Province of Manitoba Financial Review

Phase I Report

Prepared for Hon. G. Selinger
Minister of Finance
Government of Manitoba

February 8, 2000

Volume 1 - Report

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EXECUTIVE SUMMARY

On October 27, 1999, Deloitte & Touche LLP was asked to undertake a financial review of the Government of Manitoba. The first phase of this review was directed to framing the financial picture facing the Province and identifying the implications of this situation. A second phase of the review is to examine how budgets are developed, how to improve the accuracy of future budgets, and how to improve control of expenditures. The objective is to end each fiscal year with actual expenditures more in line with the budget as approved, and to report this result to the public in "full, true and plain" language.

This document presents our conclusions respecting our Phase I work. In reviewing this report, readers should be aware that it is the result of a financial review. Our findings should not be characterized as an audit of the Government of Manitoba or any of its entities. As well, our conclusions do not address questions of program performance in meeting their objectives.

A. OVERVIEW

The first year of any new government is critical. This is the time to establish principles for the longer term. However, in setting this context, the Government needs to know its current financial position. And to truly understand the current financial position, it is necessary to look at the 1999/2000 year in a larger perspective. Accordingly, this review took a longer view, looking back to 1997/1998 and 1998/1999 and forward to 2000/2001 and 2001/2002. We also sought to identify the underlying or structural condition of the provincial finances.

With this five-year perspective on the underlying financial condition, the current financial circumstances can be better understood. This understanding then points us to a set of principles on which the Government can establish its longer term fiscal strategy.

In our review of the current financial circumstances and the underlying financial condition, we have concluded that the Government faces two fundamental challenges:

1. Operating Fund Structural Challenges

The challenges:

- *Recurring and sustainable revenues are insufficient to cover the planned and forecast levels of government expenditures, particularly for health care programs.*
- *In resolving this problem, flexibility is significantly constrained by a limited ability to leverage increased revenues from existing sources, so other solutions are required.*

The Operating Fund results over the past two years and for the current year involve one-time transfers from the federal government, transfers from the Fiscal Stabilization Fund, and other non-recurring items including emergency revenues. When the impact of these special items is eliminated from the results of the prior and current years, a structural deficit becomes apparent. Initial indications of expenditure level requests for 2000/2001 suggest that this challenge will become more pronounced in the future. Finding a solution to this structural imbalance starts with recognizing its existence.

2. LONG TERM FUNDING OBLIGATIONS AND REQUIREMENTS

The challenges:

In order to sustain ***established*** *service levels and programs funded through the Operating Fund, substantial additional funding is required to provide for long term and increasingly costly obligations of the Government. In addition, there are other obligations:*

- *The $2.8 billion unfunded pension liability for civil servants, teachers and legislators, which is growing rapidly.*
- *Deferred infrastructure capital and maintenance costs for highways, post secondary institutions, public schools, health facilities and equipment, and public housing.*
- *Commitments for debt retirement.*

Continued deferral of these expenditures will only cause increased demands on the Operating Fund – for increases in pension payments to retirees, departmental requests for repair and maintenance funding, and public debt interest charges.

Given these two central findings respecting the Province's basic financial circumstances, we have focused our attention on "getting beyond 1999/2000". The objective must be a true improvement in the difficult financial reality, and this can only be done by the long term and consistent application of sound financial principles.

B. OUR APPROACH TO THE REVIEW PROCESS

Throughout our review work, we engaged in ongoing discussions with provincial officials on a number of issues as they arose. Our approach also included three key elements:

The Steering Committee

The Minister of Finance appointed a Steering Committee chaired by Ron Hikel and including senior provincial officials, the Provincial Auditor, and a representative of the business community, to oversee the review process. In addition to the Committee Chair, the membership includes: Pat Gannon, Deputy Minister of Finance; Don Potter, Secretary to Treasury Board; Jon Singleton, Provincial Auditor; Jim Eldridge, Clerk of the Executive Council; and Bev Suek, Director of TLS Enterprises. Deloitte & Touche LLP met with this group 11 times to report progress and discuss issues raised in the course of the review.

Review of Entity Information

To establish the truest possible picture of the Government's financial position, we reviewed and analyzed information provided by provincial officials. We looked at multiple sources (e.g., Treasury Board and individual Departments) where possible in order to ensure consistency and completeness.

The review covered a total of 41 organizations or "entities", including all departments as well as certain agencies and Crown corporations. The large and complex task of obtaining and reviewing information from each entity required a systematic and iterative approach to dealing with provincial officials and documentation. At the beginning of the financial review, the Chairman of the Financial Review Steering Committee wrote to the senior officials of each of the 41 entities, requesting that specific information be forwarded directly to Deloitte & Touche LLP.

Our subsequent interaction with entity officials focused on points of variance from budgeted expenditures and revenues. In the course of our discussions, we sought evidence to verify or corroborate the variance information that we had originally received. We summarized our findings in a report on each entity.

Senior officials then reviewed the summaries for their entities and were asked for a formal sign off, documenting their agreement with the completeness and accuracy of the information contained in the reports on their organizations. Through this process, a number of additional matters came to light, and we had numerous discussions with representatives of major departments through to the early part of February, 2000. The sign-off process with the 41 entities was completed on February 8, 2000.

Through the process of working with entity officials, we assessed the need for and the appropriateness of recording suggested provisions for lurking expenditures. In many cases, we concluded that the suggested provisions should not be recorded because of insufficient evidence of the Government's commitment to incur these costs. A number of these costs may, however, become unavoidable if action is not taken to resolve or mitigate these future issues.

Consideration of Asset Valuation Issues

We provided insight and advice where appropriate related to a significant number of asset valuation issues. Assets include investments made by the government, such as loans receivable, as well as property and equipment. Some of these asset valuation issues are addressed in a separate review which we report on in the document **Information Technology Major Initiatives Review**. Those relatively few valuation issues which resulted in adjustments to the projected deficit are described in Chapter II.

C. OUR FINDINGS

Highlights of our findings start with an overview of the current year's financial circumstances.

1. THE 1999/2000 FINANCIAL SITUATION – A PROJECTED DEFICIT OF $100 MILLION TO $135 MILLION

Our review found that the Province is facing the prospect of the 1999/2000 Operating Fund results bringing the deficit to the order of $100 million to $135 million. The projected deficit is the result of developments in both revenue and expenditure components of the Province's finances.

As we note throughout this report, the process for estimating revenues and expenditures to March 31, 2000 is dynamic and ongoing. The deficit we have projected is based on the most up-to-date revenue and expenditure information available to us, up to and including February 8, 2000. While we have made every effort to provide for all known items, it is reasonable to expect the new circumstances arising after February 8 will affect the amount of the deficit ultimately reported by the Province for the 1999/2000 year.

Exhibit 1 provides an overview of the projection, noting key variances and transactions that produce the projected result.

Exhibit 1 – Projected Results for 1999/2000[1]

	1999/00 Published Estimates	Variances: Approved[2]	Variances: Additional/ Anticipated[3]	Current 1999/2000 Forecast
Revenue	$5,897.5		$259.7	$6,157.2
Expenditures				
Health	2,119.3		158.6	2,277.9
Education and Training	1,180.0		18.3	1,198.3
Family Services	701.7		8.4	710.1
Public Debt	480.8			480.8
Justice	208.0		4.8	212.8
Agriculture	113.0		7.6	120.6
Emergency Expenditures (Re: Flood Assistance and Fire Suppression)	23.5	96.0	18.5	138.0
Valuation adjustments			48.3	48.3
Other	1,159.5	3.4	17.0	1,179.9
Subtotal Expenditures	5,985.8	99.4	281.5	6,366.7
Deficit Before Transfer from the Fiscal Stabilization Fund and Debt Retirement Payments	(88.3)			(209.5)
Debt Retirement Payment	(75.0)			(75.0)
Deficit Before Transfer from the Fiscal Stabilization Fund	(163.3)			(284.5)
Planned Transfer from the Fiscal Stabilization Fund[4]	184.7			184.7
Surplus (Deficit) for the Year	$21.4	($99.4)	($21.8)	($99.8)
Additional Potential Variances				(35.0)
				$(134.8)

[1]This is based on a February 8, 2000 estimate of revenue from tax collection agreements and transfer payments. A further estimate is expected before March 31, 2000.
[2]These variances have been approved by Special Warrant.
[3]While the additional, anticipated expenditures may have departmental and/or Treasury Board approval, funding authority for the expenditures has not yet been put in place.
[4]As per original published Estimates.

Projected revenues include a one-time $131 million Canada Health & Social Transfer Supplement from the federal government. The 1999 federal budget set out an allocation of this revenue over a three-year period. Consequently, Manitoba Finance may consider the transfer of about $56 million from the Operating Fund to the Fiscal Stabilization Fund. This transfer would reflect that part of the health care supplement that relates to subsequent fiscal years according to the federal calculation. Using the financial reporting framework set out in the preceding exhibit, which is the basis on which the 1999/2000 budget was prepared, the impact of the contemplated transfer would be to increase the deficit by $56 million.

2. DEVELOPMENTS SINCE OUR INTERIM REPORT

Our interim report of November 17, 1999 highlighted on page 9 that increased revenues were probable as a result of revised federal estimate information. The next federal update was expected by the Province before the end of 1999.

After the completion of our interim report, Manitoba Finance officials continued to receive information from the federal government that enabled new revenue estimates to be prepared. Manitoba Finance officials had a prevailing feeling that estimated revenues would be significantly higher than set out in our November 17, 1999 report. However, they were not sufficiently confident in the data being used in the process to formulate a specific revised revenue estimate.

Manitoba Finance officials formally notified us on January 6, 2000 of their view that revenues for the 1999/2000 year would be $191 to $321 million higher than the original budget estimate. Since then the range was narrowed to $206 to $306 million. On February 4, 2000 we were advised that the current estimate of revenue is $260 million greater than the budget. This is $218 million greater than the revenue increase projected in November.

Our interim report projected expenditures in the range of $6.31 to $6.47 billion. Our findings since that report have led us to project aggregate final expenditures of approximately $6.37 billion, near the middle of the range forecasted.

It is therefore the changes in revenue estimates that have had the greatest impact on the projected deficit. Exhibit 2 notes the differences between the interim report and this final report.

Exhibit 2 – Reconciliation to November 17, 1999 Interim Report

(in millions)	*Projected deficit noted in Nov. 17, 1999 Interim Report*	*Revisions to projections based on completed review*	*Revised projected deficit*
Revenues	$5,939.2	218.0	6,157.2
Expenditures	6,311.0	55.7	6,366.7
	(371.8)	162.3	(209.5)
Debt Retirement	(75.0)		(75.0)
	(446.8)	162.3	(284.5)
Transfer from Fiscal Stabilization Fund	184.7		184.7
Projected "Lower end" Deficit Range	***(262.1)***	***162.3***	***(99.8)***
Additional Potential Variances	(155.0)	120.0	(35.0)
Projected "High End" of Deficit Range	***$(417.1)***	***$282.3***	***($134.8)***

3. OVERALL HEALTH OF THE PROVINCE'S FINANCES

In considering the structural health of the Province's finances, we used the approach recommended by the Canadian Institute of Chartered Accountants (CICA) in its publication **Indicators of Government Financial Condition** (Toronto, Ontario 1997). This publication gives us a method of assessing the Province's general financial health.

It is apparent that progress has been made on several fronts since the mid-1990's in improving the provincial circumstances. Chapter III of this report applies the CICA framework to provide a detailed analysis of the Province's financial condition. To give an overview:

- Over the last ten years, the Province's ***ratio of net debt to GDP*** increased up to 1994, which meant that the burden of debt on taxpayers was increasing. However, since 1994, the ratio has been declining. According to the CICA, net debt is calculated as the Province's accumulated consolidated deficit. This amount represents that portion of the Province's gross liabilities that are not being used to finance specific assets like the Province's investment in Manitoba Hydro. As the Province ran surpluses and the provincial economy strengthened and grew, the ratio of net debt to GDP declined, indicating a gradual improvement in the Province's basic financial position.

- The ***net debt per capita ratio*** measures the size of the Province's net debt in relation to the size of the Province's population. An increasing ratio means that relative to the size of the population, the debt burden is increasing. A declining ratio means that the debt burden of the Province is decreasing on a per person basis. Over the past ten years, the ratio increased until 1996, at which point the situation started to improve. This improvement continued through the 1997-1999 period.

- Over the last ten years, the ***ratio of debt costs to Government revenue*** has varied between 8% and 11%. It has decreased each year since 1994. The less the Government pays in interest costs on debt, the more it has available to support programs.

In other areas the situation is less positive. Our analysis concluded that the Government still faces significant challenges in the areas of revenue sustainability and flexibility.

Sustainability Is In Question

The projected Operating Fund deficit for the current year, as summarized above and as described in detail in Chapter II, is now projected to be $100 to $135 million. However, this projection is affected to a large degree by non-recurring revenues and transfers from the Fiscal Stabilization Fund.

To more clearly understand the underlying nature of the Government's financial condition, we have completed an analysis of the past three fiscal years and the current year's projected results for the Province's Operating Fund. We calculated a "normalized" picture of each year's reported financial result by eliminating the impact of non-recurring revenues, transfers from the Fiscal Stabilization Fund and non-recurring expenditures. This is the relationship between ongoing, recurring revenues and expenditures, without the extraordinary impact of one-time revenues or expenditures.

The analysis, which is set out in the following table, indicates a deteriorating underlying surplus/deficit trend, beginning in recent years. Further, it demonstrates that expenditures at the projected 1999/2000 levels are significantly greater than anticipated continuing revenues. This gap is a structural deficit and poses a significant financial management challenge for the Government.

Exhibit 3 presents the “normalized” revenue and expenditure picture for a four year period starting in 1996/1997.

Exhibit 3 – “Normalized” Revenues and Expenditures

	Year Ended March 31			
(in millions)	*1997 Actual*	*1998 Actual*	*1999 Actual*	*2000 Projected*
Total Reported Revenues	$5,499	$5,842	$6,067	$6,342
Remove Internal Transfers and Non Recurring Items:	(6)	(268)	(324)	(456)
“Normalized” Revenues	$5,493	$5,574	$5,743	$5,886
Total Required Disbursements				
Expenditures	$5,408	$5,691	$5,887	$6,367
Add: Debt Retirement Fund Payments		75	150	75
	5,408	5,766	6,037	6,442
Remove Non Recurring Expenditures:		(217)	(173)	(186)
“Normalized” Expenditures	$5,408	$5,549	$5,864	$6,256
“Normalized” Revenues Less “Normalized” Expenditures	$85	$25	($121)	($370)
Surplus/(Deficit) as Reported/Projected	$91	$76	$30	($100)
Difference between “Normalized” and non-“Normalized”	***$6***	***$51***	***$151***	***$270***

As indicated in this exhibit, the impact of using a “normalized” display is a marked change in the level of surplus or deficit from what has been reported or projected. The difference is particularly significant for 1998/1999 and the current year. For 1999/2000, using a “normalized” approach, the deficit would be $370 million. This is substantially higher than the $100 million projected which includes using one-time transfers and non–recurring revenue.

Flexibility Is Limited

Given the financial challenges facing the Province, flexibility in revenue sources as defined in the CICA report is increasingly important. However, the Province’s ability to leverage increased revenues from existing sources is minimal. The Province faces public concerns about current levels of taxation. It is also constrained by the existing balanced budget legislation requirement that referendum approval be obtained for new tax rate increases and by the Government’s pledge to implement budgeted tax cuts. Also, the Province must consider that other provincial governments are decreasing taxes, putting pressure on Manitoba to chart a similar course to keep this economy competitive. Finally, the linkage of Manitoba’s personal income tax to the federal system may expose Manitoba to potential revenue loss when the federal government reduces taxes, as it has done recently.

4. Financial Pressures for Future Years

As part of the review, we gathered information from each department's senior officials on what they judged to be required expenditure levels for two future years, together with the most current estimates of future revenue levels. As part of the sign-off process, officials verified that this information fairly represented their current expectations of requirements to continue existing programs.

We emphasize that this information was provided to us before it was included in the 2000/2001 estimates preparation process. Consequently, the information is preliminary. It has not been subject to debate, testing or scrutiny from outside the respective departments, as will be involved in the final Treasury Board examination and approval in developing the Government's 2000/2001 budget. However, while we recognize that departments' expenditure proposals are likely to be higher than what will be approved in a budget, our review was not directed to the development of budget requests. Officials were asked to focus specifically on requirements to maintain existing programs, not to enhance them or to add new programs.

In addition to the departmental estimates, the projected expenditures noted in Exhibit 4 include enabling and other appropriation estimates at amounts equal to 1999/2000 levels, except for the removal of costs related to the PanAm Games, the Millennium Fund, and cost sharing agreements that are expiring in 1999/2000.

Exhibit 4 – Financial Pressure Overview

	Projected Impact (in millions)
Operating Fund	***2000/2001***
Revenues	
Taxation	$3,865
Other	606
Federal Government	1,742
	6,213
Expenditures	6,585
Required Debt Retirement Payments	96
	6,681
Projected Potential Impact	***($468)***

As illustrated, the financial pressures identified total approximately $470 million. This is an indication of the ongoing structural pressures tending toward a deficit.

5. Implications of the Current Year Situation, Future Financial Pressures, and the Province's Financial Health

The Government faces a probable deficit for the current year as a result of additional expenditures beyond budgeted levels. In some instances – notably Manitoba Health – the expenditures in excess of the approved budget are consistent with the spending pattern of recent years. This suggests that the roots of the current year's deficit arose from expenditure planning and management practices over a longer period of time. Treasury Board officials have confirmed this pattern.

The Government is facing the implications of the cumulative public debt (including the growing unfunded pension liability), the current year's deficit, and mounting revenue and expenditure pressures for the coming years. To address this multi-dimensional challenge, the Government will need to make choices from a limited range of alternatives, including expenditure reductions and greater public sector productivity.

Although comprehensive forecasts of the Province's operating fund budget for the next two fiscal years have not yet been made, information currently available suggests that the nature of the pressures will probably become more pronounced in subsequent fiscal years. The troubling implications of both the 1999/2000 financial picture and the mounting pressures for future years must be major considerations for the Government as it prepares its first budget and defines a long term approach to financial management and reporting.

6. FINANCIAL REPORTING AND FINANCIAL MANAGEMENT

Both financial reporting and financial management speak to the fundamental issue of accountability. Financial decisions are made, implemented, and the end results are reported back to the Legislature and the public. All three of these activities demand that individual elected representatives and public servants accept responsibility make the appropriate judgements so they fulfill their defined roles. We noted in our review work that in each area – making decisions, implementing them, and reporting on results – the Government is in a position to make further and substantive improvements.

Financial Reporting – a Need for Transparency and Clarity

Due to historical and current reporting practices, the analysis of the Province's financial condition and financial results is not a straightforward process. The Provincial Auditor has provided comments and advice related to reporting issues over a number of years. We strongly concur that issues of accounting practice require early attention from the Government.

The Government's financial reporting should be based on the principle of transparency. Transparency of financial reporting means reports are understandable and easy for the public to comprehend. More importantly, however, transparency means that the complete financial picture is presented and it is done so in accordance with recognized public sector accounting standards. As a result, the Government's financial situation should be clear and unambiguous to the observer.

Financial Management – a Need for Confidence

We have concluded that sound financial management must be a focal point for the Government and is integral to its ability to achieve its balanced budget objectives. The historical gaps, year after year, between the approved revenue and expenditure budgets and the actual amounts, and the recurring difficulties in projecting and managing financial pressures, point to a need to strengthen financial management across the spectrum – from planning to decision-making to implementation and monitoring performance.

While a focus on the financial reporting issues is appropriate and important for the new Government, we caution that resolution of presentation issues will not by itself resolve financial management problems. Confidence in Government financial management needs to be strengthened. As a first step, the Government needs to define its financial management direction.

In developing its financial management plan, a number of specific issues require early attention, including the establishment of principles for considering new revenue sources from Government Enterprises, for dealing with the pension issue, and for obtaining an appropriate return on investments in information technology.

As a matter of urgent priority, the Government also should address the challenge of health care expenditure management. This must include ensuring that better information is available to assist in this process. Finally, the Government needs to improve expenditure controls in the context of a well-defined and understood financial management framework.

A complicating factor in the relationship between Government as funder and the typical Crown organization as a program delivery organization is the distance between the two. With the number of layers of management reporting, it is difficult to achieve effective information flow, communications, and understanding. We see this particularly evident in health care, where the layers involve Government, Manitoba Health, the Regional Health Authorities, and individual health care providers (e.g., hospitals, long term care facilities, community health clinics, etc.). And, where health care providers contract for services, an additional layer is added.

The situation is also complex in education, with the Government, Manitoba Education and Training, the Council on Post Secondary Education, and education providers (e.g., universities and community colleges) all playing a part.

The level of confidence in the financial management capacity of "umbrella" organizations such as the Regional Health Authorities and the Council on Post Secondary Education is therefore extremely important, both for the Government as funder and for the organizations responsible for direct delivery of services. The understanding and commitment of all parties to common financial management principles and clearly defined roles and responsibilities are key to dealing effectively with this challenge.

Timeliness of financial information is central to the confidence factor. Good information provides the Government with an ability to act on a timely basis to properly address issues as they arise. While a degree of uncertainty is inevitable for both revenue and expenditure results compared to plans, we note that the timing can be particularly problematic. We cite two examples:

- ***Revenues:*** Corporate and individual income tax and federal transfers account for over half of the Province's revenue. Manitoba Finance's estimates of these revenues are continually adjusted as the federal government updates statistical and economic data used in the revenue calculation formulae. Prior to release of our November 17, 1999 interim report, we asked Manitoba Finance officials about the level of certainty with respect to the revenue increase projected for the year. Based on information Manitoba Finance had received and reviewed to that date, we said in our November report that increased revenues were expected to be $42 million and that increased revenues were probable.

Additional data was received by Manitoba Finance throughout December. In early January, we were informed that the total variance was thought to be $262 million, attributed primarily to new indications from the federal government respecting increases in transfer payments. In early February, this figure was revised to $260 million.

- ***Expenditures:*** Over the course of our review work, expenditure estimates for Manitoba Health varied widely, including changes in a one-week period of more than $30 million.

These examples raise issues of confidence and uncertainty that can have a profound impact on the Government's ability to plan and manage its finances. With both expenditures and revenues subject to such wide swings, good financial management is more difficult.

D. HIGHLIGHTS OF OUR RECOMMENDATIONS

We offer a number of recommendations for the Government's consideration. They are detailed in Chapter VI of this report and highlighted here.

1. DEFINE A LONG-TERM STRATEGY

A key element in planning is the development first of a fiscal framework and then a budget for the Province. We have concluded from our review that many of the financial challenges facing the Government cannot be resolved in one year, and that the traditional year-to-year focus on individual budgets will not likely contribute to the achievement of fundamental solutions in these areas. A longer term planning framework is therefore advisable, particularly in setting a course to address the structural deficit.

In our Phase II report for this financial review, we will be providing detailed recommendations on how the Government can improve (a) the accuracy of formulating annual estimates for submission to the Legislature and (b) the post-approval control of expenditures so that they will conform more closely to this approved amount.

Recommendations on Defining a Long-Term Strategy

We recommend that the Government establish a multi-year strategy for eliminating the structural deficit of the Province, for steadily reducing provincial debt including the unfunded pension liability, and for investment in critical infrastructure improvements, and that it report on progress annually to the Legislature and the public. In particular, this framework should forecast the level of expenditures the Government anticipates being able to spend on the more important areas – the Government should then act both to preserve the required level of revenues for this use and keep actual costs within the defined limits.

To assist the Government in its multi-year plan, the Fiscal Stabilization Fund can be a useful financial management tool and a cash flow mechanism. However, the Government should alter its financial reporting processes so that Fiscal Stabilization Fund transfers are no longer accounted for as revenues. This will eliminate a longstanding objection of the Provincial Auditor.

We recommend that as the Government looks at increasing revenue from certain Government Enterprises for transfer to the Operating Fund, assurances be provided that any such additional transfers will not compromise the ongoing financial strength and integrity of the Government Enterprises as they discharge their individual service delivery mandates.

2. FOCUS ON IMPROVING FINANCIAL MANAGEMENT

The financial management of the Province hinges on effective decision-making and follow-through, including strong financial controls. Given the recurring level of variance from approved budgets in the current fiscal year and in previous years, we have concluded that improvements must be made, especially in Manitoba Health. What needs to be determined is: are the variances the result of deficiencies in planning and decision-making, definition and distribution of roles and responsibilities, day-to-day program management, financial controls, or a combination of these factors?

We believe that the Government needs to decide on answers to the following questions:

- ***Planning and decision-making:*** are the decisions consistent with the established expectations and program mandates?
- ***Definition and distribution of roles and responsibilities:*** are the right decisions delegated to the right people?
- ***Performance standards:*** are standards in place that are consistent with the Governments' policy objectives?
- ***Day-to-day program management:*** is program performance monitored and managed effectively against these standards?
- ***Financial controls:*** how do potential variations from budget come about, what measures are taken and when are the issues addressed?

