Information Bulletin 1
May 2011

OFFICE OF THE
Auditor General
of British Columbia

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UNQUALIFIED AUDIT OPINIONS ARE IMPORTANT

A discussion on the 2009/10 qualified audit opinion on B.C.'s summary financial statements

AUDITOR GENERAL'S COMMENTS

Under section 11 of the *Auditor General Act*, I am legislated to report on whether the Province's financial statements are presented fairly in accordance with generally accepted accounting principles (GAAP).

Last year, I issued a qualified audit report – or a report with "reservations" – on the Province's 2009/10 Consolidated Summary Financial Statements stating that they were not in accordance with Canadian GAAP. All three of last year's reservations included in the audit report were the same as the reservations I noted in 2008/09, because government chose not to adjust its statements to conform to GAAP. Following the audit of the 2009/10 Summary Financial Statements, I recommended 138 corrections be made to be in accordance with GAAP; government chose to correct 41 of those items. Of the remaining 97 items, only three were 'material' or significant enough to include as reservations in my audit report.

Last year government amended legislation to allow it to follow accounting standards other than those required of similar senior governments in Canada. However, government advised me that it will not invoke this legislation in preparing the 2010/11 Summary Financial Statements. I will therefore, once again, be determining whether these financial statements are in accordance with GAAP.

Previously, it took government eight years to adjust for the reservation around not including schools, universities, colleges and hospitals in its consolidated financial statements. I trust that it will not take as long to address the reservations in last year's financial statements, because they are all easily corrected.

In the auditing profession, a qualified audit report is a rare occurrence. It indicates to the users of the financial statements that some of the information is not auditable or is misleading. During the last 15 years, this Office has issued qualified audit reports on the Province's financial statements 11 times. For governments that strive for transparency and accountability, this is unacceptable.

In August 2010, I submitted a report to the Legislative Assembly that discusses these reservations in detail. However, I am producing this additional report to explain clearly the significance of issuing a qualified audit report.

John Doyle, MAcc, CA
Auditor General

Definitions

GAAP: Generally Accepted Accounting Principles (the industry standard)

Material: something of significance to users of the financial statements

Opinion: the auditor's statement (or opinion) as to the quality of the financial statements. It should be a "clean opinion" with no reservations

Reservation: if certain parts of the financial statements do not follow GAAP or if not enough information is available to make a decision, the auditor may include a reservation in their audit opinion to discuss the situation

Disclosure: notes made in the financial statements to explain certain numbers or accounting policies

INTRODUCTION

On April 1, 2004, British Columbia became a leader among governments in Canada when it implemented legislation requiring that the Province's Summary Financial Statements be prepared in accordance with generally accepted accounting principles (GAAP) for senior governments in Canada,[1] the industry standard. As such, any departure from Canadian GAAP, whether material (significant) or not, puts the government in the position of being in non-compliance with legislation.

Issued by the Accounting Standards Board, an independent body, GAAP include standards that accountants use in the preparation of financial statements. GAAP give users of financial statements the most consistent basis of reporting and information for forming decisions: accountants use GAAP to prepare their financial statements, while auditors use GAAP to assess whether the standards have been met in that process and to form opinions on the fairness of financial presentation. Without GAAP as a basis for preparing and auditing financial statements, it would be difficult to compare the results of one entity with another, and the transparency and answerability of management would be difficult to measure.

The application of GAAP in preparing financial statements varies among jurisdictions because of differences in legislation, regulations and reporting entity make-up. So, although some transactions look similar from one jurisdiction to the next, how they are recorded and presented in financial statements may differ depending on the particular facts of the situation.

The Province of British Columbia requires an audit of its Summary Financial Statements through section 11 of the *Auditor General Act*. This Act requires that the Office report on whether the Province's financial statements are presented fairly in accordance with GAAP.

