

**SUPPLEMENTARY INFORMATION  
OBSERVATIONS OF THE AUDITOR GENERAL  
ON THE  
FINANCIAL STATEMENTS OF THE GOVERNMENT OF CANADA  
FOR THE YEAR ENDED MARCH 31, 2002**

**MAIN POINTS**

*The Observations explain my Report on the financial statements of the Government of Canada.*

The purpose of these Observations is to explain certain elements of my report on the financial statements of the Government of Canada as at and for the year ended March 31, 2002. My December 2002 Report to the House of Commons will discuss some of the issues included in these Observations in more detail. Here, I discuss the following issues:

- The balance in the Employment Insurance Account stood at \$40 billion on March 31, 2002, well over the \$15 billion that the Chief Actuary of Human Resources Development Canada says is the maximum amount needed. Neither the Employment Insurance Commission nor the Government, in setting the EI premium rates for 2001 and 2002, has clarified and disclosed what they consider to be an adequate balance of the Account, the time required to reach that balance, and the factors considered in setting the rates. Accordingly, for the second consecutive year I am unable to conclude that the setting of premium rates observed the intent of the *Employment Insurance Act*.
- Since 1997, the Government has recorded as expenditures some \$7.5 billion in transfers to various foundations to achieve its public policy objectives, even though most of the money is still in their bank accounts and investments accumulating interest. As reported last year, I am concerned with the accounting for these transfers.
- I encourage the Government to implement accrual accounting for its 2002-2003 financial statements. Accrual accounting will provide a more complete measure of the overall size of the Government resulting in improved reporting. It will also help to avoid the distortions in the Government's financial statements caused by its present accounting policies, such as that resulting from the deferral of small business tax instalments from 2001-2002 to 2002-2003. More importantly, accrual accounting is an essential component of management reform initiatives underway in the Government.
- I am very concerned about the Government's processes for developing, reviewing, challenging and eventually recording management estimates in its financial statements. Although they involve billions of dollars, the Government only makes a serious effort to update most of these estimates once a year - when it prepares its annual financial statements. This year, the Government made material unanticipated changes to management estimates almost six months after year end. In my view, it is essential that the Government strengthen the way it develops management estimates, in order to produce timely and reliable information throughout the year and in its financial reports.
- I encourage the Government to improve how it communicates its financial results in the *Public Accounts* and the *Annual Financial Report*. In addition to the disclosure of key indicators and Budget-to-actual comparisons, the Government should correct misinformation on the disposition of the annual surplus for the year.

I believe strongly that the Government's financial statements included in the *Public Accounts* and the *Annual Financial Report* are important accountability documents. They need to be credible, understandable, useful, and timely. While summary financial reporting by the Government of Canada continues to be among the best in the world, improvements are required to maintain this standing.

