

**Contribution Audit Policies and Processes for Western
Diversification Program (WDP) and Innovation and Community
Investment Program (ICIP)**

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TABLE OF CONTENTS

Introduction	1
Background.....	1
Objective and Scope	2
Approach	2
Summary of Recommended Objectives and Policies.....	3
Recommended Objectives	3
Recommended Policies.....	3
Contribution Audit Objectives	8
Current Objectives	8
Recommended Objectives	10
Recommended Audit Policies and Processes.....	13
1. Audit Selection	13
2. Auditor Selection.....	18
3. Coordination	18
4. Scope of Work	19
5. Approach.....	20
6. Deliverables	22
7. Results Tracking.....	25
Operational Considerations	26
Treasury Board Approval	26
Auditor Contract	26
Sample Size Calculator	27
Central Coordination and Monitoring.....	27
Budget Requirements.....	27
Appendix	
A. Interviewees and Reviewers	
B. Documentation Reviewed	
C. Possible Risk Assessment Criteria by Type	
D. Budget Requirements: Assumptions and Calculations	

INTRODUCTION

Background

Audit and Evaluation Branch (“Audit and Evaluation”) of Western Economic Diversification Canada (“WD”) undertook this project to help management revise its contribution audit policies and processes for the Western Diversification Program (“WDP”) and the Innovation and Community Investment Program (“ICIP”). To assist it with this initiative, Audit and Evaluation contracted KPMG LLP.

Under these two programs, WD contributes financially to projects that promote innovation, entrepreneurship and sustainable communities in western Canada. In 2003, the WD approved 561 projects under WDP and contributed more than \$68 million to WDP projects. It also approved 46 projects under ICIP and contributed \$13 million to ICIP projects. Recipients of contribution funding range from being small businesses and non-profit organizations, to provincial and municipal governments.

Management of WDP and ICIP are responsible for the on-going monitoring and auditing of contribution payments as set out in the programs’ respective Risk-Based Audit Frameworks (“RBAF”). Generally, management believes that its monitoring and claims verification activities are rigorous and provide adequate control to prevent material noncompliance issues. However, certain aspects of the activities need enhancement.

A key component of WD’s monitoring and claims verification activities is the conduct of a number of audits at the recipient level. These “contribution audits” are performed by external auditors and test the degree to which contribution payments have been used for their intended purpose, and recipients are in compliance with their contribution agreements. Management identified concerns with the effectiveness of contribution audits at the recipient level and, in particular, management was not clear what conclusions could be drawn from the audits overall.

Management further identified that the audit policies contained in the RBAFs are not as clear, relevant and useful as they could be. This has led, in part, to differing contribution audit practices across the regions. The report titled Risk-Based Review of the Projects Monitoring and Payment Function (Audit and Evaluation Branch, December 2003) highlighted that audit practices among the regions ranged from the use of a formal process supported by an electronic audit log, to the election not to commission external contribution audits.

To improve the effectiveness of the contribution audits and to demonstrate stewardship over public funds, WD initiated a review of its contribution audit policies.



Objective and Scope

WD's objective for this project was to develop new contribution audit policies and processes for WDP and ICIP, including policies related to:

- Selecting projects to audit;
- Defining audit objectives and conducting audits; and
- Using audit results to manage projects better, and help improve assessment and monitoring processes.

The project considered contribution audit policies for both WDP and ICIP and any mandatory processes that are necessary to implement the policies. The policies pertain to contribution audits and do not cover program audits or audits such as those that would be performed by WD's Audit and Evaluation Department.

Approach

The following activities were performed as part of this project:

- Interviewed eight representatives from WD responsible for business planning, program management, internal audit, and contribution project management (listed in Appendix A);
- Interviewed one representative from Consulting and Audit Canada ("CAC"), which performs WD's contribution audits;
- Reviewed statutory and policy documentation relevant to performing contribution audits (listed in Appendix B);
- Developed and circulated suggested objectives for contribution audits, and incorporated feedback received from reviewers;
- Analyzed project and claim volumes and values, and developed a method and criteria for selecting the audit sample;
- Developed recommended audit policies and processes, and identified significant operational implications associated with the recommendations;
- Documented and circulated the recommended policies and processes, and operational implications, and incorporated feedback received from reviewers (listed in Appendix A); and
- Submitted a draft and final report with recommended contribution audit policies and processes.



SUMMARY OF RECOMMENDED OBJECTIVES AND POLICIES

This section of the report provides a summary of the recommended objectives and policies contained in this report. Further explanation about each objective and policy is provided in the subsequent sections.

Recommended Objectives

Overall Objectives

1. Demonstrate stewardship over public funds.
2. Provide input into the effectiveness of WD's assessment, monitoring and claims verification activities.
3. Deter recipients from inappropriate use of funds, or careless or inaccurate financial and project reporting.

Specific Objectives

1. Provide assurance on the accuracy of project funding received and/or claimed from all sources, and costs incurred, paid and claimed.
2. Provide assurance that claimed costs are eligible and in accordance with the contribution agreement, and departmental and central agency guidelines.
3. Identify and report on evidence of compliance to key, selected terms and conditions in the contribution agreements.
4. Review the recipient's process of tracking and ultimately reporting project outputs and outcomes.
5. Bring to the attention of WD any matters of possible significance not included in the audit opinion.
6. Indicate the recipient's concurrence with, or at least acknowledgement of, the audit findings.

Recommended Policies

1.1 Process for Selecting the Audit Sample

- 1.1.1 The audit sample will be selected from WDP and ICIP projects that are active during the fiscal year, and that received at least one contribution payment. The sample will include projects from both programs.
- 1.1.2 WD must receive audit opinions for a sufficient number of projects each year to estimate the overall number of projects that are in compliance with their terms and conditions with a confidence level of 90% and a margin of error of plus or minus 5%.
- 1.1.3 The audit sample should be comprised of two strata:

- Stratum 1: High-risk projects. All projects with a high risk rating (100% sample); and
- Stratum 2: Randomly-selected, projects not already included in stratum 1.

