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Report of the  
**Auditor General  
of Canada**  
to the House of Commons

DECEMBER

**Chapter 5**  
Financial Management and  
Control in the Government of  
Canada



Office of the Auditor General of Canada

*The December 2002 Report of the Auditor General of Canada comprises 11 chapters, Matters of Special Importance—2002, a Foreword, Main Points, and Appendices. The main table of contents is found at the end of this publication.*

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Chapter

# 5

Financial Management and  
Control in the Government of  
Canada

*The audit work reported in this chapter was conducted in accordance with the legislative mandate, policies, and practices of the Office of the Auditor General of Canada. These policies and practices embrace the standards recommended by the Canadian Institute of Chartered Accountants.*

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# Financial Management and Control in the Government of Canada

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## Main Points

**5.1** Financial management reform has been an elusive goal in the Government of Canada for over 40 years. There has been recent progress in this area, including the implementation of accrual accounting policies in departments and the development of guidance to implement modern comptrollership. Nevertheless, more progress is needed to make financial management and control in the government a reality.

**5.2** The government has not significantly advanced its study of accrual-based budgeting and appropriations. The Treasury Board Secretariat continues to state that this complex issue requires extensive study before a decision can be made, even though the issue has been under examination for some time. In our view, resolution of this matter is needed to help make financial management and control in the government effective.

**5.3** As of 1 April 2001, all departments and agencies have successfully implemented new financial systems capable of handling accrual financial information and submitting that information to the government's central systems for preparation of the summary financial statements. As we stated in our previous reports to Parliament, departments and agencies now need to improve the quality of their financial information that supports both departmental financial reporting and analysis and, ultimately, the preparation of the government's summary financial statements. They also need to ensure that appropriate internal controls are in place for their financial accounting and information systems.

**5.4** The government's current model for departmental financial statements does not require recording and disclosure of some significant costs and liabilities. In our view, without this information, the financial statements do not provide accurate and reliable information on departments' program costs and financial positions. We encourage the government to resolve the outstanding concerns about departmental financial statements and to establish a target date for finalizing auditable departmental financial statements.

**5.5** Financial management and control is vital for achieving results for Canadians. It involves the use of financial and non-financial information in decision making, and the effective implementation of financial information systems and controls. The Office of the Auditor General of Canada fully supports the government's implementation of improved financial management and control practices, including the adoption of full accrual accounting.

**5.6** However, making financial management and control in government more effective involves more than simply preparing financial information or

implementing financial systems. A change in the way financial information is used must occur at all levels within the government to ensure that financial management and control is an integral part of government operations and decision making.

- 5.7 The Comptroller General of Canada needs to lead this change by
- building on the momentum created by the importance and priority assigned to the Comptrollership Modernization Initiative by the Clerk of the Privy Council,
  - aggressively advancing financial management and control within government so that the environment for change can be improved, and
  - developing a strategy to increase the representation of professional accountants in the positions of senior financial officer and senior full-time financial officer.

### Background and other observations

5.8 Accrual accounting refers to an underlying basis of accounting used to record the financial transactions of an entity. Accrual accounting recognizes transactions and other events when they occur, rather than when cash or its equivalent is received or paid. Expenses are recorded in the period when the goods or services are consumed, revenues are recorded in the period to which they pertain, and the multi-year benefits associated with long-lived assets are matched to the time when they are expected to be used.

5.9 Accrual financial information helps users appreciate the full scope of government—the resources, obligations, financing, costs, and impacts of its activities, including the costs of consuming assets over time. This more complete picture enables legislators to hold the government more accountable for the stewardship of its assets, the full costs of its programs, and its ability to meet short-term and long-term financial obligations.

5.10 Accrual financial information can also help improve decision making within departments. Managers will improve their focus on the stewardship of assets and liabilities under their control, consider the full costs of providing services, and examine how the full range of costs might affect their use of public funds.

5.11 In the 2001 Budget, the government stated that it had decided to delay implementation of full accrual accounting for its summary financial statements for at least one year. The government made this decision because accrual financial information was not available to allow consideration of the impact of implementation on the Budget, and because important components of the information required for implementing full accrual accounting had not been verified and audited. We encourage the government to resolve concerns that are causing delays in introducing full accrual accounting for its summary financial statements, including the processes for determining management estimates, and to implement it for the year ending 31 March 2003.

**The Treasury Board Secretariat has responded.** The Secretariat has indicated the actions it has taken or intends to take to address the recommendations. Its detailed response follows each recommendation throughout the chapter.

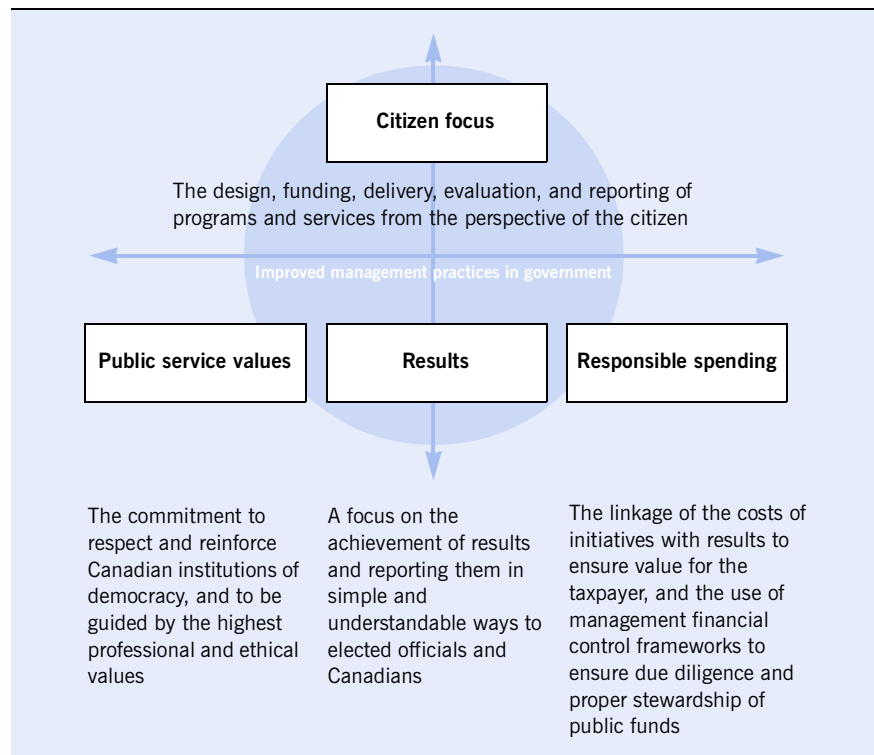


## Introduction

### Financial management and control is vital for achieving results for Canadians

**5.12** In *Results for Canadians: A Management Framework for the Government of Canada* (March 2000), the Treasury Board Secretariat outlined its framework for effective management, based on four key commitments: citizen focus, public service values, results, and responsible spending (Exhibit 5.1).

