

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 three separate, but related, topics:

- Our audit of the financial statements of the Province

This section explains the responsibilities of the government and our Office with respect to the financial statements.

- Comments on the financial statements of the Province

This section discusses anything that we believe to be significant in our audit of the Province's 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.

Our audit of the financial statements of the Province

Responsibilities of the government

2.2 The government is responsible for the preparation and the content of the Province's financial statements. The Statement of Responsibility at the front of volume 1 of the Public Accounts is signed by the Minister of Finance on behalf of the government. The Comptroller is responsible for preparing the financial statements in accordance with the government's stated accounting policies. When preparing the financial statements, the government must make significant estimates, as not all information is available or determinable at the time of finalizing the statements. Examples of where estimates are used include: the set up of tangible capital assets as only limited records were kept for prior years; the pension liability and pension expense for the public service and other groups; and allowances for loss on loans felt to be uncollectible.

Responsibilities of the Office of the Auditor General

2.3 Our Office is responsible for auditing the financial statements. An audit provides reasonable, but not absolute, assurance that the

Province's financial statements are free of material misstatement. Material misstatement refers to an item or group 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.

2.4 We obtain reasonable assurance on the financial statement figures because it would not be cost effective to obtain absolute assurance - our auditors cannot test every transaction. By applying audit procedures to test the accuracy or reasonableness of the figures appearing in the financial statements, we achieve our desired level of assurance. We use audit procedures such as tracing samples of transactions to supporting documents, testing the effectiveness of certain internal controls, confirming year-end balances with third parties and reviewing the reasonableness of estimates.

2.5 We also obtain assurance on the Crown agencies we do not audit, by reviewing the agencies' audited financial statements and, on a cyclical basis, reviewing the work of auditors of these agencies. Such agencies include New Brunswick Power Holding Corporation, New Brunswick Liquor Corporation and all eight regional health authorities. We cannot finalize the audit of the Province's financial statements until we receive the audited financial statements of all significant Crown agencies.

Comments on the financial statements of the Province

Changes to the reporting model

2.6 In October 2002, the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants approved a new reporting model for federal, provincial and territorial governments. The new standards are effective for all fiscal years beginning on or after 1 April 2005, although many governments have chosen to implement the changes prior to that date. New Brunswick has adopted the new model for its fiscal year ended 31 March 2005. The government provided a good explanation of the new reporting model in its 2004-2005 budget documents, and summarized the effects of the changes in its discussion of the results of the year, which precedes the financial statements in volume 1 of the 2005 Public Accounts.

2.7 The purpose of the new model is to change the way people assess a government's financial performance. In the past, people tended to focus only on the surplus or deficit for the year. With the new model, PSAB wants people to focus on the following five indicators of financial performance: net debt; accumulated surplus or deficit; annual surplus or deficit; change in net debt in the year; and cash flows in the year. Governments will also be focusing on costs rather than spending.

2.8 The 2005 Statement of Financial Position now includes two main measures of a government's financial position. The first measure is the traditional one, the Province's net debt. The second is a new measure, accumulated deficit.

2.9 Net debt is the difference between the Province's financial assets and its total liabilities. It provides a measure of the future revenues required to pay for past transactions and events. The accumulated deficit adjusts the net debt amount by recognizing that government borrowing, in part, has been used to acquire assets that are being used to provide future government services. These assets would include roads, schools and hospitals. The remainder, the accumulated deficit, represents the total of all annual deficits, less any annual surpluses, to that point in time, arising from the day-to-day operations of government.

Compliance with Public Sector Accounting Board recommendations

2.10 The Province now fully complies with PSAB recommendations and standards. The government made the following changes in 2005 in order to comply with the PSAB recommendations:

- Tangible capital assets are now recorded on the Statement of Financial Position and amortized over their useful lives. In the past, the Province expensed these assets in the year they were acquired or constructed.
- Prepaid expenses and inventory not held for resale are reclassified from financial assets to non-financial assets.

Timeliness of provincial financial statements

2.11 Our Office has long encouraged the government to issue its financial statements sooner. The New Brunswick government continues to issue its financial statements later than most of the other provinces in Canada. Exhibit 2.1 compares financial statement issue dates between provinces. There are only two other provinces that released its financial statements later than New Brunswick in 2005 - Prince Edward Island and Quebec.

