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## GOVERNMENT FINANCIAL REPORTING

### BACKGROUND

- 2.1 Members of the Legislative Assembly need adequate information on the Province's financial plans, performance and condition to hold government accountable for its use and control of public funds and resources.
- 2.2 The Minister and Deputy Minister of Finance are assigned various authorities and responsibilities related to the role of a chief financial officer for the Province under the provisions of the Provincial Finance Act. Certain of these assignments include the need for Executive Council approval or ratification of planned actions.
- 2.3 The Provincial Finance Act defines a number of financial reporting requirements for the Minister or Deputy Minister of Finance to meet on behalf of government. Further, Section 73 of the Provincial Finance Act requires that crown corporations' business plans, audited financial statements and proposed public financing be tabled in the House of Assembly each year.
- 2.4 As a foreign registrant of the Securities and Exchange Commission in the United States, or its equivalent in other countries, government must file required documents in order to be able to access financing or financial markets.
- 2.5 In addition to required financial reporting, government may and periodically does, at its discretion, release other financial information or reports publicly.
- 2.6 Professional standards require that the auditor of an entity with public accountability, like the Province, communicate with those having oversight responsibility for the entity's financial reporting process. For the Province's financial reporting, oversight responsibility rests, to a significant extent, with the Executive Council. In addition, the House of Assembly, including its Public Accounts Committee, has an important role in the oversight and public accountability processes for the Province's financial reports issued by government.

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### CHAPTER OBJECTIVES

- 2.7 The Auditor General Act provides a broad mandate for the Office to examine and report on the use and control of public resources by government, its controlled entities, and recipients of financial assistance. Further, Sections 9 and 9B of that Act provide for specific annual reporting by the Auditor General on the Province's consolidated financial statements (an audit, with high assurance) and government's revenue estimates (a review, with moderate assurance).
- 2.8 The annual financial statements of various crown entities and trusts, depending on statutory or other arrangements, are audited and reported upon by either

the Auditor General or a public accounting firm. We consider the results of those financial statement audits, as well as other government financial reporting, where appropriate, during the conduct of the Office's discretionary broad scope assignments in selected areas each year.

- 2.9** The purpose of this chapter is to provide summary comments and observations on the government's financial reporting, including information on the results of our review of the government's 2006-07 revenue estimates included in the May 9, 2006 budget documents, and our planning for the audit of the Province's March 31, 2006 consolidated financial statements.

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## RESULTS IN BRIEF

- 2.10** The following summarizes our principal observations in this chapter.

- The Auditor General's opinion on the 2006-07 revenue estimates, required under Section 9B of the Auditor General Act, was tabled in the House of Assembly on May 9, 2006 along with the government's budget documents. The opinion was qualified for the following:
  - First, we were not able to obtain sufficient appropriate information to complete a review of recoveries, user fees and revenues of certain governmental units. As a result of this scope limitation, the Auditor General was unable to form an opinion as to the reasonableness of the estimates of these revenues or the support for their underlying assumptions.
  - Further, sinking fund earnings and revenues of certain governmental units were excluded from the revenue estimates and included elsewhere in the estimates. As a result, the revenue estimates were not presented on a basis consistent with the Province's consolidated financial statements. In addition, certain recoveries and user fees were excluded from the revenue estimates and netted against expenses elsewhere in the estimates. To the extent of these exclusions, the 2006-07 revenue estimates are not presented in accordance with generally accepted accounting principles (GAAP).

A more detailed reporting of the results and observations from our examination of the government's 2006-07 revenue estimates included in the May 9, 2006 budget documents was provided to the Department of Finance in a management letter in June 2006.

A general election was called for June 13, 2006 before the 2006-07 budget tabled on May 9, 2006 was approved by the House. As a result, a 2006-07 budget will need to be tabled after the election. We will review and report separately on the revenue estimates for 2006-07 included in that budget.

- The target deadline for providing our opinion on the Province's March 31, 2006 consolidated financial statements, for printing purposes, is September 21, 2006. The scheduled date assumes government will meet year-end accounting and audit readiness requirements.

At this point, our preliminary planning and analysis has identified a number of issues to be addressed by government, relating primarily to compliance with GAAP. The most significant issues include:

- inclusion of comparative consolidated budget information on the financial statements, in particular on the statement of operations and accumulated deficit;
- reporting all revenues including user fees, recoveries and federal transfers, and expenses, on a gross basis, without netting revenues against expenses;
- accounting for a number of small government units previously not fully reflected in the consolidated financial statements; and
- accounting for various year-end spending initiatives approved by Treasury and Policy Board in March 2006.

