February 2017


# THE 2015/16 PUBLIC ACCOUNTS AND THE AUDITOR GENERAL'S FINDINGS

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The Honourable Linda Reid
Speaker of the Legislative Assembly
Province of British Columbia
Parliament Building
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Dear Madame Speaker:

I have the honour to transmit to the Legislative Assembly of British Columbia my report, The *2015/16 Public Accounts and the Auditor General's Findings.*

Under section 11(1) of the *Auditor General Act,* my Office is required to report on whether the Provinces' Summary Financial Statements are presented fairly in accordance with Canadian generally accepted accounting principles (GAAP).

This report speaks to the results of our financial audit of the Summary Financial Statements.

Carol Bellringer, FCPA, FCA
Auditor General
Victoria, B.C.
February 2017

# AUDITOR GENERAL'S COMMENTS

Carol Bellringer, FCPA, FCA
*Auditor General*

My office's annual audit of government's Summary Financial Statements is the largest financial audit in British Columbia. This year, it encompassed over 140 entities that form the government reporting entity, and took 70 staff in our office just over 40,000 hours to complete. It also requires assistance above and beyond our work from 26 private-sector auditing firms.

At the end of this process, I issue an auditor's report or *opinion* that is published with the Summary Financial Statements. It says whether or not the financial statements present government's financial position and results for the year fairly, and in accordance with Canadian public sector accounting standards.

For many years, we have also issued a public report – like this one – on our findings from this audit. Government is large and complex and its financial statements can sometimes be difficult for readers to interpret and fully understand. We issue this report to highlight key aspects and to draw attention to the wealth of information contained in these financial statements.

This is the fourth year in a row we have differed with government on the way it records funding from other levels of government. In previous years, we have concluded that government should have recorded a higher annual surplus than was reported; in 2014/15, that difference was $191 million. This year, we determined the surplus should only be $3 million higher. However, in total, an additional $4.2 billion in revenue should have already been recorded by government in prior years; instead, government has deferred this $4.2 billion and will record it as revenue in future years.

# AUDITOR GENERAL'S COMMENTS

As we have stated in previous reports, this practice of recording revenue when financial results could otherwise be less favourable clouds the true financial health of the province. Also, when the province's financial statements differ from Canadian public sector accounting standards, it reduces their comparability, understandability and usefulness. We have worked through and resolved many other accounting issues with government over the past few years and we still wish to do the same with this one.

Government's financial statements also tell an interesting story beyond the bottom line of the province's financial health and performance. For example, they tell us that government has signed $101 billion worth of contracts for things like BC Ferries services ($9 billion), policing ($5 billion) and electricity purchases from independent power producers ($58 billion). This year, we also compared B.C.'s contractual obligations to those of other provinces and the federal government. This report also contains information about some other items in the financial statements, like government's revenue from asset sales, and how the revenue from BC Lottery Corporation is used.

I'd also like to point out the importance of looking at the audit opinion when reading financial statements. Reading the audit opinion is the fastest way to tell whether the statements were prepared according to independent accounting standards, and therefore whether they can be relied upon. This year we found that only 34 of government's 142 financial statements were both prepared in accordance with generally accepted accounting principles and received a clean audit opinion. The others received mostly clean opinions but the statements were prepared according to accounting policies defined by government. Our office's guide *Understanding Public Sector Financial Statements* is a useful resource for those looking at government's financial statements.

# AUDITOR GENERAL'S COMMENTS

We would like to thank all of the government entities we worked with this year to complete our audit of the Summary Financial Statements, as well as the Office of the Comptroller General. And as always, our sincere thanks to both our staff and the private sector auditors for their contributions. This audit is a major undertaking and we appreciate everyone's efforts.

Carol Bellringer, FCPA, FCA
Auditor General
Victoria, B.C.
February 2017

# REPORT HIGHLIGHTS

GOVERNMENT'S FINANCIAL STATEMENTS = **LARGEST AUDIT IN BC**

40,000+ HOURS TO COMPLETE

Government should have recorded over **$4.2 BILLION** in revenue in prior years, rather than deferring to future years

**76%** of government organizations received either **QUALIFIED OR COMPLIANCE OPINIONS** for following government regulation instead of GAAP

FINANCIAL STATEMENTS TELL A STORY

B.C. GOVERNMENT HAS THE MOST CONTRACTUAL OBLIGATIONS OF ANY OTHER PROVINCE

AND IS ABOUT 2/3 AS MUCH AS THE FEDERAL GOVERNMENT

BC Lottery Corporation GENERATED **$3.1 BILLION** in revenue

CASH PRIZES = **24¢** on every **DOLLAR** taken in

GOVERNMENT EARNED **$372 MILLION** FROM **ASSET SALES**

ALWAYS READ THE AUDIT OPINION

It's the fastest way to tell if financial statements can be relied upon

# SUMMARY

THIS REPORT PROVIDES details about our audit opinion on the provincial government's Summary Financial Statements for the year ended March 31, 2016. It also includes some observations about financial information contained in those statements, a summary of new accounting standards that Canadian governments should be adopting in the future, and an information piece on Special Accounts within the Consolidated Revenue Fund.

## AUDITOR GENERAL'S AUDIT OPINION FOR 2015/16

The key message that financial statement readers should take away from reviewing an audit opinion attached to a set of financial statements is whether or not the organization has prepared the financial statements in accordance with the requirements of an appropriate financial reporting framework. In many cases, the auditor confirms that the financial statements substantially adhere to required standards, resulting in a *clean* audit opinion. However, when this is not the case, auditing standards require the auditor to issue a modified, or *qualified*, opinion, to communicate which items are not in accordance with the generally accepted accounting standards.

In British Columbia, this is the fifth consecutive year that our audit opinion on the Summary Financial Statements includes a qualification related to the inappropriate deferral of revenues from government transfers and restricted revenues. Our qualification relates to funds received for the purchase or construction of tangible capital assets. Public sector accounting standards (PSAS) require that these revenues be recognized in the annual statement of operations, unless specific requirements are met for deferral of the amount on the statement of financial position. Stated another way, the revenue can only be recorded in future years if the government has a liability to the funder, such as a requirement to repay the funds if they are not used for their intended purpose.

Instead of applying the requirements of the standards, the B.C. government enacted a regulation that requires the revenues to be recognized over the useful life of the related asset. This timeframe can be significantly longer than would be required under the standard, especially when transfers have been received for tangible capital assets, such as hospitals and bridges, which will contribute to providing public services over extended periods of time. As of March 31, 2016, this policy has resulted in the inappropriate deferral of $4.2 billion of revenue.

# SUMMARY

## THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

Most readers of the Summary Financial Statements have limited knowledge of accounting standards or the unique elements of performance that public sector financial statements are designed to communicate. Therefore, as part of this report, we have continued to include interesting pieces of information about government's financial performance as reported in the Summary Financial Statements and other accountability documents. Below are some of the items we decided to highlight this year.

### The need for better information on planned versus actual results

One of the unique aspects of Canadian public sector financial statements is the inclusion of budget information. For example, actual revenues exceeded the budget by $1.2 billion for the year ended March 31, 2016. This section discusses where budget figures are reported, why they are reported and where to find information explaining the differences. See page 18 for more on this.

### Estimates and assumptions in the financial statements

Timely financial reporting requires the use of estimates by financial statement preparers. This section discusses how the notes to the Summary Financial Statements provide readers with valuable information on the use of estimates in the statements. Using personal income tax revenue as an example, the section discusses why estimates are required and directs readers to information on measurement uncertainty in the financial statements. See page 20 for more on this.

### The B.C. Prosperity Fund

This section discusses how the B.C. Prosperity Fund, announced by government as part of Budget 2016, fits into the government reporting entity and how it will operate according to the *Financial Administration Act*. See page 22 for more on this.

### Sale of assets

The 2015/16 Summary Financial Statements include $372 million in revenue from the sale of assets. Over the last three years, there have been over $1.1 billion in asset sales, and government intends to sell more assets in the future. See page 27 for more on this.

### British Columbia Lottery Corporation

In 2015/16, the BC Lottery Corporation earned $3.1 billion in revenue. We provide some information on how this money was spent. It may surprise you to know that only 24% was paid out as prizes. See page 35 for more on this.

# SUMMARY

## Contractual obligations

Financial statements report historic results. However, they also communicate information about future transactions. One of those areas is contractual obligations. This section expands on the information we reported last year to include charts comparing the contractual obligations of federal and provincial jurisdictions across Canada. See page 36 for more on this.

## SPECIAL ACCOUNTS

Special accounts are a spending authority, separate from the annual *Supply Act*, and they are created through legislation. They can allow government to monitor different sources of revenue, and diverse activities and specific investments, separately from other programs within a ministry. The total spending authority available for all 24 existing special accounts as of March 31, 2016 is $2.3 billion. See page 50 for more on this.

## LOOKING AHEAD – FUTURE ACCOUNTING STANDARDS

In our report we identify eight accounting standards issued by the Public Sector Accounting Board that government will need to adopt when preparing the Summary Financial Statements in the future. This section includes a summary of significant changes and the timeline for implementation. This year's report also includes information on some new standards that will be applicable for government business enterprises, such as ICBC, which report their financial results in accordance with International Financial Reporting Standards.

# RESPONSE FROM THE COMPTROLLER GENERAL

I APPRECIATE THE opportunity to respond to the Office of the Auditor General's comments.

The Province of British Columbia prepares its financial statements in accordance with the *Budget Transparency and Accountability Act (BTAA)*. The BTAA requires that all financial reports be prepared in accordance with generally accepted accounting policies for senior governments in Canada, supported by regulations of Treasury Board under the BTAA. Currently, generally accepted accounting principles for senior governments in Canada are widely accepted to be *Public Sector Accounting Standards (PSAS)*.

Treasury Board may adopt all or a part of another standard such as the *International Public Sector Accounting Standards* (IPSAS) if they better represent the legislative framework that government operates under. There are currently two regulations modifying the PSAS which are outlined in this report.

In her opinion on the 2015/16 Public Accounts, the Auditor General identified one audit qualification that is outlined in this report.

## AUDIT QUALIFICATION FOR 2015/16

### Deferral of Government Transfers Revenue

Governments fund the capital requirements of public sector entities through grants that are restricted for a specific purpose such as the construction of a school, hospital or highway. Those contributions have been recorded as a liability rather than revenue when received because it best represents the ongoing obligation of the recipient to deliver the service to taxpayers for the useful life of the asset. The benefit of that treatment is that the recipient acquires low cost funding from government, government fulfills its duty to ensure taxpayer funding achieves the intended outcomes, and financial statement users are informed about the ongoing financial obligation to keep schools, hospitals or highways maintained and in service over their useful life.

While addressing this issue we have to be mindful of how other jurisdictions are applying this same guidance. Failing to work with other jurisdictions would compromise the credibility of our national public sector accounting standards. To address this issue, the Office of the Auditor General has noted criteria that they feel would be required to support deferral of restricted contributions. I do not agree that these criteria are consistent with accounting standards and could not agree to an adjustment that would materially change the reported accumulated surplus under GAAP.

The Public Sector Accounting Board (PSAB) reviewed the application of Government Transfers accounting by senior governments in 2016. While they recognized a limited difference in practice across provinces they concluded that it would not be beneficial to amend the standard at this time to prescribe treatment of restricted government transfers. I commit to working with the Office of the Auditor General to determine the best way forward for the Public Accounts of British Columbia.

# OTHER MATTERS DISCUSSED

In addition to the reservation expressed in her opinion, the Auditor General also provides observations in this report on areas of accounting or reporting that do not materially affect the financial statements.

## Financial Statement Discussion and Analysis

The report provides an overview of the Financial Statement Discussion and Analysis, and makes recommendations to improve its usefulness. The observations on improving the linkage between planned versus actual results follow last year's recommendations to improve the linkage between changes in economic results and changes in tax revenue.  I believe improvements in this area would benefit readers and will work with the Office of the Auditor General to address these observations in the next Public Accounts.

## Estimates and Assumptions in the Financial Statements

The report identifies the importance of estimates in the financial reporting process with emphasis on personal income tax estimates, a significant estimate in all provinces' financial statements. I agree with the focus on this area because an understanding of the context of the uncertainty arising from estimates as outlined in the measurement uncertainty note is critical to understanding the financial statement results.

As mentioned in the report the estimates of personal income tax, arguably the most critical estimate made, can vary significantly from the actual taxes received in the following years. The report concludes that actual results reliably fall within the stated range of measurement uncertainty, and that variances are accounted for in the year that they occur.

## The B.C. Prosperity Fund

The report outlines the B.C. Prosperity Fund and effectively describes the key characteristic, that the Prosperity Fund is a segregated part of the Consolidated Revenue Fund (CRF). The use of a special fund, like similar mechanisms in other provinces, allows government to establish rules that guide the use of operating surpluses to government priorities like eliminating taxpayer supported debt. As noted in the report this structure has no effect on the financial position or results reported in the Summary Financial Statements.

## Self-supported Crown Corporations

The report provides an overview of how self-supported Crown corporations report under a different basis of accounting than ministries and taxpayer supported Crown corporations. The modified equity basis of consolidation can result in the same transaction being recognized differently, the example given being the purchase of coal licences by British Columbia Railway Corporation. Public sector accounting standards do not currently provide for intangible assets, which would result in a write off of the purchase value. Alternately, International Financial Reporting Standards (IFRS) followed by private sector entities including British Columbia Railway Corporation, require intangible assets to be recorded when they have future commercial value as is the case with these coal licences.

## Sale of Assets

Ongoing management of assets is important in any large organization because there are costs associated with maintaining a stock of assets and the investment in non-productive assets means capital cannot be deployed to other more productive uses. Over the past three years the program has been effective in freeing up capital for productive uses and managing the costs of ongoing stewardship. Government continues to actively manage its stock of assets to ensure a high level of financial efficiency in the portfolio.

