SUPPLEMENTARY INFORMATION
OBSERVATIONS OF THE AUDITOR GENERAL ON THE FINANCIAL STATEMENTS OF THE GOVERNMENT OF CANADA FOR THE YEAR ENDED MARCH 31, 2004

MAIN POINTS

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, 2004:

- Since 1997, the Government has transferred $9.1 billion to 15 foundations. It has recorded these transfers as expenses although most of the funds remain in the foundations' bank accounts and investments, accumulating interest. I remain concerned about the manner in which the foundations are funded, the accounting for the transfers, and the accountability regime for the foundations.
- The accumulated surplus in the Employment Insurance Account stood at $46 billion at March 31, 2004. This is more than three times the $15 billion reserve that the Chief Actuary of Human Resources Development Canada considered sufficient in 2001. In my view, Parliament did not intend that the Account accumulate a surplus beyond what could reasonably be spent for employment insurance purposes given the existing benefit structure, while also providing for an economic downturn. Accordingly, I have concluded that the Government did not observe the intent of the *Employment Insurance Act.*
- The Government needs to ensure that improvements are implemented in the accounting systems and practices at the Department of National Defence and the Canadian Customs and Revenue Agency for recording military inventory and tax revenues and receivables, respectively.

FOUNDATIONS

For a number of years I have included in my audit report on the Government's financial statements a discussion of my concerns about foundations. Since 1997, the Government has recorded as expenses in its financial statements $9.1 billion in transfers to several foundations (including transfers totalling $400 million in 2003-04). These funds were transferred to foundations well in advance of need. As shown in the table below, at March 31, 2004, $7.7 billion was either still in the foundations' bank accounts and investments accumulating interest or was receivable by the foundations from the Government.

In addition to my concerns about the manner in which the foundations are funded, I have questioned the way the Government accounts for the transfers. Specifically, I have noted my view that economic substance would be better represented if expenses were recorded when the funds were distributed to the ultimate intended recipients or used for the ultimate purposes announced by the Government for this spending.

Summary financial information on foundations, 1996-97 to 2003-04

Foundation [1]	Year announced	Funding received[2]	Grants provided[3]	Interest earned	Adminis-tration	Balance March 31, 2004[4]	Funding commitments signed[5]
	($ millions)						
Canada Foundation for Innovation	1997	3,651	1,230	740	39	3,122	1,529
Canada Millenium Scholarship Foundation	1998	2,500	1,155	690	47	1,988	9
Canada Health Infoway Inc.	2001	1,200	51	83	30	1,202	42
Endowment Funds[6]	Between 2000 and 2002	389	10	48	11	416	104
Genome Canada	2000	375	188	52	19	220	198
Aboriginal Healing Foundation	1998	350	241	86	43	152	139
Foundation for Sustainable Development Technology	2001	350	6	10	7	347	37
Canadian Health Services Research Foundation	1997	152	37	14	7	122	21
Other foundations under $125 million[7]	Between 2000 and 2002	120	36	13	4	93	16
Total		**9,087**	**2,954**	**1,736**	**207**	**7,662** [8]	**2,095**

1 The foundations reflected in this 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.

2 Transfers include $100 million announced in the March 2004 Budget that were receivable by the foundations at March 31, 2004.

3 In addition to grants, this column includes eligible project expenses.

4 These balances are at the date of the latest annual reports, where March 31, 2004 financial statements are not yet available – modified to include the $100 million announced in the March 2004 Budget.

5 Figures based on representations from foundations, where not disclosed in their financial statements.

6 For endowment funds only the earnings are disbursed: these include Green Municipal Investment Fund; Pierre Elliott Trudeau Foundation; Clayoquot Biosphere Trust Society; Pacific Salmon Endowment Fund Society; Canadian Institute for Research on Linguistic Minorities, University of Moncton; and Frontier College Learning Foundation.

7 These are Foundation for Climate and Atmospheric Sciences and Forum of Federations.

8 In addition to funding for foundations and endowments, $550 million had been transferred to other organizations at arm's length from the Government, $391 million of the transferred amount had yet to be used at March 31, 2004. These organizations are Canadian Institute for Health Information; Green Municipal Enabling Fund; Precarn; Canadian Network for Advancement of Research, Industry and Education; Canadian Institute for Advanced Research and Canadian Centre for Learning.

