



Office of the Auditor General of Ontario
Bureau de la vérificatrice générale de l'Ontario

March 20, 2018

To the Standing Committee on Public Accounts

**RE: Status Report on the Special Audit of the Financial Statements of the
Independent Electricity System Operator for the Year Ended December 31, 2017**

Dear Committee Members:

Background

The public hearing on Chapter 2 was held by the Standing Committee on Public Accounts on Wednesday, February 28, 2018. As you deliberate the drafting of your report on Chapter 2 of Volume 1 of the December 31, 2017 Annual Report of the Office of the Auditor General (Chapter 2), the following update on Recommendation 5 from Chapter 2, page 55 is provided for your consideration.

Recommendation 5 states:

We recommend that the Independent Electricity System Operator (IESO), an "other government organization," use the Canadian Public Sector Accounting Standards (PSAS) in the preparation of its financial statements. Specifically, it should:

- remove market accounts recorded on its financial statements; and*
- discontinue the inappropriate use of rate-regulated accounting in the preparation of its financial statements.*

To ensure that the members of the Legislative Assembly receive financial information on the operations of the IESO prepared in accordance with Canadian PSAS, the Office of the Auditor General will conduct an attest audit of the December 31, 2017, financial statements of the IESO as permitted under the Electricity Act, Subsection 25.2(2), which states: "The Auditor General may audit the accounts and transactions of the IESO. 2014, c. 7, Sched. 7, s. 3 (1)."

Because of the serious concerns that we outlined in Section 5 of Chapter 2, we undertook and have recently substantially completed this work pursuant to Section 9 of the *Auditor General Act* and Subsection 25.2(2) of the *Electricity Act*. Unfortunately, the Board of the IESO was not supportive of my Office conducting the financial statement audit for this period in place of KPMG LLP or alternatively, through a joint audit with KPMG LLP. Therefore, our work was conducted separately but simultaneously with KPMG LLP's financial statement audit of IESO's December 31, 2017 results.

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We are aware that KPMG has issued an unqualified (clean) opinion on IESO's financial statements for the year ended December 31, 2017. They also issued an unqualified (clean) opinion on IESO's financial statements in the prior year ended December 31, 2016. The Board of the IESO did not inform us or invite us to attend the meeting where the financial statements of the IESO were approved knowing that we have significant concerns with IESO's accounting practices relating to inappropriate use of rate-regulated accounting and the inappropriate consolidation of IESO's market accounts under Canadian PSAS.

It was our concerns around the prior year statements and KPMG LLP's lack of open communication with us on significant accounting policy changes on those prior year statements that necessitated our involvement (as Auditor for the province's consolidated financial statements) during the IESO's financial statement audit this year.

Under the *Auditor General Act*:

Audit of Crown controlled corporations

9(3) Where the accounts of a Crown controlled corporation are audited other than by the Auditor General, the person or persons performing the audit,

- (a) shall deliver to the Auditor General forthwith after completion of the audit a copy of their report of their findings and their recommendations to the management and a copy of the audited financial statements of the corporation;*
- (b) shall make available forthwith to the Auditor General, when so requested by the Auditor General, all working papers, reports, schedules and other documents in respect of the audit or in respect of any other audit of the corporation specified in the request;*
- (c) shall provide forthwith to the Auditor General, when so requested by the Auditor General, a full explanation of work performed, tests and examinations made and the results obtained, and any other information within the knowledge of such person or persons in respect of the corporation. R.S.O. 1990, c. A.35, s. 9 (3); 2004, c. 17, s. 11.*

Additional examination and investigation

9(4) Where the Auditor General is of the opinion that any information, explanation or document that is provided, made available or delivered to him or her by the auditor or auditors referred to in subsection (2) or (3) is insufficient, the Auditor General may conduct or cause to be conducted such additional examination and investigation of the records and operations of the agency or corporation as the Auditor General considers necessary. R.S.O. 1990, c. A.35, s. 9 (4); 2004, c. 17, s. 11.

We were also concerned that KPMG was providing advisory services regarding the design of the accounting/financing transactions for the Fair Hydro Plan, while also performing the financial statement audit of the IESO. We have confirmed that it was the advisory work on the accounting/financing transactions that triggered and later resulted in the IESO's December 31, 2016 financial statements, being retroactively adjusted to record rate-regulated accounting on a five year old transaction and record market accounts for the first time. This improper accounting needed to be put into place to set the stage for the recording of the accounting/financing transactions of the Fair Hydro Plan in subsequent years. This set the foundation to align with the government's intent to avoid recording in the province's consolidated financial statements the deficit or net debt impact of its policy decision to collect less from ratepayers, while still having to pay generators for the purchase of power. Rate-regulated accounting is not appropriate because no independent electricity rate regulator was involved in making the Fair Hydro Plan rate reduction decision.

