

Management Practices
No. 15

**SPECIAL OPERATING AGENCIES:
FINANCIAL ISSUES**

John Dingwall



CANADIAN CENTRE
FOR MANAGEMENT
DEVELOPMENT

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CANADIAN CENTRE FOR MANAGEMENT DEVELOPMENT

A Word from CCMD

This paper is the fifth of a set of ten “issue papers” arising from a large-scale, collaborative research study on Special Operating Agencies (SOAs).

Special Operating Agencies are operational organizations which have a degree of autonomy within existing departmental structures, but which remain accountable to the deputy minister. Operating under a business plan and management framework which set out the results and service levels expected, each SOA negotiates certain financial, personnel, and administrative flexibilities from its parent department and from the Treasury Board. The aim is to give greater flexibility and scope to employees and managers in their operational roles and to encourage innovation and high performance in the delivery of services.

SOAs have functioned as a laboratory or testing-ground for change, and have pioneered such innovations as single operating budgets, person-year decontrol, and business plans. They have substantial experience with developments that are now affecting the rest of the public service.

The SOA initiative was first announced in December 1989, and the first group of SOAs was established in the spring of 1990. By 1993, enough experience with SOAs had been gained to warrant a general study, and the Canadian Centre for Management Development (CCMD) and Consulting and Audit Canada (CAC) began work on this subject. The scope of the project was expanded as the Office of the Auditor General became involved in response to interest expressed by members of Parliament (the Public Accounts Committee) who were aware of the Executive Agencies initiative in Britain and wanted information on similar developments in Canada.

It was agreed that it would be useful to have a general stocktaking of the SOA initiative, and that this would best be done as a collaborative research project involving the Canadian Centre for Management Development, Consulting and Audit Canada, the Office of the Auditor General, the Treasury Board Secretariat, and the Special Operating Agencies and their host departments. One feature of this collaboration was the development of a common research base which could be accessed by all who were involved in the research, analysis, and writing. The research base consists of interviews with the chief executive officers of the SOAs and the deputy and assistant deputy ministers to whom they reported; sets of documents, including the business plans, framework documents, and annual reports of the SOAs; and detailed profiles and self-assessments from the larger Agencies. This common research base was used in the preparation of *Special Operating Agencies: Taking Stock*, a report prepared by the Office of the Auditor General. It was also used for developing a set of papers focusing on specific issues related to SOAs. Drafts of these papers were taken into account in the preparation of the Auditor General's report.

CCMD is delighted to have collaborated in the development of this series on Special Operating Agencies and views this initiative as an excellent example of a joint research partnership. We are grateful to David Wright of Consulting and Audit Canada and to Graeme Waymark for their important contribution to this series of publications and especially wish to thank John Dingwall who prepared this paper on *Financial Issues* in his role as a faculty member in the CCMD Research Group.

Janet R. Smith
Principal

Ralph Heintzman
Vice Principal, Research

List of SOA Issue Papers

This is the fifth paper in a series on Special Operating Agencies to be published by the Canadian Centre for Management Development in partnership with Consulting and Audit Canada. This is the list of papers to be included in this series:

Overview of the Special Operating Agency Initiative
(J. David Wright and Graeme Waymark)

Special Operating Agencies: Autonomy, Accountability and Performance
Measurement
(J. David Wright)

Special Operating Agencies: Issues for Parent Departments and Central Agencies
(Alti Rodal)

Special Operating Agencies: Business Plans and Annual Reports
(Doreen Wilson)

Special Operating Agencies: Financial Issues
(John Dingwall)

Special Operating Agencies: Human Resources Management Issues
(Betty Rogers)

Special Operating Agencies: Marketing
(John Dingwall)

Special Operating Agencies: Audit and Evaluation
(Michael Thomas)

Special Operating Agencies: Management Advisory Boards
(Jane Newcombe)

Institutional Analysis of Recent Machinery-of-Government Reforms in Australia,
United Kingdom, France and New Zealand
(Denis St-Martin and Michael Collins)

Further information on this series may be obtained from: David Wright, Principal Consultant, Consulting and Audit Canada, who may be reached at (613) 995-8572.

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Finally, a special word of appreciation should go to the financial officers in Special Operating Agencies who, through interviews, provided much of the information on which this paper is based, and who also provided many helpful and thoughtful comments on the draft of this paper.

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I Introduction

This paper identifies and discusses financial issues facing Special Operating Agencies (SOAs). It is one of ten papers on specific issues related to SOAs written in parallel with a collaborative stocktaking study of SOAs, which, taken together, will provide useful information to the SOA community, to organizations which are considering SOA status, and to other interested parties.

Nature of Special Operating Agencies

Special Operating Agencies are operational organizations within existing departmental structures which remain part of their respective departments and are accountable to the deputy minister. SOAs deliver goods or services to clients within the federal government or to the general public. Operating under a business plan and management framework which set out the results and service levels expected, each SOA negotiates certain financial, personnel and administrative flexibilities from its parent department and from the Treasury Board. The aim of SOAs is to give greater authority and scope to individual employees and managers in their operational roles and to encourage innovation and high performance in the delivery of services.

SOAs demonstrate the following characteristics:

- a focus on delivering quality services;
- a stable policy framework and clear mandate;
- a business-like approach – improved efficiency and commitment to performance;
- an accountability framework – a management contract comprised of a framework document and business plan;
- tailored flexibilities and delegated authorities; and
- a challenge to managers to achieve results.

Means of SOA Differentiation

Fifteen SOAs have been established to date, and a number of organizations are seeking approval for SOA status. SOAs comprise a diverse group, varying along the following dimensions:

- *Size*: SOAs range in size from 30 full-time equivalents (FTEs) and a budget of \$5 million, to 1600 FTEs and a budget of \$600 million.

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- *Optionality*: Some SOAs provide mandatory or regulatory services, while others provide optional services on a competitive basis.
- *Funding Mechanisms*: Some are fully cost recovered and funded through a revolving fund; some are funded totally through appropriations; and others are funded through a combination of appropriations and revenues.

Each of these particular SOA characteristics raises a different set of financial issues.

Structure of the Report

This report is organized into chapters which deal with the following subjects: funding mechanisms; financial requirements and budgetary issues; pricing; information systems; and cultural differences and related skills and training issues. A concluding chapter reviews some of the issues related to the financial dimension of Special Operating Agencies.

II Funding Mechanisms

Three funding mechanisms are currently in place within the federal government: appropriations, net-voting, and revolving funds. An SOA may be funded through one or a combination of these mechanisms. In this section, the three funding mechanisms and the issues pertaining to each will be briefly described and discussed.

Appropriations

An appropriation is a parliamentary authority for an organization to receive a certain level of funding to cover salaries, operating expenses, minor capital acquisitions, controlled capital acquisitions, grants, contributions, and other transfer payments.

SOAs funded through appropriations are normally included in the same parliamentary votes as other components of the department, in which case there is no parliamentary restriction on transfers between SOA appropriations and other departmental appropriations. Similarly, there are no Treasury Board allotment controls on the SOA component of departmental appropriations. Departments are free to transfer money back and forth between the SOA and other components within the same vote, without reference to Treasury Board.

SOA appropriations are treated in exactly the same way as other departmental appropriations. In particular, any appropriation funding received by an SOA is included in the base from which Treasury Board calculates expenditure reductions for the department. It is worth noting that SOAs were among the first organizations to implement the Operating Budget concept, which allows flexibility to move funds between salaries, operations and maintenance, and minor capital. This flexibility has since been extended to all departments and agencies, and SOAs continue to enjoy its benefits.

Re-spending Authority / Net-Voting

Net-voting is a vehicle used to finance an activity from user fees and to provide the department with a degree of financial flexibility to respond to changing client demands. The authority to net-vote is normally approved on an annual basis through vote-wording in an appropriation act. Under net-voting, Parliament authorizes an organization to apply directly related revenues to costs incurred in earning those revenues. Parliament then votes an appropriation of the net financial requirements (estimated total expenditures less estimated total revenues). Specific items of expenditure for which the net-voting will apply and limits on expenditure of revenue are approved by Treasury Board.

Anticipated revenues and expenditures are reported separately in the Main Estimates, the Public Accounts, and other statements which are required by Parliament and central agencies. Any variances between the approved revenue and expenditure levels and forecasts are reviewed by Treasury Board to determine whether the approved expenditure levels need

to be adjusted downwards or upwards in light of the arrangements negotiated with the department.

Net-voting arrangements are used for organizations or activities that are not expected to be self-sustaining, but in which it is likely that a significant portion of the related expenditures can be offset by revenues. Net-voting arrangements have been established for several SOAs that fall within this category.

This mechanism can work well when the revenues of the organization are relatively stable and predictable and are actually received during the year for which the budget has been increased. In practice, however, difficulties can arise with time lags and variability in revenues. One problem is that revenue in the current fiscal year may be higher than anticipated. The arrangements approved by Treasury Board usually contain an automatic provision for giving the organization credit for these revenues, up to a certain percentage ceiling (for example, 130 percent of the amount negotiated in the Main Estimates). Any revenues in excess of this ceiling could still be credited, but this would require Treasury Board approval and inclusion in Supplementary Estimates. Conversely, if there is a shortfall in revenues during the current fiscal year, then that portion of the SOA's budget which had been negotiated in anticipation of these revenues may not be spent but will be frozen and lapsed.

The problem that proved to be a real irritant in some cases occurred when the SOA had rendered a service during one fiscal year, but did not receive the revenues until the next fiscal year. The actual cut-off date was April 15 (not March 31): revenues received before April 15 could be credited to the budget for the fiscal year in which they had been anticipated – and could thus be spent. Revenues received after April 15 were in effect lost to the organization. (They were received too late to be credited to the fiscal year which had just ended, but they were still treated as having been earned in that year and hence could not be credited in the following year.) Late payment of invoices by clients could prove costly for SOAs in that situation.

Revolving Fund

A revolving fund is a continuing or non-lapsing authorization by Parliament to make payments out of the Consolidated Revenue Fund (CRF), up to a stipulated limit, for specific purposes such as working capital, capital acquisitions, and temporary funding of accumulated operating deficits. As part of this authorization, the expenditures made for these purposes are to be offset, to the extent possible, by generated revenues. The dollar amount of the non-lapsing authority approved by Parliament must not be exceeded. (For further information and for a comprehensive discussion of revolving funds, please see *Appendix A: Revolving Funds*.)

