REPORT OF THE AUDITOR GENERAL

To the House of Assembly

On the Audit of the Financial Statements of the Province of Newfoundland and Labrador

For the Year Ended
31 March 2006

Auditor General of Newfoundland and Labrador

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Mission Statement

The Office of the Auditor General serves the House of Assembly by providing independent examinations of Government and its entities.

As legislative auditors, we audit financial statements and other accountability documents, evaluate management practices and control systems, and determine compliance with legislative and other authorities.

Our purpose is to promote accountability and encourage positive change in the stewardship, management and use of public resources.

PROVINCE OF NEWFOUNDLAND AND LABRADOR

Office of the Auditor General

12 December 2006

The Honourable Harvey Hodder, M.H.A.
Speaker
House of Assembly

Dear Sir:

In compliance with the *Auditor General Act*, I have the honour to submit herewith, for transmission to the House of Assembly, my Report on the Audit of the Financial Statements of the Province for the year ended 31 March 2006.

Respectfully submitted,

JOHN L. NOSEWORTHY, C.A.
Auditor General

Foreword

I am pleased to submit my report on the Audit of the Financial Statements of the Province for the year ended 31 March 2006. My report on findings from reviews of Departments and Crown Agencies for the year ended 31 March 2006 as well as my report on the operations of the Office of the Auditor General for the year ended 31 March 2006 will be submitted on or before 31 January 2007 pursuant to section 13(2) of the *Auditor General Act*.

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REFLECTIONS OF THE AUDITOR GENERAL

Reflections of the Auditor General

The following comments are made further to my audit of the Public Accounts of the Province for the year ended 31 March 2006. The Report provides additional information on the financial condition of Government measured by using indicators issued by the Canadian Institute of Chartered Accountants. The Report also offers comments on Government's compliance with generally accepted accounting principles and adherence to principles of sound financial accountability.

Financial Condition of the Province ***(Part 3.3)***

There is a sense of optimism about the potential prosperity of the Province and its ability to improve its financial condition. In large part, this prosperity is derived from oil revenues and the resulting economic impact on the Provincial economy and Provincial revenues.

However, we must not lose sight of the Province's enormous debt, related debt expenses and the fact that oil is a non-renewable resource with a limited life. Furthermore, there is volatility with regards to production levels and world oil prices, both outside the control of Government, which can cause significant changes in fiscal performance.

Reality of Current Financial Condition has to be Considered

To put the financial condition in perspective relative to other provincial jurisdictions I report that, at 31 March 2006, the Province had:

- a net debt of $11.7 billion which results in:
  - the highest net debt per capita of any province in Canada - approximately $23,000 for each Newfoundlander and Labradorian;
  - the highest net debt as a percentage of GDP of any province in Canada at 54.4%; and
  - being included in the lowest credit rating category of any province in Canada.

- debt expenses totalling $947 million which results in:
  - the highest interest costs as a percentage of total revenue of any province in Canada at 17%; and
  - fewer resources to allocate to programs and services as a result of the “interest bite”.

The Annual Surplus (Deficit)

In 2006 the Province recorded a surplus of $199 million, the first annual surplus since 1998. However, consider the following:

- the Province would require a surplus of $300 million each year for 40 years to eliminate its existing net debt, i.e. to be debt free.
- oil revenues are highly volatile to changes in oil prices and oil production. To illustrate this volatility, Government's projected surplus of $6 million for 2006-07 was revised in November 2006 to a deficit of $40 million. The change in economic outlook resulted for the most part from oil production issues outside of Government's control.
- the Province remains heavily reliant on transfers from the Federal government to help pay for the costs of such programs as health, education, and social services - $1.9 billion or 34% of total revenue for 2006 resulted from Federal transfers.
- health and education expenses are increasing and for 2006 amounted to $3.0 billion or over 57% of total expenses in 2006, an increase of $1.0 billion or 50% over the $2.0 billion total expenses in 2001.

In addition to these factors, there are others which could result in changes to the annual surplus or deficit, including an aging infrastructure, an aging population, out-migration, interest and currency rate fluctuations, changes in GDP, and demand for Government programs and services.

Long-term Debt Reduction Planning Essential

Because of the annual recurring theme of deficits in the Province, there has been much discussion and focus on deficit reduction and elimination. However, the Province still has billions of dollars in debt along with the resulting significant interest bite. Continued annual surpluses and a reasoned plan of debt reduction will be required if progress is to be made in eliminating this debt.

As debt decreases debt expenses will reduce, leading to a lower interest bite and more funding available for Government programs. For example, in March 2006, Government paid $1.953 billion from the proceeds of the Atlantic Accord (2005) agreement to reduce the unfunded liability of the Teachers' Pension Plan. This will result in significant debt expense reductions in the future.

It is encouraging that Government has made progress regarding the annual deficits. However, given the preceding financial indicators, prudent fiscal management has to continue and a debt reduction plan has to be developed and followed before the financial condition of the Province is turned around.

I will, on behalf of all Members of the House of Assembly, continue to monitor Government's fiscal performance and report annually as to whether progress is being made to bring the Province's finances in order.

Pensions ***(Part 4.1)***

While the Province's unfunded pension liability as at 31 March 2006 of $2.201 billion decreased significantly from $3.934 billion as at 31 March 2005, it continues to represent a significant debt for Government. The main reason for the $1.733 billion decrease was the decision by Government to use $1.953 billion of the proceeds from the Atlantic Accord (2005) agreement to reduce the unfunded pension liability of the Teachers' Pension Plan.

I note that, although there was a reduction in the Province's overall unfunded pension liability, the unfunded pension liability for three of the Province's five plans (Public Service Pension Plan, Members of the House of Assembly Pension Plan, Provincial Court Judges' Pension Plan) increased by $97 million during the year.

Although interest costs in future years should decrease as a result of the reduction in the overall unfunded pension liability, addressing the liability should remain a priority for Government.

Group Health and Group Life Retirement Benefits ***(Part 4.2)***

The liability for group health and group life insurance retirement benefits has added to the already considerable debt load of the Province and is expected to increase in each of the next four years. The net liability as at 31 March 2006 was $1.265 billion (2005 - $1.159 billion). By 2010 the net liability is expected to total $1.607 billion if action is not taken to address it, an increase of $622 million or 63% since it was first recorded in 2003.

Government should carefully manage its liability relating to group health and group life insurance retirement benefits.

Internal Audit ***(Part 5.3)***

Internal audit in Government is not sufficiently resourced to adequately perform the duties expected of a modern and effective internal audit function. In recent years, standards of practice for internal auditing have prescribed increased duties and responsibilities for the internal audit function in such areas as accountability, governance, risk management and assurance. Internal audit within Government is currently comprised of only 3 positions - in 1991 there were 21 positions.

An internal audit function is an integral part of an effective internal control system which would help prevent or detect instances of: public money not being appropriately collected and disbursed; non-compliance with legislation and/or Government policies; lack of safeguarding and accounting for the Province's assets; and weaknesses in accounting and management control systems.

The lack of internal control and management safeguards at the House of Assembly establishment which led to excess claims and questionable payments to companies highlights the importance of independent scrutiny. An effective internal audit function can help ensure that preventative and detective controls are implemented and functioning.

Government should ensure its internal audit function is sufficiently resourced.

Environmental Liabilities ***(Part 5.6)***

Although Government has started to capture information on contaminated sites, there is still no complete central inventory of such sites in the Province. Furthermore, although the Province's environmental liability relating to remediation costs for contaminated sites may be a significant amount, only $10.7 million has been recorded as a liability in the Province's financial statements. I note that a report made public by Government in January 2004 referred to an estimated cost of $237 million relating to the remediation of contaminated sites.

Government should be more proactive in identifying all contaminated sites in the Province for which it is potentially liable, determining the estimated liability associated with remediation costs, and recording the resulting liability in the Province's financial statements.

Transparency and Accountability Act ***(Part 5.2)***

On 29 November 2004, Government tabled the *Transparency and Accountability Act* which received Royal Assent on 16 December 2004. However, nearly two years later, the *Act* has still not been proclaimed and, therefore, is not in force.

Although Government has been diligent in having annual reports tabled for departments and Crown agencies, the reports provide only general information on the operations of the department or agency. The reports do not provide the information necessary to hold each entity accountable for its performance, including fiscal performance, in relation to its approved plans, using established measurable criteria. As well, there has been little progress in tabling strategic, business or activity plans in the House of Assembly.

The *Transparency and Accountability Act* should be proclaimed. Furthermore, Government should address the lack of plans being tabled in the House of Assembly and require that appropriate accountability information be included in annual reports tabled in the House of Assembly.

Acknowledgements

I acknowledge the cooperation and assistance my Office has received from the Office of the Comptroller General during the completion of my audit, as well as from officials of the various Government departments and Crown agencies. I also thank my staff for their continued hard work, professionalism and dedication.

JOHN L. NOSEWORTHY, C.A.
Auditor General

Reflections of the Auditor General

CHAPTER
2
PUBLIC ACCOUNTS

2.1 Introduction

I am often asked questions about the financial statements of the Province (commonly referred to as the Public Accounts). In this Chapter, I will address these questions in an effort to provide information, not only about the Public Accounts and my auditor's report, but also to explain the purpose the Public Accounts serve and the importance of having an audit completed.

2.2 What are the Public Accounts?

The Public Accounts contain the annual financial statements of the Province of Newfoundland and Labrador. They are a representation by Government, of the Province's financial condition as at the end of a fiscal year, and the results of its operations, the changes in its net debt and its cash flows for that year.

The *Financial Administration Act* requires that the Public Accounts show:

- the state of the public debt;
- the revenue and expenditure;
- all compromises, remissions, refunds and amounts written off; and
- those other accounts and statements that may under good accounting practice be required to show the financial position of the Province at the end of the fiscal year.

2.3 Who Prepares Them?

Government is responsible for providing the House of Assembly with the Province's financial statements. Under the *Financial Administration Act*, Treasury Board prescribes the manner and form in which the Public Accounts of the Province are prepared, with the actual statements, schedules and notes being prepared by the Comptroller General.

2.4 Why are they Prepared?

The *Financial Administration Act* requires that the Public Accounts be prepared and tabled in the House of Assembly. The Public Accounts provide an important link in an essential chain of public accountability. In an era where, in Canada and throughout the world, there is a heightened need for transparency and accountability, the preparation and audit of Government's financial statements is of increasing importance. These statements are the principal means by which Government reports to the House of Assembly and to all Newfoundlanders and Labradorians on its stewardship of public funds.

2.5 What are the Public Accounts "Volumes"?

The Public Accounts for the year ended 31 March 2006 were published in two volumes:

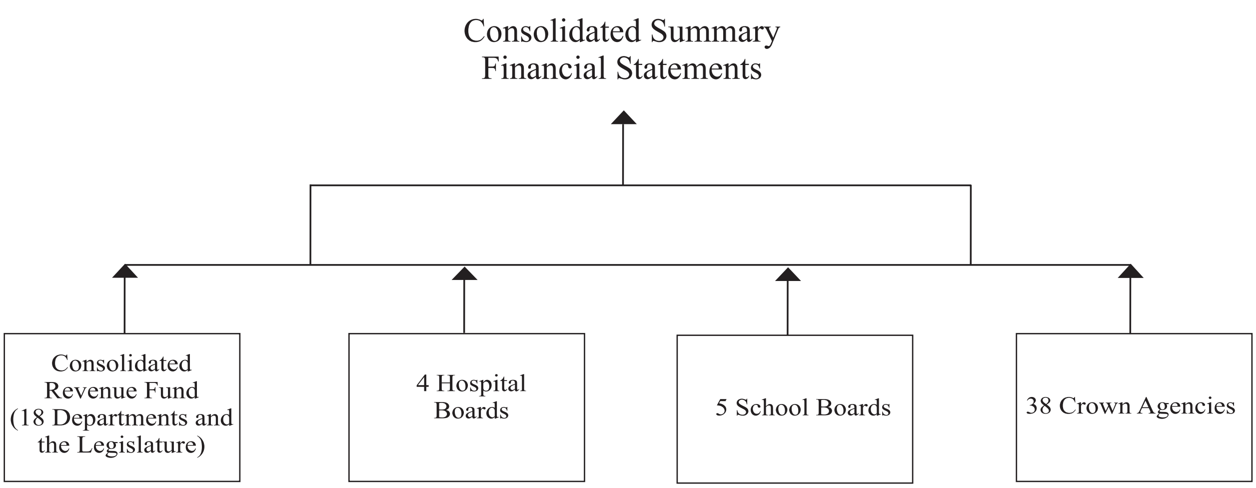
Volume I - Consolidated Summary Financial Statements

This Volume presents the consolidated summary financial statements of the Province of Newfoundland and Labrador on an accrual basis of accounting. Information contained in this Volume provides the most complete information about the operating results and financial position of the Province and combines the financial activities of the Consolidated Revenue Fund (which accounts for the financial activities of the 18 Government departments and the Legislature) and the various Crown corporations, boards and authorities which are controlled by and therefore accountable to the Government of Newfoundland and Labrador. Government departments and Crown agencies are accountable for the administration of their financial affairs and resources through a Minister.

The types of entities included in these financial statements are outlined as follows:

Figure 1

Entities Included in the Consolidated Summary Financial Statements
31 March 2006



Volume II - Consolidated Revenue Fund Financial Statements

This Volume provides information about the operating results and financial position of the Consolidated Revenue Fund only, comprised of the 18 Government departments and the Legislature. These statements are also prepared on an accrual basis of accounting.

Change in the Public Accounts This Year

Traditionally the Public Accounts consisted of four volumes - Volume I (Consolidated Summary Financial Statements), Volume II (Consolidated Revenue Fund Financial Statements), Volume III (Consolidated Revenue Fund statements on a modified cash basis) and Volume IV (financial statements of Crown corporations, boards and authorities).

However, commencing this year, Government has decided to table the information previously contained in Volumes III and IV separately from the Public Accounts. As a result, we feel that there will be a better focus on Volume I - the Province's consolidated summary financial statements - the principal financial statements of the Province.

2.6 What Statements are Included and what do they Show?

Government's financial statements are intended to reflect a fundamental difference between financial reporting for a government and financial reporting for private sector businesses. Governments use public money to provide services through various programs, with no intent to make profit. As such, a government's financial statements differ from those of business by focusing on net debt - not profit or loss. Simply put, net debt represents the amount Government will eventually have to raise to pay for carrying past liabilities, and is calculated as total liabilities less total financial assets.

The consolidated summary financial statements are comprised of five main statements:

Statement of Financial Position

This statement shows the Province's financial assets, liabilities, net debt, non-financial assets and accumulated deficit.

Financial assets (such as cash, temporary investments and receivables) are different from non-financial assets (such as roads, schools and hospitals) in that they can be used to reduce liabilities. Liabilities include borrowings as well as liabilities relating to retirement benefits, including the unfunded pension liability. The difference between liabilities and financial assets is the Province's net debt. This is the amount which the government of the day leaves for future governments to either repay or refinance.

Non-financial assets will be used in providing programs and services and therefore are deducted from net debt in calculating the accumulated deficit. It is this accumulated deficit which reflects the difference between past expenses and revenues, i.e. the net accumulation of all annual surpluses and deficits.

Statement of Change in Net Debt

This statement reflects the change in net debt for the year, calculated as the annual surplus or deficit, any changes in the net book value of tangible capital assets and any changes in other non-financial assets.

Statement of Operations

This statement reflects the annual surplus or deficit, along with a comparison of budgeted and actual revenues and expenses. The surplus or deficit is calculated as the difference between revenues and expenses for the year and represents the extent to which Government was able to raise sufficient revenues to provide for the costs of programs and services, and servicing the debt.

Statement of Change in Accumulated Deficit

This statement reflects the change in accumulated deficit resulting from the surplus or deficit for the year.

Statement of Cash Flows

This statement reflects the change in cash (and cash equivalents such as temporary investments) and the source and use of cash through operations, financing and investing activities. It also reflects acquisitions and disposals of capital assets.

