

September 2017

A hand holding a pen over a tablet with financial charts overlaid. The background features a person in a white shirt and tie, with various data visualizations including line graphs, bar charts, and a pie chart. A circular graphic with a 24% label is visible in the lower right. The overall theme is financial analysis and technology.

UNDERSTANDING OUR AUDIT OPINION ON B.C.'S 2016/17 SUMMARY FINANCIAL STATEMENTS

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CONTENTS

<i>Auditor General's comments</i>	3
<i>Report highlights</i>	5
<i>Response from the Office of the Comptroller General</i>	6
<i>Background</i>	8
<i>Generally accepted accounting principles are important</i>	8
<i>Why do auditors issue opinions?</i>	9
<i>What are the qualifications?</i>	10
<i>Qualification 1: Inappropriate deferral of revenues</i>	10
<i>Qualification 2: Inappropriate use of the modified equity basis of consolidation</i>	10
<i>Qualification 3: Inappropriate use of rate-regulated accounting</i>	11
<i>Appendix A: Audit opinion 2017</i>	14

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The Office of the Speaker of the Legislative Assembly
Province of British Columbia
Parliament Buildings
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I have the honour to transmit to the Speaker of the Legislative Assembly of British Columbia the report, *Understanding Our Audit Opinion on B.C.'s 2016/17 Summary Financial Statements*.

We conducted this audit under the authority of section 11 (1) of the *Auditor General Act*. I am required to report on whether the province's Summary Financial Statements are presented fairly in accordance with Canadian generally accepted accounting principles (GAAP).



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

cc: Craig James, Clerk of the Legislative Assembly

AUDITOR GENERAL'S COMMENTS

WE'RE RELEASING THIS short report to help legislators, the Select Standing Committee on Public Accounts and the people of British Columbia better understand our audit opinion on government's 2016/17 Summary Financial Statements. This year, we have three qualifications (concerns) about errors or inaccuracies in the statements.

Canada is fortunate to have strong, independently-set accounting standards for public sector organizations. In B.C., the *Budget Transparency and Accountability Act* (BTAA) requires government and its organizations to prepare their financial reporting according to independent accounting standards.

However, in 2010, government changed the BTAA, giving itself the ability to create regulations that can modify accounting standards. Since then, government has created two such regulations that remain in effect today—one that allows the deferral of revenue transfers, for example, from the federal government, and one that circumvents the accounting standard for rate-regulated accounting that requires an independent regulator of utility rates. These regulations reduce the objectivity of government's financial reporting.

Since 2012, we have recommended that government remove its regulation on deferring government transfers. But, this regulation is still in place, and continues to result in errors in government's financial reporting. This is the first year that we're issuing a qualification on rate-regulated accounting.

We urge government to remove its regulations and to apply generally accepting accounting principles (GAAP) without modification. The regulations that allow government to modify GAAP should be rescinded. We have worked through and resolved many other accounting issues with government in the past and we still wish to do the same with these.



CAROL BELLRINGER, FCPA, FCA
Auditor General

AUDITOR GENERAL'S COMMENTS

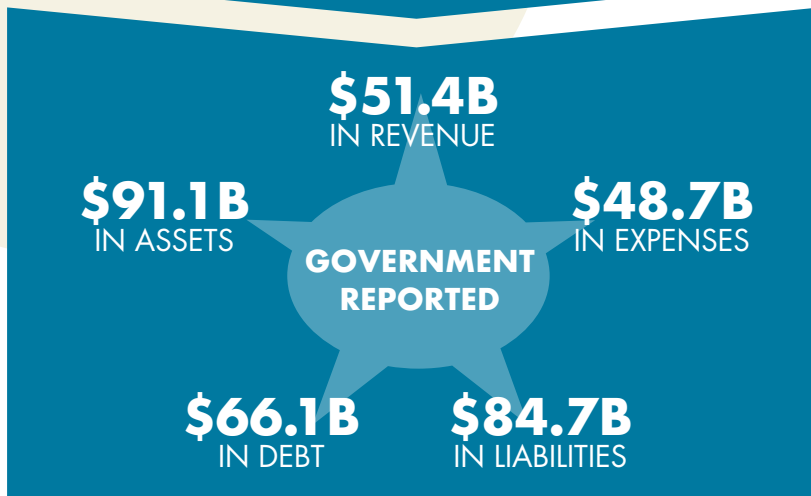
I would like to thank everyone involved in this year's audit of the Summary Financial Statements, including my own staff, auditors of other government organizations and all the individuals within government that contributed to this large undertaking.

