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Auditor General of Canada

to the House of Commons

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Chapter 10
Other Audit Observations

Appendices

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The November 2003 Report of the Auditor General of Canada comprises ten chapters, Matters of Special Importance—2003, a Foreword, Main Points, and Appendices. The main table of contents is found at the end of this publication.

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Chapter

10

Other Audit Observations

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Other Audit Observations

Main Points

10.1 This chapter fulfills a special role in the Report. Other chapters normally report on value-for-money audits or on audits and studies that relate to operations of the government as a whole. Other Audit Observations discusses specific matters that have come to our attention during our financial and compliance audits of the Public Accounts of Canada, Crown corporations, and other entities, or during our value-for-money audits or audit work to follow up on third-party complaints. Because these observations deal with specific matters, they should not be applied to other related issues or used as a basis for drawing conclusions about matters not examined.

10.2 This chapter covers new issues:

- Indian and Northern Affairs Canada—The Department needs to improve third-party intervention
- Government purchase of two Challenger aircraft—A $101-million contract to purchase two Challenger aircraft for VIP travel did not demonstrate due regard for economy and bypassed expected practices
- Natural Resources Canada—Controls over contribution payments and scientific equipment needed
- Independent reviews of security and intelligence agencies—The activities of security and intelligence agencies are not subject to consistent levels of review and disclosure

10.3 The Standing Committee on Public Accounts has requested that we continue to bring to Parliament's attention previous observations that have not been resolved. In this Report, we follow up on two of these observations:

- Parc Downsview Park Inc.—The government has initiated actions to address issues raised in our previous reports about the creation of an urban park
- The surplus in the Employment Insurance Account—Non-compliance with the intent of the *Employment Insurance Act*

Parc Downsview Park Inc.

The government has initiated actions to address issues raised in our previous reports about the creation of an urban park

In brief

We have reported annually since October 2000 that the Government of Canada has not requested—and accordingly Parliament has not provided—clear and explicit authority to create and operate an urban park being undertaken by Parc Downsview Park Inc. Furthermore, Parliament has not authorized the related spending of public funds.

We also reported on irregularities in the transfer of funds from National Defence for the development of the park and shortcomings in the corporate structure adopted for Downsview Park.

Our follow-up audit revealed that the government has initiated actions to address the issues. Although it did not request Parliament's clear and explicit authority for the creation and operation of Downsview Park, the government has deemed it a parent Crown corporation, and it will now report to Parliament through the responsible minister, currently the Minister of Transport. The government is also addressing the irregularities noted in the transfer of funds from National Defence and the shortcomings in the corporate structure of Downsview Park.

Audit objective

10.4 Our audit objective was to follow-up on matters raised about Downsview Park in our previous audit observations and to report on the progress achieved.

Background

10.5 Downsview Park was established following the closure of the Canadian Forces Base in Toronto, announced in the government's 1994 Budget. The only reference to Downsview Park was contained in the National Defence budget impact paper referred to in the 1994 Budget, which indicated that "[the] Downsview site will be held in perpetuity and in trust primarily as a unique urban recreational green space for the enjoyment of future generations."

10.6 In April 1997, the government issued an Order-in-Council authorizing Canada Lands Company Limited to set up a subsidiary corporation to develop an urban park. Canada Lands incorporated Downsview Park as a wholly-owned subsidiary Crown corporation in July 1998. Members of the board of directors were officially appointed in February 1999 and Downsview Park began operations in April 1999.

Issues

Parliamentary authority

10.7 Generally, when a new Crown corporation with unique operating characteristics is established, it receives a mandate from Parliament through legislation establishing a parent Crown corporation. The government chose to set up Downsview Park as a subsidiary of Canada Lands. It then required only an Order-in-Council to authorize the incorporation of Downsview Park.

10.8 As we noted in our last three years' reports, except for the payments made by National Defence to Downsview Park for the development of the park site, the government, including Canada Lands, met all applicable administrative and legal requirements in establishing Downsview Park. However, the individual steps taken together had the effect of leaving Parliament out of the decision-making process. The mandate of Downsview Park was not presented to Parliament for review and approval.

10.9 The House of Commons Standing Committee on Public Accounts held a hearing on this issue in 2002 and made five recommendations, including one stating that the Privy Council Office should seek parliamentary approval to make Downsview Park a parent corporation.

10.10 In its May 2003 response to the Committee's recommendations, the government stated that the corporate structure in place was designed to fulfill its commitment made in Parliament in the 1994 Budget. The government added that the financial accountability for Crown corporations provided in Part X of the *Financial Administration Act* already provides a rigorous means to ensure proper transparency and accountability of Downsview Park, through its parent Crown corporation.

10.11 However, on 3 September 2003, the government took action and brought a series of modifications to the legal framework applying to Downsview Park. Among others, an Order-in-Council made all provisions of Part X of the Act apply to Downsview Park as if it were a parent Crown corporation. In essence, Downsview Park remains a wholly owned subsidiary of Canada Lands but will report as if it were a parent Crown corporation. It will, for instance, have its own board of directors and will table its own corporate plan and annual report to Parliament through the responsible minister.

10.12 This way, although Parliament did not have the opportunity to formally approve the creation and operation of the park, Downsview Park has become fully autonomous and will now report directly to Parliament through its responsible minister, currently the Minister of Transport, as if it were a parent Crown corporation.

Public funds spent for the development of the park

10.13 We reported in previous audit reports that funds from National Defence's Vote 1 were used for the development of the park instead of being spent on National Defence's activities. We have updated the information based on a recent review that National Defence made on all past transactions with Downsview Park as follows:

- Between 1996 and 2000, National Defence paid approximately $8 million for expenditures related to the development of the park site (the payments were made to Canada Lands prior to April 1999 and subsequently to Downsview Park). In our view, these expenditures were not a valid charge against National Defence's Vote 1, which Parliament had authorized to be used for National Defence's operating expenditures.
- Further, during the same period, National Defence allowed Canada Lands and Downsview Park to keep a total of about $7 million of revenues generated from the leasing of National Defence properties, which should have been deposited in the Consolidated Revenue Fund.

10.14 In its response to the Committee report of 2002 on Downsview Park, the government indicated that steps were being taken to correct the irregularities noted in National Defence's Vote 1. In this regard, we noted that National Defence has included the amounts totalling about $15 million in its accounts receivable for Public Accounts purposes for the year ended 31 March 2003. We were also informed that National Defence intends to initiate actions to correct these irregularities.

10.15 We also reported in our previous observations that, in 2001, the government undertook one significant transaction that resulted in an infusion of approximately $19 million in cash to Downsview Park for its program activities. We concluded at the time, and it is still our view, that given the importance of this project and the nature of the transaction, it would have been preferable to obtain formal approval by Parliament.

Corporate structure

10.16 We also noted in the previous reports that the full consequences of the current corporate structure were not thought out fully when Downsview Park was created. For example, the particular structure used to create the new park was based on the assumption that Downsview Park would be eligible to receive charitable donations through a foundation and use them to develop the park. Under the *Income Tax Act*, however, the foundation could donate its funds only to a "qualified donee." Downsview Park is not a "qualified donee" for income tax purposes because it was established as a taxable, commercial, for-profit entity.

10.17 On 16 September 2003, a Royal Proclamation declared that the *Government Corporations Operation Act* is now applicable to Downsview Park. The Proclamation converted Downsview Park from a non-agent to an agent Crown corporation. This means that the corporation will be granted certain privileges normally enjoyed by the Crown. Among other privileges, a donation to an agent Crown corporation is normally classified as a donation to the Crown. Downsview Park management indicated that this is a step toward resolving shortcomings in the corporate structure, with a view of making the corporation eligible to receive charitable donations.

Conclusion

10.18 The government has initiated actions to address issues we had raised in our previous reports about Downsview Park. We believe that the government should have given Parliament the opportunity to review and approve the creation and operation of an urban park. However, with the recent steps taken by the government, Downsview Park will now be directly accountable to Parliament for its operations as if it were a parent Crown corporation. It will report through the responsible minister, currently the Minister of Transport. Also, the government is taking measures to address irregularities noted in National Defence's Vote 1 transactions and shortcomings in the corporate structure of Downsview Park.

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Indian and Northern Affairs Canada

The Department needs to improve third-party intervention

In brief

When a First Nations community delivering a program or service under a funding arrangement with Indian and Northern Affairs Canada fails to meet its obligations, the Minister has the right to intervene. The Department's Intervention Policy (2001) provides for three levels of intervention according to the seriousness of the circumstances. At the highest level of intervention, the Department selects a third party to take over the management of the funding arrangement until the problems are resolved.

We found that the selection of third-party managers did not follow the basic principles of openness and transparency required by the government's policy on transfer payments. We also found several weaknesses in the Department's administration of the third-party management process.

The Department approved the Third Party Manager Policy in April 2003—a new policy aimed at improving the process. It includes a requirement that the third-party manager be selected according to basic contracting principles and practices. We reviewed the policy and found that it does not address some of the weaknesses we identified. The Department needs to address the gaps in the new policy and develop a strategy and an action plan for implementing the policy throughout its regions.

Audit objective

10.19 The objective of this audit was to determine whether the implementation of third-party management is consistent with the principles of openness and transparency as set out in the government's policy on transfer payments and Indian and Northern Affairs Canada's Intervention Policy. We expected to find that

- the decision to intervene was timely,
- the selection of the third-party manager was open and transparent,
- the administration of the Third Party Manager Policy incorporated First Nations input,
- the Department was periodically monitoring the performance of the third-party manager,
- the funding arrangement with the third-party manager provided for the development of the management capacity of the First Nation and a strategy to end the intervention, and
- the Department's new Third Party Manager Policy (effective April 2003) addressed the weaknesses we identified in the implementation of third-party management.

Background

10.20 Indian and Northern Affairs Canada is responsible for the delivery of a wide range of programs and services to status Indians on reserves.

10.21 First Nations communities administer 85 percent of the Department's program funds through funding arrangements that generally take the form of standardized contribution agreements. They are subject to various conditions, including the minister's right to intervene.

10.22 The funding arrangements provide for intervention when

- the recipient community defaults on any of the obligations set out in the agreement;
- the recipient's auditor issues a denial of opinion or an adverse opinion;
- the council has incurred a cumulative deficit equivalent to eight percent or more of the council's total annual revenues; or
- the Department has a reasonable belief, based on material evidence, that the health, safety, or welfare of the recipient's community members is being compromised.

Intervention is intended to be temporary.

