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**Grants and Contributions
Expenditure Control
Study**

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Operations Audit Branch

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GRANTS & CONTRIBUTIONS EXPENDITURE CONTROL STUDY

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1.0 INTRODUCTION

On June 1, 1987 the Deputy Minister of the Department of Regional Industrial Expansion (DRIE) directed the Operations Audit Branch to investigate a \$79.9 million overexpenditure of DRIE's 1986/87 Grants and Contributions (Vote 10) Appropriation. The purpose of the study, as outlined in the Terms of Reference (Appendix "A"), was to:

- a) determine the cause of the overexpenditure; and
- b) recommend corrective action that would avoid a recurrence of such a situation in the future.

A detailed project plan was developed and the project team (Appendix "B") conducted a number of interviews in Headquarters and in the Quebec, Ontario and Manitoba Regions of DRIE. Central Agency personnel were also interviewed. The documents reviewed included a range of background papers, authorization documents and project files.

The fieldwork was completed on June 18th, 1987 and a presentation of preliminary facts and findings was made to the Deputy Minister, Associate Deputy Minister and the ADM, Finance, Personnel and Administration (ADM, FPA) on June 24th, 1987. Presentations were also made to the Senior Management Committee and to selected departmental personnel. Subsequently, conclusions were drawn, recommendations were developed and this report was prepared.

The short time-frame available for this assignment made it essential that the project team receive a high level of cooperation from the department. In particular, the finance and program areas ensured that staff and information were made available quickly and effectively. Also, the Office of the Comptroller General of Canada provided senior personnel to serve as advisors to the project team. This cooperation allowed the project team to provide senior management with essential information in a timely manner.

2.0 DEPARTMENTAL PROGRAMS

The Department of Regional Industrial Expansion provides a significant level of financial support to the private sector through a complex and changing mix of programs. Assistance programs range from large, national activities to small local initiatives. In most cases DRIE programs support projects which take place over a period of years, thus establishing the basis for the department's multi-year commitments.

There were 13,951 DRIE projects at various stages of development as of March 31, 1987. Some were at the application/review phase (2766), some at the contract phase (3732) while others were underway (7453). Delivery of these projects, depending on the program, can take place at Headquarters, through one of the regional or district offices, or through a provincial government.

Growth of program activity has been significant in terms of both numbers of projects and total value of offers of assistance that have been accepted by the private sector. In general, this growth has taken place in a period of person-year reductions.

Exhibits 2.1 and 2.2 outline the number of new projects by major program. The annual number of new projects (offers of assistance that have been accepted) has more than doubled over the past five years. This is significant as it is primarily the number of new projects, rather than the dollar value, that creates additional workload. The largest increases are in the Industrial Regional Development Program (IRDP) and the projects under the Economic Regional Development Subsidiary Agreements (ERDA).

Relaxation of the IRDP eligibility requirements in the summer of 1983 caused a significant increase in program activity. In November, 1984, eligibility criteria were made more stringent and the volume of activity tapered off quickly. In the case of the ERDA's, most of the agreements were signed in 1983/84. Since that time, the number of projects supported under the various agreements has grown quickly.

The growth in the dollar value of new project approvals has decreased over the past two years, with the exception of the NEDP projects. The trends of dollar expenditure approvals in Exhibit 2.3 are generally consistent with the trends of project approvals displayed in Exhibit 2.2 with the exception of the Defence Industry Productivity Program (DIPP) and the Economic Regional Development Agreements (ERDA).

EXHIBIT 2.1

DRIE PROGRAM WORKLOAD

NUMBER OF NEW PROJECTS PER YEAR

<u>Fiscal Year</u>	<u>1982/3</u>	<u>1983/4</u>	<u>1984/5</u>	<u>1985/6</u>	<u>1986/7</u>
<u>New Programs</u>					
IRDP	5	354	1,434	885	850
WTID	-	-	35	67	97
ERDA	-	1	114	460	1,106
NEDP	-	-	28	71	132
	<u>5</u>	<u>355</u>	<u>1,611</u>	<u>1,483</u>	<u>2,185</u>
<u>Traditional Programs</u>					
DIPP	87	123	62	48	122
SARDA	253	483	434	625	708
	<u>340</u>	<u>606</u>	<u>496</u>	<u>673</u>	<u>820</u>
<u>Old Programs (Declining)</u>					
EDP	449	481	75	14	2
RDIP	428	396	23	-	-
ILAP	126	106	23	-	-
	<u>1,003</u>	<u>983</u>	<u>121</u>	<u>14</u>	<u>2</u>
<u>TOTAL PROJECTS</u>	<u>1,348</u>	<u>1,944</u>	<u>2,228</u>	<u>2,170</u>	<u>3,007</u>

NOTE: The programs are described in Appendix "E".

exhibit 2.2

NUMBER OF NEW PROJECTS FOR MAJOR DRIE PROGRAMS

NO OF ACCEPTED OFFERS

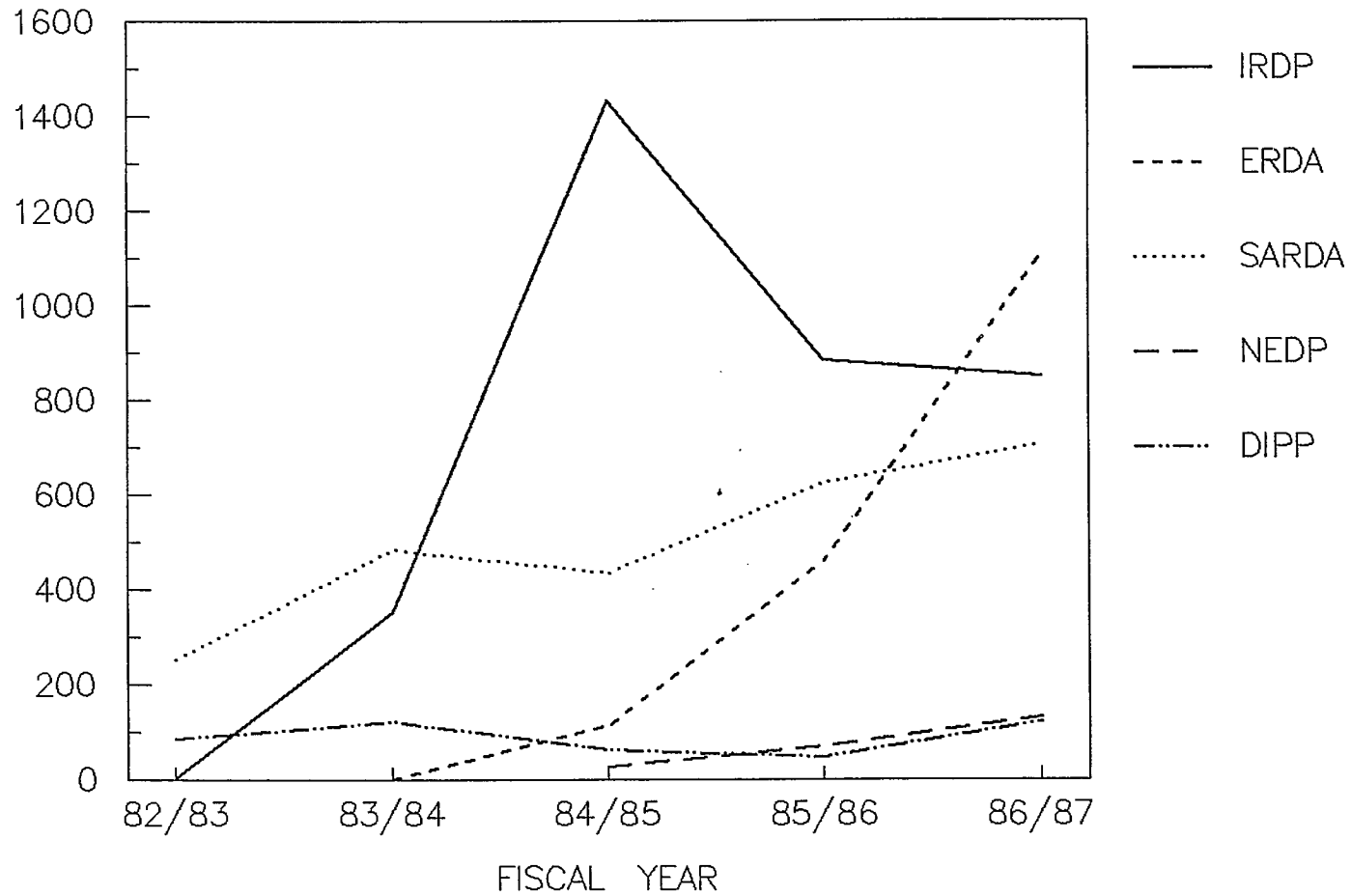
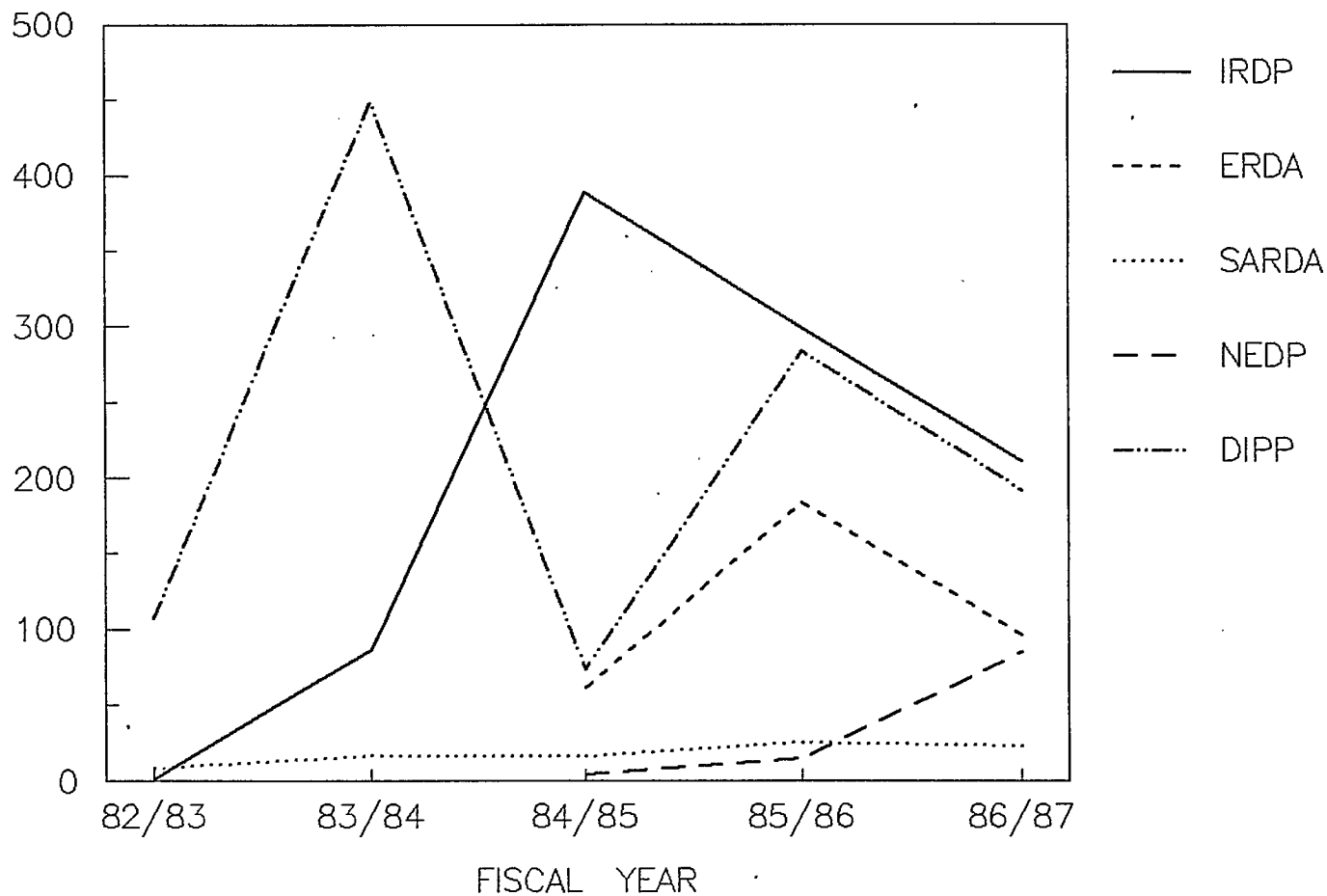


