payments remitted to Ontario based on the federal estimate are the best estimate of the corporations tax revenue due to Ontario at the end of each fiscal year.

My Office has been working with the Ontario Ministry of Finance to determine whether there are better ways to estimate and verify corporate tax revenue. The Ministry has also been working with its federal counterparts to determine the causes of significant underpayments and whether the federal government's estimation process can be improved. We will continue to work with the Ministry of Finance on this matter and encourage the Ministry to work with the federal government to improve upon the annual year-end corporate tax revenue estimate.

Potential Changes to the Standard Audit Report

The International Auditing and Assurance Standards Board (IAASB) is proposing significant changes to the current standard for audit reports on financial statements. This new standard would require auditors to provide more information in

their report on the organization, its financial statements, and the nature of the audit work performed. These proposed changes have been endorsed by the Audit and Assurance Standards Board (AASB), which sets Canadian auditing standards for financial statements. (As part of the strategy to harmonize Canadian accounting and auditing standards with international standards, the AASB incorporates new standards issued by the IAASB into its Canadian auditing standards as they are updated, making any necessary revisions to reflect circumstances in Canada.)

Currently, a financial statement audit report is generally a short, standardized report that describes the financial statements audited, the audit work performed, and the responsibilities of both management and the auditor. The auditor's opinion will either be "clean" (unmodified), indicating management has received a passing grade from the auditor, or it will contain a reservation (modified) along with an explanation for a failing grade.

One of the IAASB's key proposals is that the auditor's report for certain organizations, including reports issued on government financial statements, include a new section to communicate key audit matters that in the auditor's professional judgment were of most significance to the audit of the financial statements. These could include:

- areas identified as significant risks or involving significant management or auditor judgment;
- areas in which the auditor encountered significant difficulty, for instance in obtaining sufficient and appropriate audit evidence; and
- circumstances that required a modification to the auditor's planned audit approach, including as a result of a significant deficiency in internal control.

The 2013 IAASB exposure draft, *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing* applies to organizations whose shares, stock or debt are listed or quoted on a stock exchange for public trading. Nevertheless, the proposed standards do not restrict auditors from including key audit matters in their reports on the financial statements of non-listed entities.

We currently communicate key audit matters arising from our audit of the province's consolidated financial statements in this chapter of our annual report.

The final version of the new international standard on auditing, ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, is expected to be issued in late 2014, and would affect financial statement reporting periods beginning on or after December 15, 2015. Once this new standard is endorsed by Canadian standard-setters, it would apply to the audit of the province's March 31, 2017, consolidated financial statements.

Public Sector Accounting Board Initiatives

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

Concepts Underlying Financial Performance

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

objective is to review the appropriateness of the concepts and principles in the existing conceptual framework for the public sector.

The task force's first step was to seek input from stakeholders on the building blocks of the conceptual framework; these will form the basis for evaluating the existing concepts underlying the measurement of financial performance. To this end, the task force has issued two consultation papers: *Characteristics of Public Sector Entities* and *Measuring Financial Performance in Public Sector Financial Statements*. Respondents to these consultation papers were in general agreement with the key proposals.

The task force's next step is to issue a third consultation paper focusing on the proposed definitions of the elements of financial statements, such as assets, liabilities, revenues and expenses. PSAB plans to issue the consultation paper in the second half of 2015.

Improvements to Not-for-profit Standards

The Accounting Standards Board (AcSB) and PSAB initiated a project in 2011 to improve accounting standards for not-for-profit organizations, including government not-for-profit organizations. These standards are followed by many organizations funded by the Ontario government. In April 2013, the Joint Not-for-Profit Task Force established to lead this project issued a statement of principles containing 15 proposals, the most significant of which included:

- Contributions received would be immediately recognized as revenue, unless the terms of the contribution give rise to an obligation that met the definition of a liability.
- Government not-for-profit organizations would present "net debt" indicators, a statement of net debt as well as budgeted information.
- Government not-for-profit organizations would follow the guidance in CPA Canada's *Public Sector Accounting Handbook* on the capitalization, amortization, write-down and disposal of tangible capital assets.
- Intangibles, works of art and historical treasures (including collections), and economic interests would continue to be recognized on the financial statements.

