

Chapter

1

Managing Government
Financial Information

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set by the Canadian Institute of Chartered Accountants. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines.

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Managing Government Financial Information

Main Points

What we examined

Since 2001 we have been assessing the financial control systems and processes in federal government departments and agencies that generate financial information. For this chapter, we examined the extent to which departments have remedied weaknesses we previously identified in their internal financial controls, such as security controls in computer information systems. We looked at the extent of progress made toward implementing accrual-based budgeting and appropriations and how well departments are integrating accrual financial information into their regular decision making. We examined whether departments have strengthened their leadership in and capacity for financial management and considered what they still need to do to be ready for audits of their financial statements. In carrying out our current follow-up, we looked at 11 departments and agencies, which account for most of the government's revenues and a large part of its expenses.

Why it's important

Every year, the federal government handles billions of dollars of taxpayers' money. The 2004–05 Public Accounts of Canada reported that during the fiscal year the federal government raised \$211.7 billion in revenue, spent approximately \$210 billion, and held total assets of \$205.9 billion and liabilities of \$705.7 billion. Strong internal financial controls and complete financial information are vital if the government is to prudently manage its revenues and expenses. Effective financial controls put federal departments and agencies in a better position to manage risks and produce accurate and complete financial information for making sound decisions, exercising good stewardship over resources, and getting results for taxpayers. Gaps or weaknesses in financial controls can lead to inaccurate and unreliable financial information, poor control over physical assets, and improperly authorized financial transactions. Without good controls, an organization risks being unable to prevent or detect failures to comply with regulations, policies, and procedures.

The Government of Canada has been carrying out a government-wide project to improve the quality of financial management and internal control, an initiative that we support. An important part of this project

is improving the effectiveness of financial management practices and applying the accrual method of accounting—in addition to the cash method—to prepare financial information. Accrual accounting is a method of accounting whereby transactions and other economic events are recognized when they occur, rather than when cash or its equivalent is received or paid. This method has many advantages, the most important being that it gives managers a more complete picture of their programs' financial performance and thus offers a better tool for deciding how best to manage available resources.

What we found

- Progress in improving government financial information continues to be unsatisfactory. This is chiefly because departments and agencies make little use of accrual financial information as a regular management tool. Financial officials have indicated that departments and agencies will not use accrual financial information effectively until government-wide and departmental budgeting, financial reporting, and appropriations are done on a common basis. The Treasury Board Secretariat has been studying the issue of accrual-based budgeting and appropriations for several years.
- Departments and agencies are slowly taking action to remedy our previously reported internal financial control weaknesses. In many departments where progress has been satisfactory, the support of the deputy heads was a key factor. While the Office of the Comptroller General (OCG) is responsible for ensuring that departments and agencies employ adequate financial management and control practices, it has only recently instituted its own process to gather and evaluate information on what departments have done to respond to our earlier recommendations on financial system controls. We note, however, that the Government of Canada has made a public commitment to strengthen financial management and control, which we expect will emphasize the important role of the OCG in monitoring progress made by departments and agencies in responding to our previous recommendations.
- The departments and agencies we audited have increased the number of senior financial officials with professional designations. The Office of the Comptroller General has also continued to advance initiatives to improve departmental financial statements.

The Treasury Board Secretariat has responded. The Treasury Board Secretariat is pleased that the Office of the Auditor General has recognized the progress made to date and agrees with the direction of the recommendations in this chapter. The Secretariat's response details current or planned actions to address the recommendations made.

Introduction

The importance of sound financial information and internal controls

1.1 Every year, the federal government handles billions of dollars of taxpayers' money. The 2004–05 *Public Accounts of Canada* reported that during the fiscal year the Government of Canada had raised \$211.7 billion in revenue, spent approximately \$210 billion, and had assets of \$205.9 billion and liabilities of \$705.7 billion. Complete and reliable financial information and strong internal financial controls are central to managing the government's revenues and expenses and producing improved results for taxpayers. Establishing effective financial information systems and controls throughout the government, along with appropriate financial policies and procedures, is essential to improving the government's stewardship and leading to more informed decisions.

Accrual accounting—A method of accounting that records an entity's transactions and other economic events when they occur, rather than when the entity receives or pays cash or its equivalent (cash-based accounting).

1.2 The Government of Canada has been carrying out a government-wide project to improve the quality of the financial information that decision makers use. An important element of this project is applying **accrual accounting**, in addition to the cash method of accounting, when preparing financial information (see Appendix A for a brief explanation of accrual accounting). Accrual financial information produces a better financial picture of the government—its resources, obligations, financing, costs, and the impacts of its activities, including the costs of consuming assets over time. This more complete picture helps legislators hold the government more accountable for safeguarding its assets, appreciate the full costs of its programs, and assess its ability to meet its short- and long-term financial obligations.

1.3 Internal financial controls are also central to managing any organization effectively. An organization's financial controls contribute to the direction and culture of its financial management. To the extent that these controls are effective, an organization is better positioned to produce accurate and reliable financial information. Such information is key to developing a complete and accurate picture of an organization's financial performance.

1.4 Sound financial controls are also essential to helping an organization manage the risks it is exposed to. When these controls work properly, they increase the decision makers' assurance that financial information is reliable enough to support well-informed decisions. They also reduce the possibility of fraud and error in financial information, and they help to ensure that all transactions are properly

authorized and comply with applicable policies, procedures, laws, and regulations. Any weaknesses in financial control will increase risk.