As a result of audit work completed by this Office and by other auditors, significant internal control weaknesses have been identified in certain financial control areas which require management's attention (see Chapter 3).

- Additional appropriations of \$159.4 million for 2004-05 expenses were approved on December 20, 2005 by Order in Council 2005-572. No special warrants have been approved since our last Report. Based upon 2005-06 forecast information included in the May 9, 2006 budget documents, additional appropriations in excess of approximately \$90.0 million will be required for 2005-06.

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## PRINCIPAL FINDINGS

### Results of Review of Government's Estimates of Revenue

- 2.11** The Auditor General's Report on the 2006-07 Revenue Estimates, required under Section 9B of the Auditor General Act, was tabled in the House on May 9, 2006 along with supporting information for the 2006-07 Nova Scotia budget. Exhibit 2.1 on page 19 is a copy of the Report. It contained a reservation of opinion related to a scope limitation and non-compliance with GAAP.
- 2.12** A more detailed reporting of the results and observations from our examination of government's 2006-07 revenue estimates included in the May 9, 2006 budget documents was provided to the Department of Finance in a management letter in June 2006.

- 2.13** The management letter discusses a number of other issues and findings from our review. For instance, we were not able, based on the supporting information provided, to conclude that the Provincial economic assumptions for corporate profit growth for 2005 and 2006 were reasonable. As well, we did not agree with the decision to exclude any estimate for revenues from offshore licence forfeitures in 2006-07.
- 2.14** For purposes of the review, one new accounting standard needed to be considered - Public Sector Accounting Board Handbook (PSAB) Section 1150, *Generally Accepted Accounting Principles (GAAP)*. The section provides direction on the primary and secondary sources of reference in determining GAAP compliance (i.e., a GAAP hierarchy) for the public sector in Canada. This standard now restricts the options available in the preparation of financial information on other than a GAAP-compliant basis.
- 2.15** To ensure compliance with current requirements of PSAB and with generally accepted auditing standards, our review this year was planned to include all revenue elements in the 2006-07 budget that meet the definition of revenues under GAAP. In comparison to our previous year's review, we estimated that additional elements included this year represented more than \$1 billion. Our additional information requirements were communicated to the Department of Finance in February 2006. Difficulties encountered in obtaining sufficient information to assess the reasonableness of some revenues and the support for their underlying assumptions led to a qualification in the Report. The continued presentation of some revenues on a basis not compliant with current GAAP standards, such as netting against expenses, also led to a qualification in the Report.
- 2.16** For purposes of the review, the estimates of revenue encompassed the following components included in the government's budget:
- total ordinary revenue;
  - net income of government business enterprises;
  - sinking fund and public debt management fund earnings;
  - recoveries, user fees and other revenue netted against expenses; and
  - revenue of governmental units included in the Consolidation and Accounting Adjustments section of the budget summary.
- 2.17** The government has consistently articulated its policy of preparing its public financial reports in accordance with generally accepted accounting principles for the public sector. We note the following statements made by government with respect to the basis of accounting used for its budget.
- As part of the offshore accord process, in a February 14, 2005 letter to the Federal Minister of Finance, the then Minister of Finance stated "The Province of Nova Scotia has adopted generally accepted accounting principles and on this basis the Minister of Finance has tabled balanced budgets for the fiscal years 2002-03; 2003-04; 2004-05".
  - Further, the Nova Scotia Budget publication for 2005-06 included the following on page D10: "The borrowing program starts with the provincial budgetary

surplus that reduces requirements. As the provincial budget is produced on a fully GAAP-compliant basis, there are numerous cash versus accrual adjustments....” The Nova Scotia Budget - Assumptions and Schedules publication for 2006-07 issued with the May 9, 2006 budget documents included the same phrase.

- 2.18 Such public statements put the onus on government, as the preparer of the Province’s key financial reports, to ensure its representations are fully met not only for the consolidated financial statements, but also for the budget.
- 2.19 Accounting pronouncements also require that financial forecasts (including budgets) be prepared on a basis consistent with related financial reports.
- 2.20 The December 2005 Report of the Auditor General noted that the budget should be prepared on the same basis as the consolidated financial statements and comply with GAAP.
- 2.21 Management has indicated that they intend to work towards improving the budget presentation to make it more consistent with GAAP requirements and to improve the accessibility of materials required by this Office to perform the annual review of revenue estimates.

