National Defence Défense nationale

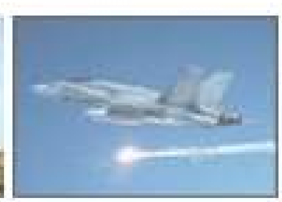
Chief Review Services Chef - Service d'examen

CRS CS Ex

Audit of Capital Asset Valuation

September 2009

7050-39 (CRS)


Canada

Table of Contents

Acronyms and Abbreviations

AAO	Asset Accounting Officer
ADM(Fin CS)	Assistant Deputy Minister (Finance and Corporate Services)
ADM(Mat)	Assistant Deputy Minister (Materiel)
AFSP	Audited Financial Statement Project
CAATs	Computer-Assisted Audit Techniques
CFSS	Canadian Forces Supply System
COS(Mat)	Chief of Staff (Materiel)
CRS	Chief Review Services
DGMSSC	Director General Materiel Systems and Supply Chain
DMG Compt	Director Materiel Group Comptrollership
DND	Department of National Defence
FAM	Financial Administration Manual
FIS	Financial Information Strategy
FMAS	Financial Managerial Accounting System
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principles
MASIS	Materiel Acquisition and Support Information System
MGMC	Materiel Group Management Committee
NBV	Net Book Value
OCI	Office of Collateral Interest
OPI	Office of Primary Interest
PMO	Project Management Office
RM	Requirements Manager
SERP	Single Enterprise Resource Planning
SOP	Standard Operating Procedures
TB	Treasury Board
WIP	Work in Progress

Synopsis

Since fiscal year (FY) 2001/02, in adherence with the Government of Canada's Financial Information Strategy (FIS) and the requirement to change from a modified accrual to full accrual accounting methodology, the Department of National Defence (DND) annual financial statements have included a schedule outlining the gross and net book value (NBV) of its capital assets.

The main objective of this audit was to determine if controls are effective in ensuring departmental capital assets are accurately recorded and properly reflected on the annual financial statements. The audit focused on those capital assets (primarily equipment including ships, aircraft and vehicles) which are recorded in the Materiel Acquisition and Support Information System (MASIS). Based on gross book value, these assets comprise approximately 67 percent of the total departmental capital assets.

Capital asset valuation could be improved by enhancing monitoring and certification processes. While completing a 100 percent validation of the Department's more than 45,000 capital assets would be a very resource-intensive task, ensuring that the 3 percent of assets which account for 90 percent of the NBV are accurately recorded could be a risk-smart first step.

In response to the audit recommendations, the Assistant Deputy Minister (Materiel) (ADM(Mat)) management action plan indicates that, as part of the Audited Financial Statement Project (AFSP), capital asset valuation processes will be reviewed and standardized, and additional controls will be introduced to mitigate risk areas. As well, roles and responsibilities will be more clearly defined and accountability will be further emphasized by introducing additional certification processes. System enhancements, including movement to a Single Enterprise Resource Planning (SERP) system, will further increase accuracy and improve efficiency.

The management action plans are sound and will address the improvements needed. The Department will monitor the progress made in implementing the management action plans and will undertake an audit follow-up if warranted.

Results in Brief

> **Overall Assessment**
>
> While progress has been made, controls must be further enhanced to ensure all capital assets, including work in progress (WIP), are completely and accurately reported in the departmental financial statements.
>
> Improved risk management, including a more robust certification process, and clarification of roles and responsibilities are warranted.

In April 2001 the Government of Canada introduced the FIS, thereby changing its basis of accounting for financial and management reporting purposes from modified accrual to full accrual. Since that time, in part to fulfill the FIS requirements, the DND annual financial statements have included a schedule outlining the gross value and NBV of its capital assets.[1] This audit was conducted by Chief Review Services (CRS) to determine if controls were effective in ensuring capital assets are accurately recorded and properly reflected on the annual departmental financial statements.

The departmental financial statements as of 31 March 2008 reported capital assets with a NBV of $28 billion, comprising 55 percent of the capital assets reported in the Government of Canada consolidated financial statements. This audit focused on those capital assets recorded in MASIS, the Department's system for recording capital equipment. Approximately 67 percent of the total departmental capital assets are recorded in MASIS.[2]

The systems and processes for recording capital equipment continue to evolve and progress has been made in increasing the accuracy and completeness of capital asset balances. Training has been provided, and ADM(Mat) accounting staff are generally aware of and strive to apply accrual accounting principles.

Further improvements are needed to ready the Department for a controls-reliant audit of the financial statements, as required by Treasury Board (TB) by 2015. Monitoring was not sufficient to ensure WIP accounts included all relevant costs, and that all capital equipment purchased directly from vendors was entered into the MASIS records. WIP and capital asset balances were certified as accurate without sufficient verification or oversight. Additional supporting documentation must be maintained, roles and responsibilities need to be clarified, and divisional capital asset accounting officers (AAO) need increased support from project officers and senior managers if capital asset valuation is to be completed in a more accurate, efficient fashion.

[1] Capital assets are defined in Financial Administration Manual (FAM) Chapter 1020-4 as an item acquired by purchase, construction, development or donation that provides beneficial ownership and control to DND, is used to achieve departmental objectives, and has a useful life greater than one year and an initial cost of at least $30,000.
[2] The remaining capital assets including land, buildings and works and some specialized (e.g., medical) equipment is recorded in other departmental information systems.

The audit focused on evaluating the controls in place, rather than verifying the recorded value of a statistical sample of assets. As such, no conclusion can be made regarding the accuracy of the reported balances—however; current controls must be improved if the risk of material error is to be reduced in the future.

Findings and Recommendations

Valuation of Capital Assets Under Construction or Newly Acquired

The Department acquires capital assets either as a direct or off-the-shelf purchase from a vendor, or by constructing or customizing an asset as part of a capital project.

Constructed Capital Assets. The majority of the Department's capital assets are constructed[3]/ customized. Costs related to assets under construction are accumulated in WIP accounts. During FY 2007/08 approximately $795 million of constructed assets was transferred from WIP to the in-service capital asset balance[4] while $4.4 billion of capital machinery and equipment remained under construction at 31 March 2008.