1.5 The government recognizes the need to strengthen financial information and internal control. With the government's 12 December 2003 reorganization plan, the Treasury Board of Canada Secretariat focussed on strengthening and supporting comptrollership and financial management in government. Specifically, the Secretariat is now responsible for ensuring that departments and agencies meet all the government's financial planning and control requirements and for overseeing their expenditures.

1.6 In 2003, the Treasury Board Secretariat also reinstated the Office of the Comptroller General (OCG) as a distinct unit within the Secretariat. The main priorities of the OCG include restoring public confidence in the government's financial management practices, improving the quality and credibility of financial information, and strengthening the role of internal audit (see **Priorities of the Office of the Comptroller General, page 21**).

1.7 In our view, as the government responds to these priorities, departments and agencies will need to have strong financial information and internal controls. This will ensure that they are relying on accurate financial information and that they meet the expectations identified by the government as critical in restoring public confidence in its financial management practices.

Focus of the audit

1.8 The chapter is a follow-up to our 2005 Status Report, Chapter 8, and other reports arising from our past audits of the government's summary financial statements. We evaluated the progress that departments and agencies have made in addressing the weaknesses we identified in our assessments of key financial controls governing selected computer information systems used for financial reporting. We also reviewed the progress and impact of various issues that we discussed in our previous work, including the following:

- advancements in implementing accrual-based budgeting and appropriations at the departmental level;
- weaknesses in central and departmental leadership and capacity;
- the integration of accrual financial information into internal reports and into the information that decision makers use; and
- the readiness of departments for audit of their departmental financial statements.

Priorities of the Office of the Comptroller General

The priorities of the Office of the Comptroller General are to strengthen the financial information and internal control framework across the federal public service by

- nurturing and developing the financial and internal audit communities;
- establishing a new financial management regime and a management control framework and updating financial management policies;
- developing certification standards and a core learning strategy for financial management and internal audit;
- setting and reviewing financial, accounting, and auditing standards and policies for the Government of Canada;
- developing a revised internal audit policy;
- developing governance and protocols for internal audit services to smaller departments and for government-wide audits;
- establishing the capacity to perform quality assessments of internal audit functions;
- leading the introduction of modern, timely, enterprise-wide financial information systems and developing associated business processes and standards;
- overseeing government spending, including policies, processes, and criteria for review and sign-off of spending proposals, and monitoring and reporting provisions; and
- providing guidance for preparing departmental financial statements and the Public Accounts of Canada.

Source: Adapted from Treasury Board Secretariat and Office of the Comptroller General documents

1.9 Further details on the audit objective, scope, approach, and criteria are included in **About the Audit** at the end of the chapter.

Observations and Recommendations

Using accrual financial information

The unresolved issue of accrual budgeting and appropriations is limiting the use of accrual financial information

1.10 Our previous chapters have highlighted a lack of progress with respect to full accrual-based budgeting and appropriations, and the impact this has had on departments' and agencies' use of accrual financial information in decision making. The House of Commons Standing Committee on Public Accounts continues to support our recommendations on accrual-based budgeting and appropriations and has repeatedly urged the Treasury Board Secretariat to act on this issue (see Appendix B).

1.11 In our 2005 Status Report, Chapter 8, we noted that departments were not using accrual financial information in their day-to-day operations. Instead, they were using the accrual method only to prepare information for the government's year-end summary financial statements and to address the requirement to include such information in Treasury Board Secretariat submissions and memoranda to Cabinet.

1.12 A department's annual cash requirements and management of cash flows will continue to be important information for Parliament. It is our opinion, however, that Parliament will be better served if it also receives budget information that is based on accrual accounting and reflects the full costs of programs as part of the estimates and appropriations process and all other forms of financial reporting. This approach would ensure that the information Parliament receives and that managers use in their decision making would be comparable with the accrual information included in the *Public Accounts of Canada* and the government-wide budget.

1.13 In this follow-up audit, we continued to find that most departments still do not use accrual financial information for managing on a day-to-day basis or making most financial decisions. Senior financial officials told us that managers have no incentive to use accrual financial information to manage their department's resources because their budgets and appropriations are based on the cash method of accounting. As a result, with a few exceptions, financial information used in decision making continues to rely on a method of accounting that, in our opinion, provides a less complete and accurate financial picture.

1.14 Furthermore, this issue does not seem to be among the Treasury Board Secretariat's priorities related to strengthening financial information. The Secretariat has been studying departmental accrual-based budgeting and appropriations for many years, but it has not yet completed this work. Following a request of the Public Accounts Committee, we expected the Secretariat to have developed and begun implementing an appropriate action plan for resolving the matter of full accrual-based budgeting and appropriations.

1.15 While Treasury Board Secretariat officials have not yet concluded their research, they have made some progress since our last audit. For example, they have consulted with departments and agencies on implementation strategies. They have also explored the impact of implementing accrual-based budgeting and appropriations

for capital assets and for updating annual spending levels. In addition, they recently hired an independent consultant to survey the practices of other governments.