#### Exhibit 5.1 Results for Canadians: Four management commitments



Source: Treasury Board Secretariat, Adapted from *Results for Canadians: A Management Framework for the Government of Canada*

**5.13** *Results for Canadians* also noted that responsible spending is both a departmental and a government-wide commitment. At both levels, it is essential to measure and evaluate results in order to deliver high-quality programs and services.

**5.14** Accordingly, the document states that departments and agencies need to measure, evaluate, and report on key aspects of programs and their performance in core areas; hold managers accountable for achieving results; and ensure unbiased analysis of performance. Further, departments need to produce information on program costs so that they can allocate resources and restructure programs in response to changing needs and priorities. They need to integrate financial and non-financial performance information, enabling them to link costs with actual or expected results. They also need to effectively manage risk and establish a proper environment of control.

**5.15** At the government-wide level, officials need to gather integrated, cross-departmental information on expenses and results. This information will make it possible to assess overall performance against policies and priorities, manage overall risk, and identify opportunities for efficiency.

#### **The government has initiatives that address financial management and control**

**5.16** The Treasury Board Secretariat has a medium-term agenda for management change to ensure a successful shift within the government toward responsible spending. The initiatives for change include the following:

- Citizen-centred Service Delivery
- Government of Canada On-line
- Modern Comptrollership
- Improved Reporting to Parliament
- Program Integrity
- Developing an Exemplary Workplace

**5.17** Of particular importance is the Comptrollership Modernization Initiative and its emphasis on financial management and control. The Secretariat started the Initiative to strengthen management capabilities in departments and agencies. The Initiative is an effort to develop standards and practices for integrating financial and non-financial performance information into a meaningful whole and communicating that information to those who need it, properly assessing and managing risk, and ensuring appropriate control systems. It also seeks to improve procurement, management of real property, asset management, and other program and financial management activities. Modern comptrollership involves all managers, not only financial officers, and is an important part of every management activity. The Initiative goes to the heart of modern management and the achievement of results for Canadians.

**5.18** The Treasury Board Secretariat introduced its Financial Information Strategy (FIS) to facilitate the meaningful use of financial data, including accrual accounting information (see the Appendix). Now part of modern comptrollership, the Strategy allows costs to be more closely linked with activities, operations, and results. It is an essential building block of integrated performance information, stewardship, and accountability.

**5.19** The revitalized Financial Information Strategy had three objectives:

- Departments and agencies would select one of seven systems approved by the Treasury Board Secretariat and implement new financial systems that would support the full accrual method of recording and reporting financial transactions.
- The government would develop new accounting policies that comply with generally accepted accounting principles for the public sector. Departments and agencies would apply those policies and take primary responsibility for the quality and completeness of detailed information. They would produce annual financial statements that can be audited.
- Government managers would have access to better financial information and use it in their day-to-day decision making.

**5.20** In *Managing for Results 2000*, the President of the Treasury Board stated that the government would introduce full accrual accounting for the *Public Accounts of Canada* in 2001–02. This final major step in improving financial information would incorporate accrual-based budgeting and financial statements.

### Focus of the chapter

**5.21** Financial management and control has been a long-standing concern of the Office of the Auditor General of Canada. The Office has carried out a number of recent audits that have monitored the government’s progress toward achieving modern comptrollership and implementing the Financial Information Strategy (Exhibit 5.2).

**Exhibit 5.2 Our recent reports on financial management and control**

Year	Observations and recommendations
1999	<p><b>November Report, Chapter 21, Financial Information Strategy: Departmental Readiness</b></p> <p>The government has not yet taken the necessary steps to get support for the Financial Information Strategy (FIS) from deputy ministers and senior management. With less than two years until the target date, we urge the government to “turn up the heat” and spur departments to accelerate their activity.</p>
2000	<p><b>October Report, Chapter 13, Assessment of Financial Management Capabilities in Departments</b></p> <p>From an assessment of financial management capabilities in five departments, the most significant challenge has been to institutionalize a strong appreciation of the role that financial management can and should play in day-to-day decision making.</p>
2001	<p><b>December Report, Chapter 1, Financial Information Strategy: Infrastructure Readiness</b></p> <p>Departments have successfully implemented the necessary FIS infrastructure but need to stabilize their systems and ensure that appropriate controls are in place. The government has also developed the necessary accrual accounting policies, but departments are at various stages of implementing those policies and the government has made slow progress toward deciding on an approach to accrual-based budgeting and appropriations. In summary, the government has accomplished a lot but still has much work to finish and should not be too quick to declare FIS a victory.</p>
2002	<p><b>April Report, Chapter 7, Strategies to Implement Modern Comptrollership</b></p> <p>The adequacy of the strategies and plans to implement modern comptrollership in seven departments was assessed and only three of the seven departments were found to have established comprehensive strategies and plans. Departments also need to establish clear target dates and indicators for modern comptrollership and to improve managers’ understanding of the initiative.</p>

**5.22** There have been calls for financial reform in the government for almost 40 years (Exhibit 5.3). Although the importance of the issue is widely recognized, we are disappointed that more progress has not been made in this area.

**Exhibit 5.3** Previous calls for financial reform

Year	Recommendation
1962	<p><b>Royal Commission on Government Organization (Glassco Commission)</b></p> <p>“An accounting system, capable of facilitating decision making by management, should provide <i>complete costs</i> of activities.” Such a system will then lead to improved decision making.</p>
1979	<p><b>Royal Commission on Financial Management and Accountability (Lambert Commission)</b></p> <p>“Comprehensive cost-based accounting systems should be developed and used in all federal departments and agencies, and these systems should meet the criteria of capturing <i>all costs</i> on a timely and accurate basis and be integrated with costing systems capable of analyzing the data thus obtained.”</p>
1987	<p><b>Office of the Auditor General, Financial Management and Control Study</b></p> <p>Current information for managers tells them where they stand in relation to their budget, but not the cost effectiveness of their operations. Although operational data are available, they can rarely be related to financial data so as to determine the costs of specific operations. The concept underlying financial management is that objectives, results, and resources should be linked.</p>
1997	<p><b>Independent Review Panel on Modernization of Comptrollership in the Government of Canada</b></p> <p>“The Panel believes modern comptrollership is about ensuring that management decision making has the benefit of rigorous, complete and integrated financial and non-financial, historical and prospective performance information as well as appropriate advice, analysis and interpretation of this information.”</p>

**5.23** In this chapter, we examined the government’s progress in implementing accrual accounting and related financial information systems. We sought answers to the following questions: What is the current status of accrual financial information and is it credible? Are the financial information systems designed to produce such information integrated into an overall control framework that will yield reliable accrual financial information? We also wanted to know what the government had decided to do about accrual budgeting and appropriations.

