



OFFICE OF THE
Auditor General
of British Columbia

**Adopting Best Practices
in Government Financial
Statements – 2002/2003**

National Library of Canada Cataloguing in Publication Data

British Columbia. Office of the Auditor General.
Adopting best practices in government financial statements. –2001/2002–

(Report)
Annual.
Report year ends Mar. 31.

Continues: British Columbia. Office of the Auditor General. Report on government financial accountability for the ... fiscal year. Report on the ... public accounts. ISSN 1488–4585.

ISSN 1705-1630 – Adopting best practices in government financial statements

1. Finance, Public – British Columbia – Accounting – Periodicals. I. Title. II. Series: British Columbia. Office of the Auditor General. Report.

HJ13.B7B74

352.4'39'0971105

C2001–960288–X



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OFFICE OF THE
Auditor General
of British Columbia

The Honourable Claude Richmond
Speaker of the Legislative Assembly
Province of British Columbia
Parliament Buildings
Victoria, British Columbia
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Dear Sir:

I have the honour to transmit herewith to the Legislative Assembly of British Columbia my 2003/2004 Report 3: Adopting Best Practices in Government Financial Statements 2002/2003.

Wayne Strelhoff, CA
Auditor General

Victoria, British Columbia
November 2003

copy: Mr. E. George MacMinn, Q.C.
Clerk of the Legislative Assembly

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As well, more than 62 other staff and contractors of the Office took part in the audit of the Summary Financial Statements and in the separate audits of various government organizations that are included in the government reporting entity.

Auditor General's Overview



Wayne Strelloff, CA
Auditor General

In this report, I present my findings on the government's progress during 2002/03 in adopting best practices in its financial accountability to the public.

An important element of these best practices—Generally Accepted Accounting Principles (GAAP)—is the concepts and standards of financial accountability recommended by the Canadian Institute of Chartered Accountants. The GAAP provide, in effect, financial accounting and reporting “ground rules” for the Summary Financial Statements and the financial statements of all Crown corporations and other organizations making up the government reporting entity.

I am encouraged to see the continued progress being made by the government in fully adopting GAAP and in resolving the issues arising in the process. The Government is determined to have all the GAAP fully implemented by the time it prepares its financial plans for the 2004/05 fiscal year. My Office is working closely with the Ministry of Finance to support this important project.

This report covers the financial information included in the 2002/2003 Public Accounts. While I am pleased that the government responded positively to most of my recommendations last year, I must nevertheless again qualify my audit report on the 2002/03 Summary Financial Statements because public schools, universities, colleges and hospitals were not consolidated there. I will make this qualification once more in 2004, but hope that will be the last time I must do so.

The government also continues to improve the presentation of its financial statements—and again I am pleased that almost all the recommendations I made last year in this area have been, or are being, implemented. This year I am making a few additional recommendations. I am asking the government to: adopt new GAAP recommendations as early as possible; better disclose amounts set aside to fund its financial obligations; better track changes in the Estimates during the year; evaluate its liability for retirement allowances; and improve the financial information it provides for each sector of government operations.

The Summary Financial Statements always provide valuable information about significant events that occurred in the year. In this report, I comment on four such transactions. Providing this

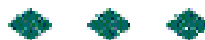
Auditor General's Overview

information will, I believe, help legislators and the public better understand these transactions and how they affect the overall financial results of the government.

In closing, I wish to acknowledge and thank all those who assisted my Office during our audit of the Summary Financial Statements, the preparation of this report, and our work on the various audits and assessments that led to the matters discussed here. I also wish to acknowledge the hard work, professionalism and dedication of my staff.

Wayne K. Strelloff, CA
Auditor General

Victoria British Columbia
November, 2003



Introduction

This report is our update on government's adoption of best practices in financial statement reporting

The Summary Financial Statements are a major means by which the government accounts for its financial performance, and so we audit them each year. This work is a significant focus of our Office.

We examine these statements with two goals in mind: first, to give assurance to the legislators and citizens of the province that the statements present fairly both the financial position of the government and the results of its operations; and second, to comment on the government's progress in adopting best practices in financial statement reporting.

We achieved our assurance goal in June 2003 when the government issued its financial statements. In a short report published with those statements in the Public Accounts for the fiscal year 2002/03, we confirmed that, with few exceptions, the statements presented the government's financial position and operations well. The exceptions we referred to in our June report relate to incomplete accounting for publicly controlled schools, universities, colleges and hospitals. The highlighted extract from our June report (shown here in the sidebar) lists the dollar effects of excluding these organizations from the government reporting entity.

The government reporting entity is not complete

The Public Sector Accounting Board (PSAB) recommends that a government's reporting entity be made up of all organizations that are controlled by the government. The government currently

As explained in note 1(c) to these financial statements, the Government's stated accounting policies contain exceptions to generally accepted accounting principles (GAAP) for senior governments, as recommended by The Canadian Institute of Chartered Accountants, related to schools, universities, colleges and institutes, and health care organizations. Had GAAP been followed as at March 31, 2003, it would be expected that financial assets increase by \$3.4 billion (\$2.8 billion at March 31, 2002), liabilities increase by \$3.7 billion (\$3.1 billion at March 31, 2002), non-financial assets increase by \$3.6 billion (\$3.1 billion at March 31, 2002), and the accumulated deficit decrease by \$3.3 billion (\$2.8 billion at March 31, 2002). Similarly, for the year ended March 31, 2003, revenues increase by \$2.4 billion (\$2.2 billion for 2002), expenses increase by \$2.2 billion (\$2.0 billion for 2002), and the annual deficit decrease by \$0.2 billion (\$0.2 billion for 2002).

Introduction

does not include school districts, universities, colleges and institutes, or health care organizations (the SUCH sector) in its reporting entity. We believe that the government controls these organizations, and so they should be included. We are pleased that the government has announced that these organizations will be included in its financial plans and reports for the 2004/05 fiscal year.

The government defers some capital grants it has made to its own organizations

Governments grant millions of dollars each year to health and educational institutions. Some of these grants are for buying, or building, tangible capital assets. These transfers are often referred to as capital grants.

Like transfer of money between two departments of a company, grants made by a ministry to a government organization present movement of money within the government reporting entity. However, as explained above, the government does not include publicly controlled schools, universities, colleges and hospitals in its Summary Financial Statements. It therefore accounts for grants made from its Consolidated Revenue Fund to these organizations as if they are transfers of funds to outside organizations. When these transfers are for capital acquisitions, the government defers expensing the grants by describing them as “prepaid capital advances,” records them as assets on its balance sheet, and amortizes them over the lifespan of the acquired tangible capital assets.