In addition to the five main statements, there are also several schedules and notes which are an integral part of the statements and which provide additional disclosure and explanation regarding significant balances, transactions and events during the year.

2.7 What Accounting Policies does Government Follow?

The consolidated summary financial statements are prepared on the accrual basis of accounting in accordance with the accounting standards established for governments by the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants (CICA), and as outlined in the significant accounting policies of the Province. Revenues are recorded when earned with expenses being recorded when liabilities are incurred, in accordance with the applicable significant accounting policies.

Since PSAB's recommendations relating to financial reporting by governments are generally accepted within Canada, section 59 of the *Financial Administration Act* requires compliance with these recommendations to properly present the financial position, results of operations and changes in the financial position of the Province at the end of the fiscal year.

Reporting Model

In October 2002, PSAB approved a new reporting model for Federal, provincial and territorial governments. The new standards are effective for fiscal years beginning on or after 1 April 2005. The new model was adopted in this Province commencing with the fiscal year ended 31 March 2004.

Along with presentation changes in the new model, Government made the following changes commencing with the 2004 fiscal year, in order to comply with PSAB recommendations:

- Tangible capital assets were recorded on the Statement of Financial Position and amortized over their useful lives. Prior to the 2004 fiscal year, these assets were expensed in the year they were acquired or constructed.

- Inventories of supplies (not held for resale) were recorded as non-financial assets. Prior to the 2004 fiscal year, these were expensed.

Specific Accounting Policies

The specific accounting policies used by Government in preparing its financial statements are included in Note 1 to the statements and deal with such things as the method of consolidation and how specific assets, liabilities, revenues and expenses are recognized.

I am pleased to note that, with the inclusion of Memorial University of Newfoundland in the government reporting entity for the 2006 fiscal year, the Province now fully complies with PSAB recommendations and standards.

Use of Estimates

When preparing its financial statements, Government makes significant estimates, as not all information is available or determinable at the time of finalizing the statements. In these cases, estimates are based on the best information available at the time the statements are prepared. Examples of where estimates are used include the accrual of retirement benefits, the amortization of foreign exchange gains or losses, and the allowance for guaranteed debt. As well, estimates have been used in recording some tangible capital assets given that only limited information is available on some older assets. These estimates are audited and are provided for under generally accepted accounting principles.

2.8 Who Audits the Public Accounts?

The Auditor General is responsible for auditing the Public Accounts. Section 11 of the *Auditor General Act* requires that the Auditor General express an opinion as to whether the financial statements included in the Public Accounts present fairly the financial position, results of operations and changes in the financial position of the Province in accordance with Government's disclosed accounting policies and on a basis consistent with that of the preceding year, together with any reservations the Auditor General may have.

2.9 Why are they Audited?

The House of Assembly is responsible for overseeing the activities of Government and holding Government accountable for its handling of public resources. To assist this process, Government provides information about how it used public resources entrusted to it. One of the main ways Government does this is through the annual preparation, and tabling in the House of Assembly, of the Public Accounts of the Province.

But what assurance do Members of the House of Assembly have that the information provided in the Public Accounts is appropriate, credible and complete? How can Members know that the information they receive accurately reflects the results of the activities of Government? The answer is that the House of Assembly uses the services of the Auditor General to assist it in carrying out its oversight responsibilities.

Consequently, the Auditor General's fundamental role in auditing the Public Accounts is to bring an independent audit and reporting process to bear upon the manner in which the financial statements are prepared and presented.

An audit provides reasonable, but not absolute, assurance that the Province's financial statements are free of material misstatement. Material misstatement refers to an item or group of items that if omitted or misstated, would alter the decisions of reasonably knowledgeable financial statement users. The tolerable level of error or misstatement is a matter of judgment.

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

We also obtain assurance on the financial information of Crown agencies which are consolidated in the Province's financial statements, by reviewing the agencies' audited financial statements and, in the case of agencies which are not audited by the Auditor General, by obtaining and reviewing information from the auditors of the agencies.

2.10 What does the Auditor's Report Show?

The Auditor's Report on the consolidated summary financial statements of the Province for the year ended 31 March 2006 reads as follows:

To the House of Assembly
Province of Newfoundland and Labrador

I have audited the consolidated statement of financial position of the Province of Newfoundland and Labrador as at 31 March 2006 and the consolidated statements of change in net debt, operations, change in accumulated deficit and cash flows for the year then ended. These financial statements are the responsibility of Government. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by Government, as well as evaluating the overall financial statement presentation.

In my opinion, these consolidated summary financial statements present fairly, in all material respects, the financial position of the Province of Newfoundland and Labrador as at 31 March 2006 and the results of its operations, the changes in its net debt and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles and, pursuant to section 11 of the Auditor General Act, in accordance with the accounting policies of the Provincial government as disclosed in Note 1 to these financial statements applied on a basis consistent with that of the preceding year.

JOHN L. NOSEWORTHY, C.A.
Auditor General

St. John's, Newfoundland and Labrador
18 October 2006

2.11 How do our Financial Statements Compare to other Jurisdictions?

The consolidated summary financial statements are the principal financial statements of the Province and are in full compliance with the requirements of Canadian generally accepted accounting principles for government. In my opinion, the Province's financial statements are as good as the financial statements of any jurisdiction in Canada.

CHAPTER 3

FINANCIAL CONDITION OF THE PROVINCE

3.1 Introduction

In this Chapter, I present key financial information contained in the Public Accounts. I also present information on the financial condition of the Province, including a discussion of financial indicators in the Newfoundland and Labrador context. These financial indicators are intended to assist the reader in interpreting the financial information contained in the Public Accounts and to more completely understand the significance of the information provided.

3.2 Key Balances in the Public Accounts

There are five key balances in Volume I of the Public Accounts, i.e. the consolidated summary financial statements - net debt, accumulated deficit, surplus (deficit), revenue and expense.

Net Debt

Net debt as at 31 March 2006 was $11.7 billion (2005 - $11.9 billion). This is the amount by which the Province's liabilities of $13.8 billion (2005 - $13.7 billion) exceeded its financial assets of $2.1 billion (2005 - $1.8 billion). It is also considered to be the amount which the government of the day leaves for future governments to either repay or refinance.

Accumulated Deficit

The accumulated deficit as at 31 March 2006 was $9.4 billion (2005 - $9.8 billion). This is the total net amount of all annual surpluses and deficits experienced by the Province. Adjustments to the opening accumulated deficit balance are made each year to reflect changes in prior year's amounts for certain entities.

Surplus (Deficit)

The consolidated surplus for the year ended 31 March 2006 was $199 million (2005 - deficit of $489 million). The $199 million surplus for 2006 is the amount by which the Province's total revenue of $5.6 billion exceeded total expense of $5.4 billion. The $489 million deficit for 2005 is the amount by which the Province's total expense of $5.0 billion exceeded total revenue of $4.5 billion.

Revenue

Total revenue for the year ended 31 March 2006 was $5.6 billion (2005 - $4.5 billion). Revenues consist of:

- own source revenues generated by the Province e.g. through taxes and fees;
- revenues received from the Government of Canada including equalization transfers; and
- net income of Government business enterprises (considered as organizations which carry on business and sell goods and services to individuals and non-government organizations as their principal activity and source of revenue - in the Newfoundland and Labrador context, these consist of Newfoundland and Labrador Liquor Corporation and Newfoundland and Labrador Hydro).

Expense

Total expense for the year ended 31 March 2006 was $5.4 billion (2005 - $5.0 billion). Expenses include:

- salaries and employee benefits;
- debt expenses;
- operating costs;
- grants and subsidies; and
- other costs to Government of providing programs and services.

Expenses are summarized in the statements by the three sectors - general government sector, resource sector and social sector.

A summary of key balances contained in the consolidated summary financial statements is provided in Figure 1.

Figure 1

Consolidated Summary Financial Statements
Key Balances
Years Ended 31 March
($ Billions)

Balance	2004	2005	2006
Statement of Financial Position			
Financial Assets	1.399	1.845	2.118
Liabilities	12.886	13.733	13.802
Net Debt	**11.487**	**11.888**	**11.684**
Non-Financial Assets	2.176	2.135	2.289
Accumulated Deficit	**9.311**	**9.753**	**9.395**
Statement of Operations			
Revenue	4.219	4.483	5.556
Expense	5.133	4.972	5.357
Annual Surplus (Deficit)	**(.914)**	**(.489)**	**.199**

Source: Consolidated Summary Financial Statements

3.3 The Financial Condition of the Province

While Government's financial condition has improved somewhat, its net debt of $11.7 billion is still quite high, with net debt per capita of $22,924 as at 31 March 2006, still the highest in the country.

Also, while the Province's economic growth has been positive, its ability to raise its own source revenue remains vulnerable to changes in the economy, including changes due to fluctuations in oil prices and production levels, the Canadian dollar and interest rates.

With regards to oil revenues, the Province is becoming increasingly reliant on these revenues due to growth in this revenue source in recent years. Actual oil revenue in 2004 was $127 million and increased by $406 million to $533 million in 2006. These revenues are generated from non-renewable resources and are very vulnerable to changes in world oil prices and production levels - both outside the control of Government. As a result, there can be significant variances between Government estimated revenue and actual revenue which can have significant impacts on fiscal performance. To illustrate, in November 2006, Government decreased its oil revenue estimate for the 2007 fiscal year by $206.7 million due to production levels being lower than expected. This had a significant impact on the expected fiscal outlook and was a major factor in changing the projected surplus of $6.2 million to a projected deficit of $39.8 million for the 2007 fiscal year.

Government has committed to addressing past annual deficits, and for 2006 reported a surplus of $199 million. However, it is important that Government continue with efforts to spend within its means and consider a reasonable plan to reduce the Province's substantial net debt of $11.7 billion.

In order for Government to eliminate or reduce its net debt, it will be necessary to have continued annual surpluses. The Province has had an annual deficit each year from 1995, with the exception of 1998 and 2006, and is projecting a deficit for 2007. There has to be a substantial improvement in Government's results of operations in order to support a reasonable plan to address the substantial net debt. By way of illustration, consider that the Province would require a surplus of nearly $300 million each year for almost 40 years to eliminate its current net debt of $11.7 billion.

Maintaining a significant net debt means incurring significant annual costs to service that debt. It also means that these annual costs could change significantly due to changes in interest rates. Debt expenses for the year ended 31 March 2006 totalled $947 million, which represents 17% of total revenues. This means that the Province spent $947 million to pay financing costs associated with past accumulated deficits and, as a result, that amount was not available to spend on programs and services. Furthermore, the Province currently has $1.0 billion in U.S. debt (net of sinking fund assets) and therefore has exposure to currency fluctuations. For example, a 1 cent change in the Canadian dollar has an impact of $11.5 million on the Province's debt.

The Province is also heavily reliant on transfers from the Federal government in order to fund its programs and services. To illustrate, of the Province's total revenue of $5.6 billion for the year ended 31 March 2006, $1.9 billion or 34% resulted from Federal transfers, including $861 million for equalization.

Aside from the risk of fluctuating revenues, Government faces continued demand for expenditures, especially in health and education. Expenses in these two departments over the last five years increased by $1.0 billion (or 50%) from $2.0 billion for 2001 to $3.0 billion for 2006, and accounted for 57% of total Government expenses for the year ended 31 March 2006.

There are other factors which could also result in changes to the annual surplus or deficit including an aging infrastructure, an aging population and out-migration.

Figure 2 provides details of the Province's liabilities, annual surplus (deficit), net debt and debt expenses for the years 1995 to 2006 as reported in the consolidated summary financial statements of the Province.

Figure 2

Consolidated Summary Financial Statements
Liabilities, Annual Surplus (Deficit), Net Debt and Debt Expenses
Years Ended 31 March
($ Millions)

Year	Net Borrowing and other Liabilities	Unfunded Pension Liability	Group Health and Group Life Insurance Benefits Liability	Total Liabilities	Annual Surplus (Deficit)	Net Debt	Debt Expenses
1995	6,535	2,686		9,221	(374)	6,831	1,004
1996	6,725	2,739		9,464	(190)	7,121	822
1997	6,730	2,943		9,673	(107)	7,254	819
1998	6,373	3,134		9,507	133	7,301	865
1999	6,758	3,352		10,110	(187)	7,851	1,008
2000	6,689	3,309		9,998	(269)	8,087	883
2001	6,801	3,348		10,149	(350)	8,437	951
2002	7,270	3,392		10,662	(468)	8,932	942
2003	7,581	3,557	985	12,123	(644)	10,616	979
2004	8,073	3,746	1,067	12,886	(914)	11,487	982
2005	8,640	3,934	1,159	13,733	(489)	11,888	940
2006	10,336*	2,201	1,265	13,802	199	11,684	947
Total					**(3,660)**		**11,142**

* Includes deferral of $1.678 billion Atlantic Accord (2005) money

Financial Condition of the Province

As Figure 2 shows, the Province has had substantial deficits and interest costs and an increasing net debt each year, with the exception of a slight decrease in 2006. The total deficit reported over the 12 year period is $3.660 billion, with total debt expenses over the same period of $11.142 billion.

Although for 2006 the Province had budgeted a deficit of $492 million, it actually had a surplus of $199 million. Figure 3 provides details on the budget forecast compared to actual results for the year ended 31 March 2006.

Figure 3

Consolidated Summary Financial Statements
Actual Compared to Budget
31 March 2006
($ 000's)

	Actual	Original Estimates	Impact on Deficit	% of Impact
Revenue				
Provincial				
Taxation	2,111,056	1,991,868	(119,188)	17.2%
Investment	296,992	278,117	(18,875)	2.7%
Fees and fines	231,179	160,438	(70,741)	10.2%
Offshore royalties	532,533	215,370	(317,163)	45.9%
Other	325,794	270,249	(55,545)	8.0%
Government of Canada	1,880,002	1,748,358	(131,644)	19.0%
Net income of government business enterprises	178,032	174,403	(3,629)	0.5%
Total Revenue	**5,555,588**	**4,838,803**	**(716,785)**	**103.5%**
Expense				
General Government Sector	1,494,843	1,519,430	(24,587)	3.6%
Resource Sector	184,546	199,688	(15,142)	2.2%
Social Sector	3,676,917	3,612,149	64,768	-9.3%
Total Expense	**5,356,306**	**5,331,267**	**25,039**	**-3.5%**
Surplus (Deficit)	**199,282**	**(492,464)**	**(691,746)**	**100.0%**

Figure 3 highlights the impact that fluctuations in oil revenue and Federal government transfers have on the Province's surplus or deficit. As the Figure shows, the significant increases in oil revenue ($317 million) and Government of Canada revenue ($132 million), were major factors in why the projected deficit of $492 million became an actual surplus of $199 million.

There is a sense of optimism about the potential prosperity for the Province and the resulting improvements to the Province's financial condition. The most significant area relates to the receipt of the $2 billion advance payment from the Government of Canada in July 2005 relating to the Atlantic Accord (2005), and the future revenues to be recognized resulting from this advance payment along with reductions in pension debt expenses. Another notable area is the continuing increase in oil revenues. These have had an immediate impact on the Province's financial position and are expected to have a significant impact on the Province's results of future operations. However, it has to be recognized that oil revenues are volatile and oil is a non-renewable resource with a limited life.

While it is encouraging that Government has made some progress regarding past annual deficits, prudent fiscal management and spending within its means has to remain a priority for Government if it is to make progress in improving the Province's financial position. As well, a debt reduction plan has to be developed and followed before the financial condition of the Province can be considered to have turned around.

3.4 Financial Indicators - Interpreting the Financial Information

An important role for my Office is to provide Members of the House of Assembly with information on the state of Government's finances. This information is necessary in order to have an informed debate about the issues that Government has to address. Issues include the ability of Government to fund programs and services, where the revenues will come from and the impact of surpluses, deficits and debt.

