

**FINANCIAL SERVICES AUDIT
OF
PREPAID EXPENDITURES
FINAL ASSURANCE AUDIT REPORT**

October 2003

Audit Division (SIV)

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EXECUTIVE SUMMARY

This report presents the findings of the audit of the Departmental practices associated with recording prepaid expenditures. The objective of the audit was to determine the extent to which the Department appropriately and consistently accounts for its prepaid expenditures in accordance with prescribed accounting standards and relevant policies.

The Department's Chart of Accounts contains nine Prepaid asset General Ledger (GL) accounts. We are concerned with the accuracy of the balance in each of these GL accounts.

The Department of Foreign Affairs and International Trade (DFAIT) policy on Accounting for Prepaid Expenses does not provide clear direction, nor does it clearly assign the responsibility for monitoring prepaid expenditures to the various departmental stakeholders. Our audit tests indicate that there is a high degree of inconsistency in the accounting treatment of prepaid expenditures both between, and within, missions. We attribute the inconsistency, in large part, to the noted policy deficiencies. We are, therefore, unable to conclude that the balances recorded in IMS for Prepaid Rent, and related expense accounts, are accurate and complete. Consequently, the accuracy of the Prepaid asset financial information disclosed in the Department's financial statements is questionable.

Recommendation Status

A total of 3 audit recommendations are raised in the report; 2 are addressed to SMS and one is addressed to SMF. Management has responded to each recommendation indicating action already taken or decisions made, as well as future action. Of the 3 recommendations, management has stated that one recommendation has been implemented. For each of the remaining 2 recommendations, management has indicated the initiatives in progress or the intended future action.

AUDIT SCOPE, OBJECTIVES, APPROACH AND TIMING

1.1 Audit Scope

1.1.1 The audit covered the Departmental accounting practices related to prepaid expenditures. More specifically, the audit assessed the IMS posting practices that apply to Crown Leased property payments by missions to ensure that prepayments and related expenses are properly recorded in the Department's financial records.

1.2 Audit Objectives

1.2.1 The overall audit objective was to determine the extent to which the Department appropriately, consistently and efficiently accounts for its prepaid expenditures in accordance with prescribed accounting standards and relevant policies. In particular, the audit focused on determining whether:

- The DFAIT policy on Accounting for Prepaid Expenses clearly articulates the scope, objective, definitions, procedures and reporting requirements related to prepayments;
- Roles, responsibilities and authorities of Departmental stakeholders with respect to the accounting of prepayments are clearly defined, communicated, understood and adequately discharged; and,
- Crown-Lease prepayments and related expenditures are properly recorded in the Department's financial records.

1.3 Audit Approach and Timing

1.3.1 The internal audit was conducted in accordance with the Treasury Board Policy on Internal Audit and the Institute of Internal Auditors Standards for the Professional Practice of Internal Auditing.

1.3.2 The audit examined the major posting processes and practices associated with Crown Leased property payments at Missions, as recorded in IMS. The examination phase of the audit was conducted during February 2003.

1.3.3 We conducted a comprehensive review of the transactions posted to 15 General Ledger (GL) accounts during the 2002/03 fiscal year, both prepaids (9 accounts) and expenses (6 accounts), to determine their purpose and use.

1.3.4 Twenty-two other expense GL accounts capture expenditures that may contain prepayments. These accounts were analyzed to assess the potential impact of

any prepayments on financial reporting requirements based on the materiality of the expenses involved.

1.3.5 Based on the information gathered, the Audit Team identified potential audit issues and made decisions regarding which GL accounts to examine in detail, as reflected in the following table.

GL Account #	Description	Notes
Prepaid Asset GL Accounts		
15500 to 15504	Five specific Prepaid Expense accounts	1
15520	Prepaid Expense - O & M	1
15525	Prepaid Expense - Capital	1
15530	Prepaid Expense - Rent	2
15560	Advance for Contributions	3
Crown-Lease Expense GL Accounts		
41450	Rental of residential buildings	2
41470	Rental of office buildings	2
41471	Rental of other office buildings	2
41475	Rental of commercial buildings	2
41480	Rental of recreational property	2
41481	Rental of other buildings (excluding office space)	2
Other Expenditures GL Accounts		
41208	Storage and warehousing	5
41496	Rental - other	4
41522	Condominium charges	4
40721 to 41495	Nineteen other expense accounts that have the potential to include prepaid expenses	5

Notes:

1. Accounts not subject to audit - GL balance was zero or immaterial and no, or few, transactions were processed during the 2002/2003 fiscal year.
2. Full coverage - review focused on whether Crown lease payments were properly accounted for and reported as either a prepayment or an expense.

