

**SUPPLEMENTARY INFORMATION
OBSERVATIONS OF THE AUDITOR GENERAL
ON THE
FINANCIAL STATEMENTS OF THE GOVERNMENT OF CANADA
FOR THE YEAR ENDED MARCH 31, 2001**

MAIN POINTS

The purpose of these Observations is to explain in more detail the meaning of my report on the Financial Statements of the Government of Canada for the year ended March 31, 2001. The main points I discuss here are as follows:

The Observations explain my Report on the Government's financial statements and my audit of them.

- The balance in the Employment Insurance Account stood at \$36 billion on March 31, 2001, which is well in excess of \$15 billion, the maximum amount considered necessary by the Chief Actuary of Human Resources Development Canada. The Employment Insurance Commission did not provide an adequate justification for the size and rate of growth of the Account balance. Accordingly, I am unable to conclude that the intent of the *Employment Insurance Act* has been observed in setting the 2001 premium rates.
- In the past five years, the Government has recorded as expenditures some \$7 billion in transfers to various foundations it created to achieve its public policy objectives, even though most of the \$7 billion, including interest, is still in the foundations' bank accounts and investments. I am concerned that the Government's accounting policy for transfers does not adequately consider situations wherein the funds are not used for their ultimate intended purpose within the year or shortly thereafter. I am also very concerned about several accountability and governance issues with these foundations.
- I am concerned that the Government created and provided \$50 million in funding to a corporation to carry out a sustainable development technology initiative before Parliament had explicitly approved either the initiative or the funding.
- This is the final year that the Government will present its financial statements on a modified accrual basis of accounting. Beginning next year, it will prepare them on a full accrual basis. Departments are in the process of accumulating necessary information. This includes, for example, capital asset values, estimates of environmental obligations, accruals of taxes receivable, and accruals of liabilities for Aboriginal claims. This task for the Government's financial community is a challenging one and though departments are making progress, they still have much to do.

I believe strongly that the Government's financial statements, included in these Public Accounts, and the Annual Financial Report published separately by the Minister of Finance are extremely important accountability documents. They must be credible, understandable, useful, and timely. I will encourage the Government to present the economic substance of its activities and transactions in its financial statements. I will also bring Parliament's attention to any instances that come to my attention wherein the Government has deviated from accepted parliamentary process.

THE OTHER MATTERS FOR PARLIAMENT'S ATTENTION INCLUDED IN MY AUDIT REPORT

Compliance with the *Employment Insurance Act*

One of my roles as a legislative auditor is to review the Government's compliance with parliamentary authority to raise taxes and other revenues and to spend public money. Further details on this compliance aspect of my mandate are provided in the section of these Observations that describe the meaning of my report.

Employment Insurance premiums and benefits are included in the revenues and expenditures, respectively, reported in the Government's Statement of Revenues, Expenditures and Accumulated Deficit. Under the *Employment Insurance Act*, a separate accounting of these revenues and expenditures must be made. This is presented in the financial statements of the Employment Insurance Account, in Section 4 of this Volume.

The *Act* also requires that in setting premiums, the Employment Insurance Commission ensure, to the extent possible, that the rate levels provide enough funding to cover program costs and that they remain relatively stable throughout a business cycle. This provision of the *Act* was in effect for the Government's fiscal year ended March 31, 2001.

In my report on the Account's financial statements, I draw attention to the size and continued growth of the balance in the Account. It increased by about \$8 billion during the year and amounted to \$36 billion at March 31, 2001. That balance is well in excess of \$15 billion, the maximum amount considered necessary by the Chief Actuary of Human Resources Development Canada.

The Commission did not provide an adequate justification for the size and rate of growth of the Account balance. Therefore, in my report on the Account's financial statements, I stated that I was unable to conclude that the intent of the *Act* had been observed in setting the 2001 premium rates.

Recent amendments to the *Act* suspended the rate-setting requirements for 2002 and 2003. The Government has indicated that the requirements were suspended so that it could undertake a review of the premium-rate-setting process. Those amendments could preclude meaningful consultations with employees and employers, and Canadians generally, on the Employment Insurance premiums to be established for 2002 and 2003. I therefore encourage the Government to complete that review expeditiously to ensure the transparency of the rate-setting process.

Transfers to Foundations

Background. Since April, 1997 the Government has created at least nine significant organizations, or foundations, to carry out certain of its public policy objectives. Six of them were announced in 2000 alone. The Government has transferred some \$7 billion in cash to these foundations and has recorded the transfers as expenditures in the financial statements. At March 31, 2001, most of the \$7 billion, including interest, was still in the foundations' bank accounts and investments, yet to be distributed to the ultimate intended recipients or used for the ultimate intended purpose of this Government spending.

This growth in the number of foundations and the amount of public money entrusted to them is having an increasingly significant effect on the Government's financial statements. We have therefore looked closely at this situation in this year's audit and have further developed our views of the accounting followed for transfers to the foundations. Table 1 provides details on the foundations and the Government's transfers to them.

I have been unable to conclude that the Employment Insurance Commission has complied with the intent of the law in setting the 2001 premium rates.