The Canadian Institute of Chartered Accountants (CICA), through the Public Sector Accounting Board (PSAB) is the professional body that approves standards for financial reporting and accounting in the public sector. It also issues research studies on public sector accounting matters.

CICA issued a Research Report in 1997 entitled Indicators of Government Financial Condition. That report identified financial indicators which it felt best describes the financial condition of a government. These indicators were categorized in terms of three elements of financial condition:

Sustainability - whether a government is living within its means;

Flexibility - whether a government can meet rising commitments by expanding its revenues or increasing its debt; and

Vulnerability - the extent to which a government relies on money from the Federal government or other outside sources to pay for existing provincial programs.

In this section, these indicators are discussed in the Newfoundland and Labrador context. Each indicator can and should be analyzed in detail, combined with other information and monitored over time.

Sustainability Indicators

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. Important sustainability indicators include:

- government's annual surplus or deficit; and
- government's net debt and a province's gross domestic product (GDP) in relation to net debt.

Each of these indicators provides useful insight into the sustainability of a government's revenue raising and spending practices.

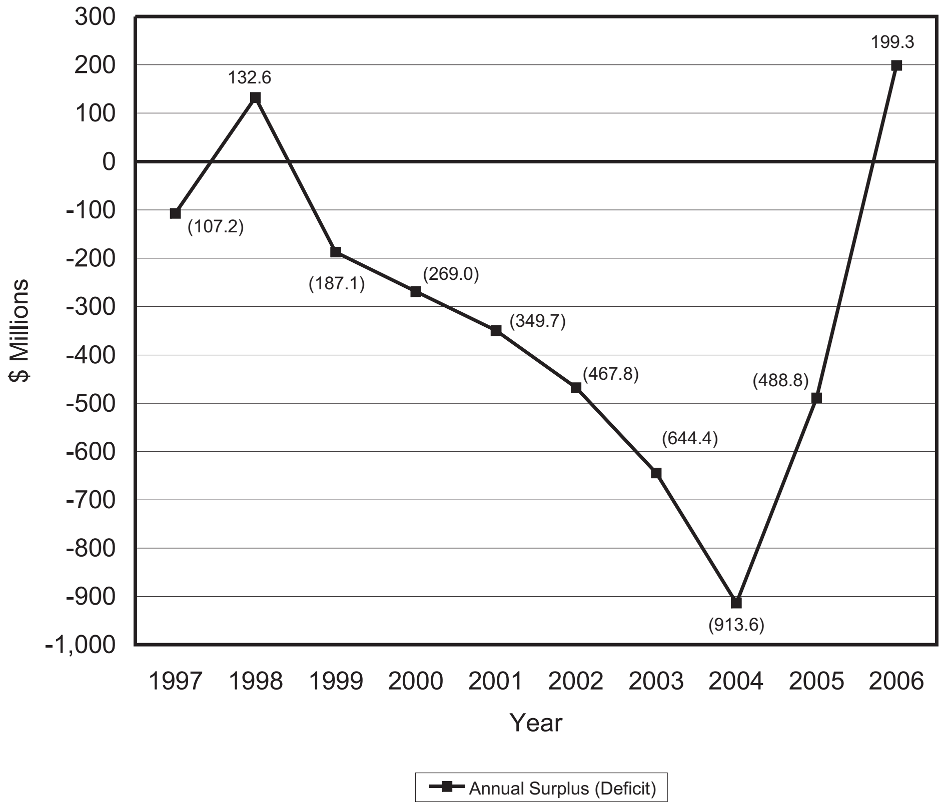
(a) Government's annual surplus or deficit

The annual surplus or deficit shows the extent to which a government spends less or more than it raises in revenues in one fiscal year. It is an indicator of whether a government is living within its means.

For the year ended 31 March 2006, the annual surplus reflected in the Province's consolidated summary financial statements was $199.3 million. Figure 4 provides details as to the annual surplus or deficit each year from 1997 to 2006.

Figure 4

Consolidated Summary Financial Statements
Annual Surplus (Deficit)
Years Ended 31 March
($ Millions)



As Figure 4 shows, with the exception of 1998 and 2006, Government has had an annual deficit each year. In 1998, there was a reported surplus of $132.6 million which resulted from a one-time payment of $348 million received from the Government of Canada related to the Labrador ferry service transfer. The Figure also shows that Government's annual deficit grew each year from 1998 to 2004, with a peak deficit of $913.6 million in 2004, the largest annual deficit recorded by the Province. Government also had an annual deficit in 2005; however, it had decreased from the record deficit in 2004, to $488.8 million. For 2006, Government had an annual surplus of $199.3 million, which was due in large part to an increase in oil revenue and an increase in Government of Canada revenue.

(b) Net debt and a province's gross domestic product (GDP) in relation to net debt

Users of a province's financial statements should look at long-term trends such as net debt to GDP and net debt as a percentage of GDP. Such trends are further indicators of whether a government is living within its means.

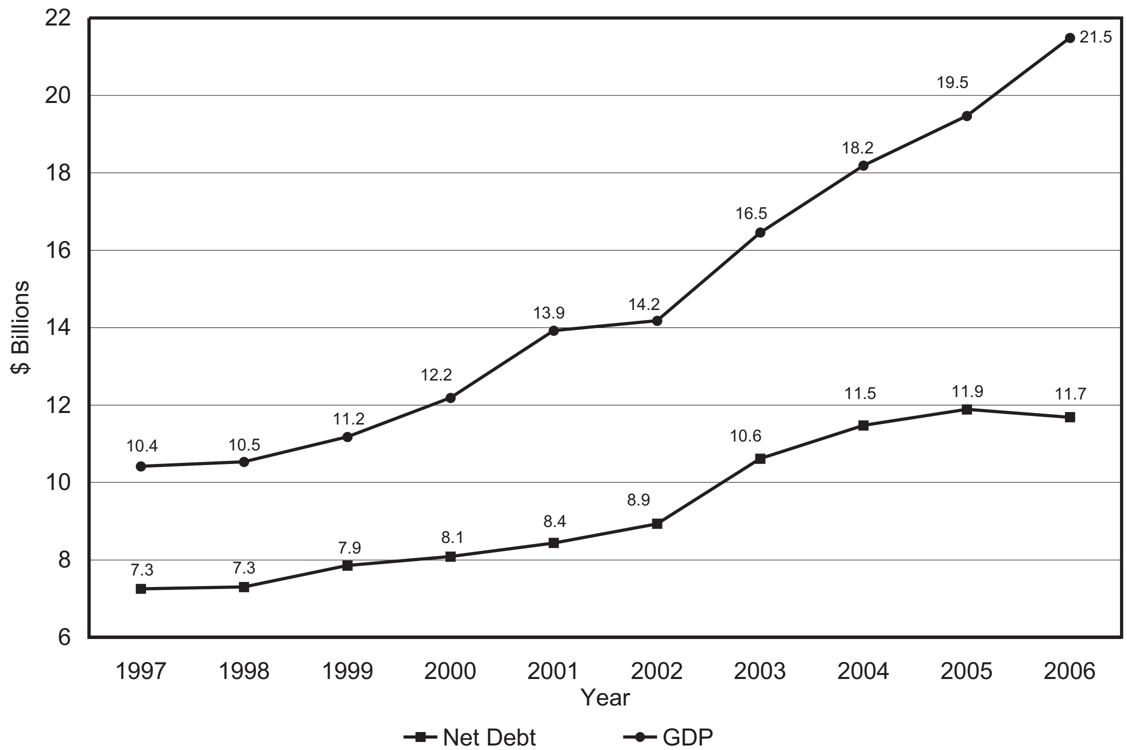
Net debt is the total of all liabilities reduced by financial assets (e.g. cash, temporary investments and receivables). It is the amount which the government of the day leaves for future governments to either repay or refinance. As at 31 March 2006, the net debt reflected in the Province's consolidated summary financial statements was $11.7 billion.

The Province's GDP is a measure of the total value of all goods and services produced in Newfoundland and Labrador in one year. It is the number most often used to indicate the size of a provincial economy. Government must manage its revenue raising and spending practices in the context of the economy of the Province.

Figure 5 provides details as to the net debt in relation to the GDP from 1997 to 2006. For purposes of this report, GDP for 2006 is reported at $21.5 billion, based on information obtained from the Provincial Department of Finance.

Figure 5

Consolidated Summary Financial Statements
Net Debt in Relation to GDP
Years Ended 31 March
($ Billions)

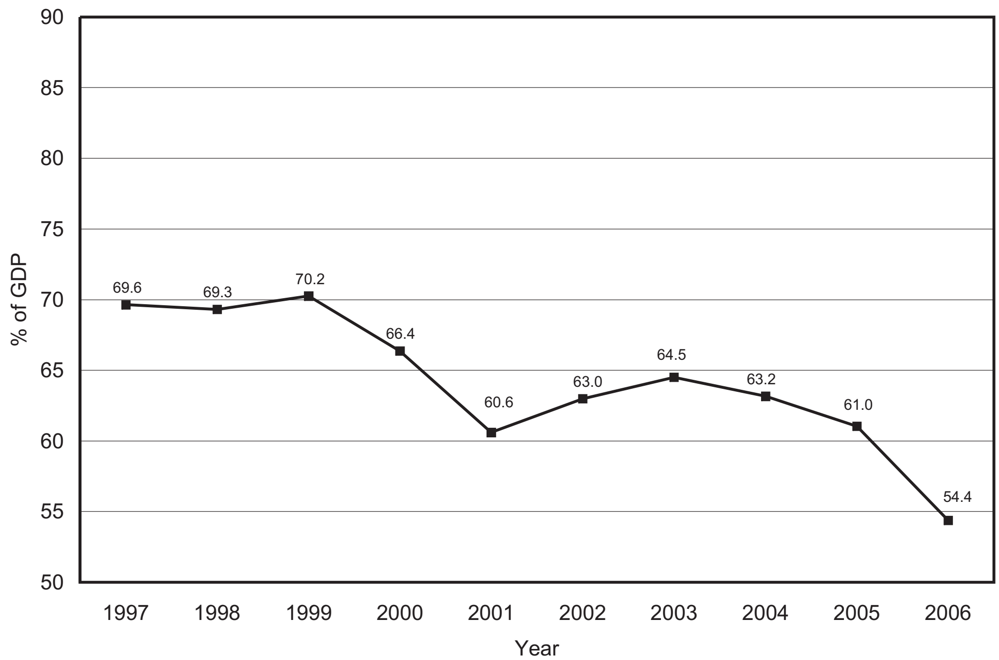


As Figure 5 shows, the GDP of Newfoundland and Labrador increased substantially from 1997 to 2006. The 2006 GDP of $21.5 billion is an increase of $11.1 billion (107%) from the 1997 GDP of $10.4 billion. Figure 5 also shows that, with the exception of 2006, the Province's net debt has increased each year since 1998.

The financial demands placed on the economy by Government's spending and revenue raising practices can be assessed for sustainability by comparing Government's net debt to the Province's GDP. The thinking behind this measure is that the larger the GDP the more debt Government can afford to carry. As Figure 5 shows, the Provincial GDP has been increasing and as a result, Figure 6 shows that the net debt as a percentage of GDP has decreased since 2003.

Figure 6

Consolidated Summary Financial Statements
Net Debt as a Percentage of GDP
Years Ended 31 March



As Figure 6 shows, the net debt of the Province as a percentage of GDP in 2006 was 54.4%, a significant decrease from the 70.2% in 1999. Although this is an improvement, the Province still has the highest net debt to GDP ratio of any province in Canada.

Flexibility Indicators

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. Important flexibility indicators include:

- interest costs as a percentage of total revenue; and
- own source revenues to GDP.

Together with a government's net debt and a province's GDP, these indicators provide insight into a government's flexibility in responding to rising commitments. For example, when a government has a large net debt and high interest costs, it has fewer resources to allocate to programs and services.

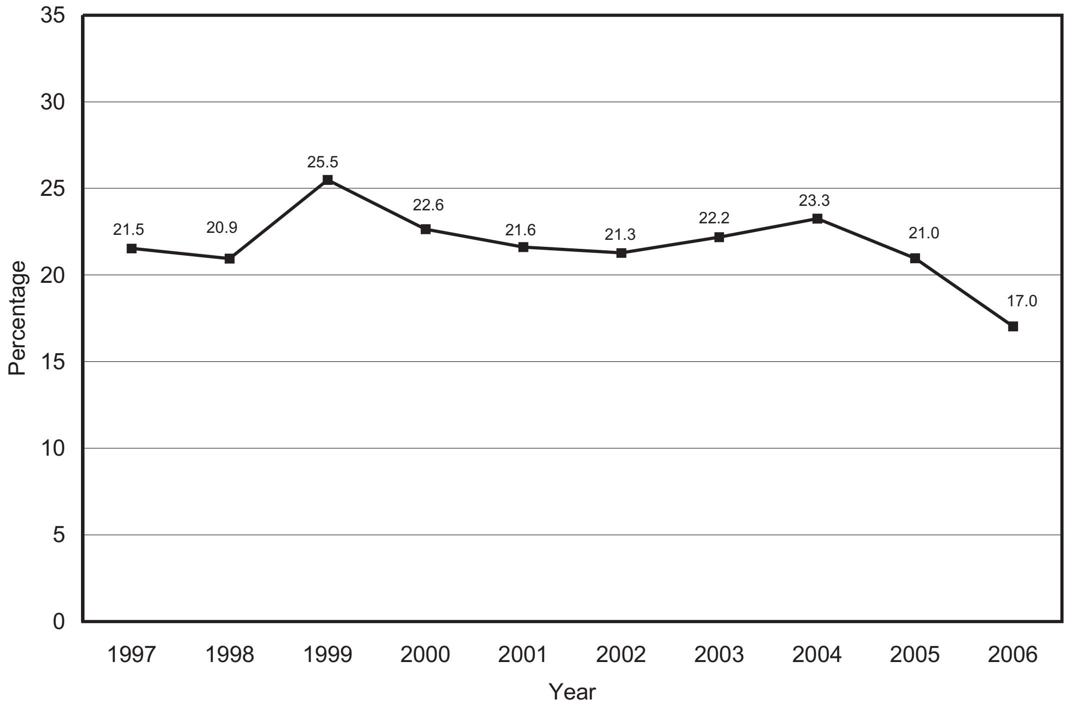
(c) Interest costs as a percentage of total revenue

Government incurs interest costs on its borrowings, as well as on its liabilities relating to retirement benefits. At 31 March 2006, Government's long-term debt net of sinking funds was $6.5 billion, its unfunded pension liability was $2.2 billion and its unfunded group health and life insurance retirement benefits liability was $1.3 billion. In 2006, Government's interest costs (debt expenses) totalled $947 million. The significance of debt expenses is that this money is not available to fund programs and services.

Interest costs as a percentage of total revenue, sometimes called the "interest bite", is an important indicator of the state of a government's finances. This indicator shows the extent to which a government must use revenue to pay interest costs rather than to pay for programs and services. Figure 7 provides information on debt expenses as a percentage of total revenue from 1997 to 2006 and shows that the "interest bite" in 2006 was 17 cents per dollar of total revenue.

Figure 7

Consolidated Summary Financial Statements
Total Debt Expenses as a Percentage of Total Revenue
Years Ended 31 March



While Figure 7 indicates a significant decrease in debt expenses as a percentage of total revenue, these costs continue to be a substantial burden for Government. With 17 cents of every dollar going to debt expenses, Newfoundland and Labrador continues to have the highest debt expenses as a percentage of total revenue of any province in Canada.

Continued reductions in the interest bite would allow Government to use more of its revenues to pay for programs and services, and use less of its revenues to pay for debt expenses.