In the 2009/10 provincial financial statements, we found areas that did not comply with GAAP: three of them were material. In fact, in 11 of the last 15 years, British Columbia's Auditors General have had concerns about the financial statements and have issued qualified audit opinions - a statement as to the quality of the financial statements that points out areas of concern regarding compliance with GAAP or a lack of evidence to support what is recorded in the financial statements.

We have produced this report to explain the significance of this issue.

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

WHY DO WE ISSUE AUDIT REPORTS?

Audit reports are an auditor's way of communicating with the financial statement user. The report is an auditor's opinion on whether the financial position of an entity is presented fairly in its financial statements. Audit reports can also bring to the reader's attention any concerns auditors have with the financial statements.

Many people assume the financial results of an entity are fairly presented, without reading the attached audit report. A standard audit report – that is, one without reservations – indicates that the statements can be held to a higher level of reliability than those without such a report.

When auditors issue a "qualified report," they are communicating that they have concerns or reservations with:

- their ability to gather sufficient and appropriate information; or
- the entity's compliance with accounting standards (GAAP).

In the case of British Columbia's Summary Financial Statements, the Auditor General qualified his report last year because the Province did not materially (significantly) comply with GAAP. We disagreed with government on its interpretation of GAAP.

During that audit, we identified 138 account balance and disclosure (notes to explain parts of the financial statements) adjustments to be made, of which government chose to adjust only 41 items. Of the remaining 97, three were material or significant enough to be included as reservations in the audit report.

In determining whether a reservation is necessary, an auditor considers the materiality or significance of the misstated items individually and collectively, in relation to the financial statements as a whole. A reservation would not be made for an immaterial misstatement or something deemed insignificant.

An auditor is required to use their professional judgement to determine materiality based on his or her perception of the users' needs. To aid the auditor, a numerical threshold for materiality is set. For example, materiality could be set at half a percent of expenses. Typically, if the misstatements found by the auditor are less than materiality (or less than half a percent of expenses as per the example), individually or collectively, then no adjustment is needed. Alternatively, if the misstatements are significant, an auditor may qualify the audit opinion for specific errors until the remaining misstatements are no longer material.

In addition to a numerical threshold, the auditor must also take into consideration qualitative factors. For example, it is possible for a relatively small amount to have a material effect on the financial statements when the amount changes a deficit into a surplus (or vice versa), alters a trend or changes a key ratio. As well, disclosure that is not complete or that provides inappropriate

Why Do We Issue Audit Reports? (Cont.)

information may be considered to have a material effect. For this reason, an auditor may express a reservation on a lack of disclosure even though that missing disclosure does not impact the reported balances in the financial statements.

The reservations noted in our 2009/10 audit report on the Province's Summary Financial Statements were for items that departed from GAAP in a way that was close to, or exceeded, the materiality threshold. We reported those items because they impact the fairness of the presentation of areas within the financial statements.

WHY DO RESERVATIONS MATTER?

A reservation is a concern that an auditor has regarding the fairness of how something is reported in a set of financial statements. An audit report with reservations can impact the operations of an entity by lowering the entity's credit rating or its share prices, or increasing the interest rates charged by its lenders, thus increasing the cost of raising money by an entity.[2]

Public corporations (entities traded on a securities exchange) are required to have unqualified audit reports annually. In British Columbia, should a public corporation be given an audit opinion with a reservation, the British Columbia Securities Commission would normally place a "cease trade" order against the corporation. The public corporation then runs the risk of being delisted by the stock exchange on which it is traded.

Although no data are available nationwide on how many qualified audit reports are issued for public corporations in Canada, or how many cease trading orders have been issued in response to qualified audit reports, it is likely that reservations on public corporations are extremely rare because of the severe consequences.

While governments are not subject to public corporation requirements, a qualified audit report could impact their credit rating or cost of debt. According to the public sector accounting standards of the Canadian Institute of Chartered Accountants, "governments are held to a higher standard of accountability than a business or a not for profit organization".[3] This does not appear to be the case in British Columbia, where the accountability for not complying with GAAP appears to have had little impact on government.