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### **Recommendation 2.1**

**We recommend that the revenue estimates included in the budget be prepared and presented in full accordance with generally accepted accounting principles.**

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- 2.22 A general election was called for June 13, 2006 before the 2006-07 budget tabled on May 9, 2006 was approved by the House. As a result, a 2006-07 budget will need to be tabled after the election. We will review and report separately on the revenue estimates for 2006-07 included in that budget.

## **Planning for the Audit of Province’s Consolidated Financial Statements**

- 2.23 Under Section 9 of the Auditor General Act, the Auditor General is mandated to examine and report on the government’s annual consolidated financial statements.
- 2.24 The December 2005 Report of the Auditor General, released in January 2006, provided summary observations and recommendations on the results of our audit of the Province’s March 31, 2005 consolidated financial statements which were released in September 2005 as part of Volume 1 of the Public Accounts. That Report pointed out some areas in which the financial statements did not fully comply with GAAP, including omission of budget comparisons and netting of revenues, and recommended changes to comply with these requirements.
- 2.25 The target deadline for providing the opinion on the Province’s March 31, 2006 consolidated financial statements, for printing purposes, is September 21, 2006.

The scheduled date assumes government will meet year-end accounting and audit readiness requirements on a timely and appropriate basis.

## GAAP compliance

**2.26** The December 2005 Auditor General's Report identified certain areas in which the Province's consolidated financial statements are not yet fully in compliance with GAAP, and recommended that steps be taken to ensure fuller compliance. Our preliminary planning and analysis indicate that the following issues will need to be addressed by management when preparing the March 31, 2006 consolidated financial statements. All were previously noted in the December 2005 Report.

- The consolidated financial statements do not include budget amounts for line items on the consolidated statement of operations and accumulated deficits or the consolidated statement of change in net direct debt. This disclosure is required by the Canadian Institute of Chartered Accountants' Public Sector Accounting Board (PSAB). The inclusion of these comparative numbers could present a challenge as the 2005-06 budget was not fully prepared or presented on the same basis as the financial statements. A reconciliation between the budget information on the statements and the approved budget for 2005-06 will need to be included in the notes to the financial statements.
- PSAB standards require that revenues and expenses be reported at gross values. However, in prior years a number of recoveries and user fees have been netted against expenses on the consolidated statement of operations and accumulated deficits rather than being reported separately as revenues. The impact of this accounting treatment is to understate both revenues and expenses reported, with no net impact on the reported surplus or deficit.
- Similarly, a number of federal transfer payment revenues have been reported as recoveries and netted against related expenses. We have been informed that these revenues are treated as recoveries in order to be consistent with treatment in the budget. However, as noted above, this presentation is not GAAP compliant.
- A number of smaller crown entities and government partnership arrangements are not yet fully and appropriately accounted for in the consolidated financial statements. The impact of this is an understatement of net assets and an overstatement of net direct debt which should be corrected in the 2005-06 results.
- When consolidating the tangible capital assets (TCA) balances of entities included in government's consolidated financial statements, those balances are not adjusted to comply with the government's TCA accounting policy requirements for such factors as thresholds and amortization rates. GAAP requires that, as part of the consolidation process, the accounting for government organizations (other than government business enterprises) be adjusted to be consistent with the government's accounting policies.

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## Recommendation 2.2

We recommend that the consolidated financial statements be prepared and presented on a basis fully compliant with generally accepted accounting principles.