**5.24** In our approach, we relied on the nature, scope, and extent of our audit of the summary financial statements of the Government of Canada. We derived our observations and findings from the work done in that audit as well as other audits conducted by the Office of the Auditor General of Canada in this area.

**5.25** As a result, this chapter is not an audit of financial management and control in government. Rather it is an account of our observations arising from the audit of the government's summary financial statements and from other audit work done by our Office and that we believe are important for improving financial management and control in government. Further details on our objectives, scope, and approach can be found at the end of the chapter in About the Chapter.

## Observations and Recommendations

### Some progress achieved

**5.26** In recent years, the government has begun to make progress in advancing financial management and control practices. Among the achievements are the following:

- The Treasury Board Secretariat has developed a series of accounting policies for accrual accounting, and departments have implemented those policies.
- The Secretariat has established a strategy for the next phase of the Comptrollership Modernization Initiative and has issued guidance to departments and agencies on preparing plans for implementation of the initiative.
- Departments have completed self-assessments on their capacity for modern comptrollership and have prepared implementation plans in response to their findings.
- As of 1 April 2001, all departments and agencies have successfully implemented one of the Secretariat's recommended information systems supporting accrual accounting.
- For 2002–03, the Clerk of the Privy Council Office's Deputy Minister performance agreements have made modern comptrollership a priority.

**5.27** The Office of the Auditor General of Canada recognizes these achievements and fully supports the government's plans and strategies for improving financial management practices in government, including the implementation of financial information systems and accrual accounting.

### More progress needed

**5.28** The government has expended considerable time, money, and effort in improving financial management practices. As a result, prior to our audit of the summary financial statements of the Government of Canada, we had expected to observe considerable improvement in the preparation of financial information, as well as in the implementation and use of the related financial information systems. What we actually observed, however, was that financial management and control in the government still needs significant improvement.

### Departments need to strengthen their internal control systems

**5.29** In our December 2001 Report, Chapter 1, Financial Information Strategy: Infrastructure Readiness, we evaluated the controls governing

selected computer information systems, along with the related management and monitoring controls, in three departments and agencies. In the past year, we continued our review of these controls in five departments and agencies and in the government's Regional Pay System (Exhibit 5.4).

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#### Exhibit 5.4 Overview of controls assessments

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##### Objective

We sought to assess the quality of controls in selected financial information systems. We wanted to determine the extent to which the controls of various departments were sufficient to ensure that financial information was accurate, complete, and properly authorized.

##### Scope

We selected two departments and one agency in 2001<sup>1</sup>, and four departments, one agency, and the government's Regional Pay System in 2002<sup>2</sup>. Each ranked among the largest departments and agencies, and was using one of the approved systems under the shared systems initiative.

##### Methodology

We documented our understanding of the various controls in the selected departments and agencies and identified and tested key controls (those responsible for preventing or detecting errors in financial information).

##### Conclusion

With the exception of the government's Regional Pay System (see Exhibit 5.5), we found that the controls did not meet the requirements. Departments, however, have been receptive to our recommendations. With proper attention, in most cases the problems can be solved within a reasonable period of time.

Notes:<sup>1</sup> Canadian Heritage, Agriculture and Agri-Food Canada, and the Canada Customs and Revenue Agency (expenditure systems).

<sup>2</sup> Fisheries and Oceans Canada, Public Works and Government Services Canada, Indian and Northern Affairs Canada, Department of Foreign Affairs and International Trade, the Canada Customs and Revenue Agency (revenue ledger system), and the government's Regional Pay System.

**5.30** With the exception of the government's Regional Pay System (Exhibit 5.5), the significant challenges that we previously identified in our 2001 Report, Chapter 1 remain (see Controls for financial information systems—challenges remain, page 10).

**5.31** The challenges that we have identified are not insurmountable. With attention, most problems could be solved within a reasonable period of time. Many departments have already taken positive steps to respond to these issues. Doing so represents an opportunity for the departments to considerably strengthen their overall control systems. Systems-based controls can generally be applied more systematically and comprehensively than manually based controls. For this reason, they are preferred.

**5.32** Departments also need to request that their internal audit function provide assurance on their financial accounting and related systems. The revised Treasury Board Policy on Internal Audit repositions the role of internal audit as a provider of assurance, including assurance of the completeness and accuracy of information for decision making and reporting.

**Exhibit 5.5 The Regional Pay System—Controls assessment**

Civilian personnel costs for the Government of Canada are about \$14 billion annually. Public Works and Government Services Canada (PWGSC) processes the government's payroll through its Regional Pay System. Departments and agencies maintain the central payroll master files used by the system to produce the biweekly payroll. PWGSC has incorporated key controls directly into the system, including authorities, edits, exception reports, reconciliations of control accounts, and segregation of duties. It has also implemented a structured program change management process that includes needs identification, program testing, and user acceptance prior to release into production. Departments maintain controls for the input, edit, and authorization of changes to the payroll master file by segregating duties surrounding data entry and verification and by ensuring that all errors are resolved. In addition, management and monitoring controls (such as comparing budgeted to actual expenditures, reviewing error analysis reports, and performing ratio analysis) are carried out by both PWGSC and departments to ensure the timeliness, accuracy, and completeness of payroll processing. On the basis of this assessment of the Regional Pay System control framework, we concluded that the controls met the objectives of the controls assessment.

This approach would strengthen the integrity of financial information within departments and help ensure the integrity of systems and information shared across the government.

**5.33 Recommendation.** The Treasury Board Secretariat should ensure that departments have established target dates and plans, including assurance from departmental internal audit groups, to address the internal control challenges in their financial accounting and information systems.

**Treasury Board Secretariat's response.** The Treasury Board Secretariat is leading several working groups to assist departments in the evolution of control frameworks surrounding their financial accounting and information systems. Certain of these groups deal separately with departmental financial statements, the classification and coding of financial transactions, system-related issues and internal audit. Each of these groups is working on a consultative basis to address issues on the basis of risk.

