



Western Economic
Diversification Canada

Diversification de l'économie
de l'Ouest Canada

Audit of Year-End Procedures

WESTERN ECONOMIC DIVERSIFICATION CANADA

Audit & Evaluation Branch

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1.0 Executive Summary

- 1.1 The audit of Year-End Procedures was identified in the approved 2011-2012 Risk-Based Audit Plan of Western Economic Diversification Canada.
- 1.2 The purpose of the audit was to assess the adequacy and effectiveness of internal controls relating to year-end procedures. Such procedures must be designed to ensure that the financial information used for managing budgets and reporting financial results is reliable and timely. This is challenging when many transactions have to be determined, communicated and processed over a relatively short timeframe at year-end, particularly in a decentralized environment as is the case in the department.
- 1.3 The audit focused on the processes that were operational at 2010-11 fiscal year-end and, where necessary, the preceding year-end.

Findings

- 1.4 Overall, the department has designed and implemented adequate year-end procedures and controls over payables, commitments and financial reporting.
- 1.5 For effective monitoring of budgets at the corporate level, data in the department's financial system must be supplemented by up to date information that regions determine in terms of new commitments, changes to existing commitments and strategies to minimize the lapse. There is a time lag between when such information is anticipated by regions to when it becomes certain to when it is approved by regional management, communicated to headquarters and recorded in the financial and project management systems. This situation is further complicated at year-end when there is large volumes of transactions to be processed over a period of two to three weeks.
- 1.6 Under these circumstances, and with regions diligently aiming to minimize lapse of their allotted funds and generally averse to declare surpluses earlier in case they may be needed for regional priorities, expected year-end budget status at the corporate level is not accurately determinable with sufficient certainty until late in the fiscal year. This gives rise to financial management and reporting risks.
- 1.7 The role of the Chief Financial Officer as key steward for department-wide financial management and support to the Deputy Head in his role as the "accounting officer" is critical in the department's decentralized organization structure to ensure that financial risks are appropriately monitored and mitigated. The recent requirement for regions to identify surpluses that can be reallocated early is a good step to foster effective financial management practices. Equally important is to ensure that any corporate initiative or funding commitment requiring regions to make changes to their budget plans or strategies is communicated to them in a timely manner.

2.0 Statement of Assurance

- 2.1 In my professional judgement as Chief Audit Executive, sufficient and appropriate audit procedures have been conducted and evidence gathered to support the conclusion that the department has established reasonable year-end procedures and controls over payables, commitments and financial reporting. Earlier identification and improved accuracy of PAYEs and timely internal communication of new funding initiatives would further strengthen financial management practices.
- 2.2 The assurance is based on a comparison of the conditions, as they existed at the time, against pre-established audit criteria that were agreed upon with management. The assurance is applicable to the policies, processes and controls examined. The evidence was gathered in accordance with Treasury Board policies, directives, and standards on internal audit for the Government of Canada. Sufficient evidence was gathered to provide senior management with the proof of the conclusions derived from this audit.

Donald MacDonald
Chief Audit Executive

3.0 Introduction

- 3.1 Sound year-end procedures are key to ensuring that financial information provided to management is reliable and timely. This in turn helps management make right decisions regarding the use of appropriations and budgetary allocations, and meet its financial reporting responsibilities.
- 3.2 Around year-end, large volumes of transactions are processed and many decisions made over a relatively compressed timeline by staff at headquarters and in the regions, making coordination and communication tasks more challenging. As at March 31, 2011, the department had recorded accounts payable and accrued liabilities to external parties of \$217.7 million, of which \$214.4 related to grants and contributions and \$3.3 million to operating expenses.
- 3.3 Corporate Finance is responsible for establishing overall year-end guidelines and timetable to meet year-end requirements of central agencies. Regional staff are responsible for applying those guidelines in their respective regions.
- 3.4 The focus of the audit was on the procedures and control activities that were in place at or around 2010-11 fiscal year-end. The audit also examined the settlement and clearance of Payables at Year-End (PAYEs) outstanding for the past two year-ends (2011 and 2010).