10.23 Funding arrangements provide for three levels of intervention, depending on the seriousness of the default. Low-level intervention requires that the First Nation's chief and council develop a remedial management plan setting out how the default will be remedied. Moderate-level intervention requires the First Nation to appoint an independent co-manager who, together with the chief and council, manages the First Nation's funding and obligations under the funding arrangement. High-level intervention is the appointment of a third party to manage the First Nation's funding and obligations under the funding arrangement.

10.24 During our December 2002 audit on the extensive reporting that the federal government requires of First Nations, we noted certain problems in the third-party management process. We decided to return and examine the process more closely.

10.25 Out of 614 First Nations in Canada, 32 were in third-party management at the time of the audit. We reviewed 10 First Nations' funding arrangements that are now under third-party management in four regions. We visited one of the four regions.

10.26 We reviewed the administration of the third-party management process against the Department's Intervention Policy. We also used the government's policy on transfer payments because that policy applies to the type of funding arrangements used by the Department to engage third-party managers. While the policy on transfer payments allows for a broad range of uses, it does not require public tendering and competitive bidding. Thus, it may not be the most appropriate means of contracting for the services of third-party managers. The Department could have followed the government's contracting policy to procure the services of third-party managers. The contracting policy requires public tendering of contracts and a competitive bidding process, whereas transfer payments are most often used to fund

eligible recipients under programs. During our examination, the Department approved a new policy aimed at improving third-party management that includes many of the requirements of the government's contracting regulations. We decided to review the new policy to see whether it addressed the problems we were observing.

Issues

Openness and transparency

10.27 We found in most cases that regional department officials selected possible third-party managers from a list of available candidates known to them in the area. Regional officials telephoned candidates on the list or otherwise invited them to bid on requests for third-party management. There was no indication of public tenders or open bidding for the work, and in the region visited no guidance to departmental staff on how to evaluate bids. The regional officials told us that the list of candidates comprises those with previous experience as third-party managers.

10.28 Only one of the four third-party management files we reviewed in the region visited contained the criteria used in selecting the manager from the region's list of candidates. Otherwise there were no criteria or formal documentation of the selection process and nothing to indicate why one candidate was selected over another.

10.29 The new policy provides clear direction about how to select third-party managers. This is important given that in the region visited, the third-party managers charged between $195,000 to $312,000 per year for fees, which are paid from the First Nations' funding. Regional offices will need to establish a list of qualified individuals or firms, using competitive tendering processes, guided by 11 explicit criteria that can be added to, as required. This should make the process more open and transparent and consistent with the government's policy on transfer payments.

First Nations' input

10.30 First Nations' input in selecting third-party managers has varied over the years in the region we visited. Representatives of one First Nation told us that involving community leaders in reviewing bid proposals and interviewing candidates had helped to foster a good working relationship between the chief and council, and the manager who eventually was appointed. In other cases, departmental officials had not included First Nations representatives in the selection process; the First Nations representatives we spoke to said that partly as a result, the communities' relationships with third-party managers were poor (Exhibit 10.1).

10.31 The First Nations representatives we spoke to suggested that their input is needed to make third-party management more effective. However, regional officials advised us that it would be inappropriate in most cases to include the First Nation in the selection of its own third-party manager. Officials said they would consider involving First Nations in establishing the list of qualified individuals or firms. The new policy does not provide for any input by First Nations in the selection process.

Exhibit 10.1 **First Nations views on third-party management**

We started our audit by asking representatives of First Nations communities for their views on third-party management and how well it works.

Some of their comments are as follows:

- Indian and Northern Affairs Canada ought to do more work with communities before the need for third-party management arises.
- The Department needs to establish a pool of qualified managers who can work with a community to co-ordinate capacity building.
- Contracting for the services of third-party managers does not follow an open and transparent process.
- The Department needs to involve the band chief and council in selecting the third-party manager, using a jointly developed process.
- Many third-party managers do not work in the community, visiting only twice a month to deliver checks.
- The third-party manager needs to be in the community more often to help build capacity and develop a relationship with the community.
- The fees that managers charge for their services are high.
- There is no process for resolving disputes over decisions made by third-party managers.

Assessment of the third-party manager's performance

10.32 The region we visited had no results-based management and accountability framework in place. The funding arrangements with third-party managers require that the third-party manager conduct detailed monthly monitoring of the First Nation's financial condition; yet we found little evidence that Indian and Northern Affairs officials assessed the manager's performance in the region. For instance, the Department needs to ensure that the third-party managers are present in the First Nations as required by the terms of their funding arrangements. Regional officials in three regions told us that they could not say how often a third-party manager is in a First Nations community.

10.33 Considering the funding administered by these managers ($4.9 million to $50 million per year in the region visited) and the fees they charge, we expected to see more rigorous monitoring and assessment of the managers' performance by the Department. While the new Third Party Manager Policy requires the managers to develop remedial management plans and debt reduction plans that can be used to help monitor their performance, more specific monitoring and assessment criteria are needed.

Timelines of intervention

10.34 For timely intervention, the Department needs to act before a First Nation goes too far into debt. We found several instances where First Nations debt levels were very high and should have triggered an earlier intervention but had not. In addition, audit opinions had been denied or qualified in

several consecutive years before the Department intervened on any level. Debt can become unmanageably high when the Department is slow to intervene. Some First Nations in the region visited had debts totalling between 22 to 55 percent of the total yearly government funding. The policy of intervening at increasingly higher levels based on financial indicators and on an assessment of the willingness of the chief and council to co-operate with the Department is a reasonable one. However, the ultimate success of any intervention depends on its use at a time and in a way that prevents a situation from worsening, so the underlying problems can be resolved.

Strategy for building the First Nations' management capacity to end third-party management.

10.35 In the region we visited, the chiefs and councils of First Nations under third-party management can apply for funding to improve their governance capacity. A chief and council, sometimes with the help of a regional tribal council, first makes a formal assessment of the need to build capacity. Assessing this need is a process that seems acceptable but that, we were told, can be slow, depending on the chief's and council's readiness to recognize that the need exists.

10.36 Another way to build capacity is to increase the job skills of the First Nation's staff; this is something community representatives told us has not been undertaken. Third-party managers told us they provide training in accounting and general administration to the staff who need it for their management responsibilities but do not prepare comprehensive training plans for all staff. In the files we reviewed, we saw no strategy or plan to successfully bring the intervention to an end. First Nations were locked into intervention at various levels for several years.

10.37 The new policy requires that a remedial management plan be developed (where possible with the assistance of the chief and council). The remedial management plan contains provisions for capacity building and training activities. However, the new policy does not address who is responsible for enhancing the capacity of the chief and council.

10.38 Departmental officials told us that to be effective, a third-party manager's staff needs to have specific skills in the problem areas of the community, for example, managing social programs. They suggested that this be one of the criteria for selecting the third-party manager of a particular First Nation. Under the new policy, there are provisions that allow the regional officials to choose third-party managers with specific skills.

Policy on debt reduction

10.39 In most of the cases we reviewed, the third-party manager had produced a debt-reduction plan and had begun to reduce the community's debt. In the region visited, as part of what it calls the "de-escalation process," regional officials we spoke to used a yearly debt-reduction target equal to 10 percent of revenues. For heavily-indebted First Nations, this could mean eight or more years of third-party management.

10.40 In the region we visited, regional officials did not permit a third-party manager to pay debts incurred by the community prior to the manager's tenure until the manager had generated a year-end surplus. Then creditors could be paid only with the Department's approval and on a pro rata basis, regardless of the interest rate the creditor has charged. Some third-party managers told us they are prohibited from negotiating with creditors to accept a percentage of the debt, or from repaying first the debts bearing the highest interest. One manager said he should be permitted to negotiate with creditors for repayment at discounted rates and then borrow funds to pay all the creditors. Some managers also said that despite the policy against repaying old debts, they had been forced by suppliers to pay off some debts in full to obtain vital supplies such as school books.

10.41 While the new policy suggests that discussing with creditors and renegotiating debts may be permissible, the third-party managers in the region we visited had not received guidance on this matter.

Three final issues

10.42 We noted three additional issues that warrant mention. First, the policy does not include a formal dispute-resolution process for decisions by the third-party manager that affect individuals. Regional officials told us that they address individual concerns on an informal basis as they come to their attention. Given that the third-party manager is not accountable to the chief and council or to the First Nation and is accountable only to the Department, it may want to consider addressing this gap.

10.43 Second, we noted that the Department has not conducted an evaluation or cost benefit analysis of the third-party intervention process.

10.44 Finally, departmental officials advised us that the new Third Party Manager Policy is being implemented during the 2003–04 fiscal year. We were told the implementation is being monitored by the Department as it performs compliance reviews. However, a formal implementation plan is required.

Conclusion

10.45 The selection of third-party managers in the regions we examined did not follow an open and transparent process that systematically included the input of First Nations. Indian and Northern Affairs Canada did not adequately monitor and assess the performance of third-party managers or ensure that agreements provided for developing the management capacity of the First Nation. The new Third Party Manager Policy addresses some of the gaps we found in the administration of third-party intervention but does not address others. The Department needs to ensure that the rules set out in its new policy are implemented so the selection of third-party managers and their administration are transparent to all involved, particularly to the First Nations. Finally, the Department needs to use the lower levels of intervention earlier and more effectively to reduce the need for third-party management.

10.46 **Recommendation.** Indian and Northern Affairs Canada should address the elements missing from its new Third Party Manager Policy, namely

- provision for First Nations input,
- chief and council capacity building, and
- dispute resolution.

Indian and Northern Affairs Canada's response

First Nations input. The audit indicates that the Third Party Manager Policy does not provide for any First Nations input in the third-party manager selection process.

Indian and Northern Affairs Canada (INAC) recognizes that the most effective resolution to ineffective delivery of programs and services is through the First Nation's involvement in remedying the situation. However, First Nations input in the selection of the third-party manager is not realistic in most third-party management situations. Our Intervention Policy states that one of the determining factors to be considered in applying this level of intervention is the Council's unwillingness to address the situation that gave rise to the default under the Funding Agreement. Factors to be considered in this respect could include election disputes that undermine the capacity of Council to deliver the programs and services. Third-party managers are often faced with making difficult decisions regarding debt reduction, while at the same time ensuring that essential services are being delivered to community members. As a result, the Third Party Manager Policy encourages First Nation input in decisions regarding remedial management plans and debt reduction plans but does not make it mandatory, since it might in certain instances cause a delay in implementing remedial measures.

Chief and Council capacity building. The management capacity of a First Nation can be divided in two areas: technical skills of First Nation employees and the governance capacity of Chief and Council. The audit states that the new policy provides for the capacity building of the First Nation staff but does not address the issue of enhancing the capacity of Chief and Council.