**Departments need to improve the quality of their financial information**

**5.34** In our audit of the government's summary financial statements, we found that many departments were experiencing problems with the quality of their financial information. Some of the problems were identified by the Receiver General function of Public Works and Government Services Canada, which regularly reviews summary information submitted by departments in fulfilling its responsibility for the accuracy and completeness of the government's central financial management reporting system. The Receiver General's quality control review has typically found the following:

- invalid combinations of financial accounts and appropriation codes;
- invalid use of restricted reporting codes;
- invalid use of selected appropriation references; and
- financial accounts with improper balances.

### Controls for financial information systems—challenges remain

- **Manual processing controls.** Control frameworks do not appropriately integrate manual processing controls within the new electronic control environment. Key processing controls for purchasing, payment, and confirmation of receipt of goods and services are performed outside the information systems environment. Manual controls are less systematic and less comprehensive in their application than electronic controls. They can also be more easily circumvented, presenting the potential for error or fraud through incomplete, inaccurate, or unauthorized activity.
- **Electronic security controls.** Electronic security controls are not well managed. The primary control mechanism in many of the new systems is the management and control of user access rights and privileges. We found that too many individuals are provided broad system access, or that individuals are given permission to perform certain functions incompatible with their other roles and responsibilities. Consequently, information could be lost or corrupted.
- **Monitoring controls.** Monitoring controls require substantial improvement. These controls are an integral part of any control framework because they engage senior management in analyzing the reasonableness of results. Without sufficient monitoring controls, data accuracy and validity may be compromised, and inaccurate or unauthorized expenditures may result. Management needs to do more than simply compare actual results with either budget figures or overall appropriation limits; such basic forms of review often fail to identify errors that have occurred but that are masked because expenses are within budget. Particular attention needs to be given to key financial performance measures (such as changes in the capital assets or liabilities under a manager's control, or the aging of accounts receivable); the review of control and subsidiary ledger accounts; the review of unusual or higher-risk transactions, including selected grant and contribution payments; the review of suspense account balances; and the performance of periodic reconciliations of key control accounts (for example, accounts receivable, intergovernmental transactions, and cash).
- **New financial systems.** Departments are not fully exploiting the capabilities of their new financial systems. In many cases, these systems are used to do nothing more than compile the results produced using previously existing systems. As a result, many departments are maintaining their original systems and processes and developing interfaces between them and the new systems, rather than seeking opportunities to improve integration of these systems and processes. This approach to systems development and integration adds to the complexity and operational costs within the department because it must maintain both old and new systems and practices. Eventually these older systems will require extensive renovation or replacement. Departments need to ensure that their information systems planning gives consideration to the integration of the older systems with the new financial systems approved by the Treasury Board Secretariat.

5.35 Our audit of the government's summary financial statements also identified problems in the quality of departmental financial information. Examples included the following:

- a lack of timely reconciliations of control and suspense accounts;
- errors in completing Public Accounts submissions;
- unreconciled interdepartmental transactions; and
- corrections to departmental financial information in the course of the audit, including several significant corrections to account balances at the very end of the audit.



**5.36** Departmental self-assessments, performed as part of preparing for implementing the Comptrollership Modernization Initiative, have also revealed a number of deficiencies in the key areas of exercising effective stewardship over resources and the ability to combine or integrate financial and other performance information for decision making (see our April 2002 Report, Chapter 7, Strategies to Implement Modern Comptrollership). Our earlier assessment of financial management capabilities in five departments yielded similar results (see our October 2000 Report, Chapter 13, Assessment of Financial Management Capabilities in Departments).

**5.37** These comptrollership capabilities and the quality of the underlying financial information used for decision making are critical to a department's ability to improve its financial management practices and to understand the financial implications of its decisions. In May 2002, the Treasury Board Secretariat issued guidance to departments and agencies on implementing the Comptrollership Modernization Initiative. To address issues identified in their modern comptrollership capacity self-assessments, departments and agencies were required to develop action plans, including a communications and development strategy, that would strengthen the elements of modern comptrollership.

**5.38 Recommendation.** The Treasury Board Secretariat should ensure that departments have plans and strategies for improving the quality of their financial information that supports departmental financial reporting and analysis and, ultimately, the preparation of the government's summary financial statements.

**Treasury Board Secretariat's response.** The Treasury Board Secretariat is taking a serious look at the financial reporting and analysis capacity and practices within departments along with the data quality of financial information. One of the major accomplishments of the implementation of the Financial Information Strategy is that, for the first time ever, all departments are now required to produce a full set of accrual-based financial statements. These financial statements are currently being evaluated at the Secretariat and feedback will be provided to departments. Based in part on this feedback, the working group on departmental financial statements will develop appropriate data quality and other standards to support departments in their financial statement preparation and analysis.

Senior full-time financial officers have been requested to attest to the ongoing data quality of their financial information and to produce financial statements for internal analysis purposes. The Treasury Board Secretariat continues to work closely with the Receiver General in the identification and resolution of data quality issues. The Receiver General monitors information provided by departments on a monthly basis and provides prompt feedback for departmental review and correction. Additional guidelines are being prepared to strengthen the integrity of year-end reporting.

### The study of accrual-based budgeting and appropriations needs to be completed

**5.39** Our most recent audit of the government's summary financial statements indicated that departments continue to face difficulty in making adjustments between accrual-based accounting for reporting purposes and cash-based accounting for budgeting and appropriations. As noted in our December 2001 Report, Chapter 1, Financial Information Strategy: Infrastructure Readiness, many departments suggested that unless the government moves to accrual-based budgeting and appropriations, managers will not focus on accrual-based information. Departments were virtually unanimous in asking that all financial information be produced on an accrual basis.

