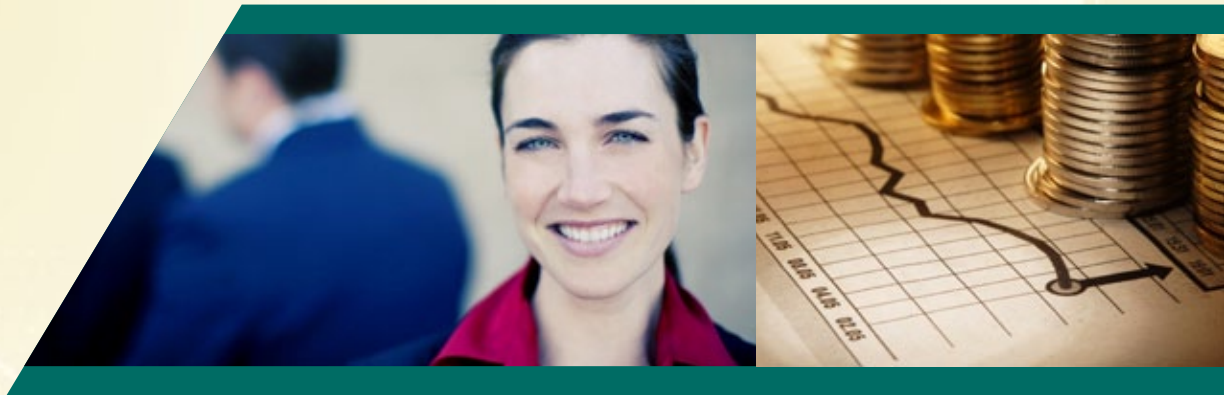


Report 4: August 2010

ASPECTS OF FINANCIAL MANAGEMENT

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The Honourable Bill Barisoff
Speaker of the Legislative Assembly
Province of British Columbia
Parliament Buildings
Victoria, British Columbia
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Dear Sir:

I have the honour to transmit herewith to the Legislative Assembly of British Columbia my 2010/2011 Report 4: Aspects of Financial Management.

John Doyle, MBA, CA
Auditor General

Victoria, British Columbia
August 2010

TABLE OF CONTENTS

	Auditor General's Comments	V
Report 4a	MANAGEMENT OF WORKING CAPITAL BY COLLEGES AND SCHOOL DISTRICTS	1
	Executive Summary	3
	Response From The Government	4
	Summary of Recommendations	5
	Detailed Report	6
Report 4b	YEAR-END GOVERNMENT TRANSFER EXPENDITURES	19
	Executive Summary	21
	Response From The Government	22
	Summary of Recommendations	23
	Detailed Report	24
Report 4c	INFRASTRUCTURE GRANTS	30
	Executive Summary	32
	Response From The Government	33
	Summary of Recommendations	36
	Detailed Report	37
Report 4d	MANAGING FRAUD RISKS IN GOVERNMENT	48
	Executive Summary	50
	Response From The Government	51
	Detailed Report	52

AUDITOR GENERAL'S COMMENTS



JOHN DOYLE, MBA, CA
Auditor General

THE EFFECTIVE MANAGEMENT of working capital is an essential function of any large business enterprise, and governments are no different. The Government of British Columbia receives billions of dollars annually in revenue through taxes and other income streams, and then expends it via payments and grants to organizations and individuals. After funds are received, and before they are expended, it is important that money be managed effectively. Ideally, money should not be dispersed until it is truly needed in order to minimize debt and cost to the taxpayer.

Given the magnitude of funds handled by government, I thought it important to look at how working capital was managed across the whole of the reporting entity. This report brings together four separate projects, three of which relate to the effective management of working capital. While the work was completed based on the 2008/09 fiscal year, I look forward to comparing future results to this benchmark and expect to supply an update later this year. There are also other aspects of working capital which I have yet to consider in detail, as well as other sectors within the Government Reporting entity that I intend to review in the future.

The first project looks at the management of working capital by colleges and school districts. Each year, government provides funds to operate educational institutions and to construct buildings and major equipment. The financial reports published clearly show that an excess of working capital has developed over time which now needs to be addressed.

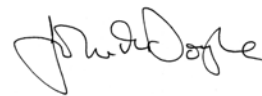
The second project examines year-end expenditures to ensure that the financial management practices and controls being employed are operating consistently year round. Government operates on an annual budget cycle that concludes on March 31st each year, at which point all government entities' unused budgets expire. This can create pressure on organizations, as the fiscal year end approaches, to spend money rather than lose unused portions of their budget.

AUDITOR GENERAL'S COMMENTS

In the third project, we examine the administration of grants provided to communities to fund infrastructure projects. To ensure the most effective use of working capital and greatest return on investment, funds must be provided at the appropriate time – if it is provided in advance of need the monies can languish in bank accounts whilst the cost of borrowing is still a burden on taxpayers. Government must also monitor the use of funds, to ensure that it gets what it pays for when results are delivered through third parties.

The final project in this report addresses the management of fraud risks in central government. Auditing standards require that I explicitly consider the potential for fraud while auditing government's summary financial statements. Fraud prevention is a key management responsibility, and the size and complexity of government means that fraud risks are real and must be managed in a coordinated manner to be most effective. In this project, broad fraud prevention guidelines are put forward that apply not only to central government, but to all public sector organizations.

Government has provided separate responses for each of the four projects. I am pleased that our recommendations have been accepted, and look forward to receiving updates on government's plans for implementation. I would like to thank everyone involved for the cooperation and assistance they provided to my staff during these audits.



August 2010

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Report 4a: August 2010

MANAGEMENT OF
WORKING CAPITAL BY COLLEGES
AND SCHOOL DISTRICTS

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TABLE OF CONTENTS

Executive Summary	3
Response from the Government	4
Summary of Recommendations	5
Detailed Report	
Background	6
Purpose and Scope of the Audit	8
Findings	8
Appendix	
Key Principles for Effective Working Capital Management	17

EXECUTIVE SUMMARY

MANAGING WORKING CAPITAL includes monitoring when cash will be available and required to meet obligations. Good financial management aims to maintain adequate working capital to meet day-to-day operational needs and minimizes the costs and risks associated with holding more working capital than is needed at any one time. By keeping working capital levels within a reasonable range of what is required to operate, government could invest surplus funds to maximize their investment return or use it to reduce its debt.

We looked at government's management of working capital and liquidity in the college (including institutes) and school district sectors, to assess whether working capital is being effectively managed to achieve best value for taxpayers. We focused on colleges and school districts because we had noted that their cash and short-term investment levels were high, relative to their annual expenditures and compared with levels in other government sectors.

Overall, we found that the provincial government is not realizing best value for taxpayers, since it does not ensure that working capital in the college and school district sectors is being effectively managed.

Government does not provide enough direction, nor adequately monitor the costs associated with excessive liquidity across the system. In general, government needs to either strengthen the requirements expected of individual entities, or centralize some aspects of cash management in these sectors in order to improve the management of working capital.

Specifically, we found that:

- Æ The majority of colleges and school districts are holding more cash and short term investments than they need
- Æ Government provides funds to colleges and school districts in excess of their current cash flow requirements
- Æ Cash flow forecasts are not always used to inform investment decisions, and working capital and investment performance in many cases is not actively managed
- Æ The decentralized approach for procuring banking and investing services is likely not achieving best value for government as a whole

RESPONSE FROM THE GOVERNMENT

GOVERNMENT WOULD LIKE TO THANK the Auditor General for his report on management of working capital by colleges and school districts and appreciates the opportunity to provide further comments. Overall, government agrees with the report findings that central agencies, ministries, and the college and school district sectors should strive to strengthen cash management practices.

Government has already initiated reviews and projects related to the Auditor General's recommendations. For example, in May 2009, government directed the Office of the Comptroller General to review the issue of cash management in the education sector and fieldwork was completed in the summer of 2009. Also in 2009, the Ministry of Finance posted a Good Practice Checklist for Investment Governance on its website. The checklist is a guide to assist government organizations with a better appreciation of prudent practices as generally applied in the investment field, and is not intended to be prescriptive, as standards may vary based on the size, nature or objectives of investment funds.

The Ministry of Advanced Education and Labour Market Development routinely monitors and analyzes the financial health of the college sector as part of its annual risk analysis. In his report, the Auditor General identifies certain current ratios and working cash percentages with comparisons to other government organizations including two large commercial Crowns, BC Hydro and the Liquor Distribution Branch. The ministry believes that comparing the relatively smaller college sector to commercial enterprises may not be the most appropriate given the size and nature of these organizations. In addition, due to the rather wide variation within the college sector, one-size-fits-all ratios and percentages are not appropriate as financial needs in smaller institutions can be significantly different from larger colleges or the overall sector average; and institutions with a lower reliance on government funding may require larger cash reserves to offset risks and own-source revenue fluctuations. The ministry will continue to work with the Ministry of Finance and the college sector to determine the best course of action for managing cash resources.

Beginning July 1, 2010, the Ministry of Education will alter the timing of cash disbursements to school districts to mitigate any continuing increase in cash balances. This change was a result of ongoing discussions between the ministry and the education sector to better manage government cash disbursements. Further consultations are planned to establish an appropriate target for working capital.

Other areas related to the recommendations that government is currently reviewing include:

- Æ The existing Government Management and Accountability Framework to ensure ongoing effectiveness as government structures, mandates and priorities evolve;
- Æ The New West Partnership project, part of government's efforts to strengthen links with other western provinces, regarding the potential benefit from aggregating the demand when procuring banking services; and
- Æ Measures to improve matching of operating funding disbursements to actual cash requirements of government organizations and to deploy the use of excess cash for better debt and cash management.

In addressing these governance issues, it should be noted that although government is responsible for financial oversight, school districts and colleges have a degree of autonomy and responsibility with respect to their own finances. The Financial Administration Act limits the Comptroller General's duties and responsibilities with respect to agencies that are not core government ministries. Responsibilities and directions are provided to school districts and colleges through letters of expectations and other written communication.

Government expresses its appreciation to the Auditor General for his continuing work in identifying areas where improvements can be achieved within government organizations and will consider this report's recommendations in connection with government's reviews and projects over the next year.

SUMMARY OF RECOMMENDATIONS

WE RECOMMEND THAT:

- 1** government should review how the accountability frameworks and the mechanisms for delivering funds interact to influence decision making in colleges and school districts around working capital management. The framework should be designed so that appropriate incentives are in place to encourage good working capital management.
- 2** government should pursue opportunities to access and reduce excess liquidity in colleges and school districts. For example, the timing of payments could be aligned with forecasted operating cash flow requirements and excess cash could be deposited with central government in order to improve investment returns or reduce government borrowing costs.
- 3** government should pursue opportunities to improve investment management either by centralizing the management of investments or by providing clear direction and support to colleges and school districts.
- 4** government should consider pursuing opportunities to allow colleges and school districts to share purchasing power and investment expertise they do not all have at present.

BACKGROUND

Cash in a business has several purposes. Standing still is not one of them. Cash is called a liquid asset because it is meant to be easily accessed and used to pay for things or be converted into something else. It is the life blood of any business, including government enterprises. Too little cash can be a problem, of course, but so can too much.

Managing working capital is an important part of any entity's financial management. It involves tracking what payments are currently owed in line with what sources are available to pay those, such as cash on hand and short-term investments. Maintaining small reserves of liquid capital is important to keep operations running, but holding too much imposes an opportunity cost on the business. The best way for an organization to manage its working capital is to understand its past and present patterns of working capital use (including levels of cash), forecast future needs, and then make decisions based on the comfort zone for the business.

At March 31, 2009, government had cash and short-term investments totalling \$7.3 billion. Of this amount:

- ⌘ \$3.7 billion was held by central government;
- ⌘ \$2.7 billion was held in the SUCH sector, composed of school districts, universities, colleges and health authorities (and health societies); and
- ⌘ \$0.9 billion was held by other government entities. (This figure excludes balances held by government business enterprises, which are accounted for by government using the equity method – only the excess of revenues over expenses is consolidated. Government business enterprises generate sufficient revenues from sources external to government to be self-sustaining.)

Our review focused on working capital in the colleges and school districts segments of the SUCH sector, as we had noted that working capital was higher in these entities than in most other parts of government. For example, the college sector had cash and short-term investments equal to 24% (\$0.2 billion) of its annual expenditure (\$1 billion) as at March 31, 2009. Similarly, school districts had cash and short-term investments equal to almost 19% (\$1.0 billion) of their annual expenditures (\$5.4 billion).

By contrast, health authorities and hospital societies held only 7% (\$0.7 billion in cash and short-term investments) of their annual expenditures of \$10.3 billion.

As shown in Exhibit 1, cash and short-term investment levels in colleges and school districts had been trending upwards until 2008 and then declined somewhat in 2009. The forecast for 2010 is another modest decline.

Central government has a significant influence over working capital levels in the province's colleges and school districts

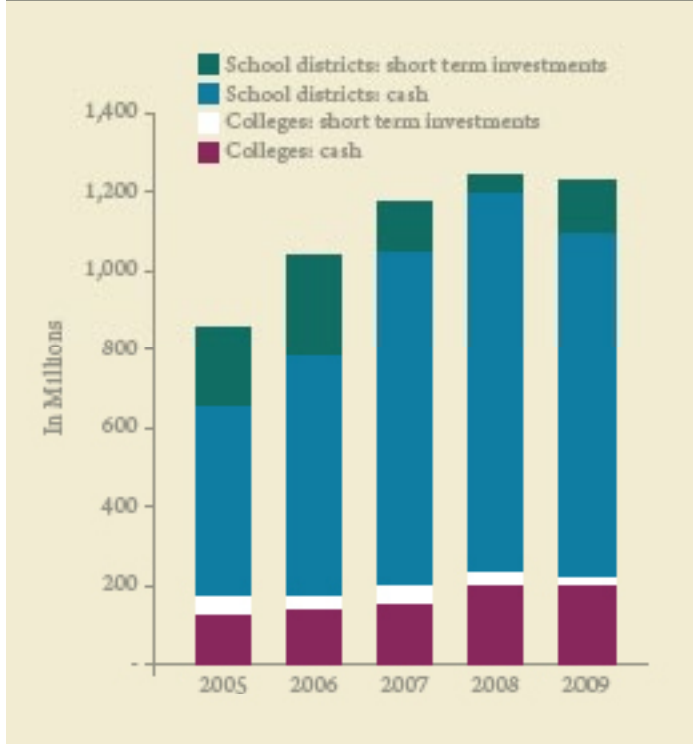
In 1995, our Office published a report titled *Management of Public Debt*. In the report, we concluded that government was properly managing the cash balances of central government (those entities comprising government ministries) in a way that helps to minimize borrowing requirements. Our work then focused on Provincial Treasury processes for planning, managing and reporting on cash surpluses and overdrafts, cash requirements information, borrowing arrangements and existing debt. The key observations made in that report remain consistent with our understanding of how cash and debt are managed today in central government, and the statements of desirable practices in that report remain pertinent today.

Why effective management of working capital is so important

By reducing working capital levels to only what is required to operate, government can improve its overall investment income or reduce borrowings and associated borrowing costs. Reduced working capital levels in government entities also decreases the risk that organizations may incur investment losses or spend in excess of their authorized budget. Achieving balance between working capital on hand with that required to operate in a large and decentralized organization such as government requires effective forecasting, monitoring and coordination.

For working capital on hand, governance and controls over banking and investments should optimize value for money by guiding and monitoring investment practices and the procurement of banking and investment services.

Exhibit 1: Combined cash and short-term investment levels in colleges and school districts for the five years, 2005–2009, ending March 31



Source: Public Accounts SUCH Statement of Financial Position as at March 31

However, the scope of the 1995 report did not extend to the management of working capital in greater government (which includes government entities such as colleges and school districts) and did not contemplate whether the timing of payments from central government to government entities was appropriate.

Provincial funding on average accounts for approximately 60% of the total revenues of colleges and approximately 90% of the total revenues of school districts. Through the mechanism of funding including the timing of payments, government significantly impacts working capital levels in colleges and school districts.

Government provides operating funding to colleges and school districts through bi-monthly transfers. The amount of funding provided is based largely on: for colleges, the instructional capacity of each college and how fully the facility is used; and for school districts, the number of students enrolled.

The total operational funding slated for fiscal 2009 amounted to \$0.5 billion (2010 estimate: \$0.5 billion) for all colleges. The total operational funding budgeted for 2009 in the school districts was \$4.5 billion (2010 estimate: \$4.6 billion).

Government also funds the majority of the capital improvements in these entities and provided capital grants totalling \$37.9 million for colleges and \$288.1 million for school districts for the fiscal year ended March 31, 2009.

Responsibility for the oversight of working capital management in colleges and school districts lies with the Comptroller General, Treasury Board and the entities themselves

Colleges and school districts have been delegated responsibility for the financial management of their organizations, including the management of working capital. However, these entities are accountable to central government, which in turn is responsible for ensuring that financial management for all of government is sound and provides good value for money.

The Financial Administration Act assigns the Comptroller General the responsibility for developing and issuing policies and guidelines for the financial management and recording of government funds. It also assigns the Comptroller General the duty to evaluate financial management throughout the government and recommend to the Treasury Board improvements considered necessary.

The Act also assigns Treasury Board the power to make regulations or issue directives regarding financial management practices. Under the Act, the Minister of Finance may also enter into “offset banking agreements” with savings institutions, government bodies and designated institutions for the efficient management of public money. Offset banking agreements are arrangements whereby the balances of entities’ accounts are offset against the overdrafts and surpluses of central government accounts at the banks government deals with.

There is considerable scope for government to monitor and direct financial management within colleges and school districts as required.

PURPOSE AND SCOPE OF THE AUDIT

The purpose of our review was to look at how well government is managing working capital and liquidity in the province's college and school district sectors, and whether that working capital is being effectively managed to achieve best value for taxpayers. We looked for answers to four key questions:

1. Is government monitoring working capital levels in the college and school district sectors to ensure working capital is being effectively managed?
2. Is government providing adequate direction to colleges and school districts about sound working capital management?
3. Do college and school district entities have appropriate policies in place to guide them in investing excess cash?
4. Are colleges and school districts receiving funding from government only as it is needed?

What We Looked At

We conducted our work in accordance with the assurance standards recommended by the Canadian Institute of Chartered Accountants. Accordingly we included tests and other procedures we considered necessary to obtain sufficient and appropriate evidence to support our conclusions.

We conducted interviews with, and examined documentation provided by staff at Provincial Treasury, the ministries of Education and Advanced Education and Labour Market Development and a representative sample of five colleges. Concurrent with our review, Internal Audit & Advisory Services (the Office of the Comptroller General) performed interviews with school districts to review cash management practices. As a result, we did not conduct formal interviews at individual school districts but instead reviewed the findings of Internal Audit & Advisory Services and also incorporated general (non entity specific) observations we have made over the years through our audit and oversight work at school districts and the annual audit work we conduct on the consolidation of all 60 school districts.

We also reviewed applicable legislation and practice in other jurisdictions, and performed a detailed analysis of financial statements

and other financial information publically available or provided to government by the college and school district sectors.

FINDINGS

The majority of colleges and school districts are holding more cash and short term investments than they need

In both “current ratio” and “working cash percentage” terms, most colleges and school districts have working capital in excess of what they require to operate. *Current ratio is a measure of an organization's liquidity and ability to meet its short-term obligations* — A current ratio greater than 1.0 means that an organization's current assets exceed its current liabilities.

Glossary of Terms

- Æ **Cash equivalents** are a type of investment held to meet short-term cash commitments. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of change in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents
- Æ **Current ratio** is an indication of the ability of an organization to meet its current financial obligations from the liquid assets it has at a point in time. The higher the ratio, the more liquid the entity's assets. The ratio is calculated as current assets divided by current liabilities.
- Æ **Short-term investments** are investments that are capable of prompt liquidation. They include such items as marketable securities, treasury bills, investment certificates and call loans.
- Æ **Working Capital** is calculated by subtracting current liabilities from current assets.
- Æ **Working cash percentage** is an indicator of what portion of an organization's annual expenditures could be funded by cash and liquid investments on hand. The ratio is calculated by dividing the sum of cash, cash equivalents and short term investments by annual operating expenditures excluding amortization (the most significant non-cash expense).

DETAILED REPORT

When determining an appropriate current ratio range for an organization, consideration must be given to the nature of the business as well as the timing of, and certainty over, cash flows. A profit-oriented enterprise with a current ratio of 2.0 is generally considered to have very strong short-term financial strength. However, a current ratio of less than 1.0 does not necessarily signal problems as long as the organization can consistently meet its obligations as they come due. We noted, for example, that both the BC Liquor Distribution Branch and BC Hydro managed to operate with current ratios below 1.0 as at March 31, 2009.

In order to reduce cash on hand and working capital, an organization must be able to accurately predict when and how much cash will be required. In a large self supporting organization like the BC Liquor Distribution Branch or BC Hydro this can be a challenge due to their complexity and uncertainty over revenues needed to fund operations or cash to flow back to government. Colleges and school districts, by comparison, have far greater certainty over their cash flows. Most of their revenues come from regularly scheduled operating grants from central government, and most of their expenditures go to bi-weekly payroll disbursements that are consistent and predictable.

Therefore, except for some seasonal fluctuations in the business – such as tuition fee revenues in colleges – colleges and school districts should be able to operate with a current ratio of less than 1.0. We found both sectors having higher current ratios than that.

As of March 31, 2009, colleges and school districts held \$957 million in commercial bank accounts, \$130 million in cash equivalents, \$160 million in short-term investments and \$115 million in long-term investments.

