



# Province of Manitoba

## Modernizing Manitoba's Financial Accountability Legislation

June 2006

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## A. An Overview of This Report

The Government of Manitoba has asked Deloitte for its assistance in addressing the question of how to modernize the Province's existing Balanced Budget Legislation. Accordingly, we have studied this question and developed a series of criteria to guide our assessment of the alternatives that have been identified. This report contains our analysis and our recommendations to the Government.

When we concluded our work, we paused to reflect broadly on our analysis. In so doing, we identified three themes that had fundamentally shaped our approach to the question and set the direction for our conclusions.

These three themes are as follows:

**1. *The Government is committed to modernizing Manitoba's financial reporting practices.***

The key driver for considering the modernization of Manitoba's Balanced Budget Legislation is the Government's decision to fully implement the requirements of generally accepted accounting principles (GAAP) for senior governments. The objective of GAAP is to provide financial information that is objectively prepared, transparent and which faithfully represents the financial circumstances that exist. The Government's policy decision to fully implement GAAP reflects a commitment to these same principles.

**2. *The migration to GAAP creates new complexities and challenges for the Government as it reports on Manitoba's finances.***

The provisions of GAAP are comprehensive and complex. Two examples are useful. First, GAAP compliant financial statements must incorporate all "controlled" entities into the Government Reporting Entity (GRE). The definition of control is broad, requiring Manitoba's financial statements to include organizations as diverse as Manitoba Hydro, University of Manitoba, government departments and many government funded crown agencies. Second, GAAP requires expenses to be recorded when the cost is incurred, not when it is paid. For example, the discovery of an environmental liability cleanup obligation results in the recording of an expense, even though it may not be paid for quite some time.

GAAP is designed to prepare general purpose financial statements that are suitable for the broad range of users who read the statements. This includes MLA's, civil servants, citizens, bond rating agencies, other governments and the media. Each of these users has a particular, unique perspective that may require more information, beyond that included in the financial statements, to permit them to make an informed assessment.

A fully GAAP compliant reporting environment is substantially different from today's Operating Fund focused environment.

**3. *Modernizing Manitoba's Balanced Budget Legislation must be done with the objective of establishing sound financial reporting requirements and credible financial management measures.***

Modernizing Manitoba's legislation is more than identifying a new Balanced Budget Legislation measure. The modernization must reflect the comprehensive nature of the reporting requirements that exist in a GAAP compliant environment. Furthermore, the recommendation of the compliance measure itself must be credible. To be credible, the measure must be relevant; what it measures must be meaningful. It must be verifiable and subject to audit. It must be comprehensive; it must be sufficiently broad to measure the financial management results of government.

Readers of this report will see these themes throughout our analysis. Their impact on our recommendations is significant. To assist readers of this report in following our analysis and in understanding the principles which form the foundation for our recommendations, we provide the following overview of this report:

## I. Setting the Context

Following this initial section, which provides an overview of the report, Section B, "Introduction", presents background information on Manitoba's recent financial reporting practices and the circumstances for revisiting Manitoba's Balanced Budget Legislation. In effect, this section frames the question which we have been asked to study.

## II. The Current Environment

We believe that there are four key components of today's circumstances that must be fully understood. This understanding must then inform the process for recommending enhancements to Manitoba's legislation. These four components, as summarized below, are the subject of the next four sections of this report.

Section	Name	Contents
C.	The Existing Legislation	The key elements of Manitoba's current Balanced Budget Legislation are summarized in this section, together with our commentary on the positive features and limitations of the current legislation.
D.	Balanced Budget Legislation in Other Provinces	The practices of Canada's other provinces are summarized for comparative purposes.
E.	Today's Situation in Manitoba	This section reviews the financial realities in Manitoba that must be considered when studying this question.
F.	The Impact of the Commitment to Summary Reporting	In this analysis, we provide an overview of the challenges and complexities inherent in implementing GAAP.

## III. The Search for a Credible Measure

The analysis of the current environment provides much food for thought. However, moving from analysis to formulating reasoned recommendations requires thoughtful consideration of alternatives and the principles that will govern the development of the recommendations.

Accordingly, this section of our report considers the following:

Section	Name	Contents
G.	Criteria for Formulating Recommendations	Criteria and objectives to consider in formulating recommendations are outlined in this section.
H.	Potential Measures of Balanced Budget Legislation Compliance	Alternatives for measuring compliance with the Balanced Budget Legislation are analyzed and weighed.

## IV. Our Suggestions

While we expect that there will be much focus on the development of a single measure of Balanced Budget Legislation compliance, it is our view that our analysis supports an expansion of the scope of Manitoba's financial accountability legislation. Therefore, our twelve recommendations collectively expand the nature of the financial reporting that we believe the Government should provide. One of these recommendations is our proposal for the measure of Balanced Budget Legislation compliance.

### **Some Final Thoughts**

The Government's commitment to comply with GAAP imposes a consistent, independent framework for reporting Manitoba's financial situation. While the provisions of GAAP require the application of professional judgment, the provisions are also intended to be definitive in establishing how various items should be reported within the Province's financial statements.

Manitoba's Balanced Budget Legislation is intended to enhance the accountability of the Government to Manitobans for its financial management practices. Therefore, information contained in GAAP compliant reports will be used to make this assessment. However, GAAP, itself, does not contain or dictate a particular measure as the preferred or primary means of assessing financial management performance. The determination of how best to assess the Government's financial stewardship is left to the reader of the financial statements.

Therefore, as we have prepared our recommendations, our intent has been to articulate the principles which we believe must be upheld in formulating Manitoba's modernized Balanced Budget Legislation. There may well be readers of this report that believe there are more effective ways to uphold these principles than the implementation of our recommendations. Our recommendations simply reflect our own view on how these principles can be best applied. Nevertheless, we firmly believe that these principles must be upheld in modernizing Manitoba's Balanced Budget Legislation.

## B. Introduction

Manitoba's Balanced Budget, Debt Repayment and Taxpayer Accountability Act (the Act) was enacted in 1995 and amended in 2000. The Act, which establishes the financial accountability of the government, has commonly become known as the Province's Balanced Budget Legislation (BBL).

Each year since it was enacted, the Government has assessed its compliance with the provisions of Manitoba's BBL. Concurrently, Manitoba's Auditor General (AG or OAG) has provided his opinion on the financial statements prepared to assess compliance with the BBL. In recent years, he has simultaneously articulated his growing discomfort with the basis of accounting used to prepare these financial statements.

The essence of his discomfort is that these financial statements are not prepared in accordance with generally accepted accounting principles (GAAP). GAAP for senior governments (i.e. federal and provincial) in Canada is established by the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants (CICA).

The financial statements used by the Government to assess BBL are the statements for the Province's Operating and Special Funds alone, as required by the Act. These financial statements differ from GAAP in several significant ways:

1. GAAP requires all "controlled" entities to be included in the Government Reporting Entity (GRE). This results in the inclusion of many entities in the Province's Summary Financial Statements that are not currently included in the financial statements of The Operating and Special Funds.
2. The Act permits and/or requires certain items to be used in determining the final annual financial result of the Operating and Special Funds that are not permitted by GAAP. Specific examples are the required funding of amounts to the Debt Retirement Fund and the option of taking from or putting back into the Fiscal Stabilization Fund.

In the 1990's, the AG's concerns that the financial statements were not in accordance with GAAP began to be addressed as the Province began to prepare Summary Financial Statements. The Summary Statements included a broader cross-section of entities that were controlled by the Province. These Summary Statements have been prepared in addition to the financial statements of the Operating and Special Funds, and in recent years they have been presented as the Province's primary financial statements. The statements of the Operating and Special Funds have been presented as the means by which to assess the Government's compliance with Manitoba's BBL.

Over the last decade, the PSAB pronouncements on GAAP for senior governments have become more comprehensive. Several Canadian provinces have adopted the provisions of PSAB GAAP for the presentation of their financial statements. Manitoba has adopted many, but not yet all, provisions of GAAP in the preparation of its Summary Statements.

In March, 2005, the Government of Manitoba announced its intention that the Province would move to fully GAAP-compliant summary financial reporting. The GAAP requirement for which entities must be included in the Summary Financial Statements has continued to evolve. The Province complied with GAAP requirements in the year ended March 2005; however, in order to give the Province sufficient time to plan for and implement recently expanded GAAP requirements, the Government's commitment was that PSAB GAAP would be fully implemented for the Province's year ended March 31, 2008. The nature of the challenges, the significance of the task and our suggested project plan and approach to this undertaking are the subject of a separate report.