INAC recognizes that, in certain instances, where a First Nation is under third-party management, there are capacity issues with Chief and Council. However, in order to be in a position to assist in capacity building, there must be a recognition of a weakness and a willingness to remedy the situation on the part of Chief and Council.

INAC will review the Third Party Manager Policy in order to address the issue of Chief and Council capacity building in instances where the Chief and Council are willing to address the situation.

Dispute resolution. The audit indicates that the policy does not include a formal dispute resolution process for decisions of the third-party manager that affect individuals.

INAC funding agreements include provisions that require a First Nation Council to maintain a system of accountability to its First Nation members, including maintaining formal dispute resolution processes by which its members may appeal decisions of the Council. Terms and conditions in the Third-Party Management Agreement specify that the third-party manager shall maintain, with respect to the programs and services provided by the third-party manager, a system of accountability to the First Nation members that meets or exceeds those of the Council. INAC will continue to monitor the implementation of the policy to ensure adherence.

10.47 **Recommendation**. Indian and Northern Affairs Canada should develop a strategy and action plan for implementing the new Third Party Manager Policy.

Indian and Northern Affairs Canada's response. INAC will take into consideration all of the audit findings and the results of its compliance reviews to develop a formal strategy and an action plan for implementing the new Third Party Manager Policy.

10.48 **Recommendation**. In consultation with First Nations, Indian and Northern Affairs Canada should conduct an evaluation of third-party manager intervention.

Indian and Northern Affairs Canada's response. INAC will evaluate the third-party manager level of intervention once it is fully implemented.

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Government purchase of two Challenger aircraft

A $101-million contract to purchase two Challenger aircraft for VIP travel did not demonstrate due regard for economy and bypassed expected practices

In brief

The Government Contracts Regulations, the Agreement on Internal Trade, and the Treasury Board Contracting Policy all exist to ensure that departments follow sound procurement principles and demonstrate prudence and probity in government purchasing. Policies and procedures inherent to good procurement practice, as well as National Defence internal procurement rules, were bypassed in the rush to procure two Challenger 604 model aircraft before the fiscal year-end. The Privy Council Office informed departments that a decision to buy two aircraft on a sole-source basis had been made.

Government regulations stipulate the exceptions under which a sole-source contract is permitted but, in our opinion, these exceptions were not applied appropriately. The decision to buy the two aircraft was not supported by the normal analysis and review usual for such a contract. Because of the lack of adequate analysis to support this acquisition, we concluded that the government was not able to demonstrate due regard for economy in this purchase.

Audit objectives

10.49 Our objectives were to determine if this transaction was in accordance with government contracting regulations and policies and whether the procedures and mechanisms established to ensure that value for money is received were followed.

Background

10.50 National Defence has a fleet of six Challenger aircraft—four are used for VIP travel and two are used as utility transport. In June 2001, a rapid depressurization occurred during a flight on one of the VIP aircraft. The problem was fixed, but it did prompt several discussions about replacing aircraft in the fleet. In August 2001 and again in October 2001, representatives from Bombardier Inc. met with officials from National Defence and the Privy Council Office to present the Challenger 604 model as an upgrade to the fleet. However, National Defence indicated that it was satisfied with the performance of the existing fleet and did not have any plans to replace its aircraft until 2010.

10.51 In November 2001, the Privy Council Office asked National Defence about the VIP fleet performance and was informed that both reliability and availability were close to 100 percent.

10.52 In early March 2002, the Privy Council Office convened senior officials from the Department of Justice, Department of Finance, Treasury Board Secretariat, Public Works and Government Services Canada, and National Defence to review the feasibility of buying two Challenger model 604 aircraft plus spare parts from Bombardier Inc. on a sole-source basis. On

18 March 2002, Bombardier Inc. presented an unsolicited proposal to sell two Challenger 604 aircraft. The offer was valid until 30 March 2002. The Privy Council Office then informed National Defence and Public Works and Government Services Canada that a decision had been made to buy two Challenger 604 aircraft. The acquisition was declared urgent and expedited. Because the amount of the contract exceeded the delegated authority of departments for non-competitive contracts, as set out in Treasury Board's contracts directive (26 June 1987), it was necessary to obtain Treasury Board approval for the expenditure and the contract. On 28 March 2002, Public Works and Government Services Canada issued the contract and took possession of two "green" Challenger 604 aircraft, meaning that the interior work was still to be done and the exterior had not yet been painted.

10.53 On 5 April 2002, National Defence paid Bombardier $92 million—$66 million for the two aircraft and $26 million in advance for the interior, equipment, and miscellaneous items, which have since been completed. The two finished aircraft were delivered eight months later, in December 2002.

10.54 This report reviewed the process to replace two of the VIP aircraft in National Defence's Administrative Flight Services Fleet.

Issues

The data available at the time of the purchase did not indicate problems with the performance of the VIP fleet

10.55 Large government acquisitions are usually initiated after departments have analyzed needs and available options, and put forward a requirements definition. In this case, National Defence had not planned to replace the Challenger VIP fleet until 2010 and was satisfied that the fleet was meeting operational requirements.

10.56 The performance of the VIP fleet is measured by reliability and availability. National Defence's Administrative Flight Services, who fly the airplanes, must have two planes available 100 percent of the time and a third available 90 percent of the time. At the time the contract was signed, National Defence reported that the reliability rate was 99.1 percent, meaning that less than one percent of flights were delayed due to mechanical problems. Transport Canada, which is responsible for maintenance, reported that aircraft availability was at 99.4 percent, meaning that less than one percent of the time only one aircraft was available. Notwithstanding the reports from National Defence and Transport Canada, the Privy Council Office determined that, in their view, new aircraft would lower the operating costs and improve the capability of the fleet by improving the flying range and providing access to shorter runways.

10.57 While one of the aircraft in the VIP fleet had experienced a rapid depressurization when the Prime Minister was on board, the problem had been fixed, and the Prime Minister and cabinet ministers had continued to fly on the same aircraft for a further 10 months. As well, that particular aircraft will remain in-service and will be converted to a utility transport aircraft for National Defence personnel along with the other aircraft being replaced. The

The new Challenger 604 replaces older models . . .

. . . and can carry up to nine passengers.

Photo: National Defence

VIP fleet will continue to fly passengers on the remaining Challenger 600 and 601 model aircraft that are not being replaced.

10.58 According to National Defence's Administrative Flight Services records, between May 2000 and February 2002, we found eight in-flight occurrences due to mechanical problems, of which only two required an aircraft to land. During that time there were approximately 1,700 flight departures. We also found that while the new Challenger 604 aircraft can land on shorter runways, there is no indication they are being used for this purpose. The aircraft do have an improved range and have been used occasionally to fly non-stop to western European cities beyond the range of the older Challengers in the fleet.

This contract did not follow the usual procedures for initiating and approving capital acquisitions

10.59 Buying new VIP airplanes was not identified in National Defence's capital plan. Nor was the acquisition subjected to the same scrutiny and approval process that is usual for large defence projects. Normally, a multi-million dollar defence acquisition is managed by a project management office and overseen by a senior review board. National Defence would not usually continue with such a purchase unless its Program Management Board had reviewed and approved project objectives and expenditures. The Challenger acquisition bypassed three key steps in the Defence Management System process:

- the identification of a capability deficiency;
- an options analysis to review risks, costs, and operational impacts, and to propose a selected option for review by a senior review board and for approval by the Program Management Board; and
- a definition phase to detail costs and risks of the approved option before submission to the Treasury Board.

10.60 Neither National Defence nor Transport Canada had time to complete a detailed technical analysis or cost estimate for the project. We were not provided with an adequate analysis supporting the need for two aircraft. We asked government officials how it was determined that two new Challengers were needed instead of one, or even three, but no documentation was provided to us.

10.61 Public Works and Government Services Canada consulted the Aircraft Bluebook and reviewed technical specifications on the Internet to price aircraft before negotiating the contract. Officials estimated that a comparable aircraft from a competitor would cost about 30 percent more than the Challenger 604. However, since no other competitors' proposals were considered, it is difficult to measure whether the chosen contractor provided the best value, particularly when we could find no consideration of life-cycle costs in the comparisons.

10.62 On 28 March 2002, the submissions from Public Works and Government Services Canada and National Defence were sent to the

Treasury Board for approval. Later that day, authority was given to enter into a sole-source contract and $93 million in funding was authorized for the fiscal year 2001–02 and $8 million for fiscal year 2002–03. That afternoon the contract was signed.

Exceptions do not appear to have been appropriately applied to support the sole-sourcing of this contract

10.63 The process for awarding contracts should be open, transparent, and competitive in accordance with applicable policies, regulations, and trade agreements. Government policy allows sole-source contracts on an exception-basis.

10.64 The sole-source awarding of this contract was based on two exceptions—urgency and compatibility with the existing fleet. We examined the basis for both exceptions and found that this contract did not clearly define the technical compatibility requirements or satisfy the criteria for urgency set out in the Agreement on Internal Trade and the Government Contracting Regulations for sole-source contracts.

10.65 Under the Agreement on Internal Trade 506.11(a), urgency would apply if an unforeseeable situation exists and goods cannot be obtained in time by open procurement. This exception cannot be used to avoid competition between suppliers. Based on the documentation, the urgency that existed stemmed from the supplier's deadline of 30 March 2002, and the decision to make the purchase in the fiscal year 2001–02. We were unable to find any analysis showing the benefit of buying the aircraft on an urgent basis or the immediate need for new aircraft by fiscal year-end.

10.66 The Government Contracting Regulations 6(d) and the Agreement on Internal Trade 506.12(a) allow sole-source contracts if there is only one supplier who can meet the requirements of the procurement to ensure technical compatibility with existing products. The Contracting Policy goes on to say that "this exception should not be invoked simply because a proposed contractor is the only one known to management." In this case, the requirements of the procurement had not been clearly defined. We could find no accompanying analysis of needs that showed only these new aircraft could meet the requirements or that other options such as refurbishing the aircraft were not acceptable.

10.67 Public Works and Government Services Canada concluded that the new aircraft should be compatible with the existing fleet, and only the same type of aircraft would be compatible. Although it was known that there were other manufacturers who could be interested in bidding, departmental officials concluded that since only one manufacturer in Canada could meet the needs, the contract would be sole-sourced.

10.68 Public Works and Government Services Canada advised the Minister that relying on compatibility as a reason for a sole-source contract was a high-risk strategy since the new aircraft were not identical to the existing fleet. Officials noted that under more compelling situations, the government had been unsuccessful in defending the use of the compatibility exception.