Revolving funds are first approved by Treasury Board, either as part of the SOA framework document or in a subsequent submission, and then by Parliament, usually as part of an Appropriations Act. There has been a link between revolving fund status and SOA status. Four of the first five SOAs were on revolving funds before they became Agencies (which is why they were selected as Agencies), and one of them went on a revolving fund on becoming an Agency. The larger Agencies established since then either have a revolving fund or are in the process of obtaining one. (For example, the Canadian Grain Commission (CGC) is moving from appropriations to a revolving fund.)

Treasury Board has been reluctant to approve revolving funds in the absence of SOA status. For instance, in one recent case a revolving fund was approved on the condition that an SOA be established. The SOA structure also allows for greater accountability and transparency for revolving funds: SOAs function within the parameters of their framework documents, and they provide business plans (for Treasury Board and the host department) and in some cases annual reports, complete with performance indicators. This represents a higher level of reporting and accountability than is seen with other revolving funds.

It is not a requirement that SOAs be funded through revolving funds. Since the cost-recovery possibilities for a number of SOAs are limited, it would not make sense to establish a revolving fund in these cases.

Revolving funds raise a number of issues of interest to current and potential SOAs. These include: materiality considerations; time period for self-sufficiency; and treatment of surpluses. The following sections address each of these issues.

Materiality Considerations

Treasury Board policy states that materiality is an important criterion in the establishment and approval of a revolving fund because of the significant costs associated with setting up and managing this fund, costs which could include the purchase or development of a new financial system to handle the requirement for accrual accounting. (See *Appendix A* for details.)

According to current practice, an organization must have at least \$10 million in revenues in order to be a candidate for a revolving fund. Approval for less than that amount is considered to be transitional; that is, a revolving fund for a lesser amount might be approved on the understanding that the \$10 million threshold would soon be reached. This threshold level is intended to limit the proliferation of revolving funds – given the costs involved, for example, in set-up and accounting systems – and to avoid the problems of lack of visibility or accountability for the monies being spent. However, both of these concerns could be addressed by linking revolving fund approvals to SOA status, as is increasingly the case. (With current trends, we are not far away from having a one-to-one correspondence between

revolving fund status and SOA status.) The reduction or removal of the \$10 million threshold would enable smaller SOAs to have their own revolving funds.

By way of example, the province of Manitoba makes a direct linkage between SOA status and revolving fund approvals. In this province it is technically impossible to have a revolving fund without being an SOA, since by legislation, the only way to have a revolving fund is through the SOA Financing Authority. Manitoba has no limits on the size of revolving funds, and one of its SOAs has a fund with only \$700 thousand in revenues. (Please see *Appendix B* for details of the Manitoba example.)

Time Period for Self-Sufficiency

The normal accounting period for an SOA is the fiscal year. Where the SOA has a revolving fund, the fiscal year serves as the accounting period for the revolving fund and for the calculation of changes to the fund authority.

The break-even period may extend over several years, and in such cases, this will be written into the framework document approved by Treasury Board. For example, the break-even period for the Passport Office is four years and for the Grain Commission five years, thus taking account of situations where significant variations in revenue exist which are beyond the control of the SOA. For the Passport Office, travel volumes can vary significantly between years, and are beyond its control; and for the Grain Commission, its bottom line depends on grain volumes which in turn depend on the weather and on international markets. In such cases, it is difficult to determine what the bottom line really means on a year-to-year basis, what the reasons really are for the variation, and what, if anything, the SOA can do about it in the short term. A longer time frame which allows for calculations on the basis of averages and trends must be used to take these factors into account and to provide a realistic basis for stabilizing the rates and the expected proportions of cost recovery.

Treatment of Surpluses

It is possible that SOAs operating on a cost-recovery basis will build up surpluses in revolving funds. Surpluses, as well as deficits, belong to the Government of Canada as demonstrated in the Public Accounts, where surpluses and deficits are reported as "Equity of Canada." This is analogous to a private sector business where profit or loss is considered to belong to the shareholders, although this does not accrue to them until paid out in dividends. The Government of Canada, as the sole shareholder in an SOA, is free to determine what action is taken with respect to any surpluses which arise.

The existence of surpluses in SOAs and their treatment emerged as an important issue over the course of this study. Agencies that had accumulated surpluses at one point or another felt that some portion of the surplus which they had earned should remain with the Agency

where it could be used for investment purposes, such as the purchase of major equipment. A contrary view holds that because SOAs with revolving funds are expected to break even, the existence of an accumulated surplus simply indicates that the fees are too high and do not accurately reflect actual costs. This is especially true of regulatory Agencies, where clients have no choice but to pay the set fees. In these cases, it could be argued, the fees should be reduced or at least frozen.

However, the profit motive that drives private industry is an important motivational tool, one which can apply equally to the SOA environment. For SOAs that are self-sufficient, achieving positive results on the bottom line is a source of pride, and striving for this goal becomes part of the culture. Removing or weakening this motivation could have a negative effect on employee morale.

For instance, not long before becoming an SOA, one organization had built up an accumulated surplus which it had hoped to use for capital investment in computer systems. Instead, it was directed to set its fees at a level low enough to reduce the accumulated surplus. Employees then found that they were working harder than ever, but that the organization was losing money – as intended by the directive. When it became an SOA, it found itself with a shortage of investment capital, with the result that many of its professional staff have had to work without computers until recently.

A restriction on surpluses makes it difficult to set financial targets and to motivate employees accordingly. In the current situation, there is some incentive to show a positive bottom line, even if the surpluses are to be returned to the Consolidated Revenue Fund: this is a matter of pride for SOAs, as indicated by the financial officers who were interviewed for this study. However, the bottom line should not be too positive: a high level of success could well attract adverse attention with no offsetting benefits. The effective incentive is to show a modestly positive bottom line, and to bring costs and revenues into approximate balance. There is no financial incentive for making a major effort to maximize revenues and minimize costs.

Private sector entities, including those which compete with optional SOAs, build a profit margin or return on assets into the pricing structure. SOAs do not have a systematic means of charging for fixed capital costs (the entire asset base) or for building in a profit margin. On the other hand, SOAs are required (or feel required), as part of the public sector, to incur costs which are unique to the government situation, such as work force adjustment, bilingualism, and the maintenance of money-losing regional operations. In some cases, certain of these costs may be covered through an appropriations component. One example would be CORCAN, which receives an annual fee of \$15.9 million from Correctional Service Canada (CSC) to cover costs related to the correctional aspects of its operations. Another example would be Training and Development Canada (TDC), which receives a regular appropriation

of \$2 million to cover the additional costs of providing courses in French, and which has recently received some supplementary funding for its regional operations.

However, there can be significant costs over and above the appropriations component, which in any event has been cut back in recent expenditure reductions. In one instance, these costs (primarily for work force adjustment and regional operations) amounted to close to ten percent of the Agency's revenues, over and above any appropriations that were received.

Private sector entities are able to retain a portion of earnings to cover items such as major capital replacement or expansion, and research and development. SOAs operating under revolving funds can and do build in a depreciation allowance to cover capital costs, but the scope for retaining the funds needed for major items of capital expenditure over time is limited. When SOAs need funds for major capital purchases, the arrangements are negotiated with either the parent department or Treasury Board on an ad hoc, case-by-case, basis.

Alternatives can be found in other jurisdictions. Manitoba, for example, provides SOAs with the opportunity to earn a return on equity and to retain a portion of their earnings. SOAs are expected to earn enough to pay down the associated long-term debt.

III Financial Requirements and Budgetary Issues

Once they have dealt with questions related to funding mechanisms, SOAs are faced with a number of other financial issues, both in starting up and in ongoing operations. This chapter discusses these issues under the following general headings: (1) Financial Requirements, which focuses on the start-up requirements; and (2) Budgetary Issues, which addresses the linkage of SOA and governmental budgetary processes and the impact of government-wide expenditure reductions on SOAs.

Financial Requirements

Start-up Costs

New SOAs face a number of start-up costs arising in part from the requirement to prepare a framework document and a business plan for Treasury Board approval. (Existing SOAs will need to update their business plans annually and may need to revise their framework documents from time to time, for example if there are changes in their mission or mandate.) The costs of developing these documents can be significant and are more onerous for smaller Agencies. Estimates range upwards from one to three Full Time Equivalents for one year, and \$200-\$500 thousand in non-salary costs.

Although these costs are incurred only once, they can act as a deterrent to the establishment of small SOAs. The start-up costs are not as significant in relative terms for larger Agencies, but can still represent a burden, especially in terms of management time. Start-up costs are further increased when the establishment of the SOA is combined with organizational change or restructuring, as was the case when Consulting and Audit Canada (CAC) was formed, and as is currently the case for the formation of Government Telecommunications and Informatics Services (combining an existing Agency with another part of the department).

It has not been the policy of Treasury Board to provide start-up funding for SOAs. The costs must be covered by the SOA itself and/or the parent department.

It should be noted that while the costs can be significant, the benefits can also be important. The documentation required for SOA status is developed through a strategic planning process which provides a sense of direction for the Agency, and which encourages it to confront certain issues (such as marketing) which had previously received less attention. This process and the resulting accountability documents can also provide a sharper focus for the Agency and a clearer sense of its mission and mandate, along with central agency recognition and ratification of the *raison d'être* of the SOA. For example, one smaller Agency commented that it was relieved to receive such recognition from Treasury Board after having been through several questionings and reviews of its mandate and of the need for its continued existence as a part of government.

Capital Requirements

New SOAs are typically faced with substantial requirements for capital funding. Because capital expenditures have been a prime target for reduction over the past decade, SOAs, like many other federal agencies and departments, have a long list of capital requirements such as computer hardware and network technology.

SOAs with revolving funds have been able to build a provision for depreciation into the fees charged, and have been able to acquire capital as a result. Those SOAs that did not have a revolving fund were unable to finance capital acquisitions in this way, and were forced to rely on appropriation funding.

To speed the process and to finance large projects, alternative means of funding capital acquisitions have been pursued. SOAs have attempted to work with host departments in planning and developing large projects. This can work well in cases where the departmental and SOA needs are consistent and the timing is appropriate to both. However, reliance on the department can result in delays, since larger departments may take some time to put their projects together and to arrange necessary funding.

A second alternative has been for SOAs to negotiate an arrangement with Treasury Board, under which Treasury Board acts as a banker, agreeing to provide funds up front in exchange for increased revenues to the Consolidated Revenue Fund or decreased reference levels in future years. An example of this is the Technology Enhancement Plan of the Passport Office, where the Treasury Board will be reimbursed a certain amount for each passport sold. The problem with this arrangement is that the SOA must compete with everyone else for a share of highly limited reserve funding from Treasury Board. The SOA must make a very compelling case before Treasury Board will consider such an arrangement. This can be costly in terms of management time and administration, and in light of the fact that each arrangement must be negotiated on an ad hoc basis in the absence of clear policy direction or guidance.