**5.40** The Standing Committee on Public Accounts has continued to support our recommendation concerning accrual appropriations and budgeting (Exhibit 5.6) and has repeatedly urged the Treasury Board Secretariat to act on this issue. The government's response has been that

**Exhibit 5.6** Standing Committee on Public Accounts: Recommendations on accrual appropriation and budget

Report date	Recommendation	Government response
1 December 1998	The Treasury Board Secretariat should complete as quickly as possible its consultations with its stakeholders in order to determine the best possible options to move the appropriations (supply) process to full accrual basis.	Progress is slower than anticipated. Response to a consultation paper is expected by 10 March 2000 from which recommendations to government will be made in the following two or three months.
22 March 2000	The Treasury Board Secretariat should complete its consultations with departments and agencies on moving to accrual appropriations.  Once the consultations are completed, the Treasury Board Secretariat should inform Parliament and the Public Accounts Committee in writing of its final decision and recommendations to the government on moving to accrual appropriations.	Responses to the consultation paper have been received and are being compiled and analyzed. Completion of the analysis is expected by September 2000, although further review of accrual-based budgeting and its relationship with appropriations may be required.
29 March 2001	The Treasury Board Secretariat should complete its consultations with parliamentarians aimed at determining the best possible options to convert the appropriations (supply) process toward full accrual basis and report the results to the House of Commons by 31 March 2002; the Government of Canada should move to an accrual-based system of appropriations (supply) by 1 April 2003.	The subject of accrual-based appropriations is very complex and requires careful review and consultation. Any decision made will have tremendous impact and consequences for government. This strongly underlies the need for very careful, rigorous, and exhaustive study before making any decisions in the area.
10 May 2001	The Treasury Board Secretariat should undertake and complete the required studies and consultations on full accrual-based appropriations, and it should prepare a set of proposals and alternatives to be presented to the House of Commons Standing Committee on Public Accounts, no later than 31 March 2002.	The subject of accrual-based appropriations is very complex and requires careful review and consultation. The decisions made respecting any contemplated changes to our budgeting and appropriations practices will have tremendous impact and consequences for government. This strongly underlies the need for very careful, rigorous, and exhaustive study before making any decisions in the area.

Source: Adapted from reports of the Standing Committee on Public Accounts

extensive study is required before a decision can be made and that there is little likelihood of meeting the Committee's suggested target date of April 2003 for introducing accrual budgeting and appropriations. These positions were restated most recently on 11 June 2002, at the meeting of the Standing Committee on Public Accounts.

**5.41** The Treasury Board Secretariat has done some preliminary research and held initial consultations with departments. In August 2001, it hired a manager to complete a study and make a recommendation by the fall of 2002. Other than these steps, the Secretariat has made little progress on the issue.

**5.42** Resolving this issue will entail a major effort, no matter which course of action is selected. We agree with the conclusion of the Standing Committee on Public Accounts in its Seventh Report to the 36<sup>th</sup> Parliament. The report noted that the pace of consultations on moving to accrual appropriations is slow, and it stated, "The government must take a clear position on this issue and enforce its position promptly; otherwise, vagueness may jeopardize implementation [of accrual financial information] overall."

**5.43 Recommendation.** By March 2003, the Treasury Board Secretariat should complete the study of accrual-based budgeting and appropriations and present the proposed approach for a common basis of planning, budgeting, and reporting, along with an implementation plan, to the House of Commons Standing Committee on Public Accounts.

**Treasury Board Secretariat's response.** In responding to the Public Accounts Committee's May 2001 report, the Treasury Board Secretariat noted the complexity of the issues associated with accrual budgeting and appropriations and the need for careful review and consultation. The full text of this response is contained in Exhibit 5.6 of this chapter and continues to be the Secretariat's position. Since the time of that response, the Secretariat has made significant progress in terms of characterizing the issues, assessing international experience, and with consultations that include the Auditor General's own staff. Consultations of adequate breadth and depth need to be concluded with a sufficient range of departmental officials as well as with other stakeholders, which include Parliament. International experience continues to evolve and will in fact be the subject of an Organization for Economic Co-operation and Development meeting in 2003 at which Secretariat officials will participate. For these reasons, along with those noted in its response to the Public Accounts Committee, the Treasury Board Secretariat is not prepared either to set or to agree to an arbitrary deadline for concluding its study, but it assures the Auditor General that the issue remains a priority on which it will continue to consult with her staff and report progress.

#### **Issues delaying accrual accounting for government financial statements need to be resolved**

**5.44** In the 2001 Budget, the government stated that it would delay the implementation of full accrual accounting for its summary financial statements for at least one year because of the timing of the Budget and

because important components of the information required to implement full accrual accounting had not been verified and audited.

**5.45** The move to full accrual accounting will require the government's summary financial statements to include, for the first time, tangible capital assets, assets for purchased or developed software, inventories, environmental liabilities, taxes receivable, prepaid expenses, employee future benefits other than pensions, and revised methods of accounting for Aboriginal claims. As a result of these changes, tens of billions of dollars of assets and liabilities will be recognized that were not previously valued and recorded in the government's summary financial statements. To a lesser extent, these changes will also affect the surplus or deficit of the government because, for example, full accrual accounting will require that tangible capital assets be amortized (expensed) over the period they are used, that inventories be expensed as used, and that tax revenues be recorded in the period to which they pertain. The Office of the Auditor General of Canada acknowledges the significance of these changes and supports the government's move to implement full accrual accounting in the summary financial statements.

**5.46** Our recent audit of the government's summary financial statements, including observations reported in the *Public Accounts of Canada* for 2002, offered some examples of how accrual accounting will provide better information on recent activities of the government:

- In the 2001 Budget, the government announced a deferral of income tax instalments for small businesses. Under the government's policy of recognizing income taxes on a cash basis, about \$600 million of income taxes were not recognized as revenue in the current fiscal year even though the taxes deferred related to that fiscal year. The estimated deferral thus reduced the overall government surplus for 2001–02 by \$600 million. Under accrual accounting standards, these revenues would have been recorded as taxes for the fiscal year, with a related amount owing to the government as part of the government's financial position. This case demonstrates how accrual accounting standards would properly match the recording of tax revenue to the fiscal year to which it pertains, and would also identify the related taxes receivable. The results for the 2001–02 fiscal year would not have been altered merely by changing the timing of cash flows.
- During 2001–02, the government paid about \$4 billion for capital assets, including several new buildings and some armoured personnel carriers. These acquisitions reduced the surplus for the year by about \$4 billion because the government's practice is to recognize the purchase of capital assets as expenditures. Under accrual accounting, such items would have been recorded as assets because they have a useful life beyond the year in which they were acquired. This method of recording the transactions would have affected the surplus for the year only by the amount that those assets and existing assets were amortized during the year, and not by the full amount disbursed. The approach would have provided a more complete picture of the government's assets and operational results.

**5.47** In addition, the government's current accounting practice of recording transfers to arm's-length organizations as expenditures in the year in which the payments are made will need to be reconsidered once the Canadian Institute of Chartered Accountants' Public Sector Accounting Board has completed a review of the accounting standards for transfer payments. By following its current accounting practice, the government does not consider whether the payments are in advance of the recipient's current operating needs or whether the funds are immediately required for the purposes intended. The result has been that, in addition to about \$7.5 billion in funds transferred to foundations (as discussed in our recent observations on the *Public Accounts of Canada* for 2002), the government has transferred some \$400 million since 1999 to a number of arm's-length organizations, and the organizations continue to hold the transferred funds in the form of either cash or investments.