**SIGNIFICANT ACCOUNTING AND DISCLOSURE ISSUES ARISING FROM MY AUDIT**

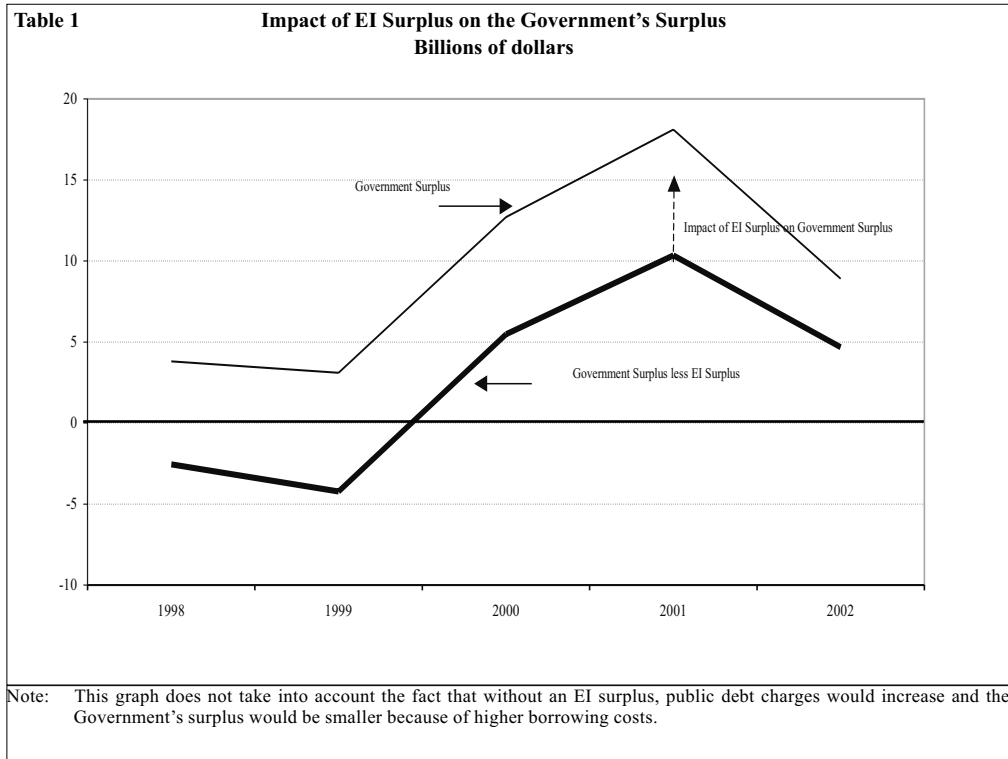
In this section of my Observations, I describe seven of the more significant issues that have arisen from my audit this year or that are still unresolved from prior years.

**1. \$40 BILLION SURPLUS IN THE EMPLOYMENT INSURANCE ACCOUNT**

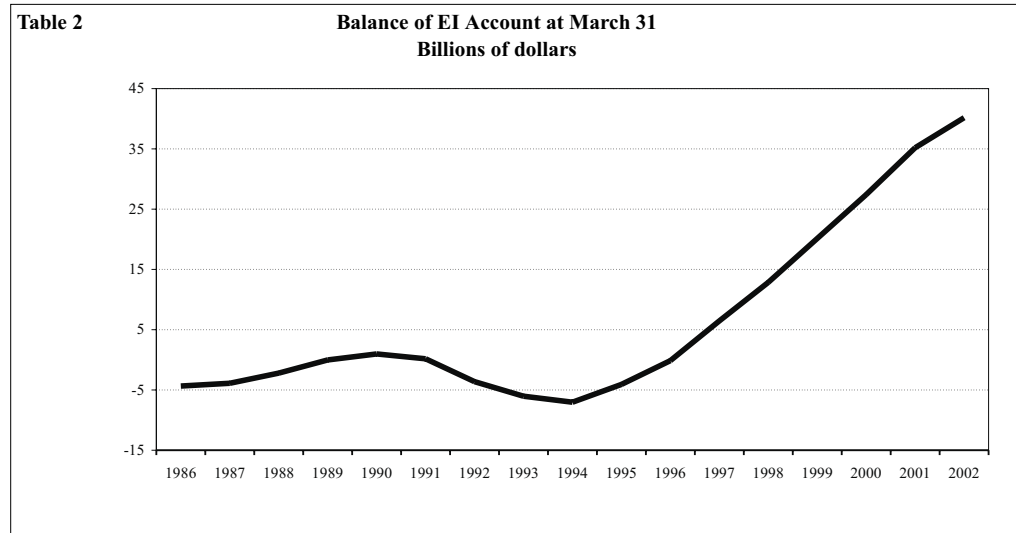
**Consolidation of the EI Account.** Employment Insurance (EI) is a major program administered by the Government of Canada. Since 1986, its revenues, expenditures, assets and liabilities have been consolidated or combined with those of other Government programs in the Government’s financial statements. Consolidation of EI is the proper accounting because EI is a Government program like any other Government program – it is controlled solely by the Government. It is the Government, either directly or through the EI Commission, that sets EI premiums and benefits. Non-consolidation of Government programs would result in fragmented reporting and difficulty in understanding the full size and scope of the Government. I therefore continue to support the manner (consolidation) in which the Government accounts for the EI program in its summary financial statements.