Results of Our Work

Draft Independent Auditor's Report -- Disclaimer of Opinion (Attachment 1)

Attachment 1 is our draft Independent Auditor's Report on the IESO's financial statements for the year ended December 31, 2017. However, we are unable to provide a signed Independent Auditor's Report at this time as the financial statements of the IESO have not yet been publicly released. However, we will provide the Committee with our final Independent Auditor's Report and a copy of the financial statements once the financial statements of IESO are released.

We draw to your attention that the Board and Senior Management of the IESO did not fully cooperate with us during the conduct of our work. In order for us perform our work in accordance with Canadian Auditing Standards we require certain information on all of our audits. Unfortunately, the Board and Management of the IESO consistently refused (while all the time insisting in correspondence that they were cooperating) to provide us with written acknowledgement of their roles and responsibilities with respect to our audit, nor would management sign a representation letter confirming that they have provided us with all relevant information that may affect the financial statements. No valid reason for these refusals was provided to us.

As a result of these refusals, we are professionally unable to provide an audit opinion on the IESO's financial statements; however, we have provided a disclaimer of opinion in our Independent Auditor's Report. The disclaimer of opinion contains information on the results of our special financial statement audit that the Standing Committee on Public Accounts may find useful.

We have highlighted significant issues with the IESO's financial statements and have indicated the related significant impact that their accounting has on the consolidated

financial statements for the province of Ontario. In completing our audit of the March 31, 2018 consolidated financial statements for the province of Ontario, we expect the province to adjust for the impact of the IESO's accounting in order for the province's consolidated financial statements to reflect the true financial impact from the government's policy decision on the province's deficit and net debt.

The special Independent Auditor's Report highlights:

1. Management and the Board's lack of cooperation;
2. Inappropriate inclusion of rate regulated assets and market accounts on the IESO's financial statements that will result in understatement of the province's annual deficit and net debt (the figures in the report reflect the financial impact only up to December 31, 2017; there will be three more months of financial impact in the province's financial statements);
3. The IESO's unfunded benefit plan liabilities are materially understated and were materially understated last year; and
4. The IESO's financial statements do not disclose that in December 2017 the IESO pledged the current and future receivables from local distribution companies (LDCs) as collateral for debt investors of the Fair Hydro Trust. This means that if IESO defaults on its payments of carrying costs to the Fair Hydro Trust, the money received from ratepayers (through LDCs) must be used to pay the Trust before power generators can be paid.

Management Letter (Attachment 2)

A copy of our letter to the IESO is also provided for your information. It further expands on our draft Independent Auditor's Report.

Conclusion

This information is provided for your consideration as you deliberate on the content of the report to be written and issued by the Standing Committee on Public Accounts following the Committee's hearing held on Wednesday, February 28, 2018.

The IESO has communicated to us that they will consider appointing us as their attest auditor for their year ended December 31, 2018. However, we remain very concerned that the accounting in the IESO's financial statements for the year ended December 31, 2017 is incorrect and we will again be requesting that the government correct the impact of this in the province's consolidated financial statements for the year ending March 31, 2018.

To the Standing Committee on Public Accounts

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If the accounting is not corrected, we will have to consider the impact of this on our Independent Auditor's Opinion on the province's consolidated financial statements. The impact at a minimum will result in a qualified audit opinion, but has the potential to result in a first time adverse opinion on the province of Ontario's consolidated financial statements. An adverse opinion would mean that the financial statements of the province do not fairly present its financial position, results of operations and changes in its financial position, as per generally accepted accounting principles. Therefore, the fact that we have to contemplate the possibility of having to issue an adverse opinion on the province's consolidated financial statements is a serious matter.

This information and an updated status will be reported in Chapter 2 of Volume 1 of our 2018 Annual Report.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Bonnie Lysyk', written in a cursive style.

Bonnie Lysyk
Auditor General

Attachments



Office of the Auditor General of Ontario
Bureau de la vérificatrice générale de l'Ontario

INDEPENDENT AUDITOR'S REPORT

To the Independent Electricity System Operator and
The Standing Committee on Public Accounts of Ontario

Report on the Financial Statements

I have audited the accompanying financial statements of the Independent Electricity System Operator (IESO), which comprise the statement of financial position as at December 31, 2017, and the statements of operations and accumulated surplus, remeasurement gains and losses, changes in net debt, and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian public sector accounting standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

My responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with Canadian generally accepted auditing standards. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

Management and those charged with governance refused to acknowledge their roles and responsibilities in my audit and they have failed to sign a management representation letter addressed to me to confirm that management has fulfilled their responsibilities for the financial statements. As a result of this refusal, I am unable to obtain assurance over the accuracy and completeness of information provided by and representations made to me by management and those charged with governance.

