October 2014

THE 2014 SUMMARY FINANCIAL STATEMENTS AND THE AUDITOR GENERAL'S FINDINGS

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of British Columbia

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The Honourable Linda Reid
Speaker of the Legislative Assembly
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Dear Madame Speaker:

I have the honour to transmit to the Legislative Assembly of British Columbia my 2014/15 Report: *The 2014 Summary Financial Statements and the Auditor General's Findings.*

Under section 11(1) of the *Auditor General Act*, my Office is required to report on whether the Province's 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 which is comprised of the 165 ministries and government organizations that make up the provincial government reporting entity.

I wish to express my thanks to all of the entities who participated in our audit, the Office of the Comptroller General, my staff and the private sector auditors who assisted in this audit. It is a huge undertaking (the largest financial audit in the province) that requires many hours and due diligence.

Carol Bellringer, FCA
Auditor General
Victoria, British Columbia
October 2014

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Carol Bellringer, FCA
Auditor General

Russ Jones, MBA, CA
Deputy Auditor General

Our annual audit of the Government of British Columbia's Summary Financial Statements is the largest audit in the province. This year, nearly 65 of our staff, as well as 28 private sector auditing firms, audited the 165 ministries and organizations that form the provincial government reporting entity.

This year, our audit opinion on the Summary Financial Statements contains two qualifications, or areas for concern. One involves the way that government records certain revenues in future years, rather than when received and used. The other qualification relates to prior years for how a Crown Corporation was classified. More information on these qualifications is available on page 15.

Our Office continues to be concerned that government has passed two regulations that allow it to override Canadian generally accepted accounting principles (GAAP). Our qualification regarding how government records certain revenues is related to one of these regulations. We encourage government to report publically, as required by accounting standards developed by independent Canadian public sector standard-setters, and to remove the regulations that create accounting policies that are inconsistent with these standards. More information on these regulations is available on page 12.

In June 2014, we published the guide *Understanding Canadian Public Sector Financial Statements*, to help those who are not familiar with public sector financial statements improve their ability to review and interpret government financial statements. The guide describes the unique aspects of financial performance and accountability in financial statements prepared in accordance with the Chartered Professional Accountant (CPA) *Canada Public Sector Accounting Handbook*. The guide is also a good resource when examining government's Summary Financial Statements.

In fact, the statements provide lots of interesting information about the bottom line, or impacts on the bottom line in coming years, as well as how government structures its finances. Without an accounting background, it would be challenging to even notice, not to mention understand, some of these interesting points. For instance, did you know that government earned $601 million from the sale of assets this year? That is much more than the prior year and contributed significantly to ensuring a balanced budget. It is important to note that assets can only be sold once and cannot be relied upon as a continuing revenue stream.

As well, it is interesting to note that while government's weighted average cost of borrowing is approximately 4%, on the $2.3 billion that government borrowed through public private partnerships this is 7.5% (see page 18).

Another matter that may be of interest to British Columbians is around the incentives that government offers oil and natural gas producers. To encourage continued exploration and development of BC's natural resources, government offers financial incentives to oil and natural gas producers. These incentives reduce the amount of royalties the producers pay to government. Details are on page 17. Of note, oil and natural gas producers have accumulated incentive credits of $1.25 billion, which they will be able to deduct from future royalties they pay to government.

More highlights of this nature are contained in this report and where we could, we hyperlinked directly to government's public accounts so you can see first-hand what we are referring to.

We have also included in Appendix B a status summary of our recommendations on the Summary Financial Statements from prior years.

We would like to thank all of the government entities who participated in this audit, the Office of the Comptroller General, as well as those involved in its completion including our staff and private sector auditors. It is a huge undertaking and everyone's efforts are appreciated.

Carol Bellringer, FCA
Auditor General
October 2014

Russ Jones, MBA CA
Deputy Auditor General

AUDIT TEAM

Bill Gilhooly
Assistant Auditor General

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I APPRECIATE THE OPPORTUNITY TO RESPOND to the Office of the Auditor General's comments. The government remains committed to providing meaningful financial statements. To this end, we continue to report our financial statements in accordance with public sector generally accepted accounting principles (GAAP), which are those accounting policies and applications that have been generally accepted by a majority of senior governments in Canada. Our key objectives in preparing the Public Accounts are to:

- provide the right level of information to help users understand the current financial position of the province and the government's annual operating results;
- report consistently so that users can easily compare results between years; and
- select accounting policies and apply accounting standards as consistently as possible with other jurisdictions in Canada.

There has been significant change in accounting standards for the public sector over the past decade. Standards in both the public and private sectors have shifted from a traditional "revenue and expense" model to an "asset and liability" model. This has been a challenge for everyone, but particularly for the public sector because governments deal not only with "exchange" transactions but "non-exchange" or "unilateral" transactions as well. In adopting these changes, we have to make sure that there are no unintended changes that result in significant financial shifts.

Our approach is to work actively with standard setters and other jurisdictions to understand how changes relate to historical practice, to identify conflicts that indicate problems either with past practice or new guidance, and to plan for implementation so that financial statements are reported on the same basis. We take this conservative approach because the risk of taking an accounting approach that is later found to be incorrect would undermine the long term usefulness of financial reporting. Financial information is most useful if it is conceptually consistent over a long period of time so that users can meaningfully compare the current year to prior years and estimates of future years. This approach has proven to be successful in managing the long term value of the province's financial statements.

In the opinion on the 2013/14 Public Accounts, the Auditor General identified two audit qualifications which are outlined in this report.

