March 2014

WORKING CAPITAL MANAGEMENT SINCE 2010

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The Honourable Linda Reid
Speaker of the Legislative Assembly
Province of British Columbia
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Dear Madame Speaker:

It is my privilege to transmit to the Legislative Assembly of British Columbia my report on *Working Capital Management Since 2010*.

My Office's work was carried out under section 11(8) of the *Auditor General Act*, in accordance with the standards for assurance engagements set out in the *CPA Canada Handbook*.

In August 2010, my Office first looked at cash flow management in the college and school district sectors and found that government was not realizing best value. Some cash was being transferred to these government organizations before it could be used. In this update report, we discuss progress made in the management of cash by the college and school district sectors and discuss common issues impacting other government organizations. The report contains two additional recommendations to inform government of the significant cost savings that are possible through better cash flow management in the broader public sector.

The most significant initiative to date has been the creation of the Central Deposit Program, which allows government organizations to invest their excess cash back with government instead of with a private sector bank. If participation increased, this program could significantly reduce the costs associated with excess cash balances. However, it would be more cost-effective if government did not provide cash in excess of what organizations are allowed to use in the first place.

I would like to thank everyone involved for their cooperation and assistance throughout the development of this report.

Russ Jones, MBA, CA
Auditor General
Victoria, British Columbia
March 2014

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AUDITOR GENERAL'S COMMENTS

Effective cash flow management is essential to any business, including that of government. Adequate cash has to be maintained to meet day-to-day operational needs. However, if too much cash accumulates before it is needed, costs are incurred that could have been avoided. Achieving the right balance in a large complex operation such as government requires a coordinated approach to the forecasting, monitoring and management of cash flow.

In August 2010, my Office first looked at cash flow management in the college and school district sectors and found that government was not realizing best value, as some cash was being transferred to these organizations before it could be used. Since then, government has made improvements to its cash management practices, but the outcomes anticipated in our 2010 report have not yet been achieved.

The most significant initiative to date has been the creation of the Central Deposit Program, which allows organizations to invest their excess cash back with government (instead of with a private sector bank). If participation increased, this program could significantly reduce the costs associated with excess cash balances. However, it would be more cost-effective if government did not provide cash in excess of what organizations are allowed to use in the first place.

In this update report, we discuss progress made in the management of cash by the college and school district sectors, but also discuss the common issues that are impacting other government organizations as well. The result is two additional recommendations to inform government of the significant cost savings that are possible through better cash flow management in the broader public sector.

I would like to thank everyone involved for their cooperation and assistance throughout the development of this report.

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GOVERNMENT WOULD LIKE to thank the Auditor General for his follow-up report on working capital management by colleges and school districts and appreciates the opportunity to provide further comments.

As recommend by the Auditor General in the 2010 report "Management of Working Capital by Colleges and School Districts", government took the following steps to enhance its cash management practices with colleges and school districts:

- Ministry of Education worked collaboratively with school districts to adjust the timing of grant payments to match cash spending patterns, reducing the build up of cash within the school year and the number of draws on government debt;
- Provincial Treasury, the Ministry of Education, and school districts worked together to pilot the Central Deposit Program, where school district cash is deposited with Provincial Treasury to earn a competitive rate of return and offset government cash requirements, reducing debt costs and debt levels.
- Ministry of Advanced Education worked with colleges to update investment policies and expectations for adherence to investment guidelines.
- Ministries of Education and of Advanced Education launched service delivery transformation initiatives to pursue opportunities for colleges and school districts to share purchasing power and other shared delivery strategies.
    - The reports of these opportunities can be found at:
      https://www.bced.gov.bc.ca/deloitte_report_august_2012.pdf
      http://www.aved.gov.bc.ca/administrative_service_delivery/docs/deloitte_report.pdf

The Central Deposit Program was launched to all school districts in February 2013, aligning with the Auditor General's recommendation from 2010. Since then deposits to the program have grown to $611 million, with $288 million deposited from the SUCH sector, all from school districts. The Central Deposit Program is now being expanded to the remainder of the SUCH sector, with health authorities to begin deposits in March 2014 and post secondary organizations being offered the program at the same time. Total deposits from the SUCH sector are expected to increase to $1 billion during 2014/2015, resulting in a significant reduction in the taxpayer-supported Debt/GDP ratio as reported in Budget 2014.