The new Government has an opportunity to address the defined financial management issues as a matter of priority, and has already moved in a number of areas (e.g., Health) to determine what actions should be taken. The Government should act quickly.

Recommendations for Improving Financial Management

We recommend that the Government focus immediate attention on more effective management of the health care budget including capital spending. We further recommend that the Government confirm a clear multi-year governance framework for the health care system, including the appropriate and clear distribution of management and reporting roles and responsibilities between Manitoba Health and health care providers in the Regional Health Authorities. This will require better and more timely financial information on actual expenditures and costs of services.

We recommend that the Government assess and enhance the governance framework for all Crown organizations with the objective of confirming for the organizations – and for the departments that fund them – an understanding and commitment to financial management principles and clearly defined roles and responsibilities.

3. MAKE FINANCIAL REPORTING MORE TRANSPARENT

The Province's reporting has improved from year to year, as recognized by the Provincial Auditor in recent reports. However, we note three particular outstanding issues related to the Province's reporting on its financial situation:

- ***The current financial reporting is not timely.*** The time lag between completion of a fiscal year at March 31 and reporting on the results (Public Accounts) is 6 to 8 months and should be much shorter.

- ***The current reporting is overly complex.*** The presentation of reporting (the published Public Accounts) should be on the same basis as the published Estimates on which the annual budget is based so that comparing performance to plan is both transparent and easy to understand. As recommended by the Provincial Auditor, the Government should prepare a summary budget based on the budgets for all entities, using the same accounting principles as for the summary financial statements. Also, summary budget amounts should be disclosed in the summary financial statements for comparison with actual results. We recognize that this is not easily done, but the Government should begin to take steps in this direction.

- ***The format for performance reporting is unwieldy and unclear.*** The Government should consider a new form of reporting that is more descriptive and explanatory.

The new Government has an opportunity to address the outstanding reporting issues as a matter of priority, and to establish a new reporting foundation in keeping with transparent and clear accountability to the Legislative Assembly and the public. The Government should act quickly.

Recommendations on Making Financial Reporting Transparent

We recommend that the Government move now to fully adopting Generally Accepted Accounting Principles (GAAP) for public sector bodies in its presentation of the financial position and results of the Province. This will give Manitobans a more accurate and consistent accounting of the Province's financial situation.

We recommend that the Government consider a new form of reporting that is more descriptive and explanatory, such as an annual report that includes:

- the consolidated financial position and results of the consolidated reporting entity (i.e. the entire government);
- discussion and analysis of the financial statements, with commentary from the Minister of Finance on the financial management strategies employed during the year and their outcomes; and,
- information on the Legislature's accountability for the taxation, departmental and federal transfer revenues and expenditure appropriations that are under its authority.

We recommend that the Government align the basis of annual reporting with the basis of budget planning so that the performance compared to budget is both transparent and easier to understand.

We recommend that the Government determine how the fiscal principles inherent in the balanced budget legislation compare with its long-term fiscal policy objectives. We recommend that the Government then amend the balanced budget legislation so that it is consistent with a clearly defined financial management framework and establish a basis for determining compliance with legislation.

We recommend that the Government present the consolidated financial position (i.e., Volume 3) as the primary picture of the Province's financial position. Further, we recommend that the Government change the presentation of the existing Volume 3 so that the Government's financial statement reflecting the entire government reporting entity also shows annual performance relative to the Government's stewardship of taxation, departmental and federal revenues, debt management and expenditure control.

With these actions, the Government will be better positioned to establish and follow a solid financial management and reporting framework. This will strengthen its ability and capacity to effectively manage the Province's finances and to keep the Legislature and the public more fully informed.

We have found the review process distinctly challenging, and have attempted to provide advice that we believe will be of benefit to the Government as it chooses its future course in managing the finances of the Province. We are grateful for the cooperation and assistance of provincial government officials in being accessible for meetings through the course of our review and responding to our requests for information and explanation.

I. INTRODUCTION

This document is the final Phase I report of Deloitte & Touche LLP to the Government of Manitoba on the Financial Review started in late October 1999 and ending in February, 2000.

A. TERMS OF REFERENCE

Following the issuing of a Request For Proposals on October 18, 1999 and the completion of a competitive process, the Government has engaged Deloitte & Touche LLP to undertake a two-phase review to establish the financial picture facing the Province.

The new Government of Manitoba wants to have a comprehensive picture of its actual starting position from a financial perspective. The Government also wants to have a clear understanding of the implications of its financial circumstances for this year and for subsequent years. With this information, the Government will be better able to set its budgetary and financial management course.

The terms of reference for the review included a five year perspective, starting in 1997/1998 and extending to 2001/2002. This longer-term perspective is essential to understanding the current situation and how it arose, as well as providing a foundation for defining expectations for future years.

PHASE I – FINANCIAL REVIEW

Deloitte & Touche LLP has been asked to estimate, with the greatest possible accuracy, those obligations which the Government must meet for the current year, the revenues it will have to do so, and the impact of the current year situation on the next fiscal two years – April 1, 2000 to March 31, 2002.

The firm has also been asked to identify the implications of this situation on (a) the Province's ability to meet debt repayment schedules under *The Balanced Budget, Debt Retirement and Taxpayer Protection Act* and (b) the ability to meet anticipated demand for public services.

The review was directed to cover 41 organizations that are Government Departments, Crown Organizations, Crown Enterprises, or Special Funds (herein called entities):

- ***Government Departments:*** organizations that are under the direct control and authority of the Government and are responsible to a Cabinet Minister.

- ***Crown Organizations:*** organizations which are funded by and responsible to the Government through a Department and/or Cabinet Minister, but which are not under the Government's direct control and authority.

- ***Government Enterprises:*** Crown corporations or agencies which are not funded from Government directly but operate with a legislated mandate and are responsible to a Cabinet Minister.

- ***Special Funds:*** distinct special purpose funds apart from the Government's Operating Fund, which house revenues from specified sources in accordance with legislation.

The 41 entities reviewed are listed in Appendix A.

PHASE II – EXPENDITURE MANAGEMENT REVIEW

As a second and related phase of work, Deloitte & Touche LLP has been asked to examine the process by which budgets are developed and make recommendations on how to improve the accuracy of future budgets. The firm has also been asked to consider the process the Government uses to ensure expenditure performance to approved budgets. The report on this phase of our review work will be issued separately.

Since 1995, the Government has spent or has commitments related to information management and information technology projects exceeding $500 million. Accordingly, based on direction from the Steering Committee, we placed a particular focus on a review of this investment. Our findings are provided in a separate report, **Information Technology Major Initiatives Review**.

B. THE REVIEW PROCESS

The review process included a project governance mechanism, guiding considerations, and our approach to obtaining and reviewing entity information.

1. PROJECT GOVERNANCE: STEERING COMMITTEE

The Minister of Finance appointed a Steering Committee chaired by Ron Hikel and including senior provincial officials, the Provincial Auditor, and a representative of the business community, to oversee the review process. In addition to the Committee Chair, the membership includes: Pat Gannon, Deputy Minister of Finance; Don Potter, Secretary to Treasury Board; Jon Singleton, Provincial Auditor; Jim Eldridge, Clerk of the Executive Council; and Bev Suek, Director of TLS Enterprises. Deloitte & Touche LLP met with this group regularly to report progress and discuss issues raised in the course of the review.

The Steering Committee provided guidance on the work plan and process and reviewed and commented on draft reports. We appreciate their assistance and support throughout the process, particularly their flexibility in allowing additional time for us to complete review activities so that we might report on them more fully.

2. GUIDING CONSIDERATIONS

A number of considerations have framed this review:

2.1 The Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants (CICA) and Generally Accepted Accounting Principles (GAAP)

A significant attribute of financial reporting is the application of consistent accounting treatment, both between periods for the same entity and between similar types of entities. As a means of achieving consistency amongst various public sector entities, the Canadian Institute of Chartered Accountants (CICA) has authorized its Public Sector Accounting Board (PSAB) to issue recommendations and guidance with respect to matters of accounting in the public sector. We have used this guiding framework as we conducted our review.

Accounting is the process of measuring, recording, classifying, summarizing, communicating and interpreting economic activity. We live in an era of accountability and accordingly, the nature of accounting and the function that it fulfills is vital to all units of society including government. For government, the use of accounting as a basis for controlling its resources and measuring its accomplishments is critical. The underlining purpose of accounting is to provide financial information to assist in the decision-making process about the entity being reported upon. Financial statements provide the most important method for communicating this financial information.

In Canada, the Canadian Institute of Chartered Accountants (CICA) is the most prominent and influential group in the development and improvement of financial reporting and accounting practices. According to the Canadian Institute of Chartered Accountants (CICA) Handbook, *"the objective of financial statements is to communicate information that is useful to . . . users in making their resource allocation decisions and/or assessing management stewardship. Consequently, financial statements provide information about; (a) an entity's economic resources, obligations and equity/net asset, (b) changes in an entity's economic resources, obligation and equity/net asset, and (c) the economic performance of the entity"*. (CICA Handbook S 1000.15.) The CICA Handbook goes on to state that the four principal qualitative characteristics of financial statements are their understandability, relevance, reliability, and comparability.

To ensure that financial statements remain understandable and relevant, they must comply with an overriding set of principles referred to as "Generally Accepted Accounting Principles" (GAAP). The term Generally Accepted Accounting Principles encompasses the rules, practices and procedures related to particular circumstances in the preparation of financial reporting and also broad principles and conventions of general application. The purpose of these broad rules is to guide in the measurement and reporting of financial events that make up the life of an entity. CICA has issued a number of significant recommendations on accounting standards that are contained in the CICA Handbook and are considered as Generally Accepted Accounting Principles.

For an entity's financial information to meet the qualitative characteristics of understandability, relevance, reliability and comparability, Generally Accepted Accounting Principles must be followed. If financial statements are not based on GAAP, they can often lead to misleading understanding of the financial position being reported. As well, information may be provided in such a manner that it would not be (a) relevant to the users, or (b) reliable (as it may not faithfully represent the underlying economic activity that has occurred in a neutral and conservative way). Lastly, if a consistent set of Generally Accepted Accounting Principles has not been applied, a comparability of financial information from one period to another and from one similar entity to another is compromised.

Generally Accepted Accounting Principles (GAAP) are the cornerstone of the CICA's foundation for proper financial reporting. Each year, the Provincial Auditor assesses the Government's adherence to GAAP, and in a number of past reports he has qualified his opinion due to the lack of full GAAP reporting.

In the course of our report, where the Government's financial reporting has not been or is currently not in accordance with GAAP, this fact is noted.

2.2 Independence

As outlined in our proposal to the Province, we identified three entities with which we have had professional service relationships within the past two years. To be certain that the reviews of these entities were independent, we engaged individual contractors to handle selected reviews. Wintemute Randle Kilimnik completed the review work related to Manitoba Lotteries Corporation, Manitoba Housing, and the Manitoba Housing and Renewal Corporation. G. Braha & Associates Ltd. conducted the review related to the Better Methods implementation, and the report on this review is included with our separately released report **Information Technology Major Initiatives Review**.

2.3 Materiality

Given the urgency of the Government's need to come to conclusions quickly about the current financial situation, the terms of reference for the review established a materiality provision as follows:

> *For purposes of this review, transactions or programs should be considered to be material if they have the potential to result in adjustments in the $10 million range for 1999/2000 or any prior period, where this is justified. In addition, consideration should be given to potential adjustments which during the present fiscal year may be less than this, but which represent a material potential cost in future years.*

2.4 Focus on Financial Results

This is a financial review and is **not an audit** of the Government of Manitoba or any of its entities, and as well **is not directed to questions of performance of programs in meeting their objectives**. The review is focused on understanding the current year's projected financial results compared to the approved budget for 1999/2000, and is not intended to assess the value provided by specific revenues and expenditures.

In establishing the exact nature of the work that we would undertake, we were guided by the principles set out in the General Review Standards of the Canadian Institute of Chartered Accountants (CICA). Section 8100 of the CICA's Assurance Recommendations indicates that:

> *"Reviews are distinguishable from audits in that the scope of a review is less than that of an audit and therefore the level of assurance provided is lower. A review consists primarily of enquiry, analytical procedures and discussion related to information supplied to the public accountant by the enterprise . . . A review consists primarily of (a) making enquiries concerning financial, operating, contractual and other information, and considering responses that, in addition to oral responses, may take the form of listings, schedules or other documents; (b) applying analytical procedures such as comparing the current and prior period information and considering the reasonableness of financial and other inter-relationships; (c) having discussions with appropriate officials of the enterprise concerning information received and the information being reported on."*

2.5 Reliance on Information Provided by Provincial Officials

To establish the picture of the Government's financial position, we have reviewed and analyzed information provided by provincial officials, looking at multiple sources (e.g., Treasury Board and individual Departments) where possible in order to ensure consistency and completeness. Within the time constraints imposed by review, we have sought corroboration regarding information provided by provincial officials. However, as confirmed with the Steering Committee at the commencement of Phase I work, **we have not conducted a substantive and direct verification process with respect to expenditure or revenue projections for individual Departments and programs.** The timeframe for the review did not allow for this analysis.

Over the course of the review, our ongoing discussions with provincial officials on a variety of issues led to a number of results:

- Our examination triggered a comprehensive review of asset valuation by departments far earlier in the year than it would otherwise have taken place.
- We contributed to discussions between the Minister of Finance and the Provincial Auditor with respect to the implementation of Generally Accepted Accounting Principles (GAAP) for financial reporting.
- We highlighted the size of the structural deficit.

We participated in extensive discussions on the issue of asset valuations, and gave consideration to several proposals for changes from provincial officials. In most instances, additional provisions were not necessary. In other instances, we agreed with the approach being put forward.

3. Approach to Obtaining and Reviewing Entity Information

The large and complex task of obtaining and reviewing information from the 41 entities required a systematic and iterative approach to dealing with provincial officials and documentation.

3.1 Orientation and Direction

As indicated, we met regularly with the Financial Review Steering Committee during the course of the assignment. During these meetings, we reported on the status of our work, discussed issues that had arisen since we had last met, and received direction with respect to specific issues that the Committee members believed should be reviewed. At the outset of the review, we sought the Steering Committee's guidance and direction on how best to proceed in dealing with the 41 entities, and followed through based on that advice.

In order to get an overview and initial orientation to the whole Operating Fund picture, we started with the perspective of central agency officials. We met with Treasury Board Secretariat staff and reviewed documentation prepared by them that contained financial information entity by entity and that also summarized information across entities. Through a series of meetings and the joint review of briefing documents that had been compiled by Treasury Board staff, we obtained an overview understanding of key issues and considerations relevant to our review of the individual entities. We used this grounding to support our subsequent review of the entity material and our discussions with entity officials.

We also met with the Provincial Auditor and his staff on several occasions to understand their broad perspective on a variety of issues relevant to our review. As part of these discussions, we sought assistance from the Provincial Auditor's Office in the identification of risk areas.

3.2 Gathering and Reviewing Entity Information

At the beginning of the financial review process, the Chairman of the Financial Review Steering Committee wrote directly to the senior officials of each of the 41 entities requesting the information noted in Appendix B. This material was subsequently forwarded to Deloitte & Touche and we assigned a working team of specialists to the review of each of the entities.

Appendix C lists the more than 300 documents and reference materials we examined in the course of our review. The working teams for each entity reviewed the material that was submitted and then met with representatives selected by the Deputy Minister or organizational head to discuss, confirm, and clarify the information provided. The number of meetings with officials depended on the magnitude and complexity of the entity and/or its financial issues. Appendix D lists in excess of 130 interviews and discussions that occurred over the course of the assignment.

Our interaction with entity officials focused on points of variance from approved budgeted expenditures or revenues. In the course of our discussions, we sought evidence to verify or corroborate the variance information that we had originally received. This evidence was normally provided through corroboration of the information by independent parties and from relevant documentation that supported the variance.

3.3 Entity Reporting

To ensure that the review process captured the entity by entity findings correctly, the Steering Committee asked that we prepare a separate report on each entity for our working files, according to the guidance contained in Section 9100 of the Assurance Handbook of the Canadian Institute of Chartered Accountants. Accordingly, each report sets out the procedures undertaken as part of the Phase I work (i.e., who we met with and which documents we reviewed) as well as the results of our completing these procedures. Generally, these results were reported under the following categories:

- Overview
- Summary of Our Work
- Historical Financial Perspective
- 1999/2000 Projected Results
- Looking Ahead to 2000/2001 and 2001/2002
- Future Issues Affecting Observations
- Other Observations (if any)

Each entity report sets out the procedures undertaken as part of Phase I work on the entity as well as the results of our completing these procedures. As required, we prepared individual reports on each of the 41 entities.

3.4 Confirmation of Findings by Senior Entity Officials

Given the extent of the review process and the importance of ensuring accuracy and completeness of our findings, we worked with the Chairman of the Financial Review Steering Committee to establish a process for senior officials to formally (in writing) confirm the information contained in each of the entity reports. Accordingly, the reports that were prepared by us for each entity were then provided to senior officials (e.g., Deputy Ministers of departments) in draft form for their review.

Following their review of the reports, and after we made changes as needed, senior officials were asked to provide a sign-off (see Appendix E for the sign-off letter) on the reports for their entities, thereby documenting their representations to us about the completeness and accuracy of the entity reports. For the departments, we met with each Deputy Minister to discuss his or her comments and observations on the reports prior to completing the sign-off process.

The 41 signed entity reports have served as significant input documents in the preparation of this final report.

C. COMPONENTS OF THE PROVINCIAL PICTURE

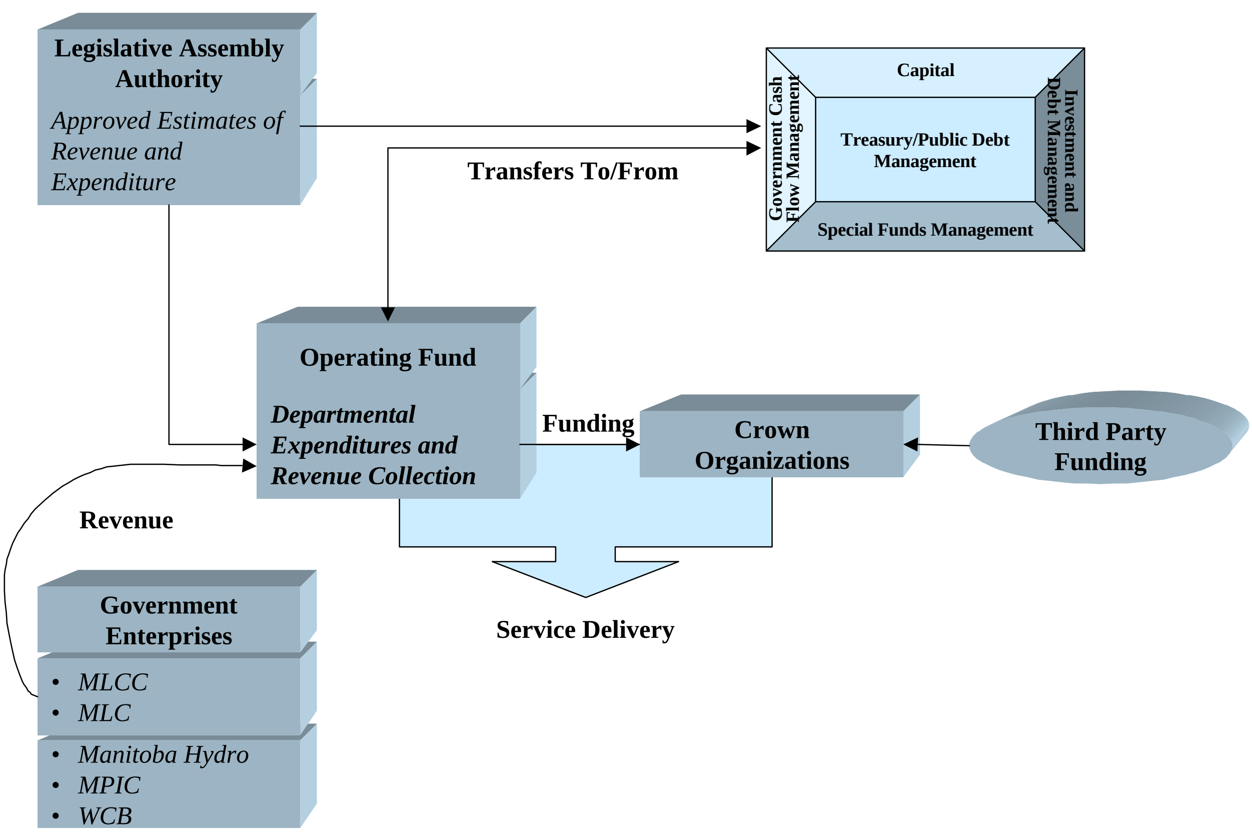
The mandate provided to us by the Financial Review Steering Committee of the Province set out four different types of organizations that were to be included within the scope of the review:

- Departments;
- Crown Organizations;
- Government Enterprises; and,
- Special Funds.

These four are the component parts of the Province's aggregate financial position, so we have used these four categories of entities to frame our perspective of the various components of the Province's financial landscape.

A description of the four categories is included in Appendix F. Their relationships in the context of government finances are illustrated in Exhibit 5.

Exhibit 5 – Understanding of Government Finances



D. ORGANIZATION OF THIS REPORT

In undertaking to report on a review of this complexity, it is essential to provide the reader with a logical and clear narrative that captures the essence of the review process and results. We have endeavoured to meet this objective and at the same time reflect carefully and comprehensively the substance of our findings.

We have organized the report into six chapters, starting with an introduction that provides the reader with the context for the review and an understanding of how we proceeded. The second chapter, ***Assessment of the Government's Financial Position***, is central to understanding the Government's current financial circumstances and how they came about. Another key theme captured in Chapter II is a look ahead to the next two years, noting the implications of an array of financial pressures that have been identified by provincial officials.

Chapter III, ***Analysis of the Financial Condition of the Province***, reports on an examination of the underlying financial health of the Province – a foundation that is pivotal to the Government's ability to plan its financial course.

Given an appreciation of the Government's current financial state (Chapter II) and the underlying financial condition of the Province (Chapter III), the reader is subsequently provided with a description of key findings and recommendations related to financial management (Chapter IV) and financial reporting (Chapter V). Our report ends with Chapter VI, detailing our conclusions and recommendations for the Government's consideration.

Chapter I	Introduction	Description of the terms of reference for the review, the review process, the components of the Province's financial picture, and the organization of the report.
Chapter II	Assessment of the Government's Financial Position	Examination of the underlying financial situation as reflected in a five-year perspective: the previous two years, the current year, and the next two years.
Chapter III	Analysis of the Financial Condition of the Province	Examination of the sustainability, flexibility and vulnerability of the Province's basic financial condition.
Chapter IV	Financial Management Issues and Recommendations	Findings and advice related to financial management aspects of the Government's situation in 1999/2000 and beyond.
Chapter V	Financial Reporting Issues and Recommendations	Findings and advice related to financial reporting aspects of the Government's situation.
Chapter VI	Our Conclusions	Highlights of our findings and advice to the Government on next steps.

II. ASSESSMENT OF THE GOVERNMENT'S FINANCIAL POSITION

We were asked in this review to estimate the Government's expenditure obligations for the current year, the revenue it will have to meet those obligations, and the impact of the 1999/2000 situation on the next two years. The objective was to produce a general picture of the Government's financial position.

We have identified six key factors shaping the overall financial reality. These factors must be understood to have an appreciation of the Government's financial position. They are:

- The legislative environment, including the balanced budget legislation;
- The main tools that the Government uses for public debt management;
- The principal fiscal management tools;
- The Operating Fund, from which the costs of government are met;
- The role of Government Enterprises as part of the main business of the Government; and,
- The Government's unfunded pension liability.

A. LEGISLATIVE IMPERATIVE: BALANCED BUDGETS

The Balanced Budget, Debt Repayment and Taxpayer Protection and Consequential Amendments Act (balanced budget legislation) became effective in November, 1995. It contains three major provisions:

1. BALANCED BUDGET/NO DEFICIT PROVISIONS

The Act stipulates that the Government cannot incur a deficit unless one of three specific circumstances arises:

- a serious disaster has occurred;
- war; or,
- reduction in revenue in a single year of 5% or more.

In the absence of one of these events, if the Government incurs a deficit, financial penalties are applied to members of Executive Council (Cabinet Ministers). Furthermore, the Act requires that any deficit incurred in one year must be offset by an equal or greater surplus in the subsequent year.

However, Section 4(2) of the Act indicates that *"if there is a general election and the party forming the government after the election is different from the party forming the government before the election, Subsection (1)*[the provision that a deficit be offset with a equal or greater surplus in the next fiscal year] *does not require the government after the election to achieve an offsetting surplus in connection with the deficit incurred in the fiscal year during which the election took place"*.