exhibit 2.3

DRIE AUTHORIZED ASSISTANCE FOR NEW PROJECTS

AUTH. ASSIST.



The increase in the DIPP dollar trend line in 1983/84 is primarily due to the approval of assistance for the helicopter program activity (\$267 million). The decline in the ERDA dollar trend line reflects the lower average dollar value of new projects.

These exhibits illustrate the dynamic nature of program management in DRIE. The level of activity can be affected by the introduction of new programs (or the phasing out of old programs), by changes in program regulation, or even by changes in overall economic conditions that affect the size, nature and timing of new project applications.

In addition to regular programs, the department also provides assistance to special projects which arise throughout the year. These are not funded through existing programs but are treated as one-of-a-kind projects. They are often of significant socioeconomic value and can represent large sums of money. The direct involvement of Ministers in these projects tends to accelerate the approval process and care must be taken to ensure adequate budgetary and accounting treatment for each transaction.

Private sector recipients, rather than DRIE project officers, regulate the overall rate of progress for the project. While DRIE may "influence" the company's actions, it does not have direct project control. Project acceleration or slippage (usually the latter) by private sector firms can have a significant impact on the level of DRIE payments in current and subsequent fiscal years. Under current arrangements, the unspent portion of DRIE's Vote 10 appropriation automatically lapses. Hence, project slippage can put unforeseen pressure on later fiscal years.

In summary, DRIE officers function within a complex program structure over which they have limited control. This environment contributed to the lapsing of budget appropriations in years prior to 1986/87 as well as to the overexpenditure in that fiscal year.

3.0 PROGRAM EXPENDITURE MANAGEMENT

Management of program commitments and expenditures in DRIE is a dynamic process that is influenced by the variety of programs, the multi-year nature of commitments, the specific terms and conditions of contribution arrangements and by a heavy dependence on the actions of private sector clients.

The quality of program expenditure management depends on a number of factors. These include:

- clearly defined roles, responsibilities and accountabilities;
- clear and enforceable contract/agreement terms and conditions;
- a well defined and understood budgetary process;
- an effective commitment control mechanism;
- reliable and timely information for monitoring, control and decision making purposes;
- visible senior management attention to the priority of expenditure management; and
- good functional direction and internal communication to ensure that all parties are fully knowledgeable about evolving circumstances.

The first five factors combine to provide an effective **operating framework** for program expenditure management. The last two factors contribute to the **operating environment**. Both are essential to good program expenditure management. The former provides the tools, the latter represents the corporate "will" or priority given to this area of activity.

These issues are discussed in chapter 5.0. However, before reviewing the "framework" and the "environment" that existed in the Department in 1986/87, the facts pertaining to that year's overexpenditure are summarized in Chapter 4.0.

4.0 GRANTS & CONTRIBUTIONS - BUDGETS & EXPENDITURES

4.1 Reference Levels

The 1986/87 Main Estimates provided \$789.0 million for DRIE Vote 10 - Grants and Contributions. During the year, a number of adjustments were made to this amount and the adjusted total at any point in time is referred to as the "Reference Level". (Exhibit 4.1).

Prior to the start of the fiscal year, in April 1986, the department incurred a \$45.0 million program cut as part of government-wide budget reductions. Subsequently, there were further cuts of \$25.4 million in the form of frozen allotments. These amounts, removed from DRIE's budget, were used to affect the funding of projects carried out by other government departments.

Additional funds were approved during the year to accommodate specific projects. A total of \$80.4 million was provided by restoring the program cut of \$45.0 million, releasing the \$25.4 million in frozen allotments and voting an additional \$10 million through Supplementary Estimates.

The adjusted reference level for DRIE Grants and Contributions (Vote 10) at March 31, 1987 was \$799.0 million.

4.2 Internal Budgets

In 1986/87, with the approval of senior management, the department continued its practice of "overbudgeting" to promote full utilization of the grants and contributions appropriation. The use of this technique in DRIE, as in other government departments, operates on the assumption that final spending will be less than the allocated budgets.

Responsibility Centre (R.C.) budgets of \$757.6 million were allocated for 1986/87, on a preliminary basis, in advance of the beginning of the fiscal year based on the approved Reference Levels. Subsequent increases to these budgets resulted in an overbudget of \$36.8 million by March, 1986. The R.C. budgets continued to fluctuate through the year, ending the year (March, 1987) at \$895.2 million, \$96.2 million over the year end reference level of \$799.0 million.

The development and evolution of the overbudget and its significance in terms of the 1986/87 overexpenditure are discussed more fully in Chapter 5.0.

EXHIBIT 4.1
 1986/87 REFERENCE LEVEL
 VOTE 10

		<u>(\$MILLIONS)</u>
1986/87 Main Estimates:		
Grants & Contribution Appropriation		\$ 789.0
Less:		
Program cut (Feb. 1986)		(45.0)
Frozen items		<u>(25.4)</u>
		\$ <u>718.6</u>
Add:		
Released of Program Cut		
(DeHavilland, Baie Verte)		\$ 42.0
(MIL/CN Ferry)		<u>3.0</u>
		45.0
Released from frozen items		25.4
(MIL/CN Ferry)		
MIL/Versatile Restructuring		10.0
(Supplementary Estimates)		
ADJUSTED REFERENCE LEVEL (MARCH 31/87)		<u>\$ 799.0</u>

4.3 Expenditures

The department spent \$878.9 million on Vote 10 - Grants and Contributions in 1986/87. This total includes both cash payments and accruals set up under the Payables-At-Year-End (PAYE) system.

The following table shows that this level of expenditure was less than the internal budgets by \$16.3 million but, due to the practice of overbudgeting, exceeded the approved reference level by \$79.9 million. Hence, the use of the overbudget technique was a significant factor in the 1986/87 overexpenditure.

BUDGET & EXPENDITURES 1986/87

AS AT March 31, 1987
(\$ MILLIONS)

	<u>EXPENDITURE</u> (Includes PAYE)	<u>VARIANCE</u>
Reference Level	\$799.0	\$ (79.9)
Internal budgets	<u>895.2</u>	16.3
Overbudget	<u>\$ 96.2</u>	

Specific expenditures by program and Responsibility Centre are illustrated in Exhibit 4.2.

Internal budgets allocated to each R.C. are detailed by program. R.C. managers are given the flexibility to shift funds between programs within their areas of responsibility, and are held accountable only for the total budget. There were six R.C.'s that overspent their allocated budgets.