1.16 Departments are also trying to include and use accrual financial information in limited situations. For example, departments record monthly payroll on an accrual basis, but only some departments incorporate this information into their monthly management reports. Other departments have incorporated accrual financial information into selected decisions.

1.17 We acknowledge the importance of cash-based information for departments and agencies and that the issue of using accrual-based budgeting and appropriations requires careful consideration. However, the Treasury Board Secretariat needs to complete its study on accrual-based budgeting and appropriations in order to advance the government's use of accrual financial information. Paragraphs 7.24 and 7.25 of Chapter 7 of this report provide an excellent example of the limitations now imposed on decision making by the current method of departmental budgeting and appropriations.

1.18 Recommendation. The Treasury Board Secretariat should promptly complete the study of accrual-based budgeting and appropriations at the departmental level. It should then present the proposed approach for a common basis of planning, budgeting, and reporting, along with an implementation plan, to the House of Commons Standing Committee on Public Accounts.

The Treasury Board Secretariat's response. As mentioned in the chapter, the Treasury Board Secretariat has engaged an independent contractor to conduct a comprehensive study of the concepts of accrual accounting to determine whether, and if so, how, they should apply to the development, documentation, and execution of the budgets and appropriations of the federal government. The study will provide information on issues such as practices in other jurisdictions and the rationale for adoption/rejection of accrual concepts in other jurisdictions; treatment of non-cash expenses and other differences between cash and accrual accounting; cultural and behavioural changes; the readiness of departments to implement any changes; and possible options and phasing for proceeding.

The Secretariat agrees with the recommendation and will use the study to make an informed recommendation to the Treasury Board as well as the Department of Finance and the Privy Council Office (given their central roles in Budget planning) on the extent and manner of

implementation of accrual concepts in the budgeting process and/or the appropriations at the government-wide and departmental levels. The Secretariat also agrees that the government will develop an appropriate implementation plan and will share this information with the Public Accounts Committee, other parliamentarians, and other competent bodies, such as the House of Commons Finance Committee.

The implementation of accrual accounting for reporting, budgeting, or appropriations has been an issue before national jurisdictions for well over a decade. Over the years, some jurisdictions made significant efforts implementing accrual accounting for financial reporting. The federal budget and the summary financial statements of the Government of Canada are now prepared on a full accrual basis, helping make Canada “a world leader in financial reporting by a national government,” according to the Auditor General. However, relatively few countries have yet extended accrual accounting to budgeting or appropriations. Canada is not alone in taking a cautious and prudent approach. The study now under way will provide the information that the Secretariat will need to determine the appropriate approach to be taken to accrual budgeting and appropriations.

Responding to identified financial control weaknesses

Computer information system controls—Security controls that are primarily preventive. They manage the access and use of financial information within various computer applications.

Management and monitoring controls—Ongoing oversight procedures or periodic evaluations that managers perform. They are useful in detecting errors, and they ensure that business processes or other controls are operating as expected.

Processing controls—Processes or practices that are useful in preventing and detecting errors and typically operate at a detailed business process (transactional) level. They are designed to ensure the integrity of financial records.

Progress has been slow in responding to key weaknesses in internal financial controls

1.19 We have been assessing selected internal financial controls in various departments and agencies since 2001. Specifically, our focus has been on financial controls related to certain **computer information system controls**, associated **management and monitoring controls**, and **processing controls**. Our objective has been to determine the extent to which these controls contributed to the safeguarding of assets and to the accuracy, completeness, and proper authorization of financial information used to produce the government’s summary financial statements.

1.20 In 2004, we began to reassess the progress of departments and agencies in dealing with the internal financial control weaknesses that we had been reporting since 2001. We first reported on the results of our follow-up in our 2005 Status Report, Chapter 8. We noted that certain departments and agencies had dealt with some of our concerns about their internal financial controls, but other weaknesses remained. When we first identified these weaknesses, we noted that, in our opinion, departments and agencies could resolve most of them within a

reasonable period. Therefore, in our 2005 Report, we indicated that we expected departments and agencies to have made more progress in this direction.

1.21 In this follow-up audit, we looked at 11 departments and agencies (see About the Audit). Our objective was to determine the extent to which each organization had dealt with the internal financial control weaknesses that we had noted in 2001, 2002, or 2003. These 11 departments and agencies account for most of the government's revenues and incur a large part of its expenses.

1.22 Our ratings reflect only the progress that each department or agency has made in addressing weaknesses we previously identified. The ratings do not compare one department with another or evaluate the quality of their entire internal financial control systems. The scope of our assessments was not large enough to identify all internal control matters that might be of interest to the government. In addition, we are aware that in evaluating the extent of progress achieved, the control weaknesses identified for each entity differ in quantity, type, and complexity, and these differences in turn influence the level of progress achieved.

1.23 Some departments and agencies have satisfactorily addressed previously identified internal financial control weaknesses in their financial application systems that we reported on in 2001, 2002, or 2003 (Exhibit 1.1).

Exhibit 1.1 Departments and agencies that have satisfactorily addressed internal financial control weaknesses we previously identified

Departments and agencies	Financial application systems that report incurred expenses
Agriculture and Agri-Food Canada	SAP
Canadian Heritage Canada	SAP
	GCIMS
Veterans Affairs Canada	FreeBalance
	Client Service Delivery Network (CSDN)
Industry Canada	SAP
Public Works and Government Services Canada	Common Departmental Financial System (CDFS)

1.24 In addition, as part of our financial audit of the public accounts submissions, we assessed the progress of Agriculture and Agri-Food Canada, Canadian Heritage, Foreign Affairs and International Trade, Health Canada, and Industry Canada in addressing previously identified internal financial control weaknesses that were not part of the financial application systems. We found that these departments had made satisfactory progress in addressing these weaknesses.