Due to its size, the EI program has a significant effect on the Government’s overall financial results. The financial statements show that approximately 10% of the Government’s total revenues come from EI premiums; and approximately 11% of the Government’s total program expenditures is for EI benefits and administrative costs. The Government’s surplus in 2001-2002 of \$8.9 billion would have been \$4 billion lower were it not for EI (see Table 1).

*The EI program has a significant effect on the Government’s financial results. The Government’s surplus of \$8.9 billion would have been \$4 billion lower were it not for EI.*



**Compliance with the Employment Insurance Act.** In compliance with the *Employment Insurance Act*, the Government uses an EI “Account” to keep track of any **accumulated** EI surplus or deficit. At times, this tracking account may show an accumulated deficit – at March 31, 1994, for instance, almost \$7 billion. At other times, the EI Account will show an accumulated surplus – \$40 billion, in fact, at March 31, 2002 (see Table 2).



EI premiums, like most other Government revenues, flow into the Government’s bank account; there is no separate bank account for the \$40 billion EI surplus at March 31, 2002.

In establishing the premium rates for the years 1997 up to and including 2001, the Chief Actuary of Human Resources Development Canada (HRDC) reviewed the accumulated balance in the EI Account and economic prospects for the next few years. Based on that review, he normally suggested to the Commission a range of premium rates for the following year. The Employment Insurance Commission then set the rate, with the approval of the Governor in Council on the recommendation of the ministers of Finance and HRDC. The rates set, however, exceeded the maximum in the range suggested by the Chief Actuary for 1998 to 2001 (see Table 3).

Year	Rate set (\$)	Range suggested by Chief Actuary (\$)
1997	2.90	2.60 to 2.90
1998	2.70	2.40
1999	2.55	2.00 to 2.50
2000	2.40	2.00 to 2.25
2001	2.25	1.75 to 2.10
2002	2.20 <sup>(1)</sup>	NA

<sup>1</sup> The rate for 2002 was first published in the October 18, 2000 Economic Statement and Fiscal Update for planning purposes.

The fact that the rates set in recent years have exceeded the maximum rates suggested by the Chief Actuary has contributed to an accumulation of the surplus in the EI Account in excess of what he considered to be sufficient. For example, each 5 cent increase in premium rates increases annual revenues by \$425 million.

Since 1997 and including 2001, the Act required that in setting premiums the EI Commission ensure that the rate levels provide enough revenue to cover program costs and maintain relatively stable rate levels throughout a “business cycle”<sup>1</sup>. Recent amendments to the Act, however, suspended these legislated requirements for two years. The amendments also stipulated that the Government, and not the EI Commission, would set the premium rates for 2002 and 2003.

The Government has indicated that the rate-setting provisions of the Act were suspended for 2002 and 2003 so it could undertake research and public consultations about the process of setting premium rates. Prior to that announcement the House of Commons Standing Committee on Finance had commented in its pre-Budget consultation report for the 2000 Budget that the EI rate-setting process was flawed. To date, Government officials have advised us that internal research has been undertaken and is continuing, but that no public consultations have taken place. Much needs to be done therefore, before the suspension expires and 2004 premium rates must be set by the EI Commission in the fall of 2003. At this writing, there has been no decision on what the balance of the EI Account should be, how long it should take to reach that balance and what other factors should be considered in setting premium rates.

**Conclusion.** I am unable to conclude that the setting of premium rates for 2001 and 2002 observed the intent of the *Employment Insurance Act*. Since 1999 this Office has been raising concerns about the Government’s compliance with the Act in these *Public Accounts*, in reports on the EI Account financial statements and in periodic Reports to the House of Commons. I urge the Government to complete its study as quickly as possible and resolve this long-standing issue.

***I urge the Government to resolve the long-standing issue of the amount and continued growth in the EI Account.***

<sup>1</sup> A “business cycle” is a recurring and widespread pattern of economic expansion and sustained decline. It can be measured between a peak or a trough and it can vary in length of time and amplitude.