In contrast, the Manitoba government has an SOA Financing Authority which is able to provide both loan and equity capital, including start-up capital for SOAs.

Systems

SOAs with revolving funds are required to provide financial information under the accrual system of accounting. With few exceptions, current government financial systems are not designed for accrual accounting, but operate under the modified cash basis of accounting. Implementation of a revolving fund will require the SOA to purchase or develop a financial system that can meet this need. To date, little in the way of shared solutions has taken place: SOAs with revolving funds have typically created or purchased their own financial systems,

at costs ranging upwards from \$200 thousand. However, these costs should decline significantly with the development of shared systems – the Common Departmental Financial System (CDFS), for example, has a revolving fund module.

While the shared systems should take care of the basic accounting needs of SOAs, including those with revolving funds, it will still be necessary for SOAs to make investments in systems which are tailored or customized to their individual needs and which are integrated with other systems, such as Executive Information Systems. For example, CORCAN and the Canada Communications Group (CCG) both have a need for systems that can handle particular requirements, such as inventory control, which are related to manufacturing. The shared systems are unlikely to provide a perfect solution to these requirements, however.

In addition, those SOAs providing optional services on a competitive basis will clearly need to invest in marketing systems and infrastructure, as was the case with the first five Agencies. (Please see the companion paper on *Marketing* for further information on this point.) Much of this can and has been done using less expensive systems which run on PC LANs, but this raises the question of how the various platforms and programs are to be integrated – a problem which has been addressed by the Agencies with varying degrees of success. The general picture is that the solutions are workable, but far from being smooth and automatic.

Investment in Personnel

In terms of investment in personnel, most SOAs appear to have continued past patterns, with no significant increases or decreases in the total resources devoted to this purpose. One exception is CCG, where the average number of training days per employee increased from 1.4 in 1990/91 to 4.6 in 1992/93. (The Government Telecommunications Agency (GTA) has also increased employee training as part of its Total Quality Management initiative.)

SOA status does provide more flexibility for conference attendance, travel, and related training – especially in cases such as attendance at trade shows where this can be combined with marketing and contracting.

In principle, SOAs recognize the importance of training and development, and several have intentions to manage the development of their human resources more systematically, but so far, there is little concrete progress to report, either in terms of establishing an inventory of existing and required skills or of devising a strategy to develop certain sets of capabilities for the organization. Some interviewees commented that there was a continuing emphasis on cost control rather than revenue generation: in such cases, training was seen as an expense rather than an investment.

Budgetary Issues

Budgetary Processes

The two key documents prepared by an SOA set the framework for its planning and budgeting. The framework or charter document is intended to link accountability to a sense of strategic direction: it encourages (and requires) strategic planning, and it defines the boundaries within which the SOA operates. The SOA's business plan outlines, on an annual basis, a series of actions that the Agency will undertake over the next fiscal period or periods. The intent of the business plan is to demonstrate that these actions will improve service to clients, increase the efficiency and effectiveness of operations, and have a positive net impact on government.

In addition to internal budgetary processes, SOAs must interface with the government-wide budgetary process. Treasury Board requires information from SOAs for assessing the individual SOA "bottom line," determining any implications for the Operating Reserve, setting reference levels for appropriations, and including the SOA appropriations and revolving fund parameters in the appropriations acts voted by Parliament. This means that SOAs must provide input for the Main Estimates, in addition to their business plans.

At the time the interviews were conducted, the Multi-Year Operational Plan (MYOP) was still a requirement. In the interviews, certain of the smaller SOAs mentioned that the MYOP process represents an administrative burden, mainly in terms of management time. On the other hand, while they were not happy with having to prepare additional documentation, the larger SOAs did not find the government-wide requirements to be time-consuming. In most instances, the MYOP submission for SOAs is simply a numbers exercise, the main task being to provide the necessary reconciliations, which can usually be done in two or three pages. In some cases, more information is required. For net-voted SOAs, it is necessary to provide the revenue projections and historical data which will be needed to determine the budget levels for the next year. (The same reconciliations and projections will be needed for the Main Estimates, even if the MYOP is no longer required.)

In the Main Estimates review, the main task of the Treasury Board analyst is to determine the implications for the Operating Reserve. For SOAs with revolving funds, the question is whether there is a projected increase in the use of the drawdown authority (in which case there would be a charge against the Operating Reserve) or whether there is a positive bottom line (in which case there would be a credit to the Operating Reserve). Further information on this point is included in *Appendix A: Revolving Funds*. Any large in-year increases in the use of the drawdown authority would be included as an information item in the Final Supplementary Estimates, with a corresponding charge against the Operating Reserve.

Treasury Board appears in most cases to treat business plans and annual reports as information items. Treasury Board's main concern is with the bottom line and with any implications for the Operating Reserve.

Impact of Government-wide Expenditure Reductions

SOAs are affected by government-wide expenditure reductions to varying degrees, depending on their funding mechanisms, their relationship with the parent department, and the extent to which they rely on the market to provide the funds they need.

Since revolving funds in both SOAs and departments are generally self-sustaining, they are exempt from government-wide reductions to operating budgets: nothing would be saved by reducing costs. In fact, a reduction in costs (for instance, for the marketing function) could well lead to reduced revenues, equal to or greater than the costs that were eliminated. When the calculations are done by Treasury Board, revolving funds are excluded from the expenditure base to which the government-wide reductions are applied.

Appropriations components of SOAs are subject to government-wide expenditure reductions to the same extent as departments and agencies. However, for those SOAs that are funded through net-voting, the net-voted portion is excluded from the reduction because the revenue portion is netted out before the appropriation is voted: reductions apply only to the voted amounts. If an SOA has revenues that are simply credited to the CRF, no portion of the appropriation is protected from expenditure reduction.

SOAs with revolving funds may in some cases make an indirect contribution to the achievement of expenditure reduction targets for the parent department. This is usually done through increases in the charges which the SOAs pay for services provided by the department. There is a great deal of variation in the types of departmental services for which SOAs are charged, and many situations are complicated and ambiguous. For example, how much rent should the SOA pay, and how much choice does it have over which premises it rents? What about utilities? Is there, or should there be, a charge to the SOA for the central management of the department? A number of SOAs reported recent increases in the scope and magnitude of such charges.

SOAs which are dependent on federal government clients have felt the impact of government-wide cutbacks through reductions in the budgets of their clients. Certain reductions have also been targeted at specific types of expenditure, such as publishing, and a threatened reduction in professional services expenditures.

By and large, the SOAs have been able to cope with this situation, albeit with some difficulty and with a feeling of "living on the edge." In some cases, they have even been able to turn certain elements of the situation to their advantage. CCG, for example, has developed

a set of “no frills” or “low frills” publishing products. For its part, CAC has increased those elements of its consulting business that involve coping with restructuring. However, a negative effect of their competing successfully in a declining market is that many of their private sector competitors who find themselves in a difficult situation are more likely to complain about competition from government Agencies.

Expenditure reductions and related measures have also affected the ability of SOAs to attract, retain, motivate, and fully utilize the personnel they need. These measures include salary freezes; limitations on the Total Executive Complement (TEC); delayering and reductions in the management category; suspension of bonus and incentive initiatives; and mandated reductions in corporate support services. While such measures affect departments and agencies as well as SOAs, their impact is particularly noticeable in SOAs which provide optional services and compete with the private sector.

All of these measures affect the ability to get the right “mix” of people and to make the best use of them for earning revenues and reducing costs. One area of impact is in recruiting and retaining those professionals and managers who are the top revenue producers, since these are precisely the people who tend to have options elsewhere. With continuing salary freezes, SOA salary scales are becoming less competitive when compared with those offered by other employers. This problem has been masked by downsizing and layoffs in both the public and the private sectors, but, as and if the recovery picks up steam, there will be more opportunities for public servants to go elsewhere.

One option to counter this situation would be to recruit and pay people at a higher level of classification, that is, at the management level. However, this approach is greatly limited by the restraints on the Total Executive Complement – one area of flexibility which has not been granted to SOAs. This constraint has been tightened by a ten percent reduction in the management category in the 1991 Budget, along with the delayering and compression of management ranks. Typically, the delayering removed the lowest category of manager, thereby reducing the opportunities for the top professionals just below the management level (at the level of “EX minus one”): this had been their gateway into the management category. With the delayering, the elimination of the SM category, and continued tight control on the TEC, there are fewer prospects for top professionals to rise to the management ranks in the public service – and little or no prospect of a salary increase if they stay in the public service.

Furthermore, there is no opportunity to pay out incentives and bonuses, except for small-scale “recognition awards.” Any incentives involving real money are ruled out in the present circumstances. (To some degree, the symbolic recognition awards can help to sustain motivation and to enable the organization to show that it values its employees. Other forms of non-financial recognition would include conference attendance and access to training opportunities.)

SOAs have lacked the flexibility to compensate their top producers, and they have been obliged, at the same time (through the Work Force Adjustment Policy), to retain a number of persons who earn little or no revenue, and who are not effectively contributing to the bottom line. Several of the SOAs mentioned that this policy was costly for them. In one instance, the cost was equal to more than five percent of the SOA's budget, whereas in others, the top SOA managers had difficulty with the Work Force Adjustment policy itself, and argued for abolishing or substantially weakening its provisions – or at least for obtaining some form of exemption for SOAs.

IV Pricing Issues

For most government organizations, financial management has traditionally focused on budgeting and expenditure control. In recent years, cost recovery has become more important, thereby increasing the need to improve revenue management capabilities. Within the government, the fullest development of cost recovery and revenue management can be seen in the revenue-dependent SOAs which operate on a revolving fund basis. This is one area in which SOAs are on the leading edge and in which they can provide useful examples for others.

SOAs that charge for services offered must determine a price structure that is fair, simple to administer, and efficient. In addition, the price structure must be adequate to recover the costs to the extent intended and expected.

While Treasury Board still approves the rates for regulatory services and certain mandatory services, SOAs which provide optional services have the flexibility to set rates for their organization, and to change these as circumstances dictate. In establishing their price structure, SOAs face a number of issues: (1) development of a costing information system; (2) identification of the costs to be recovered; (3) costing treatment of assets; (4) allocation of costs to different groups of users; and (5) selection of a pricing strategy and establishment of prices.

