

Chapter 16

**Follow-up of Recommendations
in Previous Reports**

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Follow-up of Recommendations in Previous Reports

Main Points

16.1 This chapter presents our follow-up of six audits originally published between 1995 and 1998. In the final volume of this year's Report, due to be tabled in December 2000, we will publish an additional follow-up chapter and provide a general conclusion of the government's progress in addressing the concerns we raised in previous reports.

16.2 The policy and legislative environment of the financial services sector has changed considerably since our 1995 and 1997 Reports. Canada's regulatory system for this sector is sound and the Office of the Superintendent of Financial Institutions (OSFI) has taken many satisfactory steps to deal with our previous recommendations. However, with all the expected changes that will affect the financial services sector, OSFI's ability to supervise and regulate could be challenged in the short term. Furthermore, in this changing environment, recruiting and retaining employees will become a bigger challenge.

16.3 Although progress has been slow on addressing the recommendations of our November 1995 chapter — *Revolving Funds in the Parliamentary System: Financial Management, Accountability and Audit* — recent initiatives by the Treasury Board Secretariat substantially address our recommendations.

16.4 The Canada Industrial Relations Board, formerly known as the Canada Labour Relations Board, has made progress in addressing our concerns about financial control problems. Payment to former members was the single biggest expenditure of the Canada Industrial Relations Board's \$1.7 million in transition costs. We also observed that the government, as a whole, has not taken adequate action to improve the accountability framework governing travel and hospitality expenditures of senior Governor in Council appointees.

16.5 National Defence has made significant progress in addressing its lack of plans and priorities for its capital acquisition program. The management of individual major capital projects has also improved. The Department has gone beyond its original commitments to make improvements. Nevertheless, officials estimate that the Department is still about \$750 million a year short of the amount needed to modernize and maintain readiness. The "hard choices" referred to in 1998 have been identified, but not all of them have been made.

Introduction

16.6 It is our policy to make recommendations in all of our audits that are oriented toward correcting current or future problems and improving the management of government. We encourage management of the entities that we audit to respond to us in writing, stating whether they agree with our recommendations, and how they plan to implement corrective action. We, in turn, publish their responses in our report, so that Parliament and the public will be able to judge their commitment.

16.7 It is important for readers to understand what a follow-up is, and is not. Apart from a few unique situations, it is not a second audit of the same issues. Rather, it is a report on what management tells us, or can demonstrate to us, about the progress it has made toward meeting

our recommendations since our initial report on the subject. We do not exhaustively seek or examine additional evidence to support or refute what management has told us, but we do review its claims for reasonableness and report to Parliament accordingly.

16.8 This chapter represents a change from our practice of reporting follow-up only once a year. We have included five follow-up segments in this volume that were completed in time for this Report. In the final volume of this year's Report, due to be tabled in December 2000, we will publish an additional follow-up chapter and provide a general conclusion of the government's progress in addressing the concerns we raised in previous reports.

Office of the Superintendent of Financial Institutions — 1995, Chapter 5 and 1997, Chapter 30

Assistant Auditor General: Ron Thompson
Director: Richard Domingue

Background

The financial services sector, the legislative framework and the policy environment in which the financial services industry evolves have changed considerably since 1995.

16.9 The Office of the Superintendent of Financial Institutions (OSFI) has regulatory and supervisory responsibilities for almost 500 federally regulated financial institutions (including banks, trust and loan companies, co-operative credit associations, fraternal benefit societies and all federally registered insurance companies) and over 1,150 pension plans.

16.10 In our 1995 Report, we discussed our audit of the sector of OSFI that oversees deposit-taking institutions. We made a series of recommendations dealing with the assessment of policy objectives, the accountability framework, the risk management of deposit-taking institutions, the systems and capabilities to deal with changes in the financial services sector, and the relationship among the principal players in the federal regulatory framework.

16.11 Later that year, the Public Accounts Committee heard witnesses and issued a report that focussed on several key areas for improvement. These included the need to conduct a program evaluation of the supervisory and regulatory framework, to better define the role, responsibilities and mandate of each responsible entity, to review the overlap between OSFI and the Canada Deposit Insurance Corporation (CDIC) and to design an action plan for intervention.

16.12 In our 1997 Report, we reported on the insurance and pensions operations of OSFI. We made recommendations on human resources management, the risk assessment framework and guidelines, and relationships and communications with

other regulators. The Public Accounts Committee also heard witnesses and reported that OSFI needed to review its human resources system, identify factors explaining its poor staff retention and implement measures to alleviate this problem. The Committee recommended that OSFI reorganize its risk monitoring and actuarial functions and consolidate them in the supervisory functions.

16.13 The financial services sector, the legislative framework and the policy environment in which the financial services industry evolves have changed considerably since the publication of our two chapters on OSFI. The government has undertaken numerous policy initiatives and legislative reviews. For example, the Department of Finance has published two policy papers since 1995. In addition, extensive reviews were conducted of the *OSFI Act*, the *Canada Deposit Insurance Corporation Act (CDIC Act)* and the *Pension Benefits Standards Act*. The financial services legislative framework was updated in 1997 and is currently being reviewed.

16.14 Bill C-38 was introduced in Parliament in June 2000. It followed a June 1999 policy paper published in response to a report in September 1998 by the Task Force on the Future of the Canadian Financial Services Sector (the MacKay report). Among other issues, the MacKay Task Force reviewed the regulatory framework. It concluded, “[Canada has] a strong prudential regulatory framework that, in many respects, is a model that many other countries are now emulating.” However, the report proposed measures such as streamlining regulatory practices, improving the federal prudential

regulatory framework, reviewing OSFI's statutory obligations to include consumer protection responsibilities and assuming the responsibility of balancing competition and innovation. It also made specific recommendations addressing the overlap between CDIC, OSFI and provincial regulators.

Scope

16.15 Our follow-up work included a review of status reports prepared by OSFI on the progress made in response to our two chapters. We reviewed supporting documents provided by OSFI, the Report of the Task Force on the Future of the Canadian Financial Services Sector and the Department of Finance policy papers, including the most recent set of legislative proposals. We also conducted interviews with OSFI officials. Finally, we reviewed a recent International Monetary Fund (IMF) assessment of the stability of Canada's financial system.

Conclusion

Canada has a sound regulatory framework

16.16 Earlier this year, an International Monetary Fund review concluded, "the financial system in Canada is among the soundest in the world and the regulatory framework conforms in nearly all respects with international standards." The review noted full compliance with 23 of the Basel Core Principles of Effective Banking Supervision and partial compliance with the remaining two principles (authority to change a bank's board and management, and authority to bar an individual from banking once hired). The 1999 Department of Finance policy proposals and the adoption of Bill C-38 will ensure full compliance with all principles. The review also concluded, "Canadian regulators have been at the forefront internationally in developing new regulatory approaches that are better attuned to the supervision of risks in

increasingly complex and integrated financial markets."

OSFI has taken action to address our audit concerns

16.17 OSFI has taken many satisfactory steps to deal with our recommendations. Although a formal evaluation of the regulatory and supervisory framework recommended in the 1995 chapter has not been done, the policy framework has undergone intense scrutiny and review over the last few years. In addition, OSFI's mandate and relationships have been clarified. OSFI has introduced a revised supervisory risk management framework for all federally regulated financial institutions, and reorganized its supervisory and regulatory resources. It has also implemented several human resources initiatives, improved communication with the industry and is in the process of streamlining approval requirements.

Co-ordination between OSFI and CDIC has improved but requires continuous attention

16.18 OSFI and CDIC have taken significant initiatives to improve their working relationship. Given the nature of their respective mandates, their relationship needs to be continuously reviewed to ensure that there are no inconsistencies and unproductive duplication.