## Managing the cost of debt through Advance Rate Setting agreements

The report outlines a change government made in the accounting treatment of advance rate setting agreements (ARS) in response to upcoming changes in accounting standards that would discontinue hedge accounting for financial instruments. ARS agreements are risk management instruments that eliminate the risk of interest rates changing between the time the decision is made to borrow and when the borrowing occurs. In a hedging relationship, the gain or loss on the ARS is directly offset by the corresponding loss or gain on the price of the bonds issued.

Traditionally the gain or loss on an ARS agreement was recognized over the life of the bonds issued. The change recommended in accounting standards is to recognize the full gain or loss arising from the hedge on the date the hedges are unwound and the bonds are issued. This means that there will be a revenue or expense at the beginning, offset by a difference in the cost of repayment over the life of the bond. No additional expense or revenue arises from the change.

Because this change does not fairly represent the hedging relationship as a risk management transaction we will continue to work with standard setters to develop a more representative approach to hedge accounting.

# RESPONSE FROM THE COMPTROLLER GENERAL

## Contractual Obligations

Contractual obligations continue to be a topic of interest. They are an important element of full financial disclosure because the amounts are significant, and they are an indicator of what share of government spending is committed to service providers in each future year.

## Governments' amendment to GAAP for government organizations

As noted in the report, there are currently two regulations under the *BTAA* that are required to address gaps in Canadian public sector accounting standards or their application during transition:

- B.C. Regulation 257/2010 retains the pre-existing Canadian guidance on rate-regulated accounting and is required because the International Accounting Standards Board had not decided how to address rate-regulated accounting, and Canadian standard setting bodies had not provided interim direction. Standard setters have since confirmed this approach for rate-regulated accounting. The regulation is consistent with the guidance of the Canadian Securities Administrators Association and the Canadian Accounting Standards Board.
- B.C. Regulation 198/2011 applies to organizations within the government reporting entity and clarifies the requirement to defer contributions where appropriate stipulations are in place. The regulation is required to ensure consistency between the financial reporting of Crown agencies and the legislative and regulatory requirements governing transfers from government to those entities. In my opinion, the regulation is consistent with Canadian public sector accounting standards guidance on government transfers and liabilities.

## Special Accounts

The report includes a section on Special Accounts, a budgetary mechanism established in legislation which provides authority to spend on specific programs in conjunction with the annual budget and estimates.

The report identifies differences between accounts and recommends continued review of special accounts that I will forward for consideration in the budget process. I do note that each special account is created by government in legislation to meet very specific objectives and will necessarily have differences of design that are carefully framed by legislative council and considered by the legislative assembly.

I believe that we have continued to improve the high quality of financial accountability reporting through these financial statements. We will continue to work with the Auditor General and the broader accounting community to resolve the one remaining qualification included in the Auditors report.

Carl Fischer
*Acting Comptroller General*
*Province of British Columbia*

# BACKGROUND

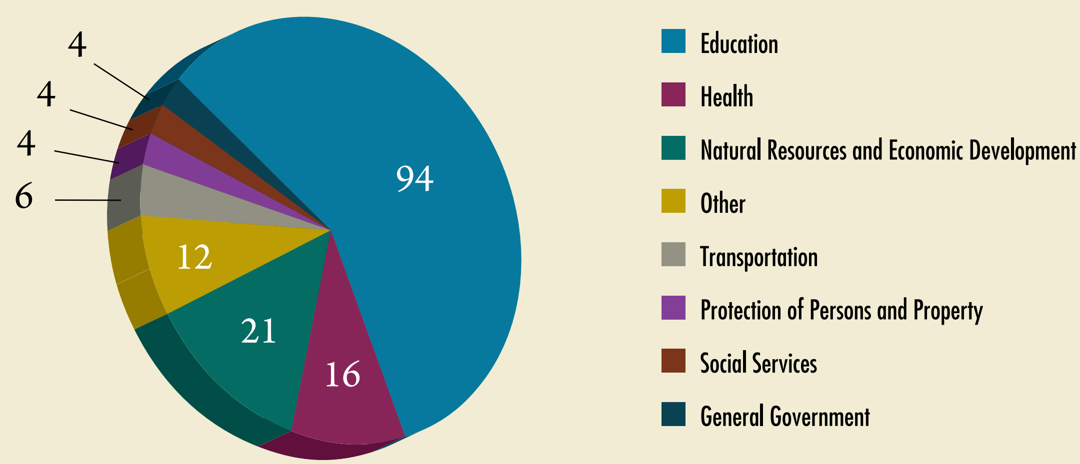
At the end of every fiscal year, the British Columbia government combines the financial information of all the entities within its control and produces a consolidated set of financial statements called the Summary Financial Statements. These statements are important to the people of B.C., providing an indication of the financial well-being of the province.

The 2015/16 Summary Financial Statements report the annual consolidated financial results of the government reporting entity (GRE). That entity includes core government (ministries), Crown corporations, colleges, school districts, universities, health authorities and other public sector entities (see Exhibit 1).

In addition to the 161 organizations summarized in the exhibit there are over 80 other subsidiary organizations already consolidated into their parent entity. For example, while the University of Victoria (UVic) is one entity out of the 161 included in the Summary Financial Statements, UVic itself has 14 subsidiary organizations included in its fiscal 2015/16 financial statements.

The list of government organizations included in the Summary Financial Statements is on pages 81 through 83 of the Public Accounts.

**Exhibit 1:** Number of government entities (including ministries, but excluding subsidiary organizations) in the 2015/16 Summary Financial Statements, grouped by sector




Source: Compiled by the Office of the Auditor General of British Columbia, based on the Province of British Columbia Public Accounts 2015/16, pages 81 to 83

# BACKGROUND

Reported in these financial statements are $48 billion in revenue; $47 billion in expenses (see Exhibit 2); $87 billion in assets; and $84 billion in liabilities.

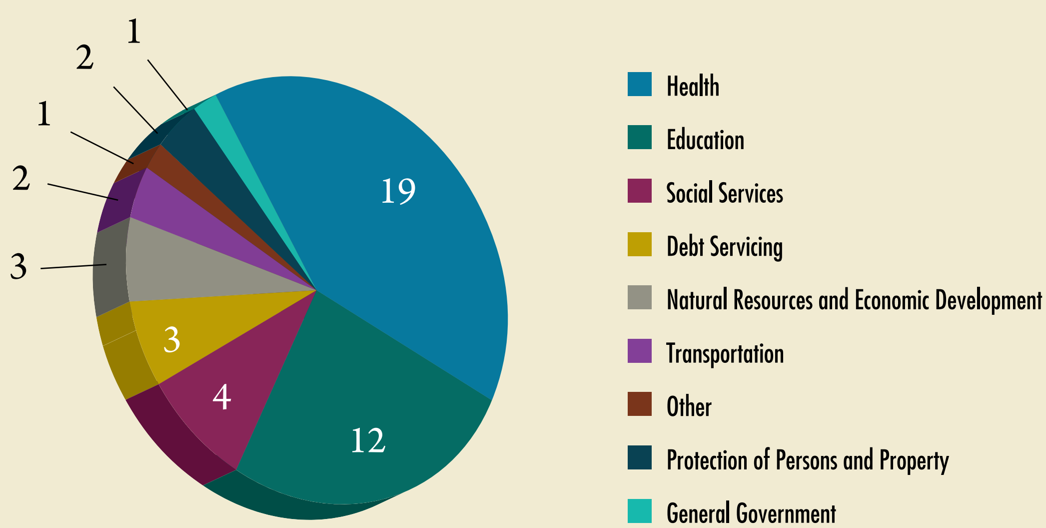
Under Public Sector Accounting Standards, government business enterprises (GBEs) are correctly consolidated using the modified equity basis. This means that only the equity in GBEs is consolidated; the GBE revenues, expenses, assets and liabilities are not consolidated on a line-by-line basis. If the GBEs were consolidated on a line-by-line basis, revenues and expenses would increase by $15 billion, and total assets and liabilities would increase by $22 billion.

Additional information about GBEs is included in the Public Accounts, pages 92-95.

Under section 11(1) of the *Auditor General Act*, we are required to report on whether the government's Summary Financial Statements are presented fairly in accordance with Canadian generally accepted accounting principles (GAAP). This is the largest financial audit in B.C., taking 70 staff and contractors in our office just over 40,000 hours to complete. The work also requires the assistance of 26 private sector auditing firms.

The Auditor General's report (or opinion) on government's Summary Financial Statements is included with the statements in government's Public Accounts.

**Exhibit 2:** Government expenses in 2015/16, by sector ($ billions)




Source: Compiled by the Office of the Auditor General of British Columbia, based on the Province of British Columbia Public Accounts 2015/16, Consolidated Statement of Operations, page 38

# BACKGROUND

The Public Accounts also include:

- the Auditor General's separate audit opinion on the Summary of Provincial Debt and related debt indicators
- unaudited information, such as government's financial statement discussion and analysis report
- information about the Consolidated Revenue Fund
- information about other aspects of the provincial debt

For the 2015/16 Summary Financial Statements, we again issued a modified audit report because government did not materially comply with one aspect of GAAP. In our view, government should have recorded over $4.2 billion in revenue in years prior to March 31, 2016, rather than deferring this revenue and recording it in future years. See Our Audit Opinion on the Summary Financial Statements section of this report.

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

THE SUMMARY FINANCIAL Statements tell readers about more than just B.C.'s annual surplus or deficit. The financial statements, and in particular the accompanying notes, provide information to enable readers to understand the overall financial health of the province.

To help readers interpret public sector financial statements, we produced a guide, *Understanding Canadian Public Sector Financial Statements,* in June 2014. The guide describes what is in the statements and notes, and provides readers with possible questions to ask when reviewing a set of public sector financial statements.

Consistent with the guide, this section of our report focuses on some of the questions readers might ask about the Summary Financial Statements, and explains where the information to answer those questions can be found.

For example (and in no particular order):

- What organizations does the provincial government control and include in the financial results? [page 14]
- How did actual results for the year compare with those in the original plan? [page 18]
- How precise are the estimates used in the financial statements? [page 20]
- To what extent is government committed to purchasing future goods and services? [page 37]
- What was the impact of non-recurring transactions, such as asset sales on the annual surplus or deficit? [page 27]
- How do the annual results of government business enterprises (GBEs) affect the overall financial position of the province? [page 23]
- How does government manage interest rate risks on debt? [page 31]

The Summary Financial Statements cannot tell the full performance story. But the Financial Statement Discussion and Analysis Report (FSD&A) that accompanies the Summary Financial Statements can answer some questions. The FSD&A gives government the opportunity to explain the annual financial results.

We have been encouraging government to improve its FSD&A since fiscal year 2006/07, because the report often lacks an explanation as to *why* there was a decrease or increase in certain amounts. In our 2014/15 report on the Public Accounts, government noted that the B.C. Financial and Economic Review, published shortly after the Public Accounts, provides additional commentary on the annual financial results. While this may be true, it would provide better information for the public if government included the discussion in the FSD&A, along with the Summary Financial Statements.

Government also publishes other documents as part of the annual budgeting, monitoring and financial reporting cycle (see Exhibit 3). These provide useful information for understanding government's planned and actual financial performance.

Below we present a few highlights of the performance information from the Summary Financial Statements, and we link it to other sources, where possible, to help you more fully understand the story behind the reported results.

## THE NEED FOR BETTER INFORMATION ON PLANNED VERSUS ACTUAL RESULTS

Annual budget documents for government and other public sector entities contain a lot of financial policy and resource allocation information. One of the unique aspects of public sector financial reporting in Canada is the inclusion of annual budget figures in the financial statements. This gives readers accountability information on how actual financial results compare with original plans.

For example, when reading the 2015/16 Summary Financial Statements, the reader can make the following comparisons from the information presented in the statements of operations and changes in net liabilities:

- actual revenues exceeded budget by $1.2 billion, or 2.7%
- actual expenses exceeded budget by $1 billion, or 2.3%
- additions to tangible capital assets were less than budget by $274 million, or 7.3%

However, although the budget figures allow for such comparisons, those figures can't explain *why* the differences exist. Government provides some information in other financial accountability documents, such as the Financial Statement Discussion and Analysis (FSD&A), but it doesn't explain the results.

Similar to a publicly listed company, the Government of British Columbia publishes unaudited quarterly financial results and forecasts for the first nine months of the fiscal year. Then, after the year-end, government publishes the audited annual financial statements along with the FSD&A. This gives government an opportunity to discuss the financial results for the year and to explain why actual results differed from planned results.

Exhibit 3 shows the documents and timing of public reports that discuss government's finances.

We said last year in our report on the Public Accounts that the FSD&A should provide an *explanation* of significant differences between planned and actual results. Government has pointed out that explanations of variances are more thorough in the B.C. Financial and Economic Review, which is published annually in July or August.

