

Chapter 2

Comments on the Province's Financial Position

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Comments on the Province's Financial Position

Introduction

2.1 This chapter covers two separate, but related, topics:

- My audit report on the financial statements of the Province

This section explains the opinion the Auditor General provides on the financial statements of the Province, and outlines the work the Office must do in order to reach a conclusion on the fairness and accuracy of the financial statements.

- Indicators of the Province's financial condition

This section takes some of the information disclosed in the Province's financial statements, adds other objective information such as the Province's Gross Domestic Product, and attempts to chart the results in a way that is clear and understandable. It shows trends in the Province's financial health over the past ten years as measured by sustainability, flexibility and vulnerability.

My audit report on the financial statements of the Province

2.2 Members of the Legislative Assembly and the public have indicated to us that the auditor's report on the Province's financial statements which I sign each year is difficult to understand. For this reason I have decided to try to explain what my audit report means and the work that we conduct to support this report.

2.3 To communicate to the Legislative Assembly my opinion on whether the financial statements of the Province have been fairly presented to the public, I use the standard audit report established by the Canadian Institute of Chartered Accountants. This report forms part of the Province's audited statements and is reproduced in Exhibit 2.1. The statements are made public in Volume 1 of the Public Accounts. My report is normally comprised of three paragraphs but can include more if there is a reservation of opinion. In such a case, if I do not feel that the statements are fairly presented, I would describe the reasons for my reservation in one or more additional paragraphs.

My report on the 2004 financial statements was the standard three paragraph auditor's report expressing my opinion that the audited statements are presented fairly. My last audit report containing a reservation was on the Province's 1998 financial statements.

Exhibit 2.1

Auditor's report on the Province's 2004 financial statements

AUDITOR'S REPORT
<p>To the Legislative Assembly Province of New Brunswick</p> <p>I have audited the statement of financial position of the Province of New Brunswick as at 31 March 2004 and the statements of revenue and expenditure, cash flow and net debt for the year then ended. These financial statements are the responsibility of government. My responsibility is to express an opinion on these financial statements based on my audit.</p> <p>I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by government, as well as evaluating the overall financial statement presentation.</p> <p>In my opinion, these financial statements present fairly, in all material respects, the financial position of the Province as at 31 March 2004 and the results of its operations and its cash flows for the year then ended in accordance with the accounting policies set out in Note 1 to the financial statements. As required by the <i>Auditor General Act</i>, I report that, in my opinion, these policies have been applied on a basis consistent with that of the preceding year.</p> <p>Daryl C. Wilson, FCA Auditor General 1 September 2004</p>

Scope of our audit

2.4 The first paragraph of the audit report outlines what has been audited. My opinion covers the financial statements and the notes for the period ended 31 March 2004 included in Volume 1 of the Public Accounts. The financial statements include the statement of financial position, the statement of revenue and expenditure, the statement of cash flow and the statement of net debt. Note 1 to the financial statements describes the extent of the Province's operations as follows:

In these financial statements, the Province is defined as the Provincial Reporting Entity. The Provincial Reporting Entity is comprised of certain organizations that are controlled by the government. These organizations are the Consolidated Fund, the General Sinking Fund, the Fiscal Stabilization Fund and certain agencies, commissions and corporations. The agencies, commissions and corporations included in this definition are identified [in the note].

2.5 The government is responsible for the preparation and content of the Province's financial statements. I am in no way responsible for their preparation. The Statement of Responsibility at the front of Volume I of the Public Accounts is signed by the Minister of Finance on behalf of the government. It notes that the government helps to ensure the integrity and objectivity of the financial statements by implementing internal controls to verify that transactions are authorized, executed and reported. The actual preparation of the financial statements is the responsibility of the Comptroller.

Work performed

2.6 The second paragraph of the audit report describes the scope of the audit and outlines the procedures we follow to support my opinion on the financial statements. We conduct our audit in accordance with Generally Accepted Auditing Standards. These standards are established by the Canadian Institute of Chartered Accountants and help ensure that all audits are conducted with the necessary care and diligence.

