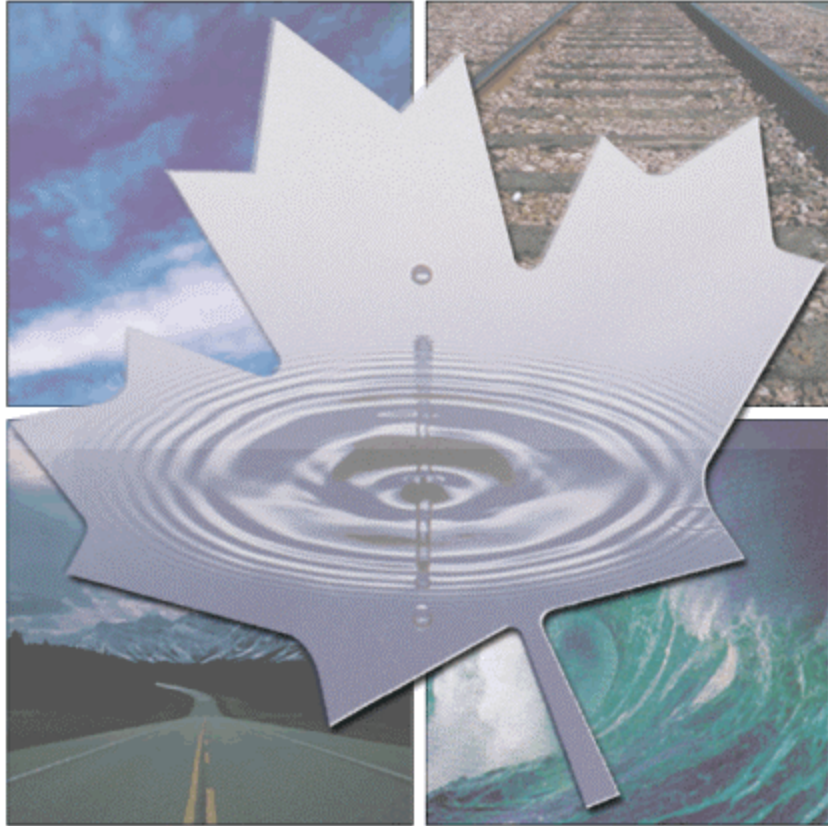




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**Final Audit Report – Cabin Security
Enhancement Contribution Program**

1577-03-009
21 April 2005

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EXECUTIVE SUMMARY

The Cabin Security Enhancement Contribution Program (CSECP) was set up in 2002, in the wake of the September 11 events, which emphasized the need to reinforce security aboard passenger aircraft. In its December 2001 budget, the federal government announced the setting up of a two-year program with a \$35 million fund to help air carriers cover the cost of security modifications to existing passenger aircraft resulting from new regulatory requirements. Management of the program was given to International Aviation and Technical Programs, within Civil Aviation. The two-year program ended on March 31st, 2004, although a significant number of claims were still being processed at the time of this audit, in the fall of 2004. Presently, \$20.2 million in payments, out of the \$35 million, have been issued in reimbursement to airline carriers.

The Audit and Review Committee (ARC) approved the audit of CSECP as part of the 2003/04 Annual Audit Plan.

The objectives of this audit were to ensure due diligence and sound management of, control over, and accountability of the Aircraft Cabin Security Enhancement Program; and provide assurance to senior management that terms and conditions of contribution agreements are complied with and that only eligible costs are reimbursed. The audit covered the management control framework of the program and examination of a selection of claim files from air carriers to determine compliance with terms and conditions of contribution agreements.

It is our opinion that CSECP is managed with due diligence and that terms and conditions in contribution agreements are complied with. Issues were identified with the way the Payable at Year-End (PAYE) account was set up and the way exchange rates were determined.

MANAGEMENT RESPONSE

Management is pleased with the outcome of the program and with the audit conclusion that the program was managed with due diligence. We find no need to provide a management action plan for this program.

AUDIT AND REVIEW COMMITTEE DECISION

The Audit and Review Committee approved the audit report and the Management Response as presented on April 21st, 2005.

1. INTRODUCTION

The Cabin Security Enhancement Contribution Program (CSECP) was set up in 2002, following the December 2001 federal budget announcement to allocate \$35 million over two years to airline carriers to help cover the cost of security modifications to existing passenger aircraft resulting from new regulatory requirements.

International Aviation and Technical Programs, within Civil Aviation, was tasked with managing this program and started reimbursing air carriers upon submission of proofs of work done. As of fall of 2004, \$20.2 million in payments were issued, representing 438 aircraft, out of a total of 515.

A significant number of claims were submitted on March 31st, 2004; the last day for eligibility of the program. This caused a backlog in the processing of the claims and was part of the reason this audit was delayed.

1.1 BACKGROUND

In the post-September 11th analysis, the international community, including Canada, was unanimous in identifying the cockpit door as the last line of defence in attempts leading to unlawful seizure of an aircraft in flight. There are two primary aircraft modifications that enhance security on board - the reinforcement and locking of the cockpit door.