1.25 Other departments and agencies have not yet satisfactorily addressed all previously identified weaknesses in their financial application systems. They have taken measures to remedy some of the weaknesses that we previously identified, but additional actions are required to satisfactorily address all remaining weaknesses (Exhibit 1.2).

Exhibit 1.2 Departments and agencies that have not yet satisfactorily addressed all internal financial control weaknesses we previously identified

Department or agency	Financial application systems that report incurred expenses
Indian and Northern Affairs Canada	Oracle
	TPMS
Transport Canada	Oracle
Canada Revenue Agency	SAP-CAS expenditure system

Department or agency	Financial application systems that report revenues
Canada Revenue Agency	SAP-revenue ledger (pre-implementation controls review)
	T1 assessment/accounting
	T2 assessment/accounting
	T4 assessment/accounting

1.26 As part of our financial audit of public accounts submissions, we also assessed the progress of Public Works and Government Services Canada, Veterans Affairs Canada, and Indian and Northern Affairs Canada in addressing previously identified internal financial control weaknesses not part of the financial application systems. While these departments have also made progress in addressing these weaknesses, they need to take further action to satisfactorily address all the reported weaknesses.

1.27 Control weaknesses have not resulted in material errors.

Despite the unresolved weaknesses in internal financial controls, we did not find any material errors in the information that departments and agencies provided to prepare the Government of Canada's 2004–05 summary financial statements. Nevertheless, as we noted earlier, any weakness in financial controls entails risk and may result in incomplete or inaccurate financial information in the future.

1.28 Factors contributing to success. For most departments and agencies, our original assessments identified weaknesses in systems that were new at the time. Where progress has been made in addressing weaknesses, we found that deputy heads strongly supported any projects intended to eliminate these weaknesses and, accordingly, senior managers had assigned a high priority to these projects. In addition, internal auditors worked with financial, information technology, and program staff to solve any problems we had identified, and they provided assurance to senior managers on the reliability of the financial information these systems produced.

1.29 Although departments and agencies may have corrected many of the previously identified weaknesses, and material errors may not have resulted, they need to continue to look for ways to improve their systems and practices and ensure that their financial information systems provide complete, accurate, and reliable information to make informed decisions. It is important that they continue building on their successes to date.

1.30 Factors contributing to slow progress. We expected to see more progress in addressing control weaknesses. Some departments cited reorganization as a factor that had resulted in competing priorities. Staff members who were responsible for maintaining financial systems had spent time on reorganization duties and on various other initiatives, such as expenditure and program reviews.

1.31 When we discussed these factors with the Canada Revenue Agency and other departments where we found that all previously identified weaknesses had not yet been satisfactorily addressed, officials informed us that addressing the weaknesses is a priority and that senior management agrees that solutions to these weaknesses must be implemented. To that end, the departments and agencies identified in Exhibit 1.2 are continuing to make progress in their efforts to respond to our previously identified internal financial control weaknesses.

1.32 In particular, the Canada Revenue Agency's progress on certain systems was slow, partly because the Agency operates more systems than other departments, as well as larger and more complex systems. Finally, while the government has moved toward reporting financial information on an accrual basis, the Agency's systems for reporting revenues were not designed to produce information on this basis, and considerable effort has been needed to remedy this situation.

1.33 We were unable to assess some departments' progress. Three departments—Health Canada, Foreign Affairs Canada, and Citizenship and Immigration Canada—were upgrading their financial application systems during our follow-up work in 2005. Because they agreed to consider the identified internal financial control weaknesses when they upgrade their systems, we decided to follow up and re-evaluate these systems later to determine if they have addressed the weaknesses.

The role of the Office of the Comptroller General in monitoring internal financial control weaknesses is increasing

1.34 The Government of Canada, with the Office of the Comptroller General (OCG) as lead, is responsible for ensuring that all departments and agencies establish good financial management practices and systems of internal financial control. However, the OCG has been concentrating on many of its other responsibilities, particularly the development of a new internal audit policy and a framework to strengthen the capacity of the government's financial community. Thus, it has been slow to fulfill its responsibility for identifying internal financial control weaknesses. Only recently has the OCG instituted its own process to evaluate what departments have done, in response to our earlier recommendations, to improve their internal financial controls.

1.35 However, some of the recent initiatives of the Office of the Comptroller General play a key role in reinforcing the importance of financial information and financial controls in departments and agencies. For example, the OCG is leading the Government of Canada initiative to create the position of Chief Financial Officer (CFO) in each department and agency. The CFO will oversee the financial management, control, and reporting functions of a department or agency. The OCG is proposing that this position also include overseeing, managing, and maintaining strong internal financial control systems. It has also agreed to reorganize and bolster the internal audit function to give auditors responsibility for assessing and reporting on the quality of internal financial control systems.