In this regard, there is no clear cut-off point at which the obligations of one government come to an end and a new government becomes responsible for financial outcomes. For instance, there is no clarity regarding the application of the Act in the event that financial outcomes are affected by decisions of a new government subsequent to an election. Such decisions could include policy decisions to make expenditures or valuation determinations that might lead to the recording of write-downs of investments in government accounts.

Attribution of expenditures to either an incoming or outgoing government would require judgements regarding when the circumstances arose that necessitated the expenditures. In any event, all recorded expenditures and valuation provisions must still be sanctioned as appropriate transactions by the Provincial Auditor in order for his opinion on the reported financial results to be without reservation or qualification.

The Government has obtained legal opinions on the provisions of the balanced budget legislation upon a change in government. We understand that these opinions indicate that a new government would not be required to run an offsetting surplus in its first budget should a deficit be incurred in the transition year. Similarly, the opinions suggest that the penalty provisions under the Act are not applicable to members of the outgoing administration which prepared the budget for the year in question, or to the incoming administration which has yet to present its first budget. As well, the legal opinions suggest that there is no requirement to offset any deficit by transfers from the Fiscal Stabilization Fund.

Finally, with respect to the Fiscal Stabilization Fund, the Act states that a targeted balance for the Fund should be 5% of operating expenditures or approximately $300 million. However, the Act does not mandate this targeted balance. Rather, the Act states that a Minister should "make every effort" to ensure that the Fund reaches at least the targeted level.

2. DEBT RETIREMENT

The balanced budget legislation contemplates that the provincial debt will be retired by approximately 2030 and at least a minimum amount will be paid on the debt each year. The payment for 1999/2000 is set at $75 million, with the required payment for 2000/2001 being approximately $96 million. These payments are treated for purposes of the balanced budget legislation as expenditures within the current year's Operating Fund transactions, although we note that this approach is not in accordance with Generally Accepted Accounting Principles (GAAP). The legislation currently does not refer to the unfunded pension liability.

3. TAXPAYER PROTECTION

Taxpayer protection relates to the balanced budget legislation that requires a referendum in the event that the Government entertains the prospect of increasing the rates of major taxes such as personal and corporate income tax, the health and education levy, and retail sales taxes. This requirement significantly limits the Government's flexibility to increase revenues from existing own-source revenues.

B. PUBLIC DEBT MANAGEMENT

Public debt management is comprised of several activities, including:

- Monitoring the Province's cash flow and debt requirements for both operating and capital items;
- Undertaking capital market activities to finance cash requirements, and managing the investments of specific funds as required;
- Managing interest rate, currency risk, and credit risk of the Province and agencies; and,
- Managing and monitoring public debt costs.

1. BORROWINGS

The Province has borrowed money for a variety of reasons, including raising the financing for:

- Loans made to Government Enterprises, such as Manitoba Hydro and to Crown organizations such as Manitoba Housing and Renewal Corporation;
- Capital asset purchases that will be used and paid for over a period of years;
- Past Operating Fund deficits and past allocations to the Sinking Fund; and,
- Investments made by the Province, such as those made by the Department of Industry, Trade and Mines.

At March 31, 1999, the Province's most recent year end, aggregate borrowings were approximately $18.6 billion (including Government Enterprises). These were offset by a sinking fund consisting of investments in the order of $5.8 billion, held for the purpose of repaying the debt. Net borrowings therefore amount to about $12.8 billion. Of this amount, about $5.2 billion is related to borrowings for loans to Manitoba Hydro. Much of the remainder of the debt arose in past years to fund tax supported programs.

2. NEW CAPITAL ASSET ACCOUNTING POLICY

A new public debt issue relates to the new capital asset accounting policy, which applies to provincial assets. Other assets, such as hospitals and schools are not affected by this policy as they are recorded in the Crown and related organizations that own them.

Before the 1999/2000 year, capital expenditures were recorded as costs of the Operating Fund in the year they were incurred and were funded out of current revenues. Beginning with the 1999/2000 year, non-infrastructure capital asset purchases are budgeted for separately and are to be financed by new borrowings. The capital assets are then to be charged to the Operating Fund by means of an annual amortization expense over their useful lives. Borrowings are then to be paid off according to the terms of the debt that have been arranged. The original approved Capital Expenditure Estimate for 1999/2000 was $113.3 million.

The annual aggregate amortization charges against the revenues of the Operating Fund are obviously not a cash expenditure, since the purchases of the capital assets were initially funded by debt. Therefore, an amount equal to the amortization should be available for cash payments against the debt.

As a consequence of this new policy, debt will be incurred for the acquisition of capital assets whereas it would not have been under the former policy. This will lead to increases in public debt that are not provided for in the current balanced budget legislation. The change has introduced a new dynamic into the management of the Province's debt and has the following implications:

- Debt retirement associated with the annual amortization of the capital assets is not currently contemplated by the debt retirement provisions of *The Balanced Budget, Debt Retirement and Taxpayer Protection Act* (balanced budget legislation). The provisions of the balanced budget legislation need to be integrated with the plans to retire debt incurred to fund capital expenditures.

- As the need to retire debt raised for capital purposes commits future cash flows, it is desirable that an overall long-term framework that integrates capital requirements of government be developed. This framework would ensure that there are no unexpected negative long term implications of capital decisions in any given year. However, we are not aware that a longer term framework has been developed to plan, monitor and control the extent of annual capital purchases and the resulting additional debt burden.

3. MITIGATING RISK

The principal risk affecting the management of public debt within the context of the entire expenditure budget of the Operating Fund is the variability of public debt costs or interest. The variability is, of course, affected by both the amount of debt, the borrowing rate, and currency fluctuation.

The amount of debt has been managed in recent years based on the provisions of the balanced budget legislation and the borrowing authorities available under *The Financial Administration Act*. Provincial officials have indicated that various strategies have been employed over time in an effort to reduce effective borrowing rates. Currently, these strategies include:

- *Utilizing the flexibility provided by the investments within the Sinking Fund to try to arrange the optimal timing for transactions in the capital markets.*

- *Reducing foreign currency denominated debt.* The Province no longer has any exposure to foreign currency other than US dollars. Exposure has been reduced from 33% in 1995 to 18% today. This reduction mitigates the risk of significant fluctuations in debt costs because of changes in foreign currency rates.

- *Holding a mix of fixed rate and floating rate debt to enable the Province to benefit from ongoing changes to market interest rates.* Currently, the Province's practice is to have approximately 15% to 20% of its borrowings in variable interest rate instruments, down from 27% in 1996.

4. The Sinking Fund

As described earlier, the Sinking Fund is comprised of investments that are held for the purpose of retiring debt. Accordingly, it is used by Manitoba Finance primarily as a liquidity management tool. For instance, cash that is to be used to repay debt is invested in the Sinking Fund until the maturity of the debt issue it is to be used to repay. In other instances, gross borrowings have been increased to fund growth of the Sinking Fund.

Manitoba Finance has indicated that Sinking Funds continue to be useful in managing public debt costs, and add greater stability to the Province's refinancing activities.

C. MANITOBA'S FISCAL MANAGEMENT TOOLS

The Government has two primary fiscal management tools – the Fiscal Stabilization Fund and the Debt Retirement Fund.

1. Fiscal Stabilization Fund

The Fiscal Stabilization Fund was established through the proclamation of *The Fiscal Stabilization Fund Act* in December, 1989. The purpose of the fund is to assist in stabilizing the fiscal position of the Government from year to year and to facilitate the Government's long term fiscal planning. The Act sets a target level for the Fund equal to 5% of the Operating Fund expenditure estimates. Based on an annual expenditure budget of approximately $6 billion, the target level is in the order of $300 million.

As of April 1, 1997, the fund contained a balance of $577 million as a result of the following transactions since its inception, as noted in Exhibit 6.

Exhibit 6 – Fiscal Stabilization Fund Transactions Since Inception *(in millions)*

Redemption of preferred shares formerly owned in Repap Enterprises Inc. (1996)	$20
Net transfers from the Operating Fund	
• *Re: sale of Manitoba Data Services (1991)*	18
• *Re: sale of Manitoba Telecom Services Inc. (1997) – gross proceeds net of amount used for health capital debt repayment*	265
• *Re: other (net surplus/deficit of 1989, 1991-1994, 1996, 1997)*	161
Interest Earnings on Fund Balance	113
Balance as at April 1, 1997	$577

A summary of the transactions of the Fiscal Stabilization Fund since April 1, 1997 is provided in Exhibit 7.

Exhibit 7 – Fiscal Stabilization Fund 1998-2000

	Year Ended March 31			
	Actual		*2000*	
(in millions)	*1998*	*1999*	*Budget*	*Projected*
Balance of Fiscal Stabilization Fund, beginning of year	$577	$565	$427	$427
Interest earnings	12	17	11[1]	11
Net Transfers out to the Operating Fund	(24)	(155)	(163)[2]	(185)
Balance of Fiscal Stabilization Fund, end of year	$565	$427	$275[3]	$253

[1] Amount as per the 1999/2000 second quarter report.
[2] $184 million transfer net of budgeted $21 million surplus for 1999/2000.
[3] Differs from the budgeted March 31, 2000 balance set out in the 1999/2000 budget document because the actual opening balance for the 1999/2000 year was $47 million higher than the estimated "starting position" in the budget.

As indicated in the exhibit, the Fiscal Stabilization Fund presently has $253 million available, assuming the transfer out of $185 million this year.

2. Debt Retirement Fund

The balanced budget legislation requires that as Government reduces the amount of the Province's debt and thereby achieves reductions in public debt costs, these cost savings are to be added to the required amount of debt reduction in future years. The objective of this provision is to have aggregate annual payments toward public debt costs and debt retirement remain approximately constant until the entire debt is repaid.

The Government may apply more towards retiring the debt if it so desires, and has done so once. In 1998/1999, an additional $75 million was transferred to the Debt Retirement Fund. Total transfers to the fund to be used to reduce provincial debt have amounted to approximately $300 million, as illustrated in the Exhibit 8.

Exhibit 8 – Debt Retirement Fund

	Year Ended March 31		
	Actual		*Budget*
(in millions)	*1998*	*1999*	*2000*
Balance of Debt Retirement Fund, beginning of year	-	$76	$230
Interest earned	1	4	-
Deposits to the Fund from the Operating Fund	75	150	75
Withdrawal to pay down general purpose debt	-	-	(305)
Balance of Debt Retirement Fund, end of year	$76	$230	-

As noted earlier in this report, the Government has obtained legal opinions that it does not have discretion as to the amount to be contributed to the Debt Retirement Fund in the fiscal year in which it assumes office. Instead, the contribution must be made according to the prescribed formula. As well, it should be noted that in spite of the additional payment of $75 million made towards the Debt Retirement Fund in the 1998/1999 year, this does not reduce the obligation for payments to be made in subsequent years. The 1999/2000 obligation remains at $75 million. In 2000/2001 the obligation increases to $96 million.

D. THE OPERATING FUND

As the centrepiece for Government revenues and expenditures, the Operating Fund is a focal point when assessing the Government's financial position. Annual estimates for Operating Fund revenues and expenditures are authorized by the Legislative Assembly. The Government reports back to the Legislature on the Operating Fund's performance after the end of the fiscal year. This is its principal means of public accountability.

In this section, we describe the key components of the Operating Fund, identify significant trends over the past two years, estimate results for the current year, note issues that may affect future operations, and give special attention to Crown organizations.

1. COMPONENTS OF THE OPERATING FUND

The Operating Fund has four components: revenue, expenditures, debt repayment requirements, and transfers from the Fiscal Stabilization Fund.

1.1 Revenues

The Province's Operating Fund has three primary sources of revenue, as noted in Exhibit 9.

Exhibit 9 – Operating Fund Revenue Sources for 1999/2000

Revenue Source	***1999/2000 Estimates (in millions)***	***Description of Revenue***
Taxation	$3,569	**Manitoba Consumer and Corporate Affairs** • Insurance corporations tax • Land transfer tax. **Manitoba Conservation** • Oil and natural gas tax **Manitoba Finance:** • Individual income tax • Corporate income tax • Retail sales tax • Levy for health and education • Corporation capital tax • Tobacco tax • Several other taxes
Federal Government	$1,723	• Equalization payments • Canada Health and Social Transfer • Other transfer payments • Cost-shared agreements
Other Revenues	$790	• Departmental activities • Payment of net surpluses from Manitoba Lotteries Corporation and Manitoba Liquor Control Commission • Revenue sharing from Special Operating Agencies • Sales of government assets • Allocations from the Fiscal Stabilization Fund[1]
Total	$6,082	

[1]As noted previously, transfers from the Fiscal Stabilization Fund are not to be considered revenue in accordance with Generally Accepted Accounting Principles.

The amount of equalization payments that the Province receives is affected by the amount of per capita revenue that is collected for the previous year, various population statistics and a variety of other factors. Generally, if Manitoba's per capita revenues rise in relation to per capita revenue in the "standard" provinces (British Columbia, Saskatchewan, Manitoba, Ontario and Quebec), its entitlement under equalization decreases. Conversely, if per capita revenues fall in relation to per capita revenue in the "standard" provinces, equalization revenues would usually increase.

1.2 Expenditures

The Departments we examined are responsible for the great majority of the annual expenditures from the Operating Fund. However, other expenditures are made from enabling appropriations and other appropriations, as described in Exhibit 10.

Exhibit 10 – Operating Fund Expenditure Categories

Nature of Expenditure	1999/2000 Estimates (in millions)	Description
Departmental	$5,838	These expenditures are the responsibility of individual government departments that fulfill their respective mandates using these monies. Individual departments are responsible for the management and monitoring of expenditures within their approved budgets.
Enabling Appropriations	$41	Enabling appropriations are under the control of Treasury Board and serve as the budgets for categories of recognized expenditures, but for which the amounts are not known at the time the annual estimates are prepared. Enabling appropriations make provision for items such as various special initiatives of the Government, wage settlements, and costs for activities to be undertaken in accordance with federal-provincial agreements.
Other Appropriations	$107	Other appropriations, also under the control of Treasury Board, serve as the budgets for categories of expenditures that are recognized will be incurred, but for which projects are to be individually approved prior to being commenced. Accordingly, these appropriations make provisions for emergency expenditures, capital initiatives and a variety of other commitments to spend on certain initiatives or pursuant to certain agreements.
Total	$5,986	

1.3 Debt Repayment Requirements

The Government is required by the terms of the balanced budget legislation to make contributions to the Debt Retirement Fund. The amount of the required payment for 1999/2000 is $75 million. For 2000/2001, the required amount is approximately $96 million.

1.4 Transfers from the Fiscal Stabilization Fund

The balanced budget legislation permits transfers of monies from the Fiscal Stabilization Fund to be reflected as revenues of the Operating Fund. The ability to utilize the Fiscal Stabilization Fund in this fashion provides a "fiscal shock absorber" to assist the Operating Fund budget to be "balanced" over a period of time.

The 1999/2000 budget contemplated a transfer of monies into the Operating Fund from the Fiscal Stabilization Fund. Accordingly, the "other revenues" of $790 million identified in Exhibit 9 include a planned transfer from the Fiscal Stabilization Fund of $184.7 million.

As the Provincial Auditor has noted in his annual reports, the Government's treatment of transfers from the Fiscal Stabilization Fund as revenues is not in accordance with GAAP.

2. Significant Trends Within The Operating Fund Over The Last Two Years

The results of the Operating Fund, as presented in Volume 1 of the Province's financial statements for the past two years, can be summarized in Exhibit 11.

Exhibit 11 – Previous Years' Operating Fund Results

	1997/1998 (in millions)		1998/1999 (in millions)	
Revenues	**Original Budget Estimates**	**Actual**	**Original Budget Estimates**	**Actual**
Taxation	$3,169	$3,251	$3,345	$3,701
Other	588	607	605	622
Federal Government	1,555	1,884	1,733	1,559
	5,312	5,742	5,683	5,882
Expenditures	5,310	5,691	5,736	5,886
Surplus (Deficit) Before Transfer from the Fiscal Stabilization Fund and Debt Retirement Payment	2	51	(53)	(4)
Debt Retirement	(75)	(75)	(150)	(150)
Surplus (Deficit) Before Transfer from Fiscal Stabilization Fund	(73)	(24)	(203)	(154)
Transfer from Fiscal Stabilization Fund	100	100	226	185
Budgetary Surplus	$27	$76	$23	$31

This budget to actual picture for the past two years illustrates significant variances in both revenues and expenditures, with a clear pattern of revenue increases being available to offset the impact of major overexpenditures. This pattern has continued into the current fiscal year.

2.1 Key Revenue Trends 1997-1999

As shown in Exhibit 11, the following revenue trends are evident over the last two years:

- **Actual vs. Budget** – actual revenues received by year end exceeded budgeted revenues by $430 and $199 million respectively over the last two years. This trend of actual revenues substantially exceeding initial estimates continues in the current year. In 1997/98, the excess was used primarily to support increased expenditures, including Manitoba's costs associated with the 1997 flood. The positive revenue variance in 1998/99 was again used to offset increased expenditures, but also to reduce the amount of the transfer from the Fiscal Stabilization Fund. For 1999/2000, the increased revenues will again offset a substantial portion of the increased expenditures.

  As Exhibit 11 indicates, revenue from taxation was significantly up from budget to actual in 1998/1999, due primarily to the delayed tax revenue from the extension of the income tax filing deadline for Manitobans affected by the 1997 flood. However, this increase in tax revenue caused a corresponding decrease in federal government equalization transfers for that year.

- **Taxation Revenues –** the actual $450 million increase in these revenues over the two years was attributable to strong growth in corporate and individual income taxes as well as retail sales tax. Concurrently, personal income tax revenues have been affected by federal and provincial income tax rate reductions in 1998/99.

- **Other Revenues –** the increase is largely from transfers from the Manitoba Lotteries Corporation and the Manitoba Liquor Control Commission.

- **Federal Government –** the decline in actual federal revenues of $325 million in 1998/1999 is the result of reduced equalization payments of $252 million, reduced revenues for emergency expenditure recoveries of $140 million, increased revenues of $45 million with respect to a transfer of responsibility for the Labour Market Development Agreement expenditures, and an increase of $22 million related to various other revenue changes. The variability of federal government revenue depends on cost-sharing agreements, the economic situation respecting tax revenue, and the impact of these factors on equalization.

2.2 Key Expenditure Trends 1997-1999

Our analysis of the past two years pointed to these trends:

- **Budget vs. Actual –** over this period, actual expenditures exceeded the budget amounts by $381 million and $150 million respectively. Key observations on these substantial additional expenditures are as follows:

  - the 1997/98 variance was partially attributable to emergency expenditures, including the costs of the 1997 flood, which were about $190 million higher than the initial budget provisions for emergency expenditures;

  - the source of these variances can be determined with reference to which departments required Special Warrants to increase their expenditure authority as previously approved by the Legislature. Departments with Special Warrants in excess of $5 million in the two preceding years are noted in Exhibit 12.

Exhibit 12 – Previous Years' Special Warrants

Department	*1997/98 Special Warrants (in millions)*	*1998/99 Special Warrants (in millions)*
Family Services	$11.8	$6.8
Health	98.6	110.3
Justice	6.2	8.0
Natural Resources	14.3	
Urban Affairs		9.9
Emergency Expenditures	190.5	
Total	**$321.4**	**$135.0**

The actual expenditures for each of the last two years were well above the budget amounts approved, and the expenditures forecast for 1999/2000 are above the prior year's actuals. Therefore, the 1999/2000 overexpenditures continue a clear trend of prior years.

Consistent with the dramatic overexpenditure pattern in Manitoba Health, this department has required more than $200 million in Special Warrants over the two-year period, which represents almost half of the total.

- **Actual Expenditure Increases** – departmental expenditure increases in excess of $5 million from 1998/99 actuals over 1997/98 actuals and 1999/2000 estimates over 1998/99 actuals are as indicated in Exhibit 13.

Exhibit 13 – Previous Years' Expenditure Increases

Department	*98/99 Actual Over 97/98 Actual (in millions)*	*99/00 Budget Estimates Over 98/99 Actual (in millions)*	*Primary explanation of increase*
Legislative Assembly		$7.1	Costs of holding the 1999 election.
Agriculture		14.2	Costs of new Agricultural Income Disaster Assistance Program.
Culture & Heritage		5.0	Increase relates primarily to new responsibilities assumed, concurrent with new revenues being obtained.
Education & training	$74.7	58.5	Increased costs of providing services; 7.2% and 5.2% respectively.
Employee benefits	6.9		Increase in pension costs and recording of severance liabilities.
Family Services	5.4	40.8	Increased costs of delivering service and 1999 implementation of one-tier social assistance in Winnipeg, with offsetting expenditure reduction in Urban Affairs. Now all amounts are paid by Manitoba Family Services, so there is no longer a grant to the City of Winnipeg for this purpose.
Government Services	11.3		Implementation of the Desktop Management Initiative, subsequently offset by a budgeted $5.3 reduction in 1999/2000.
Health	143.4	61.4	Increased costs of service delivery; increases of 7.5% and 3.0% respectively.
Highways	15.0		Increased funding for construction program and a return to normal construction levels in the year after the 1997 flood.
Housing		5.3	This increase was preceded by a reduction of $9.0 in 1998/99 over 1997/98.
Industry, Trade & Tourism	7.0		Increase over the original provision for investment losses.
Justice	14.0	13.3	Increased cost of services of 7.9% and 6.9%.
Natural Resources	26.8	35.1	Costs of floodproofing programs, in large measure offset by increased revenues from the federal government.
Urban Affairs	13.4		Increase in grant support to the City of Winnipeg for capital programs and residential street renewal.

Actual departmental expenditures were up 3.5% in 1998/1999 over 1997/1998. Only one department had declining expenditures for the period, and this was due to external influences.

Manitoba Finance actual costs for public debt were reduced by $4.8 million in 1998/99 over 1997/98 and were projected to be reduced by another $34.6 million for 1999/2000, due primarily to lower interest rates and increased debt guarantee fee revenues.

The 1999/2000 budget planned for a further 1.7% aggregate expenditure increase over the previous year. However, as set out in the following section, the increase in actual 1999/2000 expenditures over 1998/1999 actual expenditures is projected to be 8.2%. Given the records of the previous two years, this can hardly be unexpected. This pattern illustrates the need for much more efficient budget-making and expenditure control.

It is possible that, to some extent, budgets have become less likely to fully reflect costs that Government knows are unavoidable. Decision-makers may in some instances have preferred to deal with these requirements through year-end adjustments rather than make explicit provisions at the outset of the year. This pattern would only reinforce the gap between budget and actuals. Our Phase 2 report will provide recommendations to address this possibility.

3. ESTIMATED RESULTS OF THE OPERATING FUND TO MARCH 31, 2000

A major focus of this review was to estimate financial results for the Province's Operating Fund for this fiscal year.

3.1 Overview of Projected Results

Based on our findings from the review process, the estimated results for 1999/2000 are indicated in Exhibit 14 in accordance with the Government's current accounting practice. We have used this basis of reporting so that it is directly comparable to the budget as it was established. However, we note that this approach is not acceptable to the Provincial Auditor as it is not consistent with GAAP, particularly in the area of pension accounting and Fiscal Stabilization Fund transfers. We strongly recommend its modification.

The exhibit illustrates the continuing large expenditure growth year over year in the Departments of Health, Education, Family Services, and Justice.

The forecast includes all expenditures projected by the departments as required in order to continue their existing approved programming on an "as is" basis. The "Additional Potential Variances" of $35 million we have also identified include provisions for the following types of expenditures that may be incurred prior to March 31, 2000:

- The potential impact of current collective bargaining with various groups in the health care sector – $10 million;
- Settlement of existing litigation and/or contract disputes. – $15 million; and,
- A general contingency to provide for likely further adjustments prior to year end consistent with historical experience – $10 million. This contingency is consistent with the terms of reference for the financial review that transactions not affecting the Province's financial results by $10 million or more should not be considered material.

Additional expenditures related to these items could amount to as much as $35 million. Therefore, the forecast deficit for the 1999/2000 year, after the Fiscal Stabilization Fund transfer of $185 million, is currently estimated to be between $100 and $135 million. Exhibit 14 illustrates these results.

