

Chapter 33

Other Audit Observations

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Other Audit Observations

Main Points

33.1 The *Auditor General Act* requires the Auditor General to include in his Reports matters of significance that, in his opinion, should be brought to the attention of the House of Commons.

33.2 The “Other Audit Observations” chapter fulfils a special role in the Reports. Other chapters normally describe the findings of the comprehensive audits we perform in particular departments, or they report on audits and studies of issues that relate to operations of the government as a whole. This chapter reports on specific matters that have come to our attention during our financial and compliance audits of the Public Accounts of Canada, Crown corporations and other entities, or during our value-for-money audits.

33.3 The chapter normally contains observations concerning departmental expenditures and/or revenues. The issues addressed generally involve failure to comply with authorities, and the expenditure of money without due regard to economy.

33.4 Observations reported this year cover the following:

- secret commissions/kickbacks for refueling military vehicles;
- the lack of financial control and management systems at CORCAN; and
- the Employment Insurance Account surplus.

33.5 Although the individual audit observations report matters of significance, they should not be used as a basis for drawing conclusions about matters we did not examine.

Introduction

33.6 This chapter contains matters of significance that are not included elsewhere in the Report and that we believe should be drawn to the attention of the House of Commons. The matters reported were noted during our financial and compliance audits of the Public Accounts of Canada, Crown corporations and other entities, or during our value-for-money audits.

33.7 Section 7(2) of the *Auditor General Act* requires the Auditor General to call to the attention of the House of Commons any significant cases where he has observed that:

- accounts have not been faithfully and properly maintained or public money has not been fully accounted for or paid, where so required by law, into the Consolidated Revenue Fund;
- essential records have not been maintained or the rules and procedures applied have been insufficient to safeguard and control public property, to secure an effective check on the assessment, collection and proper allocation of the revenue, and to ensure that expenditures have been made only as authorized;

- money has been expended other than for purposes for which it was appropriated by Parliament;

- money has been expended without due regard to economy or efficiency;

- satisfactory procedures have not been established to measure and report the effectiveness of programs, where such procedures could appropriately and reasonably be implemented; or

- money has been expended without due regard to the environmental effects of those expenditures in the context of sustainable development.

33.8 Each of the matters of significance reported in this chapter was examined in accordance with generally accepted auditing standards; accordingly, our examinations included such tests and other procedures as we considered necessary in the circumstances. The matters reported should not be used as a basis for drawing conclusions about matters not examined. The instances that we have observed are described in this chapter under the appropriate department headings.

This chapter contains a number of observations on matters of significance not included elsewhere in the Report.

National Defence

*Assistant Auditor General: Jean Ste-Marie
Director: Neil J. Papineau*

Secret commissions/kickbacks for refueling military vehicles

Some National Defence military and civilian personnel have been accepting secret commissions/kickbacks from retail service stations for purchasing diesel fuel for military vehicles. At the time of our audit, this abusive practice had been taking place for at least two years.

Background

33.9 As a result of the Treasury Board decision to privatize the Fleet Management Information and Government of Canada Credit Card Services, Public Works and Government Services Canada (PWGSC) was tasked with issuing standing offers with private sector firms to assist departments in the management of their vehicle fleets.

33.10 A National Master Standing Offer (NMSO) was issued to a fleet management services company on 15 December 1993 to cover the period from 1 April 1994 to 31 March 1999. The standing offer has been extended to 31 March 2000. The use of this standing offer by departments is optional. Departments can call up against the fleet management services standing offer or they can contract on their own with any of the other fleet management companies.

33.11 The services provided under this standing offer include a service card-based system (credit card) and fleet management information services. This system permits departments to benefit from the government's tax exemptions and discounts through standing offers established by PWGSC with the major fuel companies, tire and tube manufacturers, vehicle manufacturers and vehicle repair and maintenance suppliers. Other services provided under the

standing offer include maintenance management, data management, consolidated billing and payment, fleet management assistance and any combination of the above.

33.12 There are approximately 21,000 retail outlets participating in the support of this standing offer agreement. Currently, approximately 4,100 vehicle fleet credit cards are issued to the Department of National Defence (DND) and 17,100 in total to the federal government.