Twice yearly, ADM(Mat) divisions certify that the WIP balances have been verified, and that they are accurate. While divisions have been reviewing the WIP balances to ensure all in-service assets are removed, better monitoring is needed to ensure all indirect costs, such as salaries and freight, are captured and that non-capital expenses, such as spare parts, have not been included. As well, MASIS and Financial Managerial Accounting System (FMAS) WIP balances were not in agreement for almost 50 percent of accounts. Reconciling these balances would increase confidence in the accuracy of the capital asset balances.

When constructed assets are put in service, the WIP balance must be reduced by the appropriate amount, and an asset master record must be created which includes the in-service date, acquisition cost, useful life of the asset and other information. Project costing documentation was not always complete, making it difficult to confirm the accuracy of or rationale for the cost allocated to completed assets. As well, this process often was not timely. The majority of assets were in service several months before their associated costs were moved from WIP to in-service. Increased, on-going effort is being made to ensure WIP balances do not include completed assets, and consequently, improvements are expected in this area.

Direct-Purchase Assets. In order for capital machinery and equipment purchased by non-ADM(Mat) groups to be entered into MASIS, the purchaser must forward information including the acquisition cost, useful life, and in-service date to Director Materiel Group Comptrollership (DMG Compt). Current processes do not ensure this occurs. A recent ADM(Mat) initiative will require all Senior Executives to sign an annual attestation for material accountability. This attestation could be used as a means of reinforcing the requirement to ensure all direct-purchase assets are properly recorded for financial reporting purposes.

[3] In the remainder of the report, the term "constructed" includes any customization.
[4] Assets are considered in-service when they are issued to a first line unit, an operational unit commander, a responsibility centre manager or a contractor.

To ensure all capital assets, including those under construction and newly acquired, are accurately recorded in departmental information systems and financial statements, it is recommended that:

- A more comprehensive verification process to support WIP certification be implemented;
- Increased guidance be provided regarding documentation requirements and timeliness; and
- A more rigourous approach be used to ensure all groups provide ADM(Mat) with the required information to include newly acquired assets in the MASIS records.

Valuation of In-Service Assets

MASIS records as of 31 March 2008 indicate that more than 45,000 capital assets with a NBV of $14.1 billion were in service.[5] Annually ADM(Mat) staff certify, for financial statement reporting purposes, that this information is accurate; however, there is no process in place to validate the condition and existence of individual assets with the group that holds the asset (i.e., the asset custodian).

Instances were found where assets had been permanently damaged or destroyed, yet write-down or write-off had not occurred. In general, asset custodians do not have access to MASIS and have limited awareness of recorded asset details. This makes it difficult for them to know when changes are required. In addition, 57 percent of the assets did not have a location identified in MASIS. This further complicates confirmation of the asset condition and existence for financial statement reporting purposes.

To improve the accuracy and completeness of in-service asset information, it is recommended that a robust review process, which involves the asset custodians and which fully addresses all aspects of the capital asset balance certification, be implemented. The recent ADM(Mat) initiative requiring Senior Executives to sign an annual attestation for material accountability could be instrumental in resolving this issue.

Risk Management and Governance

Assistant Deputy Minister (Finance and Corporate Services) (ADM(Fin CS)) staff have identified completeness, existence and accuracy as the three principal financial risks associated with capital asset reporting. Mandatory certifications of the WIP and capital asset balances are the principal controls in place to mitigate these risks. To reduce the risk of inaccuracies, the certification process requires more rigour and must include all stakeholders.

ADM(Mat) has taken steps to reduce risk, including increased training, documentation of standard operating procedures (SOP) and use of some automated testing to identify and remedy data anomalies. When fully implemented, the requirement for annual materiel management attestations will also reduce risk. However, additional interim steps could be taken.

[5] Excluding leased capital assets.

For example, using a risk-based approach, based on materiality, to verify assets in service and WIP could be a first step. By confirming the existence and condition of only 3 percent of the assets (1,388 of 45,539) with a NBV greater than $1 million, coverage of 90 percent of the NBV of capital assets would occur.

Some aspects of governance could also be improved. Roles and responsibilities were not always clear. The relative responsibilities of the capital project team, the AAOs, ADM(Mat) divisional comptrollers, and DMG Compt were not well-defined, and varied considerably among projects. Consequently there were instances where duties overlapped and other instances where tasks, such as reconciling WIP balances, were left undone. Improved communication among these individuals will contribute to improving the completeness and accuracy of asset valuation.

To better mitigate risks, and to enhance governance it is recommended that:

- A comprehensive risk assessment be completed to determine the sufficiency and appropriateness of current controls;
- Risk-based approaches and automated continuous monitoring be used to improve the efficiency of verification processes; and
- Roles and responsibilities be clearly defined and communication among stakeholders be improved.

Note: For a detailed list of CRS recommendations and management response, please refer to Annex A—Management Action Plan.

Introduction

Background

Capital assets with a NBV of $28 billion were reported in the DND's 2007/08 financial statements. These assets comprised 55 percent of the $51 billion net capital assets reported in the Public Accounts of Canada[6] consolidated financial statements for the same year. The value of the Department's capital assets is expected to increase significantly due to the procurement of additional equipment as outlined in the Canada First Defence Strategy.[7]

In 2004, as part of a plan to transform and strengthen public sector management, TB announced that all departmental annual financial statements would be subject to audit by the Office of the Auditor General.[8] In 2007, DND engaged an external consultant to determine the Department's readiness for such an audit. The results of the assessment[9] questioned the adequacy of current controls to produce accurate values for reporting capital assets, and concluded that the Department was not prepared for a controls-reliant[10] audit in this area.

Subsequently, an audit of capital asset valuation was included in the CRS work plan for FY 2007/08.

Objectives

The objective of this audit was to assess the adequacy and effectiveness of the capital asset valuation process for financial statement reporting purposes; specifically, to determine whether:

- Control activities are adequate and result in complete and accurate asset information;
- Strategies are in place to identify and remediate areas of risk; and
- An adequate governance structure is in place.

