

# Chapter 2

## The Province's Financial Results

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# The Province's Financial Results

## Introduction

**2.1** In recent years, we have used this chapter of our Report to draw attention to six indicators of the Province's financial condition. This year, we are expanding on our discussion of the Province's financial results by looking at three subject areas:

- Indicators of the Province's financial condition

This represents a continuation of the information presented in prior years. It shows trends in the Province's financial health over the past nine years as measured by sustainability, flexibility and vulnerability.

- Financial statement discussion and analysis

This section provides suggestions and examples of the type of information we feel the government should be giving to the readers of its financial reports, in order to supplement and increase a reader's understanding of the Province's financial statements. Although the government does not provide much by way of supplementary information and explanations at the present time, we feel readers will increasingly look for this type of interpretation of the financial results. And the responsibility rests clearly with the preparers of the financial statements, not the auditors.

- Fiscal Stabilization Fund

We provide commentary relating to the objectives and effects of the Fiscal Stabilization Fund established by the Province in 2001.

## Results in brief

**2.2** In general, the indicators for the last nine years show that the Province of New Brunswick's financial condition has improved in sustainability, flexibility and vulnerability, with some deviations from this trend showing in 1999 and 2000. The indicators affected by these deviations showed more positive results in 2001 and 2002.

**2.3** We encourage the government to build on and enhance the information it now provides to New Brunswickers, and to issue a comprehensive financial report describing its financial condition in clear, concise terms that can be easily understood by a reasonably informed reader.

## Indicators of the Province's financial condition

### Scope

**2.4** In our opinion, there is a need for further discussion around the balanced budget legislation, the Fiscal Stabilization Fund and the relationship between the two. We would like to see clear, measurable objectives for the Fiscal Stabilization Fund, and a means by which the Fund is able to report on its effectiveness.

**2.5** In 1997, a research report published by the Canadian Institute of Chartered Accountants (CICA) defined financial condition as a government's "financial health as measured by sustainability, vulnerability and flexibility, looked at in the context of the overall economic and financial environment."<sup>1</sup>

**2.6** The purpose of this section of the chapter is to provide readers with useful information about the Province's financial condition using the CICA research report as a guideline.

**2.7** Though many potential indicators of sustainability, vulnerability and flexibility were considered in preparing the research report, only ten indicators were found which were relevant, necessary, measurable and clear to users of government financial information. Of these, our Office has concluded that six can be considered meaningful in the context of the Province of New Brunswick. They are:

- Sustainability* · *Net debt as a percentage of gross domestic product (GDP)*
- *Change in net debt and GDP*
- Flexibility* · *Cost of servicing the public debt as a percentage of total revenue*
- *Own source revenue as a percentage of GDP*
- Vulnerability* · *Federal government transfers as a percentage of total revenue*
- *Foreign currency debt as a percentage of total debt for provincial purposes*

### Financial results used in analyses

**2.8** In this chapter, our analyses are based on the current year financial statements as presented in the Public Accounts. These financial statements report a surplus for the year of \$143.8 million. Prior year numbers used in our analyses may include restated figures obtained from the Office of the Comptroller.

**2.9** The 31 March 2000 financial statement expenditure figures included \$903.8 million relating to the capital cost of the Fredericton to Moncton highway. This transaction resulted in a one-time increase in expenditure and a corresponding increase in net debt of \$903.8 million

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1. *Indicators of Government Financial Condition*, 1997 published by the Canadian Institute of Chartered Accountants.

in 2000. The magnitude of this transaction has a significant impact on the analyses that follow.

## Sustainability

**2.10** Sustainability is the degree to which a government can maintain existing programs and meet existing creditor requirements without increasing the debt burden on the economy.<sup>1</sup>

**2.11** It is now well understood by the general public that increases in the cost of servicing the public debt can directly impact the quantity and quality of programs and services to which the public has access. Accordingly many provinces, including New Brunswick, are striving to reduce their debt in order to ensure an optimum amount of funding is allocated to programs and services.

**2.12** There are circumstances when governments may tolerate increases in their debt load. For example, when revenues are increasing, a higher cost of servicing the public debt might be tolerated without impacting existing programs and services. However, the ability to generate such revenues (e.g. through taxes, user fees, or licenses) is closely linked to the performance of the economy.

**2.13** Therefore, any growth in New Brunswick's debt must remain in line with growth in the economy to ensure that our Province can sustain its programs and services. If debt is growing faster than the economy, New Brunswick will suffer reduced capacity for sustainability. Programs and services offered to the public may eventually suffer.

**2.14** Gross Domestic Product (GDP) is the total value of all goods and services produced in the Province during a specific period. GDP is often used to measure the growth of the economy.

### *Net debt as a percentage of GDP as a measure of sustainability*

**2.15** Net debt is an accounting measure of the extent to which total liabilities of the Province exceed financial assets. The net debt of the Province increases with deficits and decreases when surpluses are experienced. The financial statements for 2002 indicate that net debt stands at \$6.654 billion - \$844 million more than its level nine years ago, but \$260 million less than in 2000.