A handwritten signature in black ink that reads "Carol Bellringer". The signature is written in a cursive, flowing style.

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

REPORT HIGHLIGHTS

GOVERNMENT'S FINANCIAL STATEMENTS
= LARGEST AUDIT IN B.C.
INCLUDES **150+** ORGANIZATIONS
40,000+ HRS TO COMPLETE



GOVERNMENT SHOULD APPLY GAAP
(generally accepted accounting principles)
WITHOUT MODIFICATION –
REGULATIONS MODIFYING GAAP SHOULD BE RESCINDED



ALWAYS READ THE AUDIT OPINION
It's the fastest way to tell if financial statements are reliable.

Three qualifications/concerns:

- 1. GOVERNMENT REVENUE TRANSFERS** → increases surplus by \$0.9B
- 2. TRANSPORTATION INVESTMENT CORPORATION** → changes type of debt
- 3. RATE - REGULATED ACCOUNTING** → impact on surplus unknown

SURPLUS REPORTED = \$2.7B

RESPONSE FROM THE OFFICE OF THE COMPTROLLER GENERAL

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

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

Treasury Board may adopt all or a part of another standard such as the *International Public Sector Accounting Standards* (IPSAS) if they better represent the legislative framework that government operates under. As noted in the report, there are currently two regulations under the BTAA that are required to address gaps in Canadian public sector accounting standards or their application during transition.

In her opinion on the 2016/17 Public Accounts, the Auditor General identified three audit qualifications that are outlined in this report. These qualifications arise from disagreement with the accounting policy choices of government rather than from error or inconsistency in accounting.

AUDIT QUALIFICATIONS FOR 2016/17

Deferral of Government Transfers Revenue

The Public Sector Accounting Board (PSAB) reviewed the application of Government Transfers accounting by senior governments in 2016. While they recognized a difference in practice across provinces they concluded that it would not be beneficial to amend the standard at this time to prescribe treatment of restricted government transfers.

In the 2016/17 fiscal year, the financial statements of British Columbia, Alberta, Ontario, Quebec, and Nova Scotia followed a policy of deferring restricted revenues because it best reflects the sustainability basis of financial management, characterized by the objective of achieving balanced budgets. Alternately, the financial statements of Saskatchewan, Manitoba, New Brunswick, Prince Edward Island, and Newfoundland and Labrador followed a policy of immediate recognition because it best reflects their reliance on transfer payments by minimizing annual deficits. British Columbia is the only jurisdiction that

RESPONSE FROM THE OFFICE OF THE COMPTROLLER GENERAL

receives a qualification on this issue. I do not agree that the recommended approach can be considered “generally accepted” in Canada.

Modified Equity Basis of Consolidation

Since being established TIC has not received any subsidy or support from taxpayer sources and has been able to support its operations and meet all obligations from its own funding sources. In fiscal year 2016/17 the traffic volume and revenue performance was 10% greater than estimated in the forecast model, the same model used to assess its self-supporting nature in 2013/14. Additionally, the George Massey Tunnel Replacement Project has not been procured, and can have had no effect on the status of TIC at the reporting date of March 31, 2017.

Commitments to reduce or remove tolls were made subsequent to the reporting date. Those commitments and their effect are disclosed in Note 38, Subsequent Events on page 81 of the 2016/17 Public Accounts.