Annex B contains the criteria used to assess the objectives.

---

[6] Public Accounts of Canada, 2007-2008, page 1.13, Table 1.2, Government of Canada Detailed Statement of Financial Position.
7 Canada First Defence Strategy, released in 2008-09, page 12, Chart 3: Canada First Defence Strategy – Total Defence Spending 2008-09 to 2027-28.
[8] Target dates for completion of these audits for the 22 largest departments range from FY 2007/08 to FY 2012/13, DND's current target for full readiness is FY 2014/15.
[9] Department of National Defence Audit Readiness Assessment, prepared by PricewaterhouseCoopers LLP, March 2007.
[10] In a controls-based audit, the auditor places reliance on well-functioning internal controls. This reliance reduces the requirement for substantive testing and results in a more efficient audit.

Scope

The audit focused on capital assets which are recorded in MASIS, excluding capital leases.[11]

The financial statement total capital asset balance is based on summary values recorded in FMAS. Detailed information relating to each asset—including historical cost, in-service date, and useful life—is recorded in one of five supporting information systems depending on the type of asset.[12] Based on the gross asset value, MASIS contains detailed information on 67 percent of the reported assets as shown in Table 1.

With the exclusion of leased tangible capital assets, capital assets recorded in MASIS had a gross value of $36.3 billion and an NBV of $18.5 billion as of 31 March 2008.

Asset Class	FY 2007/08 Financial Statement Gross Value	MASIS Gross Value for Asset Class 31 March 2008
Land, Buildings & Works	$7.8B	$0
Machinery & Equipment	$12.4B	$9.3B
Ships, Aircraft & Vehicles	$28.7B	$22.6B
Leased Tangible Capital Assets	$1.1B	$1.0B
Work in Progress	$5.3B	$4.4B
Total	**$55.3B**	**$37.3B (67%)**

Table 1. Capital Assets Recorded in MASIS. MASIS contains detailed information on 67 percent of the capital assets reported in the financial statements. Details regarding the remaining capital assets are recorded in other departmental information systems. The highlighted values ($9.3 billion in machinery and equipment; $22.6 billion for ships, aircraft and vehicles; and $4.4 billion for work in progress) are included in the audit scope.

Annex C provides an overview of the departmental process to account for capital assets throughout their lifecycle.

[11] Capital leases were excluded based on materiality, and because policies and procedures for recording this type of asset are different than for owned assets.

[12] For example, information relating to buildings and works is recorded in the Realty Asset Accrual Accounting System, while information relating to medical equipment is recorded in Computer Assisted Materiel Management System. The financial statement capital asset values also include repairable items, valued at under $30,000, which are recorded in CFSS, rather than MASIS. For additional information regarding the reporting of repairable items, refer to CRS audit on Audit of Accounting for Capital Assets – Repairable Items, 7050-35, December 2007.

Methodology

The following methodology was used to assess both the method of valuing newly acquired capital assets (off-the shelf direct buys, and constructed or customized capital assets) and the process for confirming the value of existing assets:

- Reviewed relevant departmental policies and guidelines, including the FAM 1020-4, Handbook 201 – Accrual Accounting for Capital Asset in DND, TB capital asset policies, and Canadian generally accepted accounting principles (GAAP);
- Reviewed departmental processes to account for capital assets and WIP;
- Interviewed key departmental stakeholders within the ADM(Mat) and ADM(Fin CS) organizations;
- In total, reviewed 206 capital asset and WIP transactions. Transactions were selected to represent a cross-section of the process and therefore the number of sample items used to review any particular stage in the process varied; and
- Used computer-assisted audit techniques (CAATs) to analyze FMAS and MASIS data to ensure data consistency.

The audit focused on examining processes and the controls in place, rather than using extensive sampling to confirm the accuracy of recorded values. This is consistent with the approach that will be used in a controls-reliant audit.

Findings and Recommendations

Valuation of Capital Assets Under Construction or Newly Acquired

Current controls need to be strengthened to ensure newly acquired capital assets and those under construction are completely and accurately recorded.

Methods of Acquisition

Capital assets can be purchased directly from the vendor (off-the-shelf) or constructed/customized to meet DND-specific requirements, generally as part of a capital project. Based on dollar value, the majority of the Department's capital assets are constructed.

The process to assign a value to constructed equipment includes:

- Tracking direct and indirect costs incurred during the construction period in FMAS and MASIS using WIP accounts;
- Transferring the accumulated value from the WIP account to a detailed asset master record in MASIS when construction is complete and the asset is put in service; and
- Adjusting the capital asset class account in FMAS accordingly.

For direct-purchase assets:

- A WIP account is not required; and
- A detailed asset master record is established in MASIS and the applicable capital asset class account in FMAS is updated at the time of purchase.

Accuracy of WIP Balances

At 31 March 2008, the value of WIP related to capital equipment was $4.4 billion.[13] ADM(Mat) staff certifies that the WIP balances in FMAS:[14]

- Reflect the underlying assets remaining under construction;
- Do not include items that are not to be capitalized (e.g., spares, inventory, furniture, etc.);
- Include all pertinent financial transactions; and
- Are based on transactions that were recorded in accordance with departmental accounting policies and procedures.

[13] The financial statements reported a total WIP balance of $5.3 billion which includes both capital equipment and buildings under construction.
[14] WIP balances are certified at the end of the fiscal third quarter (31 December) and at year end (31 March) by DMG Compt and divisional comptrollers within ADM(Mat).

A standard review process should be established to support this certification as, to date, most groups have focused on ensuring completed (in service) assets have been removed from the WIP account. During the audit, 17 projects with WIP balances totalling $1.1 billion were reviewed. While all in-service assets had been removed from these balances, there was not sufficient confirmation that all relevant costs were recorded, and that only valid capital costs were included.