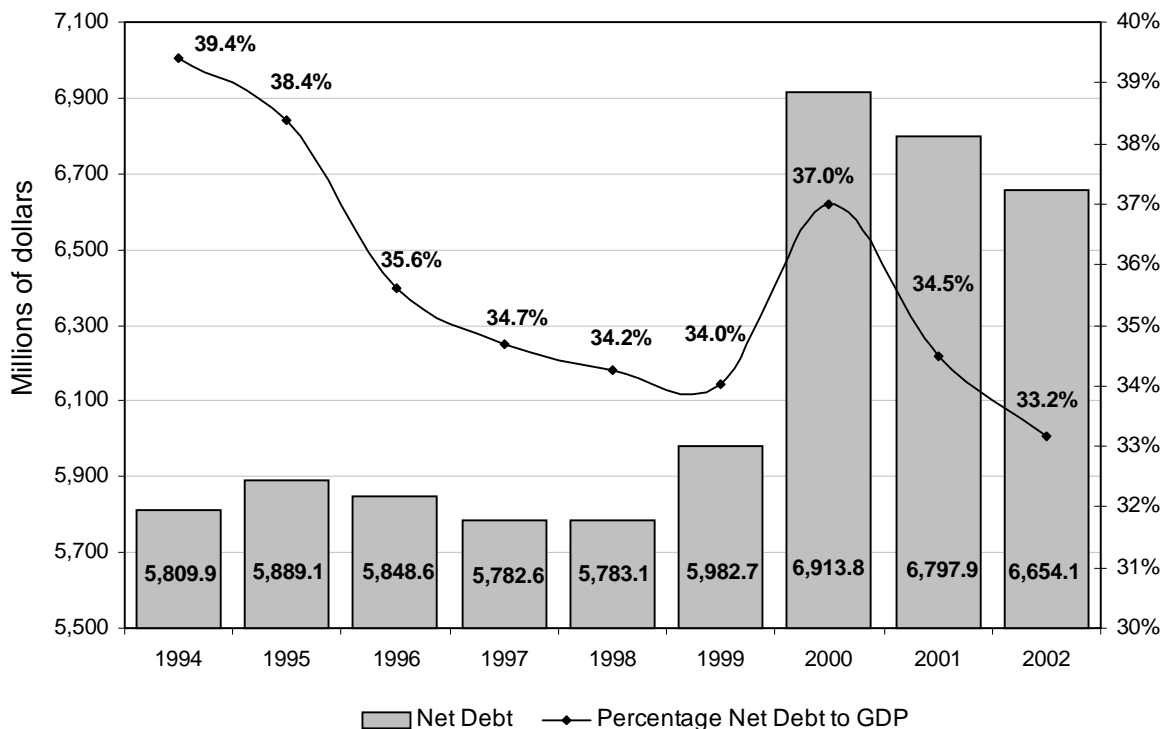
**2.16** The New Brunswick economy has also grown. Exhibit 2.1 shows that the Province's net debt to GDP ratio generally decreased (favourable) over the last nine years – showing the Province's increasing ability to sustain existing programs and services. The only exception to this trend came in the year 2000 as a result of recording the debt for the Fredericton to Moncton highway.

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1. *Indicators of Government Financial Condition*, 1997 published by the Canadian Institute of Chartered Accountants.

Exhibit 2.1

Net debt as a percentage of GDP<sup>1</sup> for the last nine years



**Change in net debt and GDP as a measure of sustainability**

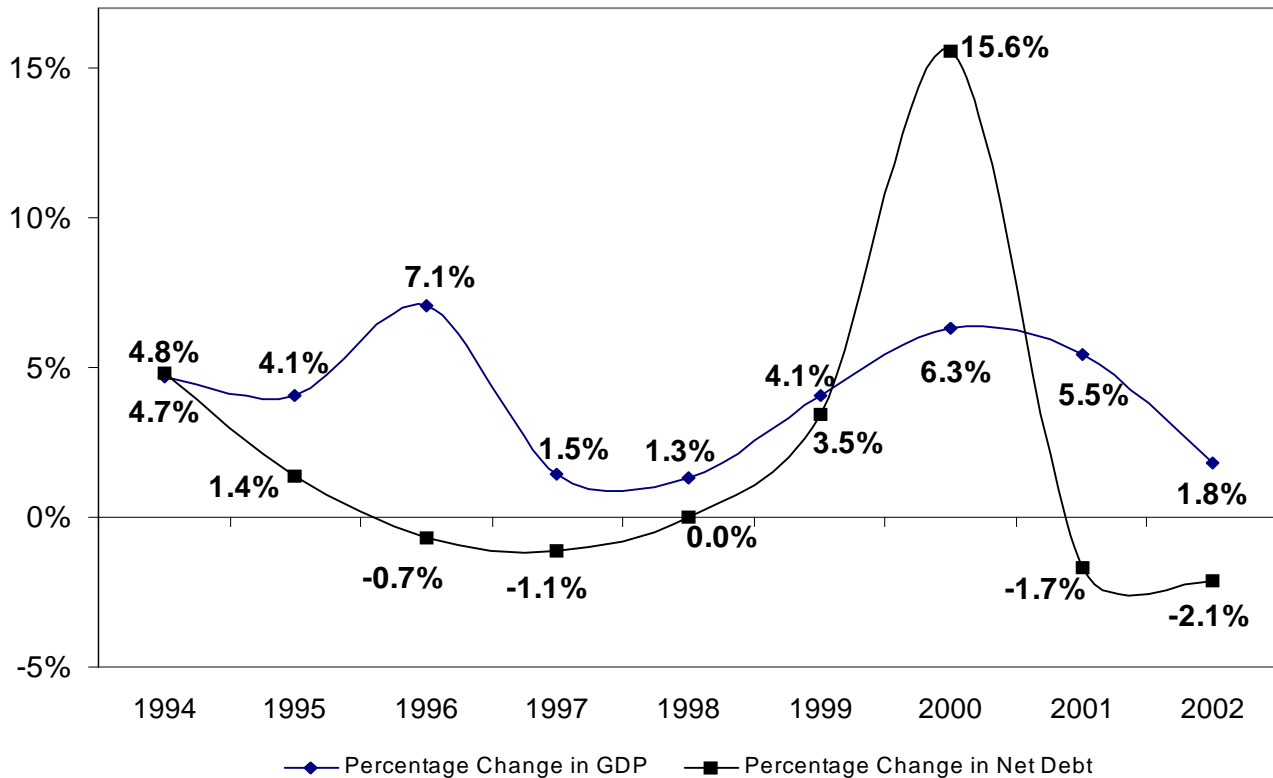
**2.17** The Province can positively influence sustainability in two ways: by increasing surpluses and by increasing growth in the economy. Though governments use various political, legislative and regulatory powers to stimulate the economy, the effect is neither guaranteed nor timely.

**2.18** The rate of growth in the surplus or deficit and their impact on net debt is much more controllable. Exhibit 2.2 shows that the Province has experienced economic growth in excess of growth in the net debt (favourable) since 1994, with the exception of the year 2000. The deviation in the year 2000 resulted from the effects of the Fredericton to Moncton highway.

1. GDP is measured on a calendar year basis. The GDP used in our tables for each 31 March year end is the GDP for the calendar year ended during that fiscal year. GDP information is provided by N.B. Department of Finance: actual GDP for calendar years 1993-2000; estimated for 2001.

## Exhibit 2.2

Change in net debt and  $GDP^1$  for the last nine years



## Flexibility

**2.19** Flexibility is the degree to which a government can increase its financial resources to respond to rising commitments, by either expanding its revenues or increasing its debt burden.<sup>2</sup>

**2.20** Funding for programs and services is provided by either revenue or borrowing during the year. It is a useful measure of flexibility to know to what extent the Province is able to raise revenue from existing and potential sources should new commitments arise.