Rate-Regulated Accounting

The use of rate regulated accounting has not been the subject of audit qualification in previous years and the Auditor General has confirmed the appropriateness of the accounting treatment in reports on this subject in 2011 and 2014. Under modified equity accounting the results of BC Hydro are consolidated directly from their audited financial statements without adjustment

or conformation. For the fiscal year ending March 31, 2017 the financial statements of BC Hydro did not receive a similar qualification on this issue.

In this report the Auditor General notes that the accounting standard for rate regulated accounting provides for the regulatory actions of an independent regulator, or the entity’s own governing board if it is so empowered by statute or contract. With regard to the Public Accounts of British Columbia, cabinet is the governing board of the government and has been empowered by the *BC Hydro Public Power Legacy and Heritage Contract Act* to make rate regulating decisions as required by the accounting standard.

Since 2007/08 the Public Accounts have attracted eleven qualifications, including these three. Of those, eight have been resolved without financial adjustment to the financial statements. We will continue to work with the Auditor General and the broader accounting community to resolve these three remaining qualifications included in the Auditors report.

BACKGROUND

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES ARE IMPORTANT

WE AUDIT THE province's Summary Financial Statements (SFS) each year. This is the largest financial audit in B.C., covering over 150 organizations that make up the government reporting entity (GRE). This includes ministries, Crown corporations, school districts, colleges, universities and health authorities. This work takes our office over 40,000 hours, and we audit \$51 billion in revenue, \$48 billion in expenses, \$91 billion in assets and \$85 billion in liabilities, as reported by government.

Government publishes our audit opinion (the results of our audit) in its annual [Public Accounts report](#), along with its SFS. Our audit opinion states whether government has shown its financial position and results for the year fairly, in accordance with Canadian generally accepted accounting principles (GAAP). Our fiscal 2016/17 audit opinion on the SFS (see [Appendix](#)) indicates that, except for our three qualifications, the statements fairly present the financial performance of government, in accordance with Canadian public sector accounting standards, which is the appropriate GAAP framework.

We weren't able to assess the overall impact on the financial statements of all three qualifications. That's because we couldn't put a dollar figure to government's departure from rate-regulated accounting standards. However, our qualification on federal government revenue transfers shows that government's reported surplus should be higher by \$864 million, for a total surplus of \$3.6 billion, rather than the \$2.7 billion that government reported. Our qualification on the Transportation Investment Corporation doesn't affect the surplus, but it does affect how government classifies the debt.

All levels of government across Canada use public sector accounting standards as they were specifically designed for the public sector by the Public Sector Accounting Board—an independent standard-setting body. These standards create consistency in financial reporting, and allow the financial statements of all provincial governments to be comparable.

Starting in the 2004/05 fiscal year, B.C.'s *Budget Transparency and Accountability Act* required government to prepare its SFS in accordance with GAAP. This demonstrated government's commitment to provide the people of B.C. with high-quality financial reporting on its performance. It also ensured that the financial results for the province can be more easily compared with those of other Canadian jurisdictions. However, in 2010, government changed the *Budget Transparency and Accountability Act* to allow itself to enact regulations that modify GAAP.

BACKGROUND

Government regulations that modify accounting standards

BC Regulation 257/2010 (as amended in 2011) – Directs BC Hydro and the government to use the United States Financial Accounting Standards Board Accounting Standards Codification 980 (ASC 980) to account for the effects of rate regulation, except for the requirement for an independent third-party regulator.

BC Regulation 198/2011 – Directs government organizations to continue the practice of deferring restricted revenue contributions, which includes revenue transfers from the federal government.

WHY DO AUDITORS ISSUE OPINIONS?

Audit opinions are an auditor's way of communicating whether the financial statements of an entity are presented fairly. Audit opinions explain any concerns auditors have with the quality and accuracy of financial reporting.

A standard audit opinion—one that doesn't have qualifications—indicates that the financial statements can be held to a higher level of reliability than those with qualifications. When auditors issue a qualified opinion, they are expressing concerns about their ability to gather sufficient and appropriate information, or they have concerns about the entity's compliance with generally accepted accounting principles (GAAP).