Among ADM(Mat) divisions:

- Only one division had a documented process in place to ensure all relevant direct and indirect expenditures were included in the WIP balances;
- One reviewed project had not included any indirect salary costs (approximately $30 million at the time of the audit). Using CAATs, it was determined that 71 projects (37 percent) had not included indirect salary costs in the WIP balance. While the full impact can only be determined through detailed review, it is possible that an understatement may have resulted;
- With one exception, there was no evidence that expenditures in WIP were compared to budgeted or total project expenditures to date in order to ensure completeness; and
- One division stated that they were conducting reviews to ensure that non-capital items were not included in WIP; however, these reviews were not documented.

WIP Recorded in Both FMAS and MASIS

The current process requires that WIP be recorded independently in FMAS and MASIS. Because of the duplication of effort and additional manual processing involved, this approach adds complexity, is inefficient, and increases the risk of inaccuracy. Although ADM(Mat)/DMG Compt indicated they reviewed WIP balances in both systems and reconciled those with significant variances, almost half of the total WIP accounts had unreconciled differences. The variances were low dollar value; however, their prevalence reduces the confidence that can be placed in either balance. The SERP project, currently under way, is expected to address this issue by eliminating the requirement to create WIP accounts in both systems.

Documentation to Support Capital Cost

When assets are put in use they are "capitalized" by recording the in-service date, useful life, historical cost and other information on an asset master record in MASIS. For constructed assets, the allocated cost is removed from MASIS and FMAS WIP accounts. In cases where multiple assets are acquired through the same capital project, sometimes over an extended period of time, it becomes more difficult to properly allocate the costs incurred to each constructed asset.

Thirty-eight projects had capitalized assets from WIP accounts during FY 2007/08. Four of these projects (representing 65 percent of the value capitalized) were reviewed:

- For two of the four reviewed projects, sufficient documentation was not available to confirm that a rational methodology had been used to allocate costs and that all costs had been considered.

- In one of these cases, two transport aircrafts were capitalized. A project costing sheet, created only after capitalization had occurred, did not clearly document how the allocation of indirect costs (approximately $20 million per aircraft) had been derived.

Responsibility for documenting capital asset values was unclear. In some cases, the AAO was involved in determining and documenting the allocated capital cost of assets. In other cases this responsibility rested with the project team and the AAO provided little input or review.

Timeliness of Capitalization

More timely capitalization of assets will contribute to the completeness and accuracy of asset values.

Of the 1,839 assets, including betterments,[15] capitalized in FY 2007/08, 28 percent with a combined value of $304 million had been put in service in prior fiscal years. While adjusting entries may have been made to ensure some of these assets were properly reflected in prior year financial statements, it is likely that some understatement of the capital asset balance occurred.

In addition, for assets associated with 64 percent of reviewed projects, capitalization occurred in the correct fiscal year but only after a four- to seven-month delay. Timeliness of capitalization will become increasingly important as the Department moves towards quarterly and monthly financial statements.

Most capitalization transactions from WIP accounts are processed at year-end. In FY 2005/06, 64 percent of these transactions occurred in fiscal period 13 and 14;[16] this increased to 74 percent in FY 2007/08.

Capitalization was delayed for several reasons:

- The in-service date was sometimes not easily determined due to acceptance testing requirements;
- Rather than capitalizing based on incomplete costs, the process was sometimes delayed until final invoices were received; and
- Project teams did not always provide the AAOs with all of the necessary information on a timely basis.

Notwithstanding the preceding factors, implementing processes to encourage prompt capitalization of assets would help balance the workload by reducing the year-end surge, and would increase the in-year accuracy of capital asset records.

[15] A betterment is recorded when costs of $30,000 or more are incurred to significantly improve the performance or useful life of a capital asset, specifically, satisfying at least one of the following conditions: there is a significant increase in the quality or quantity of physical output or performance; or the operating costs are significantly lowered; or the useful life of the asset is extended.
[16] Fiscal periods 13 and 14 are accounting periods, April and May, used for transactions that relate to the FY that ended on 31 March, but were processed after that date.

Recording Direct-Purchase Capital Assets

A portion of the Department's capital assets is purchased directly from vendors. These assets are not customized, and a WIP account is not needed. For these assets, an asset master record should normally be created at the time of purchase[17] and the capital asset balance updated accordingly.

ADM(Mat) funding, or funding from the recipient group, e.g., Chief of the Land Staff or Chief of the Air Staff, can be used to purchase such assets. When ADM(Mat) funding is used, there is little risk that the asset will go unrecorded as the ADM(Mat) procurement officer provides the AAO with the information required to create an asset master record in MASIS. However, when assets are purchased using non-ADM(Mat) funding, better controls are needed to ensure the assets are recorded in MASIS and subsequently included in the financial statements:

- Six purchases, totalling $2 million, included in the audit sample met the capital asset definition, but had not been recorded in MASIS;
- Twenty Remote Operated Vehicles purchased using $2 million non-ADM(Mat) funding had not been recorded in MASIS while identical vehicles purchased with ADM(Mat) funding had been recorded; and
- A level one comptroller estimated that $10 to $12 million in capital assets had been purchased by their group in FY 2006/07 and again in FY 2007/08 which were not recorded as capital assets in MASIS. A regional office within this group had maintained a spreadsheet of all capital asset purchases—$2.7 million in FY 2007/08—but had not forwarded the information to ADM(Mat) for inclusion in MASIS.

Although the DND Handbook 201 – Accrual Accounting for Capital Assets in DND[18] states "…the RC manager who funds a purchase is responsible for informing the source system Office of Primary Interest (OPI) about the asset information," there was no process in place to ensure this occurred when purchases were funded by L1 organizations other than ADM(Mat).

In FY 2007/08, payments over $30,000 by non-ADM(Mat) groups for capital items totalled $181 million. The extent to which this represents unrecorded capital assets cannot be readily determined without examining the details of each purchase.[19] However, based on current procedures, there is a risk that some capital assets are not reported in the departmental financial statements.

