NBF Government Credit - Ontario releases unaudited financial statements for 2015-16

Unaudited financial statements reveal smaller-than-planned deficit for 2015-16

Faced with an ongoing dispute with the provincial Auditor General (AG) over pension accounting, **Ontario took the unusual step of releasing *unaudited* financial statements for the 2015-16 fiscal year**. If you can look past the accounting noise, which is unlikely to have material bearing on the province's credit rating, you'll see an **underlying improvement in the budget balance and a better revenue hand-off for the current fiscal year**. Meanwhile, the government reiterated once more its **commitment to end the budgetary red ink by 2017-18** and to remain in balance in 2018-19.

Budget result and accounting issue:

- The unaudited statements show **Ontario ran a $5.0 billion deficit last fiscal year**, equivalent to 0.7% of GDP. That's a noteworthy, **$3.5 billion improvement over the original plan** (i.e., the $8.5 billion deficit laid out in the 2015 budget). It's also a somewhat **healthier fiscal result than that telegraphed in the February 2016 budget** (a $5.7 billion deficit). **The deficit would have been even narrower, down to just $3.5 billion or less than half that originally planned, were it not for a disagreement with the AG over pension accounting.**
- So what's the deal with this "accounting issue"? As per the province's press release: "Despite best efforts to resolve concerns, the Province's professional accounting staff and the Auditor General continue to have differences of opinion about the appropriate application of public sector accounting standards as they relate to pension accounting. This ongoing discussion has delayed the tabling of the Province's financial statements." More specifically, **the dispute centres around the accounting treatment of pension assets for two jointly-sponsored pension plans** (the OPSEU Pension Plan and Ontario Teachers' Pension Plan). There's a difference of opinion on how pension assets should be treated when plans are in an accounting surplus. In the past, Ontario recognized pension assets (which arise when a government's total contributions exceed the recognized cumulative benefit expense of a plan), since these assets were viewed as providing scope for future contribution decreases. The AG prefers a "full valuation" approach, which writes off the value of excess pension assets of jointly-sponsored plans, since the government does not have unilateral access/claim to the assets of such plans. Faced with this accounting impasse, and rather than delay release of the financial statements further (they should have been out last week), **the province approved a regulation that *temporarily* adopts the AG's recommended treatment of pension assets**. **So, while they're unaudited, the financial statements effectively incorporate the AG's preferred approach to pension accounting.** The government is now actively encouraging the AG to issue an audit opinion of the consolidated financial statements, so that the public accounts can be formally tabled. Note that the Public Sector Accounting Board (PSAB) has established a task force to study pension accounting standards and the province will engage an expert panel and undertake consultations around the issue. Nor is this the first time a provincial government has clashed with the local AG over pensions. So stay tuned for more info.
- Back to the numbers. In addition to the above-noted impact on the budget balance—a deficit of $5.0 billion in 2015-16 rather than a smaller $3.5 billion shortfall had the accounting treatment used during the prior decade and a half been retained—**changing the accounting for pension assets adds an *additional* $10.7 billion to Ontario's net debt level and accumulated deficit**. Again, this results from writing off the value of pension assets in the two aforementioned plans. So provincial net debt jumped up $20.6 billion vs the $5 billion budgetary shortfall, with much of the difference traced to the perhaps temporary legislated treatment of pension assets. At $305 billion, **Ontario's net debt was equivalent to 40.9% of GDP**, up from the 39.6% level estimated most recently (in February).
- Note that the **legislated pension accounting change has no impact on total or gross provincial debt**, which is the preferred debt metric for some rating agencies. **Nor does the legislated change alter Ontario's cash requirements or borrowing needs.** Moreover, a stronger revenue base means a better handoff to 2016-17, which (all else equal) supports achievement of this year's fiscal targets. Residual reserves and contingencies also protect current and future year budget targets.
- Refer to the consolidated financial statements for greater information on the accounting change.

Additional highlights:

- The finer details reveal a **buoyant revenue picture**, reflecting a solid economic expansion and proceeds from government asset sales to support an ambitious infrastructure plan. Top line revenue surged nearly 10% year-on-year, coming in $4 billion or 4% above the original budget plan. Excluding proceeds from the first step towards partial privatization of Hydro One, taxation revenues stood $1.7 billion above plan. It should also be noted that total revenue ended 2015-16 on a stronger footing than had been estimated more recently; there's almost $2 billion of extra revenue compared to February's interim estimate. That's a stronger revenue handoff to be sure.

- **Federal transfers** were largely in line with plan, accounting for 17.8% of provincial revenue. That's the **lowest share in five years**, reducing the so-called vulnerability to shifts in federal transfer policy.
- On the spending side, it's important to distinguish the pension expense impact from the legislated change in pension accounting from underlying, some might say *real*, program spending. The pension asset adjustment is largely to blame for the $1.9 billion in above-plan program outlays last fiscal year. A look at key spending areas shows some extra health outlays (linked to drug costs), with health accounting for a bit more than 40% of program spending. Still, Ontario has the lowest level of per capita program spending of all the provinces.
- Notwithstanding the accounting adjustment to net debt, **interest costs remain a source of fiscal relief**. While interest charges rose year-on-year, the rate of increase was less than expected, as the government took full advantage of demand for its debt to lock in low interest rates for longer. That theme will remain decidedly intact in 2016-17. Given the revenue surge, **the province's interest bite (the share of revenue eaten up by interest costs) once again moved lower, to just 8.5% or the lowest level in a quarter century**.
- In recent years, a greater focus on domestic debt markets has seen the foreign currency share of total debt step lower. Over five years, that ratio has moved from 25.4% to 18.8% as at 2015-16. What hasn't changed is the province's hedging policy, which effectively negates the province's exposure to foreign currency moves. (FX exposure is a scant 0.3% of Ontario's debt.)

Don't confuse these unaudited financial statements, which are backward looking, with a forward-looking assessment of Ontario's fiscal fortunes. Again, **set aside the accounting noise and temporary adoption of the AG's preferred approach on pension assets, and there are some encouraging developments on provincial revenue**. A stronger prior-year revenue hand-off, and an upbeat economy, bolster the province's 2016-17 fiscal outlook and give the government confidence that its key commitment of erasing the deficit by 2017-18 remains within reach. This fiscal commitment should remain front and centre as we go through a fall update and ultimately digest a 2017 provincial budget. In the meantime, we'll see how this pension accounting issue is resolved. Finally, for those looking for details on the province's economic performance, we'll be treated to the Q2 economic accounts any day now. Looking back, the second quarter wasn't a great one for North America, but most private sector forecasters—including National Bank—see Ontario sitting at or very near the top of the provincial growth charts in 2016, with real GDP growth running nicely above potential. That relatively enviable provincial growth ranking is quite likely to remain intact through 2017 as well.

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