33.13 National Defence obtains fuel for its military vehicles either at fueling depots on the DND military bases or off the military bases at numerous retail service stations (gas stations) across Canada. When DND military and civilian personnel refuel off the military bases, they usually pay for their purchases using vehicle fleet credit cards issued per the National Master Standing Offer referred to above.

33.14 National Defence diesel purchases at the retail service stations through this NMSO totalled \$1,518,000 in 1997–98 and \$2,117,000 in 1998–99.

33.15 DND does not centrally co-ordinate the issuance of these vehicle fleet credit cards. All responsibility for these cards has been devolved to the individual military bases and each military

base decides whether it will use such cards.

Scope

33.16 The Office of the Auditor General received a complaint alleging that DND military personnel were receiving cash rebates for refueling military vehicles with diesel fuel. As a result of this complaint, the Office undertook to examine the DND diesel fuel purchases for 1997–98 and 1998–99.

33.17 The scope of our examination was limited to a review of a small sample of retail service stations in two provinces and a small number of DND bases. This review included examining departmental and third party records in detail and interviewing departmental and private sector parties. Our review was confined to examining purchases of diesel fuel using vehicle fleet credit cards and did not look at general purchases using other types of credit cards. The findings in this audit are the results of this limited review.

Issues

33.18 Our review of National Defence purchases of diesel fuel from retail service stations determined that numerous cash rebates were made to some DND military and civilian personnel by retail service stations. Cash rebates had been made during the 1997–98 and 1998–99 fiscal years and the practice was still ongoing at the time of our review.

33.19 In our view, these cash rebates constitute secret commissions/kickbacks. Secret commissions are generally defined as the giving or receiving of a thing of value to an agent to influence a business decision without the knowledge or consent of the principal. Kickbacks are a type of secret commission that usually involve an overbilling scheme. They almost always involve a purchasing function of an organization and usually involve employees with purchasing responsibilities. With reference to this

matter, the agent is the employees and the principal is the Crown.

33.20 From the review of our sample of retail service stations in two provinces, over 200 DND military and civilian personnel have accepted cash rebates from retail service stations during the 1997–98 and 1998–99 fiscal years. Military and civilian personnel from 18 of a total 22 military bases have been accepting these cash rebates. The military bases involved are from the three Commands: Maritime Command, Land Force Command and Air Command.

33.21 The amount of the cash rebate varied, depending on the quantity of diesel fuel purchased and the rebate rate offered by the individual retail service stations. The stations offered various rebate rates of two cents to five cents per litre of diesel fuel. Cash rebates varied from \$4 to over \$70 per vehicle refueled. Though the individual cash rebate payment is not large, the cumulative total nationally could be substantial over the years. The amount of cash rebates determined from our sample was \$15,600 for diesel fuel purchases totalling \$216,700.

33.22 We found that some retail service stations inflated the diesel fuel price per litre to DND above the normal selling price to pay for the cash rebates. In addition, one of those stations inflated the price further to charge an administration fee for paying the cash rebates. Therefore, prices for diesel fuel were inflated by some retail service stations from five to nine cents a litre above their normal selling price.

33.23 Our review determined that diesel cash rebates were accepted by DND military and civilian personnel for 763 out of a total of 861 diesel fuel purchases where sufficient quantity was purchased to warrant a cash rebate. Therefore, diesel cash rebates were accepted 88 percent of the time when available to DND military and civilian personnel. Where a cash rebate was not accepted, the rebate amount was sometimes deducted from the

In our view, these cash rebates constitute secret commissions/kickbacks.

Individuals from three other federal departments and one Crown corporation were also accepting diesel fuel cash rebates.

We are concerned about the ethical conduct of some DND military and civilian personnel.

vehicle fleet credit card charge to reflect a reduction of the cost of diesel fuel purchased. We found only 40 incidents where the rebate amount was deducted from the diesel fuel charges on the credit card receipts. These 40 incidents were handled in an acceptable way for dealing with diesel fuel rebates, that is, reducing the amount charged on the vehicle fleet credit cards and thereby reducing the total fuel costs to the Crown. Retail service station personnel advised us that it was an industry practice to make cash rebate payments to truck drivers for diesel fuel purchases.