As shown in Exhibit 2, colleges had an average current ratio of 1.42 at March 31, 2009. This was in excess of the average current ratio in the health sector but less than the university and school district sectors. School districts had a current ratio of 3.10 as at March 31, 2009 which was well in excess of the rest of the SUCH sector. However, we noted that the current ratio in school districts declined to 2.35 at June 30, 2009 due to seasonal changes in current liabilities.

Exhibit 2: Average working capital in the SUCH sector as at March 31, 2009

	Health authorities & hospital societies	Universities	Colleges	School districts	Total
Cash and cash equivalents	424	442	211	876	1,953
Short-term investments	299	257	29	128	713
Working cash	723	699	240	1,004	2,666
Amounts Receivable	433	138	37	66	674
Prepaid expense and inventory	168	48	10	6	232
Current assets	1,324	885	287	1,076	3,572
Amounts payable and accrued liability	1,208	417	123	299	2,047
Deferred revenue	-	104	79	48	231
Current liabilities	1,208	521	202	347	2,278
Working capital	116	364	85	729	1,294
Current ratio	1.10	1.70	1.42	3.10	1.57
Operating expenses (excl. amortization)	9,808	3,107	978	5,141	19,034
Working cash percentage	7.4%	22.5%	24.5%	19.5%	14.0%

Source: Prepared by the Office of the Auditor General

Exhibit 3: Reduction in working cash if all of the SUCH sector had the same working cash rate ratio as the health sector

	Health authorities & hospital societies	Universities	Colleges	School districts	Total
(\$) Millions	Sensitivity: Working cash				
	If ratio was = Health sector, then working cash would be				
	723	229	72	379	1,403
	Over (under) actual	(470)	(168)	(625)	(1,263)

Source: Prepared by the Office of the Auditor General

The working cash percentage reflects the rate at which cash is consumed, and tells a different story. It measures how much cash is on hand compared with annual operating expenditures, excluding amortization (the most significant non-cash expense). For example, as shown in Exhibit 2, colleges have an average working cash percentage of 24.5%, indicating that many colleges could, in theory, operate for a number of months without any source of revenue. By contrast, Health Authorities are operating with sufficient cash and short-term investments to fund only 7.4% of their annual expenditures (excluding amortization). Later in the report we also note that within each of the college and school districts sectors there is significant variation between individual entities.

As shown in Exhibit 3, if all segments of the SUCH sector had a working cash percentage comparable to the Health Authorities and Hospital Societies, then working cash in the sector could be lower by \$1.26 billion.

Overall, the majority of colleges and school districts are being very conservative in their approach to managing working capital

A need for clear direction - We found that many colleges and school districts appear to be unwilling to accept even minimal liquidity or investment risk and instead opt to hold most or all of their funds in a bank account or in cash equivalents. While this approach does minimize the risk of cash shortages and reduces the administration involved with managing cash flow and investments, it also incurs significant costs, such as foregone investment returns and the opportunity to pay down government debt.

From our observations and discussions with entities, many colleges and school districts seemed to be more concerned about potential

investment losses (no matter how remote the possibility) than about the opportunities they were passing up to improve investment earnings. This may be because the public is more likely to notice news of an actual financial loss suffered by these entities than of a missed opportunity to achieve better investment returns. In the absence of clear direction from government, many colleges and school districts are not actively managing their excess funds to achieve best value.

Ideally, all entities in the SUCH sector should have investment policies to address the balance between acceptable risk and investment returns. We found that two of the five colleges we sampled had developed investment policies and another two were in the process of developing them. We understand that most school districts have formal investment policies, but some do not.

Having an investment policy is only the first step, however. It must be translated into the process of actively managing liquidity and investments.

Advantages of central coordination – Although government organizations are responsible for managing their cash flow and investments without direction or interference from government, this model is not always conducive to good working capital management. Central coordination is required for a large organization such as government. In other jurisdictions such as England and some states in Australia, a higher degree of central control and coordination allows government to consolidate cash and improve the overall efficiency of working capital and debt management right across the system. For example, we noted that the Department of Treasury and Finance in the Government of Western Australia limits the operating cash held by state entities to 5% of budgeted recurring payments (total operating and financing).

Holding more working capital than necessary results in higher interest costs to government and lost investment earnings

Not using excess funds to pay down debt – Income earned on cash and investments in the colleges and school districts averaged 2.19% during the fiscal year ending March 31, 2009. Government's average cost of borrowing for debt issued during the same period was approximately 4.64%. Had the surplus cash and short-term investments held by the colleges and school districts been lower by \$750 million, for example, and been used to reduce borrowings, the cost savings (interest costs net of lost earnings) for 2008/09 would have been about \$18 million.

Not investing excess funds for best value – Had the colleges and school districts deposited their excess cash with government's investment manager to invest they could have earned higher investment returns. Even a one percent improvement in investment returns would translate into significant additional funds for government operations.

Central government uses the British Columbia Investment Management Corporation (bcIMC) (see sidebar) to invest its surplus funds; however, school districts and colleges do not invest with bcIMC. For the fiscal year ending March 31 2009, bcIMC's short term funds earned more than what was earned by school districts and colleges. The bcIMC's Short-term Fund One (ST1) had a return of 2.3%, the Short-term Two Fund (ST2) had a return of 3.2% and the Short-term Bond Fund had a return of 7.5% (10 year return was 5.7%).

As discussed later in this report, much of the cash and short-term investments present in colleges and school districts is not required or used to fund short-term operations. Therefore, for a significant portion of the balances held, investment in funds with a longer investment horizon than a fund like ST1 would likely be appropriate. Investment horizon is the length of time a sum of money is expected to be invested. The investment horizon depends on when and how much money will be needed, and influences the optimal investment strategy. In general, the longer the investor's horizon, the more risk he/she should be willing to accept in order to increase investment returns.

As is being done elsewhere, the British Columbia government should consider placing limits on the level of liquidity permitted in government organizations and either centralize excess cash to reduce borrowings or provide specific guidance with respect to investment of excess cash.

Many colleges and school districts lack the investment expertise that is available to central government. Therefore, providing them with access to pooled funds and expertise could improve investment returns and allow these entities to focus on what they do best: delivering education services. For example, in Alberta an arrangement exists whereby government organizations can place their excess cash into a professionally managed investment fund. This fund is managed to provide competitive interest income while maintaining appropriate security and liquidity over depositor's capital.

The better solution may be to consolidate excess cash so that it can be better managed centrally to improve investment returns or reduce government borrowings. Government organizations could still have access to these funds when required, but in the meantime central management could improve value for government as a whole. This concept is currently applied within central government and at the British Columbia Liquor Distribution Branch where cash is swept daily into central government and at the British Columbia Lottery Corporation where cash balances are swept periodically into central government.

British Columbia Investment Management Corporation: Government's expert investment advisor and fund manager

bcIMC provides fund management services for public bodies and publicly administered trust funds. It does so by offering investment services and investing client funds in public equities, fixed incomes, mortgages, real estate, private placements, currency and infrastructure. Funds are invested based on the client's preferences for liquidity, risk and return with lower risk investments generally having lower returns.

Many bcIMC clients require liquid holdings, and the funds called ST1, ST2 and ST Bond are designed for that purpose. bcIMC's ST1 fund invests in very short-term debt securities issued, insured, or guaranteed by a Canadian government; the ST2 fund invests in short-term government and corporate debt securities; and the Short-term Bond Fund invests in Canadian dollar debt securities issued or guaranteed by the Government of Canada, sovereign governments or supranational entities, provided the non Canadian securities are rated as investment grade by ratings agencies. www.bcimc.com

Government provides funds to colleges and school districts in excess of their current cash flow requirements

Operating funding received is in excess of what is required to meet current cash flow needs

Colleges and school districts are held accountable for expenditures each year in part through their annual audited financial statements, which are prepared on an accrual basis of accounting in accordance with generally accepted accounting principles. Under their governing legislation, colleges are not permitted to incur an annual operating deficit (where expenses exceed revenues) unless an estimate of the liability or expenditure has first been approved by the Minister of Finance and the Minister of Advanced Education and Labour Market Development.

School districts may incur an annual deficit in their operating statement to the extent they have an accumulated surplus from previous years (that is, cumulative expenses cannot exceed cumulated revenues since inception of the school district). School districts may also incur a deficit to the extent that their amortization expense exceeds the amortization of capital grants into revenue (see discussion below).

School districts began recording liabilities associated with employee future benefits and vacation pay for the first time on July 1, 2004, and are permitted to incur a deficit to the extent these amounts were unfunded. Otherwise, the creation of or increases in a cumulative deficit, as well as a deficit reduction plan, must be approved by the Minister of Education.

Financial statements prepared on an accrual basis include expenditures and liabilities for which settlement in cash may not occur for a long time, if at all. For example, long-term employee benefits such as accrued sick time, retiring allowances and post-retirement benefits are reflected in the annual and cumulative surplus or deficit. The financial statements also reflect accrued vacation pay which is typically settled as employees take vacation (a non-cash liability). School districts are permitted to incur a deficit for the unfunded portion of the liabilities associated with employee future benefits and vacation pay as at July 1, 2004. However, when school districts began preparing full accrual financial statements in 2004 (i.e. began recording employee future benefits, vacation pay and

capital asset amortization), government provided \$152 million of funding from 2004 - 2007 to fund these accrual liabilities.

The estimated usage of capital assets is recorded as amortization expense each year independent of when the cash flow associated with purchasing the related asset occurred. Government grants for the purchase of capital assets are amortized to revenue on the same basis as the amortization expense for the related asset (effectively offsetting the related expense). However, to the extent that organizations fund their own capital purchases and amortization expense is not offset by related grant revenues, it reduces the operating surplus (the excess of revenues over expenses). School districts are permitted to incur a deficit to the extent that amortization expense exceeds the amortization of capital grants into revenue. However, colleges must find other sources of revenue (or cost reductions) to offset expense to the extent it is not offset by capital grant revenues. For the year ended March 31, 2009, capital asset amortization expense exceeded capital grant revenues in colleges by \$28 million.

In order to be in compliance with these surplus requirements, colleges, and to a lesser extent, school districts, have to receive funding that is often in excess of what they need to meet current cash flow requirements. Colleges and school districts tend to budget conservatively to reduce the risk of non-compliance with the requirements noted above and, therefore, normally have an operating surplus in each year. However, as colleges cannot incur a deficit in any year, an accumulation of surpluses and working capital can occur.

The Ministry of Advanced Education and Labour Market Development noted that colleges are expected to build reserves in order to contribute towards future capital projects. However, the use of excess funds for capital projects can create budgetary pressure over the longer term as amortization expense erodes an increasing portion of the annual budget with each capital investment made. Colleges must therefore reduce other expenditures or find additional sources of revenue. It is a difficult situation where the level of revenues (and cash inflow) required to meet budgetary requirements can exceed the current cash flow requirements, as many expenditures do not have corresponding cash flows. Although school districts have been afforded more flexibility we note that school districts can also experience budgetary pressures before they experience cash shortages. For example, for the year ended June 30, 2009 two school districts incurred cumulative operating deficits requiring permission from the Ministry, yet both still held cash and cash equivalents exceeding 10% of their annual budgets.

To the extent that these organizations receive funds from government that offset expenditures not associated with current cash outflows, it is cash that often cannot be spent on current operations (as the recording of additional expense may result in a deficit). This cash therefore can accumulate and become trapped. The flexibility afforded school districts to access cumulative surpluses and to incur deficits for some significant non-cash expenditures means that the receipt of funding by school districts can be better aligned with cash outflows as compared to colleges. However, as noted, the majority of school districts and colleges are holding more cash and short term investments than they need to operate.

Colleges and school districts receive their annual operating funding in 24 equal bi-monthly increments. However, cash inflows are not required evenly throughout the year as other cash inflows and outflows are not as evenly distributed. For example, tuition revenues are received by colleges at the beginning of semesters and school districts normally pay teachers over a 10-month period versus a full year. If operating funding payments were adjusted to better match forecasted cash requirements, the overall level of cash throughout a given year could be reduced. This matching approach is currently used for the distribution of capital funding, discussed next.

Funding for capital projects is being deployed only as required; however, proceeds from the disposition of provincially funded assets are being retained by school districts

For major capital projects like the construction or renovation of buildings, colleges and school districts negotiate Capital Project Agreements with their ministries. This allows them to access funds through Provincial Treasury as required. Funds are released to colleges and school districts upon request, but those requests can be put forward only on an as-needed basis to make required payments as the capital projects progress. This is consistent with the principle of good practice whereby funds should only be deployed as required.

There is a problem, however, in dealing with the proceeds of capital dispositions funded by the Province, which are retained until authorized to be spent. We believe this practice has resulted in poor cash management, as capital funds are left on deposit well before they can or plan to be used.

According to the *School Act*, when a school district disposes of a capital asset, the proceeds of disposition must be proportionally allocated between the school district and the Ministry (that is, government) according to their original contributions. However, in practice the portion of the proceeds relating to the Ministry's capital contribution is retained by the school district and is restricted for use on future capital projects with the approval of the ministry. As at June 30, 2009, the total balance of these ministry-restricted capital funds in school districts was \$55 million.

The *College and Institutes Act* provides that a college that disposes of land or buildings must not spend the proceeds of that sale without the consent of the minister. However, the Ministry of Advanced Education and Labour Development has informed us there are currently no proceeds of disposition being held in the college sector.

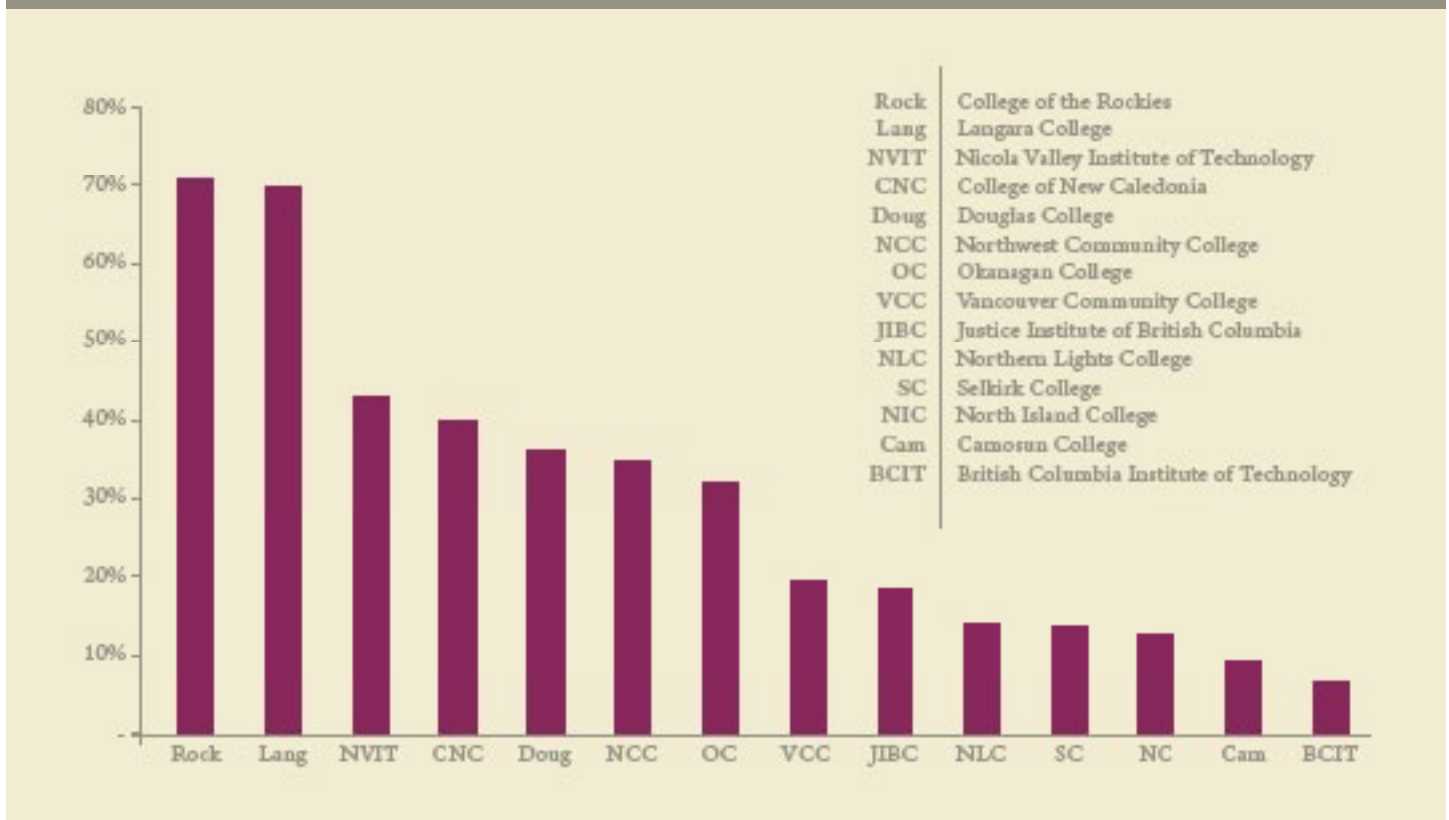
Cash flow forecasts are not always being used to inform investment decisions, and working capital and investment performance in many cases is not actively managed

Given that the majority of colleges and school districts keep cash balances in their operating account in excess of what is required to fund their current operations, cash flow forecasts, in most cases, do not appear to drive decisions regarding what portion of excess cash to invest. There is no penalty attached to holding excess working capital, so the only consequence to colleges and school districts is foregone investment revenue to government.

Cash flow is not the limiting factor for expenditures in colleges and school districts, as they generally hold cash in excess of what they could spend while still complying with restrictions in place over expenditures. Therefore, colleges and school districts appear to focus more heavily on monitoring the accounting results (as this is what they are held accountable for) rather than on determining cash flow requirements or managing working capital.

No benchmarks have been established for appropriate working capital operating ranges or levels in colleges or school districts. The Provincial Treasury has not provided specific targets, as it functions more as an advisor to ministries and government entities. Similarly, we found no specific guidance in the government-wide Core Policy and Procedures Manual, nor have colleges and school districts received specific guidance from their ministries on appropriate levels of liquidity.

Exhibit 4: Working cash percentage for each college in British Columbia, as at March 31, 2009



Source: Audited college financial statements for fiscal year ending March 31, 2009

Our analysis of college and school district financial information revealed significant variations in liquidity across the various entities. Exhibit 4 shows how the working cash percentages for all colleges in the province as at March 31, 2009, range from a high of 71% to a low of 7%. This means that, in theory, some colleges could operate for the majority of a fiscal year without any source of cash inflow and without accessing long term investments, if any. Other colleges have sufficient cash to fund only three to four weeks of operations. This is a significant spread for entities that are performing similar functions indicating that many have cash and short-term investments well in excess of what they require to operate.

Exhibit 5 presents the working cash percentages for the 10 largest school districts in British Columbia (in terms of expenditures). These 10 districts collectively represent 50% of the total expenditures of the school district sector. Although less variation was noted than in the colleges, most school districts have sufficient cash and short-term

investments to operate for two or more months without any source of cash inflow. As most cash inflow is received through scheduled bi-monthly operating grants, holding cash reserves sufficient to fund two or more months of operations is not necessary.

The working cash percentages presented in Exhibits 4 and 5 do not reflect the level of long term investments held, as it is a measure of short-term liquidity. In general, balances in excess of what is required to fund current operations should be invested over the longer term in order to improve investment income.