Recruiting and retaining qualified employees at OSFI is still a significant challenge

16.19 The competition for talent in the financial sector is fierce, especially in Toronto. OSFI needs to continue its efforts to become more competitive in the financial sector labour market if it is to fulfil its mandate in evermore challenging circumstances. As argued by the Superintendent, "OSFI's biggest challenge is still to retain, recruit, train and develop more people who can understand and

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OSFI needs to continue its efforts to become more competitive in the financial sector labour market if it is to fulfil its mandate in evermore challenging circumstances.

Canada's financial services sector is about to undergo profound changes that could affect OSFI's ability to fulfil its mandate.

The OSFI Act was amended in 1996 to include a legislated mandate.

work with an increasingly complicated financial services industry and the more complex risks to which that industry is exposed.”

OSFI's supervisory ability could be under pressure in the short term

16.20 With the proposed legislative amendments, Canada's financial services sector is about to undergo profound changes that could affect OSFI's ability to fulfil its mandate. For example, new entrants in the financial system, merging financial institutions or an increased presence by foreign financial institutions could erode OSFI's regulatory and supervisory ability. The International Monetary Fund recently reported, “Growth in the numbers of small-sized institutions could lead to increased numbers of exits of financial institutions in future years, and stretch OSFI's and CDIC's current level of supervisory resources and procedures.”

Observations

There is no formal evaluation of the regulatory framework for deposit-taking institutions

16.21 Our 1995 chapter recommended that the government assess the validity of the policy objectives for deposit-taking institutions and evaluate how well the regulatory and deposit insurance system meets these objectives. The Public Accounts Committee supported this recommendation. In its report to the House of Commons, the Committee suggested that the government carry out a comprehensive evaluation of the system for supervising and regulating federally regulated financial institutions.

16.22 The Department of Finance argues that legislative sunset clauses ensure that legislation is periodically reviewed at least every five years. Furthermore, with the MacKay report in 1998, the June 1999 policy paper and the

June 2000 legislation introduced in Parliament, the Department argues that comprehensive reviews of Canada's financial sector and regulatory framework have been undertaken in consultation with the industry and with consumer groups.

OSFI's mandate and relationships were clarified

16.23 In our 1995 chapter, we noted the lack of clarity in the mandates of OSFI, CDIC and the Department of Finance. We also discussed the issue of overlapping statutory responsibilities between CDIC and OSFI and its impact on the regulatory burden of financial institutions. In addition, we reported that there was no clear division of responsibilities between OSFI and CDIC and that no accountability framework existed. The chapter recommended that the Department of Finance clarify its role and its responsibility for the functioning of the regulatory and deposit insurance system, in particular the co-ordination of activities of OSFI and CDIC. It also recommended that the mandate of the Financial Institutions Supervisory Committee (FISC) be clarified and its functioning as a mechanism for consultation and exchange of information be reviewed.

16.24 **The OSFI Act was amended in 1996 to include a legislated mandate.** OSFI developed five objectives that are critical to the successful achievement of its mission: public confidence, safeguard from undue loss, cost effectiveness, competition and high-quality service. OSFI believes that these objectives and a clear mandate better enable the public, financial institutions, and other interested parties to understand its roles and the manner in which it is expected to carry out its responsibilities. The objectives set standards against which OSFI can be held accountable and its performance can be assessed. OSFI has developed and implemented some measurement indicators related to its strategic objectives, and more are planned.

16.25 Measures have been taken to review and update CDIC's Standards of Sound Business and Financial Practices and OSFI is working on new guidelines.

The Department of Finance announced in 1999 that the Standards by-laws would remain at CDIC and that they would be updated to streamline the associated administrative process. CDIC and OSFI are collaborating in developing the proposed changes to CDIC Standards, OSFI guidelines and related processes.

16.26 OSFI's and CDIC's working relationship has improved.

A guide to intervention for federal financial institutions, published in 1995, describes in detail how OSFI and CDIC are to co-ordinate interventions. In addition, OSFI and CDIC have embarked on significant initiatives to improve their working relationship, such as the establishment of the OSFI/CDIC Liaison Committee and the OSFI/CDIC Working Group on standards and information. The OSFI/CDIC Strategic Alliance is regularly reviewed and is in the process of being revised in light of the proposed changes to financial institutions legislation. These initiatives have resulted in enhanced co-ordination and information sharing between the two agencies.

16.27 OSFI and CDIC need to continue monitoring their relationship to ensure that there is no unproductive overlap.

The mandates of OSFI and CDIC are different but they do intersect in certain areas. For example, both agencies have risk assessment functions and capabilities. Parliament has adopted a regulatory system that provides checks and balances and healthy tension between the two organizations. OSFI and CDIC need to monitor their relationship continuously to ensure cost-effectiveness, consistency and proper sharing of information.

16.28 OSFI is addressing the effectiveness of FISC. Although OSFI does not believe that the mandate of the

Financial Institutions Supervisory Committee needs to be reviewed, steps have been taken to enhance and broaden the topics of discussion. For example, to make the agenda relevant to more members and to increase attendance at the quarterly meetings, broad financial sector issues are now discussed as opposed to simply exchanging information on problem areas or strategies for dealing with troubled institutions. To increase the Committees' effectiveness, OSFI recently reconvened members to seek their views on FISC and is to refine the agenda further.

Risk assessment, monitoring and supervisory practices have been reviewed and implemented

16.29 To fulfil its strategic objective of "safeguarding against undue loss", OSFI needs to have strong and effective supervisory practices. Our 1995 and 1997 chapters contained numerous observations on these practices and recommendations for improvements.

16.30 The 1995 chapter recommended that OSFI:

- give priority to strengthening its supervisory practices and reallocate resources between examination and monitoring activities;
- formalize the processes for exercising discretionary powers so that its remedial measures would be timely;
- strengthen the assessment of specialized risk areas such as treasury, securities and management information system; and
- enhance the examiners' risk assessment and management capabilities.

16.31 In the 1997 chapter, we complimented OSFI for developing performance measurement for its regulatory regime. We recommended that OSFI:

- develop a more rigorous system of determining insurance companies ratings;

A reliance-based approach should allow OSFI to concentrate its supervision on activities that are more likely to affect an institution's risk profile, and allow it to better carry out its early intervention mandate.

- focus better on key risk areas of life insurance companies;
- review the role of the actuarial staff and improve its relationship with examiners and analysts;
- strengthen its relation with foreign regulators; and
- integrate the monitoring and examination functions of the Pension Benefits Division.

16.32 Since these reports were published, OSFI has taken a number of initiatives to enhance its supervisory program for financial institutions, pension plans and insurance companies and to better fulfil its safeguarding mandate. Some of these measures are still in progress.

OSFI has taken a number of initiatives to enhance its supervisory program for financial institutions, pension plans and insurance companies and to better fulfil its safeguarding mandate.

16.33 In 1996 the government introduced an early intervention policy. The intervention policy included a legislated mandate for prompt intervention by OSFI and by the financial institutions. This included the power to close institutions in trouble. Guides to intervention for each industry group were also published, clarifying the steps the Supervisor shall take when conditions deteriorate.

16.34 A new supervisory framework was implemented. In 1997 OSFI formed the Regulatory and Supervisory Practices Division to enhance OSFI's risk management methodology. It developed a risk-based supervisory framework to assess the safety and soundness of financial institutions. The new framework, implemented in 1998-99, is designed to enable OSFI to assess the inherent risks associated with a financial institution's significant activities (such as credit risk, operational risk and liquidity risks) as well as the quality of its risk mitigation for those activities (such as internal audit, board oversight, compliance and financial analysis).