The separate report examined the challenges inherent in implementing the Government's commitment to GAAP reporting. This commitment includes not only fully GAAP compliant annual summary statements, but also annual budgets prepared on a summary basis and interim summary financial statements prepared on a fully GAAP compliant basis. The report set out a recommended implementation plan and addressed the likely resource requirements to meet the Government's commitment. Significant implementation risks were highlighted, together with issues that are likely to arise in the future as GAAP compliance is sustained.

With the adoption of fully GAAP-compliant summary financial reporting, questions have been raised related to the applicability of the existing BBL. The existing legislation requires the measurement of a financial result presented in the financial statements of the Operating and Special Funds. These statements have not and would be neither required nor permitted under GAAP.

To that end, the Government has engaged Deloitte to study this issue and provide recommendations on how Manitoba's financial accountability legislation should be modernized.

## C. The Existing Legislation

The current government was elected to its first term in 1999. At the time of its election, the Government articulated a view that compliance with BBL was a priority. The amendment of Manitoba's BBL to require additional financial commitments was among the first legislative changes pursued by the Government in 2000.

Compliance with the existing BBL has been a significant focus for the Government. It has managed the Province's financial affairs to ensure that it has been in compliance with the requirements of the Act in each year that it has been in office. Therefore, we believe that it is important to understand the major principles inherent in the existing legislation prior to beginning the analysis required to generate recommendations on the modernization of Manitoba's BBL.

Based on our reading of Manitoba's existing BBL, the following are the key principles upon which the existing legislation has been established.

### 1. Holding the Government Accountable for Financial Stewardship

In our view, the fundamental purpose of the existing BBL is to hold the Government accountable for the way in which it expends the revenues that are within the legislature's control. With the exception of certain defined special or extraordinary circumstances, the Government is required to produce a positive result (i.e. a surplus) in the Province's Operating Fund.

The Operating Fund is comprised of the revenues and expenses of the Government departments that are accountable to the legislature. The accountability inherent in the BBL for the way in which the Operating Fund's revenues are deployed also includes provisions that there must be stipulated general purpose debt repayments and contributions to reduce the Province's unfunded pension liability. Essentially, the premise for these mandatory payments is a financial management objective of reducing the Province's general purpose debt and unfunded pension liability through repayments from current revenues.

Further, the existing BBL holds the Government accountable for contemplated tax increases. In fact, the legislation limits the Government's ability to unilaterally increase revenues available for operational spending through tax increases.

### 2. The Measure of BBL Compliance

The determination of the BBL's defined positive or negative balance (i.e. surplus or deficit) for the year in the Province's Operating Fund is calculated according to the following formula:

Operating Fund Revenues

- Operating Fund Expenditures

- Transfers for Mandatory Debt Retirement & Pension Fund Contributions

+/- Transfers to or from the Fiscal Stabilization Fund

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Positive or Negative balance (i.e. Surplus or Deficit)

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The existing BBL does not provide clear direction related to the way in which changes to accounting principles should be handled. For example, where the Government has begun to use new GAAP pronouncements to affect the accounting for the Operating Fund, the impact of these changes in accounting policies on the BBL measure is not addressed in the legislation.

### 3. Sanctions for Non-Compliance

In the event that a Government produces a non-compliant negative balance financial result (i.e. a deficit is incurred), the Government is required in the following year to carry a positive balance (i.e. surplus) sufficient to at least offset the deficit. In addition, members of the Executive Council are penalized through a legislated reduction in their salary.

## **Our Observations**

We have reflected on the provisions of the Act as well as the principles contained therein. These reflections have also taken recent developments in GAAP into account. Therefore, we provide the following observations on Manitoba's BBL.

### *Positive Features*

We believe that the most important element of the existing BBL is that it imposes a level of fiscal discipline upon the Government. This discipline is achieved through the legislated constraints on spending and the requirements to provide funding for debt repayment and pension plan contributions. The Government has managed the financial affairs of the Province each year to ensure that a positive net result was achieved each year. It is our view that the terms of the BBL influence the Government's behaviour and its approach to managing Manitoba's financial affairs.

### *Limitations of the Existing Legislation*

Over time, the Province's financial reporting has become more complex as some elements of GAAP have been incorporated into the Province's financial statements for the Operating and Special Funds. At the time the existing BBL was first enacted, the accounting principles employed by the Government for the Operating and Special Funds were relatively basic. In essence, they required that the Government's departments account for revenues and expenditures that would be settled in the near term. As cash was received or became receivable, revenues were recorded. Similarly, as expenses were paid or became payable, expenses were recorded.

Consequently, the reported surplus or deficit was a measure of whether the Departments, in aggregate, had spent more or less than the total taxation and other revenues that were raised by the Government. Therefore, the achievement of a surplus meant that there could be reduction of the Province's general purpose debt in the current year. Conversely, the incurrence of a deficit would generally require a corresponding increase in the Province's general purpose debt.

Over the last decade, as GAAP for senior governments has evolved, a number of new accounting standards have been pronounced. Some of these policies have been incorporated into the Province's preparation of the financial statements of the Operating and Special Funds. Some have not (as set out in the notes to those statements), although such policies have been incorporated into the Province's preparation of Manitoba's Summary Financial Statements. As a consequence, the AG's opinion on the Province's Summary Financial Statements for the March, 2005 fiscal year was unqualified.

The effect of the new GAAP pronouncements that have been incorporated into the preparation of the financial statements of the Operating and Special Funds are significant. This effect has been to substantially reduce the degree to which the reported surplus or deficit is indicative of the ability to repay or the need to further borrow more general purpose debt. For example, the evolution of PSAB GAAP has continually increased the amount of non-cash expenses which must be accrued in the Province's financial statements. Examples of such items which must be accrued according to GAAP today include:

- Amortization of capital assets, which is a non-cash expense;
- Accruals for employee future benefits such as pensions – while these amounts clearly represent the cost of employee service rendered during the period, the amounts are not paid until a substantially later date;
- Certain commitments to provide funding in the future result in the requirement that the total amount of all future funding be recorded as an expense of the current period.

The inclusion of these items as expenses, as required by GAAP, provides a clearer aggregate picture of the total cost of decisions and employee service in the period under consideration. However, their inclusion as expenses means that the reported surplus or deficit for that year is not a clear indication of whether general purpose debt must increase or can be decreased as a result of the current year's operations. This is inconsistent with one of the original principles upon which Manitoba's BBL was drafted.

In addition, over time, as other jurisdictions have moved to fully implement PSAB GAAP, there has not been consistent comparability of Manitoba's financial statements to those of other provinces.

## D. Balanced Budget Legislation in Other Provinces

Various provinces have adopted some form of BBL to establish a framework for their financial reporting. Each BBL framework adopts a different approach to the nature of the accountability that the elected government has to the electorate.

The approaches to BBL employed by other provinces, together with their respective stances on the adoption of GAAP, serve as useful reference information for this study. The information on BBL legislation in other provinces has not been gathered to provide definitive guidance on the approach which Manitoba should take. Nonetheless, a survey of the practices of other provinces can be instructive.

The BBL provisions that exist in Canada vary significantly between provinces. In this section, we summarize the facets of BBL on which there is significant variability.

### 1. Variability of BBL Provisions

#### a) Nature of Accountability

Each province's BBL holds the provincial government accountable for some aspect of the province's financial management strategy or for its financial reporting of actual results. However, the legislated provisions of the provinces vary significantly as to the specific actions or outcomes that are mandated.

Examples of the various activities or outcomes which are required in different jurisdictions are set out below:

- Documenting a fiscal plan for the upcoming year.
- Documenting a long term fiscal plan covering a future period (e.g. four years).
- Delivering a positive result (i.e. a surplus position) for the fiscal year.
- Producing a post –yearend report setting out actual outcomes achieved compared to target outcomes established in the annual fiscal plan.
- Maintaining a specific reporting timetable for the preparation and tabling of the budget.
- Maintaining a specific timetable for the preparation and release of quarterly and/or year end financial information, including any required post-yearend report.

#### b) Specifying Reporting Standards

Some provinces require that the provincial financial statements be prepared according to GAAP. In contrast, other provinces provide no mention of the accounting principles which are to be used.

Further, some provinces anticipate the possibility of changes to GAAP and legislate how related accounting policy changes are to be handled. Other provinces are silent on this question. Some of the provinces that anticipate GAAP changes are prescriptive on the way accounting policies changes should affect the measurement of the province's surplus or deficit for determination of BBL compliance.