2.7 As a result of our audit procedures, I have obtained reasonable, but not absolute, assurance that the Province's financial statements are free of material misstatement. Material misstatement refers to an item or an aggregate of items that if omitted or misstated, would alter the decisions of reasonably knowledgeable financial statement users. The tolerable level of error or misstatement is a matter of judgment. We have calculated this level for the Province's financial statement audit as a percentage of total expenditures. This is a method accepted by the accounting profession. Reasonable assurance is obtained because it would not be cost effective to obtain absolute assurance on the financial statement figures. My auditors cannot test every transaction. To gain reasonable assurance, we obtain the information and documents supporting the figures appearing in the financial statements and on a test basis apply audit procedures to ensure the accuracy or reasonableness of this information. Procedures used to obtain audit evidence to support my

opinion include tracing samples of transactions to supporting documents, testing the effectiveness of certain internal controls and confirming year-end balances with third parties.

2.8 To prepare financial statements, significant estimates must be used because not all information is available or determinable at the time of finalizing the statements. The government is responsible for preparing or obtaining (from third parties) these estimates. In the course of our work, we review and assess the reasonableness of these estimates. We perform this assessment by using our professional judgment in accordance with the guidelines provided by the Canadian Institute of Chartered Accountants. These estimates can affect assets, liabilities, revenues and expenditures. Examples of where estimates are used in preparing the figures appearing in the Province's financial statements include: the pension liability and pension expense for the public service and other groups; allowances for loss on loans felt to be uncollectible; and allowances for loans guaranteed by the Province for which the Province may be held liable.

2.9 To obtain assurance on the Crown agencies we do not audit, we review, on a cyclical basis, the entities' financial statements and the supporting accounting firms' audit files. Such agencies include New Brunswick Power Corporation, New Brunswick Liquor Corporation and all eight Regional Health Authorities. The purpose of our review is to ensure that the audits of these entities were carried out with due care and diligence and that the work performed is sufficient for our purposes. If we were to find that the work performed by an accounting firm was not sufficient for our purposes, we would then be required to perform additional procedures to obtain the level of assurance we require.

My opinion on the audited financial statements

2.10 Finally, it is in the third paragraph of the audit report where I state my opinion on the fair presentation, in all material respects, of the financial statements.

2.11 My responsibility to express an opinion on the financial statements is assigned to me under section 10 of the *Auditor General Act*. This section of the Act states:

The Auditor General shall examine the several financial statements ... and shall express his opinion as to whether they fairly present information in accordance with stated accounting policies of the Province and on a basis

consistent with that of the preceding year, together with any reservations he may have.

2.12 The stated accounting policies of the Province on which I express my opinion are outlined in Note 1 of the financial statements. While the Province decides on the accounting policies it uses for its financial statements, my assessment of the fairness of these policies must be made against an acceptable standard. This standard is set by the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants. The objective of the Board is to encourage uniformity in financial statements and to increase the comparability between government financial statements.

2.13 In addition to expressing an opinion on the fair presentation of financial information, I must also express an opinion on whether the financial statement information is presented on a basis consistent with that of the prior year. This means that if a change in policy has occurred, then the comparative figures appearing in the financial statements should be restated according to the new policy. If this is not done then I would point this out in my audit report. An example of a policy change occurred in the fiscal year ended 31 March 2003 when the Province discontinued including the results of the Workplace Health, Safety and Compensation Commission in its financial statements.

Areas not covered by my opinion

2.14 I would like to mention some areas that my audit report does not cover. My audit report on the Province's financial statements is not an opinion on the economy, efficiency or effectiveness of the Province's operations. Our findings in these areas can be found in the various chapters of the Auditor General's Report each year. My report on the financial statements is not an opinion on the integrity of each internal control system used within government. My Office conducts work in these areas on a cyclical basis. Significant findings are then reported in our chapter on other audit work in departments and Crown agencies. Finally, my report does not provide assurance that the government has complied with all laws and regulations under which it operates. Our review of these is conducted through separate compliance audits or as a part of a performance audit.

Indicators of the Province's financial condition

Background

- Vulnerability*
- Federal government transfers as a percentage of total revenue
 - Foreign currency debt as a percentage of total debt for provincial purposes

2.15 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."¹

2.16 Some of the information presented below has been included in the discussion of the Results for the Year in Volume I of the Public Accounts. We are pleased to see such analysis included in the Public Accounts. However not all of the indicators are presented there and the Public Accounts information is for a five not a ten-year period. For these reasons we will continue to present this section as we have in prior years. We continue to encourage the government to include in the Public Accounts a comprehensive discussion and analysis of its financial results.