Exhibit 4.2

GRANTS AND CONTRIBUTIONS (VOTE 10)
BUDGETS AND EXPENDITURES
1986/87

REGION	IRDP			ERDA			DIPP			CIRB			NEDP			OTHER			TOTAL		
	BUDGET	EXPEND.	VAR	BUDGET	EXPEND.	VAR	BUDGET	EXPEND.	VAR	BUDGET	EXPEND.	VAR	BUDGET	EXPEND.	VAR	BUDGET	EXPEND.	VAR	BUDGET	EXPEND.	VAR
NEWFOUNDLAND	6.5	6.1	0.4	31.3	35.4	(4.1)									19.4	19.3	0.1	57.2	60.8	(3.6)	
P.E.I.	3.0	1.5	1.5	6.0	5.4	0.6											0.0	9.0	6.9	2.1	
NOVA SCOTIA	7.5	4.4	3.1	41.0	21.3	19.7									1.0	0.9	0.1	49.5	26.6	22.9	
NEW BRUNSWICK	46.0	50.7	(4.7)	9.0	8.6	0.4									5.0	4.5	0.5	60.0	63.8	(3.8)	
QUEBEC	84.0	88.6	(4.6)	40.6	37.2	3.4				16.0	21.4	(5.4)			25.4	23.5	1.9	166.0	170.7	(4.7)	
ONTARIO	49.0	49.6	(0.6)	4.5	2.9	1.6				5.0	8.6	(3.6)			6.5	4.0	2.5	65.0	65.1	(0.1)	
MANITOBA	6.2	6.4	(0.2)	22.7	19.0	3.7									8.1	7.1	1.0	37.0	32.5	4.5	
SASK	1.6	1.4	0.2	9.7	7.9	1.8									14.7	13.9	0.8	26.0	23.2	2.8	
ALBERTA	4.9	1.9	3.0	8.5	4.1	4.4									1.6	1.0	0.6	15.0	7.0	8.0	
B.C.	12.1	14.3	(2.2)	12.5	6.4	6.1									5.4	5.2	0.2	30.0	25.9	4.1	
IND. MKTG.	42.0	44.2	(2.2)				164.7	186.9	(22.2)	40.0	43.1	(3.1)			73.8	66.1	7.7	320.5	340.3	(19.8)	
NEDP													40.0	43.3	(3.3)				40.0	43.3	(3.3)
OTHER															20.0	12.8	7.2	20.0	12.8	7.2	
	262.8	269.1	(6.3)	185.8	148.2	37.6	164.7	186.9	(22.2)	61.0	73.1	(12.1)	40.0	43.3	(3.3)	180.9	158.3	22.6	895.2	878.9	16.3
OVERBUDGET																			(96.2)		(96.2)
																			799.0	878.9	(79.9)

5.0 FINDINGS & ANALYSIS

This Chapter explores a number of issues that have been raised in connection with the 1986/87 budget overexpenditure. They are discussed under the following headings:

- ° Environment;
- ° Management Attitudes;
- ° Departmental Systems;
- ° Budgets, Reference Levels and Commitments;
- ° Commitment Control;
- ° Forecasting;
- ° Contract Terms & Conditions;
- ° Major Projects;
- ° Management Reporting; and
- ° Roles and Responsibilities.

Each subsection presents a basic description of the issue, the findings and analysis and a general conclusion as to the nature or extent of its contribution to the overexpenditure.

5.1 Environment

a) Departmental Management

The Department of Regional Industrial Expansion was formed in 1982 through a merger of the former departments of Industry Trade & Commerce and Regional Economic Expansion. Since its creation, there have been three Ministers, six Ministers of State, five Deputy Ministers and five Associate Deputy Ministers. Each new appointment has resulted in varying degrees of organization, policy and systems changes and have inhibited the establishment of a stable operating environment.

b) Financial and Program Information Systems

The department has a consolidated corporate data base (CDB) which contains financial, program and establishment related data. The primary systems linked to the CDB are the Resource Management Accounting System (RAMS) and the Program Resource Information System for Management (PRISM). These systems have been changing constantly since their introduction in 1983/84. In the 1986/87 fiscal year, the modifications continued with the addition of a new PRISM subsystem to monitor the Economic and Regional Development sub-agreements and a new Commitment Forecasting Module (CFM). The latter

system is directly linked to the CDB and replaces the former, stand-alone Operational Planning and Update System (OPUS).

In summary, the systems that provide financial and program information are still evolving and will continue to do so in the changing DRIE environment. However, they were not stable or complete enough in 1986/87 to serve management needs for timely, quality information.

c) Grants and Contribution Expenditures

DRIE has had a history of lapsing against the Vote 10 appropriation. As illustrated in the following table, the gross lapse (the lapse against the original appropriation) has been consistently above 20%. There was an expectation internally, and among central agencies, that lapses would continue to occur despite DRIE's requests for additional funds, many of which were denied. As a result, DRIE's appropriation was increasingly used by the Cabinet Committee on Economic and Regional Development (CCERD) as a secondary policy reserve to fund projects in other government departments. The net lapse (the lapse against the original appropriation less amounts "frozen" by CCERD) remained significant until 1985/86 when there was a substantial reduction.

	LAPSING AGAINST VOTE 10 APPROPRIATION	
	<u>GROSS</u>	<u>NET</u>
83/84	241 million - 24%	225 million - 22%
84/85	197 million - 20%	159 million - 16%
85/86	219 million - 22%	33 million - 3%
86/87		(80) million -(10)%

Over the past two years, the financial environment has started to shift. The department incurred budget cuts of \$345.0 million. In addition, there was growing resistance on the part of Treasury Board (T.B.) to permit the reprofiling of budgets to future years as slippages in forecasted expenditures were identified. The department was also under increasing pressure to fund new initiatives from existing budgets.

These changes started to affect the actions of departmental management. In 1986/87, there was a growing concern over future funding problems by headquarters financial management. However these concerns tended to relate to future years and not to the 1986/87 fiscal year. It was not until September, 1986

that there was any real suggestion of a problem when a year-end deficit of \$13.0 million was forecasted in the August 31 financial report. It rose to \$28.0 million in the following month but the report noted that a "forecast deficit of this amount is not considered too significant as it is within the margin of forecasting error".

In summary, the departmental environment with its frequent managerial organizational and systems changes along with a history of significant lapsing influenced management's attitude towards the priority and need for strong financial management. However, attitudes started to change in 1986/87 and were reinforced by the problems that became evident at the end of the year.

5.2 Management Attitudes

The internal environment focussed priority attention on organizational and operational issues not on financial management. The major lapses over the years convinced management and staff that overspending would be unlikely. Past budgetary lapses caused a year-end push to process as many claims as possible. This push was, in some areas, greater in 1986/87 than it had been in prior years and contributed to the overexpenditure.

The departmental view of resource management can be illustrated by the fact that the department continued to use the financial manuals of predecessor departments and failed to prepare a new manual tailored to the needs of the new department. Also, the finding of a recent survey indicated that there was no felt need in the Department for a new manual. Finally, in late 1985 the Management Committee discontinued the practice of regularly receiving and reviewing Financial Management Reports.

As noted, the importance of financial management, under the pressure of circumstances, gradually shifted during 1986/87. This gave added significance to a number of initiatives including the reestablishment of financial reporting in September, the development of a new Commitment Forecasting Module (CFM) to assist managers in their forecasting activities, the study and issuance of a new directive on cash forecasting, and the commencement of work on the Financial Manual. All of these activities were positive steps but had little impact on the financial results in 1986/87.

The environment and management attitudes had an effect on the way in which information was collected, analysed and reported. Most importantly, it affected the credibility of

the information. Despite warning signals, people did not believe that the potential overexpenditure problem was real. Managers who saw their own budgets as "tight", did not believe that their colleagues would actually spend their full allocation.

In summary, management throughout the department was focused mainly on program delivery, on the development of new programs, on the introduction of organizational changes and on policy development, to the detriment of financial management. This attitude affected significantly the way in which management perceived, and dealt with, the financial pressures which arose during 1986/87.

5.3 Departmental Systems

As noted earlier, DRIE financial and program systems have changed continually since their development in 1983/84. Until recently, they have not been widely accepted or used by management and staff.

Over the past two years, RAMS and PRISM have been the object of several reviews and audits. The first of these was an audit of PRISM conducted by the Auditor General which was reported in 1985. The main thrust of the audit observations centered on the poor quality of data. A number of changes were made in response to these observations, but the problem persisted and became particularly evident during the current departmental review of the 1986/87 overexpenditure.

Post-implementation reviews of RAMS and PRISM also raised the issue of data integrity. The reviews noted that:

- ° RAMS is not able to handle and analyse aggregate commitment information;
- ° improvements are required in the reporting of recoveries and receivables;
- ° data input is not being done on a timely basis;
- ° regional information requirements are not being met; and
- ° data extraction is often difficult.

The issues have been recognized by the department's senior management and action has been taken to address them. A positive step taken on April 1, 1987, was the introduction of a new Commitment Forecasting Module (CFM). This system is explained in greater detail in section 5.5 on Commitment Control.

The Operations Audit Branch is currently auditing the PRISM system to assess the operational and management policies, standards and procedures, to determine the quality of the data and the degree to which the PRISM supports departmental policies and directives. The scheduled completion date for this project is early September.

In summary, the systems that provide information on program activity are only now maturing to a point where they have a greater degree of reliability and acceptance by departmental managers and staff. However, significant problems still exist and the output of departmental systems do not yet respond to the monitoring and decision-making information needs of managers. This has only been accomplished, in recent weeks, through the addition of extensive, temporary, manual methods to supplement the automated systems.

5.4 Budgets, Reference Levels and Commitments

Traditionally, internal budgeting in the department involved calling for a budget from each Responsibility Centre, comparing the total requests to the funds available and subsequently negotiating an appropriate figure with each R.C. The process usually produced budget requests far in excess of funds available.