(d) Own source revenues to GDP

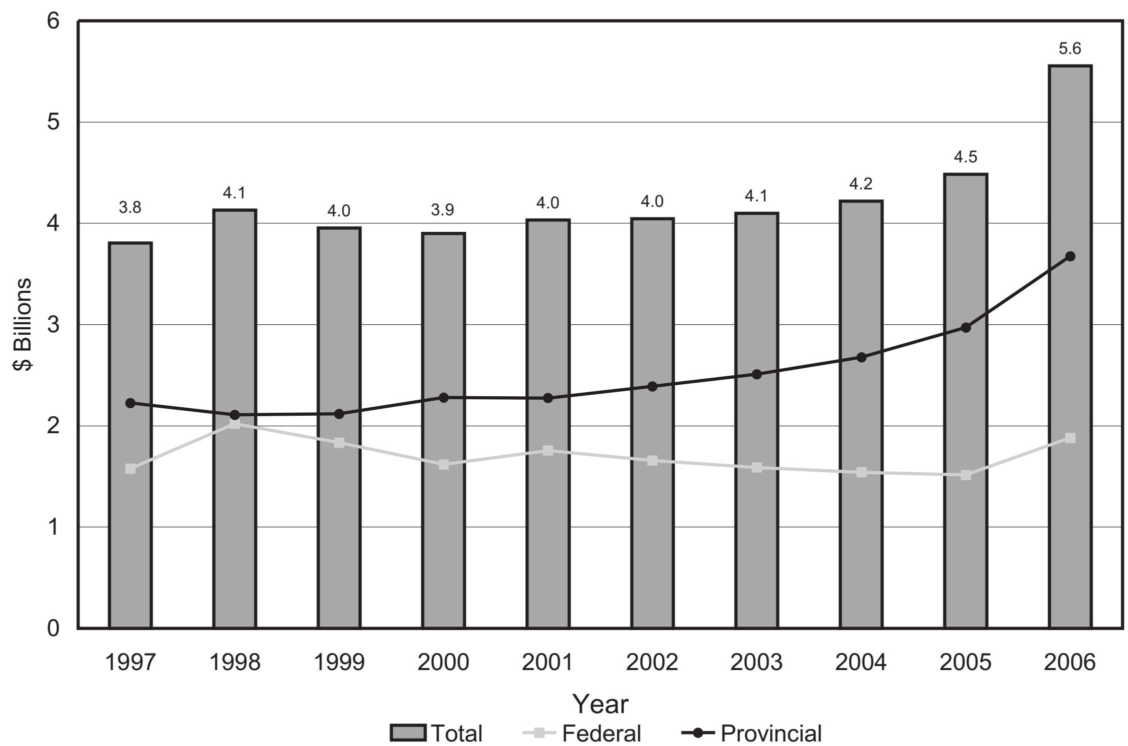
The Government of Newfoundland and Labrador raises revenue from two general sources. The first revenue source is from within the Province. This source is called “own source revenue”. The second source of revenue is transfers from the Federal government.

Government's own source revenue to GDP reflects how much revenue Government can raise from the Provincial economy e.g. through taxes and fees. It shows the extent to which Government obtains its revenues from the Provincial economy as opposed to transfers from the Federal government, and the flexibility it has in increasing its financial resources through own source revenues if faced with decreases in Federal government revenue.

Figure 8 provides information on own source and Federal revenues from 1997 to 2006.

Figure 8

Consolidated Summary Financial Statements
Revenue by Source
Years Ended 31 March
($ Billions)



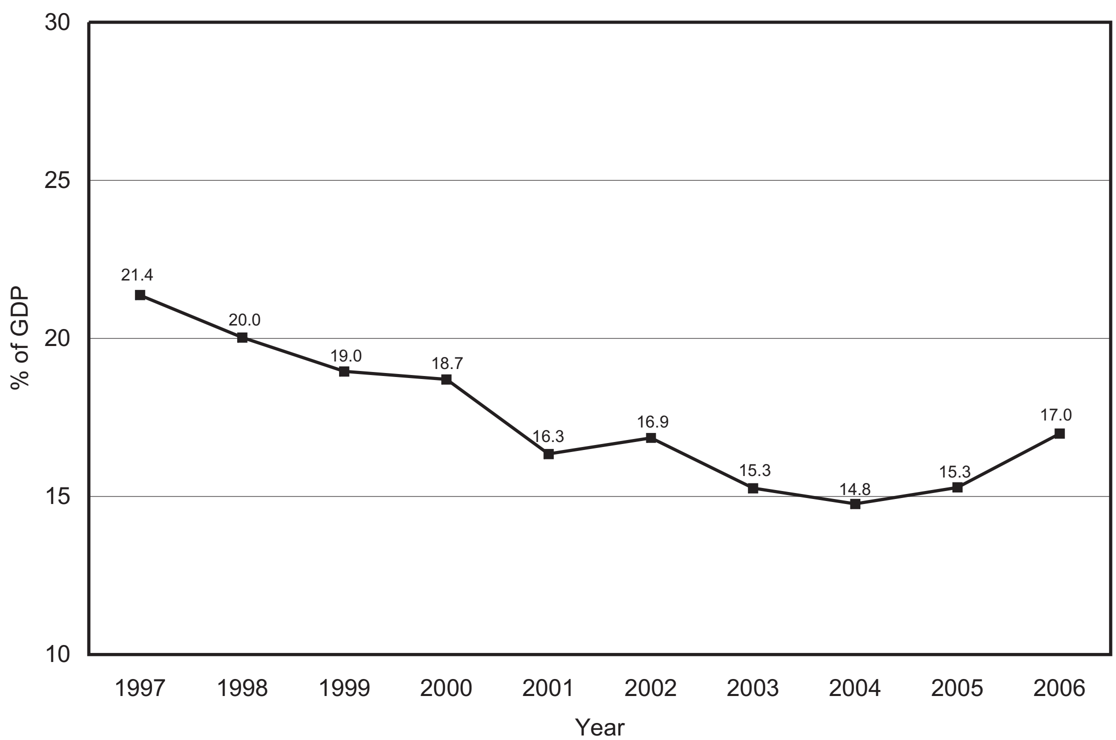
As Figure 8 shows, although a substantial portion of our total revenue continues to come from the Federal government, with the exception of 2006, Federal contributions have been on a decline since 2001. At the same time, Provincial revenues have increased. As a result, Federal revenues as a percentage of total revenues have declined from 44% in 2001 to 34% in 2006.

Another important factor to consider is the comparison of the change in a government's own source revenue to the size of the economy as indicated by the GDP.

Figure 9 provides information on this indicator from 1997 to 2006.

Figure 9

Consolidated Summary Financial Statements
Own Source Revenue as a Percentage of GDP
Years Ended 31 March



As Figure 9 shows, revenue raised from sources within the Province, as a percentage of GDP, declined from 21.4% in 1997 to 14.8% in 2004, with an increase to 17.0% in 2006. This means that since 2004 the Province has been taking more income out of the economy.

Vulnerability Indicators

Vulnerability is the degree to which a government becomes dependent on, and therefore vulnerable to, sources of funding outside its control or influence. This indicator measures the extent to which a government can manage its financial affairs without having to rely on others. Important vulnerability indicators include:

- Federal government revenues compared to own source revenues;
- foreign currency debt to total government debt; and
- oil revenues as a percentage of own source revenues.

(e) Federal government revenues compared to own source revenues

A significant portion of Government's revenue in this Province consists of transfers from the Federal government such as equalization, Health and Social Transfers and cost-shared programs.

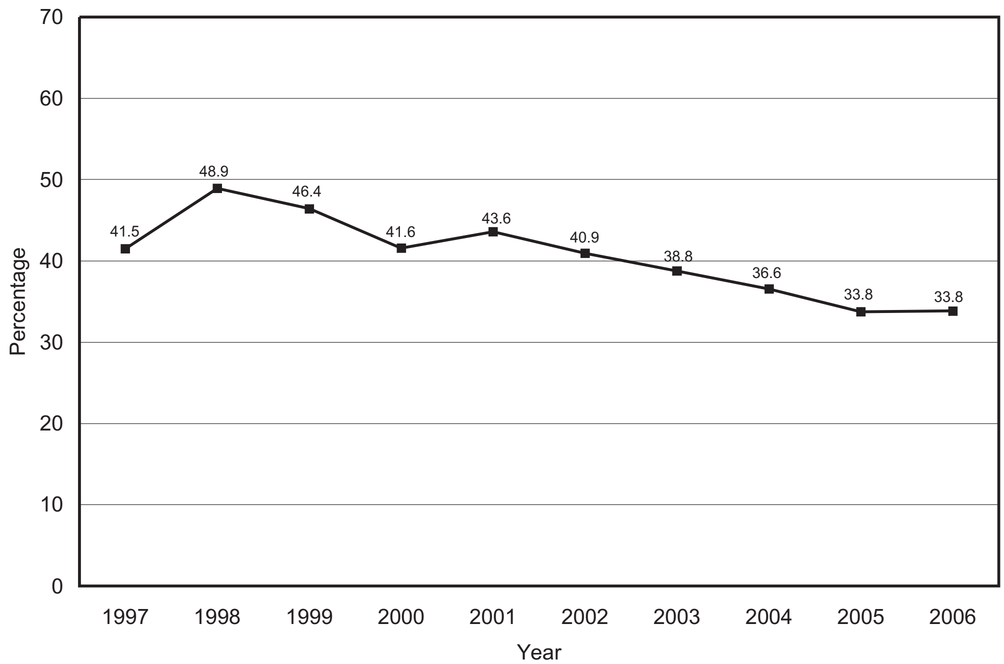
In the case of equalization, the Federal government calculates the amount of these transfers by comparing the ability of a province to raise revenues with a set standard for other provinces in Canada. As a result of this calculation, the annual amount of equalization transfers due to Newfoundland and Labrador is significantly affected by the performance of other provincial economies.

A comparison of Federal government revenues to own source revenues reflects how dependent Government is on transfers from the Federal government and how vulnerable Government is to changes in these transfers in its ability to finance its programs and services.

Figure 10 provides information on the percentage of Federal revenues compared to the Province's total revenues from 1997 to 2006.

Figure 10

Consolidated Summary Financial Statements
Federal Revenues as a Percentage of Total Revenues
Years Ended 31 March



As Figure 10 shows, Federal revenue as a percentage of total revenue has generally declined since 1998. This decline is due in large part to decreases in the Province's entitlement relating to Federal government equalization payments. These decreases in entitlement are impacted by factors including decreases in the Province's population.

As indicated in Figure 10, over the past ten years, Federal revenue as a percentage of total revenue ranged from a high of 48.9% in 1998, which resulted from a one time payment of $348 million related to the Labrador ferry service transfer, to a low of 33.8% for 2005 and 2006.

The lower the percentage of Federal revenues as a percentage of total revenues, the less potential impact, i.e. the vulnerability the Province has related to any change in these revenues.

(f) Foreign currency debt to total government debt

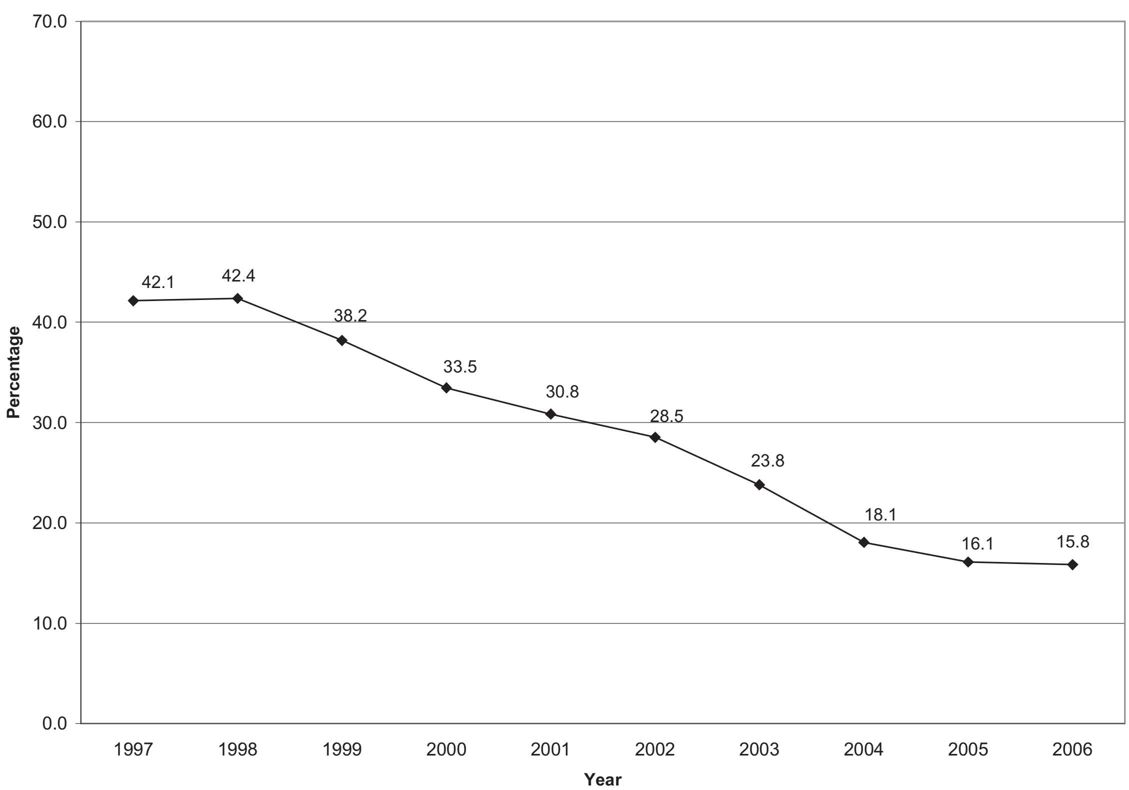
Of the $6.5 billion in total borrowings (net of sinking fund assets) as at 31 March 2006, $1.0 billion was foreign (U.S.) debt.

A comparison of a government's foreign debt to its total debt reflects the degree to which it is vulnerable to currency swings.

Figure 11 provides information on the Province's foreign currency debt as a percentage of its total debt from 1997 to 2006.

Figure 11

**Consolidated Summary Financial Statements
Foreign Currency Debt as a Percentage
of Total Debt (Net of Sinking Funds)
Years Ended 31 March**



As Figure 11 indicates, over the last ten years, foreign currency debt as a percentage of total debt has been steadily decreasing from a high of 42.4% in 1998 to a low of 15.8% in 2006.

While Government is still vulnerable to currency swings, this risk has been minimized given the decline in the amount and percentage of foreign currency debt held. An increase/decrease of one cent in the foreign exchange rates at 31 March 2006 would have resulted in an increase/decrease in foreign borrowings of $11.5 million.

(g) Oil revenues as a percentage of own source revenues

There is a growing reliance by Government on oil revenue to fund its programs and services. This revenue source as a percentage of Provincial revenues has increased substantially in recent years. To illustrate, in 2004 oil revenue was $127 million (4.7% of own source revenue) while in 2006, oil revenue was $533 million (14.5% of own source revenue).

However, world oil prices are highly volatile and production levels relating to such non-renewable resources can vary significantly. Therefore, changes in these factors can result in significant differences between budget forecasts and actual. As a result, Government's financial position can be significantly impacted by factors outside its control. Figure 12 shows budget and actual oil revenue from 2004 to 2006 along with budget and revised forecasts for 2007.