A qualification should be rare and represents a concern about the fair presentation of the financial statements. For the 2016/17 Summary Financial Statements, the audit opinion is, once again, qualified, because the statements did not comply with GAAP.

WHAT ARE THE QUALIFICATIONS?

QUALIFICATION 1: INAPPROPRIATE DEFERRAL OF REVENUES

This is the sixth consecutive year that we've disagreed with government on the way it records revenue from other levels of government. When the federal government transfers money, it often requires provinces and territories to use the funds for a specific purpose, such as the purchase or construction of an asset, like a new building, bridge or highway.

Generally accepted accounting principles (GAAP) requires governments to record these funds in their books as soon as the building is bought or built. Governments can only show the revenue in future years under special circumstances, such as when there are specific repayment terms if conditions attached to the transfer are not met.

However, instead of applying these standards, the B.C. government created its own regulation that requires the money to be recorded a little bit each year for as long as the new asset is deemed useful. For example, if the B.C. government receives \$40 million to build a highway in 2017, it is not recording the \$40 million as revenue in 2017. Instead, it records \$1 million a year over the 40-year life of the highway.

As noted in our audit opinion, if government had recorded the transfers according to GAAP, its reported

revenue for the year would be \$0.9 billion higher. Up to March 31, 2017, government has inappropriately deferred \$5.1 billion in revenue.

Not following GAAP clouds the true financial health of the province. By recording revenue in future years, government could make less favourable financial results seem better than they are.

QUALIFICATION 2: INAPPROPRIATE USE OF THE MODIFIED EQUITY BASIS OF CONSOLIDATION

Government considers the Transportation Investment Corporation (TIC), which is responsible for the Port Mann Bridge and the George Massey Tunnel Replacement Project, a self-supporting Crown corporation. However, in our opinion, it doesn't meet the criteria to be considered as such.

If the TIC was self-supporting, it would bring in enough revenue from tolls to cover all its costs and debt, but it does not.

Whether the TIC is a self-supporting entity changes the way that government accounts for TIC's financial results in the Summary Financial Statements (SFS). The difference doesn't change government's bottom line, but the details do matter. For example,

WHAT ARE THE QUALIFICATIONS?

government should actually record the TIC's \$3.4 billion in self-supported debt as taxpayer-supported debt. This represents a \$722 increase per British Columbian.

QUALIFICATION 3: INAPPROPRIATE USE OF RATE-REGULATED ACCOUNTING

Utility companies like BC Hydro often use rate-regulated accounting to defer certain expenses and revenue to future years. That means customers using BC Hydro's utilities pay rates that do not match all of today's costs. Rather, some of those amounts can be deferred and will impact rates paid by tomorrow's customers.

From an accounting perspective, these deferrals mean items that would otherwise affect today's bottom line can be set aside and recognized later. Rather than increasing rates dramatically in one year (for example, to cover unusually high costs from a storm that damaged utility lines) and then lowering them in following years, rate-regulated accounting allows the company to smooth out the recovery of the costs over a longer period.

These companies are typically overseen by an independent regulator that plays a critical role in the rate-setting process. One of the roles of the regulator is to ensure that the amounts deferred can reasonably be absorbed in future rates. If not, the amounts should

flow through to the current year's bottom line—adding to or subtracting from the current year's surplus or deficit.

As we mention previously, the *Budget Transparency and Accountability Act* (BTAA) allows government to issue regulations on accounting policies. In 2011, government issued a regulation (amending BTAA regulation 257/2010) requiring BC Hydro and the government to adopt a recognized accounting standard for rate-regulated accounting—the United States Financial Accounting Standards Board Accounting Standards Codification 980 (ASC 980). This accounting standard for the application of rate-regulated accounting is acceptable under Canadian public sector accounting standards.

Part of the accounting standard requires that an independent third-party regulator establish an entity's rates. The entity's own governing board may also approve rates, provided it is empowered by statute or contract to do so. Regulation 257/2010, however, waives the requirement for an independent third-party regulator, contrary to ASC 980.