3. Excluded from coverage as SIV has an ongoing program which separately examines contribution expenditures.
4. Limited coverage - review focused on whether account postings included amounts that should have been coded to one of the Crown Lease Expense GL accounts.
5. Limited coverage - review focused on whether account postings included amounts that should have been coded to one of the Prepaid Asset GL accounts.

1.3.6 For the GL's included in the audit scope, audit programs were developed to test compliance with policies and procedures which govern prepayments.

BACKGROUND

2.1 Policy Direction

2.1.1 Treasury Board (TB) Accounting Standard 3.3 states that, for accrual accounting purposes, prepaid expenses are payments made for goods/services to be received in future fiscal years. In addition, the standard states that amortization of any prepayment should be expensed in a systematic and rational basis.

2.1.2 Chapter 10 of the DFAIT Accounting Manual describes prepaid expenses as “current assets that arise when payment for a good or service is made prior to when the service is rendered or the good received within the same accounting period”. The Policy also states that any prepayment with a monthly value greater than \$50K is required to be set up as a prepaid expenditure and expensed on a monthly basis. Several options are then provided as to how prepayments with monthly values less than \$50k should be processed. The policy finally notes that a year-end entry at March 31st is required to expense an appropriate amount if the prepayment period crosses fiscal years.

2.1.3 Several GL accounts are established in the Chart of Accounts for prepaid expenditures. The only account with significant activity is GL 15530 - Prepaid Rent. Other accounts available include prepaid postage, transportation and communication, professional services, utilities, repair and maintenance, operation and maintenance, and capital.

2.2 Roles and Responsibilities

2.2.1 Roles, responsibilities and Central Agency Reporting requirements, as they pertain to Prepaid Expenses, are described in Chapter 10, Section 6 of the DFAIT Accounting Manual. Responsibilities are assigned to:

- SMS for developing and publishing a departmental policy and procedures on prepaid expenses;
- SMS for ensuring that systems functionality and configuration are complete for the proper recording and reporting of prepaid expenses;
- SMF for implementing and administering the departmental Prepaid Expenses accounting policy and procedures and ensuring that a proper financial coding structure exists for the recording and reporting of prepaid expense; and,

- HQ/Mission Managers for recording all prepaid expenses in IMS and charging the appropriate expense GL account as the good/service is consumed.

2.3 Prepaid Expenditures - Tombstone Financial Data

2.3.1 The following table provides the March 31, 2002 and 2003 IMS balance of the General Ledger (GL) accounts selected for examination.

Selected Crown Lease GL Accounts Tombstone Financial Data			
GL #	GL Account Title	Balance @ 31/03/02	Balance @ 31/03/03
Prepaid Asset GL Account			
15530	Prepaid Expense - Rent	\$ 5,646,000	\$ 4,199,000
Crown Lease Expense GL Accounts			
41450	Rental of residential buildings	\$ 58,963,000	\$ 66,297,000
41470	Rental of office buildings	\$ 39,075,000	\$ 44,680,000
41471	Rental of other office buildings	\$ 157,000	\$ 159,000
41475	Rental of commercial buildings	\$ 689,000	\$ 1,699,000
41480	Rental of recreational property	\$ 129,000	\$ 145,000
41481	Rental of other buildings	\$ 423,000	\$ 392,000
Total		\$ 99,436,000	\$ 113,372,000
Other Expenditure GL Accounts			
41496	Rental - other	\$ 23,000,000	\$ 25,203,000
41522	Condominium charges	\$ 6,800,000	\$ 6,793,000
41208	Storage and warehousing	\$ 604,000	\$ 654,000
Total		\$ 30,404,000	\$ 32,650,000

SUMMARY OBSERVATIONS AND RECOMMENDATIONS

3.1 Policy Direction and Procedures

3.1.1 Treasury Board Accounting Standard 3.3 specifies four categories of prepayments: prepaid expenses, deferred charges, transfer payments paid in advance and payments made prior to the completion of the work, delivery of goods or rendering of the service. The DFAIT policy on Accounting for Prepaid Expenses (herein referred to as the Prepaid policy) deals only with the *prepaid expenses* category. It does not describe the rationale for excluding the other three categories from its scope of coverage.