1.1.4 The sample size of stratum 2 must allow reporting of separate results for the stratum to a confidence level of 90% and a margin of error of +/- 5%.

1.2 Selection Criteria

1.2.1 Selection criteria for projects to audit are outlined by stratum:

	Selection Criteria
Stratum 1: High-Risk	All active projects with contribution payments made during the current fiscal year that have a risk rating of "high" as calculated using the WDP and ICIP Risk Assessment Tool.
Stratum 2: Random	Simple random sampling of all projects with contribution payments made during the current fiscal year and not eligible for inclusion in stratum 1. WD could consider an alternative, probabilistic sampling method such as systematic sampling based on a calculated dollar interval. This would bias the sample significantly towards large dollar projects and would need to be disclosed when reporting estimates of WD's overall compliance rate.

1.3 Risk Assessment

- 1.3.1 High-risk projects must be identified using a risk assessment tool designed for WDP and ICIP projects.
- 1.3.2 The risk assessment for each project must be reviewed annually and as new information becomes available (e.g. through regular monitoring activities).
- 1.3.3 The risk rating "high" must denote projects that have a significant risk of breaching financial or non-financial terms of their contribution agreement.

1.4 Frequency and Timing

- 1.4.1 Contribution audits should occur after WD has completed its internal review of claims submitted to date on the project and within 90 days of the fiscal year end in which the claims were processed.
- 1.4.2 On a quarterly basis, WD should identify projects for audit while ensuring that all projects that comprise the population for stratum 2 have an equal probability of



being selected over the course of the year.

2.1 Auditor Selection

- 2.1.1 Contribution audits must be performed by an auditor that is qualified and permitted to issue a financial audit opinion in the province of the recipient, and that is independent of the recipient and all of its partners, including WD and other funders.
- 2.1.2 WD must contract auditors to follow specified terms and conditions for conducting its contribution audits.

3.1 Coordination

- 3.1.1 WD should coordinate its contribution audits of projects included in its sample with other funding agencies when feasible and appropriate.
- 3.1.2 WD may accept the results of contribution audits performed by another funding agency on a selected project if the audit and associated work meets WD's audit objectives and all elements of the required scope of work (see 4. Scope of Work).

4.1 Scope of Work

- 4.1.1 The scope of the work to be completed must be defined such that it will meet the objectives of the contribution audits.
- 4.1.2 The scope of the audit and the extent of responsibility assumed by the auditor must be clearly defined in writing for each audit. The nature of the claims and the specific terms and conditions of the Agreement subject to audit could vary considerably and accordingly, it is important that there be a clear understanding and agreement as to the scope of the audit.
- 4.1.3 The scope of the audit and the matters to be reported on must be within the auditor's professional competence.
- 4.1.4 The audit engagement should clearly state the criteria, which the auditor will use to evaluate compliance. Criteria are benchmarks against which the subject matter of the engagement can be evaluated. Without suitable criteria, inappropriate conclusions may be drawn. Characteristics of suitable criteria are relevance, reliability, neutrality, understandability, and completeness.
- 4.1.5 WD must clearly define any additional areas that will be subject to review, in particular the key terms and conditions, which are to be reviewed in the scope of the work being completed.



5.1 Approach

- 5.1.1 All audits are to be conducted in accordance with generally accepted auditing standards established by Section 5815 of the Canadian Institute of Chartered Accountants Handbook ("CICA HB") Audit reports on Compliance with Agreements, Statutes and Regulations ("Section 5815"). Section 5815 provides guidance to an auditor engaged to express an audit opinion as to a client's compliance with criteria established by provisions of agreements, statutes or regulations.
- 5.1.2 The auditor should comply with the general and examination standards of Section 5100 CICA HB.

6.1 Reports

- 6.1.1 The auditor must provide a written opinion that the claim or groups of claims are in compliance, in all material respects, with the criteria as described in the contribution agreement. The opinion should be attached to the statement of claims and contributions audited.
- 6.1.2 The auditor should provide support for recommended claim adjustments and conclusions.
- 6.1.3 The auditor should provide specific compliance items reviewed, a schedule of evidence considered and related findings.
- 6.1.4 The auditor should provide an overview of the performance tracking process and findings related to the reasonableness of the process and results reported.
- 6.1.5 The auditor should provide general observations and findings related to matters not specifically within the scope of the audit, but which may be of interest to WD in its assessment or management of the project.

6.2 Audit Opinion

- 6.2.1 The auditor's report should cover the audit work relating to the following objectives:
- Project funding received from all sources has been completely and accurately reported;
 - Claimed project costs are accurate and valid costs; and
 - Claimed costs are eligible and in accordance with the contribution agreement, and departmental and central agency guidelines.
- 6.2.2 The auditor's report should follow the standards

established by CICA HB Section 5815.

- 6.2.3 The auditor should clearly state the specific Sections of the Agreement, which have been considered by the auditor. The auditor should also provide any interpretation of the provisions of the Agreement that the auditor has made in order to conclude on the report.

6.3 Reporting Process

- 6.3.1 The auditor must submit the results of a contribution audit to WD within 15 days of completing the audit.
- 6.3.2 The auditor must provide WD with an opportunity to discuss the report within 10 days of receiving it.
- 6.3.3 Audit reports must be submitted to the WD officer responsible for the projects being audited and to WD headquarters.

7.1 Results Tracking

- 7.1.1 Contribution audit results must be tracked and aggregated organization-wide such that WD can:
- Identify trends or recurring problems;
 - Adjust selection and risk assessment criteria;
 - Identify any opportunities to improve monitoring and claim verification processes;
 - Identify the need to further stratify the audit sample; and
 - Estimate and report on project compliance overall.