Budget 2014 and the Auditor General's report confirms the importance of the Central Deposit Program as an effective short term initiative to address excess liquidity and idle working capital balances in government organizations, including the SUCH sector. Government will follow up by working with organizations on the use of their surplus cash to achieve service delivery objectives, which is consistent with the recommendations of the Auditor General.

An ongoing balance sheet management strategy will involve working with individual government organizations to jointly identify and fund capital projects through the use of excess cash. The long term goal is a gradual decline of cash on government's balance sheet as a means of reducing borrowing requirements.

We agree with the Auditor General's recommendation to address systemic issues preventing effective cash flow but recognize that government is subject to legislative requirements in the preparation of budgets, management of financial operations, and reporting financial results.

In 2004 British Columbia was the first jurisdiction to require all financial reports be prepared on the basis of Generally Accepted Accounting Principles (GAAP). A change to this complex, interrelated system is a comprehensive undertaking that will affect not only systems and processes of financial management, but legislative authorities and governance relationships between government and organizations across the broader public sector. Having responded effectively to the cash management problems that arise from budgeting on a GAAP basis, government commits to undertaking a longer term review of the financial framework to determine the best course of action that is consistent with our commitment to sound financial management and a sustainable fiscal plan.

Budget 2014 highlights many of the issues raised in the Auditor General's report and government has provided, on page 49 of the Budget and Fiscal Plan, a balance sheet management plan which is consistent with the measures recommended by the Auditor General.

Government expresses its appreciation to the Auditor General for his work in assisting government in identifying areas where improvements can be achieved within government.

EXECUTIVE SUMMARY

Why is cash important to a business?

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.

Source: Management of Working Capital by Colleges and School Districts, Office of the Auditor General of British Columbia, August 2010

In August 2010, we reported that most school districts and colleges had been receiving more cash from the Province than they were actually permitted to spend, based on the legislative and financial control frameworks set up by government. As a result, significant amounts of cash had built up, which was essentially trapped in the bank accounts of these organizations.

The result was an overall higher cost to government. While cash on deposit with banks earned interest, the Province's average cost of borrowing was greater. If these organizations were only provided the cash that they needed (and were permitted to spend), the Province could avoid these higher costs. For example, a reduction in cash and investment balances of about 40% could have avoided about $16 million in additional interest expense for 2013 and about $82 million in total over the last five years.[1]

Since our 2010 report, we have asked for, received and published two self-assessments from government on its progress of improving working capital management. While government has made progress in a number of areas, the outcomes we anticipated in the first report have not yet been achieved. We decided to carry out this more in-depth follow-up work to inform government of the significant cost savings that are possible through better cash flow management in the broader public sector.

We found some modest improvements in cash management, but government has not yet addressed the underlying issues that result in some cash being deployed to government organizations before it is needed or can be used. To address the causes of the problem, government must be willing to change some of its business practices, including reviewing the systemic issues preventing effective cash management. A collaborative solution may be necessary, requiring cooperation and consultation between government, elected and appointed boards, and senior management.

Government's most significant response to date has been the creation of the Central Deposit Program, where school districts can invest their excess cash back with government.[2] This program, if expanded, has the potential to significantly reduce the interest costs associated with holding excess cash. However, it only deals with excess cash after it has already been deployed. It would be more cost-effective if government did not provide cash in excess of what organizations are allowed to use in the first place.

1 While this figure demonstrates potential savings, the percentage of excess cash is likely greater than 40%. The $16 million is based on an approximate $500 million reduction in cash balances and represents the estimated net cost savings after reflecting interest income that would be forgone with decreased cash balances.

2 Introduced by Provincial Treasury in fiscal 2011/12, the Central Deposit Program allows school districts to earn a competitive interest rate on funds deposited with government instead of with banks or credit unions. This allows the Province to use the cash to meet operational needs rather than borrow new cash from the market.

