Office of the
Auditor General
of British Columbia

March 2024

The Audit of B.C.'s 2022/23 Summary Financial Statements: Areas of Interest

Office of the Auditor General of British Columbia

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The Honourable Raj Chouhan
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Dear Mr. Speaker:

I have the honour to transmit to the Speaker of the Legislative Assembly of British Columbia the report, *The Audit of B.C.'s 2022/23 Summary Financial Statements: Areas of Interest*.

Under Section 11(1) of the *Auditor General Act*, my office is required to report on whether the province's Summary Financial Statements are presented fairly in accordance with Canadian generally accepted accounting principles. This report, issued under Section 11(8) of the *Auditor General Act*, speaks to the results of our financial audit of the Summary Financial Statements and related audit work.

Michael A. Pickup, FCPA, FCA
Auditor General of British Columbia
Victoria, B.C.

March 2024

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Source: Getty Images

The Office of the Auditor General of British Columbia acknowledges with respect that we conduct our work on Coast Salish territories. Primarily, this is on the Lekwungen-speaking people's (Esquimalt and Songhees) traditional lands, now known as Victoria, and the W̱SÁNEĆ people's (Pauquachin, Tsartlip, Tsawout and Tseycum) traditional lands, now known as Saanich.

Report at a glance

Why we did this report

- This is our second report on the financial audit work we completed for the Province of B.C.'s 2022/23 Summary Financial Statements.
- The first report focused on our Independent Auditor's Report and aided Members of the Legislative Assembly in scrutinizing the $80 billion of public sector financial activity last fiscal year.
- This report describes matters that came up in our audit that warrant attention because of their potential influence on the government's future financial results.

Areas of interest

The income tax estimation challenge

- Personal and corporate income tax revenues provided $26.5 billion, or 32%, of provincial revenues in 2022/23.
- Government's method of estimating income taxes has resulted in significant adjustments.
- For example, in November of fiscal year 2022/23 government adjusted for $4.3 billion in additional revenue related to fiscal 2021/22.
- For fiscal year 2023/24, in consultation with our office, government updated their year-end estimate by using federal tax return filings (as of June 30, 2023).
- Our audit found this method was much less subjective.
- Government's year-end surplus was $1.86 billion lower than its initial estimate.

Government direction on electricity rates: the impact on BC Hydro's accounting

- In B.C., rate regulation helps electricity customers avoid volatility in the rates charged by energy providers.
- BC Hydro's rates must be reviewed and approved by the British Columbia Utilities Commission (BCUC) in order for rate-regulated accounting to apply.
- When government issues direction (about BC Hydro) to the BCUC, it interferes with the independent regulation of electricity rates.
- It may mean rate-regulated accounting can't be applied to some transactions, leading to financial impacts for BC Hydro.
- In the fall of 2022, government directed the BCUC to order BC Hydro to issue a $320 million credit to residential and commercial customers.
- Every residential customer (including non-BC Hydro customers) received a $100 credit.
- We raised concerns about using rate-regulated accounting for the household credit because it wasn't independently reviewed by the BCUC.
- BC Hydro later changed its approach by taking the credit payment from net earnings instead of its rate-regulated deferral accounts.
- We recommend government:
  - consult relevant parties to understand how its directions may impact BC Hydro's ability to apply rate-regulated accounting; and
  - assess how such directions could affect the Summary Financial Statements.
- We recommend BC Hydro:
  - continue to assess the impact of government directions on the use of rate-regulated accounting standards; and
  - alert government when its directions are likely to impact BC Hydro's ability to use rate-regulated accounting.

Report at a glance *(continued)*

New accounting standards: better planning, communication would reduce the risk of reporting errors

- Government applied new accounting standards – covering asset retirement obligations and financial instruments – for fiscal 2022/23.
- We identified significant departures from the new standards.
- Early engagement with us would have ensured implementation of the new standards met requirements and reduced year-end corrections.
- Lessons from last year can be useful when two more new standards (for revenue and public-private partnerships) are applied for fiscal 2023/24.

Asset retirement obligations:

- The asset retirement obligations standard came into effect in fiscal 2022/23, four years after it was issued in 2018.
- Government guidance to public sector organizations included inconsistencies with the standard, increasing the risk of material error.

Financial instruments:

- The financial instrument related standards didn't apply to B.C.'s financial statements until fiscal 2022/23.
- However, they have been required in all other organizations in the government reporting entity since fiscal 2012/13.
- Government corrected the three significant departures from the standards (including one incomplete statement) that we identified.