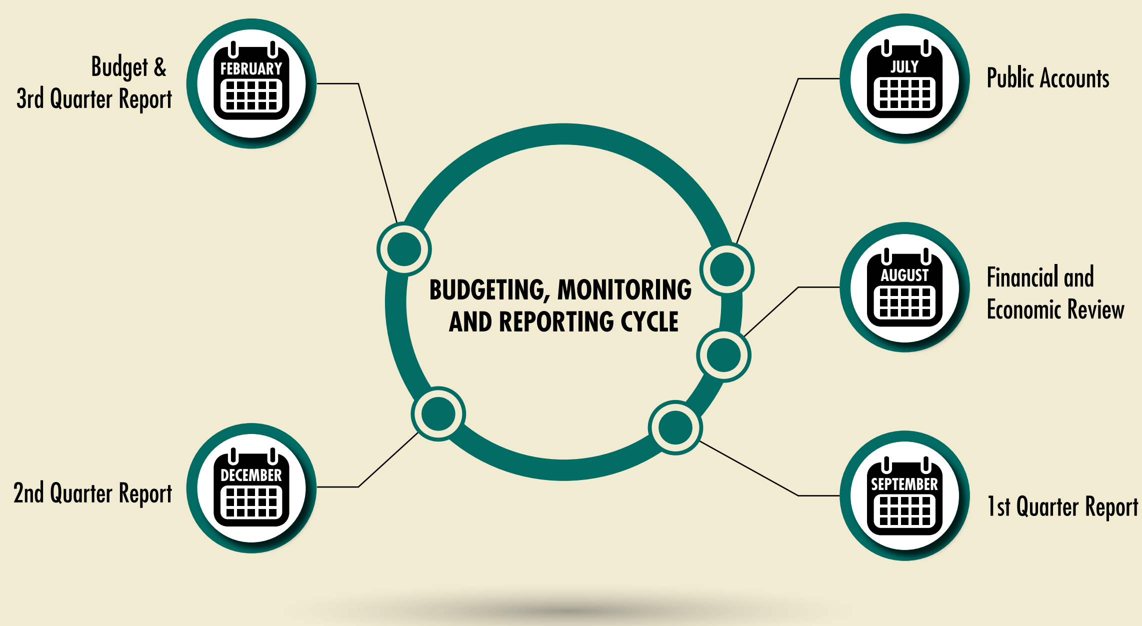
# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

We continue to be of the opinion that the explanations in the Financial and Economic Review should be included in the FSD&A.

The FSD&A is on pages 11 to 29 of the Public Accounts. Page 19 shows the major variances in planned and actual revenues and expenses between the announced 2015/16 Budget planned operating surplus and the actual surplus for the year ended March 31, 2016. However, government does not explain *why* the actual results for specific revenues or expenses were higher or lower than the budgeted figures. The analysis presented only quantifies the differences. For capital asset additions, the analysis identifies (on page 12) that capital investment under-spending was due to project delays, but it provides no further details.

In June 2015, we published a report, *Budget Process Examination Phase 1: Revenue*, in which we looked at the processes government used to develop the economic and revenue forecasts in its 2014/15 Budget and Fiscal Plan. We will also be publishing a report that focuses on the preparation of operating expense, capital spending and debt forecasts contained in the 2015/16 Budget and Fiscal Plan. That report will be available on our website.

**Exhibit 3:** Government's financial reporting cycle




Source: Office of the Auditor General of British Columbia

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

## ESTIMATES AND ASSUMPTIONS IN THE FINANCIAL STATEMENTS

When the Summary Financial Statements are prepared, government cannot precisely determine all the amounts that are to be recorded in the statements. This is true for the preparation of all government financial statements: for the government to report on the financial results for a set period of time, it must make estimates and assumptions. For some transactions, the actual amounts will be known shortly after the government releases the Summary Financial Statements; for other transactions, the actual amounts may not be known for decades.

One example of a common long-term estimate is how many years a building, such as a hospital, will provide health care services. When a hospital is built, government will record the cost as a tangible capital asset on the statement of financial position, and amortize (expense) the cost over the estimated life of the hospital – say, 40 years. The service life of the building, and therefore the annual amortization expense, is an estimate. The accuracy of these historical estimates will not be known until the building reaches the end of its useful life and is no longer used to provide services.

Another example where estimates are necessary is the annual cost of employee pensions. The annual expense recorded in the financial statements is generally determined by an actuary, and is based on future assumptions of salary increase, investment returns and the longevity of pensioners (among other things). While the pension expense recorded is based on the best available information at the time, changes and adjustments to these estimates are made in the financial statements on a forward looking basis for as long as the pension plan is in place.

How estimates affect the annual financial results is described in the Summary Financial Statements, note 2: Measurement Uncertainty. Public Sector Accounting Standards require that items subject to significant measurement uncertainty be disclosed in the financial statements, and when it is reasonably possible that estimated amounts will change in the near term, the dollar amount of the uncertainty should also be disclosed.

For dollar amounts subject to estimate, management is expected to choose the most likely figures – those they feel confident of being final – and recording those figures in the financial statements. Then, as more accurate information becomes known in the ensuing year(s), adjustments are made to the amounts in the current-year financial statements (rather than going back and making a correction of figures in statements for previous years).

### Personal income tax revenue estimates

One of the most significant amounts subject to measurement uncertainty is personal income tax revenue. When government prepares the Summary Financial Statements, it records an estimate of the revenue from this source – which in fiscal 2015/16 accounted for 17.6% of the province's revenue. Government must estimate personal income tax revenue because people file income tax returns at different times of the year and not always when government needs to report this revenue as part of its financial statements.

Note 2 to the Summary Financial Statements shows that the amount of personal income tax revenue recorded in the 2015/16 fiscal year was $8,380 million. However, the actual amount could end up being higher or lower by up to $400 million.

Personal income tax revenue in a fiscal year comes from tax returns from two separate calendar years. So, when reporting this revenue for the fiscal year ending March 31, 2016, government must record nine months of revenue from the 2015 calendar year and three months of revenue from the 2016 calendar year. However, the tax assessments for the 2015 calendar year will not be finalized until December 2016 and the 2016 tax assessments won't be available until one year later. This means precise revenue figures from personal income tax cannot be determined until 21 months after the fiscal year-end date. As a result, government estimates these revenues using the best information available.

## Accuracy of personal income tax estimates

Given the measurement uncertainty for personal income tax revenue (plus or minus $400 million), it's easy to wonder how accurate government's estimates have been in the past.

Government estimates personal income tax revenue based on information received from the Canada Revenue Agency and forecasts of economic activity. Government's Financial and Economic Review (F&E Review) includes a section explaining the differences between the budget and actual results for the fiscal year. For the past five years, the section analyzing revenue has provided information on the impact of prior year tax assessments on the current year reported income tax revenue. These amounts are the difference between the estimated revenues for those years and the actual revenues when finalized.

For the past five years, government's estimates fell within the disclosed range of measurement uncertainty. For four of the past five years, government underestimated personal income tax revenue by amounts between $106 million and $386 million. In one year, the revenue was overestimated by $179 million. In all cases, the changes in revenue were reported in subsequent fiscal years, in keeping with the accounting requirements for changes in estimates.

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

## THE B.C. PROSPERITY FUND

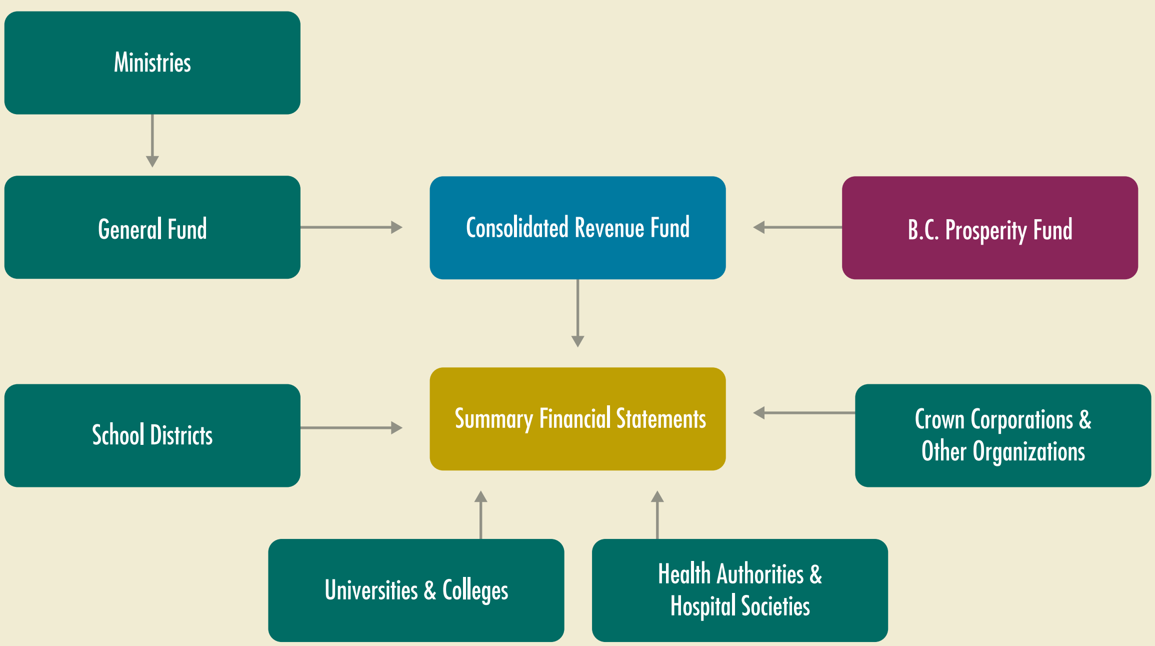
In February 2016, as part of Budget 2016, government announced the creation of the B.C. Prosperity Fund, established with an initial commitment of $100 million – an amount to come from the forecast 2015/16 surplus. According to government, the fund will be "a long-term legacy" intended to:

- help eliminate provincial debt over time
- make investments in health care, education, transportation, family supports and other priorities that provide future benefits
- preserve a share of today's prosperity for future generations

The B.C. Prosperity Fund was created through an amendment to the *Financial Administration Act* in March 2016. It is a separate set of accounts (a special fund) within the Consolidated Revenue Fund (CRF). The structure of the Prosperity Fund in relation to the Summary Financial Statements is shown in Exhibit 4.

Before the B.C. Prosperity Fund was created, the General Fund and the CRF were essentially one and the same. Now, the B.C. Prosperity Fund and the General Fund together make up the CRF.

**Exhibit 4:** How the B.C. Prosperity Fund relates to the Summary Financial Statements




Source: Office of the Auditor General of British Columbia

## THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

The B.C. Prosperity Fund is a way for government to set aside, and account for, a portion of its accumulated surplus and earmark it for a specific purpose. However, from the perspective of the CRF and the Summary Financial Statements, the arrangement is similar to moving cash from your chequing account to your savings account. You aren't creating any more money – you're just putting it aside to save for something specific.

The legislation creating the B.C. Prosperity Fund has rules about how the balance will grow and how it can be used.

In certain circumstances, government may transfer funds to the B.C. Prosperity Fund. When government runs an annual surplus, Treasury Board has the option to transfer all or a portion of the surplus from the General Fund to the B.C. Prosperity Fund. The fund also retains the earnings on any investments held.

The legislation also sets out the rules for when the funds can be used and for what purpose. For example, 25% of all transfers and earnings of the fund are set aside in perpetuity. The remaining 75% of the fund may be used for debt repayment or other specified program spending. The purpose and amount spent depends on whether or not any taxpayer supported debt remains in the Summary Financial Statements. Until taxpayer supported debt is eliminated, at least 2/3 of money paid out of the fund must be used to reduce taxpayer supported debt.

The financial statements of the B.C. Prosperity Fund are on page 6 of the unaudited CRF Extracts to the 2015/16 Public Accounts. As of March 31, 2016, the B.C. Prosperity Fund consisted of an account receivable (so, money owed) from the General Fund for $100 million. There were no cash or investments in the Prosperity Fund. Because the new fund is part of the CRF, there is no need for it to have its own cash balances.

## HOW SELF-SUPPORTED CROWN CORPORATIONS AFFECT THE ANNUAL AND ACCUMULATED SURPLUS OF GOVERNMENT

In our 2014/15 report on the Public Accounts, we discussed how dividends received by government from self-supported Crown corporations (also known as government business enterprises, or GBEs) are not revenue. Government consolidates these GBEs into the Summary Financial Statements using the modified equity method of consolidation, as required by PSAS (see sidebar). We explained that government records as revenue the net earnings of GBEs, not the cash dividends received from GBEs.

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

***Modified equity accounting*** is the method of consolidating self-supported GBEs into the Summary Financial Statements. Most government organizations (that is, taxpayer supported Crown corporations, school districts, universities, colleges and health entities) are consolidated using a *line-by-line method*, meaning that each line in the entity's financial statements is added to a similar line in the Summary Financial Statements. However, with the *modified equity method*, only the GBE's net income is included as revenue on the statement of operations, rather than revenues and expenses, and the GBE's net equity (assets less liabilities) is included as a financial asset on the statement of financial position.

Self-supported GBEs use International Financial Reporting Standards as the basis for their accounting policies. Taxpayer-supported organizations and the Summary Financial Statements use Public Sector Accounting Standards as the basis for their accounting policies. Unlike entities consolidated on a line-by-line basis, under modified equity accounting the accounting policies of GBEs are not required to be conformed to the accounting policies used in the Summary Financial Statements.

What we did not highlight in last year's report, or mention in the sidebar, is that an additional type of income in the GBEs, known as *other comprehensive income*, affects the *accumulated surplus* figure in the Summary Financial Statements.

When preparing their financial statements using International Financial Reporting Standards, the GBEs divide their annual results from operations into two types of income: *net earnings* and *other comprehensive income*.

Other comprehensive income typically includes market value changes in investments and other unrealized changes, such as estimated changes in pension liabilities. It measures changes that could affect net earnings in the future but have not yet been solidified. The unrealized income or loss is "parked" in accumulated surplus until, for example, an investment is sold and the gain or loss on sale is realized. The realized gain/loss is then included in net earnings.

**Other comprehensive income** represents unrealized income or loss during the year that is recorded directly in accumulated surplus, rather than in annual net earnings.