16.35 Reliance-based approach should facilitate focus on high-risk activities. OSFI relies on off-site monitoring while on-site work focusses on in-depth evaluations of risks in selected business lines. This approach means that OSFI relies greatly on the work of an institution's internal management and control function. A reliance-based approach should allow OSFI to concentrate its supervision on activities that are more likely to affect an institution's risk profile, and allow it to better carry out its early intervention mandate.

16.36 OSFI reorganized its supervisory and regulatory resources. The organizational distinction between analysis and examination was eliminated in 1998. OSFI integrated the full range of supervisory functions in the new position of Relationship Manager, assigned to every institution. This individual is responsible for maintaining contact with the institution and for establishing the level of intervention based on its financial health.

16.37 OSFI also established a Specialist Support Sector to provide in-depth technical support to the Relationship Manager. It is composed of specialists who focus on selected activities or issues through cross-system reviews and seek to better understand the prudential implications of emerging systemic risks. The Specialist Support Sector is subdivided into eight divisions: accounting, financial analysis and data management, capital markets, capital, compliance, credit risk management, financial services technology specialist, and actuarial.

16.38 A new risk rating scheme is presently being developed. The new rating scheme will replace the CAMEL financial institution rating (capital, asset quality, management, earnings and liquidity) and will be applicable to all federally registered financial institutions. It should be ready for consultation next

year. The rating criteria will capture areas such as corporate governance and will be linked to new corporate governance guidelines and the supervisory framework. The scheme will be subject to review and comments by the industry before it is adopted.

16.39 New lines of communications have been established with major foreign regulators. OSFI has entered into several memoranda of understanding with major foreign regulators. Relationship Managers are now contacting these regulators whenever deemed necessary.

16.40 The monitoring and examination functions of private pension plans are now integrated as recommended. OSFI has developed a Risk Assessment System that captures actuarial information. It has also developed an intervention process whereby high-risk pension plans are identified and closely monitored so that problems can be dealt with in a timely manner. The on-site examination function has been transferred from Toronto to Ottawa, where pension supervisors are completing their training in on-site examination. OSFI has introduced regular peer review and quality control processes. It has also established an Intervention Committee within the Pension Division to regularly review problem pension plans.

Improved communication with the industry and streamlined compliance requirement

16.41 In 1995 we recommended that OSFI clarify its governance expectations concerning the board of directors, senior management and internal auditors of regulated institutions. We further recommended that OSFI explore avenues of achieving cost efficiencies to reduce demands on the industry, and that OSFI be more transparent in disclosing its analyses. For example, the CAMEL risk

rating was given as an area where enhanced transparency would be desirable.

16.42 In 1997 we recommended that OSFI develop standards of sound business practices for the property and casualty insurance industry and that both OSFI and the Department of Finance review the compliance requirements and consider methods of reducing any negative impact on insurance companies. We also recommended that OSFI strengthen its communication with insurance company officials and that it work to adopt multilateral agreements to enhance the consistency of the federal-provincial pension plan regulatory framework.

16.43 OSFI meets regularly with boards of directors and management. OSFI is now conveying its expectations as part of the supervisory program. It believes that corporate governance requirements are well known and understood. Nonetheless, it will clarify its expectations on corporate governance and best practices with the publication of corporate governance guidelines, soon to be released.

16.44 OSFI has taken measures to improve its efficiency and to reduce compliance costs. Many of the recent initiatives that OSFI has taken should have a positive impact on its efficiency and compliance costs. These initiatives include development of the new supervisory framework, the focus on corporate governance, creation of Relationship Managers, establishment of a Specialist Group, the increased reliance on self-assessment and new internal audit requirements.

16.45 OSFI has introduced user fees for selected regulatory services. The user fees were designed to more fairly allocate costs to the users of those services.

Many of the recent initiatives that OSFI has taken should have a positive impact on its efficiency and compliance costs.

A new organizational structure has created opportunities for advancements that allow staff to assume more responsibility and broaden their experience.

OSFI has developed a medium-term human resources strategic plan entitled *Your Vision — Our Mission*.

16.46 The legislation before Parliament contains provisions to streamline OSFI's regulatory approval process. A number of transaction applications will need only the Superintendent's approval instead of ministerial approval. Furthermore, under a new notice-based approval process, applications will be automatically approved 30 days following their receipt, unless the Superintendent raises concerns.

16.47 The rating results under the new supervisory framework will be shared with regulated financial institutions. Once the new rating system is developed and implemented, OSFI will be informing institutions of their overall rating.

16.48 OSFI is drafting standards of sound business for the property and casualty insurance industry. OSFI is waiting for CDIC's Standards to be reviewed before going ahead with its own standards to ensure comparability. The new OSFI Standards should be finalized by the end of 2001.

16.49 Overlapping regulatory framework for pension plans is being addressed. The Canadian Association of Pension Supervisory Authorities (CAPSA) has formed a permanent secretariat and a committee to consider a reference model statute that could eventually be adopted by every jurisdiction. OSFI, a member of CAPSA, is actively supporting such a model law.

OSFI has improved human resources management practices

16.50 In our 1995 and 1997 chapters, we made a number of recommendations on OSFI's human resources management. In both chapters, we highlighted the need to enhance the skills and competencies of the examination staff. In 1997 we identified other human resources management issues, such as the need to attract and retain qualified staff and the importance of having a framework for

human resources management that is responsive to OSFI's changing needs. We also recommended that changes be made to the human resources framework in areas such as classification and compensation, and that the recruitment and retention strategies be based on documented analysis. The Public Accounts Committee reinforced the importance of better human resources management systems.

16.51 OSFI is seeking to become a learning organization. OSFI has developed a suite of training and self-learning programs that respond to its needs in both technical and non-technical areas. Six percent of OSFI's budget is earmarked for training and professional development. OSFI now performs office-wide annual training needs assessments to ensure that the training and learning programs are need-based and timely. Whenever possible, the training courses will include a combination of academic and industry specialists and OSFI expertise in order to ensure that the most current industry-specific issues are being presented. A new organizational structure has created opportunities for advancements that allow staff to assume more responsibility and broaden their experience. In addition, the new Specialist Support Sector has a mandate to provide expertise to the other OSFI sectors through sharing information with front-line supervisors and regulatory staff in support of their activities.

16.52 OSFI has developed a medium-term human resources strategic plan entitled *Your Vision — Our Mission*. The plan provides direction for the continuing evolution of human resources management, with linkages to the Office's strategic plan. OSFI has implemented, or is in the process of implementing, a number of important initiatives to recruit candidates for vacant positions and retain qualified employees. These initiatives include a new classification system, flexibility options afforded to OSFI as a

separate employer, the development of competency profiles for all jobs at OSFI, improved compensation and performance pay, and options for staffing and recruiting such as the Career Management Program, which recruits new employees directly from universities and provides them with on-the-job and external training.

16.53 OSFI has also recognized the need to improve its information-reporting

capabilities for human resources management. It agrees that sound information on programs relating to human resources management depends on thorough analysis based on comprehensive information. A new human resources management system that integrates information such as retention, vacancy and pay rates was implemented in April 2000.

Revolving Funds in the Parliamentary System: Financial Management, Accountability and Audit — 1995, Chapter 24

*Assistant Auditor General: Ron Thompson
Director: John Apt*

Background

16.54 A revolving fund is a “revenue re-spending authority.” Once Parliament authorizes a revolving fund for an organizational unit of the government, the managers of that unit can re-spend its revenues on an ongoing basis for approved purposes and within agreed limits. For the year ended 31 March 1999, there were 17 revolving funds with approximately \$1.2 billion in revenues and expenses.