Prior to FY 2005/06, ADM(Fin CS) sent a call letter to senior managers reminding them to report any capital assets purchased during the year to the appropriate source system OPI. In support of this, they provided a listing, prepared by ADM(Mat), of the capital assets held by each group, as currently recorded in MASIS. There was no evidence that

[17] As for constructed assets, the asset master record is created when the asset is put in-service. For direct purchase assets, this normally occurs at the time of purchase; however, it can be delayed due to acceptance testing.
[18] Part A of page 13 of 76.
[19] While a payment may exceed $30,000, it may be for multiple items which do not meet this threshold. Also, some of this spending is for repairable spares which are not recorded as standalone capital assets.

this process was followed in the subsequent two FYs. ADM(Fin CS) year-end instructions do identify the requirement to report capital asset information to ADM(Mat); however, this has not been sufficient to ensure the complete recording of direct-purchase capital assets. A recent ADM(Mat) initiative will require all Senior Executives to sign an annual attestation for material accountability. This attestation could be used as a further means of reinforcing the requirement to ensure all direct-purchase assets are properly recorded for financial reporting purposes.

Recommendations

To increase confidence in the accuracy of WIP balances, strengthen controls by:

- Documenting the process to be used to certify the WIP balance, ensuring it confirms accuracy and completeness;
- Documenting acceptable variance level between MASIS and FMAS WIP; and
- Ensuring that the SERP project addresses inefficiencies and inaccuracies related to the use of two systems. **(OPI: ADM(Mat)/COS(Mat)/DMG Compt)**

To ensure constructed assets are capitalized in an accurate and timely fashion and are adequately supported, provide more detailed guidance regarding:

- Documentation which must be maintained to support the allocation of asset costs, in-service date and useful life; and
- The extent to which AAOs are expected to review this documentation for reasonableness prior to capitalization. **(OPI: ADM(Mat)/COS(Mat)/ DMG Compt)**

To provide greater assurance that all direct-purchase capital assets are accurately recorded in MASIS:

- Annually, provide senior managers with information of assets recorded in MASIS, for which they are the custodian, and require confirmation that no additional capital assets were purchased during the year (potentially in conjunction with the materiel management attestation process). **(OPI: ADM(Mat)/COS(Mat)/DMG Compt in consultation with ADM(Fin CS))**

Valuation of In-Service Capital Assets

More controls are needed to ensure all reported in-service capital assets exist and are appropriately valued.

Over 45,000 capital assets, with a NBV of $14.1 billion,[20] were in service as of 31 March 2008 according to MASIS records. While ADM(Mat) divisional staff certified that this information is accurate[21] there is currently no process in place to confirm with asset custodians that individual assets exist, and that their condition and useful life remain unchanged.

Confirmation of Asset Existence

In many cases, the asset custodian and location cannot be readily identified. For 57 percent of the capital assets, representing 25 percent of the NBV, the asset location was not recorded in MASIS. In addition, 31 percent of the capital assets did not include information that would identify the custodian division (e.g., Director General Maritime Equipment Program Management). This complicates confirming that the asset actually exists for financial statement reporting purposes. With the exception of some large equipment fleets, there was no evidence that ADM(Mat) staff had confirmed the existence of recorded assets prior to certification.

Confirmation of Asset Condition

Asset custodians should confirm, on a regular basis, that the asset condition has not changed more than expected, and that the estimate of remaining useful life remains valid. This is currently not occurring.

The useful life of many of the recorded assets may be reduced as a result of on-going Canadian Forces operations. The impact of use in operations must be factored into the determination of an asset's useful life in order to accurately determine its annual amortization expense.

Several examples were observed where the asset condition was not consistently and accurately considered when certifying the capital asset balance:

- At 31 March 2008, departmental documentation indicated that two Unmanned Aerial Vehicles with a NBV of $2.7 million had been destroyed; however, their asset master records showed they were still in service. The records had not been adjusted because formal approval for write-off had not been received. This caused the capital asset balance to be overstated.
- The value of a specific asset was written-down by $4.6 million to reflect its reduced value due to corrosion. The corrosion was identified in October 2004 but the asset was not written-down until April 2007 (fiscal period 13).

[20] Excluding leased capital assets.
[21] As required by ADM(Fin CS) as part of the process to validate asset information in the annual financial statements.

- No disclosure was made of the reduced value of the same asset due to fire. The fire caused significant damage and rendered the vessel unusable for more than two years.
- The value of a CF-18 aircraft had not been adjusted when parts were removed and placed in inventory. As a minimum the aircraft value should have been reduced by the value of the parts (to avoid double-counting), and if there was no intent to replace these parts, the aircraft value should have been reviewed for reasonableness, given the fact that it was no longer operational.

While departmental policy[22] requires that an asset's value be written down when there is a permanent impairment or when there has been a significant reduction in its value, more guidance is needed as to what is considered significant. Monitoring and oversight must be enhanced to ensure values are adjusted accordingly. Only one write-down was recorded in FY 2006/07 and none in FY 2007/08.

Capital Asset Balance Certification Process

At year-end, ADM(Fin CS) requires that ADM(Mat) staff certify that:

- The FMAS balances have been reconciled to the detailed records maintained in the source system of record (i.e., MASIS);
- The information contained in the source system of record is accurate and complete for the purposes of supporting the balances in FMAS;
- All pertinent financial transactions have been included; and
- The transactions were recorded in accordance with departmental accounting policies and procedures.

Current review processes only ensure the first element of this certification is met, i.e., MASIS detailed records are consistent with the summary FMAS amounts. The remaining elements are currently not being fully addressed.

ADM(Mat) recognizes this weakness, and acknowledged in the May 2008 certification that they could not "ascertain the accuracy of the information in MASIS including asset existence, location and value." The ongoing AFSP initiative is being relied on to introduce the required corrective measures. The initiative to have all Senior Executives complete an annual materiel management attestation could also assist in addressing this issue.

Recommendation

Improve the accuracy and completeness of in-service asset information by:

- Developing a more robust review process which involves the asset custodians and that fully addresses all aspects of the capital asset balance certification (potentially as part of the materiel management attestation process).
  (OPI: ADM(Mat)/COS(Mat)/DMG Compt)

[22] FAM Chapter 1020-4-6 Equipment and Weapon Systems, paragraph 38.