**5.48** Our most recent audit of the government's summary financial statements revealed that more work is needed to complete the government's summary financial statements on a full accrual basis. The Canada Customs and Revenue Agency, the Treasury Board Secretariat, and the Department of Finance Canada have agreed on a methodology for determining tax revenue on a full accrual basis, but the resulting figure had not been fully verified and audited at the time of writing this chapter. In addition, we have identified problems in the unit prices and quantities used by the Department of National Defence in its valuation of consumable inventories. These are government supplies held for use in operations, with a useful life of over one year (mainly National Defence ammunition and spare parts).

**5.49** The Canada Customs and Revenue Agency states that it is reasonably confident in the process that it has followed in its initial determination of the accrual estimate for tax revenue. While the information has been reviewed by the Agency, the Treasury Board Secretariat, and the Department of Finance, it has not yet been fully verified and audited. National Defence also states that it is confident that it will be able to resolve the outstanding issues regarding the valuation of consumable inventories and therefore meet its obligations with respect to the implementation of accrual accounting. Delays in finalizing either of these issues, however, could jeopardize the recording of these assets in the government's summary financial statements and ultimately the implementation of full accrual accounting for those statements.

**5.50** Our most recent audit of the government's summary financial statements, including our observations reported in the *Public Accounts of Canada* for 2002, noted that the government made significant changes to some of its current management estimates almost six months after the end of the 2001–02 fiscal year. The government's summary financial statements, like those of most other large organizations, include a number of significant management estimates. These estimates affect billions of dollars of reported assets and liabilities and ultimately the surplus or deficit for the year. Examples of the government's more significant management estimates currently include the estimation of losses on loans and investments, the determination of its liability for pension obligations, and the estimation of

losses arising from various claims against the government. As the government moves toward adopting full accrual accounting, management estimates will become a more important part of the process of preparing the government's summary financial statements. Management estimates, in a full accrual environment, will be required in the recording of tax revenues, environmental liabilities, Aboriginal claims, and numerous other amounts. As a result, we believe that the government needs to improve its processes for developing, reviewing, challenging, and eventually recording management estimates.

**5.51** Finally, the government encountered difficulties in preparing its summary financial statements for the fiscal year ending 31 March 2002 because it had to convert some of the full accrual financial information submitted by departments back to the government's required presentation under its existing stated accounting policies. In particular, the government had difficulties in ensuring an accurate reversal of tangible capital assets and related expenses recorded on an accrual basis of accounting back to the government's existing practice of recognizing such items as expenditures when purchased. Although the government was eventually able to properly adjust the accrual financial information, we believe that it needs to resolve the outstanding issues related to the implementation of full accrual accounting to prevent such difficulties in the future.

**5.52 Recommendation.** The Treasury Board Secretariat should resolve the outstanding issues related to the implementation of full accrual accounting in the summary financial statements, including the processes for determining management estimates, and prepare the government's summary financial statements on a full accrual basis for the year ending 31 March 2003.

**Treasury Board Secretariat's response.** The Minister of Finance announced in his October 2002 Economic and Fiscal Update the intention of the government to implement full accrual accounting in the upcoming budget and summary financial statements of the government provided that the accrual amounts for fiscal 2001–02 have been verified and audited with the support of the Auditor General.

**5.53** As noted in earlier observations on the *Public Accounts of Canada* and in our December 2001 Report, Chapter 1, Financial Information Strategy: Infrastructure Readiness, the government's present model for departmental financial statements does not require the recording of some significant liabilities and costs: environmental liabilities; allowances for loans, investments, and advances; employee termination benefits; and contingent liabilities. In our view, without this information, the financial statements do not provide accurate and reliable information on departments' program costs and financial positions.

**5.54** The Treasury Board Secretariat has told departments that it plans to deal with these items once the other aspects of accrual accounting have been addressed and the departments have appropriate management control frameworks in place.

**5.55 Recommendation.** The Treasury Board Secretariat should promptly resolve the outstanding accrual accounting and management control framework issues regarding departmental financial statements and establish a target date for finalizing auditable departmental financial statements.

**Treasury Board Secretariat's response.** The Treasury Board Secretariat has already devolved to departments the recording of certain transactions previously recorded centrally. The working group on departmental financial statements will address the issue of departmental management control frameworks. Concurrently, the Secretariat will study the remaining transactions recorded centrally to ensure that, in future, departmental financial statements present information both fairly and fully. Departmental financial statements will continue to disclose their stated accounting policies. In addition, certain departmental financial statements are being audited.

### Leadership, skills, and support

**5.56** Our observations arising from the audit of the government's summary financial statements have indicated that departments and/or central agencies are experiencing difficulty with their internal control systems, the quality of their financial information, and the preparation of their accrual financial statements—all important aspects of improving financial management and control in the government.

**5.57** But improving financial management and control in the government is not simply a matter of recording transactions and preparing financial statements, or of implementing new financial systems. If it were, the government would have spent a considerable amount of time and money, and received little benefit in return. For example, the Treasury Board Secretariat estimated that \$635 million has been spent on implementing new financial systems and moving to accrual accounting; however, we are uncertain whether this estimate is reliable because we have concerns about the completeness and accuracy of the information on which it is based (see our December 2001 Report, Chapter 1, Financial Information Strategy: Infrastructure Readiness).

**5.58** Plans to improve financial management practices, adopt accrual accounting, and upgrade financial information systems are merely the tools and framework that make improved financial management and control possible; they do not in themselves ensure that financial management and control in the government is effective or successful. For the government to realize the full return on its considerable investment in these initiatives, it needs to effectively integrate accrual accounting and the improved financial systems with modern comptrollership, the other elements of the Financial Information Strategy, and the elements of responsible spending and results reporting noted in *Results for Canadians*. Successful integration of these various initiatives must then be followed by decision making within departments, by senior officials in the government and by parliamentarians, that is based on accrual financial information and the new financial systems, within the broader management framework of the government.

### Central leadership and support are needed

**5.59** As outlined in *Results for Canadians*, the Treasury Board Secretariat is responsible for guiding departments and agencies as they improve their management and accounting practices. Within the Secretariat's organizational structure, the Comptroller General of Canada is responsible for handling matters related to financial management. This officer needs to provide the senior leadership to ensure that all of the key financial management initiatives of the government are integrated, by creating the right environment for change and by developing a strategy for success.