The combination of excluding the SUCH sector and deferring capital grants made to it has resulted in a very complex approach to financial reporting. Although the government has right of access to billions of dollars of public assets, it has chosen not to include these assets in its Summary Financial Statements.

We believe that because the SUCH sector is part of the government reporting entity, all its revenues, expenses, assets and liabilities should be fully included in the Summary Financial Statements. If this were done the government would not be deferring grants made to its own organizations. All capital grants recorded as prepaid capital advances would—as they should—be treated as internal transfers of funds within the government, and instead all assets be properly recorded. The result would be clearer and more understandable financial statements.

Introduction

PSAB is currently reviewing the accounting treatment of government transfers. We have advised PSAB that we support deferral of capital grants to organizations outside of the government reporting entity when it can be shown that the acquired capital asset is used in delivering a government service.

We said that our second goal in examining the Summary Financial Statements was to inform Members of the Legislative Assembly and the public about the government's progress in adopting best practices in financial accountability. This report is intended to meet that goal. Where we consider it appropriate, we have also made recommendations for improvements.

Government continues its focus on adopting best practices in its financial accounting and reporting

The publication of the Summary Financial Statements is the result of a year-round effort. Daily transactions must be accumulated into the correct accounts, and the final balances of the different government organizations must be combined appropriately to produce the financial statements. The government diligently reviews the processing, accumulation and combination of the transactions to ensure the financial statements properly represent the operating results and financial position of the whole of government. Adopting best practices based on financial statement concepts and generally accepted accounting principles (GAAP) recommended by the Canadian Institute of Chartered Accountants (CICA) helps the government achieve this goal.

The Summary Financial Statements are a central feature of government financial reporting. They are a way for government to tell legislators, policy-makers and the public how it has administered public financial resources. Because many government transactions are complex, it is important that the accounting policies chosen to record them are the best ones for making the transactions understandable and conveying what actually happened. Deciding which are the best accounting practices to use requires significant professional judgement.

Introduction

According to the Public Sector Accounting Board (PSAB) those practices chosen should result in financial statements that:

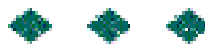
- provide an accounting of the full nature and extent of the financial affairs and resources that the government controls, including those related to the activities of its agencies and enterprises;
- describe the government's financial position in a way that is useful for evaluating the government's ability to finance its activities, meet its liabilities and commitments, and provide future services;
- describe the changes in the government's financial position, showing the sources, allocation and consumption of the government's resources, how the government's activities affected its net debt, and how the government financed its activities; and
- demonstrate the accountability of the government for the resources, obligations and financial affairs for which it is responsible.

As auditors, we measure against these objectives the accounting and reporting practices adopted by the government, and we compare them to GAAP and other standards of the CICA, and to what our peers across Canada are doing. Considering these outside sources helps us decide objectively what the best practice is in each circumstance.

The Government of British Columbia either already follows, or has committed itself to adopting, most of what makes up best practice across Canada. This year, for example, the financial statements were published within three months of the year-end — a considerable improvement from five years ago when the financial statements were published almost seven months after the year-end. As well, the government continues to work on fully adopting GAAP for the Summary Financial Statements in 2004/05, and on consistently and appropriately applying GAAP in school districts. It has also improved its explanations of the significant events of the fiscal year, and made progress on the separate financial reporting of the major sectors of government operations, such as health, education and transportation.

Introduction

We are pleased with the government's focus on improving the Summary Financial Statements, and we look forward to working again with the government to further improve the presentation of this year's statements.



Financial Statement Issues

All issues we come across are addressed but only a few result in a reservation

Management is responsible for preparing the financial statements, and auditors are responsible for expressing an opinion on whether the financial statements fairly present the financial position and results of operations.

In any financial statement audit, it is almost inevitable that we will find something that concerns us. For example, it may be the adequacy of control processes, the accuracy of financial transactions, or the way those transactions are presented. We don't expect to find every error and control weakness that exists, but we do plan our audit work so that we can be confident we will discover any significant ones. From those we note, we first decide whether one or more of them (individually or taken together) could, if not corrected, make the financial statements misleading. We try to resolve the matter by discussing it with officials of the government, but if it is not corrected and we believe the financial statements remain misleading, we then express an opinion with a reservation. The purpose of the reservation is to alert users of the financial statements to our conclusions and, where possible, to provide sufficient information that users can see for themselves the effect of the error.

We also report publicly—as in this report—on other findings that we hope will assist the government in continuing to improve the quality of its financial reporting.

Bringing schools, universities, colleges and health care organizations into the government reporting entity is the most important financial reporting issue in British Columbia

Fundamental to the preparation of public sector financial statements is the question of which organizations should be included. According to PSAB, the answer is that a government should include those organizations it controls.

Whether or not school districts, universities, colleges and institutes, and health care organizations (SUCH) should be part of British Columbia's government reporting entity is a matter we have discussed with the government for several years. Our

Financial Statement Issues

opinion is that the SUCH sector is part of the government reporting entity and so should be included in the Summary Financial Statements. However, because the government excluded it, we once again qualified our audit opinion on the 2002/03 statements.

The government has committed to following GAAP fully in preparing its financial plans and report, and so will be including the SUCH sector in its reporting entity starting in the 2004/05 fiscal year. Public universities make up an important part of the SUCH sector. Their governance structure is complex and differs from that of almost all other government organizations. While the government has presented a case for excluding universities from the government reporting entity, it has nevertheless agreed to combine financial activities and the balances of public universities in its financial plans and reports for the 2004/05 fiscal year.

The SUCH sector has a considerable effect on understanding government finances, well beyond the overall dollar amounts mentioned in our audit report. For example, we say in our report that total expenses shown in the statements would increase by \$2.2 billion if SUCH were included, but the total increase is the net result of many changes to the types of expenses. For example, billions of dollars currently reported as government grants to schools, universities, colleges and hospitals would be better defined in terms of salaries paid to teaching, nursing and support staff working in these organizations, other operating costs and tangible capital assets used in delivering health care and educational services.

The inclusion of the SUCH sector in government's financial reporting would also affect the government's total surplus/deficit measure. In 2002/03, for example, it would reduce the deficit for the year by \$0.2 billion.

