Office of the Auditor General

Our Vision

A relevant, valued and independent audit office serving the public interest as the House of Assembly's primary source of assurance on government performance.

Our Mission

To make a significant contribution to enhanced accountability and performance in the provincial public sector.

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1 Message from the Auditor General

I am pleased to present my January 2012 Report to the House of Assembly. This new Report consolidates all our reporting on financial management issues. It includes work completed by my Office during 2011.

The report contains five chapters in addition to this introduction. These chapters report the results of our financial audits and reviews; our audit of governance and control over treasury management at the Department of Finance; provide financial information and analysis related to the sustainability of government finances; report the results of our review of agency audit opinions and managment letters; and follow up our 2005 to 2009 financial recommendations.

The Problem with Long-term Debt

Our Chapter on financial indicators identifies an issue that affects the long-term sustainability of government operations.

The province's ongoing indebtedness is a drain on current and future resources and limits the ability of government to make choices in providing services to its citizens.

For the last few years much of the world has been immersed in an economic and financial crisis, the roots of which may be said to lie primarily in excessive household and public sector debt. Governments which appear otherwise stable and prosperous face impossible debt servicing costs, an inability to borrow at reasonable rates, and potential default on sovereign debt; they find themselves hindered in their ability to respond to the effects of the financial recession in their countries or states.

Nova Scotia, like most provinces and like the federal government, has accumulated long-term debt gradually over a period of decades, under several different governments.

Long-term debt is incurred whenever the government spends more than it receives in taxes and other revenues, and therefore borrows to finance its spending. A certain amount of this borrowing is incurred to finance large capital projects that otherwise might not be affordable in the short-term. For the most part, however, borrowing occurs to finance operating deficits. Government, in other words, in any given

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year, spends more than it earns. It does so in order to provide services to its citizens today, while deferring payment for those services until tomorrow. This decision has a number of effects.

Firstly, to the extent that current spending is financed by long-term debt, repayable at a future date, government decisions to spend are divorced from the need to raise funds to pay for that spending. Those making the spending decisions are not fully accountable to those who, in the future, will be required to pay for those decisions.

The recipients of government services – the current citizens of the province – receive services which they do not have to completely pay for. To the extent those services are not paid for out of current revenues, payment is deferred, through government debts, often for a very long period of time. In effect, people receive services today that their children will pay for tomorrow.

As this practice continues, and government debt accumulates, interest on that debt consumes an ever increasing proportion of government revenue. The full cost of the original services is hidden in the long-term cost of the interest on the loans required to pay for them. As this interest cost increases, government becomes constrained in its ability to provide future services.

At present, about 9% of revenue received by Nova Scotia (approximately $860 million) is needed to pay interest on loans obtained to pay for services delivered in the past. This money is not available to finance other expenditures on basic needs such as health, education and infrastructure. In effect, we are all poorer today because of government spending in the past.

Finally, government becomes vulnerable to swings in national and global interest rates. Current rates are at historic lows as a result of the financial crises; however, they will increase at some point. As some governments are discovering, increasing costs of borrowing can have devastating impacts on a government's finances.

Government's practice of borrowing to pay for current expenditures raises ethical questions. Is it right for Nova Scotians to expect, and receive, government services that they as a group do not completely pay for, deferring part of the payment to future generations? Is it right to add significant interest costs that continue for an indefinite period of time to the cost of services, again paid for by future taxpayers? And is it right for governments to decide to spend more than they earn, for short-term benefits, deferring payment to dates far in the future, if at all?

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I take the view that, while governments have the ability to spend in excess of their revenues, to do so is not financially responsible, except in exceptional circumstances. Governments may need to borrow in times of emergency, such as war or natural disaster; they may need to undertake very large scale capital projects, such as dams or major hospitals, that would be unaffordable without debt; and they may need to finance short-term downturns in the economy. In any such case, the borrowing government should consider what is an appropriate and reasonable pay-back time, to minimize the cost to the taxpayer.

In all other cases, I believe government has a responsibility to its citizens to live within its means. That involves paying for its spending from current revenue.

Further, government has a responsibility to pay back its borrowings. Long-term debt is damaging to the province. Government should have a goal to eventually eliminate long-term debt and should have a plan for doing so. That is only possible through operating surpluses, as painful as they may be.

This province has had periods during which surplus revenue has been used to pay down long-term debt. Those periods have been the exception to the norm. Nevertheless, it has been demonstrated to be possible.

