

**SUPPLEMENTARY INFORMATION
OBSERVATIONS OF THE AUDITOR GENERAL
ON THE
FINANCIAL STATEMENTS OF THE GOVERNMENT OF CANADA
FOR THE YEAR ENDED MARCH 31, 2007**

The purpose of these Observations is to comment on and explain certain elements of my Report on the Financial Statements of the Government of Canada as at and for the year ended March 31, 2007.

YEAR-END TRANSACTIONS

In Budget 2007, the government announced various one-time transfers to support a number of initiatives regarding such areas as health care, post-secondary education and training, and the environment. Related to these announcements, the 2006-07 Statement of Operations includes \$4.5 billion of expenses for agreements that were entered into under the authority of the government with various parties before March 31, 2007. Payment authority for these expenses was given to the government by the passing of an *Act to implement certain provisions of the budget tabled in Parliament on March 19, 2007*, (Bill C-52); this act received royal assent on June 22, 2007.

Specifically, I would like to highlight the following items:

- \$1.5 billion paid to a trust (Clean Air and Climate Change Trust Fund) for provinces and territories to support projects designed to achieve reductions in greenhouse gas emissions and air pollutants;
- \$.6 billion paid to a trust for Ontario, Manitoba and Saskatchewan relating to post-secondary education and training; and
- \$.6 billion paid to a trust for provinces and territories in support of patient wait times guarantees.

We focused on such agreements that were entered into at or near year-end to ensure that the expense was recognized in the proper period and that transactions have been entered into with appropriate authority. The above-noted obligations were created prior to March 31, 2007 by the government's communication of its intention to transfer these funds to the provinces and territories for these purposes, and the provinces and territories acceptance of these arrangements.

The agreements anticipate that the provinces and territories will use these funds over several years. However, the agreements allow for the provinces and territories to ask that payments be accelerated – in effect, the provinces and territories could access all their funds immediately. The terms of the communications of the government's intention to transfer these funds and the establishment of the agreements make it clear that the government had relinquished its discretion to avoid settlement of these obligations.

In accordance with Public Sector Accounting Standards, government transfers are recognized in a government's financial statements as an expense in the period that the events giving rise to the transfer occur, as long as:

- the transfer is authorized;
- eligibility criteria, if any, have been met by the recipient; and
- a reasonable estimate of the amount can be made.

In assessing the accounting for these transactions, I concluded that the government's accounting treatment was acceptable because the government:

- had entered into agreements with appropriate authorities;
- had authorization from Parliament, to make the payments through trusts, with the passing of the *Budget Implementation Act* before the financial statements were finalized;
- had not included in the trust agreements or letters to the provinces and territories any condition to be eligible to receive these funds that would have to be met by the province or territory, subsequent to March 31, 2007; and
- had known the amount of the transfer.

DEPARTMENTAL FINANCIAL STATEMENTS

As announced in 2004, part of the government's plan to transform and strengthen public sector management included measures to strengthen comptrollership and oversight. As part of this plan, one of the initiatives was to have all annual financial statements of departments audited. The Office of the Comptroller General's strategy to implement this initiative is to focus on 22 large departments. I understand that in the near future, the government will be examining its priorities and strategies for matters related to financial management, including departmental financial statements.

In the past, I have expressed support for this ambitious undertaking as a component of the Office of the Comptroller General's plan for strengthening financial management in the government. I believe the process of preparing for audited departmental financial statements should result in the strengthening of controls and accounting environments.

This year, I reviewed the progress that these 22 departments have made toward meeting this objective and have identified key areas where work needs to be done – by departments and by the central agencies – in order to be ready for audited departmental financial statements. My Office had discussions with the representatives in departments and reviewed documentation, where available.

Departmental level - status

In 2005-06, the Office of the Comptroller General, after consultation with my Office, requested that these 22 large departments undergo an audit readiness assessment. Departments have been contracting with external auditing firms to conduct these assessments. The assessment was designed to determine whether departmental internal financial control processes were well documented and existed within a sound internal control environment; by focusing on whether systems are in place to provide all of the information needed to prepare the financial statements; whether controls are adequate and documented; and whether there are appropriate financial staff in place in the departments to support an efficient audit. The intent was to identify key areas for improvement and address any previously uncorrected weaknesses that may have been reported by my Office.