Exhibit 14 – Projected Results for 1999/2000

	99/00 Published Estimates	Variances: Approved[1]	Variances: Additional/ Anticipated[2]	Current 1999/2000 Forecast
Revenue	$5,897.5		$259.7	$6,157.2
Expenditures				
Health	2,119.3		158.6	2,277.9
Education and Training	1,180.0		18.3	1,198.3
Family Services	701.7		8.4	710.1
Public Debt	480.8			480.8
Justice	208.0		4.8	212.8
Agriculture	113.0		7.6	120.6
Emergency Expenditures (Re: Flood Assistance and Fire Suppression)	23.5	96.0	18.5	138.0
Valuation adjustments	-		48.3	48.3
Other	1,159.5	3.4	17.0	1,179.9
Subtotal Expenditures	5,985.8	99.4	281.5	6,366.7
Deficit Before Transfer from the Fiscal Stabilization Fund and Debt Retirement Payments	(88.3)			(209.5)
Debt Retirement Payment	(75.0)			(75.0)
Deficit Before Transfer from the Fiscal Stabilization Fund	(163.3)			(284.5)
Planned Transfer from the Fiscal Stabilization Fund	184.7			184.7
Surplus (Deficit) for the Year	$21.4	($99.4)	($21.8)	($99.8)
Additional Potential Variances				(35.0)
				$(134.8)

[1]These variances have all been approved by Special Warrants.
[2]Additional, anticipated expenditures may have departmental and/or Treasury Board approval, funding authority for the expenditures has not yet been put in place.

Projected revenues include a one-time $131 million Canada Health & Social Transfer Supplement from the federal government. The 1999 federal budget set out an allocation of this revenue over a three-year period. Consequently, Manitoba Finance may consider the transfer of about $56 million from the Operating Fund to the Fiscal Stabilization Fund. This transfer would reflect that part of the health care supplement that relates to subsequent fiscal years according to the federal calculation. Using the financial reporting framework set out in the preceding exhibit, which is the basis on which the 1999/2000 budget was prepared, the impact of the contemplated transfer would be to increase the deficit by $56 million.

As we note throughout this report, the process for estimating revenues and expenditures to March 31, 2000 is dynamic and ongoing. The deficit we have projected is based on the most up-to-date revenue and expenditure information available to us, up to and including February 8, 2000. While we have made every effort to provide for all known items, it is reasonable to expect the new circumstances arising after February 8 will affect the amount of the deficit ultimately reported by the Province for the 1999/2000 year.

3.2 Reconciliation of Current Projected Deficit to Interim Report

Our first assignment in this review was to produce an early and preliminary snapshot of the Government's financial circumstances so that the Government could quickly formulate its fiscal strategy, including expenditure controls and revenue negotiations with the federal government. The November 17, 1999 interim report provided this early indication of the financial situation, focusing attention on the areas of major change from the approved budget to forecast expenditures and revenues in the Province's Operating Fund. We reported a potential deficit of $262 to $417 million for the 1999/2000 fiscal year.

We also said that two federal/provincial events could improve this interim financial outlook. These factors were described in the November 17, 1999 report on page 9 as follows:

- *"Manitoba Finance receives revised estimates from the Federal Government based on the various factors that affect the determination of federal revenue accruing to the Province. Information that will be provided in late November will enable the Department to revise its revenue forecasts early in December. In the event that these revised forecasts show enhanced revenue, the forecasted deficit would be reduced accordingly. Manitoba Finance is currently of the view that that the revenue will not be eroded by this revised forecast, but may very well be increased beyond the $41.7 million reflected in the interim report projection."*

- *"The Province of Manitoba continues to pursue the sharing of 1999 flood related costs with the Federal Government. To date, the Federal Government has not indicated any willingness to initiate cost sharing programs for any of the emergency expenditures that have been incurred by the Province. In the event that the Federal Government's position on this matter was to change, the recovery of certain of the flood related emergency expenditures would also reduce the deficit."*

Deloitte & Touche LLP has relied on Manitoba Finance officials for revenue information. We have had no contact with the federal government on this issue. Revised revenue projections were subsequently reported to us by Manitoba Finance officials, who are in contact with the federal government. Further information on revenue was provided to us on January 6, 2000, with updated information provided in early February.

Exhibit 15 – Reconciliation to our November 17, 1999 Interim Report

(in millions)	***Projected deficit noted in Nov. 17, 1999 Interim Report***	***Revisions to projections based on completed review***	***Revised projected deficit***
Revenues	$5,939.2	218.0	6,157.2
Expenditures	6,311.0	55.7	6,366.7
	(371.8)	162.3	(209.5)
Debt Retirement	(75.0)		(75.0)
	(446.8)	162.3	(284.5)
Transfer from Fiscal Stabilization Fund	184.7		184.7
Projected "Lower end" of Deficit Range	***(262.1)***	***162.3***	***(99.8)***
Additional Potential Variances	(155.0)	120.0	(35.0)
Projected "High end" of Deficit Range	***$(417.1)***	***$282.3***	***($134.8)***

Three key observations are relevant when considering the changes between the earlier deficit projection and our current projection of the deficit:

- In November 1999, Manitoba Finance advised us that updated revenue estimates could not be completed prior to release of new economic and population data by the federal government late in December, 1999. The increase in revenue that we were informed of in January 2000 significantly improves the projected position.

- Projected expenditure levels have increased by $56 million. Except for certain valuation adjustments amounting to $10 million, as recommended in the Information Technology Major Initiatives Review, the increases are essentially consistent with those set out in the interim report. These include:
  - A $33 million valuation provision for the Province's investment in the Health Information Network; and,
  - Increased emergency expenditures of $20 million.

  These increased expenditures were partly offset by some reduced expenditures in other areas.

- The $155 million estimated for additional potential variances has declined since the interim report primarily due to:
  - Confirmation that $53 million of the potential costs would be incurred (as set out immediately above);
  - Settlement of litigation with the Manitoba Medical Association, which eliminated a $27 million claim;
  - Expectation of offsetting revenue from the federal government to eliminate Agricultural Income Disaster Assistance (AIDA) expenditures of $20 million; and,
  - A policy decision not to extend AIDA assistance to negative margins ($8 million).

The chronology of events and their financial implications since the release of our November 17, 1999 report are noted in Exhibit 16.

Exhibit 16 – Chronology of Events Since Interim Report

Event	Financial Impact (in millions)
Projected deficit November 17, 1999	($262)
Additional information received to December 31, 1999	
Necessity of Health Information Network write-off became highly likely	(33)
Additional expenditures projected for the balance of the year	(26)
Projected deficit based on information available at December 31, 1999	(321)
Expenditure changes identified during the sign-off process in January and February	
Health	31
Other, in aggregate	(18)
Better Systems valuation provision	(10)
Formal advice from Manitoba Finance on increased revenue – January 6, 2000	220
Formal advice from Manitoba Finance on increased revenue – February 4, 2000	(2)
Current deficit projection	***($100)***

The most significant changes since our interim report in November have been in revenue projections. Current expenditure projections are essentially consistent with our interim findings.

With respect to the issue of valuations on key Government investments, we note the following differences between the interim report and our final findings:

Exhibit 17 – Valuation Adjustments since Interim Report

Investment	Interim Report[1]	Final Report[2]
Faneuil	$23 million	$5.6 million
Health Information Network	$33 million	$33.0 million
Better Systems Initiative	Not identified	$9.7 million

[1]This amount represents the estimated book value of assets identified in the interim report for valuation assessment.
[2]Amount of valuation provision included in final report projected deficit.

Faneuil review: As described in our interim report, Industry Trade and Mines has completed an analysis of its investment in Faneuil ISG. The department has concluded that the company's prospects for success point to the conclusion that a valuation provision is now not required against the Province's loans to the company. Nevertheless, $5.6 million of the Province's investment is in the form of non-retractable preferred shares. PSAB's recommendations for such investments, that have no fixed term of repayment, require that a provision be taken against the carrying value of these shares.

Health Information Network: The Province's investment in HIN, as a result of its agreement with SmartHealth Inc., is expected to be approximately $33 million at March 31, 2000. Our report **Information Technology Major Initiatives Review** recommended that this investment be written off. Accordingly, a provision for this full amount has been included in our projection. The ultimate cost for the conclusion of the agreement with SmartHealth Inc. will be a factor in determining the amount which will ultimately be provided for.

Better Systems Initiative (BSI): To date, the Province has invested in excess of $60 million in its Better Systems initiative, which is a project to develop increased functionality for particular government departments. Based on an analysis of the costs incurred to date, the leaders of this initiative believe strongly that $9.7 million of the investment will have no future benefit. We have reviewed details of this and concur.

The provisions for HIN and BSI are consistent with the findings detailed in our report **Information Technology Major Initiatives Review**, made public February 2, 2000.

Other valuation considerations have related to projects including the Urban Shared Services Corporation's investment in food services facilities. At the current time, a provision has not been made, as the Government's plan for this investment has not been fully formulated. At the time that the corporation's business plan is finalized, there will be a need to assess the recoverability of the investment made to date.

In the following sections, we describe the significant revenue and expenditure variances from the 1999/2000 budget levels.

3.3 Significant Revenue Variances Identified for the 1999/2000 Year

Revenue variances for the current year are projected to be substantial. An overview is provided in Exhibit 18.

Exhibit 18 – Significant Revenue Variances

	1999/2000 (in millions)	
Revenue Source	Initial Revenue Estimates	Current Revenue Projections
Taxation	$3,569	$3,630
Federal Government	1,723	1,911
Other	605	616
Total	**$5,897**	**$6,157**

Exhibit 19 summarizes the nature of the revenue changes totalling $260 million that have been identified. $42 million of this total was projected in our November 17, 1999 interim report.

Exhibit 19 – Significant Revenue Variance Explanations

Variance Explanation	Variance Amount (in millions)
Corporate Income Tax – corporate taxable income is higher than anticipated.	$98.6
Individual Income Tax – anticipated taxable income levels were overestimated, in part due to distortions in prior year data caused by filing extensions granted to 1997 flood-affected taxpayers. Federal and provincial tax rate reductions have also had a significant impact.	(49.0)
Mining Tax – there is more mining activity than expected.	6.8
Equalization Payments – the size of the equalization pool is now expected to be larger than first estimated by the federal government. Manitoba's share of the pool has increased because of its per capita revenue level in relation to other provinces and its improved relative population statistics.	173.0
Education Revenue from the Federal Government – Millennium Scholarship Fund revenue.	11.3
Other, in total	19.0
Total	**$259.7**

Note: The $260 million compares to the $42 million identified in our November 17, 1999 interim report.

As indicated, the changes include both increases and decreases in projected revenues for 1999/2000. The decrease in individual income tax is nearly $50 million. However, this is partially offset by increases in corporate income tax, mining tax, and education revenue from the federal government. The most dramatic increase, however, is in equalization payments of $173 million. The total increase of $260 million is significantly beyond the mid November 1999 expectations of Finance officials.

Income tax and federal equalization transfer revenues are subject to much more uncertainty than other revenue. For equalization, this uncertainty is because the transfers are dependent on economic and fiscal performance in several provinces. The data used to calculate equalization must be updated to reflect new information as it is available, and as it is revised for previous years when actual economic and fiscal results become clear. For example, equalization entitlements for the 1997/1998 and 1998/1999 years are still subject to revisions. Revenue ultimately depends on the last federal government estimates received during a fiscal year, despite the fact that entitlements are still subject to alteration in subsequent fiscal years.

1998 is the most recent year for which actual income tax assessment data is available, and decisions in the federal budget may affect income tax revenue for the 1999 year, which will affect the revenue for 1999/2000.

The most recent official federal government estimate for Manitoba's equalization entitlement for the current year is $960 million. Manitoba Finance officials have revised this estimate upward based in part on updated income tax collection data, new demographic data and economic and fiscal data for the current year. A further increase with respect to prior year entitlements is also expected. The current estimate of $1,143 million, which has been discussed by Manitoba Finance and federal officials, is expected to be substantially confirmed when the next set of official federal estimates for equalization are released later this month.

3.4 Significant Expenditure Variances Identified for the 1999/2000 Year

Understanding the variety of forces affecting specific expenditures has been a key consideration in reviewing the significant variances from the approved budget. As set out in the following exhibit, in some cases the variance has been provided for through Special Warrants, which are Orders-In-Council approving additional expenditures when the Legislature is not in session. A Special Warrant results in a revised 1999/2000 budget for the affected Department.

Exhibit 20 summarizes the significant expenditure variances from the approved budget projected for 1999/2000, by category.

Exhibit 20 – Significant Expenditure Variances for 1999/2000

	1999/2000 (in millions)			
Expenditure Area	Initial Expenditure Estimates	Current Expenditure Projections	Over-expenditure	Special Warrant Authorization[1]
Emergency expenditures	$23.5	$138.0	$114.5	$96.0
Manitoba Health	2,119.3	2,277.9	158.6	-
Manitoba Education and Training	1,180.0	1,198.3	18.3	-
Manitoba Family Services	701.7	710.1	8.4	-
Manitoba Justice	208.0	212.8	4.8	-
Manitoba Agriculture	113.0	120.6	7.6	-
Valuation adjustments	-	48.3	48.3	-
Other	1,640.3	1,660.7	20.4	3.4
Totals	**$5,985.8**	**$6,366.7**	**380.9**	**$99.4**

[1] *Authorization for overexpenditure*

As confirmed by provincial officials through their sign-offs of our review findings, variances are primarily related to meeting obligations arising from existing government programs, as well as emergency expenditures approved throughout the year.

The information provided by Deputy Ministers indicates that the aggregate expenditure variances can be attributed as follows:

Exhibit 21 – Significant Expenditure Variances for 1999/2000

Nature of the variance	Amount (in millions)
Expenditures authorized by Treasury Board	
• Special Warrant funding is in place	$99.4
• Special Warrant Funding is not yet in place	13.1
Treasury Board has not authorized the expenditure but it:	
• is required by statute or some other authority such as a contract between the Government and another party	107.6
• has been authorized within the department	17.4
• is required to maintain 1998/1999 service levels	59.6
• is required to respond to increased program demand or volumes	0.5
• represents emergency expenditures, not yet approved	19.0
Discretionary initiatives of the government	
• Before September 30	0.8
• After September 30	13.3
Valuation adjustments to be recorded during 1999/2000	
• Health Information Network	33.0
• Better Systems Initiative	9.7
• Faneuil	5.6
Other	1.9
Total	**$380.9**

Details of the major variances are provided in Exhibit 22. More detailed descriptions of these variances, together with other less significant variances, are set out in Appendix G.

Exhibit 22 – Significant Expenditure Variance Explanations

Area of Expenditure	*Individual Variance (millions)*	*Departmental Total Variance (millions)*
Emergency Expenditures		
• Forest fire suppression	$12.2	
• Disaster Flood Assistance in southwestern Manitoba	13.2	
• 1997 flood program – flood proofing	18.5	
• 1999 flood-related costs – compensation for unseeded rural farm land	70.0	
• Other	0.6	
Total Emergency Variance		***$114.5***
Manitoba Health		
• Deficits of Regional Health Authorities to be funded by Manitoba Health	$52.5	
• Impact of wage settlements with the Manitoba Nurses Union, Canadian Union of Public Employees and other unions	64.1	
• Impact of an arbitration award on medical payments to be made to physicians under the terms of the Manitoba Health agreement with the Manitoba Medical Association	27.9	
• Increased costs for Pharmacare for increased claims volumes and increased drug costs	13.1	
• Required increase in the Province's contribution to the operations of Canadian Blood Services	7.4	
• New Government election promises re: "hallway medicine"	8.7	
• Other items	(15.1)	
Total Health Variance		***$158.6***
Manitoba Education and Training		
• Additional costs that have been incurred as a result of unanticipated increases in adult education enrolment	$11.6	
• Unbudgeted expenditure that will be incurred related to disbursements from the Millennium Scholarship Fund. *However, this amount will be fully funded by the Federal Government and therefore an additional $11.3 million of revenue has been included in the revenue forecast for 1999/2000.*	11.3	
• Other items	(4.6)	
Total Education and Training Variance		***$18.3***
Manitoba Family Services		
• Funding the 1999/2000 operating deficit of Winnipeg Child & Family Services	$8.0	
• Other	0.4	
Total Family Services Variance		***$8.4***

Area of Expenditure	*Individual Variance (millions)*	*Departmental Total Variance (millions)*
Manitoba Justice		
• Increased correctional staff	$4.1	
• Increased Courts costs	0.8	
• Other items	(0.1)	
Total Justice Variance		***$4.8***
Manitoba Agriculture		
• Excess of actual 1998 AIDA (Agricultural Income Disaster Assistance) claims by producers over the initial estimate of $12 million	$9.0	
• Other	(1.4)	
Total Agriculture Variance		***$7.6***
Valuation adjustments (See Exhibit 17 for details)		
• Health Information Network	$33.0	
• Better Systems Initiative	9.7	
• Investment in Faneuil	5.6	
Total Valuation Adjustments		***$48.3***

4. Financial Pressures on the Operating Fund For 2000/2001 and 2001/2002

The current year will clearly have an impact on the coming two fiscal years. The established revenue and expenditure patterns indicate financial pressures facing the Government on a number of fronts.

As part of the review process, we gathered information from each department's senior officials on required expenditure levels for future years, together with the most current estimates of future revenue levels. As part of the sign-off process, officials verified that this information fairly represented current expectations of requirements to continue existing programs. ***We emphasize that this information was provided to us before it was included in the 2000/2001 estimates preparation process. Consequently, the information is preliminary and has not been subject to debate, testing or scrutiny from outside the respective departments (e.g., final Treasury Board examination and approval in the process of developing the Government's 2000/2001 budget).***

The aggregation of this information provides the following overview of what departmental officials indicate will be required and the basis for their assumptions. In addition to the departmental estimates, the projected expenditures noted in the exhibit include enabling and other appropriation estimates at amounts equal to 1999/2000 levels, except for the removal of costs related to the PanAm Games, the Millennium Fund, and cost sharing agreements that are expiring in 1999/2000.

Exhibit 23 – Financial Pressure Overview for 2001/2002

	Projected Impact (in millions)
Operating Fund	***2000/2001***
Revenues	
Taxation	$3,865
Other	606
Federal Government	1,742
	6,213
Expenditures	6,585
Required Debt Retirement Payments	96
	6,681
Projected Impact	***($468)***

Revenues have been projected based on departmental estimates of what they consider to be reasonable revenue levels. These revenues do not include any transfer from the Fiscal Stabilization Fund.

The forecast for income tax and federal transfer revenue for 2000/2001 is subject to considerably more uncertainty at this point. The federal government has provided first estimates of advance payments on account for income taxes to be paid for the 2000 tax year. However, the first estimate for equalization for 2000/2001 has not yet been provided. Manitoba Finance estimates are based on the most recent demographic, economic and fiscal data available. Federal and provincial budgets may have a substantial impact on these estimates.

The significant pressures in key departments that drive the expenditure increases are set out in Exhibit 24.

Exhibit 24 – Financial Pressure in Key Departments for 2000/2001

Entity	*Area of Financial Pressure*	*Potential Impact on 2000/2001 Over Projected 1999/2000 Results (in millions)*
Health	Anticipated additional funding requirements for: • Regional Health Authorities • Pharmacare • Medical practitioners	$137
Education	Anticipated additional funding requirements for: • Commitment to public school funding • Commitment to reduce tuition fees • Commitment to grow college enrollment	98
Justice	Anticipated additional funding requirements for all expenditure areas	35
Family Services	Anticipated additional funding requirements for all expenditure areas	38
Others	All other government departments, net	25
Totals		**$333**

Departments have also indicated that these anticipated expenditure increases will flow over to the next year (2001/2002) as part of the base expenditures of Government. Further pressures for 2001/2002 will become more acute if revenue and expenditure growth patterns hold.

On the other hand, revenue estimates supplied by individual departments and Manitoba Finance (not including any transfers from the Fiscal Stabilization Fund) are estimated to increase only 0.9% over the projected 1999/2000 levels. However, when the future expenditure pressures are combined with the fact that many of the 1999/2000 overexpenditures become a part of the ongoing “base expenditures” of departments, expenditure levels are expected to rise by more than 3%.

Therefore, the structural challenge identified in 1998/1999 and 1999/2000 is also apparent when looking at the 2000/2001 potential situation. While some of the identified expenditure increases may be found, on further analysis, to be unjustified, the significance is in the overall pattern. The clear implication is that stronger expenditure control will be essential if a deficit is to be avoided.

5. Issues That May Affect Future Operations of Departments

Departmental officials identified quite a number of areas where future operations could be affected by existing issues and circumstances. To summarize these comments, they typically fell into one of the following categories:

- The impact of the item could be in the next two fiscal years; however, the amount is currently very difficult to estimate.

- Agreements that govern some particular aspects of the department's activities and/or expenditures will expire shortly – for example, cost-sharing agreements with the federal government and infrastructure agreements with the City of Winnipeg and the federal government. The ability to renew, renegotiate or discontinue such agreements will have an impact on future cash outflows.

- Issues that were identified as having a direct impact on forecasted expenditures for 2000/2001 and 2001/2002 will continue beyond that time frame – in some cases becoming more pronounced as time moves on.

- With the extent of current and ongoing investments in new technology, the Government will need to take actions as required (including additional expenditures) to ensure that it gets value from the new systems. This issue is described more fully in our separate report **Information Technology Major Initiatives Review**.

- Pressures that are apparent are particularly strong in the area of infrastructure programs. Relevant Departments have referred to unacceptably high levels of "deferred maintenance" or "infrastructure deficits" that will be subject to discussion in upcoming budget deliberations.

With respect to this last area of pressure, Exhibit 25 highlights information provided by departments on the infrastructure issue.

Exhibit 25 – Financial Pressure Related to Infrastructure

Organization	Description	Estimate, if available
Public Schools Finance Board	Identified needs include repairs for aging buildings, technology infrastructure development, and new facilities. 352 Manitoba schools were built before 1960.	$93 million of roof repair, mechanical system repairs and access modifications have been identified. An additional $50 million of school replacement and upgrading costs are also projected.
Council on Post-Secondary Education	The universities have a list of deferred maintenance. Similar issues exist for the college facilities owned by Government Services.	$200 million in projects have been identified.
Government Services	Existing repair and maintenance budget is inadequate.	$4 to 5 million more per year to keep up.
Highways	Maintenance fleet is very old. Repair and maintenance funding for roads is inadequate. Rehabilitation of roads is required.	Replacement cost approximately $100 million. Additional $17 million per year to keep up. Additional $60 million per year.
Health	Capital needs are significant. Equipment.	Initial 2000/2001 capital request is for over $260 million; which is about double what has been done in each of the last several years. Not quantified.
Housing	Modernization and improvement of public housing stock.	About $88 million to be spent over 10 years. Only $20 million of funding is now in place.
Intergovernmental Affairs	New agreements that may be signed – successor to Winnipeg Development Agreement; a new Canada/Manitoba Infrastructure Agreement; other partnership/cost sharing agreements are also possible.	Not quantified.
Manitoba Water Services	Infrastructure needs for Water and Sewer in Rural Manitoba.	$400 million of possible projects now exist.

A comprehensive listing of the issues identified by the departments as potentially affecting future operations is set out in Appendix H. These will necessarily be considered by Government in its future budgetary deliberations. We urge readers to carefully examine this information in order to fully appreciate the fiscal position of the Province. The extent to which these matters will significantly affect future financial planning and management will need to be assessed and addressed in the context of the new Government's financial planning process.

An understanding of the current health of public sector infrastructure and program operations will be an important consideration in the planning and review process leading to budgetary decision-making. The central reality inherent in the information provided to us in the course of our review is a longer-term and structural challenge (i.e., a deficit) facing the Government as it defines its spending priorities. The Government will need stronger budgeting and expenditure control processes to support its effective management of public finances. Our Phase II report will address this issue.

6. Crown Organizations

We examined the following Crown organizations that receive significant funding from the Operating Fund:

- Child and Family Services Agencies (3)
- Communities Economic Development Fund
- Council on Post-Secondary Education
- Criminal Injuries Compensation Board
- Economic Innovation and Technology Council
- Government Information Systems Management Organization (Man) Inc.
- Health Information Services of Manitoba
- Legal Aid Services Society
- Manitoba Agriculture Credit Corporation
- Manitoba Cancer Treatment and Research Foundation
- Manitoba Crop Insurance Corporation
- Manitoba Development Corporation
- Manitoba Health Services Insurance Plan
- Manitoba Housing and Renewal Corporation
- Manitoba Trade and Investment Corporation
- Manitoba Water Services Board
- Public Schools Finance Board
- Special Operating Agencies' Financing Authority (oversees 17 SOAs)

Here are our findings.

6.1 Purpose and Funding of Crown Organizations

Certain of the Government's services are delivered through these Crown organizations that typically operate under the governance of a separate board of directors. Each respective board is charged with ensuring that the organization meets its service mandate within the framework of the budget established for the organization.

The budgets that are developed for each organization contain one or both of the following revenue sources:

- An operating grant may be provided by a provincial department to fund the operations of the organization.

- The organization may generate its own revenues from service it provides. For instance, several of the organizations whose principal purpose is to make investments earn significant interest revenue.

The most significant grants paid by departments to Crown organizations are to the Council on Post-Secondary Education, the Public Schools Finance Board, Child & Family Services Agencies, and the Health Services Insurance Fund.

Where the organizations must borrow money to finance investments, all long term borrowings are achieved through advances from the Province of Manitoba. As at March 31, 1999, advances of this nature amounted to approximately $750 million, and were primarily for Manitoba Agricultural Credit Corporation and the Manitoba Housing and Renewal Corporation.