Risk Management and Governance

Risk management is currently applied in an *ad hoc* fashion. More clearly defined roles and responsibilities and better communication among stakeholders are needed to improve the effectiveness of risk mitigation strategies.

Risk Mitigation

In the recently completed Financial Risk Management Framework[23] ADM(Fin CS) staff identified completeness, existence/occurrence, and accuracy/valuation as the three financial risks related to capital asset reporting. Such identification of risks is an essential first step, and should be followed by an assessment of the likelihood and impact of the risks, and the development of appropriate risk mitigation strategies.

DMG Compt has used an informal approach to risk management and has responded to problems as they arose. Risk mitigation efforts have included:

- Raising awareness of common errors through training sessions;
- Revising the WIP Status Report based on problems identified;
- Developing SOPs for staff at the DMG Compt level; and
- Using automated approaches to identify and remedy some data anomalies.

While these efforts have resulted in incremental improvement, a more comprehensive risk-based approach to verification and monitoring of capital asset records must be developed if completeness and accuracy is to be assured. In addition, completing a comprehensive risk assessment may highlight areas where controls are not working as intended (e.g., the certification processes) or where there is duplication of effort (e.g., WIP reviews).

Risk-based Verification and Monitoring

The WIP and asset balance certifications, which ADM(Fin CS) requires ADM(Mat) to complete, are fundamental controls intended to mitigate the risk of incomplete and inaccurate records. While the certifications are signed, they are not yet accompanied by a robust risk-based approach to verification that is required to complete a confident, unqualified certification.

Given the magnitude and diversity of the capital asset population, completing a 100-percent verification is likely not feasible, nor is it the most effective use of resources.

Materiality could be used as initial criteria to prioritize verification efforts. For example:

- Confirming the existence and condition of capital assets with a NBV greater than $1 million would provide coverage of 90 percent of the reported total NBV, while reducing the number of assets to be verified by 97 percent (from 45,539 to 1,388);
- Similarly, reviewing WIP accounts with a balance greater than $10 million (33 percent of total accounts), would provide coverage of approximately 94 percent of total amount of the WIP balance.

[23] ADM(Fin CS) Financial Risk Management Framework, September 2008.

Oversight could be further enhanced by the implementation of CAATs-based continuous monitoring indicators. The following situations, which warrant additional review, were determined using such automated tests:

- For the 4,767 capital assets included in both in the Canadian Forces Supply System (CFSS) and MASIS, less than half had the same quantity on hand in both systems. For 1,582 items, the CFSS quantity exceeded the quantity recorded in MASIS. The financial statements may be understated as a result.
- 265 inventory items in CFSS (with a total value of $126.4 million) have a unit price greater than $30,000, while nine (total value of $28.8 million) have a unit price greater than $500,000. Some, potentially, should be considered capital assets.[24]
- Thirty-seven percent (71 of 191) of active projects at FY 2007/08 year-end did not include any salary costs. This could result in understatement of capital asset values.

Use of information from these or other indicators would assist management to focus on high-risk areas.

Governance

Clearly established roles and responsibilities, and open communication among all stakeholders are two aspects of governance that serve to mitigate risks. With regards to capital asset valuation, improvements could be made in both these areas.

The relative roles and responsibilities of capital project staff, AAOs, divisional comptrollers, and DMG Compt have not been clearly defined. Divisions used varying approaches which led to unclear accountability. For example:

- While AAOs in some divisions were reviewing the WIP recorded costs, other divisions were relying totally on capital project staff for accurate accounting.
- At times, DMG Compt had assumed responsibility for reviewing the WIP balances, leaving the divisional comptrollers unclear as to their role.
- In some cases, capital asset values were determined by the AAO whereas in other cases the AAO simply input the value into MASIS based on information provided by the project team.

In a few cases, the AAO was an integral part of the project team, providing advice on accrual accounting issues. However, for the most part, they were viewed simply as administrative support. Their lack of involvement in the project delayed the transfer of information, resulting in untimely capitalization, and reduced their ability to challenge costing assumptions, to verify that costs were fully substantiated, or to contribute to project status reports. Additional senior management support of the AAO role is warranted.

[24] Inaccurate unit prices may also play a role.

Recommendations

To better manage risks associated with capital asset valuation:

- Implement a risk-based approach to verifying WIP and in-service capital asset balances;
- Develop additional continuous monitoring tools; and
- Conduct a comprehensive risk assessment to determine the sufficiency and appropriateness of current controls. **(OPI: ADM(Mat)/COS(Mat)/DMG Compt in consultation with ADM(Fin CS))**

To enhance capital asset governance processes:

- Ensure roles and responsibilities of all stakeholders are clearly defined and implemented;
- Improve communication between AAOs and capital project teams; and
- Ensure AAOs receive sufficient senior management support to fulfill their role. **(OPI: ADM(Mat)/COS(Mat)/DMG Compt in consultation with ADM(Fin CS))**

Annex A—Management Action Plan

Valuation of Capital Assets Under Construction or Newly Acquired

CRS Recommendation

1. To increase confidence in the accuracy of WIP balances, strengthen controls by:
   a. Documenting the process to be used to certify the WIP balance, ensuring it confirms accuracy and completeness;

Management Action

DMG Compt 4 will meet with the Level Two Comptrollers to document and enforce the use of current WIP procedures and implement a standardized process in ADM(Mat) based on best practices.

OPI: ADM(Mat)/COS(Mat)/DMG Compt **Target Completion Date:** FY 2009/10

Management Action

AFSP will evaluate the short-term processes and assess whether risks are mitigated by effective controls over the next two years. During the second phase of the AFSP (2010-2012), gaps that have been identified will be analyzed and a proposed remediation plan will be put forward. This must include all phases of constructing an asset, from procurement to the in-service process.

OPI: ADM(Mat)/DGMSSC/Mat AFSP Team RM **Target Completion Date:** FY 2011/12

CRS Recommendation

b. Documenting acceptable variance level between MASIS and FMAS WIP; and

Management Action

DMG Compt 4 will establish an acceptable level of variance between MASIS and FMAS.