I observed that progress in departments is varied. Specifically:

- Five departments are still in the process of having the external audit firm conduct the assessment or are selecting the audit firm for the assessment.
- Of the remaining seventeen, twelve departments have prepared an action plan that involves addressing specific deficiencies identified, setting time frames for resolution, and assigning responsibilities.
- Estimated time frames to have the deficiencies addressed and departments ready for an external audit range from 2007 to beyond 2010.
- Some departments have engaged the external audit firm to assist in preparing documentation, whereas other departments are using their internal audit function for this activity.

While I expected to see some variation in time frames to address deficiencies, I would have expected to see an action plan in place by now for each department so that the status can be monitored by senior departmental management and the Office of the Comptroller General.

My Office also had the opportunity to review the 17 readiness assessment reports. Common themes arising from these reports included:

- lack of documentation to support balances, policies, procedures and controls for key business processes; and
- challenges with information technology, such as the difficulties in transferring information arising from the manual adjustments required in many of the legacy systems.

I am also concerned with systems that were never designed as accounting systems being used as accounting subledgers and, as a result, requiring extensive manipulation of data in order to prepare financial statements. This manual processing, which by its nature has a higher inherent risk of error, often results in unexplained differences. We have noted in previous years' Observations these types of concerns with Canada Border Services Agency, Canada Revenue Agency and National Defence.

Government level - status

The Office of the Comptroller General has committed to monitoring the results of the readiness assessments and to working with departments to ensure that corrective action is taken as required. In meetings my Office held with the departments, many indicated they would like to have more involvement by the Office of the Comptroller General. Departments have expressed support for a recent initiative by the Office of the Comptroller General whereby all 22 departments meet on a monthly basis to share best practices.

In 2005-06, the Office of the Comptroller General issued revised guidance to departments through Treasury Board Accounting Standards that illustrated a set of financial statements and accompanying notes. At that time, the Office of the Comptroller General committed to resolving a few accounting and reporting issues. It was agreed that my Office and the Office of the Comptroller General would work together in researching and analyzing these significant issues. While discussions have occurred with my Office and external consultants, I am concerned that final resolution of these issues remains outstanding.

The Office of the Comptroller General needs to assume a more proactive role in order to advance this initiative. In my view, the Office of the Comptroller General should increase its efforts to:

- centrally monitor key issues arising from readiness assessments and provide additional advice and guidance to departments;
- ensure that departments address the control weaknesses that my Office has previously reported and those issues arising from the readiness assessments;
- require and monitor departmental action plans; and
- provide direction to departments on key issues such as accounting matters.

When departments are ready for an audit, my Office will gladly play our part in the process. In my view, it is not appropriate to proceed with these audits if the likelihood of a qualified audit opinion or non controls-based audit is high. The focus of this initiative needs to be on the ultimate objective of improving internal controls and providing better financial information.

Summary

Based on the information provided to us, many departments have a long way to go before achieving the goal of readiness for an efficient audit of their financial statements. In addition, the Office of the Comptroller General needs to re-evaluate the overall strategy, including the expected deadlines for audited departmental financial statements, and reinforce with the departments the original objective of this initiative. I will continue to work with the government as it moves toward this goal.

ACCRUAL-BASED BUDGETING AND APPROPRIATIONS BY DEPARTMENTS AND AGENCIES

In the past, I have reported my concern that after years of studying the accrual-based budgeting and appropriations issue for departments and agencies, the government had not yet taken a position on this matter. Moving to full accrual-based budgeting and appropriations will have an impact on departments' and agencies' use of accrual financial information in decision making. Currently, departments and agencies use the accrual method of accounting to prepare information for the government's summary financial statements, unaudited financial statements for departmental performance reports and to address the requirements to include such information in Treasury Board submissions and memorandums to Cabinet. However, departmental budgets and appropriations are still not presented on an accrual basis.

