SUPPLEMENTARY INFORMATION
OBSERVATIONS OF THE AUDITOR GENERAL
ON THE
FINANCIAL STATEMENTS OF THE GOVERNMENT OF CANADA
FOR THE YEAR ENDED MARCH 31, 2008

For the tenth consecutive year, the government has received an unqualified audit opinion on the summary financial statements. I congratulate the government on this accomplishment especially because an unqualified audit opinion is achieved by few countries. Each year, this involves a great deal of work by public servants throughout government, both in individual departments and in central agencies. The purpose of these Observations is to comment on matters that will require continuing attention in future years.

MANAGEMENT ESTIMATES—CANADA REVENUE AGENCY

Allowance for doubtful accounts

The allowance for doubtful tax receivables is a significant management estimate that must be assessed each year in my audit of the financial statements of the government. For 2008, the amount of tax receivables is $74.6 billion, and the associated allowance or amount determined to be uncollectible is $8.7 billion.

A project to develop a new methodology for the government's allowance for doubtful tax receivables began in Fall 2006 with involvement of a joint working group of the Department of Finance, the Office of the Comptroller General and Canada Revenue Agency. In the Spring 2007, I encouraged the government to proceed with the project and to discuss the proposed methodology with us as soon as possible to ensure that it would meet each of our needs.

This project was an important initiative by the government to improve the quality of this complex management estimate. The government used its new estimation model, which now considers historical loss experience and the aging of tax receivables, for determining this year's allowance estimate.

Throughout this project data integrity problems, concerns with management assumptions and mathematical errors were noted, which contributed to ongoing refinements of the methodology. As a result, delays were encountered in finalizing this year's estimate. We are of the view that the Office of the Comptroller General and the Department of Finance should have more actively monitored progress to ensure timely completion of this important project, including ensuring the data integrity issues were resolved on a timely basis.

For 2008, I have concluded the government's estimate relating to the allowance for doubtful tax receivables is presented fairly in the government's financial statements. However, in my view, improvements are still required before the government can expect to have a reliable and timely methodology for estimating its allowance for doubtful tax receivables in future years.

I expect to receive a detailed plan from the government, with firm commitments, for improving the current estimation model and addressing the data integrity concerns.

Tax revenue estimates

Accrual accounting for tax revenues is intended to ensure that the government recognizes tax revenues in the period when the taxable activity occurs, rather than when the government receives the cash. Tax revenues are the largest and most significant of the management estimates in the government's financial statements. It is important that the government regularly monitor the reliability of its estimation processes and modify them, where necessary, to improve the accuracy of its reported tax revenues. Since the introduction of accrual accounting in 2003, my Office has regularly expressed to the government the need for constant monitoring and improvement of the process by which it produces the year-end tax revenue estimates.

Last year, I reported that the government continually understates its tax revenues earned but not yet assessed at year-end, particularly in the area of corporate tax revenues. These amounts are included in the following year's revenues reported in the Public Accounts and have been consistent from year to year. As a result, the understatement is not significant enough for us to conclude that the financial statements do not fairly present the government's financial position and results of operations. An extra year of comparative data now confirms that this pattern is continuing.

In March 2008, the Standing Committee on Public Accounts asked for modifications to the tax revenue estimation methodology. In response, three changes were made to the methodology and in the March 31, 2008 tax revenue estimates. These changes are designed to address some of the recurring variances between actual and estimated individual and corporate taxes. The impact of these changes on the overall accuracy of the government's reported tax revenues will only be known in the future when tax assessments are completed.

While I recognize the complexity of the process and the time it continues to demand, identifying and implementing improvements to this management estimate on an ongoing basis needs to continue to be a priority.

DEPARTMENTAL FINANCIAL STATEMENTS

Last year I discussed an initiative of the government to transform and strengthen public sector financial management, which included a plan to have the annual financial statements of 22 large departments audited. I reviewed the progress of these departments toward meeting this objective and identified key areas of work that needed to be done. This year, my Office has continued to follow the progress made on this important initiative.