6.2 Significant 1999/2000 Crown Organization Operating Deficits/Surpluses

Departments have reported that several Crown organizations require funding over and above budgeted amounts for the 1999/2000 year. The funding for these requirements has already been included in the 1999/2000 deficit projection by being incorporated within departmental projections. A summary of defined supplementary requirements for Crown organizations is set out in Exhibit 26.

Exhibit 26 – Crown Organization Additional Requirements for 1999/2000

Crown Organization	*Related Department*	*Additional Requirement (in millions)*	*Explanation*
Public Schools Finance Board	Education & Training	$9.9	Adult education enrollment in excess of initial estimates resulted in increased funding of about $11 million, offset by various sundry savings.
Child & Family Services Agencies	Family Services and Housing	$8.0	Increased cost of maintaining service levels.
Health Services Insurance Fund	Health	$151.2	Increased Pharmacare costs ($13.1), deficits of Regional Health Authorities ($52.5), wage settlements with health care workers ($64.1), increased physician compensation ($27.9), new government election commitments ($8.7) and various spending reductions ($15.1).
Health Information Systems Management (Man) Inc.	Health	$33.0	Provision for a 100% valuation allowance on the corporation's investment in the Health Information Network.
Total		**$202.1**	

These additional requirements flow through to departments, and are therefore reflected in departmental indications of overexpenditures for 1999/2000. The magnitude of these items, though, highlights the degree to which the expenditure variances for 1999/2000 occur in organizations that are accountable to government departments rather than in the departments themselves.

6.3 Significant Crown Organization Cumulative Surpluses/Deficits

Several Crown organizations have sizable accumulated surpluses or deficits as a result of prior years' operations. The significant ones are as follows:

Exhibit 27 – Crown Organization Cumulative Results

Organization	*Accumulated Surplus (Deficit) (in millions)*	*Comments*
Manitoba Agricultural Credit Corporation	($17.8)	The corporation has incurred losses over the last several years that have been funded by advances from the Province.
Manitoba Crop Insurance Corporation	$195.0	This surplus is comprised entirely of specifically identified insurance reserves, to absorb future significant claims.
Special Operating Agencies (SOA) Financing Authority	$42.0	This surplus is the cumulative total across 17 Special Operating Agencies. Typically, these surpluses are invested in assets used in operation of the SOAs.
Manitoba Housing & Renewal Corporation	($16.0)	Surpluses in each of the last two fiscal years have allowed this deficit to decrease.

6.4 Financial Pressures That May Affect Crown Organizations in Future Years

Provincial officials have indicated that these Crown organizations are facing significant expenditure pressures. In some cases, there is a need for increased funding in 1999/2000 because of immediate program demands. In other instances, the pressure is reflected in anticipated future costs to deal with facilities or equipment that have deteriorated due to constraints on repair and maintenance expenditures in prior years.

Since it is departments that will fund the organizations, the pressures for increased funding in 2000/2001 are, of course, reflected in departmental projections of expenditure requirements for that year. These pressures are described in Section 3.4 of this chapter. The most significant are in those entities providing education and health care services.

Factors that may affect the operations beyond 2000/2001 are set out in detail in Appendix H. The more significant of these pressures are highlighted in Exhibit 28.

Exhibit 28 – Financial Pressures Affecting Crown Organizations

Crown Organization	*Factors Affecting Future Operations*
Manitoba Crop Insurance Corporation	The end to certain federal agricultural safety net programs in future years will bring pressure to increase funding to this entity.
Council on Post Secondary Education	The following factors all interact in a very dynamic way to bring pressures for increased expenditures in the future: • Election promises of the new government related to tuition increases and increased enrollment in colleges. • Escalating operating costs due to collective bargaining agreements and ever increasing technology costs. • Increased maintenance and capital funding to address deferred maintenance.
Public Schools Finance Board (PSFB)	The following factors create pressure on the PSFB: • The age of many Manitoba school buildings is 35 to 40 years, resulting in substantial repair and maintenance requirements. • Escalating operating costs due to collective bargaining agreements and ever increasing technology costs. • Significant requests for capital funding for new or expanded school facilities.
Manitoba Housing and Renewal Corporation (MHRC)	The following factors create pressure on MHRC: • Substantial modernization and improvement expenditures are required for deteriorating buildings. • The terms of the Social Housing Agreement recently signed with Canada Mortgage & Housing Corporation will provide MHRC with some additional flexibility in funding certain housing programs.
Health Services Insurance Fund (HSIF)	The following factors create pressure on the HSIF: • Information technology needs of Regional Health Authorities, especially the Winnipeg Regional Health Care Authority, will require significant expenditures. • Continued anticipated increases in medical compensation, drug costs, health care worker wages and other hospital operating costs suggest the need for continued annual funding increases to health care.
Manitoba Water Services Board	The value of required water and sewer projects currently identified in rural Manitoba far exceeds the funding available for these types of projects over the next five years.

E. GOVERNMENT ENTERPRISES

The fourth major component of the Province's financial situation consists of the five Government Enterprises: Manitoba Hydro, Manitoba Public Insurance, Manitoba Lotteries Corporation, Manitoba Liquor Control Commission, and the Manitoba Workers Compensation Board.

These enterprises have different fiscal year ends. Manitoba Hydro, Manitoba Lotteries Corporation and Manitoba Liquor Control Commission all end March 31. Manitoba Public Insurance has a February 28 year end, and the Workers Compensation Board has a December 31 year end. Accordingly, in the exhibits that follow, a reference to the "1997/98 year" will mean the year ended March 31, 1998, February 1998 or December 1997, depending on the individual Government Enterprise.

1. GOVERNMENT ENTERPRISES REVENUE SUMMARY

The magnitude of the Government Enterprises is indicated by their total revenue, as illustrated in Exhibit 29.

Exhibit 29 – Government Enterprise Revenue

	(in millions)		
Enterprise	***1997/1998 Revenue Actual***	***1998/1999 Revenue Actual***	***1999/2000 Revenue Projected***
Manitoba Hydro	$1,041.1	$1,081.6	$1,124.2
Manitoba Public Insurance	473.8	509.2	514.1
Manitoba Lotteries Corporation	361.0	373.0	352.4
Manitoba Liquor Control Commission	366.3	379.9	391.0
Manitoba Workers Compensation Board	209.3	216.6	185.1
Totals	**$2,451.5**	**$2,560.3**	**$2,566.8**

The $2.6 billion of Government Enterprise revenue is significant when comparing it to the Government's $6 billion total Operating Fund revenue. Comparing the two, the Government Enterprises revenue is 42% of the size of the Operating Fund revenue. This underlines our view that government financial reporting must include these entities to be complete.

2. GOVERNMENT ENTERPRISES PROFITABILITY SUMMARY

The annual profitability of the Government Enterprises is indicated by their net surplus or deficit, as illustrated in Exhibit 30.

Exhibit 30 – Government Enterprise Profitability

	(in millions)		
Enterprise	***1997/1998 Financial Result Surplus (Deficit)***	***1998/1999 Financial Result Surplus (Deficit)***	***1999/2000 Financial Projection Surplus (Deficit)***
Manitoba Hydro	$110.5	$100.1	$141.7
Manitoba Public Insurance	76.2	38.3	61.2
Manitoba Lotteries Corporation	220.0	225.0	225.0
Manitoba Liquor Control Commission	149.4	151.5	153.0
Manitoba Workers Compensation Board	23.9	14.7	4.5
Totals	**$580.0**	**$529.6**	**$585.4**

Of these earnings, approximately $375 million annually from the Lotteries Corporation and Liquor Control Commission goes directly to the Government. The WCB's earnings are moved into its own reserves. Manitoba Hydro uses its earnings to finance capital infrastructure. MPI's is used for reserve growth and surplus.

The 1999/2000 results for WCB are adversely affected by legislation that introduced a new category of liability coverage.

While it appears that the enterprises have some more capacity to contribute to government revenues and we understand that Crown Corporations Council has been asked by the Government to consider this possibility, the Government will have to give due consideration to the specific needs and circumstances of each enterprise. For example, the Manitoba Liquor Control Commission's ability to make revenue payments may be adversely affected by the impact of sales of private wine stores to licensees (restaurants, lounges, etc.).

3. GOVERNMENT ENTERPRISES CUMULATIVE SURPLUS/EQUITY POSITION

As a result of their profitable operations, the Government Enterprises have all accumulated substantial surpluses or retained earnings. A summary of their individual and cumulative positions as at the conclusion of the 1999/2000 year is provided in Exhibit 31.

Exhibit 31 – Government Enterprise Cumulative Positions

	Nature of Surplus at 1998/99 Year End (in millions)			*Total Surplus as a Percent Of*	
Enterprise	*Restricted*	*Unrestricted*	*Total*	*Year End Assets*	*Annual Revenues*
Manitoba Lotteries Corporation	nil	$10.0	$10.0	*	*
Manitoba Liquor Control Commission	nil	nil	nil	*	*
Manitoba Public Insurance Corporation	64.3**	76.0	140.3	11.8%	27.6%
Manitoba Workers Compensation Board	68.6**	-	68.6	9.4%	31.7%
Manitoba Hydro	-	665.9	665.9	8.5%	61.6%
Totals	**$132.9**	**$751.9**	**$884.8**		

* *These calculations are not relevant as all or virtually all of the corporations' surplus is transferred annually to the Operating Fund of the Province of Manitoba.*

** *These restricted funds have been established by the Boards of the corporations. In the case of the reserves of MPIC, the level of the reserve has been approved by the Public Utilities Board. In the case of WCB, the restricted reserves are short of the $96 million target which has been set using formulae established by the Office of the Superintendent of Financial Institutions of Canada for minimum continuing capital and surplus requirements.*

While surpluses are substantial, some are necessarily set aside as appropriate reserves to preserve financial stability. In Hydro's case, the surplus assists in financing investment in capital projects.

4. Government Enterprise Contribution to Consolidated Fund Revenue

Government Enterprises that contribute to Consolidated Fund revenue are currently limited to the Manitoba Lotteries Corporation and Manitoba Liquor Control Commission. The contributions historically and for the current year are as noted in Exhibit 32.

Exhibit 32 – Government Enterprise Contributions to the Consolidated Fund

	(in millions)		
Enterprise	***1997/1998 Transfer to Consolidated Fund***	***1998/1999 Transfer to Consolidated Fund***	***1999/2000 Projected Transfer to Consolidated Fund***
Manitoba Lotteries Corporation	$220.3	$225.1	$225.0
Manitoba Liquor Control Commission	149.4	151.5	153.0
Totals	**$369.7**	**$376.6**	**$378.0**

The other three Government Enterprises do not make direct contributions to Consolidated Fund revenue, and legislative amendments may be required to allow for such an approach. However, payments by these enterprises have indirectly contributed to certain departmental revenues through various taxation and service arrangements, such as debt guarantee fees, capital tax, payroll tax and water power rental agreements. In the case of Manitoba Hydro, these amounts exceed $100 million annually.

5. Factors Affecting Future Operations of Government Enterprises

Each of the Government Enterprises has projected its profitability for the current fiscal year as well as each of the next two years. In addition, each entity has identified major factors expected to affect its future operations. This information is set out in detail in Appendix I.

6. Relevant Comparisons with Other Jurisdictions

In considering issues related to Government Enterprises in Manitoba, the Government can look to approaches taken in other jurisdictions as an indication of what might be possible or appropriate. Generally, other governments have liquor and gaming revenue transferred directly to government revenue, as is the case in Manitoba. However, the issue of particular interest is the provision of dividends from Government Enterprises to the Operating Fund. In a number of provinces, for example, Crown utilities provide such dividends.

7. Overall Trends related to Government Enterprises

The overall trends related to Government Enterprises can be characterized according to two groupings.

7.1 Sustainable Revenue Sources

Manitoba's Government Enterprises have been profitable over the past few years. In the case of the Lotteries Corporation and the Liquor Control Commission, these profits have significantly augmented the government's general revenues in the Operating Fund, contributing about $370 to $380 million per year. This contribution, as a percentage of the Province's total revenues, declined from 6.4% in 1997/98 to about 6.1% in the current year.

Both Manitoba Lotteries Corporation and the Manitoba Liquor Control Commission project profits at approximately these same levels into the next several years, indicating the likelihood of a sustainable revenue source. However, the projections do not include any expectation of substantial growth in income for the two enterprises, nor do they include provision for any potential revenue reduction as a result of the anticipated establishment of First Nations casinos. Accordingly, it is apparent that the Operating Fund revenue generated by these particular enterprises will not keep pace with the rate of projected growth in provincial expenditures.

7.2 The Potential for More Direct Contributions

Manitoba Hydro, Manitoba Public Insurance, and the Workers Compensation Board all face distinct operational challenges. In the case of the two insurance service providers, the dynamic relationships between reserve levels, premium/rate levels and loss and/or claim experience must be prudently managed. Almost two thirds of the retained earnings of these entities represent reserves against future operating risks. We note that the levels of these reserves are considered to be reasonable based on independent third party standards.

In the case of Manitoba Hydro, profitability has been and is expected to continue to be strong. However, the corporation will need to deal with (a) ongoing capital investments in service capacity, (b) management of potential costs related to the Northern Flood Agreement, and (c) ongoing discussions with municipalities that would like to impose taxes on the corporation. All of these factors will place limits on the use of future operating profits.

We understand that the Government is assessing options for having Government Enterprises (excluding the Workers Compensation Board) pay dividends to the Province's Operating Fund. This approach is based on a view that the Province should receive greater returns for its substantial investment in the enterprises. While it is apparent that there is some capacity for dividends to be paid, the Government will need to address a number of issues before acting. For example, legislative changes may be required to allow for such an approach. Also, prudence would be required to ensure that the ongoing profitable operation of the enterprises is not impaired.

An additional consideration would involve policy deliberations with respect to rate/premium levels. Manitoba taxpayers/consumers currently enjoy comparatively low rates for the services provided by these enterprises, and the interrelationship of these rate/premium levels and the capacity of the corporations to pay dividends must therefore be explored. In Chapter VI, we set out our views on the various facets of this issue. We note that even if, by way of illustration, half of MPI and Hydro profits were paid as dividends, the additional revenue to the Government would be just over $100 million. While quite significant, this amount would not by itself be sufficient to end the structural deficit facing the Government.

It is our understanding that both Manitoba Hydro and Manitoba Public Insurance have provided options to the Crown Corporations Council respecting potential additional revenue that could be transferred to general revenue. They merit further, careful review and consideration.

F. THE UNFUNDED PENSION LIABILITY

The Government currently has an unfunded pension liability of approximately $2.8 billion relating to its obligation for the future pension benefits or current and retired civil servants, teachers, and Members of the Legislative Assembly. The Government operates on a "pay as you go" basis, paying its portion of the pensions as they become due to individuals upon their retirement. In 1999/2000, the estimated cash cost of this approach is about $116 million.

We note that this issue was highlighted in the August 8, 1988 **Summary Report – A Review of Government Accounting Policies and Financial Obligations to March 31, 1988** submitted by Stevenson Kellogg Ernst & Whinney to the Minister of Finance. At that time, the total unfunded liability was approximately $1.17 billion and the annual cash cost of pensions paid out was $37 million. This review noted:

> *"The major problem is that since 1961 the Province has not paid its share of employees' pensions into the Pension Fund; nor has this liability been accounted for in the financial accounts.*
>
> *These pensions are known and predictable future obligations of the government, just like any other liability. The cost is incurred when the pension is earned each year the individual is employed. By not recording the cost and obligation and then setting aside specific funds for pensions and **investing them so that they earn a return,** the government is in effect borrowing these funds. This burdens future rather than present governments and taxpayers with the unrecognized cost of the pensions. It also significantly increases the future cost of the pensions, which must then be paid by future taxpayers."*

Stevenson Kellogg Ernst & Whinney recommended that the Government begin accounting for public sector pensions on a current basis, and develop an action plan with clear targets for dealing with the funding problem. The firm concluded this would be "*the best course to both portray accurately the province's financial position and safeguard the security of future pension benefits"*. However, in the intervening 11 years, no action has been taken.

With respect to the current approach to dealing with pensions, the provision to fund payments to current retirees is $116 million in 1999/2000. It is projected at $119 million for 2000/2001 and $126 million for 2001/2002. Looking forward, this cost is expected to continue to grow due to increased costs for current service retirees and interest growth in the liability. Continuing with the current approach will mean these costs will continue to grow for the foreseeable future. Action is required.

G. CONCLUSIONS ON THE GOVERNMENT'S FINANCIAL POSITION

The conclusions from our assessment of the Government's general financial position are as follows:

- *The Balanced Budget, Debt Repayment and Taxpayer Protection and Consequential Amendments Act* sets the context for the financial situation, imposing a number of "rules of the road" related to balanced budgets, debt retirement, and referenda on major tax rate increases. These provisions fundamentally limit the Government's financial flexibility and should be modified to give greater scope for action while maintaining the obligation to reduce debt.

- The Fiscal Stabilization Fund will stand at a balance of $253 million at the end of this fiscal year. The Government will need to determine how it will use this fiscal management tool to meet its commitment to balance its budgets in the future, recognizing that the amount remaining at the end of 1999/2000 will not be sufficient to balance the 2000/2001 situation given defined financial pressures.

- The Government is obligated to contribute to the Debt Retirement Fund, which has implications for both the current and future years.

- The Operating Fund deficit projection for 1999/2000 has improved over earlier projections, due almost entirely to a substantial increase in federal government transfers. However, the revenue and expenditure pattern of the previous two years, combined with apparent financial pressures for the next two years, point to a structural deficit. Plans to follow through on announced tax rate reductions exacerbate this situation.

- Crown organizations, which are entities funded from the Operating Fund but only indirectly controlled by the Government, are a source of significant financial pressures in the current and upcoming years. This reflects, in part, Government's insufficient means to control expenditures.

- Government Enterprises already provide considerable revenue to the Operating Fund, and they appear to have potential as a source of additional revenue. It is unlikely that the potential additional revenue from Government Enterprises would be sufficient to balance the budget. Nevertheless, consideration should be given to Government Enterprise dividends in the Government's multi-year fiscal framework.

- The unfunded pension liability is a continuing source of major concern and has significant future cost implications if the Government's approach to this situation does not change. It must be addressed soon.

The implications of the Government's overall financial situation are quite clear. The Fiscal Stabilization Fund, as a fiscal shock absorber, combined with the contemplated additional Government Enterprise revenue are together insufficient in magnitude to help the Government resolve the structural deficit situation. This reality points to the need for the Government to consider two options. First, it must consider stronger financial planning and management measures in its expenditure program. Second, it must look at its revenue sources to determine where it might lever new or additional revenue. In order to achieve its balanced budget objectives, the Government will need to clearly define and consider these options before it makes choices, honestly assessing the feasibility of each.

III. ANALYSIS OF THE FINANCIAL CONDITION OF THE PROVINCE

In Chapter II, we discussed the fiscal position of the Province. Here we present our analysis of the underlying financial condition.

The Canadian Institute of Chartered Accountants (CICA) has published **Indicators of Government Financial Condition (1997)**. The CICA intended this approach to deal with the inadequacy of traditional audited financial statements in providing a complete picture of government's financial condition. Unless otherwise noted, graphs are based on GAAP financial results and other information supplied to us by the Provincial Auditor's office.

In assessing the implications of the 1999/2000 situation for future years, it is important to understand how the Government arrived at the current position. In this chapter, we assess the Province's financial position using this framework.

An overview of the CICA Indicators of Government Financial Condition is contained in Appendix J and we urge readers to examine it closely.

A. MEASURES OF SUSTAINABILITY – THE FIRST PRIORITY

Sustainability is the degree to which a government can maintain existing programs and meet existing creditor requirements without increasing the debt burden on the economy. Indicators of sustainability include the *annual surplus or deficit* and *the ratio of net debt to provincial Gross Domestic Product*. In an environment of steadily increasing health costs, this factor is paramount to successful financial management.

1. ANNUAL SURPLUS OR DEFICIT

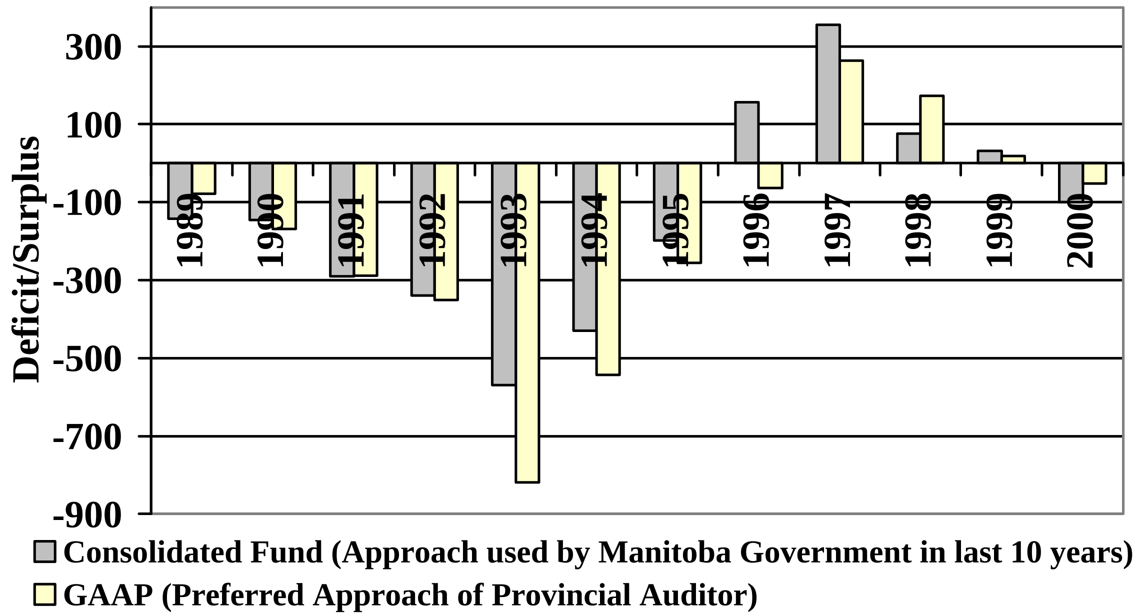
The annual surplus or deficit is an indicator of whether the Government is managing annual expenditures to levels supportable by the Province's revenues. In short, the level of actual annual revenues should define the acceptable level of expenditures.

The GAAP Approach to Measuring the Surplus or Deficit

The Manitoba Government historically has used the Operating Fund to measure its surplus or deficit on an annual basis. However, the Provincial Auditor has indicated that a more appropriate measure is the surplus or deficit of the consolidated government reporting entity, including all Government Enterprises and prepared using Generally Accepted Accounting Principles (GAAP). This is the "larger" government which includes Government Enterprises.

The following chart reflects the trends in both measures.

Chart A-1 Annual Surplus or Deficit of the Manitoba Government Using Two Definitions of "Government"



By either measure, the Province's financial picture has reflected more positive results in recent years than early in the 1990's. However, using GAAP, the actual surpluses have been smaller and the deficits larger than the Government reported to the public.

Applying Generally Accepted Accounting Principles, the 1999/2000 deficit is expected to be as noted in Exhibit 33. This calculation is consistent with the determination of the reported Volume 3 results in prior years.

Exhibit 33 – Projected GAAP Deficit for 1999/2000

GAAP Adjustments	*1999/2000 Impact of Adjustment*
Forecast deficit of Operating Fund	($100)
Eliminate effect of Fiscal Stabilization Fund transfer	(185)
Eliminate effect of Debt Retirement Fund transfer	75
Adjust pension expense to GAAP basis	(123)
Manitoba Hydro, MPI and WCB net surplus	207
Estimated aggregate net surplus of Crown Organizations	50
Other	24
Projected GAAP Deficit	***($52)***

A "Normalized" View of Financial Results

As described in Chapter II, the Operating Fund deficit for the current year is now projected to be $100 to $135 million. However, this projection is affected to a large degree by the non-recurring revenues and transfers from the Fiscal Stabilization Fund. Without the Fiscal Stabilization Fund, which represents one-time income earned in previous years, the deficit this year would be in the range of $285 to $320 million.

Therefore, ***to more clearly understand the underlying nature of the Government's financial condition, we have completed an analysis of the past three fiscal years and the current year's projected results for the Province's Operating Fund. Using a "normalized" picture of each year's reported financial result, this eliminates the impact of non-recurring revenues, transfers from the Fiscal Stabilization Fund and non-recurring expenditures.***

This analysis, which is set out in Exhibit 34, also indicates a deteriorating surplus/deficit trend beginning in recent years. Further, it demonstrates that expenditures at the projected 1999/2000 levels are significantly greater than the anticipated continuing revenues. This gap poses a significant financial management challenge for the Government.