Earlier we explained how the government defers the capital grants—prepaid capital advances—it makes to the SUCH sector and why our concern about this complex accounting treatment will automatically be resolved once the SUCH sector is included in the government reporting entity. A similar transfer made by the government to British Columbia Transit is a good example to demonstrate the appropriate accounting of prepaid capital advances to an organization included in the government reporting

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entity, as indeed that is what happens with the prepaid capital advances made to that company. Being a Crown corporation, British Columbia Transit is part of the government reporting entity, and so on consolidation the prepaid capital advances made to it, almost \$1 billion, will be replaced by the tangible capital assets it helped to buy.

We note that, based on current PSAB recommendations, capital advances made to organizations outside the reporting entity must be fully expensed in the year they were made. The reason is that the government does not own the assets it helps the recipient organization buy.

Changes to the government reporting entity

In previous years, regional hospital districts have been included as part of the SUCH sector because they were controlled by the government (for example, the government could change the districts' budgets). Recent legislation, however, has changed the government's responsibilities and control of the Regional Hospital Districts. Therefore, beginning in 2002/03, the hospital districts are excluded from the government reporting entity.

The Workers' Compensation Board has also undergone significant changes to its governance structure and relationship to government, to the extent that it too is no longer controlled by government. Financial information about WCB is included in a note to the Summary Financial Statements, and we are continuing to monitor the relationship between the government and the board. At present, for 2002/03, we consider WCB to be outside the government reporting entity.

As well, we believe that the British Columbia Pension Corporation and British Columbia Investment Management Corporation should be included in the Summary Financial Statements because the government is their sole shareholder and therefore owns them. The government, however, disagrees on the grounds that its shareholding does not carry with it the power to appoint the board. As the assets, liabilities, revenues and expenses of the two Crown corporations are small enough that their absence from the Summary Financial Statements does

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not have a material impact on the statements, we have issued no qualification to our opinion.

Overall, we are pleased with the government's commitment to include the complete SUCH sector in its financial plans and reports starting the 2004/05 fiscal year. We expect not to have to qualify our audit opinion on the matter of the government reporting entity when the SUCH sector is fully consolidated in the Summary Financial Statements.

Other significant issues and recommendations

In our audit, we came across a number of significant issues we believe the government should work on with a view to adopting best accounting and reporting practices. They involve:

- moving to early adoption of CICA recommendations,
- disclosing amounts set aside to fund future expenses,
- disclosing estimates on the statement of operations,
- obtaining an actuarial valuation of the liability for the retirement allowance,
- improving the financial information provided about sectors of government operations, and
- improving the way interest expense and debt are disclosed.

Not included in this list are the less significant items we have reported directly to the appropriate ministries, Crown corporations and other government organizations.

At the end of this section, we also provide a progress report on government's implementation of the recommendations we made last year.

Moving to early adoption of CICA recommendations

When an accounting recommendation is issued, the CICA sets the date by which the new accounting standard should be adhered to. In most cases, this is within a year, but it can take longer. The CICA encourages earlier adoption of standards, which we agree is good accounting practice.

Financial Statement Issues

For example, the CICA released a new standard in December 2002 requiring that a long-lived asset to be sold be disclosed in the financial statements as an “asset held for sale.” This must be done when management commits to a plan for selling the asset provided:

- the asset is ready to be sold,
- an active program to locate a buyer has been initiated,
- the asset is being actively marketed at a reasonable price, and
- the asset is likely to be sold within one year (an exception to this requirement applies where events or circumstances beyond management’s control permit an extension).

The importance of disclosing a long-lived asset held for sale lies in the comparability of financial statements from year to year, and the usefulness of the information contained in them. Clearly, if government decides to change the way it does business and to sell some of its assets in the process, this is important information that people reading the financial statements should know about—and what they should know is not only what assets are being sold, but also how this sale influence revenues and expenses.

Providing such information is important when government remains committed to selling an asset at the date of the financial statements.

The date the new CICA standard came into effect was May 1, 2003. Because that followed the government’s year-end, the government was not required to apply it in preparing its 2002/03 Summary Financial Statements. However, since the standard was originally released in 2002, long before the year-end, the government could have adopted it. Had it done so for the 2002/03 fiscal year, the net assets of the British Columbia Ferry Corporation, for example, would have been shown as assets held for sale at March 31, 2003. All the steps required by GAAP had been taken during the 2002/03 fiscal year, culminating in the Royal assent on March 18, 2003, and the transfers of control to the BC Ferry Authority occurring just after the year-end on April 2, 2003.

Showing the net assets of British Columbia Ferry Corporation as assets held for sale would have affected the financial statements significantly: non-financial assets on the Statement of Financial Position would have been reduced by \$568 million, being reclassified

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as financial assets, and net liabilities would also have been reduced by the same amount.

During the 2002/03 fiscal year the government also announced its intention to sell certain assets of the Coquihalla Highway and British Columbia Railway Company. The new standards were not applied to these assets either.

Information about these significant events were provided in a note to the Summary Financial Statements.

We recommend that, to the extent practical, the government adopt new CICA recommendations before their formal effective date.

Disclosing amounts set aside to fund future expenses

From time to time, the government or a third party may apply restrictions on the use of some provincial assets. The government, for example, may formally designate certain assets to indicate its intention to use them for a specific purpose. Or there may be restrictions because of agreements with the external parties who contributed the assets, or because of legislation or an act of other governments that is binding on the province.

A case in point is the BC Forestry Revitalization Trust which was created by a deed of trust in March, 2003, between the Province and a chartered bank, the initial trustee. The provincial Forestry Revitalization Act required the government to pay \$75 million into this trust in the 2002/03 fiscal year, which it did. The purpose of these funds is to mitigate the adverse financial impacts resulting from the reduction in harvesting rights brought about by the Act. The government recorded the liability for \$75 million, and then cleared its liability by transferring money to the trust account at the bank.

We note that the reduction of harvesting rights did create a certain liability for the government at March 31, 2003, and so recording an expense to set up the \$75 million liability is good accounting, and results in appropriate measure of the annual surplus/deficit. However, the transfer of the \$75 million into the trust account does not, in our opinion, extinguish the government's liability.