As required by accounting standards, when government consolidates self-supported GBEs into the Summary Financial Statements:

- the net earnings are included as revenue and affect the reported surplus or deficit for the year

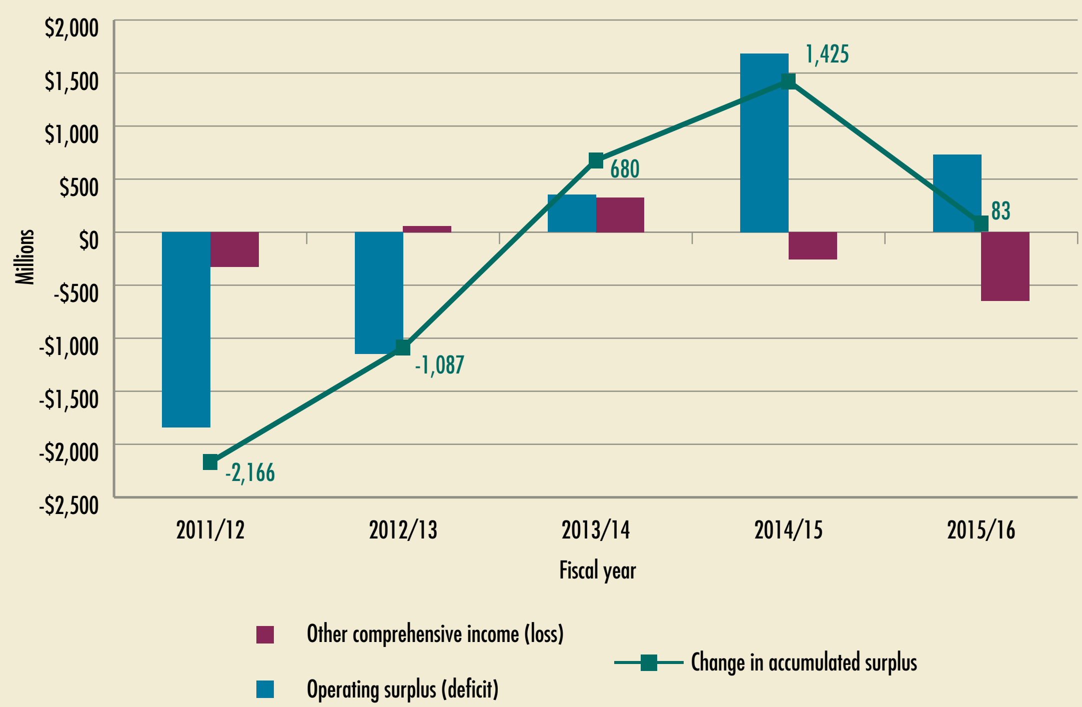
## THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

- the other comprehensive income is recorded as an adjustment directly to accumulated surplus

The accumulated surplus is the *equity* that government has built up over all the years it has published its financial statements. In simple terms, equity is the accumulation of all past annual surpluses and deficits. For government, however, the accumulated surplus is (as noted above) also affected by the other comprehensive income of GBEs. So, to understand how the financial position (accumulated surplus) of government changes each year, we need to consider other comprehensive income in addition to the annual surplus or deficit.

Exhibit 5 shows the change in accumulated surplus for the five-year period, 2011/12 to 2015/16, by operating surplus (deficit) and other comprehensive income (loss). Other comprehensive income (loss) has varied over the last five fiscal years between a gain of $327 million in 2013/14 and a loss of $647 million in 2015/16.

**Exhibit 5:** Comparison of the annual surplus (deficit) and other comprehensive income (loss) with the annual change in Summary Financial Statements accumulated surplus, for the five fiscal years ending March 31, 2012 to 2016 ($ millions)




Source: Compiled by the Office of the Auditor General of British Columbia from government's annual Public Accounts

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

From disclosures in the Summary Financial Statements, readers can derive the following about the current-year change in government's overall financial position when other comprehensive income is considered:

- While government recorded an annual surplus of $730 million for fiscal 2015/16, the accumulated surplus increased by only $83 million (a difference of $647 million).
- GBEs incurred other comprehensive income losses of $647 million.
- The other comprehensive income losses are referenced in the statement of operations to pages 94–95 of the Public Accounts. Losses by ICBC of $671 million (in the Protection of Persons and Property sector) account for the majority of current-year other comprehensive losses. Delving further into ICBC's annual financial statements shows that the other comprehensive losses relate mainly to changes in the unrealized value of investments. At March 31, 2015, ICBC had unrealized investment gains. During the year, those unrealized gains were solidified, and the income included in net earnings. As a result there was a decrease, or *loss*, in the other comprehensive income.

## INTANGIBLE ASSETS: THE PURCHASE OF COAL LICENCES

Ministries and government organizations use different accounting standards from those used by GBEs. Ministries and taxpayer-supported government organizations use Public Sector Accounting Standards (PSAS), and GBEs use International Financial Reporting Standards (IFRS).

One difference between PSAS and IFRS is that PSAS does not allow *intangible* assets to be recorded on the statement of financial position, whereas IFRS standards do allow those assets to be recorded. Organizations using PSAS must expense their intangible asset costs in the year of purchase while a GBE would record an asset. Therefore, what type of government entity acquires intangible assets impacts the government's financial position and results.

Examples of intangible assets include artwork, items of historical significance, goodwill (the amount paid above the market value of assets when purchasing a company), rights, patents and licences.

During the 2015/16 fiscal year, the British Columbia Railway Company (BCRC) – a GBE – purchased 61 coal licences from a group of coal mining companies in the Klappan permit area of B.C. for $18 million.

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

The Klappen area is in the Stikine region, about 800 km northwest of Prince George. According to government, the companies intended to further develop a mine, but their discussions with the local First Nation were not moving as quickly as desired, preventing their progress. BCRC used its cash reserves to acquire the licences as an agent of government, and made the transaction without affecting government's net income.

BCRC discloses these licences in its financial statements as an asset (interest in mining rights) on the consolidated statement of financial position. Because BCRC follows IFRS, these mining rights meet the definition of an asset. The $18 million purchase by BCRC is recorded as an asset, which means there is no impact on its net income for the period. However, BCRC did have to give up $18 million in cash.

Had a ministry, such as Energy and Mines, purchased these licences from the companies, the purchase would have been accounted for as an intangible asset and expensed during the year – and the result would be a lowering of the annual surplus in the Summary Financial Statements by $18 million.

The coal licence purchase agreement gives the companies a 10-year option, expiring on May 1, 2025, to repurchase the licences at the original price, after government and the First Nation have developed a shared vision for the Klappan area.

When the companies repurchase the licences, again there will be no impact to government's net income (aside from the interest income that might have been earned on the $18 million in cash that was paid out).

The asset will be removed from BCRC's financial statements and its cash reserves replenished. If, for some reason, the companies do not repurchase the coal licences, then at some point in the future, government may have to sell them or expense the licences if their value declines.

Had this purchase occurred through a ministry, there would be an increase in the surplus for the year of $18 million when the licences are repurchased by the companies, as revenue would be recorded for their sale.

## SALE OF ASSETS

The 2015/16 Summary Financial Statements include $372 million in revenue from the sale of tangible capital assets.

The majority of this revenue came from the Release of Assets for Economic Generation (RAEG) program. We discussed surplus asset sales and the RAEG program in our 2014/15 report on the Public Accounts.

Government announced the RAEG program in 2012. It is intended to generate income for government and increase economic activity in the province through the sale of surplus properties and assets. Under the program, surplus properties are defined as those:

- no longer in use
- not required for future utilization
- where there is no strategic benefit to government being the owner

## THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

In the Summary Financial Statements, the cash proceeds and revenue from the sale of tangible capital assets can be determined from the Statement of Cash Flows, page 40.

Since fiscal 2013/14, government has recorded almost $800 million in revenue from the RAEG program (see Exhibit 6). In the 2015/16 fiscal year, the majority of RAEG revenue comes from the sale of the Dogwood-Pearson land by the Vancouver Coastal Health Authority, which generated revenue of $280 million.

The $290 million in asset sales in 2013/14 relates to the sale by BC Housing of the Little Mountain property in Vancouver.

Budget 2016, issued in February 2016, does not provide specific details on the expected revenue from asset sales in the 2016/17 fiscal plan. However, government did disclose that there will be future revenue gains from the RAEG program and from the sale of assets to non-profit societies. The sale of land and buildings to existing non-profit housing societies is being run through BC Housing, and is called the Non-Profit Asset Transfer (NPAT) program.

The NPAT program is expected to provide proceeds from asset sales of about $500 million over the next few years. When the asset sales occur, revenue will be recorded in the Summary Financial Statements.

To finance the sale, most non-profit housing societies will obtain a mortgage to buy the land from the province, and the province will provide additional subsidies to the independent housing societies for the term of their mortgages, which could be 30–35 years. While the NPAT program will result in the government recording revenue when the land sales occur, the subsequent 30–35 years of mortgage subsidy payments to those housing societies will likely be double the amount of revenue earned in the near term, given the mortgage interest that the housing societies will pay.

**Exhibit 6:** Revenue from the sale of tangible capital assets, by program, 2013/14 to 2015/16 ($ millions)

| | 2013/14 | 2014/15 | 2015/16 | Total |
|---|---|---|---|---|
| Release of Assets for Economic Generation Program | $311 | $125 | $358 | $794 |
| Other asset sales | $290 | $10 | $14 | $314 |
| Total revenue | $601 | $135 | $372 | $1,108 |

Source: Compiled by the Office of the Auditor General of British Columbia from government's Summary Financial Statements and supporting documents

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

Some of the details of one known future land sale were noted in the Summary Financial Statements, note 39: Subsequent Events. Together, three First Nations have agreed to purchase the provincially owned portion of the Jericho Lands area of Vancouver, near the University of British Columbia, for $480 million. The two parcels of land, totalling 38.8 acres, will be sold in two phases, each for $240 million. The first parcel of land was contracted to be sold on November 1, 2016, and the second parcel on November 1, 2017. Government will correctly record this revenue in the Summary Financial Statements in fiscal 2016/17 and fiscal 2017/18 when the land sales occur.

While the government is expected to record revenue for the sale of the Jericho Lands in fiscal 2016/17 and fiscal 2017/18, the majority of the proceeds from the sales will come in later fiscal years. The agreed schedule of payments provides for $41 million to be paid in November 2021, $56 million to be paid in November 2022, and $317 million to be paid in November 2023 (with interest paid to government at an annual rate of 2%).

Government also agreed to pay a total of $100 million in accommodation payments to the three First Nations. These accommodation payments, which have repayment conditions if the land sale does not complete, were authorized on March 31, 2016. They have been recorded as an expense in fiscal 2015/16.

### ACCOMMODATION PAYMENTS

Government has a legal duty to consult with and potentially accommodate First Nations whose rights may be infringed upon by proposed activities within their traditional territories. Accommodation for infringement on First Nation's rights can take many forms, including joint decision making, project cancellation, training and capacity building, sharing of revenues, and monetary compensation.

The public has viewed some asset sales from the RAEG program with great interest. As a result, our Office is conducting a performance audit on the RAEG program as part of our Performance Audit Coverage Plan. We are also performing an audit related to the NPAT program. Our website has details on these audits.

# THE CENTRAL DEPOSIT PROGRAM

As of March 31, 2016, government held $3.9 billion in cash and temporary investments. Most of this cash was held not by ministries but by the organizations that are consolidated into government's Summary Financial Statements.

In our August 2010 report *Aspects of Financial Management*, we first stated our concern that government's cash management practices had resulted

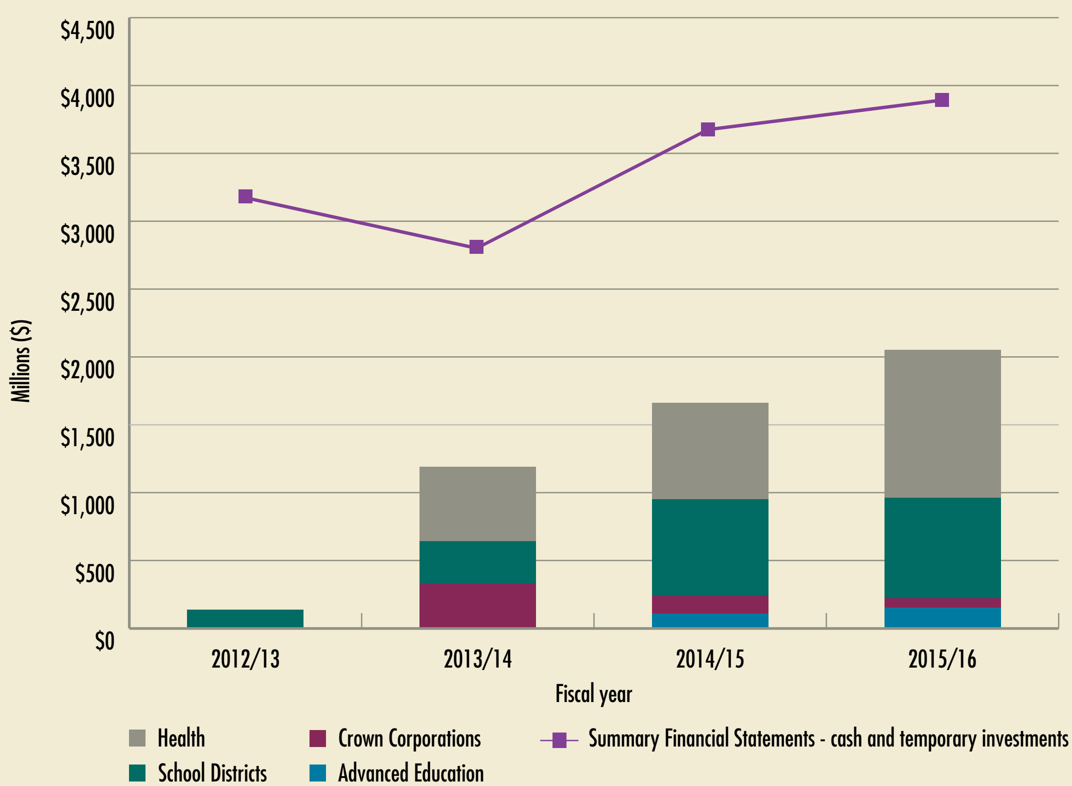
# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

in the unnecessary borrowing of billions of dollars. In March 2009, government held $5.2 billion in cash and temporary investments, much of which was sitting idle in the savings accounts and low yield investments of government organizations. We didn't think it made sense for the Ministry of Finance to have to borrow money when government organizations held so much of it.