Foundation	Government Expenditures on Foundations Recorded in Fiscal Year Ended March 31						Table 1 Foundations' Cash and Investments
	1997	1998	1999	2000	2001	Total	March 31, 2001 ¹
	(\$ millions)						
Canada Foundation for Innovation ⁴	800		200	900	1,250 ²	3,150	3,041 ²
Aboriginal Healing Foundation ³		350				350	324
Canada Millennium Scholarship Foundation ⁴		2,500				2,500	2,493
Canadian Foundation for Climate and Atmospheric Sciences ³				60		60	62
Genome Canada ³				160	140 ²	300	306 ²
Green Municipal Enabling Fund ⁵				25		25	26
Green Municipal Investment Fund ⁵				100		100	105
Foundation for Sustainable Development Technology in Canada ³					100 ²	100	100 ²
Canada Health Infoway Inc. ³					500	500	500
Total	800	2,850	200	1,245	1,990	7,085	6,957
Note:							
<ol style="list-style-type: none"> 1. These balances are at the date of the latest annual report where March 31, 2001 financial statements are not yet available. It is estimated that interest of \$0.6 billion was earned on the \$7.1 billion transferred, \$0.6 billion has been paid to ultimate recipients or used for the ultimate purpose, and \$0.1 billion has been paid in administration costs, leaving the balance of \$7.0 billion at March 31, 2001. 2. The amount shown for 2001 was not actually received by the foundation at March 31, 2001. However, because it is reflected at that date as an account payable by the Government, we have reflected the amount as an asset of the foundation. 3. The foundation was created under the <i>Canada Corporations Act</i>. 4. The foundation was created under separate legislation. 5. The fund is not a separate corporate entity; it is administered by an existing organization. 							

There are many delivery vehicles the Government could have chosen to achieve its objectives, including departments, special operating agencies, Crown corporations, existing private sector organizations that carry out similar activities, or these foundations. Government officials explained to me that the foundation vehicle was chosen for the following reasons:

- ◆ Because they are intended to be at arm's length from the Government, foundations can attract funding from the private sector.
- ◆ Funding agreements allow the foundations to operate independent of the day-to-day involvement of the Government, including its rules and regulations. In this way, they are expected to achieve greater efficiency, flexibility, citizen participation, and client satisfaction.
- ◆ The foundations have the freedom to take reasonable risks and adopt innovative ways of achieving, in a more cost-effective way, the Government's objectives for which they are responsible.

The Government has recorded transfers to the foundations as expenditures in its financial statements, and it has therefore been able to report a smaller surplus (or larger deficit) each fiscal year since 1996-1997. It is a clearly stated Government strategy that spending initiatives will be introduced only when the Government is reasonably certain that it has the necessary resources to do so, and the availability of resources does not become apparent until near the end of the fiscal year. This is an appropriate and prudent practice. But it has been suggested that

The creation and funding of foundations should not be driven by a desire to achieve a particular accounting result.

accounting rules are leading to the choice of the foundations – and their funding – as the delivery vehicle for those spending initiatives. In my view, decisions as to the vehicles to be used to deliver Government objectives and the amount and timing of their funding should be based on sound economic and policy analysis; they should not be based on the goal of achieving a desired accounting result such as reducing the reported annual surplus. In other words, decisions as to whether an initiative is affordable and how to account for it are quite distinct and should be made on different bases.

In order to record the transfers as an expenditure in the fiscal year, the legislation to create the foundations or to provide additional funding to existing foundations must receive royal assent in the year, or early in the next fiscal year. For such foundations as the Canada Foundation for Innovation and the Canada Millennium Scholarship Foundation, an announcement was made in the February Budget; legislation was introduced in March or April; and royal assent was granted before Parliament recessed in mid-June for the summer.

In cases where the Government did not use legislation, it sometimes was instrumental in creating a not-for-profit corporation under the *Canada Corporations Act*. Funds were transferred to the corporation as soon as it had been created. This removed from the controls required under the *Financial Administration Act* public money that will not be received by the ultimate intended recipients or used for the ultimate intended purpose for years to come. For such corporations as the Foundation for Sustainable Development Technology in Canada and Canada Health Infoway Inc., a limited group of directors had signing authority over millions of dollars of taxpayer-funded investments before a full board of directors was established and operating. While the use of the funds is subject to a detailed funding agreement between the Government and the newly created corporation – including a clause that prohibits the funding of projects until a full board is established – we noted that if the corporation were dissolved for some reason, its remaining assets would be liquidated. They would not be returned to the Government, but would be distributed to prior recipients of funding or to organizations with similar objectives.

Accountability and governance of the foundations. In Chapter 23 of our November 1999 Report, we recognized that the foundations have potential benefits. We were told of the competence, dedication, and sense of public service exhibited by those then involved in managing the foundations. However, we noted that while enthusiasm, client good will, and the determination of foundation appointees to gain public confidence and to make the foundations succeed might offset weak accountability and governance structures in the short term, alone they were not enough to ensure long-term success.

Many of the foundations we examined had been put together in an ad hoc way that placed accountability to Parliament at risk unnecessarily. We noted that Parliament had limited means – in some cases, no means – of holding the Government to account for the federal functions the foundations performed or the federal objectives they were to achieve. Since Treasury Board Secretariat (TBS) had not tracked or evaluated trends, successes, or issues emerging from the establishment of the foundations, we recommended that it assess the appropriateness of the use of the foundations, what they had cost, and how effective or responsive they had been. I plan to publish a report on the progress made since that time in my April 2002 Report.

I am concerned that these huge amounts of public money are provided up front to foundations when there is such limited assurance of proper controls and accountability and the funds are not to be spent by them for years and years to come. Government officials explained to me that providing up-front funding – together with iron-clad agreements that even in the event of dissolution, any remaining funds held by the foundations would not be returned to the Government – demonstrates to the foundations and its partners that no matter what happens, the funding for these initiatives will be there. And it will not be subject to changes in the objectives of future governments.

The practice of funding foundations years before they need the money, as well as the accountability arrangements for them, deserve a thorough debate in Parliament.

In my view, this limits the flexibility of future parliaments and governments to respond to changing circumstances and priorities. The up-front funding of – and accountability arrangements for – foundations therefore deserve a thorough debate in Parliament before any further public money is transferred to them.