Audit Objective

- 3.5 The objective of this engagement was to determine how well the department has designed and implemented controls relating to year-end procedures, particularly as they related to:
- commitments and budgetary management;
 - payables and accruals; and
 - departmental and public accounts reporting.

Key Risks

- 3.6 Management designs controls to manage risks. The audit examined the processes and controls that management has designed to mitigate the following key risks:
- transactions at year-end cause departmental spending to exceed appropriations;
 - appropriations lapse despite a need to fund projects;
 - errors are made in financial information due to incorrect application of policies, miscommunication, large volume of transactions and complexity of reporting requirements;
 - payables and accruals are not properly supported by documentation; and
 - central agency requirements are not complied with.

Audit Scope

- 3.7 The audit examined the policies, procedures and control activities that were operational at the end of the most recent fiscal year (2010-11). The audit also examined the settlement and clearance of Payables at Year-End (PAYEs) outstanding as at the past two year-ends (2011 and 2010).

Acknowledgements

- 3.8 The audit team would like to thank management and staff at headquarters and the regions for their cooperation and assistance throughout the engagement.

4.0 Observations and Recommendations

4.1 Payables at Year-End (PAYEs)

Criteria: Accounts payable and accrued liabilities at year-end are valid, accurate, and determined in accordance with Treasury Board and departmental requirements.

Criteria: Transactions and events are recorded in the correct accounting period.

Criteria: Outstanding payables recorded at year-end are cleared in a timely manner.

- 4.1.1 Accounts payable and accrued liabilities recorded at year-end historically represent a significant portion of the department's annual grants and contributions. As of March 2011, these payables were \$214.4 million, or 55% of grants and contributions for the year. This ratio is consistent with the preceding two years, where PAYEs were in the range of 53 to 58% of grants and contributions. The payables at March 2011 represent about 610 projects, of which 76 were approved in 2010-11.
- 4.1.2 Setting up PAYEs is an involved process. It requires a clear understanding and awareness of what tasks are expected at year-end and when they must be completed. To facilitate this, Corporate Finance prepares annual instructions and communicates the policies and procedures for identifying and recording various transactions and balances, including accounts payable and accrued liabilities. The 2010-11 policies and procedures, based on the Receiver General of Canada and departmental requirements, provided clear and comprehensive guidance to staff. Corporate Finance also provided training to all staff involved with the year-end and PAYE processes. Staff found training to be helpful in clarifying and addressing issues, concerns and requirements.
- 4.1.3 For grants and contributions, project officers use a variety of methods and sources of information to identify, quantify, record and report PAYE liabilities. Officers review outstanding cash flows and commitments for projects to determine how much of the outstanding balance is expected to be utilized before year-end closing. In order to set up a PAYE, staff must consider claims paid, cancelled commitments and/or re-profiled funds between fiscal years. Some regions confirm liability amounts and their expected clearance timelines with recipients. Transactions are recorded in accounting and project systems once the appropriate approvals for re-profiling and de-commitment have been obtained. For the PAYE amounts, officers must take steps to gather evidence of expenditures incurred by contribution recipients up to the end of the fiscal year.
- 4.1.4 The officers obtain the best possible evidence that recipients are able to provide for the expenditures incurred. We found that supporting PAYE documentation in project files, particularly for estimates, varied in its persuasiveness of the expenditures incurred. Of the 40 PAYE samples selected from the 2010-11 year-end, audit tests indicated that 9 were supported by actual claims and invoices, 28 were estimates based on documents such as emails, letters, lists of charges, file notes or purchase orders, and 3 were a combination of actual claims and estimates. All samples were coded correctly on PAYE input forms, with evidence of managerial review and appropriate approvals required under the *Financial Administration Act*. The audit noted that three different input forms were being used by regions, although steps are underway to develop one standard PAYE input form.