Costing Information

SOAs require information on the costs of the various inputs that relate to service delivery in order to determine the most appropriate price for services. If the SOA provides more than one type of service, the costs should be separated by service line. There are three major types of costs:

- direct costs that are incurred in providing the services and which are precisely attributable to the services;
- program support costs incurred in performing functions that are not directly involved with service delivery, but which support service delivery activities; and
- overhead costs for corporate and administrative services incurred in support of the operating activities of the organization, but outside of the service delivery stream.

Many financial systems are not designed to maintain cost information in line with these or other similar definitions. An organization may require separate costing systems to provide the necessary information.

Identification of Costs to be Recovered

Once an SOA has established a system to provide information on the costs of inputs, it must determine which costs are to be recovered through the fees charged for the service. Many SOAs incur costs which are related to activities other than the delivery of services. These can be referred to as non-service objectives, and may relate to satisfaction of broader government goals, regulatory activities, or policy definition. Inclusion of these costs in the pricing structure could put a competitive SOA at a disadvantage with private sector organizations without similar costs. It can also be argued that inclusion of these costs is not a fair charge to clients, especially in cases where the service is mandatory or regulatory.

As noted in the previous section on expenditure reductions, these types of costs are becoming more of a problem for SOAs: appropriations for these broader service components are being reduced, yet the expectation remains that these services will be maintained, thereby putting pressure on the revolving funds to make up the difference. For example, the appropriations which cover CCG's support of the Privy Council Office (PCO) communications activities and the library depository program have been reduced, leaving the difference to be made up from CCG's revenues.

A related problem is the recoverability of overhead costs which stem from the SOA's position as part of the government. As noted previously, these can involve costs for items such as bilingualism, work force adjustment, and the maintenance of money-losing regional facilities. For example, CORCAN operates facilities in some out-of-the-way locations which are inherently unprofitable, but which need to be maintained as part of CORCAN's mandate to provide services across the prison system. Furthermore, with reductions in the appropriations component for both CORCAN and the rest of Correctional Services, there is pressure to charge more and more of the prison system overhead to CORCAN's revolving fund. There are no hard and fast rules, and there is much scope for interpretation, for example on questions such as how much of the lighting and heating systems should be charged to the department or to CORCAN (and thence to CORCAN's clients). In fact, the possibilities for charging overhead services to SOAs and their clients are considerable, and may even raise questions such as: What share of the operations of the deputy's office and the minister's office should be charged to the SOA and to its clients?

Some SOAs are in the position of trying to recover overhead costs which they cannot control in either the short run or the long run, since these matters are decided by the parent department or by central agencies. The best example of this is perhaps Training and Development Canada, which was obliged to move from facilities in Ottawa to the Asticou complex in Hull as a result of a broader governmental decision to make fuller use of Asticou. This move has involved additional costs in terms of rent and utilities, and may also have resulted in some loss of revenue since a number of clients have indicated that they find the new location less convenient. In such cases, the additional costs will either have to be covered

through higher charges to clients, or they will appear as decreases to the bottom line of the Agency.

The choice of maintaining a non-revenue-generating activity is, in some instances, with the Agency itself, but the SOA may feel an obligation to maintain the activity as part of its broader mandate. A case in point would be CAC, which supports the publication of the journal *Optimum*. While this has some wider benefits in terms of marketing and visibility for CAC, it does cost money to maintain this service for the government as a whole. Strictly speaking, it could be argued that CAC should eliminate all such activities in the interests of cutting its costs and its prices. However, if it did so, it would not be fulfilling its wider mandate, and would lose part of its *raison d'être* for remaining in the public service.

In principle, activities which are in the wider public interest should be funded by appropriations. However, as appropriations are being reduced across the entire system, this may not be a realistic solution in the current circumstances.

Costing Treatment of Assets

The issue associated with the treatment of assets concerns historical versus replacement costs. Historical costs are more easily documented and easier to apply. Replacement costs, on the other hand, while they are considerably more judgmental, could be considered to reflect the true cost of service provision, since costs to replace assets can be significantly different from the price paid originally.

This question arises particularly for computer equipment, where the rates of obsolescence and depreciation can be very high (up to 50 percent per annum). In some cases, the SOA may not have full control over its systems, and may be forced to operate older "legacy systems" with a higher cost structure. A good example of this is the Canadian Heritage Information Network (CHIN) which operates on a mainframe system that CHIN would like to replace. However, it does not have the capital to do this by itself, and needs to rely on departmental funding which in turn is linked to larger projects that can take some time to approve and arrange. (CHIN did have an innovative idea for financing a new system. As part of the larger accommodation strategy for its building, it was obliged to move from one floor to another, and CHIN suggested that it would actually be cheaper to replace the mainframe with a UNIX system than to move the older system to new, specially equipped premises. However, the rules were that the accommodation funds could be spent on the move, but not on new equipment.)

Prices for Different Groups of Users

Prices may vary for different groups of users. For example, the following groups can be distinguished:

- “core clients” whom the SOA must serve (usually free of charge or at a reduced price) as part of its mandate versus paying clients;
- Canadian versus international clients; and
- clients with the ability to pay versus clients who have difficulty in paying.

Typically, these factors are combined in a given instance. For example, the Canadian Heritage Information Network provides services free of charge to Canadian museums (its core clients, many of whom would find it very difficult to pay), but recovers its costs from private companies and cultural institutions outside Canada.

One question that arises is whether the SOA is, in fact, permitted to charge differential prices. In some cases, this option is specified either in the mandate of the SOA or through a wider policy (such as the Museums policy which specifies that CHIN is to provide free services to Canadian museums). In other cases, there is no clearly spelled-out policy, and there may be some debate about the extent to which different clients can be charged different prices.

Another question concerns the extent to which it is desirable to charge differential prices, and, if so, the prices to be charged. The tendency is to set these prices on the basis of marketing considerations rather than full cost, since the returns from the paying clients may well be an SOA's only revenues. As appropriations are reduced, revenues become more important and are a key source of funds for any new initiatives.

In deciding market prices, international clients often set the standard for the pricing. For example, the Canadian Intellectual Property Office (CIPO) has a strong incentive to charge the international going rates for patents and trademarks (assuming that the levels of service are equivalent), since over 90 percent of its clients are international. If the price is set below the international level, then CIPO is missing out on revenues that could easily be obtained from non-Canadians. If the price is set substantially above the international levels, then this is a disincentive to register in Canada and to make the technology available here.

Selection of Pricing Strategy and Establishment of Prices

Under the current policy, the objective for SOAs operating under full or partial cost recovery is to break even over time, so the pricing strategy should be geared to this goal.

From this perspective, prices which result in a consistently large profit or loss are indicative of problems in the pricing strategy.

Cross-subsidization among service elements should be avoided, that is, proceeds from the sales of one service should not be used on a consistent basis to offset the costs of other services and to price them below their full cost. Three options for the pricing strategy are identified: full cost pricing; market-based pricing; and negotiated pricing.

In *full-cost pricing* (the standard cost-recovery approach as prescribed by Treasury Board), the actual costs relating to the provision of a service are tracked and included in the price for that service, along with an overhead allocation. This is an appropriate strategy for a regulatory or mandatory function such as the Passport Office. A possible drawback to this approach is that it may not provide a compelling incentive to control costs, since these can be passed on to clients in cases where competition is limited or nonexistent. On the other hand, the prices of these services may be highly visible, with the potential to become politically controversial if the costs and prices get out of control.

One such example would be the Grain Commission, where the clients (farmers) scrutinize the prices very carefully and have the power to ensure that they are not increased without their being consulted and involved at each step of the process: they require detailed justifications for any proposed increases. One effect of moving to revolving fund status and upgrading the financial systems at the same time is to provide more precise cost information on the different facets of the Grain Commission's operations, so that the charges for each of the services will more precisely reflect the associated costs. (Previously, there had been some inadvertent cross-subsidization between services, simply because the cost data were less refined.)

In *market-based pricing*, the organization sets its prices on the basis of the rates prevailing in the market in order to ensure that the service will be competitive. Details of market prices may be difficult to obtain as competitors are not always willing to provide information about operations. The use of a market-based price provides an incentive for the organization to control costs, since these cannot be passed on to customers in prices which are higher than the market can bear.

Questions concerning market-based pricing are discussed in detail in the companion paper on marketing in SOAs. In the market-based approach, prices are set on the basis of a more general strategy, such as product life-cycle management. This strategy tends to involve some cross-subsidization between different products and services (which may be combined, packaged, and priced in ways which do not directly reflect their current costs but rather their longer-term market potential).

SOAs that are dependent on the market have the freedom to set their own rates for their products and services, and it appears that their autonomy in this respect has not been called into question by central agencies, despite the recognition that some cross-subsidization is involved in their pricing strategies.

One crucial service which financial systems can provide is information on whether a product or service is in fact profitable (or likely to be so), taking into account the total costs involved in providing it. Financial systems can also help to indicate areas of profit potential. An example is the Transport Canada Training Institute (TCTI), which runs a residential training facility and is therefore in the business of providing both training and hotel services. The costs of both components need to be calculated and reflected in TCTI's pricing strategy and in its decisions on which specific services are the most profitable.

A third approach, *negotiated pricing*, sets a price which reflects the distribution of benefits between the client and the provider. A case in point would be the negotiations between farmers and the Grain Commission over the cost of maintaining the Grain Research Laboratory, which provides specific benefits to the clients (in the form of quality assurance and increased marketability of the product) and general benefits to the industry and the country (in terms, for example, of product safety). The solution has been to charge half the research costs to the clients, with the government providing the other half. This has been handled through one large appropriation which covers the Grain Commission's entire operations. Now that the Grain Commission is moving to a revolving fund, the funding for research becomes more visible and perhaps more vulnerable. Logically, half the research costs should be charged to the revolving fund, with the other half being covered by an appropriation. However, experience shows that a small appropriation alongside a large revolving fund is difficult to maintain intact in a time of general expenditure reductions.

Under the negotiated pricing approach, an SOA selects a pricing strategy which most closely fits its market, and establishes prices for services provided. It is important that all cost information used as the basis for pricing be made as visible as possible. The SOA must also monitor costs on an ongoing basis in order to ensure that the prices remain reasonable. Prices should not be changed frequently in response to the ongoing analysis since this will cause confusion on the part of customers.

However, the SOA should be prepared to be flexible in setting prices so that the organization can respond to operational considerations and market opportunities. For example, Consulting and Audit Canada may make a conscious decision to reduce prices for certain consulting services in order to establish a relationship with a new client with high potential for substantial contracts in the future. Similarly, prices may be reduced when staff are between projects, under the premise that reduced revenue is preferable to no revenue. A client who demands services within a short time frame during a peak period may be charged a

higher price if there is a lack of available staff and a consequent need for overtime or contracting out.