I have also expressed concerns about the accountability regime for the foundations and that accounting considerations may be preventing the Government from making all the necessary improvements. In other words, the accountability and governance structures for the foundations may be influenced by the desire to ensure that transfers to foundations can be treated as expenses immediately, rather than when these funds are used by the foundations for their ultimate purposes. In my view, decisions on funding and accountability should be based on the need for sound management of public funds; they should not be based on the goal of achieving a desired accounting result.

In past reports I have indicated that while I have questions about the Government's accounting for transfers to foundations, I cannot state unequivocally that the Government has not complied with current accounting standards established by the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants. I have also noted in previous Observations that PSAB had two projects of relevance to our discussion of the accounting for foundations. Currently, we are discussing with officials of the Treasury Board Secretariat the implications of one of these projects, the recent PSAB standard on the government reporting entity, which is to be implemented by the 2005-06 fiscal year. We will review the Government's interpretation of this new standard in the coming year.

We also continue to monitor progress on the other PSAB project, which seeks to revise guidance on the accounting for government transfer payments, including multi-year funding.

With regard to the accountability regime for foundations, the 2004 Budget restated the Government's commitment, first announced in the 2003 Budget, to make improvements. My expectations for these improvements include credible reporting of results, effective ministerial oversight, and adequate external audit. While the Budget commitments appear to place more emphasis on some of these elements (notably reporting) than on others, they are nonetheless encouraging.

I plan to examine the accountability regime for foundations, including the extent to which the Government has acted on its commitments, in an audit to be included in my February 2005 Report.

I wish to reiterate that I express no view on the merits of foundations as a vehicle to deliver government programs. Nor should my comments be interpreted in any way as a criticism of the individuals in charge of the foundations. My concerns relate solely to the funding of these organizations in advance of need; the existing provision for their accountability and governance; and the way the Government accounts for its transfers to them.

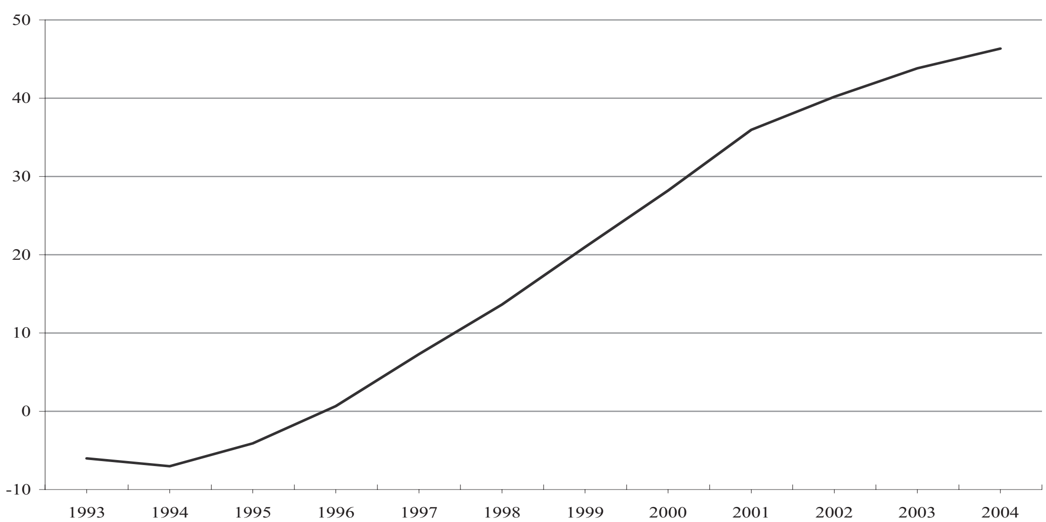
EMPLOYMENT INSURANCE ACCOUNT SURPLUS

Another long-standing issue I have included in my audit report has been the Employment Insurance (EI) surplus. In 2003-04, the Employment Insurance surplus grew by an additional $2 billion (including interest revenue of $1 billion on the balance of the Account) to reach $46 billion. This is more than three times higher than the reserve the Chief Actuary said was sufficient in his 2001 report on Employment Insurance premium rates. Because Employment Insurance is a government program, EI premiums, benefits and other transactions are included in the financial statements of the Government of Canada. The impact of including the Employment Insurance program in the Government's accounts was to increase the Government's annual surplus by $2 billion for 2003-04 and reduce the accumulated deficit at March 31, 2004 by $46 billion.