Accounting for transfers to the Foundations. I believe that the basis of accounting used by the Government did not envision these transfers to the foundations. The recognition of transfers as expenditures was based on the fact that funds spent in a given year had been received by the ultimate intended recipient or used for the ultimate intended purpose in that year, or shortly thereafter. In fact, TBS's own policy on transfer payments indicates that payments should not be made in advance of need. However, it should be noted that this policy also provides for exceptions, subject to approval by the Treasury Board – and such approval was granted for the transfers to the foundations.

The ultimate intended purpose of the \$7 billion in Government initiatives is to encourage innovation, help with the costs of post-secondary education, and so on, by providing grants to qualified recipients in the most effective way. The actual payment of those grants to the intended recipients is the real economic event that takes place, not the transfer to the distribution agent. Consequently, economic substance would be better presented in the Government's financial statements by recording expenditures in the years the grants are provided by the conduit foundations to the ultimate intended recipients, or used by the foundations directly for the government's ultimate intended purposes.

And, in fact, TBS requires this of departments, stating that their "financial statements should present the economic substance of transactions and events even though their legal form may suggest a different treatment"¹.

In the National Accounts, transfers between the Government and the Canada Foundation for Innovation and the Canada Millennium Scholarship Foundation are considered intragovernmental transfers. Cash transfers are accounted for as expenditures only when disbursed to the ultimate intended recipients by those foundations.

Further, I question whether, in substance, some of these foundations are truly at "arm's length" from the Government given the following considerations²:

- Most foundations are legally obliged to achieve Government policy objectives as their prime mandate.
- The chairperson and a minority of the board of directors are, in many cases, appointed by the Government (in some cases, though, the minority is a slim one - 7 of 15 directors). There is significant Government influence in the appointment of the remaining directors.
- In some cases, the Government created the foundations through its own legislation and all or most of their funding comes solely from the Government.
- The legislation often prescribes things like the location of the foundations' head office, prohibitions on borrowing money and application of an official languages policy to the foundations as though they were federal institutions.
- In some foundations not created by legislation, the Government selects the initial board members and drafts the foundations' letters patent and by-laws; changes to those by-laws must be approved by the Government.

1 Paragraph 2.6 of the TBS Financial Information Strategy Accounting Manual.

2 It should be noted that while some of these considerations apply variously to other grants and contributions programs, it is their collective applicability to the foundations that raises questions about the arm's-length relationship.

Accounting for transfers to the foundations does not reflect the economic substance of Government spending.

- In most cases, detailed funding agreements between the Government and the foundations establish what criteria the foundations must use for support to recipients, how the funds are to be invested, and how any remaining funds are to be distributed in the event of dissolution.
- In many cases, there is a clear Government presence in the promotion and marketing of significant grants made to recipients.

Summary and conclusion. I have raised several concerns that are summarized below:

1. Creation of some foundations and additional funding to existing ones requires approval by Parliament before the Government's financial statements are finalized to achieve a desired accounting result.
2. Public money is sometimes put at undue risk because it is transferred to the foundations years in advance of need, contrary to the Government's policy for most transfer payments.
3. In most cases, were a foundation to be dissolved for some reason, any remaining funds would not return to the Government.
4. Parliament has limited means of holding the Government or the foundations accountable for the federal functions they are to achieve.
5. This new vehicle for achieving Government objectives limits the flexibility of future governments and parliaments to respond to changing circumstances and priorities.
6. The accounting for transfers to the foundations does not present the economic substance of Government spending.
7. Summary-level information on the Government's activities as they relate to some of the foundations is presented inconsistently between the National Accounts and the Public Accounts.
8. Although many of the foundations are intended to be at arm's length from the Government, it is questionable whether they actually are.

Because of these concerns, I seriously considered whether I would qualify my opinion on the Government's financial statements or draw Parliament's attention to this serious matter in a separate paragraph of my report. I have chosen the latter option.

I cannot state unequivocally that the Government has not complied with objective accounting standards established by the Canadian Institute of Chartered Accountants' Public Sector Accounting Board (PSAB). Objective accounting standards promulgated by PSAB cannot anticipate all the new things governments will do, and the Government's own stated accounting policies allow it the latitude to record these transfers as expenditures of the year in which the foundations were announced. However, PSAB does recommend that financial statements be prepared to present the substance of transactions and events.

In light of questions and concerns raised about the accounting by governments in Canada for transactions such as those involving the foundations, PSAB has initiated two projects to clarify accounting standards in these areas. The Government should closely monitor progress on these two projects, due to the amount of public money involved with the foundations and the resultant distorting effects of its current accounting policies.

I urge the Government to change its policies as they relate to the foundations in next year's financial statements to properly account for the substance of these transactions. This change

The Government should present the substance of transfers to the foundations in its 2002 financial statements that will be prepared on a full accrual basis of accounting.

should be consistent with other changes to introduce accrual accounting next year. As noted later in these Observations, accrual accounting will present the use of resources by the Government in its financial statements rather than the current presentation of the cash used to acquire resources. The change I am suggesting goes hand in hand with the move to accrual accounting.

The change I am suggesting for the foundations can also be made in accordance with existing PSAB standards. Naturally, the change would be re-visited at the time PSAB completes its work. However, because the change introduced by the Government would reflect the underlying economic substance of transactions with the foundations, it is unlikely further material modifications to accounting policies would be necessary.

MATTERS REQUIRING ATTENTION THAT ARE NOT INCLUDED IN MY AUDIT REPORT

The Canada Foundation for Sustainable Development Technology³

I have serious concerns with the events surrounding a \$100 million grant to the Canada Foundation for Sustainable Development Technology.