Even though B.C. has an independent third-party regulator, government has issued a number of directions that the regulator must follow in the rate-setting process. In effect, because government brings the accounting results of BC Hydro into its Summary Financial Statements (SFS), government's directions are impacting its own bottom line.

In our opinion, government's role is not that of a third-party regulator, nor is it a governing board

WHAT ARE THE QUALIFICATIONS?

empowered by statute or contract to establish rates. Since the directions must be taken into account by the regulator, the SFS are not in accordance with the independence requirements of ASC 980, and therefore are not acceptable under Canadian public sector accounting standards.

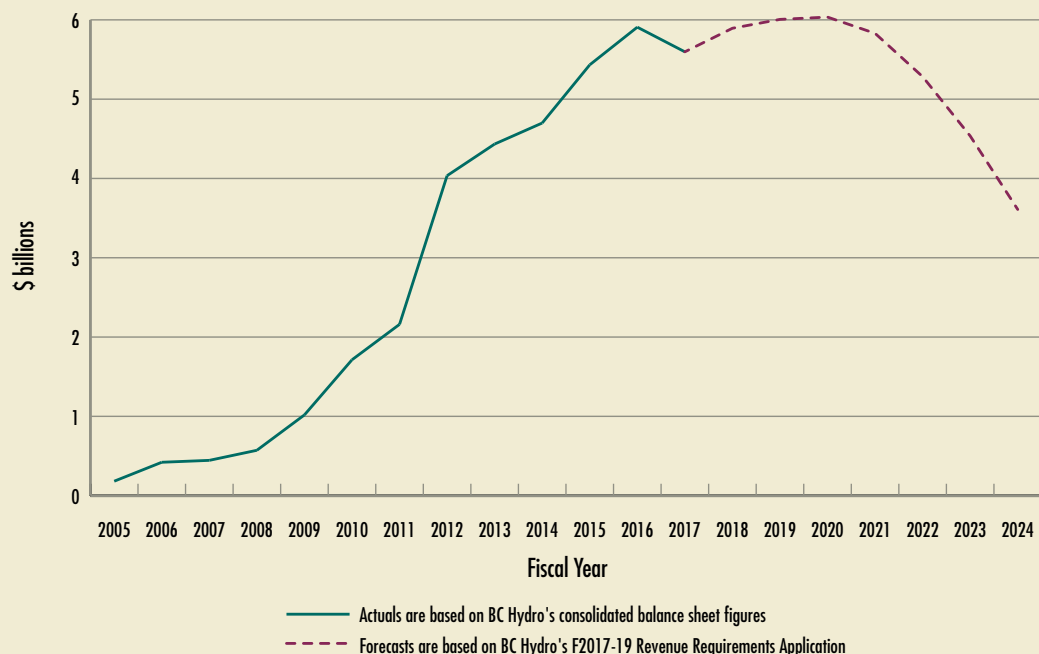
One example of such a direction is when government directed the regulator to establish a rate-smoothing regulatory account. This account allows for the deferral of the difference between the forecast revenue required by BC Hydro (as determined by an independent regulator) and the forecast revenue BC Hydro is expected to earn as a result of government direction. In effect, government has not allowed BC Hydro to

generate the revenue required in 2015, 2016 and 2017 to recover its cost of service.

As of March 31, 2017, BC Hydro has deferred \$6.1 billion in expenses (2016: \$6.3 billion) and \$0.5 billion in revenues (2016: \$0.4 billion), for a net regulatory asset balance of \$5.6 billion (2016: \$5.9 billion). This net balance is considered an asset recoverable from customers in the future.

There are 28 separate regulatory deferral accounts. By 2019, these balances are forecast to exceed \$6 billion, but by 2024, are forecast to be down to \$3.6 billion. Since the mid-2000s, the accounts have increased significantly, as shown in Exhibit 1.