The process was changed for the 1986/87 fiscal year. The Resource Management Branch in Headquarters allocated "notional" budgets prior to the beginning of the fiscal year based on their knowledge of historic R.C. spending patterns, the total funds available and, in some instances, discussion with R.C. managers. In some cases the notional budgets were subsequently adjusted upward in response to specific requests made by individual R.C.'s and accepted by the ADM, FPA and by senior management.

As noted in Chapter 4, "overbudgeting" was a key technique used by the department in 1986/87 as it had been in earlier years. It is a generally accepted approach to budgeting that encourages a fuller utilization of available funds. It involves the allocation of internal budgets that exceed the actual funds available (approved reference levels). It is an approach that was particularly appropriate to DRIE with its history of lapsing.

A second factor that must be considered is the approved Reference Level which represents the total funding that a department can anticipate for a particular year. It is set well in advance and is subject to change over time to accommodate policy decisions of government.

The final factor, commitments, arises out of the multi-year nature of projects supported by departmental programs. A commitment is a legal obligation covered by a formal contribution agreement (contract). The amount of money that will flow against the commitment in a specific year is based on a forecast. Hence the department refers to the total of these individual forecasts as the "forecasted cash flow based on existing commitments".

The relationship between the internal budgets, the approved Reference Levels and the forecasted cash flow based on existing commitments is quite complex and will be examined in two parts. First, the relationship between the Reference Levels and the internal budgets, including the overbudget will be reviewed. Subsequently the forecasted cash flow based on existing commitments and the Reference Level will be examined.

a) Internal Budget vs Reference Levels.

Prior to the start of the 1986/87 fiscal year, DRIE had a Vote 10 Reference Level of \$789.0 million. In addition, Treasury Board had approved funding of \$22.8 million from their Contingency Vote which brought the total to \$811.8 million. At that time, Responsibility Centre budgets of \$757.6 million had been allocated leaving a surplus of \$54.2 million (Exhibit 5.1).

In February, 1986, the 1986/87 Reference Level was altered by a \$45.0 million program reduction which reduced the surplus to \$9.2 million. Further R.C. budget increases in March resulted in an overbudget of \$36.8 million prior to the start of the fiscal year.

Throughout the year further adjustments took place. The "Adjusted Reference Level" was increased by \$42.0 million in November, 1986 and again in March, 1987 by \$38.4 million for major new projects. The year-end Adjusted Reference Level reflected in the Financial Management Reports was \$824.4 million.

Funds available were affected by a number of T.B. approvals which provided for temporary draws on the Contingency Vote until supplementary monies were voted by Parliament. The approvals for projects which flowed funds in 1986/87 are illustrated in Exhibit 5.1. The amount shown is based on total approvals less the amount reimbursed to Treasury Board as a result of Supplementary Estimates or the restoration of funds that were previously "cut" or "frozen".

EXHIBIT 5.1
DRIE VOTE - 10 OVERBUDGET
1986/87

DATE	ADJUSTED REFERENCE LEVELS* (\$ Millions)	ADD T.B. APPROVAL** (\$ Millions)	(LESS) FROZEN ALLOTMENTS (\$ Millions)	FUNDS AVAILABLE (\$ Millions)	ALLOCATED R.C. BUDGETS (\$ Million)	SURPLUS (OVERBUDGET) (\$ Millions)
JAN./86	789.0	22.8		811.8	757.6	54.2
FEB./86	744.0	22.8		766.8	757.6	9.2
MAR./86	744.0	22.8		766.8	803.6	(36.8)
APR./86	744.0	22.8	6.0	760.8	809.5	(48.7)
MAY /86	744.0	22.8	13.3	753.5	809.4	(55.9)
JUNE/86	744.0	23.5	16.3	751.2	802.4	(51.2)
JULY/86	744.0	23.5	15.8	751.7	802.5	(50.8)
AUG./86	744.0	23.5	22.8	744.7	802.5	(57.8)
SEPT/86	744.0	23.5	23.8	743.7	817.6	(73.9)
OCT./86	744.0	23.5	23.3	744.2	818.6	(74.4)
NOV./86	786.0	37.7	83.3	740.4	818.6	(78.2)
DEC./86	786.0	37.7	80.8	742.9	868.8	(125.9)
JAN./87	786.0	37.7	80.4	743.3	885.2	(141.9)
FEB./87	786.0	38.4	25.4	799.0	885.2	(86.2)
MAR./87	824.4	0	25.4	799.0	895.2	(96.2)

* The Adjusted Reference Level data was extracted from the Financial Management Reports.

** The Approvals represent funding from T.B. Vote 5 Contingency for projects that flowed money in 1986/87. T.B. Vote 5 was reimbursed when departmental funding was made available in November/86 and March/87.

Funds available were also adjusted by frozen allotments. This is a mechanism, used primarily by Treasury Board, to restrict spending in DRIE to accommodate the funding of projects in other government departments or to transfer funds to another Vote through Supplementary Estimates. In November, 1986 there was a large increase in this total to cover an anticipated \$55.0 million expenditure for G.M. Ste-Thérèse. The need for these funds did not materialize and there was a release from the frozen allotment of a similar amount in February 1987. The year-end frozen allotment was \$25.4 million.

Internal budgets allocated to Responsibility Centres were adjusted upwards early in the new year to accommodate a variety of items. The major ones were:

Newfoundland	ERDA Subagreements	-	\$ 6.0 million
Quebec	Petromont	-	\$20.0 million
	IRDP	-	\$20.0 million
	CIRB	-	\$10.0 million
Ontario	CIRB	-	\$ 5.0 million

Throughout the year there were a number of other adjustments such as an additional \$10.0 million for the Native Economic Development Program, \$14.0 million for Enterprise Cape Breton and additional monies for projects where new funds had been obtained. In some cases the increases were partially offset by decreases to other areas. However, the net effect was a continuing increase in R.C. budgets.

Part of the rationale for the overbudget was based on the expectation that further funds would be forthcoming from the CCERD Policy Reserve to accommodate specific projects. The amounts had been approved and funds were to flow to DRIE if the projects took place. These potential resources were added to the approved Reference Levels to produce an "Adjusted Reference Level". This figure therefore overstated the actual Reference Level by an amount that reached a high of \$88.5 million in June of 1986. In the Financial Management Report, the "Adjusted" figure was referred to as "Total Funds Available".

While the potential increases were included in the "Funds Available", no separable allotments were established in Responsibility Centre budgets. In some cases the R.C. budgets were adjusted upward by the appropriate amount at a later date when the funds were actually received.

This treatment of "potential funding" tended to understate the overbudget position, yet it was used as the basis for management reporting. Exhibit 5.2 shows the extent to which the Financial Management Reports understated the overbudget throughout the year.

The overbudget grew from \$36.8 million prior to the beginning of the fiscal year, peaked at \$141.9 million in January 1987, and stabilized at \$96.2 million by the end of the year. R.C. budgets were not adjusted downward with the program cut in February 1986, or when expected funds did not materialize.

In summary, the way in which the overbudget arose at the beginning of the year, its evolution throughout the year and the manner in which it was reported to senior management contributed significantly to the 1986/87 overexpenditure. Further, the absence of any action to downsize the scope of the grants and contributions activity in response to fiscal restraint added to the problems of 1986/87 and subsequent years. This can be illustrated by the fact that projects continued to be approved throughout the 1986/87 fiscal year and these approvals resulted in the flow of \$121.8 million in that year.

b) Commitments vs Reference Levels

The commitments reported throughout 1986/87 were, in effect, the forecasted cash flow arising out of existing project commitments, most of which were entered into in previous years. The relationship between this number and the Reference Level at any point in time provided an indication of budget flexibility. In the years prior to 1986/87, the commitment level has generally been below the Reference Level. However, Exhibit 5.3 illustrates that as the Reference Level was falling, the commitment level (forecasted cash flow) was increasing. In 1986/87, the forecasted cash flow exceeded the Reference Level throughout the year.

In past years, the forecasted cash flow fell significantly at the end of the year as projects slipped and payments were reprofiled into future years. In 1986/87 this drop did not occur. In fact, the level of commitments actually went up at the end of the year.

The impact of a forecasting error in a period of surplus funds is minimal. The impact of the error in 1986/87, however, was significant.