The statement of principles has generated high levels of interest from stakeholders in the public and private not-for-profit sectors because its proposals are expected to have far-reaching implications on the financial statements of not-for-profit organizations. For example, the statement of principles proposes to remove the not-for-profit organization's ability to defer capital contributions and recognize these amounts in revenue on a basis consistent with the amortization recorded on the related tangible capital asset. The statement of principles proposes that capital contributions should be recorded in revenue except in those circumstances where the contribution gives rise to an obligation that meets the definition of a liability. Many not-for-profit organization stakeholders are concerned that the organization's annual results will be distorted if it is not allowed to follow the traditional accounting practice of deferring capital contributions over the useful life of the related tangible capital asset. As well, the proposed change will challenge the province of Ontario's ability to hold its controlled government not-for-profit organizations accountable for balanced budgets in those later years when amortization is recorded on the tangible capital asset for which the capital contribution was recorded in revenue in an earlier period. The AcSB and PSAB received approximately 300 comment letters on this topic. They are analyzing this feedback and considering the next steps in the process.

Assets

Assets are one of the most critical elements of the financial statements. Asset recognition affects not only the statement of financial position, but also

directly impacts revenues, expenses, surplus/deficit and other elements of the financial statement.

Currently, the PSAB accounting standards define assets as "economic resources controlled by a government as a result of past transactions or events and from which future economic benefits are expected to be obtained." PSAB acknowledged that the current guidance on this topic is limited and proposed to provide further guidance to help preparers and auditors determine whether an item meets the current definition of an asset.

In August 2013, PSAB issued a statement of principles that proposed additional guidance on assets, contingent assets and contractual rights. The statement of principles proposed:

- additional guidance on the definition of assets;
- disclosure requirements for assets; and
- definitions and standards on disclosure requirements for contingent assets and contractual rights.

The comment period ended in November 2013; based on the feedback, PSAB issued an exposure draft in August 2014 proposing three new standards: *Assets, Contingent Assets and Contractual Rights*.

There has been general support for the proposed principles and guidance in the statement of principles. The exposure draft proposes:

- enhanced guidance on the definition of assets;
- information about the types of assets that are not reported should be disclosed;
- contingent (possible) assets should be disclosed; and,
- contractual rights to future assets and revenues should be disclosed.

PSAB is seeking comments on the exposure draft until November 3, 2014.

Asset Retirement Obligations

The objective of this project is to develop a standard that addresses the reporting of legal obligations associated with the retirement of long-lived tangible capital assets currently in productive use. For example, there may be obligations associated with decommissioning an electricity generating facility.

PSAB issued a statement of principles in August 2014 that proposes a new section on retirement obligations associated with tangible capital assets controlled by a public-sector entity. The main features of this statement of principles are as follows:

- A retirement obligation should be recognized when there is a legal, constructive and equitable obligation to incur retirement costs in relation to a tangible capital asset.
- Upon initial recognition, the entity would increase the carrying amount of the related tangible capital asset by the same amount as the liability. Therefore, the initial recognition of an asset retirement obligation will increase net debt reported by a public-sector entity.
- The estimate of a liability for retirement obligation should include costs directly attributable to retirement activities, including post-retirement operation, maintenance and monitoring.
- A present value technique is often the best method with which to estimate the liability.
- The carrying amount of the liability for a retirement obligation should be reviewed at each financial reporting date.
- Subsequent remeasurement of the liability can result in either a change in the carrying amount of the related tangible capital asset or an expense.

PSAB asked stakeholders to submit comments on the statement of principles by November 21, 2014.