#### c) Sanctions for Non-Performance

About half of the provinces that have BBL require that, in the year following a year in which a deficit is incurred, the government must either plan for or actually deliver a financial result that is positive. The amount of the positive result must equal or exceed the quantum of the deficit in the preceding year. In some provinces, this requirement to "make up" the deficit applies only if the deficit exceeds a stipulated magnitude.

Two jurisdictions, including Manitoba, also provide for penalties against the members of the province's Executive Council in the event of non-compliance. Typically, these penalties take the form of salary reductions for the members of Cabinet.

**d) Financial Management Strategies Inherent in the Legislation**

The BBL in many provinces is silent on the nature of the financial management priorities that should be pursued by their government. The emphasis in the legislation of these provinces is primarily on defining the specific information which must be provided by the government to outline its plans and strategies for financial management for the upcoming year(s).

Several provinces mandate some element of financial management strategy in their legislation. Such provisions are relatively unsophisticated and typically include any or all of the financial management strategies that are already inherent in Manitoba's BBL legislation:

- Mandatory debt repayment.
- Required contributions to unfunded pension deficits.
- Restrictions on the ability of the government to raise taxes in the absence of a positive referendum result.

## E. Today's Situation in Manitoba

The recommendations that are to be made on modernizing Manitoba's BBL must be firmly grounded in today's financial realities in Manitoba. The following items summarize that reality.

### 1. The Government's Intent

The Government has repeatedly and strongly articulated its commitment to maintain BBL in Manitoba.

### 2. Flaws in the Current Measures

Since the 1990's, Manitoba's AG has taken issue with the measure of BBL compliance. In the early days of his concern, the AG voiced his objections to the Province's practices. Over time, principally as a result of advancements in GAAP and its broader adoption throughout Canada, the AG's objections evolved into expressions of alarm at the apparent misalignment between contemporary standards and the Province's financial reporting practices. The AG's concerns have continued to increase. In 2005, the AG's audit report on financial statements of the Operating and Special Funds included a substantial qualification related to non-compliance with GAAP.

### 3. Commitment to Summary Reporting

In response to the concerns voiced by the AG and developments related to financial reporting in other provinces, the government has announced its commitment to fully implement PSAB GAAP for its 2007/08 fiscal year. This announcement commits the Government to account for its stewardship of the financial resources within its responsibility through the preparation of summary financial statements. These summary statements will include the full GRE, as defined by GAAP. These GAAP compliant financial statements will serve as the Province's general purpose financial statements. They will also comprise the primary means of reporting the Province's financial position and results. These are the financial statements that will be audited by Manitoba's AG.

As described earlier, the financial statements of the Operating and Special Funds (including the Debt Retirement Fund and the Fiscal Stabilization Fund) are prepared in order to assess the government's compliance with the BBL. The principal implication of the move to summary reporting is that the Operating and Special Funds will no longer exist as a discreet, separately measurable (or presented) component of government within the annual general purpose financial statements. Similarly, certain of the current practices, such as transfers to and from the Fiscal Stabilization Fund and the Debt Retirement Fund, will not be permitted in the future as GAAP is implemented.

### 4. Significant Decision Points

In our view, Manitoba's BBL must be modernized to take several factors into account. These factors include the Government's commitment to summary reporting, recent advances in GAAP and the general evolution of public sector approaches to financial management and reporting.

Consideration of these factors has prompted members of Government and the civil service to contemplate the following types of questions. These questions will need to be addressed in formulating the recommendations contained in this report:

- Should the existing BBL measure be retained in some format? If so, this concept will need to be defined within the BBL legislation, because it will be a non-GAAP measure. Defining such a concept in the BBL legislation would be a significant challenge.
- The migration to full PSAB GAAP implementation means that the financial statements that will be prepared in future will be for a fundamentally different entity than was used heretofore to measure compliance with the BBL. The new entity, comprised of the GAAP-defined GRE, will be substantially expanded and include additional entities. Consequently, the entities within the summary financial statements will be subject to varying degrees of governance and oversight. There are many different types of relationships between the individual entities and the government. How should this be taken into consideration in the formulation of modified BBL?

- Should Manitoba's BBL be reflective of the practices of the most advanced of Canada's provinces that have moved to full PSAB GAAP? In 1995, Manitoba was a front-runner in the development of BBL. Many other provinces have since followed and have further evolved their own requirements.

After the practices of other provinces are surveyed, should some of the features of other provincial BBL legislation be adopted in Manitoba?

- Is the financial management objective of reducing general purpose debt from current revenues (which is inherent in the current BBL) still the appropriate financial management objective? In other words, is the financial management priority that existed in 1995 when the legislation was developed, the same priority that exists today? If not, are there other potential measures of BBL compliance?

## F. The Impact of the Commitment to Summary Reporting

The implementation of GAAP brings three major advantages. First, the preparation of financial statements from year to year will be done in a consistent manner. This consistency will facilitate the comparability of Manitoba's financial statements with those of other senior governments in Canada. Second, it provides a broader view of the Province's financial situation as a result of the inclusion of all entities that are within the control of government. The GAAP definition of "control" will consider relationships that exist as a result of funding arrangements, policy direction and/or direct operational responsibility. Third, implementation of GAAP provides an independent standard to govern the preparation of financial statements. This reduces the ability of the preparer of the financial statements to influence the reported results through exercising their own judgment on the presentation of the financial situation.

The implementation of summary reporting will also require a new, broader perspective when reading the Province's summary financial statements. Our view on some of the more essential elements of the new, broader perspective that should be understood and considered as recommendations for modernization of Manitoba's BBL are formulated is set out below:

### 1. Consistency and Comprehensiveness vs. Simplicity

As described above, the purpose of PSAB GAAP is to achieve consistency in the manner of reporting by all senior governments. PSAB GAAP has continued to expand as it has begun to address more and more of the unique aspects of government financial reporting. For example:

- PSAB GAAP statements have a much broader scope than the Government's current financial statements because more entities must be included.
- There is a substantially enhanced requirement to estimate the current value of liabilities that will be settled in the future. Such estimates are generally difficult to quantify. These liabilities will not affect the Province's cash flow for some time, even though they are recorded as current expenses. Examples include the cost of pension benefits earned by employees and the obligation to incur costs for environmental remediation.
- Recent amendments to GAAP have also required the consideration of long term funding arrangements such that recording of long term funding arrangements may be accelerated. The aggregate amount of funding over a future period must, in some circumstances, be fully recorded as an expense of the current period in which the decision to make the funding has been made.

When BBL legislation was first enacted in Manitoba 11 years ago, the requirements of GAAP were substantially less definitive than they are today. As described earlier in this report, a reported deficit at that time was a strong signal of the need to increase the Province's general purpose debt. There was an apparent linkage between the reported result and the impact on general purpose debt. One of the implications of the GAAP standards that will be used in the preparation of summary statements is that the perceived simplicity of this apparent linkage is lost. It is expected that readers of Manitoba's financial statements will say that PSAB GAAP financial statements are more complicated and more difficult to understand than the financial statements prepared today. It is expected that this observation will be made even by those who have significant training in GAAP.

### 2. Assessing Specific Financial Management Achievements

Generally, when an organization seeks to measure and report on whether a particular financial management objective has been achieved, reports and information designed specifically for that purpose are prepared and used. These reports are customized so that they consider and report precise information on the specific matter under consideration.

GAAP financial statements, however, are designed so that the application of the consistent GAAP standard (and format) leads to the preparation of comparable general purpose financial statements from period to period. As a consequence, the ability to discern specific financial information of interest to a particular reader on the achievement of a specific financial management objective can be compromised.

For example, the current BBL contains the financial management objective that there must be a specified amount of debt repayment out of the current year's operating revenues. Therefore, in order to determine whether there is a positive balance for purposes of BBL compliance, the aggregate expenditures deducted from the Province's revenues must include the specified debt repayment. However, the provisions of GAAP do not permit the deduction of debt repayments in the measure of the financial result for the year.

Today, the financial statements prepared to assess compliance with the current BBL provide a single measure to assess compliance, albeit one that is not in accordance with GAAP. In the future, following the implementation of summary reporting, the Province's general purpose financial statements, prepared in accordance with GAAP, would require further analysis by a knowledgeable reader to determine whether the Province's debt repayment objectives have been achieved.