EXHIBIT 5.2
VOTE - 10 OVERBUDGET COMPARISON
1986/87

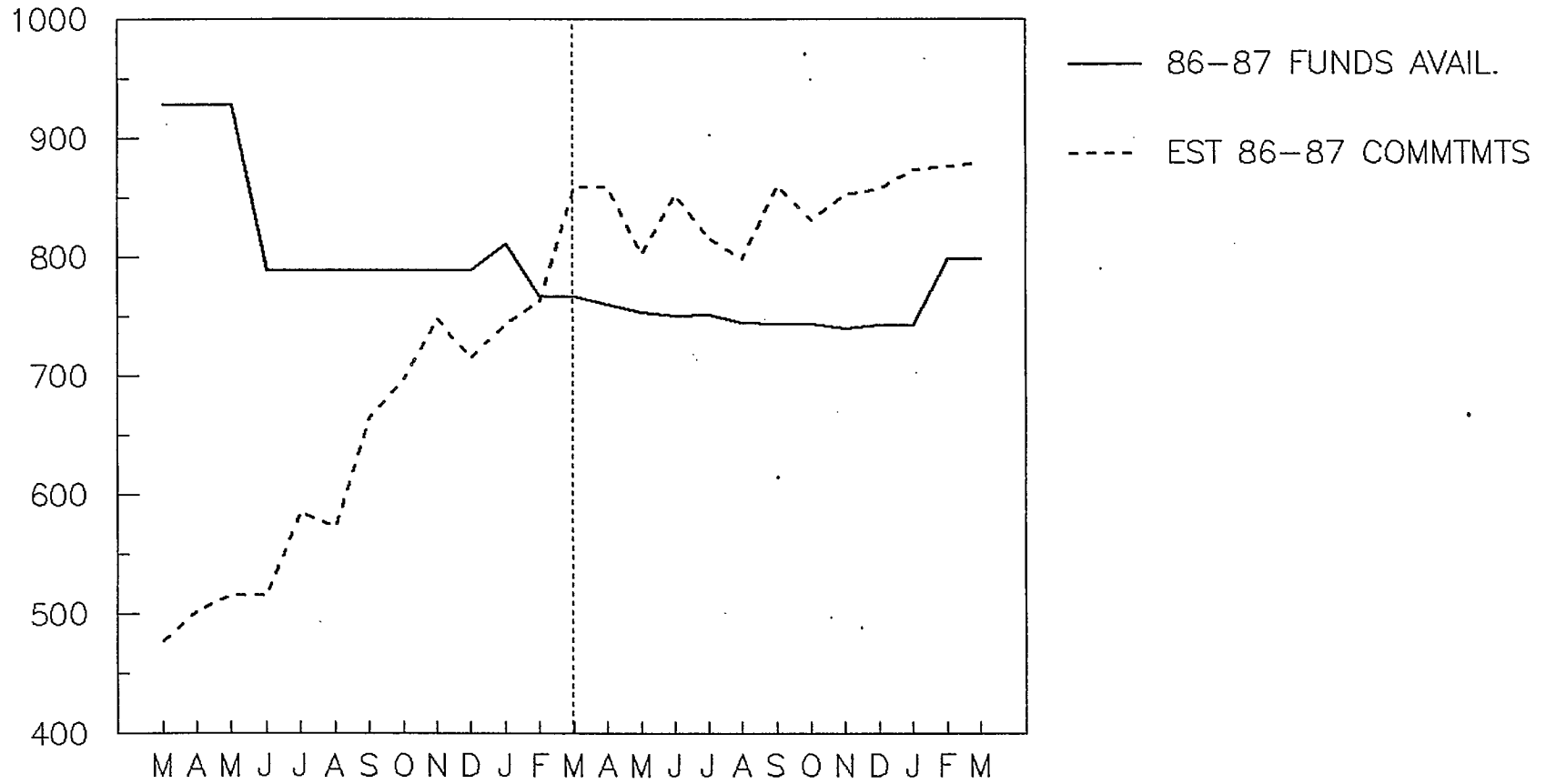
DATE	PER FINANCIAL MANAGEMENT* REPORT (\$ Millions)	PER EXHIBIT 5.1** (\$ Millions)	VARIANCE (\$ Millions)
APR./86	N.A.	(48.7)	N.A
MAY /86	26.2	(55.9)	82.1
JUNE/86	37.3	(51.2)	88.5
JULY/86	(14.2)	(50.8)	36.6
AUG./86	(18.1)	(57.8)	39.7
SEPT/86	(33.2)	(73.9)	40.7
OCT./86	3.1	(74.4)	77.5
NOV./86	(56.8)	(78.2)	21.4
DEC./86	(104.6)	(125.9)	21.3
JAN./87	(121.9)	(141.9)	20.0
FEB./87	(86.3)	(86.2)	0.1
MAR./87	(96.2)	(96.2)	0

* This column represents the overbudget figure extracted from the departmental Financial Management Report.

** The overbudget figures in this column is in accordance with the calculation in Exhibit 5.1.

exhibit 5.3

86-87 FUNDS AVAILABLE / COMMITMENT COMPARISON



Reduced Referenced Levels, combined with increasing commitments, put the department into a higher risk situation than had existed in past years. Such an environment mitigated against the use of the overbudget technique, suggested a requirement for very careful cash management and raised the issue of program downsizing. However, because of the financial information and attitudinal problems noted earlier, it was only at the beginning of the 1987/88 fiscal year that the department was able to recognize the warning signals and act upon them.

5.5 Commitment Control

In 1984, Treasury Board Circular 1984-42 allowed departments greater flexibility in the control over commitments while setting out the minimum systems requirements. DRIE has largely met the basic system requirements, but has fallen short in the quality of the commitment information related to expected cash flows. Problems include delays in the entry of new projects into the system and in the updating of project information. These were aggravated by the existence of a separate, stand alone commitment control and reporting system and the consequent need for the entry of data into both the corporate data base (CDB) and the Operational Planning Update System (OPUS).

The replacement of OPUS on April 1, 1987, with a new Commitment Forecasting Module (CFM) linked directly to the Corporate Data Base, eliminated this duplication. It should now be easier to maintain a current data base. However, this will only happen if management and staff perceive it to be important. Attitude is a critical element to success.

A second issue related to commitment control is the manner in which the data elements are defined. The current definition of commitments includes "year-to-date expenditures", "existing commitments", "in-process commitments" and "planned commitments". The commitment terminology is neither clear nor applied in a consistent manner across the department. Only the term "existing commitments" meets the Treasury Board definition which states:

"only actual undertakings that are expected to result in charges to appropriations should be considered as commitments."

The Directive states further that:

"intentions to enter into arrangements at some future date should not be recorded or reported as commitments.

Any such initiatives must be distinct from commitments."

The commitment control system, while it meets the basic requirements, was not fully effective. The amount of commitments rose to a high risk level in 1986/87 with only a limited response by management. Based on the review to date, the primary problem appears to be the quality and credibility of the data.

5.6 Forecasting

a) The Quality of Forecasts

Forecasting in the DRIE grants and contributions environment is a difficult and imprecise activity at best. However, in recent years, even taking into account the difficulty of the task, the product of internal forecasting had been weak.

The Responsibility Centres have traditionally based budget requests on a forecast of funds required to meet existing commitments and to cover planned new business. While this pattern was repeated in 1986/87, the department was working with a much lower Reference Level due to budget cuts. The R.C. forecasts did not seem to recognize the new fiscal environment. In June, 1986 the combined R.C.'s forecasted spending of \$1,157 million. This total was \$400 million in excess of the approved Reference Level and \$350 million over the internally allocated budgets. The Headquarters forecast at this date was \$814 million, a discount of \$343 million from the R.C. forecast total.

As the year progressed, the forecasts began to improve. By the last quarter the R.C. forecasts were more accurate than the Headquarters forecast (Exhibit 5.4).

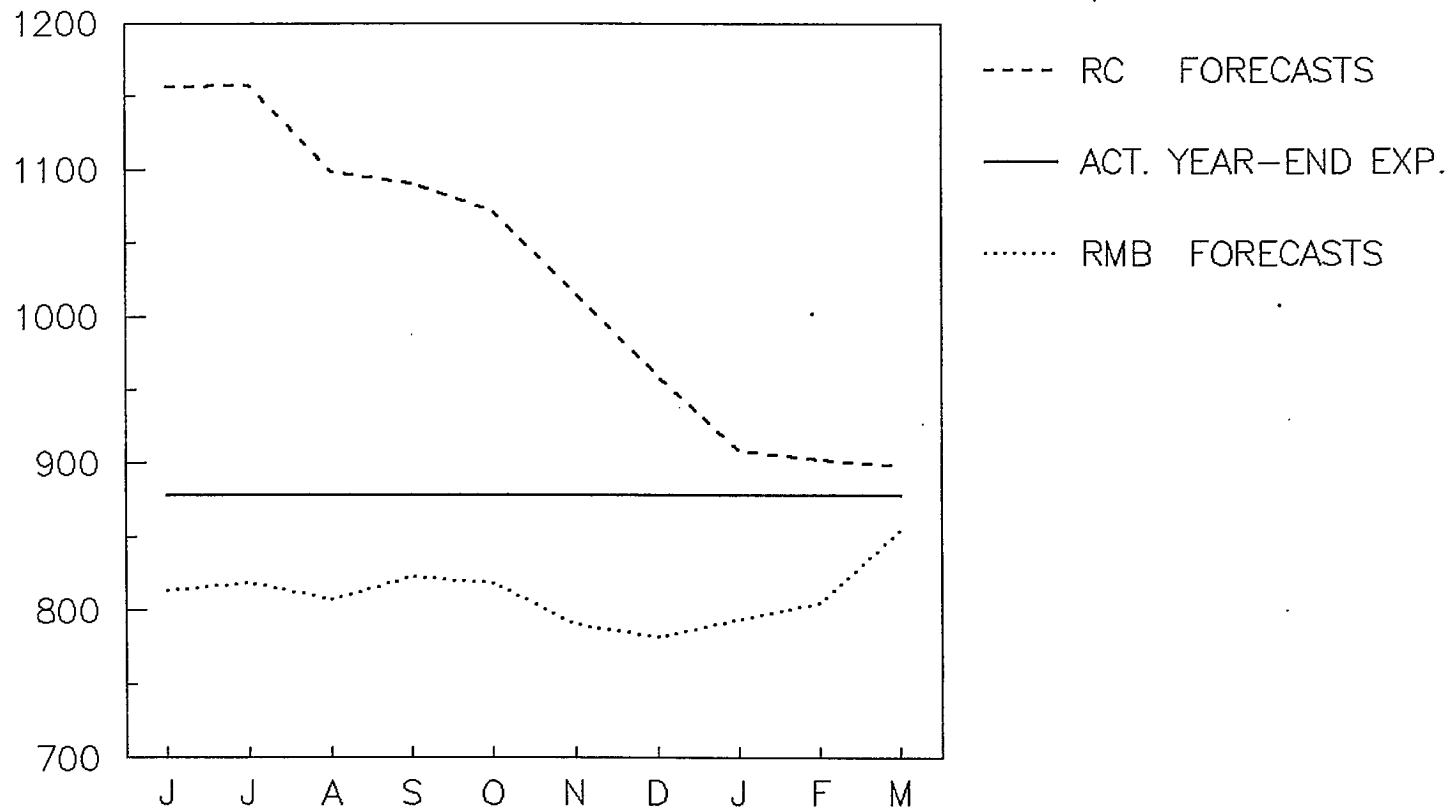
b) Discounting Practices

Initially forecasts are prepared in the Responsibility Centres. The process can vary depending on the mix of programs and projects. Essentially it involves the accumulation of all project spending forecasts by program. Subsequently the total is usually discounted to provide for slippage that is expected to occur.