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion, I have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, I do not express an opinion on the financial statements.

Other Matter

The financial statements of the IESO for the year ended December 31, 2016 were audited by another auditor who expressed an unqualified opinion on those financial statements on March 22, 2017.

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Report on Matters Arising from Special Audit

Auditor General Act

As the Auditor General, I have a responsibility under the Auditor General Act (Act) to report on matters that are significant to the consolidated financial statements of the Province of Ontario. When something of the magnitude, described below, affects the consolidated financial statements of the Province of Ontario, I am also responsible under the Act to take additional steps to understand and investigate the transactions.

Inappropriate Inclusion of Rate Regulated Assets and Market Accounts

As described in Notes 2d, 2e, 3, 5, 7 and 14c to these financial statements, the IESO has recognized rate regulated and market account assets and liabilities. IESO is considered an "other government organization" under Canadian public sector accounting standards. Rate regulated accounting is not permitted in an "other government organization" under Canadian public sector accounting standards and therefore, the regulated assets recognized by the IESO should not be recognized. The market accounts recognized track mainly buy and sell transactions between electricity market participants (electricity power generators and power distributors). These market accounts, as recorded on the financial statements are not assets and liabilities of the IESO. Under the current Market Rules, the IESO has no access or discretion to use the market account assets for its own benefit, nor does the IESO have an obligation to settle the market account liabilities in the event of default by market participants.

Beginning in July 2017, as part of its legislated role in the *Fair Hydro Plan Act, 2017*, the IESO incurs a shortfall arising from the difference between the amounts it collects from power distributors and it pays to contracted power generators. The electricity price ceiling imposed by the Fair Hydro Plan Act exposes the IESO to financial risk such that it is now responsible for obtaining financing to cover the shortfall in market settlement. To fund this legislated shortfall, the IESO receives advances from Fair Hydro Trust, a related party. At the same time, the IESO records the sale of a rate regulated asset to the Fair Hydro Trust in an amount equal to the shortfall, thereby removing the impact of the shortfall on the annual surplus and eliminating the obligation to the Fair Hydro Trust. This approach constitutes a departure from Canadian public sector accounting standards.

These departures will impact the Province's consolidated financial statements for the year ended March 31, 2018 unless corrected by the Province. Based on the transactions for the period up to December 31, 2017, the estimated impact on the Province's consolidated financial statements is as follows:

- Understatement of Annual Deficit by \$1.353 billion
- Overstatement of Total Financial Assets by \$2.045 billion
- Overstatement of Total Liabilities by \$0.627 billion
- Understatement of Provincial Net Debt by \$1.418 billion
- Understatement of Accumulated Deficit by \$1.418 billion

Inappropriate Discount Rate Used on Unfunded Retirement Benefit Plans

As described in Note 2i to these financial statements, the IESO uses an expected return on plan assets as the discount rate to value all of its pension and other post-employment plan liabilities. IESO provides certain non-registered defined benefit pensions and other employee future benefits through two unfunded non-registered benefit plans. As these unfunded plans have no plan assets, it is inappropriate to use an expected rate of return on plan assets for the discount rate. In accordance with PSAS, the IESO should use a discount rate based on their cost of borrowing for these unfunded plans. The impact of using an inappropriate discount rate is likely to be material to the IESO with a reportable difference on the Province's consolidated financial statements.

Disclosure Deficiency Regarding Collateral and Security Agreement for the Fair Hydro Trust

Pursuant to a Security Agreement between the IESO and the Fair Hydro Trust dated December 21, 2017, the IESO has pledged the market receivables from local distribution companies as collateral for the statutory obligation of the IESO to pay the carrying costs of the Fair Hydro Trust under Regulation 206/17 of the *Ontario Fair Hydro Plan Act, 2017*. The pledge under the Security Agreement subordinates the claims of power generators in favour of the claims of the Fair Hydro Trust, a related party to IESO. The notes to the financial statements of IESO do not disclose the existence or the terms of the Security Agreement. This disclosure is material to the IESO and a reportable difference on the Province's consolidated financial statements. Under the current Market Rules, the IESO has no access or discretion to use the market account assets for its own benefit.