## 2. TRANSFERS TO FOUNDATIONS

Since 1997, the Government has used several foundations to carry out certain of its public policy objectives. It has transferred some \$7.5 billion to them and has recorded the transfers as expenditures in its financial statements (see Table 4). Much of the \$7.5 billion was still in the foundations' bank accounts and investments at March 31, 2002 accumulating interest. It had yet to be distributed to the ultimate intended recipients or used for the ultimate purposes announced by the Government for this spending.

Foundation <sup>1</sup>	Government Expenditures Recorded in Fiscal Year ended March 31 (\$ millions)							Foundation's Cash and Investments <sup>2</sup>
	1997	1998	1999	2000	2001	2002	Total	March 31, 2002
Canada Foundation for Innovation	801		200	900	1,250		3,151	2,964
Canada Health Services Research Foundations	13	13	13	73	13		125	124
Canada Millennium Scholarship Foundation		2,500					2,500	2,346
Aboriginal Healing Foundation		350					350	278
Genome Canada				160	140		300	276
Green Municipal Investment Fund <sup>3</sup>				100		100	200	211
Other foundations under \$100 million <sup>4</sup>				72	52	10	134	133
Canada Health Infoway Inc.					500		500	516
Foundation for Sustainable Development Technology					100		100	101
Pierre Elliott Trudeau Foundation <sup>5</sup>						125	125	125
<b>Total</b>	<b>814</b>	<b>2,863</b>	<b>213</b>	<b>1,305</b>	<b>2,055</b>	<b>235</b>	<b>7,485</b>	<b>7,074</b>

1 The foundations included in the table have each received over \$10 million in total funding from the Government since 1997 specifically for spending in a future year more than a year ahead; this has been announced publicly in a Budget or in some other way.

2 These balances are at the date of the latest annual report where March 31, 2002 financial statements are not yet available. It is estimated that \$1 billion of interest and other returns on investment were earned on the \$7.5 billion transferred, \$1.3 billion has been paid to ultimate recipients or used for the ultimate purposes, and \$0.1 billion has been paid in administration costs, leaving the balance of \$7.1 billion at March 31, 2002.

3 These are endowments, that is, only the earnings on the endowment are disbursed.

4 These are: Foundation for Climate and Atmospheric Sciences; Clayoquot Biosphere Trust Society; Forum of Federations; Pacific Salmon Endowment Fund Society; Canadian Institute for Research on Linguistic Minorities – University of Moncton; and Frontier College Learning Foundation (Endowment fund).

*The Government has transferred some \$7.5 billion to foundations and has recorded these transfers as expenditures. Much of the \$7.5 billion was still in the foundations' bank accounts and investments at March 31, 2002.*

**Recent developments.** In 2001-2002, the Government announced its intention to create two new foundations: the Africa Fund (commitment of \$500 million), the Strategic Infrastructure Foundation (minimum commitment of \$2 billion), and to transfer funds to the Pierre Elliott Trudeau Foundation (\$125 million). In addition, the Budget indicated that any surplus at the end of fiscal year 2001-2002 - the actual surplus is \$8.9 billion - would be dedicated to the Strategic Infrastructure Foundation and the Africa Fund. Only the Pierre Elliot Trudeau Foundation received a contribution during the year; it would appear that the Government will meet its objectives for the Africa Fund and the Strategic Infrastructure Foundation through normal departmental programs and appropriations processes and subject to the usual accountability provisions to Parliament.

Transfers to foundations for 2001-2002 declined to \$235 million from \$2 billion in 2000-2001.

**Accounting for transfers to the foundations.** While transfers for the year declined, as I stated last year, I continue to be concerned about the accounting for these transfers.

The Government's accounting policy results in expenditures being recognized when money is transferred to the foundations. Economic substance would be better represented in the Government's financial statements if expenditures were recorded in the years when the foundations make grant payments to the ultimate intended recipients or use the money themselves for the Government's ultimate intended purposes.