Part of government's response to our report was to create the Central Deposit Program, which enables government organizations to deposit their excess cash with the Ministry of Finance – similar to depositing their money with a bank. The organizations earn interest at a rate competitive with what they could otherwise earn through their financial institution. And the Ministry of Finance has access to the deposited cash, which means it can reduce its borrowing needs from banks or other lenders.

Exhibit 7 shows the value of program deposits held by the Ministry of Finance as of March 31, 2013 through 2016, by sector. This shows the extent of cash from government organizations that Provincial Treasury could use to reduce borrowing. These deposits are compared with the overall balance of cash and temporary investments held by all government organizations in the Summary Financial Statements.

**Exhibit 7:** Deposits held in the Ministry of Finance's Central Deposit Program as of March 31 for the four-year period, 2012/13 to 2015/16, compared with cash and temporary investments in the Summary Financial Statements ($ millions)




Source: Compiled by the Office of the Auditor General of British Columbia from Ministry of Finance figures

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

The Central Deposit Program started in fiscal year 2012/13 with a test group of school districts. In 2013/14, access to the program was broadened to include health authorities, post-secondary institutions and Crown corporations.

The large Crown corporation balance in 2013/14 was solely the result of the BC Transportation Financing Authority selling its substantial investment portfolio. The proceeds of that sale were deposited in the program and then used to pay for transportation projects rather than government having to borrow more money for those.

In 2014/15, government encouraged all of its organizations to participate in the program rather than individually holding and investing their cash balances. Participation increased in the advanced education, school district and health sectors. However, as Exhibit 7 also shows, although the use of the Central Deposit Program has increased, so has the overall balance of cash and temporary investments in the Summary Financial Statements. This more recent trend is counter to the government's long term goal of a gradual decline in cash balances that government communicated in their response to our March 2014 report *Working Capital Management Since 2010*.

## MANAGING THE COST OF PROVINCIAL DEBT THROUGH ADVANCE RATE SETTING AGREEMENTS

As of March 31, 2016, the total taxpayer-supported and self-supported debt in the Summary Financial Statements was just over $66 billion. The interest expense for fiscal 2015/16 was almost $2.8 billion.

For the most part, borrowing for all government entities is done centrally, within the Provincial Treasury department of the Ministry of Finance. Provincial Treasury regularly monitors the government's cash position and future borrowing needs. It actively manages the provincial debt portfolio to try to ensure that the cost of debt remains as low as possible. Any unnecessary increases in the cost of debt will reduce the amount of money available for public services.

Managing the cost of provincial debt includes the use of various *derivative financial instruments*, including currency swaps, interest rate swaps, forward foreign exchange contracts and advance rate setting agreements. Derivative instruments help to counter the possibility that interest rates or the cost of foreign currencies may change and thus cause an increase in debt interest and repayment amounts. Note 20 to the Summary Financial Statements briefly describes the risk management and derivative financial instruments in use.

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

Accounting for the cost of debt is not always straightforward. In addition to regular debt interest payments, there are debt issue costs, premiums/discounts on debt issue, and the above-noted derivative financial instrument costs to consider. Some costs may be recorded as an expense over the term of the debt; others must be expensed right away.

During our audit this year, we noted that the use of *advance rate setting agreements,* and the subsequent losses incurred as a result of them, was increasing significantly.

An advance rate setting (ARS) agreement is what the name implies: an agreement with third parties that effectively allows government to lock in an interest rate in advance of when it borrows.

Government enters into an ARS agreement when it must borrow in the near future, and it closes out the agreement when it borrows in the debt market. Entering into such an agreement is seen as advantageous if interest rates go up, but disadvantageous if interest rates fall.

Some people may look at these ARS agreements and say the government is speculating on future interest rates. Other people see the agreements as allowing good management of government's debt portfolio. We did not find any evidence of speculation. For each advance rate setting agreement we reviewed, there was a related borrowing when the ARS agreement was closed out.

During our audit of the Summary Financial Statements, when we saw the large losses that were generated during the year, we considered whether

### AN EXAMPLE OF HOW THE ADVANCE RATE SETTING (ARS) AGREEMENT WORKS

Say government agrees, through an ARS agreement, to pay or receive in one year the difference in the interest amount that would be payable on a 20-year Government of Canada bond. (In reality, government "sells short" [sells a bond it does not own] a 20-year Government of Canada bond, and delays the settlement for a year).

Between the time the ARS agreement is entered into at year 0 and is closed out at year 1:

- If interest rates increase, then government receives a payment (generating a gain) on the transaction. However, government also faces borrowing at the higher interest rate.
- Alternatively, if interest rates decrease, then government must make a payment (generating a loss) on the transaction. However, government also obtains its borrowing at a lower interest rate.

In either case, the overall cost of the 20-year debt will be approximately the rate that existed at year 0.

the accounting for ARS agreements was correct. Government had, for many years, been deferring any gains or losses incurred when the agreements were closed out and adding those gains or losses to net income over the term of the related borrowing.

We concluded that an ARS agreement is a separate transaction from the borrowing and, as such, the gain or loss incurred when an ARS transaction is closed out should be included in net income during the year. Government agreed that the ARS balance should be written off and, as a result, for the 2015/16 Summary Financial Statements, it made an adjustment to increase interest expense by $216 million.

Although government has reduced the use of ARS agreements for most government entities that need to borrow, it has, since March 31, 2016, continued to enter into ARS agreements for BC Hydro. Between April 1 and August 31, 2016 BC Hydro entered into agreements based on a debt value of $1.2 billion.

## THE FOREST ENHANCEMENT SOCIETY OF B.C.

During 2015/16, the Forest Enhancement Society of B.C. was created under the *Society Act*. The society, set up to complement government's existing forest stewardship programs, will focus on wildfire risk reduction, forest rehabilitation and wildlife habitat restoration, and it also provides interface fire education through the FireSmart program.

In February 2016, soon after the society was created, government announced plans to provide it with $85 million in funding – a significant allocation of tax dollars to provide to a new society with no history of operations.

How government accounts for the $85 million depends on whether the society is deemed to be controlled by government or not (see sidebar). If it *is* controlled by government, the money would be consolidated into the Summary Financial Statements and not recorded as an expense until the society spends it. If the society is *not* controlled by government, then the $85 million would be recorded as a grant expense in the fiscal year ending March 31, 2016.

For the fiscal year ended March 31, 2016, government concluded that the Forest Enhancement Society of B.C. was not under government control and therefore should not be included in the government reporting entity. The $85 million was therefore expensed in the Summary Financial Statements.

We analyzed the information available to determine if we agreed with government's assessment that the society is independent of government. Because many of the society's operating policies and administrative structures were still being developed at March 31, 2016, we could not state that there was a preponderance of evidence indicating control. So, for fiscal 2015/16 at least, we concur with government that the society should not be included in the government reporting entity. Going forward, we will monitor the operations of the society and its interactions with government to identify possible indicators of government control. If it is determined that government controls the society, then the society should be consolidated into the Summary Financial Statements.

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

## DETERMINING WHETHER OR NOT AN ENTITY IS UNDER GOVERNMENT CONTROL

How government structures the delivery of services to the people of B.C. changes. Government creates new organizations, transfers programs between them or closes them down based on evolving needs.

Because the financial statements of provincial government organizations are consolidated into the Summary Financial Statements, it is important for government to determine which organizations are controlled by it. An organization is included if it meets the Public Sector Accounting Standards (PSAS) *criteria for control by government*. However, determining whether an entity is controlled by government is not always easy, can change over time and may require significant professional judgment.

For the 2015/16 fiscal year, the organizations controlled by government are on pages 81 to 83 of the Public Accounts.

For accounting purposes, control is defined as the power to govern the financial and operating policies of another organization, with expected benefits or the risk of loss to the government from the other organization's activities. PSAS provides guidance for assessing whether or not control exists. There are four indicators that are the most persuasive when determining control, supported by seven secondary indicators.

### *Persuasive indicators of control include when government:*

- has the power to appoint or remove the majority of the members of the organization's governing body
- has ongoing access to the assets of the organization, the ability to direct the ongoing use of those assets or has ongoing responsibility for losses
- holds the majority of the voting shares
- has the unilateral power to dissolve the organization

### *Other indicators of control include the power to:*

- nominate or appoint a significant number of the members of the governing body
- appoint or remove the CEO or other key personnel
- establish or amend the mission or mandate of the organization
- approve or require amendments to the organization's business plans or budgets
- establish borrowing or investment limits
- restrict the revenue-generating capacity of the organization
- establish or amend the organization's policies

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

## BRITISH COLUMBIA LOTTERY CORPORATION

Government business enterprises (GBEs) contributed approximately $2.7 billion or 5.7% of government revenues in fiscal 2015/16. The B.C. Lottery Corporation (BCLC) is one of the larger contributors to this revenue source. This section discusses how the revenues of BCLC are spent.

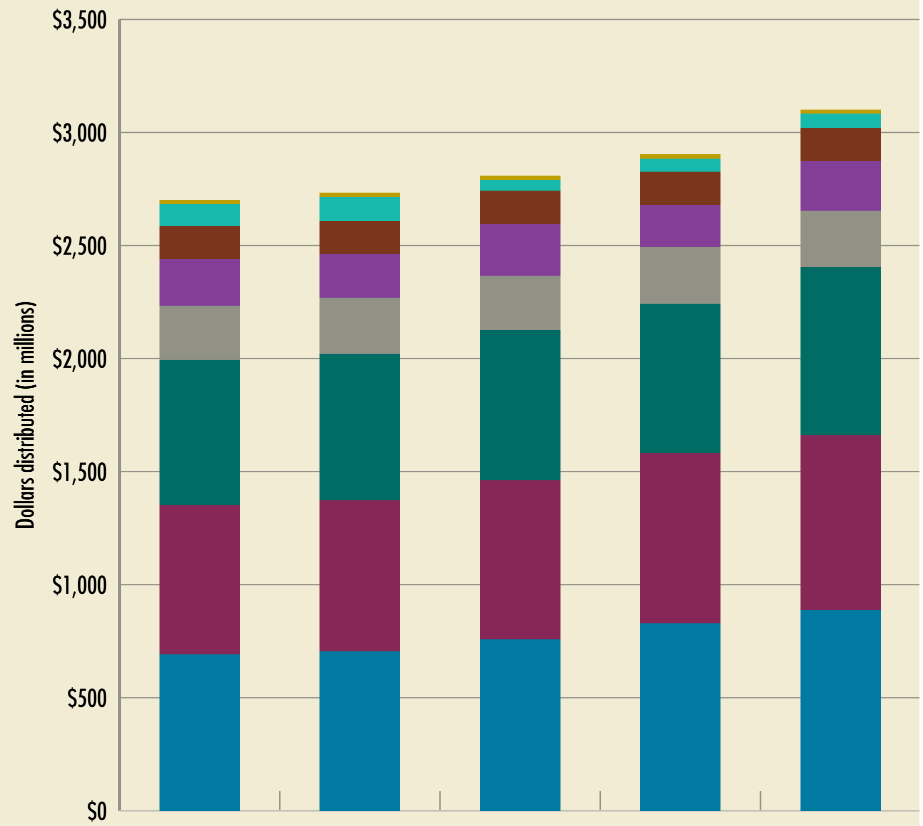
In B.C., all commercial lottery, casino, bingo and internet gaming activities are managed by the BCLC. BCLC also conducts and manages gaming activities through private sector companies, such as casinos and lottery ticket sales outlets. Gaming activities generate a lot of revenue for government. Over the past five years, BCLC revenues have increased from $2.7 billion in 2011/12 to $3.1 billion in 2015/16. After paying prize winners and other expenses, BCLC transfers its remaining income to the CRF.

Exhibit 8 shows, for the last five fiscal years, where government uses the revenue generated by BCLC. The discussion and figures described below refer to fiscal 2015/16 figures.

- Prizes represent the amounts paid out by BCLC on all gaming activities. Of the $3.1 billion in revenue generated, $745 million (24%) was paid out in prizes. Put another way, for every dollar gambled, about 24 cents was won in return.
- BCLC's direct expenses were $772 million, of which about 89% were commissions and fees paid to lottery retailers and gaming facility service providers.
- Administration expenses represent the cost of running BCLC. In 2015/16 this cost was $218 million, or 7% of revenue. Of the $218 million, 42% was for employee salaries, wages and benefits; 34% was for the depreciation of buildings and equipment; and 12% was for advertising, marketing and promotion. The remaining 12% was comprised of property and other operating expenses.
- Payments to community organizations and to host local governments represented 4% and 3% of revenue, respectively. A non-profit community organization may apply for a grant, for example, to recover the cost of a festival or for a program that enhances B.C.'s environment. Host local governments are given a percentage of the net income of gaming establishments located in their vicinity. Payments representing 0.3% of revenue were also made for local economic development. Government also spent 0.3% of revenue on horse racing purse enhancements.
- The Health Special Account receives $147 million of BCLC funds each year (5% of revenue). We discuss special accounts on page 50 of this report. These funds are provided to the Ministry of Health and, according to the special account vote description, are to be spent on the administration, operation and delivery of health care, health research, health promotion and health education services.
- The majority of other expenses, which represent 2% of revenue, are taxes paid to the federal and provincial governments in accordance with the *Excise Tax Act* and *Provincial Services Tax Act* regulations.