(Unsigned)

Toronto, Ontario
March 8, 2018

Bonnie Lysyk, MBA, FCPA, FCA, LPA
Auditor General

**Independent Electricity System Operator
Special Audit of the Financial Statements for the Year Ended
December 31, 2017
Management Letter as of March 20, 2018**

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1. INAPPROPRIATE ACCOUNTING POLICIES

Fair Hydro Plan Transactions and Variance Accounts, Smart Meters and PSAB Transition Item and Market Accounts

The IESO has recognized rate regulated and market account assets and liabilities. IESO is considered an "other government organization" under Canadian public sector accounting standards. Rate regulated accounting is not permitted in an "other government organization" under Canadian public sector accounting standards and therefore, the regulated assets recognized by the IESO should not be recognized. The market accounts track mainly buy and sell transactions between electricity market participants (electricity power generators and power distributors). These market accounts, as recorded on the financial statements are not assets and liabilities of the IESO. Under the current Market Rules, the IESO has no access or discretion to use the market account assets for their own benefit, nor does the IESO have an obligation to settle the market account liabilities in the event of default by market participants.

Beginning in July 2017, as part of its legislated role in the Fair Hydro Plan Act, 2017, the IESO incurs a shortfall from the difference between the amounts it collects from power distributors and it pays to contracted power generators. The electricity price ceiling imposed by the Fair Hydro Plan Act exposes the IESO to financial risk such that it is now responsible for obtaining financing to cover the shortfall in market settlement. To fund this shortfall, the IESO receives advances from Fair Hydro Trust, a related party. At the same time, IESO records the sale of rate regulated and market accounts assets and liabilities to the Fair Hydro Trust in an amount equal to the shortfall, thereby removing the impact of the shortfall on the annual surplus and eliminating the obligation to the Fair Hydro Trust. This approach constitutes a departure from Canadian public sector accounting standards, as these are not assets and liabilities of IESO. As a result, a loan of \$1.179 billion and the remaining shortfall of \$199 million has not been recorded in Total Liabilities with corresponding losses on the statement of operations totalling \$1.378 million.

The use of the market accounts on the statement of financial position allows IESO to not have the shortfall impact the statement of operations.

Effect on Statement of Operations and Accumulated Surplus

If the IESO had correctly excluded the regulated assets and market accounts, the effect on the statement of operations for the years ended December 31, 2017 and 2016 would have been as follows:

	2017 (\$ thousand)	2016 (\$ thousand)
Surplus/(deficit) as presented	(3,146)	234
Effect of removal of regulated assets	25,535	23,138
Effect of recognizing shortfall related to Fair Hydro Plan	(1,378,475)	-
Surplus/(deficit) in accordance with Canadian public sector accounting standards	(1,356,086)	23,372

Effect on Statement of Financial Position

If the IESO had correctly excluded the regulated assets and market accounts, the effect on the statement of operations for the years ended December 31, 2017 and 2016 would have been as follows:

	2017 (\$ thousand)	2016 (\$ thousand)
Total Financial Assets as stated	2,195,615	1,862,279
Effect of removal of regulated assets	(39,529)	(65,064)
Effect of removal of market accounts - assets	(2,005,167)	(1,692,752)
Total Financial Assets in accordance with Canadian public sector accounting standards	150,919	104,463

	2017 (\$ thousand)	2016 (\$ thousand)
Total Liabilities as stated	2,289,298	1,959,452
Effect of recognizing financing from Fair Hydro Trust	1,179,000	-
Effect of recognizing liability for shortfall in Fair Hydro Plan	199,475	-
Effect of removal of market accounts - liabilities	(2,005,167)	(1,692,752)
Total Liabilities in accordance with Canadian public sector accounting standards	1,662,606	266,700

	2017 (\$ thousand)	2016 (\$ thousand)
Net Debt as stated	(93,683)	(97,173)
Effect of removal of regulated assets	(39,529)	(65,064)
Effect of recognizing liability for shortfall in Fair Hydro Plan	(199,475)	-
Effect of recognizing financing from Fair Hydro Trust	(1,179,000)	-
Net Debt in accordance with Canadian public sector accounting standards	(1,511,687)	(162,237)

	2017 (\$ thousand)	2016 (\$ thousand)
Accumulated Surplus as stated	13,920	14,488
Effect of removal of regulated assets	25,535	23,138
Accumulated impact of regulated assets	(65,064)	(88,202)
Effect of recognizing shortfall related to Fair Hydro Plan	(1,378,475)	-
Accumulated surplus in accordance with Canadian public sector accounting standards	(1,404,084)	(50,576)

Recommendation

OAGO recommends the IESO adjust its December 31, 2017 financial statements and the comparative period to remove the effects of adopting rate-regulated accounting. In addition, the IESO should recognize a liability and a corresponding loss for the shortfall and the financing received as at December 31, 2017.