Many factors, including the Government's role in the creation of the foundations; their obligation to achieve Government policy objectives; the Government's role in the appointment of directors; and the prescriptive nature of detailed funding agreements between the foundations and the Government, lead me to question whether these foundations are truly "arms-length" from the Government, and therefore whether the Government's accounting for transfers to them as if they are "arms-length", is appropriate.

The Public Sector Accounting Board of the Canadian Institute of Chartered Accountants (PSAB) has initiated a project to study the government financial reporting entity, which, among other things, is intended to clarify how to determine whether organizations such as those in Table 4 should be included in government financial statements notwithstanding their legal form. A second PSAB project on accounting for government transfers may also have implications to this issue.

**Accountability and governance of the foundations.** I am also concerned about the accountability and governance of the foundations - in fact, more concerned than about the accounting for transfers to them - for a number of reasons, including (see Chapter 1 of my April 2002 Report for more details):

- Reporting to Parliament by the foundations is not adequate for parliamentary scrutiny; none of the foundations submit corporate plans for tabling in Parliament; and not all provide annual reports with a credible description of accomplishments.
- Foundations have been established in an ad hoc way, and Parliament has not had an opportunity to consider fully the resulting changes in how it authorizes and oversees this public spending.
- Weak oversight of foundations is limiting ministers' answerability to Parliament.
- Parliament is not receiving reports on independent, broad-scoped audits that examine more than the financial statements of foundations, including compliance with authorities, propriety, and value for money

While some improvements in accountability and governance structures have been made, I plan to continue to examine these concerns.

**Conclusion.** I urge the Government to change its accounting policies as they relate to the foundations to properly account for the substance of these transactions. This change should be consistent with other changes to introduce accrual accounting. 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. In addition, I urge the Government to resolve the concerns I have raised about accountability and governance of the foundations.

***I urge the Government to change its policies as they relate to the foundations in its financial statements to properly account for the substance of these transactions.***

### 3. ACCRUAL ACCOUNTING DELAYED

As I noted in last year's Observations, the Government was to have implemented accrual accounting in 2001-2002. However, at the time of the December 2001 Budget, important components of the information required to implement accrual accounting had not yet been verified. As a result, it announced a delay in the implementation of accrual accounting for the financial statements of the Government for at least one year. Discussions with Government officials have led us to believe that accrual accounting might be implemented in 2002-2003 as data quality improves and I complete my audit. My December 2002 Report will provide more information on the status of accrual accounting in the Government. I strongly support the use of accrual accounting by the Government and urge it to implement this important initiative fully.

Accrual accounting recognizes transactions and other events when they occur, and not when cash or its equivalent is received or paid. Expenses are recorded in the period when the goods or services are consumed; revenues are recorded in the period when they are earned; and multi-year benefits associated with long-lived assets are expensed over the expected length of time they will be used. There are many reasons why accrual accounting is superior to the Government's current modified accrual basis of accounting, which I will discuss further in my December 2002 Report. Below I cite two examples of how accrual accounting would avoid the distortions caused by the Government's current accounting policies.

***Deferral of small business tax instalments.*** The December 2001 Budget announced a six-month deferral of small business corporate income tax instalments for the last quarter of 2001-2002. The deferral was to assist small businesses with the economic slowdown. The Government estimates the actual take-up of this initiative by small businesses at about \$600 million.

The Government generally follows cash accounting principles for tax revenue and therefore will recognize the deferred payments as revenue in 2002-2003. However, the \$600 million clearly relates to economic activity in 2001-2002. It normally would have been recognized as tax revenue in 2001-2002, but it was not included in the surplus for that year. By altering the timing of cash receipts, revenue has been shifted from one fiscal year to another.

Accrual accounting would not allow the distortion of reported financial results by altering the timing of the cash receipt or disbursement. Under accrual accounting, this \$600 million would be recorded as revenue in 2001-2002 and the amount due would be reflected as a receivable.

Other distortions in tax revenue can also occur. For example, collection lags in personal or corporate tax or even systems breakdowns can distort tax revenue from year to year under a cash basis of accounting.

**Transfers paid in advance of need.** In addition to the transfer of funds to foundations, the Government has provided transfers to other organizations well in advance of need (see Table 5).