16.55 In our 1995 chapter, we recommended that the Treasury Board Secretariat strengthen its policies governing revolving funds. The chapter noted that the Secretariat needed to improve its oversight of organizations that operate revolving funds. The Secretariat agreed to take the recommendations into account when the next revisions to the revolving fund policy were made.

Scope

16.56 Our follow-up consisted of a review of actions taken by the Treasury Board Secretariat in response to our recommendations. We held discussions with Treasury Board staff, reviewed the Guide on Revolving Funds issued in December 1997, and reviewed the revised policy and related documents. Our work was designed to provide a moderate level of assurance that our recommendations have been addressed. We did not specifically examine the revolving funds or the practices of the departments involved.

Conclusion

16.57 Progress on addressing the recommendations of our November 1995 chapter has been slow. For example, the Treasury Board Secretariat issued the draft Guide on Revolving Funds in December 1997 and it remains in a draft format. The revised Policy on Special Revenue Spending Authorities, which includes the policy on revolving funds, was approved for distribution in June 2000.

16.58 Nevertheless, the use of the Guide by revolving fund management and implementation of the revised policy substantially address the recommendations we made in 1995.

Observations

16.59 The table in Exhibit 16.1 provides our 1995 recommendations and the Treasury Board Secretariat response. A summary of the current status of these recommendations is presented in the following paragraphs.

16.60 Additional guidance on relationship between revolving fund and host department. Treasury Board policy requires departments to obtain Treasury Board approval of the roles and responsibilities of the Deputy Head and the revolving fund management when a revolving fund is established. This agreement should be reviewed every three to five years as part of the mandate and viability review to ensure that it continues to be appropriate. The draft Guide on Revolving Funds states that the relationship between the unit operating a revolving fund and the host department should form part of the framework document in order to link accountability

A Guide on Revolving Funds and revised policy have now been issued.

to a sense of strategic direction and provide stability.

16.61 Strengthened criteria for granting and reviewing revolving funds.

The general criteria for establishing a revolving fund are listed in Appendix B of the Treasury Board policy. The draft Guide provides criteria and issues to be considered when establishing a revolving fund, as well as those to be considered when assessing the continuing need for the

revolving fund. The mandate and viability of revolving funds are to be reviewed every three to five years. Mandate and viability reviews have been requested from all organizations that operate revolving funds. These reviews are to be completed by May 2001.

16.62 Adoption of Generally Accepted Accounting Principles. The policy requires that financial statements be prepared in accordance with Treasury

Exhibit 16.1

Recommendations of Our 1995 Chapter on Revolving Funds

November 1995 Chapter 24	
Office of the Auditor General Recommendations	Treasury Board Secretariat Response
24.57 Treasury Board should provide additional guidance in its policies, or in some other appropriate vehicle, on the general organizational relationship between the unit operating a revolving fund and the host department.	Within the existing government framework, consisting of legislation, regulations and Treasury Board policies, this recommendation will be taken into account when the next revisions to the revolving fund policy are made.
24.65 Treasury Board should strengthen the criteria for granting revolving funds and for periodically assessing and reaffirming their continued appropriateness.	This recommendation will be taken into account when the next revisions to the policy are proposed.
24.70 Treasury Board should adopt Generally Accepted Accounting Principles as the standard financial accounting measure for all revolving funds.	The Treasury Board Secretariat recognizes the importance and usefulness of Generally Accepted Accounting Principles, and this recommendation will be taken into account when the next revisions to the policy are proposed.
24.77 Treasury Board should require that units using revolving funds adopt a form of annual reporting that includes financial statements, performance reporting using an established available framework and a comprehensive "Management Discussion and Analysis" section. These reports should be submitted to Treasury Board and be available for public scrutiny.	The Treasury Board Secretariat recognizes the usefulness of this recommendation, and it will be given full consideration when the next revisions to the policy are proposed.
24.84 Treasury Board should issue guidelines for independent validation of disclosed information on revolving funds that calls attention specifically to compliance with authority as well as to the fairness of the financial statements, and that identifies who carried out the validation.	The Treasury Board will take this recommendation into account when the next revisions to the policy are made.
24.93 Treasury Board Secretariat should consider alternative strategies and approaches for oversight of revolving funds.	Independent of the funding mechanism chosen for an activity, the government considers and implements alternative strategies and approaches for oversight as appropriate. Examples are provided in the recent publication "Framework for Alternative Program Delivery".
24.99 Treasury Board staff should assess how best to build the appropriate capacity needed to support better use of revolving funds and accrual accounting.	The Treasury Board Secretariat agrees with this recommendation, and had already taken steps prior to the commencement of the audit to achieve these ends.

Board Secretariat accounting policies based on Generally Accepted Accounting Principles (GAAP).

16.63 Strengthened annual reporting.

The policy requires that financial and operational performance of the revolving fund be assessed relative to the business plan every three to five years. The draft Guide provides guidance on preparation of the framework document and business plan, including performance measures and targets and reporting requirements. It also describes each of the required financial statements.

16.64 Independent validation of

disclosed information. The policy requires financial statements to be audited to assess compliance with the Treasury Board Secretariat accounting policies. The draft Guide provides a model, objective and scope in Sections 7040 through 7042.

16.65 Alternative strategies for

oversight. Departments will be required to submit to Treasury Board, with the Annual Reference Level Update, a multi-year business plan that will include planned use of their drawdown authority, a long-term capital plan if applicable, and the rates to be charged in the next fiscal year. In addition, the results of the mandate and viability reviews will be analyzed by the Treasury Board Secretariat and recommendations will be made as appropriate. This measure will assist in ensuring appropriate Treasury Board oversight of organizations that operate revolving funds.

16.66 Capacity to support better use of revolving funds and accrual

accounting. Training for program analysts was planned for this summer. The Treasury Board Secretariat recognizes that this type of training is an ongoing requirement.

Canada Labour Relations Board — 1997, Chapter 26

*Assistant Auditor General: Jean Ste-Marie
Director: Sue Morgan*

Background

16.67 We reported to Parliament on the Canada Labour Relations Board (CLRB) in December 1997. The report focussed on travel expenditures, allowances, and benefits reimbursed to the Chair and members of the CLRB. The report also made recommendations to address financial control problems.

16.68 We observed that some of the CLRB's financial practices would not bear the closest public scrutiny. We reported that there were no time frames for former Board members to complete cases, and questioned the cost effectiveness of their open-ended appointment.

16.69 We also commented that the CLRB's travel and hospitality rates for its Governor in Council (GIC) appointees were significantly higher than the rates applicable to public servants.

16.70 We made specific recommendations affecting the CLRB and government-wide recommendations affecting other entities that have authority to establish their own travel and hospitality policies.

16.71 Subsequent to our audit, Parliament passed Bill C-19, which came into force 1 January 1999. This legislation was introduced to modernize and improve the collective bargaining process for federally regulated industries. The Bill established the Canada Industrial Relations Board (CIRB) as a representational, quasi-judicial tribunal responsible for interpreting and applying the Canada Labour Code. The CIRB is the successor to the CLRB.

16.72 In response to our audit, the Comptroller General issued a letter to

deputy heads and senior financial officers about the financial management responsibilities of Governor in Council appointees. The Treasury Board Secretariat also revised the wording of the Special Travel Authorities. The government issued an order-in-council directing that entities with the authority to establish their own travel and hospitality policies be guided by Treasury Board Special Travel Authorities and Hospitality policy.

