

**SUPPLEMENTARY INFORMATION
OBSERVATIONS OF THE AUDITOR GENERAL
ON THE
FINANCIAL STATEMENTS OF THE GOVERNMENT OF CANADA
FOR THE YEAR ENDED MARCH 31, 2006**

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, 2006:

**AUDIT OPINION IN ACCORDANCE WITH CANADIAN GENERALLY
ACCEPTED ACCOUNTING PRINCIPLES**

This year there has been a change in my Report on the Financial Statements of the Government of Canada. For the first time, my opinion states that “these financial statements present fairly, in all material respects, the financial position of the Government as at March 31, 2006 and the results of its operations, the changes in its net debt and its cash flows for the year then ended in accordance with the stated accounting policies of the Government set out in Note 1 to the financial statements, *which conform with Canadian generally accepted accounting principles*”.

This change reflects the issuance by the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants (PSAB) of its standard on generally accepted accounting principles. The issuance of this standard reflects the consensus view of the Canadian public sector accounting community that standards issued by PSAB have been acknowledged as generally accepted and are seen to be a suitable primary source of generally accepted accounting principles.

This significant development has taken many years of diligent work by many people in the government accounting community and should lead to better financial reporting across the Canadian government community.

As a result of this development, the Canadian Institute of Chartered Accountants (CICA) has revised its auditing standards and now requires the auditors of the financial statements of senior levels of government to report on fair presentation in accordance with Canadian generally accepted accounting principles for the public sector.

However, recognizing the importance of following our legislative mandate, which requires me to opine as to whether the Government’s financial statements “...present fairly information in accordance with stated accounting policies of the federal government...,” my opinion refers to both bases.

I would also like to note, that as a result of this change the Government has chosen to amend its accounting policy note to indicate that its stated accounting policies are based on Canadian generally accepted accounting principles for the public sector. They further elaborate that the presentation and results using the stated accounting policies do not result in any significant differences from Canadian generally accepted accounting principles for the public sector. While I would prefer that the Government had indicated its commitment to conforming to Canadian generally accepted accounting principles, the fact that there are no significant differences between the two bases of accounting allows me to issue an unqualified opinion for this year. However, should any significant differences arise in the future, I would seriously consider issuing an opinion with qualification.

GOVERNMENT REPORTING ENTITY

This year, the Government has applied the Public Sector Accounting Board of the Canadian Institute of Chartered Accountants revised standard on the government reporting entity. This revised standard changes the requirements for determining which organizations should be considered to be part of the government for purposes of financial reporting. Under this new standard, organizations should be considered part of the government if they are “controlled” by the government. This differs from the previous standard, which also considered ownership and accountability.

The standard defines control for accounting purposes as “the power to govern the financial and operating policies of another organization.” It indicates that this control can be exercised by establishing an organization’s fundamental purpose and eliminating or significantly limiting the ability of the organization to make future decisions by predetermining the financial and operating policies of the organization.

Organizations that are determined to be controlled by the government are treated as part of the government reporting entity. The summary financial statements of the Government of Canada would then reflect their assets, liabilities, expenses, and revenues. Transfers to these organizations would not be treated as expenses until the organization uses these funds for their intended purposes.

This is a particularly challenging standard to apply because the government must consider the preponderance of evidence to judge whether the organization is controlled by the government; there is no single rule or criterion to establish control.

The Government has determined that, starting in 2005-06, a number of organizations will be included within the government reporting entity, including the following key entities:

- Canada Foundation for Innovation
- Canada Millennium Scholarship Foundation
- Canada Foundation for Sustainable Development Technology
- Aboriginal Healing Foundation
- St. Lawrence Seaway Management Corporation

The implementation of this new standard has reduced the Government’s opening accumulated deficit at April 1, 2005 by some \$5.1 billion. A complete description of the impact of this accounting policy change is included in Note 2 to the financial statements.

In undertaking the analysis required to implement this standard, the Government has focussed on the more significant entities and those considered most likely to be controlled. In my view, this is a reasonable approach. I should note, however, that it does present the possibility that the accounting treatment of some entities, which currently are not significant, may need to be revisited in the future.