Exhibit 2.1

Provinces' financial statement issue dates

Province	2005 financial statement issue date	2004 financial statement issue date
British Columbia	June 29, 2005	June 29, 2004
Alberta	June 29, 2005	June 29, 2004
Saskatchewan	July 13, 2005	June 29, 2004
Manitoba	September 8, 2005	September 30, 2004
Ontario	September 27, 2005	September 27, 2004
Nova Scotia	September 28, 2005	September 30, 2004
Newfoundland and Labrador	November 29, 2005	November 30, 2004
New Brunswick	December 1, 2005	November 3, 2004
Prince Edward Island	*	February 3, 2005
Quebec	*	March 22, 2005

* not issued at the time of preparing this chapter.

Comments on the approach used by the Province for setting up tangible capital assets

2.12 As mentioned earlier, to comply with the recommendations of PSAB, the Province recorded tangible capital assets on its Statement of Financial Position. This new requirement provided the government with an excellent opportunity to determine what physical assets it owns and how much they cost. The government had a choice on the approach for setting up the assets. It could do the bare minimum to meet the PSAB requirements (generate a number for the financial statements) or it could spend extra time to develop an extensive inventory of its assets, their cost and remaining useful life. The government chose to do the bare minimum, which is shown by the following government decisions.

- It chose **high** thresholds for assets to be set up - higher than most other provinces. Individual assets that cost less than \$100,000 (except for vehicles and land) are not recorded as tangible capital assets.
- It chose **not** to capitalize any furniture and equipment (except for the first time equipping of new buildings), computer equipment or major software development projects, unlike other provinces. These assets represent significant expenditures for the Province.
- It chose **not** to separately identify costs for individual buildings and highways. Instead, it allocated all expenditures for buildings and all expenditures for highways into two pools. This means that the amounts showing in the financial statements cannot be supported by listings of individual assets, or records of particular road construction projects.

Indicators of the Province's financial condition

Background

2.13 We believe that by making these choices, the Province lost a great opportunity to demonstrate good stewardship and improve asset management.

2.14 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

2.15 Some of the information presented below has been included in the discussion of the Results for the Year in volume 1 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

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

2.17 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:

- | | |
|-----------------------|---|
| <i>Sustainability</i> | <ul style="list-style-type: none"> • <i>Net debt as a percentage of gross domestic product (GDP)</i> • <i>Change in net debt and GDP</i> |
| <i>Flexibility</i> | <ul style="list-style-type: none"> • <i>Own source revenue as a percentage of GDP</i> • <i>Cost of servicing the public debt as a percentage of total revenue</i> |

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

- 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

2.18 In this section, our analyses are based on the current year financial statements as presented in the Public Accounts. These financial statements report a decrease in net debt for the year of \$131.5 million. Prior year numbers used in our analyses may include restated figures obtained from the Office of the Comptroller.

2.19 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 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

2.20 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 five years.

Sustainability

2.21 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

2.22 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.

2.23 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

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

ability to generate such revenues (e.g. through taxes, user fees, or licenses) is closely linked to the performance of the economy.

2.24 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.