After reading the report, you may want to ask the following questions of government:

1. How will government improve the way it estimates income tax revenues and the accuracy of the amounts it reports in the financial statements?
2. When issuing BC Hydro-related direction to the BCUC, how will government consider the financial reporting impacts (e.g., BC Hydro's ability to continue using rate regulated accounting)?
3. How will government change its approach to implementing complex accounting standards?

Background

Each fiscal year the Ministry of Finance produces the *Public Accounts of the Government of the Province of B.C.* It provides key accountability information about the province's finances and includes the Summary Financial Statements (SFS), prepared by the Office of the Comptroller General.

The SFS consolidates the revenues, expenses, assets and liabilities of the government reporting entity, or GRE. The GRE includes 23 ministries, over 15 special offices, and 141 organizations within government's control (e.g., Crown corporations, health authorities, and schools).

The *Auditor General Act* requires our office to audit the SFS and report to the Legislative Assembly on whether the statements are fairly presented in accordance with generally accepted accounting principles. Our audit, the largest public sector audit in the province, involves our staff and contractors. In 2023, the audit took more than 60,000 combined hours to complete. As well, numerous B.C. accounting firms audit individual government organizations.

The Independent Auditor's Report is the main product of the SFS audit. It was a focus of our first report on our 2022/23 financial audit work (*Summary Financial Statements Audit: Supporting the Role of MLAs*) released in November 2023 to help MLAs formally scrutinize government's $80 billion of reported financial activity.

Here, we report on three matters of interest emerging from the audit that warrant greater attention.

Source: Getty Images

Areas of interest from the 2022/23 audit

The income tax estimation challenge

Government's method

Personal income and corporate income taxes are two of the three largest sources of government revenue, at $17.3 billion and $9.2 billion, respectively. They contributed 32% of provincial revenues for fiscal 2022/23.

The income tax revenues that appear in the Summary Financial Statements are estimates. This is because the federal government finalizes tax returns after the province's financial statements are completed.

Government is required to record an adjustment in the current year's Summary Financial Statements if the actual personal and corporate income tax revenues differ from estimates it made the year before.

For several years, the size of these adjustments indicates that the estimation method hasn't been reliable enough for financial statement reporting. Since 2013/14, these adjustments have averaged $1.1 billion annually (see "Table 1" on page 8).

In fiscal 2022/23, government increased its recorded personal and corporate income tax revenues by $2.5 billion and $1.8 billion to account for differences between its estimates and actual revenues related to the previous fiscal year (2021/22).

The adjustment resulted in a $4.3 billion mid-year revenue increase that would have been recorded in fiscal 2021/22 year-end if government had used firmer information about income tax revenues.

Using fiscal 2021/22 as an example, the surplus was understated by $4.3 billion, meaning that government had $4.3 billion unknown to it at the time. A reliable estimation process would also mean adjustments in a subsequent year wouldn't be as significant, and the reported current year revenue would be reasonable.

Table 1: Estimate of annual surplus (deficit) based on government's subsequent adjustments (amounts in $ millions)

Fiscal year	Reported surplus/(deficit)	Personal income tax adjustment made in subsequent fiscal year	Corporate income tax adjustment made in subsequent fiscal year	Adjusted surplus/(deficit)	Difference
2021/22	1,306	2,510	1,788	5,604	**4,298**
2020/21	(5,468)	1,284	(171)	(4,355)	**1,113**
2019/20	(322)	97	(92)	(317)	**5**
2018/19	1,535	(57)	403	1,881	**346**
2017/18	314	762	874	1,950	**1,636**
2016/17	2,737	(292)	681	3,126	**389**
2015/16	811	853	295	1,959	**1,148**
2014/15	1,683	316	210	2,209	**526**
2013/14	327	386	94	807	**480**

Source: Office of the Auditor General

Government revised year-end estimates

Given this history of large adjustments, we looked for alternative ways to obtain audit assurance that government's income tax revenue estimates reported in the 2022/23 Summary Financial Statements were reasonable. This involved working with Treasury Board staff. We also consulted our counterparts in other provinces and the Office of the Auditor General of Canada.

Personal income tax

Government identified that the federal government produces personal income tax sharing statements which would provide a reasonable basis for estimating tax revenue. When we compared the statements received in prior years to the final revenues, we agreed that the statements, received in late July, provided a more accurate estimate. Government incorporated this data in their calculation of the personal income tax revenue recorded in the fiscal 2022/23 Summary Financial Statements.