Exhibit 34 – "Normalized" Revenue and Expenditures Using the Current Accounting Procedures

	Year Ended March 31			
(in millions)	*1997 Actual*	*1998 Actual*	*1999 Actual*	*2000 Projected*
Total Reported Revenues (including transfers from the Fiscal Stabilization Fund)	$5,499	$5,842	$6,067	$6,342
Remove Internal Transfers and Non Recurring Items:				
Transfers from Fiscal Stabilization Fund		(100)	(186)	(185)
Canada Health Transfer				(131)
Prior Year Federal Adjustments in Excess of Expected Amount			(110)	(100)
Emergency Expenditure and Flood Proofing Cost Recoveries from Federal Government	(6)	(168)	(28)	(40)
"Normalized" Revenues	$5,493	$5,574	$5,743	$5,886
Total Disbursements				
Expenditures	$5,408	$5,691	$5,887	$6,367
Debt Retirement Fund Payments		75	150	75
	5,408	5,766	6,037	6,442
Remove Non Recurring Disbursements:				
Extra Debt Repayment			(75)	
Valuation Adjustment				(48)
Emergency Expenditures and Flood Proofing Costs		(217)	(98)	(138)
"Normalized" Expenditures	$5,408	$5,549	$5,864	$6,256
"Normalized" Revenues Less "Normalized" Expenditures	$85	$25	($121)	($370)
Surplus/(Deficit) as Reported/Projected – Volume 1	$91	$76	$30	($100)
Difference between "Normalized" and non-"Normalized"	$6	$51	$151	$270

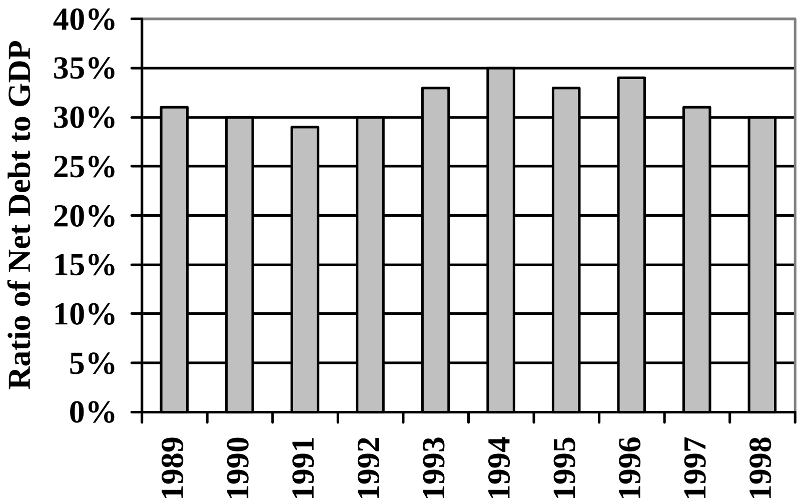
The $370 million excess of "Normalized" Expenditures over "Normalized" Revenues projected for the year ending March 31, 2000 is substantially above the projected deficit of $100 million that results from using the existing accounting rules. This is due primarily to federal government transfers of $231 million that cannot be expected to occur in subsequent years. In addition, a transfer from the Fiscal Stabilization Fund of $185 million does **not** represent true third party revenue and is also not sustainable due to the limited sources of one-time revenue from 1989 to 1998 in the Fiscal Stabilization Fund. It is preferable for Manitobans to have the full, true and plain picture of their financial circumstances.

2. Ratio of Net Debt to Gross Domestic Product (GDP)

The net debt to GDP ratio measures the level of debt that a government is carrying relative to the Province's Gross Domestic Product (GDP). In calculating this and other ratios, we have used the definition of "net debt" set out by the CICA's PSAB. Net debt represents the amount of the

Province's deficit accumulated over time. It represents that portion of the Province's debt that is not invested in assets. The GDP is a measure of the size of the Province's economy. Consequently, an increasing ratio means that the Province's net debt is increasing faster than the size of the economy is growing. A declining ratio means exactly the converse, with the burden of debt decreasing in relation to economic growth. Manitoba's performance on this measure in recent years is presented in the following chart.

Chart A-2(a) Ratio of Net Debt[1] to GDP



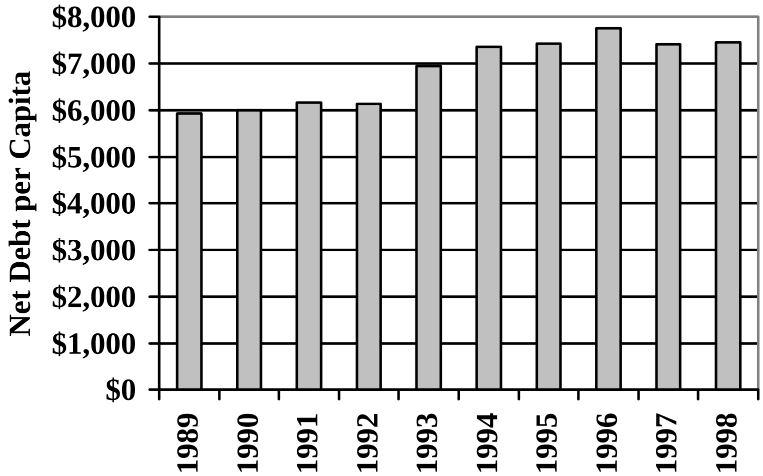
[1]PSAB defines net debt as the Province's liabilities, including the unfunded pension liability, less its assets

Over the last ten years, the Province's ratio of net debt to GDP increased in the period up to 1994. This meant that the burden of debt on taxpayers was becoming more onerous. Since 1994, however, the ratio has been declining somewhat. As the Province ran surpluses, its ratio of net debt to GDP declined, reflecting a gradual improvement in the Province's financial position.

3. RATIO OF NET DEBT PER CAPITA

The net debt per capita ratio measures the size of the Province's net debt in relation to the size of the Province's population. A declining ratio means that the debt burden of the Province is decreasing on a per person basis. An increasing ratio means that relative to the size of the population, the debt burden is increasing. Manitoba's record on this measure is noted in the following chart.

Chart A-2(b) Ratio of Net Debt[1] per Capita



[1]PSAB defines net debt as the Province's liabilities, including the unfunded pension liability, less its assets

Over the past ten years, the ratio (or burden) increased until 1996. At that point, the situation started to improve and this has continued through the 1997-1998 period. However, the debt per person is still well above what it was in 1989.

4. CONCLUSION ON SUSTAINABILITY – THE FIRST PRIORITY

In recent years, the achievement of surpluses in the Province's summary financial statements displays an improvement in the sustainability of the Province's financial position. However, gains on this front in the most recent year (1998/99) were quite modest. In the current year, substantial expenditure variances were not fully covered even though revenues are at levels substantially higher than budgeted. It is possible that the underlying position has again begun to deteriorate.

More importantly, looking to the future, the analysis of "normalized" expenditure and revenue levels indicates that ***existing ongoing, continuing revenue sources are insufficient to fund the continuing rate of increase in the expenditure base***. The gap between ongoing revenues and anticipated future expenditures amounts to approximately $370 million based on the projected results for 1999/2000. Accordingly, ***the financial sustainability of the Government's existing programs is questionable***. In other words, it is apparent that the Government will not be able to maintain its existing programs by relying on current revenue sources and rates.

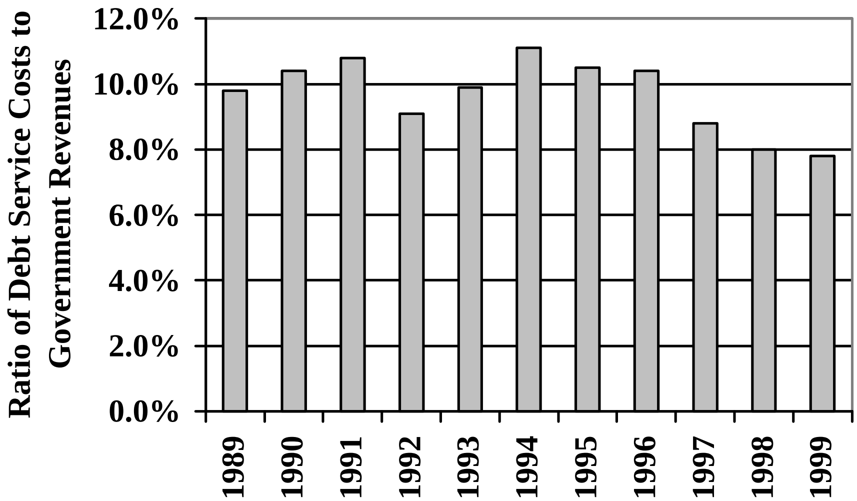
B. MEASURES OF FLEXIBILITY – THE SECOND PRIORITY

Flexibility is the degree to which a government can increase its financial resources to respond to rising commitments, by either expanding its revenues or increasing its debt burden. Indicators of flexibility include the ratio of debt service costs to government revenue and the ratio of own source revenue to provincial Gross Domestic Product.

1. Ratio of Debt Service Costs to Government Revenue

The more the Government pays in interest costs on its debt, the less it has available to support public programs. Over the last ten years, the ratio of debt costs to Government revenue has varied between 8% and 11%. However, it has decreased each year since 1994. This means that the proportion of government revenues used to fund debt service costs has steadily declined for each of the last five years. This again is an indication of improvement.

Chart B-1 Ratio of Debt Service Costs[1] to Government Revenue



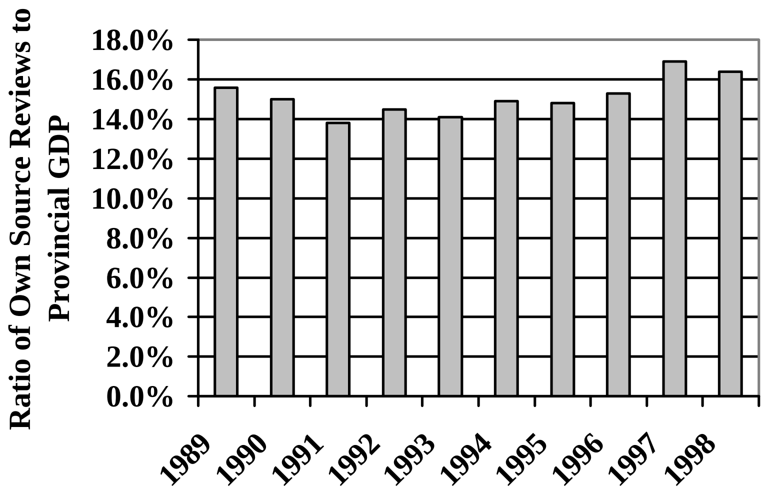
[1]Debt service costs are costs associated with the Province's aggregate borrowings.

As illustrated, in 1997, 1998, and 1999, the rate of debt service costs decreased noticeably, largely reflecting the impact of falling interest rates.

2. Ratio of Own Source Revenue to Provincial GDP

The ratio of own source revenue (raised from taxes in Manitoba) to provincial GDP highlights the extent to which a government is removing money from the Province's economy. As the ratio increases, the Government's flexibility is decreased. Over the last ten years, this ratio has remained relatively stable, with a slight increase in 1997 and 1998.

Chart B-2 Ratio of Own Source Revenue to GDP



This means that since 1991, an ever increasing proportion of provincial revenues has been generated within the province. It could be viewed that, on balance, this self-reliance is positive.

3. Conclusion on Flexibility – The Second Priority

Reductions in borrowing rates in recent years have increased the Province's flexibility, making more of its general revenues available for program spending. However, the magnitude of the Province's own source revenues in relation to the size of the Province's economy has increased during this same period. Therefore, overall financial flexibility has been reduced because of the steady increase of revenues representing an even larger portion of the economic output of the Province.

The Government also is constrained in flexibility due to *The Balanced Budget, Debt Repayment and Taxpayer Protection and Consequential Amendments Act*. As described in Chapter II, this legislation sets out, under threat of penalty of salary reduction to the members of Executive Council:

- the relationship between revenues and expenditures that must exist each year;
- minimum annual debt repayment amounts, which effectively require the revenue available because of reduced debt costs to be channelled into increased debt repayment rather than programs; and,
- the requirement that a referendum be held if rate increases to major taxes are contemplated.

Generally, the Government has limited flexibility in dealing with its deteriorating financial circumstances.

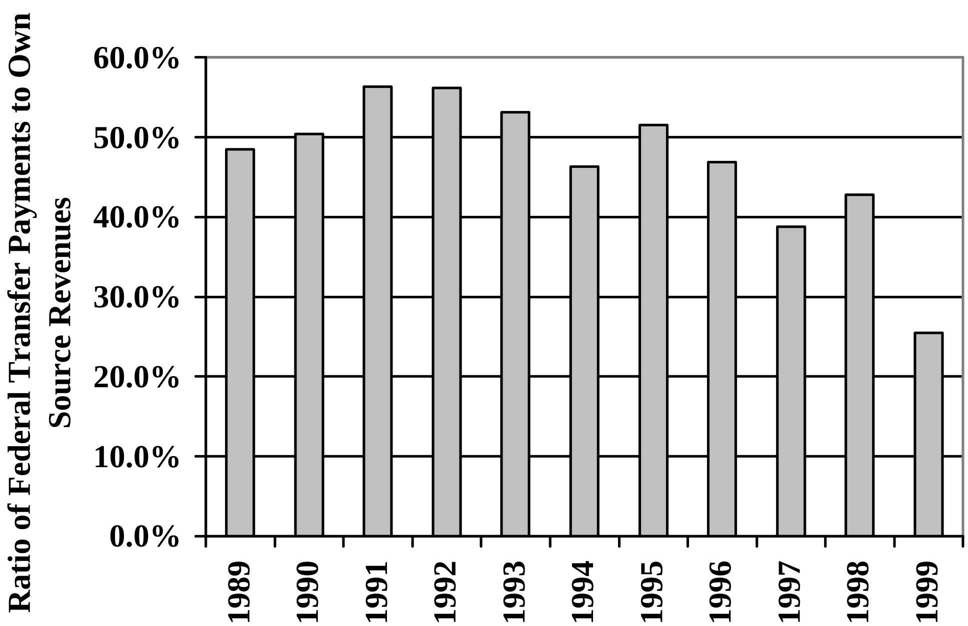
C. MEASURES OF VULNERABILITY – THE THIRD PRIORITY

Vulnerability is the degree to which a government becomes dependent on, and therefore vulnerable to, sources of funding outside its control or influence, both domestic and international. Indicators of vulnerability include the ratio of federal transfer payments to provincial revenues and the ratio of foreign currency debt to net government debt.

1. RATIO OF FEDERAL TRANSFER PAYMENTS TO PROVINCIAL REVENUES

The ratio of federal transfer payments to provincial revenues measures the Province's dependence on revenues from sources which are outside of its control. The primary external revenue source for the Province is transfers from the federal government. The experience over the last ten years has been a general decrease in this ratio. This reflects a reduction in federal government support in recent years.

Chart C-1 Ratio of Federal Transfer Payments to Provincial Revenues



2. Ratio of Foreign Currency Debt to Net Government Debt

The Province's Treasury Branch has adopted a policy of reducing foreign currency exposure. The ratio of foreign currency debt to net government debt is down considerably from a decade ago, from 33% in 1995 to 17% currently. This reduction mitigates the risk of debt costs rising because of changes in foreign currency rates and further improves the Province's financial position. This is a positive development.

3. Overall Conclusion on Vulnerability – The Third Priority

Based on this framework for measuring financial condition, the measures of vulnerability show improvement in the last several years. The Province has become proportionately more reliant on revenues it generates within Manitoba (see above) and proportionately less reliant on federal transfer payments. This development has incurred both as a result of an increase in the absolute magnitude of Manitoba's own-source revenues and significant, continuing decreases in the absolute amount of federal transfer payments.

However, a conclusion that the Province is less vulnerable as a result of federal government revenue reductions is questionable. This view does not recognize the importance of ongoing and substantive federal government financial support to the Province. We would argue that this dependence makes the Government's financial condition more, not less, vulnerable.

An additional consideration is the fact that Manitoba's income taxes are determined as a percentage of federal income tax revenues generated within Manitoba only. Federal income tax rate reductions have a direct and negative impact on Manitoba's income tax revenues unless the Government increases its tax rate.

With respect to revenues generally, variability is a consistently complicating factor for the Government. The issue is particularly problematic as it relates to federal government transfers. The variability in the amount of federal revenue has been and is again this year dramatic when comparing budgeted to actual/forecast results. Additionally, the timing of the Government's ability to estimate the level of federal transfers to be received creates great uncertainty. As noted earlier in this report, in the current year, information received in January was substantially different from that which could be estimated in early November of 1999.

D. OVERALL CONCLUSION ON THE PROVINCE'S FINANCIAL CONDITION

Considerable progress has been made in recent years in improving the financial position of the Province of Manitoba. However, several more significant challenges remain. The most critical of these issues is the ***lack of sustainability*** of the Province's current and anticipated expenditure levels. The Province cannot indefinitely rely on one-time and non-sustainable revenue sources, or it will be forced back into a deficit. Further challenges lie in the ***limited flexibility*** that the Government has to manage these circumstances, particularly in increasing existing own-source revenues. With respect to ***vulnerability***, we suggest that the message is mixed – an improvement in the area of foreign currency debt, but a dramatically decreased reliance on federal government transfers which makes the Province ***increasingly dependent on own-source revenues***. This reality points to a need for the Government to consider *new or enhanced* sources of revenue and the need for much tighter expenditure controls.

IV. FINANCIAL MANAGEMENT ISSUES AND RECOMMENDATIONS

Both financial reporting and financial management speak to the fundamental issue of public accountability. Financial decisions are made, implemented, and the end results are reported back to the Legislature and the public. All three of these activities demand that individual elected representatives and public servants accept responsibility and exercise judgement as they fulfill their defined roles. We have noted in our review work that in each area – making decisions, implementing them, and reporting on results – the Government is in a position to make substantive improvements.

Due to the diligence of the Provincial Auditor in assessing the Government's performance, financial reporting has received major attention. We have concluded that financial management must be a focal point for the Government. The historical gaps in both revenue and expenditures from approved budgets to actual amounts, and the recurring difficulties in projecting and managing financial pressures, point to a need to strengthen financial management across the spectrum – from planning to decision-making to implementation and monitoring performance.

While a focus on the financial reporting issues is appropriate and important for the new Government, we caution that the resolution of outstanding issues in this area will not by itself resolve apparent financial management issues. Confidence in financial management needs to be strengthened. As a first step, the Government needs to define its financial management priorities and direction.

Timeliness of financial information is central to the confidence factor. Good information provides the Government with an ability to act on a timely basis to properly address issues as they arise. While a certain degree of uncertainty is inevitable for both revenue and expenditure results compared to plans, we note that the timing can be particularly problematic. We cite two examples:

- Revenues: Prior to release of our November 17, 1999 interim report, we asked Manitoba Finance officials about the level of certainty with respect to the revenue increase projected for the year. Based on information Manitoba Finance had received and reviewed to that date, we said in our November report that increased revenues were expected to be $42 million. Additional data was received by Manitoba Finance throughout December. In early January, we were informed that the total variance was thought to be $262 million, attributed primarily to new indications from the federal government respecting increases in transfer payments. In early February, this figure was revised to $260 million.

- Expenditures: Over the course of our review work, expenditure estimates for Manitoba Health varied widely and continuously, including changes in a one-week period of more than $30 million.

These examples raise issues of confidence and uncertainty that can have a profound impact on the Government's ability to plan and manage its finances. With both expenditures and revenues subject to such wide swings, good financial management is more difficult.

We found financial management issues in all four components of the Province's financial position. We discuss these below.

A. TREASURY FUNCTION AND SPECIAL FUNDS

We have considered the situation related to the Province's treasury function and special funds and have reached these conclusions:

1. STRATEGIES FOR THE USE OF THE FISCAL STABILIZATION AND DEBT RETIREMENT FUNDS

The existing *Fiscal Stabilization Fund Act* permits the Government to use the Fund as a financial management tool – drawing monies from the Fund in lean years and "setting aside" surplus monies in years where significant surpluses are experienced. In this way, the Fund is used as a mechanism to assist the Government in its management of the Province's cash flow. The Fund has been central to the reporting of balanced budgets.

By virtue of the way that the transfers from the Fiscal Stabilization Fund have been accounted for since its establishment, the use of this financial management tool has had a significant impact on the reported annual surplus or deficit position reported in Volume 1 of the Public Accounts. However, the Provincial Auditor has noted that this treatment of these transfers from the Fund is fundamentally inconsistent with Generally Accepted Accounting Principles. Using the accounting procedures sanctioned by the senior professional accounting body in Canada, more of the budget surpluses of the past years would not have occurred.

Further, we agree with the Provincial Auditor that the Government should move to fully adopting Generally Accepted Accounting Principles for public sector bodies in its presentation of the financial position and results of the Province. With a GAAP approach, the use of transfers from the Fiscal Stabilization Fund will no longer be accounted for as revenue. The Fund will become solely a financial and cash flow management tool available to the Government in achieving compliance with the balanced budget legislation. Government will need to articulate a strategy for how and when it will use the Fund for financial management purposes.

Similarly, transfers from the Province's Operating Fund to the Debt Retirement Fund have affected the annual reported surpluses. Alternatively, with the application of GAAP, Debt Retirement Fund transfers would not have an impact on the reported surplus or deficit. Instead, the Fund would be used solely as a tool for the Government to repay the Province's debt. Given this more appropriate perspective, the formulation of debt retirement policies and strategies would then become of critical importance.

We recommend that the Government move now to fully adopting Generally Accepted Accounting Principles for public sector bodies in its presentation of the financial position and results of the Province. This will give Manitobans a more accurate and consistent accounting of the Province's financial situation.

We recommend that the Government alter its financial reporting processes so that Fiscal Stabilization Fund transfers are no longer accounted for as revenues. We further recommend that the Government use the Fiscal Stabilization Fund strictly as a financial management tool in the context of a multi-year financial management strategy.

We recommend that the Government formulate alternative but obligatory debt retirement priorities and strategies.

2. A Framework for Managing/Monitoring the Use of Borrowings to Fund Capital Spending

Under previous accounting policies of the Province, capital spending was budgeted for in departmental appropriations or in other appropriations as part of the annual Consolidated Fund Estimates. With the move (beginning in 1999/2000) to the capitalization of fixed assets (non-infrastructure) purchases, the annual Estimates include a (non cash) charge for amortization of fixed assets and provide separate capital spending approval. This spending is financed through the issuance of new debt.

Intuitively, cash equal to the annual amortization of fixed assets in the Consolidated Fund is available to pay down this debt. However, we are not aware that any longer term framework has been developed to ensure that capital spending (and by implication, new public debt to finance the spending) is approved at levels that provide for the reasonable and sustainable repayment of the debt from cash resources provided by the Operating Fund. This is especially important because of the pressure on greater capital expenditures for health services and because of the apparent substantial infrastructure maintenance backlog that will almost certainly require large capital investments to replace existing infrastructure.

In addition, substantial capital expenditures in health and education are approved annually. Provincial funding for these takes the form of annual payments to fund the external debts incurred to build facilities. Consequently, capital approvals in any given year will commit future Operating Fund expenditures.

The development of a long-term view on capital expenditures, including full understanding of future year funding implications – especially in health – should be a priority of Government. Health capital expenditures almost always bring subsequent operating cost increases. Accordingly, the long-term view should take these future operational costs of new facilities into account. We understand that this is currently not being done.

We recommend that the Government develop an overall multi-year framework to govern the capital budgeting process. This process should integrate the capital requirements of all departments. The framework should consider the source of funding for capital purchases, the required debt service payments on monies borrowed to fund the capital spending and the Government's ability to make the required debt service payments from cash flow generated by the operations of the Province.

We recommend that health capital spending adopt a more long-term view with respect to both anticipated capital needs and the amount of future operating funding committed by current capital approvals.

B. OPERATING FUND

Financial management issues related to the Province's Operating Fund are centred on the Government's need to effectively plan, make decisions, implement, and monitor revenue and expenditure measures. We have identified a number of considerations that necessarily have an impact on the Government's ability to set its financial management course.

The Province's Operating Fund is a large and complex entity, with numerous revenue streams, a significant number of types of expenditures, and a multitude of transactions. For the budget to be truly balanced, the Government must manage its resources more effectively despite constant change. For example, the stability of revenue sources changes over time, notably the level of federal government transfers. The creation and use of the Fiscal Stabilization and Debt Retirement Funds has created another layer of complexity. And the Government faces emergency situations that demand unplanned expenditure commitments. These factors create a complicated financial management environment. However, a significant portion of the Province's revenue and expenditure picture is relatively stable and predictable and can be more expertly managed by the Government. The predictable revenue and the tool of expenditure control must be major factors in setting the annual approved budget.

1. A STRUCTURAL FINANCIAL CHALLENGE

As described earlier in this report, we have completed an analysis of the past three fiscal years and the current year's projected results for the Province's Operating Fund to produce a "normalized" picture of each year's reported financial result, eliminating the impact of non-recurring revenues, transfers from the Fiscal Stabilization Fund and non-recurring expenditures.