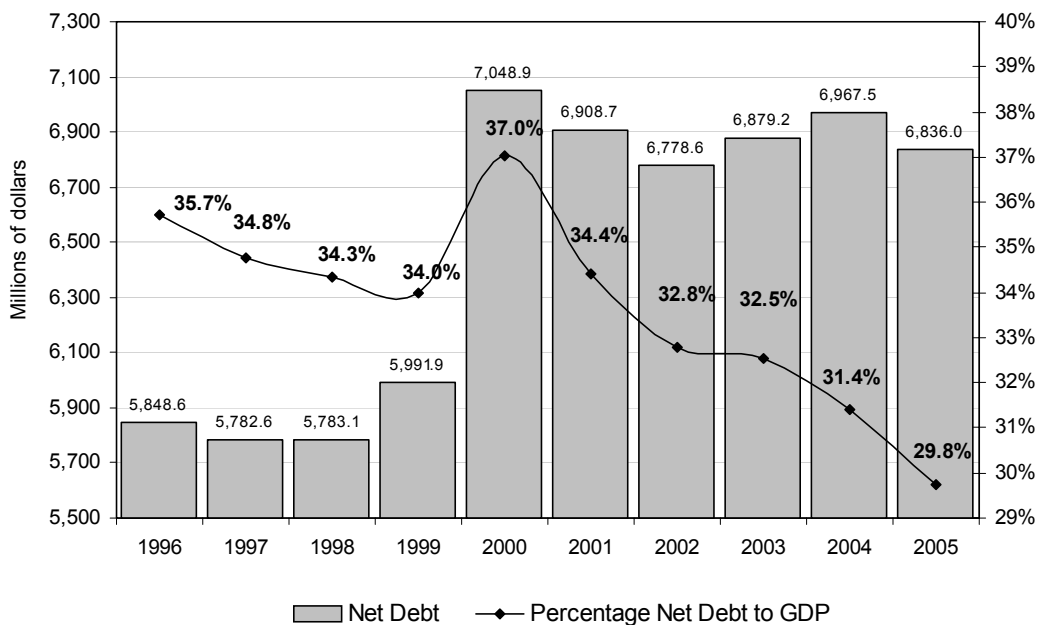
2.25 Gross Domestic Product (GDP) is the total value of all goods and services produced in the Province during a specific period. GDP is often used to measure the growth of the economy.

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

2.26 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 2005 indicate that net debt stands at \$6.836 billion - \$987.4 million more than its level ten years ago, but \$212.9 million less than in 2000.

Exhibit 2.2

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



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 1995-2004.

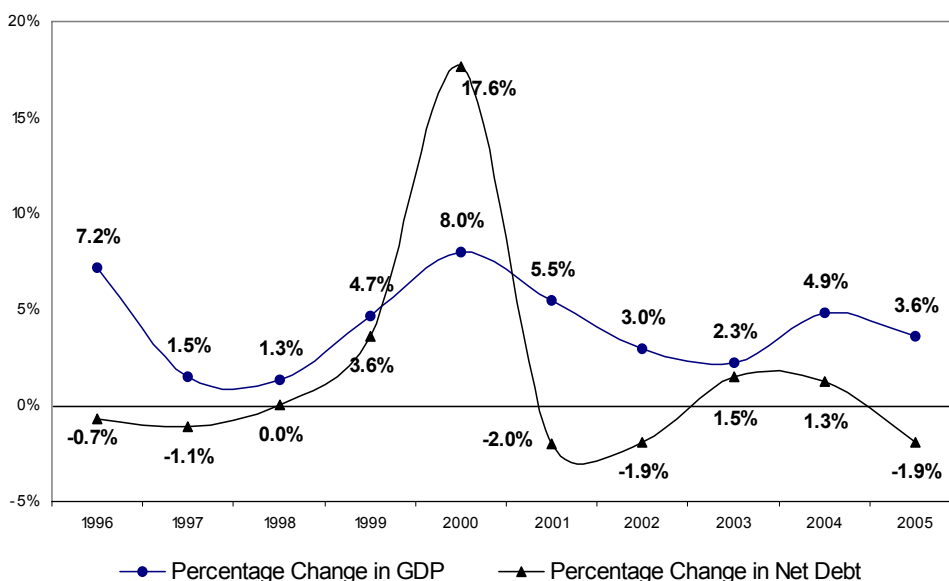
2.27 The New Brunswick economy has also grown. Exhibit 2.2 shows that the Province's net debt to GDP ratio generally decreased (favourable) over the last ten years – showing the Province's increasing ability to sustain existing programs and services. The only exception to this trend came in the year 2000 as a result of recording the debt for the Fredericton to Moncton highway.

Change in net debt and GDP as a measure of sustainability

2.28 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.

Exhibit 2.3

Change in net debt and GDP¹ for the last ten years



2.29 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 1996, with the exception of the year 2000. The deviation in the year 2000 resulted from the effects of the Fredericton to Moncton highway.