OAGO recommends the IESO remove the market accounts from its December 31, 2017 financial statements and the comparative period.

Management Response

The IESO disagrees with the Auditor General's statement that PSAS does not permit rate-regulated accounting. Rather, PSAS is silent with respect to rate-regulated accounting. In absence of a clear position on this issue, standard accounting practice dictates that an entity is entitled to consult another accounting standard. As a result, the IESO consulted US GAAP, the only accounting framework in North America that provides guidance on rate regulated operations.

After extensive discussions with external auditors, the IESO Audit Committee of the Board, as well as the Board of Directors, the IESO adopted aspects of the US GAAP accounting framework allowing the IESO to recognize a regulatory asset on its financial statements. This change brings the IESO in line with (6 of 8) other independent system operators across North America, and is supported by the IESO's external auditors as well as the Office of the Provincial Controller.

In its role as the electricity market administrator, the IESO operates and settles approximately \$17 billion through the electricity market transactions, where money is constantly flowing to and from market participants, such as consumers and generators. This role requires the IESO to temporarily hold and transfer money between market participants (like Local Distribution Companies and Generators), including recovering costs associated with Global Adjustment.

The change to include market account assets and liabilities on our financial statements provides increased transparency around the value of transactions that flow through Ontario's electricity market, and the IESO feels the public reporting of market accounts is relevant to the needs of its financial statement users.

These changes in no way affect the IESO's operational costs, or the financial impact on electricity ratepayers.

Auditor General's Response

None of the six independent system operators (ISOs), which IESO indicated they were comparable to, follow Canadian public sector accounting standards (PSAS).

Five of these six ISOs operate in the United States and follow U.S. accounting standards. Furthermore, all five of these ISOs act as a "central counterparty" in their respective real-time electricity markets pursuant to an order issued by the Federal Energy Regulatory Commission, the United States federal agency that regulates the transmission and wholesale sale of electricity. Central counterparties act as the buyers to every seller, and the seller to every buyer. This means that the five ISOs are direct parties to the market transactions. This contrasts with the Market Rules for the Ontario Electricity Market, which state that, "The IESO shall not be a counter-party to any trade transacted through the real-time markets" (Chapter 9, Section 6.9.2).

The remaining ISO is the Alberta Electric System Operator (AESO). Unlike the IESO, the AESO follows International Financial Reporting Standards. IFRS contains a restricted exemption for the recognition of "regulatory deferral accounts", which is not available to IESO under Canadian PSAS.

PS 1000.30 indicates that an entity preparing financial statements in accordance with Canadian PSAS should be comparable to other entities preparing financial statements in accordance with Canadian PSAS. Given the key differences between IESO and its North American peers outlined above, we do not believe that an entity preparing financial statements in accordance with Canadian PSAS should be aligned with private sector entities, especially those preparing financial statements in accordance with different financial reporting frameworks.

Value of Plan Assets for IESO Pension Plan

The IESO's accounting policy for determining its retirement benefit liability and expense does not comply with public sector accounting standards. The IESO shows the funded status of its pension plan on a market value basis, while using a market-related value of plan assets to determine the expected return on plan assets.

As the IESO uses a market-related value of plan assets to determine the expected return on plan assets (a component of retirement benefit expense), it must use that same basis in determining actuarial gains and losses. The IESO determines the market-related value of plan assets using the average value of assets over three years as at the measurement date of September 30. As at December 31, 2017, the market value of plan assets was \$545.400 million (2016 – 523.756 million) and the market-related value of plan assets was \$537.587 million (2016 – \$506.791 million).

In order to estimate the adjustment to the retirement benefit liability and expense, we require an actuarial re-valuation for accounting purposes for 2018.

Recommendation

OAGO recommends the IESO apply its basis of valuation for plan assets consistently when determining both its retirement benefit liability and expense. The IESO should also consult its actuary, AON Hewitt, to determine the amount of any necessary adjustment to retirement benefit liability and expense in its December 31, 2018 financial statements.

Management Response

The IESO will consult its actuary to determine appropriateness of adjustment in its December 31, 2018 financial statements.

The IESO has opted to use a market-related value of assets for the purposes of determining pension expense and accrued pension liability, per Section PS 3250, Paragraph 35. If IESO disclosed the funded status of the pension plan using the market-related value of assets rather than the market value of assets, there would be no impact on either the pension expense or the accrued pension asset and liability.