This analysis indicates a deteriorating surplus/deficit trend in recent years. It also demonstrates that expenditures at the projected 1999/2000 levels are significantly greater than anticipated continuing revenues. This gap poses a significant financial management challenge for the Government.

The Province's recent financial history, the projections for the current year and the forecasts for the following year all suggest that the demands for expenditures will consistently outstrip the annually generated revenues of the Province. By using transfers from the Fiscal Stabilization

Fund and by utilizing one-time unsustainable revenues substantially in excess of those budgeted from the federal government (e.g., the CHST supplement transfer), the Government has achieved a surplus position in its Volume 1 reporting over the past two years. However, in the absence of substantially increased and certain revenues, continuation of this approach is not sustainable or appropriate.

Acknowledging this fundamental imbalance of revenues and expenditures must be a cornerstone of this Government's long-term financial management framework.

> *We recommend that the Government immediately develop a plan to address the structural deficit in the Operating Fund, and begin implementation in 2000.*

2. A Need to Establish and Maintain Spending Priorities

In the face of the unsustainable position highlighted above, it is of paramount importance that the Government identify areas of higher spending priority and set targets to reduce costs in other areas.

We understand that historically, the Government's spending restraint efforts have tended to focus on nominal "across the board" reductions in program budgets. However, the extent of the clearly unsustainable balance of expenditures and revenues means that this approach will be insufficient to produce the required financial results. Given that there is a need to increase spending in those areas identified as policy priorities by the new Government, substantive offsetting reductions in spending are necessary in other areas. To determine where reductions can and should be made will be a difficult task. It will inevitably involve changes to the operational and administrative arrangements of Government. Part of this must be further consideration of steps to increase public sector productivity by redesigning government processes, operations and structures.

We will address this issue further in our Phase II report on the Government's budget and expenditure management process.

> *We recommend that the Government actively pursue further opportunities for the enhancement of public sector productivity by using alternative service delivery and other means.*

3. Evolving Human Resources Issues

The Government faces particular human resources challenges around delivery and management of government programming. A key consideration will necessarily be to determine the required staffing levels to deliver the new Government's highest priority services.

A second consideration relates to the need to renew the public sector workforce, a factor that can be affected to some degree by the large number of retirements expected over the next few years. A key element in attracting and retaining younger people in all areas of the public sector is compensation.

$560 million of the total $6 billion budget is for civil service compensation. Further, a significant part of the $6 billion goes to health care and education, where the largest part of expenditures is for compensation. Accordingly, the management of the public sector compensation framework is a key issue for the Government.

We recommend that the Government include in its financial management framework an approach to public sector compensation and employment that (a) aligns resources to approved programs, (b) rewards competence and productivity, and (c) addresses the issues of precedent, expectations, and the Government's capacity to deliver public services.

4. FINANCIAL MANAGEMENT OF THE HEALTH PORTFOLIO

Because of the dominant impact of health spending on the overall budget, the strength of financial management in this area is especially important to the Government's ability to ensure effective use of limited resources. Financial management of the health care budget was therefore a focal point of our review.

The role of Manitoba Health in managing health care expenditures has been evolving over the past several years, most recently with the establishment of Regional Health Authorities. However, the department remains the fundamental source of management information for the Government's decision-making in this high priority and expansive area.

We worked with Manitoba Health officials to understand and validate the significant expenditure variances identified for the current year. However, it became apparent that Manitoba Health had difficulty obtaining current and precise information about certain costs being incurred by individual health care facilities. We were advised that the information was maintained and controlled by health care providers and that current, accurate information on the financial aspects of many of the operations of the health care system was not centrally available. Manitoba Health indicated that these requirements for operational or financial information are addressed primarily through ad hoc efforts to gather specific pieces of information.

This situation, combined with a continuing series of large variances from budgeted expenditures, gives support to the new Government's decision to focus attention on more effective management of health care spending. Central to this process should be the confirmation of a clear governance framework for the health care system, including the distribution of appropriate management and reporting roles and responsibilities between Manitoba Health and health care providers. In the longer term, this will require major improvements in the systems to collect, report and project critical information.

The degree of fluctuation in estimating Manitoba Health expenditures for the current year has been substantial, involving swings in the order of $30 million in a period of weeks. This is evidence of the financial information deficiencies that need to be addressed.

As we understand it, the timing of the budget process for Manitoba Health and Regional Health Authorities is particularly problematic. By the time that RHAs are informed of their budgets and the RHAs then inform their health provider organizations of their budgets, the fiscal year has already started, and in some instances is well along. This delay inevitably has an impact on both the current year and future year expenditures, as program assumptions are made and their related costs become embedded in the expenditure base. Government needs to tackle this timing issue with a view to earlier communications of budgetary parameters to the RHAs.

A significant component of health care expenditures is the funding to support approved capital programs and annual debt service for capital investment in earlier years. Treasury Board staff analysis of health capital commitments has identified that:

- It is not uncommon for the actual costs of capital projects to be much higher than the initial estimates. This can be the result of poor estimating, a revision to scope, or the impact of changes in construction market circumstances due to the passage of time.
- Mid-year approvals have at times resulted in increases to the annual capital program.
- Future year commitments have frequently not provided for the impact of related operating costs to run the capital facilities. In many instances, these are substantial.

The approved capital programs involve a commitment of substantial funding for future years just to service the debt costs. For example, by 2003/04, the annual spending by Manitoba Health for capital debt service costs will have grown to more than $130 million.

The health capital program will necessarily be a focus for the Government as it deals with defined financial pressures for future years.

We recommend that the Government immediately focus attention on more effective management of the health care budget.

We recommend that the Government confirm a clear multi-year governance framework for the health care system, including the clarification of management and reporting roles and responsibilities between Manitoba Health and health care providers in the Regional Health Authorities. This will require better and more timely financial information on actual expenditures and costs of services.

We recommend that the Government adopt both short-term and long-term approaches to improving health care management information systems.

5. THE PENSION ISSUE

In recent years, two significant pension liability issues have been identified with respect to the Province's pension liabilities. First, the Provincial Auditor has disagreed with the Province's failure to record pension costs for the current service of employees throughout the year in the Operating Fund. Second, the $2.8 billion pension liability is completely unfunded, an issue that has been highlighted for several years and requires a solution.

The financial accounting and reporting of pensions are dealt with in the following chapter. However, regardless of the way in which the unfunded pension liability is accounted for, a significant financial management issue is inherent in these circumstances. Over the past 10 years, the unfunded pension liability has increased from $1.17 to $2.8 billion. This unfunded liability represents the present value of the pension benefits to which Government of Manitoba employees, teachers and MLAs are entitled for services provided to the current time. This amount will continue to increase as employees continue to provide service.

The Province's current approach of funding only the payments which are made to retirees in a given year has two specific implications:

- As a result of the significant increase in retirements from the civil service anticipated over the next decade, the "cash cost" to fund payments to retirees will grow substantially. By way of illustration, payments to retirees have grown from $37 million in 1988 to $116 million in 1998/99.

- The annual growth in the pension liability attributable to current services is not funded. Consequently, the unfunded pension liability has continued to grow.

Manitoba Finance has developed options that the Government might consider for funding the pension plan. In addition, the Government should obtain an accurate projection of ongoing financial implications of the pension issue under a variety of funding options. The Government's preferred option should be identified and acted upon. Clearly, given the sheer magnitude of the unfunded liability, the resolution of this issue can only be achieved with a long term strategy to retire this debt. Any delay in formulating and beginning to implement this strategy will compound the issue by permitting the unfunded liability to increase.

As the Government evaluates which of the options it wants to implement, we suggest that clear principles be used to test the merits of each proposed strategy. The following represent the ideals Government should aim for in addressing the pension issue:

- The Government's contribution to the pension plan should be sufficient to at least offset the increase in the liability attributable to the current services of employees, teachers, and MLAs. In other words, the unfunded pension liability should not be allowed to increase beyond its present level.

- In addition to maintaining the unfunded liability at a consistent level, additional contributions should be considered so that over a specified period, the amount of the unfunded liability will be significantly reduced and ultimately fully eliminated.

However, since the cash required to achieve these ideals is unlikely to be readily available, an alternative framework would be to:

- Begin payments at levels in excess of current "pay as you go" requirements. Some contribution annually toward the unfunded liability would be progress, however modest.

- Begin addressing current service costs. For instance, consider funding current service costs of all new employees coming into government.

Adherence to principles is critically important because the unfunded pension liability is different from a typical debt obligation. Traditional debt obligations contractually require interest payments to maintain the debt level at a consistent amount until payments beyond the amount of the interest reduce the obligation. In the case of the unfunded pension liability, there are no contractual arrangements requiring the Province to make "the principal and interest" payments. The payments which the Province has made to cover the pensions of existing retirees are currently insufficient to meet even the interest costs associated with the unfunded pension liability. Therefore, in the absence of a commitment by the Government to adhere to the above two principles, the unfunded pension liability continues to grow.

However, the Government should begin viewing the pension liability as part of the Province's aggregate debt. Addressing the pension and debt repayment issues could then be grouped as a "debt retirement" objective.

We recognize that the Government's action on the pension issue must deal with the practical reality of the Government's resource capacity to deal with the situation over time.

We recommend that the Government adhere to the following principles when determining how to approach the pension issue:

(1) Begin payments at levels in excess of current "pay as you go" requirements. Some contribution annually toward the unfunded liability would be progress, however modest.

(2) Begin addressing current service costs. For instance, consider funding current service costs of all new employees coming into government.

6. GOVERNANCE OF CROWN ORGANIZATIONS

As described earlier in this report, a considerable portion of the services funded by Government are provided to Manitobans through Crown organizations. The expenditure variances for the current year for these entities indicate that approximately $202.1 million of the 1999/2000 expenditure variances will be incurred by such Crown organizations. In particular, the deficits of the Regional Health Authorities and Winnipeg Child and Family Services are over and above amounts that were set out in the original approved budget.

The expenditure management and control processes that the Government currently utilizes places significant accountability on government departments for the funding allocated to them in the annual estimates process. Departments are required to seek Treasury Board approval in advance of incurring specific unbudgeted expenditures. With respect to general operations, the departments are required to keep Treasury Board regularly informed as to the status of their spending vis-a-vis their budget estimates.

The departments, in turn, provide funding to Crown organizations. The Crown organizations are required to provide considerable information to the departments to which they are responsible.

This information assists departments in monitoring expenditure levels. However, where Crown organizations spend more than was approved in their original budgets, the departments appear to see their role as primarily to indicate that increased funding for the Crown organization will be required.

Expenditure variance circumstances can arise for one or two reasons for Crown organizations. First, unanticipated costs may surface as they do for any program. However, another scenario is that the originally budgeted funding may have been inadequate to begin with, in order to permit the organization to achieve the objectives set out in its mandate. Crown organizations may be operating on the basis that their fulfillment of mandate takes precedence over management of resources within budget levels. The obvious solution is to bring the approved budget or expenditure limit and the service delivery objectives into line at the start of the year, and then to aggressively control expenditures to this level.

A clearly complicating factor in the relationship between Government as funder and Crown organizations as program delivery mechanisms is the distance between the two. With the number of layers of management reporting, it is difficult to achieve effective and timely information flow, communications, and understanding. We see this particularly evident in health care, where the layers involve Government, Manitoba Health, the Regional Health Authorities, and individual health care providers (e.g., hospitals, long term care facilities, community health clinics, etc.). Where health care providers contract for services, an additional layer is added.

The situation is also complex in education, with the Government, Manitoba Education and Training, the Council on Post Secondary Education, and education providers (e.g., universities and community colleges). The level of confidence in "umbrella" organizations such as the Regional Health Authorities and the Council on Post Secondary Education is therefore extremely important, both for the Government as funder and for the organizations responsible for direct delivery of services.

The understanding and commitment of all parties (Crown organizations and their funding Departments) to sound financial management principles and clearly defined roles and responsibilities are key to dealing effectively with this challenge.

We recommend that the Government assess and enhance the governance framework for Crown organizations with the objective of confirming for Crown organizations – and for the departments that fund them – an understanding and commitment to financial management principles and clearly defined roles and responsibilities.

C. GOVERNMENT ENTERPRISES

Historically, Manitoba Liquor Control Commission and Manitoba Lotteries Corporation have transferred the amount of their annual surplus to the Province's Operating Fund. Such transfers or dividends have not been paid from Manitoba Hydro or the Manitoba Public Insurance Corporation.

We are aware that the Government is considering the strategies employed in other provinces where a regular return on the provinces' invested capital is paid by the Government Enterprises to the Operating Fund of the Province. Such a strategy in Manitoba would require the Government to consider two particular matters. First, legislative amendments may be required in order to make the transfers possible. Second, a government policy framework would need to be developed to govern the nature and extent of revenue transfers or dividends.

As the Government is contemplating the allocation of a certain portion of a Government Enterprise's annual income or a portion of a Government Enterprise's accumulated/retained surplus, the following factors must be considered when determining the amount of such transfers to the Operating Fund:

- How much of the annual income is required to be reinvested in the enterprise's business to enable it to maintain and expand its service delivery capabilities? What is the business basis for the accumulation of the reserves to date?

- Does the amount of the contemplated transfer impair the enterprise's ability to operate in its business environment?

- Where one of the public policy objectives is the provision of low cost service to Manitobans, what will the impact be in terms of rate/cost increases to consumers of the enterprise's service? Further, what constraints is the Government prepared to place upon itself with respect to the impact that such transfers might have on rates/costs?

- How will the obligation to pay dividends integrate with regulatory protection of the public interest?

These questions need to be answered before the Government implements the collection of dividends from enterprises for the Province's Operating Fund.

Private sector companies pay both income tax and dividends, and the approach to Crown Enterprises in Manitoba could involve either or both revenue-producing measures. We understand that Ontario has recently addressed the taxation issue, and Manitoba may benefit from a review of that situation. Also, in assessing the appropriate policy framework for Manitoba, the Government will need to consider both short-term and long-term perspectives, and determine which approach best serves each timeframe.

With the clarity of a well-articulated framework, Manitoba taxpayers will be able to more readily appreciate the rationale for the revenue policy and have the assurance that the Province's Operating Fund is not being enriched at the expense of the financial strength of the Government Enterprises or through a disguised "tax".

We recommend that as the Government looks at increasing revenue from selected Government Enterprises for transfer to the Operating Fund, assurances be provided that any such transfers will not compromise the ongoing financial strength or integrity of the Government Enterprises as they discharge their individual service delivery mandates.

D. FINANCIAL MANAGEMENT ISSUES AFFECTING MULTIPLE COMPONENTS OF PROVINCIAL FINANCES

In the course of our review, we found a number of financial management issues that affect more than one component of the Province's financial position.

1. Business Cases for Technology Projects

As we are reporting on separately, the Province has made substantial investments in information technology. We were advised by officials from several departments that they anticipate their costs of operation will increase as a result of newly implemented technologies.

When information technology projects are envisioned and then distilled into an executable strategy, the benefits to be obtained from the investment should be articulated and quantified. This articulation of the targeted benefits of the investment is an essential component of sound management in determining whether there will be sufficient return on the investment to support the technology expenditure. The benefits that might be achieved include improved service delivery capacity or decreased costs of operations through identification and realization of improved efficiencies.

Now that the Better Methods and Desktop Management technology projects have been implemented, a more focused effort to realize the improved service delivery capacity or decreased costs should become a part of the Province's technology management strategy. Using the information systems produced by these two projects to provide better information to management and to improve productivity will ensure that the Province realizes an appropriate level of return on its investment.

We recommend that the Government actively undertake a more focused effort to realize improved service delivery capacity and cost control in its ongoing technology projects.

2. Internal Controls in the SAP Transaction Processing Environment

During our discussions with many departments, finance and administrative officials indicated that in their view, controls over the processing of departmental transactions, particularly purchases and payments, were not as strong as they were formerly under the system that preceded SAP.

We note that it is clear that internal controls in the SAP environment are substantially different in appearance and form than in systems such as those formerly used by the Province, and that it is common for new users of SAP systems to feel that a degree of internal control has been lost in the new system environment. This is because the nature of the controls, themselves, are substantially different.

However, we also note that SAP is not yet fully implemented. In particular, on-line approvals by managers is one key component not yet implemented, a fact that can contribute to weaker controls.

Given the importance of internal controls to overall financial management, the Government will need to ensure the new SAP environment serves this purpose effectively. A preliminary review may indicate that controls are adequately achieving the same control objectives as were present in the former system. It may simply be that the nature of the controls themselves is substantially different. It may also be possible that there are justifiable concerns that can be identified by the departments that should be appropriately addressed. However, the identification of this concern by the departments should serve as a call to ensure that the level of controls, particularly over purchases and payment, is appropriate.

> *We recommend that the Government assess the appropriateness of internal controls, particularly over purchases and payments, in the new SAP environment.*

3. MAINTENANCE EXPENDITURE DEFERRALS

During our discussions with government departments and Crown agencies, officials indicated a large number of areas they consider to have experienced an unacceptably high level of maintenance expenditure deferrals. This term refers to circumstances where departmental and entity officials believe that normal and appropriate repair, maintenance and facilities expansion that should have been done to maintain the long term operating capacity of individual capital facilities has not been completed due to inadequate funding. More significant items identified are noted in Exhibit 35.

Exhibit 35 – Maintenance Expenditure Deferrals

Department/Entity	Nature of Concern
Public Schools Finance Board	Aging school facilities and increased expectations for technology capabilities result in significant pressures to increase capital spending on school facilities.
Council on Post-Secondary Education	Universities who own and maintain their own capital assets and the colleges where this function is performed by the Department of Government Services both identify the need for significant upgrades, repairs and expansion of post-secondary facilities and equipment to maintain and expand program offerings and accommodate plans for increased enrolments.
Manitoba Government Services	The annual budget provided for repair and maintenance of government facilities is less than what the department believes is an appropriate level. As a consequence, the condition of various government facilities is reported to be deteriorating.
Manitoba Highways	Concerns: • funding to maintain the maintenance equipment fleet is inadequate; • funding to repair existing roadways is inadequate; and, • funding for major rehabilitation of particular roadways is insufficient.
Manitoba Health	Maintenance of hospital facilities, acquisition of state-of-the-art equipment and the need to accommodate increased patient loads has created significant pressure on capital spending.
Manitoba Housing	The Department has compiled a substantial list of modernization and improvement projects that need to be done to adequately maintain the Province's housing stock.
Manitoba Water Services Board	A substantial backlog of required rural water treatment projects has been compiled. The funding required for these projects exceeds the funding which is anticipated to be available over the next five years.
Manitoba Intergovernmental Affairs	The Department anticipates continued discussions with the City of Winnipeg regarding the City's capital and infrastructure needs.

In each of these cases, the responsible department had formulated its own views on the seriousness of the situation. The relevant department has also registered its concern about the need for increased funding with Treasury Board and the Department of Finance.

However, a comprehensive survey of these circumstances has not yet been prepared. In order for the Government to make decisions about which of these areas is to be given priority when capital and maintenance funding allocations are made, it would be appropriate to have this studied with a view to:

- Applying the same criteria to assess the seriousness of each one of the expenditure deferrals;
- Developing a comprehensive understanding of what the true magnitude of these deferrals is; and,
- Preparing a plan to begin to meet the confirmed needs once the details have been reviewed.

It would be unreasonable to initiate such a study with the expectation that new monies will be available to address every need. On the other hand, without a complete view and an appropriate comparison of the degree of need for each of these areas, it will be virtually impossible for the new Government to make considered decisions that take all competing priorities into account.

We recommend that the Government review and assess the deferral of maintenance expenditures and then develop a long term and steady course of action for addressing the problem, once the dimensions are clear.

V. FINANCIAL REPORTING ISSUES AND RECOMMENDATIONS

Financial reporting is central to the Government's accountability framework, and has been a focal point of our review.

Achieving transparency in financial communications generally and in financial reporting specifically must be central to all entities.

A. ACCOUNTABILITY / REPORTING CONTEXT

The objective of financial statements and financial reporting of all public or private enterprises is the communication of information to users. To enable an organization to effectively communicate financial information, the information must be prepared on a timely, reliable basis and must be relevant to the users' needs. In reviewing the appropriateness of the financial reporting of the Province of Manitoba, these considerations must be taken into account. Key users of the financial information cover a broad spectrum of interested parties including members of the Legislative Assembly, the general public, creditors, and bond rating agencies.

A significant attribute of financial reporting is the application of a consistency of accounting treatment, both between periods for the same entity and between similar types of entities. As a means of achieving consistency amongst various public sector entities, the Canadian Institute of Chartered Accountants (CICA) has authorized the Public Sector Accounting Board (PSAB) to issue recommendations and guidance on matters of accounting in the public sector.

The PSAB "issues such recommendations and guidance to serve the public interest by strengthening accountability in the public sector through developing, recommending and gaining acceptance of accounting and financial reporting standards of group practice". PSAB has formulated the following financial statement objectives that should be used as a point of reference in the evaluation and recommendations of financial reporting matters with respect to the Province of Manitoba.

1. Financial statements should communicate reliable information relevant to the needs of those for whom the statements were prepared in a manner that maximizes its usefulness. As a minimum, this requires information that is clearly presented, understandable, timely and consistent.

2. Financial statements should provide an accounting of the full nature and extent of financial affairs and resources for which the Government is responsible, including those related to the activities of Government agencies.

3. Financial statements should demonstrate the accountability of the Government for the financial affairs and resources entrusted to it:

a) Financial statements should provide the information useful in evaluating the Government performance in the management of the financial affairs and resources.

b) Financial statements should provide information useful in assessing whether financial resources were administered by the Government in accordance with the limits established by the appropriate legislative authorities.

4. Financial statements should account for the sources, allocation and the use of the Government's resources, the accounting period and show how Government financed its activities in the period and how it met its cash requirements.

5. Financial statements should present information to display the state of the Government's finances.

a) Financial statements should present information to describe the Government's financial condition and accounting at the end of the accounting period. The financial statements should provide information that is useful in evaluating the Government's ability to financing its activities and to meet its liabilities and commitments.

b) Financial statements should provide information that is useful in evaluating the Government's ability to finance its activities and to meet its liabilities and commitments.

> *We recommend that the Government now fully adopt the financial reporting objectives articulated by the Public Sector Accounting Board of the CICA.*
>
> *We recommend that the Government indicate that for all external financial reporting of its financial position and results of operations, the consolidated government reporting entity, using full application of Generally Accepted Accounting Principles (GAAP), will be the basis for financial reporting.*

B. EXISTING PROVINCE OF MANITOBA FINANCIAL REPORTING TO THE PUBLIC

The public accounts of the Province of Manitoba are prepared by statutory requirement, in accordance with *The Financial Administration Act*. For the fiscal year ended March 31, 1999, the Province produced its financial information in four volumes as follows.

1. VOLUME 1

Volume 1 contains the financial statements of the Operating Fund and Special Funds of the Government and schedules of supporting information. The financial statements in Volume 1 only reflect transactions and balances of the Operating Fund and Special Funds of the Province of Manitoba. The Volume 1 financial statements however, are what are principally used for the budgeting process and follows the accounting principles used in that process.

In addition, the financial statements are used to assess the Government's compliance with *The Balanced Budget, Debt Retirement and Taxpayer Protection Act*. When the Government communicates both its budget estimates for the year, as well as its financial results vis-a-vis these estimates, it is the Volume 1 financial statement which is commonly being referred to when describing the Government's financial position.

However, other significant financial activities of the Government which occur outside the Operating Fund and the Special Funds are not included in the Volume 1 financial statements. In addition, the accounting principles used for Volume 1 are not in accordance with GAAP. The presentation of the Volume 1 financial statements, which excludes many of the non-Operating Fund entities, is in and of itself not in accordance with Generally Accepted Accounting Principles. In addition, Volume 1 financial information does not include provision for the pension liability to which the Province of Manitoba has a significant and unfunded obligation.

2. VOLUME 2

Volume 2 contains details of compensation paid to employees as well as payments to corporations, firms and other individuals in Governments and Government agencies.

3. VOLUME 3

Volume 3 contains the summary financial statements of the Government and schedules of supporting information. These financial statements reflect the consolidation of the financial operations of all organizations integral to the overall operation of Government in performing its executive function.

The calculation of projected Volume 3 results for 1999/2000 would be as noted in Exhibit 36.

Exhibit 36 – Calculation of Projected Volume 3 Results for 1999/2000

Calculation	*Amount (millions)*
Projected Volume 1 deficit	($100)
Add:	
Projected income from Government Enterprises not otherwise included:	
• Workers Compensation Board	4
• Manitoba Hydro	142
• MPIC	61
Projected income from Crown Organizations	50
Adjust pension expense to GAAP basis	(123)
Other	
• Eliminate effect of Fiscal Stabilization Fund transfer	(185)
• Eliminate effect of Debt Retirement Fund transfer	75
• Other	24
Projected Volume 3 Deficit	***($52)***

The Volume 3 summary financial statements provide a much more comprehensive picture of the various entities for which the Government is responsible. For the year ended March 31, 1999, the Government did appropriately include all entities within the definition of the financial reporting entity with the exception of the Regional Health Authorities (RHAs), which were not included. It is noted in the summary financial statements that the RHAs are in the transitional phase of development and the RHAs would be included for the fiscal year 1999 – 2000 and subsequent years.