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We believe that creating the trust bank account and transferring the funds to it is simply the government's way of formally designating that cash for a specific purpose (namely, mitigating the adverse impacts of the legislated reduction in harvesting rights). The government has also predetermined the account's financial and operating policies by restricting who is eligible to receive funds, and by specifying:

- the structure of the accounts that must be maintained,
- the rules regarding transfers of funds and income allocation, and
- the formula for determining distributions from the account and funding agreements that must be entered into between the trustee and the recipient.

For these reasons we think the government is still liable for the \$75 million. Furthermore, extinguishing the liability by transferring cash to a trust fund is a return to cash accounting, a practice that the Province left behind many years ago when it adopted accrual accounting practice.

The substance of this transaction is that a liability has been created. We believe that this liability should continue to be recorded in the government's financial statements, and should only be reduced as conditions are met for money to be paid to outside parties.

We recommend that the government record the BC Forestry Revitalization Trust account, and any similar self-established trust accounts, as part of its restricted assets and continue to show its liabilities in its financial statements until they are discharged in substance.

Disclosing estimates on the statement of operations

It is good practice by both government and non-government organizations to compare actual revenues and expenses with what they budgeted. For governments this is also a reporting requirement. In BC, the government provides such comparison in its financial statements. In recent years, however, the government's presentation of its estimates of revenues and expenses in the Summary Financial Statements has undergone many changes as the government moves to fully consolidated Estimates.

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It is usual for at least a whole year to pass between the time the government presents the budget and the time it prepares the financial statements. This means that if the budget is to be meaningfully comparable to actual results, some budget components need to be regrouped to reflect any reorganizations and other operational changes. Because the restated budget is then in a different form from what was originally approved by the Legislative Assembly, the Summary Financial Statements provide in a note a reconciliation to the original budget.

We found that government's records supporting the changes referred to in the note, reconciling the restated Estimates to the original amounts, are not always adequately kept. We believe that the process followed by the government in restating the Estimates must improve to enable us to audit them efficiently.

We recommend that the government improve its record-keeping process to provide clear and sufficient support for all revisions and restatements of the original Estimates presented in the note to the Summary Financial Statements.

Obtaining an actuarial valuation of the liability for the retirement allowance

The cost of an employee to a government organization is more than just the amount of the pay cheque. Staff also receive paid vacation, health care, retirement and other benefits. In keeping with good accounting practice, these costs should be recorded each year by the organization as part of the total annual cost of employing each worker, the costs should not simply be expensed when they actually need to be paid.

For example, the provincial government records as a liability any vacation that has been earned but not taken at the end of each year, and pension plans obtain actuarial valuations of their future costs so they can make provision for those costs by adjusting what they currently invoice the government.

One special benefit available to public service employees is the retirement allowance. A retiring employee who will receive a pension is also entitled to a payment equal to one month's salary if he or she has completed 20 years of service. The employee can also receive an extra amount equal to one-fifth of his or her monthly salary for each additional year over 20, up to a maximum of three months' salary (which corresponds to 30 years of service).

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At March 31, 2003, the government had set aside just over \$51 million to pay this allowance. This amount does not represent government's liability for retirement allowances.

At present, the government waits until an employee has completed 20 years of service before recording any liability. In our view, this is contrary to good accounting practice based on the concept of recording the complete cost of employment as the employee works. It is also contrary to PSAB requirements.

We believe that the government should obtain an actuarial valuation of the liability for the retirement allowance. This would allow it to record an expense each year as employees work towards and beyond 20 years of service and on to eventual retirement.

We recommend that the government obtain an actuarial valuation so that an expense for the retirement allowance can be recorded for each year that an employee works.

Improving the financial information provided about sectors of government operations

Last year, we recommended that the government provide complete financial information about the main sectors of government operations. This sectoral information (sometimes also referred to as “segmented” information) gives readers a better understanding of government operations and the financial aspects of program delivery.

This year, promoting such understanding has become even more important with the government now releasing a discussion paper each fall about its next budget, and the Legislative Assembly appointing a committee of MLAs to solicit the views of British Columbians about the budgetary issues facing the government. Shedding light on government operations by sector is one way to get a more informed response.

We found considerable improvement last year in the government's disclosure of sectoral information on the statements of “Financial Position by Sector” and “Operations by Sector” in the Summary Financial Statements. Now each ministry's activities are allocated to the appropriate sectors, giving a far better picture of

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the financial position and the operations of the government's major sectors—health, education, social services, transportation, and so on.

As the government starts to publish its service plans and reports related to its operations in these sectors, corresponding financial information will become increasingly important to add value to the operational information. We therefore encourage the government to take its current practice further, publishing complete sectoral financial information in its 2003/04 public accounts.

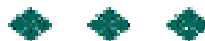
We recommend the government annually provide, in the Public Accounts, complete sectoral financial information.

Improving the way interest expense and debt are disclosed

Interest expense and debt are not disclosed consistently. On the statement of operations, part of the cost of borrowing is disclosed as interest expense and part (as explained in note 29 of the Summary Financial Statements) is combined with the health, education and transportation costs.

The cost of borrowing can be disclosed in one of two ways: to show it as an overall cost to the government, or to allocate the cost of borrowing as part of what is spent on health, education, transportation, etc. The government's current disclosure is neither completely one nor the other. We are told the government will resolve this issue in 2003/04.

We recommend that the government be consistent in the way in which interest and debt are allocated to the functions and sectors.



Status of Prior Year Recommendations

The recommendations we made to the government last year (resulting from our audit of the 2001/02 Summary Financial Statements) and the status of their implementation (based on our audit of the 2002/03 Summary Financial Statements) are reported here.

Recommendation

That the Ministry of Education complete its review of school district accounting and reporting issues by the end of the 2002/2003 school year.

Status

The Ministry of Education has now substantially completed its review. Full implementation of GAAP will be made by school districts by July 1, 2004. This revision means that the first formal, audited annual GAAP-based financial statements for school districts will be for the period July 1, 2004, to June 30, 2005.

Recommendation

That the government be consistent in how it allocates interest expense to appropriate functions.

Status

The government was still inconsistent in its allocation method in the 2002/03 statements. However, we are told this issue will be resolved in 2003/04.

Recommendation

That the note disclosures about contingent liabilities be written in a way that reflects a level of disclosure appropriate to the relative significance of the issues.

Status

This recommendation has been satisfactorily implemented.

Status of Prior Year Recommendations

Recommendation

That the government annually provide, in the Summary Financial Statements, complete segmented financial information.

Status

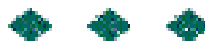
The government has significantly improved the presentation of its sectoral financial information.