1.36 Additional detailed guidance about the role of the CFO and about internal audit's expanded focus on internal financial controls would strengthen the importance of financial controls in departments and agencies and demonstrate the OCG's commitment to this issue. Finally, as the Office of the Comptroller General seeks accounting support from the private sector to assess the ability of departments to prepare audited financial statements, it could also use this expertise to assess internal financial control systems.

1.37 Recommendation. The Office of the Comptroller General should

- work closely with internal auditors and senior financial officials in departments and agencies to develop a strategy for strengthening internal financial controls,
- develop an implementation plan that includes deadlines by which departments and agencies must identify and remedy any weaknesses in their internal financial control systems and that provides for assessing and monitoring the progress in addressing those weaknesses, and
- regularly monitor the actions of departments and agencies to assess their progress against this plan.

The Treasury Board Secretariat's response. The Treasury Board Secretariat agrees with the direction of the recommendations and acknowledges the importance of continuing to strengthen internal financial controls. To this end, the Secretariat has commenced initiatives to improve and strengthen the policy environment surrounding internal financial controls. The new internal audit policy requires that departmental deputy heads approve the department's internal audit plan. The audit plan should address audits identified by the Office of the Comptroller General (OCG), including audits that address fundamental controls. The audit plan should also support an annual opinion from the Chief Audit Executive on departmental risk management, control, and governance processes. The OCG has already started working with departmental chief audit executives and with senior financial officers to develop the process required to support the identification of key financial controls requiring audit coverage, as outlined in the new policy.

As mentioned in the chapter, the OCG regularly reviews internal audit reports and management letters in order to monitor and help remedy control weaknesses in departments and agencies.

In addition, the initiative to audit departmental financial statements will significantly affect and improve the financial control environment in departments. In preparation for the audit of their departmental financial statements, each department must ensure that its processes are well documented and exist within a sound internal control environment. While this initiative initially focusses on large departments, as part of its preparation, each department must undergo an audit readiness assessment by an external auditing firm, which will include an assessment of the control environment. The OCG will monitor the results of these assessments and will work with departments to ensure that corrective action is taken as required. The Treasury Board Secretariat is confident that, through these initiatives, we will continue to achieve progress in improving internal financial controls.

Improving financial management practices

Financial capacity is increasing in strength

1.38 In February 2005, we noted that the departments and agencies we examined had made some progress in increasing the number of senior financial staff with professional designations. In our current audit, we updated our 2002 statistics for 11 of the larger departments and agencies we had been monitoring. We found that 16 of 22 senior financial officers and senior full-time financial officers now have a professional accounting designation, up from the 8 of 22 that we reported in December 2002. The attention of departments and agencies and of the Office of the Comptroller General to this matter has clearly produced positive results and indicates what can happen if the government treats an issue as a priority.

1.39 During our last audit, we also noted that the Government of Canada, with the Office of the Comptroller General as lead, had not yet clarified what steps departments and agencies needed to take to implement the position of Chief Financial Officer. By August 2005, two departments we had examined in our 2002 audit had taken steps to initiate or adapt the structure of their financial function to accommodate a CFO. The remaining nine departments told us they were awaiting more guidance from the OCG.

1.40 Within the Office of the Comptroller General, there is now an Assistant Comptroller General who is responsible for capacity building, community development, and developing the model for the CFO position within departments, in accordance with the plans and priorities established by the OCG. Next steps will now be to develop, implement, and monitor government-wide requirements for

professional certification and to build capacity in financial management. Such actions will allow the government to further strengthen its financial management capacity and enhance the role of the Chief Financial Officer.

Progress in improving departmental financial statements continues

1.41 The Office of the Comptroller General has recently developed a schedule to start assessing, beginning in 2005–06, the extent to which most large government departments are ready to have their financial statements audited. External auditors and internal departmental auditors will carry out these assessments. OCG officials are now developing guidance for departments to start preparing for these assessments and have updated other guidance on how to prepare departmental financial statements. Although additional actions are still required, the other guidance has substantively advanced the outstanding issues related to preparing departmental financial statements that we highlighted in our 2005 Status Report.

1.42 We noted that some departments have taken initiatives to improve the process for preparing financial statements. One department has employed external consultants to review and assess its financial statements. Another is pursuing the possibility of producing its monthly financial statements on an accrual basis, instead of merely at year-end.

1.43 As reported in previous chapters, however, departments normally prepare their financial statements only once a year, for the purpose of reporting to the Office of the Comptroller General. In most cases, officials prepare these statements after year-end and after they have gathered information for public accounts. As in previous audits, we found no evidence that these financial statements are used for regular decision making in departments or that senior management committees review them.

Assessing progress in improving financial information

1.44 Since 2002, we have been calling attention to various weaknesses in the government's internal financial control systems and its preparation and use of financial information. However, progress in dealing with these weaknesses has been slow and uneven.

1.45 In assessing the government's progress in responding to our previous recommendations on improving financial information, we have provided a rating of our level of satisfaction (Exhibit 1.3).