WE RECOMMEND THAT:

1 government fund organizations based on cash needs and that organizations be permitted to spend the full amount of funding received.

2 government review and amend its accountability and monitoring requirements to improve the effectiveness of its cash flow management.

BACKGROUND

Managing cash and investments is an important part of any entity's financial management activities. It involves tracking what expenses need to be paid and ensuring there is enough cash on hand, or short-term investments that can be cashed in, to cover those expenses. Maintaining small reserves of cash and short-term investments is important to keep operations running, but holding too much imposes a cost on the business.

The best way to manage cash flow is to: understand how and when cash is used; forecast future cash needs; and make decisions based on the business's comfort zone and risk tolerance.

In August 2010, our Office released a report titled *Management of Working Capital by Colleges and School Districts*. We looked at cash and investments in these sectors, assessing how well government was managing working capital and liquidity in the colleges and school districts to achieve best value for taxpayers.

We focused on colleges and school districts because their total cash and the value of their short-term investments were particularly high relative to their annual expenses and compared with cash held by other government sectors. Overall, we found that there was significant surplus cash in the college and school district sectors, and working capital was not being effectively managed.

Our specific findings:

- The majority of colleges and school districts were holding more cash and short-term investments than they needed for their business.
- Government provides funds to colleges and school districts in excess of their current cash flow needs.
- Cash flow forecasts were not always used to inform investment decisions. In many cases, working capital and investment performance was not actively managed.
- Each entity was procuring its own banking services instead of central government using its combined purchasing power to negotiate master banking agreements. As a result, the colleges and school districts were likely not achieving best value for government as a whole.

Excess cash could be used to reduce the Province's overall borrowing requirements. At March 31, 2009, government had cash and short-term investments totaling $5.2 billion,[3] which excluded balances held by self-supporting government business enterprises such as BC Hydro and ICBC.

3 The total cash balance in the 2009 Summary Financial Statements was $7.3 billion. However, this included a balance of approximately $2 billion in short-term investments that was part of government's strategy to address uncertainty during the 2008–2009 financial crisis, and that was not a component of regular cash flow management.

Of this amount:

- $1.6 billion was held by the Consolidated Revenue Fund (CRF)[4];
- $2.7 billion was held in school districts, universities, colleges and health authorities (and health societies), collectively known as the SUCH sector; and
- $0.9 billion was held by other taxpayer-supported government entities, which receive some or all of their funding directly from government.

Our 2010 report included four recommendations:

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.
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 that they do not all have at present.

Scope of our work

Our work was carried out during September and October 2013, under section 11(8) of the *Auditor General Act*, in accordance with the standards for assurance engagements set out in the *CPA Canada Handbook*.

As this report is an update of a prior report, we included updated figures from the most recent fiscal period. In our 2010 report, we focused on how cash flow was managed by colleges and school districts. This was also the focus of this follow-up work. Additionally, we conducted interviews and performed analyses in the broader SUCH sector to establish that the key issues identified in this report are common to the entire sector. As a result, we limited our focus on certain operational issues originally reported on, including investment policies and banking services.

Conclusion

Overall, we found that government is not yet managing its cash flow to achieve best value for taxpayers.

There have been improvements in cash management, but some cash is still being deployed to the SUCH sector before it is needed or can be used. If expanded, the recently created Central Deposit Program has the potential to significantly reduce many of the costs associated with excess cash. However, a more cost-effective approach would be for government not to provide cash in excess of what organizations are allowed to spend in the first place.

4 The Consolidated Revenue Fund comprises the ministries, the Legislative Assembly, central agencies and offices of the Legislature.