There is no single approach to discounting. Small projects may be grouped together and a "historic"

exhibit 5.4

VOTE 10 FORECASTS 1986/87



discount factor applied to the total. The forecast spending for large projects is usually assessed on an individual project basis. The discount in these situations could be based on a knowledge of the company, the current status of the industry, the prevailing economic climate in the region or any number of other factors. Final figures are provided to the Resource Management Branch (RMB) in Headquarters. The quality of the forecasts is linked to the quality of project tracking. This has been identified as an area of weakness in recent years.

RMB reviews the forecasts received from the Responsibility Centres and in some cases requests further information or clarification. As noted earlier, R.C. forecasts have traditionally overstated potential spending, despite their discounting process. Hence, RMB provide a further level of discounting at the corporate level. The difference between the R.C. forecast line and the RMB forecast line (Exhibit 5.4) illustrates the extent of the discount. In June, 1986 it was \$343 million. By March, 1987 it had dropped to \$44 million.

Discounting practices at Headquarters have been formally in place for almost two years. The process, and the initial discount factors, were approved by the Management Committee in 1985 to bring some reality to the resource information. The RMB discount factors were based on historic expenditure and lapsing patterns. There were different factors applied to each program and the process recognized that R.C. forecasts improved as the year progressed. The RMB forecasts underestimated the year end spending. This variance ranged from a high of \$113 million in December 1986, to a low of \$40.0 million in March, 1987 and averaged \$84.0 million, close to the final overexpenditure for the year.

The rationale for Headquarters discounting is clear. However, once RMB assumed this responsibility, it tended to reduce or remove R.C. accountability for forecasting. This served to weaken the process and the product. The past year has seen a reversal of this trend and, in some areas, accountability has been enhanced by including the accuracy of expenditure forecasts as a factor in the annual performance appraisal process.

Discounting is a valid technique when applied to the probability of slippage in a large population of projects. It is not an appropriate technique to offset weak R.C. forecasting. Its use by RMB tended to be for the latter reason.

c) Spending Patterns

Forecasts in Headquarters were affected by the spending patterns that were evident for most of the year. Spending in 1986/87 started out at a slower pace than in previous years as illustrated in the following table. There was nothing in the spending pattern to the end of December, 1986 that suggested a problem.

SPENDING PATTERNS
(Cumulative)

	1984/85		1985/86		1986/87	
	<u>\$ Million</u>	<u>%</u>	<u>\$ Million</u>	<u>%</u>	<u>\$ Million</u>	<u>%</u>
Oct.	262.5	33.9	231.1	32.5	213.9	24.3
Dec.	381.8	49.4	333.0	46.9	369.3	42.0
Mar.	610.3	78.9	489.9	68.9	653.2	74.3
P13/14	773.3	100.0	710.6	100.0	878.8	100.0

The "signals" arising out of spending patterns tended to contradict the earlier information on commitments and Reference Levels. The slow pace of spending was noted on several occasions in the Financial Management Reports and seemed to contribute to the conservative spending forecasts being produced by Resource Management Branch.

d) Claims Control

A problem that became evident at the end of the year was the inability of the department to identify the value of claims-in-process. Statements produced on May 5, 1987 included an estimate of 1986/87 overspending of \$46 million. Subsequently, this figure rose to \$79 million. The department did not seem to know the value of claims in the "pipeline" and were unable to forecast accurately. This is an important weakness in the expenditure control framework.

The procedure for handling claims within a R.C. needs to be better defined. In some instances they are logged into a central register prior to being distributed to the appropriate officer for review. In other cases they are distributed directly. In the latter situation, the R.C. has no way of knowing the value of claims on hand that may be charged to the fiscal year. Knowledge of

this figure is essential to the R.C.'s ability to forecast accurately. It would also provide strong substantiation when challenged by RMB on the validity of the forecasts.

e) Payables-At-Year-End (PAYE)

The government operates on a cash system of accounting until the end of the fiscal year. The PAYE system provides for the accrual of accounts payable that are chargeable to the "old year".

In 1986/87 there was \$101.2 million in payables set up under this system. It was suggested that this was a contributing factor to the overexpenditure.

The approach to PAYE in 1986/87 was consistent with previous years and the timing of the cut-off dates was the same. Further, the payables set up in 1986/87 (\$101.2 million) were similar to 1985/86 (\$96.2 million).

It is concluded that the PAYE system had no impact on the overspending in 1986/87.

f) Forecasting Initiatives

In 1986/87 two key initiatives were undertaken to improve internal forecasting. A new computerized Commitment Forecasting Module was developed and a study of cash forecasting resulted in the issuance of a Directive designed to strengthen the process and improve the product. The Directive, distributed in June, 1987, set out the responsibilities and accountabilities of both line and staff officials. These initiatives were positive but, because of timing, had little impact on the 1986/87 fiscal year.

In summary, forecasting in the department has been weak. The use of discounting, while a legitimate technique, was applied in a manner that reduced the overall accountability of line management. In addition, the double discounting increased the risk of error in a year where there was little or no budget flexibility.

5.7 Contribution Agreement Terms & Conditions

The variety of assistance programs, the size and nature of projects and significant differences amongst private sector recipients makes the contribution agreement preparation process quite difficult.

In the past, both provincial governments and the private sector, (particularly the small business community) have criticized the complexity of the DRIE contribution agreements. At the same time, however, audits and other reviews have faulted the terms and conditions of DRIE contracts because of:

- ° a lack of precise project definition;
- ° inadequate requirements for progress and results data;
- ° a lack of adequate cost information; and
- ° a wide variation in the quality of contractual arrangements.

Also, the ability of the department to adequately enforce contribution agreements has also been debated over the years. There have been a number of examples where project milestones were missed by significant periods of time.

In 1984-85 a "use it or lose it" clause was inserted into certain agreements in an attempt to control project slippage that caused delayed claims or payments. In practice, the clause was not used as the delays were often due to factors beyond the control of the company. Enforcement of the clause in such circumstances could be perceived as unfair and may have created a problem for the company.

In summary, difficulties associated with contractual arrangements for federal contributions have existed for a number of years. They affect the ability of the project officer to manage the "corporate client" and accurately forecast the timing of project cash flows. While it is unlikely that the impact of these problems was any greater in 1986/87 than it has been in previous years, it is an issue that warrants further review. Contribution agreements containing the necessary terms and conditions to promote effective departmental monitoring and control are a prerequisite to good project management.

5.8 Major Projects

Major, socioeconomic projects that move quickly from initiation to funds flow have always been a factor in DRIE. Until recently, they have not been a problem as DRIE has had ample budget flexibility to accommodate such ventures.

In 1986/87 there were a large number of these projects under consideration. The September, 1986 Financial Report showed

23 projects valued at \$1,162 million that were either underway or under consideration. Fifteen of these projects had the potential to flow \$193 million in 1986/87. As the year progressed, the status of these projects changed. By March 31, 1987 the list included 33 potential projects valued at \$1,476 million. However, only nine of these were shown as having an impact on 1986/87 for a total of \$109 million.

The changing nature of the major project activity makes it very difficult to forecast. It was suggested that they were a key contributor to the 1986/87 overexpenditure.

A review of major projects over the past year indicated that many projects did not materialize. Further, as noted earlier, in some cases new funding was provided when the project was approved. Others slipped from the 1986/87 fiscal year to 1987/88. In this latter category, the G.M. Ste-Thérèse project was a major factor. It was scheduled to flow \$55.0 million in 1986/87 and a similar amount in 1987/88. However, by the end of the year, the final project approval dictated 1987/88 funding for the full amount.

The only new major projects that resulted in an unexpected draw on existing departmental funds were Petromont (\$20.0 million) and a portion of MIL/Versatile (\$3.5 million).

In addition, there were a number of smaller projects, usually under a million dollars, that were unexpected and drew on existing funds. However, the available information did not permit the team to fully identify these projects nor to compare the total against previous years.

In summary, the major projects did squeeze an already tight resource base and added a factor of uncertainty to financial management. However, they were not a major contributing factor to the 1986/87 overexpenditure. The impact on 1987/88 will be much greater.

5.9 Management Reporting

Resource reporting to the Management Committee was discontinued in late 1985. The decision was based on the results of a management survey that suggested limited interest and/or need on the part of Committee members. Reports continued to go to the Deputy Minister and Associate Deputy Ministers.

In September 1986, formal financial reporting to Management Committee was reestablished. Reports have been submitted to Management Committee on a monthly basis since September 1986. While the information is quite extensive, there are some deficiencies.