Schedule 7 to the summary financial statements notes that the statements comprising the Government Reporting Entity include the Operating Fund and Special Funds, all crown organizations, and Government Enterprises (including all Crown corporations). This inclusion of entities within the Government reporting entity is consistent with the PSAB recommendations which state that "the Government reporting entity should comprise the organizations that are accountable for the administration of their financial affairs and resources either to a Minister of the Government or directly to the Legislature, and are owned or controlled by the Government".

Government control is defined as "an organization when without requiring the consent of others or changing the existing legislative provisions, the Government has the authority to determine the financial and operating policies of that organization". The determination of the financial operating policies of an organization allows the Government to establish the fundamental basis of the conduct of the organization's financial affairs as well as the deployment of its resources. In addition to the previously mentioned exclusion of the RHAs from the financial statements for the year ended March 31, 1999, two other deviations from GAAP were noted.

Certain assets under development in the systems area have not been re-stated to the expenditure basis of accounting for such capital assets. This was a transitional treatment as the Government is currently moving to the full capitalization of its capital assets. The new capitalization policy will be fully implemented for the year 1999/2000. Secondly, it was noted that material adjustments resulting from changes in accounting policies were not being appropriately recorded in prior periods. Instead, it is the Government's practice to prospectively reflect the effects of such adjustments in the accumulated Government deficit. In other words, prior years' balances are not being re-stated. As well, it should be noted that the summary financial statements which fully account for the estimated Governmental Pension Liability stood at an amount of $2.8 billion as at March 31, 1999.

4. VOLUME 4

Volume 4 contains the detailed financial statements of funds, organizations, agencies and enterprises which have been consolidated and summarized in the Volume 3 financial statements and form a reference for such summary financial statements.

C. THE PROVINCIAL AUDITOR'S VIEWS

We have taken careful note of the Provincial Auditor's views with respect to the Government's financial reporting practices. In his report dated March 1999, he commends the Government for the continued improvements in the summary financial statements (Volume 3), the 1998/99 improvements in the reporting of employee severance benefits, and the planned changes for 1999/2000 with respect to accounting for capital assets and the inclusion of the RHAs. However, the Provincial Auditor continues to be very concerned about accounting matters related to the Consolidated Fund financial statements (Volume 1). These can be summarized in four areas.

1. Reporting Entity

As previously noted, the Volume 1 Consolidated Fund Financial Statements (CFFS) contains only the Operating and Special Funds of the Government and provides an incomplete picture of the financial operations of the Government.

We recommend that the Government present the consolidated financial position (i.e., Volume 3) as the primary picture of the Province's financial position.

We recommend that the Government change the presentation of the existing Volume 3 so that the Government's financial statement reflecting the entire government reporting entity also shows annual performance relative to the Government's stewardship of taxation, departmental and federal revenues, debt management, and expenditure control.

We recommend that the Government consider a new form of full, true and plain reporting that is more descriptive and explanatory, such as an annual report that includes:
- *the consolidated financial position and results of the consolidated reporting entity;*
- *discussion and analysis of the financial statements, with commentary on the financial management strategies employed during the year; and,*
- *information on the Legislature's accountability for the taxation, departmental and federal transfer revenues and expenditure appropriations that are under its authority.*

2. Inappropriate Disclosure and Accounting Treatment of Inter-Fund Transfers

Included in CFSS Volume 1 for the year ended March 31, 1999 are three separate inter-fund transfers:

a) from the Operating Fund to the Fiscal Stabilization Fund: $31 million;
b) from the Fiscal Stabilization Fund to the Operating Fund: $186 million; and,
c) from the Operating Fund to the Debt Retirement Fund: $150 million.

As noted by the Provincial Auditor, only the first of these inter-fund transfers is appropriately disclosed "after the surplus" for the year had been determined. Transfers b) and c) are disclosed as revenue and expenditure elements within the Operating Fund and have been utilized for the creation of a budgetary surplus for the year. As the Provincial Auditor notes, "since these transfers do not represent economic activities of the Government with other parties, they should not be disclosed as revenue" or expenditure transactions.

We recommend that the Government not characterize as revenue or expenditure transactions inter-fund transfers that do not represent actual economic activities of the Government.

3. PENSION LIABILITIES EXCLUDED FROM THE CONSOLIDATED FUND

As previously noted, the CFSS Volume 1 financial statements do not incorporate any provision for the unfunded pension liability owing to employees, teachers, and MLAs for past service pension benefits. These liabilities are estimated to be $2.8 billion as at March 31, 1999 and neither the pension liability nor the change from the prior year have been incorporated into the CFSS financial report. Instead, the Government chooses to show the pension expense on a "cash basis" as it is paid.

The experience of other jurisdictions with respect to the reporting of employee pension liabilities is as noted in Exhibit 37.

Exhibit 37 – Other Jurisdictions on Pensions

Jurisdiction	*Pension liability on Statement of Financial Position for Consolidated Revenue Fund*	*Pension liability on Statement of Financial Position for Reporting Entity*	*GAAP Pension expense recorded in annual expenses for Consolidated Revenue Fund*	*GAAP Pension expense recorded in annual expenses for Reporting Entity*
British Columbia	Yes	Yes	Yes	Yes
Alberta	N/A	Yes	N/A	Yes
Saskatchewan	No	Yes	No	Yes
Manitoba	**No**	**Yes**	**No**	**Yes**
Ontario	N/A	Yes	N/A	Yes
Quebec	N/A	Yes	N/A	Yes
New Brunswick	N/A	Yes	N/A	Yes
Nova Scotia	Yes	Yes	Changing to PSAB	Changing to PSAB
Prince Edward Island	Yes	Yes	Yes	Yes
Newfoundland	Yes	Yes	Yes	Yes
Northwest Territories	N/A	Yes	N/A	Yes
Yukon	Yes	Yes	Yes	Yes

Source: Manitoba Finance
N/A = not applicable

As indicated, many provinces are moving to GAAP reporting, so Manitoba is currently in the minority.

4. TIMING OF VOLUME 1 VS. VOLUME 3

The 1998/99 Volume 1 CFSS was completed and released by the Minister of Finance on September 10, 1999, but the Volume 3 summary financial statements were not tabled until November 1999, eight months after the end of the year and 18 months after the budget approval. Accordingly, the Provincial Auditor has significant concerns that the Volume 1 financial information is made public and discussed a full 2 months in advance of the much more complete reporting entity information. We agree that from an accountability and reporting perspective, this timing difference is inappropriate.

We recommend that the Government issue full Generally Accepted Accounting Principles (GAAP) financial statements and report on compliance with the balanced budget legislation as a single plain language report.

D. OUR PERSPECTIVE ON THE ISSUES

In considering the financial reporting issues, we offer a number of comments for the Government's consideration.

1. UNDERSTAND THE DIFFERENCES BETWEEN FINANCIAL REPORTING AND FINANCIAL MANAGEMENT ACTIVITIES

In our opinion, proper financial reporting and proper financial management are distinct activities and disciplines that should not necessarily use the same tools and metrics. For example, while all public companies pay significant attention to their GAAP based annual results, many other management accounting tools and measures are used to assess the impact of financial management decisions and the organization's stewardship of its resources.

2. SHIFT THE GOVERNMENT'S REPORTING FOCUS TO GAAP AND CONSOLIDATED REPORTING ENTITY

Clearly from an annual external reporting point of view, it would be preferable if the Province was to move to a full GAAP basis of accounting. In effect, this would make the existing information in Volume 3 the single report that the Province puts forward as a presentation of its financial position.

This approach, combined with the advances in data collection and reporting that are being made by Manitoba Finance, will likely eliminate the Provincial Auditor's need to qualify his audit with respect to the issues that have historically been in dispute. As a result, the Provincial Auditor would be able to provide an Unqualified Auditor's Report stating that the financial statements have been prepared in accordance with Generally Accepted Accounting Principles for public sector organizations. Public understanding will benefit from this.

3. PROVIDE SPECIAL PURPOSE REPORTING ON THE OPERATING FUND

The existence of *The Balanced Budget, Debt Retirement and Taxpayer Protection Act* essentially requires that Volume 1 remain – perhaps in a modified format and title and with different timing – within the Province's reporting structure. If nothing else, it is a special report on the Government's compliance with the terms of the balanced budget legislation.

The Provincial Auditor is concerned that the existing legislation is directed towards an inappropriate measure of the Government's stewardship of its resources, and that only the consolidated (Volume 3) view can provide this picture. With a change in the legislation, this concern can be resolved.

Manitoba Finance officials have indicated that they do not concur with the Provincial Auditor's view on the current legislation, because the consolidated results of the Province contained in the existing Volume 3 include the profits of all Government Enterprises (e.g., Workers Compensation Board, Manitoba Hydro, etc.) on a modified equity basis. And they fairly note that it is quite conceivable that the Government could authorize expenditures in excess of taxation and federal revenues and incur additional public debt to finance this Consolidated Fund deficit, while at the same time still showing a consolidated GAAP surplus because of the "offsetting" Government Enterprise profits. This would result, in effect, in a misrepresentation of the health of the Government's financial position since the Government Enterprise profits are not readily accessible as a revenue source to finance operations. Manitoba Finance, therefore, indicates that Volume 1 is a fairer representation of the Government's financial position.

To the extent that the purpose of the existing balanced budget legislation was to ensure that additional public debt is not incurred as a result of the expenditures authorized by the Legislature, this view of Manitoba Finance is a legitimate perspective. Furthermore, if the Government has committed itself to retiring general purpose debt, then the inclusion of a stipulated debt repayment amount as the determination of whether the Government has been a good steward of taxation, department and federal revenues is also appropriate.

We conclude that the Provincial Auditor's views are valid with respect to Volume 1. However, we also see value in the perspective of Manitoba Finance officials that the Volume 1 report be recast and issued as a special purpose report of the Government. If the situation respecting the use of Government Enterprise profits changes as a result of Government policy, then the argument for Volume 3 as the fundamental reporting document is enhanced considerably – that is, if the Government does begin to receive dividends from the Crown enterprises, than this information in Volume 3 will make this evident.

We recommend that the Government amend the balanced budget legislation so that it is consistent with a clearly defined financial management framework and establish a new basis for determining compliance with legislation. Also, we recommend the Government give serious consideration to changing the name of the legislation so that it is not easily confused with terms used in the entire reporting entity (i.e., Volume 3) and so that it is clearly a measure of financial management, not a standard for financial reporting.

We recommend that the Legislature have the Provincial Auditor report annually on its compliance with this revised legislation. This would provide a second measure for evaluating the Government's performance in its stewardship of these revenues.

4. Lever the SAP Reporting Potential

All entities, large and small, must have effective accounting and management systems to track their financial, economic and operational activities. Effective systems provide for ease of recording and summarization of activities and provide useful information for both internal and external decision-makers. One of the most important tools in producing this information is an effectively operating day-to-day accounting and management information system.

As part of the Better Methods initiative undertaken by the Province, an enterprise-wide resource production and planning system (ERP) utilizing the software of SAP has been implemented. A review of this implementation is the subject of our earlier report on major information technology initiatives.

A successfully implemented mature system provides the foundation for better decision making. First, the timeliness of information is critical in any entity and the Government is no exception. However, there is often a significant tradeoff between timeliness and accuracy (i.e., the faster the information is prepared, the less likely it will be reliable). Obviously, information becomes less useful as the time span between the occurrence of the event and the reporting of that information widens. A major benefit of an ERP system is that it allows for timely capture, summarizing and reporting of transactions in a reliable manner. As a result of an earlier decision, Manitoba now has the capacity to do this.

A second attribute of a sophisticated management information system is the level of detail and variety of manners in which information can be reported. One of the major enablers of this attribute is the ability of the system to capture information at a very detailed level which then allows for the subsequent reporting of such transactions in a variety of manners through different aggregations and summarization models. Again, an effectively implemented and operated ERP management information system will allow for current information to be reported from a variety of perspectives to assist in the decision making process.

The Government's investment in the new SAP system has been significant, and the value of this investment needs to realized to the fullest extent possible. With SAP, the Government should be able to move to accrual accounting throughout the year and provide much more timely reporting at the end of each quarter and at year end. With more accurate information more quickly available to all levels of management, the Government will be positioned to greatly improve its reporting and management's ability to act quickly when action is needed.

We do not here provide a specific recommendation related to the SAP system, but address the issue in our separate report, **Information Technology Major Initiatives Review.**

VI. FINAL CONCLUSIONS

The financial position of the Province as identified in the Phase I work will be a key context-setting element as the Government shapes its financial management framework. For the Phase II work, Deloitte & Touche LLP will focus on advising the Province on an appropriate approach and process to guide its budget planning, expenditure decision-making and control, and performance management and accountability. The effectiveness of these internal processes will be a key success factor in helping the Government to ensure sound management of the Province's financial resources.

In this chapter, we highlight key conclusions and provide recommendations to the Government on next steps following receipt of this report.

A. DEFINE AND IMPLEMENT A LONG-TERM STRATEGY

A key element in planning is the development of a fiscal framework and budget for the Province. We have concluded from our review that many of the financial challenges facing the Government cannot be resolved in one year, and that the traditional year-to-year focus on individual budgets will not likely contribute to achievement of meaningful results. A longer term planning framework is therefore advisable, particularly in setting a course to address significant financial issues over a manageable period of time.

Determine the Approach to Balanced Budgets and the Fiscal Stabilization Fund

The new Government has publicly committed itself to "balanced budgets" and will need to determine precisely what this means and how it is going to accomplish this objective.

The current balanced budget legislation is clearly the starting point. The legislation articulates the "balanced budget" concept, but is complicated by issues like the application of appropriate accounting principles. Fundamentally, the concept as included in the legislation is to refrain from borrowing money in the process of achieving the Government's current spending priorities.

The existing legislation is founded on three key assumptions:

- Debt repayment to retire the debt over a period of 30 years is good and desirable;
- Fiscal Stabilization Fund transfers can legitimately be used to supplement revenues in lean years; and,
- In good years, some current revenues of the Fiscal Stabilization Fund can be appropriately set aside for later use.

Set Priorities and Build a Fiscal Policy Framework

As a related issue, the Government also needs to articulate, at a Cabinet policy level and on an early basis, its highest spending priorities. In the process of reaching conclusions on priorities, the Government will need to answer the following questions:

- Which program areas over the long term are to be further enhanced and/receive more funding?
- Which program areas are to be reduced or eliminated entirely because they are lower priority?
- Which administrative practices are going to be streamlined?
- How important is debt repayment and precisely how will it be accomplished?
- What is role of Government Enterprises in providing regular revenue to the Consolidated Fund?
- What is the Government's philosophy regarding "rainy day funds" (i.e., the Fiscal Stabilization Fund)?
- How important is it to make progress on the long-standing pension funding and reporting issues?
- How important is it to integrate the cash flow of the Consolidated Fund with the repayment of debt incurred to support capital spending authority?

By answering these and other questions, the Government will build towards the establishment of a fiscal framework for the Province. By making this context transparent to the public, the Government will ensure an appropriate accountability mechanism and encourage public review of the established fiscal policy.

Clarify the Performance Framework for Government

It is incumbent on Government to provide for public accountability and reporting in such a way that the public can make its own judgements on the performance of the Government's stewardship over Consolidated Fund revenues. The Government needs to make clear to the public how it is achieving the Government's spending priorities without further increasing public debt.

Part of the "scorecard" picture will necessarily be related to the balanced budget legislation. However, this legislation could benefit from changes in order to help provide clarification of two important principles:

- What expenditures should be made out of current Consolidated Fund revenues?

- The role of Fiscal Stabilization Fund transfers in contributing to the stewardship of Consolidated Fund revenues.

RECOMMENDATIONS FOR THE LONG-TERM STRATEGY

- We recommend that the Government establish a multi-year strategy for eliminating the structural deficit of the Province, for steadily reducing provincial debt, and for investment in critical infrastructure improvements, and that it report on progress annually to the Legislature and the public.

- We recommend that the Government immediately develop a plan to address the structural deficit in the Operating Fund, and begin implementation in 2000.

- We recommend that the Fiscal Stabilization Fund become solely a financial management tool as part of a multi-year financial management strategy. The Government should alter its financial reporting processes so that Fiscal Stabilization Fund transfers are no longer accounted for as revenues.

- We recommend that the Government formulate alternative but obligatory debt retirement priorities and strategies.

- We recommend that the Government adhere to the following principles when determining how to approach the pension issue:
  - Begin making annual payments at levels in excess of current "pay as you go" requirements. Some contribution annually toward the unfunded liability would be progress, however modest.
  - Begin addressing current service costs. For instance, consider funding current service costs of all new employees coming into government.

- We recommend that the Government review and assess the deferral of maintenance expenditures and develop a long term and steady course of action for addressing the problem, once the dimensions are clear.

- We recommend that as the Government looks at increasing revenue from selected Government Enterprises for transfer to the Operating Fund, assurances be provided that any such additional transfers will not compromise the ongoing financial strength or integrity of the Government Enterprises as they discharge their individual service delivery mandates.

- We recommend that the Government include in its financial management framework an approach to public sector compensation and employment that (a) aligns resources to approved programs, (b) rewards competence and productivity, and (c) addresses the issues of precedent, expectations, and the Government's capacity to deliver public services.

B. FOCUS ON IMPROVING FINANCIAL MANAGEMENT

The financial management of the Province hinges on effective decision-making and follow-through, including strong financial controls. Given the level of variance from approved budgets in the current fiscal year and in previous years, we have concluded that improvements need to be made in this area, moreso in some entities (e.g., in Manitoba Health) than in others. What needs to be determined is whether the variances are the result of deficiencies in planning and decision-making, definition and distribution of roles and responsibilities, day-to-day program management, financial controls, or a combination of these factors.

We believe that the Government needs to find answers to the following questions:

- ***Planning and decision-making:*** are the decisions consistent with the established expectations and program mandates?

- ***Definition and distribution of roles and responsibilities:*** are the right decisions delegated to the right positions?

- ***Performance standards:*** are standards in place that are consistent with the Governments' policy objectives?

- ***Day-to-day program management:*** is program performance monitored and managed effectively against these standards?

- ***Financial controls:*** how do potential variations from budget come about and what measures are taken and when to address the issues?

The new Government has an opportunity to address the defined financial management issues as a matter of priority, and has already moved in a number of areas (e.g., Health) to determine what actions should be taken. The Government should act quickly.

RECOMMENDATIONS FOR IMPROVING FINANCIAL MANAGEMENT

- We recommend that the Government alter its financial reporting processes so that Fiscal Stabilization Fund transfers are no longer accounted for as revenues. We further recommend that the Government use the Fiscal Stabilization Fund strictly as a financial management tool in the context of a multi-year financial management strategy.

- We recommend that the Government focus immediate attention on plans for the more effective management of the health care budget.

- We recommend that health capital spending adopt a more long-term view with respect to both anticipated capital needs and the amount of future operating funding committed by current capital approvals.

- We recommend that to the degree possible and appropriate, the Government consider implementing stronger financial management measures to influence the results for the 1999/2000 year.

Additional consideration will be given to financial management issues in our Phase II report, including the recommendations noted in section D, *Incorporate Expenditure Management Recommendations into Phase II Review*.

C. MAKE FINANCIAL REPORTING TRANSPARENT

The Province's reporting has improved from year to year, as recognized by the Provincial Auditor in recent reports. However, we note three particular outstanding issues related to the Province's reporting on its financial situation:

- ***The current reporting is not timely.*** The time lag between completion of a fiscal year and reporting on the results (Public Accounts) should be much shorter.

- ***The current reporting is overly complex.*** The basis of reporting (the published Public Accounts) should be aligned with the basis of planning (the published Estimates) so that the performance compared to plan is both transparent and easy to understand. As recommended by the Provincial Auditor, the Government should prepare a summary budget based on the budgets for all entities based on the same accounting principles used for the summary financial statements. Also, summary budget amounts should be disclosed in the summary financial statements for comparison with actual results.

- ***The format for performance reporting is unwieldy and unclear.*** The Government should consider a new form of reporting that is more descriptive, more easily read, and explanatory. As recommended by the Provincial Auditor, this may be framed as an annual report to enhance the Public Accounts, and would include: high-level summarized information, commentary on significant budget fluctuations, and long-term graphical trend analysis of government debt, taxation and program levels.

The Government should act quickly. The new Government has an opportunity to address the outstanding reporting issues as a matter of priority, and to establish a new reporting foundation in keeping with transparent and clear accountability to the Legislative Assembly and the public.

RECOMMENDATIONS FOR MAKING FINANCIAL REPORTING TRANSPARENT

- We recommend that the Government now fully adopt the financial reporting objectives articulated by the Public Sector Accounting Board of the CICA.

- We recommend that the Government move now to fully adopting Generally Accepted Accounting Principles for public sector bodies in its presentation of the financial position and results of the Province. This will give Manitobans a more accurate and consistent accounting of the Province's financial situation.

- We recommend that the Government indicate that for all external financial reporting of its financial position and results of operations, the consolidated government reporting entity, using full application of Generally Accepted Accounting Principles (GAAP), will be the basis for financial reporting.

- We recommend that the Government not characterize as revenue or expenditure transactions inter-fund transfers that do not represent actual economic activities of the Government.

- We recommend that the Government consider a new form of full, true and plain reporting that is more descriptive and explanatory, such as an annual report that includes:
  - the consolidated financial position and results of the consolidated reporting entity;
  - discussion and analysis of the financial statements, with commentary on the financial management strategies employed during the year; and,
  - information on the Legislature's accountability for the taxation, departmental and federal transfer revenues and expenditure appropriations that are under its authority.

- We recommend that the Government present the consolidated financial position (i.e., Volume 3) as the primary picture of the Province's financial position.

- We recommend that the Government change the presentation of the existing Volume 3 so that the Government's financial statement reflecting the entire government reporting entity also shows annual performance relative to the Government's stewardship of taxation, departmental and federal revenues, debt management and expenditure control.

- We recommend that the Government align the basis of reporting with the basis of planning so that the performance compared to plan is both transparent and easier to understand.

- We recommend that the Government determine how the fiscal principles inherent in the current balanced budget legislation compare with its own long-term fiscal policy objectives.

- We recommend that the Government then amend the balanced budget legislation so that it is consistent with a clearly defined financial management framework and establish a basis for determining compliance with legislation. Also, we recommend the Government give serious consideration to changing the name of the legislation so that it is not easily confused with terms used in the entire reporting entity (i.e., Volume 3) and so that it is clearly a measure of financial management, not a standard for financial reporting.

- We recommend that the Legislature have the Provincial Auditor report annually on compliance with this revised legislation. This would provide a second measure for evaluating the Government's performance in its stewardship of these revenues.

- We recommend that the Government issue full Generally Accepted Accounting Principles (GAAP) financial statements and report on compliance with the revised balanced budget legislation as a single plain language report.

- We recommend that the Government report on results on a more timely basis.

- We recommend that to the degree possible and appropriate, the Government consider implementing recommended changes in financial reporting for the 1999/2000 year.

D. INCORPORATE EXPENDITURE MANAGEMENT RECOMMENDATIONS INTO PHASE II REVIEW

We have reached a number of conclusions in Phase I that should be addressed in the context of our Phase II work on the expenditure management process. The key recommendations that relate to the Government's expenditure management process are as follows:

- We recommend that the Government develop an overall multi-year framework to govern the capital budgeting process. This process should integrate the capital requirements of all departments. The framework should consider the source of funding for capital purchases, the required debt service payments on monies borrowed to fund the capital spending and the Government's ability to make the required debt service payments from cash flow generated by the operations of the Province.

- We recommend that the Government confirm a clear multi-year governance framework for the health care system, including the clarification of management and reporting roles and responsibilities between Manitoba Health and health care providers in the Regional Health Authorities. This will require better and more timely financial information on actual expenditures and costs of services.

- We recommend that the Government assess and enhance the governance framework for Crown organizations with the objective of establishing for Crown organizations – and for the departments that fund them – an understanding and commitment to financial management principles and clearly defined roles and responsibilities.

- We recommend that the Government adopt both short-term and long-term approaches to dealing with the need to improve management information systems related to health expenditures.

- We recommend that the Government actively undertake a more focused effort to realize improved service delivery capacity and cost control in its ongoing technology projects.

- We recommend that the Government assess the appropriateness of internal controls, particularly over purchases and payments, in the new SAP environment.

- We recommend that the Government act to ensure effective financial management practices, including planning and decision-making, definition and distribution of roles and responsibilities, day-to-day program management, and financial controls.

- We recommend that the Government actively pursue further opportunities for the enhancement of public sector productivity by using alternative service delivery and other means.