Flexibility

2.30 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.²

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

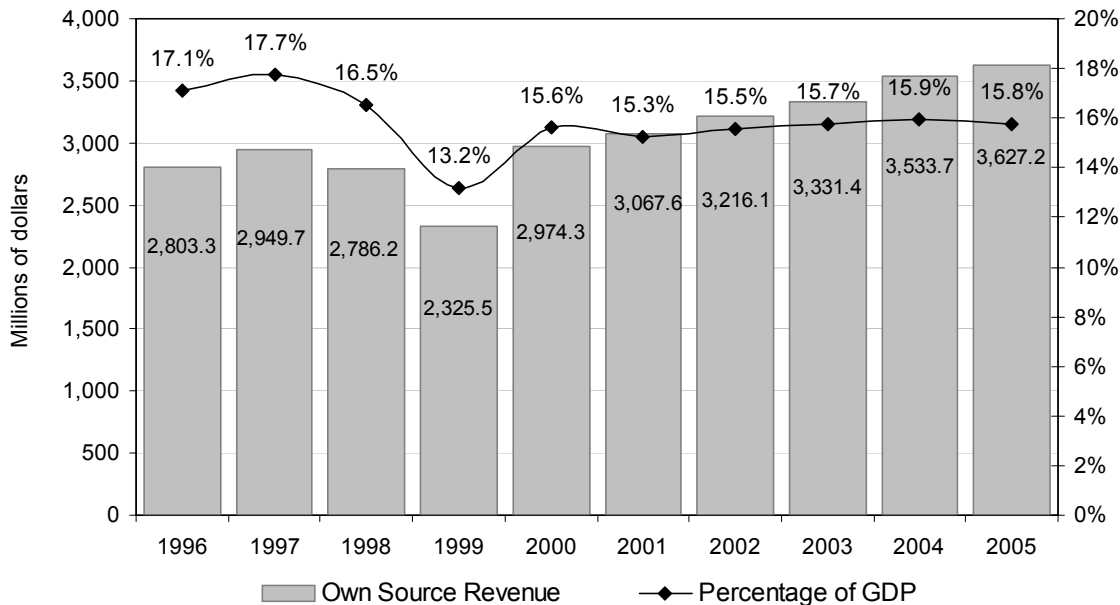
2.31 Funding for programs and services is provided by either revenue or borrowing during the year. It is a useful measure of flexibility to know to what extent the Province is able to raise revenue from existing and potential sources should new commitments arise.

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

2.32 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.

Exhibit 2.4

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



2.33 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 four years of the ten-year period, but has been relatively stable for the past six years. However, the current percentage is still lower than the 1996 to 1998 period.

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

2.34 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.

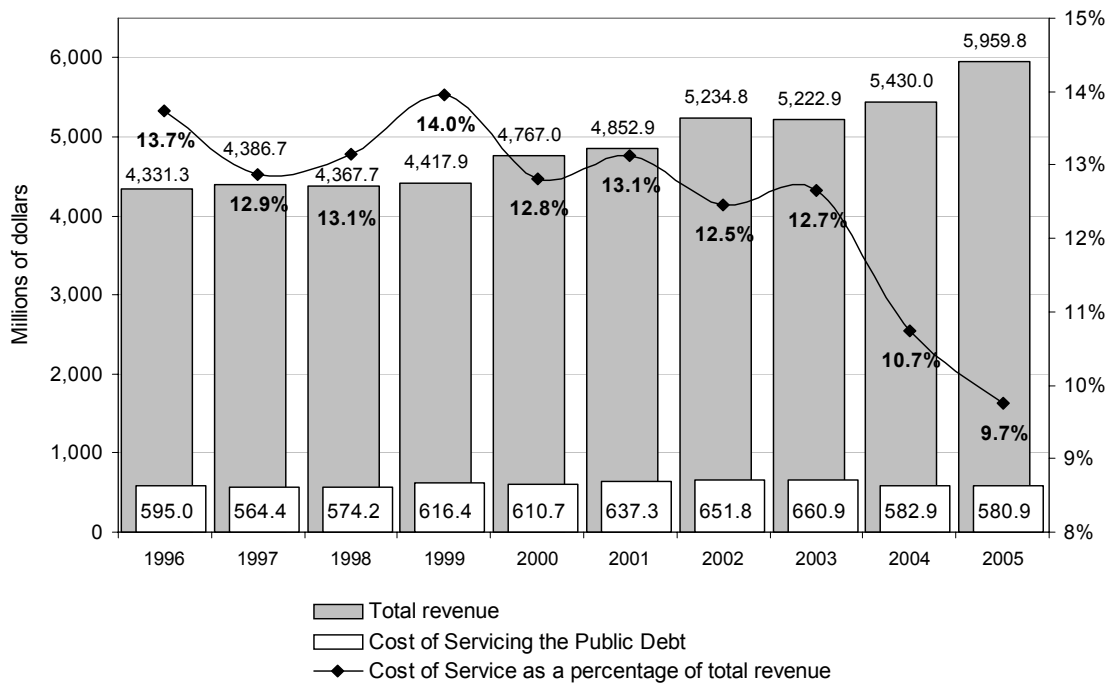
Cost of servicing the public debt as a percentage of total revenue (or "interest-bite") as a measure of flexibility