Corporate income tax

Accounting standards state that if a reasonable estimate of tax revenue (whether personal or corporate) can't be made, cash receipts from taxpayers can be used as a basis for estimation.

Government uses cash received (from the federal government) as the basis for estimating the corporate income tax revenue, resulting in large adjustments (see Table 1). The cash received from the federal government is an estimate, not actual cash receipts from taxpayers as required by accounting standards.

If better information is available, it should be used to provide more accurate financial reporting. For fiscal 2022/23, we looked for alternative ways to estimate year-end reported corporate income tax revenues.

As with personal income tax, the tax sharing statements provided a more accurate basis for estimation.

2022/23 financial statement estimates incorporated new data

Ultimately, government used the July 2023 tax sharing statements in its estimation of both personal and corporate income tax revenues in the Summary Financial Statements. They still met the Public Accounts deadline of August 31, despite waiting for the tax sharing statements.

Our audit work concluded that use of tax sharing statements for estimating both personal and corporate income tax revenues was appropriate. Until government can demonstrate a more reliable method, we anticipate continuing to use the tax sharing statements provided in July as the basis for assessing government's personal and corporate tax estimates.

As a result of using the tax sharing statements, government updated its estimates and reduced its reported surplus by $1.86 billion. Composed of reductions of $500 million in personal and $1.36 billion in corporate income tax revenues.

Source: Getty Images

BC Hydro and rate-regulated accounting

Background

The provincial government created the British Columbia Utilities Commission (BCUC) in 1980 through the *Utilities Commission Act* (the act). The BCUC is responsible for balancing the interests of ratepayers (customers) with the interests of the utilities it regulates. Under the act, the BCUC is the sole judge of whether a rate is unjust, unreasonable, or unduly discriminatory. The act allows the government to provide binding direction to the commission.

Rate regulation sets the rates utilities are allowed to charge after balancing the interests of the company, shareholders and customers. The regulator ensures business costs are reasonable, sets prices that are fair, and allows the company to sustain itself while providing a reasonable rate of return to shareholders. Rate regulation also affects the timing of rate increases and has a financial impact on ratepayers and the utility being regulated.

Rate-regulated accounting changes how utilities record revenues and costs in their financial statements. It allows the utility to transfer costs or revenues from one year to a later year, recovering or refunding the amounts through the rates it charges.

The act outlines a rate-setting framework that's consistent with International Financial Reporting Standards (IFRS) for regulatory deferral accounts and regulated operations. For this reason, BC Hydro has the option to apply rate-regulated accounting and have regulatory deferral accounts.

Regulatory deferral accounts can be assets or liabilities:

- Assets are amounts that would normally be recorded as expenses that have been incurred but are being deferred, indicating they will be recovered through future rates.
- Liabilities are amounts that would normally affect net income but are being deferred, indicating they will be refunded through future rates. Regulatory liabilities can arise for refunds of amounts previously collected from customers, current collection of future costs, or refunds of gains.

Government issues directions to the BCUC specific to BC Hydro under Section 3 of the *Utilities Commission Act*. Some of those directions have either bypassed or overridden the BCUC's standard regulatory review process for setting rates. As a result, rate-regulated accounting may not be appropriate for the transactions that arose from the directions. An example of this is discussed below (see "Government direction: $320-million BC Hydro customer credit" on page 11).

There is a risk the cumulative impact of directions could make it inappropriate for BC Hydro to continue to apply rate-regulated accounting.

Since government is the sole shareholder of BC Hydro, this could have cascading impacts on the province's accounting. In fact, in fiscal 2016/17 and 2017/18, government directions significantly limited the BCUC's ability to apply the rate-setting framework with respect to BC Hydro's use of rate-regulated accounting. We assessed this impact as being material to the province's 2016/17 and 2017/18 Summary Financial Statements and qualified those audit reports.

Impact of government directions on BC Hydro's 2022/23 financial statements

For the fiscal year ended 2018/19, BC Hydro implemented International Financial Reporting Standards, including IFRS 14 (Regulatory Deferral Accounts). Government also made a number of changes giving the BCUC the ability to influence costs and rates. These changes were sufficient to remove the Summary Financial Statements qualification on the use of rate-regulated accounting.