Background. Included in “other transfer payments” on the Statement of Revenues, Expenditures and Accumulated Deficit is a \$100 million transfer payment to the Foundation for Sustainable Development Technology in Canada⁴. An equivalent amount is included in accounts payable and accrued liabilities on the Statement of Assets and Liabilities.

On May 29, 2001 I was asked to appear before the Standing Senate Committee on Energy, the Environment and Natural Resources to discuss Bill C-4, introduced to establish the Foundation. In my opening statement to the Committee, I expressed concern about the process followed in the transfer of \$100 million to fund this initiative. I stated that my Office had not yet audited the transfer; our eventual audit would cover whether appropriate authority for this transfer was in place at the time it was made and whether the transfer was accounted for properly. I did not question, however, the fact that the ministers of both Natural Resources and Environment have the authority to undertake this type of activity under existing programs through the *Energy Efficiency Act* and the *Department of Environment Act*.

In my audit of the Government’s financial statements, I have now examined this transaction. At the date of completing these Observations, \$50 million of the \$100 million account payable had actually been paid to the Corporation. Assuming, in the normal course of expected events, the ultimate completion of the Supplementary Estimates process and the resulting *Appropriation Act* for 2001-2002, I have found that the legal interpretation of the authority used for those payments is acceptable. I have found that the \$100 million transaction was accounted for as a liability and expenditure in accordance with the stated accounting policies of the Government of Canada, as set out in Note 1 to the financial statements. However, my audit of this transaction raised several concerns that I would like to bring to Parliament’s attention.

³ In these Observations, the Canada Foundation for Sustainable Development and Technology — established by Bill C-4 — is referred to as “the Foundation”. The Foundation for Sustainable Development Technology in Canada — established under the *Canada Corporations Act* — is referred to as “the Corporation”.

⁴ Ibid.

The process used to create the Foundation. Table 2 shows a chronology of the events related to the Foundation.

<i>Canada Foundation for Sustainable Development Technology</i>		<i>Table 2</i>
<i>Chronology of events</i>		
Date	Event	
February 28, 2000	The Sustainable Development Technology Fund was proposed in the February 2000 Budget.	
October 4, 2000	Bill C-46 to create the Foundation was introduced but died on the order paper due to the election call.	
February 2, 2001	Bill C-4 was given first reading in the House of Commons. The Bill proposed the creation of the Canada Foundation for Sustainable Development Technology and proposed that any corporation incorporated under Part II of the <i>Canada Corporations Act</i> , continue as the Foundation.	
March 8, 2001	A not-for-profit corporation named the Foundation for Sustainable Development Technology in Canada was established by four Canadian citizens under Part II of the <i>Canada Corporations Act</i> .	
March 26, 2001	A funding agreement was signed between the Government and the Corporation. The funding agreement sets out the duties of the Corporation, the determination of eligible recipients of funding, and the criteria for selection of projects, as well as other governance matters.	
March 31, 2001	The Government's fiscal year ended. Bill C-4 had passed second reading, and third reading debate commenced in the House of Commons on April 5, 2001.	
April 9, 2001	\$25 million was paid to the Corporation by Natural Resources Canada.	
April 11, 2001	\$25 million was paid to the Corporation by Environment Canada.	
June 14, 2001	Bill C-4 was given royal assent as the <i>Canada Foundation for Sustainable Development Technology Act</i> . It is anticipated that this Fall, the Corporation will cease to exist and the entity will continue as the Foundation.	

The Corporation created by four Canadian citizens – and not the Foundation proposed in the Bill - would have been able to carry out the Government's objectives as outlined in the February 2000 Budget even if Bill C-4 had not received royal assent. The Senate Committee reacted very strongly to this as well as to the process used by the Government to create the Foundation. Appended to its Report to the Senate at Third Reading of the Bill was the following statement:

“The actions of the Government of Canada in creating a private sector corporation as a stand-in for the Foundation now proposed in Bill C-4, and the depositing of \$100 million of taxpayers' money with that corporation, without the prior approval of Parliament, is an affront to members of both Houses of Parliament. The Committee requests that the Speaker of the Senate notify the Speaker of the House of Commons of the dismay and concern of the Senate with this circumvention of the parliamentary process.”

This statement was the subject of a motion that was discussed in the Senate until the beginning of the summer adjournment. Further debate on the motion was adjourned until September 2001, when the Senate would reconvene.

The responsible Senate Committee reported that the Government's actions were: "...an affront to members of both Houses of Parliament... [and a] circumvention of the parliamentary process".

The four Canadian citizens who created the Corporation had signing authority, for several months, over a corporate bank account that received an initial investment of \$50 million in public money before Parliament had approved either the transfer or the sustainable development technology initiative. It should also be noted that the funding agreement between the Government and the Corporation – as well as the Corporation’s letters patent – provides that in the event of dissolution or winding-up of the Corporation, its remaining assets will not return to the Government. They would be distributed to recipients of prior funding that are still carrying on sustainable development technology projects.

As I stated earlier in these Observations, while the funding agreement prohibits the funding of projects before a full board of directors is established, this \$50 million of public money is not subject to the controls of the *Financial Administration Act*. I have also been unable to discover why it was necessary to make, in advance of parliamentary approval of Bill C-4, such a large transfer of funds to the Corporation to enable it to set up its offices and committees and to hire staff. In my view, a much smaller amount would have been sufficient.

I emphasize that my comments are not directed at these four individuals and in no way reflect on their honesty and integrity.

A spending authority for minor and unforeseen expenses was used to pay \$50 million to the Corporation.

The authorities used to fund the Foundation. Table 3 provides an analysis of the authorities used – and that will be used - to pay the \$100 million to the Corporation and the Foundation. I have concluded, provisionally, that Environment Canada and Natural Resources Canada made the two \$25 million payments in April 2001, using an acceptable legal interpretation of parliamentary authorities. My conclusion is provisional on the assumption that Parliament will approve the Supplementary Estimates, as described in Table 3.