Exhibit 1.3 Progress in addressing recommendations on improving financial information

Recommendation	Progress
<p>The Treasury Board of Canada Secretariat should promptly complete its study of accrual-based budgeting and appropriations at the department level and implement an approach for a common accrual basis of planning, budgeting, and reporting. (February 2005 Status Report, Chapter 8, paragraph 8.43, also consistent with March 2004 Report, Chapter 6, paragraph 6.58)</p>	○
<p>The Office of the Comptroller General, in conjunction with department and agency deputy ministers, should ensure that departments and agencies have strategies, where applicable, for improving the quality and use of accrual financial information that supports their regular financial reporting, analysis, and decision-making process. (February 2005 Status Report, Chapter 8, paragraph 8.56, also consistent with March 2004 Report, Chapter 6, paragraph 6.81)</p>	○
<p>The Office of the Comptroller General, in co-operation with departmental and agency management, internal audit groups, and audit committees, should ensure that departments and agencies identify and address the internal control weaknesses in financial information systems within a reasonable period. (February 2005 Status Report, Chapter 8, paragraph 8.37, also consistent with March 2004 Report, Chapter 6, paragraph 6.92)</p>	○
<p>The Comptroller General, in conjunction with senior financial officials in departments and agencies, should develop a vision, strategy, and implementation plan with key milestones for promoting and improving the financial capacity in departments and agencies that are consistent with the government’s announced support in this area. (February 2005 Status Report, Chapter 8, paragraph 8.25, also consistent with March 2004 Report, Chapter 6, paragraph 6.51)</p>	●
<p>The Office of the Comptroller General should promptly resolve any outstanding issues regarding departmental financial statements and develop a plan to achieve the commitment of having audited financial statements within five years. (February 2005 Status Report, Chapter 8, paragraph 8.63, also consistent with March 2004 Report, Chapter 6, paragraph 6.98)</p>	●

- **Satisfactory** — Progress is satisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.
- **Unsatisfactory** — Progress is unsatisfactory, given the significance and complexity of the issue, and the time that has elapsed since the recommendation was made.

Conclusion

1.46 Departments and agencies need to continue to improve their internal financial controls. In our view, until the government has addressed our concerns about internal financial control, the quality of financial information that departments and agencies use for many of their key decisions will be at risk.

1.47 We are also concerned that, with a few exceptions, most financial information for use in decision making continues to be primarily based on the cash method of accounting. This information provides a less complete and less accurate picture of a department's or agency's financial situation than does information prepared by the accrual method.

1.48 Although departments and agencies have increased the number of senior financial officials with professional designations, and the Office of the Comptroller General has continued to advance initiatives to improve departmental financial statements, the use of accrual financial information as a regular management tool needs to be increased. Currently, accrual financial information is mainly used as part of a year-end exercise to comply with requirements for preparing the government's summary financial statements.

1.49 Finally, and most important, the government still has not resolved the issue of accrual-based budgeting and appropriations at the departmental level. Although we acknowledge that the government needs to consider this issue carefully, the Treasury Board Secretariat has been studying it for many years and has not yet resolved the issue. We continue to believe that the government must adopt a common basis for budgeting, appropriations, and financial reporting at the departmental level. Only then will it be able to improve the use of accrual financial information.

About the Audit

Objective

The objective of this audit was to assess the extent to which departments and agencies have addressed the key internal financial control weaknesses we identified in our 2001, 2002, and 2003 control assessments. We conducted those assessments as part of our audit of the federal government's summary financial statements. The objective of that audit is to report on the fairness of the presentation of the summary financial statements.

We also examined other elements of previous chapters, particularly the progress on the issue of accrual-based budgeting and appropriations to determine the progress the government had achieved in each area.

Scope

The scope of the audit included the following departments: Canadian Heritage, Agriculture and Agri-Food Canada, Veterans Affairs Canada, Public Works and Government Services Canada, Foreign Affairs Canada/International Trade Canada, Indian and Northern Affairs Canada, Transport Canada, Citizenship and Immigration Canada, Industry Canada, and Health Canada.

In addition, our audit scope included the Treasury Board Secretariat, because it is responsible for government-wide financial accounting, management, and control issues. We also included the Canada Revenue Agency in our scope, but only relative to the follow-up on any previous assessments of the financial application systems.

Approach

We audited the summary financial statements in accordance with Canadian generally accepted auditing standards, and we assessed whether the statements were fairly presented in accordance with the government's stated accounting policies.

Our audit procedures included testing transactions and account balances, performing analyses, confirming year-end balances with third parties, reviewing significant internal controls, and discussing significant matters with government officials.

As a result, this follow-up relies on the nature, scope, and extent of our audit of the summary financial statements. It contains some of our observations and findings from this earlier audit work and from other audits the Office of the Auditor General conducted in the area of financial management and control.

Additional work included interviews with senior officials and a review of documents containing accrual financial information that managers used to support their financial decisions.

Criteria

The criteria we used are based on the actions we expected the government to take in response to our recommendations in our March 2004 Report, Chapter 6, and February 2005 Status Report, Chapter 8, and

on the government's announcements in its 12 December 2003 reorganization plan and its 2004 Budget (commitments to strengthen financial management and control).

We expected that

- departments and agencies would have improved their internal financial control systems and addressed all the significant weaknesses we had identified, and that they would have begun integrating accrual financial information into their regular decision-making processes;
- departments and agencies would have increased their professional accounting capacity and developed appropriate plans to implement the Chief Financial Officer's new oversight responsibilities;
- the Treasury Board Secretariat would have actively overseen and monitored the actions that departments took to improve their financial control systems, professional accounting capacity, use of accrual financial information, and preparation of financial statements;
- the Secretariat would have concluded its study of accrual-based budgeting and appropriations and would have developed an implementation plan; and
- the Secretariat would have finished developing the remaining accrual accounting policies and practices for departments and agencies, which would result in departmental financial statements that are ready for audit.