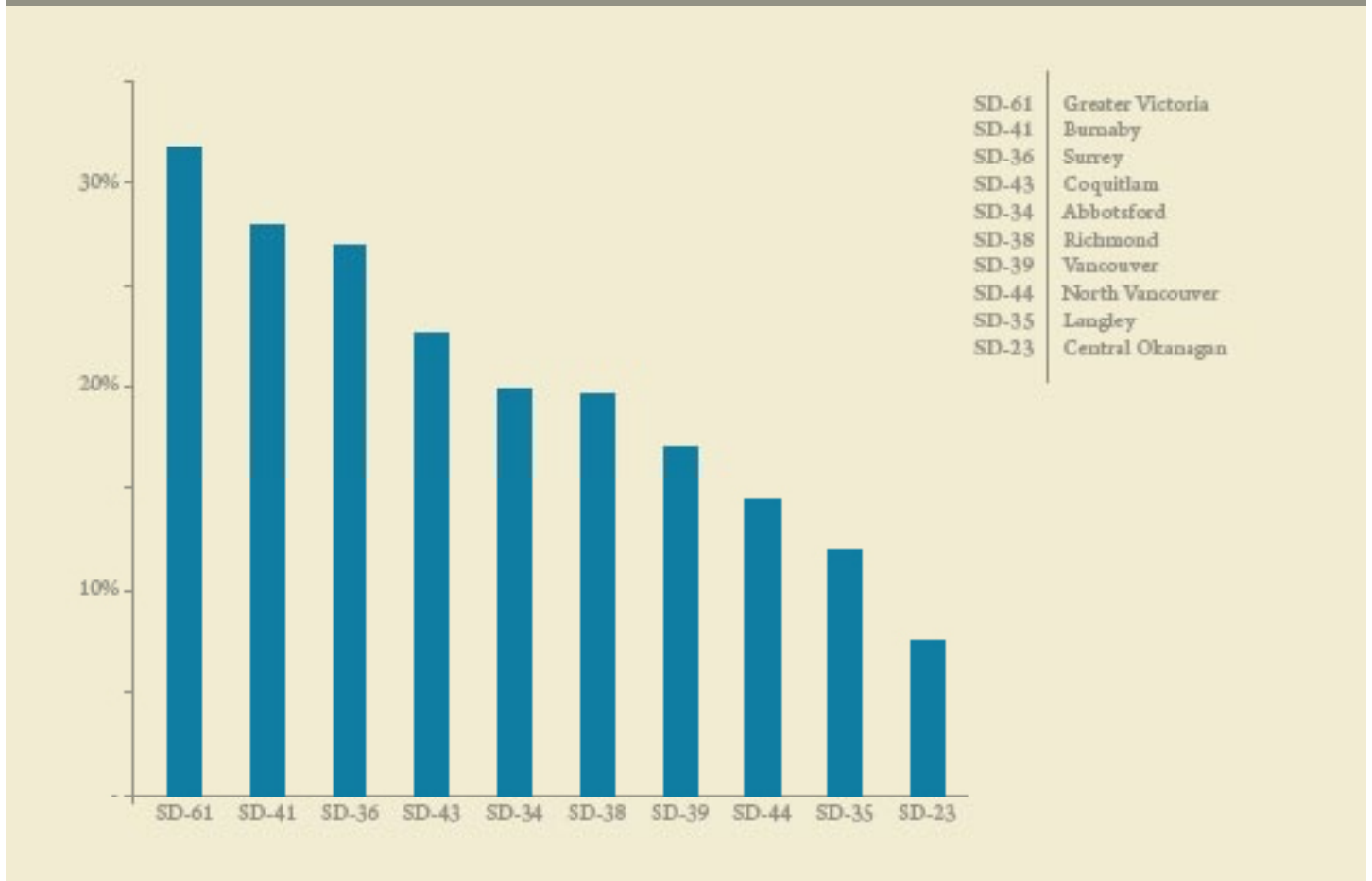
Some colleges and school districts with a low working cash percentage also have significant long term investments indicating more active management of the balance between liquidity and investment performance. However, others with a low percentage have relatively low levels of both cash and investments including long term investments. The right balance should not be the same

DETAILED REPORT

for all; however, given that within each of the college and school district sectors the circumstances are similar we should expect less variability than there is.

As described in the preceding section, the degree to which entities, particularly colleges, can access cash also depends on the amount of non-cash expenses they have. For example, a very capital intensive college may have significant amortization expense, reducing its ability to spend cash relative to other colleges.

Exhibit 5: Working cash percentage for the 10 largest school districts in British Columbia (in terms of expenditures), as at June 30, 2009



Source: Audited school district financial statements for fiscal year ending June 30, 2009

Government regularly monitors and influences some important aspects of financial health and financial management, such as budgeting and capital planning. However, we found that government does not provide clear direction or accountability over how excess cash should be managed. College and school district administrators are experts in and focus their attention on the delivery of education services. Therefore, it is not surprising that in the absence of clear direction and specific accountabilities, there is variability with how working capital is managed.

Some organizations told us that their ability to plan is hindered by uncertainty over certain components of funding. For example, during fiscal 2008/2009, colleges and school districts were notified of changes to their annual facility maintenance funding well into the year. As well, some organizations reported that they sometimes receive unexpected special grants during a fiscal year, which can create difficulty using it, due to the short timeframe required to effectively implement the programs. Lack of certainty over funding weakens planning effectiveness, and can, over time, result in some hoarding of cash to mitigate the risk over uncertain revenues.

The decentralized approach for procuring banking and investment services is likely not achieving best value for government as a whole

Selecting banking services requires analyzing the expected service costs, the compensation paid for free cash balances or investment returns and the reduction of interest costs of overdraft balances. Favourable terms have a positive impact on working capital management.

Each college and school district is responsible for procuring its own banking and investment services. We found that these entities are conscious of the costs involved in banking and therefore move towards changing banking providers when they feel related costs are too high and the service too low. However, the college staff we interviewed were wary of the cost and time involved in making such changes.

Although colleges and school districts use individually competitive procurement processes for banking and investment services, we doubt that they are able to be obtaining overall best value to government. Given the size of government banking requirements, the central coordination of procurement for these services could benefit colleges and school districts substantially.

KEY PRINCIPLES FOR EFFECTIVE WORKING CAPITAL MANAGEMENT

The goal of good cash flow management is to “have the right amount of money in the right place and at the right time to meet the government’s obligations in the most cost effective way”. Achieving this balance in a large complex organization such as government requires a coordinated approach to forecasting, monitoring and the management of working capital.

From our review of best practice guidelines and practice in other jurisdictions, we have compiled key principles to effective working capital management in a large complex organization such as government.

Accountability for effective working capital management

In many jurisdictions, the key mechanism for accountability over financial management is rigorous control over expenditures. This is the case in B.C. and many other jurisdictions. However, accountability over expenditures alone will not encourage good working capital management as it correlates only to cash outflows and does not reflect the cost associated with the pooling of idle cash within the system.

The objectives of cash management should be clearly defined and translated into both policy and accountability and monitoring processes to ensure objectives are being achieved. Achieving this in a large decentralized organization requires a certain degree of central coordination and monitoring. To the extent that responsibility is delegated to government organizations, appropriate accountability mechanisms should be in place to provide the right incentives. For example, the government of Western Australia has a cash management policy whereby a limit on operating working cash in government agencies is determined based on budgeted operating and financing payments. Operating cash in excess of this limit that cannot be explained is recovered by adjustment to future contributions or by transferring excess cash to central government accounts.

Establishing this framework requires careful consideration of what objectives are to be achieved and how to design policies and accountability mechanisms to encourage the desired results. Once in place, frequent monitoring is required to ensure results are consistent with objectives.

Accurate and timely forecasting of cash flows

Forecasting is the government’s ability to predict where and when cash will be coming into government and where and when it will be needed. Good forecasting is essential and requires the government have skilled staff with the right information systems in place to ensure that all its significant cash flows are identified and reasonable predictions of planned expenditures are produced. The more accurately cash flow is forecasted, the greater the reduction to liquidity that can be made. Therefore, the cost associated with holding excess liquidity should be appropriately balanced with the administrative cost associated with increasing forecasting precision. Having stand-by facilities such as a credit line can also reduce the risk associated with potential cash shortages.

Effective working capital management requires high quality forecasting of cash flows across government including departments and government organizations. Therefore, having appropriate accountability over and monitoring of forecast performance is important. As an example, the United Kingdom introduced a system of incentives and penalties to encourage good forecasting. Departments with a poor forecasting record have penalties deducted from their expenditure provisions, which are in effect recycled to those with a better record. The penalties are geared to the extra market cost that the cash managers face in having to borrow or lend at short notice as a result of forecasting errors.

Integration of debt and cash management

The integration of cash and debt management ensures that decisions surrounding the issuance of debt are taken in the context of the government’s overall cash flows. Accurate cash flow forecasting for all of government is key to provide government with the information needed to better match the issuance of debt with system wide cash flow requirements.

Management of receipts and disbursements in order to maximize cash flow

A fundamental principle underlying good cash flow management is to strategically manage cash receipts and disbursements in order to maximize cash flow. This means managing collections to maximize the timeliness and ultimate collection of amounts receivables and managing payments so that liabilities are not paid in advance of the due date (while at the same time avoiding late payment charges). This also means that government transfer payments should not be paid in advance of needs; payments should be timed to correspond as closely as practicable to recipients' cash flow requirements.

Maximize investment yields at the lowest risk and cost

The goal of investing is to improve returns on cash while maintaining required liquidity and minimizing risk. The goals and objectives of investing should be clearly defined and engrained within investment policies and accountability and governance frameworks. An effective investment policy outlines investment philosophy, roles, and responsibilities. It also defines acceptable types of investments and provides objectives and guidelines for investing. With the establishment of appropriate policies and objectives, organizations can balance risk thresholds and liquidity needs more effectively in order to achieve the best possible yields.

In a large decentralized organization like government, proper accountability and monitoring is required to ensure policies are consistently applied.

Report 4b: August 2010

YEAR-END GOVERNMENT TRANSFER EXPENDITURES

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TABLE OF CONTENTS

Executive Summary	21
Response from the Government	22
Summary of Recommendations	23
Detailed Report	
Background	24
Purpose and Scope of the Audit	24
Audit Conclusion	27
Findings and Recommendations	27

EXECUTIVE SUMMARY

THROUGH THIS AUDIT, we explored whether government demonstrates effective management and control over public money with specific focus on how government spends money during March. We were interested in whether, during this last month of the fiscal year, the push to make use of budgeted funds might lead to a lapse in effective money management.

Since the Financial Administration Act does not allow annual spending amounts to be carried over to the next year, instances of funds being spent at the end of the fiscal year just to use remaining budget can occur. Faced with losing unspent funds, ministries may potentially make hasty spending decisions and overlook normal financial control provisions.

We therefore analyzed the total monthly expenditures from the past three fiscal years (2006-2009) and paid special attention to the notable spike that typically occurred every March. During this month, we noticed that government transfers (payments made by the Province to organizations like health authorities and school districts for which no goods or services are directly received) make up a significant portion of government expenditures and demonstrate the sharpest spending increase.

Accordingly, we focused our audit on government transfers made from the Consolidated Revenue Fund in March 2009 and on the following three questions:

- ◆ Are year-end government transfers being made using sound financial management practices?
- ◆ Are year-end government transfers complying with normal financial control provisions?
- ◆ Do year-end government transfers include appropriate accountability provisions to ensure that funds are used for their intended purpose or otherwise recovered?

Our analysis was conducted with the understanding that many factors influence government spending patterns with the overall economic environment usually having the greatest effect in determining how and when government spends.

During our audit, we found that, in March 2009, government transfers had generally been pre-planned and not made in haste.

Funds were spent with appropriate approval, documentation and in accordance with formal agreements and eligibility criteria.

However, we did find that some spending decisions were motivated by budget availability instead of by immediate need. In order to reduce the amount government borrows and, in turn, the amount of interest it pays, the ministries should base their spending decisions on when the recipients would use the funds and only pay when those funds are needed.

We also found weaknesses in government's management and accountability of these public funds. We expected government to monitor how funds are being spent through clear reporting requirements, measures indicating the effective use of funds and a process for recovering funds not used for intended purposes.

Instead, we found that some of the March 2009 samples we examined did not contain clear reporting requirements or sufficient accountability indicators. Also, very few agreements stipulated how excess funds would be used or recovered.

Furthermore, the ministry informed us that they are comfortable giving unconditional grants to recipients with whom they have built a trusting, long-term relationship because the ministry can simply adjust future grants as needed. While this strategy may help ensure that funds are spent as intended, it is no substitute for good accountability.

Finally, we noticed that in a few cases senior financial staff were unclear on how to classify government transfers and subsequently compromised recording and reporting accuracy. However, for the most part, entitlement transfers were handled correctly.

Despite these and a few other areas for improvement, we found that customary financial control practices were followed in dealing with year-end government transfer payments.

RESPONSE FROM THE GOVERNMENT

WE APPRECIATE THE OPPORTUNITY to respond to the Office of the Auditor General's report. The Auditor General's report acknowledges the strength of government's controls over transfer payments, and makes recommendations to support continued improvements to government's processes.

Governments fund a significant amount of program and service delivery through transfers to individuals and independent organizations. The Province is conscious of the need for sound administrative processes to ensure needed programs and services are funded, that funding achieves the intended public policy objectives, and that accountability and transparency is maintained.

The importance of government transfers as a service delivery mechanism means that considerable effort is applied each year to manage the amount of transfers that can be committed to while maintaining sufficient flexibility to respond to opportunities for further funding, as actual results become known throughout the year, and as forecasts evolve for future years. The Auditor General's report recognizes the effectiveness of governments' processes and makes recommendations for continued improvement.

The government has in place a variety of effective resources and processes to help ensure that value is received for taxpayer funding provided through its grant programs. The government will review each of the Auditor General's suggestions and where they are appropriate to the circumstances will adopt all or portions of those suggestions.

Findings and Recommendations

RECOMMENDATION 1: *We recommend that, in keeping with good financial management practices, government not advance significant government transfers until the funds are needed by the recipient, unless the results of a cost-benefit analysis show there is a net benefit.*

In some cases it may be appropriate to provide funding only when required by the recipient. However, as noted in the report, in some cases the recipient organization or the project being funded can achieve greater benefits through receiving funding at the beginning

of a project. Early funding provides security to allow recipients to leverage other financing, as well as provide security for underlying contractors of grant recipients.

Those benefits are not limited to financial gains but can result in valid non financial gains such as continued independence from government and the ability to maximize efficiency, effectiveness, and economy through flexibility in delivering projects or ongoing programs. Government policy requires that transfer payments support broader program objectives which go beyond purely financial objectives. Documentation of the assessment of transfer payments ability to meet those broader objectives should be done consistently.

RECOMMENDATION 2: *We recommend that all transfer agreements include appropriate accountability requirements and provisions to recover or re-direct any funds not spent for the intended purposes.*

The government believes in the use of appropriate accountability measures to allow monitoring of the use of government funding. In many cases provisions to recover or re-direct funding are an appropriate mechanism to help ensure funds are used as intended.

In some cases government transfers are part of an ongoing funding relationship where closely administering specific transactions on an individual basis may not be as efficient as managing the outcomes achieved through a long term financial relationship. In those cases it is possible to achieve accountability for the broader outcomes achieved by the recipient without the administrative inefficiency of sending cheques back and forth between collaborative partners.

RECOMMENDATION 3: *We recommend that government ensure that government transfers are recorded consistently to provide better information for financial management and decision making.*

While defining categories of transfers consistently is a useful internal procedure the information is never reported at the detailed level of entitlements, grants, and transfers under agreement. It is good program management to ensure the appropriate controls are in place to segregate this information consistently and the main focus must be to ensure that public reporting remains understandable and useful.

We thank the Office of the Auditor General for its support in our continued improvement of government's policies and practices.

SUMMARY OF RECOMMENDATIONS

WE RECOMMEND THAT:

- 1** in keeping with good financial management practices, government not advance significant government transfers until the funds are needed by the recipient, unless the results of a cost-benefit analysis show there is a net benefit.
- 2** all transfer agreements include appropriate accountability and provisions to recover or re-direct any funds not spent for the intended purposes.
- 3** government ensure that government transfers are recorded consistently to provide better information for financial management and decision making.

BACKGROUND

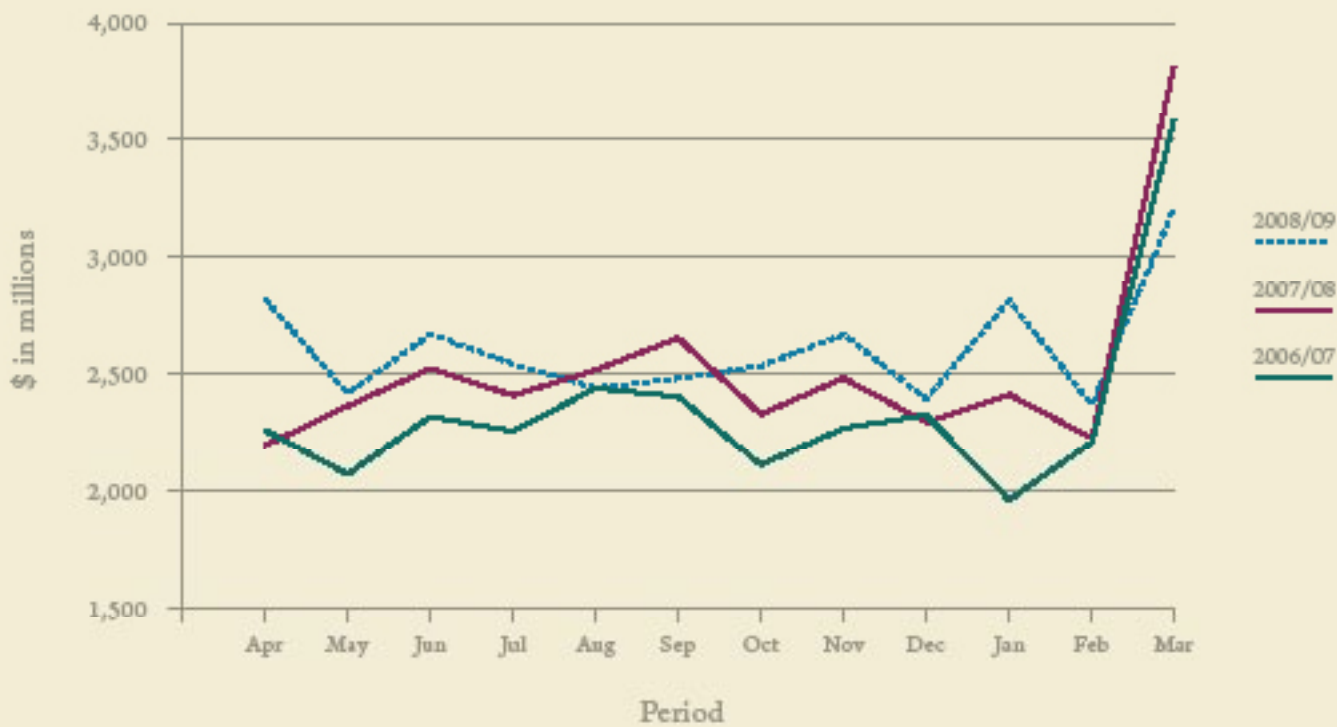
Each year, the Province of British Columbia spends billions of dollars in public money to administer and provide a wide range of services and goods to its citizens. In 2008/09, the Province made expenditures of \$31.4 billion from the Consolidated Revenue Fund. These expenditures include salaries and benefits, operating costs, government transfers and other expenses such as interest and financing expenses. With amounts as large as this, it is essential that government demonstrate effective management and control over the spending of public money.

We were interested in examining the extent to which effective control might be circumvented in the last month of the fiscal year in order to use unspent budget that would otherwise lapse, therefore we

performed an analysis of total monthly expenditures for three fiscal years, 2006/07–2008/09. The level of expenditures was relatively stable from month to month (see Exhibit 1). The notable exception is the significant increase that typically occurs every March. Some of this March spike is attributable to necessary expenditure adjustments (such as catch-up payment of late invoices) that are made at the end of the fiscal year. The economic climate in 2008/09 is the main reason there was less discretionary spending in March 2009 than in the same month in the two preceding years.

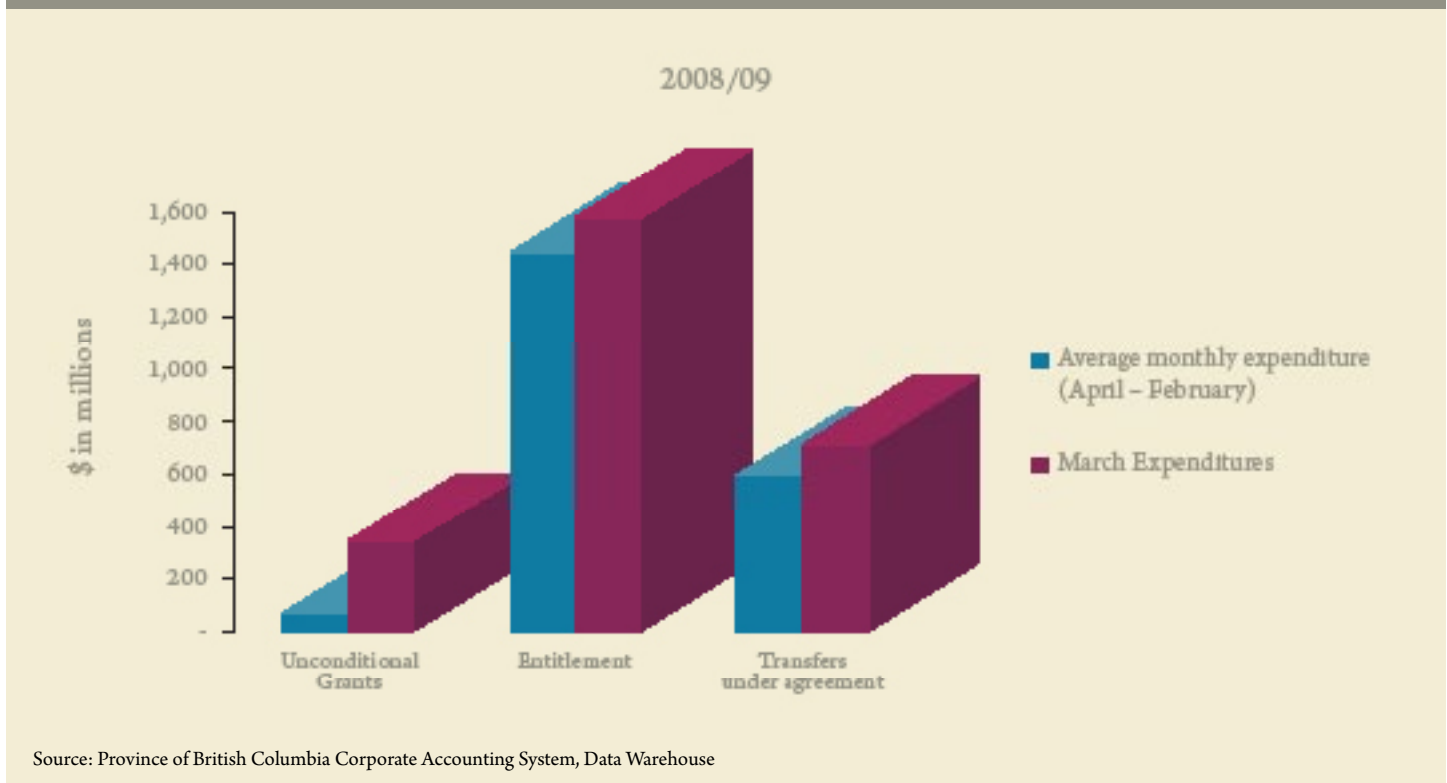
The category of expenditure which had the sharpest increases in the final month is called government transfers. Government transfers are payments made by the Province to organizations and individuals for which no goods or services are directly received and include other government organizations such as health authorities and school districts. Government transfers form a significant portion of government expenditures, making up over 80% of annual expenditures from the Consolidated Revenue Fund in each of the three fiscal years, 2006/07 – 2008/09.