Note: This issue will be resolved at the source once DND moves to a single instance ERP (current target date is April 1, 2010).

OPI: ADM(Mat)/ COS(Mat)/DMG Compt **Target Completion Date:** FY 2009/10

CRS Recommendation

c. Ensuring that the SERP project addresses inefficiencies and inaccuracies related to the use of two systems.

Management Action

DMG Compt 8 has engaged in MASIS blueprinting of the SERP project in order to address issues resulting from the capital asset audit. DMG Compt 4 will assess the first outcome and all subsequent system tests of the SERP to ensure that inefficiencies and inaccuracies related to the use of the two systems are corrected prior to implementation.

OPI: ADM(Mat)/COS(Mat)/DMG Compt **Target Completion Date:** FY 2009/10
(To liaise with PMO MASIS and SERP Project Team)

ANNEX A

CRS Recommendation

2. To ensure constructed assets are capitalized in an accurate and timely fashion and adequately supported, provide more detailed guidance regarding:
   a. Documentation which must be maintained to support the allocation of asset costs, in-service date and useful life; and

Management Action

DMG Compt 4 will improve the process whereby Level 2 Comptrollers will ensure that each MASIS input template includes an electronic sign-off that states “reviewed by _____________”. A summarized cost breakdown is mandatory and attached to the MASIS input template. Useful Life and In-Service dates are currently mandatory fields to be completed on each template.

OPI: ADM(Mat)/COS(Mat)/DMG Compt **Target Completion Date:** FY 2009/10

Management Action

DMG Compt 7 will explore with DFA the utility of initiating a working group that will include representatives of DFA, DMPP 7 and DMG Compt 4, 7 and 8. The working Group will assess the current situation and propose recommendations to Departmental Senior Leadership to ensure that all capital assets are accurately recorded in MASIS.

OPI: ADM(Mat)/COS(Mat)/DMG Compt **Target Completion Date:** FY 2009/10

CRS Recommendation

   b. The extent to which AAOs are expected to review this documentation for reasonableness prior to capitalization.

Management Action

This recommendation will be addressed under MAP # 6.

ANNEX A

CRS Recommendation

3. To provide greater assurance that all direct-purchase capital assets are accurately recorded in MASIS:

    - Annually, provide senior managers with information of assets recorded in MASIS, for which they are the custodian, and require confirmation that no additional capital assets were purchased during the year (potentially in conjunction with the materiel management attestation process).

Management Action

DMG Compt 7 will explore with DFA the utility of initiating a working group that will include representatives of DFA, DMPP 7 and DMG Compt 4, 7 and 8. The working group will assess the current situation and propose recommendations to Departmental Senior Leadership to ensure that all capital assets are accurately recorded in MASIS.

On 14 April 2009, DFA in ADM(Fin CS) issued a memo for all L1s other than ADM(Mat) to ensure that information on locally managed and acquired equipment and software capital assets is entered into MASIS for FY 2008/09. Spreadsheets were also forwarded by DFA to L1s. These spreadsheets include the following situations:

- Adjustment to opening balances of Capital Asset GL accounts;
- Direct purchase of capital assets or capital leases, betterments, and leasehold improvements;
- Write-downs, write-offs and disposals;
- Completion of capital assets recorded as WIP; and
- Capital assets that have formally been declared surplus.

This initiative was re-established by DFA after being interrupted for FY 2006/07 and FY 2007/08. Furthermore, starting in FY 2009/10, DMG Compt 4 will produce lists of capital assets recorded in MASIS. These lists will be provided to L1s.

OPI: ADM(Mat)/COS(Mat)/DMG Compt **Target Completion Date:** FY 2009/10

Valuation of In-Service Capital Assets

CRS Recommendation

4. Improve the accuracy and completeness of in-service asset information by:

    - Developing a robust review process which involves the asset custodians and that fully addresses all aspects of the capital asset balance certification (potentially as part of the materiel management attestation process).

Management Action

The “Asset Custodian” is responsible for certifying existence and condition of their assets annually. Capital Assets and materiel management policies are being reviewed and additional internal controls implemented where needed. These initiatives will provide Senior Leadership with greater asset information in MASIS, but further initiatives will be required as the systems evolve to ensure Senior Leadership receive the best information possible.

OPI: ADM(Mat)/DGMSSC/Mat AFSP Team RM **Target Completion Date:** FY 2009/10

ANNEX A

Management Action

DMG Compt 7 will explore with DFA the utility of initiating a working group that will include representatives of DFA, DMPP 7 and DMG Compt 4, 7 and 8. The working group will assess the current situation and propose recommendations to Departmental Senior Leadership to ensure that all capital assets are accurately recorded in MASIS.

On 14 April 2009, DFA in ADM(Fin CS) issued a memo for all L1s other than ADM(Mat) to ensure that information on locally managed and acquired equipment and software capital assets is entered into MASIS for FY 2008/09. Spreadsheets were also forwarded by DFA to L1s. These spreadsheets include the following situations:

- Adjustment to opening balances of Capital Asset GL accounts;
- Direct purchase of capital assets or capital leases, betterments, and leasehold improvements;
- Write-downs, write-offs and disposals;
- Completion of capital assets recorded as WIP; and
- Capital assets that have formally been declared surplus.

This initiative was re-established by DFA after being interrupted for FY 2006/07 and FY 2007/08. Furthermore, starting in FY 2009/10, DMG Compt 4 will produce lists of capital assets recorded in MASIS. These lists will be provided to L1s.

OPI: ADM(Mat)/COS(Mat)/DMG Compt **Target Completion Date:** FY 2009/10

Risk Management and Governance

CRS Recommendation

5. To better manage risks associated with capital asset valuation:

    a. Implement a risk-based approach to verifying WIP and in-service capital asset balances;

Management Action

DMG Compt 7 will provide a sampling extract to DMG Compt 4 to verify WIP and in-service capital asset balances using a risk-based approach.