Scope

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

2.18 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. We have, over the years, focused on these same six indicators in order to present readers with consistent analysis over a ten-year period. 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

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

Financial results used in analyses

2.19 In this chapter, our analyses are based on the current year financial statements as presented in the Public Accounts. These financial statements report a deficit for the year of \$103.2 million. Prior year numbers used in our analyses may include restated figures obtained from the Office of the Comptroller.

2.20 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. The magnitude of this transaction can be seen in Exhibit 2.2. The net debt increased to a higher level in that year and has remained at, or close to, that level ever since.

Results in brief

2.21 In general, the indicators for the last ten 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. For the most part, the indicators affected by these deviations showed more positive results in the past four years.

Sustainability

2.22 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.¹

2.23 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 control their debt in order to ensure an optimum amount of funding is allocated to programs and services.

2.24 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.

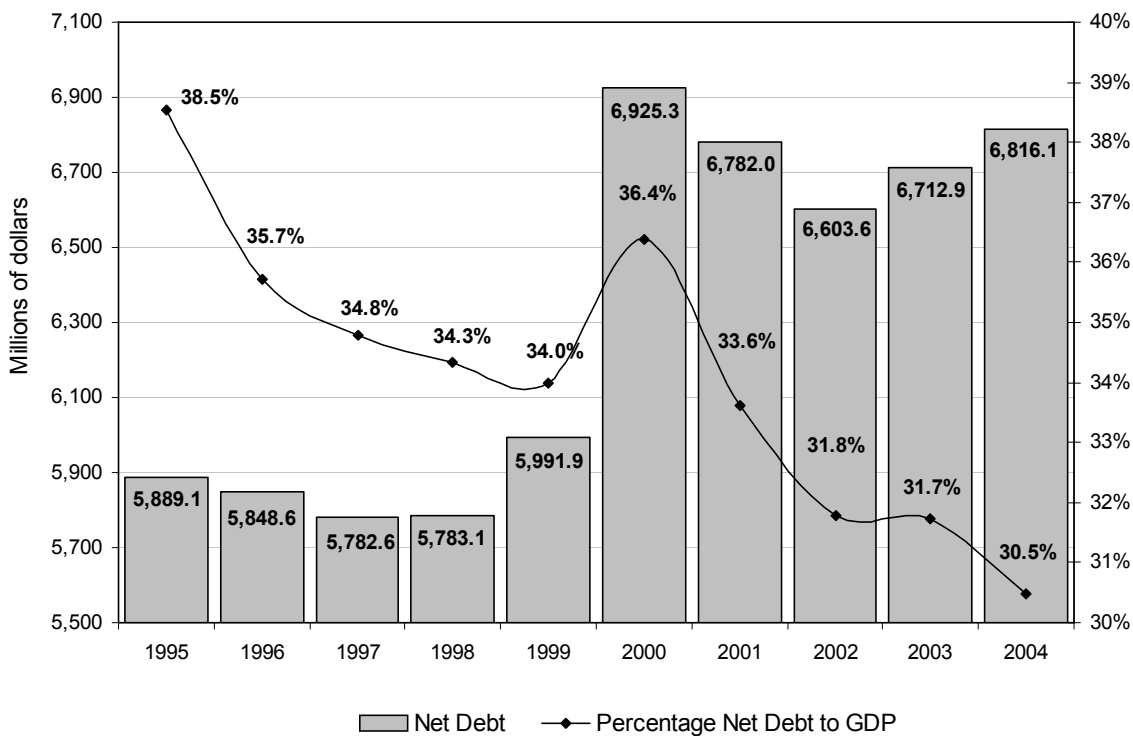
1. *Indicators of Government Financial Condition, 1997* published by the Canadian Institute of Chartered Accountants.

2.25 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.

2.26 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.