Figure 12

Consolidated Summary Financial Statements
Oil Revenues: Budget, Actual and
Percentage of Own Source Revenues
Year Ended 31 March

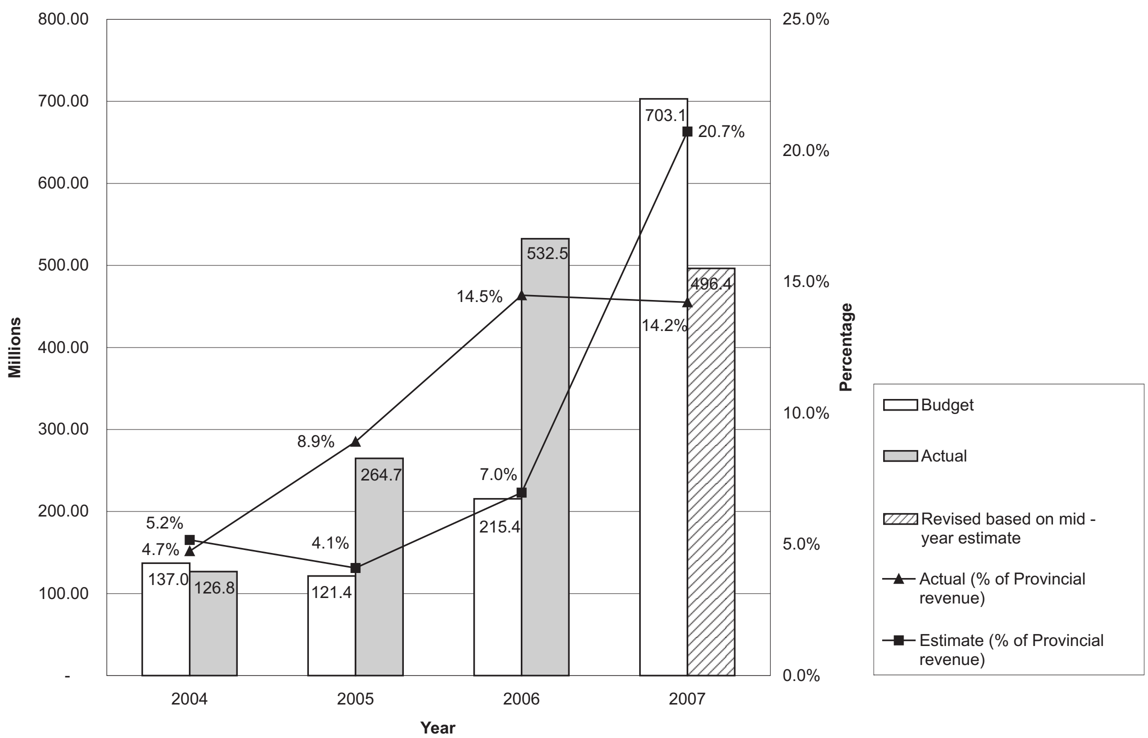


Figure 12 outlines differences between the budget forecasts and actual oil revenues from 2004 to 2006 (and forecasted for 2007) which, for the most part, are attributable to changes in oil prices and/or production levels. For example, in 2006 while oil revenue was budgeted at $215 million, actual oil revenue was $533 million, an increase of $318 million or 148%. This change could have been in either direction and highlights the vulnerability associated with this revenue source. Furthermore, although oil revenue was budgeted for 2007 at $703.1 million, in November 2006, Government reduced its oil revenue estimate by $206.7 million to $496.4 million in large part as a result of production issues.

Given its lack of control over oil prices and production levels, and its increasing dependence on this revenue source, Government has to carefully consider the degree to which it relies on this revenue source to fund its programs and services.

CHAPTER
4
COMMENTS ON
SELECTED FINANCIAL INFORMATION

4.1 Retirement Benefits - Pensions

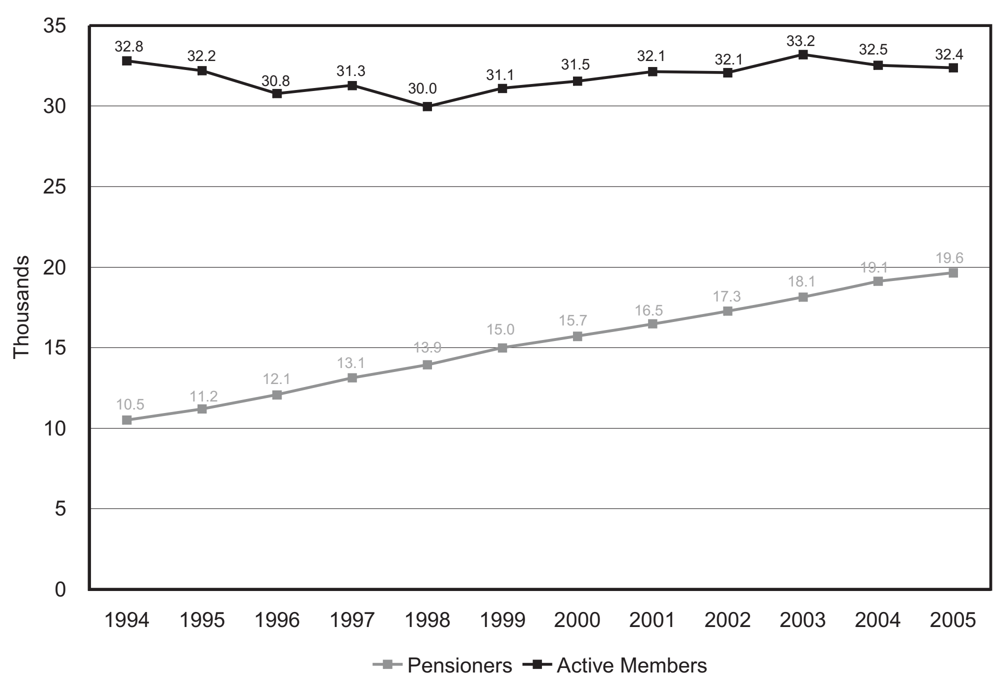
Pensions Administered under the Newfoundland and Labrador Pooled Pension Fund

Prior to 1967, public service salaries and pension benefits were paid under the authority of the *Civil Service Act*. Under that legislation there were no employee or employer contributions to a pension plan and pension benefits were paid out of the Consolidated Revenue Fund. In 1967, legislation was enacted which required that employees contribute to a pension plan. Employees' pension premiums were paid into the Consolidated Revenue Fund and pension benefits continued to be paid out of it.

In 1981, legislation was enacted which created the Province of Newfoundland and Labrador Pooled Pension Fund and required that employee and employer pension premium contributions be paid into the Fund. Subsequent to the establishment of the Fund, pension benefits were paid by the Fund irrespective of whether the employee had contributed pension premiums to it. Figure 1 provides historical data for the Fund relating to pensioners and active members for the past 12 years.

Figure 1

Province of Newfoundland and Labrador Pooled Pension Fund
Population History: Pensioners and Active Members
Years Ended 31 December
(000's)



As at 31 December 2005, the Province of Newfoundland and Labrador Pooled Pension Fund was comprised of the following five pension plans:

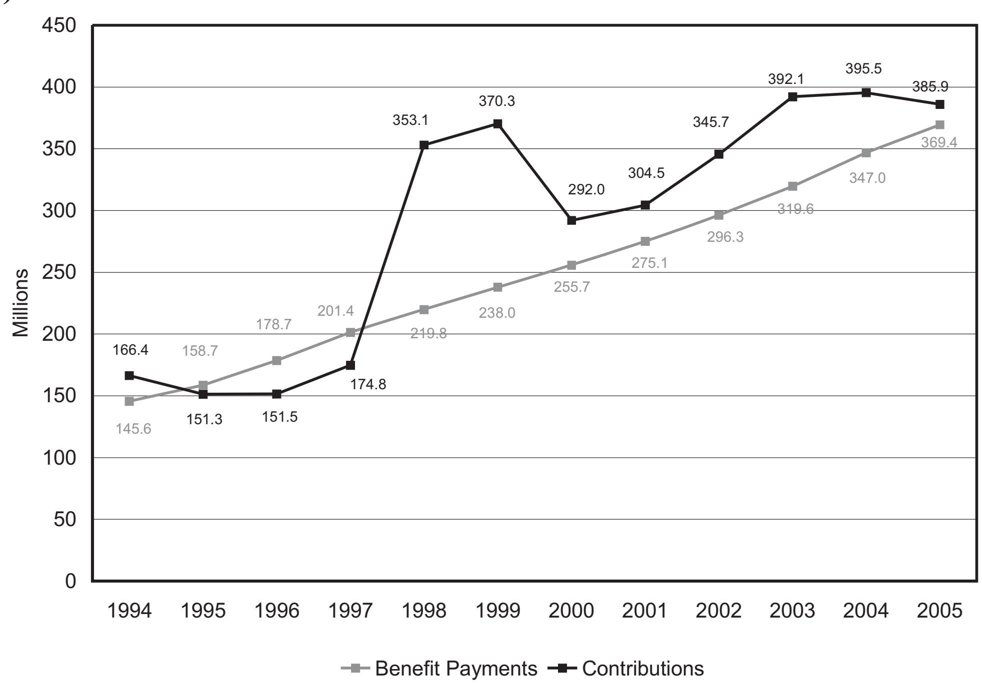
- Public Service Pension Plan;
- Teachers' Pension Plan;
- Uniformed Services Pension Plan;
- Members of the House of Assembly Pension Plan; and
- Provincial Court Judges' Pension Plan.

All employee and employer contributions are deposited into the Fund and pension benefits to plan members and other pension payments are made from it.

For the year ended 31 December 2005, approximately 32,400 employees, Members of the House of Assembly, and the employer paid pension premiums totalling $385.9 million into the Pension Fund under the five pension plans. During the same period, the Fund provided benefits totalling $369.4 million to approximately 19,600 retirees. Figure 2 provides historical data for the Fund relating to pension benefits paid and pension contributions received for the past 12 years.

Figure 2

Province of Newfoundland and Labrador Pooled Pension Fund
Pension Benefit Payments and Contributions
Years Ended 31 December
($ Millions)



Memorial University of Newfoundland Pension Plan

Commencing with the year ended 31 March 2006, the Province included Memorial University of Newfoundland (MUN) in its reporting entity. Therefore, the consolidated summary financial statements include, for the first time, financial information relating to the MUN pension plan.

MUN's plan is a defined benefit pension plan for its full-time employees and is administered separately from the plans administered under the Province of Newfoundland and Labrador Pooled Pension Fund.

As at 31 March 2006, the MUN plan had 3,055 active participants and 1,299 pensioners. For the year ended 31 March 2006, the employer and employees paid pension premiums totalling approximately $34 million, and provided benefits to pensioners of approximately $27 million.

Unfunded Pension Liability

The unfunded pension liability as at 31 March 2006, including the unfunded liability of the MUN plan of $18.7 million, totalled $2.201 billion. This is a decrease of $1.733 billion from the balance of $3.934 billion as at 31 March 2005. The main reason for the decrease in the unfunded pension liability was the decision by Government to use $1.953 billion of the proceeds from the Atlantic Accord (2005) agreement to reduce the unfunded pension liability of the Teachers' Pension Plan.

The $2.201 billion unfunded pension liability continues to represent a significant debt for Government. Information on the overall unfunded pension liability from 1997 to 2006 is outlined in Figure 3.

Figure 3

Consolidated Summary Financial Statements
Unfunded Pension Liability
As at 31 March
($ Billions)

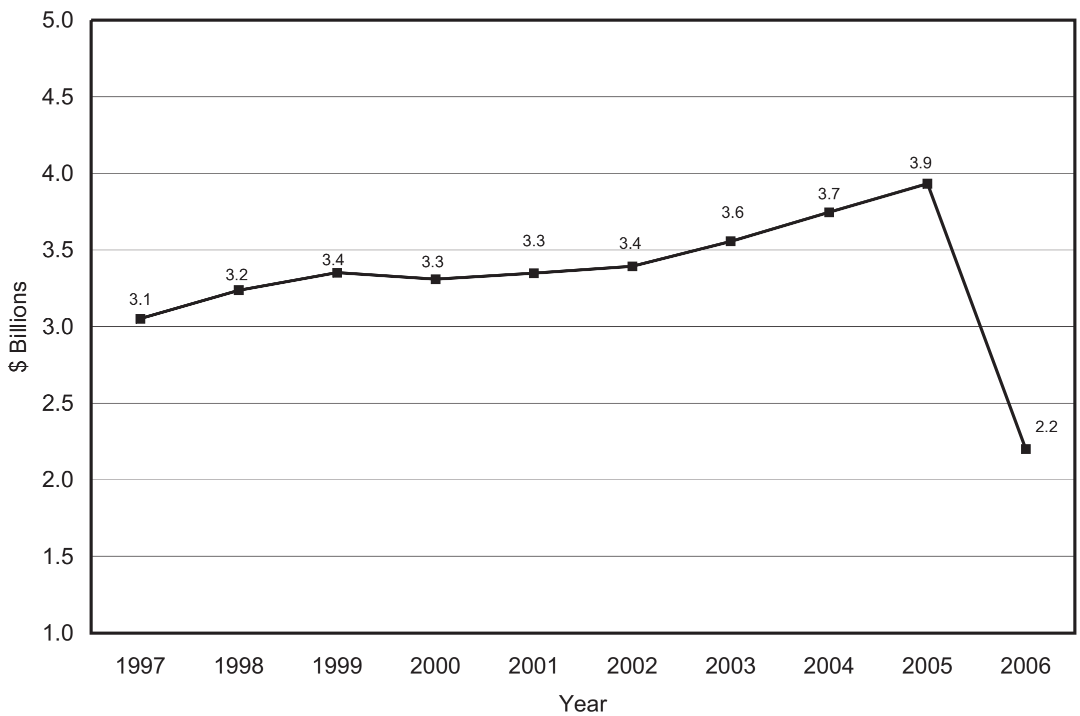


Figure 4 provides details of the Province's $2.201 billion unfunded pension liability as at 31 March 2006.

Figure 4

Consolidated Summary Financial Statements
Unfunded Pension Liability by Plan
As at 31 March
($ Millions)

Plan	Unfunded Liability 2005	Contributions Employees	Contributions Employer	Special Payments	Current Service Costs	Current Amortization	Interest Expense	Other Adjustments	Unfunded Liability 2006
PSPP	1,671.1	(78.0)	(78.4)	(60.0)	129.4	28.3	142.9	.3	1,755.6
TPP	2,043.6	(36.2)	(33.7)	(2,019.2*)	53.6	33.0	169.0	(10.0)	200.1
USPP	175.4	(2.3)	(2.3)	(20.0)	4.8	1.1	13.9	-	170.6
MHAPP	40.3	(.4)	(6.0)	-	2.0	2.5	3.3	10.4	52.1
PCJPP	3.2	(.2)	(.2)	-	.8	-	.2	.2	4.0
MUNPP	-	(13.5)	(14.3)	(7.0)	25.3	6.3	6.1	15.8	18.7
	3,933.6	**(130.6)**	**(134.9)**	**(2,106.2)**	**215.9**	**71.2**	**335.4**	**16.7**	**2,201.1**

* Comprised of $1.953 billion Atlantic Accord (2005) money, special payment of $56 million and a transfer of $10 million from the Members of the House of Assembly Pension Plan.

As Figure 4 shows, although the total unfunded pension liability decreased from 2005, mainly as a result of a one-time special contribution of $1.953 billion from the Atlantic Accord (2005) money to the Teachers' Pension Plan, the unfunded liability increased by a total of $97.1 million in three pension plans - the Public Service Pension Plan ($84.5 million), the Members of the House of Assembly Pension Plan ($11.8 million) and the Provincial Court Judges' Pension Plan ($800,000).

Special Payments

(a) Public Service Pension Plan

Commencing during the 1998 fiscal year, Government started to make special payments to the Public Service Pension Plan to address the Plan's unfunded liability. Government contributed $30 million in each of the fiscal years 1998 and 1999, $40 million in each of 2000, 2001 and 2002, $45 million in 2003, and $60 million in each of 2004, 2005 and 2006. Government has indicated that its contribution will continue at $60 million until the unfunded liability is extinguished. As at 31 March 2006, the net unfunded liability for the Public Service Pension Plan was $1.756 billion (2005 - $1.671 billion). Therefore, even with the $60 million special payment, the unfunded liability increased by $84.5 million during the year.

(b) Teachers' Pension Plan

During the 1999 fiscal year, Government negotiated a collective agreement with the Newfoundland and Labrador Teachers' Association which included provisions to address the unfunded liability of the Teachers' Pension Plan. In accordance with the agreement, Government agreed to contribute up to $815 million to the Plan over a 14 year period. Government paid $166 million towards this commitment in 1999 and 2000, and paid $76 million in each fiscal year from 2001 to 2005. Additional annual payments were to be made in installments of $76 million until the remaining balance of an initial obligation of $815 million, plus interest, had been paid.