### *Own source revenue as a percentage of GDP as a measure of flexibility*

**2.21** One could assume that any additional funding for new programs or services might not be possible from existing revenue sources. A reasonable alternative would be to raise revenue from new provincial sources. However, the Province is only able to extract a finite amount of dollars from the economy of New Brunswick before the economy begins to falter. Though the exact capacity of the economy to bear such a burden is not known, one can determine the relative increase or decrease over time.

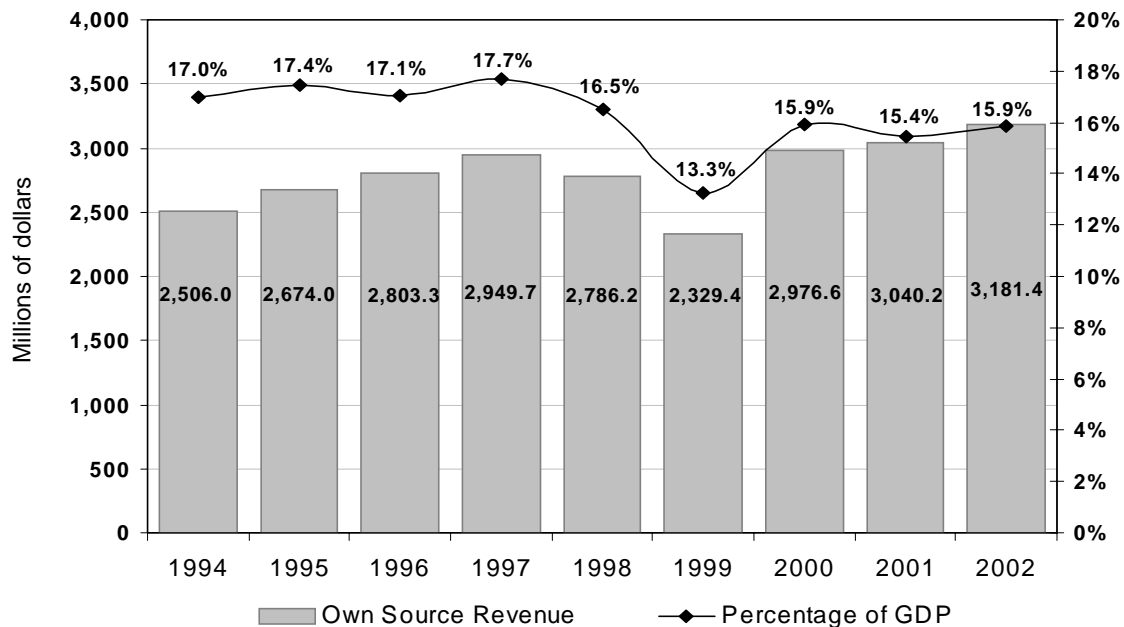
1. GDP information provided by N.B. Department of Finance.

2. *Indicators of Government Financial Condition*, 1997 published by the Canadian Institute of Chartered Accountants.

**2.22** Exhibit 2.3 shows the extent to which the Province has removed dollars from the provincial economy through taxes and user fees/licenses during the last nine years. This exhibit shows that the dollars extracted by the Province from the New Brunswick economy as a percent of GDP gradually decreased (favourable) in this time frame. This indicates an increase in flexibility.

Exhibit 2.3

Own source revenue as a percentage of GDP<sup>1</sup> for the last nine years



**2.23** The large reduction in own-source revenue in 1999 was due to a \$450 million one-time write-down in the Province's investment in the New Brunswick Power Corporation.

*Cost of servicing the public debt as a percentage of total revenue (or "interest-bite") as a measure of flexibility*

**2.24** One of the most publicized factors which affects the flexibility of governments is the cost of servicing the public debt.

**2.25** The cost of servicing the public debt is comprised mainly of interest on the funded debt of the Province. It also includes foreign exchange paid on interest and maturities during the year, the amortization of foreign exchange gains and losses, and the amortization of discounts and premiums which were incurred on the issuance of provincial debt. It does not include principal repayments on the funded debt of the Province.

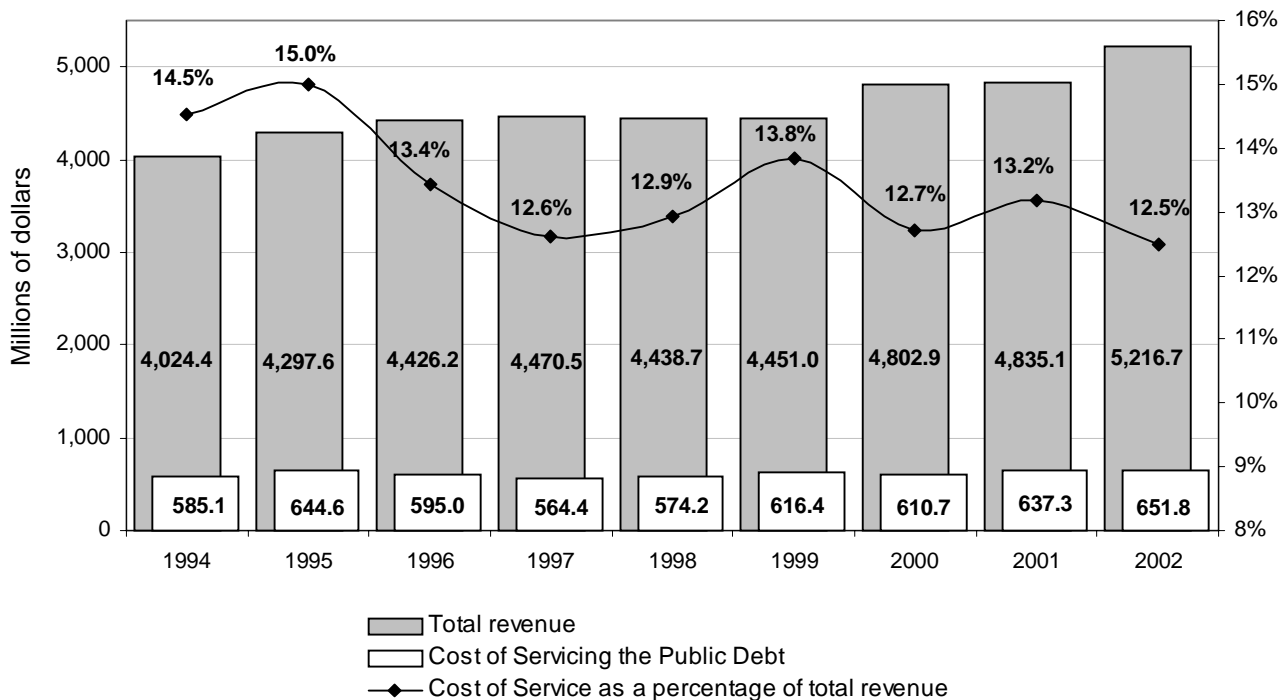
**2.26** Exhibit 2.4 shows debt servicing costs as compared to total provincial revenue for the last nine years.