Exhibit 2.2

Net debt as a percentage of GDP¹ for the last ten years



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

2.27 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 2004 indicate that net debt

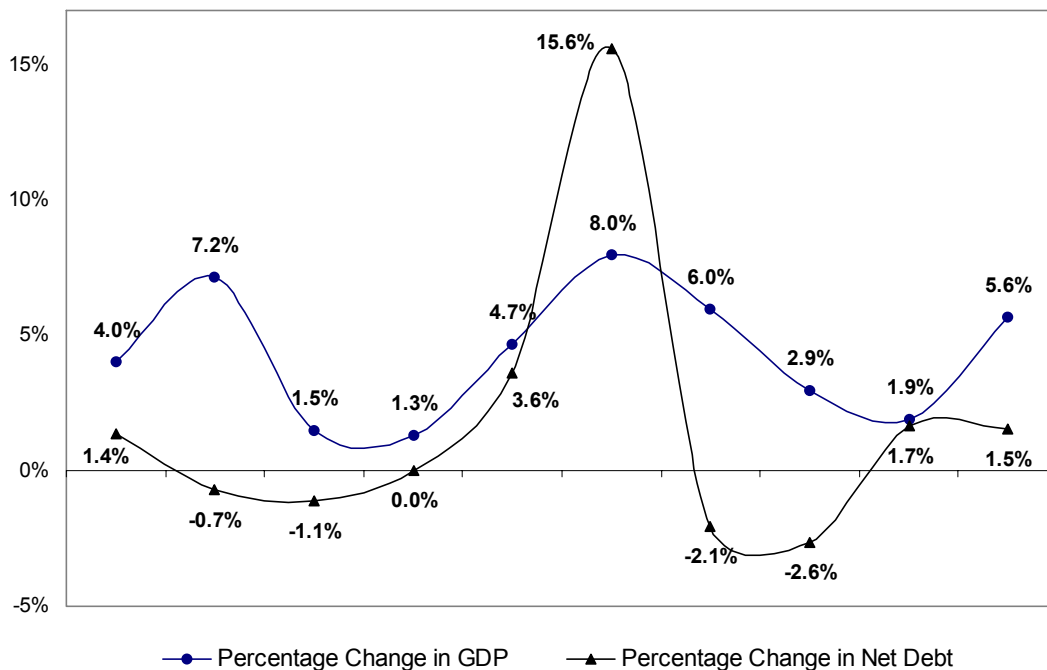
1. GDP is measured on a calendar year basis. The GDP used in our tables for each 31 March year end is the GDP for the calendar year ended during that fiscal year. GDP information is provided by N.B. Department of Finance: actual GDP for calendar years 1994-2003.

stands at \$6.816 billion - \$927 million more than its level ten years ago, but \$109.2 million less than in 2000.

2.28 The New Brunswick economy has also grown. Exhibit 2.2 shows that the Province's net debt to GDP ratio generally decreased (favourable) over the last ten 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.

Exhibit 2.3

Change in net debt and GDP¹ for the last ten years



Change in net debt and GDP as a measure of sustainability

2.29 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.

2.30 The rate of growth in the surplus or deficit and their impact on net debt is much more controllable. Exhibit 2.3 shows that the Province has experienced economic growth in excess of growth in the net debt (favourable) every year since 1995, with the exception of

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

the year 2000. The deviation in the year 2000 resulted from the effects of the Fredericton to Moncton highway.

Flexibility

2.31 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.¹

2.32 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

2.33 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.