- ° All data in the Grants and Contribution section is based on forecasts for total year spending. The only information on actual expenditures, at a point in time, is contained in a brief overview table in the front of the report or in the R.C. summaries in the back of the report.
- ° There are no interim budget milestones that permit actual performance to be measured at a point prior to the end of the fiscal year.
- ° There is no distinction between budget funds received and funds expected, but not yet received.
- ° The Major Initiatives schedule includes both approved projects as well as those that are still under consideration but not yet finalized. This mix can be misleading. Further, it is not clear as to what constitutes a "major initiative".
- ° The report summary tends to be descriptive. It does not focus senior management's attention on key issues that should be reviewed at the Management Committee meeting.
- ° The length of the Financial Management Report makes it an impractical document for review or discussion at a Management Committee meeting.
- ° The distinction between existing and planned commitments is not suitably highlighted.

These observations suggest areas of potential improvement to the format and content of the Financial Management Report. However, prior to making changes, there should be a more detailed review of the information needs of management for monitoring and decision making purposes.

In addition to the form of the Financial Management Reports, the tone of the analysis and recommendations is important. The following section paraphrases the key advice contained in these reports on a monthly basis starting in August, 1986 and continuing to the year-end. It was in August that the first indication of a potential deficit arose.

August, 1986

The report forecast a \$13 million deficit. Both GM/Ste-Thérèse (\$55 million) and Versatile (\$57 million) were included in the forecast (Subsequently G.M. did not flow funds in 1986/87, and new funds were provided for

all but \$3.5 million of the Versatile project). This report also noted that expenditures were running below the pace experienced in previous years.

September, 1986

The deficit forecast was \$28.0 million. This amount was "not considered too significant" and would be "covered through project cash management" if it occurred. The report noted that the department did not have any room to enter new commitments that would result in significant cash flows in 1986/87. Again, the low rate of expenditure was noted.

October, 1986

The forecast moved to a year-end surplus of \$13 million. The change from the previous month was due to the addition of \$10 million to planned Reference Levels in the form of a transfer from the Department of National Defence along with a variety of smaller items. The tight budget situation was again noted along with the fact that spending continued to be below that of previous fiscal years.

November, 1986

The forecast again shifted to a deficit of \$19.0 million due to an expected increase in spending for the Versatile project and "a more conservative approach to forecast discounts applied by the Comptroller". The pace of grants and contributions spending continued to be below that of previous years.

December, 1986

The December forecast was "subjected to a more rigorous review and certain increased requirements for major projects" were factored into the calculations. However, the deficit forecast actually dropped to \$7 million. The rate of spending moved above that of previous years due to large "lumpy" payments.

January, 1987

The deficit forecast moved to \$20 million. The numbers included the G.M. and Versatile projects and noted that if "the G.M./Ste-Thérèse project does not proceed, there could be a surplus at the end of the year." If the project goes ahead "the deficit will be handled through

cash management at the end of the year". This report noted that the rate of expenditures had accelerated due to the large "lumpy" payments.

February, 1987

The movement of the GM payment to 1987/88 reduced the pressure on 1986/87 and resulted in a forecast surplus of \$4 million. While the rate of spending had accelerated, there appeared to be no concern for 1986/87.

March, 1987

The March report, produced on May 5, 1987 forecast a year-end \$46 million deficit. It explained that "the \$50 million difference over last month's forecast is due primarily to increased requirements of \$15.0 million in IRDP, \$14.0 million in DIPP, \$13 million in NEDP and \$5 million in CIRB. Historical discount factors used in previous forecasts appear to have been too high."

This study deals with the 1986/87 fiscal year. As outlined above, the Financial Management Reports did not trigger any alarm bells that indicated a serious year-end position. While deficits were being forecasted and the budget was tight, both the words and the tone of the message suggested that the situation was manageable. It should be noted that while there was no significant worry about 1986/87 until the end of the fiscal year, very real concerns were being expressed about potential problems in 1987/88 starting in the fall of 1986.

The manner in which the reports were received at the Management Committee is reflected, to a degree, in the Agendas and Records of Decision. The Financial Management Reports were generally tabled and accepted with little discussion. On February 10, 1987 there was a quarterly budget review where the Committee decided that the "Grants and Contributions budgets for ADMs/RXD's for fiscal 1986/87 would not be adjusted". There was no concern expressed about potential problems. On April 15, 1987 the 1987/88 Grants & Contributions financial position was reviewed and concern was expressed that "the department was quickly running out of Vote 10... funding for 1987/88".

In summary, there is nothing in the Records of Decision to indicate senior management awareness of the extent of the problem that was developing in 1986/87. The form and tone of the management reports, along with the manner in which the

overbudget was calculated and reported (Section 5.4) therefore contributed to the lack of real concern over the year-end position until it was too late.

5.10 Roles and Responsibilities

The review of roles and responsibilities was limited to an overview of functional guidance in the area of financial management and the accountability for forecasting.

a) Functional Guidance

The overall finance function is concentrated in Headquarters. However, each Regional Office does have financial staff with responsibilities that correspond to those of the Financial Operations Branch and the Resource Management Branch in Ottawa.

Headquarters has responsibility for the development of financial policies and procedures. The Comptroller is expected to provide guidance to the regions but has not been able to exercise direct control. He does not have a role in the selection or appointment of regional financial staff, nor does he participate in the annual appraisal of regional financial managers.

This relationship between Headquarters and regional financial personnel limits the ability of the Resource Management Branch to challenge regional forecasts. Until recently, RMB did not have the direct authority, the influence, or the information to dispute seriously a forecast of a Regional Executive Director or an Assistant Deputy Minister at Headquarters.

b) Accountability

Effective management of the operational and financial aspects of individual projects is the essential starting point to good management of the individual programs and hence, to the overall grants and contributions appropriation. In the past, accountability for these activities has not been clear.

The weak accountability environment has had a particular impact on cash forecasting. While forecasts have been poor in the past, there have been no visible repercussions. The practice of discounting at the corporate level further reduced the accountability, reasonableness and accuracy of R.C. forecasts. The information that received senior management attention

was the discounted figure produced by the Resource Management Branch not the individual R.C. forecasts.

Some Responsibility Centres have now included the quality of forecasting as a factor in the annual employee appraisal but the practice is not yet widespread.

The recent Cash Forecasting Directive sets out the specific roles, responsibilities and accountabilities much more clearly than in the past. The new procedures will strengthen the process and should contribute significantly to the quality of the output.

The subject of roles, responsibilities and accountabilities for financial as well as project/program management may offer scope for further study beyond the overview provided in this report. However, it can be stated that the informal relationship that existed between the Headquarters financial staff, particularly in the Resource Management Branch, and the individual Responsibility Centres, limited the effectiveness of the central challenge function and inhibited the accountability of line managers and regional financial staff.

6.0 CONCLUSIONS & RECOMMENDATIONS

CONCLUSIONS

The 1986/87 overexpenditure of the Vote 10 - Grants & Contributions appropriation by \$79.9 million was caused by the interplay of a number of factors. While it is impossible to measure the precise impact of each factor, the more significant ones are outlined below.

- ° The operating environment and consequent management attitudes resulted in a lower priority for cash flow management than was warranted in a period of increasing risk.
- ° Falling Reference Levels, and the growing level of commitments, made 1986/87 a high risk year. This factor was not fully recognized by senior management and was not reflected in the Financial Management Reports. Hence, there was little or no action taken to downsize the scope of departmental grants and contributions activity in response to fiscal restraint.
- ° Systems weaknesses affected the timeliness and quality of financial and program information and reduced management's ability to identify the seriousness of the problem in time to take corrective action.
- ° The use, and lax control, of an overbudget in this period added to the risk of overexpenditure. Further, the manner in which it was reported to senior management tended to underestimate this risk.
- ° The corporate practice of discounting Responsibility Centre forecasts that had already been discounted, the use of historical discounts factors in a period of rapid change, and the lack of accountability for cash flow management were all factors contributing to the inability of officials to forecast accurately.
- ° Difficulty in determining the value of claims-in-process reduced R.C. managements awareness of the growing problem and limited their ability to respond to the financial information needs at the corporate level.
- ° Major projects, funded from the departmental A-Base, squeezed an already tight budgetary situation.

RECOMMENDATIONS

Recommendations for corrective action cover a broad range of issues. They are grouped under the same general headings as the findings and analysis in Chapter 5. In some instances recommendations are very specific. In other cases they reflect the limited time available to the study team for the planning, fieldwork and analysis phase and suggest a need for further study.

Environment and Attitude

The events of the past several months have altered both the operating environment and the attitudes of senior management and many of the departmental officers. The priority now given to the financial management of grants and contributions should be reinforced.

- 1.0 Senior Management should demonstrate, through actions and decisions, the importance of strong grants and contributions financial management. Reports should be reviewed at least monthly by Management Committee and key conclusions or decisions should be documented and disseminated to program managers.

The attitudes of managers and officers will be influenced greatly by a clear understanding of the prevailing financial situation and the implications for 1987/88 and beyond. This communication must start at the highest level and must reach individual project officers.

- 2.0 The Deputy Minister should advise departmental senior management of DRIE's financial situation for the current and future years. This communication should outline the steps that are being taken at the corporate level and the expected role of R.C. Managers. The managers, in turn, should communicate the same information to their program and project officers along with an assessment of the effect on their Responsibility Centre.

Departmental Systems

The weaknesses in the financial and program information systems, the timeliness and completeness of the information in the system, and the difficulties in responding to the information needs of management affect the on-going utility and reliability of the current departmental systems.

- 3.0 DRIE should undertake a review of information systems and data integrity, building on other studies recently completed or currently underway. The review should focus on the future requirements of the evolving department rather than on the difficulties of the past.