### **3. Susceptibility to External Factors**

The potential for substantial variability in the reported result in the Province's annual summary financial statements is large because of the number of large, relatively autonomous entities whose results are included in the GRE. This potential variability arises primarily from 5 entities. These include:

- Manitoba Hydro-Electric Board
- Manitoba Public Insurance Corporation
- Manitoba Crop Insurance Corporation (since amalgamated with Manitoba Agricultural Credit Corporation to create Manitoba Agricultural Services Corporation)
- Manitoba Lotteries Corporation
- University of Manitoba

The extent of the volatility of their operations is significant. When assessed over the most recent ten year period, Manitoba Hydro is the most volatile. The absolute value of the variance between its best and worst financial result over that decade is almost \$900 million. For the remaining four organizations, this same measure was \$60 million for the least volatile (University of Manitoba) and \$175 million for the most volatile (Manitoba Public Insurance Corporation).

When the volatility of these reported results is further examined, it becomes apparent that the substantial swings in profitability for these entities relates largely to factors outside of the short-term control of either the Government or management of these entities. Examples of such factors include:

- Weather storms or periods of drought, resulting in less hydro electric power production capacity at Manitoba Hydro or significant insurance claims on Manitoba Public Insurance Corporation and Manitoba Crop Insurance Corporation.
- The impact of legislation, such as the impact of the smoking ban on Manitoba Lotteries Corporation.
- Variability in the timing and amount of grants and the funding received by the University of Manitoba for capital, research and endowment purposes.

These particular entities are included within the GRE because the relationship between the Province and the entity meets the GAAP definition of "control". The GAAP definition of "control" considers many factors in addition to whether the Government has day to day operating authority over the organization.

In the case of the organizations named above, their day to day operational decisions are made by their own management under the direction and oversight of the organization's own Board. Consequently, the Government would not mandate that management undertake any specific corrective action in the event that one of these organizations begins to experience a difficult financial year. The governance relationship between these entities and the Province does not provide the Government with the authority to intervene in the day to day operations of those organizations in that way.

Consequently, the ability of the Government to initiate a short-term “financial turnaround” in the face of difficult circumstances is limited. The Government’s response to these situations will be principally in the form of the influence over the policy direction of the entity. This is consistent with the government’s mandated obligation to provide long term direction to these organizations.

#### **4. GAAP Will Change**

GAAP standards are set by the PSAB of CICA. Changes to GAAP are made frequently to add clarification, to address new issues and to respond to situations where there is inconsistent application of GAAP across senior governments.

Updates, revisions and additions to GAAP are becoming more frequent. GAAP is also becoming more complex. Therefore, the Province’s commitment to abide by the GAAP standard will require that the Province adopt all new changes to GAAP that are approved by PSAB. Doing so will require forethought and resources.

#### **5. Limitation of General Purpose Financial Statements**

As described earlier, the provisions of GAAP have been designed with the intent of producing consistently prepared financial statements which faithfully represent the underlying economic events and situations. Consequently, GAAP is developed for a broad spectrum of financial statement users who, in turn, must do their own reading and analysis of the statements.

The readers of general purpose financial statements must then read the entirety of the financial statements in order that they might form their own impression of the overall health of the organization. This overall impression, in turn, will influence their evaluation of the stewardship of the organization’s financial resources. Consequently, general purpose financial statements are not particularly conducive to the establishment of a simple, single point of measurement which can legitimately claim to provide a comprehensive assessment of the organization or its management.

#### **6. Difficulty in Estimating “The Starting Point”**

The Province’s implementation of PSAB GAAP will result in the inclusion of new entities in its summary statements. The most significant of these additions is public schools. Public schools do not currently prepare their financial statements in accordance with GAAP. Instead, a legislated basis of accounting known as FRAME is used.

Analysis is currently underway to identify the most significant differences between PSAB GAAP and FRAME. Further analysis will then be required to quantify the impact of the conversion of public schools’ FRAME statements to a GAAP basis.

Based on the accounting policy differences which are already understood today, it is clear that the aggregate financial position of public schools, as presented under GAAP, will be materially different from that presented under FRAME. However, it is not currently known whether the annual aggregate surplus or deficit to be reported by public schools on a GAAP basis will significantly differ from the current annual aggregate result for public schools presented on a FRAME basis.

Therefore, it becomes somewhat difficult to have definitive information about the Province’s summary financial statement “starting point”. It is unclear what the expected annual financial result of public schools will be under GAAP. It is also not known what the aggregate net debt position of public schools will be after their financial statements are converted to a GAAP basis.

## G. Principles for Formulating Recommendations

All of the information in the preceding sections of this report must be considered and balanced in formulating recommendations for the modernization of Manitoba's BBL. As the information is considered, it is helpful to reflect on key principles that should affect the evaluation of alternatives.

We have identified two sets of principles that we believe are helpful in evaluating alternatives for the modernization of BBL.

### 1. Financial Management Objectives

Our Financial Review report to the Province of Manitoba in February 2000 highlighted three specific financial management objectives that should be regularly measured to assess the health of the Province's financial situation. We believe it is helpful to review these objectives, since any legislated BBL compliance measure should consider these concepts.

The objectives are:

- a) Sustainability – The ability to maintain existing programs and meet existing creditor requirements without increasing the debt burden on the economy.
- b) Flexibility – 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.
- c) Vulnerability – 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.

We believe that individual recommendations for modernizing Manitoba's BBL should consider these objectives. The recognition that these are important dynamics affecting the way the Government manages Province's finances should affect the way that the recommendations are crafted. For instance, an important feature in the management of the provincial finances is flexibility – the ability to respond to a situation in a variety of ways, without undue limitation on the options. Therefore, the modernization of the BBL should ensure that the Government is afforded appropriate flexibility in meeting the legislation's revised requirements.

### 2. Financial Reporting Objectives

In its most recent Annual Report, the Government has stated several objectives that it wishes to achieve in the way that the Province's financial reporting is done. Therefore, we believe that the recommendations to modernize the BBL and the requirements imposed upon the Government for financial reporting should adhere to these attributes, which are set out below:

Transparency	
Definition	Impact
Access by financial statement users to full, complete and understandable information.	The information provided to assess the Government's stewardship of the financial resources for which it is responsible (including BBL compliance) must be full, complete and understandable.

<b>Accountability</b>	
<b>Definition</b>	<b>Impact</b>
Those accountable for a particular financial outcome should be held responsible, through the monitoring of measurable financial targets, to achieve the performance objective.	Those who are held responsible for performance must have an ability to control and/or respond on a timely basis to the factors that affect the measurement of performance. Ultimately, the Government has accountability for all entities included in the GRE. However, in the case of some entities, such as the departments, the Government can immediately decide whether or not to incur particular expenses. In other entities, the Government's influence is achieved over a longer term, since it is achieved through policy direction or changes to legislative accountability frameworks.

<b>Consistency</b>	
<b>Definition</b>	<b>Impact</b>
Measurement of financial matters, including performance measures, should be prepared in the same way each time. A consistent framework or approach to measurement should be used.	The achievement of consistency in the preparation of financial information limits the ability of the preparer of the information to influence the measure through subjective judgment. Therefore, financial reporting and the related measures should be prepared on a consistent basis that minimizes the ability of the preparer to influence the reported result.

<b>Timeliness</b>	
<b>Definition</b>	<b>Impact</b>
Those who use the Province's financial statements and measures of BBL compliance to assess the Government's financial management performance should be provided with information within sufficient time that it can be appropriately acted upon to achieve maximum impact.	Consideration should be given to setting out formal reporting timeline standards or targets.

<b>Simplicity</b>	
<b>Definition</b>	<b>Impact</b>
The Province's reporting on financial matters should be easily understandable to citizens, without regard for their level of financial literacy.	While the GAAP financial statements will likely be seen as quite complex, as described earlier, it would be desirable for key components of the government's reporting on financial matters to be easily understood.

# H. Potential Measures of Balanced Budget Legislation Compliance

We believe that there are fundamentally three potential measures of BBL compliance which can be considered. Any one of these measures could be selected. Alternatively, some variation or combination of multiple measures, could be put forward as the new standard for BBL compliance.