1. GDP information provided by N. B. Department of Finance.

**2.27** This exhibit shows the cost of servicing the public debt increased in 2002 over 2001 by \$14.5 million to \$651.8 million. It also shows that the Province has decreased its overall “interest-bite” percentage from its 2001 level of 13.2% to its current level of 12.5%. This level has declined from the peak of 15.0% in 1995. The exhibit indicates that, on a percentage basis, the Province has more of its total revenues available for current needs today than it did nine years ago.

Exhibit 2.4

*Cost of servicing the public debt as a percentage of total revenue for the last nine years*



## Vulnerability

**2.28** Vulnerability is the degree to which a government becomes dependent on, and therefore vulnerable to, sources of funding outside its control or influence, both domestic and international.<sup>1</sup>

**2.29** Funding for programs and services can only come from two sources: revenue or borrowing.

### *Federal government transfers as a percentage of total revenue as a measure of vulnerability*

**2.30** In 2002, 39% of the Province's total revenue came from federal transfers. This is significant because revenue from federal sources is not considered to be as controllable as revenue generated in the Province.

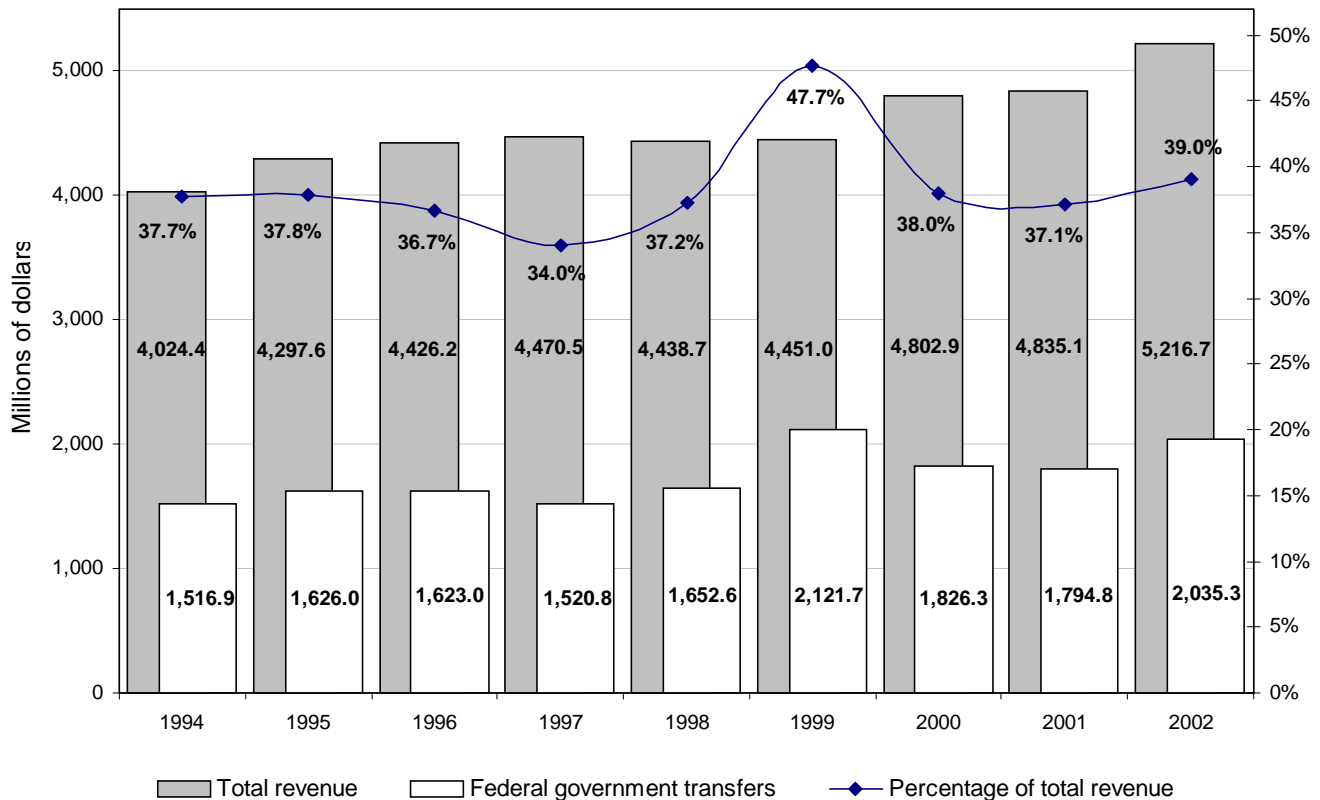
**2.31** Own-source revenue is more controllable because the government can directly impact the amount generated using tax legislation as well as implementation or adjustment of user-fees/

1. *Indicators of Government Financial Condition, 1997* published by the Canadian Institute of Chartered Accountants.



licensing rates. Federal transfers are subject to very different variables - few of which are under the jurisdiction of the provincial government. Federal fiscal policy decisions can severely impact provincial governments by determining the amount and timing of future transfers.

Exhibit 2.5  
Federal government transfers as a percentage of total revenue for the last nine years



**2.32** Increasing New Brunswick's reliance on federal transfers will leave the Province more vulnerable to variables outside of its own control. Exhibit 2.5 details the Province's reliance on federal transfers over the last nine years.