33.24 Although our limited sample of retail service stations was directed at DND, our review uncovered that individuals from three other federal government departments and one Crown corporation were also accepting diesel cash rebates for refueling government vehicles, using vehicle fleet credit cards. We found that the extent of the cash rebate practice involving these other government entities was small.

33.25 The acceptance of cash rebates by DND military and civilian personnel and employees of other departments contravenes the Treasury Board Travel Directive, which states, “Should a benefit be awarded to an employee, it shall immediately become the property of the Crown unless the benefit was awarded as the result of a program sanctioned by the Treasury Board.” These cash rebates are also in contravention of the Treasury Board Policy on Conflict of Interest and Post-employment Code. One of the principles of that policy is “employees shall not solicit or accept transfers of economic benefit, other than incidental gifts, customary hospitality, or other benefits of nominal value, unless the transfer is pursuant to an enforceable contract or property right of the employee.” Furthermore, the acceptance of cash rebates is not in accordance with the *Financial Administration Act* and, in regard to DND personnel, it is not in

accordance with the *National Defence Act*.

33.26 National Defence Headquarters was not aware of which military bases used these vehicle fleet credit cards; nor was it monitoring the extent of use. DND has national guidelines on the restrictions and obligations imposed on the transportation officers or users of vehicle fleet credit cards. DND military and civilian personnel responsible for vehicle fleet credit cards at some DND bases were not aware of these guidelines.

33.27 Our review of the military bases determined that the controls and authorizations at each military base for vehicle fleet credit cards varied substantially. Historical logs for custody of credit cards were not maintained at most military bases reviewed. In addition, monthly statements of the fleet management services company for fuel charges were paid by most DND military bases without adequately verifying whether all charges were incurred or appropriate.

33.28 We also determined that National Defence had received a similar complaint about diesel cash rebates being paid to DND military personnel prior to the Office of the Auditor General receiving a complaint. DND military police investigated the complaint but closed their investigation file as being unsubstantiated.

Conclusion

33.29 In our limited review, we found that a large number of DND military and civilian personnel from 18 military bases were involved in this abusive practice of accepting cash rebates for refueling military vehicles. This raises a serious issue — that is, the insufficiency of control measures in place to safeguard the Crown against the risks associated with these vehicle fleet credit cards. More important, we are concerned about the ethical conduct of DND military and

civilian personnel participating in this practice.

33.30 The participation of individuals from other departments and a Crown corporation in accepting cash rebates raises similar concerns.

***National Defence's response:** The Department of National Defence is currently not in a position to fully*

corroborate the accuracy of the information provided in this Audit Note. However, the practice described in this report is not consistent with the values of the Department of National Defence and the Canadian Forces and we are committed to bringing it to an end. We are also committed to examining the adequacy of controls governing the use of vehicle fleet credit cards.

CORCAN – A Special Operating Agency of Correctional Service Canada

Assistant Auditor General: Maria Barrados

Director: Amjad Saeed

Lack of financial control and management systems at CORCAN

CORCAN needs to implement a full financial control and management system that would produce reliable and auditable financial statements as prescribed in its Charter.

Background

33.31 In 1992, Parliament approved the establishment of CORCAN, which provides work-related training and experience to offenders in institutions operated by Correctional Service Canada. It also provides employment-related services in the community to help offenders reintegrate into society upon their release. CORCAN operates in a businesslike manner, with total revenues of \$73 million in 1998–99 from the sale of goods and services in industries such as manufacturing, agriculture and construction.

33.32 CORCAN is designated as a special operating agency, that is, a unit within the traditional government structure that has been given additional administrative and financial flexibility to achieve specific, agreed-upon results.

33.33 When CORCAN became a special operating agency, Parliament authorized it access to a \$45 million revolving fund to be used for working capital, to acquire capital assets and to cover any operating losses. A revolving fund is a continuing or non-lapsing parliamentary appropriation.

33.34 At the same time, the Treasury Board approved a Charter outlining the accountability and reporting framework under which CORCAN was to operate.