Exhibit 1: Total monthly expenditure (accrual basis) comparison for three fiscal years, 2006/07–2008/09



Source: Province of British Columbia

Exhibit 2: Government transfer payments, 2008/09



Government transfers fall into three categories:

- ◆ *Unconditional grants* are made at government’s discretion. Government does not control or participate in the ongoing activities of the grant recipients, such as payments to the Vancouver Organizing Committee for the 2010 Olympic and Paralympic Winter Games.
- ◆ *Entitlements* are non-discretionary payments made to eligible recipients under statute, formula or regulation rather than through ongoing contractual requirements. Examples include temporary or disability assistance payments to eligible recipients.
- ◆ *Transfers under agreements* are payments or reimbursements made under contract, formal agreement or shared cost agreements, and where government has significant control over how the funds are to be spent. Examples include British Columbia Medical Association contract payments.

Government transfers in March 2009 were significantly higher (see Exhibit 2) than the average monthly expenditures in each of the previous 11 months. (The small spikes in April and January, shown

in Exhibit 1, did not affect the 11 month average since these were due primarily to the timing of accounting entries.) March entitlements were 9% higher than average; transfers under agreements were 20% higher than average; and unconditional grants were 400% higher than average. March 2008 and March 2007 showed even larger increases when compared with their respective years’ monthly averages.

Many factors affect government spending patterns, but the overall economic environment usually has the greatest effect in determining how much a government spends and when. Economic conditions in British Columbia during 2008/09, for example, led to spending limitations in December 2008 on both unconditional grants and transfers under agreements. These limitations were part of a larger budget exercise to control discretionary expenditures. Some of the government transfers affected were subsequently approved later in the fiscal year. In March 2009, the Legislature approved an additional \$457 million in government transfers. The global financial crisis resulted in rising unemployment and falling revenues in municipalities across British Columbia. In the interest of stimulating the economy and spurring employment, the Province accelerated

DETAILED REPORT

\$186 million in spending to local governments. The ministry that provided the stimulus funds informed us that indicators measuring the success of this stimulus will not be available until well after the spending has occurred. We contacted three recipients who received stimulus funding and we were told that 98% had been spent by December 31, 2009. Because the Financial Administration Act does not allow Legislature-approved spending amounts in any one year to be carried over to the next year, instances of funds being spent just because there is budget room left at the end of the fiscal year can occur. Faced with losing those funds if they are not granted before the close of the fiscal year, ministries can potentially make spending decisions hastily, circumventing sound financial management practices or normal financial control provisions.

PURPOSE AND SCOPE OF THE AUDIT

In this audit, we examined government transfers made from the Consolidated Revenue Fund in March 2009, focusing on finding answers to three key questions:

1. Are year-end government transfers being made using specific elements of sound financial management practices?
 - ❖ Transfers planned for in advance of March;
 - ❖ Prior funding relationships existed or assessment of new funding relationship performed; and
 - ❖ Recipients' cash flow needs considered – funds needed shortly after receipt.
2. Are year-end government transfers complying with normal financial control provisions?
 - ❖ Transfers are unconditional grants or are made in accordance with formal agreements, statute, formula or regulation; and
 - ❖ Funding decisions made and approved using the normal control framework.
3. Are year-end government transfers including appropriate accountability provisions?
 - ❖ Objectives and performance measures clearly defined in the contract or agreement; and
 - ❖ Recovery or re-direction of funds is allowed when the recipient has not complied with grant purposes or conditions.

Exhibit 3: March 2009 government transfers included in our audit sample (by transaction type)

Category of Transfer	Number of Samples	Total Value of Samples (millions \$)	Average Value of Samples (millions \$)
Unconditional grant	15	52.2	3.5
Entitlements	11	56.2	5.1
Transfers under agreement	17	260.2	15.3
Total	43	368.6	8.6

Due to the large number of March 2009 government transfers, we chose to limit our audit to larger transactions that we considered high risk. These are not typical of the normal transactions in March. A summary of the number, total dollar value and average dollar value of the sample transactions we included in our audit are presented in Exhibit 3. Our overall findings and conclusions about year-end spending practices and accountability by the British Columbia government are based on these samples.

What we looked at

To answer our key questions in this audit, we examined documentation provided to us by the ministries, including project proposals, approval documents and funding agreements. To confirm that the normal control framework had been used in March 2009, we compared ministry processes and controls with those documented in the Province's Core Policy and Procedure Manual.

We also discussed the transactions with ministry executive personnel to gain a contextual understanding of the circumstances under which the year-end transfers were made.

We did not audit the work of the transfer recipients in completing the projects or make any assessment of their work.

AUDIT CONCLUSION

For most of the March 2009 sample transactions we audited, we found that normal financial control practices were followed in dealing with year-end government transfer payments. Overall, we found that cash flow management is not a main focus at the ministry level, and in some cases public funds were transferred before they were required. We also found one case where government accountability over the use of funds was reduced to allow early payment.

FINDINGS AND RECOMMENDATIONS

We expect government to use sound financial management and control practices in making year-end transfer decisions, as well as to monitor the transfers to ensure that they are used for the intended purpose and that recipients are held accountable for the use of those funds.

In our review of the March 2009 transactions, we found that government transfers had generally been planned for in advance of March; prior funding relationships existed with grant recipients; and funding decisions made were supported by sufficient documentation (except for cost-benefit analysis as discussed below). Payments were made in accordance with formal agreements and eligibility criteria, and all transfers were approved at the appropriate level.

However, we also found several weaknesses in the management and control of these public funds. First, recipient cash flow requirements had not generally been considered, and some payments appeared to have been motivated more by the availability of budget than by the immediate need of recipients.

Second, a formal agreement was amended to allow a grant to be made in March – this reduced government's accountability and limits its ability to recover funds in the future should those funds not be used for the original purpose. As well, some transfer agreements lacked clear reporting requirements or indicators to measure effective use of funds, and very few agreements stipulated how funds would be recovered if they were not spent as intended.

Third, we found that senior financial staff were sometimes unclear about how to classify government transfers between the three categories, a weakness that compromises recording and reporting accuracy.

For the most part, the entitlement transfers were correctly handled. In just a few cases we noted that government transfers in this category should have been classified as unconditional grants, not entitlements. Therefore, the rest of our findings presented below pertain only to unconditional grants and transfers under agreement.

Year-end payment decisions in March 2009 were not always based on when the funds were needed

Good financial management by government includes making payments when the funds are needed, and not before. By adhering to this principle, government can reduce the amount it borrows and reduce the amount of interest it pays.

In general, we found little evidence in our March 2009 sample transactions that ministries had based their funding decisions on when the recipients would actually use the funds.

Because of the downturn in the economy in 2008/09, both government and ministry officials were well aware of coming budget cuts and of the fact that less funding would be available in the next three years. As a result, the Legislative Assembly approved \$186 million in provincial transfers to local governments to be made in 2008/09 that had been scheduled to occur in future years. The Legislative Assembly also approved nearly \$84 million to fulfill British Columbia's initial financial commitment toward the provision of security for the 2010 Winter Olympic and Paralympic Games and other financial obligations related to the 2010 Paralympic Games. These payments were first budgeted in 2009/10 but, as the Minister of Finance stated in the Legislature, "Because the budget is so tight next year, we're looking for opportunities to flow some of these grants in this fiscal year rather than the next fiscal year."

As a result, in a small number of cases, government transfers that had originally been budgeted in 2009/10 were changed from being reimbursements of eligible expenditures to being unconditional lump-sum payments, which allowed the recording of the payments within the 2008/09 fiscal year.

As part of the \$186 million mentioned above, two payments we examined were made by a ministry to municipalities under a revenue-sharing program. While municipalities normally receive only one payment per year under this program, in March 2009 they received another unconditional grant. Although public reporting requirements exist for the municipalities involved, there are currently no requirements for the municipalities to report back to the ministry on how the funds are used. We contacted our two sample municipalities who informed us that they had spent all or substantially all of the funds by December 31, 2009. The ministry told us that it is working on increasing recipient accountability for these grants.

In a few other cases, we found that some ministries had made one-time unconditional grants in March 2009 even though staff knew that the recipients would be using the money over the next three-year period. In two of the sample transactions we examined, agreements already in place were amended so that the unconditional grant could be made in March. Again, this approach concerns us because it reduces accountability over the use of public funds.

We were told that only in a small number of cases did ministries perform a cost-benefit analysis to ensure that it was in the government's best interest to forward grants in advance of recipient need.

It is necessary for government to record its transfers in the year in which recipients meet all of the eligibility requirements. However, this may not preclude government from waiting to distribute the funds until they are actually required. We will be discussing possible options with government on this topic.

RECOMMENDATION 1: *We recommend that, in keeping with good financial management practices, government not advance significant government transfers until the funds are needed by the recipient, unless the results of a cost-benefit analysis show there is a net benefit.*

Proper accountability was not always maintained in the March 2009 transfers and in one case was even reduced to allow early payment

As discussed above, the two types of government transfers that may be paid out under agreements are unconditional grants and transfers under agreements. Unconditional grants are made at the government's discretion, but the government does not control or participate in ongoing activities of the grant recipients. Transfers under agreement are more formal. They include payments and reimbursements made under contract, formal agreement or shared cost agreement, with government having significant control over how the funds are to be spent.

Accountability over unconditional grants

Although government does not control or participate in activities of the recipients of unconditional grants, we do expect government to be able to ensure that the grants are used for their intended purpose and in compliance with funding letters or agreements. Effective monitoring procedures are essential to gain this assurance. Funding decisions for unconditional grants are often based on estimates. If actual costs end up being less than the grant amount, we would then expect the funding letters to describe what the excess may be used for or if the excess is to be returned to the Province.

We found that some unconditional grants made in March 2009 did have specific reporting requirements, thus enabling the ministries to ensure the funds are used for intended purposes. These agreements did not, however, always stipulate how excess funds would be used or recovered. And while reporting to third parties was sometimes required (such as a public report to municipal residents), there

was no requirement for reporting back to the ministry. We also found that although reporting and monitoring mechanisms were in place in some cases, they were not formally documented in the agreement between the ministry and the recipient. In one instance, an unconditional grant was given out but no letter describing the purpose of the grant accompanied the payment.

By making year-end transfers using unconditional grants the Province loses the ability to monitor and recover the funds if they are not spent as specified. However, ministries informed us that in cases where trust has been built through long-term relationships, they are comfortable giving unconditional grants as the ministry can make adjustments to future grants if the recipients do not spend the money as planned. While this may decrease the risk that funds are not spent as intended, it is no substitute for good accountability.

Accountability over transfers under agreement

We expected to find that for this type of agreement — where government has significant control over how the funds are to be spent — reporting requirements would be clear, indicators would be in place to measure the effective use of funds, and a process for recovering funds if a recipient did not comply with transfer conditions would be stipulated.

Instead, we found that for the March 2009 samples we examined: reporting requirements back to the ministry were not always clear; formally documented accountability indicators were lacking, thus increasing the risk that funds would not be properly used; and a process for the recovery of funds had not been stipulated, although in some cases the condition was made that government could re-direct funds.

In one instance, we found that a recipient was required by the terms of the contract to submit a progress report, analysis of eligible costs and a claim form before receiving payment from the ministry. This contract was amended in March, however, and the majority of the remaining balance was paid out in a lump sum (a 15% holdback was retained). Thus, not only were the accountability requirements circumvented with the amendment, but the ministry lost the ability to recover the advance if the funds were not spent as intended.

RECOMMENDATION 2: *We recommend that all transfer agreements include appropriate accountability requirements and provisions to recover or re-direct any funds not spent for the intended purposes.*

How government transfers should be recorded is not clear

We expected ministries to be recording their government transfer expenditures in keeping with the three payment categories: unconditional grant, entitlement and transfer under agreement. Doing so enables government to manage its transfers effectively.

In fact, we found that for many of the March 2009 transactions in our sample, senior financial staff were unclear about how to record government transfers. For example, there was a tendency overall to incorrectly record unconditional grants as transfers under agreement. Inconsistent recording of government transfers compromises the effectiveness of financial management.

RECOMMENDATION 3: *We recommend that government ensure that government transfers are recorded consistently to provide better information for financial management and decision making.*

Report 4c: August 2010

INFRASTRUCTURE GRANTS

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TABLE OF CONTENTS

Executive Summary	32
Response from the Government	33
Summary of Recommendations	36
Detailed Report	
Background	37
Purpose and Scope of the Audit	39
What We Found and Recommended	40
Appendix	
Best Practice Examples	47

EXECUTIVE SUMMARY

GOVERNMENT OFFERS A NUMBER of programs to support community infrastructure throughout British Columbia. These programs are cost-shared between the Province and local governments and, for some programs, the federal government as well.

The Ministry of Community and Rural Development and the Ministry of Transportation and Infrastructure administer several significant community infrastructure programs. Since 2001, these ministries have allocated more than \$900 million in federal and provincial funding, representing both a large proportion of government expenditures and significant funding received by municipalities, regional districts and non-government organizations.

Since the Province does not directly receive goods or services in return for this funding, it is essential that these programs be properly managed to ensure that public funds are spent appropriately and with accountability. This audit examined the ministries' management of several infrastructure programs, in particular whether they had processes in place to ensure that:

- ♦ selected projects provide value to the community and meet the goals of the programs;
- ♦ the most deserving projects are funded; and
- ♦ the success of individual projects and overall programs could be determined and publicly reported.

The audit found numerous good management practices in place. Programs are designed to ensure that projects provide value, potential applicants are well-informed and applications are being consistently appraised.

However, there were areas for improvement. In the planning phase, success factors for the programs are not being quantified and the risk management strategy is undocumented. Some projects that were not recommended for funding still received funding, and accountability for funding was weakened in March 2009 in some provincial programs. Finally, monitoring procedures are inadequate, and the program and project results are not being reviewed or publicly reported.

We make a number of recommendations to address these areas. These recommendations, and the lessons learned from this audit, are not only pertinent to the specific ministries examined, but also to any government agency managing similar programs.

RESPONSE FROM THE GOVERNMENT

THE MINISTRIES of Community and Rural Development and Transportation and Infrastructure appreciate the time and effort from the Office of the Auditor General (OAG) to produce the Infrastructure Grants Report (Report) and its recommendations. The ministries agree with the principles underlying the Report's recommendations. The Report will assist with the ongoing improvement of these programs. Program staff found OAG staff to be courteous and professional.

These infrastructure programs are focused on local government infrastructure outcomes, often designed to support improved public and environmental health. The ministries work collaboratively with numerous stakeholders at the federal, provincial, and local levels (such as, but not limited to, Environment Canada, Fisheries and Oceans Canada, provincial Ministry of Environment, provincial Ministry of Health Services, local provincial Health Authorities, provincial Ministry of Energy, Mines and Petroleum Resources, and the Union of British Columbia Municipalities (UBCM)) to ensure the programs are progressive, utilize the expertise of different organizations and maximize the program benefits.

The ministries believe that the greatest effort for the overall risk management strategy must be spent at the front end of the programs prior to project approvals. Ensuring that approved projects, the majority of which are put forward by local governments, have undergone rigorous technical, financial, planning and environmental assessments, strongly supports the success of these programs and effectively manages the priority risks, such as mitigating public and environmental health concerns in our communities.

The risk management strategy employed by the ministries for these programs has proven successful, and has been validated annually by provincial and federal audits. Risk is considered throughout the life cycle of every program. Appropriate monitoring and reporting procedures are practiced for compliance, tracking and forecasting purposes.

Through the Joint Secretariat Committee that represents the provincial and federal governments, as well as the UBCM, the federal government produces Annual Funding Program Progress Reports, which clearly articulate program results including identifying

emerging issues/concerns and measurable benefit performance. These reports are used to monitor the progress of the program to help ensure that the goals and objectives of the program are met.

The Province of British Columbia (Province) has a long-standing relationship with local governments, and respects the transparent and responsible management practices of local governments. Sharing project delivery responsibility with local government partners decreases program delivery risks. In accordance with the *Local Government Act and the Community Charter*, the ministries recognize local governments as an independent, autonomous and responsible level of government. By their nature, local governments are also funded by, and answerable to, the same taxpayer as the Province. The ministries endeavour to run infrastructure projects as efficiently as possible and provide as much discretion to local government as is prudent for an equal contributing partner.

The Report does not include the processes and procedures in place with our funding partners, the federal and local governments. In many cases, program delivery is a shared responsibility, and a comprehensive view of all funding partners may provide a more holistic view on program delivery.

This audit primarily focused on whether documented policy existed to support the administration of the programs. It did not examine the overall success of the program results and program delivery. However, we believe that these programs are extremely successful in meeting their desired outcomes: implementing core infrastructure in our communities, reducing our infrastructure deficit, and, in many cases, addressing serious public and environmental health issues.

While the ministries agree with the underlying principles in the Report, we believe that these programs are already designed to meet those objectives. Each recommendation is addressed individually, as follows:

RESPONSE FROM THE GOVERNMENT

RECOMMENDATION 1:

“that specific, measurable, outcome-oriented goals be set for each program so that the ministry can develop benchmarks and collect appropriate information to publicly report program results.”

RESPONSE: *The ministries will continue their ongoing efforts to improve program goals and objectives, recognizing the challenges in developing appropriate quantitative and qualitative measures with the delivery of complex and diverse infrastructure programs.*

The Joint Secretariat for the federal/provincial programs provides an annual program progress report to Infrastructure Canada. Western Economic Diversification, as part of the Joint Secretariat that manages the delivery of the programs, takes the lead on drafting the report on behalf of both governments. The ministries also collect information used to support pre-established, outcome-oriented goals, and does report out in its Service Plan(s). A general reporting out on program results is also required at the end of a program. As none of the programs reviewed by the OAG had been completed, the OAG was not able to comment or review the benefits of this general reporting out process. A new information management system being developed by the Ministry of Community and Rural Development will improve the programs' ability to report out on program progress.

RECOMMENDATION 2:

“that ministries employ principles of proper records management, including: retaining records for the complete legislated retention period and documenting risk assessments, reasons for funding decisions and reviews of expenditure claims and progress reports.”

RESPONSE: *The current federal and provincial programs are designed to address a wide variety of risks. The process to accept, review and select applications, combined with the review of progress and claim forms, all contribute to mitigating project and program risks. The ministries understand that the OAG's concerns are not with the risk management practices currently in place, but rather that the documentation of those existing practices could be enhanced. The ministries consider that enhancements to the existing risk management documentation are a straightforward action that can easily be taken.*

With one exception noted in the Report, the ministries maintain full records for all of their infrastructure programs. While clear eligibility

and evaluation criteria were established for the first year of the LocalMotion program, some elements of the assessment process were not well documented. The ministries recognized that improvements were necessary and adopted a fully documented process for the subsequent years of that program.

RECOMMENDATION 3:

“that procedures be established to enable the Province to reconcile sources of federal and provincial funding for each project, in this way ensuring compliance with Canada/British Columbia cost-shared agreements and provincial program funding guidelines.”

RESPONSE: *Both ministries regularly monitor the various sources of provincial funding awarded to recipients. Additionally, the federal government, through Western Economic Diversification, monitors other federal funding sources and identifies any circumstances where there is a potential to exceed the federal funding limitations. This is one of the roles performed by the federal government as part of the joint federal/provincial secretariat that manages federal/provincial programs.*

RECOMMENDATION 4:

“that an overall plan for monitoring projects be established for provincial programs. It should include the audit of a sample of projects annually, particularly all higher risk and/or higher value projects, to ensure that only claims for valid expenditures are paid, and projects are completed as required.”

RESPONSE: *The ministries will continue to audit high risk and/or high value projects throughout the project/program life cycle. The ministries are also considering incorporating audit processes found in the federal/provincial infrastructure programs in infrastructure programs run solely by the Province. All infrastructure programs, including provincial programs, have existing monitoring procedures, a claims process based on eligible costs, and quarterly and final progress reporting.*

RECOMMENDATION 5:

“that in keeping with good financial management practices, government not advance significant government transfers until the funds are needed by the recipient, unless the results of a cost-benefit analysis show there is a net benefit.”

RESPONSE FROM THE GOVERNMENT

RESPONSE: *The ministries will continue to evaluate the costs and benefits of advance payments and accelerated funding on a case-by-case basis. The Province has made the decision to accelerate funding in the past. For example, in 2009, there were many compelling reasons to accelerate funding. These included the availability of matching federal funds and the downturn in the economy. Though not standard practice, the Province made the decision at the time to accelerate infrastructure funding with the goal of stimulating the economy and creating immediate jobs.*

In closing, the ministries would like to reiterate their appreciation for the work that you and your staff have done. We recognize the value of independent audits, and understand that a significant amount of valuable time and effort went into this Report. The ministries will continue improving the infrastructure funding programs and use the findings and recommendations of this Report. The ministries are always open to comments and suggestions on how to improve their programs, and will carefully weigh the value for effort of all recommendations.