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

**Exhibit 8:** Distribution of BCLC gaming revenue for the five-year period, 2011/12 to 2015/16 ($ millions)




| | 2011/12 | 2012/13 | 2013/14 | 2014/15 | 2015/16 |
|---|---|---|---|---|---|
| Gaming regulation and responsible gaming programs | 19 | 18 | 19 | 19 | 19 |
| Other expenses | 96 | 106 | 47 | 59 | 62 |
| Health Special Account | 147 | 147 | 147 | 147 | 147 |
| Administrative expenses | 206 | 191 | 228 | 186 | 218 |
| Community organizations, host local governments, economic development and horse racing purses | 240 | 248 | 241 | 250 | 250 |
| Prizes | 642 | 650 | 666 | 660 | 745 |
| Direct expenses | 659 | 667 | 702 | 754 | 772 |
| Consolidated Revenue Fund | 692 | 705 | 759 | 829 | 888 |

Source: Compiled by the Office of the Auditor General of British Columbia

- Payments for programs to regulate gaming and to promote responsible gaming were $19 million, representing 1% of revenue.
- As noted above, all remaining amounts are paid into the Consolidated Revenue Fund, where their use is unrestricted. In 2015/16, this amount was $888 million, or 29% of BCLC revenue.

# CONTRACTUAL OBLIGATIONS

Most information in the Summary Financial Statements relates to transactions that have happened in the past. However, some parts provide information about future transactions. For example, when government signs a contract committing to significant future payments, it reports those future obligations in note 27(c): Contractual Obligations.

Note 27(c) summarizes, by government sector and for both taxpayer-supported and self-supported entities, the contractual obligations that are expected to be paid in each of the next five years and beyond. Total contractual obligations as of March 31, 2016, are $101 billion. Government's website provides further details about the contracts.

Governments enter into contracts with third parties for various reasons. Long-term agreements to purchase services or supplies can, for example, be an effective way to guarantee government a specified quantity of goods or services at pre-determined prices.

However, agreements can also limit the flexibility of future governments to change financial operating arrangements, and the payments can become onerous if the future cost of those goods and services goes down.

Public Sector Accounting Standards define contractual obligations as "obligations of a government to others that will become liabilities in the future when the terms of those contracts or agreements are met."

In financial statements, there is an important distinction between a *liability*, which is a current obligation, and a *contractual obligation*, which is a future obligation. Until a transaction or event occurs under a contract or agreement, a government does not have a liability. The contractual obligations note discloses information about the unperformed portion of government's agreements and contracts.

## The difference between debt and contractual obligations

One of the common misconceptions we hear is that contractual obligations are the same as debt. This is simply not true.

Debt is money that government has already borrowed and must repay in the future. Debt can also include obligations for a capital lease (for example, a vehicle or piece of equipment that has already been obtained, but financed by the lessor) or an asset built for government but financed through a public-private partnership.

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

Contractual obligations are agreements to obtain goods or services in the future. There is no liability for payment until the goods or services are received, and therefore no debt. The contractual obligations are only recorded as transactions in the financial statements in future years, when the terms and conditions of the related contract or agreement are met.

Only when contractual obligations are *paid for* could there be an increase in debt. Government tends to incur debt for capital asset construction and to pay for operating expenses without borrowing – but this is not a hard and fast rule. There is no direct link between a contractual obligation and debt.

## Is there a need to be concerned about government's contractual obligations?

Even knowing that contractual obligations are not debt, having over $100 billion in contracts outstanding sounds like a lot of money tied up. It is: about twice the amount that the government spends every year on its programs and services. However, when analyzing contractual obligations, both the magnitude and time frame they relate to are important. Some contracts entered into will be paid out over about 50 years.

## What the Public Sector Accounting Standards (PSAS) say about contractual obligations

The disclosure of contractual obligations provides good information to users of financial statements. This is required by PSAS, although the standards do not specify in detail what the disclosure should look like. PSAS states that contractual obligations should be disclosed in the financial statement notes and the disclosure should include "descriptions of their nature and extent and the timing of the related expenditures." PSAS also notes that the types of obligations that would be disclosed include those that involve speculative risk, are abnormal in size, are an unusual transaction, or will impact spending many years into the future.

PSAS also states that ongoing programs, such as health and welfare, do *not* need to be disclosed if there are no contracts and the government maintains complete discretion around the programs. For example, while it is almost certain that government will continue to pay for health costs and government assistance to its citizens, no contracts are in place with individuals and government has the ability to change or restrict those payments. Only when a government enters into a contract or agreement does a contractual obligation exist, and some discretion to avoid the obligation is lost.

## What government discloses in the Summary Financial Statements

As already noted, government discloses contractual obligations by sector, type of government entity and year, in note 27(c) of the Summary Financial Statements.

# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

The largest contractual obligation in place is for BC Hydro to purchase power from independent power producers, for $58 billion. This obligation will extend for 55 years. The next largest contractual obligation is for the Ministry of Transportation and Infrastructure: $9 billion in payments to BC Ferries under the Coastal Ferry Services Agreement, which extends for another 47 years. As shown in Exhibit 9, contractual obligations have been relatively stable over the last five fiscal years.

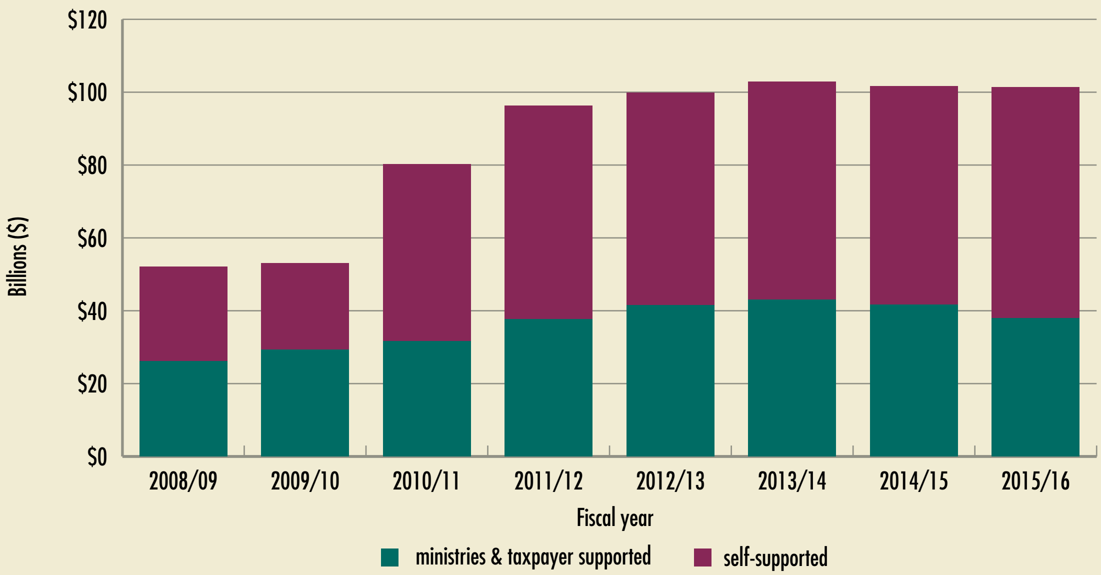
## How B.C.'s contractual obligations compare with other jurisdictions

We looked at the contractual obligations disclosure of other provinces and the federal government for the year ending March 31, 2015 (the latest year all information was available). We wondered how the details and the dollar amounts disclosed by B.C. compared to other jurisdictions. What we found is that the details of what and how different jurisdictions disclose their obligations is different. Some jurisdictions, including B.C., provide the obligations of GBEs in one place, and some do not. Some jurisdictions include capital lease payments, and some do not. Some jurisdictions only disclose contracts over a certain dollar value. Some jurisdictions provide details outside of the contractual obligations note. We looked at the publicly available information across the Canadian jurisdictions to piece together their total contractual obligations. What we found is shown in Exhibit 10.

For 2014/15, B.C. disclosed contractual obligations of $102 billion. Except for the federal government, with contractual obligations of $151 billion, B.C. had the most obligations of any province. The additional obligations in B.C. are largely due to BC Hydro's $58 billion in power purchase agreements with independent power producers. Quebec's contractual obligations include $38 billion for agreements with power producers.

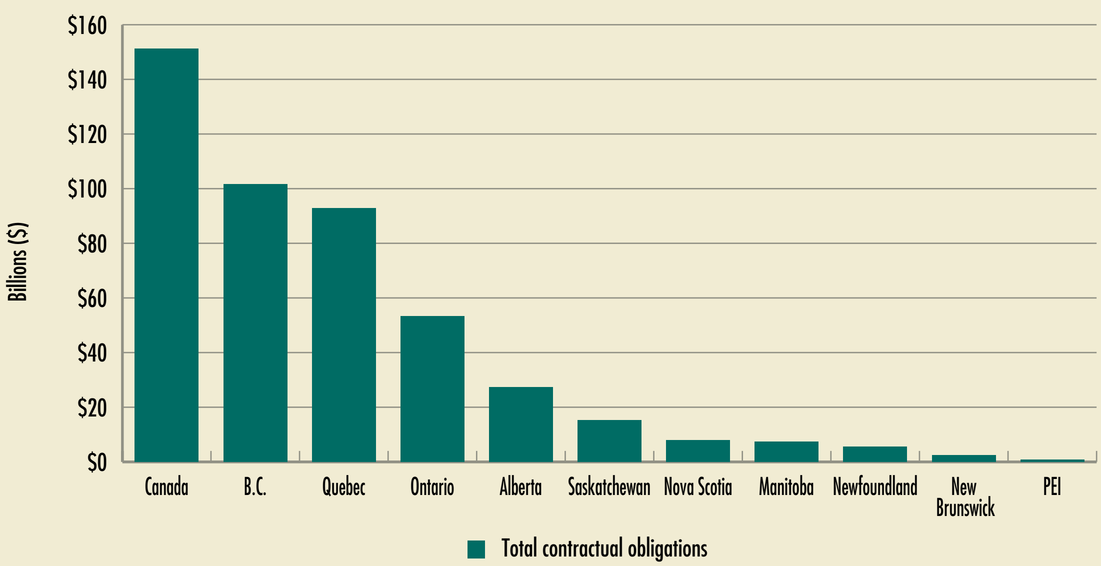
# THE SUMMARY FINANCIAL STATEMENTS TELL AN INTERESTING STORY

**Exhibit 9:** Contractual obligations reported by taxpayer-supported and self-supported organizations, 2008/09 to 2015/16 ($ billions)




Source: Compiled by the Office of the Auditor General of British Columbia, based on B.C.'s annual Summary Financial Statements

**Exhibit 10:** Total contractual obligations by Canadian jurisdiction, as of March 31, 2015 ($ billions)




Source: Compiled by the Office of the Auditor General of British Columbia from the Public Accounts of each jurisdiction

# OUR AUDIT OPINION ON THE SUMMARY FINANCIAL STATEMENTS

## CANADIAN GENERALLY ACCEPTED ACCOUNTING PRINCIPLES ARE KEY TO CREDIBLE FINANCIAL REPORTING

ALL LEVELS OF government across Canada use a form of generally accepted accounting principles (GAAP) specifically designed for the public sector. These are the Public Sector Accounting Standards (PSAS), and they were developed by the Public Sector Accounting Board (PSAB), an independent standard-setting body. Independence in standard setting is important because it takes into account the views of the public – the users of financial statements – as well as those who prepare and those who audit the financial statements.

Independently developed standards help create consistency in financial reporting. Canadians should expect, for example, that the accounting for a transaction in the financial statements prepared by one province will be consistent with those prepared by another province. This cannot occur unless all provinces follow the same accounting standards and apply them consistently.

Auditors use independently developed standards as the benchmark to determine whether government's financial statements comply with GAAP. For the B.C. government's Summary Financial Statements, that standard is PSAS.

Accounting for most transactions is consistent across Canadian governments. However, the way each jurisdiction applies GAAP does vary sometimes because of differences in legislation, regulations, composition of the government reporting entity, and interpretation of the accounting standards. In addition, auditors may also interpret the accounting standards differently, resulting in differences of opinion between the government and auditors in one jurisdiction, but not another.

## ACCOUNTING FOR GOVERNMENT TRANSFERS

Starting in the 2004/05 fiscal year, B.C.'s *Budget Transparency and Accountability Act* (BTAA) required government's Summary Financial Statements to be prepared in accordance with GAAP. This

# OUR AUDIT OPINION ON THE SUMMARY FINANCIAL STATEMENTS

demonstrated government's commitment to providing the people of B.C. with high-quality financial reporting on government's performance. It also ensured that the financial results of the Province can be more easily compared with those of other Canadian jurisdictions.

Since the BTAA was implemented, there have been developments in the setting of standards. One accounting standard in particular – *government transfers* – was debated for several years. The most contentious aspect of this standard has been in deciding when governments, such as B.C.'s, should record the revenue they receive from other governments. Some people believe the revenue should be recorded close to the date it is received. Others believe, particularly if the revenue is to be used to acquire capital assets, that the revenue should be recorded a bit each year, for the same number of years as the asset (e.g., a hospital or a bridge) will provide service.

Recording the revenue over a number of years can help make government's annual net surplus/deficit figure less volatile.

It became apparent in the development of the government transfers standard that governments would be required to record revenue sooner rather than later. The standard states that revenue can be recorded later only if the transfer agreement creates an *obligation* that meets the definition of a *liability* on the part of the receiving government. As an example, the recording of revenue could be deferred if there was a requirement to pay the money back if it wasn't used as intended. In most government transfers, it is difficult for a liability to exist once the funds have been used for their purpose. For example, if B.C. were to receive money from the Government of Canada to help build a bridge, once the bridge is built, the funds will have been used for their purpose and it would be difficult to argue that B.C. has a liability to Canada.

Of course, accounting standards and transfer agreements can be interpreted in different ways by different people. One person, for example, might read an agreement that says the funds must be used to build a bridge *to provide ongoing service* between two points, and interpret that to mean a liability exists to ensure the bridge provides service for many years.