The Charter includes, among other things, a description of the accounting, evaluation and audit functions. Under the accounting function, the Charter states that “CORCAN will ensure a full financial control and management accounting system providing for regular review of actual costs, revenues, operating performance and cash flows compared to budget. The accounting system will meet the standards established by the Treasury Board for the operation of a revolving fund.”

33.35 Treasury Board policies for accounting for revolving funds require that:

“As a minimum, the accounting system must provide for:

- the preparation and submission of both periodic and year-end data to the Receiver General on a modified cash basis of accounting in accordance with Receiver General directives to meet all requirements for keeping accounts as a budgetary appropriation; and
- the preparation of both periodic and year-end statements on an accrual and cost basis in accordance with private sector accounting practices.

The display and disclosure of assets and liabilities in the financial statements, as well as the method used to calculate depreciation, shall conform to generally

recognized accounting practices and shall be consistent from year to year.”

Issues

Results of our recent audits of CORCAN

33.36 In 1996, we raised concerns that CORCAN was not meeting its goal of financial self-sustainability or its mandate to provide offenders with work-related training and experience. In April 1999, we reported that both these concerns were not adequately addressed. In addition, we noted that after six years of operations and receiving annually approximately \$18 million for training from Correctional Service Canada, CORCAN has reported accumulated losses totalling \$12 million. These losses, together with funds used to finance working capital needs and to acquire capital assets, have used \$32 million of the \$45 million revolving fund authority as at 31 March 1999. Since CORCAN reports that only about \$13 million remains in the revolving fund as at 31 March 1999, it is critically important that management have assurance that its financial management accounting system is generating accurate and reliable financial statements. This will assist in its decision making.

CORCAN's efforts to produce auditable financial statements

33.37 In the fall of 1996, CORCAN, with the assistance of Consulting and Audit Canada, took the initiative to engage an independent accounting firm to audit the 31 March 1997 financial statements. One year later, the firm formally communicated to CORCAN management its inability to express an unqualified audit opinion on those financial statements “due to pervasive problems within the reporting system and controls at CORCAN.”

33.38 The firm identified several accounting deficiencies that CORCAN

would have to address in order to be in a position to receive an unqualified audit opinion on its annual financial statements. These deficiencies included inaccurate accounting for construction contracts and for capital assets, lack of control over accounts payable, and poor procedures related to the physical inventory count and valuation of livestock.

33.39 Due to CORCAN's inability to obtain an unqualified audit opinion as at 31 March 1997, management was advised by the accounting firm that CORCAN could benefit more by spending its time and effort in addressing these known deficiencies rather than proceeding to an audit.

33.40 Upon our request, CORCAN, with the assistance of the accounting firm, provided us with a status report to 15 October 1998 on the deficiencies identified in 1997. The report stated, “It is our intent to complete work on these issues by the end of this fiscal year and be able to have an independent audit of our 31 March 1999 financial statements.”

33.41 Our follow-up of the issues in August 1999 revealed that draft reports on policies, procedures and internal controls for three CORCAN business lines and the corporate accounting function were prepared by the independent accounting firm. In these draft reports, the most significant findings related to the lack of an “overall control environment”. The emphasis on management's “control consciousness” is the most critical condition for creating a positive atmosphere conducive to the effective operations of the accounting systems and controls. The draft reports also noted that a “significant leap” is required in order for CORCAN to undergo an independent audit in an efficient and effective manner.

Conclusion

33.42 In the seven years since Correctional Service Canada obtained authority to establish its prison industries

It is critically important that management have assurance that its financial management accounting system is generating accurate and reliable financial statements. This will assist in its decision making.

An accounting firm's audit reports noted that a “significant leap” is required in order for CORCAN to undergo an independent audit in an efficient and effective manner.

as a special operating agency with special powers and new authorities, CORCAN has not maintained a sound financial control and management accounting system that would produce reliable and auditable financial statements as prescribed in its Charter. The maintenance of such a system is critical for effective decision making and accountability. Taking our past and current concerns together, we believe that CORCAN has not adhered to either its Charter document or the policies for special operating agencies approved by the Treasury Board.