SUMMARY OF RECOMMENDATIONS

WE RECOMMEND THAT:

- 1** specific, measurable, outcome-oriented goals be set for each program so that the ministry can develop benchmarks and collect appropriate information to publicly report program results.
- 2** ministries employ principles of proper records management including retaining records for the complete legislated retention period and documenting risk assessments, reasons for funding decisions and reviews of expenditure claims and progress reports.
- 3** procedures be established to enable the Province to reconcile sources of federal and provincial funding for each project, in this way ensuring compliance with Canada/British Columbia cost-shared agreements and provincial program funding guidelines.
- 4** an overall plan for monitoring projects be established for provincial programs. It should include the audit of a sample of projects annually, particularly all higher risk/or higher value projects, to ensure that only claims for valid expenditures are paid, and projects are completed as required.
- 5** in keeping with good financial management practices, government not advance significant government transfers until the funds are needed by the recipient, unless the results of a cost-benefit analysis show there is a net benefit.

BACKGROUND

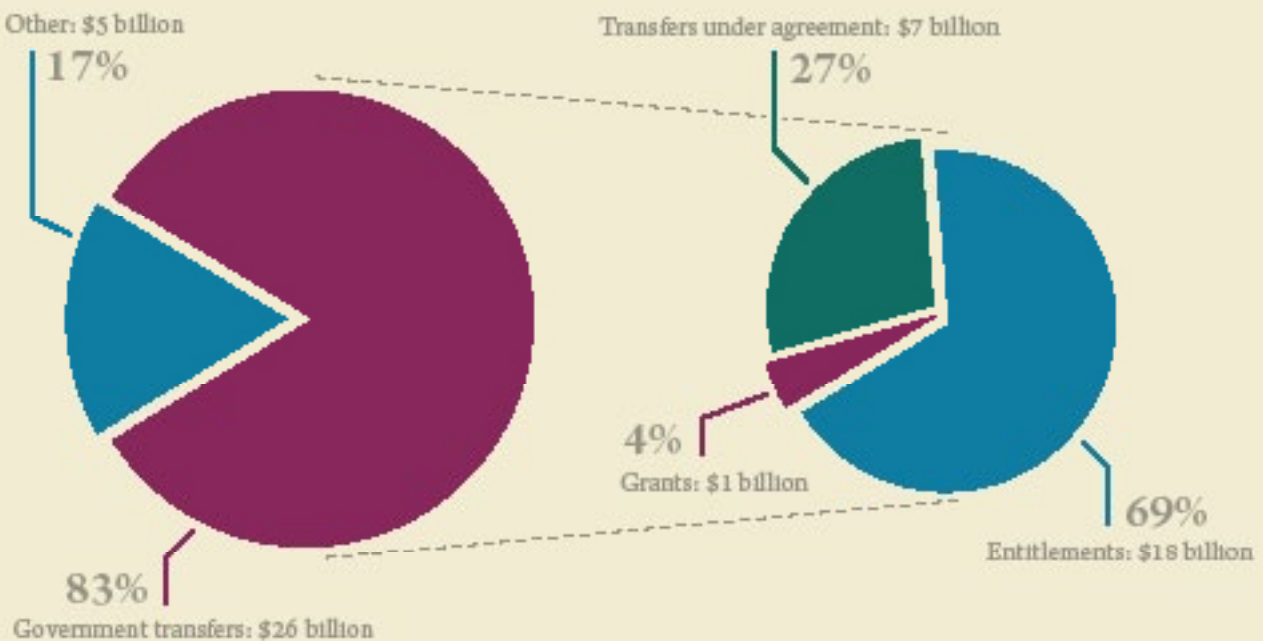
In 2009, provincial expenditures in British Columbia totalled \$31 billion. Government transfer payments accounted for \$26 billion, or 83% of that total (Exhibit 1). Transfer payments allow government to achieve its goals by funding organizations that carry out work in support of government priorities. Examples include operating grants given to non-government organizations, school districts, universities, colleges and various entities in the health sector.

Because the Province does not directly receive goods or services in return for the funding it provides through transfers, it is essential that these programs be properly managed to ensure that public funds are spent appropriately and with accountability.

The “government transfers” category of provincial expenditures includes grants, transfers under agreement and entitlements. In this audit, we focused on grants and transfers under agreement, which in 2009 composed 31% of the total government transfers (4% as grants and 27% as transfers under agreement). Given the significance of this spending component, the lessons learned from this audit are pertinent not only to the ministries whose grant and transfer under agreement programs we reviewed here, but to all government agencies managing similar programs.

Several significant local government infrastructure programs are delivered under the direction of the Ministry of Community and Rural Development and the Ministry of Transportation and Infrastructure. Together these ministries support local communities through a number of local government infrastructure grant and transfer under agreement programs. Some of these are Canada/British Columbia cost-shared programs; others are cost-shared between the Province and local governments or non-government organizations.

Exhibit 1: Total provincial expenditures in British Columbia in 2009 (based on the Consolidated Revenue Fund)



Since 2001, more than \$900 million in federal and provincial funding has been allocated by the ministries of Community and Rural Development and Transportation and Infrastructure to local government infrastructure programs in British Columbia. This represents both a large proportion of government expenditures and a significant amount of funds received by municipalities, regional districts and non-government organizations. Infrastructure programs fund projects in both large and small communities across the province, affecting many British Columbians.

Different types of local government infrastructure programs

The Province offers a number of local government infrastructure programs to support communities throughout British Columbia. All programs are cost-shared between the Province and local governments. For some programs, a third party, the federal government, also shares a set percentage of project costs.

Canada/British Columbia programs

British Columbia participates in national joint funding arrangements between the federal government and the provinces. Under the joint funding agreements between Canada and British Columbia, the federal and provincial governments each fund up to one-third of eligible project expenditures. Local governments are responsible for the remaining third plus any cost overruns.

The Building Canada Fund — Communities Component is the latest version of a longstanding Canada/British Columbia cost-sharing initiative. Previous initiatives include the Canada/BC Municipal Rural Infrastructure Fund, launched in 2006, and the Canada/BC Infrastructure Program, launched in 2001. These programs fund local and regional infrastructure needs, such as drinking water, wastewater, public transit, green energy, local road projects, cultural, recreational, tourism and connectivity projects.

British Columbia administers joint-funded agreements on behalf of the three levels of government. The Ministry of Community and Rural Development administers all water and wastewater and green energy projects and the Ministry of Transportation and Infrastructure administers all the other Canada/British Columbia cost-shared projects.

Provincial programs

In addition to the Canada/British Columbia cost-shared programs, the Province has established a variety of provincially funded infrastructure programs. These are administered and funded exclusively through the Ministry of Community and Rural Development. The four larger programs offered are as follows:

- ◆ The \$80 million BC Community Water Improvement Program provides funding to improve water and wastewater infrastructure.
- ◆ The \$71 million Towns for Tomorrow program provides funding over five years for local governments of communities with populations of 15,000 or less, for projects that address the effects of climate change and contribute to the overall health, sustainability and liveability of the communities. Projects include the construction of water treatment systems, wastewater systems, public transit projects, local road infrastructure, cultural projects (such as museums and art galleries) and recreational projects (such as sports facilities).
- ◆ The \$40 million Local*Motion* program provides funding for capital projects that promote physical activity, reduce vehicle dependency and associated greenhouse gas emissions, and increase mobility for seniors and people with disabilities. Projects include the construction of bike paths, walkways and greenways. Funds are also available for projects that support the development of community playgrounds and children's parks.
- ◆ The \$20 million Spirit Squares program provides funding for capital projects to create or improve outdoor public meeting and celebration spaces that promote government's vision of greener, healthier, more liveable communities.

During the period covered by our audit, the Towns for Tomorrow and Local*Motion* programs were provincial-only programs. In March 2009, after the time period covered by our audit, the federal government announced it would also support specific projects under the two programs.

PURPOSE AND SCOPE OF THE AUDIT

The purpose of this audit was to examine how the Ministry of Community and Rural Development and the Ministry of Transportation and Infrastructure are managing their grant and transfer under agreement programs to meet the goals and objectives of the Province.

Our work was guided by the following key questions:

- ◆ Are the grant and transfer under agreement programs being planned to ensure that selected projects both provide value to the community and meet the goals of the programs?
- ◆ Are processes in place to ensure that the most deserving projects are funded?
- ◆ Are processes in place to determine, and publicly report on, whether individual projects and overall programs are successful?

To answer these questions, we audited local government infrastructure grant and transfer under agreement programs under the administration of the two ministries approved from April 2005 to March 2009. We included the following in our audit, as detailed in Exhibit 2:

Canada/British Columbia cost-shared local government infrastructure grant programs:

- ◆ Canada/BC Municipal Rural Infrastructure Fund
- ◆ Building Canada Fund — Communities Component

Provincial/local government infrastructure grant programs:

- ◆ BC Community Water Improvement Program
- ◆ Towns for Tomorrow
- ◆ LocalMotion
- ◆ Spirit Squares

Exhibit 2: Grant and transfer under agreement programs included in our audit

Canada/British Columbia cost-shared local government infrastructure grant program	Number of projects	Combined Canada/British Columbia commitment (\$)
Canada/BC Municipal Rural Infrastructure Fund	103	146,652,738
Building Canada Fund — Communities Component	41	110,518,866
Total	144	257,171,604
Provincial/local government infrastructure grant program	Number of projects	Provincial commitment (\$)
BC Community Water Improvement Program	87	79,883,074
Towns for Tomorrow	159	50,630,363
LocalMotion	122	40,497,218
Spirit Squares	62	17,963,450
Total	430	188,974,105

Source: Compiled by the Office of the Auditor General of British Columbia

Our approach

To assess overall administration of the programs, we conducted interviews with ministry staff involved in developing and administering the infrastructure programs. We also reviewed ministry processes and controls.

To assess whether the most deserving projects are being funded and the results monitored and reported, we reviewed approximately 80 project files. From this sample, we selected 10 completed projects which we visited to evaluate project results. We also audited a sample of expenditures claimed by grant recipients to assess whether the expenditures were eligible costs under the related program, and whether they were reported accurately within the contracted period.

What we did not look at

We did not examine the contribution of other levels of government. For instance, we did not examine the work of municipalities in completing specific projects, nor did we audit the planning, risk assessment or reporting done by the federal government for Canada/British Columbia cost-shared programs.

WHAT WE FOUND AND RECOMMENDED

Grant and transfer under agreement program planning and reporting

We expected the grant and transfer under agreement programs to be well planned so that they would provide value to communities by fulfilling specific funding needs. We therefore looked for evidence that the Ministry of Community and Rural Development is setting quantifiable program goals, establishing a robust risk management strategy and designing appropriate accountability requirements for the programs.

Success factors are not being quantified during program planning for most provincial programs

When a grant program is established, its overall goals and specific, measurable performance objectives should be clearly defined and documented. Clear benchmarks for success should also be set. Only in this way can the program be monitored, measured and evaluated.

We found that all of the provincial programs we examined had broad overall goals, supported by more specific underlying objectives. Although these objectives act as performance measures for each program, they lack specific and quantifiable achievement targets. Without such benchmarks, it is impossible to conclude whether a program has ultimately been successful. The BC Community Water Improvement Program is an exception to this finding as this program's overall goals are tied into the Ministry of Community and Rural Development's service plan goals, which are specific and quantified annually. In Exhibit 3, we give an example of how goals and objectives could be effectively quantified.

Program results are not being publicly reported

Regular review and public reporting of whether funded programs are achieving intended outcomes has not yet occurred. For Canada/British Columbia cost-shared programs, reporting will be the responsibility of the federal government and will not occur until the

Exhibit 3: Example of effective goals and objectives for the LocalMotion program

The overall program goals for the LocalMotion program are to assist local governments in creating vibrant and integrated communities and, more specifically, to:

- ◆ reduce community greenhouse gas emissions, with an emphasis on getting people out of their cars;
- ◆ advance the ActNow BC principle of being physically active; and
- ◆ build seniors-friendly and disability-friendly communities.

None of these goals on its own provides a clear target against which to measure success. Examples of quantifiable outcome goals could be to:

- ◆ reduce community greenhouse gas emissions by 3,000 tonnes over the duration of the program;
- ◆ provide 150,000 more British Columbians with access to safe walking trails or bike paths on which to be active; and
- ◆ ensure 100% of the projects funded accommodate seniors and those with disabilities.

Source: Compiled by the Office of the Auditor General of British Columbia

programs are complete. Although the Province reports monthly to Canada on the progress of the Municipal Rural Infrastructure Fund and the Building Canada Fund, this information is not available to the public but instead is used to compile public updates on the implementation of Canada's Economic Action Plan — provided periodically online. This is the type of interim ongoing public reporting we suggest at the provincial level for the Municipal Rural Infrastructure Fund and the Building Canada Fund. We found substantial reporting regarding budgets, schedules, ground breakings and ribbon cuttings, but no reporting regarding whether programs are successfully meeting objectives. For programs the size and duration of the Municipal Rural Infrastructure Fund and the Building Canada Fund, it is not reasonable to leave measuring and reporting to the end of the program.

For provincial programs, the Ministry of Community and Rural Development is responsible for reporting. Although water improvement projects do report on one result related to outcomes, the ministry does not have the capacity to easily consolidate project results to report on overall program results. It is in the process of developing the Local Government Information System, which should enable users to collect, collate and evaluate outputs and outcomes of projects. In place of this at present, project reporting is input driven — for example, the number of dollars spent or number of projects funded is both publicly and internally reported.

Although there has not yet been a formal public review of programs, we did find evidence that lessons learned from branch experiences and internal audit work are used by ministry staff to improve current programs.

RECOMMENDATION 1: *We recommend that specific, measurable, outcome-oriented goals be set for each program so that the ministry can develop benchmarks and collect appropriate information to publicly report program results.*

Risk management strategy

We expected a risk management strategy to be in place as part of program design. Such a strategy would consist of a documented initial risk assessment for each program, ongoing risk assessments to identify new risks that may arise over the course of a program, and a specific fraud risk management process.

Although staff at the Ministry of Community and Rural Development told us they had considered risks in developing each provincial grant

program and we observed strategies in place that mitigated some specific grant program risks, we found no documentation of initial risk assessments. We therefore could not review and conclude as to the adequacy of the risk considerations. As well, we found no documentation to show that ongoing risk assessments are being conducted — assessments necessary to ensure identified risks are appropriately managed and to detect new risks emerging during a program.

Without a comprehensive, documented risk assessment, it is not possible for staff to ensure that all risks have been identified and that appropriate risk management strategies are in place. Appendix 1 provides examples of risks and potential risk management strategies for consideration when developing and documenting their risk assessment.

Funding decisions

To ensure that the most deserving projects are funded, we expected to find processes in place for: notifying all potential applicants of funding availability; considering only eligible applications; and assessing and approving all applications against consistent, objective and pre-established criteria. In this way, not only would the potentially best applications be received, but the best projects would be selected and approved.

Furthermore, we expected all eligibility, project assessment and funding decisions to be well documented, thus ensuring transparency. Lastly, we expected there to be a division of duties between the individuals who appraise the applications and those who approve the funding.

Potential applicants are well-informed

For a grant program to be awarded in a fair and transparent manner, all potential applicants should be notified of the availability of funding, and given enough information to be able to adequately complete applications.

We found that programs are being adequately promoted to potential applicants through the Union of British Columbia Municipalities, ministry and program websites, and emails sent to municipality Chief Administrative Officers. The information provided is complete and includes eligibility requirements and appraisal criteria. Some local governments we interviewed told us they had to contact the ministry to gain additional information or clarification of more complicated facets of the application process. In our view, this is reasonable and to

be expected given the complexity of some of the applications and the limited resources of some local governments.

Applications are being properly checked for eligibility and are fairly and consistently appraised

We found that applicant eligibility, except for LocalMotion 2007 as discussed below, is being properly reviewed, proven and documented through the use of various checklists and other review measures.

Eligible applications are then being appraised fairly and consistently against predetermined and documented appraisal criteria. The assessments are being appropriately documented and program staff have the skills required to assess applications with due diligence. Adequate procedures also exist to ensure the quality of the appraisal process.

Some projects that were not recommended still received funding

The vetting process and ranking of applications are handled by operational staff at the ministries. All funding decisions are made by committees: a management committee for the Canada/British Columbia cost-shared programs, and a committee of Cabinet members for the provincial programs.

For Canada/British Columbia cost-shared programs, the management committee — composed of representatives from the federal, provincial and local governments — selects projects based on recommendations from the two ministries (Community and Rural Development and Transportation and Infrastructure). The management committee accepts the recommendations of the ministries in awarding funding.

For provincial programs, the Ministry of Community and Rural Development makes recommendations based on the results of the application assessment process. We found that funding was awarded to seven projects that were not recommended for funding by the ministry, in addition to the projects that were recommended.

We found that, in order to fund these additional projects, the committee of Cabinet members reallocated funding from future

years of the program, thus staying within the overall program limit. We found no documentation to support the approval of any of the additional projects.

Inadequate records for LocalMotion 2007

Throughout most of our audit, we were unable to review the 2007 LocalMotion round of funding awards because no records were available. Recently, we were provided with some documentation, in the form of eleven pages of handwritten notes on the local government's project idea(s) but this is inadequate to support distribution of \$20 million. There was no evidence of screening for eligibility or assessment of each application against consistent, preestablished assessment criteria. For these reasons, while adequate records did exist for LocalMotion 2008 and 2009, for LocalMotion 2007 alone, we could not determine whether the most deserving projects had been funded, whether applicant eligibility had been proven and documented, and whether applications had been appraised fairly and consistently.

Funding limits for the LocalMotion program were overridden

The LocalMotion 2007 program guide states that the maximum funding for each local government would be capped at \$1 million per year. In seven instances we found projects funded above this limit, with no documented reasons to explain why the funding limit was exceeded. As screening and scoring records were also unavailable to review, we could not be assured that these projects were more deserving of funding than others not selected or not receiving as large a grant. Neither could we determine whether the additional funding provided to these projects resulted in other projects not being funded.

Monitoring and Reviewing

We expected the ministries responsible for the two types of programs to have established a process to determine and publicly report on whether individually funded projects and the overall granting programs are successful. Such a process should involve establishing adequate monitoring procedures for funded projects, requiring grant recipients to report results of projects, and using data collected from applicants to report publicly about whether programs meet their objectives.

Monitoring and reviewing procedures are inadequate

For ministries to ensure that funded projects have been completed as agreed to, it is important that every grant recipient's final report outlining the results of the project be reviewed and a sample of projects visited.

We found that all the programs we examined have established adequate reporting requirements, in that final reports are required, and that grant recipients understand the requirements and have been submitting final reports as projects are completed. In several cases though, we found no evidence that staff were reviewing these reports.

For provincial programs, we found that no site visits have been made by ministry staff to any projects since 2007. This raises the risk that funding could be used for an unapproved project or that an unapproved variation to a funded project could occur during the period of the grant.

Canada/British Columbia cost-shared program project results too early to review

For the Canada/British Columbia cost-shared programs, understandably, no one from the federal or provincial governments has yet made a site visit to a Municipal Rural Infrastructure Fund because construction on these projects has only recently begun. Similarly, in the case of the Building Canada Fund, projects have only recently been awarded funding. We learned that during an earlier version of this program, a reasonable proportion of sites were visited.

Reviewing progress reports

Reporting requirements by applicants include submission of quarterly progress reports with photographs of the infrastructure under construction. A final report is also required, prepared in accordance with a template and also supported with photographs. In several cases, we found no evidence that staff were reviewing these reports.

Review of reports consists of more than logging whether reports are received but entails ensuring reports are signed off by the appropriate

responsible official and information submitted is reasonable. Without documentation of review, it is impossible to know whether staff assessed the reports and whether this important monitoring control worked effectively. In addition, procedures to ensure compliance with the terms of Canada/British Columbia cost-shared agreements and provincial program funding guidelines are deficient.

Reviewing expenditure claims

Detailed review of expenditure claims is necessary if ministries are to ensure that recipients make valid expenditures from the public funding they have received. We found that expenditure claims for the provincial grant programs we examined were not always adequately reviewed.

When submitting a claim, grant recipients must include a summary of expenditures by classification. This is important because only certain types of expenses are eligible. We also noted that although grant recipients often included invoices in their claim submissions, the ministries did not require this. In most cases, invoices were reviewed only if the ministry had questions about a specific amount. While we did not expect staff at the Ministry of Community and Rural Development to review invoices on every claim, we did expect a documented review of a sample of claims as a way of confirming that claims for only eligible expenditures were paid.

For the provincial programs, we found that a significant portion of the agreements lacked clauses enabling the Province to recover funds if recipients did not comply with the funding conditions. Lack of a recovery clause in the agreements makes adequate and prompt expenditure claim review especially important. If ineligible claims are discovered while a project is ongoing, amounts can be recovered through deductions from future claims. However, once projects are completed, any ineligible claims paid but discovered only after the fact cannot be recovered.

RECOMMENDATION 2: *We recommend that ministries employ principles of proper records management including retaining records for the complete legislated retention period and documenting risk assessments, reasons for funding decisions and reviews of expenditure claims and progress reports.*

Compliance with funding guidelines

Each program has guidelines for project funding that set specific limits on federal and provincial contributions. We expected the

DETAILED REPORT

Province to have procedures in place to ensure that federal and provincial governments bore no more than their agreed share of infrastructure costs. Such procedures are necessary throughout the project life cycle because sources of funding for individual projects can change from what was planned at the project outset. For example, additional provincial or federal grants may be received.