2 Other variables also impact these items. Note that, to date, a qualified audit report has not impacted the Province's credit rating or cost of debt.
3 Canadian Institute of Chartered Accountants, *Public Sector Accounting Handbook*, section 1100, appendix A, point 9.

THE 2009/10 RESERVATIONS

The GAAP departures resulting in reservations for the 2009/10 British Columbia Summary Financial Statements are explained in both the Office's audit report and our *Observations on Financial Reporting: Summary Financial Statements 2009/10* report. A discussion of why the reservations were necessary follows.

The three reservations found on the Province's 2009/10 Summary Financial Statements were:

- failure to properly consolidate the Transportation Investment Corporation
- failure to provide for deep-well credits
- inappropriate netting of oil and gas producer royalty credits

Next we discuss each of these separately.

FAILURE TO PROPERLY CONSOLIDATE THE TRANSPORTATION INVESTMENT CORPORATION

Our first reservation on the 2009/10 Summary Financial Statements concerns how the Province is consolidating a specific entity, the Transportation Investment Corporation (TIC).

At the end of every fiscal year, the Province combines all the financial information of all entities within its control and produces a consolidated set of financial statements: the Summary Financial Statements.

In public sector consolidations, the method of consolidating different entities depends on what type of organization an entity is classified as. Public sector GAAP standards have specific criteria for classifying organizations. For the purposes of the Summary Financial Statements, an entity can be part of government (e.g. a ministry), a government business enterprise (GBE; e.g. BC Lottery Corporation), a government not-for-profit enterprise (e.g. Community Living BC) or an "other government organization" (e.g. Oil and Gas Commission).

Most types of organizations are consolidated on a line-by-line basis. The exception is GBEs, which are consolidated on a modified equity basis. When a government organization is consolidated on a line-by-line basis, each item from the organization's financial statements is added into the Province's financial statements after transactions with other government organizations and ministries are removed and adjustments are made to bring the items under the same accounting standards. When a GBE is consolidated on a modified equity basis, transactions are consolidated differently. For example, only the initial contribution of money to the organization from the government (adjusted for annual earnings or loss) is included in the Province's financial statements. In addition, the accounting standards followed

Failure to properly consolidate the Transportation Investment Corporation (Cont.)

by the organization are not adjusted to be the same as government's, nor are adjustments made for transactions with other government organizations and ministries, apart from those involving the sale of assets.

Although the Transportation Investment Corporation (TIC) is defined as a GBE by government and consolidated on a modified equity basis, in fact the entity does not meet all four GAAP criteria of a GBE. It should therefore be consolidated on a line-by-line basis. The two criteria it does not meet are that the entity:

1. as its principal activity, sells goods and services to individuals and organizations outside of the government reporting entity; and
2. in the normal course of its operations, maintains its operations and meets its liabilities from revenues received from sources outside of the government reporting entity.[4]

Currently, the TIC is responsible for the Port Mann Highway Improvement project, which includes replacing the existing bridge and building facilities to collect tolls from users. The new bridge is currently under construction. Until it is built and the toll booths are operational, it will not be "selling" a service to anyone. The only revenue source the corporation currently has is the interest income being earned on the funds provided by government debt.

The financial model developed by the TIC forecasts that it will not be profitable until 2017/18. In our analysis of the model, we identified a number of areas where further clarification is needed. As well, many variables could impact the future revenue estimates in the financial model and, therefore, the date that the TIC actually becomes profitable.

For these reasons, the TIC does not meet the GAAP criteria of a government business enterprise, and it should be consolidated on a line-by-line basis as required by the standards.