16.73 This follow-up report focusses on the corrective action taken by the CIRB and the government on our recommendations in the 1997 chapter.

Scope

16.74 We reviewed the government's progress since December 1997 in improving the accountability of Governor in Council appointees for their travel and hospitality expenses.

16.75 We examined travel and hospitality expenses of the CIRB Chair and the members. We also examined the CIRB's performance levels, the assignment of cases to former Board members and the per diem amounts paid to the former members.

16.76 We reviewed actions taken by the Treasury Board Secretariat and the Privy Council Office. In addition, we reviewed the performance reports of the six entities that have established their own travel and hospitality policies (the same six entities featured in our 1997 chapter).

Conclusion

16.77 Our follow-up work indicates that the CIRB has made progress in addressing the recommendations that dealt with the financial control problems. To a large

The Canada Industrial Relations Board is the successor to the Canada Labour Relations Board.

The Canada Industrial Relations Board has incorporated most of the Treasury Board rates in its policies.

The Canada Industrial Relations Board paid its former members a significant amount in per diem expenses.

degree, it is using Treasury Board rates for the Chair's and the Board members' travel and hospitality expenses.

16.78 However, the CIRB paid its former members significant per diem amounts for completing their cases. As well, the continued appointments of former members are still open-ended unless the Chair exercises his discretion to withdraw and reassign cases. On average, it was taking longer to hear and to process cases in the three-year period.

16.79 The government as a whole has not taken adequate action to address our concerns about the need to improve the accountability framework governing travel and hospitality expenses of senior Governor in Council appointees.

Observations

CIRB's travel and hospitality policies

16.80 Under its new legislation, the CIRB has the same authority to establish its own travel and hospitality policies as the CLRB had. As part of its policies, the CIRB has incorporated most of the Treasury Board rates for the Chair and the Board members.

16.81 The CLRB had 14 full-time Governor in Council appointees. As the deputy head, the Chair (GIC-10) of the CLRB had "full discretion" over his travel expenses. The Chair claimed actual expenses. The five Vice-Chairs (GIC-9) and eight members (GIC-5) were reimbursed for their travel expenses using a per diem system that required no receipts.

16.82 At the time of our follow-up review, the CIRB had 11 full-time Governor in Council appointees: the Chair (GIC-9), four Vice-Chairs (GIC-7), and six members (GIC-5). In May 2000, the Governor in Council appointed an additional Vice-Chair and six part-time members in the regions. The Chair, at level 9, retains discretion under the

Treasury Board's Special Travel Authorities. However, the CIRB's travel policy applies to all Board members, including the Chair. The Vice-Chairs and the other members do not have discretion over their travel expenses. They are required to follow the CIRB's travel and hospitality policies, which are similar to the Treasury Board's policies.

16.83 Our review of a sample of travel and hospitality expenses of Board members and the Chair indicates that the CIRB is using the Treasury Board rates to a large degree.

Continued appointment of former Board members in the transition period

16.84 In our 1997 chapter, we recommended that the government take the necessary steps to reintroduce legislation to clarify authority and responsibilities within the Board. Bill C-19 provided the Chair of the CIRB with control over assignment of cases and clarified the authority and responsibilities within the Board.

16.85 In 1997, we questioned the CLRB's use of former members to hear cases long after their full-time terms had expired. We recommended that the government limit the continued appointment of former Board members to a reasonable period.

16.86 When the new legislation came into force in January 1999, it provided for the former members to complete the cases they had heard while on the CLRB. The former members were paid a per diem rate set by the Governor in Council. We observed that the continued appointments of former members are still open-ended — that is, with no termination date. However, in order to terminate the arrangements with the former members, the Chair would have to exercise a transitional provision of Bill C-19, which would provide him with the discretion to withdraw and reassign any cases not disposed of within one year

following the legislation's coming into force.

16.87 Effective 1 January 1999, the CIRB inherited 542 cases from the CLRB; 408 of these cases were reassigned to CIRB members and 134 cases remained with the former members. As at 31 March 2000, there were 43 unresolved CLRB cases. In May 2000, the CIRB advised us that there were only 10 unresolved CLRB cases. The former Board members collectively disposed of 91 cases during January 1999 to March 2000.

Payment to former members was the major transition cost

16.88 Under normal circumstances, tenures of Board members are staggered to ensure continuity in the Board's operations. However, with the implementation Bill C-19 on 1 January 1999, the new CIRB was created and the CLRB abolished, ending the terms of all the Board members. This led to one-time transition costs of \$1.7 million. The CIRB told us that, with the new Board only partially staffed, it had no choice but to have certain former members return to handle the CLRB's outstanding cases.

16.89 The CIRB paid its former members \$895,000 in per diem expenses and \$43,000 in travel expenses for the period of January 1999 to March 2000. From April 1997 to December 1998, the CLRB had paid \$53,000 in per diem expenses and \$12,000 in travel expenses to its former members. The travel expenses do not include prepaid airfare costs.

16.90 The payment to the former members was the single biggest

expenditure of the CIRB's \$1.7 million in transition costs. In 1997, we reported that the CLRB had spent about \$1.7 million in per diem expenses during the eight years between April 1989 and March 1997.

Overall decline in performance levels

16.91 There was an overall decline in performance levels. We looked at the three-year period but did not distinguish between files processed by the CLRB and the CIRB. We note that the total number of completed cases increased in 1999-2000 compared with previous years. The CIRB disposed of 852 cases in 1999-2000; 605 cases had been disposed of in 1998-99 and 626 cases in 1997-98. On average, however, it was taking longer to hear and to process cases in the three-year period than it did in the preceding years. Exhibit 16.2 shows increasing case processing times from 1997-2000. The CIRB told us that it has made progress in reducing the processing times for cases received after 1 January 1999.

16.92 The CIRB advised us that the following factors negatively affected processing times:

- extraordinary increase in workload resulting from new cases;
- delays in appointing new members to the CIRB; and
- difficulty in re-assigning cases already heard by former CLRB Vice-Chairs.

16.93 Our review of the CIRB's workload indicates that the growing backlog of cases is due to a significant increase in new cases. The CIRB told us that the workload increase stems from

	1997-98	1998-99	1999-2000
Days to process case without public hearings	129	150	176
Days to process case with public hearings	330	560	403

Exhibit 16.2

Canada Industrial Relations Board Case Processing Times — 1997-2000

Source: CIRB performance information

major structural and technological changes being experienced by clients such as the airline, telecommunications and broadcasting industries. The CIRB advised us that it will be implementing more aggressive administrative steps, such as alternative dispute resolution, to handle the increasing workload.

Accountability by senior Governor in Council appointees

16.94 In 1997, we recommended that the Privy Council Office and the Treasury Board Secretariat clearly explain to the Governor in Council appointees the role of deputy head and senior financial officer under *the Financial Administration Act* and Treasury Board regulations and policies.

16.95 In August 1999, the Privy Council Office issued a booklet called “A Guide Book for Heads of Agencies — Operations, Structures and Responsibilities in the Federal Government.” It provides an overview of government operations and the role of the deputy head.

16.96 In response to our audit, the Comptroller General issued a letter in December 1997 to all deputy heads and senior financial officers about their respective financial management responsibilities under the *Financial Administration Act*. The letter reiterated the Treasury Board’s comptrollership policy requirement that the senior financial officer consult the Deputy Comptroller General when the actions of the deputy head would pose a financial risk or violate government policy.

16.97 The Treasury Board’s Policy on Responsibilities and Organization for Comptrollership does not adequately deal with senior Governor in Council appointees whose travel and hospitality expenses deviate from Treasury Board policies. The comptrollership policy relies on the senior financial officer, a

subordinate to the deputy head, to notify the Deputy Comptroller General about financial management irregularities involving the deputy head.