Readiness assessments and action plans

In my 2007 Observations, I reported there were still departments that needed to undergo an audit readiness assessment. I am pleased to report that all of the 22 large departments have now completed an assessment of audit readiness. Common observations resulting from these reviews continue to be related to a lack of documentation to support balances and challenges with departmental information technology, such as manual adjustments required in many of the legacy systems.

The government has required that all departments implement a strategy to address the identified key areas for improvement. As with any significant undertaking, once these key areas have been identified, an action plan is needed to address specific deficiencies and related actions, establish time frames for resolving these issues, and assign responsibilities.

This year I observed that departments vary considerably in the quality and progress of their delivery on their action plans

- Eleven departments have prepared detailed action plans addressing specific deficiencies and stipulating deadlines for resolution and assignment of responsibility. In these departments, senior managers or delegated individuals have been monitoring progress.
- The remaining departments have summary level action plans or are in the process of preparing and finalizing the specific details of their action plan.

There is also considerable variation in the projected time frames within which departments expect to address deficiencies and be prepared for an external audit. One department has indicated that it is ready now. Two departments anticipate being ready during the 2008–09 fiscal year. Three departments expect to be ready by 2009–10. The remaining sixteen departments have indicated that they will be ready only after 2011.

First time review of departments' readiness

During the fall of 2008, my Office will undertake a review of the readiness of the Department of Justice to prepare departmental financial statements that are auditable using reliance upon controls as the primary source of audit assurance. Department of Justice management and the Office of the Comptroller General have determined that the Department is ready for this evaluation.

Government Level—Status

Over the past year, the Office of the Comptroller General has taken several steps to strengthen its role and the support it provides to the departments toward advancement of this initiative. These steps include

- coordinating monthly meetings with the departments to share best practices and provide necessary guidance,
- reviewing all completed audit readiness assessment documents,
- reviewing unaudited financial statements, and
- developing and discussing with departments a draft policy on financial information and reporting related to the production of audited financial statements.

In discussions my Office had with the departments, many indicated that they are benefiting from the monthly meetings and that some guidance is being provided. It is important for the Office of the Comptroller General to continue providing this support and to work with the departments to identify their specific needs.

As part of the Management Accountability Framework, the Treasury Board of Canada Secretariat continues to assess the progress each department is making in its preparation for audited departmental financial statements, including the actions each department has taken to resolve internal control weaknesses previously reported by my Office.

Continuing challenges

It has now been two years since the Office of the Comptroller General committed to resolving some key accounting and reporting issues. Although the Office of the Comptroller General has conducted discussions with my Office and external consultants, final resolution of these issues has yet to be achieved. The most significant of these outstanding issues relate to

- recognition of an asset or liability for an amount due to or from the Consolidated Revenue Fund,
- recognition of appropriations on the statement of operations,
- recognition and expanded guidance relating to services provided without charge, and
- recognition of liabilities that are currently only recorded centrally and not on the departments' financial statements.

Summary

I reiterate one of my comments from last year, that when departments are ready for an audit, my Office will gladly play its part in the process. This initiative needs to continue to focus on the objective of improving internal controls and providing better financial information.

Based on the information provided to us, and based on our discussions with the departments and the Office of the Comptroller General, I am pleased that progress has been made on this initiative. However, it is still my view that most departments have much work to do to achieve the goal of readiness for an efficient audit of their financial statements, and that the Office of the Comptroller General must continue to provide leadership on this project.

ACCRUAL-BASED BUDGETING AND APPROPRIATIONS BY DEPARTMENTS AND AGENCIES

I reported last year that the government was making some progress on the issue of accrual budgeting and appropriations for departments and agencies. This year, the government has continued its effort with a focus on the departments' implementation of accrual-based budgeting, but not accrual appropriations.