Recommendation

That the government consider the possibility of obtaining assurance on an interim financial statement of school districts as at March 31 each year, for inclusion in the Summary Financial Statements

Status

The government is considering a proposal for preparing at March 31 of each year a consolidated financial statement of all school districts for inclusion in the government's Summary Financial Statements. Assurance on this consolidated financial statement would be provided by the Auditor General.



The Financial Effects of Four Important Decisions on the Summary Financial Statements

The Summary Financial Statements are complex and serve a general purpose. In putting them together annually, the government summarizes a great deal of information, including that concerning the impact of, and the transactions resulting from, important decisions that have been made. A fuller explanation helps readers understand the role these decisions play in shaping the government's finances. We discuss four such decisions and the related transactions that played a significant role in shaping the financial statements of the government in 2002/03:

- changing the accounting policy on recording equalization payments
- writing down the investment in British Columbia Ferry Corporation in anticipation of transfer of control to BC Ferry Authority
- accounting for the government's restructuring exit expenses
- writing-off net assets of regional hospital districts

Changing the accounting policy on recording equalization payments

The 2002/03 fiscal year was the second time that British Columbia received equalization payments from the federal government. In 2001/02, the first year that these payments were received, equalization was recorded on a cash basis: the Province recorded as revenue the cash it received from the federal government during the year. In 2002/03, the government decided to improve its accounting practice by using the accrual basis to determine how much equalization should be recorded.

The accrual basis of accounting means recording in the fiscal year the equalization payments that are due to the Province for that year, not simply the cash it received. When the Province made a detailed review of the calculations behind the payments made by the federal government, and adjusted them for more recent information on the provincial economy and population, it found that the federal government had overpaid \$188 million in the current year. It also found that some of the payments received should have been recorded as relating to the prior year. Consequently, the Province recorded revenues of \$543 million for 2002/03, \$159 million for 2001/02 (compared to the \$226 million recorded previously), and \$68 million for 1999/2000 (nothing previously recorded).

The Financial Effects of Four Important Decisions on the Summary Financial Statements

The accrual basis of accounting is the preferred basis for accounting for revenues and expenses, and we support the government in this change.

Writing down the investment in British Columbia Ferry Corporation in anticipation of transfer of control to BC Ferry Authority

In March 2003, the Coastal Ferry Act was passed, providing the government with the necessary authority to transfer controls in the British Columbia Ferry Corporation (BC Ferries) to BC Ferry Authority.

Investments that are to be held for a lengthy period of time (as is the case with investments in Crown corporations) are usually recorded at their actual cost. But if something happens—a permanent change in circumstances, for example—that indicates the investment is not worth what it is recorded at, its value should be adjusted. This was the case with the Province's investment in BC Ferries.

About 10 years ago, the government partially funded the purchase of certain ferries from its general fund. The corporation had accounted for the \$139 million grant it received by immediately reducing the cost of the ferries that it purchased, and recorded the net cost on its financial statements, which it then amortized each year. This is appropriate accounting for a corporation in the private sector that receives government assistance to buy assets. However, BC Ferries was part of government, and so it was necessary to make an adjustment to the book value of the ferries each year when BC Ferries' financial statements were consolidated in the Summary Financial Statements. With this adjustment, the ferries were recorded in the financial statements of the government at their full cost—that is, the cost shown on BC Ferries financial statements increased by \$139 million, less an amount representing what would have been the correct amortization. This would make the book value of these assets in the Summary Financial Statements in March 2003 almost \$72 million more than that indicated in the corporation's financial statements.

The agreement between the government and the new B.C. Ferry Authority specified that the government would transfer its control in the BC Ferries to the B.C. Ferry Authority for an amount equal to the net book value of the corporation, as shown on the

The Financial Effects of Four Important Decisions on the Summary Financial Statements

corporation's March 31, 2003, audited financial statements. Because of the adjustment described above, this meant that the government would receive \$72 million less for the corporation than the amount it was including in its Summary Financial Statements as the book value of the corporation's net assets. Since substantially all conditions of the transfer of control were met before the year-end, it was necessary to write down the value of those net assets at March 31, 2003. In the 2003/04 fiscal year the non-voting preference shares and bonds of British Columbia Ferries Services Inc. will replace the provincial government's equity in BC Ferries.

We agree with the accounting practice followed by the government in recording this write-down in its 2002/03 financial statements.

Accounting for the government's restructuring exit expenses

The British Columbia government has embarked on a significant restructuring of government operations. In some cases, the restructuring results in one-time expenses that are not associated with the continuing activities of government. An example is the penalty paid to cancel a contract that is no longer needed.

These costs are shown separately on the statement of operations, and are described further in the notes to the Summary Financial Statements.

According to the government plan the restructuring is to be carried out over three years. As each annual restructuring plan is approved, the associated estimated costs are recorded. However, the Summary Financial Statements show only expenses made by central agencies and organizations which are fully consolidated in the Summary Financial Statements. Because government business enterprises are not consolidated line by line, these costs would not be included in the statement of operations, however, they are disclosed in the notes to the Summary Financial Statements. Therefore the \$169 million expense shown on the statement of operations as "restructuring exit expenses" does not include the similar expenses of government business enterprises, estimated at \$80 million.

The Financial Effects of Four Important Decisions on the Summary Financial Statements

Adding the amount expended by the government business enterprises to those costs borne directly by the taxpayer, the total restructuring exit costs for the government as a whole were \$249 million in 2002/03 (\$435 million in 2001/02).

Writing-off net assets of the regional hospital districts

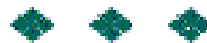
The funding of major capital project costs in the health care sector is ordinarily shared by the provincial government and the local regional district on a 60/40 basis. A number of years ago, 33 regional hospital districts (RHDs) were created to borrow funds to finance these capital projects. Annually, to pay off their debt and cost of borrowing, RHDs were also receiving grants from the Province and property tax levies from the local regional district.

Starting in December 2000, after the regionalization of health care delivery and the creation of new local health authorities, the flow of the provincial grants changed. The local health authorities took on the responsibility for the 60% provincial share of major capital project costs, and the Province began sending the grants to the local health authorities instead of to the RHDs.