3.1.2 The Prepaid policy and procedures provide unclear direction. For example, it:

- (a) mentions the multi fiscal-year impact as the last consideration to take into account when deciding whether an expense should be recorded as a prepayment. TB Accounting Standard 3.3 views the fiscal year overlap as the key criteria supporting a prepayment accounting treatment;
- (b) provides too many options for recording a prepaid asset and subsequently expensing it in future accounting periods;
- (c) does not clearly indicate which Funds to use when recording a prepaid asset and subsequently expensing it in future accounting periods;
- (d) does not clearly describe the circumstances under which each of the nine Prepaid asset GL accounts, contained in the Department's Chart of Accounts, are to be used by stakeholders in support of achieving the Policy's objective;
- (e) does not, in the case of Crown-Lease payments, specify:
 - the mandatory content and format of the information to be entered in the Text and Allocation data fields of IMS input documents;
 - how to use Order numbers when posting entries to the prepaid rent and expense GL accounts;
 - the requirement to identify the period covered by the lease payment;
- (f) does not clearly assign the responsibility for monitoring prepaid expenditures.

3.1.3 SMF and SMS confirmed that the Prepaid asset account balance should, for internal and external reporting purposes, **only** reflect expenditures which relate to activities covering *more than one* fiscal year. While the DFAIT Prepaid Policy recognizes this reporting standard, it also calls for the recording of prepaids that are subsequently expensed *within* the fiscal year. The requirements of the Prepaid policy are, therefore, not consistent with SMF's expectations as to the basis for recording and reporting prepaids.

3.1.4 The results of our audit tests indicate that there is an inconsistent accounting treatment of prepaid expenditures between and within Missions. We attribute, in large part, this inconsistency to the policy deficiencies described above. Examples of the inconsistency include:

- prepayments for lease periods within the same fiscal year are either charged directly to an Expense GL account or charged to the Prepaid asset GL account and then either expensed on the same day or by fiscal year end;
- prepayments are properly recorded in the Prepaid asset GL account but are not always charged to an Expense GL account in a subsequent fiscal year;
- prepayments are charged to an Expense GL account but are not always adjusted to reflect the prepaid amount (i.e., asset) attributable to future fiscal years by the year end;
- the entire balance in the Prepaid asset GL account is sometimes transferred to an Expense GL account before the lease's payment term has expired.

The above noted inconsistencies adversely impact the accuracy of the Department's financial statements and any corporate use made of the related IMS data.

Recommendations for SMS

3.1.5 SMS, in consultation with SMF and other stakeholders, should simplify and strengthen DFAIT's Prepaid Policy and procedures by:

- **specifying whether its scope covers all four, or just the prepaid expense, category of prepayments specified in the TB Accounting Standard 3.3 and describing the supporting rationale;**
- **removing the requirement to record prepayments that are subsequently expensed in the fiscal year;**

- identifying which Fund to use when recording a prepaid asset and subsequently expensing it in future accounting periods;
- describing the type of transactions that are to be recorded against each of the prepaid asset and related expense GL accounts;
- defining the content and establishing a standard format for the Text and Allocation fields for the IMS entries posted to leased property prepaid and expense GL accounts; and,
- articulating and assigning the responsibility for monitoring prepaid asset and expense GL account balances.

3.1.6 SMS should provide CFSI officials with the revised Prepaid Policy per 3.1.5 so that they may update the IMS training materials and manual accordingly.

SMS Response

3.1.5 SMS agrees with all recommendations and has assigned them to SMSP who will consult with all stakeholders for development of a revised departmental policy. The headquarters policy was completed and posted on the departmental web site. The Mission policy will be completed by January 2004.

3.1.6 SMSP has also been assigned the responsibility to liaise with CFSI. The policy was sent to CFSI on July 2003. CFSI is to arrange a meeting with the trainers and SMSP to review the new policy for incorporation into the IMS training material by February 2004.

Recommendation for SMF

3.1.7 SMF should update, as necessary, the Department's Chart of Accounts to ensure that it is consistent with the Prepaid asset and Expense GL Accounts referred to in the revised Prepaid Policy.

SMF Response

3.1.7 The proposed adjustments were discussed with SMSP and the resulting changes to the Department's Chart of Accounts were made before in July 2003 for headquarters GLs. Mission GLs will be changed in January 2004, when SMS have finalized the policy.