Audit Qualifications for 2013/14

Deferral of Government Transfers Revenue

I am not in agreement with the OAG with respect to the qualification regarding the recognition of government transfers. 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. We will continue to work with the Auditor General, other jurisdictions and the standard setters to resolve the issue.

Basis of Consolidation of the Transportation Investment Corporation

The Auditor General has concluded that the Transportation Investment Corporation is self supported and should be accounted for as a Government Business Enterprise.

Other Matters Discussed with Government

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

Accounting Standards

We believe that a national accounting standard for the public sector is important to the credibility of government financial statements. In the audit opinion, the Auditor General agrees that the accounting policies used in the preparation of the Summary Financial Statements are consistent with Canadian Generally Accepted Accounting Principles.

While all jurisdictions in Canada look to these standards, there are differences in application across Canada that arise from unique legislative requirements and governance frameworks developed through legislation to regulate the administration of government. When standards are evolving, it is the responsibility of Government to thoughtfully establish transitional accounting policies that will maintain continuity.

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:

- BC 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.
- BC 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. The regulation is consistent with Canadian public sector accounting standards guidance on government transfers and liabilities.

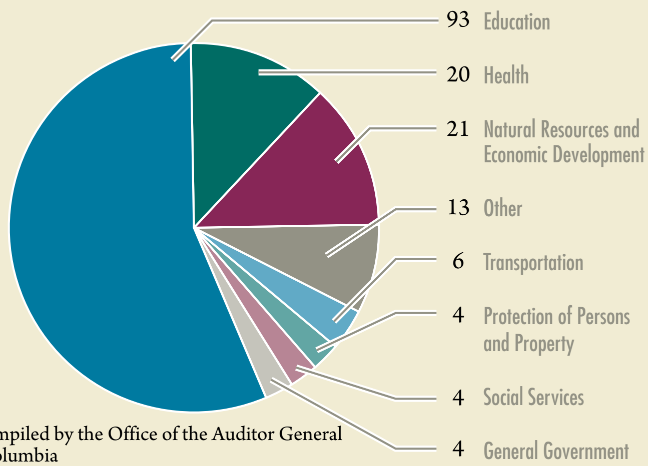
Being able to resolve several areas of disagreement that have been identified since our adoption of Public Sector Accounting Standards in 2004 is a very positive result and confirms the thoughtful and measured approach we have taken over the past decade. We will continue to work with the Auditor General and the broader accounting community to resolve the one remaining qualification included in the Auditors report.

Stuart Newton
Comptroller General
Province of British Columbia

BACKGROUND

At the end of every fiscal year, the Province combines the financial information of all the entities within its control and produces a consolidated set of financial statements called the Summary Financial Statements. The Summary Financial Statements are important to the people of British Columbia, as among other things, they provide an indication of the financial well-being of the Province. The 2013/14 Summary Financial Statements report the annual consolidated financial results of 165 ministries and organizations that made up the government reporting entity, including core government, Crown corporations, colleges, school districts, universities, health organizations and other public sector entities (see Exhibit 1).

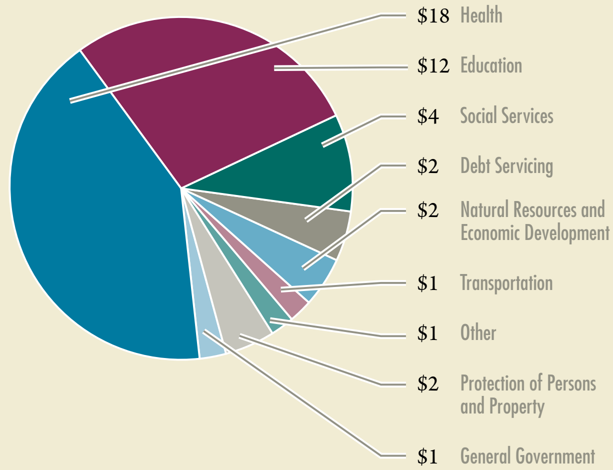
Exhibit 1: The 165 government ministries and organizations consolidated in the 2013/14 Summary Financial Statements, grouped by sector



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

Overall, $43 billion in revenue, $43 billion in expenses (see Exhibit 2), $80 billion in assets and $78 billion in liabilities are included in these financial statements.

Exhibit 2: Government expenses in 2013/14, grouped by sector ($ billions)



Source: Province of British Columbia Public Accounts 2013/14, pg. 42

Under section 11(1) of the *Auditor General Act*, our Office is required to report on whether the Province's Summary Financial Statements are presented fairly in accordance with Canadian generally accepted accounting principles (GAAP). This is the largest audit in British Columbia, taking nearly 65 staff in our Office around 49,000 hours to complete. It also requires assistance above and beyond our work from 28 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 (available at www.fin.gov.bc.ca/ocg/pa/13_14/Pa13_14.htm). The Public Accounts also include our separate audit opinion on the Total Provincial Debt and related Debt Indicators. In addition, the Public Accounts contains unaudited information, such as government's financial statement discussion and analysis report, and information about the Consolidated Revenue Fund and other aspects of the provincial debt.

In the case of British Columbia's 2013/14 Summary Financial Statements, we issued a modified report this year because the Province did not materially comply with GAAP in two significant areas:

- inappropriate deferral of revenues; and
- the comparative figures being materially misstated due to the lack of full consolidation of the Transportation Investment Corporation for the previous year.

This report discusses these qualifications and other items of interest contained within the government's Summary Financial Statements.