We found that both the Ministry of Community and Rural Development and Ministry of Transportation and Infrastructure had adequate procedures in place to identify other sources of funding at a project's outset.

For Canada/British Columbia cost-shared programs, we found that the Ministry of Community and Rural Development had an acceptable process in place to ensure that federal contributions did not exceed established limits at a project's end. At the Ministry of Transportation and Infrastructure, we found no evidence of such a process. The ministry assures us there is an effective process in place and there has been no instance where the federal government has withheld paying its share of eligible costs due to proponents exceeding federal funding guidelines.

We found no process in place to ensure that provincial contributions did not exceed established limits at a project's end. During our site visits to local governments, we noted two instances (both in provincial programs) in which the provincial share of funding exceeded established limits. Exhibit 4 provides an example of where we found funding to be in excess of the established requirements.

RECOMMENDATION 3: *We recommend that procedures be established to enable the Province to reconcile sources of federal and provincial funding for each project, in this way ensuring compliance with Canada/British Columbia cost-shared agreements and provincial program funding guidelines.*

Programs have been adequately designed to ensure specific projects provide value

For a grant program to provide value to the community, it should address a specific funding need. For the programs we examined, we noted a dual aspect to need: need for the overall program and need for the specific project in the community. Need for the overall programs

Exhibit 4: Example of a funding exception

The LocalMotion program is a cost-shared program where 50% of the eligible costs of the project will be paid by the Province and 50% must be paid by the local government. Under the agreement, if a third party, including another provincial agency, contributes to a project, that contribution must be deducted from the project's total eligible cost and the provincial share calculated on the balance.

In one case, we found that an applicant had applied for LocalMotion funding and identified no other sources of provincial funding in the application. Later, the applicant received a grant from a provincial Crown corporation and applied the grant to the applicant's share of the funding. This resulted in the project being 75% funded by the Province — equal to excess funding of \$10,000 — and only 25% funded by the applicant.

What happened			What should have happened		
20,000		Provincial Crown corporation	80,000		Total eligible costs
40,000		Provincial government	(20,000)		Provincial Crown corporation
60,000	75%	Subtotal	60,000		Revised eligible costs
20,000	25%	Local government	30,000	50%	Provincial government
80,000		Total eligible costs	30,000	50%	Local government

Source: Compiled by the Office of the Auditor General of British Columbia

is marked by the desire to meet either specific infrastructure needs or the policy objectives of government — both being acceptable means of defining need.

The applicants who are requesting funding must demonstrate need for a specific project in a community and how the community will benefit. This is achieved in a number of ways. For example:

- ◆ Local governments rank the priority of their projects on the application form.
- ◆ Due to specific program rules, local governments are able to submit only one application per program per year.
- ◆ Local governments are able to submit only two applications for the duration of the program.

Overall, we found that grant and transfer under agreement programs address specific funding needs and, therefore, are designed to provide value.

Effective accountability procedures have been developed

For the ministries to ensure that each project provides value, we expected them to have developed effective accountability procedures, such as determining the most appropriate funding strategy for a program, based on the program's risks and goals.

For all of the Canada/British Columbia cost-shared programs and most of the provincial programs we reviewed we found adequate accountability procedures. Funds are being provided under an agreement that requires recipients to:

- ◆ use funds for a specified purpose;
- ◆ provide detailed information on expenditures incurred; and
- ◆ report on project results.

These agreements also provide for local governments to be reimbursed for valid expenditures only after those expenditures are incurred and reported on.

For the Canada/British Columbia cost-shared programs, we found that annual expenditure claim audits were being conducted to mitigate the risk of ineligible claims. Such audits were not being done for provincial programs.

Accountability for funding weakened in March 2009 in some provincial programs

In two cases, we found that the Province weakened accountability for funding. Both instances occurred in March 2009 with the intention of stimulating the economy. The Province provided a total of \$47.3 million to Towns for Tomorrow and LocalMotion projects by grant rather than by transfer under agreement. With grants, should the recipients opt to use the monies for alternative projects, the Province has no recourse to recover the funds. The transfer under agreement process thus provides an important accountability control that should not be bypassed.

The agreements for certain projects in the BC Community Water Improvement Program, Towns for Tomorrow and LocalMotion were amended to provide for a \$30.2 million lump-sum advance payment of future claims, again justified with the intention of stimulating the economy. This amounted to up to 90% of the agreed project funding for some projects. Funds under these programs are not normally provided until after the expenditures are incurred and reported on by local governments.

Although recipients must still file expenditure claims and quarterly progress reports, we think that the Province took on additional risks in altering these agreements. We recognize that the Province's ongoing relationship with local governments creates a strong incentive for local governments to comply with requirements. The Ministry of Community and Rural Development also has the ability to retain a 10-15% hold-back if reports are not filed or if funding is used for purposes other than what was approved. However, the agreements do not allow the Province to recover previously transferred funds, which increases the risk to the Province of unapproved use occurring.

This greater risk could have been partially mitigated had strong controls around the review of final expenditure claims been exercised before hold-backs were paid out. We did not find such controls in place.

RECOMMENDATION 4: *We recommend that an overall plan for monitoring projects be established for provincial programs. It should include the audit of a sample of projects annually, particularly all higher risk/or higher value projects, to ensure that only claims for valid expenditures are paid, and projects are completed as required.*

Working Capital Management

In addition to increasing risk, these instances of advance funding — meant to stimulate the economy — incorporated no means to measure effectiveness. In September 2009, six months after the BC Community Water Improvement Program, Towns for Tomorrow and LocalMotion lump-sum advance payments occurred, we visited nine communities that received the advance funding. We were told that:

- ◆ two local governments had spent all of the advance funding received on approved projects;
- ◆ three local governments had spent only some of the advance funding received, and one of these had put the funds toward a different project than that for which the funding had been approved; and
- ◆ four local governments had not spent any of the advance funding received, suggesting that the funds were not actually required when provided.

These results highlight a key accountability weakness. Circumventing established funding processes and controls for these programs — especially without implementing compensatory controls — sidesteps the accountability requirements established to ensure public funds are used as intended and provide value to communities.

As well, advance funding has a significant impact on the borrowing and working capital of the Province. The funds advanced to local governments create the need for the Province to borrow money. If the funds advanced are not immediately required by local governments, as we found might be the case, this points to inefficient working capital management. We expected the ministry to be able to tell us when funds were spent by local governments, but this information was not available. For provincial borrowing and working capital to be optimized, ministries should provide funding to local governments only when it is actually required for each project.

RECOMMENDATION 5: *We recommend that in keeping with good financial management practices, government not advance significant government transfers until the funds are needed by the recipient, unless the results of a cost-benefit analysis show there is a net benefit.*

APPENDIX: BEST PRACTICE EXAMPLES

Examples of best practices in risk management identification

Specific risks to grant programs could include:

- ◆ the possibility of 'double-dipping' (that is, grant recipients being able to obtain grant funding for the same project purpose from more than one source);
- ◆ the effect of partial or insufficient grant funding on the viability of projects;
- ◆ fraud or misrepresentation;
- ◆ breaches of privacy or security of on-line application systems;
- ◆ grants being awarded to ineligible individuals/organisations or organisations which may not be able to complete a project effectively;
- ◆ grants being awarded for projects or activities which are inconsistent with grant program objectives;
- ◆ use of grant funds for purposes contrary to the terms and conditions of the grant;
- ◆ changes in the status/competence of the recipient which could adversely affect their ability to carry out or complete relevant project work;
- ◆ heightened sensitivities in the lead up to elections;
- ◆ pressure to implement programs urgently;
- ◆ individuals or organisations being treated inequitably in appraisal of applications and awarding of grants;
- ◆ grant programs not contributing to achievement of the strategic objectives of the funding organisation;
- ◆ incremental and undocumented changes in interpretation of grant program objectives or guidelines over time;
- ◆ actual or perceived conflicts of interest;
- ◆ unapproved variations to projects during the period of the grant; and
- ◆ shared accountabilities.

Source: Australian National Audit Office, Administration of Grants Better Practice Guide

Examples of best practices in risk management identification

Appropriate strategies and controls:

- ◆ Accept the risk and leave it untreated.
- ◆ Avoid the risk by choosing a different course of action.
- ◆ Treat the risk, bearing in mind there is a trade-off between the cost of the treatment and the benefit from the level of reduction in the risk achieved.
- ◆ Transfer the risk to the grant recipient — the appropriateness of transferring the risk needs to be considered in terms of the capability of the recipient to manage the risk. In general, the party best equipped to manage the risk at least cost should accept the responsibility. Neither party gains from any attempt to naively transfer risk — the better approach is to decide on the most beneficial allocation of risk.
- ◆ Retain the risk — sometimes risks must be retained following risk reduction measures or because of other reasons that require them to be retained by the public sector organisation.

Source: Australian National Audit Office, Administration of Grants Better Practice Guide

Report 4d: August 2010

MANAGING FRAUD RISKS IN GOVERNMENT

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TABLE OF CONTENTS

Executive Summary	50
Response from the Government	51
Detailed Report	
The Nature of Fraud	52
The Size of the Fraud Problem in the Public Sector	53
What We Did	53
The Need for Fraud Risk Management Principles	54
Our Findings Compared with Good Practice	55
Appendix 1: Guidelines for Managing the Risk of Fraud in Government	
The Need for a Fraud Risk Strategy	60
The Five Principles Underpinning a Sound Fraud Risk Strategy	61
Appendix 2: Common Fraud Indicators	68
Appendix 3: Recommended Reading	70

EXECUTIVE SUMMARY

No one charged with governing or managing organizations, whether in the public or the private sector, wants to think they could become the victim of fraud committed by individuals within or outside their employ. The fact is, however, that virtually all organizations face this risk – and for some the results can amount to significant losses of assets and reputation. It is well understood that the responsibility for preventing and detecting fraud lies with those that govern and manage organizations.

Sound fraud risk management is critical if government is to protect public assets. British Columbians trust their government to be taking the necessary steps to safeguard public resources from all potential threats of theft and misuse, including that of fraud. And, for its part, the government has the responsibility to do just that.

Fulfilling this responsibility first requires government to have a good understanding of what the potential for fraud is, by type and size, in all areas of the public sector's operation. Having this information, government can then develop the policies and procedures that are imperative to managing the identified fraud risks effectively and cost-efficiently.

We set out to look at the quality of fraud risk management guidance being used by the public sector in British Columbia. However, we found that there was no such generally accepted guidance available or in use across the province, nor was there a centrally coordinated oversight or management of fraud prevention, detection, investigation or reporting.

As a result, we instead shifted our focus to drafting “good practice” principles for fraud risk management in the public sector and then using these to assess government's performance in its ministries.

A definition of fraud

According to *Black's Law Dictionary* (2009), fraud is “a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.”

We concluded that although government has a number of embedded controls designed to prevent and detect fraud, it needs to improve its oversight and management of fraud risks by taking a more strategic, comprehensive approach in accordance with good practices.

We recommend that government adopt the five fraud risk management principles we have drawn up (presented in Appendix 1) and use them as the basis for developing and implementing a comprehensive fraud risk management strategy.

In developing a comprehensive fraud risk management strategy, government may also find useful the list of common fraud indicators we compiled based on our literature review (see Appendix 2) and the list of readings that we think are most relevant to British Columbia's public sector environment (see Appendix 3).

The issuance of these principles is the first phase of our planned work in this area of fraud risk management. In the next phases we will compare how well the rest of the government reporting entity is doing relative to our five good practice principles, assessing its performance against these principles or against future guidelines government may develop and implement.

RESPONSE FROM THE GOVERNMENT

Government thanks the Office of the Auditor General for this timely information on fraud risk management.

Government agrees that it has a responsibility to safeguard public resources from the threat of theft, fraud and misuse. We have been aware of and have been working with the information referenced in the report from the Association of Certified Fraud Examiners and the Institute of Internal Auditors, over the last few years to improve fraud risk management and fraud awareness.

The existing control framework in place addresses the risks of fraud, theft, error and misuse of government resources. Government identified and has actively managed a number of the examples of fraud mentioned in the report's executive summary.

Government takes a comprehensive approach to managing all risks including fraud by assigning ministries with responsibility to develop risk management plans as part of their service plan, programs and operations. Also, Internal Audit & Advisory Services develops a corporate risk assessment which is used to develop the annual audit plan.

As noted in the report, controls for preventing and detecting fraud, such as continuous monitoring of controls and transactions, are embedded in our existing control framework.

Government agrees with the intent of the five principles and the related best practices. Specific principles and actions included in the report will be reviewed in light of our existing controls and policies to determine the applicability to our provincial context.

THE NATURE OF FRAUD

Fraud occurs in many forms. *Internal fraud* can be committed by employees:

- ♦ misappropriating assets – for example, stealing inventory, not recording all sales, setting up fictitious employees on the payroll, setting up false suppliers or shell companies, falsifying expense claims, or using business credit cards inappropriately; or
- ♦ making fraudulent statements or claims – for example, falsifying academic or training credentials or “cooking” financial records (such as creating fictitious revenues or concealing expenses).

External fraud can be committed by outside parties such as contractors or suppliers misappropriating an organization’s assets. Billing for services not provided and falsifying eligibility for claims are examples of this type of fraud.

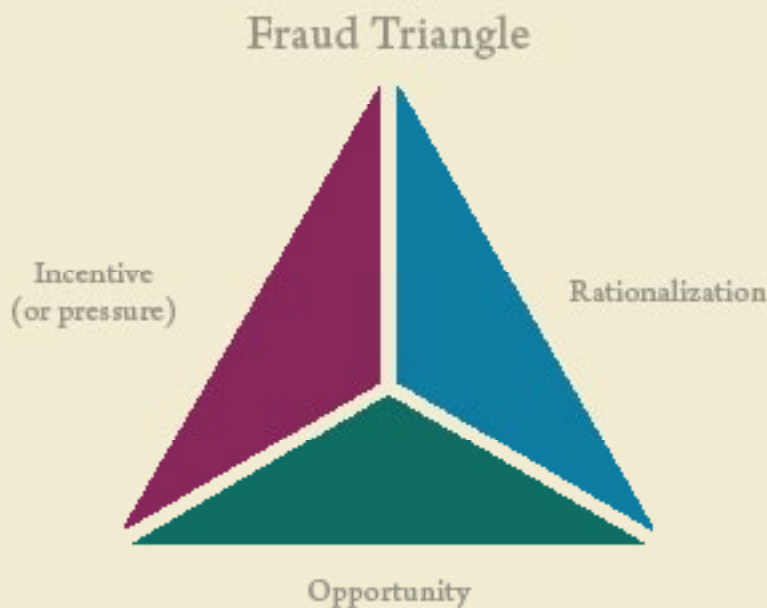
Fraud can also occur if an employee colludes with a party outside the organization. This can lead to corruption-related fraud, such as conflict-of-interest schemes and kickbacks.

One way to understand and consider the risk of fraud is to look at the three factors that are present in every fraud situation (Exhibit 1):

- ♦ *Incentive* (or pressure) – the need by the individual (or individuals) to commit fraud (e.g., need for money)
- ♦ *Rationalization* – the mindset of the individual (or individuals) that enables him or her to justify committing fraud
- ♦ *Opportunity* – the situation that enables fraud to occur (often when internal controls are weak or non-existent)

Fraud risk management involves structures and processes to mitigate risk of loss due to fraud. These structures and processes are aimed at creating deterrence in the “opportunity” aspect of the triangle because the “incentive” and “rationalization” aspects are more difficult to directly influence or control.

Exhibit 1: Incentive, rationalization and opportunity are the three elements of the “fraud triangle”



Source: Dr. Donald R. Cressey

THE SIZE OF THE FRAUD PROBLEM IN THE PUBLIC SECTOR

Fraud is a significant problem for public sectors in jurisdictions worldwide. However, quantifying the extent of fraud is difficult because of the nature of concealment by the perpetrators, and a lack of reliable reporting. However, some estimates are available, which indicate the size of the problem:

- ◆ The Association of Certified Fraud Examiners, based in the U.S., estimated that the median fraud level reported in a survey of public sector, private sector, non-profit and government organizations was 7% of revenue (*2008 Report to the Nation on Occupational Fraud*).
- ◆ The U.S. Department of Justice reported fraud settlements and judgements in 2009 under the False Claims Act of \$2.5 billion;
- ◆ In terms of fraudulent claims to social benefits, the New Zealand government reported \$42 million in benefit fraud in 2006/07, equal to about 0.5% of total national expenditures. This estimate is close to that reported in the UK's 2008 National Audit Office/HM Treasury *Good Practice Guide*, which put benefit fraud at about 0.6% of expenditures. The UK National Audit Office report *International Benchmark of Fraud and Error in Social Security Systems* (2006) notes the rate of benefit overpayment in Canada in 1994 to be 3.0–5.0% of benefit expenditures.

While the vast majority of government employees and those outside parties providing goods and services to government are likely honest and trustworthy, the chance to benefit through an act of fraud – even what seems a very minor act – is a temptation for many individuals. Across British Columbia's public sector, numerous cases of fraud are reported annually, involving small to large amounts of money. Among the most common cases are purchase card misuse by employees, and inventory theft.

Specific recent examples like those below from recent years show the range in fraud form and extent in the provincial public sector:

- ◆ An employee of the Public Guardian and Trustee misappropriated \$1 million of assets that were held in trust, and also made fraudulent statements on an employment application. While 97% of the funds were recovered, the case cost over \$1 million to investigate and sanction.

- ◆ A logging company allegedly defrauded the Ministry of Forests recently of over \$600,000 by manipulating software that reduced total assessed stumpage revenue.
- ◆ Purchase card fraud is a commonly cited employee related fraud in government's fraud tracking system.
- ◆ An employee at one of the province's colleges created, submitted and approved fictitious invoices for payment, resulting in over \$400,000 being fraudulently billed. Significant amounts were also spent to investigate and follow through the process.
- ◆ Two former employees of one of the province's school districts have been accused of diverting cheques payable to the school district – worth over \$160,000 – to their own bank account.
- ◆ The police recently alleged that a Ministry of Health contractor double-billed the ministry and the Provincial Health Service Authority for tens of thousands of dollars in 2007 by influencing a senior ministry employee to directly award the contract and control approval of invoices. Charges have recently been laid and the allegations have not yet been proven in court.

All of these provincial public sector examples serve to illustrate why establishing a fraud-aware culture, backed up with a well-designed, well-functioning system of internal controls to address fraud risks, is so critical for the province. Only in this way can government help prevent significant fraud losses, as well as maintain public confidence in government's ability to safeguard the province's assets and property.

WHAT WE DID

We set out to look at the quality of fraud risk management guidance being used by the public sector in British Columbia. When we began planning this work, however, we quickly found that although government's general control environment does have a number of practices designed to prevent or detect errors or fraud, there was no such generally accepted guidance available or in use across the province. We also learned that there was no centrally coordinated oversight or management of fraud prevention, detection, investigation or reporting.

As a result, we instead shifted our focus to drafting "good practice" principles for fraud risk management in the public sector and then using these to assess government's performance in its ministries.

First we researched what other public sector jurisdictions and organizations around the world have done to improve their approach to fraud risk management. Second, from the many common principles and themes that emerged, we developed guidelines appropriate to a public sector environment, including British Columbia. Finally, we compared central government's existing fraud risk management practices in its ministries with those in our good practice guidelines.

Although we did not assess the fraud risk management strategies in the greater public sector, the principles nonetheless are still applicable to any government organization.

Our background research showed that government can reduce the opportunity for fraud by adopting a principle-based, strategic approach to fraud risk management to complement the existing embedded internal control schemes it has in place. Essential elements of such an approach include:

- ◆ assessing fraud risks in each program;
- ◆ assigning responsibility for fraud risk management;
- ◆ putting appropriate preventative and deterrence measures in place and monitoring their performance;
- ◆ putting appropriate detective, investigative and disciplinary programs in place and monitoring their performance; and
- ◆ reporting regularly on all fraud risk management activities and results.

THE NEED FOR FRAUD RISK MANAGEMENT PRINCIPLES

Taxpayers should have confidence that public funds are managed prudently and appropriate risk mitigation procedures are in place to protect public assets from fraud and misappropriation. Robust fraud risk guidelines are an important part of an overall strategy for effectively managing this risk. Common guidelines set the stage for good fraud prevention practices to be consistently applied across the entire public sector.

The governments in the United Kingdom and Australia, for example, have published and implemented good practice guidance for public sector fraud risk management. As well, the National Fraud Initiative of the UK's Audit Commission has been carrying out proactive fraud and error detection work by matching data received from various

government entities. Audit Scotland, the Northern Ireland Audit Office and the Auditor General of Wales all carry out similar detection work. The UK Audit Commission reported that over £450 million (about CAN \$750 million) in fraud and error has been detected since the commission's inception in 1996 to early 2009.

The set of good practice guidelines we developed for managing risk in British Columbia's public sector is presented in Appendix 1. These guidelines are built on five principles:

Principle 1: Government should have a well-developed understanding of the fraud risk inherent in its programs

Principle 2: Fraud risk in government should be managed through clear roles and responsibilities

Principle 3: Government should have appropriate preventative and deterrent measures in place and regularly monitor their performance

Principle 4: Government should have appropriate detective, investigative and disciplinary procedures in place and regularly monitor their performance

Principle 5: Government should have effective reporting procedures in place to communicate the results of its fraud risk management activities to its stakeholders, such as Members of the Legislative Assembly and the public

By adopting these principles, government would be committing to:

- ◆ acquiring a more comprehensive understanding of the fraud risk inherent in its programs and documenting this information in a comprehensive risk register;
- ◆ articulating and assigning clearer roles and responsibilities for fraud risk management;
- ◆ implementing or improving appropriate fraud preventative and deterrent measures and regularly monitoring their performance;
- ◆ creating a stronger anti-fraud culture in government by improving appropriate detective, investigative and disciplinary procedures for fraud; and
- ◆ communicating the results of all fraud risk management activities to stakeholders, such as Members of the Legislative Assembly and the public.