The Treasury Board of Canada Secretariat engaged a consultant to study the issue and presented its final report to the Standing Committee of Government Operations and Estimates during the fall of 2006. The Standing Committee of Government Operations and Estimates issued its own report on accrual budgeting and appropriations in the federal government and made numerous recommendations; the first one being that the government adopt full accrual accounting for budgeting and appropriations. The Standing Committee on Public Accounts also issued a report and recommended that the government present to Parliament for discussion and debate a model, including projected costs and benefits, on extending full accrual accounting to budgeting and appropriations to departments and agencies, within the next year.

The government responded that the Treasury Board of Canada Secretariat is currently developing a model for full accrual-based budgeting and appropriations. Once developed, this model, including information on implementation requirements, is to be presented to Parliament for further discussion and debate. The government has committed to presenting this model to Parliament by March 2008.

I am pleased that the government is moving forward on the issue of full accrual budgeting and appropriations for departments and agencies; and I am encouraged by the attention that two parliamentary committees have placed on this important issue. It will be important for the government to maintain its momentum on advancing this issue and meeting its commitment.

MANAGEMENT ESTIMATES – TAX REVENUES

Accrual accounting for tax revenues is intended to ensure that tax revenues reported in the government's financial statements reflect more accurately the underlying economic activity during the fiscal period, and that the tax amounts owed to the government are reported in the financial statements. In other words, tax revenues are recognized in the period when the taxable activity occurs, rather than when the government receives the cash.

In 2003, the government introduced full accrual accounting resulting in a change from the cash basis of accounting to an accrual method of recognizing tax revenues. The government developed a methodology to accrue tax revenues, based on a combination of taxes assessed as at a certain date, and estimates of amounts earned but not yet assessed, based on cash received. The same methodology has remained in place, with few significant modifications since that time.

As the largest and most significant management estimate affecting the Government of Canada's financial statements, it is important that the government regularly monitor the reliability of its estimation process and modify it, where necessary, to improve the accuracy of its estimates. Since the introduction of accrual accounting in 2003, my Office has regularly expressed to the government the need to do this.

Annually, the Canada Revenue Agency conducts analyses of actual tax results in comparison with previous estimates. These results show evidence of a continued understatement of tax revenues when compared to actual results, particularly in the area of corporate tax revenues. However, these analyses have not prompted modifications that have significantly improved the tax estimation methodology.

The issue is not significant enough to conclude that the financial statements do not fairly present the government's financial position and results of operations as the amount of misstatement is consistent from year to year. However, in my view, the government needs to address this weakness in the tax financial reporting process. While I recognize the complexity of the process and the time it continues to demand, identifying and implementing improvements to this management estimate should be a priority. With more than four years experience in identifying causes of variances between actual and estimated amounts, it is time to implement improvements.

PAYABLES AT YEAR-END POLICY

During discussions in prior years, it became apparent that my Office and the Office of the Treasury Board Secretariat had different interpretations of Section 37.1 of the *Financial Administration Act* and the government's policy on Payables at Year-End (PAYE). The difference involves whether debts per Section 37.1 of the *Financial Administration Act* includes all items that would be recognized as liabilities. This difference results in a lack of clarity on the nature of items to be appropriately charged to an appropriation.

The Treasury Board Secretariat is currently revisiting many of its policies in its "Policy Suite Renewal" project. We indicated to the Office of the Comptroller General that, in our view, there needs to be greater clarity regarding charges to appropriations. We are concerned that it remains highly possible that the departments will not charge amounts against their appropriation nor record a liability because they do not meet this legally binding definition, but they are in substance liabilities. I continue to encourage the government to clarify its position with respect to the substance of these transactions, and ensure that expenditures are properly and consistently charged to appropriations, and recognized as liabilities at year-end.

Given the importance of ensuring that expenditures are properly and consistently charged to appropriations, it is important that the Office of the Comptroller General resolve this matter.