Related Party Transactions

PSAB initiated a project in September 2010 with the objective of issuing a new accounting standard that defines a related party in the context of the public sector and describes the measurement and disclosure requirements for related parties and related party transactions. Transactions between related parties may not be conducted under the same terms as in transactions between unrelated parties;

detailed disclosures allow users to assess the effect of related party transactions on a reporting entity's financial position and financial performance.

Following the publication of several documents for comment, including an exposure draft and a re-exposure draft, PSAB issued a second re-exposure draft for public comment earlier this year. This new re-exposure draft proposes to create two *Public Sector Accounting Handbook* sections on related party transactions: *Related Party Disclosures* and *Inter-entity Transactions*.

The objective of the first proposed section, *Related Party Disclosures*, is to define a related party and to provide guidance on disclosing sufficient information about the terms and conditions of related party transactions. The key proposals included in this section are:

- A related party exists when one party has the ability to exercise control or shared control over the other. Two or more parties are related when they are subject to common control or shared control.
- Individuals who are members of key management personnel and close members of their family are included in the definition of related parties; however, the standard would not require disclosure of key management personnel compensation arrangements, expense allowances and other similar payments routinely paid in exchange for services rendered. The determination of whether an individual is included in key management personnel requires judgment.
- Two entities that have a member of key management personnel in common may be related depending upon that individual's ability to affect the policies of both entities in their mutual dealings.
- Disclosure should include adequate information about the nature of the relationship with related parties involved in related party transactions, including the types of related party transactions that have been recognized, the amounts of the transactions classified by financial statement category; the basis of measurement used, the amount of the outstanding balances at period end, and the terms and conditions attached to these balances.
- Disclosure is required only when transactions and events between related parties have or could have a material financial effect on the financial statements.
- Determining which related party transactions to disclose and the level of detail to provide is a matter of judgment.

The purpose of the second section, *Inter-entity Transactions*, is to provide guidance on how to account for transactions that take place between organizations under the common control of a government entity. The most significant proposals are:

- Inter-entity transactions occurring in the normal course of operations and on similar terms and conditions to those adopted if the entities were dealing at arm's length should be recorded at the exchange amount. Transactions in the normal course of business generally relate to ongoing operating revenues and expenses and do not include the transfer of assets or liabilities.
- Transfers of assets or liabilities between entities are measured based on the amount of the consideration received in exchange:
  - if the consideration received approximates the fair value of the assets or liabilities transferred, the transaction should be measured at the exchange amount;
  - if the consideration received is nominal or nil, the transaction should be measured at the carrying amount by the provider and at the carrying amount or fair value by the recipient; and
  - in all other instances, the transaction should be measured at the carrying amount.
- Allocated costs and recoveries should be measured at the exchange amount.

PSAB accepted feedback on the revised proposals until mid-September 2014.

Statutory Matters

Under Section 12 of the *Auditor General Act*, the Auditor General is 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 the Auditor General report on any transfers of money between items within the same vote in the Estimates of the Office of the Assembly.

Legislative Approval of Expenditures

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

After the Orders for Concurrence are approved, the Legislature still needs to provide its final approval for legal spending authority by approving a Supply Act, which stipulates the amounts that can be spent by ministries and legislative offices, as detailed in the estimates. Once the Supply Act is approved, the expenditures it authorizes are considered to be Voted Appropriations. The *Supply Act, 2014*, which pertained to the fiscal year ended March 31, 2014, received Royal Assent on March 3, 2014.

The Supply Act does not receive Royal Assent until after the start of the fiscal year—and sometimes even after the related fiscal year is over—so the government usually requires interim spending authority prior to its passage. For the 2013/14 fiscal year, the Legislature passed the *Interim Appropriation for 2013-2014 Act, 2013* (Interim Act). The Interim Act received Royal Assent on June 13, 2013, and authorized the government to incur up to $116.3 billion in public service expenditures, $4.2 billion in investments, and $199.6 million in legislative office expenditures. The Interim Act was made effective as of April 1, 2013.