V Information Systems

Depending on their nature and the funding mechanism or mechanisms in place, SOAs may require modified or new information systems to meet business needs and to satisfy the reporting requirements of Treasury Board and host departments. This chapter analyzes what such systems would require, and also looks at the rationale for financial systems and services that are centralized within a department, as compared with those that operate autonomously within an SOA.

Requirements for New Systems

The system requirements for an SOA will depend, initially, on its funding basis:

- those funded by straight appropriations must account for operations on a modified cash basis, as is the case for departments and agencies across the government; thus, a new financial system is not required;
- those funded by net-voting also maintain their accounts on a modified cash basis, but since they charge for services they must have a cost accounting function which may require a new system. (However, the forecasting of revenues and expenditures required under net-voting arrangements can usually be provided through existing departmental systems.);
- those using revolving funds must have a financial system that uses the double entry, accrual accounting methodologies; they must also have a cost accounting system, since they are required to charge for services on a full cost basis.

The other relevant factor is the SOA's marketing approach. SOAs that offer optional services in a competitive market will need marketing systems and infrastructure if they wish to survive. In these cases, it is important to have a financial system that can serve wider functions, such as the following:

- It can help in tracking sales and in establishing patterns of demand for goods and services, along with indicating the buying patterns of clients. This is especially useful for Agencies such as GTA and CCG which have account executives who are specifically interested in keeping track of clients and their buying patterns.
- It can help in developing strategies and making decisions on products and services by indicating, for example, which products are profitable and which are not. This requires tracking costs and revenues by products, services, and projects. Several of the SOA financial officers who were interviewed for this study complained that their current financial systems provided incomplete or highly aggregated data for this purpose.

- It can help to provide a picture of the organization as a whole, often as part of an Executive Information System. This requires a close linkage between financial data and other sources of information, which in turn requires compatible hardware and software (preferably operating on one hardware platform). Some SOAs such as TDC indicated that they were giving high priority to developing such a system.

In addition to the marketing requirements, some SOAs require more specialized systems for operational control, for example, the tracking of inventory and supplies for manufacturing purposes.

Required Capabilities

Accrual Accounting

As noted above, SOAs that operate with revolving funds are required to maintain accounts under the accrual accounting method. An organization's operating results can be more easily assessed under an accrual system of accounting, since the accrual method records revenues as they are earned and expenditures as they are incurred, thus providing more timely reporting of transactions and a better matching of revenues with the expenditures required to earn them. The advantages of accrual accounting have been recognized in other jurisdictions such as Australia and New Zealand and this system is, in fact, mandated by legislation in New Zealand.

The accrual method records a number of non-cash transaction types, the most significant of which is depreciation, under which the cost of capital is charged against the revenues generated during the asset's useful life, thus enabling an SOA to build the capital costs of assets into the cost base for individual goods and services.

Because revolving funds must also determine the cash requirements of the fund, the accrual records must be reconcilable to the modified cash basis of accounting. This is done for both the Main Estimates and the Public Accounts, where the financial statements of the SOAs are integrated with those of the parent departments. With few exceptions, the financial systems used by federal departments and agencies operate on the modified cash basis. The older systems would normally require revision or redesign in order to serve the needs of revolving funds. The newer systems have a wider range of capabilities: for example, the Common Departmental Financial System (CFDS) has a revolving fund module, which is now being implemented.

Cost and Revenue Tracking

All SOAs with significant amounts of revenue require systems that are able to track costs and revenues and relate them to specific products and services. This is essential for

determining whether a product or service is contributing positively or negatively to the Agency's bottom line. A costing system is also essential for setting a fee structure. If cost recovery is initiated under an appropriation, charges to clients internal to the government are based on incremental costs, while for external clients, recovery may be at full cost, may exceed full cost, or may be set at market value.

Under net-voting, the recovery of costs from internal clients is generally limited to the total expenditures charged to the appropriation, excluding any non-cash transactions (such as depreciation). External clients are charged full costs or an appropriate fee.

Under a revolving fund, the recovery of costs is usually on a full-cost basis, including non-cash items, regardless of the client. For revolving funds, these costs include items such as the SOA's share of departmental overhead, interest on the use of its drawdown authority, Public Works and Government Services Canada (PWGSC) accommodation and cheque issue charges, and employee benefit and insurance plan costs. (As noted above, there can be substantial differences of opinion over which departmental services should be invoiced to the SOA and factored into the overheads to be charged to the client.)

An added challenge faced by a number of SOAs is the maintenance of a clear distinction between different product and service lines. One way to address this challenge is through the use of Activity-Based Costing (ABC) techniques. ABC is gaining wide popularity in the private and public sectors because of its focus on tracking and allocating the costs (including the overhead costs) involved in a specific activity, product, or service. As an added feature, ABC can provide useful management information for process improvement and staff deployment. As many SOAs are interested in pursuing ABC techniques in the near future, systems that can adapt to the ABC methodology will be important.

In some cases, parent departments may have a cost accounting system in place that would serve the needs of the SOA. However, sophisticated cost accounting is still in its infancy across the federal government, so the existing options are limited.

Time Tracking

A number of SOAs that charge for services include the cost of employee time related to the service. In the case of an Agency like Consulting and Audit Canada, the time spent on a particular assignment is the prime determinant of the fee charged. Thus, a system that tracks employee time and assigns the time to products or services is important. Time-tracking systems require a high degree of customization, and in many cases such systems have to be developed to fit the particular organizational environment, although the basic elements of such a system may be transferable between organizations. Consulting and Audit Canada, for example, is hoping to sell its system to other organizations.

Time-tracking systems are usually developed using database packages which run on personal computers. While these systems may meet the time-tracking needs of the Agency very well, they will need to be integrated with the financial systems that tend to run on larger machines. At present, the reconciliations are typically done by patching the data between different systems: this can work as a temporary expedient but is not desirable as a longer-term solution.

Marketing Information

As noted above, financial systems can be used in a variety of ways to provide relevant information to assist with marketing. For example, the financial system can provide information on sales trends, market reaction to products and services, and client information. A close working relationship between the financial and marketing components of the Agency is important to make maximum use of the financial system in this way.

While a number of SOAs mentioned that it was a priority to develop a close connection between the marketing and financial systems, they were still in the early stages of development and were faced with solving certain problems along the way. In the client organizations, for example, the persons or units receiving the bills were not necessarily those receiving the service. (For more information on marketing systems, please see the companion paper on *Marketing*).

Integration

Ideally, the different systems in use by an SOA would be linked together through an Executive Information System (EIS) which uses a common interface to access information in systems in an easily understandable format, usually through a graphical user interface which presents the information in visual form. This is particularly well suited for an Agency where financial and performance indicators can be readily interrelated. For example, CORCAN uses the EIS developed by Correctional Service Canada, with positive results. However, the development of an EIS usually requires some degree of integration of the underlying systems.

Centralized versus Autonomous Financial Systems and Services

The financial systems requirements for SOAs can be fairly specific, and different (at least in degree) from those of a federal department. In addition, it is important that the SOA's financial system be linked with other systems and data. For example, the Canada Communication Group uses a system that is well adapted for manufacturing and for inventory tracking.

In many cases, the requirements can be met more easily and effectively if the SOA has its own financial system and financial services capability. SOAs need their own financial

systems, or at least a voice in choosing and setting up the system that will be used. A departmental financial services unit is necessarily focused on other priorities, and may not have the same knowledge and understanding of SOA operations and activities that would be found within an internal financial services function.

In some instances, however, SOAs are being obliged to give up their internal financial units and to transfer this function to the corporate financial services function in the host department, for reasons related to restructuring, consolidation, and projected cost savings. The reaction among SOAs to this move varied according to their previous experience with their own systems. In one case, the previous system had been costly and problematic, and the SOA considered that it would actually be better to use the departmental services. In another, the SOA's financial system had worked very well and was being integrated with other functions in the Agency, with the result that the SOA felt it was losing a great deal in the transfer of the financial function to the host department.

As a practical matter, it is important for the financial systems of the SOA and the parent department to be well coordinated. This is essential if the department is to be run as an integrated unit, and if tools such as Executive Information Systems are used (as is increasingly the case). The challenge is to ensure this integration without sacrificing the autonomy of the SOA. One option is to develop and implement a common financial system for departments, and to ensure that this system will consider the specific needs of SOAs and can be readily interfaced with other systems and data. It has been noted that the purchase of a financial system is a major cost for a new SOA. Across the government, the use of one or two standard but customizable systems would be a cost-effective alternative to having each SOA buy or develop a unique system.

VI Cultural Issues

SOAs and departments differ in several ways. The autonomy of SOAs, the higher degree of flexibility and authority which they enjoy, and, for a number of SOAs, the concepts of optionality, competition and self-sufficiency are key factors which distinguish them from departments. It is not surprising, therefore, to find cultural differences between SOAs and federal departments and agencies. This chapter highlights some of these differences from the financial perspective, and also briefly discusses the different skills that may be required in an SOA and the training needed to develop these skills.

Cultural Differences

From a financial perspective, cultural differences can be seen primarily in those SOAs which charge for services, both under net-voting and revolving-fund mechanisms. One noticeable difference is a greater awareness of the importance of the operation's financial dimension, along with a sense that financial viability depends in large part on the efforts of individual employees rather than on outside forces. This is in sharp contrast with the view inside a department where an "appropriations mentality" exists, and employees have a sense of "living on an allowance" which can be reduced at any moment in successive rounds of expenditure cutbacks. The approach of employees within an SOA is different, because the Agency can generate revenues to cover at least part of the expenditures and offset some of the cuts.

SOAs may have a greater sense of distinctiveness and common fate than a regular branch or division of a department, a sense that is likely to be more widespread and not simply confined to a few managers. In a department, one responsibility centre may be underspending while another may be overspending – but all are merged into the same larger organization, with the view that in the end, overall budgets will be met. Within an SOA, there is a sense of individuality and distinctiveness in financial matters, and a sense of being independently accountable – or at least more visible.

In an SOA, the financial perspective dominates, whereas in a number of departments, it is common to hear complaints about inefficient, cumbersome, and convoluted procedures, and about unnecessary numbers and layers of managers. Generally, the complaints at the departmental level concern the style of management and its personal impact on employees, rather than the costs to the organization itself. In revenue-dependent SOAs, however, there is a much stronger focus on the financial costs of inefficient procedures, micro-management, and top-heavy management structures. These costs are seen as a burden by the people who actually earn the revenues and contribute positively to the bottom line. The same holds true for overhead expenditures and corporate services, which SOAs view chiefly in terms of their financial impact.