Budgets, Reference Levels and Commitments

The use of the overbudget technique is an acceptable management tool in selected circumstances. However, in DRIE's current environment it creates an unacceptable risk when it is applied in the manner that it was used during 1986/87.

- 4.0 The use of the overbudgeting technique for grants and contributions should be suspended until appropriate action has been taken, in response to this and other reviews, and an acceptable financial control framework has been reestablished in DRIE. Subsequently, the technique of overbudgeting should only be used in selected situations and only after a thorough assessment of the risks has been reviewed by senior management.

Departmental management did not seem to appreciate the fact that the 1986/87 "forecasted cash flow based on existing commitments" had moved significantly above the Reference Level prior to the start of the fiscal year. Further, the potential risk associated with this situation was not fully understood.

- 5.0 The relationship between the forecasted cash flow (based on existing commitments) and prevailing Reference Levels should be tracked for current and future years on an on-going basis. The "risk" should be analysed and reported, at least monthly, to senior management. This data should be used as a key element in the assessment of the department's ability to absorb new initiatives. As well, it should be contained in any request for additional funding from the Policy Reserve.

The multi-year nature of DRIE contribution agreements, the size and uncertainty of some projects, and the heavy reliance on clients over whom the department has limited control makes it very difficult to forecast accurately within the confines of an annual appropriation. It is quite possible that a major expenditure could accelerate or be delayed and result in either an overexpenditure or a lapse that is beyond the control of departmental officials.

- 6.0 Departmental officials should explore, with the Department of Finance and the Treasury Board Secretariat, the possibilities of alternative funding arrangements for Vote 10, Grants and Contributions that would provide some non-lapsing multi-year flexibility especially for major projects where the department's ability to control the flow of funds is limited.

Commitment Control

The lack of credibility of current commitment information, the rapid growth on future-year commitments, and the limits that have been placed on future-year resources suggests the need for strong control over both expenditures and commitments. There is a danger of reprofiling existing commitments to future years and/or structuring new business in a way that avoids current year expenditures difficulties but adds to the problems of future years.

- 7.0 The department should undertake a more detailed review of the adequacy of the commitment control system in place and examine the degree to which the new Commitment Forecast Module will meet the requirements of the new control regime.
- 8.0 Each Responsibility Centre should conduct continuing reviews of the "commitment base" and identify projects where funding can be reprofiled into future years as well as projects that may be in default as a result of non-compliance with the contribution agreement.

The definition of a legal commitment has been blurred in the department through the use of terminology that is not only confusing to departmental officers, but also inconsistent with Treasury Board requirements.

- 9.0 The definition of the term "commitment" should be clarified by the legal advisor. Subsequently, the internal terminology should be modified to ensure a clear distinction between current obligations and future intentions. Finally, the new terminology should be reflected in the Commitment Forecast Module and communicated throughout the department.

The control over future expenditures starts with the delegated authority to enter into commitments. A recent review of delegated signing authorities has been carried out and includes recommendations for strengthening the controls.

- 10.0 The recommendations of the recent report on the Review of Financial Delegations should be implemented.

Forecasting

A major review of grants and contributions cash forecasting was undertaken and a new Directive was issued at the end of May, 1987. Lessons learned from this study, and other review activities related to the overexpenditure, could impact on the contents of the Directive.

- 11.0 The ADM, Finance, Personnel and Administration should review the recent Cash Forecasting Directive and make adjustments in the forecasting process, as required. Further, he should formally ensure that the Directive is implemented. Particular emphasis should be given to the requirement for "certification" of all R.C. systems by the ADM, Finance, Personnel and Administration.

The practice of discounting Responsibility Centre forecasts at the Corporate level, while justified, tends to weaken the process and reduce accountability.

- 12.0 The current practice of central discounting of Responsibility Centre Forecasts should be suspended. Each Responsibility Centre should be held accountable for its own forecasts, with the Corporate financial group in a strong analysis and challenge role. In future, the technique of corporate discounting should be carried out in a more prudent and defined manner and only with the prior approval of the Management Committee.

The lack of reliable information on claims-in-process limits a manager's ability to monitor the performance of an organization and reduces the ability to forecast accurately. This is especially true at the end of the year.

- 13.0 The ADM, Finance, Personnel and Administration should establish guidelines and practices for Responsibility Centres to ensure claims are registered prior to their distribution to project officers for review.

The quality of project management can influence the quality of financial management and financial forecasting. Time did not permit a detailed review in this area, but it appears to be an issue that warrants further investigation. It is particularly relevant at a time when the focus will be on improved management of existing projects rather than on the assessment and delivery of new projects as has been the case in past years.

14.0 A review of current project management practices should be undertaken with a view to establishing minimum standards and guidelines that can be used as part of the accountability process.

Contribution Agreement Terms & Conditions

Lack of control over projects, and the level and timing of the associated cash flows, contributes to the forecasting and cash management difficulties of the department.

15.0 DRIE should undertake a review of the contract terms and conditions that are currently being used in contribution arrangements with a view to enhancing departmental control over project management and cash flow.

Major Projects

Major projects can have a significant impact on spending in both current and future years. Hence they warrant special attention.

16.0 DRIE should define the term "Major Project" and establish a means of tracking all such projects from the initiation phase, through the analysis and approval phases, to project completion. Consideration should be given to the use of internal allotments to control funds associated with these unique and sometimes volatile activities.

Management Reporting

The current Financial Management Reports do not fully meet decision-making requirements of DRIE management, especially in this period of limited resource flexibility.

17.0 The ADM, Finance, Personnel and Administration, in consultation with his colleagues, should restructure the current Financial Management Reports to better meet the information and decision-making needs of all levels of management. Consideration should be given to different levels of reports with a detailed report going to all managers and a much shorter, issue oriented, report provided for review by the Departmental Management Committee.

18.0 Financial Management Reports should clearly distinguish between expenditures, commitments and anticipated activities. They should recognize that, while some

projects may not have reached the legal commitment stage, the funds should be "set aside", perhaps through the use of an internal allotment, until a decision has been taken at the Ministerial or Cabinet level.

Roles and Responsibilities

This subject was examined in the recent Cash Forecasting study. The subsequent Directive established the roles, responsibilities and accountabilities from the Project Officer to the ADM level. This document would provide a useful base to develop a broader statement of roles, responsibilities and accountabilities for all aspects of grants and contributions financial and program management.

19.0 Roles, responsibilities and accountabilities of all parties involved in the financial management of grants and contributions should be better defined and documented. Performance against specific accountabilities should be incorporated into the annual appraisal process.

As part of the definition of roles and responsibilities, the department should strengthen the role of the R.C. financial officers, and formalize the linkage between these positions and the ADM, Finance, Personnel and Administration. This direction and control is important to the maintenance of a strong financial system.

20.0 The department should strengthen the role of the financial officer in the management and delivery of funded programs. Consideration should be given to the options of a strong, clearly defined functional reporting relationship between the R.C. financial managers and the ADM, Finance, Personnel and Administration or a direct reporting relationship.

FINALIZATION OF THE STUDY

This draft of the Grants and Contributions Expenditure Control study will receive limited distribution within DRIE to facilitate a complete review by the key senior managers. Copies are also being forwarded to:

- ° Privy Council Office
- ° Department of Finance
- ° Treasury Board Secretariat
- ° Office of the Comptroller General

The comments of both internal and external reviewers will be considered by the Operations Audit Branch in the preparation of their final report scheduled for mid August.

APPENDICES

- A. TERMS OF REFERENCE
- B. THE PROJECT TEAM

APPENDIX "A"

TERMS OF REFERENCE

APPENDIX "A"

G & C EXPENDITURE CONTROL STUDY

TERMS OF REFERENCE

Purpose

The purpose of the study is to determine the cause of the overutilization of DRIE Vote 10 - Grants and Contributions appropriation and to recommend the type of corrective action required by the department to avoid recurrence of such a situation in the future.

Scope

The study will be restricted to review of the management control framework for the Vote 10 - Grants and Contributions appropriation, and the expenditure patterns of 1986/87. Answers to the questions posed will be largely drawn from:

- the expertise and advice of outside consultants and central agency staff provided to the study;
- interviews of a limited sample of regional, headquarter's operating and financial staff;
- examination of forecasting, commitment and expenditure flows for a sample of major headquarters projects and regional offices.
- the findings of previous studies and reports related to the above questions.

Detailed verification of DRIE's forecasting/commitment/expenditure control system will not be performed in this study.

Issues

We propose a two-part study which will provide answers to the following questions:

A. Why was the 1986/87 Vote 10 Appropriation overutilized?

1. What model was used to establish the reference levels for programs and responsibility centres?
2. What were the actual factors influencing the expenditure patterns for major responsibility centres and programs?
3. To what extent does the budgeting process and assumptions employed reflect the actual nature of expenditure flows?
4. What adjustments occurred to reference levels over the years and how were they accommodated?
5. How do DRIE's management practices affect its ability to effectively manage/control the Vote 10 appropriation? Consider, for example, incentive for budgetary restraint and accountabilities for effective use of budgets.

B. What Action, if any, is needed?

1. Will the existing government and departmental budgetary systems, including current and past directives, prevent future over-utilization of the Vote 10 appropriation?
2. How can any unacceptable risk be minimized in a cost-effective manner?
3. What alternative procedures and management practices may be effectively used?

APPENDIX "B"

THE PROJECT TEAM

APPENDIX "B"

GRANTS & CONTRIBUTIONS EXPENDITURE CONTROL STUDY

THE PROJECT TEAM

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