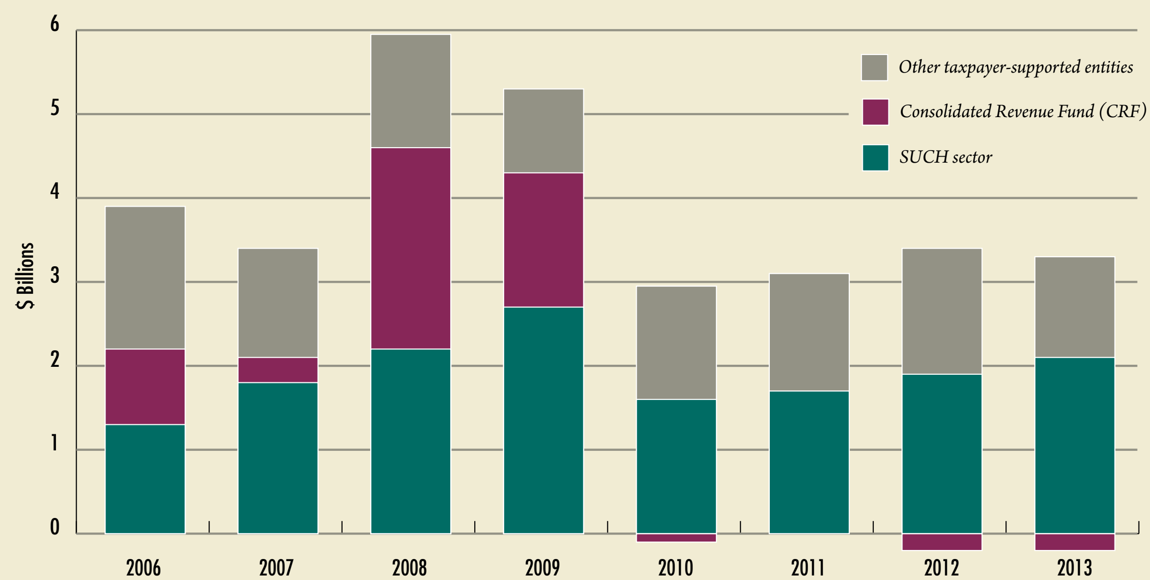
GOVERNMENT'S ACTIONS SINCE OUR 2010 REPORT

Cash and short-term investments

Since March 31, 2009, government has reduced its overall cash and short-term investment balance from $5.2 billion to $3.1 billion (see Exhibit 1). The Consolidated Revenue Fund has gone from being a $1.6 billion cash and short-term investment balance at March 31, 2009 (deliberately high in response to the financial crisis) to having an overdraft of $84 million at March 31, 2013.[5]

During this same period, cash and short-term investments in the school districts, universities, colleges and health organizations (SUCH) sector have remained largely unchanged at about $2.8 billion, which accounts for about 90% of the total for all of government. As at June 30, 2013, approximately $244 million of this balance was on deposit with Provincial Treasury's Central Deposit Program.

Exhibit 1: Cash and investment balances by sector, 2006–2013



Source: Office of the Auditor General of British Columbia

5 Provincial Treasury collectively manages a system of over 1,100 bank accounts for the Consolidated Revenue Fund. Many smaller Crown corporations have "offset banking" agreements with Provincial Treasury. In 2012/13, this allowed Treasury to overdraw central government accounts by $84 million (offset by deposits in other accounts). This system minimizes the overall interest costs to the Province.

Central Deposit Program

The Central Deposit Program currently provides school districts with the option of investing their excess funds back with government instead of with a bank. The Province manages these funds centrally, reducing the amount of money it needs to borrow and, therefore, to pay interest on. Because the program is voluntary, Provincial Treasury has needed to offer an interest rate high enough to compete with the deposit rates of private sector banks.

At June 30, 2013, participating school districts had $244 million on deposit in the program. This represented approximately 20% of their total $1.2 billion in cash and investments. However, we found that program participation varied. Some districts had invested as much as 60% of their cash and investments, yet over half of all the districts were not participating in the program at all.

The program addresses part of the second recommendation from our 2010 report, which was that government should pursue opportunities to access and reduce excess liquidity in colleges and school districts. The program has reduced some of the costs associated with excess cash, and has the potential to further reduce it if participation increases. However, to the extent that the surplus cash arises from provincial funding paid in excess of when it is needed and can be used, it would be more cost-effective if government only provided what can actually be used by the system.