4.1.5 One measure of the validity and accuracy of PAYEs is the number and amount of subsequent adjustments made after PAYEs have been set up.

- As of November 2011, there were 100 entries processed against grants and contribution PAYEs set up in March 2011 to reduce PAYEs by \$2.2 million (over accruals) and 40 to adjust PAYEs upwards by \$0.8 million (under accruals). Eight of these 140 adjustments were for amounts over \$100,000. Total PAYEs as at March 2011 were \$214.0 million. The net adjustment was less than 1% of the original payables established.
- For the 2009-10 grants and contribution PAYEs of \$180.0 million, there were 230 entries made to adjust over accruals of \$6.6 million and 145 to adjust under accruals of \$3.6 million. Eighteen entries were over \$100,000 each. The net adjustment was 1.7% of the original payables established.

Corporate Finance and regional staff followed Treasury Board Policy that permits offsetting PAYE under accruals against over accruals. Any net over accrual represents monies for which the spending authority granted to the department has lapsed as the funds are returned to the Receiver General for Canada.

4.1.6 Transactions and events should relate to the 2010-11 fiscal year in order to be set up as a PAYE as at March 2011. This was the case for the samples tested.

4.1.7 Since grants and contribution PAYEs set up at year-end represent expenses incurred by recipients, it is reasonable to expect that these payables would be settled or cleared soon after the year-end. Some PAYEs remain outstanding due to delays by recipients in submitting their claims or other required documentation. Project officers and managers use various reports and worksheets to track clearance of outstanding PAYEs.

- The department established quarterly targets to measure performance for settlement or clearance of 2010-11 PAYEs: 60% clearance by the first quarter, 85% by the second quarter, and 100% by the third quarter. Three regions met or exceeded the targets for the first two quarters. The third quarter data was not yet due at the time of the audit. All regions showed a higher year-over-year clearance and settlement rates for 2010-11 PAYEs compared to the results for 2009-10.
- As of November 2011, there were 9 projects with holdbacks over 18 months old totalling \$750,000.

- 4.1.8 Materiality limits for setting up PAYEs are useful so that staff efforts at year-end are focused on amounts that are significant for financial reporting, particularly when timelines are tight. Treasury Board Policy on PAYEs suggests a materiality of the lesser of \$5,000 and one-half of one percent of the appropriation authority. Departments may however set a lower limit.
- WD has not specified any limit for recording PAYEs related to grants and contributions. We found that 8-10% of grants and contribution PAYE entries at March 2011 were for amounts under \$5,000. These entries totalled only \$120,000 of the total transfer payment liabilities of \$214.4 million (or just over 0.05%).
 - For PAYEs related to operating expenses, the department has specified a materiality limit of \$500. However, about 20% of the operating expense PAYEs at March 2011 was below the department's materiality limit. These payables totalled only \$5,000 of the \$1.8 million in operating expense accruals (or just under 0.3%).
- 4.1.9 The total of "small" grants and contribution accruals above (\$120,000) is considerably lower than the department's historical net over accrual (approximately \$3 million – see 4.1.5). If these trends continue in the future, then the department could save busy staff resources by not setting up any PAYEs below materiality, and still be able to effectively charge them against old year expenses once they are received due to the projected net over accruals that will emerge.
- 4.1.10 For operating expense PAYEs, audit tests confirmed that they were properly supported by documentation of liability, correctly coded and promptly paid after the year-end.

Recommendation # 1: The department should establish an appropriate materiality limit for setting up PAYEs related to grants and contributions, and consistently apply the current materiality limit for operating expense PAYEs.

4.2 Commitments and Year-End Budget Management

Criteria: Commitments at year-end are determined accurately and properly in accordance with Treasury Board and departmental requirements.

Criteria: Year-end budgetary surpluses and deficits are identified correctly and early.