One element which is clearly noticeable in most SOAs is what one might call a “revenue consciousness” and a “marketing mentality” – the awareness that there are revenue opportunities out there to be pursued and developed, and that much could be done if only the SOA were to take the necessary initiatives. Yet there exists, at the same time, a sense of caution, given the sensitivities and complaints about competition in addition to the requirement that SOAs break even and not make a profit: it can be considered risky to be too entrepreneurial or too competitive. This caution leads to a careful and deliberate strategy, one that is pursued over the longer term and focused on finding and keeping lines of business which would help to sustain the SOA. This problem was recognized from the inception of the first Agencies, when one of the analyses of the financial risks read as follows: “There are two types of financial risk: financial loss, and financial success.”

Given the above factors – the importance of revenues, the question of competition and security, and the focus on longer-term development of the Agency and its markets – it is not surprising that one of the distinguishing features of SOAs in terms of attitudes and mindsets is their “investment mentality,” tempered by a “business-case approach.” When compared to other organizations in the public sector, SOAs have a more apparent investment mentality, at least with respect to physical capital. This sense is reinforced and sustained by the fact that some SOAs have some latitude to maintain and even increase ongoing capital expenditures by building them in as a depreciation charge in their revolving fund.

SOAs vary in the degree to which they focus on the bottom line. In some cases, one can sense that the bottom line is everything and that other objectives are a distraction or an encumbrance. For SOAs which are fully cost recovered, this tendency is understandable, given the pressures on the bottom line. However, it should be emphasized that fully cost-recovered SOAs are not necessarily representative of existing or future SOAs. The opportunities within the federal government for complete cost recovery are limited.

Required Skills and Training

In view of the differences between SOAs and other federal government organizations, it is not surprising that different skill sets are necessary to ensure the success of an SOA. From the financial perspective, the following skills and knowledge requirements have been identified (not all of which will apply to all SOAs):

- an ability to manage financial systems;

- knowledge of accrual accounting and an ability to manage and account for revolving funds;

- an ability to address new issues and problems, such as the need to reconcile different accounting methods;

- knowledge of information management systems, particularly the ability to extend the Agency's financial system and to integrate this with other systems to track clients, support the marketing function, develop information to be used in planning and performance management, and match costs and revenues; and

- analytical abilities to plan for the Agency's financial future, such as the use of historical information to set forecasts of expenditures and revenues and to translate these into cost information and pricing strategies, which must be monitored and revised as necessary.

Many of the financial personnel within the federal government have formal finance and accounting training based on the accrual method of accounting. When financial professionals enter the government, the modified cash basis of accounting appears foreign. However, over a period of years working in a government environment, these professionals become familiar and comfortable with the government accounting system and may need refresher training in accrual accounting. In cases of personnel without the same level of prior accounting training, more rigorous, comprehensive training may be required.

In some of the interviews with the senior financial officers of SOAs with revolving funds, it was mentioned that it took people varying lengths of time to shift away from an “appropriations mentality.” In government, the usual mindset was to work within fixed budgets and strict commitment controls, whereas in the revolving-fund environment, the need was to shift from the “budget-ceiling” approach to the “business-case” approach. The key question was whether a given set of expenditures would generate revenues which were equal to or greater than the expenditures. In the experience of these SOA officials, it could take from one to three years for people to adapt to the new approach.

VII Conclusion

In arriving at conclusions for this study, it is necessary to go back to the original objectives and principles set out when SOAs were first established. The basic objectives were twofold: to save money, and to improve service. The basic principles can be identified as follows:

- Autonomy and distinctiveness
- Focus and specificity
- Accountability on the basis of results
- Flexibility and freedom.

Autonomy and Distinctiveness

In financial terms, many SOAs are distinctive and different in that they have respending authority in the form of revolving funds or net-voting, and they focus on revenue generation and marketing. It would therefore seem appropriate for them to have independent financial systems, or a measure of control and influence over the departmental systems – in other words, SOAs should have some financial autonomy. Departments, however, are concerned with the way the SOAs fit into the departmental structure and the ways in which the systems will be interfaced and integrated: a departmental Executive Information System is one way of meeting these concerns.

Given the significant costs in purchasing or developing a financial system for an SOA, an argument can be made for developing common or shared systems which would take into account the distinctive needs of SOAs. While certain of these needs are in some respects similar, SOAs are a varied group, and it would be difficult to come up with a “one-size-fits-all” solution. For example, while some SOAs such as CORCAN and CCG need a manufacturing-type system, others need one which is more oriented towards marketing and customer tracking. Two or three standards might well be appropriate.

The development of SOA financial systems should take account of the government-wide systems being developed in line with the Treasury Board Blueprint for Renewing Government Services through Information Technology. This approach envisages the use of some common underlying databases (or at least some compatible formats and common standards), with different modules and applications running on top of them, depending on the needs and choices of the departments and agencies. For SOAs, such systems would need to include options and capabilities such as the following: accrual accounting and revolving funds; marketing; manufacturing; and time tracking. If these capabilities were not included directly, there would need to be mechanisms for interfacing them smoothly and automatically.

One advantage of designing these systems to accommodate the needs of SOAs is that the resulting systems would thereby be better adapted to meeting the emerging needs of departments themselves – one more reason for addressing the concerns of SOAs at an early stage. A further benefit would be to reduce the start-up costs for new SOAs (by reducing the systems costs).

Even if it is assumed that the common departmental systems would in due course meet most of the needs of SOAs, it may still be necessary for SOAs to have their own financial capabilities, if only to customize and adapt the common systems. One of the benefits of distinctiveness and autonomy is a higher level of “financial consciousness” – an increased concern for costs, revenues, and the bottom line. This presupposes that the SOA is autonomous, distinct, and separately accountable.

Focus and Specificity

Related to their autonomy and distinctiveness is the sense of focus to be found in many SOAs. This focus is based on financial results which relate to an identifiable and distinct set of products and services and a coherent set of clients and purposes. (For further information on the configuration of products and services, please see the companion paper on *Marketing*.)

Generally speaking, the smaller the SOA, the easier it is to attain the necessary focus. Smaller organizations have a real sense of focus and have been quite entrepreneurial (using their vote-netting authority), despite being on appropriations. In larger SOAs, the challenge is to develop a coherent focus on related groups of products, services, clients, and purposes. Because they are larger, they have more scope for setting up their own units and systems, with a greater degree of specialization, such as a financial function and a marketing function. While certain advantages come from larger size (up to at least the level of the largest current Agency), at some point the focus will be lost, dissipated, or scattered.

One of the main disadvantages of a scattered focus is cross-subsidization. When significant cross-subsidization exists, the criteria for a revolving fund are contravened. In a situation where cross-subsidization occurs, the SOA's competitors can more easily raise the issue of unfair competition. The force of these charges varies with the size of the Agency. Large Agencies have more exposure and visibility on this issue, and are more open to these charges. Cross-subsidization may also have a negative impact on client relations. The existence or suspicion of cross-subsidization suggests to clients that some of their money is being spent on someone or something else, yet when cost-recovery arrangements are negotiated with clients, one of their key demands is that the funds be reinvested into the service for which they are paying. Cross-subsidization becomes particularly significant when one group of clients or customers is subsidizing another, and especially when the service is mandatory or regulatory, and when clients have no choice but to pay.

One interesting question is the extent to which there is subsidization between revolving funds and appropriations. In some cases, as noted above, SOAs receive appropriations to cover activities which serve wider public purposes and which cannot be fully cost-recovered. With continuing expenditure reductions, the current trend is for the appropriations component to be eroded, and for the revolving fund to subsidize more of the appropriations-funded activities. It would be difficult to argue that appropriations were being used to subsidize the revolving funds.

Accountability on the Basis of Results

In financial terms, the SOA mechanism can be useful for strengthening accountability, and can be most useful when revolving fund approvals are linked to SOA status, for the specific reasons noted in *Appendix A: Revolving Funds*.

One precondition for accountability on the basis of results and the “bottom line” is sufficient focus and specificity, as noted in the previous section. How would one really know what the bottom line was if there was significant cross-subsidization? Which sets of results, for which sets of clients, would be most important?

Another question to ask is this: If SOAs are accountable for results, why can they not show consistently positive results? If a positive bottom line is the measure of excellence for SOAs, why can they not be consistently profitable? Currently, the requirement and the expectation is that SOAs should break even, and the supposition is that if the SOA is consistently profitable, then its fees are too high. This sends a mixed message: be successful, but not too successful.

Flexibility and Freedom

When SOAs were first established, the ideal was to reconcile deficit control and reduction with the maintenance and even the enhancement of service levels. The only way in which this can be done is to allow the SOAs considerable discretion over how they contribute to the deficit effort, and to exempt them from expenditure reductions on the cost-recovered components of their budgets (as has been done). In part, the rationale for this is that a number of SOAs are already being affected by the reductions in the budgets of their government clients. In addition, if expenditure reductions were to force the SOA to reduce its level of service, then its revenues could decline by an amount equal to or greater than the reduction in cost, in which case nothing would be saved. While some understanding of the effects of expenditure reductions on SOAs has been demonstrated, SOAs have been subjected to the full force of reductions and restraints on personnel-related matters, including delayering, restructuring of the management category, strict limits and reductions affecting the Total Executive Complement, pay and salary freezes, and the inability to pursue the questions of bonuses, incentives, and gainsharing in any serious way. This has affected the ability of SOAs

to compensate the top performers and revenue producers – those who provide the service for which clients are most willing to pay.

One other area of flexibility worth re-examining is major capital. While the larger SOAs have been successful in covering most of their requirements through their revolving funds, the arrangement has, to a large extent, been “pay as you go.” The arrangements for major capital expenditures and for “up-front” capital investments have been ad hoc for the most part, and smaller agencies have had to rely on the parent department for larger-scale investment. As shown clearly in the example of Manitoba (*Appendix B*), significant advantages can be obtained by making major up-front investments in capital. It is likely that SOAs at the federal level would have shown more rapid productivity and service improvements if larger capital investments had been made sooner – including investments in “human capital,” such as training and skills development.

In general, it does not appear that SOAs have as yet made any large-scale investments in people – their greatest asset. Some encouraging signs were noted in a few specific areas (such as training and conference attendance) for certain Agencies, but nothing is being done that is significantly different from that being done by other departments and agencies. (Questions on these points were asked in all the interviews conducted specifically for this study. The main response was that there had been some incremental improvements, but little in the way of large-scale initiatives except for CCG's training program in service quality.)