Given the Government’s review of all significant entities, I am satisfied that its interpretation of this new standard and its presentation in the financial statements is in accordance with Canadian generally accepted accounting principles for the public sector.

I am pleased that the Government has addressed this difficult issue. The implementation of this standard enhances the Government’s summary financial statements in two ways. First, it gives a more complete picture of the Government by including organizations that, while not owned, are controlled by the Government and deliver government programs using public money, such as the Canada Foundation for Innovation and the Canada Millennium Scholarship Foundation. Second, by including these entities, the Government’s summary financial statements reflect expenses related to these organizations, when funds are used for their ultimate purposes, rather than when they were transferred to these organizations. Together, this results in a financial statement that provides a more complete and fair presentation of the Government’s financial position and results.

YEAR-END TRANSACTIONS

The 2005-06 Statement of Operations includes \$3.6 billion in expenses that were entered into pursuant to authority given to the Government through *An Act to authorize the Minister of Finance to make certain payments* (Bill C-48). These transactions include \$320 million for payments for foreign aid as well as \$3.3 billion in transfers to the provinces and territories.

The latter obligations were created prior to March 31, 2006 by the Government's communication to the provinces and territories of its intention to transfer these funds to provinces through irrevocable trust agreements.

The letter indicated that the amount of the transfer would depend on the size of the federal government's surplus, which would be determined upon close of the Government's accounting records in the summer of 2006. The terms of the letter made it clear that the Government had relinquished its discretion to avoid settlement of this obligation. Since at March 31, 2006, the only uncertainty was the amount of the obligation, and thus the Government was obligated to make a payment, these amounts were recorded as expenses in 2005-06.

As with previous arrangements, the Budget and the Schedule to the Trust Agreements anticipate that the provinces will use these funds over several years. However, the agreements allow for the provinces to ask that payments be accelerated—in effect, the provinces could access all their funds immediately.

In assessing the accounting for these transactions, I concluded that the Government's accounting treatment was acceptable because the Government:

- had agreed to make the payments (with the amounts to be determined by formula);
- had not included in the letter or trust agreements any condition to be eligible to receive these funds that would have to be met by the provinces subsequent to March 31, 2006; and
- had authorization from Parliament to make the payments.

STATUS OF ITEMS REPORTED IN PREVIOUS YEARS

Observation	Current Status
<p>Netting</p>	<p>In past reports I have indicated my concern that the Government did not produce its Annual Financial Report on the same basis as its summary financial statements.</p> <p>I was concerned that the Government had maintained its practice of netting certain expenses against revenue in the Annual Financial Report. (This practice was discontinued in the summary financial statements in 2004.)</p> <p>In the May 2006 Budget, the Government took action to address this issue and improve the comparability and transparency of its financial information by presenting its Budget 2006 forecast on a gross basis. It further indicated that the <i>Annual Financial Report of the Government of Canada</i> and <i>The Fiscal Monitor</i> results would also be presented on a gross basis.</p> <p>I am pleased with this development as it enhances the clarity of the Government's financial reporting by removing a potential source of confusion.</p>
<p>Canada Revenue Agency/ Canada Border Services Agency — Tax revenues</p>	<p>In the past I have indicated my view that improvements need to be implemented in the accounting systems and practices for tax revenue at the Canada Revenue Agency and the Canada Border Services Agency. 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 to present revenues and receivables on an accrual basis of accounting. This process involves extensive manual processing and numerous reconciliations. Despite this process, 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.</p> <p>While management of both agencies have identified underlying causes of some of these differences, unexplained differences continue to exist at year-end.</p>
<p>National Defence inventory</p>	<p>In past years I have reported that improvements in the accounting systems and practices related to inventory were needed at National Defence. Historically, the Department maintained inventory systems focused primarily on keeping track of quantities. This resulted in less emphasis on cost accuracy, and errors were made in the valuation of inventory.</p> <p>While noteworthy improvements have been made in the recording of both quantities and values; issues, such as obsolescence, remain in the overall valuation of inventory, and therefore continued monitoring is recommended to ensure the cost of inventory be properly reflected in the summary financial statements.</p> <p>The Department of National Defence continues to focus effort on the proper recording of inventory, particularly as part of the year-end financial work. The Department has several initiatives underway to further address these problems, and our Office will continue to monitor these closely.</p>