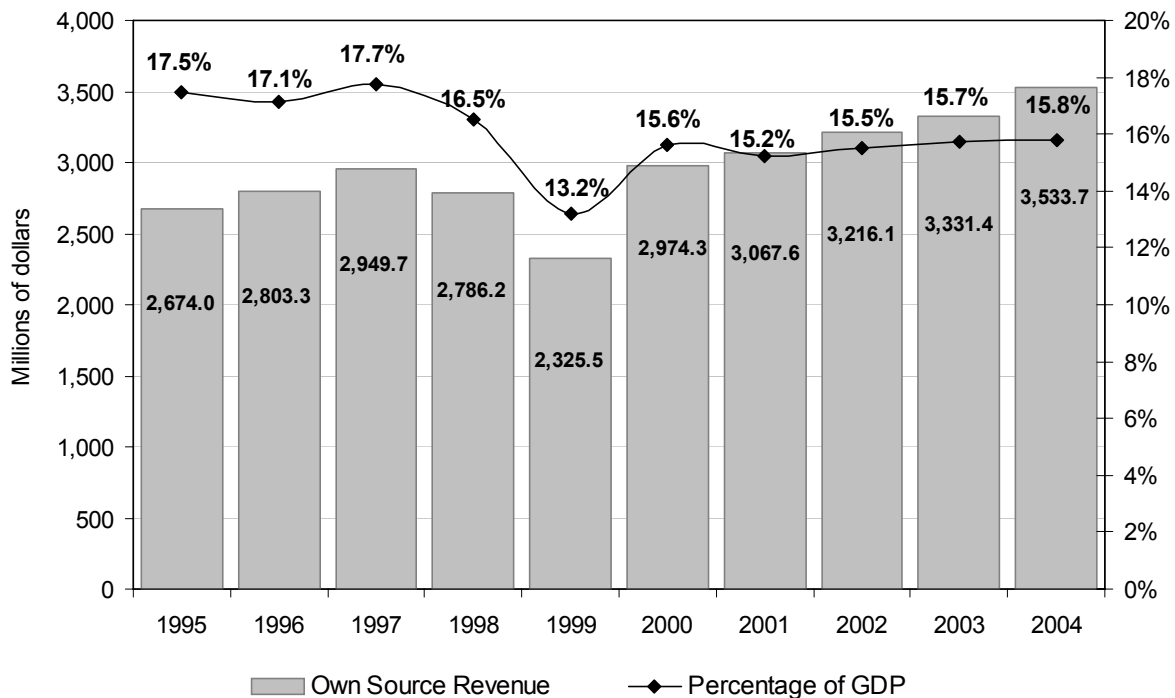
2.34 Exhibit 2.4 shows the extent to which the Province has removed dollars from the provincial economy through taxes and user fees/licenses during the last ten years. This exhibit shows that the dollars extracted by the Province from the New Brunswick economy as a percent of GDP decreased (favourable) during the first six years of the ten-year period, but has been gradually increasing for the past four years. However, the current percentage is still lower than the 1995 to 1998 period.

2.35 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.

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

Exhibit 2.4

Own source revenue as a percentage of GDP¹ for the last ten years



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

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

2.37 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.

2.38 Exhibit 2.5 shows debt servicing costs as compared to total provincial revenue for the last ten years.

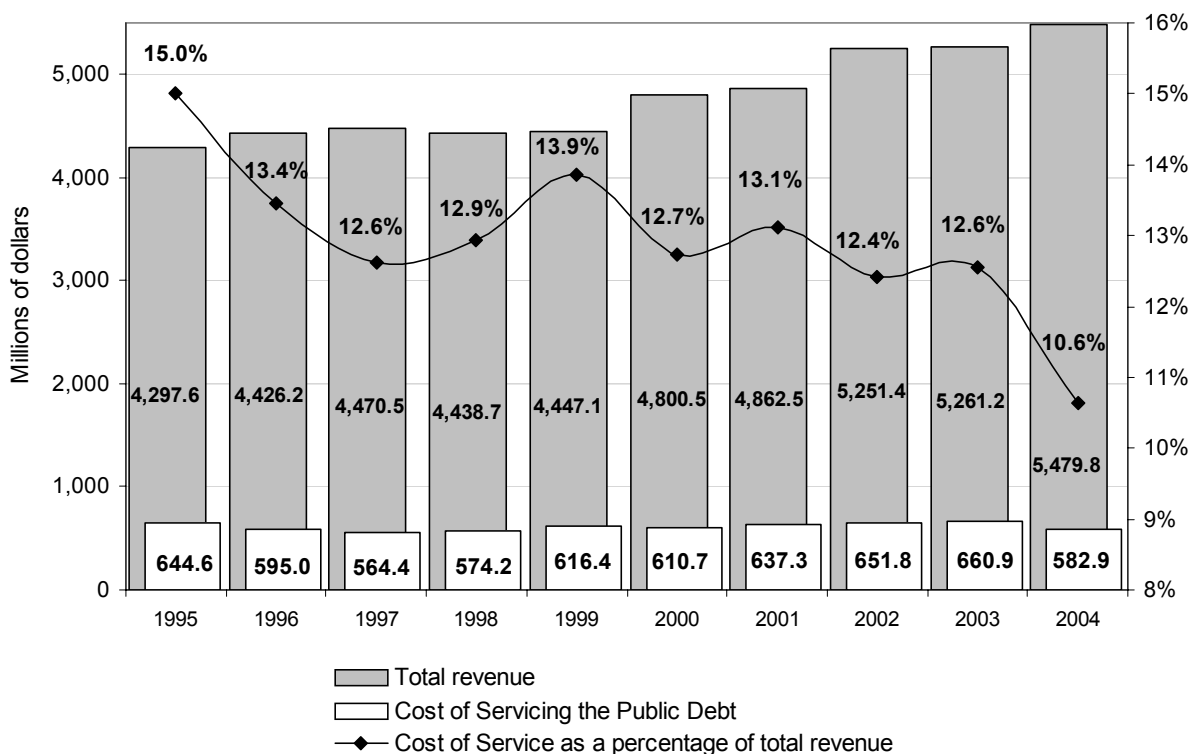
2.39 This exhibit shows the cost of servicing the public debt decreased in 2004 over 2003 by \$78 million to \$582.9 million. It also shows that the Province has decreased its overall “interest-bite” percentage from its 2003 level of 12.6% to its current level of 10.6%.