**5.60** Departmental managers will not change their behaviour or practices unless they perceive a benefit to doing so or a consequence to not changing. They need to know *why* they should change. The new environment for change needs to provide departments with an understanding of the reasons and objectives for change, the incentives for change, and the tools and guidance for effecting change. All of these elements need to be balanced with effective monitoring and oversight.

**5.61** With the inclusion of the aspects of modern comptrollership as a priority in the Clerk of the Privy Council Office's 2002–03 Deputy Minister performance agreements, the profile of financial management has been raised, including both the requirement to incorporate financial information into decision making and reporting to Parliament and the requirement to implement appropriate control systems. The Comptroller General could build on this initiative by encouraging deputy heads to incorporate elements of modern comptrollership and accrual accounting in the performance objectives of their staff; offering deputy heads information on the benefits, best practices, and achievements of modern comptrollership and accrual accounting; and suggesting that they periodically address their departments' progress in implementing modern comptrollership and accrual accounting.

**5.62** The establishment of a strategy and implementation plan for the next phase of modern comptrollership has been an important step toward advancing financial management and control in the government because it includes the following:

- creating conditions for long-term success of the initiative by building a better understanding of comptrollership, putting in place essential tools and guidance, and strengthening accountabilities for management improvement;
- developing a comprehensive learning strategy for comptrollership;
- providing ministers with a more integrated picture of the state of comptrollership;
- emphasizing modern comptrollership as a foundation for modern management;
- obtaining a long-term commitment to modern comptrollership from all departments and agencies; and
- developing an approach to measuring progress across the government.



**5.63** All of these items are important to advancing financial management and control in the government, particularly the implementation of full accrual financial information for decision making and the effective use of financial information system capabilities. As we noted, however, in our April 2002 Report, Chapter 7, Strategies to Implement Modern Comptrollership (discussing the Treasury Board Secretariat's monitoring of modern comptrollership), the Comptroller General may need to advance financial management and control in the government more aggressively if the desired outcomes are to be achieved.

**5.64** The Comptroller General could do so by increasing the monitoring of financial management and control practices in departments and by embedding additional incentives directly into government operations. For example, the Comptroller General could reject any Treasury Board submissions that do not incorporate the use of accrual-based information; provide challenge and feedback on financial results and information prepared by departments on a full accrual basis, such as departmental financial statements or departmental performance reports; require departments to report on the adequacy of their internal controls; and demonstrate commitment by resolving the outstanding issues of accrual budgeting and appropriations and of accrual accounting for the summary-level and departmental financial statements.

**5.65 Recommendation.** The Comptroller General of Canada should aggressively advance financial management and control in the government by monitoring and influencing departmental and government-wide use of accrual financial information and financial information systems, as well as by introducing other incentives directly into government processes.

**Treasury Board Secretariat's response.** The government has implemented full accrual accounting at the departmental level in the 2001–02 fiscal year. The Government-wide Implementation-Strategic Plan of its modern comptrollership initiative for 2001–04 is structured around three priorities: understanding and awareness, tools and guidance, and accountability.

Specific actions are being taken by the Treasury Board Secretariat to support all three priorities. For example, guidance on the preparation of departmental modern management action plans has been published; specific tools on integrated control systems and the integration of financial and non-financial information are under development; and the new Web site launched by the Secretariat gives managers access to over 300 best practices.

A modern management accountability and reporting framework is also under development and will be implemented over the next two years. The Treasury Board Secretariat is developing communities of practice so that organizations can learn from each other by sharing their experiences. The Secretariat is now meeting with departments and agencies on their individual action plans and on their efforts to entrench and sustain modern comptrollership as their way of doing business.

### Departmental leadership and skills are needed

**5.66** As stated in *Results for Canadians*, the government's new management framework requires individual departments to foster sound decisions by producing information on program costs and results. Departments need to link costs with actual or expected results by integrating financial and non-financial performance information. Under the Comptrollership Modernization Initiative, individual departments are required to manage their resources wisely, with due regard to economy, efficiency, and effectiveness. They need to deal effectively with risk and to establish a proper internal control environment. Departments need modern management practices and frameworks, along with the necessary infrastructure to be able to fulfill these requirements and effectively deliver programs (*Guidance for Developing Action Plans for Implementing Modern Comptrollership*, Treasury Board Secretariat).

**5.67** This approach to financial management means that the quality of the required decisions and analysis will depend on the people who prepare and use the information—those who explain the numbers, those who use them to support decisions with financial analysis, and those who foresee problems and recommend corrective action using the financial information.

**5.68** The Clerk of the Privy Council Office's performance agreements with deputy heads call for them to advance the Comptrollership Modernization Initiative at a departmental level and to therefore introduce the use of accrual financial information in their departments. We support this approach and believe that it needs to also apply to other senior officials in each department—in particular, the senior financial officer and the senior full-time financial officer since these officers hold the most senior financial positions within a department.

**5.69** In today's management environment, senior financial officers are expected to provide support to their senior management group for key decisions. The senior financial officers must promote the use of accrual financial information by senior officials within the department and convince them of the benefits of using that information in daily decision making. Consequently, those responsible for advancing financial initiatives in a department would benefit from backgrounds and professional training in accounting. These qualifications would enable them to fully understand the impact of full accrual accounting on departmental decisions, such as the costing of activities and alternative delivery mechanisms, the assessment of the adequacy of revenues relative to costs in a cost recovery situation, and the analysis of capital asset acquisitions. Senior financial officers must also be able to provide coaching and supervision to the staff who are charged with accurate and timely preparation of this departmental financial information.

**5.70** In a survey of nine of the largest departments covered in our most recent audit of the government's summary financial statements, we sought to identify whether the individuals holding the positions of senior financial officer and senior full-time financial officer were professional accountants. We discovered that the incumbents were professional accountants in only

33 percent of the cases and that, collectively, the departments that they managed accounted for 63 percent of the government's total operating budget of almost \$180 billion.

**5.71** We acknowledge that the incumbents of these positions have a broad range of experience and academic credentials, including a Master of Business Administration degree in a few cases. Further, we recognize that many qualities are required of senior financial officers. We would have expected, however, a higher percentage of the senior financial officers to be professional accountants. By contrast, 80 percent of the senior financial officers in the 10 top revenue-generating Canadian public companies were professional accountants. As previously stated, we believe that a background and professional training in accounting is a beneficial attribute in championing the key financial management initiatives of the government and ensuring the quality of an organization's financial information.

**5.72** We are also aware that the departments concerned have more junior staff with accounting designations, but senior levels within the organization need to establish the environment for change and ensure the successful implementation of the government's financial management initiatives. The senior leadership responsibility cannot be delegated to more junior positions.