Accordingly, CSECP was set up to provide funding to airline carriers to install approved new cockpit doors in eligible Canadian registered aircraft, that meet specific penetration and intrusion characteristics.

1.2 AUDIT OBJECTIVES AND SCOPE

The objectives of this audit were to:

- Ensure due diligence and sound management of, control over, and accountability of the Aircraft Cabin Security Enhancement Program; and
- Provide assurance to senior management that terms and conditions of contribution agreements are complied with and that only eligible costs are reimbursed.

The audit covered the management control framework of the program, including contribution agreements with their terms and conditions, risk assessment, approval of payments, information used for decision-making, reporting processes and monitoring activities.

The audit also included examination of a selection of claim files from air carriers to determine compliance with terms and conditions of contribution agreements.

1.3 CRITERIA

The following criteria were assessed during the audit:

1. An effective management control framework has been established to monitor and examine claims from air carriers and to report on results.
2. Claims are reimbursed as per terms and conditions in contribution agreements.
3. Management has an effective and efficient information management system to keep track of all claim files.
4. Program management have all the necessary resources – financial, human, material – to manage this program effectively and efficiently.

1.4 METHODOLOGY

The conduct of this audit was done using the following methodology:

- Interviews with program management and staff; interviews with staff from Accounting Operations; interview with Financial Management Advisor;
- Examination of relevant documentation, including:
 - a selected sample of 30 claim files for thorough examination; documents to be examined included supplier's invoices, shipping invoice, labour rate charges and so on;
 - a review of extracted data from the database for reconciliation with Schedules A and B of each contribution agreements;
 - a review of a sample of payments processed by Finance;
 - a reconciliation of a list of aircraft reimbursed, against the Civil Aircraft Registry to confirm all aircraft reimbursed were registered in Canada at the time the program was in force; and
- Analysis of the control framework in place in Ottawa, including calculations and analysis made by program management.

1.5 STRUCTURE OF REPORT

Section 2 of the report details the audit findings; section 3 provides recommendations for improvement.

2. FINDINGS

This audit tested a sample of 30 claim files for compliance with terms and conditions of contribution agreements by airline carriers and tested the management control framework in place. In addition to the sample of 30 claim files, this audit also reviewed all payments issued by the program (at the time the audit work was completed) and reconciled this information against Schedules A and B of all contribution agreements in force. Information from the program's database was used for this test.

It is our opinion that CSECP was managed with due diligence and that terms and conditions in contribution agreements were complied with. Issues were identified with the way the Payable at Year-End (PAYE) account was set up and the way exchange rates were determined.

2.1 CONTROL

The management control framework in place is being applied and is effective. In all contribution agreements, Schedule A lists all aircraft eligible for a reimbursement, while Schedule B provides the maximum contribution, referred to as the "cap" for each type of aircraft. Final payment is only issued once the air carrier has completed and signed the Certificate of Compliance, as displayed in Schedule C of contribution agreements, and once TC has received all required information and documentation from the recipient.

2.1.1. Eligible Aircraft

A total of 515 aircraft were identified from various air carriers as eligible for replacement or reinforcement of cockpit doors. At the time of this audit, which ended in November 2004, 438 claims had been submitted for reimbursement under CSECP and a total of \$20.2 million had been paid out in contribution to air carriers. Our audit tests indicate that only aircraft listed in Schedule A were reimbursed, as required by contribution agreements terms and conditions.

A reconciliation of a sample of reimbursed aircraft to the Civil Aircraft Registry confirmed that they were registered in Canada at the time the program was in place. Contribution agreements with air carriers specify that, to be eligible for reimbursement, aircraft in Schedule A must be registered in Canada at the time the cockpit door kit was replaced or modified and a claim for reimbursement was submitted to TC. The Civil Aircraft Registry keeps a database of all aircraft registered in Canada, including historical data of former registered aircraft. Reconciliation was done for a sample of such claims and confirmed that these aircraft were eligible under this provision.

2.1.2. Maximum Contribution

REMOVED – ATIP . Each contribution agreement has a specific cap for each type of aircraft, as determined by TC and as listed in Schedule B. Audit tests did not find any case where payments exceeded the authorized cap for each type of aircraft.

2.1.3. Certificate of Compliance

The final payment is only issued once the air carrier has completed and signed the Certificate of Compliance. Contribution agreements state that the reimbursement is to be done in three payments:

1. Where a Supplementary Type Certification (STC) has not been approved by Civil Aviation for the installation, a first payment of 75% of the total to be made upon submission of relevant documentation, such as supplier's and shipping invoices, and labour charges;
2. For aircraft that have been STC approved as per the conditions as stated in section 571.06 of the *Airworthiness Manual*, a second payment of up to 25%, less a hold-back of \$2,000 on the first aircraft and then a 1% holdback on subsequent aircraft.
3. Once the Certificate of Compliance has been issued and provided to the CSECP program management and once all claims for a given air carrier have been processed, a third and last payment will be processed to release the 1% holdback payments on each aircraft.