33.43 Subsequent to completion of our audit work, CORCAN's management informed us that CORCAN has recently completed a review of its accountability structure and of a sound management control framework and considers implementation of these as a prerequisite to maintaining a reliable and efficient financial control system and management accounting and reporting system. CORCAN believes that it will be in a position to receive a favourable audit opinion on its financial statements for the fiscal year ending 31 March 2001.

Human Resources Development Canada

Assistant Auditor General: Maria Barrados

Director: Basil Zafiriou

The Employment Insurance Account surplus

The *Employment Insurance Act* enjoins the Canada Employment Insurance Commission to set premium rates at levels that will cover program costs while remaining relatively stable over a business cycle. At the end of fiscal year 1999, the cumulative surplus in the Employment Insurance (EI) Account stood at \$21 billion, a level much higher than the Chief Actuary of Human Resources Development Canada considers sufficient for purposes of the EI Act. The Act does allow the Commission discretion in setting rates and establishing an appropriate level of reserves. However, to provide Parliament and the public with a better appreciation of how that discretion is being used, the Commission should explain the factors it relies upon to set premium rates and the EI Account reserve it considers necessary for purposes of the EI Act.

Background

33.44 The report of the Auditor General on the financial statements of the Employment Insurance (EI) Account for the year ended 31 March 1999 drew attention to the fact that the surplus of the Account had grown during the year by \$7.3 billion, to \$21 billion (see Exhibit 33.1). At this level, the surplus in the Account was much higher than the Chief Actuary of Human Resources Development Canada (HRDC) considers sufficient for purposes of the *Employment Insurance Act*, under which the Account has been established. The reason for drawing attention to this matter is that the size of the surplus and its rate of growth raise questions about the factors that the Canada Employment Insurance Commission relies upon in setting premium rates and determining the level of reserves it considers necessary for purposes of the *Employment Insurance Act*.

Issues

The size of the surplus

33.45 Section 66 of the *Employment Insurance Act* requires the Canada Employment Insurance Commission to set employment insurance premiums at a rate that it considers will, to the extent possible, ensure enough revenue to cover EI Account payments and maintain relatively stable rate levels over the business cycle. The rate set by the Commission (which is composed of representatives of employees, employers and the government) must be approved by the Governor in Council at the recommendation of the ministers of Human Resources Development and of Finance.

33.46 The Chief Actuary of HRDC has estimated that a reserve of \$10 billion to \$15 billion (attained just before a downturn) should be sufficient to guarantee stability of the rates over the

business cycle. Further, the Chief Actuary has estimated that an employee premium rate between 1.90 and 2.10 percent of insurable earnings would meet the costs of the EI program over the long term.

33.47 The employee premium rate for 1999 was set at 2.55 percent (and 1.4 times that, or 3.57 percent, for the

employer premium). At the existing premium rate, the cumulative surplus in the EI Account will likely exceed \$26 billion by the end of the current fiscal year. The cumulative surplus in the EI Account is already considerably larger than the amount the HRDC Chief Actuary considers sufficient to satisfy the requirements of the EI Act. And the

Exhibit 33.1

**Employment Insurance
Account
1999 Auditor's Report**



AUDITOR GENERAL OF CANADA

VÉRIFICATEUR GÉNÉRAL DU CANADA

AUDITOR'S REPORT

To the Minister of Human Resources Development

I have audited the balance sheet of the Employment Insurance Account as at March 31, 1999 and the statement of operations and surplus for the year then ended. These financial statements are the responsibility of the management of the Canada Employment Insurance Commission. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Employment Insurance Account as at March 31, 1999 and the results of its operations and its cash flows for the year ended in accordance with the accounting policies set out in Note 2 to the financial statements.

I wish to draw to your attention that the surplus of the Employment Insurance Account has increased during the current year by \$7.3 billion, to \$21 billion. Under the Employment Insurance Act, and as described in Note 5 to the financial statements, premium rates should be established at a level sufficient to ensure that there will be enough revenue over a business cycle to pay the amounts authorized, while maintaining relatively stable rates throughout the cycle. The Act does not define the level of surplus or reserve deemed sufficient to meet the objective. However, according to a report by the Chief Actuary of the Department of Human Resources Development on employment insurance premium rates for 1999, a reserve of between \$10 and \$15 billion, attained just before an economic downturn, should allow meeting all additional costs during the period of decline. In my opinion, in view of the current level of the surplus, clarification and disclosure of the factors to be used in determining an appropriate level of reserve are necessary.