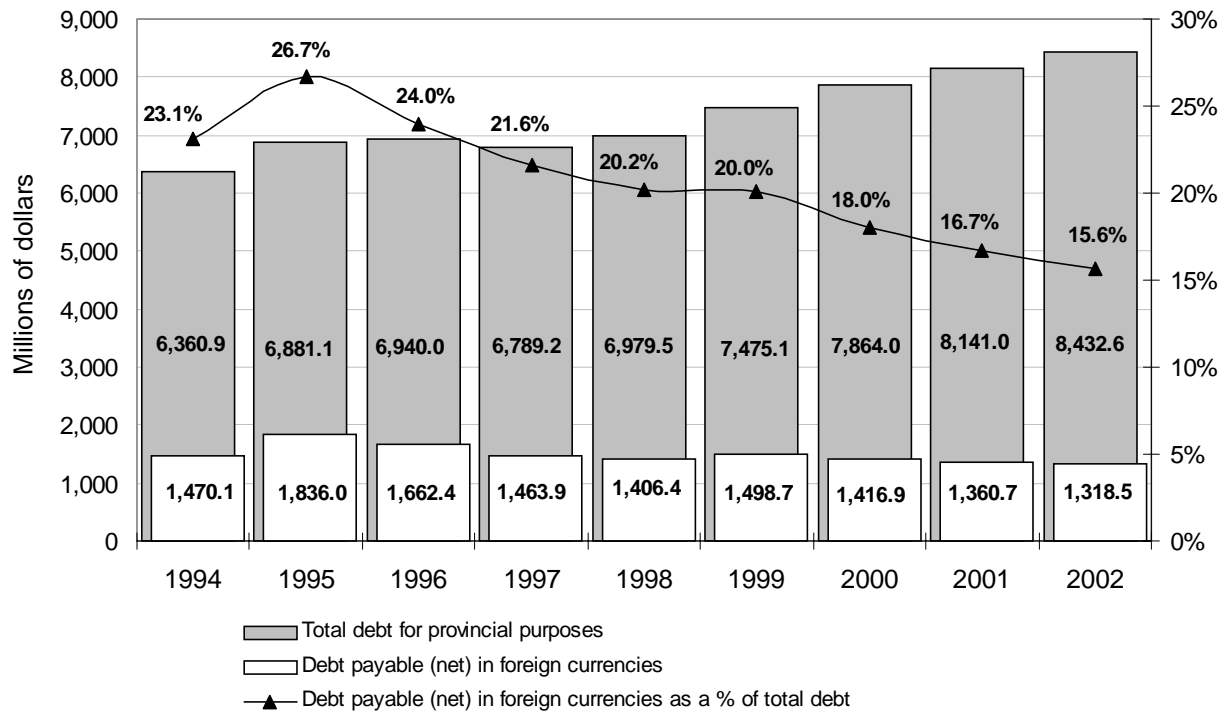
**2.33** This exhibit demonstrates that approximately 39 cents of each dollar of revenue received by the Province comes from the federal government. Though a significant fluctuation occurred in 1999, the trend has been generally stable. We note, however, that federal revenue as a percentage of total revenue in 2002 is the second highest percentage in the last nine years. In 1997 the province's position was more favourable at 34 percent.

**Foreign currency debt as a percentage of total debt for provincial purposes as a measure of vulnerability**

**2.34** When borrowing is required, there are choices to be made by the Province. For instance, if the Province chooses to issue its debt in a foreign currency instead of Canadian dollars, the Province will assume the risk of foreign exchange fluctuations. Such fluctuations can increase or decrease the amount ultimately payable in Canadian dollars for interest, and later, redemption of foreign currency debt.

*Exhibit 2.6*

*Exposure to foreign currency risk for the last nine years*



**2.35** Exhibit 2.6 shows the relationship of foreign currency debt to total debt for provincial purposes over the last nine years. The Province has several alternatives to reduce (hedge) the risk associated with debt repayable in foreign currencies:

- purchasing assets denominated in foreign currencies for the Province's sinking fund;
- entering into debt swap agreements which allows repayment of the debt in Canadian dollars; and
- entering into forward contracts (which allow the Province to purchase foreign currency at a stipulated price on a specified future date).

**2.36** The exhibit reflects the Province's exposure to foreign currency risk after eliminating the effect of hedges against foreign currency fluctuations.

**2.37** The above exhibit demonstrates that the Province's vulnerability to foreign currency risk has experienced continuous decline (favourable) since its 1995 peak of 26.7% to the 2002 level of 15.6%.

## Summary

**2.38** In general, over the last nine years, the indicators of sustainability, flexibility and vulnerability show that the Province of New Brunswick's financial condition has improved. The only exception to this trend is the percentage of total revenue received from federal government transfers, which has remained relatively stable over the last nine years.

## Financial statement discussion and analysis

**2.39** In the private sector, it is common to see management discussion and analysis of financial results included in an annual report to the stakeholders of a company. This information is provided to help readers understand the entity's financial position and results of operations. It can help explain not only what happened, but also why it happened and what the future implications are. This type of narrative supplements the financial statements and helps to interpret them for the reader.

**2.40** In our opinion, governments should include this type of information in their annual financial reports. Supplementary discussion and analysis would provide readers with a better understanding of government financial statements, and government financial condition.

**2.41** The responsibility for providing this supplementary information rests with the preparers of the financial statements, not the auditor. The suggestions and examples we are providing in this section of the chapter are to illustrate the type of information we feel the government should be providing in its annual financial reports. It is not our intention to usurp government's role in this regard; government best understands, and can best explain, its financial results.

## Information provided now

**2.42** We have been encouraged to see the government include, in Volume 1 of the Public Accounts, what it calls a "major variance analysis." This is a useful supplement to the Province's financial statements, and a good first step towards a discussion and analysis of the financial results. However, as we will discuss, the current major variance analysis has some deficiencies, in that it provides little in the way of explanations of the results, nor does it examine trends or implications. In the paragraphs that follow, we provide some suggestions for the information that government could provide to the readers of its annual financial reports.

## Information that could be provided

### *Financial statement highlights*

**2.43** It would be useful to provide a narrative overview of the primary financial statements provided by the government, and a brief explanation of the message that each financial statement conveys. The narrative could also provide a brief, concise description and explanation of the significant events and conditions that shaped the information presented in the financial statements. For example, it could describe any major changes that occurred during the year, major unplanned events and any significant amounts included in the financial statements. The change in accounting policy at NB Power relating to foreign currency translation, that caused an increase in the Province's opening net debt of \$172 million, is an example of a major change that had a significant effect on the 2002 financial statements.

