Office of the Auditor General

Improving Manitoba’s Balanced Budget Legislation

Agenda

- Early days of government accounting
- Public Sector Accounting Board (CICA)
- The Pension story
- The Rainy Day Fund Story
- The Balanced Budget Story
- Two Sets of Financial Statements – A cause of confusion
- Considerations for strengthening BB Legislation
Early Days of Government Accounting

- Focus only on Operating Fund
- Financial statements prepared on a cash basis
  - Reflected importance of legislative authority over spending
- Dropped in Manitoba in 1963 except for pensions

Weaknesses of Cash Accounting

- Easy to manipulate bottom line by paying bills in desired year
- Ignores important liabilities and hence costs of government programs incurred during year
- Ignores important assets (receivables, capital assets)
- Dropped in Manitoba in 1963 (we think except for pensions)
Weaknesses in Cash Accounting

- “Cash information on its own provides insufficient information for decision-making and accountability. It is inadequate for assessing or identifying the assets government controls, the liabilities it is obliged to meet and the revenues and expenses resulting from increases or decreases in those assets and liabilities.” –source CICA

Need for National Standards

- Cash basis being used inconsistently across Canada
- Increasing complexity of government meant that significant operations were being overlooked
- Recognition that private sector standards served private sector well and that most (but not all) of these could be paralleled in government
Financial Reporting Structure (Government Reporting Entity)

Summary Financial Statements

- Operating Fund (includes some Revenue from Crowns)
- Rainy Day Fund
- Debt Retirement Fund
- Other Special Funds (11)
- Crown Organizations (54)

Other Special Funds (11)
- Manitoba Hydro
- Liquor Control Commission
- Manitoba Lotteries Corporation
- Manitoba Public Insurance
- Other Agencies and Enterprises (21)

Public Sector Accounting Board

- Creation of PSAB, was authorized by the Canadian Institute of Chartered Accountants in the 1980’s
- Accounting standard setter of senior government (public sector) accounting practices for over twenty years
Public Sector Accounting Board

- Follows rigorous process in setting standards
- Involves preparers, budgeters and auditors in developing the standards
- Includes a process facilitating public input to proposed standards

Government Accounting Standards

- Evolved from an expenditure (cash) based accounting to an expense basis
- Reflects recognition of tangible capital assets
- Accrual accounting is fundamental
Generally Accepted Accounting Principles

• “Generally accepted accounting principles (GAAP) encompass broad principles and conventions of general application together with rules and procedures that determine accepted accounting practices at a particular time. Establishing generally accepted accounting principles for any sector is an evolutionary process. GAAP evolves and adapts to changes in economic or social conditions.” – source CICA

Accrual Accounting

• “Recognizes the financial effects of transactions in the period(s) in which they occur irrespective of whether cash has been received or paid.”
• “In contrast, “cash basis of accounting” recognizes the financial effects of transactions only when cash has been received or paid.”
Government Reporting Model

- Model is intended to only apply to Summary Financial Statements
- Incorporates full accrual accounting
- Requires recognition of capital assets
- Emphasis on net debt and change in net debt
- Net debt is characterized as the future revenues required to fund past transactions
  - Equivalent to accumulated deficit in private sector

The Pension Story

- an employee earns pension benefits with each year of service
- accrual accounting requires that the estimated cost of the benefits earned each year and not paid, be recorded as an expense and a liability (or an increase in a liability)
The Pension Story

- Pension costs are high enough (6-7% of salaries) that they should be considered when making public policy decisions about new programs or the value for money of existing programs

Changes in Pension Accounting in MB

- PSAB approved an accounting guideline requiring accrual of pension costs in the 80s
- Since that time MB has continued to follow cash accounting in the Operating Fund (i.e. ignores in excess of $150 million in costs each year and an accumulated liability of 3.4 billion)
- In 1998, the government began to accrue pension costs in Summary Financial Statements
The Rainy Day Fund Story