However, in March 2006, Government reached an agreement with the Newfoundland and Labrador Teachers' Association and contributed a total of $2.019 billion for the 2006 fiscal year. This amount was comprised of $1.953 billion Atlantic Accord (2005) money, special payment of $56 million and a transfer of $10 million from the Members of the House of Assembly Pension Plan. There are no more planned special payments after fiscal 2006. As at 31 March 2006, the net unfunded liability for the Teachers' Pension Plan was $200.1 million (2005 - $2.044 billion).

(c) Uniformed Services Pension Plan

During the 2002 fiscal year, the Province agreed to a five-year commitment to provide an annual payment of $20 million to the Uniformed Services Pension Plan. As at 31 March 2006, the net unfunded liability for the Uniformed Services Pension Plan was $170.6 million (2005 - $175.4 million).

(d) Members of the House of Assembly Pension Plan

During the 2002 fiscal year, the Province agreed to a five-year commitment to provide an annual payment of $7.5 million to the Plan. However, these payments will only be allowable under the Federal *Income Tax Act* to the extent that they fully fund the registered component of the Plan. There were no special payments made during 2006. As at 31 March 2006, the net unfunded liability for the Members of the House of Assembly Pension Plan was $52.1 million, an increase of $11.8 million over the 2005 unfunded liability of $40.3 million.

(e) Provincial Court Judges' Pension Plan

No special payments have been made to the Provincial Court Judges' Pension Plan since its inception in fiscal 2004. As at 31 March 2006, the net unfunded liability for the Provincial Court Judges' Pension Plan was $4.0 million, an increase of $800,000 over the 2005 unfunded liability of $3.2 million.

(f) MUN Pension Plan

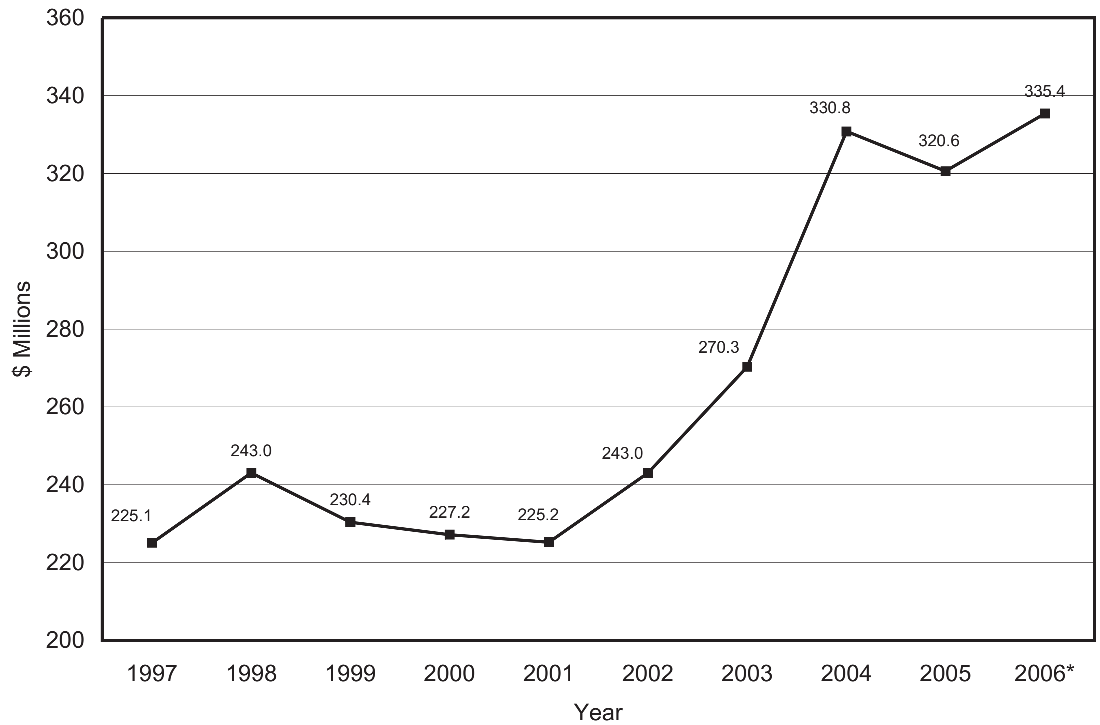
During the 2006 fiscal year, MUN made a special payment of $7 million as the first of a series of planned special payments to the MUN Pension Plan. As at 31 March 2006, the net unfunded liability for the MUN Pension Plan was $18.7 million. (MUN was included in the consolidated summary financial statements for the first time in 2006).

Interest Costs

The interest costs relating to the pension plans each year from 1997 to 2006 are outlined in Figure 5.

Figure 5

Consolidated Summary Financial Statements
Interest Costs on the Unfunded Pension Liability
Years Ended 31 March
($ Millions)



* 2006 includes $6.1 million interest related to the MUN Pension Plan (prior years numbers have not been restated to include MUN)

Figure 5 indicates that since 2001 there has been a significant increase in interest costs associated with the Province's unfunded pension liability. In 2001, interest costs amounted to $225.2 million while in 2006, interest costs were $335.4 million, an increase of $110.2 million or 49%.

As a result of the additional special payment of $1.953 billion to the Teachers' Pension Plan being made in March 2006 the interest costs in that year still remained at prior years' levels. Interest costs in future years will decrease as a result of that contribution. It is noted that interest costs reflected in the Province's Estimates for 2007 are $157.1 million, a decrease of $178.3 million from actual interest costs for 2006.

Recommendation

Government should continue to closely manage the Province's unfunded pension liability.

4.2 Retirement Benefits - Other than Pensions

Active and retired public sector employees are eligible to participate in group health and group life insurance plans. Plans for active and retired Government employees, Members of the House of Assembly and Provincial Court Judges are managed by Government. Plans for teachers are managed by the Newfoundland and Labrador Teachers' Association and plans for employees of Memorial University of Newfoundland are managed by the University.

As at 31 March 2006, the plans provided benefits to a total of 17,502 retirees. Obligations for retirement benefits result from a commitment by Government to provide benefits to employees on retirement in return for their current services. Extended health care and life insurance benefits are a form of compensation offered for current services rendered by employees and accrue over the years employees work. The fundamental accounting task is to determine the amount of the total obligation for future retirement benefits and to determine the cost of future benefits for each year of employee service (current service cost).

Prior to 2004, Government did not reflect either the liability or the total current service cost for group health and group life insurance retirement benefits in the Province's financial statements - the only costs recognized were Government's payments made to the plan administrators.

In May 2002, the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants prescribed accounting standards requiring that governments record a liability and expense in their financial statements for these retirement benefits. While these standards were to be implemented for years beginning after January 2004 (i.e. for the 2005 fiscal year), Government in this Province decided to implement the new standards for the 2004 fiscal year.

A net liability as at 31 March 2006 of $1.265 billion (2005 - $1.159 billion) is recognized in the Province's consolidated summary financial statements relating to group health and group life insurance retirement benefits.

Figure 6 provides information regarding the net liability as extrapolated to 31 March 2010.

Figure 6

Province of Newfoundland and Labrador
Group Health and Group Life Insurance
Net Liability
As at 31 March
($ Billions)

	2003	2004	2005	2006	2007 f	2008 f	2009 f	2010 f
Accrued Benefit Obligation	0.985	1.206	1.289	1.457	1.469	1.552	1.637	1.723
Unamortized Experience Losses	-	0.139	0.130	0.192	0.153	0.141	0.128	0.116
Net Liability	**0.985**	**1.067**	**1.159**	**1.265**	**1.316**	**1.411**	**1.509**	**1.607**

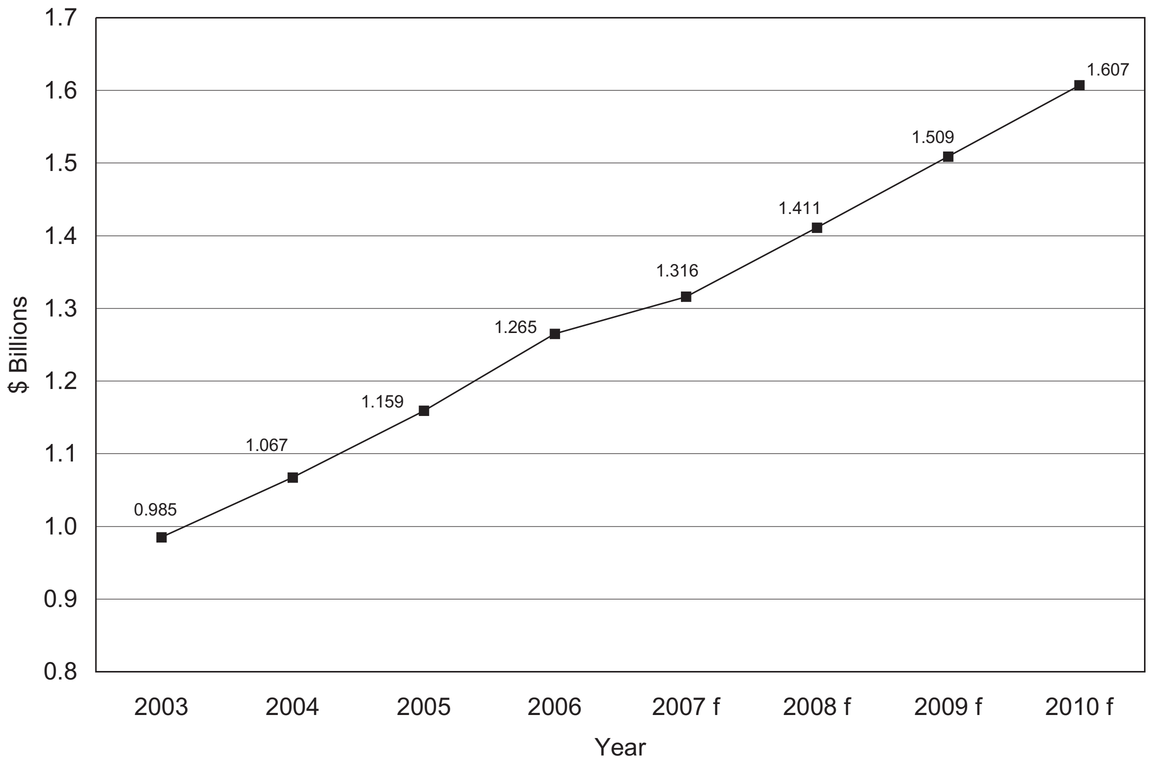
f - forecasted
Source: Public Accounts and Actuarial Valuation

The liability for retirement benefits other than pensions has added to the already considerable debt load of the Province and, as Figure 6 shows, is expected to increase in each of the next four years. By 2010 the net liability is expected to total $1.607 billion, an increase of $622 million or 63% over 2003, if action is not taken to address it.

Figure 7 shows graphically the steady increase in the net liability.

Figure 7

Group Health and Group Life Insurance
Net Liability
As at 31 March
($ Billions)



f - forecasted

Recommendation

Government should carefully manage its liability relating to group health and group life insurance retirement benefits.

4.3 Debt

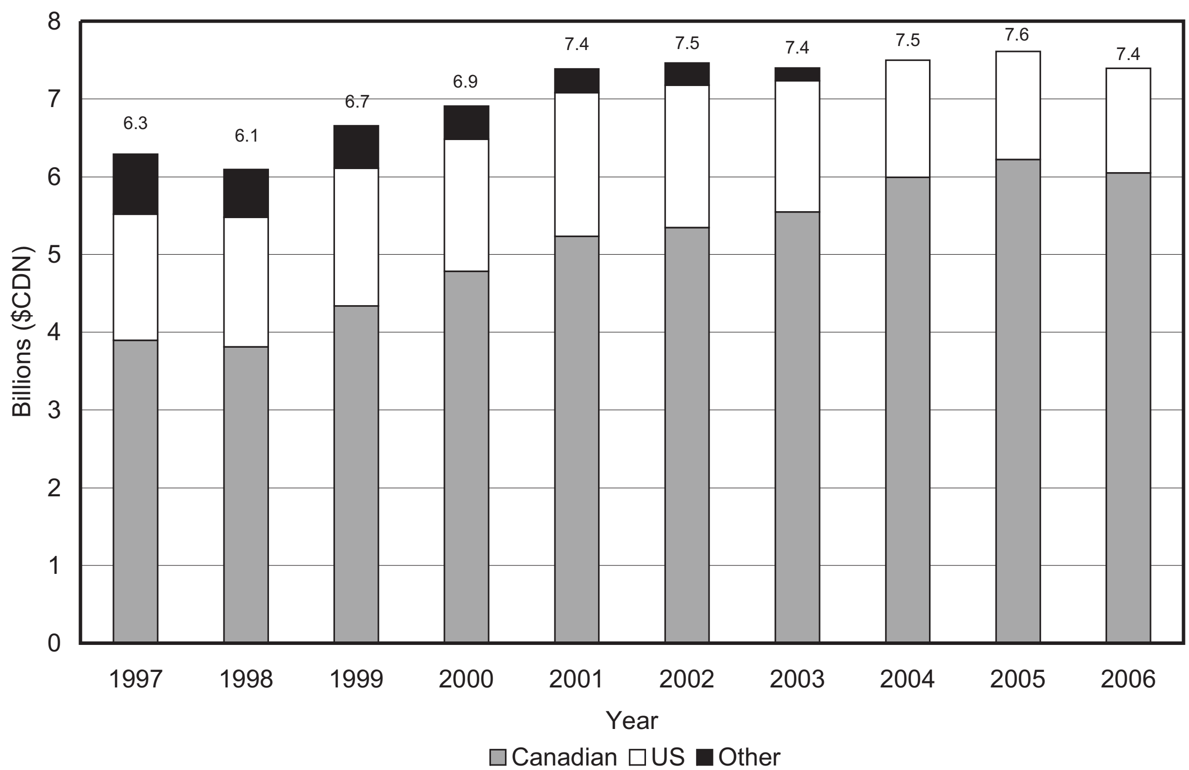
As at 31 March 2006, borrowings were reported in the Consolidated Statement of Financial Position at $6.5 billion, which represents total borrowings of $7.4 billion less sinking fund assets of $864 million. Total borrowings consist of general debentures, amounts borrowed from the Government of Canada and its agencies, as well as other notes and loans payable by the Province. The total borrowings of the Province, net of sinking fund assets for various debentures, is comprised of $5.837 billion in debt reflected in the Consolidated Revenue Fund, $234 million in Newfoundland and Labrador Municipal Financing Corporation debt, $206 million in Student Loan Corporation of Newfoundland and Labrador debt, $190 million in health care organization debt, $37 million in Newfoundland and Labrador Housing Corporation debt, and other miscellaneous debt of $25 million.

The net borrowings of $6.5 billion do not include the borrowings of Newfoundland and Labrador Hydro. This accounting policy is consistent with the recommendations of the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants which requires that the net equity position of a government business enterprise such as Newfoundland and Labrador Hydro be recorded in the consolidated summary financial statements of the Province. In the audited financial statements of Newfoundland and Labrador Hydro for the year ended 31 December 2005, the Corporation reported debt of $1.5 billion ($1.6 billion - 31 December 2004).

Figure 8 shows the total borrowings as at 31 March for each year from 1997 to 2006 as disclosed in the Consolidated Statement of Financial Position. The Figure provides a breakdown of Canadian and foreign currency debt.

Figure 8

Consolidated Summary Financial Statements
Borrowings
As at 31 March
($ Billions)



As Figure 8 shows, there were only Canadian and U.S. denominated borrowings as at 31 March 2006. The Canadian denominated borrowings totalled $6.0 billion and accounted for 82% of total borrowings.