The new government transfers accounting standard was put in place with an effective date starting with the fiscal year ending March 31, 2013. The Government of B.C. prefers to record government transfer revenue over the life of the asset for which the revenue was received. The B.C. Comptroller General's interpretation of the standard is that this deferral is allowed under PSAS.

Despite this interpretation, in 2010, the government changed the BTAA to allow itself to enact regulations that can modify GAAP. In 2011, BTAA Regulation 198/2011 was enacted. This requires taxpayer-supported organizations to record revenue, from contributions that were received to acquire tangible capital assets, over the life of the asset acquired.

The province's Summary Financial Statements are now prepared in accordance with PSAS, which is the form of GAAP for government, but government has allowed itself to modify the Summary Financial Statements through regulations that amend GAAP. We further discuss the impact of government's accounting regulations below.

## AUDIT OPINION FOR 2015/16

Our fiscal 2015/16 audit opinion on the Summary Financial Statements indicates that, except for the inappropriate deferral of revenue, the statements fairly present the financial performance of government in accordance with Canadian PSAS.

Since the government transfers standard became effective in fiscal 2012/13, we have included a qualification on our audit opinion about government's inappropriate deferral of revenue. The contributions received are usually for the purchase or construction of tangible capital assets, such as buildings and bridges. Government is recording the revenue over a period of time, when it should be recorded as soon as the asset is bought or built.

This means that rather than recording it as income, when the assets are bought or built, the funds are recorded as a liability (deferred contribution). The deferred contributions are then reduced each year, and recorded as revenue, over the same number of years as the related assets are amortized. For example, if government buys a building in 2015 for $40 million, it's not recording the $40 million as revenue in 2015. Rather, it records $1 million a year over 40 years.

In our view, this is not in accordance with PSAS and has resulted in government inappropriately deferring $4.2 billion in contributions. These contributions should have been recorded as revenue in prior years, meaning that government's accumulated surplus (equity) should be higher by $4.2 billion.

One of the key indicators of government performance, the *net liabilities* figure, is measured as government's financial assets less its liabilities. Net liabilities measures how much government must raise as revenue in the future to discharge its liabilities. Based on our view, the error in the Summary Financial Statements causes the net liabilities figure to be overstated by $4.2 billion, meaning government would have to raise $4.2 billion *less* than the financial statements indicate.

The effect of the error on the annual operating surplus (net income) was quite small this year –understated by only $3 million. In the previous year, the difference was an understatement of $191 million.

## GOVERNMENT'S AMENDMENTS TO GAAP FOR GOVERNMENT ORGANIZATIONS

Section 23.1 of the *Budget Transparency and Accountability Act* (BTAA) requires the provincial government and its entities' accounting principles to (i) conform to Public Sector Accounting Standards

# OUR AUDIT OPINION ON THE SUMMARY FINANCIAL STATEMENTS

(PSAS), or (ii) conform to PSAS as modified by Treasury Board regulation.

For the past four years, Treasury Board regulations modifying PSAS have been in force. In our view, one of those regulations results in many government organization's financial statements no longer being compliant with PSAS. We are concerned about this. We encourage government to use PSAS and remove any regulation that is inconsistent with these independent standards.

To date, government has passed two regulations under the BTAA that direct organizations to apply specific accounting policies. One of them, B.C Regulation 198/2011, causes a significant impact to the Summary Financial Statements and to many taxpayer-supported organizations. It directs government organizations to continue deferring government transfers and restricted revenues rather than recording the revenue sooner – despite the PSAS standard that sets stricter requirements for the deferral of revenue. Government has expressed consistently that this is an acceptable interpretation of the new accounting standard. However, we disagree, as do other independent auditors of government organizations in B.C. We assert that this regulation actually *changes* the PSAS standard.

When government organizations comply with Regulation 198/2011, they are not complying with GAAP. As a result, many of those organizations received from their auditor either a non-GAAP compliance audit opinion or a modified GAAP audit opinion this year. See types of audit reports, below.

Although this regulation applies to government organizations, and not directly to the Summary Financial Statements, government's central accounting policies allow for the recording of revenue in this manner. Therefore, when the accounts of the organizations are consolidated, it causes error in the Summary Financial Statements.

## TYPES OF AUDIT REPORTS

In Canada, audit reports represent an auditor's independent, professional opinion on whether an organization's financial statements are presented fairly, in accordance with GAAP. Audit reports can also identify any concerns auditors have with the quality of the financial statements.

The auditors of the 2015/16 audit of government entities (included in the Summary Financial Statements) issued three types of audit reports:

1. unmodified
2. modified (concerns expressed as qualifications)
3. compliance

### Unmodified report

An unmodified report, also referred to as a clean opinion, means the auditors are satisfied that the financial statements are fairly presented.

# OUR AUDIT OPINION ON THE SUMMARY FINANCIAL STATEMENTS

## Modified report

A modified report, issued only on rare occasions, means that auditors have concerns with:

- the lack of availability of sufficient and appropriate information to enable users to make an informed decision
- uncorrected errors caused by the entity's application of GAAP

A modified report may contain one of the following:

- a qualification, when there is an error or omission in the financial statements that the auditor can quantify and explain, so that a user can consider the effect on the financial statements
- an adverse opinion, when an error or omission is so material or pervasive that even though it can be quantified and explained, the auditor considers that the financial statements as a whole are misleading
- a disclaimer of opinion, when the auditor is unable to obtain sufficient appropriate audit evidence to form an opinion

To determine whether a modified report is necessary, the auditor considers the significance of the errors or missing information in relation to the financial statements as a whole. The auditor sets a numerical threshold for materiality, and if the errors are less than that, the report wouldn't need to be modified.

Alternatively, if the errors exceed that threshold, then the auditor might modify the audit opinion for those errors. Before doing that, however, the auditor presents these errors to management of the organization to allow them an opportunity to correct them.

In addition to a numerical or quantitative error, the auditor must also consider qualitative factors. For example, if a small error would change an overall deficit into a surplus (or vice versa), or if a disclosure in the notes is not complete or provides inappropriate information, then the auditor may consider this to have a material effect on the financial statements and therefore to be the subject of a modification of the opinion.

## Compliance report

A compliance audit report means the auditors have found that an entity's financial statements are presented in accordance with its chosen or legislated framework rather than in accordance with GAAP. The entity must include a note with its financial statements explaining how they would be different if the entity were adhering to GAAP; and the auditor's report must reference this note.

We discuss compliance audit opinions on page 47.

# OUR AUDIT OPINION ON THE SUMMARY FINANCIAL STATEMENTS

## AUDITOR'S REPORTS FOR GOVERNMENT ENTITIES

The 2015/16 Summary Financial Statements consolidate the financial results of 161 ministries and government organizations controlled by the province. Of these, 142 entities received separate audit opinions. We rely on the results of these separate audits when forming our overall opinion on the Summary Financial Statements.

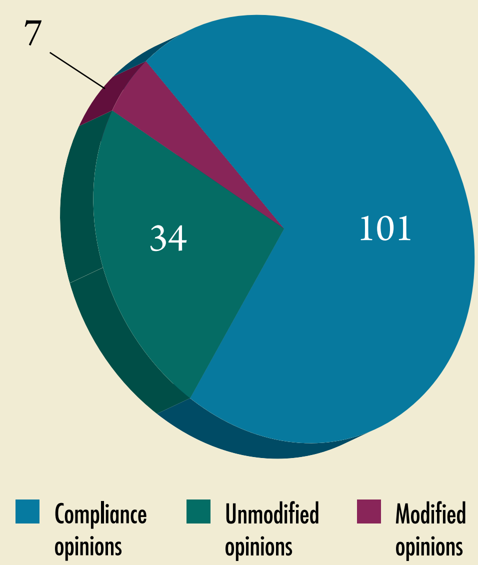
Concerns with financial statements raised by independent auditors should be rare, yet a large number of government organizations receive compliance or modified audit reports (see Exhibit 11).

101 of the 142 entities receiving separate audit opinions were provided with compliance audit reports because they were required to follow the BTAA regulations government issued and this forced the deferral of certain government transfers and restricted revenues. As a result, the government organizations' auditors considered that their financial statements were not consistent with GAAP, however they received unmodified (or *clean*) audit opinions because the entities had prepared their financial statements in compliance with the financial reporting framework established by government regulation.

Thirty-four entities received an unmodified audit report (the entity's financial statements were fairly presented), and 7 organizations received modified (or *qualified*) audit reports.

All of the seven modified audit reports were issued by our office. Whereas last year, we may have issued a compliance audit report, this year, as described in the section below, we felt that the government entities provide general purpose financial statements that are subject to a fair presentation accounting framework, and as such are not eligible to receive a compliance audit opinion.

**Exhibit 11:** Compliance and other types of auditors' reports issued for government entities for 2015/16




Source: Compiled by the Office of the Auditor General of British Columbia

# OUR AUDIT OPINION ON THE SUMMARY FINANCIAL STATEMENTS

## FAIR PRESENTATION VERSUS COMPLIANCE AUDIT REPORTS FOR GOVERNMENT ORGANIZATIONS

In the current B.C. government reporting framework, an organization might receive a *clean compliance* audit opinion, but – depending on the terms of the audit engagement agreed to by the auditor – the same set of financial statements might receive a *modified* (or qualified) *fair presentation* audit opinion.

In our 2014/15 Report on the Public Accounts, we discussed our reconsideration of whether we should continue to issue compliance audit opinions. We noted that such opinions may not be appropriate for general purpose financial statements that are designed to meet the common financial information needs of a wide range of users. We planned to revisit the applicable auditing standards in place and, during 2015/16, we completed that review.

Exhibit 12 summarizes key differences in the independent auditor's report structure and wording when an entity complies with Regulation 198/2011 and there is a material, but not pervasive, departure from Canadian PSAS. The guide we published in 2014, *Understanding Canadian Public Sector Financial Statements*, helps users understand the independent audit report attached to a set of financial statements.

**Exhibit 12:** Fair presentation versus compliance audit opinions

| | |
|---|---|
| Fair presentation opinion | ◆ The audit report will include an additional section called ***Basis for Qualified Opinion.*** The independent auditor quantifies within the audit report the impact of the accounting departure on the reported results.<br>◆ The title for the opinion paragraph is ***Qualified Opinion.*** |
| Compliance opinion | ◆ The audit report will include a section titled ***Emphasis of Matter***. This section directs readers to the disclosures provided by management describing the differences between the financial reporting framework prescribed by law or regulation and the appropriate GAAP framework.<br>◆ The opinion provided cannot use the phrase "fairly presents" unless required by law or regulation. |

Source: Office of the Auditor General of British Columbia

# OUR AUDIT OPINION ON THE SUMMARY FINANCIAL STATEMENTS

In Canada, the Auditing and Assurance Standards Board, an independent standard-setting body, develops standards that provide the basis for auditors in Canada when providing audit opinions and other assurance on financial statements and related financial information.

Under Canadian Auditing Standards (CAS), *general purpose* financial statements are prepared in accordance with a financial reporting framework designed to meet the common needs of a wide range of users. A widely used, acceptable reporting framework, such as PSAS, along with a wide distribution of the financial statements, would lead an auditor to determine that the financial statements are for a general purpose. This would lead to a fair presentation opinion.

Readers of widely available financial statements should expect that if the financial statements are not prepared in accordance with GAAP, then the audit opinion should be modified (qualified).

In 2012, our initial view was that in circumstances where there were material conflicts between the financial reporting standards under PSAS and the requirements of the *Budget Transparency and Accountability Act* (the law prescribing the financial reporting framework), auditors should consider the framework to be compliance rather than fair presentation, and therefore provide a compliance opinion.

During 2015/16, we updated our view on the appropriateness of issuing compliance opinions for financial statements intended to be used for public accountability purposes. For public sector entities we audited, we now provide our opinion on the financial statements in accordance with Canadian PSAS. Canadian PSAS is the appropriate financial reporting framework that organizations should use to prepare their general purpose financial statements.

We came to our conclusion based on two key judgments:

1. Government's financial reporting framework is an acceptable general purpose framework, as it encompasses financial reporting standards established by a recognized standard-setting organization in Canada (PSAB). However, government's framework includes a requirement in law or regulation that conflicts with the standards. This conflict is material to the financial statements for several public sector entities and cannot be resolved through additional disclosures or by amending the description of the financial reporting framework. Under these circumstances, it is necessary to modify the audit opinion.
2. Government's financial reporting framework meets the CAS definition of a fair presentation framework, as government's framework encompasses financial reporting standards established by PSAB, and those standards are designed to achieve fair presentation.

Overall, we believe the provision of a qualified audit opinion on a recognized reporting framework (PSAS) will allow better comparison with other entities across Canada (who also follow PSAS). Even though an opinion might be qualified, other users across Canada

## OUR AUDIT OPINION ON THE SUMMARY FINANCIAL STATEMENTS

are aware of what the accounting standards are for the public sector. It is more difficult for readers to compare financial statements when the generally accepted accounting standards have been modified, because the accounting standards used are not as apparent.

As a result of our updated view on the use of compliance opinions, the number of modified audit opinions we issued increased by six for fiscal 2015/16, and the number of compliance opinions decreased by the same number.

During 2015/16, the other audit firms in B.C. that were providing compliance, rather than fair presentation, audit opinions have continued to report under a compliance basis. We plan to have further discussions with government and audit firms on this issue.

# SPECIAL ACCOUNTS

## How can government spend money?

Government cannot spend money unless there is an Act (that is, the legal authority) in place to allow that. For most spending, this authority comes each year when the Members of the Legislative Assembly debate government's Estimates and the Budget and Fiscal Plan, and ultimately pass a *Supply Act*. The *Supply Act* is the main legal authority for ministries and independent offices to spend money through approved annual budgets, called voted appropriations.