CONTRIBUTION AUDIT OBJECTIVES

Current Objectives

WD's current objectives for conducting contribution audits do not establish the overall purpose for conducting audits. Rather, the objectives focus on the conduct of specific audits. Some of these audit-specific objectives are not well defined, achievable or important. The audit-specific objectives also differ unnecessarily between WDP and ICIP.

Lack of Overall Objectives

Interviewees perceive that WD's stakeholders have broader objectives for contribution audits than those outlined in the RBAFs. These overall objectives include:

- Helping to ensure projects and programs meet their objectives, and reported outcomes/outputs are accurate;
- Complying with central agency requirements;
- Obtaining input on the effectiveness of the monitoring and claims verification processes;
- Obtaining input into the assessment of future projects (e.g. of a similar nature, risk profile, or with the same recipient); and
- Streamlining and/or focusing internal audits.

Unclear Objectives

Some of the current objectives are not clearly defined, for example:

- "Financial reports contain accurate and reliable information." It is unclear what the term "financial reports" refers to.
- "Verify and report on compliance to the agreement" is very broad.

Overlap in Objectives

Some of the objectives overlap or are redundant, for example:

- "Verify and report the costs incurred and claimed" and "Ensure that claimed expenditures have been incurred and are in accordance with the contribution agreement..."
- "Verify and report on compliance to the agreement," "Ensure that claimed expenditures...are in accordance with the contribution agreement..." and "Provide assurance that recipients are achieving...the performance expectations of the agreement."

Unachievable Objectives

Some of the objectives extend beyond the scope of the WD's contribution agreements and cannot be performed by an auditor cost-effectively or at all. Examples include:

- "Financial operations are conducted properly."
- "Financial statements are presented fairly."
- "An adequate internal control system exists to account for and manage the contribution received."
- "Verify and report on compliance to the agreement" where compliance includes non-financial requirements such as environmental mitigation measures, other legal requirements, and performance output or outcomes.
- "Provide assurance that recipients are achieving and accurately reporting the performance expectations of the agreement."

Lower-Priority Objectives

While interviewees ranked objectives related to claim expenditures and compliance as being the most important objectives, they did not perceive objectives related to financial operations to be important for contribution audits. These objectives were ranked low, and were confirmed through interviews to be unimportant to WD. The table below provides interviewees average ranking of objectives.

Average Ranking of Importance

Objectives	Rank
Ensure that claimed expenditures have been incurred by the recipient and are in accordance with the contribution agreement, the Departmental and central agency guidelines.	1
Verify and report the costs incurred and claimed.	2
Verify and report on compliance to the agreement.	3
Bring to the attention of WD any other matters considered to be of significance or requiring management action.	4
Provide assurance that recipients are achieving and accurately reporting the performance expectations of the agreement.	5
Financial reports contain accurate and reliable information.	6
An adequate internal control system exists to account for and manage the contribution received.	7
Financial operations are conducted properly.	8
Financial statements are presented fairly.	9
Indicate the concurrence, or otherwise, of the recipient with the audit findings.	10

Some of the less important objectives were originally included based on central agency guidelines, but do not appear to be pertinent to WD's environment.

*Recommended
Objectives*

WD should consider two groups of objectives for its contribution audits: overall objectives pertaining to the need for conducting contribution audits; and objectives pertaining to the purpose of conducting a specific contribution audit. Overall objectives highlight the uses and benefits of following a contribution audit policy. Specific objectives give guidance to WD and the auditor with respect to the audit scope and approach required to conduct the audits.

Overall Objectives

The following recommended objectives relate to the conduct of contributions audits in aggregate. They answer the question: Why conduct contribution audits at all?

Overall Objective 1: Demonstrate stewardship over public funds.

This objective equates to complying with central agency policies and is necessary. It can be met following a risk-based approach.

Overall Objective 2: Provide input into the effectiveness of WD's assessment, monitoring and claims verification activities.

This objective offers value directly to WD. It has possible implications for tracking and aggregating audit results.

Overall Objective 3: Deter recipients from inappropriate use of funds, or careless or inaccurate financial and project reporting.

This objective suggests contribution audits, though not designed to detect fraud, can serve as a preventive control. It has implications for audit selection criteria and sample size.

Other possible, overall objectives were considered, but are secondary in nature and not drivers of contribution audit policies. These objectives included:

- Helping to ensure projects and programs meet their objectives; and
- Streamlining and focusing internal audit activities.

Specific Objectives

The following recommended objectives relate to the conduct of specific contribution audits and answer the question: What does WD want to achieve through the conduct of audits?

There are six specific objectives compared to the ten listed in the



RBAF for WDP. The recommended objectives attempt to reduce redundancy and overlap among the current objectives, and focus on areas of greatest importance (i.e. costs, compliance and performance).

Specific Objective 1: Provide assurance on the accuracy of project funding received and/or claimed from all sources, and costs incurred, paid and claimed.

Interviewees ranked cost verification as being high in importance. To meet this objective, audits must test the accuracy and completeness of costs incurred, paid and claimed. Audits must also test if total contributions exceed costs or allowable stacking limits.

By focusing on projects, this objective allows WD to audit specific claims, groups of claims or the entire project as appropriate. It also leaves it up to the auditor to assess the degree of reliance it needs to place on recipients' internal controls.

Specific Objective 2: Provide assurance that claimed costs are eligible and in accordance with the contribution agreement, and departmental and central agency guidelines.

Interviewees ranked cost eligibility as being high in importance. To meet this objective, audits must test the eligibility of claimed costs. The objective focuses on costs as distinct from claims, allowing WD to audit specific claims, groups of claims or the entire project as appropriate.

Specific Objective 3: Identify and report on evidence of compliance to key, selected terms and conditions in the contribution agreements.

Interviewees ranked determination of compliance as being high in importance. However, testing full compliance is not feasible for contribution audits. The wording of this recommended objective allows WD to specify key terms and conditions to consider based on the nature of the project and the cost/benefit of auditing each condition. It also places the burden of proof of compliance on the recipient, reducing audit costs and avoiding the issue of auditors being unqualified to assess compliance directly.