Auditor General's Response

Using a market-related value of plan assets rather than market value of assets will result in an impact to future pension expense and liability through the amortization of actuarial gains/losses.

Discount Rate Selected for Non-Registered Defined Benefit Plan and Other Post Employment Benefits

The IESO currently uses the same discount rate for its employee registered pension plan (RPP), the non-registered pension plan (non-RPP) and other post employment benefit plan (OPEB). Unlike the RPP, which is funded through employee and employer contributions, the non-RPP and OPEB plans are unfunded and benefits are paid by IESO as they fall due.

The most significant assumption used in the actuarial calculations of a pension or OPEB plan is the discount rate. In determining the discount rate, Canadian PSAS allows financial statement preparers to base their assumptions on either an expected rate of return on *plan* assets currently held in the fund or the *entity's* cost of borrowing. In determining the discount rate for its funded RPP, the IESO uses a discount rate based on an expected rate of return on the plan assets held in trust by the RPP. This is appropriate under Canadian PSAS. In determining the discount rate for its unfunded non-RPP and unfunded OPEB plans, the IESO elected to use the same rate of return based on the plan assets held in trust by the RPP. Since these plans are unfunded and the RPP assets are not available to the plans, it is inappropriate to use this discount rate for these plans.

The generally accepted practice among entities reporting under Canadian PSAS is to use a discount rate based on the entity's cost of borrowing for unfunded plans and a discount rate based on expected plan asset returns for partially or fully funded plans.

The expected impact of using a discount rate based on the cost of borrowing in valuing the unfunded non-RPP and OPEB plans is material and should be adjusted in the current and prior years. Based on a calculation made by IESO's actuary, the impact of a 100 to 200 basis point reduction in the discount rate results in an increase of \$25 million to \$55 million, respectively, to the non-RPP and OPEB total defined benefit plan obligations as at December 31, 2017.

Recommendation

OAGO recommends the IESO select a discount rate for the non-RPP and OPEB plans based on IESO's cost of borrowing and management's best estimate of expected long-term experience and short-term forecast. Using this rate, IESO should adjust its December 31, 2016 and 2017 financial statements for the correction of this error.

Management Response

The IESO is aware that the Public Sector Accounting Board recently issued an invitation to comment on how the discount rate under PSAB is determined. When changes are made, the IESO will review and consider adopting a new discount rate methodology, if appropriate.

Section PS 3250 does not recommend a specific methodology for determining the discount rates to measure the liability of benefit programs; however, two examples are identified in the standard as reference points for determining an acceptable discount rate. The two examples include the expected return on plan assets and the organization's cost of borrowing. Further, the IESO believes that an inconsistency in valuation of overall pension benefit would be created if different discount rates were used for the registered pension plan and the other plans.

Given this, the IESO believes that its discount rate assumptions for the other plans are within the bounds of reasonableness and will maintain the current discount rates for the pension and

OPEB plans in its 2017 financial statements. More specifically the discount rate on the registered pension plan is determined with reference to the expected return on plan assets and the discount rates assumptions for the other plans are determined with reference to the discount rate on the registered pension plan.

Auditor General's Response

We reviewed other government organization financial statements consolidated into the province of Ontario's financial statements. We found that when there are no plan assets, these government organizations use a discount rate based on a cost of borrowing. Similarly, this is also the policy used in the preparation of the province of Ontario's consolidated financial statements.

Disclosure Deficiency Regarding the Collateral Pledged Pursuant to the Security Agreement between IESO and the Fair Hydro Trust

Pursuant to a Security Agreement between the IESO and the Fair Hydro Trust dated December 21, 2017, the IESO has pledged the market receivables from local distribution companies (LDCs) as collateral for the statutory obligation of the IESO to pay the carrying costs of the Fair Hydro Trust under Regulation 206/17 of the *Ontario Fair Hydro Plan Act, 2017*. The pledge under the Security Agreement subordinates the claims of power generators in favour of the claims of the Fair Hydro Trust, a related party to IESO. Effectively, this means that if IESO defaults on its payments to the Fair Hydro Trust, the money received from ratepayers (through LDCs) must be used to pay the Trust before power generators can be paid. The notes to the financial statements of IESO do not disclose existence or the terms of the Security Agreement.

Recommendation

OAGO recommends the IESO disclose the Security Agreement and the pledging of market receivables as collateral in the notes to the financial statements.

Management Response

As of March 20, 2018, no response has been received from management.