INTRODUCTION

Canadian generally accepted accounting principles: key to credible financial reporting

For the fiscal year starting April 1, 2004, British Columbia became a leader among governments in Canada, when legislation enacted in 2001 came into force requiring the Province's Summary Financial Statements to be prepared in accordance with Canadian generally accepted accounting principles (GAAP).[1]

GAAP includes standards that accountants use in the preparation of financial statements, and that auditors use to assess whether the standards have been met, and to form an opinion on the fairness of the statements. These standards are the yardstick by which auditors provide their independent opinions on each entity's financial statements. By adopting these standards, government demonstrates its commitment to carrying out high-quality financial reporting and producing credible, consistent financial statements that are comparable with those of other jurisdictions. Financial statements that depart from GAAP put the government in the position of being non-compliant with its own legislation.

All levels of government across Canada use a form of GAAP specifically designed for the public sector called Public Sector Accounting Standards (PSAS). These standards are issued by the Public Sector Accounting Board, an independent standard-setting body. The principles are developed by independent standard-setters. Independence in developing accounting standards is extremely important, given that the goals of those who prepare financial statements are typically not the same as the goals of those who rely on the objectivity of the information provided. How each jurisdiction applies GAAP can vary by differences in legislation, regulations, composition of the reporting entity, and interpretation of the accounting standards.

Government's amendments to generally accepted accounting principles

Section 23.1 of the *Budget Transparency and Accountability Act* requires the provincial government and its entities to conform to GAAP. However, as noted in prior years, government also gave itself the ability to make regulations that change GAAP as it chooses.

Changing GAAP significantly reduces the objectivity of financial reporting. Instead of using an independently agreed-upon, standard measure to assess financial performance, government can determine how its financial performance should be measured and reported to British Columbians.

Our Office is concerned that government has created accounting policies that are inconsistent with independently developed accounting standards and that may obscure the true financial position of government. We encourage government to report to the public as required by accounting standards developed by independent Canadian public sector standard-setters, and to remove the regulations that create accounting polices that are inconsistent with these standards.

1 See the *Budget Transparency and Accountability Act*, section 23.1

To date, government has passed two regulations under the Act that allow them to override Canadian GAAP. The first one relates to deferring expenses or revenues into the future:

> **B.C. Regulation 257/2010** – Government directed BC Hydro to adopt part of a U.S. accounting standard (FAS980 Regulated Operations) by 2012/13 to account for the effects of rate regulation.

Rate-regulated accounting allows the deferral (or smoothing) of expenditures and revenues over multiple years when they would otherwise be accounted for as an expense or revenue in the current year. For more information on this, see our follow-up report on *BC Hydro: The Effects of Rate-Regulated Accounting*, issued in June 2014.

Although B.C. Regulation 257/2010 was issued at a time when it appeared rate regulated accounting would soon not be allowed in Canada, Canadian accounting standards will now permit rate-regulated accounting until fiscal years beginning on or after January 1, 2015 (i.e., until the Province's 2016 fiscal year) and, therefore, there has been no impact to the Summary Financial Statements as a result of this regulation.

The second regulation relates to deferring contributions/revenue from other governments and non-government sources into the future:

> **B.C. Regulation 198/2011** – In 2012/13, new accounting standards for government transfers came into effect. These standards set stricter rules on what kinds of revenue can be deferred and accounted for at a later date. The result of the new standard would be government recording revenue from other governments sooner. This regulation directs government organizations to continue deferring government transfers and restricted revenues. Government has expressed consistently that this is an acceptable interpretation of the new accounting standards. However, our Office and other independent auditors of government organizations in British Columbia do not consider the regulation to be an acceptable interpretation of the standards and feel that it actually changes them.

When government organizations defer these types of revenues in accordance with the regulation, they are not complying with GAAP. As a result, many of those organizations received either a non-GAAP compliance, or a modified GAAP audit opinion this year. See types of audit reports.

Although this regulation does not apply directly to the Province's Summary Financial Statements, the statements include the results of the organizations that it does apply to. Since government has not adjusted for how the regulation has been applied by the organizations when consolidating them, this then impacts the Summary Financial Statements. See our 2013/14 Audit Opinion.

Types of audit reports

Audit reports represent an auditor's independent, professional opinion on whether an entity's financial position and results of its operations are presented fairly in its financial statements. Audit reports can also identify any concerns auditors have with the quality of the financial statements.

For the 2013/14 audit of government organizations that make up the Summary Financial Statements, three different types of audit reports were issued:

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

Modified report

On the rare occasion that auditors issue a modified report, they are saying that they have concerns with:

- the availability of sufficient and appropriate information for users to make an informed decision; or
- errors caused by the entity's application of accounting standards (GAAP).

A modified report may contain 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; or
- a disclaimer of opinion, where the auditor is unable to obtain sufficient appropriate audit evidence to form an opinion.

In determining whether a modification is necessary, an auditor considers the materiality or significance of the errors or missing information in relation to the financial statements as a whole. In addition, the auditor considers the errors individually and in total. A numerical threshold for materiality is set, for example, at half a percent of total expenses. If that were the case and the misstatements found by the auditor were less than this, then no modification of the opinion would be needed. Alternatively, if the misstatements exceeded the threshold, the auditor might modify the audit opinion for those errors. Before doing that, however, the auditor presents these errors to management to allow them an opportunity to correct them.