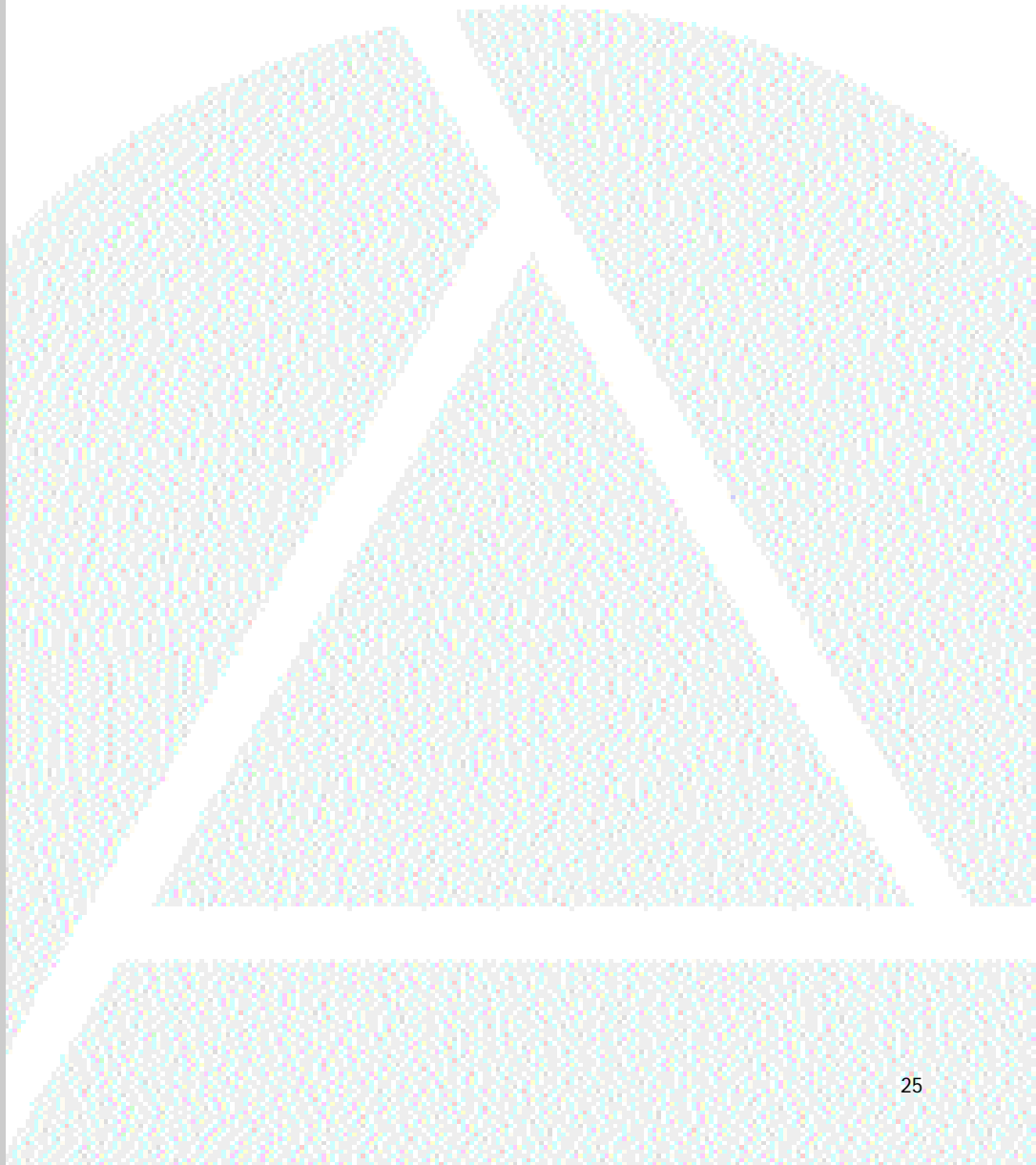
This meant that the only funds flowing to the RHDs were the property tax levies from the local regional districts, and the only assets and debts held by the RHDs were those relating to the 40% share that was the responsibility of the local regional districts. However, since the Province controlled the RHDs, they were still consolidated in the SUCH sector, despite the fact that the assets, liabilities, revenues and expenses in the RHD financial statements were no longer transactions of the provincial government.

This led to the Hospital District Amendment Act, passed in the spring of 2003. The Act removed the powers that gave the government control over the RHDs.

At the time, the RHDs had net assets of \$340 million, which would be written off if health organizations were consolidated in the Summary Financial Statements. This amount has been included in calculating the effects of excluding the SUCH sector from the government's 2002/03 Summary Financial Statements.



Response from the Ministry of Finance



Response from the Ministry of Finance

We appreciate the opportunity to respond to the Auditor General's comments. We feel this report recognizes the significant and continuous improvements we have made to our financial statements. We further appreciate the review by the Auditor General's office and their acknowledgement of the government's progress in adopting best practices including:

- *Release of the Public Accounts on June 27, 2003, among the very best in terms of timeliness;*
- *The government's diligence in reviewing processing, accumulating and combining of transactions to ensure proper representation of the operating results and financial position of the whole of government;*
- *Support for the deferral of capital grants to outside organizations where the asset is used in delivering a government service;*
- *The acknowledgement that significant professional judgement must be applied in determining accounting policies chosen;*
- *The government's commitment to include the Schools, Universities, Colleges and Health Authorities (SUCH) sector in its 2004/05 fiscal year, and the expectation that this will remove the current qualification of the province's summary financial statements;*
- *The acknowledgement that even though some Public Sector Accounting Board (PSAB) guidance was not yet required, the province disclosed relevant details of pending events such as restructuring of British Columbia Ferry Corporation, British Columbia Rail and the Coquihalla Highway;*
- *The completion of the Ministry of Education review of school district accounting and reporting and the move to GAAP accounting for schools beginning July 1, 2004;*
- *The improvements to the note disclosure for contingent liabilities; and*
- *The significant improvement to sectoral financial reporting information.*

We are already, generally, following the recommendations of the PSAB of the Canadian Institute of Chartered Accountants in our reporting, with the exclusion of the SUCH sector from the government reporting entity being the only major exception. This exception will be addressed when the SUCH sector is included in the government reporting entity with the 2004/05 budget to be tabled in February, 2004.

Response from the Ministry of Finance

The movement to full implementation of generally accepted accounting principles (GAAP) is a major undertaking, not just an accounting issue. We have been working closely with the independent Accounting Policy Advisory Committee to resolve issues. Much work has been done, and remains to be done, for the province to achieve this goal.