Since then, government has issued and extended a number of directions that make it more difficult for the BCUC to apply its regulatory framework. Under the legislative framework and its mandate, the BCUC reviews and approves the amount and timing of customer refunds by way of its independent regulatory review process. Government direction overrides this process. While government is within its right to issue these directions, the accounting impacts need to be understood.

Government direction: $320-million BC Hydro customer credit

In the third quarter of fiscal 2023 government issued Order-in-Council 571. It required the BCUC to direct BC Hydro to use $320 million from its regulatory deferral accounts to deliver a one-time credit of $100 to every household in the province. Remaining credits went to commercial customers.

Thirty million dollars (of the $320 million) was removed from regulatory deferral accounts and paid to non-BC Hydro residential customers. Under rate-regulated accounting, the amounts in these accounts belonged to BC Hydro's residential, commercial and industrial customers. This action meant that BC Hydro customers were paying $30 million to non-BC Hydro residential customers.

Further, under the normal process, the allocation of refunds from the regulatory deferral accounts to the different customer classes (residential, business, and industrial) would have been based on customer consumption. Government's initial direction would have meant industrial customers would lose the approximately $80-million credit to which they were entitled.

Source: Office of the Auditor General of British Columbia

BC Hydro initially accounted for the credits ($320 million) as directed by government, taking the funds out of the regulatory deferral accounts. But because the credits weren't subject to the BCUC's rate-setting process, regulatory deferral accounts shouldn't have been affected. This resulted in a $320 million understatement of BC Hydro's regulatory deferral accounts, and an overstatement of its net income and equity.

We issued a modified review report on BC Hydro's third-quarter unaudited condensed consolidated interim financial statements. It said that the accounting for customer credits was not appropriate in the circumstances.

In order to prevent a similar finding at year-end, BC Hydro worked with government and the BCUC to have the $320 million reinstated to the regulatory deferral accounts. As a result, government issued a new letter to BC Hydro to reinstate the regulatory deferral accounts and fund the $320 million from its operations. BC Hydro then applied to the BCUC to reinstate the $320 million to their regulatory deferral accounts, which the BCUC subsequently approved. This means that all customer classes had their credits restored, which will be refunded through future rates.

As a result of the reinstatement prior to March 31, 2023, we were able to issue an unmodified Independent Auditor's Report on BC Hydro's year-end financial statements.

Government direction: net income

For many years, government has issued net income directions regarding BC Hydro's allowed earnings. These directions have an overarching impact on the BCUC's rate-setting process and the earnings that support BC Hydro's long-term ability to operate without government's financial support. Due to long-standing government net income directions, the regulator hasn't been able to conduct a regulatory proceeding to determine a reasonable rate of return on equity (earnings) for BC Hydro.

While we don't consider BC Hydro to be offside with rate-regulated accounting standards this year, net income directions are a future risk area that government and BC Hydro should actively monitor to avoid losing the ability to apply rate regulated accounting.

With government's current net income direction to BC Hydro set to expire in March 2025, BC Hydro will apply to the BCUC to determine its allowed earnings for fiscal years beginning April 2025.

We recommend government:

- consult relevant parties (including the BCUC, BC Hydro, and the Office of the Comptroller General) when they plan to issue directions to the BCUC through the *Utilities Commission Act* to understand if they may impact BC Hydro's ability to apply rate-regulated accounting; and
- assess how such directions could impact the province's Summary Financial Statements.

We recommend that BC Hydro:

- continue to assess the impact of government directions, both individually and collectively, on the use of rate-regulated accounting standards; and
- alert government when their directions are likely to impact BC Hydro's ability to use rate-regulated accounting.

Implementing new accounting standards

Two new, complex accounting standards came into effect in fiscal 2022/23: "asset retirement obligations" and "financial instruments." Early discussions between an organization and its auditors can develop mutual understanding of the requirements of the new standards and how to meet them.

Asset retirement obligations

The new asset retirement obligations standard describes how government should account for any costs that government is legally required to incur when a tangible capital asset is taken out of service.

For example, when a school is remodeled or torn down there can be costs to remove and dispose of asbestos, as required by WorkSafeBC regulations. The new standard defines which costs should be estimated, and how and when they should be recorded in financial statements.

The standard requires organizations to recognize these expenses over the useful life of the associated asset – not just when they're incurred. It also includes requirements for financial statement presentation and disclosure.

This complicated new accounting standard was issued in 2018. As government's auditor, we needed to make sure they applied the standard appropriately and consistently. With over 160 entities, we expected government would have an implementation plan and would consult us so that we would know the impact on our audit.