Table 5 Organization	Government Expenditures Recorded in Fiscal Year Ended March 31 (\$ millions)					Organization's Cash and Investments <sup>1</sup>
	1999	2000	2001	2002	Total	March 31, 2002
Canadian Institute for Health Information	95			95	190	125
Green Municipal Enabling Fund		25		25	50	45
Precarn		20			20	21
Canadian Network for the Advancement of Research, Industry and Education (CANARIE)				110	110	110
Canada Institute for Advanced Research				25	25	25
Total	95	45	0	255	395	326

<sup>1</sup> These balances are at the date of the latest annual report where March 31, 2002 financial statements are not yet available. It is estimated that \$16 million was earned on the \$395 million transferred, \$83 million has been paid to ultimate recipients or used for the ultimate purposes, and \$2 million has been paid in administration costs, leaving the balance of \$326 million at March 31, 2002.

Unlike the foundations these organizations are clearly arms-length from the Government. Transfers to them are largely recorded on a cash basis of accounting by the Government – that is, transfer payments due are recorded as expenditures. The Government does not consider whether the payments are in advance of need or whether the funds are immediately required for their ultimate intended purpose in deciding how to account for them. This may need to change with the introduction of accrual accounting.

The PSAB has a project under way that looks at the issue of government transfers. It will address whether grants paid several years in advance should be recorded as prepaid expenses under accrual accounting.

**Conclusion.** I remain convinced that accrual accounting is superior to the Government's current accounting policies. It provides a more complete measure of the overall size of the Government which should enhance accountability to Parliament; it eliminates the distortion of reported financial results caused by altering the timing of cash receipts or disbursements; and it is an essential component of management reform initiatives underway in the Government. I encourage the Government to resolve concerns which are causing delays in the full introduction of accrual accounting and implement it for the 2002-2003 financial statements.

***I encourage the Government to implement accrual accounting.***

#### 4. MANAGEMENT ESTIMATES

In common with most other large organizations and as disclosed in Note 1 to the financial statements, the Government's financial statements include a number of significant management estimates. These estimates affect billions of dollars of reported assets and liabilities, the amounts reported on the statement of revenue and expenditures and ultimately, the surplus or deficit the Government reports for the year. Examples of some of the more significant management estimates include valuation allowances for loans and investments, pension liabilities and best estimates of losses arising from contingent liabilities.



I am very concerned about the Government's processes for developing, reviewing, challenging and eventually recording these estimates in its financial statements. Although they involve billions of dollars, the Government only makes a serious effort to update most of these estimates once a year – when it prepares its annual financial statements. More frequent in-depth reviews – at least quarterly – are necessary if the Government is to have up to date, timely and reliable information on its financial position.

This year, the Government made material, unanticipated changes to management estimates almost six months after year end. The Government should not be discovering adjustments to its accounts involving hundreds of millions of dollars six months after year end.

***Accrual accounting will require the government to strengthen the way it develops management estimates.***

As the Government moves to adopt accrual accounting, management estimates will become an even more important part of the process of preparing the Government's financial results. In addition to the estimates already mentioned above, accrual accounting will require management estimates in the recording of tax revenues, environmental liabilities, additional Aboriginal claims and numerous other amounts. Given the shortcomings in the Government's existing processes for these estimates and the increased importance of management estimates in an accrual accounting environment, I am concerned that the Government may not yet be in a position to produce timely, reliable financial statements on a full accrual basis.

***Conclusion.*** In my view, in order to produce timely and reliable information throughout the year and in its financial reports, particularly in an accrual accounting environment, it is essential that the Government strengthen the way it develops management estimates. It needs to clearly communicate its policies and expectations to all those involved in developing these estimates and implement a much more rigorous and timely challenge and review function.

## **5. MUTUAL FUND TRUST CAPITAL GAINS REFUNDS**

The Canada Customs and Revenue Agency (CCRA) collects personal income taxes on behalf of the Government and all provincial and territorial governments except Quebec. The arrangements with the provinces and territories are undertaken pursuant to Tax Collection Agreements (TCAs) between Canada and the provinces.