According to our *Observations on Financial Reporting: Summary Financial Statements 2009/10*, the financial impact that the TIC's consolidation has on the statements is as follows:

- Cash is understated by $15 million.
- Equity in self-supported Crown corporations is overstated by $138 million.
- Loans for the purchase of assets recoverable from agencies are overstated by $540 million.
- Tangible capital assets are understated by $948 million.
- Accounts payable and accrued liabilities are understated by $291 million.
- Taxpayer supported debt is understated by $544 million.
- Self supported debt is overstated by $544 million.
- Contractual obligations (as disclosed in the notes to the Summary Financial Statements) totalling $1,993 million should be classified as being for taxpayer-supported Crown corporations instead of for self-supported Crown corporations.

4 The *CICA Public Sector Handbook* defines GBE characteristics in section 1300.28.

FAILURE TO PROVIDE FOR DEEP-WELL CREDITS

Our second qualification pertained to the Province's failure to set up a provision or liability for the deep-well credits given to oil and gas producers. These credits are used to reduce the amount of royalties that the oil and gas producers must pay to the Province when they extract oil or gas from a well drilled to a specified depth. This incentive program, authorized by order-in-council and established by regulation, was initiated to encourage further development of the oil and gas resources.

Deep-well credits are actually an expense incurred by the government to promote the development of British Columbia's oil and gas resource and should be recorded as a liability of the Province. For the credits to be recorded as a liability and be in accordance with public sector GAAP, they must have the following three essential characteristics of liabilities:

- They must embody a duty or responsibility to others, leaving a government little or no discretion to avoid settlement of the obligation.
- The duty or responsibility to others must entail settlement by future transfer or use of assets, provision of goods or services, or other forms of economic settlement at a specified or determinable date, on occurrence of a specified event, or on demand.
- The transactions or events obligating government must have occurred already.[5]

The first characteristic is met as a government regulation establishes the right to the credit. Thus, after the well is drilled, there is little discretion for government to avoid settlement when oil or gas is extracted from it. The second characteristic is met because the credit is used against the royalty payment the producer must make for extraction of the oil and gas. This is the "specified" event that requires the "economic settlement" of the liability. And the third characteristic is met as soon as the oil or gas company drills a well to the required depth.

Air Miles® rewards given out by airlines represent a similar situation. Airlines give Air Miles to individuals who have made a past purchase to earn the reward. The Air Miles may be used only in future transactions, the timing of which is unknown. As soon as a purchase has been made

5 Liability characteristics defined by GAAP are described in the *CICA Public Sector Handbook* section 1000.45.

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Failure to properly consolidate the Transportation Investment Corporation (Cont.)

that qualifies for Air Miles, the airline owes the Air Miles to that individual and this is acknowledged by providing the individual a statement showing the Air Miles earned. In other words, the liability, or amount owing, should be recorded by the airline when the Air Miles are earned. Not all Air Miles will be redeemed, so airlines would make an estimate as to how many are redeemed and set up the amount owing accordingly.

The timing of when oil and gas production begins may vary; however, based on historical trends, government has enough information to provide a reasonable estimate on how many credits will be used, and how many are incurred during the year. Government estimates that there is a 90% likelihood the credits will be used by the oil and gas companies. Government calculates a credit based on information received from the oil and gas producers. Each well's credit bank is shown on the invoices sent to the producers, as is the adjustment made to royalty revenue. The total amount that should be recorded as a liability in the Summary Financial Statements is easily determinable.

According to our *Observations on Financial Reporting: Summary Financial Statements 2009/10*, the financial impact on the statements of not recording deep–well credits is as follows:

- Expenses are understated by $177 million.
- Liabilities are understated by $177 million.

INAPPROPRIATE NETTING OF OIL AND NATURAL GAS PRODUCER ROYALTY CREDITS

In addition to the deep-well credits noted above, the Province rewards credits to oil and natural gas producers for other programs, such as road construction and summer drilling. The Province records all of these credits as a reduction to royalty revenues in the Summary Financial Statements. Public sector GAAP requires that both revenues and expenses be recorded on a gross basis (the one exception is taxation).[6] That is, expenses and revenues are not allowed to be netted against one another. They must be recorded in separate lines on the financial statements.