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

This is a significant decrease, attributable mainly to the strengthening of the Canadian dollar against its U.S. counterpart, and also to a general lowering of interest rates. The level has also declined from the peak of 15% 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 ten years ago.

Exhibit 2.5

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



Vulnerability

2.40 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.¹

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

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

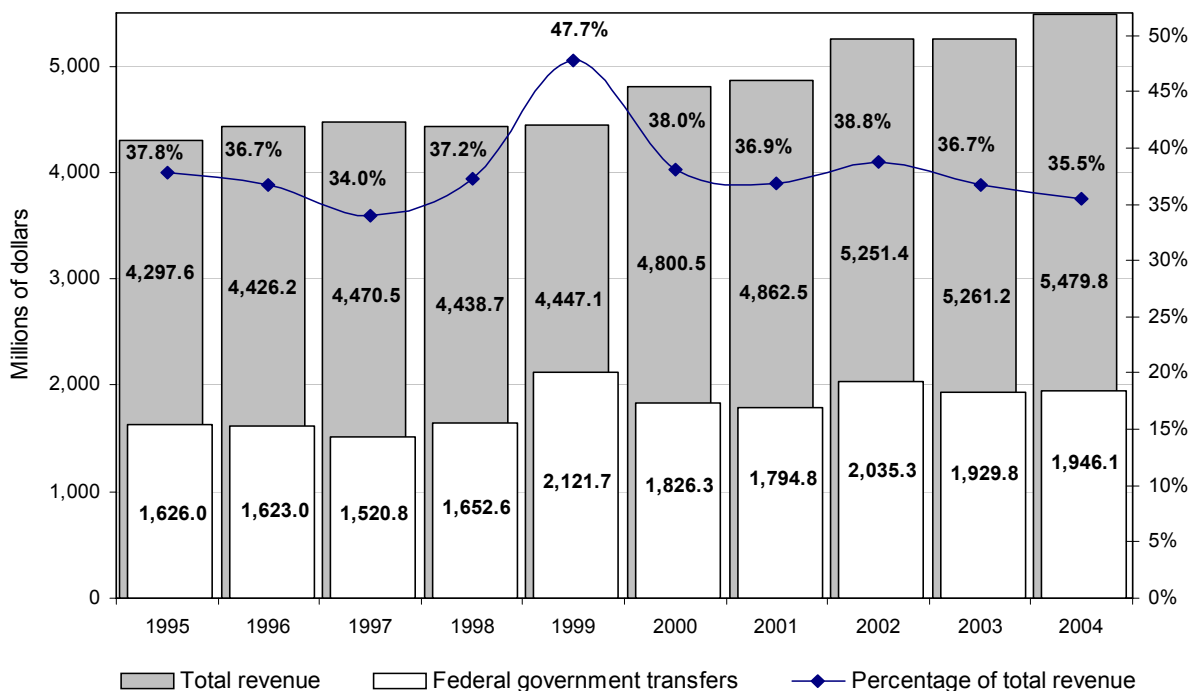
Federal government transfers as a percentage of total revenue as a measure of vulnerability

2.42 In 2004, 35.5% 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.

2.43 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/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 2.6

Federal government transfers as a percentage of total revenue for the last ten years