<i>Canada Foundation for Sustainable Development Technology Authorities Used</i>		<i>Table 3</i>
Date	Event	
March 22, 2001	A temporary transfer of \$25 million is approved by Treasury Board to Vote 10 of each of Environment Canada and Natural Resources Canada from Treasury Board Vote 5, the Government Contingencies Vote.	
March 30, 2001	<i>Appropriation Act # 1</i> receives royal assent, providing interim supply to the Government.	
April 5, 2001	A Treasury Board Decision letter is sent to each department authorizing the \$25 million transfer to its Vote 10, from Treasury Board Vote 5.	
April 9, 2001	\$25 million is paid to the Corporation and charged to Natural Resources Canada Vote 10.	
April 11, 2001	\$25 million is paid to the Corporation and charged to Environment Canada Vote 10.	
June 14, 2001	<i>Appropriation Act #2</i> receives royal assent, providing Environment Canada with 2001-2002 spending authority for Vote 10 in the amount of \$2.85 million for the “grants listed in the Estimates...” and providing Natural Resources Canada with 2001-2002 spending authority for Vote 10 in the amount of \$0.6 million for the “grants listed in the Estimates...”	

December, 2001 (This is a projection as anticipated by TBS.)	<i>Appropriation Act #3</i> (the actual number will depend on the number of supplementary estimates required by the Government for 2001-2002) is expected to receive royal assent and to provide supplementary spending authority of \$50 million to Vote 10 of each of Environment Canada and Natural Resources Canada. The full amount for the Canada Foundation for Sustainable Development Technology is expected to be listed separately in the grants section for these two departments. Upon approval, Treasury Board Vote 5 is expected to be replenished for the \$25 million advanced to each of these two departmental votes in April 2001.
January, 2002 (after <i>Appropriation Act # 3</i> has received royal assent)	\$25 million is expected to be paid to the Foundation by each of Natural Resources Canada and Environment Canada and charged to the Vote 10 of each.

The Government Contingencies Vote authorizes the Government to “supplement other appropriations for payroll and other requirements and to provide for miscellaneous minor and unforeseen expenses not otherwise provided for ...”⁵. It is likely that Parliament will approve the Supplementary Estimates, retroactively authorizing the two \$25 million payments to the Corporation and the replenishment of the Government Contingencies Vote. However, I question whether it was appropriate for the Government to use a general contingency vote to provide \$50 million in temporary authority so the departments could make the grant payments to the Corporation, all before Bill C-4 received royal assent.

The Government Contingencies Vote has been used in the past to supplement other departmental grants and contributions votes. And in the Supplementary Estimates, the Government discloses in detail how Vote 5 was used. However, given the recent phenomenon of creating foundations, as I described earlier, and the size of the transfers, it may be appropriate that the practice of making significant grants under temporary authority from Vote 5 be reviewed.

I also question Government statements that the Corporation had to be established and the funds transferred to it quickly or the spending authority for the initiative would lapse. Parliament had not granted any spending authority for 2000-2001; therefore, there was no spending authority to lapse.

Finally, should Parliament not approve the Supplementary Estimates and thereby not give retroactive approval of the spending authority for the \$50 million already paid to the Corporation, my reading of Vote 10 for both Environment Canada and Natural Resources Canada leads me to conclude that these two \$25 million payments could not be charged to that Vote. This is because the grants to the Corporation do not fit within any of the classes of grants currently described in the Estimates of those departments. In addition, significant grants that are not part of a class of grants and contributions programs are required to be listed separately in Estimates documents. These two \$25 million grants are significant and are non-recurring transfers that are not part of an existing grants and contributions program of either Environment Canada or Natural Resources Canada.

So, should Parliament not approve the Supplementary Estimates, the Government would be required to seek the return of the \$50 million from the Corporation, since no money may be paid out of the Consolidated Revenue Fund without the authority of Parliament. At the same time, the Government is bound by the terms of the funding agreement with the Corporation. Any action to recover the funds would put the Government in breach of that agreement.

Parliament will not explicitly authorize the spending authority used for the first \$50 million in payments to the Corporation until December 2001, when the next 2001-2002 Supplementary Estimates are normally approved.

In my view, should Parliament not approve the Supplementary Estimates, other expenditures under more generally worded votes that received a transfer of spending authority from Vote 5 would not be in violation of those Votes' wording.

Conclusion. In conclusion, I find this series of transactions very troubling. The Senate Committee stated that traditional parliamentary process has been circumvented by the creation of this not-for-profit corporation. The transfer of a large sum of public money – much larger than in my view was necessary – to the Corporation before Parliament had approved either the initiative or the funding, was inappropriate. Furthermore, I can determine no compelling reason for the haste in which this occurred. While the Government obviously attempted to carry out this initiative before the fiscal year ended, I can only presume that it went through an unusual series of events around March 31, 2001 simply to achieve a desired accounting result. In its desire to record the expenditure in the 2000-2001 fiscal year, the Government did the following to legitimize this accounting entry:

1. Worked with four Canadians to ensure that a Corporation existed at March 31, 2001 to which a liability could be recorded.
2. Signed a funding agreement with the Corporation in the last week of the fiscal year to demonstrate its commitment to pay the \$100 million.
3. Paid \$50 million to the Corporation as early as possible in the new fiscal year, notwithstanding that Parliament had not yet explicitly approved either the initiative itself or its funding.

I certainly hope that in the rest of my tenure as Auditor General of Canada, I will not see another such series of events carried out to achieve a desired accounting result.