OUR FINDINGS COMPARED WITH GOOD PRACTICE

Central government does not have an overall, coordinated or comprehensive understanding of fraud risks across all its programs

Comprehensive fraud risk assessments should be regularly conducted so that government has a good understanding of the types of fraud that can occur. Results of these assessments would normally be documented in a fraud risk register. Without such assessments, it is difficult for government to know where to target its efforts and resources efficiently in managing the risk of fraud in its programs and operations.

A centralized approach to fraud risk management will ensure there is an organized process in place to manage the overall risks, identify gaps in the overall strategy, and allow resources to be efficiently deployed.

We found several gaps in British Columbia's current practices compared with good practice:

- ◆ Government does not currently have an overarching fraud risk management strategy. Staff in the Office of the Comptroller General have told us, however, that they plan to prepare a strategy in the near future, after our guidelines have been published. We were also advised recently that the Comptroller General is now considering carrying out a project on government-wide fraud

Some current controls, strategies used by central government that assist in managing its fraud risks:

- ◆ Several ministries have compliance and enforcement groups in areas such as income assistance, gaming, and medical service plan;
- ◆ The Corporate Compliance and Controls Monitoring Branch provides a risk-based compliance review of certain payment types;
- ◆ Internal Audit & Advisory Services (IAAS) has several staff dedicated to investigative work, and also carry out or

risks, as noted in the IAAS 2010/11 audit plan.

- ◆ Fraud has not been identified as a key risk in the Internal Audit and Advisory Services' Corporate Risk Assessment – this despite a recent report from a branch in the Office of the Comptroller General which stated that exposure to some financial risks (including fraud) during 2008/2009 was unacceptably high.
- ◆ Government does not maintain a dedicated fraud risk register. Such a register allows all types of fraud to be identified, their likelihood of occurring to be assessed, mitigation efforts to be checked against existing controls, gaps in control work to be identified, and additional mitigation efforts to be planned as necessary, taking into account the tolerance to accept risk and subject to cost-benefit constraints.
- ◆ The Risk Management Branch of the Ministry of Finance has prepared an Enterprise Risk Management (ERM) Guideline for the province's public sector, based on the Australia-New Zealand model. Fraud risk is one of the several types of risk to manage.

One of the first ERM activities called for in the guideline is the coordination of initial risk identification and analysis, using a standard risk register template. However, no central agency in government has been made responsible for coordinating such work. The Risk Management Branch itself has no mandate for monitoring or evaluating fraud risks in ministries. Currently, it only collates the incidence and loss reporting data it receives from ministries and submits this data to the Office of the Comptroller General. The branch also does not analyze the data or assist ministries in fraud risk assessments, as required in government's core policy and procedures manual.

oversee risk and control reviews on new financial systems, and some fraud awareness sessions;

- ◆ All public servants are required to take an Oath of Office when they commence employment to conduct themselves with integrity and ethically, and comply with the Standards of Conduct;
- ◆ Awareness building by the Comptroller General through year-end meetings with ministry Chief Financial Officers, and required annual declarations about internal controls in the context of the annual audit on the Public Accounts. There are also some references to fraud in training provided to financial staff that approve expenditures.

Good practice suggests that a centralized approach to fraud risk oversight, assessment and monitoring should be used so that resources can be effectively targeted at the highest risk areas.

Although we have noted these gaps, that does not mean that government is absent in managing its fraud risks. Government's general control environment does include a number of practices that are designed to some degree to prevent or detect errors or fraud, as shown in the sidebar. Although the fraud risk components are embedded in these controls, they are not guided by an overall fraud risk framework.

Fraud risk in government could be managed in a more well-coordinated, well-communicated manner

Setting clear responsibilities for managing fraud risks is important so that the effort achieves results efficiently and so that mitigation procedures and corrective actions are consistently applied. Currently, government's Core Policy and Procedures Manual requires general loss incidents (including those of suspected fraud) to be reported immediately to a supervisor, and within 24 hours to the ministry Security Officer and Chief Financial Officer, the Risk Management Branch, and the Office of the Comptroller General. The ministry Executive Financial Officer is required to advise and seek guidance immediately from the Comptroller General and the human resources consultant assigned to the ministry. The Executive Financial Officer is also required to contact police, if warranted. The Office of the Comptroller General may direct its Internal Audit and Advisory Services to conduct or otherwise assist in an investigation of an incident.

While this policy appears to be robust, we found several gaps:

- ◆ There is no overarching structure that directs anti-fraud resources and tools across government. We were also told that government investigative units generally operate in isolation.
- ◆ We were advised that ministries do not always seek guidance from the Public Service Agency (government's central human resource organization) early on in the investigation process to find out how they should deal with employees involved in potentially fraudulent activity. In some suspected instances of fraud, better outcomes might have resulted if the Public Service Agency had been consulted earlier in the process.

Government could improve its measures in place for preventing and deterring fraud, and regularly report on the results of its activities

Creating a strong anti-fraud culture within government is an important step in mitigating risks of potential losses due to fraud. For example, ministries could adopt preventative measures such as regular fraud awareness training and criminal record checks for employees in key financial positions. They could also adopt improved deterrence measures such as a government-wide fraud hotline and regular reporting of sanctions.

Once implemented, preventative and deterrence measures should then be regularly monitored to ensure they continue to be effective.

We identified several areas where government is making progress, and others where it should bring preventative and deterrence measures in line with good practice:

- ◆ Requiring criminal record checks (CRC) as a condition of employment for designated positions is a preventative method to ensure that those with a history of fraud convictions are not placed in positions of trust over government assets. Up until recently, this practice had not been widely adopted within government for financial positions.

In April 2010, however, government announced new security screening policy and processes requiring new employees applying to designated positions to successfully complete a CRC before appointments are confirmed. Although these new requirements were driven to help protect the privacy of citizen information and vulnerable clients, it also applies to specific types of financial positions of trust over government assets.

- ◆ Government has not always publicized its cases of successful fraud prosecution. According to good practice literature, letting both inside and outside audiences know about frauds detected and sanctions carried out after the justice processes are complete, establishes an appropriate tone from the top, and is considered a useful deterrent to anyone else tempted to commit a fraudulent act. They can also be used as case studies for lessons learned for employee fraud awareness training, and to make improvements to internal controls.
- ◆ Internal activities by government to increase fraud awareness to its employees have been limited. Internal Audit and Advisory Services makes occasional presentations to ministry Chief Financial Officers, some OCG staff, and several ad hoc groups.

There are also several references to fraud in training provided to staff that approve expenditures. We found no regular in-depth fraud awareness training being provided to all employees, or even staff in key positions.

- ◆ The Corporate Compliance and Controls Monitoring Branch (3CMB) within the Office of the Comptroller General produces an annual statistics report of reviews of payment monitoring it has conducted during the year. This report is distributed to ministry Chief Financial Officers to help increase cross-government compliance and awareness.
- ◆ Government legislation and policies do not define fraud and do not specifically provide for independent “whistleblower” protection (that is, protection for people, either inside or outside of government, who report suspicious actions).

Currently, the Standards of Conduct policy section on allegations of wrongdoing indicates that employees will not be subject to discipline or reprisal for bringing an allegation of wrongdoing forward if it is done in good faith. Confidentiality is assumed, however, the standard also notes that third party disclosure of this confidential information may be required under legislation, such as the Freedom of Information and Protection of Privacy Act (FOIPPA). This act also includes whistleblower protections for privacy related offences.

There are also a number of other acts that provide for internal whistleblower type protections, although they are not specifically fraud related, including: E-Health (Personal Information Access and Protection of Privacy) Act, Wildfire Act, Forest and Range Practice Act, Personal Information Protection Act, Employment Standards Act, the Human Rights Code and the Labour Relations Code.

The Financial Administration Act also requires employees to report certain matters to the Comptroller General relating to expenditure and payment authorizations, although it is not clear if this applies to cases of suspected fraud.

- ◆ No government-wide fraud hotline (or “tip line”) for reporting suspicious activities exists. Two government branches in different ministries appear to operate hotlines in isolation. The Office of the Comptroller General also receives calls on an ad hoc basis. It would be difficult to determine whether or not employees have the confidence with the current system to report their concerns or suspicions.

One of the key tools reported in good practice literature for preventing and detecting fraud is a centralized fraud hotline. For example, the Association of Certified Fraud Examiners

reported in 2008 that 50% of all frauds detected in government cases were the result of tips to a hotline (Exhibit 2). Of those tips, 58% were generated by employees. In our view, a hotline set up in British Columbia’s public sector to enable employees and third parties (such as suppliers and members of the public) to alert government to potential fraud would be a valuable tool for fraud risk management.

A vital part such a tool must also be whistleblower protection in place to assure that those individuals providing tips will be adequately protected from retribution.

The effectiveness of government’s fraud investigations are hampered by several factors

Although government, like many organizations, has controls in place to help prevent frauds, they nonetheless still occur. Although not all suspicious activities or allegations turn out to be frauds, they still need to be investigated and assessed.

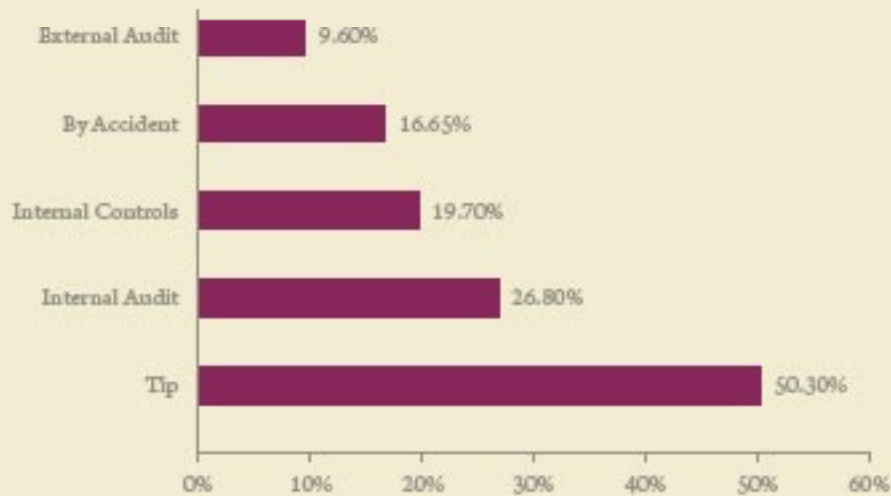
In British Columbia, the only government body performing fraud investigation work on a cross government basis is the Internal Audit and Advisory Services. Most of the work performed by the four staff dedicated to this area is reactive (investigating incidents) rather than proactive (preventing incidents). Some analytic work is also carried out by the 3CMB group and provided to Internal Audit and Advisory Services. There are also several compliance and enforcement units in a few ministry program areas (for example, the Ministry of Housing and Social Development and the Ministry of Forests, and the Ministry of Health).

As well, in the government’s service agreement with the RCMP, there is provincial funding for one resource position within the RCMP’s Commercial Crime Section allocated to government fraud investigations. We were told that only the most serious or largest cases of fraud have the potential to be prosecuted, which is governed by Crown Counsel charge approval guidelines.

The rate of successful corrections and sanctions made has also been limited. We noted, for example, that:

- ◆ The Internal Audit and Advisory Services investigations group has a spreadsheet tracking tool to record allegations brought to its attention. About 70 cases have been recorded since 2007 when the group was formed. Two cases have been successfully prosecuted to date and another six other cases are

Exhibit 2: Sources of fraud detection in the U.S. government, 2008 (by percentage of total frauds detected)



Source: Association of Certified Fraud Examiners, 2008 Report to the Nation on Occupational Fraud.

Note: The sum of the percentages in this chart exceeds 100% because in some cases respondents to the ACFE survey identified more than one detection method.

currently going through the charge and court process. A number of other allegations investigated have been deemed to be unfounded and closed. In some instances, staff at Internal Audit and Advisory Services have had to re-perform investigations that ministry staff tried to complete on their own. We were told that this “go it alone” approach by ministries has also sometimes resulted in unsuccessful or unfavourable outcomes rather than what was intended. On top of that, it contravenes government’s policy requiring ministries to report loss incidents (discussed in the next section).

- ♦ Ministry staff are not always forthcoming or co-operative with IAAS investigators, resulting in some IAAS investigation reports containing limitation of scope clauses, or intervention from senior management. This lack of cooperation also contravenes government’s policy around annual loss-reporting process (discussed in the next section).

Government is not reporting fully on the results of its fraud risk management activities to its stakeholders

It is important that those responsible for managing fraud risk in the public sector receive regular reporting on fraud risk management activities. This reporting should be comprehensive so trends can be identified, losses minimized, and the effectiveness of activities assessed.

External reporting to the public helps highlight the importance that government places on managing fraud risk. This reporting can describe the activities undertaken in the period, the results of those and previous activities, and the corrective actions and sanctions that resulted. Such reporting also helps act as a deterrent from future loss by making those individuals considering fraud aware of the likely consequences of their actions.

Current government policy, as laid out in the Core Policy and Procedures Manual, requires ministries to report to the Risk Management Branch, losses they have experienced through general loss incidents and illegal activities. This reporting is supposed to detail the number of loss incidents, the value of losses and recoveries, the net loss and the reason for losses. It is also to describe the safeguards and loss control measures implemented by the ministry. The Risk Management Branch must then publish all the results on its website and that of the Government Security Office.

We found several gaps and weaknesses in government's current reporting practices:

- ◆ The most recent report of the Risk Management Branch available at the time of our work was for the fiscal year ending March 31, 2006. We found that neither that report nor previous ones met government's own policy requirement sufficiently because they did not include the reasons for the losses or the safeguards and loss control measures implemented.
- ◆ Although the Risk Management Branch collates government loss information sent to it from the ministries, it is not receiving all cases of suspected fraud as the policy manual requires. We were also told that ministries sometimes choose to handle fraud cases on their own.
- ◆ Section 35 of the Financial Administration Act requires the Comptroller General to deliver a statement to the Treasury Board and Auditor General each year outlining (amongst other things) any significant irregular government expenditure and payments. Our Office has not received a report for the 2008/09 fiscal year or recent prior years. However, we have received a summary of of government's fraud related investigations for the last several years, since the investigation group was set up.
- ◆ Government policy requires that asset loss reporting statistics be published annually by the Risk Management Branch. The statistics currently on the branch's Internet (accessible to the public) and intranet (internal to government) websites are out of date (the latest statistics shown are for fiscal 2006/07) and lack detail to enable readers to draw meaningful conclusions.
- ◆ Government policy requires the Risk Management Branch to provide the Comptroller General with a monthly report and analysis of all loss incidents. We found this reporting was not being supplemented with the required analysis. Furthermore, we found no evidence that the branch has been following up, investigating or reporting to the Comptroller General any unusual fluctuations in the number of events reported by the ministries. Such analysis and follow-up of these reports by the branch could, we think, lead to more fraud threats being identified and investigated.

THE NEED FOR A FRAUD RISK STRATEGY

All governments have a fiduciary responsibility to establish and follow a comprehensive set of fraud risk management policies and procedures so that taxpayers can be confident that public resources are being appropriately safeguarded. Such policies and procedures – governing assessment, roles and responsibilities assignment, deterrence, prevention, detection, investigation and sanctioning – should be developed as part of an overall fraud risk strategy to help a government mitigate its exposure to fraud risk.

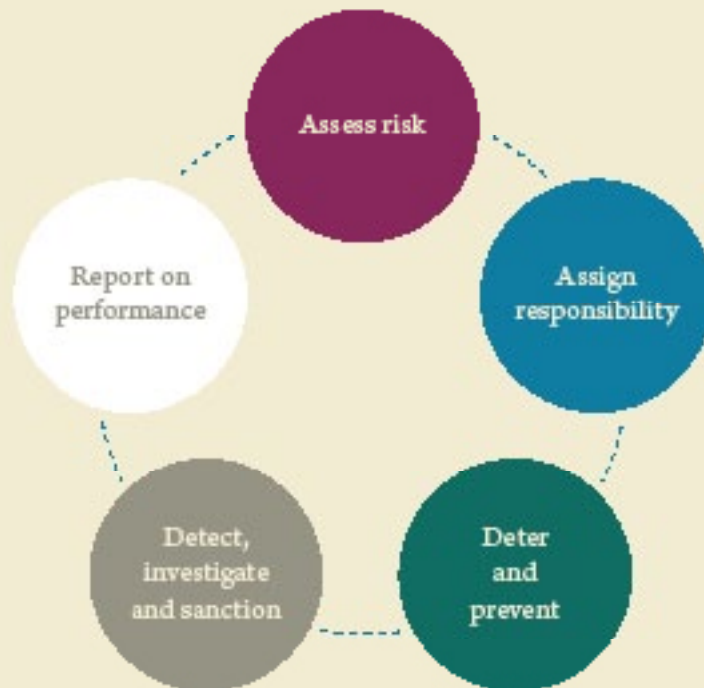
Exhibit A1 shows the five key steps necessary to build a robust fraud risk strategy.

A strategic approach like this offers government several advantages:

- ◆ It promotes the efficient and effective use of financial and human resources by enabling government to focus its management efforts in high risk areas.
- ◆ It enables government to provide staff and stakeholders, such as Members of the Legislative Assembly and the public, with clear, detailed guidance as to how fraud and fraud risk will be managed across the public sector.
- ◆ It enables government to set specific and realistic program objectives and performance measures that can be readily monitored and evaluated.

By adopting a risk-based focus to fraud management, government would be able to determine which business areas are the most susceptible to fraudulent activity and should therefore receive the highest level of anti-fraud measures.

Exhibit A1: The five main steps of a fraud risk strategy



Source: Adapted from the NAO/HM Treasury Good Practice Guide “Tackling External Fraud” and the Association of Certified Fraud Examiners / Institute of Internal Auditors / American Institute of Certified Public Accountants joint report “Managing the Business Risk of Fraud: A Practical Guide”

THE FIVE PRINCIPLES UNDERPINNING A SOUND FRAUD RISK STRATEGY

Principle 1: Government should have a well-developed understanding of the fraud risk inherent in its programs

Government, like any organization, needs to have a good understanding of the potential for fraud that exists in its various operations. This entails studying and analyzing its exposures, by size and type, to frauds that could occur. Without having a well-considered and documented understanding of fraud risk, government will be reactive instead of proactive and will not be able to efficiently and effectively mitigate its risk of loss due to fraud.

Fraud occurs in many forms. *Internal fraud* can be committed by employees:

- ♦ misappropriating assets – for example, stealing inventory, not recording all sales, setting up fictitious employees on the payroll, setting up false suppliers or shell companies, falsifying expense claims, or using business credit cards inappropriately; or
- ♦ making fraudulent statements or claims – for example, falsifying academic or training credentials or “cooking” financial records (such as creating fictitious revenues or concealing expenses).

External fraud can be committed by outside parties such as contractors or suppliers misappropriating an organization’s assets. Billing for services not provided and falsifying eligibility for claims are examples of this type of fraud.

Fraud can also occur if an employee colludes with a party outside the organization. This can lead to corruption-related fraud, such as conflict-of-interest schemes and kickbacks.

Establishing a fraud risk register

A fraud risk register provides government with a critical tool for documenting the types and occurrences of fraud risk in its programs and operations.

The register should include the identification of each kind of risk, an assessment of the likelihood of its occurrence, the estimated significance (financial, legal and reputational) of the risk, and suggested responses to managing the risk. Such responses should be based on an assessment of the incentives (or pressures) and the opportunities to commit fraud – essentially, where a fraud incident could happen and who might commit it.

The initial risk assessment should consider the inherent risk of fraud in government, absent of any existing controls.

Assessing incentives and opportunities: In assessing *incentives* that might compel individuals to commit fraud, one element to consider is the pressure on employees to achieve performance goals. For example, understanding bonuses and other performance-based pay within government, and the basis on which these are calculated, can help identify areas where a fraud incentive might exist.

In assessing *opportunities* that might give someone reason or temptation enough to commit fraud, it is important to think like a potential fraudster. Ask: Where are controls weak? How could controls be circumvented? How could the fraud be concealed?

Weak controls and a lack of segregation of duties can signal to some individuals a potential opportunity for committing fraud. The ability for senior management to override controls is another area of risk that should be assessed.

Gathering information about past frauds: Opportunities for committing fraud are always changing (consider how communication and information management technologies have changed access to information) and must therefore be constantly watched for. However, understanding the different types of fraud that government has already encountered in the past provides invaluable information for developing effective fraud prevention and detection techniques. This information should be captured as part of the case management system discussed under Principle 4, below.

Given the types of fraud seen in government environments, the following information should be tracked:

- ♦ the nature of the fraud;
- ♦ the duration and frequency of the fraud;
- ♦ the level of complexity or sophistication of the fraud;

- ◆ whether the fraud was committed by an employee, by an external party, or by both; and
- ◆ whether the fraud was an opportunistic incident or part of a targeted, organized crime?

Assessing frauds by type: A team approach to fraud risk assessment should be used to ensure that all types of potential frauds and all existing controls and possible corrective actions are considered. Financial managers, internal auditors, program staff, risk management staff, legal advisors and human resources staff should all be part of the assessment process to achieve best results.