The Interim Act provided the government with sufficient authority to allow it to incur expenditures from April 1, 2013, to when the *Supply Act, 2014*, received Royal Assent on March 3, 2014. The spending authority provided under the Interim Act was intended to be temporary, and it was repealed when the *Supply Act, 2014*, received Royal Assent. The *Supply Act, 2014*, also increased total authorized expenditures of the legislative offices from $199.6 million to $203.9 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, 2014.

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 published and tabled in the Legislature.

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

Figure 13 summarizes the total value of Treasury Board Orders issued for the past five fiscal years.

Figure 14 summarizes Treasury Board Orders for the fiscal year ended March 31, 2014, 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 2013/14 fiscal year are expected to be published in *The Ontario Gazette* in December 2014. A detailed listing of 2013/14 Treasury Board Orders, showing the amounts authorized and expended, is included as Exhibit 4 of this report.

Figure 13: Total Value of Treasury Board Orders, 2009/10–2013/14 ($ million)

Source of data: Treasury Board

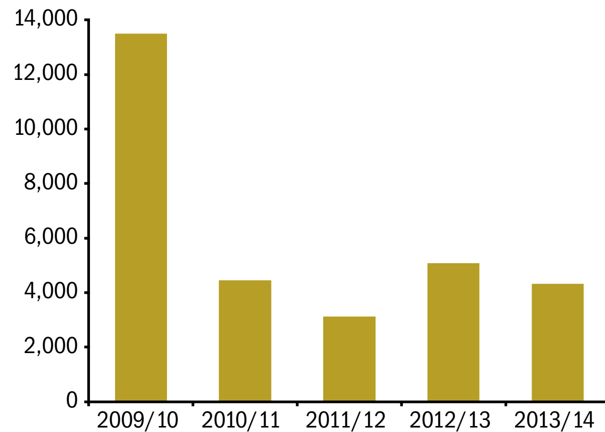


Figure 14: Total Value of Treasury Board Orders by Month Relating to the 2013/14 Fiscal Year

Source of data: Treasury Board

Month of Issue	#	Authorized ($ million)
April 2013–February 2014	46	2,180
March 2014	35	1,427
April 2014	16	318
July 2014	1	407
Total	**98**	**4,332**

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 15** shows the transfers made within Vote 201 with respect to the 2013/14 Estimates.

Figure 15: Authorized Transfers Relating to the Office of the Assembly, 2013/14 Fiscal Year ($)
Source of data: Board of Internal Economy

From:		
Item 6	Sergeant at Arms and Precinct Properties	(18,500)
To:		
Item 3	Legislative Services	18,500

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 2013/14 fiscal year, receivables of $390.1 million due to the Crown from individuals and non-government organizations were written off. (The comparable amount in 2012/13 was $395.8 million.) The write-offs in the 2013/14 fiscal year related to the following:

- $146.7 million (2012/13 – $92.1 million) for uncollectible retail sales tax;
- $104.3 million (2012/13 – $60.4 million) for uncollectible corporate tax;
- $68.0 million (2012/13 – $86.5 million) for uncollectible receivables under the Student Support Program;
- $15.8 million (2012/13 – $15.1 million) for uncollectible employer health tax;
- $8.6 million (2012/13 – $48.0 million) for uncollectible receivables under the Ontario Disability Support Program;
- $6.6 million (2012/13 – $7.7 million) for uncollectible receivables related to two bankrupt nursing homes; and
- $40.1 million (2012/13 – $86.0 million) for other tax and non-tax receivables.

Volume 2 of the 2013/14 Public Accounts summarizes the writeoffs by ministry. Under the accounting policies followed in the preparation of the province's consolidated financial statements, a provision for doubtful accounts is recorded against accounts receivable balances. 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.