The Financial Information Strategy (FIS): The move to full accrual accounting

For a number of years, the Government has been implementing FIS, which has three components: the implementation of new financial systems; the adoption of full accrual accounting; and the provision of improved financial information to managers. My Office continues to fully support this important initiative.

My Office's work to date indicates that while the Government has made significant progress, it needs to do further work to fully meet its objectives for FIS. In my December 2001 Report, I will discuss the Government's progress in implementing the new financial systems and providing improved financial information. Here, in these Observations, I will focus solely on the adoption of full accrual accounting.

This will be the last year that the Government will prepare its financial statements on a modified accrual accounting basis. Beginning in 2001-2002, it will move to full accrual accounting in accordance with the recommendations of PSAB. It should be noted that the 2000-2001 amounts shown for comparison in next year's financial statements will not change from those reported in this Section of *Public Accounts* Volume I, except the restatement of the Accumulated Deficit for the opening impact of the accounting policy changes.

The move to full accrual accounting means that for the first time, the Government's financial statements will include tangible capital assets, assets for purchased or developed software, environmental liabilities, taxes receivable, prepaid expenses, and revised methods of accounting for Aboriginal claims. These amount to tens of billions of dollars of assets and

The financial statements that will appear in next year's Public Accounts will be fundamentally different; they will be based on full accrual accounting principles.

liabilities not previously valued and recorded on the Government's audited financial statements. More changes, such as recording inventories and changing the accounting policy for employees future benefits, will be implemented in 2002-2003.

I caution readers that the following discussion is not based on any detailed audit work performed by my Office. In this year's audit, we concentrated on the 2000-2001 financial statements and had conversations with departments only about their progress toward the move to full accrual accounting. Now that the 2000-2001 audit is completed, we will begin our audit of the information departments are capturing for full accrual accounting.

The Government has made significant progress in issuing policy guidance over the past year. TBS has issued Accounting Standards (TBAS) and an Accounting Manual with examples of the kinds of accounting entries that will be required. The Assistant Comptroller General's accounting policy committee, which includes representatives from Finance, TBS, and my Office, meets regularly to review progress. Based on my discussions with departments, however, they still have a significant amount of work to do to be ready for my audit of the accrual accounting balances at April 1, 2001, which will begin immediately, and my audit of the accrual accounting balances at March 31, 2002 which will begin next year.

As we have noted in previous Report chapters on FIS, departmental finance staff will be under severe pressure during this time. They have their normal functions to fulfil, such as getting government payments out, depositing and accounting for public money received, and the myriad others asked of them. But in addition, many of them are dealing with the trials and tribulations of implementing new and complex accrual accounting systems. On top of all this comes full accrual accounting and my audit of it; the financial community in the Government has generally not had to deal, until now, with the complexities of accrual accounting. TBS recognizes this and is attempting to strengthen the financial community and its understanding of accrual accounting, but it will take time for that community to be comfortable with this fundamental change.

While the move to full accrual accounting will affect all Government departments and agencies, some of them are more crucial to its successful implementation. In next year's audit, I will pay particular attention to the more significant accrual accounting balances described below.

Tangible capital assets. In this year's audit, my Office conducted an initial review of departments' readiness to record tangible capital assets. This review and our ongoing consultations indicate that the Government has done a significant amount of work in this area. Many departments have chosen to rely on the Book Value Calculator developed by the Chief Appraiser of Public Works and Government Services Canada, and we have agreed that this is a reasonable approach. While we have not yet begun our audit, we note that some significant challenges remain. At this writing, for example, National Defence has not yet fully determined its opening balances, but departmental officials had assured me that this work would be completed by the fall. Further, discussions with officials in certain departments indicated that the implementation of the policy on capitalization of software was proving to be a challenge.

Environmental liabilities. Departments have been reporting some of their environmental liabilities to TBS for several years now, in accordance with the draft Policy on Accounting for Costs and Liabilities Related to Contaminated Sites. Preliminary inquiries in a small sample of departments indicate that progress is being made in assessing identified contaminated sites. In addition, the Government initiated the Federal Contaminated Sites Assessment Initiative to help departments estimate the liabilities associated with contaminated sites. A report by TBS

All departments and agencies have a lot of work to do to achieve the objective of implementing full accrual accounting.

on the initiative anticipates that the Government will be able to make a reasonable estimate of the total liability based on the contaminated sites assessed, but that it will not be possible to develop this estimate until March 31, 2002. Given the challenge inherent in arriving at this estimate, I emphasize the importance of assessing enough sites to allow for a suitable estimate of the liability in time for the 2001-2002 deadline.

Accrual of tax revenue. Accrual accounting for tax revenue represents a fundamental change for the Government, from the cash basis of accounting it now uses to a method based, to the extent that it is possible, on assessments. This change is a significant challenge for the Canada Customs and Revenue Agency (CCRA). It has a small team responsible for the implementation of accrual accounting for tax revenue. The team works under the direction of a steering committee of officials from CCRA, the Department of Finance, and TBS. My officials work closely with these committee members. The CCRA team has made a lot of progress but still has much to do. The process it is currently using to apply the accrual methodology is a mostly manual one, and this has made it difficult for the team to meet various target objectives and dates.

Aboriginal claims. The move to accrual accounting for contingent liabilities will mean a change in how the Government records its liability for Aboriginal claims. The change will affect the amounts recorded for comprehensive claims, for claims being pursued through the courts, and for claims being pursued through Indian and Northern Affairs Canada (INAC). In previous observations, my Office has expressed concerns about INAC's ability to meet the 2001-2002 deadline for quantifying these liabilities. The Department has made progress during the current year but still has further work to meet the 2001-2002 deadline.

Departmental financial statements

As part of its FIS and modern comptrollership initiatives, the Government is moving forward with developing departmental financial statements. The TBAS for Departmental and Agency Financial Statements governs how they are to be prepared.