The auditor must also consider qualitative factors. For instance, a discrepancy of a relatively small amount could have a material effect on the financial statements if the amount changes a deficit into a surplus (or vice versa), alters a trend, or changes a key ratio. As well, disclosure that is not complete or that provides inappropriate information may be considered to have a material effect. For example, we included a qualification in our 2011/12 audit opinion on the Summary Financial Statements because the Province had not disclosed required financial information related to certain government business enterprises, even though this lack of disclosure had no impact on the reported balances in government's financial statements.

Compliance report

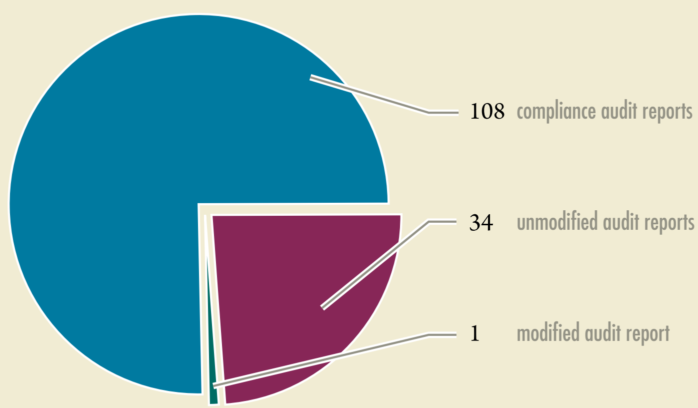
Auditors can also issue a compliance audit report if an entity's financial statements are presented according to its chosen or legislated framework, but not in accordance with GAAP. The entity must include a note with its financial statements explaining how they would be different if it were adhering to GAAP, and the auditor's report must reference this note.

Auditor's reports for government organizations

This past fiscal year, 108 of the 143 organizations receiving separate audit opinions received compliance audit reports because they followed the regulation government issued related to the deferral of certain contributions/revenue which is inconsistent with GAAP. Thirty-four received an unmodified audit report (the entity's financial statements were fairly presented), and one organization (BC Transportation Financing Authority) received a modified audit report because of how it treats material government transfers and restricted revenues.

Concerns with financial statements should be rare, yet there are a notable number of organizations that received compliance or modified audit reports this year (see Exhibit 3).

Exhibit 3: 2013/14 compliance and other types of auditors' reports for government entities



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

AUDIT OPINION FOR 2013/14

Modification 1: Inappropriate deferral of revenues

At March 31, 2014, government deferred $3.8 billion of revenue, mainly relating to the purchase or construction of assets, such as buildings and highways.

These revenues come from two sources: transfers from other governments and restricted revenues from non-government sources.

While there are different accounting standards for these two types of revenue, the effect is basically the same. The funds should be recognized as revenue in the statement of operations, as they are used for the asset purchase or construction. Instead, Government is accounting for this revenue in future years over the life of the assets.

Arguments can be made in support of either approach. However, the Public Sector Accounting Board set a standard after public consultations to prevent inconsistencies. This standard requires that funds received for the purchase or construction of assets should be recognized as revenue as they are used for the purchase or construction, unless there are stipulations attached to the transfer that create a liability (i.e., a situation where money is owed at a later date) that extends beyond the time of purchase or the period of construction.

For example, if $10 million was received to help fund the construction of a building, Public Sector Accounting Standards (PSAS) would require that the revenue be recognized over the two or three years it may take to construct the building. But the government is recording as revenue 1/50th, ($200 thousand), each year for the next 50 years, assuming for this example that the building has an expected useful life of 50 years.

As described above, there are instances where government would be permitted under the accounting standards to recognize the funds over the life of the asset, and some of the transfers received by the government are correctly accounted for in this manner. For example, if the funds were received to build a bridge, but some of the funds had been designated in the transfer agreement to maintain the bridge over its useful life, the funds designated could be recognized as revenue over the life of the bridge.

However, in our view, $3.8 billion of the funds received do not have stipulations attached to them that create a liability after the purchase or construction is complete, and so should have not been deferred.

This issue first came up last year when the current standard for accounting for government transfers became effective. At that time, government should have adjusted all of the funds received in prior years and in fiscal 2013 that should no longer be deferred. Because they did not do this, the total error at March 31, 2014 is $3.8 billion, and most of that should have been adjusted last year. The amount relating to operations for the year ending March 31, 2014 is $232 million, which is the amount by which revenue (and the surplus) should be increased.

Modification 2: Removing the qualification for Transportation Investment Corporation

This year we removed our long-standing audit qualification related to the Transportation Investment Corporation's (TIC) consolidation in the Province's Summary Financial Statements.

The TIC is a public Crown corporation established in 2008 to design, build and operate the Port Mann/Highway 1 Improvement Project, which includes the new Port Mann Bridge. Since its inception, government has classified the TIC as a government business enterprise (GBE).

This classification is important since GBEs are consolidated differently than taxpayer supported government organizations. Taxpayer supported organizations are fully consolidated, which means adding in all of the assets, liabilities, revenues and expenses to the Summary Financial Statements on a line-by-line basis, and making appropriate adjustments to remove transactions between the organizations. Government Business Enterprises are consolidated on the modified equity basis, which means that only the government's investment in the GBE and the earnings (or losses) of the GBE are included in the Summary Financial Statements. See Investment in, and surpluses of, government business enterprises.

To be classified as a GBE, an organization must be able to pay its bills from sales to people or organizations outside of government. In the case of the TIC, this means that it pays its bills from the tolls it receives from those crossing the Port Mann bridge.