In addition to our work in moving to GAAP, the Office of the Auditor General and the Office of the Comptroller General have been working together to urge PSAB to change GAAP to improve reporting by allowing the deferral of capital grants to organizations outside of the government reporting entity. In our view, this is consistent with our move to full accrual accounting many years ago and improves program costing.

Changes in accounting recommendations occur frequently. We ensure that we implement changes within the recommended implementation timeframe. With an organization as large as the government reporting entity it is not always practical or advisable to do early implementation of recommended changes to accounting. Where practical, we have provided additional disclosure that is not yet required, e.g. disclosure of BC Ferry and BC Rail restructuring and the potential public private partnership related to the Coquihalla Highway.

Where clear decisions to dispose of assets or operations have not yet been made, it would be inappropriate to change our reporting and then have to change it back the following year because the final decision was different from the anticipated one. A case in point is the public private partnership arrangement contemplated for the Coquihalla Highway. Proposed arrangements varied from asset disposal to a range of partnering options. With-out a clear decision, we determined that it would be better to leave the existing treatment in place and disclose information of this potential partnership arrangement.

With regard to the Auditor General's comments on BC Forestry Revitalization Trust, we do not agree with the Office of the Auditor General's characterization of the trust. The BC Forestry Revitalization Trust was a properly constituted trust that met all the GAAP guidance for establishment of an independent trust. The Auditor General agreed with us that this was appropriately an expense in the 2002/03 fiscal year. When the province decided that the forest industry had to be restructured and revitalized, it realized that it had an obligation to facilitate changes to the industry. The trust was established to describe and confine the

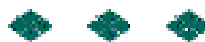
Response from the Ministry of Finance

province's obligations related to revitalization of the forestry industry while allowing for others (industry) to contribute to this revitalization through payments to the trust. The trust was not a method of avoiding reporting a provincial liability. Additionally, the trust is not a restricted asset of the province. The province is not the beneficiary of the trust and cannot access the assets of the trust.

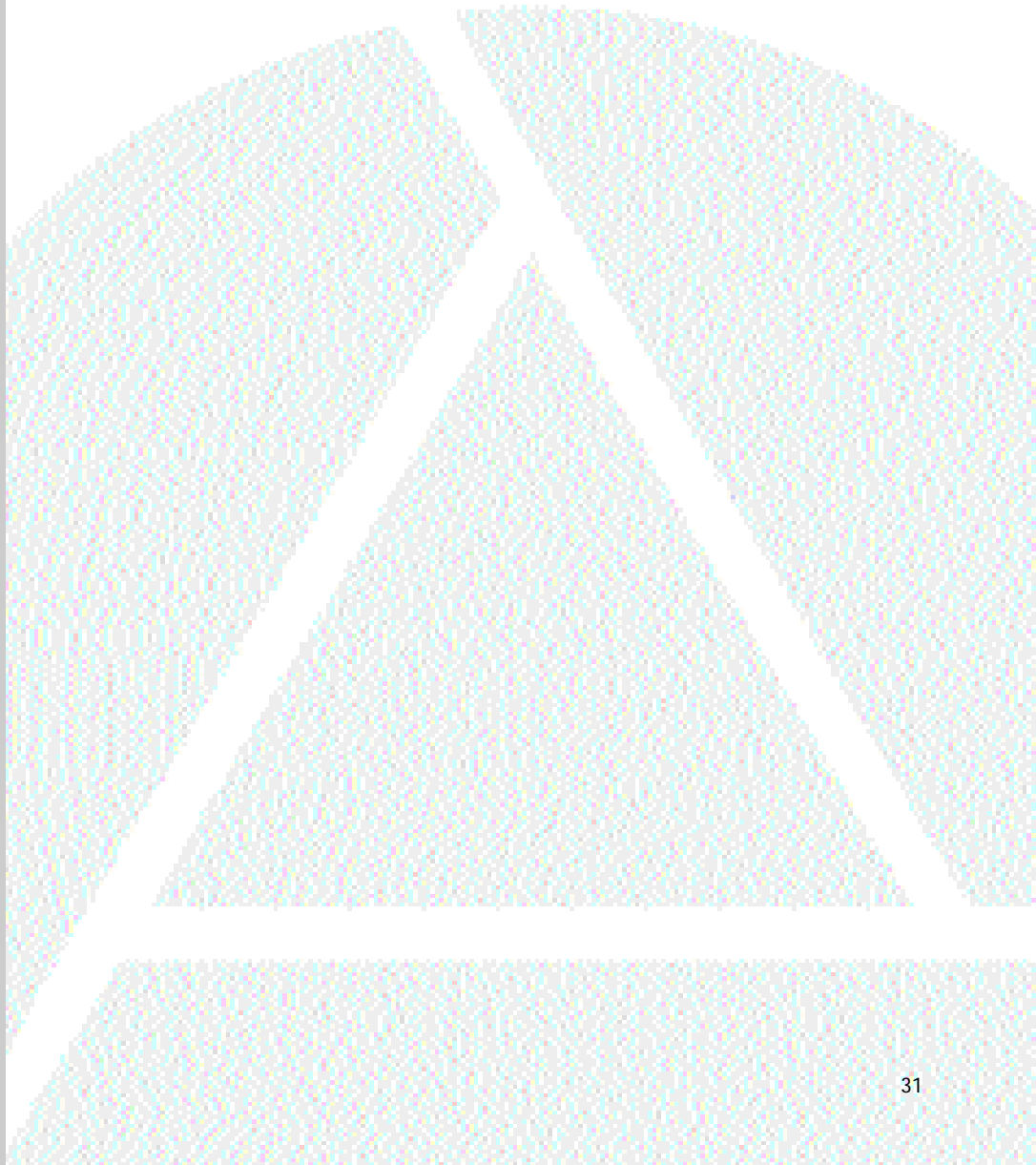
With respect to the Auditor General's recommendation that we set up a liability for employee retiring allowances, an actuarial valuation is currently being sought by the government. This will provide us with the required information for the 2003/04 Public Accounts.

We have improved sector reporting as indicated in the Auditor General's report but no further expansion is planned for reporting in this area at this time as implementing GAAP is our number one priority. Our current reporting is consistent with PSAB recommendations and we do not believe it is appropriate to change this without further direction from PSAB. We also wish to monitor the work underway at PSAB in terms of improving reporting as well as the presentations of other jurisdictions.