But the *Supply Act* is only one way that government is authorized to spend. In some cases, the enabling legislation for a government entity, such as a university or a Crown corporation, provides the authority to spend money. In the 2015/16 Estimates, spending authorized in the *Supply Act* was about $37 billion, but total spending by all of government was over $50 billion. The difference is the authority that comes from other Acts, such as the *University Act*, the *Hydro and Power Authority Act*, and the *Special Accounts Appropriation and Control Act*.

## What is a special account?

As of March 31, 2016 government had 24 special accounts that are managed through various ministries. These accounts are intended to serve a special purpose, and because they are created through specific legislation, such as the *Special Accounts Appropriation and Control Act*, they are subject to specific rules. For example, the *Supply Act* authorizes spending for one year only, and ministries cannot carry unspent amounts forward to the next year. However, for special accounts, ministries can carry forward a balance, which can be spent beyond the end of the fiscal year.

A special account can allow government to monitor different sources of revenue, diverse activities and specific investments, separately from other accounts within a ministry. For example, government may wish to separately track and report an endowment contribution that has been received and invested, including the revenues and expenses related to the endowment's use. Or it may wish to track the revenue received from a specific tax or levy, and any associated program expenses.

The legislation that creates a special account is passed only once, and it authorizes all future spending from that account – whether the special account exists for one year or for decades. Legislators can debate planned spending (in the Estimates) for special accounts, but they do not need to approve it. Their predecessors did that in the originating legislation, which may be from long ago. The special account legislation may also authorize government to collect certain revenue and allocate it to the special account.

Once created, a special account exists indefinitely until its legislation is amended to remove it. For example, the BC Arts and Culture Endowment Special Account was created in 1967, and is still in operation today.

Government reports on the revenues, expenses and ending balances of its special accounts each year. The list of accounts can be found with government's Public Accounts, in the Consolidated Revenue Fund Supplementary Schedules.

# SPECIAL ACCOUNTS

## How much does government spend through special accounts?

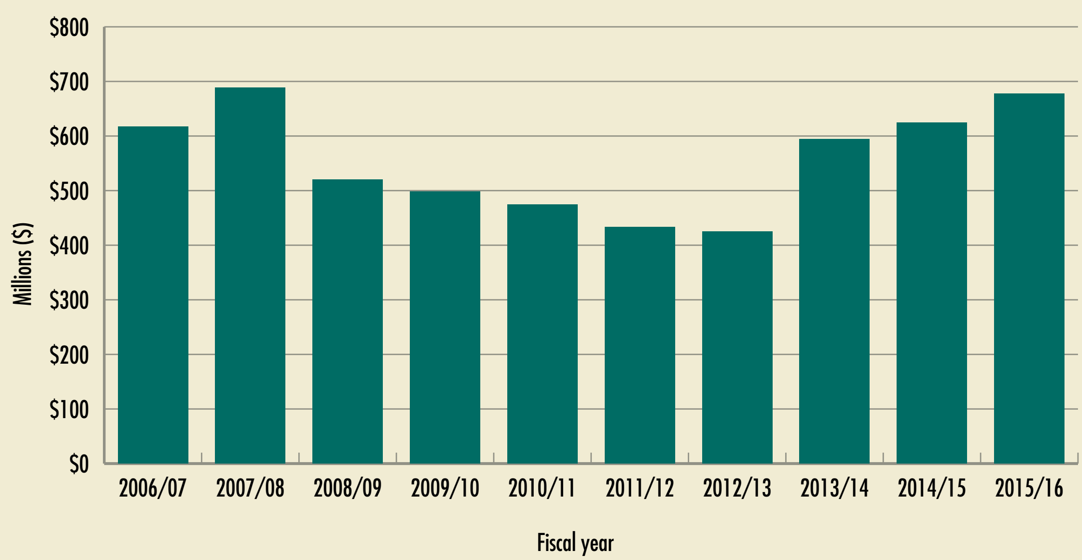
In the last ten years, government has spent between $400 million and $700 million annually through B.C.'s special accounts (see Exhibit 13). The BC Timber Sales Account, Crown Land Special Account, and Health Special Account combined have had the majority of spending over that time.

An important measure of a special account is the spending authority – the potential for future spending – available under it. As of March 31, 2016, there was a balance of $2.3 billion in all special accounts. After subtracting $0.5 billion for amounts that either cannot be spent or for which there is already a committed use, there is $1.8 billion available to be spent in the future. Three of the 24 special accounts combined account for $1.4 billion of that balance: BC Timber Sales Account, British Columbia Training and Education Savings Program, and Insurance and Risk Management Account.

## How does balanced budget legislation affect special accounts?

Special accounts are part of government's overall fiscal plan, and the amount spent is budgeted, recorded and tracked in the same way as other items in the Estimates. The amount to be spent by each ministry through special accounts is separately identified within

**Exhibit 13:** Special account spending for the 10-year period, 2006/07 to 2015/16 ($ millions)




Source: Compiled by the Office of the Auditor General of British Columbia from B.C. Public Accounts Supplementary Schedules to the Consolidated Revenue Fund

# SPECIAL ACCOUNTS

the Estimates. Because there are limits on overall spending within the fiscal plan, B.C.'s balanced budget legislation limits what ministries can spend each year through special accounts.

For example, a ministry may have an annual fiscal plan spending cap of $900 million. If a special account within the ministry had $25 million available and the ministry wanted to spend that entire balance, then the spending for other ministry operations would be limited to $875 million.

## How much of the special accounts balance is cash and investments?

In most cases, special accounts are simply a *notional accounting balance* within the Consolidated Revenue Fund. A notional balance is a cash or investment accounting entry. It is not a specific, one-to-one cash or investment account held in a bank or investment firm.

However, a few special accounts do have their own dedicated cash and investment accounts, and in some cases these amounts are substantial. From a cash management perspective, it makes sense to reduce cash and investments that are being held for future purposes, because it reduces the amount of debt government might incur if it needs to borrow to cover current costs.

As of March 31, 2016, over $300 million was set aside in dedicated cash and investment accounts for special accounts. This is less than in previous years, indicating that government has improved its cash management practices. For example, as of March 31, 2013, over $900 million was held as cash and investments within special accounts. During 2013/14, the British Columbia Training and Education Savings Program (formerly the Children's Education Fund) special account liquidated cash and investments of over $300 million. Government replaced the investments with an internal investment certificate – in effect, an IOU to itself. During 2014/15, the Housing Endowment Fund was similarly liquidated, reducing cash and investments by over $300 million.

## Who manages special accounts?

Government assigns the administration of each special account to a ministry. Day-to-day administration of special accounts is subject to government's core policy and procedures and to any other requirements under the *Financial Administration Act*. Individual special account legislation may also set requirements for how the account is administered, such as defining the sources of revenue and eligible expenses.

Ministries sometimes report on special accounts separately from other transactions. This can happen through a website, annual service plans, or one-time reports. There is basic reporting of all special accounts in government's Budget documents and year-end Supplementary Schedules to the Public Accounts.

Ultimately, all of the special account transactions and balances are consolidated into the government's annual Summary Financial Statements, along with the other transactions and balances for ministries, Crown corporations and all other government organizations.

# SPECIAL ACCOUNTS

## Why is our office reporting on special accounts?

A few years ago, we set out to examine special accounts, in part to explain how they work and why they exist. Our findings didn't warrant a full report, but are useful to summarize here.

We examined three special accounts in detail:

- British Columbia Training and Education Savings Program (formerly the Children's Education Fund)
- Innovative Clean Energy Fund
- First Nations Clean Energy Business Fund

Specifically, we wanted to assess whether ministry administrative practices ensured that each account was:

- in compliance with government's financial management framework (core policy and the *Financial Administration Act*)
- in compliance with the special account's enabling legislation
- effectively governed
- achieving its intended outcomes

## What we found

Overall, ministry practices were ensuring that the three special accounts were operating in compliance with government's financial management framework. The accounts also complied with required aspects of legislation, including their special account enabling legislation. We concluded that, generally, the accounts were being effectively governed.

At the same time, we determined there could be better measurement and reporting of the expected outcomes for the three special accounts, to determine whether the accounts are achieving their intended outcomes.

A common shortcoming was the limited measuring, tracking and reporting of program outputs and outcomes. In any government program, it's important to know whether the program objectives are met, not just that funds have been spent. The question that government must ask and answer is: Has the spending made a difference in achieving desired outcomes? Being able to measure a special account's success (or lack of it) would help indicate whether changes should be made to the operation of the special account.

We also found there was a lack of specific written guidance for ministries in administering their special accounts. The Ministry of Finance provides informal guidance on a case-by-case basis only.

We noted several differences in how special accounts are administered. For example:

- It was unclear whether a special account should be funded notionally or with actual cash and investments. Because government's debt continues to increase to support cash requirements, government must increase its borrowing to fund special accounts that hold cash and investments – and that borrowed money incurs interest payments. Even if the borrowed money is invested, the cost of borrowing is generally higher than the average rate of return on a cash account, a short-term investment or bonds.

The cost of borrowing the money does not come out of the special account in question. The balance in the account will increase because of the interest income it is earning, but government has to find a voted appropriation outside of the special account to pay the borrowing costs. Therefore, we would expect to see notional cash and investment balances being held.

- Among the 24 special accounts, there was variation in whether or not they received interest income on their notional account balances, and whether the ministry should charge administration fees to the account. Some of this inconsistency is due to differences in the legislation that created each special account (often many years ago). However, written guidance would help to alleviate the problem.

A third area where there could be improvement relates to a lack of formal guidance on when special accounts are the most appropriate vehicle to achieve government's objectives – i.e., when should a special account be created, amended or closed. In some cases, special accounts have been closed or the balances transferred into new special accounts. Ministries should periodically review the ongoing need for a special account in achieving the government's objectives and, if there is no ongoing need for the account, determine, along with the Ministry of Finance, whether legislation should be brought forward to discontinue the special account.

# LOOKING AHEAD: NEW CANADIAN PUBLIC SECTOR ACCOUNTING STANDARDS AND INTERNATIONAL FINANCIAL REPORTING STANDARDS

OVER THE NEXT few years, beginning with fiscal year 2017/18, eight new Canadian Public Sector Accounting Standards (PSAS) could impact the Summary Financial Statements. For example:

- For the year ending on March 31, 2018, government will need to adopt amendments made in the Introduction to the Public Sector Accounting Handbook, and new rules for accounting and disclosure related to five other areas: related parties, assets, contingent assets, contractual rights and inter-entity transactions.
- For the year ending on March 31, 2019, government will need to adopt new rules for accounting and disclosure related to restructuring transactions.
- For the year ending on March 31, 2020, government will need to adopt new rules for accounting and disclosure related to financial instruments.

We have advised government that early analysis of the new reporting standards is prudent and we will work with government through this process. Examples of additional disclosure these upcoming standards will require in the Summary Financial Statements include:

- Government will need to disclose information about *significant related party transactions* when the transactions occur at a value different from that which would have been arrived at if the parties were unrelated.
- Government will need to disclose information about *contingent assets*. This is a new concept in public sector accounting. Contingent assets can arise when there is a current situation that will be resolved in the future but it is outside government's control. The outcome or resolution will confirm whether an asset exists. For example, when government is involved in a lawsuit, the resolution is not within its control, but government may feel resolution will likely be successful and, so, include related disclosures.
- Government will need to disclose *contractual rights*, another concept new to public sector accounting. A contractual right arises out of a binding contract or agreement that has clear economic consequences and is enforceable by law, such as the right to receive lease payments.
- Government will need to record *specific financial assets and liabilities*, such as publicly traded equities and certain derivatives, using fair value. This is a change from current accounting standards, where most financial assets and liabilities are recorded on a cost basis. When government adopts this change, it will need to prepare a new statement called the statement of remeasurement gains and losses. This reports the impact of unrealized changes in the fair value of financial assets and liabilities, until the amounts become realized and are reported in the statement of operations.

# LOOKING AHEAD:
## NEW CANADIAN PUBLIC SECTOR ACCOUNTING STANDARDS AND INTERNATIONAL FINANCIAL REPORTING STANDARDS

Over the next few years, new International Financial Reporting Standards (IFRS) could also impact the Summary Financial Statements.

Government business enterprises (GBEs) generally use IFRS to prepare their financial statements. Examples of these self-supported GBEs are BC Hydro, ICBC and BC Lottery Corporation. When government consolidates these entities using the modified equity method, PSAS does not require any adjustments to be made to convert from IFRS accounting policies to PSAS policies. Therefore, any upcoming changes in IFRS may have an impact on the Summary Financial Statements equity in, and revenue from, self-supported Crown corporations and agencies.

Some of the more significant changes to IFRS accounting standards being implemented over the next few years:

- IFRS 9 Financial instruments – Effective in fiscal year 2018/19 (with earlier adoption permitted), the classification and measurement of financial assets and liabilities will be amended, affecting impairment of assets and hedge accounting. The standard could result in an earlier recognition of impairment losses. The requirements for documenting and testing hedging activities will become less stringent.
- IFRS 15 Revenue from contracts with customers – Effective in fiscal year 2018/19, a framework for the recognition, measurement and disclosure of revenue will be established.

  The core principle is that an entity should recognize revenue in a manner that considers the transfer of goods and services to customers in relation to the consideration the entity expects to receive in exchange for those goods and services – that is, the revenue recorded should be consistent with when the goods or services are provided.
- IFRS 16 Leases – Effective in fiscal year 2019/20, lessees will be required to recognize nearly all leases (including what are currently operating leases) on their balance sheet. A right-of-use asset and rental payment liability will be included on the balance sheet, and amortization of the asset and lease interest expense included in the income statement. Exceptions will be permitted for short-term leases and leases of low value assets. One consequence of the new model is expected to be a front-loading of lease expenses over the lease term, meaning the expense will be higher near the beginning of the lease than at the end of it.

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