For the past five years, we have disagreed with government about the TIC's classification as a GBE, as the TIC did not generate enough income from tolls to pay its expenses, and we were unable to reach a conclusion on the validity of its cash flow projections for future years from its financial modeling. As a result, we included a qualification in our past audit opinions on the Province's Summary Financial Statements.

In forming our opinion each year, we re-evaluate our analysis by assessing the current facts against the PSAS accounting standards. Over the last year, several conditions at the TIC changed:

- Fiscal 2013/14 was the first full year of operating the bridge for the TIC.
- Introductory (discounted) tolls were eliminated in January 2014 when the improvements to the highway corridor were substantially completed.
- Although traffic on the bridge is lower than originally anticipated, we reviewed the TIC's latest cash flow projections from its financial modeling and concluded that the projections are plausible based on current long term assumptions about ridership growth and tolling rate increases, showing how the corporation will maintain its operations and meet its liabilities in the future. The current model, reflecting updated traffic forecasts and toll increases, anticipates positive cash flows from operations by fiscal 2021/22.

In conclusion, the TIC now meets the criteria for classification as a GBE. The construction phase is substantially complete, tolling has been in place for a full year of operations, and the TIC has implemented its planned tolling strategy (removed the introductory toll rates). However, because we modified our opinion in prior years and it impacts the comparative figures presented in the Summary Financial Statements, audit standards require us to reference it one last time in this year's opinion.

Looking forward, we will continue to evaluate the classification of the TIC each year to ensure the corporation's actions and financial results are consistent with its plans.

THE SUMMARY FINANCIAL STATEMENTS CAN TELL AN INTERESTING STORY

The Summary Financial Statements tell much more than just the Province's bottom-line. While they are not always the easiest to follow if you do not have an accounting background, they are packed with important information, particularly in the notes, and tell an interesting story about the financial health of our province. To help readers understand and learn from these types of statements, our Office produced a guide *Understanding Canadian Public Sector Financial Statements* in June 2014.

The guide describes the information that can be obtained from the statements and notes, and includes suggested questions to ask about public sector financial statements.

In this section of the report, we highlight some information that is important for understanding the bigger picture of the 2013/14 Summary Financial Statements of the Province. We provide hyperlinks to the statements where appropriate.

Surplus asset sales

When assessing financial performance, it is important to look for, and understand, the impact of one-off events, such as the sale of government owned land or buildings.

Last year, government earned $601 million from the sale of assets: $311 million from government's program to release surplus assets, such as two former gravel pits in Surrey and a surplus parcel of land in Kamloops; and, close to $290 million from the Little Mountain property in Vancouver. This is significantly larger than the $13 million earned the prior year. Although only a small percentage of total revenues, the gain is a significant part of the bottom line for the year, which was reported as a $353 million surplus in the 2013/14 Summary Financial Statements.

Next year, government is budgeting $200 million in asset sales to help meet its overall target of a $384 million surplus.

In the Summary Financial Statements… The gross revenues received from the sale of the assets are included in the $3.2 billion of Miscellaneous Revenues on the Consolidated Statement of Operations on page 42. However, the amount can be seen on the Consolidated Statement of Cash Flow on page 44, which discloses the total sales of $662 million, which resulted in a gain of $601 million over the original cost and selling expenses.

Oil and natural gas incentives

To encourage production of oil and natural gas in BC, the province provides financial incentives to oil and gas producers. Last year, this program provided producers with $587 million in incentives.

As well, oil and natural gas producers pay the province a royalty for the right to extract resources that the province owns. When they make that payment, the producers simply reduce the royalty amount that they owe government by the incentive amount that they are entitled to.

Of interest though, is how government records the royalty revenues and the incentive expenses. The incentive expenses are deducted from the royalty revenues, and only the net amount is shown in the statement of operations. The incentives claimed are quite large – almost 30% of the gross royalty revenue received by government in fiscal 2014.

In addition, producers have incurred expenditures that will qualify for $1.25 billion in incentive credits, but have not yet produced enough oil or natural gas to claim these amounts. When these producers claim their incentive credits, that money will be deducted from the royalties that they owe, thereby reducing the amount of money government will generate. In this case, this represents a reduction of $1.25 billion in revenue in future years if all the incentives are used.

In the Summary Financial Statements… The amount of the incentives can be found in the narrative to the natural resource revenue in note 29 on page 79.

Net liabilities

For the Province to pay its liabilities, it needs cash or assets that can readily be converted to cash (e.g., investments cashed in, or accounts receivable collected). If the Province has more liabilities than accessible cash (financial assets), it is said to have net debt or net liabilities. More information on these terms is available in our guide *Understanding Canadian Public Sector Financial Statements* published in June, 2014.

Net liabilities provide readers with important information regarding the Province's need to raise revenues in the future to pay its existing obligations. Government often borrows money to purchase capital assets. These assets are usually used to provide services rather than to generate revenue. The borrowing for these assets adds to the amount future taxpayers will have to repay. This results in an increasing net liabilities figure which signals a need to generate future revenue.

The Province showed net liabilities of almost $39 billion at March 31, 2014 on their consolidated statement of financial position, an increase of about $750 million over the prior year.

In our audit opinion, we explain that this includes almost $4 billion of revenue that should not have been deferred. Had this been adjusted by government, net liabilities would have been $35 billion.

Government Business Enterprises carry an additional $29 billion in net liabilities. Readers have to know to look for the information about these self-supported Crown corporations to understand the complete picture.

The Province's adjusted net liabilities of $35 billion and the GBE net liabilities of $29 billion therefore total $64 billion.