2. INTERNAL CONTROL DEFICIENCIES

Bank Reconciliations Not Properly Prepared for 2016 and 2017

The cash clearing account ("AP-Payment Clearing Account") had a balance of \$8.111 million (2016 - \$7.152 million) as at December 31, 2017 and was not regularly reconciled or reviewed by management. As a result, there was an unexplained difference between the cash accounts recorded in the general ledger and the December 31 bank statements. Although the cash accounts agreed with bank records, the package did not provide a reconciliation for the "AP-Payment Clearing Account" recorded as part of cash on the statement of financial position. This account incorporates all the differences between the cash balances in the G/L and the bank statements, which are the items to be reconciled in the bank reconciliation process.

This issue was not identified by management or raised by IESO's auditor during the 2016 audit. Subsequent to us bringing this issue to management's attention, management discussed this with KPMG.

In response to our request, IESO's finance and accounting department investigated the difference and determined that it primarily comprised of two items: 1) Outstanding cheques in the TD bank account (\$2.026 million) and 2) four invoices from 2016, which were not cleared as they were paid outside of normal processes (\$5.909 million). In the latter case, the four invoices were market-related payments that were part of Conservation programs. Management corrected these errors.

Recommendation

We recommend that the IESO prepare a proof of balance of the A/P clearing account, which incorporates all the differences between the general ledger and the bank balances, on a monthly basis. The proof of balance should research and explain differences between the aggregated bank balances and the total cash balance on the statement of financial position on an itemized basis. The IESO should assign this responsibility to an employee who does not have access to cash and who does not record cash receipts, cash disbursements, or general journal entries. Lastly, a supervisor should review the monthly proof of balance and authorize any correcting entries.

Management Response

The IESO prepares timely and appropriate bank reconciliations, and has sufficient internal controls over bank transactions.

The IESO agrees that the noted issue was not appropriately adjusted in a timely manner, but notes that this was an isolated event related to the merger of the former IESO and OPA. The identified issue does not have any impact on the IESO's net surplus or deficit and a repeated event has not occurred.

In the future the IESO commits to preparing timely reconciliations of general ledger accounts and conducting proof of balances throughout each fiscal year, in order to continue to ensure that a repeated event does not occur.

Auditor General's Response

The merger of the former IESO and OPA occurred on January 1, 2015.

Security Deposits Not Fully Tracked and Reconciled to General Ledger

IESO obtains security deposits on certain contracts and procurement applications. The balance per the general ledger is \$16.800 million (2016 - \$17.538 million). When the OAGO requested a detailed breakdown of the account balance, management informed the OAGO that they do not regularly review the detailed balances.

Upon investigation of the balance by the program area, the security deposit balance was comprised of two items: 1) deposits for contracts for \$14.700 million and 2) procurement applications for \$0.800 million.

There is an unexplained balance of \$1.279 million. Management corrected these errors.

Without performing a detailed breakdown or reconciliation, IESO does not track the cash flows on an individual basis and management does not know who is owed a refund on security deposits.

Recommendation

OAGO recommends the IESO prepare reconciliations for each of its significant general ledger accounts on a monthly basis. The IESO should assign this responsibility to an employee who does not record cash receipt, cash disbursement, or journal entry transactions. Lastly, a supervisor should review the monthly reconciliation and authorize any correcting entries.

Management Response

The IESO commits to preparing timely reconciliations of general ledger accounts and conducting proof of balances throughout each fiscal year.

Manual Override of Controls by Human Resources and Review of Manual Changes Made to Payroll Systems

During testing of payroll, the OAGO identified two control weaknesses – 1) Manual override of controls by Human Resources and 2) Review of manual changes made to payroll systems.

OAGO observed instances where an HR associate bypassed the normal process and manually entered an employee's compensation change in the HR Management System. OAGO requested and received evidence that supported the compensation change, but there was no evidence of review and approval. This manual bypass resulted in an underpayment of salary and management corrected after the issue was brought to their attention.

Given these observed instances of manual override, there is a risk that employees who received compensation changes did not receive retroactive payments for the week in which the change became effective. There is also a potential risk of error and/or fraud as nobody is responsible for reviewing manual entries in the HR Management System.

OAGO noted that HR Management System automatically interfaces most compensation changes to the Payroll System on a daily basis. However, payroll must enter some payroll changes, such as severance payments, retroactive payments, and certain dates manually into the Payroll System. Furthermore, payroll has the ability to override certain information.

In discussions with payroll, OAGO determined that payroll associates are responsible for both making manual entries in the Payroll System and reviewing those changes for completeness and accuracy. OAGO observed evidence that payroll associates reviewed payroll registers, but there was no evidence of supervisor review or sign-off. As a result, there is a lack in segregation of duties between the preparer of payroll information and the reviewer. OAGO also noted that payroll could not provide a report summarizing all payroll changes for each pay period. The Payroll System does not appear to have this functionality readily available.