**5.73 Recommendation.** The Comptroller General of Canada should develop a strategy and action plan for improving the representation of professional accountants in the positions of senior financial officer and senior full-time financial officer.

**Treasury Board Secretariat's response.** The role of the senior financial officer in government departments is often much broader than issues of finance and accounting and in many respects is considerably more varied than that found in the private sector. For this reason, incumbents have been drawn from a variety of disciplines pertinent to the overall role that they have been asked to play. This is particularly the case for smaller departments and agencies. Although the role of the senior full-time financial officer is more focussed in the domain of finance and accounting, the government believes that competencies and academic qualifications, other than simply a professional accounting designation, can be quite appropriate for these positions. It is quite possible for incumbents to have acquired extensive experience and knowledge in areas of accounting and financial reporting without necessarily acquiring an accounting designation. The government has the utmost confidence in the executives filling these roles at the present time.

With the implementation of accrual accounting and modern comptrollership, it is expected that the capacity of financial officers to enhance financial reporting for decision making will be greatly increased. Their knowledge of accrual accounting and budgeting concepts will be prerequisites for this to fully succeed. The government intends to study the profile of its entire financial community, and the concern expressed by the Auditor General will be given full consideration in succession planning.

## Conclusion

**5.74** Financial management and control is vital for achieving results for Canadians. It involves the use of financial and non-financial information in decision making, and the effective implementation of financial information systems and controls. The Office of the Auditor General of Canada fully supports the government's implementation of improved financial management practices, including the adoption of full accrual accounting.

**5.75** Financial management reform has been an elusive goal in the Government of Canada for over 40 years. While there has been some progress in this area, more work is needed to strengthen financial management and control in the government and to make it effective. This involves more than simply preparing accrual financial statements or developing guidance on modern management practices. A change must occur at all levels in the way that the government uses financial information.

**5.76** First and foremost, it is essential that the government resolve the issue of accrual budgeting and appropriations. While we accept that this issue is complex and needs to be carefully considered, we note that the government is still far from being able to propose the way forward after almost five years of studying the issue. In our view, until government-wide and departmental budgeting, financial reporting, and appropriations are put on a common basis, effective financial management and control in the government will not be achieved.

**5.77** Second, the Comptroller General of Canada needs to build on the momentum created by the importance and priority assigned to the Comptrollership Modernization Initiative by the Clerk of the Privy Council. The Comptroller General could do so by aggressively advancing financial management and control in the government, including monitoring and influencing departmental use of accrual financial information and requiring reports on the adequacy of internal controls, developing a strategy to increase the representation of professional accountants in the positions of senior financial officer and senior full-time financial officer, and embedding other incentives directly into government processes.

**5.78** Departments need to improve the quality of their financial information that supports departmental financial reporting and analysis and, ultimately, the preparation of the government's summary financial statements. They also need to improve their monitoring control practices; develop appropriate internal controls that integrate electronic and manual processing controls, including effective electronic security controls; and fully exploit the capabilities of their new financial systems. Further, departments need to engage their internal audit functions in providing assurance on their financial accounting and related systems, as required by the Treasury Board's Policy on Internal Audit.

**5.79** Finally, the government needs to resolve the outstanding issues regarding departmental and summary accrual financial statements, including the processes for determining management estimates, so that it can adopt full accrual financial reporting for the summary financial statements for the year ending 31 March 2003.

## About the Chapter

### Objectives

For this chapter, we wanted to determine the extent of the government's progress in implementing accrual accounting and in implementing financial information systems designed to produce accrual-based financial information. We also wanted to know what the government had decided to do about accrual budgeting and appropriations.

### Scope

The findings and conclusion presented in this chapter are derived from the results of our most recent audit of the summary financial statements of the Government of Canada, from other audit work performed by the Office of the Auditor General of Canada in this area, and from meetings with government officials.

The audit of the summary financial statements was conducted according to Canadian generally accepted auditing standards. We assessed whether the summary financial statements were fairly presented in accordance with the government's stated accounting policies. Our resultant opinion and observations on matters related to accounting treatments and disclosures are included in the *Public Accounts of Canada* for 2002.

### Approach

We did not develop a separate strategy and criteria for our work. Instead we relied on the nature, scope, and extent of our audit of the summary financial statements of the Government of Canada. As a result, this chapter is not an audit of financial management and control in the government. Rather it is an account of our observations arising from the audit of the government's summary financial statements and from other audit work done by the Office of the Auditor General of Canada and that we believe are important for improving financial management and control in the government.

The procedures we followed included testing a sample of transactions and account balances, performing analyses, confirming year-end balances with third parties, reviewing significant internal controls as necessary, and discussing significant matters with government officials.

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## Appendix Accrual accounting

### What is accrual accounting?

Accrual accounting refers to an underlying basis of accounting used to record the financial transactions of an entity. Accrual accounting recognizes transactions and other events when they occur, rather than when cash or its equivalent is received or paid.

Accrual accounting records expenses in the period when the goods or services are consumed, it records revenues in the period to which they pertain, and it matches multi-year benefits associated with long-lived assets to the time when they are expected to be used.

### Why is accrual accounting important in government?

Accrual accounting helps users appreciate the full scope of government—the resources, obligations, financing, costs, and impacts of its activities (including the costs of consuming assets over time). This more complete picture enables legislators to hold the government more accountable for the stewardship of its assets, the full costs of its programs, and its ability to meet short-term and long-term financial obligations.

Accrual accounting can also help improve decision making within departments, for example, as follows:

- Managers increase their focus on the stewardship of assets because all assets are recorded in the financial accounts of the department. Managers become more aware of the assets under their control and the need to consider such issues as maintenance requirements, replacement policies, the identification and disposal of excess assets, risks such as loss caused by theft or damage, and the full impact of assets on service delivery.
- Managers increase their attention to the management of liabilities under their control because existing and potential liabilities are recognized. Managers become more aware of their responsibility for these liabilities and the need to develop plans for managing them, including identifying the impact of existing liabilities on future resources. If liabilities are not recognized, there is less reason for managers to consider certain issues and effectively manage those liabilities.
- With all the costs of operations being recorded in the accounts of the department, managers become more aware of the complete picture of their financial performance (all costs and revenues). Managers are then more inclined to consider all of those costs in making various decisions, such as the evaluation of the cost-effectiveness of in-house delivery versus contracting for services, the appropriateness of a cost-recovery policy, or the amount to charge other departments for services provided.