• Created in 1989
• Created by transferring $200 million from Operating Fund (creating a deficit in the Operating Fund) to the new fund
• Between 1989 and 1999, the transfers were shown as revenue or expense
• Since 1999, transfers shown as transfers below bottom line

The Rainy Day Fund Story

• Used to facilitate the balancing of the Operating Fund’s annual results
• Primary activities are inter-fund transfers to and from the Operating Fund
• Fund Balance as at March 31, 2003 - $235 million
The Balanced Budget Story

- Passed in November, 1995
- Focus on Operating Fund
- Froze existing accounting policies in place unless AG agreed to a change
  - i.e. cash basis of accounting for pension costs retained
- Allowed transfers from Rainy Day Fund to be used create a positive balance
The Balanced Budget Story

- The transfers being used to achieve a positive balance are akin to a transfer from a savings account to a chequing account
- Amount of transfer is determined by government
- This allows government to choose its bottom line (rather than reflect real changes in economic circumstances in its Operating Fund financial statements)

Shortcomings of Operating Fund Focus

- Focuses only on one (admittedly important) component of the government entity
Shortcomings of Operating Fund Focus

- Proponents of Operating Fund focus claim it is relevant because it shows the tax supported activities of government.
- However, this argument fails on 3 points:
  - In 2003, 837 million of revenue in OF was from Crown corporations.
  - OF ignores pension costs that will ultimately have to be paid through taxes.
  - Rainy Day Fund transfers are essentially left over money from the sale of MTS.
Financial Reporting Structure
(Government Reporting Entity)

Operating Fund - Crown Revenue Compared to Other Revenues

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
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</thead>
<tbody>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manitoba Lotteries Corporation</td>
<td>220</td>
<td>225</td>
<td>225</td>
<td>239</td>
<td>248</td>
<td>266</td>
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<tr>
<td>Manitoba Liquor Control Commission</td>
<td>149</td>
<td>152</td>
<td>156</td>
<td>158</td>
<td>163</td>
<td>166</td>
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<tr>
<td>Manitoba Hydro Electric Board: Water Power Rental</td>
<td>54</td>
<td>46</td>
<td>46</td>
<td>51</td>
<td>107</td>
<td>95</td>
</tr>
<tr>
<td>Guarantee Fee</td>
<td>29</td>
<td>31</td>
<td>42</td>
<td>63</td>
<td>72</td>
<td>74</td>
</tr>
<tr>
<td>Capital Tax</td>
<td>25</td>
<td>26</td>
<td>27</td>
<td>28</td>
<td>29</td>
<td>33</td>
</tr>
<tr>
<td>Distribution of Retained Earnings</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>203</td>
</tr>
<tr>
<td></td>
<td>452</td>
<td>454</td>
<td>469</td>
<td>529</td>
<td>619</td>
<td>837</td>
</tr>
<tr>
<td>% of Other Revenue</td>
<td>8.5%</td>
<td>8.4%</td>
<td>8.0%</td>
<td>8.5%</td>
<td>10.1%</td>
<td>13.5%</td>
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<tr>
<td>Other Revenue</td>
<td>5,290</td>
<td>5,428</td>
<td>5,869</td>
<td>6,223</td>
<td>6,125</td>
<td>6,182</td>
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<tr>
<td>Total</td>
<td>5,742</td>
<td>5,882</td>
<td>6,338</td>
<td>6,752</td>
<td>6,744</td>
<td>7,019</td>
</tr>
</tbody>
</table>

* Estimated
Operating Fund - Crown Revenue

Shortcomings of Operating Fund Focus

- Even though budget “balanced”, deficits can occur and net debt to GDP go up
Consider a Hypothetical Citizen

Starts year with the following assets:
- chequing account $1,000
- savings account $5,000
Total assets $6,000