16.98 We asked the Treasury Board Secretariat about any follow-up action that it had taken since the December 1997 letter. The Secretariat advised us that no follow-up action was required, because the onus to seek assistance and advice rests with the senior financial officer.

16.99 We noted in our 1997 chapter that conflicting phrases such as “full discretion” and “general principles” created confusion and the government should clarify “the general principles.” Consequently, the Treasury Board Secretariat changed the phrase “full discretion” to “discretion” in the Special Travel Authorities.

16.100 The revised Special Travel Authorities state, “heads of departments and agencies have discretion over commercial accommodation selected, telephone calls, [and] meals and incidentals in excess of the per diems, based on receipts.” The Special Travel Authorities elaborate on “discretion” in the following manner:

This discretion should be exercised with prudence and probity, mindful that all expenditures must further government objectives. Although specific circumstances may warrant exceptional expenses, the basic norm should be comfortable and convenient, but not excessive. A benchmark may be found in the provisions of the Treasury Board Travel Directive.

16.101 The Special Travel Authorities emphasize the responsibility of senior Governor in Council appointees for their own travel and hospitality expenses. However, they are still too vaguely worded, leaving the senior Governor in Council appointees to determine their own standard for “the basic norm.” The

Treasury Board Secretariat did not clarify the “general principles.” Accordingly, we conclude that the policies governing senior Governor in Council appointees’ travel and hospitality expenses have essentially not changed.

Order-in-council introduced in 1997

16.102 In 1997, we recommended that the government propose legislation to Parliament containing guidelines for travel and hospitality expenditures by entities that have the authority to establish their own policies. We reported that 36 of the 52 entities we consulted have the authority to establish their own travel and hospitality policies, which can vary from Treasury Board policies.

16.103 In response, the government introduced an order-in-council in December 1997. It directed that organizations with the authority to establish their own travel and hospitality policies be guided by Treasury Board’s Special Travel Authorities and Hospitality Policy. This direction does not apply to judges and to Governor in Council appointees in Crown corporations.

16.104 An order-in-council such as the one made in December 1997 does not override provision for travel and hospitality authority in an entity’s enabling legislation. Thus, for Governor in Council appointees in entities that have travel and hospitality authority, the order-in-council merely provides guidance.

Monitoring of travel and hospitality expenses

16.105 Although the majority of Governor in Council appointees are in entities that have authority to establish their own policies, the Treasury Board Secretariat does not monitor their travel and hospitality expenses.

16.106 There are about 360 full-time Governor in Council appointees in the 52

boards, agencies and commissions. Of these appointees, 339 are in 36 entities that have the authority to establish their own policies. For the majority of the Governor in Council appointees, Treasury Board policies and the order-in-council serve only as guidance.

16.107 In view of the open and varying authority framework governing travel and hospitality expenses of Governor in Council appointees, we believe that more concrete steps are needed to monitor their practices. Although the government has moved to clarify financial management responsibilities, in our opinion the Treasury Board Secretariat has not taken adequate measures to improve the accountability of Governor in Council appointees for their travel and hospitality expenditures.

Reporting to Parliament

16.108 In 1997, we commented that 6 of the 36 entities with authority to do so had established their own travel and hospitality policies. We recommended that those entities report to Parliament on their policies and the resulting additional costs in comparison with Treasury Board policies for public servants.

16.109 Two of the six entities subsequently reported to Parliament in 1998 and 1999 that they had their own policies. A third entity did not report to Parliament because, in the entity’s opinion, the difference between its own policy and the Treasury Board policies was small. The three remaining entities advised us that they had been unaware of any requirement to report to Parliament.

16.110 The reporting requirement was outlined in part in the December 1997 letter of the Comptroller General to deputy heads and senior financial officers. The Treasury Board Secretariat indicated to us that reporting to Parliament is now an ongoing requirement.

Treasury Board policies for travel and hospitality expenses of senior Governor in Council appointees have essentially not changed.

The Treasury Board Secretariat does not monitor travel and hospitality expenses of Governor in Council appointees.

Department of National Defence — Equipping and Modernizing the Canadian Forces — 1998, Chapter 3

Assistant Auditor General: David Rattray

Principal: Peter Kasurak

Background

16.111 In 1998 we audited the capital equipment program of National Defence, which accounts for spending of \$1.4 billion a year. We assessed how well the Department was maintaining the modern, multi-purpose forces required by the government's policy. According to departmental business plans, the Department would require \$11 billion in capital funds over the next five years but would receive only \$6.5 billion, resulting in a \$4.5 billion shortage.

16.112 Officials told us they were taking action but "hard choices may have to be made." The Department was working on a long-term examination of the Canadian Forces, including capabilities, future force size, force development priorities and new ways to support operations. Force reductions and reduced military readiness were possible outcomes of the Department's planning.

16.113 Planning was hampered by a lack of adequate policy guidance, clear priorities and performance information. We also found that other countries were doing better at linking capital spending to policy objectives and were providing more information to their legislatures.

16.114 The Public Accounts Committee agreed with our findings and recommended that the Department improve its planning and also provide Parliament with a comprehensive defence review and assessment, capital acquisition plans and relevant indicators in its annual Departmental Performance Report.

Scope

16.115 We followed up on our recommendations and those made by the Public Accounts Committee. We reviewed budget and force structure review files and interviewed departmental officials responsible for the capital budget.

Conclusion

16.116 The Department has made significant progress in addressing its lack of plans and priorities and linkages between policy and its force structure. However, officials estimate that each year the Department is still about \$750 million short of the amount needed to modernize and maintain readiness. The "hard choices" referred to in 1998 have been identified but not all of them have been made.

16.117 The government rejected the Public Accounts Committee's recommendation that Parliament be provided with more information on whether the capital equipment program was succeeding in meeting defence capability goals.

Observations

The capital budgeting and force planning processes have been improved

16.118 The Department has taken steps to improve its processes for capital equipment planning and budgeting. These steps substantially address our recommendations and those of the Public Accounts Committee that the Department complete its force employment scenarios, force development framework and strategic assessments. Specifically, we note the following progress:

National Defence has taken steps that substantially meet our recommendations and those of the Public Accounts Committee.

- Force employment scenarios describing the possible use of the Canadian Forces have been completed and are being used to screen individual projects and requirements and to plan the most recent force structure adjustments.

- A much more disciplined force development framework has been designed and put in place. This framework is based on a “Canadian Joint Task List”, which is an inventory of individual military tasks that the various force employment scenarios may require. A Senior Management Oversight Committee, chaired by the Deputy Minister and the Chief of the Defence Staff, has approved relative levels sought for the top-level capabilities. This guidance will allow a more rational and transparent basis for funding some projects in preference to others. It also provides explicit links back to policy goals. In May 2000, the duties of the Senior Management Oversight Committee were taken over by the Joint Capability Requirement Board, chaired by the Deputy Minister, Chief of the Defence Staff or the Vice Chief of the Defence Staff. The change made this process a formal part of the Department’s management process.

- The Department has conducted its own analyses of the total budget requirements generated by both current policy goals and its existing force structure. These analyses largely confirm our 1998 findings and provide a much sounder basis for planning.

- The Department has announced that it intends to rethink its force structure. In *Shaping the Future of Canadian Defence: A Strategy for 2020* published in June 1999, the Department stated that it had a five-year target for designing a “viable and affordable” force structure based on a modernization program allocated a minimum of 23 percent of the Defence budget. As a first step, the current Defence Planning Guidance 2000 has set

an interim goal of 21 percent by April 2004.