Under that TBAS, departments and agencies as defined in section 2 of the *Financial Administration Act* will be required to produce annual financial statements for the year ending March 31, 2002. This applies to some 90 departments and agencies.

Under the TBAS, departments will not record certain significant liabilities and costs - for instance, their environmental liabilities; allowances for loans, investments, and advances; employee termination benefits; contingent liabilities; and services provided by other departments without charge. In my view, without these liabilities, costs, and asset valuation allowances, the proposed departmental financial statements will not provide reliable information on departments' program costs or on their financial position.

Further, while the TBAS calls for departments to include their financial statements in their departmental performance reports, TBS has decided not to require them in the reports for 2001-2002. Given my concerns about the reliability of departmental financial statements were the TBAS in its present form to be applied, I concur with the decision to defer publishing the statements until these issues are resolved.

In my view, producing departmental financial statements that are auditable and present fairly the departments' financial position, results of operations, and cash flows is an important goal. Published financial statements should be meaningful to readers and should not provide misleading information. TBS and departments still need to do a significant amount of work to realize that goal fully.

The TBS policy on departmental financial statements needs to be revised before the statements are published as a reliable source of accountability information.

Previous years' observations not yet resolved

Table 4 provides a summary of previous years' observations that have not yet been resolved. The foregoing has addressed the matters related to full accrual accounting that were raised in previous years and they are therefore not included in the table.

<i>Previous years' observations not yet resolved</i>		
Observation	Year raised	Description of issue
Offsetting Child Tax Benefit disbursements against revenues – "netting"	1992, 1994, 1999, 2000	The Government has offset disbursements under the Canada Child Tax Benefit program against personal income tax revenues. In the financial statements, the disbursements are shown on both a gross and a net basis. However, these disbursements are more properly classified as program spending and should only be reported on a gross basis.
Statement of Transactions of the Debt Servicing and Reduction Account	1997, 1999, 2000	The Debt Servicing and Reduction Account applies specific revenues against charges associated with public debt. However, the very nature of the Consolidated Revenue Fund ensures that all revenues are deposited into it and all expenditures coming from it are authorized by Parliament. As a result, there is no need to issue a separate audited statement; disclosure in notes to the statements would suffice. Also, the accrual basis of accounting for tax revenue will require a significant amount of effort in the CCRA, because the <i>Debt Servicing and Reduction Account Act</i> requires that the Account's financial statements be prepared on a cash basis.
Simplified and useful financial statements	1999, 2000	The Annual Financial Report should be revised so that it is more useful and understandable to a wider variety of users.
Dictating accounting treatment in legislation	2000	The legislation in 1999 and 2000 authorizing the CHST Supplement in those years contained wording that appeared to dictate the accounting treatment to be followed.

MY AUDIT REPORT EXPLAINED

This section of my Observations discusses the messages that I convey in my audit report, how I arrive at the audit opinion included in my report, and what my audit provides and does not provide. I have structured my report to highlight key messages. This year, my report contains three main sections.

The audit opinion in my report

Normally, my audit opinion consists of three paragraphs, and an additional paragraph of explanation when I reserve my opinion.

My responsibility. The introductory paragraph of my opinion lists the financial statements it covers. It is important to note that my audit opinion covers only the financial statements and related notes contained in Section 1 of Volume I of the *Public Accounts of Canada*. It does not extend to the more detailed information presented in other sections of Volume I, or to Volume II.

The Government's responsibility for the financial statements includes fully explaining them to the Public Accounts Committee.

The introductory paragraph concludes by confirming that the financial statements are the responsibility of the Government, and that my responsibility is to form an opinion on the financial statements as required by section 6 of the *Auditor General Act*. My audit responsibilities are explained, but what are - or should be - the Government's responsibilities?

At the beginning of Section 1 of Public Accounts Volume I is the Statement of Responsibility signed by the three deputy ministers responsible for the Public Accounts. The Statement gives a good summary of their roles, but those roles go much further. These officials must be able to fully explain the important messages in the financial statements. They must be able to explain why the numbers have changed from one year to the next. And they must be able to explain any variances from the Budget and the Estimates that have previously been provided to Parliament and Canadians. These explanations should be made to Parliament through the House of Commons Standing Committee on Public Accounts. The Committee should have the opportunity to hear these explanations, and to understand the story the financial statements tell and the significance of the messages in my report and the Observations.

The scope of my audit. In the second paragraph of my opinion, I state that my audit of the Government's financial statements has been conducted according to Canadian generally accepted auditing standards prescribed by the Canadian Institute of Chartered Accountants. (I follow those standards to ensure that my audit is conducted with appropriate rigour and professionalism.) I indicate in the same paragraph that I perform my audit procedures to assess whether the financial statements are free of material misstatement.

I further explain that my audit includes assessing the reasonableness of significant estimates made by the Government. There is a good deal of judgment required in preparing and auditing financial statements of an entity the size of the Government of Canada. Many of the significant amounts reported in the financial statements, such as allowances for the valuation of various assets and liabilities, are estimates made by the Government. When considering whether misstatements exist in these estimates, I determine for each estimate a range of values that I believe would be reasonable. If the Government's estimate falls within that range, I conclude that the estimate is reasonable.

Finally, in the scope paragraph, I note that my audit includes assessing the Government's accounting policies and evaluating the overall presentation of the financial statements. To make that assessment, I must base my judgments on independent standards. The standards that I continue to use are those recommended by PSAB. The Government's stated accounting policies are based on those recommendations, and my opinion, in turn, is expressed in terms of those stated accounting policies.