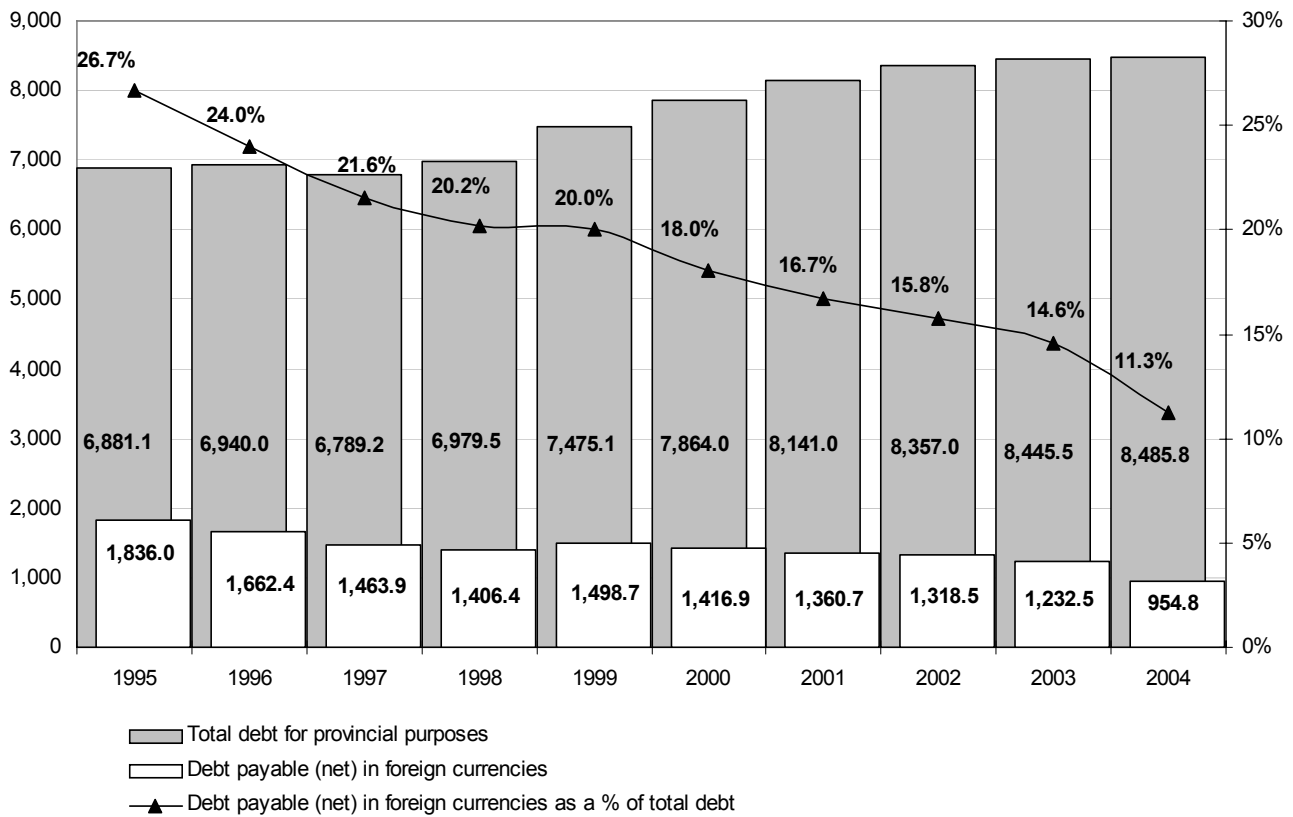


2.44 Increasing New Brunswick's reliance on federal transfers will leave the Province more vulnerable to variables outside of its own control. Exhibit 2.6 details the Province's reliance on federal transfers over the last ten years. Though a significant fluctuation occurred in 1999, this exhibit shows that the trend over the past ten years has been generally stable.

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

2.45 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 2.7
Exposure to foreign currency risk for the last ten years



2.46 Exhibit 2.7 shows the relationship of foreign currency debt to total debt for provincial purposes over the last ten 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).

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

2.48 The exhibit also demonstrates that the Province's vulnerability to foreign currency risk has experienced continuous decline (favourable) since its 1995 peak of 26.7% to the 2004 level of 11.3%.

Summary

2.49 In general, over the last ten years, the indicators of sustainability, flexibility and vulnerability show that the Province of New Brunswick's financial condition has improved. While there were unfavourable deviations in 1999 and 2000 with some of the indicators, these for the most part have improved in the past four years.