There is some commonality between the existing fleet (models 600 and 601) and the Challenger 604 model; Bombardier identified that 80 percent of the mechanical parts are the same. However, the avionics (the electrical and electronic equipment in an aircraft) are different, and while the engine of the Challenger 604 is a newer model of the Challenger 601 engine, it is a different type than the Challenger 600 engine. For pilot-certification purposes, Transport Canada has designated the Challenger 604 as a separate aircraft type. Pilots with the VIP fleet must take additional training before they can fly these aircraft.

10.69 Before a sole-source contract is signed, Public Works and Government Services Canada may post an Advanced Contract Award Notice (ACAN) for 15 days prior to signing the contract to allow other suppliers to come forward. The purpose of an ACAN is to provide transparency and fairness and to ensure that the government is made aware of all its options. However, in this case the government had no expectation that another supplier would submit a valid statement of capabilities since the requirement was specifically for two new Challenger 604 aircraft and, therefore, an ACAN was not posted.

10.70 Public Works and Government Services Canada did issue a Contract Award Notice (CAN). A CAN allows suppliers 10 days to file a complaint with the Canadian International Trade Tribunal if they wish to show that they should have been allowed to bid.

10.71 The role of the Canadian International Trade Tribunal is to review contracting challenges. It has rejected some cases of sole-source contracts that were justified on the basis of a need for compatibility. In one specific ruling in 1996, the Tribunal ruled that ensuring new products are compatible with existing ones should be a consideration when evaluating proposals but is not grounds for eliminating all but one supplier. In another ruling in 1999, the Tribunal concluded that justifying a sole-source contract on compatibility grounds, without providing a needs analysis that establishes that competition is not possible, deprived other suppliers of the opportunity to compete. Nevertheless, the Tribunal can only rule if complaints are submitted, and in this case no suppliers challenged the contract.

An advance payment of $26 million was made in return for discounts and interest

10.72 The Government Contracts Regulations and the Treasury Board Contracting Policy allow for advance payments if warranted. The policy states that advance payments are normally the exception—progress payments would be more common—and should be considered only in extraordinary circumstances, that is, when they are considered essential to program objectives. In this case, we could find no analysis that indicated advance payments were essential to the program objectives.

10.73 Contracting policy calls for an economic advantage to the Crown before considering advance payments. In this case, the contractor had agreed to reduce the price of each aircraft by about $1.5 million and to pay interest on some of the advance. Interest was to accrue at 6 percent annually on unliquidated portions of about $20 million of the advance payment but only

until the end of 2002. After 2002, interest was not charged. According to the contract, these benefits are not due to be paid until all costs are finalized and the contract is closed.

10.74 Although the aircraft, interior work, and equipment have been delivered, the contract had not yet been closed at the time of this audit to finalize the costs of spare parts and publications. National Defence calculated that about $3.7 million in discounts and interest was owed to the Crown since December 2002. But after applying adjustments and contract amendments, the actual amount due was about $3.2 million. During the course of our audit the contractor paid an interim amount of about $3.2 million at the end of August 2003.

Conclusion

10.75 Because the Privy Council Office informed Public Works and Government Services Canada and National Defence in March 2002 that a decision had been made to buy two Challenger 604 aircraft before fiscal year end, the departments bypassed policies and procedures to quickly submit a $101-million expenditure for approval.

10.76 Because the usual procedures inherent in normal contracting practices were not followed and exceptions were not appropriately applied, the government cannot demonstrate that due diligence was exercised in the awarding of this contract.

10.77 The government policies on contracting and the acquisition of capital assets exist to ensure that decision-makers are provided with the information and analysis they need to protect the public interest and to exercise due regard for economy. In this case, decisions were made without the full analysis and reviews expected of a large procurement project.

Privy Council Office response. The government disagrees with the conclusions of this audit, both in terms of the strength of the rationale supporting the acquisition and on the specifics of the chosen procurement strategy.

On the basis for the decision itself, the government considered anticipated improvements in terms of the non-stop flying range of the aircraft, access to runways, serviceability, operating costs, and easing the integration of the new aircraft within the existing fleet. On that basis, the replacement of older aircraft in the fleet with new aircraft of the same type was considered the best alternative. The acquisition decision was driven by a broad range of considerations that more fully reflected the value of the service in terms of capability and cost.

On the procurement strategy, the government proceeded with a streamlined procurement process that supported its policy interests, fiscal objectives, and operational realities. The decision was taken to procure replacement aircraft that were considered compatible with those in the existing fleet from the only manufacturer capable of producing the required aircraft type. This strategy ensured the integration of the new aircraft into the existing fleet and offered a clear advantage in terms of creating industrial benefits in Canada. Sound professional judgment guided this decision in recognizing that if this

procurement was directed to a supplier of a different aircraft type, the acquisition and long-term support costs could have been much higher. Any legal risk of a challenge under the Agreement on Internal Trade by a foreign supplier with a marketing presence in Canada was more than fully offset by the countervailing benefits that arose through a procurement approach directed to the sole Canadian supplier. In the end, no challenge was made.

Public Works and Government Services Canada response. Public Works and Government Services Canada, as the contracting authority, conducted the procurement process of the Challenger 604 aircraft for the Administrative Flight Services Fleet in accordance with the relevant Government Contracts Regulations, the Agreement on Internal Trade, and the Treasury Board Contracting Policy. The governing legislation and policies provide exceptions that may be invoked in specific circumstances. It is the opinion of the Department that certain exceptions contained in the legislation and policies were applicable to this procurement, and consequently, PWGSC cannot accept the observations of the Auditor General that these requirements were by-passed.

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Natural Resources Canada

Controls over contribution payments and scientific equipment need improvement

In brief

As a result of our recent work at Natural Resources Canada, we identified two areas that require immediate attention—controls over contribution payments and scientific equipment. These areas are important to ensure that the Department makes good use of its resources to meet the needs of its science-based programs.

We found that Natural Resources Canada needs to improve its financial information and monitoring used to manage contribution payments and scientific equipment, and to comply with Treasury Board policy. In particular, it needs to coordinate information and management across the Department. This would help protect its assets, determine the appropriate amount of money to invest, maximize the benefits gained from its expenditures, and provide good accountability information to Parliament.

Audit objective

10.78 Our objective was to determine whether financial information and monitoring used to manage selected contribution payments and scientific equipment is adequate and complies with relevant authorities.

Background

10.79 **Contribution programs.** Natural Resources Canada makes transfer payments to a variety of individuals, profit and non-profit organizations, academic institutions, provinces, territories, and municipal and regional governments for programs that contribute to its objectives. Over the last five years, the Department's transfer payments increased by more than 700 percent—from $48 million in 26 programs for 1998–99 to $392 million in 36 programs for the 2002–03 fiscal year. This change occurred as a result of both increases in long-standing programs and the introduction of new programs.

10.80 We selected 16 contribution programs from each of the Department's operating sectors (Minerals and Metals, Energy, Earth Sciences, and Forestry). We tested a variety of large and small programs across the Department, including both statutory and non-statutory programs. This accounts for $210.4 million in expenditures over the period from 1998–99 to 2002–03 and represents 44 percent of the Department's contribution programs. We selected programs that have existed since the new Treasury Board requirements for transfer payments came into place in June 2000 (Exhibit 10.2).

10.81 **Scientific equipment.** According to Natural Resource's 2001 Long Term Capital Plan, it has approximately 5,000 items of scientific equipment that cost $188 million and that have a replacement value of $270 million.

10.82 To test selected aspects of scientific equipment, we selected two departmental sectors—Minerals and Metals and Earth Sciences. These sectors are responsible for 75 percent of the Department's $270 million in holdings of scientific equipment.

Exhibit 10.2 **Contribution programs and their expenditures from 1998–99 to 2002–03, Natural Resources Canada**

Contribution program	Expenditures 1998–99 to 2002–03 ($ thousands)
Asbestos Institute	725
Canada Newfoundland Development Fund	15,413
Canada Nova-Scotia Development Fund	8,727
Canadian Forestry Association	348
City of Calgary Electrical System	939
Class Contributions	18,269
Climate Change Action Fund	61,850
First Nations Forestry Program	11,989
Forest Engineering Research Institute of Canada	10,822
Forintek Canada Corporation	20,397
Forintek Value Added	4,000
Industry Energy Research and Development	12,589
International Energy Agency International Energy Agency/Forestry	2,806 724
Model Forest Program	35,149
Ocean Drilling Program	2,994
Youth Employment Strategy	2,663
Total	**$210,404**

Source: Natural Resources Canada

Issues

Contribution programs

10.83 We noted a number of problems with Natural Resources Canada's contribution programs.

10.84 **Contribution agreement with terms contrary to those approved for the program.** A $1 million contribution project for provincial employees' salaries, unemployment and pension benefits, and provincial computers and accessories was approved under the Canada Newfoundland Development Fund Agreement. However, under the terms and conditions of the Agreement approved by the Treasury Board for this program, these provincial costs are excluded from eligible costs unless specifically approved by the responsible ministers. No such approval was received.

10.85 **Inadequate basis for payment.** Treasury Board policy states that contribution payments should be based on the achievement of objectives or a reimbursement of eligible expenses. In 5 of the 16 programs we tested, payment was to be made based on the achievement of objectives. In all cases, departmental managers did not have sufficient information from contribution payment recipients to support an informed assessment about the achievement of objectives. These programs accounted for more than $35 million of expenditures from 1998–99 to 2002–03. Moreover, in two cases representing more than $20 million in expenditures from 1998–99 to 2002–03, where payment was made based on eligible expenses, we found there was no evidence to support their eligibility.

10.86 **Overlapping agreements.** In January 1997, under the Newfoundland Offshore Development Agreement, Natural Resources Canada agreed to invest $2.5 million to fund the Canadian Centre for Marine Communications. The purpose was "enhancing the commercial viability of the geomatics industry through the identification and exploitation of national and international opportunities."

10.87 On 26 January 2001, under the GeoConnections contribution program, the Department entered into a second agreement with the Canadian Centre for Marine Communications. Natural Resources Canada paid $76,900 to create and deliver a one-day demonstration at a site in Lisbon, Portugal, on 7 March 2001 "to show that a shared network can be achieved using Canadian Technology."

10.88 These two agreements funded research on the same subject, at different times, in the same organization. However, the two branches of Natural Resources that signed the agreements were not aware of each others' funding initiatives. The Department needs to ensure that information is available department-wide on contribution agreement projects.