L. Denis Desautels, FCA
Auditor General of Canada

Ottawa, Canada
July 23, 1999

surplus can be expected to continue growing as long as the premium rate exceeds the rate that the Chief Actuary deems sufficient to cover the ongoing costs of the EI program.

33.48 The legislative provisions relating to setting premium rates are not very precise. The expressions “enough revenue” and “relatively stable rate levels” are not defined in the Act. This ambiguity is compounded by the requirement that rate stability be established with reference to the “business cycle”. While the term “business cycle” may have a clear meaning in economics, the length and amplitude of business cycles are not predictable with certainty. Thus, the law as it now reads gives the Employment Insurance Commission considerable discretion in setting EI premium rates and determining the appropriate level of EI reserves. That discretion must be exercised within the process of consultation, recommendation and approval outlined in paragraph 33.45.

33.49 However, if meaning is to be attached to the *Employment Insurance Act*, the discretion used in setting rates cannot be unlimited. Employment insurance revenues are collected in order to finance activities sanctioned under the Act; and there must be some level of reserves that suffices for that purpose. The HRDC Chief Actuary has advised the Commission that a level of \$15 billion (attained just before the onset of a recession) should suffice. The level now is substantially higher than that — and rising.

33.50 The Chief Actuary’s estimates are based on calculations and assumptions that are clearly set out in his annual report to the Employment Insurance Commission. Although the Commission has no obligation to accept the advice of the Chief Actuary, we believe that if it disagrees with the Actuary’s estimates, it ought to explain why. If it has other factors that it considers in setting rates, it

should explain those also. Otherwise, Parliament and the public are left to speculate about the factors driving decisions concerning one of the government’s largest and most visible programs.

Impacts on the government’s financial statements

33.51 The rate at which EI premiums are set has important consequences for the government’s financial statements overall. Since 1986, the EI Account has been consolidated in the government’s Summary Financial Statements. This treatment conforms with CICA (Canadian Institute for Chartered Accountants) standards concerning the accounting for activities closely controlled by governments, and parallels the treatment accorded similar other special purpose accounts and Crown corporations.

33.52 Consolidation means that surpluses or deficits in the EI Account have a direct impact on the government’s budgetary balance. For example, had other things remained unchanged, in the absence of the \$7.3 billion EI surplus for 1998–99, the government would have recorded a \$4.4 billion deficit, rather than the realized \$2.9 billion surplus. Similarly, in the absence of the \$21 billion EI reserve, the federal government’s net debt would have been \$598 billion at 31 March 1999, rather than the reported \$577 billion.

Conclusion

33.53 The *Employment Insurance Act* enjoins the Canada Employment Insurance Commission to set premium rates at levels that will cover program costs while remaining relatively stable over a business cycle. The current surplus in the EI Account significantly exceeds the amount the HRDC Chief Actuary considers sufficient to keep premiums stable over time, at a level that will meet authorized program costs. Legislation does allow the Commission discretion in

The current surplus in the Employment Insurance Account significantly exceeds the amount the Chief Actuary of Human Resources Development Canada considers sufficient to keep premiums stable over time.

setting rates and establishing an appropriate level of reserves. However, to provide Parliament and the public with a better appreciation of how that discretion is being used, we believe the Commission should explain the factors it relies upon to set premium rates and determine the EI Account reserve it considers necessary for purposes of the EI Act.

Human Resources Development Canada's response: *Employment insurance (EI) premium rates are set in keeping with the process set out in Section 66 of the Employment Insurance Act using the analysis supplied by the Chief*

Actuary. The Canada Employment Insurance Commission sets the premium rate each year with the approval of the Governor in Council on the recommendation of the ministers of Human Resources Development and of Finance. The Commission is made up of representatives of workers, business and government. Each year they attempt to reconcile their varying perspectives in the goal of reaching a unanimous position. For each of the last three years, they have successfully reached a consensus on the EI premium rate. This has resulted in lower EI premiums in each of those years.