While OAGO did not note any errors in its testing relating to these control gaps, the lack of controls could lead to incorrect payments to employees or unnoticed fraudulent transactions.

Recommendation

OAGO recommends the IESO prevent HR associates from overriding controls when entering compensation changes in HR Management System. Alternatively, the IESO should determine whether it is possible for HR Management System to generate exception reports. A supervisor should review and approve exceptions against supporting documentation on a timely basis.

OAGO recommends the IESO ensure that an individual that is not responsible for entering information into the system reviews changes to the Payroll System data against supporting documentation each pay period. In addition, in order to facilitate this review, the Payroll System system should be able to generate a summary of all changes and/or exceptions each pay period. Alternatively, IESO should focus on automating the process and reducing the need for manual entries.

Management Response

The IESO agrees that there is an opportunity to enhance the internal controls with respect to HR Success Factors.

Due to a system limitation, manual entries for compensation changes may be required in unique instances. Manual entries are only made if supporting evidence is provided.

Additionally, compensating controls exist when manual processes are used. Specifically, manual data changes made in the HR Success Factors system are reviewed and approved by the Supervisor, Compensation & Benefits.

Although supporting evidence is provided and compensating controls exist, there is an opportunity to enhance the internal controls. This need was previously identified by the IESO and will be addressed as part of the HR Success Factors system enhancement, scheduled to be implemented in Q3 2018.

The IESO is in the process of upgrading its payroll system. Automation is a key focus of this project and it is IESO's intent to reduce the need for manual entries. This project is expected to be completed by Q3, 2018.

Any changes to payroll system data are reviewed and signed-off by an employee's supervisor. Specifically, if a payroll change is made by a payroll associate, it is captured in an employee's timesheet that then requires approval by the employee's supervisor.

In addition to timesheet sign-off, the IESO has other compensating controls in place. Specifically, the IESO uses three-way payroll reconciliations to compare payroll data to timesheet data and the payment file from the bank. These reconciliations are prepared by a Financial Analyst and reviewed by the Manager, Accounting and Finance.

3. OTHER MATTERS

Process Descriptions and Control Narratives Not Available

OAGO requested the IESO to provide descriptions and/or narratives of the entity's internal controls related to financial reporting. The IESO stated that it did not have any process descriptions or narratives, and instead asked the OAGO to acquire this documentation from its auditor, KPMG LLP.

OAGO subsequently obtained and reviewed the documentation from KPMG LLP, but determined that it was not sufficiently detailed for OAGO purposes of carrying out the audit of IESO's December 31, 2017 financial statements. As a result, the OAGO had to carry out detailed walkthroughs and interviews to gain an understanding of the IESO's key processes and internal controls that related to financial reporting.

The lack of process descriptions and control narratives is a business risk to IESO. Management is responsible for ensuring sufficient internal documentation of processes and internal controls exists. These documents should be updated and retained by management.

After we left the field and during final reporting, we were provided process narratives. However, we noted some of the narratives have not been updated since 2008. For example, IESO's payroll narrative has not been updated to reflect the new Human Resources information system that tracks employee hires, promotions, and terminations.

Recommendation

OAGO recommends the IESO to update and maintain process descriptions and/or narratives of its internal controls related to financial reporting. OAGO will provide the updated narratives under a separate cover to the CFO that IESO can build from and maintain.

Management Response

The IESO will continue to review and update its process descriptions and control narratives related to financial reporting, as appropriate. However, the IESO disagrees with the assertion that it lacks process descriptions and control narratives related to financial reporting, and believes the current documents are accurate and effective.

Auditor General's Response

At the time of our audit this was not the case.

CSAE 3416 Report on Market Settlement Operations System

The IESO engages Ernst & Young to perform an audit of the IESO's description of its settlement operations system for processing user entities' transactions and the suitability of the design and operating effectiveness of key controls over these processes. According to the most recent CSAE 3416 report, the audit covers the period from January 1, 2017 to June 30, 2017.

OAGO noted that the IESO obtains this CSAE 3416 report on a bi-annual basis, in accordance with the Market Rules.

As the design and operating effectiveness of controls over the settlement operations is key the audit of IESO's financial statements, it would be cost-effective for the IESO to request EY to perform the audit engagement on an annual basis.

Recommendation

As a best practice, OAGO recommends the IESO to engage an auditor to perform the CSAE 3416 audit on an annual basis with a full year of coverage over operating effectiveness.

Management Response

The IESO will consider this recommendation in future years.

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