## 1. Reported Summary Net Surplus or Deficit

This measure would be the surplus or deficit presented in the Statement of Revenues and Expenses presented in the Province's Summary Financial Statements. Accordingly, it would be a GAAP based measure. Our evaluation of this alternative follows:

Advantages	Disadvantages
<ul style="list-style-type: none"> <li>• Simple, straightforward and easy to determine.</li> <li>• Conceptually consistent with today's BBL in its focus on the reported "bottom line result".</li> <li>• Not subject to challenge of bias.</li> <li>• Expected that the amount will be audited without qualification by the Auditor General.</li> </ul>	<ul style="list-style-type: none"> <li>• Ability to influence the operations of GRE-included entities to achieve a balanced result is reduced due to the factors described earlier in this report.</li> <li>• The measure does not reflect a particular financial management plan or objective.</li> <li>• This income-based measure does not particularly relate to increases and decreases in general purpose debt in the same way that the current BBL does.</li> </ul>

## 2. A Calculation Focused on Departmental Estimates

This measure would require the development of a calculation of a reported result which would approximate the existing Operating Fund result. The motivation to do this would be to essentially retain the current measure. The desirability of this approach is substantially influenced by a person's point of view.

Advantages	Disadvantages
<ul style="list-style-type: none"> <li>• The measure is focused on accountability of the Government for the expenses that are within the legislature's control.</li> <li>• Allows the objectives of a particular financial management approach and philosophy to be incorporated into the BBL measure.</li> </ul>	<ul style="list-style-type: none"> <li>• The OAG has consistently described this approach as not in accordance with GAAP.</li> <li>• The Government could be subject to criticism that the development of the calculation reflects its own self-interest. This would particularly be the case if and when legislation might be subsequently amended.</li> </ul>

## 3. Develop a New Measure

The Government could choose to develop a new measure of fiscal accountability, based on the GAAP financial statements. From our perspective, there are two alternatives:

### a) Adjusted Summary Net Surplus or Deficit

The measure of BBL compliance could be a calculation based on the Summary Statement of Revenues and Expenditures. The calculation could begin with the reported summary net surplus or deficit, and be adjusted for stipulated items. Consideration of this measure would require weighing the following benefits and challenges.

Advantages	Disadvantages
<ul style="list-style-type: none"> <li>• The same advantages as identified for Alternative 1 would apply</li> <li>• An objectively determined GAAP measure could legitimately be adjusted to provide the Government with reasonable flexibility in responding to unforeseen events.</li> <li>• Similarly, a GAAP based measure could incorporate adjustments to address financial management priorities.</li> </ul>	<ul style="list-style-type: none"> <li>• Ability to influence the operations of GRE-included entities to achieve a compliant result is reduced due to the factors described earlier in this report.</li> <li>• An income-based measure does not particularly relate to increases and decreases in general purpose debt in the same way that the current BBL does.</li> <li>• While the measure would be GAAP based, it could be open to criticism for including adjustments that are subject to too much judgment.</li> </ul>

b) A Non-Surplus Based Measure

The Government could focus on measuring something which relates more directly to one or more financial management objectives, rather than the reported surplus or deficit. The Province currently tracks a number of financial indicators and reports on them in its annual report. Each indicator is designed to measure a different feature of the Province's financial situation. The measures that are currently tracked include:

- Total expenses as a percentage of GDP.
- Net debt per capita.
- Net debt as a percentage of GDP.
- Debt servicing costs as a percentage of revenue.
- Unhedged foreign debt as a percentage of net debt.
- Own-source revenue as a percentage of GDP.
- Federal transfer payments as a percentage of own-source revenue.

Implicit in the selection of any one of these or any other measure is a value judgment on what constitutes the most important element of the Province's financial management strategy. Each of these measures is individually useful in evaluating a different facet of the Province's financial health.

Advantages	Disadvantages
<ul style="list-style-type: none"> <li>• The measure can be matched to the prevailing financial management philosophy of government.</li> </ul>	<ul style="list-style-type: none"> <li>• This represents a significant shift in focus from the current BBL.</li> <li>• The measure selected is likely more difficult to understand than the other potential BBL measures.</li> </ul>

# I. Recommendations

We believe that the modernization of Manitoba's BBL requires more than simply an updating of the BBL compliance measure. The Government's commitment to summary reporting, recent advances in GAAP and the general evolution of public sector approaches to financial management and reporting all point to the need to expand the scope of Manitoba's financial accountability legislation.

In formulating our recommendations, we have reflected on the objectives and criteria that were described in Section G of this report, particularly the financial reporting concepts of transparency, accountability, consistency, timeliness and simplicity. As a consequence, our recommendations collectively expand the nature of the financial reporting that we believe the Government should provide. Our recommendations also set standards for specific financial information that we believe should be reported in addition to the proposed BBL compliance measure.

When considered in aggregate, our recommendations reflect the view that a full and comprehensive assessment of the Government's stewardship of Manitoba's financial situation requires more than the simple consideration of a single BBL compliance measure.

We recommend that the following recommendations be incorporated into the modernization of Manitoba's existing BBL:

- 1. The tabling of the Province's annual summary budget each Spring should be accompanied by the tabling of a summary of the Government's long term financial management strategy for the GRE. This strategy should include the objectives for several measurable financial outcomes. The outcomes to be measured should be selected by the Government to reflect its own financial management priorities. Long-term objectives should be set together with measures that outline what would constitute meaningful progress within the current budget year.*

The concepts of transparency and accountability make it desirable for the Government to set out the context in which its annual budget is being tabled. The most relevant context for the annual budget is the financial strategy which the Government has chosen to pursue in the foreseeable future.

The Government's financial management strategy for the GRE is comprised simply of the Government's top financial priorities. Examples of such priorities could include:

- Maintaining appropriate levels of net debt;
- Making deliberate shifts in the allocation of financial resources to different programs and priorities;
- Dedicating certain revenues to particular purposes;
- Creating a shift in the relative proportions of revenue sources;
- Consistently measuring certain aspects of the Province's finances in proportion to the size of the provincial economy.

Providing a summary of the Government's longer term fiscal priorities allows the annual budget to be read with a view to understanding how the upcoming year's financial activities contribute to longer term goals. It would be appropriate for each of the established priorities to be accompanied by a measurable financial outcome so that assessments can be made in the future on the Government's success in achieving its goals. We believe that the long term view should cover the next four years.

The Government's financial priorities can be reasonably expected to shift over time depending on the Province's economic circumstances, unforeseen events which occur and other factors. Therefore, the latitude for implementation of this recommendation should be sufficiently broad, so that the Government is free to select those measurable financial objectives that best reflect the financial management decisions it takes and financial management strategies it chooses to adopt at any particular time. Priorities and objectives will necessarily change over time as Governments respond to new circumstances and developments.

To facilitate assessment of the Government's achievement of its goals, objectives for the measurable financial outcomes should be established for the end of the current budget year and for the end of the next four year period (including the current year). Clearly, the achievement of specific financial outcomes over a four year period can be challenging because it is not possible to anticipate all of the events that will shape the Government's financial position over that time period. Nevertheless, we believe it is appropriate for the Government to articulate those financial priorities which it believes can and should be achieved and then to establish reasonable objectives for which there is a high likelihood of success.

*2. The tabling of the Province's annual summary financial statements should be accompanied by a comparison of actual financial achievements with the measurable financial outcomes that were highlighted in the government's financial management strategy. The comparison should principally consider the actual results achieved versus the one-year objectives set out in that year's financial management strategy and budget. The comparative analysis should be accompanied by analysis and commentary on the relationship between the reported results and the financial management strategies in place for the current year and that have been set for the upcoming years.*

In our view, the principles of accountability and simplicity require that when actual financial results for a fiscal year are reported, they be accompanied by reporting on the related measurable financial outcomes. Providing this additional information is a natural corollary to the establishment of objectives as part of the Government's financial management strategy as described in Recommendation 1.

The identification of which actual outcomes are to be reported in any year should be done by referring to the financial management strategies which have been previously documented and published. This would include financial management strategies published in preceding years and the strategy which accompanied the budget for the year which is being reported upon. The current year's strategy obviously includes the objectives set for the current year and for upcoming years.

Since it is reasonable to expect that the Government's priorities and objectives may change over a four year period, the Government must be provided with some latitude to report on those factors that are most meaningful in light of its most recently articulated financial management strategy. Therefore, we would expect that the primary emphasis in this reporting would be on direct comparisons of actual results with one year objectives. This should be accompanied by commentary and analysis, likely more broad in nature, on the Government's longer term financial progress and achievements.

We suggest that the comparative analysis include at least the following:

- Direct comparison of actual results for the current year with the measurable financial objectives set out in the financial management strategy that accompanied the budget for that year.
- Discussion and analysis of the current year results in relation to the financial management strategies that were in place for the current year and that have been articulated for the upcoming years. This should include discussion of whether the actual results for the current year will cause the government to revisit its most recently established financial management strategies.