My opinion. My opinion is not a statement of fact; it expresses my professional judgment. The opinion paragraph states my conclusions as to whether the financial statements present information fairly in accordance with the Government's stated accounting policies, and whether those policies were applied on the same basis as in the preceding year.

My opinion on each of these aspects of the Government's financial statements for 2001 does not include any reservations. Readers are therefore entitled to conclude that the amounts shown in the financial statements are fairly stated within the limits of materiality in accordance with the Government's stated accounting policies set out in Note 1 to the financial statements. Readers may also conclude that the accounting policies used by the Government to prepare the financial statements are the same policies as were used last year.

Although my opinion on the financial statements is free of reservations, I have underscored two serious concerns in my audit report.

Other matters in my report

In the “other matters” section of my report, I raise important issues that concerned me during my audit and that I want to bring to Parliament’s attention. The issues I have raised this year are not reservations of my opinion; the financial statements of the Government of Canada are presented fairly in accordance with its stated accounting policies. In my view, however, these other matters are of such importance to Parliament, other readers and to the future financial reporting of the Government that they warrant direct mention in my report. This is the first time an Auditor General has ever included such matters in an audit report on the Government’s summary financial statements. A more detailed discussion of these issues was provided earlier in these Observations.

Additional information in my report

It is often difficult in a short-form audit report to summarize the rationale and circumstances behind a reservation or other matter. My report therefore refers readers to these Observations for additional information.

How I arrive at my opinion

Before beginning my audit, I make a judgment based on the Government’s total expenditures, as to what dollar magnitude (materiality) of misstatements in the financial statements would change or influence the decision of a person who relied on them and had reasonable knowledge of the Government and its activities. That dollar amount is then used as a basis for determining the nature, extent and timing of the audit work required. For this year’s audit, I set materiality at approximately one half of one percent of total gross expenditures of \$175 billion.

To be in a position to render my audit opinion, Canadian generally accepted auditing standards require that I have reasonable assurance that my audit will reveal any misstatements aggregating to more than my predetermined level of materiality. In planning my audit, I accept some small amount of risk that my audit procedures will fail to detect whether the financial statements are materially misstated. I accept this minimal risk because it is cost-effective to do so. In conducting my audit, however, I perform specific audit procedures that reduce this risk to a level I consider acceptable. These procedures include, for example, testing a sample of transactions and account balances, performing analyses, confirming year-end balances with third parties, and reviewing significant internal controls as necessary.

If I conclude, after completing these audit procedures, that in the aggregate the financial statements are free of material misstatement, I report that the information is presented fairly. If I conclude that the statements contain material misstatements but the overall usefulness of the statements is not impaired, I describe the nature and extent of my concerns. I then go on to say that information is presented fairly except for the issues noted in my reservations.

Matters that come to my attention during the audit that are significant but do not result in a reservation of my opinion are raised in my report as other matters.

Finally, in all of my audit work on these financial statements, I also take account of the basic requirement that the Government comply with parliamentary authorities to spend, borrow, and raise revenues.

What my audit report provides and does not provide

My audit of these financial statements does not address all value for money issues including authority and control matters; my periodic Reports to Parliament should be reviewed for those.

To summarize, my report on the Government's financial statements provides my opinion on whether they present information fairly. It sets out any other matter I believe should be brought to Parliament's attention. An auditor's report enhances the credibility of reported financial results or, in some cases, may alert readers to problems or issues in the financial statements that need to be resolved. In describing what my report provides to readers, however, it is important to highlight what it does not do. It does not address the issue of the economical, efficient and effective use of resources by the Government; that aspect of our work is separate from our audit of the Government's financial statements.

Furthermore, my audit of the Government's financial statements is neither extensive enough nor specifically designed to provide assurance as to the integrity of each of the Government's many and varied systems of internal control, nor as to its compliance with the spending limits on each of its several hundred individual appropriations. My Office conducts additional work in each of these areas on a cyclical basis in departments and Crown corporations. I consider the results of all of that work in developing my report on the Government's financial statements. If the work has identified issues that I believe are significant to the users of the financial statements, I will mention them in my report as other matters, or in my Observations, as I did this year.

Finally, my audit of the Government's financial statements is not designed to, and my report does not, provide assurance that all the transactions of the Government are in compliance with laws and regulations. In previous reports to the House of Commons, my Office has reported different cases of non-compliance with authorities. We continue to audit compliance, and I will report to Parliament any significant cases of non-compliance that come to my attention.

CONCLUSION

Two of my priorities are to ensure that the Government's financial statements are credible and reflect the economic substance of transactions and events, and to speak out if I see any instances of actions that erode Parliament's control over the Government.

I believe strongly that the Government's financial statements, included in these *Public Accounts*, and the *Annual Financial Report* published separately by the Minister of Finance are extremely important accountability documents. They must be credible, understandable, useful, and timely. My predecessor said this continually and I subscribe fully to that ideal.

One of my priorities during my term as Auditor General will be to encourage the Government to present in its financial statements the economic substance of transactions and events. Although I am not their auditor, I will continue to watch closely the nine foundations noted in these Observations - and any new foundations created in the future by the Government - to ensure that they are reflected properly in the Government's financial statements.

Another of my priorities as Parliament's auditor will be to report any deviations from accepted parliamentary process that come to my attention and that could result in the erosion of Parliament's control over the Government. I will raise such issues in my Observations and my periodic Reports.

Finally, I will continue to monitor the Government's FIS closely, including its efforts to prepare its financial statements on a full accrual basis of accounting in accordance with the recommendations of PSAB.

In all of this, I will work closely with the House of Commons Standing Committee on Public Accounts. The Committee plays an invaluable role in ensuring that the Government considers my recommendations and observations seriously. The matters I have raised in these Observations only serve to heighten the importance of this Committee's work.