Sinking Funds

Many of the debentures held by the Province have sinking fund requirements. Sinking funds are a pool of cash and investments accumulated during the life of the debentures to repay the debt at maturity.

Figure 9 is a summary of sinking funds as at 31 March 2006 along with the related debenture debt outstanding and the net amount left after reducing the debt by the amount of the sinking funds.

Figure 9

Consolidated Summary Financial Statements
Borrowings and Sinking Funds
As at 31 March 2006
($ Millions)

	Debt Outstanding	Sinking Fund Balance	Balance net of Sinking Fund
Total Debt with Sinking Funds	4,288	864	3,424
Total Debt without Sinking Funds	3,105	-	3,105
Total	**7,393**	**864**	**6,529**

As Figure 9 shows, Government had approximately $864 million in sinking funds at 31 March 2006.

Figure 10 shows borrowings net of sinking funds for each of the past ten years.

Figure 10

Consolidated Summary Financial Statements
Borrowings and Sinking Funds
As at 31 March
($ Millions)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Borrowings	6,291	6,093	6,654	6,909	7,384	7,464	7,398	7,501	7,612	7,393
Sinking Funds	985	1,042	1,097	1,210	1,284	1,007	819	724	775	864
Net Borrowings	**5,306**	**5,051**	**5,557**	**5,699**	**6,100**	**6,457**	**6,579**	**6,777**	**6,837**	**6,529**

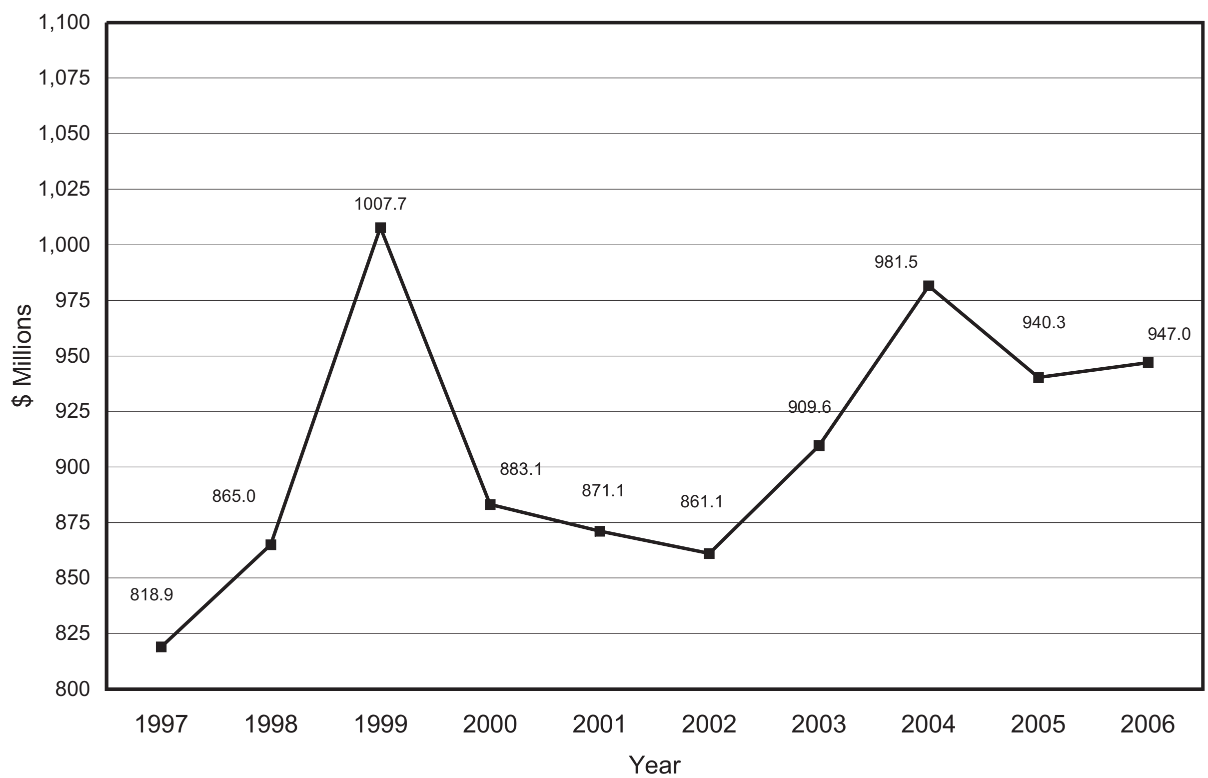
Debt Expenses

The Province's debt expenses for 2006 as recorded in the consolidated summary financial statements totalled $947.0 million, which consists of $335.4 million for the unfunded pension liability, $73.0 million for the net liability for group health and life insurance retirement benefits, and $538.6 million for the Province's borrowings. Total debt expenses for the Province each year from 1997 to 2006 is outlined in Figure 11.

Interest costs as a percentage of total revenue, sometimes called the "interest bite", is an important indicator of the state of a government's finances. The "interest bite" in 2006 was 17 cents per dollar of total revenue (2005 - 21 cents per dollar).

Figure 11

Consolidated Summary Financial Statements
Debt Expenses
Years Ended 31 March
($ Millions)



Credit Rating

The Province's credit rating will affect the debt servicing costs over time because the interest that the Province will have to pay on its borrowing will decrease as the credit rating improves and conversely the interest costs will increase as the credit rating declines.

The Province's credit ratings as established by the three most recognizable rating agencies are outlined in figures 12, 13 and 14.

Figure 12

Province of Newfoundland and Labrador
Credit Ratings Established by
Dominion Bond Rating Service

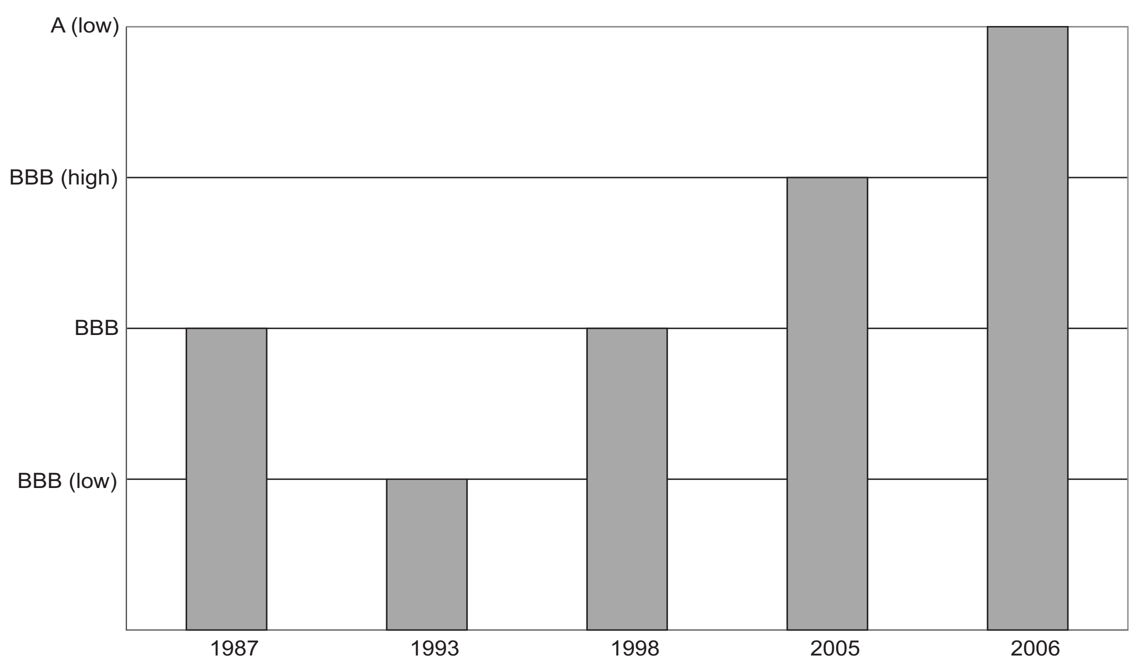


Figure 13

Province of Newfoundland and Labrador
Credit Ratings Established by
Moody's Investors Service

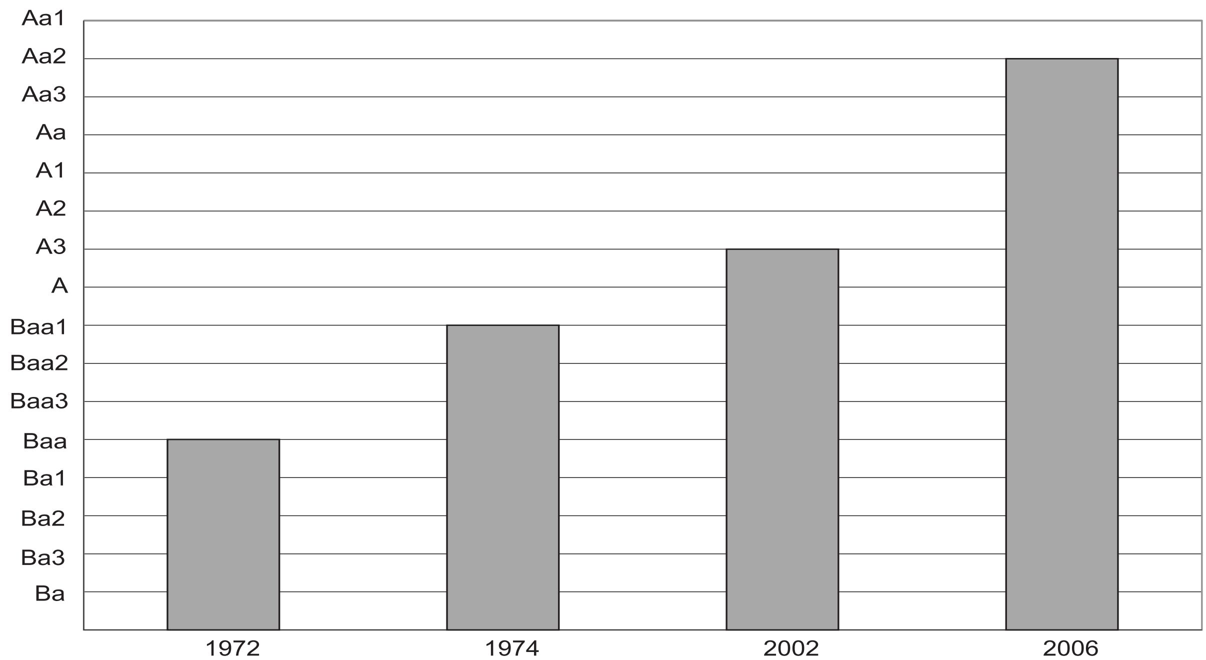
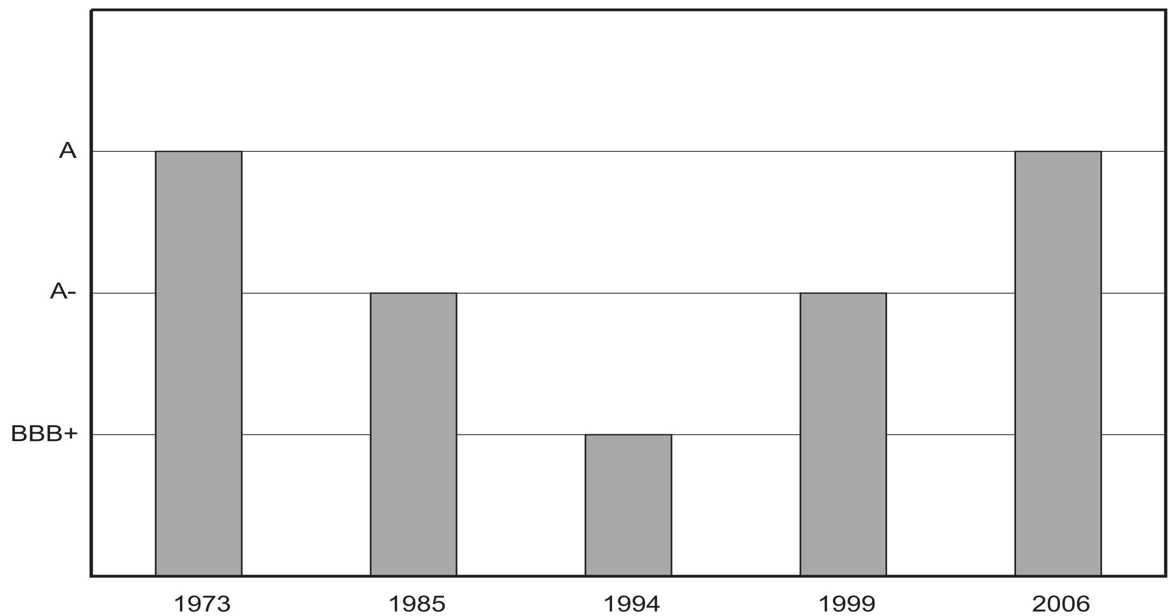


Figure 14

Province of Newfoundland and Labrador
Credit Ratings Established by
Standard & Poor's



Although this information shows that the Province's credit rating set by each of the three rating agencies has improved, as figures 15, 16 and 17 show, this Province is still included in the lowest credit rating category of any province in Canada.

Figure 15

Credit Ratings Established for Canadian Provinces by Dominion Bond Rating Service