10.89 **Need for contribution not supported.** Evaluations form an important part of the information used to decide future investments. In 2002, Natural Resources Canada evaluated contributions of $4 million that it had provided to one company from 1998 to 2002 under the Value-Added program. The evaluation supported the Department's decision to continue the program. However, we found that the evaluation was not broad enough to provide reliable information for decision making. For instance, it noted but did not consider the other $26.8 million from 1998 to 2003 received by the company from other Natural Resources Canada contribution programs. Nor did it consider $36.1 million received from other federal departments and provinces from 1998 to 2003. The Department needs to consider contributions from all sources in its evaluations to ensure that it has full information to form its conclusions.

10.90 In May 2002, the Department announced further contributions to the same company of about $30 million over a two-year period. Without an appropriate analysis, the Department cannot determine if the additional assistance was provided only at the minimum level to further the attainment

of the stated objectives of the transfer payment program and the expected results as required by Treasury Board policy.

10.91 Natural Resources Canada does not have an accurate record of the total amount of contributions repayable. In the 2002–03, Natural Resources Canada reported $146 million of potentially recoverable contributions. However, for the majority of the $25 million in contributions we reviewed, the Department did not know how much was actually repayable, did not have a proper tracking system for repayable contributions, and had not initiated collection action as required by Treasury Board policy (Exhibit 10.3).

Exhibit 10.3 Example of the management of a repayable contribution at Natural Resources Canada

Signed contribution agreements create valid enforceable obligations to pay Canada the sums of money specified, at the rates specified, and for the periods specified. Re-payment of the contribution is triggered by the terms of the contribution agreement.

Background. Under the Industry Energy Research and Development program, Natural Resources Canada manages a portfolio of repayable contributions. It reported potentially repayable amounts of $20.3 million for contributions made over a period of three fiscal years (2000–01, 2001–02, 2002–03). This represents 16 percent of the total amount of potentially recoverable contributions of $146 million at 31 March 2003.

Under the Industry Energy Research and Development program, three officers manage the portfolio of 29 contribution agreements with 26 recipients. At the time of our audit, 4 repayment dates had not yet been triggered, 9 recipients had started repaying their contribution, and 16 recipients had not started paying at all despite the fact that repayment dates had passed.

Depending on the wording in the agreement, recipients are obliged to file a report every 6 or 12 months on either the commercial gross revenue or the gross sales resulting from the contributions received.

Repayment terms in the agreement are stated as a percentage of gross revenue or sales. Repayment is triggered by the terms and conditions in the agreement—usually when gross revenue or sales reach a pre-determined level. The repayment schedule in the agreement is set up to recover the contribution over a period of no more than 10 years. At a minimum, recipients are required to repay one percent of gross revenue or sales annually.

Key terms for repayment not monitored or audited. Officers should be enforcing the reporting requirements set out in the agreements that would provide information to trigger repayment. The officers are not following up on this properly. Some of the recipients are audited to ensure that they comply with the contribution agreement. These audits pay no attention to the key terms for repayment.

Treasury Board policy not adhered to. Receivables should be recorded in accordance with the schedule established by the agreement. However, officers responsible for setting up receivables establish them only when the recipient makes the first payment. The officers allow repayment amounts to be delayed and/or extend the repayment period without interest.

Insufficient support from central departmental level. As there was no departmental procedure or guidance to govern the management of repayment amounts, we were informed that the officers developed their own procedures with the assistance of a private sector contractor. This could result in multiple, inconsistent systems and processes. For example, we found that departmental staff responsible for other contribution programs do not use the one-percent-minimum repayment rule.

10.92 We found that, contrary to Treasury Board policy, the Department has not established department-wide policies and procedures for

- providing guidance to staff responsible for repayable contributions,
- monitoring to verify when conditions for repayment come into effect,
- recording accounts receivable when conditions for repayment come into effect, and
- calculating and charging interest on over-due accounts.

10.93 **Accountability information for Parliament is inadequate.** For each transfer payment program with transfers in excess of $5 million, the Treasury Board requires the Report on Plans and Priorities to include supplementary descriptive material, such as stated objectives, expected results and outcomes, and milestones (a significant point in development) for achievement. We found that the stated objectives, expected results, outcomes, and milestones in the Report for the 16 contribution programs we audited were too vague to hold the Department accountable (Exhibit 10.4).

Exhibit 10.4 **Example of inadequate accountability in Natural Resources Canada's *Report on Plans and Priorities***

Stated objective	Expected results	Outcomes	Milestones
Economic and social benefits: Sustainable financing transfer program	Provide assistance to Canada's forest sector ($33.7 million)	❶ Greater economic opportunities; encouraging investment in innovative and higher-value uses of natural resources ❷ Expanded access to international markets ❸ Increased capacity of Aboriginal, rural, and northern communities to generate sustainable economic activity	No milestones were provided

Source: Adapted from Natural Resources Canada's *Report on Plans and Priorities,* 2003-04

Management processes need improvement

10.94 Because of the problems we identified in the contribution programs, we reviewed some management processes to identify possible causes of the problems.

10.95 **No formal policies or procedures.** To ensure departmental accountability, Treasury Board policy requires departments to develop policies and procedures for contribution agreements. Policies and procedures are required to ensure that results achieved under contribution agreements are adequately monitored and that suitable information from recipients and third parties delivering programs are obtained. Natural Resources Canada does not have such documented policies or procedures.

10.96 **Compliance monitoring needs improvement.** In 6 of the 16 programs we examined, Natural Resources Canada managers relied solely on audited financial statements for recipient organizations as a whole to provide assurance that recipients were complying with the contribution agreement. However, the scope of these audits does not provide assurance that recipients complied with the agreements.

10.97 **Risk-based priority setting not used in monitoring.** We found that program managers audited recipients of transfer payments on a sporadic basis. We found no documented evidence of the reasons for selection or the analysis of program risks. To address this problem, in June 2003 the Department issued a guide for managers on how to audit recipients. However, as recipients frequently receive contributions from more than one program, managers also need information about recipients and contributions on a department-wide basis. This would help them to accurately assess risks and determine where to focus their efforts. Such information is not readily available on a department-wide basis and is not addressed in the guide for managers.

10.98 **No central monitoring or oversight.** Natural Resources Canada relies on individual program managers to carry out project monitoring and results assessment. In light of the weaknesses identified, Natural Resources Canada needs a strong central review function to ensure that the monitoring and assessment is adequate. We found that central financial managers lack the information required for oversight at the corporate level.

10.99 **Weaknesses identified by internal audits still exist.** In late 2000, the Department undertook an internal audit of 13 of its contribution programs. It identified a number of issues, including a lack of criteria for selecting recipients, inadequate audits of payments, and few evaluations of the program results. In response to the findings, management agreed to improve its accountability framework for transfer payments by February 2001.

10.100 The Department reported a second internal audit of class grants and contributions in early 2002. Again, the internal audit found weaknesses, including lack of support for payments and insufficient monitoring of results and compliance with agreements. Departmental managers committed to implementing a revised accountability management framework for transfer payments. This framework came into effect in October 2002.

10.101 However, as the results of our audit show, the problems identified by previous internal audits remain.

Scientific equipment

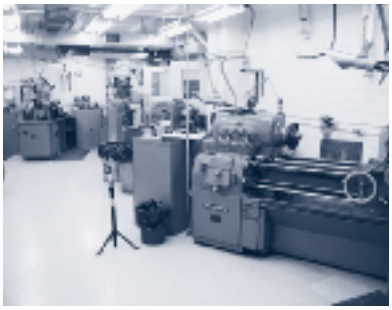
10.102 We noted a number of problems with Natural Resources Canada's scientific equipment.

10.103 **Some assets were not recorded; others were recorded twice.** In one sector we selected for testing, we compared the spending records (2001–02 and 2002–03) for capital items costing over $10,000 to the capital assets records. We found significant discrepancies; some assets were not recorded and others were recorded twice. Exhibit 10.5 summarizes our findings.

Exhibit 10.5 Comparison of the spending records of capital items costing over $10,000 to the capital assets records

	Spending records	Capital assets records
	2001–02	
($ millions)	$3.8	$4.7
capital items	99	154
	2002–03	
($ millions)	$5.5	$3.0
capital items	94	68

Source: Office of the Auditor General calculations based on data from Natural Resources Canada



These two laboratories provide similar services in the Department . . .

. . . and are located across the street from each other (paragraph 10.105).

10.104 In another sector, we compared equipment on hand to what was recorded in the capital assets records. We found $12 million of unrecorded equipment.

10.105 **Underused laboratories performing similar work.** In April 1998, assistant deputy ministers from two sectors signed an agreement to share services of one laboratory to consolidate holdings and optimize the way assets are used. However, no similar agreement exists for the other two science sectors in the Department. We found a large laboratory unit in one of the sectors that is providing similar services as another laboratory in one of the sectors covered by the agreement. These laboratories are operating across the street from each other. Managers agreed that the Department could extend such common service agreements, which would save money by using staff, equipment, and space in a more economical way. This would also allow them to dispose of unneeded equipment.

10.106 **Similar equipment purchased.** We found that departmental staff purchased similar scientific equipment costing from $200,000 to $900,000. The staff did not consider that similar equipment and trained staff in other laboratories were available nearby.

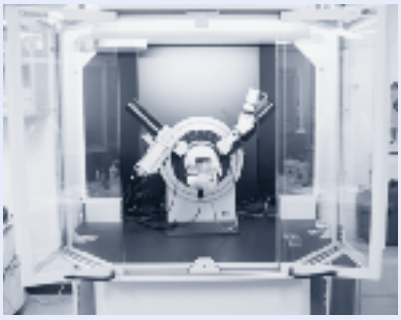
10.107 We reviewed some management processes to identify possible causes of the scientific equipment problems.

10.108 **Changes needed in capital allocation planning.** The annual planning framework of the two sectors we reviewed comprises the preparation of 13 separate divisional capital plans for new and replacement equipment. The plans are based on input from 58 groups in 26 different locations. Each sector reviews its own divisional acquisition plans. The sectors do not use the same criteria in the planning process to allocate funds within each sector. Instead, the sectors focus on individual acquisitions; employees do not consider factors such as limiting total capital assets across the Department. Staff do not analyze costs and benefits for the purchase or use of equipment across the Department.

10.109 Recognizing the problems with the sectoral approach, in 2002 the Department formed a cross-sectoral committee to establish criteria and to allocate special capital funding provided by the Treasury Board. While this was an improvement, the Department did not go far enough. Three of the four criteria were based on strategic considerations. The fourth criterion—optimal service—was not considered during the allocation process.