*3. A target timetable for the tabling of each year's budget, financial management strategy, financial statements and year end annual report should be established. There should be adherence to this schedule except in the event of an election or an extraordinary set of circumstances.*

There are many factors which affect the timing of the tabling of various financial documents by the Government. Nonetheless, the principles of timeliness and consistency suggest that every effort be made by the Government to maintain a predictable schedule for reporting. This could be achieved by allowing the Government flexibility to set the dates for the tabling of each of these reports as it chooses, so long as it is done by a stated deadline. The use of a "no later than" concept provides the electorate and other users of the Government's financial reports with certainty on the dates by which these reports must be prepared, tabled and released.

4. *The use of GAAP, as established by CICA's PSAB, should be prescribed as the Province's financial reporting standard.*

The Government has made a commitment to implement PSAB GAAP for its year ended March 31, 2008. It has committed that this will be the standard that will be used by the Province to prepare its financial statements in the future.

The selection of this standard for the Province's financial reporting should be included as part of the Province's financial accountability legislation to ensure that it remains the standard in the future. These provisions should require that where there are additions to, deletions from, or revisions to GAAP as determined by CICA's PSAB, such required changes to GAAP will be implemented by the Province.

5. *A single BBL measure should be developed to assess compliance with the new legislation. We suggest that this BBL measure be developed based on three principles:*

- a) It should be based on the surplus or deficit information reported in the Statement of Revenues and Expenses within the summary financial statements.*
- b) The measure of BBL compliance should be a multi-year measure.*
- c) The measure should provide some flexibility to provide the Government with an opportunity to respond to extraordinary circumstances.*

#### **a) Using Summary Results**

##### Our Thinking

Reaching a conclusion on the recommended BBL compliance measures is a challenge. This is because there are legitimate, persuasive arguments for each of the alternatives, including non-GAAP measures. We have concluded that a measure based on the reported surplus or deficit contained in the Statement of Revenues and Expenses within the summary financial statements is preferable for the reasons identified below.

The principles of consistency, transparency and simplicity point to the need for a measure that is straight-forward and which is subject to minimal, if any, influence by the preparer of the BBL compliance measure calculation. It is our view, in today's financial reporting environment, that the most consistent and transparent measure is one which is determined based on GAAP reporting.

We have explained, at length, in this document, the complexity inherent in GAAP reporting. Nonetheless, GAAP is indeed a common accounting standard set by the CICA for all provinces, independent of the interests of any particular senior government in Canada. Further, while the provisions of GAAP are themselves complex, the notion of using the reported surplus or deficit is a simple one that can be easily understood by citizens of the Province.

##### An Obvious Challenge

Admittedly, the shift from the current BBL compliance measure to a GAAP-based measure is a significant shift in the focus of the measure. In fact, there will be some that will argue that what is gained in the name of consistency, transparency and simplicity is offset and perhaps lost by virtue of the fact that all GRE-included entities are included in the new proposed measure. The inclusion of additional entities in the BBL compliance measure reduces the measurement of the Government's stewardship of the taxation and other revenues that are directly within the Government's day-to-day control.

Such a challenge must therefore be answered. We believe that there are two key components to the response:

- The Government of Manitoba is ultimately responsible to oversee the delivery of all public services in the Province. The provision of these services to the public is often undertaken by relatively autonomous organizations that have been established by Government for this

purpose. These organizations typically receive significant funding from the Province and/or are accountable to the Government in some fashion.

Therefore, the combined financial result of all of these entities, as captured in the “full GRE” GAAP financial statements, represents the aggregate financial result of the delivery of public services in the Province. Therefore, if considered with this perspective, the financial result presented in the GAAP financial statements represents a legitimate basis for the assessment of the financial management achievements of the Government over the longer term.

- As described earlier in this report, the Government’s ability to directly influence the day to day operations of many entities included within the GRE is limited by the legislated governance relationships. By virtue of the governance relationships that do exist with such entities, the Government’s influence is achieved in the longer term through means such as policy direction, legislative change and alteration of funding arrangements.

Accordingly, it is conceivable and reasonable that the GRE could experience a deficit in any particular year as a result of factors which are outside of the Government’s immediate ability to control. Nevertheless, the long term financial health of all entities delivering public services still remains a key responsibility of Government. Therefore, if the BBL compliance measure is constructed with sufficient flexibility to provide the Government with time to respond to anomalous circumstances, the GAAP financial statement-based measure is meaningful.

#### **b) Balancing Over a Multi-Year Period**

Achieving a positive result or a surplus begins with establishing a budget that is reasonable and achievable in light of expected events and circumstances. Once the budget is set, actual results must be actively monitored and managed to ensure that responses to in-year events mitigate the impact of adverse developments. As the Government manages the Province’s financial affairs, with the intent to comply with BBL, there are several factors that affect its ability to rapidly reverse the impact of adverse developments.

Use of the summary result is based on the premise that the Government can ultimately influence the operations of all entities included in the GRE. However, with the exception of the Government departments, this influence is limited, by design, to the ability to establish the policy framework and the legislative mandate within which each GRE entity must operate. Consequently, the time required for the Government to meaningfully affect the financial performance of GRE included entities will generally extend beyond the end of any particular fiscal year.

As a consequence, it is conceivable that a summary loss position might be largely attributable to the operations of certain GRE included entities whose operations are governed by their own boards of directors. In such circumstances, the Government would clearly need to ensure that over the longer term, the particular entity generated sufficient surplus to “cover off” the previous loss. However, in practical terms, it is also conceivable, depending on the size of the loss, that such an effort might require several years.

If there was a significant loss in a GRE included entity, a requirement that a surplus be achieved in each and every year would then leave a government with several options. The government could consider directly intervening in the management of the affected entity. However, in many cases, existing legislation would limit the means and/or timing of such an intervention. Alternatively, the government could choose to reduce expenditures in areas where it has direct and immediate control, in order to offset a significant loss in a GRE included entity. These areas of significant control are the expenditures of the government departments, the largest of which are health, education, family services and housing, and advanced education and training.

While there is a natural tension between competing priorities, such a situation would require an absolute choice between priorities for that year. It is conceivable that maintaining a surplus to comply with BBL within that fiscal year could only be achieved by making substantial reductions in departmental spending. In the short term, the government may conclude, as a matter of public policy, not to do so because the resulting service reductions are not acceptable.

The situation could be further exacerbated by specific events in the Province, such as an economic downturn. Specific events can increase those departmental costs that are based primarily on demand levels in the short term. Even on their own, large increases in these costs in one particular year could result in “worse than budget” performance, and non-compliance with BBL, in the extreme. In another potential scenario, significant unexpected reductions in taxation or federal transfer revenues could have a similar impact. Clearly, over the longer term, government would have to address these types of situations to restore fiscal balance. Nevertheless, in the short term, it may have only modest ability to address deficit-creating factors or it may, as a matter of policy, choose not to do so.

Therefore, it is our view that a government may reasonably end up incurring a summary deficit in an individual year. This situation may exist as a result of choice or circumstance. Such a result, though, would not be acceptable on a sustained basis over a number of years.

In today’s BBL environment, the flexibility to address such circumstances is provided by the ability of a government to use the Fiscal Stabilization Fund. However, this mechanism for providing flexibility will not be available in the GAAP based measurement that we are proposing.

A means of providing short term flexibility under the new proposed BBL measure is required. In our view, though, this short term flexibility must be accompanied by the long term obligation to “make up” the negative result with future surplus(es). It may ultimately take some time to “make back” a loss; nevertheless, we believe that, in principle, the government, including GRE included entities, should generally be responsible to make up these losses unless there are highly unusual, extenuating circumstances.

This analysis leads us to the conclusion that the BBL measure should be a multi-year measure. The number of years incorporated into the measure is a matter of judgment. From our point of view, two years seems to be too short of a time frame. A two year measure would provide only a bit more flexibility. Conversely, a period of five years or more seems too long, since it would be a time period that would extend beyond the length of a normal majority government mandate.

Our suggestion would be a four year period. This provides significant flexibility, but does not extend beyond the length of a typical government mandate. Accordingly, we recommend the balanced budget measure be calculated as the aggregate reported surplus or deficit over the four year period ended on March 31 of each year.

### **c) The Need for Flexibility**

The Government’s summary financial position is affected not only by the financial management decisions that are made, but also by events and circumstances which are beyond the control of the Government and/or the Boards governing individual GRE included entities. In fact, the existing BBL enumerates several such items and provides the Government with flexibility in managing its financial situation. This is achieved by permitting the exclusion of the financial impact of certain events in the calculation of the BBL measure.