I have noted that in the 2003 Budget legislation, the Government set the 2004 premium rate at $1.98 per $100 of insurable earnings. The intention was to equal projected premium revenues with program costs for that year. While this may ensure that the surplus does not grow significantly in the year commencing January 1, 2004, it does nothing to address the surplus that has accumulated.

Balance of the Employment Insurance Account at March 31

Billions of dollars



Figures have been adjusted to reflect accrual accounting before 2002.

Section 66 of the *Employment Insurance Act* (which is currently suspended) requires that as far as possible, premiums paid by contributors provide the EI Account with enough revenue over a business cycle to pay authorized amounts charged to the Account while maintaining relatively stable premium rates. In my view, this means that Employment Insurance premiums should equal expenses over a period of time, while providing for a sufficient reserve to keep rates stable in an economic downturn.

I note that in its 2003 and 2004 Budgets, the Government stated that the following principles of rate-setting would guide its ongoing consultations:

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

These principles are, in my view, consistent with an interpretation that Parliament intended the EI program to be run on a break-even basis.

Parliament did not intend, in my view, that the Account would accumulate a surplus beyond what could reasonably be spent for employment insurance purposes, given the existing benefit structure, while also providing for an economic downturn. Accordingly, in my opinion, the Government did not observe the intent of the *Employment Insurance Act*.

When it first suspended section 66 of the Act, the Government indicated that it would undertake research and public consultations on the process of setting premium rates. Those consultations had not taken place by the February 2003 Budget. In that Budget, the Government formally announced that it would conduct consultations on a new rate-setting process to be implemented for 2005.

In the 2004 Budget, the Government informed Canadians that it was reviewing the results of the consultations and reiterated its intention to introduce legislation to implement a new mechanism for setting premium rates. However, the 2004 Budget legislation gave the Governor-in-Council the authority to set the rate once more, for 2005, in the event that the legislation was not passed in time.

The EI surplus has grown to \$46 billion by March 31, 2004. I note with disappointment that, at this writing, legislation addressing this issue is still not in place. I strongly urge the Government to resolve this long-standing matter.

ONGOING ACCOUNTING CHALLENGES

In the past, as a result of my audit of the summary financial statements of the Government of Canada, I have noted issues relevant to the broader financial management of the Government that I have discussed in my Reports to Parliament, in chapters on financial management and the use of financial information. I will continue this practice with a chapter in my February 2005 Report.

Items that focus specifically on the Government's financial statements I report in my Observations on the financial statements of the Government of Canada. This year, I would like to discuss the Department of National Defence's progress and its continued difficulties in recording and tracking the cost of its inventory. I also discuss the Canada Customs and Revenue Agency's[1] challenges in dealing with the limitations of its financial reporting systems in the recording of tax revenue and receivables.

National Defence

Inventories at the National Defence account for the largest part of the \$6.1 billion in Government inventories. Historically, the Department maintained inventory systems focused primarily on keeping track of quantities; as a result, cost accuracy was not emphasized and errors were made in the recording of costs. Last year I discussed many of the difficulties that

[1] On December 12, 2003 the government announced a restructuring which resulted in the creation of the Canada Border Services Agency (CBSA). Responsibility for the administration of the *Customs Act* has been transferred in large part to the CBSA.

National Defence faced in this area. I also noted that this situation was not unique to Canada and that many other national governments had found determining the cost of military inventory a daunting task.

At that time, National Defence committed to a strategy for enhancing its practices to ensure that appropriate controls were in place to:

- record the costs of current purchases properly in its inventory system;
- relieve the costs of old inventory properly over time as the inventory is used; and
- monitor usage properly and determine ongoing adjustments to reflect the obsolescence of inventory items.