I have no specific recommendations to government in this respect. I raise the issue out of concern for the wellbeing of this province, for the financial health of the government, and for the best interests of the people of Nova Scotia. I urge enhanced awareness of the risks associated with government debt; and I urge greater consideration of the ethical questions involved in excessive government borrowing and its costs to future generations.

2 Results of Financial Audits and Reviews

The opinion on the review of the revenue estimates, dated April 4, 2011, was qualified because the Estimates did not consider all revenues in the consolidated entity. It was further qualified because no estimate was made of these revenues and we were therefore unable to determine whether the revenue estimates were materially misstated as a result of their exclusion. We have recommended repeatedly, and again this year, that these revenues be estimated. Department of Finance management informed us that they do not plan to implement this recommendation. We urge government to address this issue in time for the release of the 2012-13 Budget.

This Chapter also focuses on the results of our audit of the consolidated financial statements. Volume 1 of the Public Accounts, which includes these financial statements, was released on July 28, 2011. The audit opinion dated July 21, 2011 was unqualified. The release of the Public Accounts was well in advance of the September 30th legislated date under the Finance Act. We commend the province for providing timely and relevant financial reporting results to the public.

This Chapter includes several recommendations for improvements in financial management processes. In particular, we noted weaknesses in the province's internal control framework, including the need for departments to complete a risk assessment related to financial reporting. We recommended that departments identify how they monitor the internal controls used to ensure transactions are appropriately authorized; assets are safeguarded; and financial records are properly maintained.

Finally, we report the results of our agency audits. No significant matters arose from the legislated audit work we performed in four government agencies.

The response at the end of this Chapter was received from the Department of Finance and we have published it verbatim. We disagree with certain of the responses. For instance, we disagree with the response provided to Recommendation 2.1 in which it is stated that the inclusion of all revenues in the revenue estimates would require changes in the provincial budgeting process. Further, it is not clear from some of the responses whether the department agrees or disagrees with the recommendations, and whether, if agreed, they will be implemented.

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Recommendations

Recommendation 2.1
The Department of Finance should ensure that the revenue estimates for 2012-13 include all revenues of the consolidated entity, including all agencies' third party revenues in a schedule as proposed by Deloitte LLP, to ensure the budget is prepared and presented fully in accordance with Canadian generally accepted accounting principles.

Recommendation 2.2
The Department of Finance should obtain support for estimates of third-party revenues of government units.

Recommendation 2.3
The Department of Finance should assign responsibility for an independent review of inputs to, and results of, the models to forecast petroleum royalties.

Recommendation 2.4
Department of Finance staff should review fiscalization formulas for personal income tax and harmonized sales tax revenues and ensure the formulas reflect how these revenues are earned during the year. Any adjustments resulting from the review should be recorded in the general ledger revenue accounts on a timely basis.

Recommendation 2.5
The Department of Finance's Government Accounting Division should verify the accuracy and completeness of information to support the disclosure of contractual obligations in the consolidated financial statements prior to providing that information to this Office as audit evidence.

Recommendation 2.6
The Department of Education should expense all grants made to universities unless there are eligibility requirements which the universities must meet in a subsequent period.

Recommendation 2.7
The Department of Finance's Government Accounting Division should ensure receipt of entity financial statements on time. Progress of the entity audits should be monitored to ensure audits and related auditor communications are completed and available to the Office of the Auditor General based on the predetermined deadline.

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Recommendation 2.8
The Department of Finance's Controller's Office should establish a timeframe for completion of the internal controls and financial reporting project and monitor progress to completion.

Recommendation 2.9
The Department of Finance should require departments to identify the risks related to financial reporting, especially risks related to fraud and error, and to complete a related risk assessment. This assessment should be updated on a periodic basis.

Recommendation 2.10
The Department of Finance's Controller's Office should provide guidance to departmental, board and agency management to complete the review and documentation of internal controls.

Recommendation 2.11
The Department of Finance's Controller's Office should provide guidance to departmental, board and agency management to assist in assigning roles and responsibilities to individuals throughout government for the design, implementation, operation and maintenance of internal controls as part of the documentation of internal controls.

Recommendation 2.12
The Department of Finance's Controller's Office should identify how management monitors internal controls over financial reporting and take steps to ensure these processes are operating effectively.