Parliament has not been provided with a full appraisal of the capability of the Canadian Forces

16.119 We recommended that the Department provide to Parliament sufficient information on military capabilities, performance and resources so that it could better review the Department’s Estimates. The Public Accounts Committee recommended that the Department include in its annual Performance Report a comprehensive defence review and assessment and provide indicators that would show how well the capital acquisition plan met defence capability goals.

16.120 The government rejected these recommendations as either impractical, as in the case of an annual comprehensive statement, or already addressed by various public documents.

16.121 None of the documents that the Department cited provide a great deal of information on the state of the Canadian Forces. The Department’s 1999 Performance Report provides very little quantified data on whether the Canadian Forces have met military readiness and performance standards. Only vaguely worded statements are provided, such as “we have exceeded expectations,” “the Department of National Defence and the Canadian Forces are working hard to meet the challenges they are currently facing,” and “. . . even with additional resources, Defence will have to continue to make hard choices. . . . The Canadian Forces cannot be all things to all people. Priorities must be set and decisions must be made.” The Chief of the Defence Staff’s Annual Report on the State of the Canadian Forces does not assess the overall state of equipment and provides only a list of new equipment received. According to the Report on Plans and Priorities - 2000, “. . . the Canadian Forces are now more combat capable than

The government rejected recommendations to tell Parliament more about the capability of the Canadian Forces.

A budget shortfall still exists.

they were ten years ago.” This statement is not fully explained, but appears to rest on the fact that some new equipment was received.

16.122 The Department continues to develop performance indicators for reporting to Parliament; however, according to the Defence Planning Guidance 2001, they will not be completed until 2001. Officials told us that the Department would provide Parliament with a “snapshot” appraisal of Canadian Forces capabilities in the next reporting period.

Documents show a major decline in capability, a continuing budget crisis and imminent restructuring of the Canadian Forces

16.123 Documents indicate that the budget crisis is continuing to place the Canadian Forces under severe stress and that cuts affecting force structure and readiness are continuing. The publicly available Defence Planning Guidance 2000 and 2001 announced several changes to force structure:

- The Navy will lose the operating budget for two KINGSTON class maritime coastal defence vessels, for which the acquisition payments were just completed. The admirals on the East and West coasts may continue to operate these two vessels if they can find funds internally. The Navy will also retire two mine sweeper auxiliaries.

- The Air Force has removed 8 of its 14 Challenger jets and will remove its Silver Star aircraft from service by 2001-02. This will suspend the Canadian Forces’ ability to conduct its own

electronic warfare training until contract support can be secured. In addition, two DASH-8 aircraft were declared surplus.

- The Department called for a 10 percent reduction in infrastructure from its component parts.

16.124 The business plans of the individual services for the 2000 planning year indicate that additional reductions are planned. The Air Force faces the largest cuts: the CF-18 fleet may be reduced from 122 to 80 aircraft and, overall, the Air Force will shrink from 460 aircraft to 257. The Army has not yet determined how it will restructure itself, but it could also face significant reductions in its order of battle. The Navy points to problems in maintaining fleet readiness and intends to adopt a new readiness policy.

16.125 A review of the Department’s budgetary situation concluded in November 1999 that the Department had lost all flexibility to cope with cumulative resource pressures and was “out of manoeuvring room.” Defence planners estimated that the Department would require over \$1 billion annually in additional funding to operate even a smaller force while modernizing, revitalizing infrastructure and maintaining readiness. The federal Budget for 2000 added \$400 million to the first year of the three-year planning period, and funds will grow to about \$600 million in the final year. A significant shortfall therefore remains.

16.126 In summary, there is a need to provide Parliament with a more complete picture of the capabilities of the Canadian Forces.

Department of National Defence — Buying Major Capital Equipment — 1998, Chapter 4

*Assistant Auditor General: David Rattray
Principal: Peter Kasurak*

Background

16.127 In 1998 the Department of National Defence was responsible for capital equipment programs costing about \$6.5 billion over the next five years. Our audit focussed on analysis of requirements and options; risk management; test and evaluation; project management, monitoring and control; and the implementation of best practices in project management. We audited six major capital projects with a total value of \$3.3 billion.

16.128 We found several shortcomings in how the Department managed major equipment projects. Management did not conduct adequate analyses to justify its spending decisions, and options analyses were poorly done. Only one project out of six met our expectations for risk management. Test and evaluation processes were satisfactory, but commercial off-the-shelf equipment was sometimes not tested under actual military conditions. As a result, deficiencies appeared after the equipment was in service. The Department lacked an implementation plan for renewal of the capital acquisition process.

16.129 The Public Accounts Committee held hearings on our report and recommended that the Department strengthen its process for assessing requirements and options, conduct operational testing, particularly of off-the-shelf equipment, and develop and implement a framework for reporting project performance to senior management.

Scope

16.130 We followed up on our recommendations and those made by the Public Accounts Committee. We interviewed the managers responsible and reviewed documentation. We also reviewed all internal audits of capital projects completed by the Department since the time of our audit.

16.131 In addition, we reviewed four newer capital projects to determine if improvements made by the Department in its management processes were being implemented. The projects we selected were Clothe the Soldier, Search and Rescue Helicopter, Maritime Helicopter and the Submarine Capability Life Extension project. We did not audit these projects fully against our original criteria, nor did we attempt to form an opinion on the overall management of these four projects.

Conclusion

16.132 The Department has taken action to reform its management systems in line with our recommendations and those of the Public Accounts Committee. The Department has gone substantially beyond its original responses to us and to the Committee.

16.133 Improvement in the management of individual projects is evident, but is not yet universal.

Observations

Analysis of requirements and options is improving

16.134 In 1998 we reported that three of six projects audited did not meet standards

The Department has taken action on our recommendations.

for analysis of requirements and five of six did not meet standards for options analysis. As a consequence, we found that the equipment purchased often did not meet the actual needs of field forces.

16.135 The Department has taken steps to improve its analyses. It has created an intranet site for its Materiel Acquisition and Support Desktop. This document includes detailed guidelines for developing a statement of requirements and some guidance on how to conduct an options analysis. The guidelines for the statement of requirements are based on those of the Project Management Institute and incorporate other improvements such as specifying the use of the Department's standard conflict scenarios.

16.136 Senior management has become much more involved in determining fundamental requirements through the use of the Joint Capability Requirement Board. New tools, such as conflict scenarios and the Canadian Joint Task List, are now used to assess options.

16.137 We found evidence of improvement in the Clothe the Soldier and the Maritime Helicopter projects. According to an internal audit, the statement of requirements for the Clothe the Soldier project was complete, valid and reviewed by users. The statement of requirements for the Maritime Helicopter is well documented and is based on a series of operational research studies.

16.138 However, not all projects showed improvement. The Submarine Capability Life Extension project, through which the Department will purchase four used British submarines for about \$800 million, was weak in several ways. The Submarine statement of requirements was completed only a month after our audit report was tabled to Parliament. The statement is incomplete, as it does not define the requirement stated in the 1994 White Paper for submarines to deploy as part of a Canadian Task Group. Although the statement places heavy stress on

surveillance in Canadian waters for fisheries patrol and counter-smuggling operations, the utility of submarines for this task is poorly substantiated. The option of using long-range patrol aircraft for surveillance was not examined.