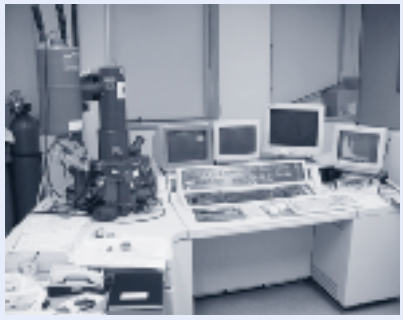
10.110 The Department needs to integrate this new approach into its ongoing planning processes and consider optimal service when deciding what and how much scientific equipment to buy.

10.111 **Equipment usage not managed.** The 58 group leaders in the two sectors audited know the hours and percentage of time that their scientific equipment is used. Yet, there is no formal requirement to measure that usage or to report on it so that management can use the information to decide the best way to allocate resources.



There are two powder X-ray diffractometers located in laboratories on the same street. One was purchased in 1985 for $500,000. It has a dedicated staff and is used 70 percent of the time. The second one was purchased in 2001 for $216,000. It has no dedicated staff and is used about 20 percent of the time.

There are five electron microprobe analyzers located in laboratories across the street from each other. They cost approximately $900,000 each. The newest one, purchased in 1995, is used only 20 percent of the time. Two older pieces, purchased in 1984 and 1985, are used only 10 percent and 40 percent of the time respectively. Two pieces purchased in 1992 are presently used 80 percent of the time, although this usage is expected to drop.



Natural Resources Canada has four scanning electron microscopes located in laboratories close to each other. They were purchased between 1983 and 1994 at a cost of about $200,000 to $280,000 each. Those purchased in 1992 and 1994 are used only 50 percent and 60 percent of the time respectively. The oldest piece of equipment is used 20 percent of the time. The equipment purchased in 1989 is currently used 90 percent of the time; however, usage is expected to drop.

Source: Natural Resources Canada

10.112 During our audit, the Department compiled a list of several items of similar scientific equipment that cost between $100,000 and $250,000. These items were used 10 to 25 percent of the time. As of July 2003, senior management had taken no action to optimize the use of this underused equipment.

10.113 Natural Resources Canada needs an ongoing process to track the use of equipment to make the best use of it.

10.114 **Monitoring and follow-up of capital assets records process lacking.** The Department relies on the operational sectors to perform periodic physical counts and to verify that the capital assets records are accurate, complete, and reliable. Corporate services is responsible for ensuring that the Department's financial records, including the capital asset records, are accurate. Given the discrepancies we found in the capital assets records, it is clear that management in the sectors and in corporate services has not provided adequate oversight to ensure that this work has been carried out effectively.

10.115 **Two optimization exercises overlap**. In March 2003, each of the two sectors we examined began to analyze their demands for science service functions and to compare the costs of alternative ways to deliver their services. An intradepartmental committee has been established for a similar purpose. It met for the first time in June 2003. In the two sectors we audited, we were unable to find any sign that these separate attempts to analyze demands for equipment and services were being co-ordinated. Without a formal way to co-ordinate the efforts of various committees and managers, the Department will likely have difficulty integrating the results of these separate exercises.

10.116 **Internal audit conclusions not properly supported**. In 2001–02, the Department's internal auditors concluded that its capital assets, including equipment, were completely and accurately recorded.

10.117 We reviewed the working papers from that audit and found that the audit did not include tests to verify that assets existed or that capital asset records were complete. We would have expected an audit of capital asset records to include these tests. The Department needs to ensure that its internal audit reports are supported by appropriate audit procedures and adequate evidence.

Conclusion

10.118 We found a number of weaknesses in the financial information and monitoring that we audited, which is used for managing the contribution programs and scientific equipment. The Department failed to comply with Treasury Board policies for contributions and asset management. Natural Resources Canada needs to correct these weaknesses to help protect its assets, determine the appropriate amount of money to invest, maximize the benefits gained from its expenditures, and provide good accountability information to Parliament.

10.119 **Recommendation.** Natural Resources Canada should improve its financial information and monitoring used to manage the contribution

programs and scientific equipment in compliance with Treasury Board policies. In particular, it should co-ordinate information and management across the Department. In addition, Natural Resources Canada needs to correct the instances we reported where it contravenes Treasury Board policy.

Natural Resources Canada's response. Natural Resources Canada (NRCan) agrees with the recommendations of the Auditor General and, in addition to taking action on specific observations, has implemented or is in the process of implementing measures to better manage both departmental assets and contribution programs. As part of these initiatives, NRCan is making improvements to the clarity of its contribution program objectives and reports to Parliament in order to ensure that Canadians have adequate information to hold the department accountable for the resources entrusted to it.

Contribution programs. The contribution programs managed by NRCan have grown substantially over the past five years and will continue to grow as the government works to meet its Kyoto greenhouse gas reduction targets. With this growth, NRCan recognizes the need to improve its control and management of contributions programs. In fact, substantial progress has already been made. Extensive training has been and will continue to be given to managers who administer contribution programs. As well, a guide to the audit of recipients has been distributed to all managers to assist them in controlling and assessing the results of their programs. In October 2002, the Department implemented a Transfer Payment Management Framework that clearly outlines roles and responsibilities of stakeholders and supports prudent management of transfer payments. Further to this framework, a Centre of Expertise has been established that will improve the horizontal coordination of all contributions, provide policy advice and guidelines, and monitor centrally the management of all programs. In addition, the Department has begun implementation of a Grant and Contribution Tracking and Management System that will provide managers with better program-specific and Department-wide information and monitoring capabilities. The monitoring system will also track the implementation of departmental follow-up to internal audits. This system, along with the Centre of Expertise, will help ensure that contribution programs are managed consistent with program terms and conditions and Treasury Board policies.

Scientific equipment. NRCan has undertaken a review of its departmental policy and guidelines on asset management to ensure that the management of assets is done in an effective manner throughout the Department and in compliance with Treasury Board directives. In conjunction with this review, the Department's Asset Management System is being examined to ensure that it contains and produces accurate information for management decisions.

In addition, NRCan has taken several steps to ensure better management of scientific equipment, in keeping with the diverse nature of the Department's scientific mandate and the regional locations of many of its laboratories. First, improvements have been made to the existing Capital Project Priority Ranking Framework to make it a more robust tool in making Department-

wide decisions on capital purchases. Second, the December 2002 Report *The Future of Science and Technology at Natural Resources Canada* recommended the creation within NRCan of a laboratory and equipment review mechanism. The Department has acted on this recommendation. The Laboratory Coordinating Committee, reporting to the new Chief Scientist at NRCan, will identify options for the replacement or acquisition of major capital equipment, including cross-sectoral pooling of capital resources and sharing of facilities and equipment, as well as co-investment in major capital assets with external partners.

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Independent reviews of security and intelligence agencies

The activities of security and intelligence agencies are not subject to consistent levels of review and disclosure

In brief

Security and intelligence agencies' compliance with the law and ministerial direction is subject to widely varying levels of independent review—in some cases, to no review at all. Review bodies also provide varying levels of details in their reports.

Independent review is important because of the intrusive powers of agencies and departments involved in intelligence gathering and law enforcement. Accordingly, we would have expected that intrusive powers would be subjected to a level of review proportionate to the level of intrusion.

Audit objective

10.120 This audit observation is a result of a larger project examining the National Security Enhancement Initiative announced in the 2001 Budget. Our objective was to determine if there are gaps in the extent and nature of the external review of Canada's security and intelligence agencies and in the disclosure of findings.

Background

10.121 Canada's security and intelligence community consists of numerous players: the Canadian Security Intelligence Service, the Royal Canadian Mounted Police, National Defence, the Communications Security Establishment, the Department of Foreign Affairs and International Trade, Citizenship and Immigration Canada, the Canada Customs and Revenue Agency, and the Financial Transactions and Reports Analysis Centre of Canada.

10.122 These departments and agencies are involved to varying degrees in the actual collection of intelligence, with varying levels of intrusion into peoples' lives. In some cases, information is gathered through the use of covert means such as surveillance and wiretaps. In other instances, the information is gathered using public sources such as the media or by compulsory reporting of financial transactions to the government. Many of these intelligence-gathering organizations received extra funding following the events of 11 September 2001. Organizations in the security and intelligence community have wide-ranging mandates. We focussed only on a portion of them during our audit.

10.123 The *Anti-terrorism Act*, proclaimed in December 2001, altered certain mandates as a way of ensuring better protection for Canada against terrorist activities. The debates that surrounded the *Anti-terrorism Act* and other similar reviews by parliamentary committees highlighted the fact that, notwithstanding the desire to increase Canada's capacity in the fight against terrorism, many parliamentarians were strongly committed to ensuring that civil liberties of Canadians were protected.

10.124 Our audit focussed only on those agencies involved in the collection of intelligence within Canada—either directly or in an assistance role—as their activities have the highest potential to affect Canadians. We assessed the level of external, independent review over each agency and the ability of review bodies to report their findings to Parliament. Citizenship and Immigration Canada and the Department of Foreign Affairs and International Trade do not collect intelligence about Canadians in Canada.

10.125 **Canadian Security Intelligence Service.** The Canadian Security Intelligence Service is Canada's primary security intelligence agency. It collects and analyzes information on suspected security threats to Canada to advise government of these threats. The *Canadian Security Intelligence Service Act* specifies that the Service may collect information "to the extent that it is strictly necessary." Service policies fully reflect this principle.

10.126 The Service uses a wide range of investigative techniques such as physical surveillance and interviews with individuals. Ultimately, the Service may be authorized to "intercept any communication or obtain any information, record, document or thing" related to suspected threat activities. Permission to proceed with the most intrusive measures is provided by the courts through warrant applications.

10.127 **Royal Canadian Mounted Police (RCMP).** The RCMP is Canada's federal law enforcement agency. Prior to 1984, when the Canadian Security Intelligence Service was created, the RCMP was also responsible for fulfilling Canada's requirements for security intelligence.

10.128 The *Anti-terrorism Act* altered the RCMP's role in national security. By defining terrorist support as a criminal offence, the Act provided for a larger role for the RCMP. RCMP officials stress that their involvement in national security is criminal law enforcement. The RCMP has become much more active in investigating criminal activity related to national security and will receive $576 million over six years under the Public Security and Anti-terrorism funding package. Of that amount, $300 million is for Integrated National Security Enforcement Teams, Integrated Border Enforcement Teams, and Investigations Operational Support. By virtue of its role as a police agency, the RCMP is empowered to use a variety of investigative tools such as wiretaps. Before proceeding to those methods, the RCMP, like the Canadian Security Intelligence Service, must have warrants authorized by a court.

10.129 **Communications Security Establishment.** The Communications Security Establishment's mandate is three-fold:

- to acquire information from the global information infrastructure (signals intelligence) for the purpose of providing foreign intelligence,
- to help ensure the protection of the government's electronic information and of information technology infrastructure, and
- to provide technical and operational assistance to federal law enforcement and security agencies.