Recommendation 2.13
The Department of Finance's Taxation and Fiscal Policy Division should assess the design and effectiveness of the controls over model-based revenue processes, including the preparation of journal entries. Improvements should be made as needed and these internal control activities should be monitored on an ongoing basis.

Recommendation 2.14
The Department of Finance's Capital Markets Administration Division should review the support and calculations of transactions posted to SAP to ensure the accuracy of the account balances it manages. In addition, the Division should regularly assess the control activities over calculations and ensure they are appropriate and are operating effectively.

Recommendation 2.15
The Department of Finance's Taxation and Fiscal Policy Division should review access to systems on a regular basis and adjust access as required. The access rights of individuals no longer employed by the Taxation and Fiscal Policy Division should be removed immediately.

Recommendation 2.16
The Department of Finance's Corporate Services Unit should perform reconciliations of model-determined revenues and related accounts receivable or payable for all open years. This should be done on at least an annual basis.

Recommendation 2.17
The Department of Finance's Capital Markets Administration Division should prepare monthly reconciliations to trustee statements and the general ledger should be updated each month to reflect the results of transactions.

Recommendation 2.18
The Department of Finance's Controller's Office should ensure the province's general ledger is updated on a regular basis throughout the year and that the general ledger supports the forecast updates.

Recommendation 2.19
The Department of Finance's Controller's Office should provide guidance to those entities forming part of the government reporting entity which will be adopting, for the first time, generally accepted accounting principles for the public sector for the year ended March 31, 2012. The Government Accounting Division should initiate appropriate measures to ensure all these entities will meet the reporting deadlines for next year's audit.

3 Governance and Control Framework

Substantial investment activity is conducted through the Liability Management and Treasury Services Division of the Department of Finance, and monitored for compliance by the Department's Compliance and Reporting Division. The Liability Management and Treasury Services Division's transactions are accounted for by the Department's Capital Markets Administration Division.

We conducted an audit of the governance and control framework in these divisions in 2011. Our audit was a follow-up to a 2004 audit on this framework performed by a private-sector audit firm. That audit resulted in a denial of opinion. We repeatedly recommended that the province engage a private-sector firm to conduct a follow-up audit to determine if the deficiencies leading to the denial of opinion had been resolved.

We concluded the deficiencies had been substantively resolved. The governance and control framework in these divisions provides for the identification of major risks that impact investment activity. These risks are controlled through policies related to borrowing limits and credit ratings; compliance with these policies is monitored on a daily basis. In addition, the province's Debt Management Committee provides adequate oversight and challenge to the activities of these divisions, and reports its results to the Minister of Finance on an annual basis.

We further concluded that controls over transactions are adequate, but we made recommendations for improvement. A risk assessment should be prepared to determine if certain risks, such as lack of segregation of duties, have been adequately addressed through current processes. We have also recommended the need to independently calculate interest income related to sinking fund investments, and that there be evidence that reconciliations to custodian statements have been reviewed.

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Recommendations

Recommendation 3.1
The Department of Finance's Capital Markets Administration Division should perform an independent calculation of interest activity in the province's sinking fund accounts and reconcile these calculations to the custodian statements. The Capital Markets Administration Manual should be updated to include accurate reconciliation processes.

Recommendation 3.2
Management of the Department of Finance's Capital Markets Administration Division should ensure the review of reconciliations is documented.

Recommendation 3.3
Management of the Department of Finance's Liability Management and Treasury Services, Capital Markets Administration, and Compliance and Reporting Divisions should complete a risk assessment of roles and responsibilities and ensure controls exist to mitigate identified risks.

Recommendation 3.4
The Department of Finance's Liability Management and Treasury Services Division should verify that changes made to limits and other parameters in the Millennium system are accurate.

Recommendation 3.5
The Director of the Department of Finance's Capital Markets Administration Division and the Compliance and Reporting Division should have read-only access to the Millennium system.

Recommendation 3.6
Management of the Department of Finance's Compliance and Reporting Division should update the Compliance Manual to ensure it reflects the complete range of debt and investment policies to be monitored.

Recommendation 3.7
The Department of Finance's Liability Management and Treasury Services Division should update the Governance Guidelines to indicate the review processes to be conducted by the Debt Management Committee with respect to the reports received from the Compliance and Monitoring Division.

4 Indicators of Financial Condition

In recent reports, we have included information on certain indicators of sustainability, flexibility and vulnerability. This year we have focused our Report on sustainability indicators. Additional indicators can be found under the Publications tab on our website at oag-ns.ca.