Tax revenues are classified as non-exchange transactions. That is, no individual or entity receives something of equal value when paying taxes to the government. Royalty revenues, on the other hand, are classified as exchange transactions. The oil and gas producers, for example, receive oil and gas public assets in exchange for paying royalty monies to the Province. Royalty revenues are therefore not taxation revenue.

This means that the Province is not in compliance with the standards when it nets oil and gas credits (which are considered an expense) against royalty revenues in the Summary Financial Statements. Because the amount of credits is material, this presentation does not accurately show the economic substance of the separate royalty revenue earned in the fiscal year, or of the amount spent on the credit transaction stream. This is misleading to readers.

According to our *Observations on Financial Reporting: Summary Financial Statements 2009/10* the financial impact on the statements of inappropriate netting is as follows:

- Royalty revenues are understated by $444 million.
- Incentive credit expenses are understated by $517 million.
- Deficit for the year is understated by $73 million.

It is not that the government does not have the information to record the oil and gas credits as an expense instead of a reduction of revenue. In the unaudited section of its publication *Office of the Comptroller General, Public Accounts 2009-2010*, the government discloses in a footnote the amount of credits it deducted from oil and gas royalty revenues as $444.6 million.[7]

OTHER MATTERS

Public sector accounting standards are currently in a state of transition in Canada. Many government entities are, or will soon be, moving to new accounting frameworks.

We are reassessing the appropriateness of how the provincial government has classified its entities, at this time examining how the Liquor Distribution Branch is accounted for in the Summary Financial Statements. As in the case of the Transportation Investment Corporation, government has been accounting for the branch as a government business enterprise, but the entity does not appear to meet the GAAP criteria. Its materiality on the Summary Financial Statements is currently being assessed.

COMMENTS

The Auditor General welcomes your feedback and/or questions on this information bulletin, as well as your suggestions for potential audits.

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6 *CICA Public Sector Handbook* section 1200.080-1200.081 notes that the only exception to recording revenue on a gross basis is tax revenues, against which tax expenditures are allowed to be netted.

7 *Office of the Comptroller General, Public Accounts 2009-2010*, page 115.

APPENDIX A – FAILURE TO PROPERLY CONSOLIDATE THE TRANSPORTATION INVESTMENT CORPORATION

Statement of Problem

Government has classified the Transportation Investment Corporation (TIC) as a government business enterprise and therefore is consolidating the TIC into the Summary Financial Statements using the modified equity method of accounting. In our opinion, the TIC does not meet the criteria to be classified as a government business enterprise and therefore should be consolidated on a line-by-line basis. This means the accounting is not in accordance with public sector accounting standards (that is, GAAP).

Background

The purpose of the TIC is to develop and operate toll highways. The first one is the Port Mann Highway Improvement project, which includes the Port Mann Bridge and improvements to Highway 1.

The service that government will sell to the public is the use of the Port Mann Bridge. However, the bridge is not expected to be ready for use or begin collecting tolls until 2013/14 according to the financial model as of December 31, 2009. Even government's projections in this financial model suggest the TIC will not achieve a profitable status for almost a decade – beginning in 2017/18.

Analysis

Public Sector Accounting Handbook, section 1300, "Government Reporting Entity," contains the accounting guidance for determining how the TIC should be classified and therefore how it should be consolidated in the Summary Financial Statements.

Per PS1300.28: A government business enterprise is an organization that has all of the following characteristics:

(a) it is a separate legal entity with the power to contract in its own name and that can sue and be sued;

(b) it has been delegated the financial and operational authority to carry on a business;

(c) it sells goods and services to individuals and organizations outside of the government reporting entity as its principal activity; and

(d) it can, in the normal course of its operations, maintain its operations and meet its liabilities from revenues received from sources outside of the government reporting entity.