Specific Objective 4: Review the recipient's process of tracking and ultimately reporting project outputs and outcomes.

This objective enables the auditor to address project performance, an important area of compliance, without the need to assess performance directly. The auditor's findings will relate to the reasonableness of recipients' performance tracking processes and information reported to date, but will not be used to formulate an audit opinion on those processes and information. As audits will be performed before or shortly after project completion, auditors will not likely be able to comment on final project outcomes reported.



Specific Objective 5: Bring to the attention of WD any matters of possible significance not included in the audit opinion.

This objective is important to obtain findings from the auditor related to project or recipient issues that the auditor does not consider material (i.e. that would not be mentioned in an audit opinion), and to obtain input into the project risk assessment or decision to perform subsequent audits.

Specific Objective 6: Indicate the recipient's concurrence with, or at least acknowledgement of, the audit findings.

While interviewees considered recipient concurrence to be a less important objective, it is a useful tool to validate the results of the audit.



RECOMMENDED AUDIT POLICIES AND PROCESSES

This section outlines recommended policies and specific processes, where necessary, to achieve the objectives for contribution audits. Brief rationale for recommended policies is provided following each group of policies.

The policies are intended to be mandatory. In some cases, specific processes must be followed in order to comply with the policy. Any such mandatory processes follow the policies they support.

Policies in this section relate to:

1. Audit selection;
2. Auditor selection;
3. Coordination;
4. Scope of Work;
5. Approach;
6. Deliverables; and
7. Results tracking.

1. Audit Selection

1.1. Process for Selecting the Audit Sample

Recommended Policies

- 1.1.1 The audit sample will be selected from WDP and ICIP projects that are active during the fiscal year, and that received at least one contribution payment. The sample will include projects from both programs.
- 1.1.2 WD must receive audit opinions for a sufficient number of projects each year to estimate the overall number of projects that are in compliance with their terms and conditions with a confidence level of 90% and a margin of error of plus or minus 5%.
- 1.1.3 The audit sample should be comprised of two strata:
 - Stratum 1: High-risk projects. All projects with a high risk rating (100% sample); and
 - Stratum 2: Randomly-selected, projects not already included in stratum 1.
- 1.1.4 The sample size of stratum 2 must allow reporting of separate results for the stratum to a confidence level of 90% and a margin of error of +/- 5%.

Rationale for Policies

Policies related to the sample of projects to audit are intended to:

- Demonstrate WD's stewardship over public funds in an unbiased and defensible manner. WD will be able to report the estimated percentage of projects in receipt of contribution payments in the current year that were in material compliance with their agreements;
- Obtain meaningful (i.e. statistically valid) data as input as to the effectiveness of its project assessment, monitoring and claims verification activities; and
- Result in a probability of being audited that is sufficiently large that contribution audits may become a deterrent against inappropriate claims.

The terms and conditions for WD and ICIP, which form the basis for contribution agreements, are similar. Additionally, WD uses substantially the same monitoring and verification activities for WD and ICIP projects. Therefore, in the interest of efficiency, a single audit sample can incorporate projects from both programs.

WD must demonstrate extra vigilance around high-risk projects. Also, assuming an accurate assessment of risk, these projects should have an inherently higher probability of not complying with their contribution agreements than the population of projects as a whole. Therefore, both to demonstrate diligence and to improve the effectiveness of performing contribution audits, it is important to stratify the sample based on project risk.

While the sample size of the random sample will be sufficient to provide significant results for WD as a whole it would be too costly to achieve statistical significance in each region or in each program. The sample criteria would give projects in each region and program an equal probability of being selected.

The recommended policies will result in a sample size of at least 35 audits each fiscal year. In addition to the projects included in the sample, WD may elect to audit projects that meet special criteria for the purpose of addressing high-risk or problem areas (e.g. specific regions or programs), or create a further deterrence (e.g. type of recipient).

The sample is based on projects, not claims. This allows WD the flexibility to audit groups of claims for greater efficiency.



Required Processes

1.1.a Central Coordination

As the sample will be based on all eligible projects, regardless of region, it must be generated centrally. WD must develop specific, mandatory processes and responsibilities for:

- Maintaining a registry of projects and necessary information to generate the sample;
- Generating samples for each stratum; and
- Allocating funds to regions for contracting auditors based on the sample selected.

1.1.b Sample Size Determination

Stratum 1 is comprised of a 100% sample of high-risk projects. The sample size for stratum 2 must be based on a simple random sampling method and must be calculated based on a confidence level of 90% and a margin of error of +/- 5%. To minimize the number of audits performed, WD should consider the following:

- Assume a 100% compliance rate (percentage of unqualified audits) and draw additional samples as required should the compliance rate be lower. This assumption is reasonable given that all WD reviews all project claims. Any compliance issues should be detected and rectified through this process; and
- Determine if the selected projects have already been audited by another agency in a manner that meets WD requirements (as outlined in recommended policies 3.1.1 and 3.1.2).

Subsequent years' sample sizes should be based on a compliance rate equal to or less than the prior year's rate.



1.2 Selection Criteria

Recommended Policy

1.2.1 Selection criteria for projects to audit are outlined by stratum:

	Selection Criteria
Stratum 1: High-Risk	All active projects with contribution payments made during the current fiscal year that have a risk rating of "high" as calculated using the WDP and ICIP Risk Assessment Tool.
Stratum 2: Random	Simple random sampling of all projects with contribution payments made during the current fiscal year and not eligible for inclusion in stratum 1. WD could consider an alternative, probabilistic sampling method such as systematic sampling based on a calculated dollar interval. This would bias the sample significantly towards large dollar projects and would need to be disclosed when reporting estimates of WD's overall compliance rate.

Rationale for Policy

The selection criteria directly support the sample requirements for each stratum, and eliminate ambiguity and judgment in how projects should be selected for auditing.