- 4.2.1 Key financial management controls over commitments, budgets and resources are addressed in the two frameworks issued by Corporate Finance: the Core Grants and Contribution Management Framework and the Operating Budget Management Framework. The key principles underlying these frameworks are:
- Regional and corporate collaboration;
 - Early reallocation of funds not required by regions;
 - Early identification of reprofiling and slippage; and
 - Coordinated approach to resource use to minimize lapse of spending authority.

Adherence to these principles is essential for the proper functioning of the department's decentralized system of resource management based on regional budgets and departmental objectives. These principles also guard against the risk of spending beyond the limits authorized by appropriations.

- 4.2.2 Corporate Finance is responsible for monitoring and managing appropriations, budgets, expenditures and commitments at the departmental level, while regions have similar responsibilities for their resources at the regional level. To carry out these responsibilities within the framework of the above-noted principles, it is important that there is accurate, reliable and transparent forecasting of expenditures and commitments, particularly as they relate to grants and contributions. To facilitate this, Corporate Finance has developed a Grants and Contributions Forecasting Module, which relies on the information from the department's financial and project management systems, and tracking worksheets of de-commitments and re-profiling determined by regions.
- 4.2.3 Regions are required to submit their budget forecast to Corporate Finance 9 times a year, including monthly forecasts for December, January and February and weekly forecasts throughout March. The forecasts are intended to correctly identify current commitments, slippages and/or shortfalls so that appropriate strategies can be employed to reallocate resources to minimize any lapse of spending authority while remaining within the parliamentary appropriations for the department. These forecasts are reviewed and discussed by regional staff and management, with final submissions to headquarters signed by Regional Finance Manager and Assistant Deputy Minister. Corporate Finance reviews regional budget and forecast submissions and prepares departmental level reports and updates for the Executive Committee.
- 4.2.4 We reviewed monthly and weekly regional and consolidated departmental forecasts prepared over the last four months of 2010-11 and make the following observations:
 - The department was able to fully utilize its "core" grants and contribution budget of \$127.0 million except for a small lapse of \$89,000. Despite this very small lapse in "core" funding, the department did not come close to exceeding its overall grants and contributions appropriation. This was due to the large amount of targeted grants and contributions in 2010-11 (and for most years in the past), all of which are included under one departmental appropriation for grants and contributions. However, starting in 2011-12, these targeted grants and contributions should almost all have ended. That will increase the need to manage the "core" funding very closely in order to stay within the overall appropriation.
 - Three regions continued to forecast nil surpluses until very late in the year; between one and three weeks before the year-end. These forecasts were based on regional plans and expectations of additional commitments, decommitments or reprofiling to offset any potential available funds in their budgets. And, all regions combined reported a much higher free balance three days before the year-end than they did on the date of their previous forecasts: \$0.8 million on March 25, 2011 and \$2.5 million on March 29, 2011. Early identification and reporting of surplus funds provides more time to senior management for deliberations on how such funds may be best re-invested.