Timing of payments

At the time of our 2010 report, the Ministry of Education provided equal biweekly grant payments to school districts throughout the year. Because of the school calendar, though, districts' cash needs varied from month to month. The Ministry worked with the school districts to revise its grant payments schedule to better match the size of the payments needed; however, as the *School Act* requires the Ministry to pay the districts 100% of approved funding by the end of June, there were limited benefits that could be achieved. Greater benefits could only be achieved with changing this requirement in the *School Act*.

Investment policies

In 2010, we identified that colleges and school districts were getting little or no return on their significant cash and investment balances. Recognizing that these organizations were not in the business of investment management, our 2010 report's third recommendation was that "government should improve investment management either by centralizing the management of investments or by providing clear direction and support to colleges and school districts."

In response, the Ministry of Advanced Education asked all post-secondary institutions to review guidance from the Ministry of Finance and update their investment policies. All post-secondary institutions have completed this process and received approval from their boards. The Ministry of Advanced Education also reviewed the policies developed and confirmed they were consistent with the guidance.

The Ministry of Education does not have formalized investment guidance for school districts. However, the reduction of cash levels in school districts, supported by the Central Deposit Program, would eliminate the need for most districts to have formal investment policies.

Shared services arrangements

Our fourth recommendation in the 2010 report was that government look at ways for the education sector to pursue efficiencies from shared purchasing power and investment expertise. Both the Ministries of Education and Advanced Education undertook an even broader review of potential for efficiency through shared services. The results of these reports are available on their websites.[6]

Responding specifically to the potential to reduce banking service fees, the Ministry of Finance surveyed school districts to determine the types and costs of their current banking services. While no decision has yet been made to consolidate banking services, a new financial service agreement being negotiated by the Province has the option of including other government organizations, such as school districts, at a later date.

While savings have not yet been realized, this is a step towards government being able to leverage its greater purchasing power to obtain lower fees for other government agencies.

IMPEDIMENTS TO EFFECTIVELY MANAGING CASH FLOW

Cash flow management is important because the Province's average cost of borrowing exceeds average interest earned on deposits and short-term investments. As a result, there is a real cost associated with holding more cash than is required.

The goal of cash flow management is to have the right amount of money in the right place at the right time to meet obligations in the most cost-effective way. To meet this goal, an organization needs to maintain adequate cash to meet day-to-day operational needs while minimizing the costs associated with holding more than is needed at any one time. Achieving this balance in a large, complex organization, such as government, requires a coordinated approach and the right accountabilities to ensure cash flow is managed efficiently for government as a whole.

Because large surplus cash balances still remain in the SUCH sector, there are opportunities for significant interest cost savings. For example, a 40% reduction in government's cash and short-term investments could have saved about $16 million in interest expense in 2013 and $82 million total over the last five years. This figure is just an illustration of the potential savings. The percentage of excess cash is likely greater than 40%.

The underlying issues that result in some cash being deployed before it is needed (or can be used) led to our first recommendation in the 2010 report, which was that "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." These ongoing issues are described in more detail in the next section.

6 Ministry of Advanced Education: http://www.aved.gov.bc.ca/administrative_service_delivery/
Ministry of Education: http://www.bced.gov.bc.ca/deloitte_report_august_2012.pdf

Legislative and governance arrangements

A key financial management mechanism for any government is rigorous control over expenses. In British Columbia, this is achieved in part through the accountability requirements of the *Balanced Budget and Ministerial Accountability Act*. For the broader public sector, the spirit of these requirements is laid out in various acts, regulations and letters of expectation between government and governing boards of government organizations.

Generally, the balanced budget concept means that expenses cannot exceed revenues in each fiscal year: an organization cannot have a deficit for the year. While the details can vary by sector (see text box), invariably some cash becomes trapped because it cannot be spent (otherwise expenses would be greater than revenue). For colleges and other organizations that must meet the no-deficit test every year, this trapping of cash can occur to a greater extent than for school districts.

Financial statements prepared in accordance with generally accepted accounting principles (GAAP) are not meant to reflect only transactions that occur within the fiscal year being reported. Therefore, the accounting results reported for a fiscal year do not, and are not meant to, correspond exactly with cash inflows and outflows.