1.3 Risk Assessment

Recommended Policies

- 1.3.1 High-risk projects must be identified using a risk assessment tool designed for WDP and ICIP projects.
- 1.3.2 The risk assessment for each project must be reviewed annually and as new information becomes available (e.g. through regular monitoring activities).
- 1.3.3 The risk rating "high" must denote projects that have a significant risk of breaching financial or non-financial terms of their contribution agreement.

Rationale for Policies

The risk assessment tool formalizes officers' perceptions of project risk, and supports a uniform approach to assessing risk.

Required Processes



1.3.a Revising and Maintaining the Risk Assessment Tool

The current risk assessment tools for WDP and ICIP need to be standardized and revised to more accurately reflect project risk. Appendix C provides suggested risk assessment criteria grouped by three types of risk elements:

- Recipient Risk;
- Project Risk; and
- Compliance Risk.

In addition, risk elements need to be weighted to ensure their impact on the total risk score reflects their impact on the risk of a project not complying with its terms and conditions. WD must track incidents of temporary or complete failures to comply and correlate them to the risk elements and scores. It must adjust the risk elements and weightings as necessary to improve the risk assessment's predictive ability over time.

1.3.b Tracking Risk Assessments

In order to identify high-risk projects requiring an audit, and to correlate failure incidents to risk elements and scores, WD must maintain a central registry of current risk ratings for each project.

1.4 Frequency and Timing

Recommended Policies

- 1.4.1 Contribution audits should occur after WD has completed its internal review of claims submitted to date on the project and within 90 days of the fiscal year end in which the claims were processed.
- 1.4.2 On a quarterly basis, WD should identify projects for audit while ensuring that all projects that comprise the population for stratum 2 have an equal probability of being selected over the course of the year.

Rationale for Policies

Conducting audits after a desk review will:

- Increase the effectiveness of the audits at helping to identify potential weaknesses in the claim verification process;
- Allow WD project monitoring officers to provide input into the focus of the audits, particularly around areas of concern and compliance with key terms and conditions; and
- Allow WD to assume an initial compliance rate of 100% for the purpose of determining its sample size.

The recommended timing of audits is intended to distribute the audits throughout the year. However, WD may determine that it is simpler to select and audit all projects following the end of the



fiscal year. This may strain CAC audit resources.

Required Processes

WD should select projects to audit following the timing and frequency in the table following:

	Timing and Frequency
Stratum 1: High-Risk	Projects to be audited at least once annually: <ul style="list-style-type: none"> • Upon determining that a project is high risk; • As deemed necessary to follow up on prior audits or known issues; or • As logistically feasible (e.g. not all at year end; coordinated with other agencies).
Stratum 2: Random	Projects to be audited once annually, selected quarterly based on one quarter of the estimated total annual number of qualifying projects excluding projects considered in previous quarters of the current fiscal

2. Auditor Selection

Recommended Policy

- 2.1.1 Contribution audits must be performed by an auditor that is qualified and permitted to issue a financial audit opinion in the province of the recipient, and that is independent of the recipient and all of its partners, including WD and other funders.
- 2.1.2 WD must contract external auditors to follow specified terms and conditions for conducting its contribution audits.

Rationale for Policy

In addition to complying with central agency requirements, this policy follows best practice to ensure objective and professional audits.

3. Coordination

Recommended Policy

- 3.1.1 WD should coordinate its contribution audits of projects included in its sample with other funding agencies when feasible and appropriate.
- 3.1.2 WD may accept the results of contribution audits performed by another funding agency on a selected project if the audit and associated work meets WD’s audit objectives and all elements of the required scope of work



(see 4. Scope of Work).

Rationale for Policy

This policy helps to reduce the number of redundant audits performed on a single project within a given year by multiple funding partners. Coordinating audits, particularly between federal government departments is recommended in central agency guidelines.

4. Scope of Work

Recommended Policies

- 4.1.1 The scope of the work to be completed must be defined such that it will meet the objectives of the contribution audits.
- 4.1.2 The scope of the audit and the extent of responsibility assumed by the auditor must be clearly defined in writing for each audit. The nature of the claims and the specific terms and conditions of the Agreement subject to audit could vary considerably and accordingly, it is important that there be a clear understanding and agreement as to the scope of the audit.
- 4.1.3 The scope of the audit and the matters to be reported on must be within the auditor's professional competence.
- 4.1.4 The audit engagement should clearly state the criteria, which the auditor will use to evaluate compliance. Criteria are benchmarks against which the subject matter of the engagement can be evaluated. Without suitable criteria, inappropriate conclusions may be drawn. Characteristics of suitable criteria are relevance, reliability, neutrality, understandability, and completeness.
- 4.1.5 WD must clearly define any additional areas that will be subject to review, in particular the key terms and conditions, which are to be reviewed in the scope of the work being completed.

Rationale for Policies

The recommended policies are consistent with best practices followed by the auditing profession.

Required Processes

Following the selection of the audits, WD must clearly define the scope of the work required to the auditor. This needs to be done in context of the specific objectives of the WD contribution audits.



For each project or claim selected for audit, WD needs to define the specific scope of the audit to be completed with respect to the specific claim(s) to be audited and an accounting period for auditing contributions received.

All audits at a minimum should consider the following:

- Project funding received from all sources has been completely and accurately reported;
- Claimed project costs are accurate and valid costs; and
- Claimed costs are eligible and in accordance with the contribution agreement, and departmental and central agency guidelines.

For each project or claim selected, WD needs to clearly define additional areas that are to be reviewed.

Responsibility for reporting on compliance with the terms and conditions of the funding agreement rests with the funding recipient. The responsibility of the auditor is to report on whether the recipient has met the terms of conditions of the funding agreement. The recipient must prepare and provide sufficient reporting and evidence that they have met the terms and conditions of the agreement. Insufficient reporting and/or evidence to support that compliance has been met should be reported.