An analysis of uncontrollable events or circumstances that might be considered as eligible for exclusion requires that the existing list of exclusions in the current BBL be expanded to contemplate the inclusion of all GRE entities in the summary financial statements. These additional entities are subject to additional influences that do not have a similar impact on the provincial departments.

For instance, we cite the following examples of events or circumstances for which it is reasonable that the Government be provided some flexibility in the assessment of compliance with BBL:

- *Natural disasters* – costs to remediate and address situations such as floods, forest fires and pandemics.
- *Weather related losses* – history has shown that severe droughts affect the results of Manitoba Hydro; similarly hail storms will affect the results of the Manitoba Public Insurance Corporation and Manitoba Agricultural Services Corporation (including the operations of the former Manitoba Crop Insurance Corporation).
- *Regulatory decisions* – as an example, the Public Utilities Board could require Manitoba Public Insurance Corporation to control or lower rates so as to “use up” a surplus generated by

previous operations. Such a decision would implicitly preclude future profits from “making up” the resultant losses.

- *Acts of war* – responses to clear and imminent public security threats must be determined decisively, based on many factors beyond simply financial considerations.

The financial implications associated with such responses are normally significant and unexpected. The BBL measure should reflect this reality by providing the Government with a means to either exclude these items from the BBL measure or, at least, to provide a mechanism that would provide some additional flexibility in managing the financial implications of such circumstances.

The current BBL measure provides the Government with flexibility by allowing the Government to exclude the financial implications of several types of situations from the calculation of the BBL compliance measure. These exclusions are permitted on the basis that the financial implications of these situations are beyond the government’s control.

The new BBL compliance measure could do the same. It could simply permit the Government to extract or exclude costs associated with specifically defined types of circumstances or events from the calculation of the BBL compliance measure. The types of costs which could be excluded would be the kind of items outlined earlier in this Section (c). Caution would need to be exercised in the development of the list of permitted exclusions to ensure that it does not, in effect, reduce the rigor of the BBL legislation.

For example, it would be inappropriate to designate the entire summary deficit for a year for exclusion, when that summary deficit was the aggregate of many small entity deficits that were primarily attributable to their operations. Similarly, it would be inappropriate to designate some part of the summary deficit for exclusion where the deficit was due to general departmental overspending, unless the deficit was related to the cost of responding to a single crisis such as a flood or a pandemic.

We believe that it will be in the government’s own interest not to rely heavily on such exclusion provisions, unless they truly relate to one-time, uncontrollable factors.

#### **d) Possible BBL Measure**

The primary purpose of our recommendation on the establishment of a BBL measure is to ensure that the three principles identified are upheld. To assist the Government in devising a BBL compliance measure which is in keeping with these principles, we have developed a suggested BBL measure. The appendix to this document provides an illustration of how the detailed calculations related to our proposal would work.

See the material in Appendix 1 under “Possible BBL Measure”, including Table 3, for detailed illustration of the application of this concept.

#### **e) The Need for Additional Information**

In our view, the Government’s commitment to maintain some measure of BBL compliance is best achieved through the identification of a single BBL compliance measure. Hence, we have made Recommendation 5.

However, we also hold the view that there are other aspects of the Government’s approach to the management of the Province’s financial affairs that should be appropriately monitored and assessed by the electorate and users of the financial statements. Therefore, we have also developed Recommendation 7 which would require reporting by the Government on the spending of revenues which are directly within its control. While this reporting would not be the BBL compliance measure, it would indeed provide additional information that would parallel the information inherent in today’s BBL measure.

6. *The Auditor General should be required to provide an audit report on the calculation of the annual BBL compliance measure, as described in Recommendation 5.*

Again, in the interests of transparency, consistency and simplicity, we believe it would be appropriate for the AG to provide an audit report on the Government's calculation of the annual BBL compliance measure. This would be an audit report that would be separate and apart from AG's report on the Summary Financial Statements.

We expect that since the measure is calculated using figures from the audited GAAP summary statements of the Province, the AG could issue such a report without the discomfort that exists today on the appropriateness of the calculation of the BBL compliance measure. The focus of the AG's audit should be the calculation of the GAAP based measure, including the determination of the impact of accounting policy changes, as outlined in Recommendation 11.

7. *There should continue to be accountability of the Government for the spending of revenues directly within its control. Therefore:*

- a) *It would be desirable for the government's annual financial management strategy to establish targets for spending through the Legislature's approved estimates.*
- b) *The Government's post year end annual report should then contain a specific comparison of the actual revenues and expenses incurred during the fiscal year with the departmental estimates included in that year's budget. This comparison would be outside of the audited GAAP financial statements, as it is a non-GAAP measure.*
- c) *The government could retain the Fiscal Stabilization Fund (in concept and in practice) to enable transfers to and from this fund to be available, as permitted under the current BBL, to balance the Operating Fund revenues and expenses.*

As described earlier in this report and at the conclusion of our supporting explanation for Recommendation 5, a single measure of BBL compliance should not be understood to be the one and only appropriate measure for assessing the Government's stewardship of the Province's finances. There are other relevant measures and assessments that can and should be made. These assessments include the progress which the Government is making in achieving its long term financial goals, as set out in Recommendations 1 and 2.

Similarly, the move to GAAP-based summary reporting and a related BBL compliance measure does not invalidate interest which the electorate and the users of financial statements have in how the Government manages the spending of revenues which are directly within its control.

Therefore, we recommend that the Government continue to budget and report on the spending of the taxation and other revenues for which it is directly accountable to the Legislature. In fact, we would propose that the Government continue to provide financial information similar to that which is currently included in the Statement of Revenue and Expenses for the Operating and Special Funds. This information would clearly need to be outside of the audited GAAP financial statements of the Province since the information would not be prepared in accordance with GAAP.

Notwithstanding that the information would be presented outside of the audited financial statements, we believe that it should be reported because it provides useful information to users of the financial statements.

8. *The following features of the existing BBL could be retained in the context of new legislation:*

- a) *The requirement for a referendum to increase taxes.*
- b) *Provisions for penalties on the Executive Council if BBL compliance is not attained (consideration should be given to not applying penalties in the first year of a newly elected government).*
- c) *The requirement to annually deposit funds into the Debt Retirement Fund to be used to reduce general purpose debt.*

The individual aspects of the existing BBL listed immediately above are features which could continue to exist in the context of new legislation. In fact, if retained, these provisions would be compatible with the preceding recommendations.

The determination of whether these features should be retained is less a question of technical accounting and/or financial analysis and much more a reflection of the Government's agenda, policies and priorities. Hence, the Government will need to consider its view on each of these matters to determine whether they reflect the Government's financial priorities, its policy platform and its intent.

9. *The following features of the existing BBL should be eliminated as they would no longer be applicable:*

- a) *The exemption from penalties for non-adherence to BBL compliance in the event of a significant revenue decrease.*
- b) *The exemption from BBL compliance in the event of a change in government*

The use of the proposed rolling four year calculation incorporates considerable flexibility for Government action to avert a non-compliant situation. In our view, this flexibility makes the measure sufficiently resilient that several existing BBL provisions that were originally designed for that purpose should be eliminated. For example, moving from a single year measure, as currently exists, to the proposed rolling four year measure provides time for the Government to respond in the event of a significant revenue decrease.

Similarly, the existing provisions that exempt an incoming government from BBL compliance in the year of the change in government, is inconsistent with the use of a multi-year measure. This is because an essential element of an incoming government's approach to financial management is reckoning with both the short and long term implications of the financial situation that the outgoing government has left. Nevertheless, the timing of an election may be such that an incoming government is accountable for the BBL measure related to a year where it had little or no impact on financial management for that year. In these instances, we would anticipate that the incoming government may choose to pass a legislative provision exempting itself from the need to comply with the BBL measure for that year only.

10. *The name of the existing BBL should be altered to reflect the expanded nature of its requirements.*

Manitoba's BBL essentially establishes the parameters for the accountability of the Government in its reporting on financial matters. The recommendations which we have identified in this report further expand that accountability. That accountability is expanded not just through the revision to the BBL compliance measure. In fact, the accountability is extended to:

- Articulating financial management strategy and priorities.
- Reporting on the achievement of those priorities.
- Establishing GAAP as the standard for financial reporting.
- Requiring reporting on departmental spending in addition to the BBL measure.