Audit work completed

Audit work for this chapter was substantially completed on 14 October 2005.

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Appendix A The accrual method of accounting

What is accrual accounting? Accrual accounting refers to a method of accounting that records an entity's financial transactions and other economic events when they occur, rather than when the entity receives or pays cash or its equivalent. It records expenses as goods or services are consumed, and it records revenues in the period to which they pertain. It recognizes the life-cycle costs associated with long-lived assets.

An example. Assume that in 2005, a department purchases a fleet of trucks for \$1.2 million. The trucks have a useful service life of six years. Under the cash method, government accounts would record the trucks in 2005 as a one-time expenditure of \$1.2 million. However, under the accrual method, the accounts would record the same purchase much differently. Because the trucks have an expected service life of six years, the purchase would appear as follows in the 2005 accounts:

- Expense in 2005: \$200,000, or one sixth of \$1.2 million—the expected use per year
- Assets (trucks): \$1 million (\$1.2 million purchase price less the \$200,000 expense for the use of the assets)

Accrual information clearly presents a very different—but more accurate—picture of the organization's financial results for 2005. On the basis of this information, managers become aware of the cost of owning the fleet over time. They can focus on the stewardship of assets, because the assets are now clearly and transparently recorded in the department's financial accounts. For example, the \$200,000 will be an expense recorded every year for the life of the trucks, and the trucks will also continue to be reflected as assets until they are fully consumed or sold. Thus, managers can see the need to consider the costs of maintaining, disposing, and replacing assets. When these costs are visible, managers are also more likely to consider risks, such as loss due to damage or theft.

Benefits. Accrual accounting records the estimated costs and liabilities associated with events, such as an environmental event or accident, when they occur. For example, if a serious chemical spill occurred on government property, the government would record in the accounts the estimated cost of cleaning it up, along with other potential financial liabilities, when the accident happened, not when the bills were paid in the future. Because the costs and future liabilities are recognized and recorded, managers are more likely to be concerned about how to manage them.

In essence, accrual accounting improves government decision making because what “gets recorded, gets managed.” When all the costs are visible, managers are more likely to consider those costs when making decisions.

Appendix B House of Commons Standing Committee on Public Accounts: Recommendations on accrual-based budgeting and appropriations and the government’s response

Report	Recommendation	Response
December 1998	The Treasury Board Secretariat should complete its consultations with its stakeholders as quickly as possible in order to determine the best possible options to move the appropriations (supply) process to a full accrual basis.	Progress is slower than anticipated. Response to a consultation paper is expected by 10 March 2000, from which recommendations to the government will be made in the following two or three months.
March 2000	<p>The Treasury Board Secretariat should complete its consultations with departments and agencies on moving to accrual appropriations.</p> <p>Once the consultations are completed, the Treasury Board Secretariat should inform Parliament and the Public Accounts Committee in writing of its final decision and recommendations to the government on moving to accrual appropriations.</p>	<p>Responses to the consultation paper have been received and are being compiled and analyzed.</p> <p>Completion of the analysis is expected by September 2000, although further review of accrual-based budgeting and its relationship with appropriations may be required.</p>
March 2001	The Treasury Board Secretariat should complete its consultations with parliamentarians aimed at determining the best possible options to convert the appropriations (supply) process to a full accrual basis and report the results to the House of Commons by 31 March 2002; the Government of Canada should move to an accrual-based system of appropriations (supply) by 1 April 2003.	The subject of accrual-based appropriations is very complex and requires careful review and consultation. Any decision made will have tremendous impact and consequences for government. This strongly underlies the need for very careful, rigorous, and exhaustive study before making any decisions in the area.
May 2001	The Treasury Board Secretariat should undertake and complete the required studies and consultations on full accrual-based appropriations, and it should prepare a set of proposals and alternatives to be presented to the House of Commons Standing Committee on Public Accounts, no later than 31 March 2002.	The subject of accrual-based appropriations is very complex and requires careful review and consultation. The decisions made respecting any contemplated changes to our budgeting and appropriations practices will have tremendous impact and consequences for government. This strongly underlies the need for very careful, rigorous, and exhaustive study before making any decisions in the area.
December 2002	<p>The government should adopt the integration of full accrual-based budgeting and appropriations into the Canadian Expenditure Management System and advise the Public Accounts Committee when the decision has been made.</p> <p>Once the decision is made to move toward full accrual-based budgeting and appropriations, the Treasury Board Secretariat should immediately prepare an action plan together with an implementation timeframe and table both these documents with the Public Accounts Committee.</p>	Adopting the integration of full accrual-based budgeting and appropriations into the Expenditure Management System could have far-reaching implications for government and for Parliament. Unlike accrual accounting, there is no international consensus on the adoption of accrual budgeting. Those countries that have implemented accrual budgeting have adopted specific accrual tools to suit their specific need and to help them implement much broader reforms. Moreover, some countries have indicated that their accrual budgeting frameworks are not yet proven and may be subject to change in the context of lessons learned. We intend to learn from their experience.