10.130 The Communications Security Establishment reports that over the past several years there has been a substantial increase in the level of assistance to these agencies, especially the RCMP. In these instances, the Establishment is working under the authorities of the law enforcement or security agencies and is subject to any limitations imposed on those agencies by law.

10.131 The *Anti-terrorism Act* resulted in broader powers for the Communications Security Establishment. Previous to the passage of the Act, it was not permitted to intercept private communications that entered or left Canada. Under the Act, the Minister of National Defence may authorize the Communications Security Establishment to intercept such communications acquired while targeting foreign entities abroad during specific or related activities. Authorization is based on a number of conditions, including having satisfactory measures in place to protect the privacy of Canadians.

10.132 **National Defence.** National Defence's primary mandate is the defence of Canada. Intelligence activities abroad or in Canada are conducted in support of this mandate. The Department and the Canadian Forces are concerned with defence intelligence—that is, collecting information on the military capabilities and intentions of foreign states and entities. They have the capacity to collect domestic intelligence but do so only in rare circumstances and under clear legal authority in support of domestic Canadian Forces operations, to protect the safety of defence personnel and assets, or in support of mandated federal departments and agencies. In the latter case, they are operating under the authorities of the department or agency and are subject to any limitations imposed on them by law. There are three units that may be involved in domestic intelligence collection: the National Counter-Intelligence Unit, the Canadian Forces Information Operations Group, and the Canadian Forces Joint Imagery Centre.

10.133 The National Counter-Intelligence Unit is primarily responsible for the identification and investigation of security threats to National Defence and the Canadian Forces. It also provides liaison with other security agencies such as the Canadian Security Intelligence Service. Its investigations may include the use of search warrants, physical surveillance, and communication intercepts. Permission to proceed with the most intrusive measures is provided by the courts through warrant applications. Investigations can extend beyond Defence employees where the security of the Department or the Canadian Forces is involved. It is their practice to hand over the investigation to the lead agency—usually the RCMP or the Canadian Security Intelligence Service—if the subject of the investigation is other than a defence employee.

10.134 The Canadian Forces Information Operations Group conducts signals intelligence collection activities in support of the Canadian Forces. The Group is also involved in signals intelligence collection in support of the Communications Security Establishment. In this case, the collection activities are subject to the Communications Security Establishment's mandate and review mechanisms. All of the Canadian Forces Information

Operations Group's activities are subject to the laws of Canada, in particular the *Criminal Code* and the *Privacy Act*.

10.135 The Canadian Forces Joint Imagery Centre may under certain circumstances co-ordinate the collection of images of areas of Canada to support the domestic and international operations of the Canadian Forces. As well, the Centre may provide support to other Government of Canada interests, such as securing information on forest fires and floods. There are express limitations on the role of National Defence and the Canadian Forces in collecting imagery intelligence on Canadian individuals and groups within Canada.

10.136 The Canada Customs and Revenue Agency (CCRA). The Customs portion of the Agency has an active intelligence service with over 200 intelligence officers and analysts. Intelligence officers may collect information, execute search warrants, and access some individual tax return information. This is usually undertaken within the context of a smuggling investigation. Customs participates in many joint force operations with various police agencies. Customs also has a Counter-Terrorism and Counter-Proliferation Section operating out of its national headquarters. This group liaises with the Canadian Security Intelligence Service, the Communications Security Establishment, and the RCMP. Information that is collected regionally is provided to this section. Information will in turn be provided to the Canadian Security Intelligence Service or the RCMP when a Customs official has reasonable belief that the information relates to the national security or defence of Canada.

10.137 Financial Transactions and Reports Analysis Centre of Canada. After the *Anti-terrorism Act* was passed, the Centre's mandate was broadened to allow it to detect and deter terrorist financing. Originally, it was restricted to activities related to money laundering. Its current role is to receive, collect, and independently analyze transaction reports provided by a variety of partners (including financial institutions, financial intermediaries, and the Canada Customs and Revenue Agency) and to disclose relevant information to law enforcement and security agencies where appropriate.

10.138 The Centre operates at arm's length from law enforcement, and there are numerous safeguards in place before it can disclose information to law enforcement and security agencies. (For further information see the April 2003 Report of the Auditor General, Chapter 3, Canada's Strategy to Combat Money Laundering.)

Issues

Review powers are inconsistent

10.139 Having the ability to review the work of security and intelligence agencies depends on two things: the legal authority to conduct reviews and to gain access to necessary information and the possession of resources required to do the work. We expected external review to be consistent among security and intelligence agencies. That is to say, similar powers of intrusion would be subject to similar levels of after-the-fact review. We found that the powers to review security and intelligence agencies vary widely.

10.140 **Canadian Security Intelligence Service (CSIS).** The actions of the Service are reviewed by two bodies external to the Service: the Office of the Inspector General and the Security Intelligence Review Committee. The mandate of the Inspector General is to monitor if and how well the Service is complying with its operational policies, to review its operational activities, and to submit a certificate to the Solicitor General each year. The certificate states the extent to which the Inspector General is satisfied with the annual report of the director of the Service to the Minister. The certificate states specifically, in the opinion of the Inspector General, whether the Service has undertaken any action that contravenes the *Canadian Security Intelligence Service Act* or ministerial direction, or whether the Service has made any unreasonable or unnecessary use of its powers. The Inspector General has access to all information except for advice to, and certain discussions between, ministers. He is also entitled to receive explanations and reports from the director and employees of the Canadian Security Intelligence Service.

10.141 In addition to the Inspector General's review, the activities of the Canadian Security Intelligence Service are also reviewed by the Security Intelligence Review Committee. The Committee's mandate is broad and includes reviewing the performance of the Service. It includes

- reviewing the director's annual report and the Inspector General's certificate,
- arranging for or conducting reviews of the legality of the Service's conduct and reviews about whether it has made any unreasonable or unnecessary exercise of its powers, and
- investigating complaints made against the Service.

10.142 As is the case with the Inspector General's access, the Committee has access to all information held by the Service except for advice to, and certain discussions between, ministers. The Committee may also request information, reports, and explanations as it deems necessary from the director and Service employees. This access allows the Committee, for example, to review warrants to determine whether the Service has abided by the principle of collecting information strictly to the extent necessary.

10.143 Subsequent to the attacks of 11 September 2001, the government decided to increase funding of the Canadian Security Intelligence Service by 36 percent by 2006–07. The Service intends to increase its staffing by over 280 full-time positions. The budgets of the Inspector General and the Security Intelligence Review Committee have remained relatively static since 2001.

10.144 **Royal Canadian Mounted Police.** The RCMP is reviewed by the Commission for Public Complaints Against the RCMP. Its mandate is to review public complaints about RCMP members' conduct. The Commission is established on the model of civilian oversight of police services, rather than that of an inspector general of a security and intelligence service. Unlike the Canadian Security Intelligence Service, the RCMP is not subject to reviews

aimed at systematically determining its level of compliance with the law and ministerial direction.

10.145 Under the civilian oversight model, investigations are initiated by a complaint, rather than an independent review plan. The RCMP itself initially investigates the complaints and provides a report to the complainant. If the complainant is not satisfied with the RCMP's disposition of the complaint, the individual may ask the Commission to conduct a review. The Chair of the Commission may then ask the RCMP to investigate further, initiate her own investigation into the matter, or hold a public hearing.

10.146 The Commission does not have the same level of access to RCMP information as the Inspector General and the Security Intelligence Review Committee have to CSIS information. Whenever the Commission reviews how the RCMP has dealt with a complaint, the legislation indicates that the Chair has access to "relevant material."

10.147 If the Chair chooses to proceed with her own investigation of a subject that she deems to be in the public interest, her power to access information is not specified in the legislation. In fact, the legislation does not provide for the random access to RCMP files and operations that would allow the Commission to provide Parliament with broad assurance relating to compliance with the law, especially in terms of appropriate use of intrusive powers.

10.148 This falls short of the explicit powers given to the Inspector General and Security Intelligence Review Committee who can access all information held by the Canadian Security Intelligence Service and request explanations from staff. The Commission for Public Complaints Against the RCMP and the RCMP are currently in Federal Court to determine if the Commission should have access to certain information held by the RCMP that the Commission believes to be relevant.

10.149 RCMP officials told us that their main concern regarding access to police files is that the identity of confidential informants might be disclosed. They might be injured or killed if their identities were revealed. Other review agencies are bound by oaths of secrecy that prevent them from disclosing this type of information.

10.150 RCMP officials also told us that because they investigate with a view to criminal prosecution, they must closely follow the law while collecting evidence; otherwise evidence would be excluded and the prosecution could fail. In their opinion, other security and intelligence agencies that do not lay criminal charges are not subject to this discipline. We note, however, that the RCMP counterterrorism strategy focusses not on prosecuting but on "preventing, detecting and deterring terrorist activity in Canada and abroad." RCMP documents cite "preventive measures," including the expansion of intelligence collection activities. The RCMP has informed us that while their investigations focus on criminal intelligence and activity, prosecution is not always possible for a variety of reasons, including difficulty in using classified information.

10.151 **Communications Security Establishment.** The Communications Security Establishment is reviewed by the Communications Security Establishment Commissioner. The Commissioner is responsible for reviewing the Establishment's activities to ensure that they are in compliance with the law and for investigating complaints. The Commissioner must also inform the Minister of National Defence and the Attorney General of any activity the Commissioner believes may not be in compliance with the law.

10.152 The Communications Security Establishment Commissioner has all the powers of a commissioner under the *Inquiries Act*, namely the power to enter any public office, full access to all records, and the ability to summon individuals to give testimony.

10.153 Changes proposed in Bill C-17 would give the Commissioner new responsibilities for reviewing the lawfulness and compliance with ministerial authority for activities to protect computer systems and networks undertaken by National Defence or the Canadian Forces. The Commissioner would also be empowered to deal with complaints arising from such activities.

10.154 **Canadian Forces, the Canada Customs and Revenue Agency, and the Financial Transactions and Reports Analysis Centre of Canada.** These organizations do not have a specific agency to independently review their compliance with law and ministerial direction. The Privacy Commissioner carries out a limited review to ensure that obligations under the *Privacy Act* are respected (as applicable to all federal departments and agencies). The Office of the Auditor General and each organization's internal auditors may conduct compliance audits. In the case of Canada Customs, the courts would review information used in a criminal prosecution.