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

2.36 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.

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

*Exhibit 2.5
Cost of servicing the public debt as a percentage of total revenue for the last ten years*



2.38 This exhibit shows the cost of servicing the public debt decreased in 2005 over 2004 by \$2 million to \$580.9 million. It also shows that the Province has decreased its overall "interest-bite" percentage from its 2003 level of 12.7% to its current level of 9.7%. 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 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.

Vulnerability

2.39 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

2.40 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

2.41 In 2005, 39.1% 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.

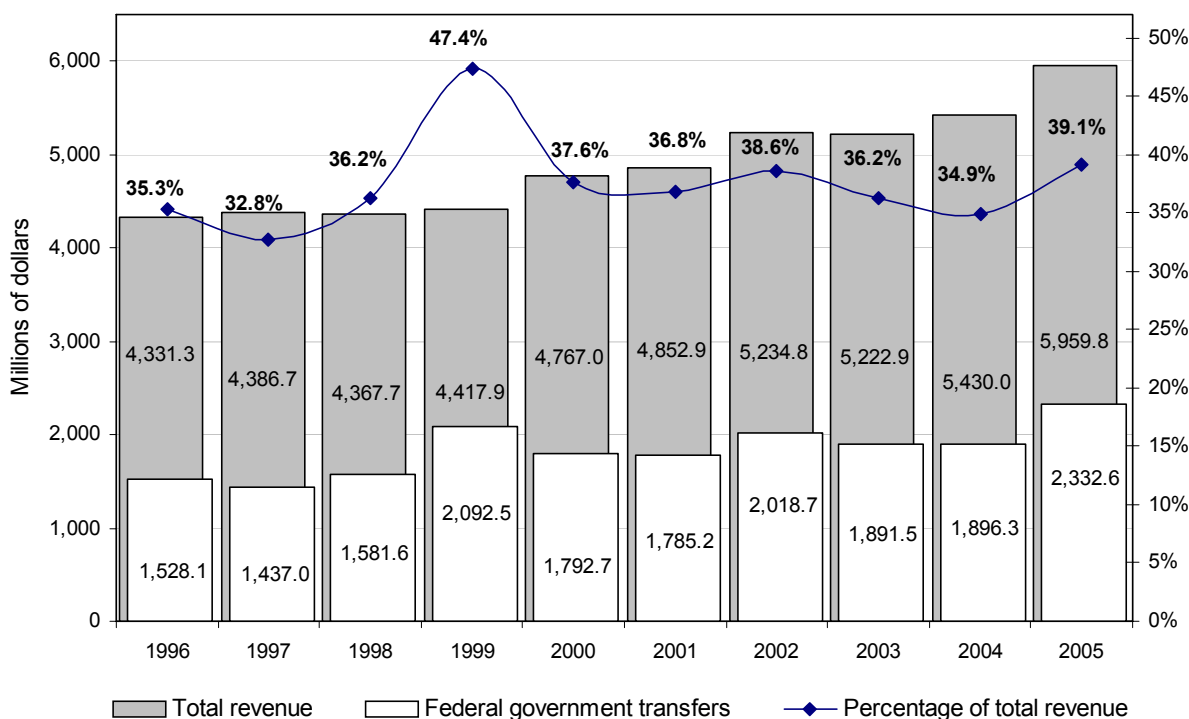
2.42 Own-source revenue is more controllable because the government can directly impact the amount generated using tax legislation as well as implementation or adjustment of user-fees/licensing rates. Federal transfers are subject to very different variables, few of which are under the jurisdiction of the provincial government. Federal fiscal policy decisions can severely impact provincial governments by determining the amount and timing of future transfers.