During year:
- earns a salary of $20,000
- has expenses of $22,000
- losses in dry cleaning business $7,000
- dental work he can’t pay for $4,000
**Parallel to Current BB Legislation**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
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</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$20,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>22,000</td>
</tr>
<tr>
<td>Loss before transfer</td>
<td>2,000</td>
</tr>
<tr>
<td>Transfer from savings account</td>
<td>3,000</td>
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<tr>
<td>Positive Balance</td>
<td>1,000</td>
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</table>

**Using Normal Accounting**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$20,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>22,000</td>
</tr>
<tr>
<td>Losses on dry cleaning business</td>
<td>7,000</td>
</tr>
<tr>
<td>Dental work charged to credit card</td>
<td>4,000</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>33,000</strong></td>
</tr>
<tr>
<td><strong>Loss for the year</strong></td>
<td><strong>($13,000)</strong></td>
</tr>
</tbody>
</table>
Change in Assets/Liabilities

<table>
<thead>
<tr>
<th></th>
<th>Beginning of Year</th>
<th>End of Year</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chequing = BB Legislation</td>
<td>$1,000</td>
<td>$2,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Savings</td>
<td>5,000</td>
<td>2,000</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Debt on dry cleaning</td>
<td>-</td>
<td>(7,000)</td>
<td>(7,000)</td>
</tr>
<tr>
<td>business</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit card debt</td>
<td>-</td>
<td>(4,000)</td>
<td>(4,000)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$6,000</td>
<td>$(7,000)</td>
<td>$(13,000)</td>
</tr>
</tbody>
</table>

Should Organizations Issue Two Sets of Financial Statements

• In MB, is a legislated requirement
• In the citizen’s world this has to be confusing
• Question is: “Which statements are the real ones? Which one shows a real and complete picture of the results of government activities?
Each Financial Statement reflect dramatically different results

- 2003 Operating Fund (Special Purpose) Financial Statements reflected a $4 million annual surplus (as chosen by government)
- 2003 Summary Financial Statements (General Purpose) reflected a $184 million annual deficit (not chosen by government)

Operating Fund Financial Statements

- Includes the net annual operating revenues of Manitoba Lotteries Corporation and Manitoba Liquor Control Commission
- Includes revenue generated from Manitoba Hydro-Electric Board such as guarantee fees, water power rentals fees, capital tax and the 2003 distribution of retained earnings
- But does not include the operating results of all government organizations
Operating Fund Financial Statements

• Impact of recognizing the increase in the pension liability
  – Results in an annual deficit in 1996 and from 1998 to 2003
  – 1997 would still have a surplus -includes the revenue from the sale of Manitoba Telephone System

<table>
<thead>
<tr>
<th>Operating Fund Operating Results</th>
<th>1995 - 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Revenues before Transfers</td>
<td>157</td>
</tr>
<tr>
<td>Change in the Unrecorded Pension Liability</td>
<td>(200)</td>
</tr>
<tr>
<td>Unrecorded Employee Future Benefits - Health Care Sector</td>
<td>-</td>
</tr>
<tr>
<td>Adjusted Net Operating Results</td>
<td>(43)</td>
</tr>
<tr>
<td>Positive Balance for Purposes of Balanced Budget Legislation</td>
<td>157</td>
</tr>
</tbody>
</table>

* First year Balanced Budget Legislation in effect
* Includes the Sale of Manitoba Telephone System

Office of the Auditor General
Comparison of Accumulated Results – Operating Fund

- Cumulative Adjusted Net Operating Fund Results ($millions)
- Cumulated Positive Balances for Balanced Budget Purposes ($millions)

Summary Financial Statements

- Include the annual operating results of all the government controlled organizations
- Includes the Operating Fund annual results without the transfers to and from the Debt Retirement Fund and the Fiscal Stabilization Fund
- Provides better information
- Results in more informed decision-making
Financial Reporting Structure (Government Reporting Entity)

Summary Financial Statements

- Since 1997, reflects the expense for the increase in the unfunded pension liability (2003, $183 million)
- Excludes from revenue, the distribution of retained earnings from Manitoba Hydro-Electric Board to Operating Fund (2003, $203 million) but includes its change in equity (2003, $71 million)
### Annual Results