5. Approach

Recommended Policies

5.1.1 All audits are to be conducted in accordance with generally accepted auditing standards established by Section 5815 of the Canadian Institute of Chartered Accountants Handbook ("CICA HB") Audit reports on Compliance with Agreements, Statutes and Regulations ("Section 5815"). Section 5815 provides guidance to an auditor engaged to express an audit opinion as to a client's compliance with criteria established by provisions of agreements, statutes or regulations.

5.1.2 The auditor should comply with the general and examination standards of Section 5100 CICA HB as follows:

General standard

The examination should be performed and the report prepared by a person or persons having adequate technical training and proficiency

in auditing, with due care and with an objective state of mind.

Examination standards

- (i) *The work should be adequately planned and properly executed using sufficient knowledge of the entity's business as a basis. If assistants are employed they should be properly supervised.*
- (ii) *A sufficient understanding of internal control should be obtained to plan the audit. When control risk is assessed below maximum, sufficient appropriate audit evidence should be obtained through tests of controls to support the assessment.*
- (iii) *Sufficient appropriate audit evidence should be obtained, by such means as inspection, observation, enquiry, confirmation, computation and analysis, to afford a reasonable basis to support the content of the report.*

Rationale for Policies

The recommended policies are consistent with best practices followed by the auditing profession and are intended to ensure audits are performed consistent with Canadian generally accepted auditing standards.

Required Processes

Audit

The audits should be supported by an adequate plan. As part of the planning phase the auditor should confirm the scope of the audit in accordance with the direction provided by WD.

The auditor should plan and perform the audit to obtain reasonable, but not absolute, assurance that the client's claim is in compliance with the criteria established by provisions of the funding agreement taken in all material respects. Absolute assurance in auditing is not attainable because of such factors as: the nature of audit evidence which is based on the use of testing and where much of the evidence available to the auditor is persuasive, rather than conclusive; the inherent limitations of internal control; and the characteristics of fraud.

Because of the nature of fraud, including attempts at concealment through collusion and forgery, an audit planned and performed in accordance with Canadian generally accepted auditing standards may not detect fraud. Further, while effective internal control reduces the likelihood that errors, fraud, or illegal acts will occur and remain undetected, it does not eliminate that possibility. Accordingly, there is a risk that material errors, fraud, and other illegal acts may exist and not be detected by an audit performed in accordance with Canadian generally accepted auditing standards. Also, the audit will not be designed to detect matters that are immaterial to the claim.

Additional Areas

The auditor should consider the control environment and whether



appropriate reliance can be placed on internal controls in planning the audit.

While not being engaged to report on the recipients internal control the auditor should communicate to WD, any significant weaknesses in the recipient's internal control structure that come to the auditors attention during the audit.

The auditor should confirm that any additional work to be completed at the direction of WD on key terms and conditions is within the auditor's professional competence.

The auditor and WD should agree on the form of the reporting to be provided on matters relating to compliance with key terms and conditions. The auditor should plan the work accordingly such that it will support the required reporting.

6. Deliverables

6.1 Reports

Recommended Policy

- 6.1.1 The auditor must provide a written opinion that the claim or groups of claims are in compliance, in all material respects, with the criteria as described in the contribution agreement. The opinion should be attached to the statement of claims and contributions audited.
- 6.1.2 The auditor should provide support for recommended claim adjustments and conclusions.
- 6.1.3 The auditor should provide specific compliance items reviewed, a schedule of evidence considered and related findings.
- 6.1.4 The auditor should provide an overview of the performance tracking process and findings related to the reasonableness of the process and results reported.
- 6.1.5 The auditor should provide general observations and findings related to matters not specifically within the scope of the audit, but which may be of interest to WD in its assessment or management of the project.

Rationale for Policy

The auditor's report must satisfy the specific contribution audit objectives. The auditor should not make recommendations in its report, but rather leave the interpretation of the audit results and the decision to take any necessary, remedial action to WD. This affords WD the latitude to respond to the audit results in a manner that is most appropriate given its desire to see each project succeed, and to maintain relations with other funders and

the recipient.

It is not generally accepted practice to request access to or copies of the working papers of auditors. There is no compelling reason for WD to review auditors' working papers.

6.2 Audit Opinion

Recommended Policies

- 6.2.1 The auditor's report should cover the audit work relating to the following objectives:
- Project funding received from all sources has been completely and accurately reported;
 - Claimed project costs are accurate and valid costs; and
 - Claimed costs are eligible and in accordance with the contribution agreement, and departmental and central agency guidelines.
- 6.2.2 The auditor's report should follow the standards established by CICA HB Section 5815.
- 6.2.3 The auditor should clearly state the specific Sections of the Agreement, which have been considered by the audit. The auditor should also provide any interpretation of the provisions of the Agreement that the auditor has made in order to conclude on the report.

Required Processes

A suggested auditor report consistent with the recommended policies is provided on the next page. WD should request auditors use such a standard report for all contribution audits, subject to modifications required as a result of specific circumstances.



AUDITOR'S REPORT to WD

I have audited the eligibility of Claim number for XYZ, for compliance with the criteria established by Sections of the WD Agreement (“the Agreement”) dated xx . Compliance with the criteria established by the provisions of the Agreement is the responsibility of the management of XYZ and the interpretation of the provisions as further described in Note 1 attached. My responsibility is to express an opinion on this compliance based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether XYZ complied with the criteria established by the provisions of the agreement referred to above. Such an audit includes examining, on a test basis, evidence supporting compliance, evaluating the overall compliance with the Agreement, and where applicable, assessing the accounting principles used and significant estimates made by management.

In my opinion, as at December 31, 20XX, XYZ is in compliance, in all material respects, with the criteria as described in Sections to of the Agreement.

(signed).....

City

Date

6.3 Reporting Process

Recommended Policies

- 6.3.1 The auditor must submit the results of a contribution audit to WD within 15 days of completing the audit.
- 6.3.2 The auditor must provide WD with an opportunity to discuss the report within 10 days of receiving it.
- 6.3.3 Audit reports must be submitted to the WD officer responsible for the projects being audited and to WD headquarters.