The above definition requires that an entity have all four characteristics in order to meet the definition of a government business enterprise. Therefore if any one of the criteria is not met, the TIC cannot be classified as a government business enterprise. We agree that the TIC meets the characteristics for items (a) and (b). We disagree that the TIC meets the characteristics of items (c) and (d). Therefore, it cannot be classified as a government business enterprise and be in accordance with GAAP.

PS1300.28(c) requires an entity to be selling goods or services to individuals and organizations outside of the government reporting entity as its principal activity. The current principal activity of the TIC is constructing the new Port Mann Bridge. As the bridge is still under construction and not in operations, i.e. not collecting toll revenues, the TIC is not selling goods or services and therefore does not meet the criteria set out in PS1300.28(c).

PS1300.28(d) requires an entity to maintain its operations and meet its liabilities from revenues received from sources outside of the government reporting entity in the normal course of its operations.

As previously mentioned, the TIC's current principal activity is constructing a bridge. It does not have any revenues from sources outside of the government reporting entity. The government currently supports the use of toll revenues to finance, operate and maintain the bridge. However, since the bridge is not yet in service, it has not yet begun to collect any revenue from outside the reporting entity. As noted above, tolls will not begin to be collected until fiscal 2013/14 when construction is substantially complete.

Government "invested" in the TIC with an upfront payment of $100 million. As well, the TIC borrowed $20 million during fiscal 2008/09 and an additional $520 million in fiscal 2009/2010. Therefore, the TIC does generate some investment income from the funds it holds, but these funds are not sufficient to maintain the TIC's operations or meet its liabilities and they do not qualify as a good or service that is sold. The TIC's financial statements show a net loss from operations of $7.8 million in fiscal 2008/09 and a net loss from operations of $4.5 million in fiscal 2009/10.

According to the financial model mentioned above, the TIC will continue to run deficits for the next seven years, totalling $191 million (2011-2017). This total increases to $209 million if losses from 2008-2010 are included. The TIC is projected to earn a continuous annual profit beginning in 2018.

For these reasons, the TIC does not meet the criteria set out in PS1300.28(d).

Conclusion and Recommendation

The Transportation Investment Corporation does not meet the definition of a government business enterprise and therefore should be fully consolidated in the Summary Financial Statements. Our Office will continue to review the status of the TIC each year to determine if the entity meets the definition of a government business enterprise and can therefore be consolidated on the modified equity basis.

APPENDIX B – FAILURE TO PROVIDE FOR DEEP-WELL CREDITS

Statement of Problem

Unused deep-well credits earned by oil and natural gas producers have not been recorded as a liability by the Province in the Summary Financial Statements. This means the accounting is not in accordance with public sector accounting standards (that is, GAAP).

Background

Government provides deep-well credits as an incentive to industry to drill wells that would be otherwise uneconomical to drill. As at March 31, 2010, there was $176.9 million of unused deep-well credits earned by oil and gas producers for the past drilling of wells that qualify as deep wells. These credits have not yet been applied against royalty revenue (which would reduce the amount of royalties payable) and remain in the government's "deep-well bank" for deep-well credits earned but not yet used.

Each month when there is production from a deep well, the government calculates the amount of royalties payable on that production. Then, any credits in the deep-well bank applicable to a specific well are used to reduce the amount payable, which can reduce the payment to nil if there are enough credits available for that well. Any remaining credit balance is carried forward for use in future months. Therefore, the credit in the deep-well bank as at year-end is due to insufficient production from the applicable wells and hence insufficient royalties payable at that time to have used all the credits.

Analysis

Public Sector Accounting Handbook, section 1000, "Financial Statement Concepts," contains the accounting guidance for when a liability should be recognized in the Summary Financial Statements.

Per PS1000.44: Liabilities are present obligations of a government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits.

Per PS1000.45: Liabilities have three essential characteristics:

(a) they embody a duty or responsibility to others, leaving a government little or no discretion to avoid settlement of the obligation;

(b) the duty or responsibility to others entails settlement by future transfer or use of assets, provision of goods or services, or other form of economic settlement at a specified or determinable date, on occurrence of a specified event, or on demand; and

(c) the transactions or events obligating the government have already occurred.