At the time this audit was completed, Certificates of Compliance were issued to 22 air carriers.

2.1.4. Arm's Length Dealing

Contribution agreements have a clause stating that air carriers must be at arm's length with contractors who install the cockpit door kits. Some air carriers chose to install the kits themselves, instead of contracting out to a third-party. There were concerns raised that this practice did not comply with the arm's length dealing clause specified in all contribution agreements. Comparisons of labour rates charged in those instances with the industry suggest that they were competitive and acceptable. Given the reasonableness of labour rates charged, information provided by air carriers in terms of number of hours spent on installation and controls in place with regards to maximum amounts payable, no further action is required here.

2.2 PROCESSING OF CLAIMS

Audit tests indicated that all claims were processed in compliance with the terms and conditions of contribution agreements. Concerns were raised with the way the exchange rates were calculated for the purchase and delivery of cockpit door kits.

2.2.1. Procedures for Processing Claims

Our tests indicated that all claims were processed in compliance with the terms and conditions of contribution agreements. Audit tests conducted included a thorough examination of a sample of 30 claim files, complete with all relevant documentation; a reconciliation with Schedules A and B on all contribution agreements, for all selected claim files and also for all payments issued, based on information extracted from the database used by program management.

Although checklists were created for claim processing, procedures for processing reimbursement claims from airline carriers were not written. Having written procedures for managing a program is a valid control. Written procedures provide additional mitigation against the possibility of losing knowledge and expertise of processing claims. Management was informed and drafted procedures for processing claims.

Accounting Operations expressed issues with the way some claim files were submitted to them for payment. As part of the processing of claims, once program management is satisfied that a claim can be paid, it forwards it to Accounting Operations for payment. Accounting Operations selects a sample of claim files for auditing and found that some files submitted for payment were incomplete, with documentation either missing or misfiled. Management addressed the issue and Accounting Operations agreed to take over the direct supervision of the employee processing claim files for the remainder of the contribution program to ensure consistency in the filing and processing of claims.

2.2.2. The Exchange Rate

There were some instances where the exchange rate was calculated using a questionable date. Cockpit door kits were purchased from suppliers in the United States and both the kit and the shipping fees were invoiced in US currency. The labour charges were also in US currency on some claims. The exchange rate from US to Canadian currency was, in some cases, calculated as per the date the purchase order was prepared. This could lead to TC paying more for reimbursement due to fluctuating exchange rates. Although we did not determine how much the difference in cost ended up to be, it is our opinion that, according to Generally Accepted Accounting Principles (GAAP), the exchange rate should have been calculated based on the date the air carrier paid for the kit, or, if that date was unavailable, the date it was delivered.

2.3 INFORMATION SYSTEM

Management hired Consulting and Audit Canada (CAC) to develop a database system they could use to process reimbursement of claims. This system is a useful tool and has built-in control features, such as the capacity of blocking a payment that would exceed the authorized cap. It lacks, however, reporting capacities, as it was not designed for this purpose. Management can provide summary and status reports of the program using other means. Investing in modifying the database system to improve its reporting capacities would not yield significant gain, given that the program is completed.

2.4 PROGRAM MANAGEMENT

Claims were still being processed after March 31st 2004 – the date the CSECP ended. Resources had to be extended in fiscal year 2004-05 to process claims until completion. Concerns were raised with the way PAYE accounts were set up for both fiscal years.

2.4.1. Managing the Program

All reimbursement claims were not processed and completed by March 31st, 2004, when CSECP officially ended. There was a significant number of claims that were submitted on March 31st. The only employee knowledgeable of the procedures to process claims was a term employee **REMOVED – ATIP**. The Director, International Aviation, **REMOVED – ATIP** of this employee to allow for the processing of these late claims and to transfer procedures knowledge to another employee, **REMOVED – ATIP** Accounting Operations in September to ensure a better control over the processing of claim files.

2.4.2. Payable at Year-End Accounts

Unavoidable difficulties in forecasting payment dates lead to the return of nearly \$3 million to the Consolidated Revenue Fund (CRF) at the end of F-Y 2002-03. To manage payments of this two-year program, two Payable at Year-End (PAYE) accounts were set up: \$25.4 million for 2002-03 and \$2.9 million for 2003-04. This was necessary to comply with funding conditions imposed by the TBS submission and also because claims were sometimes submitted months after the fact by air carriers. Since some potential claims that were part of the 2002-03 forecast never materialized, funds set aside for these claims will have to be returned to the CRF once the final claims are processed, including holdbacks and clawbacks.

Accounting Operations was also concerned that, due to the use of the purchase order date, as opposed to the delivery or installation date, some payments made with 2002-03 funds should have come out of the 2003-04 account instead, as per accrual accounting rules.

3. RECOMMENDATIONS AND MANAGEMENT ACTION PLAN

Due to the fact that CSECP is now terminated and that this audit did not find anything significant in its tests, there is no recommendation to management.