Disclosure of findings to Parliament varies

10.155 Just as the mandates of review agencies vary, so does reporting and disclosure of findings. In general, the Security Intelligence Review Committee is limited only by security and privacy considerations in reporting its findings to the Minister, and through him to Parliament. The committee reports contain observations on the adequacy of intelligence provided by the Canadian Security Intelligence Service and on the Service's performance.

10.156 The findings of the Inspector General of the Canadian Security Intelligence Service are reported only to the Minister and to the Security Intelligence Review Committee. However, the Committee can release any important findings of the Inspector General in its annual report to Parliament, as long as these findings are unclassified and do not contain personal information.

10.157 The Chair of the Commission for Public Complaints Against the RCMP reports fully to Parliament, but the scope of her work on the security and intelligence activities of the RCMP has been very limited.

10.158 The Communications Security Establishment Commissioner focusses on whether he found any unlawful activities or activities that did not comply with ministerial authority. While his legislated mandate is not worded in as

much detail as that of the Security Intelligence Review Committee, there is nothing that precludes the Commissioner from reporting more broadly. His annual report contains few details regarding management issues or potential problems. It is the opinion of the Commissioner that the activities and findings of the Commissioner do not by definition include management issues or potential problems at the Communications Security Establishment.

10.159 Because the Canadian Forces, the Canada Customs and Revenue Agency, and the Financial Transactions and Reports Analysis Centre of Canada do not have external review agencies that monitor their security intelligence activities, Parliament receives no independent information regarding their compliance.

10.160 In the course of our audit, we reviewed the following:

- most of the reports listed in the Communications Security Establishment Commissioner's 2002–03 Annual Report,
- Security Intelligence Review Committee reports supporting key findings and recommendations in its Annual Report 2001–2002, and
- a selection of reports of the Inspector General of the Canadian Security Intelligence Service to the Minister.

We found no inconsistencies between these reports and their public reports. We did not assess the completeness of the unpublished reports.

Conclusion

10.161 Our audit found a wide range of independent reviews of, and reporting to Parliament on, security and intelligence agencies. While mandates may differ from one organization to the next, it is our opinion that there should be more consistency in the extent of independent review applied to any environment where intrusive investigative measures are used. The Commission for Public Complaints Against the RCMP, in comparison to the Security Intelligence Review Committee, does not undertake reviews aimed at systematically determining compliance with the law, nor does its mandate provide for unrestricted access to all information. The Communications Security Establishment Commissioner has a stronger mandate to review the Communications Security Establishment but provides limited information to Parliament. Other agencies with limited domestic operations have no after-the-fact review. We believe a comprehensive review of this situation would be beneficial.

10.162 **Recommendation.** The government should assess the level of review and reporting to Parliament for security and intelligence agencies to ensure that agencies exercising intrusive powers are subject to levels of external review and disclosure proportionate to the level of intrusion.

Privy Council Office's response. The various departments and agencies in the security and intelligence community operate under quite different mandates and legislation. They are therefore subject to a variety of review mechanisms and reporting requirements.

It is acknowledged that there is a need to ensure that there continue to be appropriate review mechanisms and reporting requirements as the mandates

of departments and agencies are adapted to respond to the evolving security environment. Any consideration of review mechanisms and reporting requirements must adequately consider the very important and, in some cases, fundamental differences in mandates and operations of departments and agencies.

Royal Canadian Mounted Police's response. The RCMP collects intelligence within the context of its law enforcement role. All criminal investigations, including national security matters, are subject to stringent accountability, such as judicial oversight at the investigative and prosecutorial stages.

Criminal investigations are protected from direct political influence. The reporting to the Minister and to Parliament has to be circumspect in relation to cases where charges have not yet been laid, or where the matter is still before the courts.

The RCMP recognizes the shared jurisdiction of the RCMP and the Commission for Public Complaints Against the RCMP (CPC) in the public complaint process. We believe that, using the full authority of the CPC, the current public complaint process works in the public interest.

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The surplus in the Employment Insurance Account

Non-compliance with the intent of the *Employment Insurance Act*

In brief

We have drawn Parliament's attention to our concerns about the size and the growth of the accumulated surplus in the Employment Insurance Account since our 1999 Report. The Employment Insurance rate has declined each year since 1994, yet the surplus continues to grow. In our view, Parliament did not intend for the Employment Insurance Account to accumulate a surplus beyond what could reasonably be spent for Employment Insurance, given the existing benefit structure and allowing for an economic downturn. In our opinion, the government did not observe the intent of the *Employment Insurance Act*. In the 2003 Budget, the government announced that it will conduct consultations on a new rate-setting process to be implemented for 2005.

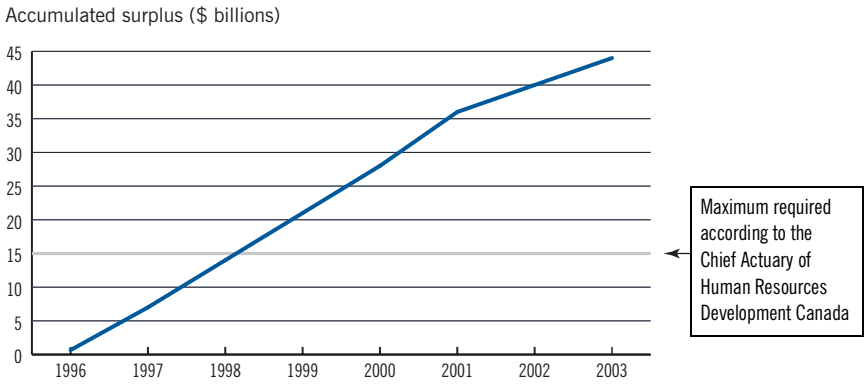
Audit objective

10.163 Our objective for this audit was to determine whether the government had addressed our concerns and to report on the progress achieved.

Background

10.164 The surplus in the Employment Insurance Account grew by $3 billion in the last fiscal year to reach $44 billion, and it is still growing. Exhibit 10.6 shows the growth of the accumulated surplus over the past seven years. For the last four years we have drawn attention to this issue in our reports on the Employment Insurance Account's financial statements and in the Public Accounts of Canada.

Exhibit 10.6 The growth of surplus amounts in the Employment Insurance Account from 1996 to 2003



Source: Audited financial statements of the Employment Insurance Account

Issues

10.165 The *Employment Insurance Act* requires that an accounting be kept of employment insurance revenues and expenditures. There have been many discussions about what the balance in the Employment Insurance Account represents. We have used terms like "notional account" and "tracking account" to describe the balance, since funds received are deposited in the

government's Consolidated Revenue Fund and not in a separate or distinct account. The balance provides a basis for managing the Account, and it is an important factor in setting premium rates, so that over time the Account breaks even.

10.166 Section 66 of the Act required that to the extent possible, the premium rate be set to provide enough revenue over a business cycle to pay amounts authorized to be charged to the Account while maintaining relatively stable rates. In our view, this means that Employment Insurance premiums should equal expenditures over some period of time, while providing for a sufficient reserve to keep rates stable in an economic downturn. In other words, we believe Parliament's intent was that this program would operate on a break-even basis over the course of a business cycle. The legislation also made it necessary for the Canada Employment Insurance Commission to make certain key decisions—such as how it would define "business cycle" and "relatively stable rates." In May 2001, the Act was amended to suspend section 66 for 2002 and 2003 to give the Governor in Council the authority to set the rates for those two years.

10.167 Nevertheless, the *Employment Insurance Act* also provides that all money collected for employment insurance purposes be credited to the Account. The only authorized amounts that can be charged to the Account are employment insurance benefits and administration. In our view, Parliament did not intend for the Account to accumulate a surplus beyond what could reasonably be spent for employment insurance purposes. The current surplus is approaching three times the maximum reserve that the Chief Actuary of Human Resources Development Canada considered sufficient in 2001. Accordingly, in our opinion the government did not observe the intent of the *Employment Insurance Act*.

10.168 In the 2003 Budget, the government announced that it will conduct consultations on a new rate-setting process to be implemented for 2005. In the interim, it set the 2004 employee rate at $1.98 per $100 of insurable earnings on the basis that premium revenues equal projected program costs for that year. We note that in the Budget Plan the government states that the following rate-setting principles would guide its ongoing consultations:

- premium rates should be set transparently and on the basis of independent expert advice;
- expected premium revenues should correspond to expected program costs; and
- premium rates should mitigate the impact on the business cycle and be stable over time.

These principles are, in our view, consistent with our interpretation that Parliament's intent was that the Employment Insurance Program would be run on a break-even basis.

10.169 In the 2003 Budget, the government invited interested parties to make their submissions for consultations on a new rate-setting process. Observations could be submitted until the end of June 2003. Senior officials

from the Department of Finance and Human Resources Development Canada held a series of meetings with representatives of business, labour, and experts in the field. Government representatives are presently studying the comments and submissions received and will report back with the results of the consultation. The government intends to introduce legislation to implement the results of the consultation, in time to have a permanent rate-setting regime in place for 2005.

Conclusion

10.170 Even with the premium rate reduction and the current public consultation process, we found that the government has not yet addressed our concerns about the surplus in the Employment Insurance Account. In our view, it was Parliament's intent that the Employment Insurance Program be run on a break-even basis over the course of a business cycle, while providing for relatively stable premium rates. However, the accumulated surplus, in the Employment Insurance Account increased by another $3 billion to $44 billion in 2002–03 fiscal year. In view of the growing size of the accumulated surplus, which is now three times larger than the maximum amount required according to the Chief Actuary of Human Resources Development Canada, we urge the government to take all the necessary steps to resolve this long-standing issue.

10.171 **Recommendation.** The Department of Finance and Human Resources Development Canada should ensure that terms such as "business cycle" and "relatively stable rates" are defined and clarify what constitutes an adequate level of reserve. Finally, the departments should take all the necessary steps needed to resolve this long-standing issue.

The government's response. The government believes that the setting of Employment Insurance premium rates has been consistent with the applicable legislation. For 2001 and prior, under Bill C-111, the Canada Employment Insurance Commission, which is independent of government, set the Employment Insurance premium rates, and not the government. With respect to Employment Insurance rate setting in 2002 and 2003, the government passed legislation (Bill C-2) that suspended the rate-setting process set out in Bill C-111 and gave the government the authority to set premium rates for both 2002 and 2003. The criteria set out in Bill C-111 were not applicable for these two years.

There has been considerable confusion about the rate-setting process. This was first highlighted in the 1999 report of the Standing Committee on Finance. In the 2003 Budget, the government launched formal consultations on a new rate-setting regime for 2005 and beyond. Interested parties had until 30 June 2003 to provide these submissions. Legislation to implement the results of the consultations will be introduced in time to have the new rate-setting regime in place for 2005.

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