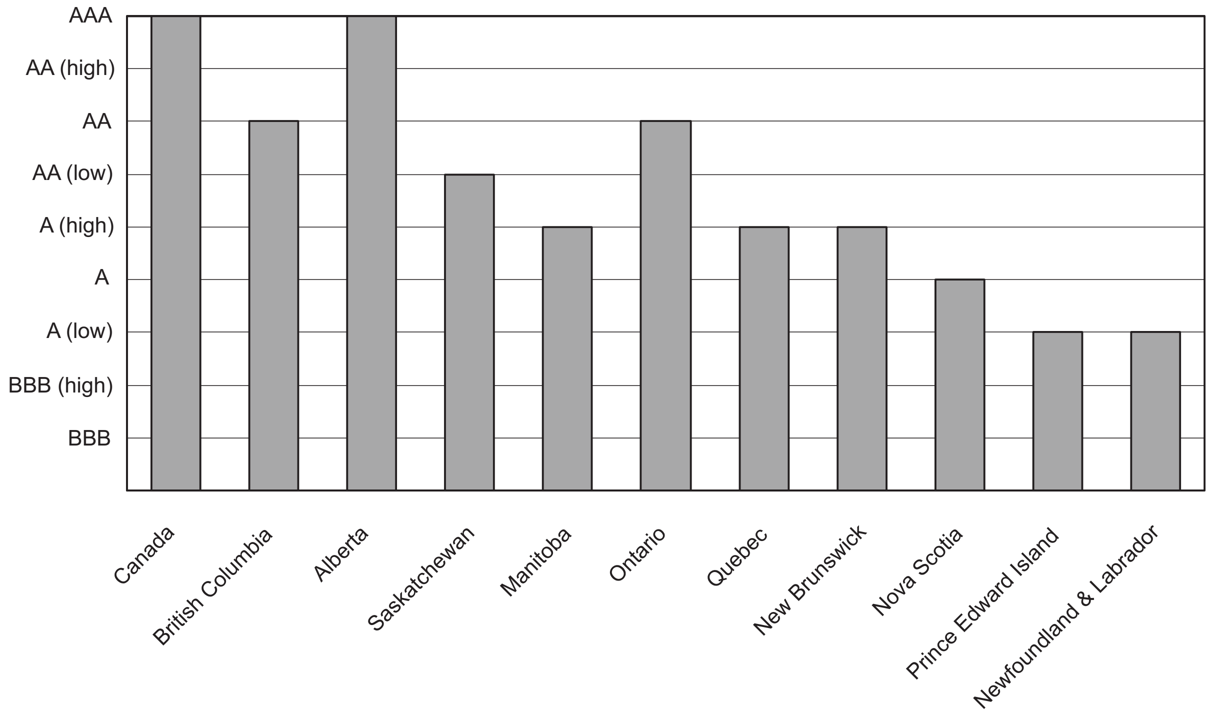


Figure 16

Credit Ratings Established for Canadian Provinces by Moody's Investors Service

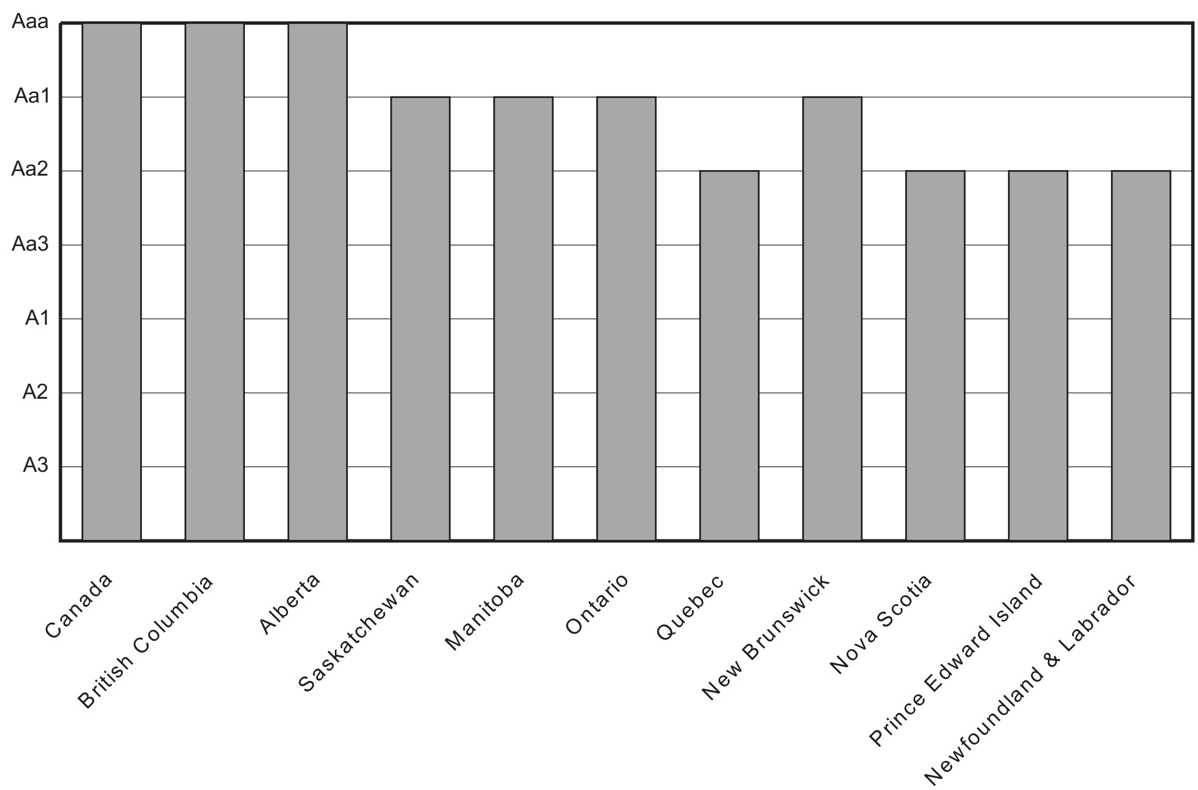
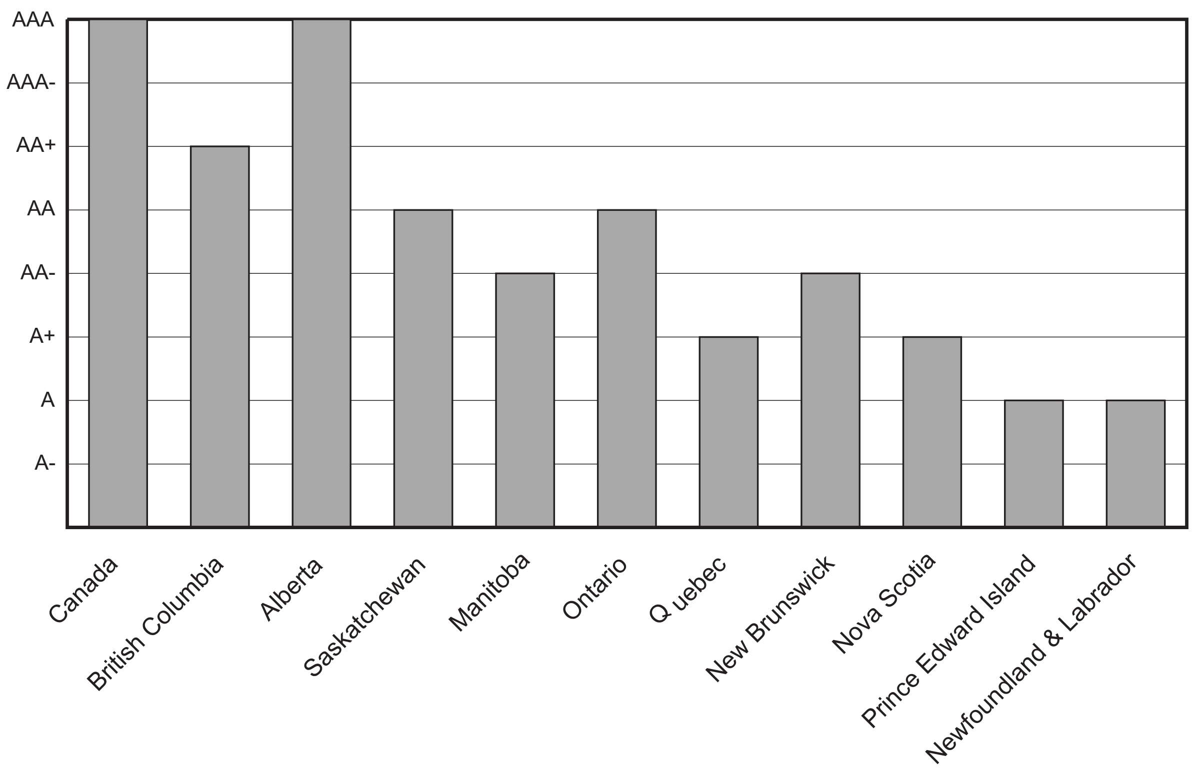


Figure 17

Credit Ratings Established for Canadian Provinces by Standard & Poor's



Comments on Selected Financial Information

CHAPTER 5

COMMENTS ON GOVERNMENT'S FINANCIAL REPORTING

5.1 Introduction

The Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants prescribes generally accepted accounting principles (GAAP) for the public sector in Canada. PSAB pronouncements represent the consensus of senior government officials, legislative auditors and other experts in public sector accounting across Canada. They represent minimum standards for governments and are the benchmark for acceptable financial reporting.

Government in this Province has made significant progress by preparing financial statements that provide information about the operating results and financial position of the Province in accordance with GAAP. However, there are still issues that should be addressed which would improve its overall financial reporting.

5.2 Reporting under the *Transparency and Accountability Act*

On behalf of the taxpayers of the Province, Members of the House of Assembly approve legislative appropriations in excess of $4 billion annually for Government departments. These appropriations are provided through the various supply acts. An additional amount of approximately $0.5 billion is allocated annually through statutory expenditures, primarily for debt expenses. Funding for most Crown agencies is provided, in turn, by the departments.

The allocation of funding to departments is provided each year through the Estimates process. Government's annual Estimates document represents the financial plan of the Province for a fiscal year, and outlines the estimated expenditures and revenues for that year. The Estimates reflect the policies, programs and priorities of Government.

A fundamental principle of accountability is that an entity cannot be accountable to itself. True accountability requires that an entity be held accountable to those who provide the resources for its operations. To be truly accountable, these entities (i.e. departments and Crown agencies) would be required to table strategic and annual operational plans in the House of Assembly as well as table annual performance reports. Strategic plans outline the long-term goals and objectives of an entity while operational plans are prepared annually and include the allocation of all resources, including financial, to further the goals and objectives contained in the strategic plan. Annual performance reports provide information on the results of activities in comparison with these plans, using measurable criteria and providing explanations for areas where performance varies from that expected.

Legislative Requirements

In previous Reports to the House of Assembly, my Office expressed concern over the lack of performance information being provided to the House of Assembly by departments and Crown agencies. As a result, my Office recommended the implementation of a legislated accountability framework for all Government departments and Crown agencies which would include the requirement to provide an annual performance report.

I was pleased, therefore, when, on 29 November 2004, Government tabled new accountability legislation in the House of Assembly. This new legislation, entitled the *Transparency and Accountability Act,* received Royal Assent on 16 December 2004. However, nearly two years later, the *Act* has still not been proclaimed and, therefore, is not in force.

The *Act* requires that strategic, business or activity plans (as applicable for each entity) be tabled in the House of Assembly every three years. It also requires that an annual report be tabled which compares actual results with the approved plan and explains any variance.

Current Reporting

There has been little progress in tabling strategic, business or activity plans in the House of Assembly, and although Government has been diligent in having annual reports tabled for departments and Crown agencies, the reports provide only general information on the operations of the department or agency. The reports do not provide the information necessary to hold each entity accountable for its performance, including fiscal performance, in relation to its approved plans using established measurable criteria.

Government has established a Transparency and Accountability Office within Executive Council to monitor accountability efforts by departments and agencies, and to provide direction and advice relating to the preparation of plans and reports. The Office continues to work with departments and agencies to develop performance based plans and reports which will meet the requirements of the *Act*.

In September 2006, PSAB issued a Statement of Recommended Practice entitled Public Performance Reporting. The Statement provides recommended practices for reporting performance information in a public performance report of a government or a government organization. As the statement indicates *"The main purpose of a public performance report is to explain in a clear and concise manner the extent to which intended goals and objectives were achieved and at what cost."* The Statement is intended to help improve consistency in performance reporting and addresses the linkage between financial and non-financial information.

Recommendation

Government should:

- *proclaim the* Transparency and Accountability Act*;*
- *address the lack of plans being tabled in the House of Assembly;*
- *address the lack of true accountability information contained in annual reports tabled in the House of Assembly; and*
- *consider the guidance provided in PSAB's Statement of Recommended Practice.*

5.3 Internal Audit

The International Institute of Internal Auditors defines internal auditing as follows: *"Internal Auditing is an independent objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.*"

In recent years, in Canada and throughout the world, there has been a heightened need for accountability and transparency. This has resulted in increased duties and responsibilities for the internal audit function in such areas as accountability, governance, risk management and assurance.

The internal audit function in Government is not sufficiently resourced to adequately perform the duties expected of a modern and effective internal audit function. Internal audit is currently comprised of 3 positions, a decrease of 18 from the 21 positions in 1991.

An internal audit function is an integral part of an effective internal control system. Without such a system, including the presence of an internal audit function, instances of the following may go undetected:

- public money not being appropriately collected and disbursed;
- non-compliance with legislation and/or Government policies;
- lack of safeguarding and accounting for the Province's assets; and
- accounting and management control weaknesses.

The lack of internal control and management safeguards at the House of Assembly establishment which led to excess claims and questionable payments to companies highlights the importance of independent scrutiny. An effective internal audit function can help ensure that preventative and detective controls are implemented and functioning.

Recommendation

Government should ensure its internal audit function is sufficiently resourced.

5.4 Government Reporting Entity

Under the standards established for governments by the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants, the Province's consolidated summary financial statements are required to include all organizations that are controlled by Government. A detailed listing of organizations and enterprises included as part of the government reporting entity is presented in a schedule to the statements.

I am pleased to report that Government included Memorial University of Newfoundland in the government reporting entity commencing with the year ended 31 March 2006. With the inclusion of the University, the consolidated summary financial statements now meet PSAB's standards for organizations and enterprises to be included in the government reporting entity.

Government considers the Workplace Health, Safety and Compensation Commission to be a form of trust and has disclosed information on the Commission's surplus ($20.9 million) and unfunded liability ($139.2 million) for the year ended 31 December 2005 in a note to the Schedule of Trust Accounts in the consolidated summary financial statements. Accounting for entities similar to the Workplace Health, Safety and Compensation Commission continues to evolve, with variations among jurisdictions in Canada.

Recommendation

Government should continue to monitor how other jurisdictions in Canada account for entities similar to the Workplace Health, Safety and Compensation Commission.

5.5 Environmental Liabilities

There are many sites in the Province which have environmental contamination resulting from such things as PCBs, old fuel storage tanks and solid waste landfills. These sites include, for example, the old Harmon airforce base, Octagon Pond, Buckmaster's Circle, Marystown Shipyard and abandoned mining properties.

In my 2002 Annual Report to the House of Assembly, I concluded that: *"There is no central inventory of contaminated sites ... The lack of a central inventory makes it more difficult for Government to determine the nature and extent of contaminated sites in the Province, the extent of progress of remediation efforts, and estimated future remediation costs to be incurred by Government."* Although Government has started to capture information on contaminated sites, there is still no complete central inventory of such sites.

Government will ultimately have involvement with all contaminated sites in the Province; however, the extent of the involvement and resulting financial costs may vary. Costs associated with remediation are usually significant - for example Government spent approximately $18.9 million to complete remediation at the former Hope Brook Gold Mine property. While it is possible that the Province may be able to recover some of the remediation costs from other parties, the remaining remediation costs associated with contaminated sites would likely be significant.

Generally accepted accounting principles require that, if a reasonable estimate of the costs of the environmental remediation of Government-owned sites can be determined and it is likely that the Province will be liable for these costs, this amount should be recorded in Government's financial statements. Note 7.(c)(vi) to the statements indicates that *"... while the Province is aware of a number of contaminated sites, the full extent of the remediation costs for these known sites is not readily determinable"*.

Although the Province's environmental liability relating to remediation costs for contaminated sites may be a significant amount, only $10.7 million has been recorded as a liability in the Province's financial statements. A financial report made public by Government in January 2004 indicated that *"The Province is facing environmental issues requiring more than $237 million for compliance with legislation and for remediation...."*

Government should be more proactive in identifying all contaminated sites in the Province for which it is potentially liable, determining the estimated liability associated with remediation costs, and recording the resulting liability in the Province's financial statements.

Recommendation

Government should continue with its efforts to identify all contaminated sites in the Province for which it is potentially liable, determine the estimated liability associated with remediation cost, and comply with generally accepted accounting principles by recording any resulting liability in the Province's financial statements.

5.6 Periodic Financial Statements

Periodic financial statements, while not specifically required by generally accepted accounting principles, are considered to be an important component of any financial accountability framework. These statements are important to effectively monitor and control Government's financial operations.

Since September 2002, Government has been preparing quarterly financial statements to show the Province's results of operations and financial position. However, officials of the Department of Finance indicated that these financial statements are only distributed to the Minister of Finance/President of Treasury Board, other Treasury Board Ministers, the Deputy Minister of Finance, the Comptroller General, various officials of the Department of Finance, and the Auditor General.

While I commend the Office of the Comptroller General for preparing such financial statements; in my opinion, these financial statements should be more widely distributed. Ideally, these financial statements should be part of accountability information provided on an on-going basis to all Members of the House of Assembly and senior Government officials.

Recommendation

Periodic financial statements should be provided to Members of the House of Assembly and senior Government officials as part of Government's accountability framework.

5.7 Basis of Accounting for Federal Revenues

Government currently records Federal revenues on a modified accrual basis of accounting. The modified accrual basis of accounting involves recording these revenues based on regular entitlements received for the current year, with adjustments made against future years' revenues when known. These revenues include equalization transfers, Health and Social Transfers, personal income taxes, corporate income taxes, and Harmonized Sales Taxes (HST). Government does not attempt to provide a reasonable estimate of future revisions. Financial reporting would be improved if all revenues were recorded on a full accrual basis of accounting.

Recommendation

Government should develop a reasonable basis for estimating future revisions to entitlements, which could be used as a basis for recording Federal government revenues on a full accrual basis of accounting.