STATUS OF ITEMS REPORTED IN PREVIOUS YEARS

Observation	Current Status
<p>Audit opinion in accordance with Canadian generally accepted accounting principles</p>	<p>Under auditing standards of the Canadian Institute of Chartered Accountants, we are required to report on fair presentation in accordance with Canadian generally accepted accounting principles for the public sector. However, recognizing the importance of following our legislative mandate, which requires me to opine as to whether the government's financial statements "...present fairly information in accordance with stated accounting policies of the federal government...", my opinion refers to both bases.</p> <p>The government's accounting policy indicates that its stated accounting policies are based on Canadian generally accepted accounting principles for the public sector, and that the presentation and results using the stated accounting policies do not result in any significant differences from Canadian generally accepted accounting principles. I would prefer that the government indicate its commitment to conforming to Canadian generally accepted accounting principles.</p>
<p>Canada Revenue Agency/ Canada Border Services Agency — tax revenue system deficiencies</p>	<p>In the past, I have indicated my view that improvements need to be implemented in the accounting systems and practices for tax revenues at the Canada Revenue Agency and the Canada Border Services Agency. The accrual of tax revenues is assessment-based and derives data primarily from the various tax program systems. These systems were never designed as accounting systems, and extensive manipulation of data is necessary to present revenues and receivables on an accrual basis of accounting. This process involves extensive manual processing and numerous reconciliations. Despite this process, unexplained differences remain between the amounts receivable in the general ledger and the various reports taken from the tax program systems to support these amounts.</p> <p>For 2006-07, Canada Revenue Agency's net amount of unreconciled differences has decreased to an insignificant amount. I acknowledge the efforts made by management in addressing this issue.</p> <p>Management of Canada Border Services Agency continue to identify underlying causes of some of these differences, however, unexplained differences continue to exist at year-end.</p>
<p>National Defence inventory, repairable spare parts and realty asset records</p>	<p>In past years, I have reported that improvements in the accounting systems and practices related to inventory were needed at National Defence. Historically, the Department maintained inventory systems focused primarily on keeping track of quantities. This resulted in less emphasis on cost accuracy, and errors were made in the valuation of inventory.</p> <p>While noteworthy improvements have been made in past years in the recording of both quantities and values; issues, such as obsolescence, remain in the overall valuation of inventory; and therefore, continued monitoring is recommended to ensure that the cost of inventory is properly reflected in the summary financial statements.</p> <p>National Defence continues to focus effort on the proper recording of inventory, particularly as part of the year-end financial work. The Department has several initiatives underway to further address these problems, and our Office will continue to monitor these closely.</p> <p>Accrual accounting also requires the recording and amortizing of costs of capital assets of the Department. The capital asset subledger system used to capture the data for land, buildings, and works has not been reconciled to the general ledger in a timely and accurate manner. It is important that National Defence ensures that the information in the subledger is accurate, complete and reconciled to the amounts recorded in the general ledger.</p>

Observation	Current Status
<p>Timely reporting</p>	<p>I have noted in the past that the usefulness of the government’s summary financial statements is diminished when they cannot be made public until six months after year-end. I have also noted that, in the present environment, there are significant challenges to the more timely preparation of the government’s summary financial statements.</p> <p>I understand that the government continues to look for ways to expedite the preparation of its summary financial statements. It is important, however, that appropriate internal controls and the fairness of estimates be maintained.</p>
<p>Clarity in terminology</p>	<p>The government continues to use the term “federal debt” rather than “accumulated deficit” in some of its publications. While I understand that this term was coined to eliminate confusion about the government’s annual surplus position, I remain concerned that used in this way, it could be misinterpreted by Canadians and leave an incorrect impression about how the annual surplus is used.</p> <p>In particular, I am concerned because this use of the term could lead to a misconception that the annual surplus is used to reduce the government’s debt. While the accumulated deficit is automatically adjusted by the amount of the annual surplus and the change in other comprehensive income, government debt is not. The annual surplus is simply the figure that indicates the difference between the government’s revenues and its expenses at the end of the fiscal year - not an amount of cash that is free for the government to use in any other way, including paying some of the debt it has incurred.</p> <p>I note that the government does take care to accurately reflect this in the Annual Financial Report. However, in my view it could explain these financial results more clearly to Canadians by using correct terms consistently in all its public statements and publications.</p>

EXPLANATION OF MY AUDIT REPORT

For readers who would like a more in-depth explanation of my audit report, I have provided that information on my website, together with my Observations (www.oag-bvg.gc.ca).