Risk management processes have been strengthened

16.139 In its original management response to our audit, the Department did not make any specific commitment to improve risk management, although officials told us that improvement in this area was an integral part of the overall reform initiative. Nevertheless, the Department has made a series of improvements that should greatly improve its capacity to reduce its risk:

- The Treasury Board Risk Management Guide has been adopted and incorporated in a new three-day extension to the Department's project management course.
- A risk management template has been included in the Materiel Acquisition and Support Desktop on the Department's intranet.
- Management teams of major projects will receive "just-in-time" risk management training.
- Reviews by the Directorate of Business Change Management and internal audits will be conducted early in the life of major projects to assess risk management plans and recommend improvements.

The risk management of individual projects is slowly improving. There is still a tendency to underestimate risk. Internal audit noted the arbitrary downgrading of assessed risk in reports to senior management.

16.140 In one case, the Submarine Capability Life Extension project, risk analysis was incomplete. Officials told us that limited access to the boats in the early phases of the project reduced their ability

to do a full risk analysis. The project team is now completing a risk management plan for the Canadianization of the submarines.

16.141 The highest level of improvement was noted in the risk management plan for the Search and Rescue Helicopter. This project's plan describes its risk management process, which is supported by a database. Working-level managers identify risks and table them at a Risk Management Committee chaired by the Project Manager. The Committee reviews the most significant risks, reports higher-level risks to senior management and ensures that the Project Profile and Risk Assessment is continuously updated. The Department has identified this as a best practice and intends to transfer it to additional projects.

16.142 In the case of the Electronic Support and Training Systems project, poor risk assessment and the mismatch between the capital acquisition program and the funds available contributed to losses beyond those reported in our 1998 audit. The case is more fully described in Exhibit 16.3.

Some action has been taken to improve test and evaluation

16.143 Our report and that of the Public Accounts Committee both called for increased test and evaluation, especially of off-the-shelf equipment. Equipment suitable for commercial use or other militaries might not be suitable for the Canadian Forces.

16.144 As with risk management, the Department made no specific commitment to improve test and evaluation in response to our original recommendation and that of the Public Accounts Committee. The Department said only that it would take action on the existing practices our audit had found inadequate. Subsequently, officials told us that the Department has

taken several steps to improve test and evaluation:

- Test and evaluation is being integrated with risk management, and project managers are required to address test and evaluation as part of their overall risk management strategy.
- Integrated Project Teams are attempting to integrate contractor and departmental test and evaluation processes.
- The Department is investigating other reform initiatives to minimize equipment performance deficiencies.

16.145 We found additional evidence that off-the-shelf purchasing includes inherent risks that require a strong test and evaluation program to minimize them. The Clothe the Soldier project, aimed at providing combat clothing and protective equipment to ground troops, was at first based on a fast-track, purchase off-the-shelf approach. However, a well-devised test and evaluation program determined that much commercial or foreign military equipment would not meet requirements. While this project has incurred both time and cost overruns beyond original estimates, the Department's re-evaluation of its requirement should be regarded as good management in that a mistaken decision was overturned and value for money was preserved.

16.146 According to an internal audit, an off-the-shelf vehicle-launched grenade, which was purchased for about \$750,000 without adequate testing for the intended use by the Canadian Forces, has not been used due to concerns about the safety and suitability of a munition potentially lethal to the troops using it. The Department needs to reappraise its position that off-the-shelf equipment is inherently less risky to purchase than developmental types.

The \$200 million Electronic Support and Training project failed to meet original requirements and was abandoned when complete.

Senior departmental management is better informed

16.147 We recommended that the Department enforce its requirement that all projects use the Cost Schedule and Performance Management Standard to report to senior management. The Public Accounts Committee made a similar recommendation. National Defence, in

co-operation with Public Works and Government Services Canada, has begun to develop a new capital project reporting system. This system exists in prototype now and is scheduled to be fully implemented by the end of 2000. At present, project reports are somewhat uneven in quality, but the better ones provide adequate information.

Exhibit 16.3

Electronic Support and Training Systems Project

The Electronic Support and Training Systems project was intended to develop, procure and install equipment necessary for the Canadian Forces to conduct electronic warfare training for the Navy, Army and Air Force. The total estimated cost of the project was \$203 million. The project began in 1988.

As our audit noted, internal project documentation suggested that the project faced technical risks with a high probability of occurrence. However, National Defence had reported to the Treasury Board that the risk of exceeding cost and falling behind schedule was a low probability and the risk of failing to meet project expectations was a low to medium probability.

At the time of our audit, elements of the project had cost overruns totalling \$22 million. Officials told us that they would deal with these overruns by adopting a non-conventional in-service support approach. We also reported that the project was 22 months behind schedule.

However, in late February 1998, before our audit report was finalized, a Senior Review Board decided to substantially reduce the scope of the project. According to officials, the installation of high-powered jamming equipment into a small commercial business jet produced unforeseen technical challenges. Efforts to solve these problems depleted the budget, and further work required to resolve system processor and integration problems created an excessively high technical risk that would not be reduced even with additional funding. A decision was therefore made not to install electronic countermeasures, electronic support systems and the system processor in the Challenger jets. This meant that the development and purchase costs of this equipment and engineering costs of the attempted installation were written off. In addition, the partially completed aircraft no longer met the requirements of the Canadian Forces.

Other components of the project, including fitting the Challenger jets with communications-jamming and chaff-dispensing equipment, were successfully completed. In addition, 19 radar-jamming, chaff-dispensing and threat simulation pods and modifications to 10 CE-133 T-bird aircraft were also completed.

In August 1999, the Department announced that the partially completed Challenger aircraft would be declared surplus in April 2000 and that the T-birds would be withdrawn from service by the end of fiscal year 2001–02. This action was taken because of the Department's overall shortage of funds and inability to support its force structure. Much of the investment has therefore been written off, leaving the Canadian Forces without the planned electronic warfare capability provided internally. The Department may recoup some of its losses through the sale of the equipment or its use by a contractor.

The Department's broader force structure decision to retire all its T-bird aircraft and Challenger jets used for electronic warfare training and medical evacuation, and to write off its investment in favour of private sector outsourcing was made, in part, because:

- inadequate risk management resulted in the Department's inability to complete the project as planned; and
- inadequate budgetary management led to the acquisition of equipment that proved to be unaffordable to operate as soon as it was completed.

16.148 The Department has also instituted two additional means of monitoring project performance:

- Annual reviews of major projects by the Directorate of Business Change Management are aimed not only at assessing the management of projects, but also providing assistance to improve any weak areas.
- Early and “quick time” reviews are done by the Chief Review Services.

Overall, management is receiving more and better information on the progress of major capital projects than at the time of our audit.

The Department is slowly improving the capacity of its people

16.149 In 1998 we noted that National Defence did not have an adequate plan to ensure that it had people with the right skills in the right place to manage major capital equipment projects. We noted, however, that it did have a civilian procurement officer development program in place.

16.150 Officials told us that the required human resources plan will be completed by the fall of 2000. The Materiel Group is recruiting 13 developmental civilian procurement officers, some with Master’s

degrees, and about five junior engineers for development. For military engineers expected to lead equipment management teams, including capital acquisition projects, equipment program management and leadership training has been established as a qualifying course to achievement of Major rank. In addition, the Materiel Group has identified performance requirements or competencies for procurement careers, and improved training programs and tools will be piloted in the fall of 2000.

The Department is continuing improvements in project management

16.151 We suggested that the Department develop a more rigorous approach to improving project management by having a plan, selecting pilot projects to test innovations and recording the results against pre-set objectives. The Department initially followed this approach but was forced to abandon it as it was too labour intensive. The Department has continued to improve project management by concentrating its resources on reviewing and providing direct assistance to its largest and highest-risk projects. It is also participating in the Federal Procurement Reform project led by the Treasury Board Secretariat.