I note that a number of improvements have been instituted. National Defence has reviewed some of its historic costs for items such as munitions and has made the necessary corrections. It has also improved the controls designed to detect errors made in the recording of inventory. It has established an interdepartmental committee to discuss ongoing challenges to improving its inventory records. And it is making changes to its information system to improve the ongoing monitoring of inventory inflows and outflows.

Unfortunately, errors continued to be made in the valuation of inventory. These largely relate to whether the costing of inventory was properly supported and whether the current-year transactions (purchases, usage, and obsolescence) were properly reflected in the summary financial statements. Most of these errors were corrected by National Defence staff but predominantly as part of their year-end effort to close the accounts. It would be preferable that these errors had not occurred in the first place, or that they had been discovered as part of the department's regular monitoring processes.

The Department has made limited progress in its efforts to determine the extent of inventory that is obsolete. It has identified a portion of its inventory as "dormant" and is currently asking managers to identify the amount of dormant inventory that should be considered obsolete and thus would require adjustment in its inventory records.

Canada Customs and Revenue Agency

Another of the challenging aspects of the Government's financial statements relates to the accrual of tax revenue, which involves, among other things, the recognition of tax receivables of $48 billion and tax payables of $33 billion.

The accrual of tax revenues is assessment-based and derives data primarily from the various tax program systems. These systems were never designed as accounting systems, and extensive manipulation of data is necessary in order to present revenues and receivables on an accrual basis of accounting. The Canada Customs and Revenue Agency has a multi-year plan to introduce accounting sub-ledgers for its revenue lines. On an interim basis, reports are generated from the program systems and reconciled to the Agency's general ledger to ensure that tax revenues and receivables are reported accurately. This process involves extensive manual processing and numerous reconciliations. Despite this, unexplained differences remain between the amounts receivable in the general ledger and the various reports taken from the tax program systems to support these amounts.

In the current fiscal year, management has identified a number of underlying causes of some of these differences. However, unexplained differences continue and I am concerned that until an accounting system is put in place, with appropriate sub-ledgers that support the amounts recorded in the general ledger and the Government's financial statements, unexplained differences will recur.

Summary

I wish to emphasize that the issues at neither National Defence nor the Canada Customs and Revenue Agency is currently significant enough to conclude that the financial statements do not fairly present the Government's financial positions and results of operations.

Nonetheless, in my view, both organizations need to address these weaknesses in the financial reporting processes they have in place with respect to these significant balances. While I recognize the extent of the challenge and the time it will demand, identifying and implementing solutions should be a priority.

STATUS OF ITEMS REPORTED IN PREVIOUS YEARS

Observation	Current Status
Timely reporting	I have noted in the past that the usefulness of the Government's summary financial statements is diminished when they cannot be made public until six months after year-end. I also have noted that, in the present environment, there are significant challenges to the more timely preparation of the Government's summary financial statements. In Budget 2004, the Government has committed to monitoring its process to determine if more timely release of its financial results is possible in the future.
Clarity in terminology	The Government continues to use the term "federal debt" in some of its publications. While I understand this term was coined to eliminate confusion regarding the Government's annual surplus position, I remain concerned that used in place of "accumulated deficit," this term could be misinterpreted by Canadians.
Departmental financial statements	In March 2004, the Government committed to having departmental financial statements audited in five years. In the past, I have expressed some concerns about the amount of work required before departments would be ready to prepare reliable financial statements. While much has been accomplished since I made that statement, I still believe a great deal more will need to be done to get the departments and agencies affected by this decision ready to have audited financial statements. I will continue to work with the Government as it moves toward this goal.
Netting	Last year I applauded the Government for generally removing netting from its summary financial statements. I did note a concern about the continued use of netting in the Annual Financial Report. I note that the Government committed in Budget 2004 to exploring ways to make the presentations in the Budget, the Annual Financial Report and the Public Accounts comparable.
Reporting to Parliament	I have recommended that the Government consider enhancements to the way it reports its financial results to parliamentarians and other interested Canadians. I understand that the Government is looking at this issue under its Improved Reporting to Parliament project.

MY AUDIT REPORT EXPLAINED

For readers who would like a more in-depth explanation of my audit report, I have provided that information on my Web site together with my Observations (www.oag-bvg.gc.ca).