Departments are not yet presenting their budgets and appropriations on a full-accrual basis. Having accrual-based budgeting results in improved financial oversight as the plans and related results are on the same basis of accounting and therefore result in better transparency and accountability. Appropriations prepared on an accrual basis would provide Parliament with information for control and approval of spending that is on the same basis as the overall government plan and the summary financial statements.

The government presented to Parliament models and implementation requirements for extending accrual accounting to budgeting and appropriations. A parliamentary *ad hoc* working group was created to review and provide advice on the accrual-based budgeting and appropriations models presented by the Treasury Board of Canada Secretariat. This group recommended a model it felt would best meet the needs of the government, although some deficiencies were noted in the recommended model.

I provided my comments on this model, including my concern that several significant issues raised in the report of the Standing Committee of Government Operations and Estimates were not addressed. In particular, the proposed model does not explain how budgeting for long-term assets and liabilities would be considered.

The government has outlined a plan to implement accrual-based budgeting on a phased basis. The implementation plan will start with a two-year pilot project involving ten departments. Starting in the 2009–10 fiscal year, this pilot group of departments will be expected to present a future-oriented statement of operations, which will include actual results to date and forecasted numbers for the remainder of the year, in their Report on Plan and Priorities, followed by a full set of future-oriented financial statements in the following year. All other departments will start in 2011–12, using the same approach as the pilot group.

I noted that the government's plan does not include a specific target date when it will put into practice accrual appropriations. The plan indicates that the government will evaluate the results and identify any issues or requirements to be addressed, such as changes to legislation, before introducing accrual appropriations. Based on the current approach, the government plans to conduct an evaluation of the costs and benefits of accrual appropriations in 2012–13, after the implementation of accrual-based budgeting.

I am disappointed that after many years of studying this issue, the models proposed by government all had an annual focus that does not include long-term budgeting for assets and liabilities and that the government has yet to make a commitment on an implementation date for accrual appropriations.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

Background

In 2008, the Canadian Accounting Standards Board confirmed that International Financial Reporting Standards (IFRS) will replace Canada's current generally accepted accounting principles. This change affects publicly accountable enterprises in Canada, including the government's Crown corporations. The official changeover date is for fiscal years beginning on or after January 1, 2011. At this time, there are no plans to replace the Canadian public sector generally accepted accounting principles – the basis of accounting for the government's financial statements.

The conversion to IFRS will have a significant impact on the underlying accounting policies for entities subject to these requirements. Below I outline the significant transition issues for both the affected entities and the government.

Impact on federal Crown corporations

In order to comply with the changeover to international standards, Crown corporations will have to undertake a rigorous conversion process. They will need to make a significant investment in human and financial resources in order to meet the deadline. It is imperative for Crown corporations to begin an analysis of these new standards that would identify differences between their current accounting policies and IFRS, and any required changes to underlying processes and information systems. It is also imperative that Crown corporations prepare action plans that address all significant aspects of the conversion to international financial reporting standards. To date, 20 of the 50 federal Crown corporations have completed or are in the process of making these necessary impact assessments.

During the year, the Treasury Board of Canada Secretariat initiated a Crown corporation discussion group to encourage information sharing within the Crown corporation community, and to discuss topics pertinent to IFRS. A significant number of Crown corporations have been attending the information sessions, showing that this type of venue can provide valuable assistance to Crown corporations dealing with strategies and challenges regarding the implementation of IFRS. I support this initiative and encourage continued sharing of best practices.

Impact on the government

Currently there are no plans to replace public sector accounting standards with IFRS. However, the requirement for Crown corporations to adopt IFRS will affect the government's preparation of its summary financial statements. Under the current framework, the accounting policies of certain Crown corporations must be harmonized with the government's accounting policies before the financial results of the Crown corporations can be consolidated and reported in the government's financial statements. The move to IFRS will thus require the government to identify the differences between the old and new accounting policies to ensure that it has all the information necessary for the adjustments required for the preparation of the summary financial statements. The government will also need to ensure it has provided proper guidance to Crown corporations for reporting the required adjustments.