### *Financial analysis review*

#### Risks and uncertainties

**2.44** Government should explain the risks and uncertainties that are inherent in the financial statements as well as the risk management strategies adopted. This type of discussion is common in the more informative annual reports in the private sector.

**2.45** One risk associated with debt is that fluctuations in interest rates could significantly affect the financial results. Debt issued in foreign currencies carries additional risks. The government might consider including information similar to that provided earlier in this chapter in Exhibit 2.6, showing its exposure to foreign currency risk, with a brief explanation of its strategy to minimize this risk.

**2.46** Government could discuss the imprecision in the financial statements due to the use of estimates. Significant liabilities in the financial statements are calculated using projections and assumptions. The best example of this is the Province's pension liability. Relatively small changes in these assumptions can cause significant changes in the financial results.

**2.47** One area of vulnerability is the government's dependence on federal government transfer payments. The government could consider including information similar to that provided earlier in this chapter in Exhibit 2.5, showing the trend of federal government transfers as a percentage of total revenue.

#### Variance analysis

**2.48** As stated earlier, the government now provides, as part of Volume 1 of the Public Accounts, a major variance analysis. We are pleased to see this. However, we feel that the current analysis leaves some room for improvement. For example, it deals solely with revenues and expenditures, omitting any discussion of other changes in the financial statements. And it makes no mention of the surplus for the year.

**2.49** Further, we find some of the information unhelpful. It answers the "what" question, but provides little insight into "why." For example, why were property tax revenues \$16.6 million higher than

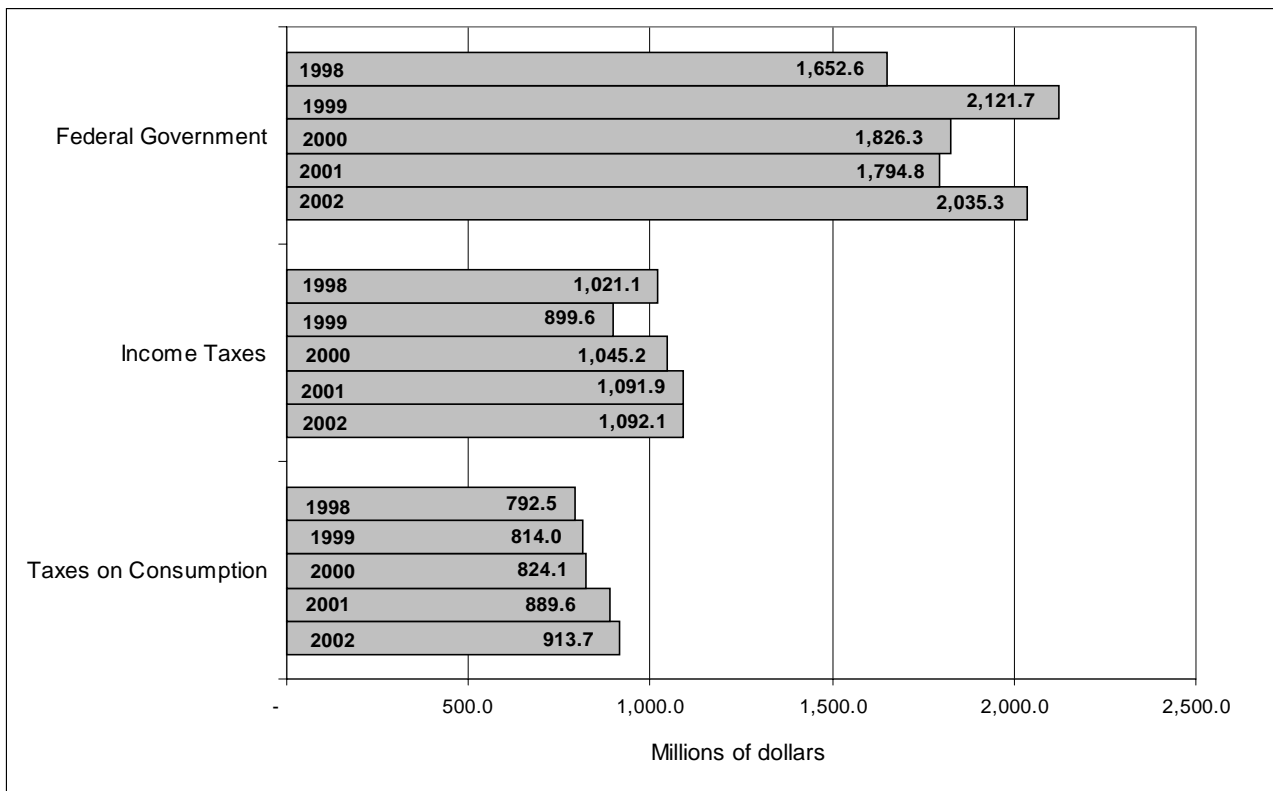
budget? Was it because of increases in tax rates, increases in property values or an increase in the number of properties? What was the reason for NB Power income being \$10 million below budget? How much was invested in the University Infrastructure Trust? Why was there a lower than anticipated growth in the long term care program in Family and Community Services? Discussion of some or all of these issues, which need not be extensive, would help a reader to understand government finances and the competing pressures governments must face while trying to balance revenues and expenditures.

Assessment of trends

**2.50** Another way to provide a reader with a better understanding of government finances is to look at trends in key financial statement numbers. Are revenues from a particular source increasing or decreasing? Are expenditures on some programs decreasing in order to provide additional funds needed elsewhere? Is government increasing or reducing its investment in infrastructure? Some or all of these questions can be answered through the use of charts and graphs.