We again thank the staff of the Auditor General for their hard work and co-operation in preparing the 2002/03 financial statements, and look forward to 2003/04.



Appendices



Appendix A

Summary Financial Statement Audit Methodology

When examining for the purpose of expressing an opinion on financial statements, auditors are expected to comply with established professional standards, referred to as generally accepted auditing standards. The source of these standards in Canada is the Canadian Institute of Chartered Accountants (CICA).

Generally accepted auditing standards consist of three main areas. There are general requirements that the auditor be properly qualified to conduct and report on an audit, and that he or she carry out the duties with an objective state of mind. Further standards outline the key technical elements to be observed in the conduct of an audit. Finally, reporting standards set out the essential framework of the auditor's report on the financial statements.

In addition to these broad standards, the CICA makes other, more detailed, recommendations related to matters of auditing practice.

Application of the Standards

We carry out extensive examinations of the accounts and records maintained by the ministries and central agencies of government, and by the Crown corporations and other public bodies of which the Auditor General is the auditor.

Also, with respect to Crown corporations that are audited by other auditors and that form part of the Summary Financial Statements, we obtain various information and assurances from those other auditors which enable us to rely on their work in conducting our audit of the government's accounts. This information is supplemented by periodic reviews by our staff of those auditors' working paper files and audit procedures.

Throughout these examinations, the Office of the Auditor General complies with all prescribed auditing standards in the conduct of its work. It must be realized, however, that the Auditor General's opinion on a set of financial statements does not guarantee the absolute accuracy of those statements. In auditing the government financial statements, or of any large organization, it is neither feasible nor economically desirable to examine every

Appendix A

transaction. Instead, using our knowledge of the government's business, its methods of operation and systems of internal control, we assess the risk of error occurring and then design audit procedures to provide reasonable assurance that any errors contained in the financial statements are not, in total, significant enough to mislead the reader as to the government's financial position or results of operations.

When determining the nature and extent of work required to provide such assurance, we consider two main factors: *materiality*, which is expressed in dollar terms, and *overall audit assurance*, expressed in percentage terms.

Materiality relates to the aggregate dollar amount which, if in error, would affect the substance of the information reported in the financial statements, to the extent that a knowledgeable reader's judgement, based on the information contained in the statements, would be influenced.

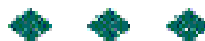
In our audit of the Summary Financial Statements, we have assumed that an error in the current year's operating results in excess of one-half of 1% of the gross expense of the government would be considered material.

Overall audit assurance represents, in percentage terms, how certain the auditor wants to be that the audit will discover errors, if any, in the financial statements, which in total exceed materiality.

In our audit of the Summary Financial Statements, we planned our work so as to achieve an overall audit assurance of 95% that the audit would detect total error in excess of materiality. In choosing the level of assurance, we consider factors such as the expectations of the users of the financial statements and the nature of the audit evidence available.

In planning our audits of financial statements, we exercise professional judgment in determining the application of these two key factors. Professional judgment is influenced by our knowledge of the requirements of readers of the financial statements, and by what is generally accepted as being appropriate by auditors of similar organizations.

We continuously revise and update our auditing methodology to keep pace with auditing best practices.



Appendix B

Government Organizations Included in the 2002/2003 Summary Financial Statements, and Their Auditors

552513 British Columbia Ltd.
 632121 British Columbia Ltd.
 634349 British Columbia Ltd.
 B.C. Community Financial Services Corporation
 B.C. Festival of the Arts Society
 B.C. Games Society
 B.C. Health Care Risk Management Society
 B.C. Pavilion Corporation
 BC Transportation Financing Authority
 BCIF Management Ltd.
 British Columbia Arts Council¹
 British Columbia Assessment Authority
 British Columbia Buildings Corporation
 British Columbia Enterprise Corporation
 British Columbia Ferry Corporation
 British Columbia Health Research Foundation
 British Columbia Heritage Trust
 British Columbia Housing Management Commission
 British Columbia Hydro and Power Authority
 British Columbia Immigrant Investment Fund Ltd.
 British Columbia Liquor Distribution Branch²
 British Columbia Lottery Corporation
 British Columbia Racing Commission
 British Columbia Railway Company
 British Columbia Securities Commission
 British Columbia Trade Development Corporation
 British Columbia Transit

Audited by	
Auditor General	Private Sector Auditors
✓	
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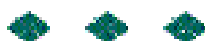
¹ The entity's financial statements were unaudited.

² A special operating agency under the Ministry of Competition, Science and Enterprise

Appendix B

	Audited by	
	Auditor General	Private Sector Auditors
Canadian Blood Services		✓
Columbia Basin Trust		✓
Columbia Power Corporation	✓	
Creston Valley Wildlife Management Authority Trust Fund	✓	
Discovery Enterprises Inc.		✓
First Peoples' Heritage, Language and Cultural Council		✓
Forensic Psychiatric Services Commission		✓
Homeowner Protection Office	✓	
Industry Training and Apprenticeship Commission	✓	
Insurance Corporation of British Columbia		✓
Interim Authority for Community Living British Columbia	✓	
Land and Water British Columbia Inc.	✓	
Legal Services Society	✓	
Oil and Gas Commission	✓	
Okanagan Valley Tree Fruit Authority		✓
Organized Crime Agency of British Columbia Society		✓
Pacific National Exhibition		✓
Partnerships British Columbia Ltd. (note)	✓	
Private Post-Secondary Education Commission		✓
Provincial Capital Commission	✓	
Provincial Rental Housing Corporation		✓
Rapid Transit Project 2000 Ltd.		✓
Science Council of British Columbia		✓
Tourism British Columbia	✓	
Vancouver Trade and Convention Centre Authority	✓	
Victoria Line Ltd.	✓	

note: This organization changed its name during the current year. It was formerly known as Duke Point Development Ltd.



Appendix C

The 2002/2003 Summary Financial Statements

Appendix D

Office of the Auditor General: 2003/04 Reports Issued to Date

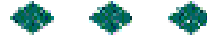
Report 1

**A Review of Performance Agreements Between
the Ministry of Health Services and the Health Authorities**

Report 2

Follow-up of Performance Reports, August 2003

These reports and others are available on our website at
<http://www.bcauditor.com>



Compiled and typeset by Graphic Designer, Debbie Lee Sawin, of the Office of the Auditor General of British Columbia
and published by the Queen's Printer for British Columbia®
Victoria 2003