Rationale for Policies

It is important to establish a turnaround time for contribution audits to ensure that WD receives results in time to take any necessary, remedial action, and to aggregate and report results. Many interviewees expressed a desire to have a debriefing with the auditors to clarify any findings in the audit report.

It is important that WD officers responsible for monitoring projects and an audit coordinator in headquarters receive the audit



reports. The officers are the most knowledgeable people to interpret the results and take any necessary action. However, for the purpose of tracking audit results and to avoid issues of officer bias, it is equally important for headquarters to receive a copy of each audit.

7. Results Tracking

Recommended Policy

- 7.1.1 Contribution audit results must be tracked and aggregated organization-wide such that WD can:
- Identify trends or recurring problems;
 - Adjust selection and risk assessment criteria;
 - Identify any opportunities to improve monitoring and claim verification procedures;
 - Identify the need to further stratify the audit sample; and
 - Estimate and report on project compliance overall.

Rationale for Policy

Audit results must be aggregated and used in order for WD to obtain benefits from contribution audits beyond those associated with auditing individual projects.



OPERATIONAL CONSIDERATIONS

Treasury Board Approval

Upon acceptance of the recommended policies and processes contained in this report, WD will need to incorporate them into the WDP and ICIP RBAFs and formally document any policies that deviate from central agency guidelines.

Revised RBAFs

The RBAFs for WDP and ICIP must be revised to reflect the new contribution audit policies and processes. WD should consider developing a common policies and processes manual governing contribution audits for multiple programs. The individual program RBAFs could then reference the manual.

WD must submit the revised RBAFs and the new contribution policies to Treasury Board Secretariat for review and approval.

Policy Divergence

As part of its submission to Treasury Board Secretariat, WD should include a document that explains significant deviations between WD's policies and central agency guidelines. Some of these deviations are noted below:

- Auditing of compliance. With respect to non-financial aspects of compliance, contribution audits will not result in an audit opinion and they will only address key areas of compliance as determined by WD;
- Auditing of financial statements, financial reporting, and financial operations, including internal controls. Contribution audits will not include an audit of these items with the exception of financial reports used to report contributions and costs to WD.
- Access to working papers. WD will not require access to the auditor's working papers.

Auditor Contract

WD should review its Memorandum of Agreement with CAC governing the conduct of contribution audits in light of the recommended policies. WD should make any revisions necessary to ensure the agreement is consistent with the policies, particularly with respect to the audit scope, approach and deliverables.



Sample Size Calculator

There are many variables involved in the calculation of required sample sizes for each stratum and for the sample overall. Similarly, a number of variables are used to determine an appropriate interval for selecting projects, should WD decide to use interval sampling. Many of the variables, such as risk ratings, forecast annual contribution amounts and the number of active projects, need to be updated before each sample is selected. As such, it is recommended that WD develop a tool to calculate sample size using a stratified sample variance formula, and determine an appropriate sampling interval. It is recommended that WD have the tool reviewed by a statistician.

Central Coordination and Monitoring

The contribution audit process should be centrally monitored and coordinated. This would include establishing processes to:

- Maintain a central registry of projects;
- Select projects to be audited;
- Manage audit expenses;
- Track the results of the audits, and identify trends and issues; and
- Estimate and report overall compliance of projects with terms and conditions.

WD will need to define these centralized processes in terms of required roles and responsibilities, systems and reporting. The processes will have a number of implications for WD, including how it tracks projects (e.g. it will now have to record risk ratings), selects projects to audit (i.e. it will now be done objectively and centrally) and allocates its audit budget (i.e. regions will not be given budgets for audits).

However, it is still expected that the regional officers responsible for monitoring projects will receive a copy of audit results and will retain responsibility for deciding upon and taking any remedial action required.

Budget Requirements

WD's current budget outlined in the WDP and ICIP RBAFs for contribution audits for WDP and ICIP combined is \$250,000. The budget necessary to implement the new policies and processes will depend upon:

- The number of projects considered to be high risk as determined using a revised risk assessment tool;
- The total number of active projects; and
- The actual compliance rate experienced in the second stratum.



Based on historical data, the minimum required annual budget for contribution audits is estimated to be at least \$175,000. Supporting calculations and assumptions are provided in Appendix D.

WD should review the budget estimate and revise it based on an actual determination of required sample sizes, and per audit costs.



Appendix A

Interviewees and Reviewers

Interviewees

Western Economic Diversification Canada

- Robert Bellehumeur
Director, Audit and Evaluation
- Al Everitt
Manager, Projects Monitoring and Payments, Alberta Region
- Les Gibson
Program Manager
- Kathy Locke
Audit and Evaluation Officer
- Kathy Mattern
Policy and Planning Officer
- Bill Perlmutter
Acting Director General of Operations, Manitoba Region
- Ron Sewell
Director, Business Planning and Resources
- Dan Snidal
Projects Monitoring and Payments Officer, Manitoba Region

Consulting and Audit Canada

- Darlene Ross
Auditor, Alberta Region

*Reviewers of
Recommended
Objectives*

- Robert Bellehumeur
Director, Audit and Evaluation
- Ray Bentley
Manager, Project Delivery
- Al Everitt
Manager, Projects Monitoring and Payments, Alberta Region
- Les Gibson
Program Manager
- David James
Director General, Operations, Saskatchewan Region
- Nadean Langlois
Director General, Operations, Alberta Region
- Kathy Locke
Audit and Evaluation Officer
- Kathy Mattern
Policy and Planning Officer
- Michelle Neilly
Director General, Operations, BC Region



- Bill Perlmutter
Acting Director General of Operations, Manitoba Region
- Jim Saunderson
Director General, Finance
- Ron Sewell
Director, Business Planning and Resources
- Brian Williams
Manager, Portfolio Management

*Reviewers of
Recommended Policies*

- Robert Bellehumeur
Director, Audit and Evaluation
- Kathy Locke
Audit and Evaluation Officer
- Kathy Mattern
Policy and Planning Officer
- Jim Saunderson
Director General, Finance



Appendix B

Documentation Reviewed

Financial Administration Act. Department of Justice Canada. December 31, 2002.