Debt and interest rates on P3 capital projects

The $41.7 billion of taxpayer-supported debt shown on the consolidated statement of financial position includes $2.3 billion of debt generated from P3 (public private partnership) projects. This includes 16 different P3 projects in seven different government organizations and two ministries as shown in Appendix A. The interest rates on this $2.3 billion of P3 debt range considerably, from 4.42% to 14.79%, and have a weighted average interest rate of 7.5%. Over the last two years, government had a weighted average interest rate on its taxpayer-supported debt of about 4% as shown in note 18.

In the Summary Financial Statements… Details around taxpayer-supported debt are disclosed in note 18 on page 64, and the P3 debt is in footnote 3.

Cash management

The Statement of Cash Flow explains the change in cash and cash equivalents (things easily converted to cash such as a redeemable guaranteed investment certificates) from the prior year, and how the entity generated cash and financed its activities during the current and prior year. The statement (explained in greater detail in our guide *Understanding Canadian Public Sector Financial Statements* published in June, 2014) presents cash flows in four categories:

1. operating activities;
2. capital activities;
3. investing activities; and
4. financing activities.

How the cash is generated and used is shown separately in each case.

Government started the 2014 fiscal year with approximately $2.2 billion in cash. Over the year, the Province generated a further $3.5 billion:

- $2.3 billion from financing activities, and
- $1.2 billion from investing activities.

It used the $3.5 billion to pay for:

- $2.5 billion of capital expenses; and
- $1 billion of operating expenses.

As such, there was relatively little change in the total cash available at the end of the year from the beginning.

When reviewing the statement of cash flow, one matter readers should question is whether the entity has excess cash that could be invested, or used to pay down debt, or avoid taking on new debt, which will reduce interest costs. In this case, government looks like it had almost $2.4 billion in excess cash at year end.

Odd as it may sound though, not all of that cash is available for use by the government. For instance, universities and colleges have restricted funds for endowments and such, and school districts often have special purpose funds for things like equipment for special needs students. The cash in these accounts cannot be used to pay down Provincial debt.

For the excess cash that remains in government organizations though, government has taken steps to start putting the money to good use by setting up its Central Deposit Program.[2] The program allows government organizations to deposit their excess cash with the Provincial Treasury instead of a financial institution. Treasury pays interest to the organization and in turn, uses the money deposited to reduce or avoid new government borrowing. For more information on the Central Deposit Program and the effectiveness of government's cash management, please see our report, *Working Capital Management Since 2010*.

In the Summary Financial Statements… "Cash and cash equivalents" is on the Statement of Financial Position, and the statement of cash flows is on pages 44 and 45.

2 The Central Deposit Program is a government initiative developed in response to our earlier report in August 2010 on Working Capital Management, which we followed up in March 2014: *Working Capital Management Since 2010*

Investment in, and surpluses of, government business enterprises

Entities such as BC Hydro and BC Lottery Corporation are known as government business enterprises (GBEs). The province invests in its GBEs by providing initial start-up funding and may loan money to a GBE for capital improvements. These organizations are intended to be self-supporting, meaning that the organization's operations must be self-sustaining through its revenue generating activities (e.g., selling power, lottery and insurance products, alcohol sales) to cover their operating expenses and meet the mandates directed by government.

As these government business enterprises are self-supporting, accounting standards do not require that they be consolidated into the Summary Financial Statements on a line-by-line basis – instead they are consolidated on a modified equity basis. Only government's amounts due from, and investments (i.e., equity) in, GBEs are recorded as assets on the statement of financial position, and the annual net earnings of the GBEs are recorded as revenue in the statement of operations.

Government is the sole shareholder of each GBE, and similar to a public company, often requires an annual dividend. If the GBE needs its cash reserves in order to expand its operations or otherwise increase its capital assets, it may not have enough cash available to pay the dividend government requires of it. Occasionally a GBE must borrow the money (usually from government) and go further in debt to pay government its annual dividend.

The $6.7 billion in accumulated surplus of the GBEs as at March 31, 2014 represents the amount that could in theory be paid as a dividend, and is described as unremitted earnings in the summary financial statements. Note 7 on page 54 shows the capital investment and unremitted earnings at the end of the year, and on page 55, the changes during the year.

Government has loaned BC Hydro and the Transportation Investment Corporation almost $19 billion

Over the years, government has loaned almost $19 billion to BC Hydro and the Transportation Investment Corporation. When Crown corporations or GBEs need money for the construction or acquisition of assets, they usually turn to government because it has significant borrowing power and can therefore access better interest rates and loan conditions.

Government borrows the money from the public bond markets and then loans it to the GBE. Government pays interest to the bondholders on a regular schedule and the bond is repaid when it comes due. In turn, the GBE makes payments to Government on the same schedule.

Because GBEs are not fully consolidated on a line-by-line basis, government records loans to these self-supported GBEs as assets. The amounts borrowed on behalf of GBEs are also recorded separately as liabilities, namely self-supported debt.

In the Summary Financial Statements… "Loans for Purchases of Assets, Recoverable from Agencies" on the Statement of Financial Position is on page 41 and note 11 on page 59.

LOOKING AHEAD – NEW ACCOUNTING STANDARDS

Over the next few years, there will be three new accounting standards that could impact the Summary Financial Statements.

1. For the year ending March 31, 2015, the current fiscal year, the Province will need to review how it records liabilities for contaminated sites.
2. In the year ending March 31, 2016, Public Sector Accounting Standards may require BC Hydro to fully adopt International Financial Reporting Standards (IFRS).
3. In the year ending March 31, 2017, the Province will need to adopt new rules for accounting and disclosure related to financial instruments.