We believe sustainability indicators are the most relevant in the current global climate in which high levels of sovereign debt have greatly reduced the ability of certain countries to raise and finance their debt. Sustainability indicators are a measure of government's ability to maintain existing programs and services, including maintaining obligations to creditors, without increasing debt or raising taxes.

Detailed reporting on sustainability is a recent development in government reporting. The International Public Sector Accounting Standards Board recently published an exposure draft for a recommended practice on government reporting: Reporting on the Long-Term Sustainability of a Public Sector Entity's Finances. It recommends that government provide projections of the sources and uses of resources over a longer term, and provide commentary on the main risks impacting these projections. The reporting is meant to supplement information found in public sector financial statements and further enhance financial reporting objectives – accountability and decision-making. Several governments, including Canada, are publishing fiscal sustainability reports as part of their annual reporting package.

Volume 1 of the Public Accounts includes several indicators of government's financial position. These include five-year trends of revenues, expenses, and net debt and accumulated deficits per capita. The current Budget Assumptions and Schedules document includes a medium-term outlook (four years) for certain assumptions, and also identifies the key variables impacting revenue estimate assumptions. We encourage government to review its present reporting and consider enhanced reporting on the long-term sustainability of its programs.

5 Review of Audit Opinions and Management Letters

Under Section 23 of the Auditor General Act, we conduct a review of the audit opinions and related management letters of agencies which comprise the government reporting entity. The majority of these entities are audited by private sector auditors; four government agencies are audited by this Office.

During our review of management letters we found auditors had identified numerous internal control and information technology deficiencies. The overall number of recommendations made by the auditors increased by 16% (23) over the previous year. 41% (69) of the recommendations made in 2011 were repeated from 2010. Control weaknesses such as lack of segregation of duties and deficiencies in access controls over financial reporting systems need to be remedied on a timely basis. Agency management should take steps now to address the deficiencies identified by their auditors, to ensure the integrity of their financial systems and financial reporting processes.

Although the majority of agency audits resulted in unqualified audit opinions, a number of entities received qualified opinions. Where possible, agencies should correct the deficiencies that lead to qualifications.

The audit opinions of several school boards were qualified due to the inability of the auditors to verify the completeness of school-based funds. In addition, several of the management letters resulting from these audits indicated weaknesses in the control systems over school-based funds, and in one instance, noted that there was a fraud involving these funds during the year. School-based funds totaled $41.6 million in 2010-11. Due to their significance, and to the weaknesses identified, we have recommended that the Department of Education work with the school boards to implement the recommendations made by their auditors and improve controls over the receipt and safeguarding of these revenues.

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Recommendations

Recommendation 5.1
The Department of Education should work with the school boards to implement the recommendations made by their auditors and develop the appropriate controls to ensure the accuracy and completeness of this revenue in boards' accounting records, and to ensure it is properly safeguarded.

6 Follow-up of 2005 to 2009 Financial Recommendations

The overall implementation rate of our recommendations related to financial reporting from our 2005 to 2009 audits is 66%. This 14% increase over the prior year's rate of 52% is partly due to a change in our calculations.

We performed a review of departments' self-assessments of their progress in addressing our recommendations. We evaluated these self-assessments and discussed the support for the implementation status. Some adjustments were made to the assessments. As a result of this review, we provide moderate assurance to readers of this Chapter. Nothing came to our attention to cause us to believe that the representations made by government, as adjusted, are not complete, accurate and reliable.

Since 2006, we have recommended that the revenue estimates included in the annual budget be prepared on a consolidated basis. The revenue estimates are prepared on a gross basis for the general revenue fund only, and not for the consolidated entity; as a result our opinion is qualified every year. This recommendation has been outstanding for a number of years; government needs to take steps to address this issue for the 2012-13 revenue estimates.

Two other recommendations have been made in successive reports. The first relates to the need for an independent follow-up audit to be conducted on divisions within the Department of Finance after a 2004 audit resulted in a denial of opinion. This audit was performed by our Office in 2011 and the results are reported in Chapter 3 – Governance and Control Framework. In addition, we have recommended that internal controls in government be identified and related roles and responsibilities for these controls be assigned. Some progress is being made toward implementation of these recommendations.

While government has taken some action to address our recommendations, implementation rates are still too low, and a number of outstanding recommendations date back several years.

Details of all financial recommendations from 2005 to 2009, along with their current status, can be found on our website at oag-ns.ca.