During the year, the CCRA discovered that it had misclassified mutual fund trust capital gains refunds in TCA reports on provincial and territorial assessed taxes. This caused the Government to overpay a number of provinces an amount totaling \$3.4 billion for tax years 1993 to 1999.

The Government announced on September 4, 2002 its intention to seek a remission of the balance due from the affected provinces and to recover \$1.4 billion from them. The recovery would commence in 2004-2005 over a ten-year period. As no interest will be charged on the \$1.4 billion principal amount, at March 31, 2002 its net present value amounted to \$982 million. The Government has accounted for the net amounts to be collected on a retroactive basis. This is described in Note 3 iv to the financial statements.

Under the equalization program, the recovery of TCA overpayments would normally lower equalization payments to seven provinces, and increase equalization payments to one province. The Government has indicated that it will ensure that the recovery of TCA overpayments would not have a negative impact on equalization payments. This provided a "benefit" of approximately \$1.2 billion to equalization receiving provinces.

***Conclusion.*** I agree with the Government's accounting in the financial statements for this error in past mutual fund trust capital gain refunds.

## 6. COMMUNICATING CANADA'S FINANCIAL RESULTS TO PARLIAMENT AND CANADIANS

The Government's financial position and annual results of operations is essential information for Parliament and for all Canadians. The Government communicates this information primarily through the *Public Accounts of Canada* and the related *Annual Financial Report* (AFR).

In my view, both of these documents can be improved and the Government could better explain its financial situation to Canadians. The *Public Accounts* contain a tremendous amount of important, but detailed information. The *Annual Financial Report*, while a much more summarized document that has been improved over the years, can be difficult to understand.

I encourage the Government to re-evaluate how it communicates its financial results to Parliament and to Canadians. Can the *Public Accounts* be simplified and streamlined? How can the AFR be made more understandable? How and where should the Government publish its financial statement discussion and analysis?

**Indicators of financial condition.** Guidance is available from the Canadian Institute of Chartered Accountants to assist the Government in this area. The "Indicators of Government Financial Condition" listed in a research study by that title in 1997 suggested a number of key indicators of financial condition such as net debt to GDP, revenues to GDP and public debt charges to revenues. These indicators, together with explanations of trends they reveal and other important factors impacting on the Government's financial results, should be included in the Government's financial reports and should be discussed with the Public Accounts Committee of the House of Commons when the *Public Accounts* are tabled in Parliament. The PSAB also has a project underway on "Financial Statement Discussion and Analysis" that should provide some useful guidance to the Government.

One of the key pieces of information in the Government's financial results is the surplus or deficit for the year. What this number represents and its trend over time must be carefully explained. I have become concerned in recent years with certain misinformation on what happens to the surplus for the year. The surplus for the year does NOT automatically pay down the debt. There is neither any law nor accounting rule that requires this. This year's surplus was applied to several areas, only one of which was the reduction of debt. Part of the surplus was used, for example, to support increases in financial assets such as loans, investments and advances.

**Budget-to-actual comparisons.** The Government's Budget is an extremely important document, particularly to the public because it establishes tax rates and sets out the Government's spending plans. A comparison of budgeted-to-actual results is equally important as it is the final link in the Government's financial accountability to Parliament for a fiscal year. It is also required by the PSAB.

***The surplus for the year does not automatically go to pay down debt. It could be applied to a number of areas, including, for instance increases in financial assets.***

The *Annual Financial Report*, published separately by the Minister of Finance, includes such a comparison. But in my view, the comparison should also be included in the *Public Accounts*. Had it been included, for example, in the Statement of Transactions, which is comparable to the main statement in the Government's Budget, the comparison would have looked like Table 6:

	2002		2001
	Budget <sup>2</sup>	Actual	Actual
<b>Budgetary transactions</b>			
Revenues	174.5	173.3	179.6
Program spending	(124.6)	(126.7)	(119.4)
Operating balance	49.9	46.6	60.2
Public debt charges	(41.7)	(37.7)	(42.1)
Less: Contingency Reserve	(3.0)		
Economic Prudence	(1.0)		
Surplus	4.2	8.9	18.1
1 The comparison is for "net" revenues and program spending as this is the basis for preparing the Budget, (see the following section of these Observations for a summary of my concerns with this.)			
2 These amounts are included in the October 18, 2000 Economic Statement and Budget Update as there was no formal Budget for the 2001-2002 fiscal year. The December 10, 2001 Budget did include updated figures for the 2001-2002 fiscal year, but these are not "original budget" figures as recommended by the PSAB.			