Exhibit 2.7

Trends in main sources of revenue

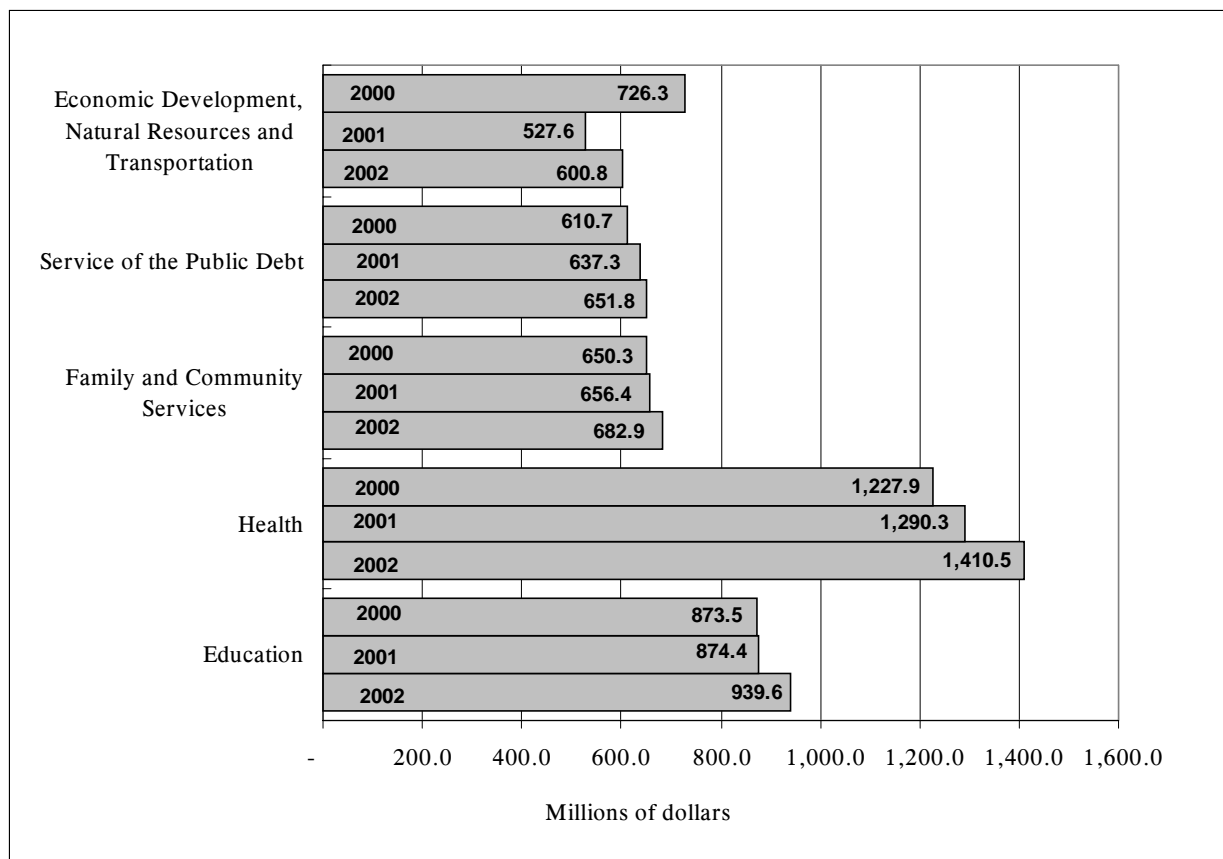


**2.51** For example, Exhibit 2.7 shows the trends in the main sources of revenue for the last five years. Although the total dollars received have increased over this period, the relationship between the different types of revenue has remained relatively stable. Exhibit 2.5 presented earlier in this chapter shows that federal government transfers as a percentage of total revenue have not changed significantly in the last

nine years. This information could be produced as part of the government's financial report to New Brunswickers.

**2.52** Assessing trends in expenditures is difficult because periodic government reorganizations result in programs transferring between departments, and departments being created and eliminated. In particular, a major reorganization in 2000 meant that meaningful comparisons could not be made with prior years. Exhibit 2.8 shows trends in major types of expenditures for the last three years. Spending on health and education continues to increase, and now accounts for almost half of all government spending. Offsetting this, the dollars spent on economic development, natural resources and transportation have reduced in absolute terms over this three-year period.

*Exhibit 2.8  
Trends in major functions of expenditures*

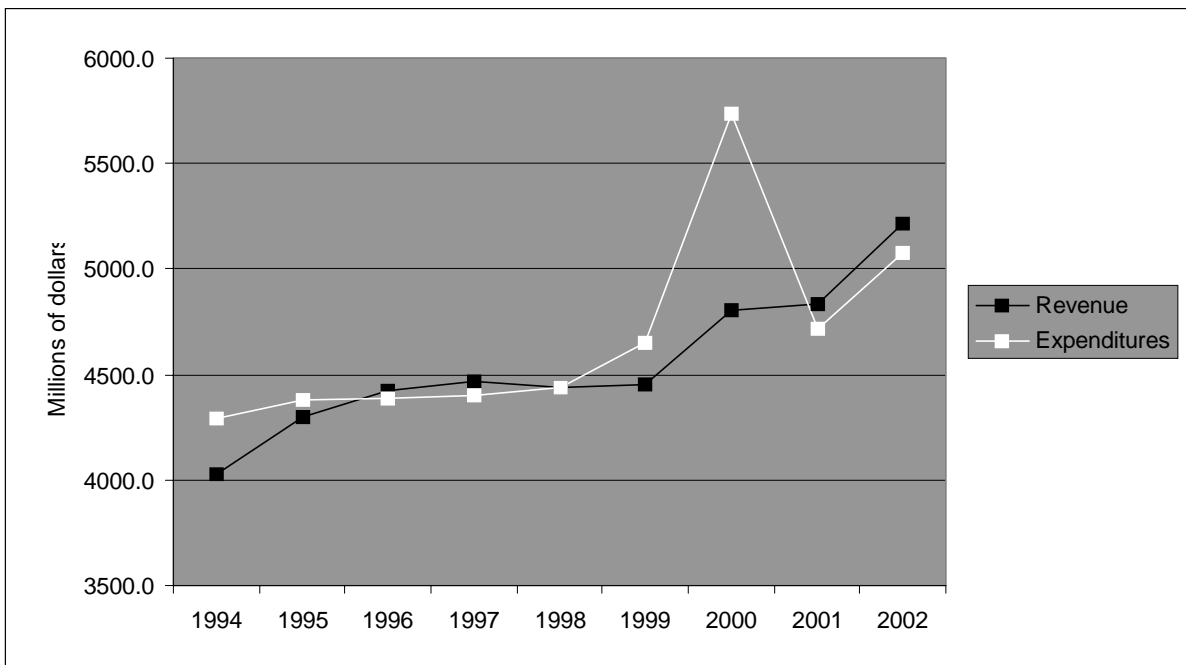


**2.53** Exhibit 2.9 shows total revenues and expenditures recorded in the government financial statements for the last nine years. Over that period, revenues have increased by 29.6% and expenditures by 18.2%.