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### Systems and controls

- 2.27** The government, and management of the Department of Finance, are responsible for the preparation of the Province's consolidated financial statements. They also have responsibilities related to the maintenance of appropriate effective internal controls, such as designing and maintaining accounting policy statements and control procedures, safeguarding assets, preventing and detecting error and fraud, and maintaining awareness of circumstances that could result in fraudulent financial reporting.
- 2.28** In conducting our audit, we will obtain a sufficient understanding of the systems and controls to plan the audit. Where we plan to rely upon controls, sufficient audit evidence is obtained to support that assessment. However, the scope of our review of government's systems and controls during the audit of the March 31, 2006 consolidated financial statements will not be planned or conducted in order to conclude on the adequacy of the overall level or quality of controls.
- 2.29** The following are some of the key control issues of which we are aware and will consider as part of finalizing our strategy and approach to the 2005-06 financial statement audit:
- the implications of the deficiencies identified in the service auditors' report on the general environmental controls for the centralized SAP infrastructure (see Chapter 3, paragraphs 3.14 to 3.26);
  - the implications of the deficiencies identified in the SAP application controls audit completed under contract for this Office (see Chapter 3, paragraphs 3.8 to 3.13); and
  - the implications of the denial of opinion and deficiencies identified in the audit of the governance and control framework of the operations of the Investment, Liability Management and Treasury Services and Capital Markets Administration Divisions completed by a private sector firm during 2004 (see December 2004 Report of the Auditor General, Chapter 3, paragraphs 3.18 to 3.21).
- 2.30** In addition to the above matters, we will also consider the results of an audit of the new SAP HR module implemented in core government April 1, 2005. The audit is to be completed by external SAP specialist audit resources sponsored jointly by this Office, the Department of Finance and the Public Service Commission.

## Miscellaneous items

- 2.31** As part of our planning for the audit of the March 31, 2006 financial statements, we have identified the following specific accounting considerations:
- accounting for various spending initiatives approved by Treasury and Policy Board in March 2006;
  - accounting for and disclosure of various federal transfers, initially recorded as deferred revenue, against specific expenses incurred; and
  - accounting for and disclosure of the various elements of the N.S. Teachers' Pension Plan amendment included in the June 22, 2005 agreement between the Nova Scotia Teachers' Union and government.

## Other Matters

### Additional appropriations and special warrants

- 2.32** Section 9A of the Auditor General Act requires, among other things, that we call attention to every case observed in which any appropriation is exceeded or a special warrant is authorized. Our last reporting under that section was in the December 2005 Report of the Auditor General, Chapter 2. We provide the following updated comments.
- 2.33** Under the provisions of Section 28 of the Provincial Finance Act, on December 20, 2005 Executive Council approved Order in Council 2005-572 approving additional appropriations for 2004-05 of \$132,992,000 for net program expenses and \$26,451,000 for debt servicing costs.
- 2.34** As per the 2005-06 forecast information released in the Minister of Finance's May 9, 2006 budget documents, subject to year-end accounting or audit adjustments, additional spending authority (additional appropriations) of more than \$90 million will need to be approved by Order in Council within 90 days of the government's release of the March 31, 2006 consolidated financial statements. We observe that while the Provincial Finance Act sets a deadline by which the additional spending authority must be approved, it does not prevent approval on a more timely and effective basis.
- 2.35** We note that since our last Report, there have been no special warrants approved by Executive Council under Section 29 of the Provincial Finance Act.

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## CONCLUDING REMARKS

- 2.36** While considerable progress had been made since 2000, further improvements are required in government's financial reporting to bring the government's budget and the Province's consolidated financial statements fully into compliance with GAAP.

**2.37** The Department of Finance indicated its intention to complete a review of its primary financial reporting vehicles to determine potential improvements. The review was to include stakeholder consultations. While we continue to support such an initiative, it is our understanding that little progress has been made during 2005-06, and approval of the terms of reference for the review has been significantly delayed.

**2.38** As indicated in the December 2005 Report of the Auditor General, we support the government's plans to review the content of its financial reports to ensure they meet the needs of users. However, revised reports resulting from this review should be in accordance with generally accepted accounting principles.

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## Report of the Auditor General to the House of Assembly on the Estimates of Revenue for the fiscal year ending March 31, 2007 used in the preparation of the May 9, 2006 Budget Address

Exhibit 2.1

I am required by Section 9B of the Auditor General Act to provide an opinion on the reasonableness of the estimates of revenue used in the preparation of the annual budget address of the Minister of Finance to the House of Assembly.

The estimates of revenue for the fiscal year ending March 31, 2007 (the 2006-07 revenue estimates) are the responsibility of the Department of Finance and have been prepared by departmental management using assumptions with an effective date of March 30, 2006 or earlier. I have examined the support provided by departmental management for the assumptions and the preparation and presentation of the 2006-07 revenue estimates. My examination did not include, and my opinion does not cover, the budget speech, the 2005-06 forecast or the 2006-07 expense estimates. Except as explained in the following paragraph, my examination was made in accordance with the applicable Assurance and Related Services Guideline issued by the Canadian Institute of Chartered Accountants. I have no responsibility to update this report for events and circumstances occurring after the date of my report.