These changes are explained in the following sections.

Liability for contaminated sites (PSAS 3260)

While government already records liabilities for environmental remediation once site assessments are made, this new standard requires it to determine if these liabilities exist regardless of whether an assessment has been made. This could significantly increase the liabilities currently recorded by government, and will increase the effort government has to make to identify and manage any such liabilities. Increased liabilities will negatively impact the bottom line, since an expense will have to be recorded when the liabilities are booked. The Province has been working on implementing this standard.

BC Hydro and International Financial Reporting Standards: Accounting for rate-regulated assets

At March 31, 2014, BC Hydro has deferred a net $4.7 billion of expenses. By deferring costs, and then expensing them over future years, BC Hydro is able to recover them from customers without sudden rate spikes, smooth their net income each year, and make an annual dividend payment to the Province. BC Hydro applies rate-regulated accounting policies set by the Accounting Standards Board of the United States of America, following a directive from the Province.[3] Canadian standards also currently allow the use of rate-regulated accounting.

The Canadian Public Sector Accounting Board requires government business enterprises (of which BC Hydro is one) to follow the standards prescribed for them by the Canadian Accounting Standards Board, which in turn follows International Financial Reporting Standards (IFRS). Under IFRS, utility companies such as BC Hydro are allowed to use rate regulated accounting until their 2016 year-end, at which point they must set aside rate regulated accounting and follow IFRS in full, which will mean not being able to defer these expenses to future years. This may change though, as there is a new standard setting project underway re-examining this.

3 For more information, see our report *BC Hydro: The effects of rate-regulated accounting* and page 41 of our *June 2014 follow-up report*

In the Summary Financial Statements… Details about regulatory accounting can be found in note 37 on page 83. Further details about BC Hydro's financial results, regulatory accounts and other information can be found on its website.

Financial instruments (PSAS 3450)

The Province's Summary Financial Statements currently record all of government's financial instruments, such as investments, at cost or the price that each investment was initially purchased for, rather than fair value or what they are currently worth if sold. Depending on the increase or decrease in value of each investment, the fair value could be considerably different than the original cost. New standards for financial instruments will require fair value accounting.

Government organizations have already implemented the financial instruments standard. As a result, some financial instruments such as equity investments, debt derivatives, and instruments held in a foreign currency are now recorded in the entity's financial statements at fair value rather than cost.

The year ending March 31, 2017 will be the first year that government will roll up the fair value totals from each entity to the Summary Financial Statements. This will provide a more accurate picture of the current value of government's investments and other financial instruments. For now, the original cost is still shown.

APPENDIX A: PUBLIC PRIVATE PARTNERSHIP (P3) DEBT AND INTEREST RATES AS AT MARCH 31, 2014

	Debt $ Millions	Interest rate
In the BC Transportation Financing Authority (note 13 of their financial statements)		
Evergreen Line Rapid Transit Project	$127	4.42%
Kicking Horse Park Bridge	$66	7.40%
Sea-to-Sky Highway Corridor	$491	7.52%
William R. Bennett Bridge	$170	7.88%
South Fraser Perimeter Road	$187	9.16%
In the Fraser Health Authority (note 6 of their financial statements)		
Jim Pattison Outpatient Care and Surgery Centre	$164	6.21%
Abbotsford Regional Hospital and Cancer Centre	$321	7.75%
(some more of this debt is in the Provincial Health Services Authority – see below)		
Surrey Memorial Hospital Redevelopment Project	$180	7.76%
In the Interior Health Authority (note 7 of their financial statements)		
Interior Heart & Surgical Centre Project	$59	5.83%
Kelowna and Vernon Hospitals Project	$147	7.62%
In the Northern Health Authority (note 6(b) of their financial statements)		
Fort St. John Hospital and Peace Villa	$31	14.79%
(note: this is for approximately 10% of the total project cost; balance funded through provincial borrowing)		
In the Provincial Health Services Authority (note 9 of their financial statements)		
Abbotsford Regional Hospital and Cancer Centre	$57	7.75%
(some more of this debt is in the Fraser Health Authority – see above)		
Northern Cancer Centre	$16	8.09%
In the Vancouver Island Health Authority (note 8 of their financial statements)		
RJH Patient Care Centre	$190	6.87%
In the Provincial Rental Housing Corporation (note 8 of their financial statements)		
SRO Renewal Initiative	$46	6.61%
In the Ministry of Natural Gas Development		
Sierra Yoyo Desan Road (project funded by industry road use fees)	$22	11.77%
In the Ministry of Technology, Innovation and Citizen's Services		
Surrey Pre-Trial Services Centre Expansion	$44	7.53%
	$2,318	

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

APPENDIX B: STATUS OF PRIOR YEARS' RECOMMENDATIONS

The report on fiscal 2013 included four recommendations, and 24 recommendations outstanding from prior years. Of these 28 recommendations, four have been repeated more than once in different years and:

- one has been implemented by government;
- two have not reoccurred;
- three we withdrew;
- ten we are not pursuing; and
- eight are still outstanding.

All recommendations are listed below.

OUTSTANDING RECOMMENDATIONS BY THEME

Departures from GAAP

2012/13 no.1 (p. 23)

> We recommend that government record government transfers as required by Canadian public sector accounting standards.

2012/13 no.2 (p. 24)

> We recommend that government record restricted revenues as required by Canadian public sector accounting standards.