The Office of the Comptroller General prepared guidance on the new standard but didn't share it with our office until after it was approved by the Treasury Board and issued to all organizations in the government reporting entity. After our review, we provided government with our concerns, including areas where the guidance wasn't consistent with the standard. These inconsistencies increased the risk of material misstatement in the Summary Financial Statements.

To address the increased risk, we expanded the scope of our work to obtain evidence that government's estimates were reasonable. For example, we performed more than 300 recalculations for government buildings owned by the Ministry of Citizens' Services.

Overall, the net impact of these differences was not significant enough for us to report it as an error in the Summary Financial Statements. It did not affect our audit opinion. However, the continued use of inappropriate assumptions and rates will impact calculations in future years and may result in significant audit differences.

As a result of the challenges encountered in auditing these balances, we provided recommendations to improve the accuracy of the asset retirement liability estimate.

Financial instruments

Government was also required to implement new standards related to financial instruments.

A financial instrument is any contract that gives rise to financial assets of one entity and financial liabilities or equity instruments of another entity. Government's financial instruments include cash, receivables, investments, payables, and debt. They also include derivative instruments such as cross-currency swaps, interest rate swaps, and forward foreign exchange contracts.

The financial instrument standards require government to provide financial statement users with information about how the instruments were measured, and the extent to which government is exposed to risks arising from the financial instruments it holds.

The standards were issued in 2011 and 2012. They didn't apply to senior levels of government until fiscal 2022/23, but they were implemented by most organizations in the government reporting entity in fiscal 2012/13. As the auditor, we needed to assess if government applied this new standard appropriately and consistently.

The Office of the Comptroller General prepared a draft of their financial statement presentation and disclosure related to the new standards but didn't share it with our office until after it was approved by the Treasury Board. After our review, we provided the Office of the Comptroller General with our concerns about the presentation and disclosure, including inconsistencies with the accounting standards. These inconsistencies increased the risk of material misstatement in the Summary Financial Statements.

While government prepared a high-level implementation work plan, it didn't consider certain key decisions, such as the required presentation and disclosures resulting from the new standards. This resulted in additional work during the year-end process for the audit team and government staff.

We identified three significant areas that government did not comply with the new standards. Government did not:

1. Appropriately present a "statement of remeasurement gains and losses" to show the change in the value of financial instruments from one period to the next and any changes resulting from financial instrument transactions that occurred during the year;
2. Breakdown the fair value of its $7.5 billion in investments between the required three categories of measurement. This breakdown is required to help financial statement users understand the level of subjectivity associated with the measurement; and
3. Outline liquidity risks relating to derivative financial instruments by disclosing the expected net amounts that government will have to pay or receive from third parties on existing contracts.

If management had not corrected these significant departures, it could have resulted in additional material misstatements being identified in our Independent Auditor's Report.

We also identified several areas in which government can continue to improve the disclosure of financial instruments in the financial statements, including disclosure of:

- credit, liquidity, and market risks;
- the province's risk management policy including the methods used to measure risks;
- fair value measurement (e.g., methods of valuation and elections government has chosen that impact the estimate); and
- sensitivity analysis for foreign exchange, interest rate, and other price risks. This includes how operations (and remeasurement gains and losses where applicable) would have been affected by changes to the relevant risk variables.

New accounting standards coming for revenue and public private partnerships

For the fiscal year ending on March 31, 2024, government will have to adopt new accounting standards for revenue (issued in 2018) and public-private partnerships (issued in 2021). The lessons from implementing the asset retirement obligations and financial instruments standards should be considered to minimize the need for significant accounting adjustments at year-end.

Burnaby Hospital Phase 2 and BC Cancer Centre public private partnership project.
Source: Infrastructure BC