Report	Recommendation	Response
February 2005	The government should extend full accrual accounting to budgeting and appropriations and set a firm timeline for its completion. The Public Accounts Committee further recommends that the government report back to Parliament annually on the progress being made in this respect.	<p>Since the impacts of adopting accrual-based budgeting and appropriations are major and far-reaching, the Treasury Board Secretariat continues to believe that a prudent and thorough approach to introducing changes in budgeting or appropriations is the most appropriate approach. Although the rate of change is slower than the Standing Committee on Public Accounts or Auditor General would like, progress is being made in the area of accrual-based budgeting.</p> <p>As announced in Budget 2005, the government will be implementing a more rigorous approach to capital planning, beginning with a few pilot departments this fall. Parliament will be asked to consider multi-year appropriations of capital funds for these pilot departments.</p> <p>The Treasury Board Secretariat is also examining the feasibility of conducting the annual reference level update exercise on an accrual basis, as well as the cash basis on which it is presently based.</p> <p>The Treasury Board Secretariat will report back to Parliament annually, through its departmental performance report.</p>

Source: Adapted from reports of the House of Commons Standing Committee on Public Accounts

Appendix C List of recommendations

The following is a list of recommendations found in Chapter 1. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Department's response
<p>Using accrual financial information</p> <p>1.18 The Treasury Board Secretariat should promptly complete the study of accrual-based budgeting and appropriations at the departmental level. It should then present the proposed approach for a common basis of planning, budgeting, and reporting, along with an implementation plan, to the House of Commons Standing Committee on Public Accounts. (1.10–1.17)</p>	<p>As mentioned in the chapter, the Treasury Board Secretariat has engaged an independent contractor to conduct a comprehensive study of the concepts of accrual accounting to determine whether, and if so, how, they should apply to the development, documentation, and execution of the budgets and appropriations of the federal government. The study will provide information on issues such as practices in other jurisdictions and the rationale for adoption/rejection of accrual concepts in other jurisdictions; treatment of non-cash expenses and other differences between cash and accrual accounting; cultural and behavioural changes; the readiness of departments to implement any changes; and possible options and phasing for proceeding.</p> <p>The Secretariat agrees with the recommendation and will use the study to make an informed recommendation to the Treasury Board as well as the Department of Finance and the Privy Council Office (given their central roles in Budget planning) on the extent and manner of implementation of accrual concepts in the budgeting process and/or the appropriations at the government-wide and departmental levels. The Secretariat also agrees that the government will develop an appropriate implementation plan and will share this information with the Public Accounts Committee, other parliamentarians, and other competent bodies, such as the House of Commons Finance Committee.</p> <p>The implementation of accrual accounting for reporting, budgeting, or appropriations has been an issue before national jurisdictions for well over a decade. Over the years, some jurisdictions made significant efforts implementing accrual accounting for financial reporting. The federal budget and the summary financial statements of the Government of Canada are now prepared on a full accrual basis, helping make Canada “a world leader in financial reporting by a national government,” according to the Auditor General. However, relatively few</p>

Recommendation	Department's response
	<p>countries have yet extended accrual accounting to budgeting or appropriations. Canada is not alone in taking a cautious and prudent approach. The study now under way will provide the information that the Secretariat will need to determine the appropriate approach to be taken to accrual budgeting and appropriations.</p>
<p>Responding to identified financial control weaknesses</p>	
<p>1.37 The Office of the Comptroller General should</p> <ul style="list-style-type: none"> • work closely with internal auditors and senior financial officials in departments and agencies to develop a strategy for strengthening internal financial controls, • develop an implementation plan that includes deadlines by which departments and agencies must identify and remedy any weaknesses in their internal financial control systems and that provides for assessing and monitoring the progress in addressing those weaknesses, and • regularly monitor the actions of departments and agencies to assess their progress against this plan. (1.19–1.36) 	<p>The Treasury Board Secretariat agrees with the direction of the recommendations and acknowledges the importance of continuing to strengthen internal financial controls. To this end, the Secretariat has commenced initiatives to improve and strengthen the policy environment surrounding internal financial controls. The new internal audit policy requires that departmental deputy heads approve the department's internal audit plan. The audit plan should address audits identified by the Office of the Comptroller General (OCG), including audits that address fundamental controls. The audit plan should also support an annual opinion from the Chief Audit Executive on departmental risk management, control, and governance processes. The OCG has already started working with departmental chief audit executives and with senior financial officers to develop the process required to support the identification of key financial controls requiring audit coverage, as outlined in the new policy.</p> <p>As mentioned in the chapter, the OCG regularly reviews internal audit reports and management letters in order to monitor and help remedy control weaknesses in departments and agencies.</p> <p>In addition, the initiative to audit departmental financial statements will significantly affect and improve the financial control environment in departments. In preparation for the audit of their departmental financial statements, each department must ensure that its processes are well documented and exist within a sound internal control environment. While this initiative initially focusses on large departments, as part of its preparation, each department must undergo an audit readiness assessment by an external auditing firm, which will include an assessment of the control environment. The OCG will monitor the results of these assessments and will work with</p>

Recommendation	Department's response
	<p>departments to ensure that corrective action is taken as required. The Treasury Board Secretariat is confident that, through these initiatives, we will continue to achieve progress in improving internal financial controls.</p>