Accounting for tax appeals

2010/11 no.4 (p. 26)

> We recommend that government record an estimate of tax appeals that have not yet been assessed as an accrued liability in the Summary Financial Statements. Because the accrual will be based on an estimate, government should also disclose the amount of uncertainty around the estimate in the Measurement Uncertainty note (note 2) to the Summary Financial Statements.

Disclosure of contractual obligations

2006/07 no.4 (p. 16), 2007/08 no.10 (p. 47), 2008/09 no.5 (p. 44) and 2009/10 no.6 (p. 26)

> We recommend that government include additional information about the nature of the contractual obligations in the Summary Financial Statements.

Separate disclosure of liabilities related to leased tangible capital assets

2006/07 no.9 (p. 26) and 2007/08 no.1 (p. 37)

> We continue to recommend that government include liabilities related to leased tangible capital assets as a separate line on the statement of financial position.

Government's financial statement discussion and analysis

2011/12 no.2 (p. 14)

> We recommend that government provide all relevant information within the Financial Statement Discussion and Analysis, supported by financial statement results, to explain how it performed as fiscal stewards of public funds.

2006/07 no.1 (p. 14)

> We continue to recommend that government present a long-term trend analysis in the Financial Statement Discussion and Analysis (FSD&A) so that it can provide better context for discussing government's financial performance. In addition, we recommend that government cross-reference the FSD&A and the Financial and Economic Review.

2006/07 no.2 (p. 14)

> We recommend that government continue to expand its Financial Statement Discussion and Analysis (FSD&A) to better cover material financial risks and uncertainties and the challenges involved in their ongoing management.

RECOMMENDATIONS IMPLEMENTED BY GOVERNMENT

Departures from GAAP

2012/13 no.4 (p. 28)

> We recommend that government provide detailed disclosure of the British Columbia Public Service Long Term Disability Plan in the notes to the Summary Financial Statements as required by Canadian public sector accounting standards.

RECOMMENDATIONS NOT REOCCURRED

Departures from GAAP

2011/12 no.5 (p. 22)

> We recommend that government not classify the Transportation Investment Corporation as a government business enterprise and instead consolidate it on a line-by-line basis in accordance with Canadian public sector accounting standards.

Classification of debt

2008/09 no.3 (p. 42) and 2009/10 no.5 (p. 26)

> We recommend that the debt of the warehouse borrowing program and of the Transportation Investment Corporation be included with taxpayer-supported debt and not self-supported debt.

RECOMMENDATIONS WITHDRAWN

Departures from GAAP

2012/13 no.3 (p. 26)

> We recommend that government record deep-well credits as a liability of the Province as required by Canadian public sector accounting standards.

Disclosure of gaming grants

2010/11 no.3 (p. 26)

> We recommend that gaming grants be classified in the statement of operations according to the purpose of the grant provided by government.

Government's financial statement discussion and analysis

2006/07 no.3 (p. 15)

> We recommend that government adopt the use of the CICA-recommended measure of "government-to-government transfers to own-source revenue" for use in the financial statement discussion and analysis.

RECOMMENDATIONS NOT PURSUING

We are not pursing the recommendations below due to the following reasons: either the recommendation is too broad, has been covered off in other reports, has been reassessed as not significant, or is under reassessment and will be replaced with new recommendations if applicable.

Government's accountability framework

2011/12 no.3 (p. 17)

> We recommend that government review how accountability frameworks, including annual balanced budget requirements, interact to influence decision-making across the government reporting entity. The framework should be designed so that appropriate incentives are in place to encourage sound financial management.

Internal control issues

2011/12 no.4 (p. 18)

> We recommend that government implement a process to ensure that all management letter points are followed up and resolved on a timely basis.

Classification of debt

2010/2011 no.2 (p. 25)

> We recommend that government include the debt of the warehouse borrowing program with taxpayer-supported debt and not with self-supported debt.

Complete disclosure of prior year adjustments

2008/09 no.4 (p. 43) and 2009/10 no.1 (p. 23)

> We recommend that, when prior year numbers have been restated, government draw attention to the restated numbers with appropriate referencing and make full disclosure of the changes that have taken place, in accordance with Canadian generally accepted accounting principles.

Ministry financial statements

2008/09 no.10 (p. 55) and 2009/10 no.2 (p. 23)

> We recommend that government require individual ministries to prepare separate financial statements as well as consolidated financial statements to show the financial results of the sectors they are responsible for.

Pension plan disclosures

2009/10 no.8 (p. 27)

> Partially resolved: We continue to recommend that government improve its disclosure of pension plans as required by Canadian GAAP.

Segmented reporting disclosure

2006/07 no.20 (p. 41) and 2007/08 no.15 (p. 49)

> Partially resolved: We continue to recommend that government, in continuing to adopt best disclosure practices, produce detailed sector schedules in the Summary Financial Statements.

Disclosure of tangible capital assets under lease

2006/07 no.8 (p. 25)

> We recommend that government create a table for tangible capital assets under lease, similar to the table presentation used for the current statement of tangible capital assets.

Direct method of cash flows

2008/09 no.7 (p. 46)

> We recommend that government present its statement of cash flow using the direct method.

Comparing budget information with the Summary Financial Statements

2008/09 no.9 (p. 54)

> We recommend that government improve its Budget and Estimates documents to include full, line-by-line budget information for each of the sectors reported in the Summary Financial Statements, and to include the budget-to-actual information in the Summary Financial Statements.

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