**2.54** Information on a government's tangible capital assets is useful in assessing a government's financial condition and future service potential. The Province's financial statements at present provide little information to help readers understand the magnitude of the

government's investment in infrastructure and other non-financial assets. Nor do they indicate to what extent the government is maintaining its stock of tangible capital assets, through timely replacement and adequate repairs and maintenance. We are encouraging government to provide more information in this area, as many jurisdictions are now doing. But there will still be a need to provide an interpretation of the information included in the financial statements themselves. Issues that the government could address include the total spending on capital assets over a period, and future expenditure requirements for maintenance and replacement.

*Exhibit 2.9*  
*Revenues and expenditures*



**2.55** There are other areas that might warrant discussion and analysis. The increase or decrease in net debt is an important indicator of a government's financial condition. Exhibit 2.1 looks at net debt as a percentage of GDP for the last nine years. The trend is encouraging. Changes in big ticket items like the unfunded pension liability indicate government's ability to cope with future demands on its financial resources. This is another positive story the government is able to tell. The pension liability recorded in the financial statements has reduced from \$1.06 billion in 1998 to \$372.6 million in 2002. This reflects a conscious effort on the part of government to ensure its pension plans are fully funded and able to meet their commitments from their own resources, potentially reducing future government expenditures.

**2.56** Information such as that described in the paragraphs above would, in our opinion, go a long way towards helping readers understand the finances of government. It might help explain the

difficulties governments face in making resource allocation decisions, the constraints under which they operate, and the implications of the choices they have to make. It could highlight their successes, and provide reasons for negative outcomes. We encourage the government to build on and enhance the information it now provides to New Brunswickers, and to issue a comprehensive financial report describing its financial condition in clear, concise terms that can be easily understood by a reasonably informed reader.

## **Fiscal Stabilization Fund**

**2.57** The Province established the Fiscal Stabilization Fund on 31 March 2001. More precisely, the Act establishing the Fund was assented to on 1 June 2001, but contained the clause “This Act shall be deemed to have come into force on March 31, 2001.” This date is significant, since the Province wished to reflect a transfer of \$100 million out of the Consolidated Fund and into the Fiscal Stabilization Fund in the accounts of the Province for the year ended 31 March 2001.

**2.58** The purpose of the Fiscal Stabilization Fund, as stated in the legislation, is “to assist in stabilizing the fiscal position of the Province of New Brunswick from year to year and to improve long term fiscal planning.”

**2.59** As stated above, the Province transferred \$100 million into the fund in the year ended 31 March 2001. A further \$100 million was transferred into the Fund in the year ended 31 March 2002.

**2.60** The existence of the Fund has generated a great deal of discussion. It is not the role of the Auditor General to question policy decisions of government. Such decisions are fully debated in the Legislative Assembly, and reflect the wishes of legislators. However, we feel we have a role to play in contributing to informed debate about two areas within our jurisdiction: accounting; and reporting on the effectiveness of programs. Specifically with respect to the Fiscal Stabilization Fund, we would like to address the following questions:

- What is the affect on the provincial financial statements of the Fiscal Stabilization Fund?
- How will the Fund report on its effectiveness?

## ***Accounting for the Fund***

**2.61** The quick and easy answer to the first question is that the existence of the Fund has no affect at all on the financial statements of the Province. This is because the Fund is part of the government entity. The Consolidated Fund and the Fiscal Stabilization Fund are components of the government financial statements. In essence they are separate pockets in the same garment. In preparing the provincial financial statements, each component is included, and any transactions between the two are eliminated. For financial statement purposes, the Fiscal Stabilization Fund is treated as if it did not exist.



**2.62** Transfers to and from the Fiscal Stabilization Fund have no consequence for accounting purposes. Taking money from one pocket and putting it into another pocket in the same garment does not increase or decrease the total amount available. That is why the published financial statements for the year ended 31 March 2001 showed a surplus of \$181.8 million, and not the widely reported but inaccurate figure of \$81.8 million. Similarly, the decrease in net debt for the year was \$181.8 million. And the financial statements for the year ended 31 March 2002 show a surplus of \$143.8 million, and not the widely reported but inaccurate figure of \$43.8 million. Net debt for the year decreased by \$143.8 million.

**2.63** Some confusion has no doubt arisen because of a note added at the foot of the Province's Statement of Revenue and Expenditure for the last two years. This note refers to the allocation of the surplus to the Fiscal Stabilization Fund. The note is carefully worded. The surplus for accounting purposes does not change because the Fiscal Stabilization Fund exists. What the Province is indicating is that a portion of the surplus will be "allocated," or set aside, and will be used for specific fiscal policy purposes.

### *Reporting on effectiveness*

**2.64** We do not question that it is prudent to set aside excess funds to be used when needed. Many households do this, saving for a major purchase. One might question whether it is prudent to borrow funds in order to put them away in a savings account, but that would be a policy decision. We point out, however, that the Province's Funded Debt at 31 March 2001, net of investments in its Sinking Funds, was \$4.5 billion. At 31 March 2002 this figure was \$4.6 billion. Bank advances and short term borrowing, in effect the Province's overdraft, were \$484.8 million at 31 March 2001, and \$352.3 million at 31 March 2002.

**2.65** Given the significant amounts the Province owes, as stated above, it is difficult to imagine how the amounts accumulating in the Fiscal Stabilization Fund will be able to "stabilize the fiscal position of the Province from year to year." Moreover, we are uncertain as to how a transfer from one provincial "pocket" to another can achieve that objective. Transferring money into or out of the Fund does not increase or decrease the finances of the Province as a whole.

**2.66** We are also uncertain about the relationship between the Fiscal Stabilization Fund and the Province's balanced budget legislation. The *Balanced Budget Act* requires that total expenditures not exceed total revenues for the period commencing 1 April 2000 and ending 31 March 2004. The Fiscal Stabilization Fund was established at the end of the first fiscal year under the balanced budget legislation. The objective of the balanced budget legislation is quite clear. It is to ensure that over a four-year period the Province does not spend more than the revenues collected. It is understandable how this discipline, every four years, would assist in stabilizing the fiscal position of the Province. Having

said this, it is not clear why the second mechanism, the Fiscal Stabilization Fund, is needed.

**2.67** In our opinion, there is a need for further discussion around the balanced budget legislation, the Fiscal Stabilization Fund and the relationship between the two. We would like to see clear, measurable objectives for the Fiscal Stabilization Fund, and a means by which the Fund is able to report on its effectiveness.