2.43 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 relatively stable. Nevertheless, except for the anomaly in 1999, as a percentage of total revenue, and also in absolute terms, federal transfers in 2005 were the highest they have been in the last ten years. To maintain comparability, revenue from 1996 to 2004 has been restated to reflect current accounting policy.

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

Exhibit 2.6

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



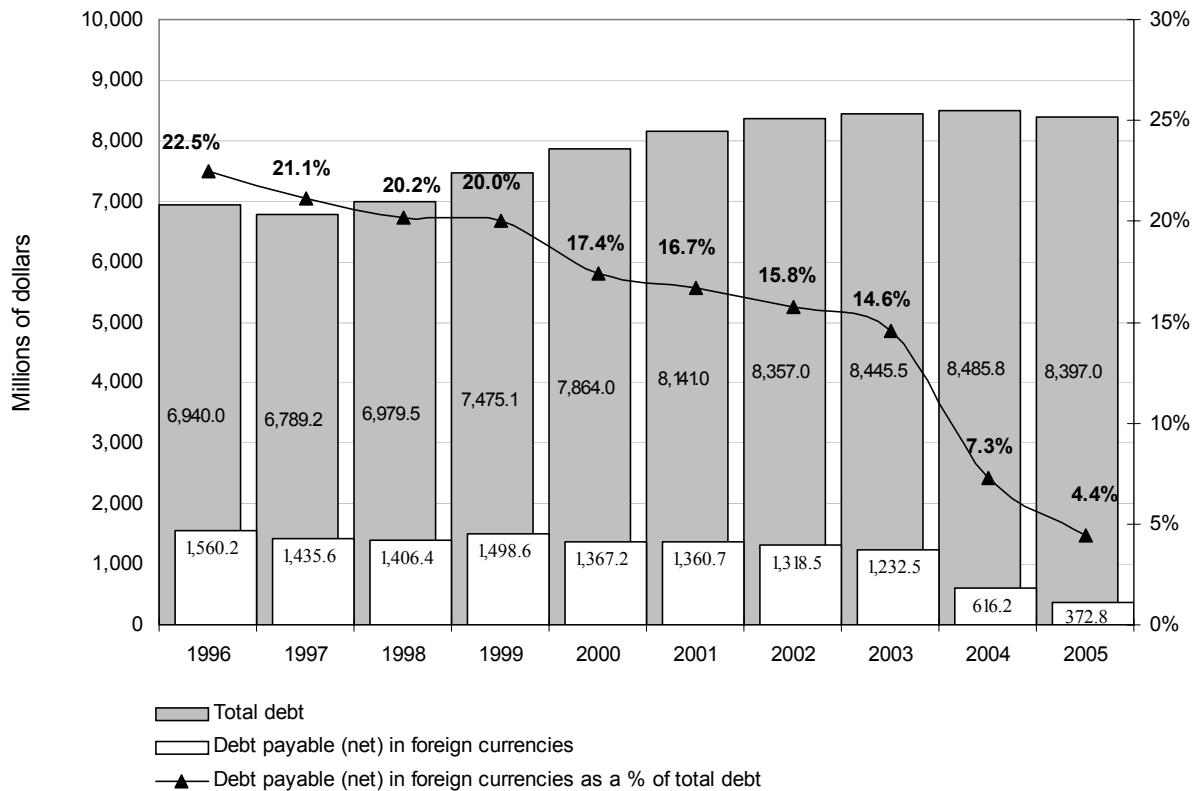
Foreign currency debt as a percentage of total debt for provincial purposes as a measure of vulnerability

2.44 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.

2.45 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).

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



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

2.47 The exhibit demonstrates that the Province's vulnerability to foreign currency risk has experienced continuous decline (favourable) since its 1996 peak of 22.5% to the 2005 level of 4.4%.

Summary

2.48 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 five years.