- The Executive Committee decided to fund a corporate priority in the last week before the year-end. This decision required all regions to process a new commitment and numerous amendments to signed agreements very close to year end. At least one region expressed concerns that the late decision disrupted its budget management strategy aimed at full or substantial utilization of its regional budgetary allotment. Regional flexibility for dealing with late initiatives diminishes as year-end approaches and the time to implement an initiative is limited. This was the case with this late decision in March 2011. Furthermore, at a very busy time for staff, implementing the new funding commitment required an increase in external and internal consultations, changes to contribution agreements and preparation of documentation to support entries in the accounting and project management systems. In addition, in order to ensure that the department has the collective free balance to support such an additional expenditure, Corporate Finance and all of the regions have to be working of the same financial details regarding existing free balances.
 - The forecast documents submitted by regions to Corporate Finance contain few details or explanations for variances. Providing more detailed variance explanations in budgets and forecasts would enhance transparency, improve communication and strengthen collaboration.
- 4.2.5 Based on historical trends, the regions use over programming throughout the year in managing their budgets towards their targets. While such a mechanism may help achieve full budget utilization, it also exposes the department to a risk of potential over commitment. For such a mechanism to work effectively, it is important that over-programming amounts are managed down in a timely manner. A review of budget tracking worksheets showed that significant amounts of overcommitted dollars for 2010-11 were not drawn down until late March 2011. However, all regions did still effectively manage within their budget allocations.
- 4.2.6 Effective in 2011-12, Corporate Finance will hold back and not allocate a small amount from departmental appropriations to the regions so that the amount acts as a safety buffer, even if this would result in a small annual lapse. This precautionary practice may also help mitigate the potential risk arising from the use of over-programming and the significantly reduced grants and contributions levels going forward. Furthermore, Corporate Finance has become more insistent in getting regions to identify, on an earlier and ongoing basis, surpluses that may be available for reallocation for corporate or regional priorities.

Recommendation # 2: The department should ensure that new funding commitments are communicated to regions well ahead of year-end to the extent possible so that regions have sufficient time to develop appropriate budget strategies to accommodate such commitments.

4.3 Financial Information Reporting

Criteria: Financial information reporting is appropriate, timely and meets Treasury Board and departmental requirements.

- 4.3.1 Departmental financial reporting is a key component of year-end procedures. Corporate Finance is responsible for the production of financial information for public accounts reporting and departmental financial statements. It coordinates with central agencies on the preparation and submission of trial balance, public accounts plates and financial statements.
- 4.3.2 To meet the 2010-11 year-end requirements and timelines set by the Receiver General, Corporate Finance developed controls such as clear instructions, process documentation, task checklists, specified deadlines, roles and responsibility assignments, reconciliation activities, and approvals of year-end plates, supporting schedules and working papers. We reviewed these controls and working papers reconciling the accounting records to the public accounts plates and financial statements for major items and concluded that controls over the 2010-11 year-end closing were in place and operating adequately.
- 4.3.3 The public accounts plates for financial information and management representations were submitted to the Receiver General on or before their due dates. The Receiver General recently reported on the department's performance in this area. It reported that all 39 documents submitted by the department were received by the Receiver General on time and without amendments. The departmental financial statements dated August 2011 were sent to the Office of the Comptroller General by the reporting deadline. These documents were reviewed by senior management and approved by the Deputy Minister before their submission to the appropriate central agency.

5.0 Conclusion

The department has established reasonable year-end procedures and controls over payables, commitments and financial reporting. Earlier identification and improved accuracy of PAYEs and timely internal communication of new spending initiatives would further strengthen financial management practices.

Summary Conclusions

Audit Area	Audit Assessment
Payables at Year-End (PAYEs)	Criteria Mostly Met
Commitments and Year-End Budget Management	Criteria Mostly Met
Financial Information Reporting	Criteria Met

6.0 Audit Approach

Planning

- 6.1 Audit planning started in August 2011 and fieldwork was completed in November 2011. Departmental employees were engaged as necessary throughout the audit process to facilitate identification of key risks, audit criteria, control elements and audit strategies.

Standards and Methodology

- 6.2 Government of Canada internal auditing standards were used for the audit. The audit was evidence-based and provides audit assurance that is fully supported. The basis for the audit examination and audit expectations were communicated and agreed to by management. The evidence was gathered through risk analysis, interviews, system and process documentation reviews, project file examinations, and project management system data reviews.

Sampling

- 6.3 Internal Audit judgementally selected a sample of 65 payables and accruals recorded at March 31, 2011 (40 relating to transfer payments and 25 to operating expenses) for testing processes and controls over PAYEs and subsequent payments. Another 38 samples were selected to test and confirm internal controls over decommitment, reprofiling and PAYE adjustment processes.

Audit Team

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