It appears that most SOAs are not yet investing in their personnel with the same care and deliberation being given to their physical capital. In order to make further progress on service enhancement, SOAs will need to invest more in training and skills development for their employees, particularly at a time when reengineering and process improvement are increasing the demand for generalist skills and cross-training in different (but related) areas of expertise, and when public service reform and changes in the labour force are making this an imperative.

Appendix A: Revolving Funds

This Appendix provides some basic information on revolving funds using SOAs as an illustration. The description here will assume that the fund is being used by an SOA, but the same points would apply to non-SOAs.

For those wishing to know more about the operation of revolving funds, the Treasury Board *Guide on Revolving Funds* is essential reading. (This document is available from the Financial Management Policy Division of Treasury Board.)

Description and History

A revolving fund is a non-lapsing statutory authorization to spend money out of the Consolidated Revenue Fund for certain specified purposes, up to a certain limit. This limit is called the drawdown authority. Any revenues received for the specified purposes of the fund may be offset against expenditures related to these purposes: this amounts to authority to respend these revenues. In effect, a revolving fund functions very much like a bank account, with a line of credit or overdraft limit set at the level of the drawdown authority. Another analogy would be a “working capital advance” or an operating loan. In point of fact, the SOA does pay interest on the drawdown.¹

The drawdown authority is approved by Treasury Board, pursuant to a submission or through the Main Estimates review, and then goes to Parliament as an information item in the Estimates. A common procedure has been to include changes in drawdown authorities as one dollar items in the Supplementary Estimates.

Before 1985, the necessary statutory authorization for establishing a revolving fund or for modifying its provisions (for instance, for changing the drawdown authority) could be provided through an appropriations act, that is, through either the Main Estimates or the Supplementary Estimates. This procedure was changed, however, pursuant to a ruling by the Speaker of the House of Commons that an appropriations act could not be used for that purpose; this was part of a more general ruling that the government could not “legislate through the Estimates.” Between 1985 and 1991, the government had to use separate legislation to establish a revolving fund or to change the provisions governing a revolving fund, including any changes in the drawdown authority. This was done through regular updates to the *Revolving Funds Act*.

1. The rate is set using the average of the rates on the Bank of Canada's daily yield curves using the 10-year bond rate, for the last three business days of the month, plus 0.25 percent.

In 1991, Parliament approved a set of revisions to the *Financial Administration Act* (FAA), which once again enabled the government to establish or modify revolving funds through the Estimates. Section 29.1(2) provides that, "A department may, in respect of approved programs or authorized expenditures, be authorized by an appropriation act...for such purposes and with such drawdown limits as are specified in the Act, to establish a revolving fund." Section 29.1(3) provides that, "The purposes and drawdown limit of a revolving fund...may be amended by means of an appropriation act."

Criteria for Approval

The criteria for approval of a revolving fund are outlined in some detail in the Treasury Board Manual (Part 6, Chapter 5, pp. 1-2 and 5). For the official version and a thorough and detailed account, the reader is advised to consult this document. What follows here is a thematic and conceptual summary. The criteria can be described and organized as follows:

Stable Mandate

The activities being covered by the revolving fund should have "a stable mandate, identifiable client groups, and operations financed in whole or in part from user fees or from other sources of revenue internal or external to the government." The activities must be separate from those financed by other appropriations.

These conditions are met by SOAs. In fact, one of the criteria for becoming an SOA is that the organization should have a stable mandate.

Self-Sufficiency

According to the Treasury Board Manual, revolving funds should involve "large, distinct, self-sustaining (or nearly self-sustaining) transactions that provide client-oriented services." It is further stated that "Self sufficiency or near self-sufficiency will be a precondition to establishment of a revolving fund."

This is true for most of the SOA revolving funds (examples are CAC, TDC, and CCG). CORCAN is an interesting exception in that one third of its revenues come not from sales but from the department (Correctional Service Canada): these are covered from an appropriation. This payment from the department is classified as a "fee," which is to cover the correctional or rehabilitation component of CORCAN, along with the additional costs of operating in a prison environment (such as security provisions).

Another interesting exception is the case of an Agency which is moving towards self-sufficiency, and is seeking a revolving fund to encourage such a move. At the outset, complete self-sufficiency may not be feasible.

Clear and Separate Purposes

According to the Treasury Board criteria, the revolving fund mechanism must support the established objectives of the organization's program, and there must be a clear link between the expenses incurred to produce goods and services and the revenue produced through their sale. Revenues and expenditures must be closely related. If demand increases, the higher service levels will be financed through increased revenues, and if demand decreases, then both the expenditures and the revenues are expected to decrease accordingly.

Not every organization or activity is eligible for revolving fund status. The purpose of a revolving fund is to cover the operating expenditures on a cost-recovery basis and, in particular, to take care of fluctuations in the level of activity as related to the demand for the service. A good example of this would be the Passport Office.

This is clearly the case for SOAs, and the revolving fund provides a useful mechanism for smoothing things out over time. The only exception would be SOAs whose volume of business fluctuates substantially; in these cases, the break-even calculations can be done over several years (four years for the Passport Office, for example, and five years for the Grain Commission).

No Cross-Subsidization

The Treasury Board criteria state clearly that there must be no cross-subsidization, since the purposes of a revolving fund must be distinct and there must be self-sufficiency, or something close to it. Strictly speaking, the unit of self-sufficiency is not the Agency as a whole, but rather the set of activities financed by the revolving fund. Some activities of the Agency could be financed by a revolving fund, while others could be financed at least in part by appropriations. For example, the normal course activities of TDC are financed through its revolving fund, while the additional costs of giving courses in French and/or in the regions are covered in part by an appropriation. The revolving fund component is supposed to be self-sustaining, while the appropriations component is considered as having a public purpose. It is important, therefore, to distinguish the purposes carefully.

As noted in the paper, however, this arrangement has come under pressure recently as appropriations have been cut. In this situation, some of the difference has been made up from the revolving funds, although strictly speaking, the activities financed from the appropriations should have been cut instead. In some cases, however, this was difficult to do.

Accrual Accounting

The Treasury Board criteria stipulate that revolving funds must use accrual accounting. This is necessary for determining whether the revolving fund is in fact breaking even. Without accrual accounting these calculations would be thrown off by fiscal year considerations. For example, at the end of the fiscal year, the receivables can account for 25 percent or more of the SOA's revenues. On a cash-based system, these would have to be recorded in the following fiscal year. Even relatively slight variations in the timing of the revenues would result in large variations in the apparent year-end balances in the fund. Accrual accounting solves this problem by attributing the revenues to the year in which the sale was made, not the year in which the revenues were actually received.

There are other reasons for using accrual accounting. For example, in addition to solving the problems arising from fiscal years, it allows the revenues and expenditures to be matched in order to determine whether a given product or service has resulted in a profit or a loss.

Materiality

According to the Treasury Board, "Materiality is an important criterion because of the significant costs associated with setting up and managing a revolving fund."

The previous threshold level for revolving funds was \$25 million, but this has since dropped to \$10 million. In some cases, it can be even lower than this, on the assumption that the revolving fund may start small and then get larger as it covers additional activities.

As discussed in the text of this paper, there is less reason at the present time for applying a \$10 million threshold for SOAs. One of the key reasons for having a \$10 million threshold was to limit the proliferation of revolving funds. However, if revolving fund approval is tied to SOA status, then the number of SOAs becomes the effective limiting factor. Another reason for a \$10 million threshold is that accounting systems used to be more expensive. Now, with lower-cost software and hardware, with common systems being developed, and with new modular, "downsized" systems running on PC LANs or workstations, the systems costs are much lower. Costs will be brought down still further as shared systems are developed and implemented across the government, for example, the Common Departmental Financial System. As costs decline, the materiality argument loses force.

Concern over proliferation of revolving funds is longstanding. In 1979, the Auditor General warned that Parliament was "close to losing control of the public purse," and cited the proliferation of revolving funds as a case in point. In fact, revolving funds had been

established for a wide variety of purposes, including some speculative ones such as the purchase and resale of agricultural commodities (Agricultural Products Board).

The government responded to this concern with the *Adjustment of Accounts Act* (1981), which abolished a long list of revolving funds. Since then, the government has been careful to control the number of revolving funds and to tighten up the purposes for which they are used.

Treatment of Capital

Revolving funds are meant to cover operating expenditures (which include minor capital). Major capital investments are covered as a depreciation item and are charged against the revolving fund each year.

Accounting, Systems, and Readiness

As noted, accrual accounting is required for revolving funds. This means that the appropriate systems must be put in place.

SOAs with revolving funds require their own financial services, or else substantial assistance from the corporate financial unit of the department. In either case, this can be expensive. In the past, acquiring the necessary computer software and hardware was costly, although lower-cost systems are now becoming available.

Some training is required to use the accrual systems and to operate a revolving fund. Financial officers will typically have studied accrual accounting in the course of their education, so what they will generally need is refresher training on this subject. In most cases, they will not have used accrual accounting recently, but the knowledge can be brought back quickly. What can take time, however, is the development of new perspectives and habits of thought in seeing financial management in terms of business cases as well as commitment control.

Accountability and Reporting

From the viewpoint of the Auditor General, Parliament, and Treasury Board, one problem in the past with revolving funds was the lack of adequate reporting and accountability information. In the current situation, there is substantial reporting of financial information in the Public Accounts and in Part III of the Main Estimates (the individual departmental spending plans). However, this information is somewhat technical and can be difficult to interpret, since the meanings of the terms are not always clear and not always defined. Some of the expenditure and revenue classifications are also somewhat judgmental and open to interpretation. In addition, the purely financial reporting does not provide a

context for interpreting the numbers. There is no indication of the underlying approach or strategy (except to some extent in Part III of the Estimates).

Through their business plans, SOAs provide useful information on the context and the strategies underlying the numbers reported in the Estimates and the Public Accounts. However, these documents are not accessible to Parliament or to the public. They are confidential (business confidential) and are limited to ministers, departmental management, and central agencies. In theory, Parliament and the public are to be informed through annual reports provided by the Agencies, but this has been done only in some cases. Consequently, in most cases Parliament has the numbers but not the basic context and strategy for reviewing SOA revolving funds.

Treasury Board Accounting for Revolving Funds

The following arrangements have existed until now for Treasury Board accounting for revolving funds.

The key points are these:

- Revolving funds are treated as *statutory* expenditures.
- Accrual accounting is used for the internal accounts, but these are reconciled to the government's cash accounts on an annual basis.
- The accounting is done on the principle that the Government of Canada is the sole shareholder for each revolving fund, and that all surpluses (and deficits) belong ultimately to the Government of Canada. The bottom line for each of the funds is shown as the "Equity of Canada."