PS1000.45(a) requires that there be little or no discretion to avoid settlement of the obligation. This characteristic is met as the government is obligated to allow the entity to use the credits awarded to it whenever royalties are payable on that well's production.

PS1000.45(b) has several options that may be applied to satisfy the characteristic. The option of future economic settlement on occurrence of a specified event is met because the credits awarded to the entity are used as a reduction of royalties payable on the future production of that well.

PS1000.45(c) requires the event obligating the government to have already occurred. This characteristic is met because the credits are awarded only once an entity has completed the drilling of a deep well.

As the deep-well credits embody all three essential characteristics of a liability, they should be recorded as such in the Summary Financial Statements.

Conclusion and Recommendation

The $176.9 million of deep-well credits earned by oil and natural gas producers, but not yet used as at March 31, 2010, meet the definition of a liability and should be recognized in the Summary Financial Statements as of that date.

APPENDIX C – INAPPROPRIATE NETTING OF OIL AND NATURAL GAS PRODUCER ROYALTY CREDITS

Statement of Problem

Government has recorded oil and gas royalty revenues in the Summary Financial Statements net of credits. This means that the accounting is not on a gross basis as required by public sector accounting standards (that is, GAAP).

Background

The Province provides incentives to oil and natural gas producers through several programs which provide credits for road construction and summer drilling and to induce activity in marginal, ultra marginal and low-production wells. These credits, which totalled $444 million in 2009/10, are being netted against oil and gas royalty revenues in the Summary Financial Statements.

Analysis

Public Sector Accounting Handbook, section 1200, "Financial Statement Presentation," contains the accounting guidance on how revenue should be recognized in the Summary Financial Statements.

In general, GAAP requires a gross basis of accounting:

> Per PS1200.080: Financial statements should disclose the gross amounts of revenue.

> Per PS1200.081: Gross revenues are disclosed to ensure that the total magnitude of a government's revenue raising is reflected in the financial statements. Such information is necessary for understanding and assessing the financial impact of a government's revenue raising and for enhancing legislative control. Tax Revenue, Section PS 3510, identifies tax concessions as an exception to this requirement for gross reporting.

Underlying the discussion of accounting for the credits is an assessment of the nature of oil and gas revenues. The question is whether producers are paying a "tax" on the oil or gas extracted, or whether the payment is in exchange for the government allowing the producers to "purchase" the right to the oil or gas.

Since PS1200.081 notes that tax concessions are an exception to the gross basis of reporting requirement, we must first make sure that the oil and gas royalty revenues do not fit the definition of tax revenue:

> Per PS3510.02: Tax transactions are non-exchange transactions.

> Per PS3510.07(b): Non-exchange transactions are transactions that are not exchange transactions. In a non-exchange transaction, an entity either receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without directly receiving approximately equal value in exchange.

> Per PS3510.07(a): Exchange transactions are transactions in which one entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of cash, goods, services, or use of assets) to another entity in exchange.

When entities make royalty payments to the government, this is in exchange for the purchase of an asset (oil or gas). This purchase provides the entities with an ownership right in the asset which can be sold, exchanged or redeemed. As a result, there is an exchange transaction that has taken place and therefore the royalty revenues received by government do not meet the definition of tax revenue.

> Per PS3510.07(d): Tax concessions (often referred to as "tax expenditures") are preferential provisions of the tax law that are only available to taxpayers and can include exemptions, deductions, deferrals and credits that affect the level and distribution of tax. They may include special tax rates. They provide tax relief of taxes previously paid or currently owing and are seen as "foregone revenue."

> Per PS1200.082: Financial statements should disclose the gross amounts of expenses.

Since the oil and gas royalty revenue is not tax revenue, the credits are not provisions of tax law and therefore do not meet the definition of tax concessions (i.e. tax expenditures.)