Exhibit 1: BC Hydro's net regulatory asset balance, 2005 – 2024



Source: Compiled by the Office of the Auditor General of British Columbia, based on BC Hydro data.

WHAT ARE THE QUALIFICATIONS?

We're not able to determine what the financial impact would have been had government not issued directions. The overall effect has been to limit rate increases, thereby increasing the deferred balance in BC Hydro's net regulatory asset accounts. As a result, from an accounting perspective, the net earnings, equity and other comprehensive income in self-supported Crown corporations and agencies, as recorded in the Public Accounts, are overstated.

Because we don't know what the regulator would have allowed BC Hydro to defer if government's directions had not been implemented, our audit opinion doesn't quantify the magnitude of this departure from

generally accepted accounting principles. Regardless, customers will have to cover all of these deferred costs in the future.

The impact of rate-regulated accounting and what it means for BC Hydro, the government, customers and taxpayers in B.C. is not widely understood. In 2018, we will issue a fuller report explaining BC Hydro's rate-regulated accounts, which we hope will assist in the understanding of this complex subject.

APPENDIX A

AUDIT OPINION 2017



OFFICE OF THE
Auditor General
of British Columbia

INDEPENDENT AUDITOR'S REPORT

To the Legislative Assembly of the Province of British Columbia

I have audited the accompanying summary financial statements of the Government of the Province of British Columbia (the Government), which comprise the consolidated statement of financial position as at March 31, 2017, and the consolidated statements of operations, change in net liabilities and cash flow for the year then ended, and a summary of significant accounting policies and other explanatory information.

Government's Responsibility for the Summary Financial Statements

Government is responsible for the preparation and fair presentation of these summary financial statements in accordance with the *Budget Transparency and Accountability Act* (BTAA) as set out in note 1(a) to the summary financial statements, and for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor General's Responsibility

My responsibility is to express an opinion on these summary financial statements based on my audit. I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the summary financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the summary financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the summary financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the summary financial statements.

In my view, the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified audit opinion.

APPENDIX A: AUDIT OPINION 2017

LEGISLATIVE ASSEMBLY OF THE PROVINCE OF BRITISH COLUMBIA
Independent Auditor's Report

Basis for Qualified Opinion

Inappropriate deferral of revenues

Government's accounting treatment for funds received from other governments and for externally restricted funds received from non-government sources is to initially record them as deferred revenue (a liability) and then recognize revenue in the statement of operations either on the same basis as the related expenditures occur or, in the case of funds for the purchase or construction of capital assets, to recognize revenue on the same basis as the related assets are amortized.

In this respect, the summary financial statements are not in accordance with Canadian public sector accounting standards which require that (i) transfers from other governments be recorded as revenues, except when the transfer meets the definition of a liability for the recipient government, and (ii) externally restricted funds received from non-government sources be recorded as revenue in the period in which the funds are used for the purpose(s) specified.

Had government made an adjustment, when this was first brought to its attention, for those funds received that in my opinion do not meet the definition of a liability or which have already been used for the purpose(s) specified, liabilities as at March 31, 2017 would have been lower by \$5,106 million, the accumulated surplus at the beginning of the year would have been greater by \$4,242 million and current year revenue would have been greater by \$864 million.

Inappropriate use of the modified equity basis of consolidation

Government has classified the Transportation Investment Corporation as a government business enterprise, which is consolidated in these summary financial statements using the modified equity basis as described in note 1(c). Under Canadian public sector accounting standards, to be classified as a government business enterprise, an organization must be able to maintain its operations and meet its liabilities from revenues received from outside the government reporting entity. Based on the conditions that existed as of March 31, 2017, in my opinion, the Transportation Investment Corporation does not meet this criteria and, therefore, is inappropriately classified as a government business enterprise. Had this organization been properly classified, it would have been accounted for using the full consolidation method and the following financial statement line items would have changed by a material amount:

	Increase/ (decrease) \$ millions
<i>Consolidated statement of financial position:</i>	
Equity in self-supported Crown corporations and agencies	475
Loans for purchase of assets, recoverable from agencies	(3,632)
Deferred revenue	(125)
Taxpayer-supported debt	3,430
Self-supported debt	(3,430)



APPENDIX A: AUDIT OPINION 2017

LEGISLATIVE ASSEMBLY OF THE PROVINCE OF BRITISH COLUMBIA
Independent Auditor's Report

Net assets	(3,054)
Tangible capital assets	3,022
Accumulated surplus	0
<i>Consolidated statement of operations:</i>	
Revenue	93
Expense	93
Surplus for the year	0

The supporting summary financial statements by sector (pages 86 to 93) and the supporting statements for self-supported Crown corporations and agencies (pages 94 to 97) would also be impacted by this inappropriate classification of the Transportation Investment Corporation by the changes described above.

Inappropriate use of rate regulated accounting

Note 37 to the summary financial statements refers to the use of regulatory accounting by the British Columbia Hydro and Power Authority (BC Hydro), a Crown corporation consolidated into the summary financial statements using the modified equity method. In accordance with the BTAA Regulation 257/2010 issued by Treasury Board, BC Hydro is required to adopt the United States Financial Accounting Standards Board Accounting Standards Codification 980 (ASC 980), which is a recognized accounting standard for the application of rate regulated accounting and is acceptable under Canadian public sector accounting standards (PSAS).

By adopting rate regulated accounting, BC Hydro is able to defer some of its expenses and revenues to future years. As at March 31, 2017 BC Hydro has recorded on its statement of financial position \$6,127 million (2016: \$6,324 million) as regulatory assets (deferred expenses) and \$530 million (2016: \$416 million) as regulatory liabilities (deferred revenue), for a net regulatory asset balance of \$5,597 million (2016: \$5,908 million).

Under ASC 980, rate regulated accounting requires that rates must be established by or be subject to approval by an independent third-party regulator, or by its own governing board empowered by statute or contract to establish rates that bind customers. Regulation 257/2010 waives the requirement for an independent third party regulator, contrary to ASC 980. While a third party regulator is in place, government has issued a number of directions to the regulator that must be followed in the rate setting process. In my view, in the summary financial statements, these directions from government do not meet the intent of the independence requirements of ASC 980, and are therefore not in accordance with PSAS.

The overall impact of government directions has been to increase the balance in BC Hydro's net regulatory asset accounts, thereby overstating the net earnings, equity and other comprehensive income in self supported crown corporations and agencies as recorded in these financial statements. I am not able to determine what the impact would have been had these directions not been issued, nor can I determine the amounts that would have been allowed had the regulatory system not included government direction, therefore I am not able to quantify the magnitude of this qualification on the statement of financial position and statement of operations included in



APPENDIX A: AUDIT OPINION 2017

LEGISLATIVE ASSEMBLY OF THE PROVINCE OF BRITISH COLUMBIA
Independent Auditor's Report

the summary financial statements. Because these government directions also existed in 2016, this qualification applies to both the 2017 and 2016 fiscal years.

Qualified Opinion

In my opinion, except for the effects of the matters described in the Basis for Qualified Opinion paragraphs, the summary financial statements present fairly, in all material respects, the financial position of the Government of the Province of British Columbia as at March 31, 2017, and the results of its operations, change in its net liabilities, and its cash flows for the year then ended in accordance with Canadian public sector accounting standards, which is one of the financial reporting frameworks included in Canadian generally accepted accounting principles.

Report on Other Legal and Regulatory Requirements

I report that, except for the effects of the inappropriate deferral of revenues and the inappropriate use of the modified equity basis of consolidation, as described in the Basis for Qualified Opinion paragraphs, the summary financial statements are presented in compliance with the *Budget Transparency and Accountability Act* (BTAA), which requires generally accepted accounting principles for senior governments in Canada, supported by regulations of Treasury Board under the BTAA.

Victoria, British Columbia
August 11, 2017



Carol Bellringer, FCPA, FCA
Auditor General





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