In any other business, once all the revenues and costs have been added up at the end of the year, any profit or loss would be considered to belong to the shareholders, not the company. This is the case for SOAs as well: any profit or loss belongs to the Government of Canada (the shareholder, represented by Treasury Board).

The accounting for a revolving fund begins with the receipt by Treasury Board in October or November of the fall update for the Main Estimates. The revolving fund section for an SOA will normally be a short item – one or two pages of the departmental document. Upon receiving this document, Treasury Board will compare the updated "bottom line" with the most recent forecast. The numbers in the most recent forecast will have been reflected in the current expenditure framework, which is now being updated through the Main Estimates process.

If the “bottom line” is better than anticipated (that is, if the drawdown is lower than expected or the surplus is higher than expected), then the difference between the new “bottom line” and the most recent forecast will be credited to the operating reserve. In the opposite situation (an increased drawdown or a lower-than-expected surplus), the difference will be booked against the operating reserve, assuming that it cannot be absorbed by the host department.

In point of fact, these calculations can be done at any time, since the basic task is to update the accounts for the operating reserve. Strictly speaking, the accounts which should be updated are those for the statutory reserve (officially called the Reserve for Statutory Overruns). However, the statutory reserve is used only to handle the larger statutory items. Smaller items (all the SOA revolving funds fall in this category) are handled through the operating reserve.

Generally, there will be a further updating of the reserve calculations for revolving funds at the time of the Final Supplementary Estimates (usually in February). However, the books for the revolving funds are not closed until the end of the fiscal year. At that point, all the reserves have been closed, so the changes from any revolving fund accounts cannot be reflected in the operating reserve. Instead, the changes are reflected in the fiscal framework for that year. It is understood that the expenditures for statutory items cannot be known exactly until the end of the fiscal year, and sometimes well beyond that. The fiscal framework makes allowance for this contingency, which can usually be forecast with some accuracy on the basis of past experience and trends.

Treatment of Surpluses and Deficits

One implication of this process is that any decision to let the SOA or the department keep any surpluses would result in a reduction in the expected level of the operating reserve, and would, in effect, be a charge against the reserve. It is not surprising that Treasury Board was unreceptive to the idea of allowing SOAs to keep any surpluses which have been built up.

One problem with this situation is that it provides no incentive for an SOA to generate a surplus. Instead, the incentive is simply to break even. If SOAs were allowed to keep a portion of any surpluses generated, they would strive to do more than break even and Treasury Board would benefit by receiving a share of this surplus. Motivation is important. For SOAs, making a profit and showing a positive bottom line becomes part of the culture, and a source of pride. The inability to earn a profit on a consistent basis makes it difficult to set challenging financial targets (as do other organizations in the private sector). There is less incentive to motivate people to reduce costs and increase revenues.

A possible solution would be to allow SOAs to retain a portion of any surpluses over and above the original forecasts given to Treasury Board, with the balance of the surpluses

being retained by Treasury Board itself as an “efficiency dividend” or “contribution margin.” The SOA portion could be kept for capital investment. In this way, retained earnings could be used for organizational development, with the objective of making the organization more viable, competitive, efficient, low cost, service-oriented and effective over the longer run. This would mean more investment in research and development, major capital, and the people of the organization. This would be one way of compensating the staff for their efforts in working harder and more efficiently.

One problem with such an approach is that any build-up of cash balances in the form of accumulated retained earnings would be certain to attract attention in a time of expenditure reductions. In such cases a business plan would be very useful for showing that any retained earnings had already been earmarked for service improvement and investments.

Another question is whether an SOA should be allowed to build up a surplus now (perhaps through charging a premium), in order to create a cushion for possible “hard times” ahead. Agencies whose break-even requirements are calculated over a multi-year period, such as the Passport Office (four years), currently operate under this arrangement.

SOAs and Revolving Funds

While there is no one-to-one correspondence between SOA and revolving fund, there is a certain convergence, one which is becoming closer over time. For its part, Treasury Board is showing some reluctance to approve revolving funds without SOA status. For instance, in a recent case which came to the Board, the revolving fund was approved on condition that an SOA be established. For organizations that are financed through revolving funds but which are not yet SOAs, the question of possible SOA status comes up regularly.

From the viewpoint of central agencies, and indeed from that of Parliament (to which the central agencies are responding), a linkage or convergence between SOA status and revolving fund status has two main advantages. First, it limits the number of revolving funds, since one must become an SOA in order to have a revolving fund. A second advantage is that SOAs, in general, provide greater accountability and transparency for tracking revolving funds and understanding their context. SOAs function within the parameters of their framework documents; they provide business plans (for Treasury Board and the host department); and in some cases they also provide annual reports (for public information). The level of reporting and accountability is much higher than it is for other revolving funds.

Appendix B: Special Operating Agencies in Manitoba

To date, Manitoba is the only other jurisdiction in Canada which has implemented SOAs. Other provinces are examining the possibility, but none has actually done it yet.

The Manitoba arrangement was designed in light of the federal experience, with the following modifications: (1) more provision for capital and start-up funds; (2) the ability to earn a profit and retain the earnings; and (3) a legislative basis (the *SOA Financing Authority Act*).

A comparison between the federal situation and the implementation in Manitoba can be useful in shedding light on the SOA initiative generally. The Manitoba arrangement is best described through the example of the Fleet Vehicles Agency, the first one established. (This was followed by the Materials Distribution Agency, whose function is basically that of stocked item supply. Two other Agencies, the Organization and Development Agency and the Vital Statistics Agency, were approved on April 1, 1994.) The Fleet Vehicles Agency is interesting not only because it was the first to be established, but also because it illustrates the key role that capital funding can play in the establishment and success of an Agency.

The approval process for the Fleet Vehicles Agency was similar to the federal initiative: approval of a charter or framework document by Treasury Board, with an ongoing requirement for an annual business plan. The major difference was that Manitoba has an SOA Financing Authority, which was set up by legislation mainly because Manitoba has no general provision for revolving funds, and there was a need for an equivalent mechanism. The Financing Authority has some additional functions, however, mostly involving the treatment of capital and assets. It is also useful for purposes of accountability, since it is the focal point of SOA finances; it provides an annual report to the Manitoba legislature which gathers together and summarizes the relevant information on the status and activities of the Manitoba SOAs. The Financing Authority operates under the direction of the Minister of Finance and is provided staff support through the Department of Finance.

When the Fleet Vehicles Agency was approved, the disposition of assets was as follows:

- The assets of the Agency, valued at \$12.3 million, were transferred in their entirety to the SOA Financing Authority, which is effectively a non-operating holding company for the Agency.
- The \$12.3 million in assets was divided into two components: a long-term debt component of \$8.2 million (held by the Financing Authority as “banker” for the Agency); and an equity component of \$4.1 million (held by the Province as “stockholder” for the Agency). In this case, the debt/equity ratio was 2:1. (In comparison, the ratio for the Materials Distribution

Agency was 1:1. Both the Organization and Staff Development Agency and the Vital Statistics Agency assumed the entire value of their nominal assets as debt, along with provisions to retire the debt in short order.)

- The Fleet Vehicles Agency signed an agreement with the Financing Authority to repay the \$8.2 million long-term debt over a period of 20 years (with annual payments of \$1 million, calculated on an interest rate of just over 10.375 percent).
- As the Agency's "stockholder" (with a \$4.1 million equity stake), the Province is entitled to any profits that the Agency declares surplus to its future needs. So far, however, the Agency has kept its profits in the form of retained earnings. (In 1993/94, the Fleet Vehicles Agency also prepaid \$1.7 million in principal on the long-term debt.)

These are the Agency's basic financial arrangements. As for capital, the ongoing requirements are being generated through the operations of the Agency. However, there was also an initial "up front" requirement for major capital funding to begin the renewal of the vehicle fleet. The arrangement in this case was that the Agency borrowed \$3.8 million from the Financing Authority in the first year of operations and \$3 million in the second year. These loans were to be repaid over a six-year time period (at the same interest rate as that used for Crown corporations).

The Agency generates its revenues from vehicle leases paid by government clients. (This is a mandatory service in the Manitoba government.) It has been profitable since its inception, and has been able to achieve some major efficiencies, mainly because of two factors: adequate capital funding and full-cost pricing.

The capital funding was critical to the operations of the Agency, permitting it to operate at a much higher level of efficiency. Since the average operating costs of a vehicle that is five years old are five times greater than for a new vehicle – and the costs rise sharply after five years – major efficiencies can be achieved by using newer vehicles and by retiring older vehicles.

This, however, requires a significant capital investment. Previously, the only source of capital funding was through a capital appropriation included in the Estimates with Treasury Board approval – and the necessary funds were not approved from that source, given the Province's highly limited funding. However, through the SOA financing mechanism it was possible to obtain the funds on the basis of a solid business case.

Another way of attaining greater efficiency was to install a computer and data processing system which made possible the precise tracking of individual vehicles on the basis of repair records and distances travelled. This, however, required a significant capital expenditure (\$600 thousand) which could not be financed under the old system, but under the

new arrangements, the money was found and the system was installed, thereby enabling the whole program to be much more tightly managed.

A further source of efficiency was from full-cost pricing which took into account the value of the capital assets tied up in the vehicles. Previously, departments would tend to keep a vehicle that they were using very little since they only paid the variable costs. However, once they were charged for the fixed costs as well they were much more inclined to return the vehicle to the pool; in this way, the utilization and turnover rates for the vehicles were increased.

On the basis of the above factors, the Fleet Vehicles Agency was able to pay down its loans ahead of schedule; finance further capital acquisitions out of its current operations; reduce its rates; and make a profit. None of this would have been possible if the SOA had not had access to adequate capital funding "up front."

All this was done during a time of expenditure reductions in which the budgets of client departments were reduced. (In this situation, the departments appreciated the rate reductions made by the Fleet Vehicles Agency: 12 percent on fixed costs and 4 percent in variable costs.) The vehicle fleet was downsized by 12 percent to match the reduction in demand and to take account of the increases in efficiency. It should be noted that as an SOA with a revolving fund, the Fleet Vehicles Agency was not subject to any direct expenditure reductions. Instead, there was an indirect impact on its revenues.

The Agency has been successful to the point that other clients, such as municipalities, school boards, provincial Crown corporations, and regional federal offices have expressed interest in using the services of the Fleet Vehicles Agency, thus raising the issue of competition with the private sector.

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2 _____ 31 - 35	2 _____ 6 - 10	2___ ADM (EX 4 and 5)	2___ University/College	2___ Female
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