As oil and gas royalty revenue and associated credits do not meet the definition of tax revenue or tax expenditures, they must be recorded on a gross basis. That is, the credits should be shown as an expense and not netted against royalty revenue in the Summary Financial Statements.

Conclusion and Recommendation

Oil and gas royalty revenues should be reported on a gross basis in the Summary Financial Statements.

APPENDIX D – RESPONSE FROM THE COMPTROLLER GENERAL

We appreciate the opportunity to respond to the Office of the Auditor General's comments. We remain committed to providing meaningful financial statements. To this end, we continue to report our financial statements in accordance with public sector generally accepted accounting principles (GAAP), which are those accounting policies and applications that have been generally accepted by a majority of senior governments in Canada.

Where there are differences in professional opinion on the application of GAAP to specific areas of accounting, as identified and quantified by the Auditor General in his opinion, we ensure the accounting policies of the province and their application are fully disclosed in the notes to the financial statements to ensure the broad range of financial statement users are able to understand the basis under which the financial statements are prepared.

In his opinion on the 2009/10 Public Accounts, the Auditor General identified three areas of reservation which are outlined in this report.

Reservations of Opinion

1. **Basis of Consolidation of the Transportation Investment Corporation**

   We believe that the Transportation Investment Corporation is best disclosed as a government business enterprise (GBE) under the modified equity basis of consolidation. The defining element of a GBE is that it is able to maintain its own operations from revenues raised outside the government reporting entity. Unlike taxpayer-supported organizations, GBE's do not receive subsidies from their parent governments. An organization does not have to be profitable to be self-supporting. The Transportation Investment Corporation will support its operations from toll revenue over the life of the program.

2. **Provision for Deep Well Credits**

   Regulation provides for an allowable deduction on the royalties payable if the well is deeper than 2500 meters. The deduction is calculated based on the depth of the well and can be calculated when the well is drilled, even though the royalties will be payable only when the well produces, which could be in future accounting periods. Because the deduction is only relevant in the calculation of royalties attributable to a specific well when they occur, there is no amount payable to the producer at the financial statement date.

   Recording an amount payable related to the costs incurred by the producer would not be appropriate because the costs are not refundable; the only provision is for a deduction in the calculation of future royalty revenues.

   Recording a liability for allowable deductions arising from deep wells would require an expense to be recorded in the current fiscal year and result in inflated revenues recorded in a subsequent fiscal year. This treatment would not represent the economic substance of the transaction because deductions are an integral part of the royalty which are only recognizable as revenue when the well produces, not when the well is drilled.

3. **Oil and Natural Gas Producers' Royalty Credits**

   Royalty revenues have been reported net of allowable deductions in the calculation of royalties' payable since the inception of these programs. Allowable deductions are part of the pricing mechanism laid out in the legislation and regulations that determine how much royalty is payable. In cases where it is more expensive for producers to access the resource, the royalty rate must reflect that additional cost or it will be uneconomical for operators and no royalty revenue will be earned. In no situation would the amount of allowable deductions be received by the Province.

   All jurisdictions in Canada that have oil and gas exploration programs establish pricing mechanisms for royalties using allowable deductions to recognize the different costs related to specific situations. In every jurisdiction, royalties are reported net of those allowable deductions. It is generally accepted that revenue should be recognized when it has been earned and it is either realized or realizable. Amounts such as allowable deductions in the pricing of a royalty will never be realized, therefore, we believe they should not be recorded as revenue. Recording these amounts as revenue would imply that the revenue is available to service debt or for increased program spending and since the revenue will never be received, that is not the case.

   The amount of allowable deductions to royalties is disclosed in footnote 2 of the Schedule of Net Revenue by Source, included in the 2009/10 Public Accounts.

We once again thank the Auditor General for this additional report on financial statement reservations for the 2009/10 fiscal year.

Sincerely,

Stuart Newton
A/Comptroller General
Ministry of Finance