Accordingly, we believe it would be appropriate for the name of the legislation to more broadly reflect the nature and intent of the legislation which is more than simply the achievement of an annual balanced budget.

*11. The new BBL should contain provisions that provide for the consistent measurement of surplus or deficit over the four year compliance period by including provisions on how changes in accounting policies should be treated.*

The establishment of GAAP as the standard by which the Province's financial reporting will be done inherently includes a commitment to implement all required changes in accounting policies that are mandated by CICA's PSAB. Therefore, it is reasonable to anticipate that changes in accounting policies may complicate the calculation of the measure itself.

For example, it is conceivable that in year 3 of the 4 year period used in a rolling four year BBL compliance measure calculation, GAAP will require a change to the accounting principles. That change may be required to be applied retroactively or prospectively. Typically the application of the change in policy would be set out in the new pronouncement itself. Unless addressed, the change in policy could lead to a situation where the basis of accounting used in the first two years of the rolling four year calculation would be different from the basis of accounting used in the last two years of the calculation.

Therefore, the legislation should make provision for all four years in the rolling four year calculation to be measured using the same basis of accounting. Such provision will likely require that the impact of accounting policy changes be calculated on certain years in the calculation as if they had been in effect in those years. In that way, all four years used in the calculation will be measured using the same accounting policies.

Because any adjustments for changes in accounting policies will be based on the provisions of GAAP, we expect that the AG would be able to consider and examine such calculations in the course of providing the recommended audit opinion on the calculation of the BBL compliance measure.

*12. The legislation should include transitional provisions to take into account the Province's staged plan for implementing GAAP reporting and the facilitation of a multi-year measure. The transitional provisions are required because the earliest comparative period for which full GAAP financial statements will be available will be the year ended March 31, 2007. These comparative statements will only be prepared in 2007/08 for inclusion in the summary financial statements for that fiscal year.*

The Province's commitment to fully implement PSAB GAAP takes effect for its year ended March 31, 2008. The financial statements for that year will include comparative figures prepared on the same basis of accounting for the preceding year ended March 31, 2007. Accordingly, at the conclusion of the 2008 and 2009 fiscal year, there will not yet be four full years of GAAP summary statements. As a consequence, it will not be possible to calculate the rolling four year measure until the 2010 fiscal year. Therefore, the new BBL legislation should include transitional provisions explaining how compliance will be measured on an interim basis for the 2008 and 2009 fiscal years.

# Appendix 1 – Illustration of a Possible Balanced Budget Legislation Measure

The purpose of this Appendix is to provide an illustration of the detailed calculations and mechanics associated with the recommended Balanced Budget Legislation measure presented as part of Recommendation 5.

## Demonstrating a Rolling Four Year Calculation

We suggest that one way of building sufficient flexibility into the actual BBL compliance measure would be for the actual measure to be calculated as the aggregate GAAP-based surplus or deficit for the current year that is being reported on, plus each of the three preceding fiscal years. Each year this “rolling four year calculation” would be done to assess BBL compliance.

The use of the rolling four year calculation provides opportunity for the Government to manage the GRE broadly to ensure that any deficits which are incurred are “made up” over the following three years. The use of the rolling calculation also allows the Government to understand at the time it sets its annual budget what result must be targeted and then achieved in the current year to ensure BBL compliance. Table 1 below sets out an example of how this calculation would be done over a period of 10 years.

*Table 1 (All figures in millions of dollars)*

	<u>2x01</u>	<u>2x02</u>	<u>2x03</u>	<u>2x04</u>	<u>2x05</u>	<u>2x06</u>	<u>2x07</u>	<u>2x08</u>	<u>2x09</u>	<u>2x10</u>
Surplus (deficit) in the annual summary financial statements	<u>\$ (135)</u>	<u>\$ 425</u>	<u>\$ (25)</u>	<u>\$ (100)</u>	<u>\$ 150</u>	<u>\$ 450</u>	<u>\$ 175</u>	<u>\$ (100)</u>	<u>\$ 125</u>	<u>\$ (225)</u>
Balanced Budget Measure				<u>\$ 165</u>	<u>\$ 450</u>	<u>\$ 475</u>	<u>\$ 675</u>	<u>\$ 675</u>	<u>\$ 650</u>	<u>\$ (25)</u>
Compliant with BBL?				Yes	Yes	Yes	Yes	Yes	Yes	<u>No</u>

Note: The Balanced Budget Measure is calculated as the aggregate surplus (deficit) for the current year and the three preceding years

## The Need for Flexibility

There is a real and legitimate concern about this approach. The concern relates to the possibility of a substantial deficit that might arise in any one year as a result of a single factor which is beyond the control of either the Government or the management of the entity affected by the event. An example would be the \$425 million loss experienced by Manitoba Hydro in 2004 as a result of the drought conditions experienced by the Province. In that year, the summary GAAP result was significantly impacted by this weather related loss.

A large summary loss, due principally to an uncontrollable weather situation can create a non-compliant BBL measure simply by virtue of the mechanics of the calculation. To illustrate this point, consider Table 2. The hypothetical results are identical to those in Table 1 with the exception of the year 2x05, which has been adjusted for a hypothetical large loss of this nature, in the amount of \$625 million.

*Table 2 (All figures in millions of dollars)*

	<u>2x01</u>	<u>2x02</u>	<u>2x03</u>	<u>2x04</u>	<u>2x05</u>	<u>2x06</u>	<u>2x07</u>	<u>2x08</u>	<u>2x09</u>	<u>2x10</u>
Surplus (deficit) in the annual summary financial statements	<u>\$ (135)</u>	<u>\$ 425</u>	<u>\$ (25)</u>	<u>\$ (100)</u>	<u>\$ (475)</u>	<u>\$ 450</u>	<u>\$ 175</u>	<u>\$ (100)</u>	<u>\$ 125</u>	<u>\$ (225)</u>
Balanced Budget Measure				<u>\$ 165</u>	<u>\$ (175)</u>	<u>\$ (150)</u>	<u>\$ 50</u>	<u>\$ 50</u>	<u>\$ 650</u>	<u>\$ (25)</u>
Compliant with BBL?				Yes	<u>No</u>	<u>No</u>	Yes	Yes	Yes	<u>No</u>

Note: The Balanced Budget Measure is calculated as the aggregate surplus (deficit) for the current year and the three preceding years

Suggested BBL Measure

The development of a BBL measure which permits exclusions for certain defined uncontrollable factors would permit the \$625 million hypothetical loss presented in the preceding table to be permanently excluded from the determination of whether the Government is in compliance with BBL.

With such a measure, the Government would designate the loss to be excluded by virtue of the exclusion provisions. Then the reported surplus (deficit) in the annual summary financial statements would be notionally adjusted to eliminate the impact of such a loss. The resulting post exclusion surplus or deficit would then be used in the rolling four year calculation. Table 3 demonstrates how this approach would handle the identical circumstances which were presented in Table 2. The table demonstrates that there would continue to be compliance with BBL for the duration of the period that would otherwise be affected by the large hypothetical one time loss in 2x05.

*Table 3 (All figures in millions of dollars)*

	<u>2x01</u>	<u>2x02</u>	<u>2x03</u>	<u>2x04</u>	<u>2x05</u>	<u>2x06</u>	<u>2x07</u>	<u>2x08</u>	<u>2x09</u>	<u>2x10</u>
Surplus (deficit) in the annual summary financial statements	<u>\$ (135)</u>	<u>\$ 425</u>	<u>\$ (25)</u>	<u>\$ (100)</u>	<u>\$ (475)</u>	<u>\$ 450</u>	<u>\$ 175</u>	<u>\$ (100)</u>	<u>\$ 125</u>	<u>\$ (225)</u>
Loss designated for exclusion					625					
Adjusted Surplus (deficit) used for BBL purposes	<u>\$ (135)</u>	<u>\$ 425</u>	<u>\$ (25)</u>	<u>\$ (100)</u>	<u>\$ 150</u>	<u>\$ 450</u>	<u>\$ 175</u>	<u>\$ (100)</u>	<u>\$ 125</u>	<u>\$ (225)</u>
Balanced Budget Measure				<u>\$ 165</u>	<u>\$ 450</u>	<u>\$ 475</u>	<u>\$ 675</u>	<u>\$ 675</u>	<u>\$ 650</u>	<u>\$ (25)</u>
Compliant with BBL?				Yes	Yes	Yes	Yes	Yes	Yes	<u>No</u>

Note: The Balanced Budget Measure is calculated as the aggregate surplus (deficit) for the current year and the three preceding years

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