OPI: ADM(Mat)/COS(Mat)/DMG Compt **Target Completion Date:** FY 2009/10

CRS Recommendation

b. Develop additional continuous monitoring tools; and

Management Action

DMG Compt 7 will provide a sampling extract to ADM(Mat) Level Two Divisions to ensure that expenditures that should be recorded as capitalized assets have been.

OPI: ADM(Mat)/COS(Mat)/DMG Compt **Target Completion Date:** FY 2009/10

ANNEX A

CRS Recommendation

c. Conduct a comprehensive risk assessment to determine the sufficiency and appropriateness of current controls.

Management Action

The objective of AFSP is to ensure risks are mitigated by proper internal controls. AFSP has mapped all the business processes and has contracted an external auditing firm to verify the sufficiency and appropriateness of current controls. Based on their findings, a risk assessment and gap analysis shall be completed by April 1, 2010 and internal controls will be implemented and/or adjusted as required in phase II and phase III of the AFSP.

OPI: ADM(Mat)/DGMSSC/Mat AFSP Team RM **Target Completion Date:** FY 2009/10

CRS Recommendation

6. To enhance capital asset governance processes:

a. Ensure roles and responsibilities of all stakeholders are clearly defined and implemented;

Management Action

This is part of effective internal controls, which is going to be assessed during the second phase of the AFSP (2010-2012).

The roles and responsibilities of certain organizations and positions within ADM(Fin CS) and ADM(Mat) with respect to capital asset accounting will be reviewed under AFSP. AFSP will clearly define who is responsible for all aspects of capital asset accounting during the second phase of the project (2010-2012).

OPI: ADM(Mat)/DGMSSC/Mat AFSP Team RM **Target Completion Date:** FY 2011/12

CRS Recommendation

b. Improve communication between AAOs and capital project teams; and

Management Action

DMG Compt will brief the senior leadership (MGMC) on an annual basis on the role of stakeholders including the AAO. DMG Compt 4 will liaise with Level Two Comptrollers to ensure they are being adhered to.

OPI: ADM(Mat)/COS(Mat)/DMG Compt **Target Completion Date:** FY 2009/10

CRS Recommendation

c. Ensure AAOs receive sufficient senior management support to fulfill their role.

Management Action

DMG Compt will brief senior leadership (MGMC) on an annual basis on the role of the AAO based on lessons learned.

OPI: ADM(Mat)/COS(Mat)/DMG Compt **Target Completion Date:** FY 2009/10

Annex B—Audit Criteria

Objective: To assess the adequacy and effectiveness of the Capital Asset Valuation Process. Specifically that:

Sub-Objective

1. Control activities are adequate and result in complete and accurate asset information.

Criteria

- All capital assets are recorded.
- All recorded capital assets are valid.
- Capital asset values are accurate and sufficiently documented.
- Financial statements are consistent with source systems information.

Objective: To assess the adequacy and effectiveness of the Capital Asset Valuation Process. Specifically that:

Sub-Objective

2. Strategies are in place to identify and remediate areas of risk.

Criteria

- Risks have been adequately identified.
- Controls are in place to mitigate risks.
- Controls are monitored and updated on a continual basis.

Objective: To assess the adequacy and effectiveness of the Capital Asset Valuation Process. Specifically that:

Sub-Objective

3. An adequate governance structure is in place.

Criteria

- Policies and procedures are clearly documented and consistent with TB and GAAP.
- Roles and responsibilities are clearly documented, defined and understood.

Annex C—Overview of Capital Asset Valuation Process

There are four main steps to the Capital Asset Valuation Process: Acquisition, Capitalization, In Service and Retirement.

Acquisition. The Department uses two methods to acquire capital assets: direct purchase and internal construction.

The direct-purchase method is typically used when assets are purchased directly from the vendor, do not require modification and can be put into service immediately. Assets purchased under this method are usually lower dollar value items, e.g., non-military motor vehicles. In FY 2007/08, $173 million[25] of departmental capital assets were acquired using the direct-purchase method.

The internal construction method is used to acquire assets that are customized to meet departmental requirements. The majority (by value) of the Department's assets are acquired through internal construction. Projects are established to manage the construction of the asset. The capital portion of the project expenditures accumulate in a WIP account until construction is completed. At the end of FY 2007/08, the Department reported $4.4 billion of WIP related to 191 capital projects[26] for machinery and equipment. ADM(Mat) staff certify the accuracy of WIP balances at the end of the fiscal third quarter (31 December) and at year end (31 March).

Capitalization. When an asset is "put in use" (i.e., issued to a first line unit, an operational unit commander, a responsibility centre manager or a contractor), the capital cost of the asset is moved from the WIP account to the appropriate capital asset account. During FY 2007/08, DND capitalized 962 assets (including both direct purchase and internally constructed assets) and completed 363 betterments.[27] Betterments are improvements that increase the useful life or add a new functionality to the asset. The cost of betterments is included in the value of capital assets.

Additionally, post-capitalization transactions are used to record assets which are identified as being in-service but which have not previously been capitalized. In FY 2007/08, 182 assets and 332 betterments[28] were post-capitalized.

In-Service. Assets that are in use are classified as in-service capital assets. In-service assets are subject to amortization based on an estimate of their useful life. At the end of FY 2007/08, the DND records included 45,539 in-service assets with a total NBV of $14.1 billion[29]. While an asset is in service, events may occur that result in a significant decrease in the asset's value or permanent impairment of its functionality. Periodic reviews of the asset are conducted to ensure that the reported value represents the asset's current condition and that write-downs or write-offs have occurred as required. ADM(Mat) staff complete an annually certification of the in-service capital asset balances.

[25] Source: FMAS data for FY 2007/08.
[26] Ibid.
[27] Source: MASIS data for FY 2007/08.
[28] Ibid.
[29] Ibid.

Retirement. Assets are disposed of when they reach the end of their useful life, upon retirement from active service or when they are surplus to operational requirements. The asset's gross value and accumulated amortization will be written-off in the source system. During FY 2007/08, the Department retired 985 assets with a NBV of $22.6 million[30].

[30] Ibid.