As we reported in 2010, for organizations to be in compliance with the no-deficit requirement, they generally have to take in more cash than they spend. This is because, while revenues are generally fairly close to the cash inflows during the year, the same is not true for expenses. Some types of expenses do not require cash or they are recognized before cash is needed. These expenses include amortization of capital assets, the recognition of liabilities associated with long-term employee future benefits, and other liabilities that will not be settled until a future date.

An example of how this can create problems is when school districts transitioned to full use of GAAP in 2005. For the first time, they had to record certain expenses such as long-term employee future benefit obligations (e.g., retirement and sick leave benefits). The Province provided extra funding to the school districts that year to offset these expenses so that the districts could comply with the no-deficit requirements. As shown in Exhibit 2, cash and investments as a percentage of annual operating expenses increased during this time because there was more cash funding received than could actually be spent.

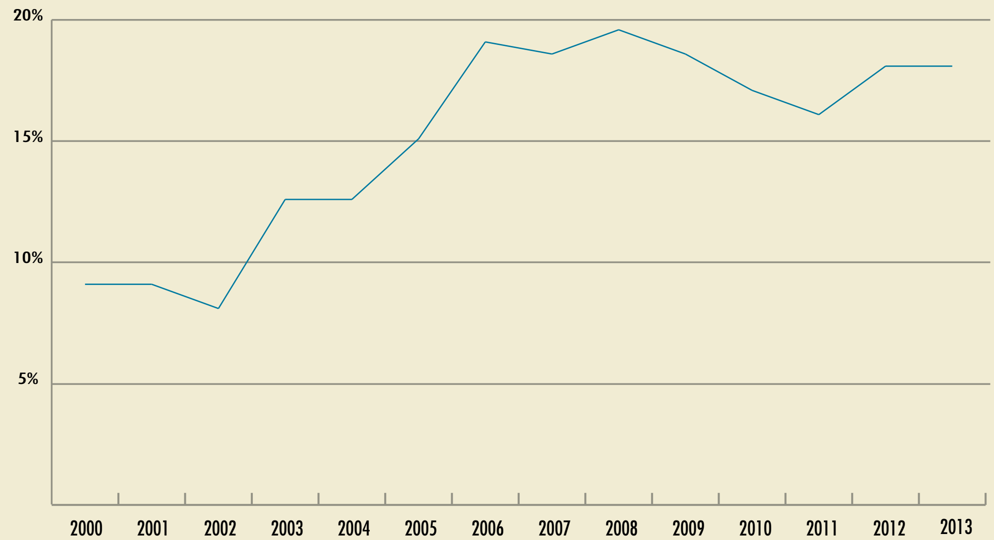
Under GAAP, revenues and expenses reflect cash flows that have occurred in the past (i.e., amortization of the cost of assets purchased in the past, such as a building), that are occurring during the current fiscal year, or that will occur sometime in the future (i.e., when liabilities such as retirement benefits are paid out/settled). In this context, the excess of revenues over expenses is an indicator of how financial position has changed during the year.

The expectation that revenues exceed expenses each year (i.e., financial position increases each year) is problematic when it is achieved by providing cash that cannot be used. Although the use of balanced budget legislation tools and other spending controls have been effective in achieving system-wide control over spending, they have also had unintended consequences for cash flow management.

School districts and balanced budget requirements

School districts' cumulative expenses cannot exceed their cumulative revenues. For example, a school district's expenses can exceed revenues in a given fiscal year, but only to the extent that revenues have exceeded expenses in prior years. School districts can also exclude certain expenses such as amortization of capital assets from this calculation while other government entities – including colleges – cannot.

Exhibit 2: Total cash and investments in school districts as a percentage of annual operating expense, 2000–2013



Source: Office of the Auditor General of British Columbia

To address this, the spirit of balanced budget requirements and government's expenditure controls could be retained, but modified to align accountability with better financial management outcomes. For example, universities already exclude unrealized gains or losses on their long-term investment portfolios from their calculation of annual surplus for accountability purposes. Removing these from the calculation recognizes that investment values are something that is managed over a period longer than a fiscal year. This same principle applies to many other aspects of financial statements prepared in accordance with GAAP.