#### Summary versus Operating Fund

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive Balance for Purposes of Balanced Budget Legislation</td>
<td>157</td>
<td>295</td>
<td>76</td>
<td>31</td>
<td>11</td>
<td>41</td>
<td>63</td>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>less unrecorded pension expense</td>
<td>(200)</td>
<td>(143)</td>
<td>(113)</td>
<td>(112)</td>
<td>(127)</td>
<td>(144)</td>
<td>(147)</td>
<td>(167)</td>
<td>(170)</td>
</tr>
<tr>
<td>Deduct (Add) Net transfers TFF/DRF</td>
<td>-</td>
<td>-</td>
<td>(25)</td>
<td>(36)</td>
<td>(110)</td>
<td>96</td>
<td>(54)</td>
<td>73</td>
<td>48</td>
</tr>
<tr>
<td>Manitoba Hydro Distribution Add Net Income from</td>
<td>(200)</td>
<td>(52)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MPI</td>
<td>(29)</td>
<td>46</td>
<td>76</td>
<td>30</td>
<td>51</td>
<td>46</td>
<td>(97)</td>
<td>(22)</td>
<td>71</td>
</tr>
<tr>
<td>Manitoba Hydro</td>
<td>70</td>
<td>101</td>
<td>111</td>
<td>100</td>
<td>152</td>
<td>270</td>
<td>214</td>
<td>71</td>
<td>24</td>
</tr>
<tr>
<td>Other Net Revenue (Expenses)</td>
<td>121</td>
<td>(97)</td>
<td>85</td>
<td>(85)</td>
<td>(105)</td>
<td>(122)</td>
<td>(151)</td>
<td>18</td>
<td>(32)</td>
</tr>
<tr>
<td>Summary Annual Operating Results</td>
<td>119</td>
<td>263</td>
<td>173</td>
<td>18</td>
<td>132</td>
<td>431</td>
<td>(10)</td>
<td>(184)</td>
<td>(110)</td>
</tr>
</tbody>
</table>

* First year Balanced Budget Legislation in effect
* Includes the sale of Manitoba Telephone System

#### Other Jurisdictions

- Only three provinces, Alberta, Ontario and Nova Scotia, and the Federal Government had an annual surplus in 2003
- New Brunswick reported a $109 million annual deficit before a $110 million transfer from its Fiscal Stabilization Fund to reflect a $1 million annual surplus for fiscal policy purposes
Considerations in Strengthening BB Legislation

- Summary Financial Statements should be used to determine compliance with balanced budget legislation
  - Incorporates the use of generally accepted accounting principles
  - Reflects the annual operations of all government activities
  - Is same basis as federal government and most provinces

- Eliminate the Operating Fund (Special Purpose) Financial Statements
  - Incomplete annual results as it fails to incorporate the operations of all government organizations
  - Non GAAP financial statements
Considerations in Strengthening BB Legislation

• How to address significant volatility
• Consider:
  – Establishing a multi-year time horizon
  – Planned Deficits (Surplus Reduction) in government organizations
    ♦ MPI – surplus distribution (2002, $81 million)

Government Financial Condition

• Indicators
  – Net Debt to Provincial GDP
  – Debt Costs to Revenue
  – Own Source Revenue to Provincial GDP
  – Federal Transfers to Own-Source Revenues
  – Foreign Debt to Net Debt
Government Financial Condition

• Indicators
  – Deficit/Surplus to GDP
  – Changes in Physical Capital Stock
  – Foreign Held Debt to Government Net Debt

Considerations in Strengthening BB Legislation

• Consider:
  – How to deal with emergencies and losses in Crown organizations and enterprises
    ♦ Natural disasters like drought
    ♦ Decline in revenue beyond a defined percentage
Concluding Thoughts

- Government financial reporting should incorporate:
  - Normal accounting rules (GAAP)
  - All government activities
  - Understandability
  - Comparability
  - REALITY !!!

Questions