Guide on the Audit of Federal Contributions—Part I: Policy. Treasury Board of Canada Secretariat. September 1982.

Guide on the Audit of Federal Contributions—Part II: Suggested Approaches and Procedures. Treasury Board of Canada Secretariat. September 1982.

Memorandum of Agreement between Department of Western Economic Diversification and Consulting and Audit Canada: 2003/2004 and 2004/2005. March 2003.

Policy on Transfer Payments. Treasury Board of Canada Secretariat. June 1, 2000.

Risk-Based Audit Framework: Western Economic Diversification Canada's Innovation and Community Investment Program. Western Economic Diversification Canada.

Risk-Based Audit Framework: Western Economic Diversification Canada's Western Diversification Program. Western Economic Diversification Canada. June 15, 2003.

Western Economic Diversification Contribution Audit Policy. Western Economic Diversification Canada. January 4, 1993.



Appendix C

Possible Risk Assessment Criteria by Type

Introduction

This appendix presents suggested risk elements that should be considered for inclusion in the risk assessment tool. This list of suggested risk elements incorporates some of the existing elements and suggestions from interviewees. The elements are organized in three groups:

- **Recipient risk.** Risk elements associated with the recipient, regardless of the nature of the project under consideration. The recipient risk should remain constant across all active projects with a given recipient. Recipient risk should be evaluated during the project assessment process. While recipient risk should be reevaluated periodically, it is unlikely to change as frequently.
- **Project risk.** Risk elements associated with the project as planned, regardless of the recipient or the eventual performance of the project. The project risk will likely remain constant over the lifespan of the project.
- **Compliance risk.** Risk elements associated with the recipient's compliance to the terms and conditions of the contribution agreement. These risk elements capture risks associated with the progress and financial performance of the project, and must be continually reassessed throughout the lifespan of the project in conjunction with WD's monitoring and claims verification activities.

Risk Assessment Criteria

Recipient Risk

- Characteristics of recipient
 - Nature of recipient (e.g. government, non-profit, industry)
 - Organization maturity
 - Financial stability (e.g. stability/liquidity of private organizations; dependability and predictability of funding for non-profit and public sector organizations)
- Project management capacity (assessment of depth and breadth of management team, and project manager—contracted or otherwise)
- Financial management capacity (assessment of experience of controller, quality of financial records/record-keeping processes and quality of internal controls)
- Previous government experience with recipient

Project Risk

- Predictability of project outputs (e.g. research project vs. business plan)



- Project complexity (e.g. multiple suppliers, simultaneous project streams)
- Project size in relation to organization size
- Nature of contribution
 - Total contribution size
 - Exposure (% of eligible expenses contributed)
 - Requirement for repayment
- Public profile

Compliance Risk

- Monitoring and claim experience
- Audit results
- Verification and monitoring controls of other funders (i.e. to what degree can WD expect other funders to help monitor compliance and prevent double dipping)
- Project progress (e.g. achievement of milestones, required extensions)
- Project financial performance (e.g. cost increases, changes in funding from other sources)



Appendix D

**Budget Requirements: Assumptions
and Calculations**

Budget Calculations

The following table presents estimated external auditor fees for conducting contribution audits in accordance with the policies outlined in this report. The table provides an estimate of fees assuming a sample size based on a 100% compliance rate. The table also provides an estimate of current audit fees.

Key assumptions used to calculate the estimates follow the table and should be used in conjunction with the information presented in the tables. The estimates are provided for illustrative purposes only. Actual fees could differ significantly from the estimates.

Estimate of Contribution Audit Fees for WDP and ICIP

Recommended Audits				
Small Sample	Stratum			Total
	High Risk		Random	
Sample Size	10		25	35
Fee per Audit	5,000		5,000	5,000
Total Fee	\$ 50,000		\$ 125,000	\$ 175,000

Current Audits				
ICIP Audits	High Risk	Stratum		Total
		High Dollar	Random	
Current Sample	5	5	5	15
Fee per Audit	5,000	5,000	5,000	5,000
Current ICIP Fee	25,000	25,000	25,000	75,000
WDP Audits				
	High Risk	Stratum		Total
		High Dollar	Random	
Current Sample	5	20	10	35
Fee per Audit	5,000	5,000	5,000	5,000
Current WDP Fee	25,000	100,000	50,000	175,000
Total Current Audits				
	High Risk	Stratum		Total
		High Dollar	Random	
Current Sample	10	25	15	50
Average Fee per Audit	5,000	5,000	5,000	5,000
Total Current Fee	\$ 50,000	\$ 125,000	\$ 75,000	\$ 250,000

Assumptions

- The sample size of the high-risk stratum is assumed to equal the sum of the estimated number of high-risk projects as outlined in the WDP and ICIP RBAFs. The actual size of the stratum will depend upon WD's redesign of its risk assessment tool, and the re-calculation of risk associated with current and future projects. The final sample size for this stratum could be significantly larger than the current 10 projects identified.
- The sample size of the random stratum assumes an average of 540 active projects a year across in total. The sample size was calculated based on a suggested minimum sample size and assumes a compliance rate among the audited projects of 100%. The random stratum sample size must be increased to reach the desired confidence level and margin of error if the actual compliance rate is lower.
- The estimate of fees is based on an average cost per audit of



\$5,000 as budgeted in the current RBAFs for WDP and ICIP. WD needs to confirm CAC's audit fees in light of the new policies and processes.

- Fees do not include GST or any expenses incurred by auditors, or any costs incurred by WD in connection with contracting the auditors.