If government organizations are not provided the funding (i.e., cash) to offset non-cash expenses for accounting purposes, they may report deficits. However, this would not be an indication of issues with financial management to the extent it related to a reduction in funding that could not be used anyway. Furthermore, as long as an organization's authority to spend was unchanged,[7] the Province could still achieve a consolidated annual surplus as required in the *Balanced Budget and Ministerial Accountability Act.* The reason for this is that, from the perspective of the Province's Summary Financial Statements, a transfer from the Consolidated Revenue Fund to a government organization is akin to moving cash from the left pocket to the right pocket. Although reduced funding may result in a deficit in a government organization, it would be offset by a corresponding surplus in the Consolidated Revenue Fund, for a net effect of zero for government as a whole.

7 As an example, this could be achieved by both reducing funding of non-cash expenses and revising the accountability requirements so that a deficit could be incurred to the extent there were non-cash expenses.

Cash flow forecasting

Cash flow forecasting predicts where and when cash will be received and spent. Accurate forecasting is essential and requires that government have skilled staff with the right information systems to ensure that significant cash flows are identified and reasonable predictions of planned expenditures are produced. The more accurately that cash flow needs are forecasted, the greater excess cash balances can be reduced. The cost associated with holding excess cash should be appropriately balanced with the administrative cost of increasing forecasting precision.

In this follow-up, we did not look at Provincial Treasury's forecasting for capital projects and ministries because we previously found that this forecasting had been generally well done. However, many government organizations do not rigorously manage their operating cash flows. They do not need to because they generally have a surplus of cash and their ministries provide regular payments based on budgeting requirements that generally exceed cash flow needs. While the recipients can invest this excess cash and gain interest income, this is not cost-effective for government as a whole. Cash flow forecasting should signal when government provides payments so that organizations receive only what they require.

To properly manage cash across over 150 government entities, effective cross-government cash flow forecasting is required to determine the right amount of cash for the system during the fiscal year.

Debt and cash management integration

The decision to borrow money (when, where, how much and for how long) should be taken in the context of whether or not government needs cash to meet current needs. This requires the integration of cash and debt management activities. Accurate and reliable cash flow forecasting from significant government organizations and Provincial Treasury should provide key information that informs when government needs to borrow money.

We wrote in our 2010 working capital report and in other reports that the integration of debt and cash management for the Consolidated Revenue Fund is well managed by Provincial Treasury. However, once cash is transferred from the fund to a government organization, Provincial Treasury can no longer access it to ensure that any surplus cash is used to reduce borrowing and minimize interest costs. Instead, each government organization independently manages its own cash and investments. Since central government often provides cash before the organization can use it, excess cash accumulates and cannot be accessed by Provincial Treasury to reduce costs.

Participating in the Central Deposit Program improves cash flow integration because the deposited funds are managed by Provincial Treasury. That money reduces government's borrowing needs, thereby saving money.

The Central Deposit Program also offers a mutually beneficial option for entities that earn significant revenues from outside government. Colleges, for example, set aside reserves partially generated by their own revenue sources for future capital projects. The program could provide them with an attractive return on their investments while helping to reduce government's overall cost of borrowing.

CONCLUSION

Overall, government is still not managing the cash flows of the broader government reporting entity to achieve best value for taxpayers.

There have been improvements in cash management, but cash is still being deployed to the SUCH sector before it is needed or can be used. If expanded, the recently created Central Deposit Program has the potential to reduce some of the costs associated with excess cash. However, it would be more cost-effective if government did not provide cash in excess of what organizations are allowed to spend in the first place.

NEW RECOMMENDATIONS

RECOMMENDATION 1: ***We recommend that government fund organizations based on cash needs and that organizations be permitted to spend the full amount of funding received.***

RECOMMENDATION 2: ***We recommend that government review and amend its accountability and monitoring requirements to improve the effectiveness of its cash flow management.***

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