Final thoughts

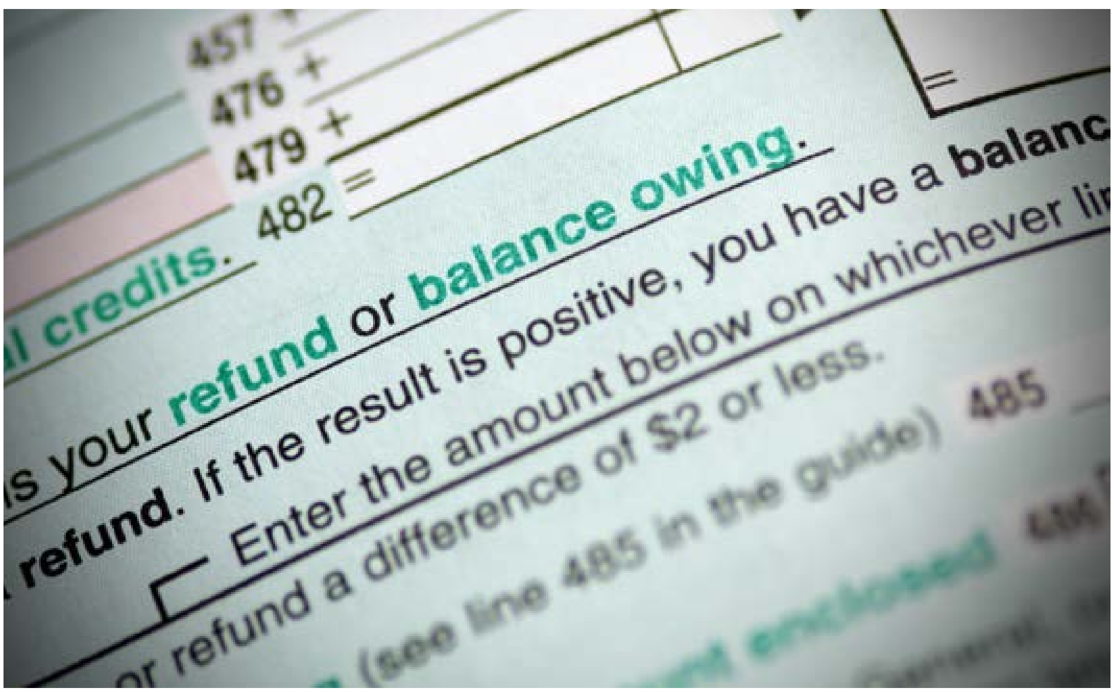
We performed the requirements of our mandate under Section 11(1) of the *Auditor General Act* for the fiscal year 2022/23 and reported the results through our Independent Auditor’s Report on the Summary Financial Statements.

The areas of interest identified in this report to the Legislative Assembly (and in our previous report, *Summary Financial Statements Audit: Supporting the Role of MLAs*) present opportunities for government to improve its financial reporting.

This year, government used more up-to-date information to estimate personal and corporate income tax revenues for financial reporting purposes. The change should provide greater accuracy in financial statement reporting and reduce the size of the adjustments needed in subsequent years.

Government needs to ensure all the impacts of its BC Hydro-related directions to the BCUC are understood, in particular the financial reporting implications. This will reduce the risk of future qualifications in our Independent Auditor’s Reports for the Summary Financial Statements.

Finally, the lessons from last year’s implementation of new accounting standards for asset retirement obligations and financial instruments should be considered as government implements other new standards. Early discussions between government and our office build a shared understanding of the requirements of new standards. They can also form the basis for guidance issued by the Office of the Comptroller General and reduce the risk of unanticipated issues arising during the audit.



Source: Getty Images

Response from the Office of the Comptroller General

The Public Accounts are government's main accountability document to the public. The annual release of the Public Accounts satisfies the legislative requirements to report publicly on the financial matters of government including the Summary Financial Statements which report government's actual results compared to the approved Budget and confirms compliance with legislated authorities.

In this report, the Auditor General has outlined three areas of interest that are reported in the Summary Financial Statements in accordance with accounting standards.

Income Tax Estimation

Income tax revenues rely on personal and corporate tax return results that will be known at a future date. Government's method of estimating income tax revenues is based on the best information available at fiscal year-end. When new information is received from the Federal government after the province's financial statements are completed, adjustments to the original estimates are made in the current fiscal year. Measurement uncertainty, disclosed in Note 2 of the Summary Financial Statements, will continue to exist due to the time between the fiscal year-end and when all tax returns have been processed by the federal government. The government's estimation process is reviewed regularly to ensure reasonableness based on the information available.

Rate Regulated Accounting

Rate regulated accounting is used to support increased investment and unpredictable expenditures at a utility company while avoiding volatility in customer rates. British Columbia Hydro and Power Authority continues to apply rate regulated accounting in accordance with the accounting standards.

Implementation of New Accounting Standards

Treasury Board approves new or modified accounting policies when updated accounting standards are issued from the standard setter. In fiscal year 2022/23, government adopted new standards related to asset retirement obligations and to financial instruments. The impacts of the new standards are reported in Note 1 of the 2022/23 Summary Financial Statements.

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