The move to international financial reporting standards will impact more than the year-end reporting process. The government will need to consider the impact of these new standards on its business decisions, such as the preparation of budgets and the estimation of cash requirements.

Conclusion

The move to IFRS is the most significant change to Canadian financial reporting in decades. It is important that the government and its Crown corporations carefully plan for the change to international standards, to ensure that the transition is both smooth and cost-effective.

STATUS OF ITEMS REPORTED IN PREVIOUS YEARS

Observation	Current status
Year-end transactions	According to public sector accounting standards, government transfers are to be recognized in a government's financial statements as an expense during the period in which 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 Budget 2008, the government announced various one-time transfers to support a number of initiatives. When I assessed the accounting for the year-end transactions of the government, I concluded that the government's accounting treatment was appropriate.
Canada Border Services Agency—Tax revenue system deficiencies	In the past, I have stated my view that improvements are needed in the Canada Border Services Agency's tax revenue accounting systems and practices. The accrual of tax revenues is assessment-based and gathers data primarily from the various tax program systems. These were not designed to function as accounting systems. Significant adjustments to accounting data are necessary to report revenues and receivables on an accrual basis. This manipulation of data involves complex and cumbersome manual processing and reconciliation. These nonetheless fail to explain differences between the amounts receivable in the general ledger and the various reports taken from the tax program systems in support of the reported amounts. Management of Canada Border Services Agency has identified underlying causes of some of their unreconciled differences. However, unexplained differences remain at year-end.
National Defence inventory, repairable spare parts and realty asset records	I acknowledge the progress National Defence has made in past years in the recording of quantities and value, and the importance the Department has placed on continued improvements in the accounting systems and practices related to its inventory. However many issues still remain such as obsolescence, pricing, policy development and the application of prescribed practices. Continued action by National Defence is recommended to ensure that the value of inventory and repairable spare parts is properly reflected in the summary financial statements. National Defence has also been challenged in the proper recording and amortizing of the costs of capital assets of the Department. In particular, the 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. The Department made progress in this area during the year as it identified this as a priority area and has strengthened business practices and system controls. It is important that the Department continues its work in this area to ensure that the information recorded in the general ledger is accurate, complete and timely.

Observation	Current status
Payables at year-end policy	In previous years, it became apparent during discussions that my Office and the Treasury Board Secretariat held different interpretations of section 37.1 of the *Financial Administration Act* and of the government's policy on payables at year-end. The difference involves whether debts per Section 37.1 of the *Financial Administration Act* include all items that would be recognized as liabilities. This difference results in a lack of clarity as to 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 quite possible that because they do not meet this legally binding definition, the departments will neither charge amounts against their appropriation nor record a liability, despite the fact that these are in substance liabilities. I continue to encourage the government to clarify its position with respect to the substance of these transactions. The government needs to ensure that expenditures are properly and consistently charged to appropriations, and that they are 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.
Audit opinion in accordance with Canadian generally accepted accounting principles	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. 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.
Timely reporting	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 also have noted that, in the present environment, there are significant challenges to the more timely preparation of the Government's summary financial statements. 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.

Observation	Current status
Clarity	The government continues to call its accumulated deficit "federal debt" in some of its publications. I understand that the government uses this wording to eliminate confusion about its annual surplus position. However, I remain concerned that Canadians could misinterpret this expression, which may leave an incorrect impression about how the annual surplus is actually used. I am particularly concerned that the use of this term could mislead Canadians into believing that the annual surplus is being used to reduce the government's debt. Although the accumulated deficit is automatically adjusted by the amount of the annual surplus and by 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. The government may not, in other words, use the annual surplus to pay off a portion of the debt that it has incurred. I note that the government does take care to accurately reflect this in the *Annual Financial Report*. However, in my view, the government could explain these financial results more clearly to Canadians by consistently using correct terms in all its public statements and publications.

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).