*A comparison between Budget and actual results should be included in these financial statements.*

The Government would then explain the differences between the Budget and actual amounts and the differences between the actual amounts for 2001-2002 and 2000-2001.

**Conclusion.** I encourage the Government to continue its efforts to communicate its financial results clearly and succinctly to Parliament and to Canadians.

## 7. PREVIOUS YEAR'S OBSERVATIONS NOT YET RESOLVED

Table 7 provides a summary of previous years' Observations that have not yet been resolved. Matters raised in the past that related to accrual accounting are not included, as they are discussed elsewhere.

Observation	Year raised	Description of issue
Offsetting Child Tax Benefit disbursements against revenues – "netting"	1992, 1994, 1999, 2000, 2001	The Government has offset disbursements under the Canada Child Tax Benefit program against personal income tax revenues. In the financial statements in the Public Accounts, the disbursements are shown on both a gross and a net basis. In the Annual Financial Report, the condensed financial statements show the disbursements only on a gross basis, however, the narrative sections of the AFR discuss detailed amounts primarily on a net basis, which is confusing. In my view, these disbursements would be classified more properly as program spending and should be reported only on a gross basis, in both the Public Accounts and the AFR.
Statement of Transactions of the Debt Servicing and Reduction Account	1997, 1999, 2000, 2001	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.

## CLOSING THOUGHTS

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

Recently, in the wake of weakened confidence in the U.S. capital markets and corporate sector, the Government described actions that would be key to fostering investor confidence in Canada. One of the elements, together with my annotations to make it relevant to the Government was:

**“Improving Financial Reporting** – Canadian companies [governments] must provide investors [taxpayers] with complete, accurate and easy-to-understand information.”

In my view, the Government of Canada should lead by example. These Observations have outlined a number of ways the Government can improve its financial reporting.

## 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 audit report to highlight key messages; this year, it contains three main sections.

### My audit opinion

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

**My responsibility.** The introductory paragraph of my audit opinion lists the financial statements the audit covered. It is important to note that this includes only the financial statements and related notes contained in Section 1 of Volume I of the *2002 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 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 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 explain fully 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* previously 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 the explanations and understand the story that the financial statements tell, as well as the significance of the messages in my report and the Observations. The Government made a presentation to the Committee when the *2001 Public Accounts* were tabled; I would like to see that practice continued and improved.

**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. 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 the 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 based on estimates made by the Government. In considering whether these estimates contain misstatements, I determine a range of values for each 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 the PSAB. The Government's stated accounting policies are based on the PSAB 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 2002 has no reservations. Readers are therefore entitled to conclude that the amounts shown in the financial statements are stated fairly within the limits of materiality and in accordance with the stated accounting policies of the Government 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 it used last year.

#### **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 again this year are not reservations of my opinion on the fair presentation of the financial statements. In my view, however, these other matters are of such importance to Parliament, to other readers, and to the future financial reporting of the Government that they warrant direct mention in my report. 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 an audit opinion 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 amount (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 about one half of one percent of the Government's total gross expenditures of \$179 billion.

Canadian generally accepted auditing standards require that to render my audit opinion, I have reasonable assurance that my audit will reveal any misstatements aggregating to more than the level of materiality I have set as acceptable. 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 further. 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**

To summarize, my audit 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. As well as describing what my audit 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 designed specifically to provide assurance as to the integrity of each of the Government's many and varied systems of internal control or the Government's 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 audit 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 for compliance, and I will report to Parliament any significant cases of non-compliance that come to my attention.