Observation	Current Status
Timely reporting	<p>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.</p> <p>I understand that the Government continues to look for ways to expedite the preparation of its summary financial statements. It is important, however, that appropriate internal controls and the fairness of estimates be maintained.</p>
Clarity in terminology	<p>The Government continues to use the term "federal debt" rather than "accumulated deficit" in some of its publications. While I understand this term was coined to eliminate confusion about the Government's annual surplus position, I remain concerned that used in this way, it could be misinterpreted by Canadians and leave an incorrect impression about how the annual surplus is used.</p> <p>In particular, I am concerned because this use of the term could lead to a misconception that the annual surplus is used to reduce the Government's debt. While the accumulated deficit is automatically reduced at the end of the fiscal year by the amount of the annual surplus, government debt is not. The annual surplus is simply the figure that indicates the difference between the Government's revenues and its expenses at the end of the fiscal year, not an amount of cash that is free for the Government to use in any other way – including paying some of the debt it has incurred.</p> <p>I note that the Government does take care to accurately reflect this in the Annual Financial Report. However, in my view it could explain these financial results more clearly to Canadians by using correct terms consistently in all its public statements and publications.</p>

Observation	Current Status
<p>Departmental financial statements</p>	<p>In March 2004, the Government committed to having departmental financial statements audited in five years.</p> <p>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 audits of their financial statements.</p> <p>One particular concern involves the slow progress by departments in responding to key weaknesses in internal financial controls (that is, computer information system controls, associated management and monitoring controls, and processing controls) identified in previous audits. While work to date has indicated that certain departments have dealt with these concerns about their internal financial controls, other departments have not yet satisfactorily addressed all previously identified weaknesses in their financial application systems.</p> <p>To this end, I support the initiative of the Office of the Comptroller General to have departments undergo an audit readiness assessment by an external auditing firm. I understand that this assessment is designed to ensure that departmental internal financial control processes are well documented and exist within a sound internal control environment. This initiative has the potential to identify key areas for improvement and address previously uncorrected weaknesses.</p> <p>Further, this initiative, coupled with the commitment of the Office of the Comptroller General to monitor the results and work with departments to ensure that corrective action is taken as required, has the potential to address many of my concerns.</p> <p>I will continue to work with the Government as it moves toward this goal.</p>
<p>Accrual appropriations</p>	<p>In the past, I have reported on my concern that the lack of progress on moving to full accrual-based budgeting and appropriations has had an impact on departments' and agencies' use of accrual financial information in decision making. Essentially, they are using the accrual method only to prepare information for the Government's summary financial statements and other limited Treasury Board Secretariat requirements. While the Treasury Board Secretariat has been studying departmental accrual-based budgeting and appropriations for many years, it has only recently completed a key study and has yet to make this public.</p> <p>I understand that the Treasury Board Secretariat will use the results of this study to make a recommendation to the Treasury Board as well as the Department of Finance and the Privy Council Office as to whether accrual concepts in the budgeting process and the appropriations at the government-wide and departmental levels should be adopted and if so, the extent and manner of implementation.</p> <p>At this time, I have not been informed of the nature of the recommendation that the Treasury Board Secretariat will make arising from this study.</p> <p>Given the importance of this initiative to the full use of accrual financial information, as well as the high level of interest displayed by parliamentary committees, I will continue to monitor progress.</p>

Observation	Current Status
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 note that in the current year it has reduced duplication in reporting by having the financial statements of departmental corporations presented in their departmental performance reports rather than in Volume III of the Public Accounts. I support this change and encourage the Government to continue its efforts to ensure that information is presented to Parliament in the most suitable manner.

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).