I was not able to obtain sufficient appropriate information to complete my review of recoveries, user fees and revenues of certain governmental units. As a result, I have been unable to form an opinion as to the reasonableness of the estimates of these revenues or the support for their underlying assumptions.

Further, sinking fund earnings and revenues of certain governmental units are excluded from the revenue estimates and are included elsewhere in the estimates. As a result, the revenue estimates are not presented on a basis consistent with the consolidated financial statements. In addition, certain recoveries and user fees are excluded from the revenue estimates and netted against expenses elsewhere in the estimates. To the extent of these exclusions, the 2006-07 revenue estimates are not presented in accordance with generally accepted accounting principles.

In my opinion, except that certain revenues have been excluded from the revenue estimates as noted in the preceding paragraph, and except for the effect of adjustments, if any, which I might have determined to be necessary had I been able to obtain sufficient information with respect to certain revenues, as discussed above,

- as at the date of this report, the assumptions used by departmental management are suitably supported and consistent with the plans of the government, as described to us by departmental management, and provide a reasonable basis for the 2006-07 revenue estimates; and
- the 2006-07 revenue estimates as presented reflect fairly such assumptions; and
- the 2006-07 revenue estimates comply with presentation and disclosure standards established by the Canadian Institute of Chartered Accountants.

Since the 2006-07 revenue estimates are based on assumptions regarding future events, actual results will vary from the information presented and the variations may be material. Accordingly I express no opinion as to whether the revenue estimates will be achieved.

Jacques R. Lapointe, CA•CIA  
Auditor General

Halifax, Nova Scotia  
May 5, 2006

## DEPARTMENT OF FINANCE'S RESPONSE

Thank you for the opportunity to comment on Chapter 2, Government Financial Reporting of the June 2006 Report of the Auditor General. This chapter deals primarily with three items; the review of the 2006/07 Revenue Estimates, the upcoming audit of 2005/06 audit of the Public Accounts and the System and Control findings, the details of which are provided in Chapter 3 of this same report. I will provide comment on that Chapter in a separate response.

As far as the audit of the 2005/06 Public Accounts audit is concern, I will reserve comment until that process is complete other than to say that the items mentioned were previously discussed with the Office of the Auditor General (OAG) and in management's view have no material impact on the financial results included in the Public Accounts. That leaves the 2006/07 Revenue Estimates Review to provide comment on.

The OAG has, for a number of years, provided a qualification on the Revenue Estimates of the Province. The qualification primarily related to departmental expenditure budgets being presented on a net as opposed to gross basis. The issue of netting revenues against expenditures has merit from a departmental accountability perspective, but is not compliant for GAAP presentation purposes. Staff indicated to your office that this presentation concern would be included in the proposed review of our financial documents. Based on the review to date by Government Accounting, we have determined that changes will be made in our presentation which will move more of the revenue sources into our ordinary revenue, starting in the 2007/08 budget.

It was not until late in the budgetary process that it became apparent the current review would expand its scope to contain all five elements included in paragraph 2.14 of your report. Since 1994 when the OAG review of revenues commenced, the review was confined to the first two items; Ordinary Revenue and Net Income from Government Business Entities. Thus, the broader review was unanticipated by management until your letter of April 21, 2006. In Management's opinion, once the OAG's intentions were known, there was not sufficient time for inclusion of the remaining three items without impacting Budget Day. In some cases, management would have required significant time to prepare and present the required documentation. In all cases, we believe that the OAG review of this material could not be completed within the proposed time lines.

The inclusion of revenue of government units included in the Consolidation and Accounting Adjustments section would require the Province to move to consolidated budgeting. (It should be noted that revenue of government units refers to non-provincial revenue sources for consolidated entities such as municipal contribution to school boards and foundation contributions to health

authorities.) The move to consolidated budgeting would be a major undertaking which would completely change the current budget methodology used by the Province. I do not anticipate any change in this direction in the near future. However, to address this concern, the Province will, starting with the 2005/06 Public Accounts, provide a reconciliation between the Estimates presentation and the Public Accounts.

Finally, a review of recoveries would require, amongst other things, a review of expenditure estimates, which clearly goes beyond the mandate of section 9B of the *Auditor General's Act*.

In conclusion, readers of this Chapter should also take note that the Province, once again, was able to obtain assurance that the revenues included in Ordinary Revenue and net income from Government Business Entities are reasonable.