Estimating the potential significance of various fraud risks: After considering the types of frauds that could be committed, the next step is to estimate the potential significance of each. This is most often done through statistical modelling and in-depth research. Statistical modelling by way of reviewing a sample of transactions for fraud and then extrapolating the results over the entire population is relatively simple. However, several factors may influence the accuracy of estimates:

- ◆ The population may not be homogeneous, making a representative sample difficult to extract.
- ◆ The available data may not be complete and thus not truly representative of all the fraud threats.
- ◆ It may be difficult to classify irregularities detected in the sample as clearly erroneous or fraudulent. Irregularities are not always the result of fraud, but may have occurred through negligence, incompetence or genuine mistake.

An example of *in-depth research* used to estimate risk significance would be applying published fraud statistics of other similar jurisdictions to the particular government operation and then estimating a level of fraud. Alternatively, an external firm could be engaged to conduct fraud penetration and data security testing against government operations.

Establishing appropriate controls for each risk identified: Risks identified should then be “mapped” to existing controls, and new controls should be designed and implemented as necessary to fill in gaps.

Both preventative and detective controls should be in place for risks that involve potential collusion or override by government managers, as controls such as segregation of duties will not likely be sufficient to detect fraud in those cases.

Planning appropriate responses to each risk identified: Responding to each fraud risk will depend on what government’s risk tolerance is. A “zero fraud” policy, while theoretically the ideal goal to promote, will not likely be achievable since the cost to address all the fraud risks identified may be too high. Therefore, in risk response planning, it is important to consider what risks are worth covering, and what residual ones are not.

Principle 2: Fraud risk in government should be managed through clear roles and responsibilities

Establishing clear roles and responsibilities for managing fraud risk must begin first with establishing a focused and clearly explained fraud risk management policy. The policy should be part of the organization’s operational manual, available to all staff. The requirement to comply with all operational policies – including the organization’s fraud risk management policy – should also be included in the standard terms and conditions of employment contracts for all staff.

Developing a comprehensive fraud risk management policy

An organization should ensure that its fraud risk management policy includes:

- ◆ a definition of fraud and a description of the organization’s attitude to fraud and commitment to investigating and prosecuting fraud;
- ◆ an explanation of staff responsibilities in preventing and reporting fraud;
- ◆ assurance that reported incidents or suspicious activities will be managed in a professional and confidential manner;
- ◆ a summary of the possible consequences of fraudulent behaviour (including disciplinary action, termination of employment or contract, counselling, and legal action to recover fraud losses); and
- ◆ a statement about arrangement for protecting “whistleblowers” (individuals who report suspected cases of fraud).

The fraud policy should also require employees and contractors to report suspected fraud immediately to the individual with the designated responsibility, ideally through a hotline. The fraud policy should promote the awareness of this hotline and the fact that protection exists for employees using the service.

Government should ensure that employees at all levels, plus contractors, have acknowledged through an annual sign-off that they have read the fraud risk policy and the organization's code of conduct and are abiding by those policies. The sign-off may also include an acknowledgement that the employee is not aware of anyone committing fraud against the government. Having a conflict-of-interest policy in place also ensures that employees and contractors must come forward and disclose any potential or actual conflicts of interest they may have in carrying out their work.

Assigning roles and responsibilities

Assigning responsibility and accountability for managing fraud risk is important to ensure that the anti-fraud measures implemented by government can be effectively applied. The fraud risk management policy should assign responsibilities at all levels of staff so that everyone knows who is expected to do what in mitigating the risks.

This approach works best if fraud resources are integrated and coordinated within government. In large government organizations and in central government, it may be even more cost-effective to create a specialist unit that can focus exclusively on dealing with fraudulent activities.

Having a central, coordinated function in place for fraud risk management can also help ensure there is a systematic and organized process for the management of fraud risk. This will enable better efficiencies to be achieved in committing resources to fight fraud and also help illuminate any gaps in government's anti-fraud strategy.

Principle 3: Government should have appropriate preventative and deterrence measures in place and regularly monitor their performance

Prevention measures aim to stop frauds from occurring. These measures are the first line of defence against fraudsters, and it is essential that the measures be effective in stopping the majority of fraudulent activity. Frauds that circumvent these preventative and deterrence measures will require subsequent detective measures if they are to be found.

Developing and promoting an anti-fraud culture

Government can deter fraud by influencing the attitude towards it. Employees who view fraud as socially unacceptable or criminal are less likely to commit it than those who might try to justify doing it. Government should set the right tone from the top regarding its intolerance of fraud and make clear that ethical behaviour is expected throughout the organization.

Government can communicate deterrence messages to staff in many ways, for example by:

- ♦ *Establishing a robust fraud risk management policy* (as discussed under Principle 2)
- ♦ *Publicizing the fact that preventative, deterrence and detective controls are in place* – Effective preventative controls that are in place, working and well known throughout the organization will also serve as strong deterrents because most people are afraid of getting caught. Continuous communication and reinforcement of all controls are important. The message needs to get out to both internal parties (employees) and external parties (suppliers and contractors). Getting the message out to service deliverers that fraud will not be tolerated will also help get the same message out to service users (e.g., benefit claimants).
- ♦ *Conducting reference checks and criminal record checks* – Criminal record checks and background checks are important preventative and deterrent measures. The people being hired (employees and contractors) are in a position of trust and authority. A past history of criminal activity is a red flag for fraud. Before conducting criminal record checks, the government organization should consult with its Human Resources department and legal advisors to ensure legislation such as the Human Rights Act is not violated. A policy that encourages criminal record checks for all staff in a position of financial management and trust over public funds is good practice and government should consider requesting this from all such employees and contractors before beginning a business or employment relationship.

Confirming reference checks and educational history can also uncover fraudulent statements. Any embellished or falsified statements represent increased risk that needs to be considered in the hiring process.

- ♦ *Making it known that previously disciplined employees and contractors will be red-flagged in the Human Resources system* to prohibit their obtaining future employment or contract work in government.

- ◆ *Including in supplier contracts information about government's fraud policy* – All contractors should be made aware of the fraud policy and required to sign off in the contract that they have read the terms of the policy and will comply with it.
- ◆ *Stressing in new employee orientations the organization's anti-fraud culture and fraud risk management program* – Initial orientation about the organization's anti-fraud culture and ongoing education on the fraud risk management program are important for all employees. This will help reinforce the tone from the top.
- ◆ *Running annual fraud awareness training programs* – Fraud awareness training for staff should include defining fraud, explaining the fraud risk management policy, and giving examples of public sector fraud and of red flags that should alert employees to suspicious behaviour. Attendance at these training sessions and at periodic refreshers should be mandatory.
- ◆ *Regularly monitoring compliance with internal controls and communicating the findings of that work with all employees* (this is both a preventative and detective measure and is discussed in detail under Principle 4) – The importance a government organization attaches to its Internal Audit department is an indication of its commitment to maintaining internal controls. With respect to fraud risk management, Internal Audit can be involved in fraud investigations, conducting internal control reviews and making recommendations for improvement, monitoring fraud hotlines and providing fraud awareness training sessions.
- ◆ *Publicizing internally across the organization information about frauds that have been detected and the disciplinary action taken*
- ◆ *Establishing fraud hotline and whistleblower protection* (this is both a preventative and detective measure, and is discussed in detail under Principle 4) – It is important that employees and third parties have a process to report instances of non-compliance with the expected behaviour. A hotline for reporting tips anonymously is a common way. Those who do report fraud (whistleblowers) must also know they will be protected.

Limiting some employee roles and responsibilities

The level of authority granted to initiate and approve transactions should be reasonable for the employee's level of responsibility. This is especially important where fraud controls are few and duties are not well segregated.

In a good fraud risk management program, all fraud prevention and deterrent procedures are documented, along with the respective roles and responsibilities, and these procedures are monitored on a regular basis to ensure they remain effective and the responsibilities assigned to employees remain appropriate.

Making fraud risk an integral part of new program development

Considering the risk of fraud attacks when developing new programs can reduce later costs for implementing fraud prevention and detection measures. Internal Audit should be consulted early in the development process to assist with the identification of financial risks and the appropriate strategies to mitigate them.

Maintaining a continuous review of existing controls

Even though government may have instilled effective controls when a program was launched, those controls might become ineffective over time. This can result, for example, through fraudsters developing more complex methods of attack or through changes occurring in the business process of the program. Advances in information technology may also mean that new, more cost-effective controls are available to replace original controls.

For this reason, it is critical that organizations continuously and systematically review of controls.

Principle 4: Government should have appropriate detective, investigative and disciplinary procedures in place and regularly monitor their performance

Tackling fraud head-on using proactive methods of detection is good practice. Detective procedures are required to uncover frauds when preventative measures are not in place or are not strong at mitigating the risk. Detecting frauds and prosecuting fraudsters will not only reduce losses to an organization but also deter other potential fraudsters. Fraud detection will also help to identify new threats, or themes, that are developing. Based on these developments, the organization's strategic approach to managing fraud risk can be suitably updated (if necessary).

Important to keep in mind is that these are not intended to *prevent* fraud occurring. The cost-effectiveness of prevention techniques versus detective techniques should be considered when designing fraud controls. It may be more cost-effective to have good detective measures in place versus preventative controls.

Detecting fraud activities

Establishing detection measures: Reconciliations, independent reviews, physical inspections, analysis and audits are all process controls designed in part to detect fraudulent activity. The design of these process controls is best done after first analyzing the types of frauds that could be committed in the government environment.

Two especially good proactive detection measures to analyze financial data are installing fraud hotlines and using computer-assisted techniques.

- ♦ *Fraud hotlines:* Fraud hotlines are the most common source of detected frauds, and can be a cost-effective way for staff – and even members of the public – to report suspicious activity.
- ♦ *Computer-assisted techniques:* Techniques such as data matching and data mining can also aid in detecting suspicious activity.

Data matching uses computers to match different data files and scan for abnormalities. For example, matching a series of electronic payment transfers to an approved supplier list can be used to look for suspicious payments.

Data mining uses computer models to generate patterns, themes or associations that may help identify suspicious activity. For example, sorting an organization's credit card transaction data by payee or transaction day can be used to look for suspicious activity.

The advantage of data matching and data mining is that a large amount of transaction data can be reviewed and analyzed in a relatively short time. Operators can also easily filter and prioritize data based on pre-determined risk assessments.

Before undertaking this work, however, government should be aware and take account of any legislation that may limit the collection and use of personal information for purposes of data matching.

Guideline for setting up a fraud hotline:

- ♦ A single free telephone number should be used. This can be supplemented by an online email submission form or regular mailing address.
- ♦ The hotline's existence and number should be well advertised.
- ♦ The message should be reinforced that information received through the hotline will be kept confidential and employees will not face any retribution for reporting their suspicions.
- ♦ Assigned staff or pre-recorded messages should use standard pre-defined questions when calls are taken to enable the capture of all pertinent information.
- ♦ A system should be used to log the calls and monitor their follow-up.
- ♦ The call data should be analyzed at regular intervals to allow management to adjust its strategic approach to managing fraud risk (if necessary). Call volume, call type and percentage successful outcomes are all aspects that should be reviewed.
- ♦ The fraud-related issues detected through the tips should be communicated to the appropriate authorities according to the organization's established fraud policy.

Monitoring effectiveness of detection methods: It is important to assess the effectiveness of the detective measures in use through continuous monitoring. Measurement criteria to monitor fraud detection performance in government include:

- ♦ number of known frauds committed;
- ♦ number and status of fraud allegations that require investigation;
- ♦ number of fraud investigations resolved;
- ♦ number of whistleblower allegations received through the hotline;
- ♦ number of employees who have not had fraud awareness training;
- ♦ number of employees in key financial positions who have not had background checks;
- ♦ number of employees and suppliers/contractors who have not signed the code of conduct; and
- ♦ number of fraud audits performed by Internal Audit.

Investigating and responding to fraudulent activities

Having clear fraud investigation practices and strong sanctions in place are good ways for public sector organizations to show staff, suppliers and the public that government is serious about managing fraud risk. Investigations and sanctions not only deal with newly uncovered (or potential) fraud cases, but may also deter other people from committing fraud in future. As well, government can improve its chances of recovery from fraud losses and minimize its exposure to reputation damage by having sound investigative and disciplinary processes in place.

When a fraud has been detected it should be stopped at the earliest opportunity. Management should determine how the fraud was perpetrated and if any weak controls can be identified. Weak controls may be an indicator that the fraud was not an isolated incident and other similar frauds may be underway.

Centralizing the investigative process: A process for how allegations of fraud and fraud investigations is to be conducted should be clearly laid out by government and followed. The fraud policy should mention who is to conduct or manage the investigation process. A centralized detective and investigative function allows for better control over the fraud risk exposure, and allows for resources to be focused on those risks identified as priority. It also helps ensure that consistent corrective actions and sanctions are applied consistently.

Centralizing the investigative process also enhances the communication process within government in that all the information can then be managed in one place. For this function to operate effectively, there must be an appropriate level of authority and an adequate number of skilled investigators.

Conducting investigations: The investigation team should document and track the steps of the investigation, items collected as evidence, requests for documents and other information, interview meeting notes, conclusions drawn from analysis of evidence, and interviews conducted. A case management system should be used where the allegations of fraud can be logged and monitored. If the allegations are determined to warrant further investigation, a clear, high-quality investigative process should be in place both to mitigate losses and to ensure that appropriate corrective action is taken (for example, improving controls and handing out sanctions such as employment termination or the possible laying of criminal charges).

Actions taken must also be applied consistently and fairly by type of fraud committed and level of employee. The Human Resources department and legal counsel should be consulted early on in the investigative process and before any disciplinary, civil or criminal proceedings. If it is likely that the case will proceed with criminal charges, police should also be involved to ensure sufficient and appropriate evidence and documentation are collected in the case file.

Prioritizing investigations: Investigative work should always be assigned on a risk basis to ensure that the greatest threats receive the highest priority. Likely remediation costs (for example, investigation costs, legal fees) should also be determined so that government can assess the likely cost outlay relative to the determinable fraud loss. In this way, cases that have the greatest possibility of generating positive outcomes can be given the highest priority.

Taking corrective action: In some cases – for example, to mitigate loss and preserve evidence – it may be necessary to take corrective action before the investigation is complete. Those under investigation may need to be suspended or re-assigned while the investigation is ongoing and assets may need to be protected. Management should seek legal advice before taking any actions.

Important to keep in mind as well is that employees may be under an obligation to respond to their employer's questions while they are still employed. Thus, if they are fired before the investigation is complete, this obligation will no longer exist and investigation delays could result.

Possible corrective actions include:

- ♦ criminal referral (which may be a legal obligation; legal counsel and senior management should be consulted before the investigation unit pursues this action);
- ♦ civil action (government may wish to pursue civil action to recover funds);
- ♦ disciplinary action (for example, termination, suspension with or without pay);
- ♦ an insurance claim; and
- ♦ remediation to the existing business process and internal controls.

Reporting the findings: A report on investigation findings should be prepared by, or submitted to, a central investigations unit. The external auditor should also be notified of all fraudulent activities. The external auditor will also want to conduct an

assessment of whether there is a more serious and pervasive problem rather than relying on management's own assessment. This makes it critical that all known frauds be communicated in a timely manner to the external auditor.

The investigations unit should also keep track of performance measures such as:

- ♦ issue resolution time (by category of complexity);
- ♦ repeat incidents (to highlight control or business process weaknesses that have not been addressed); and
- ♦ value of loss recovered and prevented (this can help demonstrate the value of fraud risk management actions, but the value of the deterrence message should also be considered).

These measures should be reviewed on a regular basis to determine whether the investigative process continues to operate effectively.

Principle 5: Government should have appropriate reporting procedures in place to communicate the results of its fraud risk management activities to its stakeholders

Internal reporting on fraud risk management activities

A reporting mechanism should be in place to enable government departments to report instances of known losses immediately to the individual with the designated responsibility as prescribed in the fraud policy. By having timely information from all departments, that individual will be able to spot trends of losses by type and decide what investigative and corrective actions are required.

Those staff responsible for fraud risk management throughout government should also receive regular, comprehensive reports on fraud risk management activities. This will help them identify trends and move to mitigate losses effectively and efficiently. Such reports reviewed regularly can also illuminate where program or operating procedural changes may be required. If a good case management system is in place in the centralized investigative unit, then this reporting will be easier to complete.

Reporting externally on fraud risk management activities

External reporting about government's efforts to manage fraud risks helps communicate from the top the importance that government places on managing this highly important risk area.

External reporting should address:

- ♦ the activities undertaken in the reporting period;
- ♦ the results of those and previous activities;
- ♦ the corrective actions taken; and
- ♦ the sanctions that resulted.

APPENDIX 2: Common Fraud Indicators

Managers and staff should be vigilant to any warning signs that might indicate a fraud is being perpetrated. Potential indications that a person might be involved in fraudulent activity are if he or she:

- ◆ seems under stress without a high workload;
- ◆ is first to arrive in the morning, last to leave at night;
- ◆ is egotistical (e.g., scornful of system controls);
- ◆ is a risk-taker or rule-breaker;
- ◆ is reluctant to take time off work;
- ◆ refuses a promotion;
- ◆ exhibits wealth inconsistent with salary;
- ◆ exhibits a sudden change of lifestyle;
- ◆ is a new staff member who resigns quickly;
- ◆ has a cozy relationship with suppliers or contractors;
- ◆ is a supplier or contractor who insists on dealing with one particular member of staff;
- ◆ is disgruntled at work, a complainer; and
- ◆ is greedy or is known to have genuine financial need.

APPENDIX 2: COMMON FRAUD INDICATORS

Internal Audit departments and similar assurance type departments should also be vigilant while performing engagements. Potential indications of an environment in which fraud is possible include:

- ◆ unusual employee behaviour (e.g., a supervisor who opens all incoming mail; managers bypassing subordinates; subordinates bypassing managers; an employee who refuses to comply with normal rules and practices, fails to take leave, lives beyond his or her means, regularly puts in long hours working, often expresses job dissatisfaction, or acts secretly or defensively);
- ◆ key documents missing (e.g., invoices, contracts);
- ◆ inadequate or no segregation of duties;
- ◆ absence of controls and audit trails;
- ◆ inadequate monitoring to ensure that controls work as intended;
- ◆ documentation that is photocopied or lacking essential information;
- ◆ missing expenditure vouchers and official records;
- ◆ excessive variations to budgets or contracts;
- ◆ bank and ledger reconciliations that are not maintained or cannot be balanced;
- ◆ excessive movements of cash or transactions between accounts;
- ◆ numerous adjustments or exceptions;
- ◆ overdue pay or expense advances;
- ◆ general ledger that is out of balance;
- ◆ duplicate payments;
- ◆ ghost employees on the payroll;
- ◆ large payments made to individuals;
- ◆ crisis management coupled with a pressured business environment;
- ◆ lack of established code of ethical conduct;
- ◆ lack of senior management oversight;
- ◆ unauthorized changes to systems or work practices;
- ◆ lack of rotation of duties;
- ◆ policies not being followed;
- ◆ post office boxes being used as shipping addresses;
- ◆ lowest tenders or quotes being passed over with minimal explanation recorded;
- ◆ single vendors;
- ◆ unclosed but obsolete contracts;
- ◆ service needs being described in ways that can be met only by specific contractors;
- ◆ service requirements being split up to get under small purchase requirements or to avoid prescribed levels of review or approval;
- ◆ vague specifications;
- ◆ unclear disqualification of a qualified bidder;
- ◆ climate of fear or an unhealthy corporate culture;
- ◆ high staff turnover rates in key controlling functions;
- ◆ chronic understaffing in key control areas;
- ◆ low staff morale/lack of career progression/weak management;
- ◆ consistent failures to correct major weaknesses in internal controls;
- ◆ management that frequently overrides internal controls;
- ◆ an employee reluctant to take leave, or an employee on leave stipulates that work must not be done until he or she returns; and
- ◆ lack of use of commonsense controls such as changing passwords frequently, requiring two signatures on cheques or restricting access to sensitive areas.

It is important to note that anyone exhibiting one or more of these behaviours does not guarantee that a fraud is being perpetrated; however they can indicate a higher fraud risk is present and that the related internal controls should be examined and remediated as needed.

APPENDIX 3: Recommended Reading

- ◆ Association of Certified Fraud Examiners (ACFE), *2008 Report to the Nation on Occupational Fraud and Abuse*, 2008.
- ◆ Institute of Internal Auditors (IIA), The American Institute of Certified Public Accountants (AICPA), Association of Certified Fraud Examiners (ACFE), *Managing the Business Risk of Fraud: A Practical Guide*, 2009.
- ◆ The Institute of Internal Auditors (IIA), *Fraud Prevention and Detection in an Automated World*, 2009.
- ◆ Institute of Internal Auditors (IIA), *Internal Audit and Fraud*, 2009.
- ◆ Canadian Institute of Chartered Accountants (CICA), *Canadian Auditing Standard 240 - The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, 2010.
- ◆ HM Treasury, National Audit Office, *Tackling External Fraud*, 2008.
- ◆ HM Treasury, *Managing the Risk of Fraud: A Guide for Managers*, 2003.
- ◆ Audit Scotland, Audit Commission, *National Fraud Initiative 2008/09: Handbook Scotland*, 2009.
- ◆ The Audit Office of New South Wales, *Fraud Control: Developing an Effective Strategy*.
- ◆ The Audit Office of New South Wales, *Fraud Control Current Progress and Future Directions: Guidance on Better Practice*, 2005.
- ◆ KPMG, *Profile of a Canadian Fraudster: Survey Report 2009*, 2009.