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Accrual Accounting, the National Security Exception, and Defence Production

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General Sir Arthur Currie's greatest victory was at the Battle of Amiens, which German Field Marshall von Ludendorff described as the "blackest day of the German Army in the history of the war," and which Field Marshall Lord Byng of Vimy described as "the finest operation of the war."

The battle of Amiens launched the famous "Hundred Days," in which the four divisions of the Canadian Corps defeated 47 German divisions in successive battles, and ended with the Armistice which brought the First World War to its conclusion

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The views expressed are those of the author and do not necessarily represent the views of the Conference or its members.

Introduction

If we deconstruct the working title that was originally provided by the conference organizers for this paper, "The Hardware—What Can Wait, and What Can't," we find that there are two implicit assumptions within it.

That first is that the Canadian defence capital budget represents a "Zero-Sum Game," in which the various interest groups within the defence community are competing for a share of a budget wholly inadequate to meet the re-capitalization needs of all, and that defence planners are thereby forced into a zero-sum conflict to determine the re-capitalization projects which are the most critical.

The second implicit assumption is that the defence acquisition cycle is so long as to effectively mean that replacement equipment may have lost the technology race by the time that it is delivered.

The first assumption has been effectively eliminated through the adoption by Treasury Board of what is termed "accrual accounting." This has been expressed in footnotes in each of Budgets 2004, 2005, and 2006, related to the Defence Budget's capital programme.

This, in turn, opens up the possibility of a massive Canadian re-armament programme the likes of which has not been seen since the time that Brooke Claxton and CD Howe held the Defence and Defence Production portfolios respectively.

Unfortunately, the capacity of the

current acquisition process to handle such an expansion is hopelessly inadequate and requires drastic reform.

Put another way--we need another CD Howe!

Accrual Accounting and the “Zero-Sum Game” Hypothesis

In 1995[1] the Government announced its decision to shift the basis of the federal government accounting system from what is known as ‘expenditure based accounting’ to what is known as ‘accrual based accounting.’

“Accrual based accounting,” is, of course, the normal, every-day accounting system used by most business in the private sector.

Where the two systems differ significantly is in their treatment of capital purchases of goods which will not be consumed in the year of purchase, but, rather “used up” over a multi-year period. In the “expenditure based system” such purchases are “expensed” 100% in the year of purchase. In the normal accounting system, they are taken onto the “Balance Sheet” at their purchase cost and “depreciated” in equal annual payments over the course of their useful lives.

The 2004 Defence Budget Statement included a footnote[2] indicating an initial application of accrual accounting to defence. First came a statement promising a solution to the Search and Rescue aircraft (SAR) replacement question:

> “Another major priority for Canada’s military is the purchase of modern Fixed Wing Search and Rescue aircraft (SAR) to replace older Hercules aircraft and Canada’s fleet of Buffalo aircraft. Under Defence’s current plan, deliveries of the new aircraft will begin much later in the decade.”

This was followed by what was really an accrual budgeting statement:

> “This budget sets aside non-budgetary resources to allow the Department of National Defence to move this acquisition forward in time without displacing other planned capital investments.
>
> By doing so, the Government will accelerate the process so that deliveries of the replacement SAR planes to Canada’s military can begin within 12 to 18 months. This measure will allow Defence to spend an additional $300 million on capital in 2005–06 and similar amounts in subsequent years until this procurement is completed.”

And the technical footnote[3] followed:

> “Under accrual accounting, the acquisition of capital assets has no direct budgetary impact in the year in which the asset is acquired. Instead, the amortization of the asset over its useful life is recognized in the budgetary balance. The acquisition of capital assets does, however, directly affect non-budgetary transactions and financial source/requirements.”

A similar statement[4] was found in Budget 2005:

> “The $12.8-billion increase over five years in defence funding is the largest such increase in the last 20 years. It will cover the full costs of the activities described above, including the additional annual personnel and operating and maintenance costs associated with any capital that is acquired.

In the budgetary funding estimates shown in the summary table at the end of this chapter, the actual cost of the capital is spread over its life, and the annual budgetary amounts include only a fraction of the full capital cost. However, DND will have to pay the full costs of the capital in cash in the years that it is acquired. The Government will make that cash available to DND as it is needed.”

And another statement[5] is found in Budget 2006:

“The cost of major capital equipment is spread over it’s life, so the annual budgetary amounts include only a portion of the full capital cast. As was the case with the budgetary increases provided last year, the full cost of capital acquisitions will be provided on a cash basis in the years they are required.”

Treasury Board has moved to develop guidelines as to the life expectancies of various capital classes in the Treasury Board Capital Asset Amortization Guidelines,[6] as the table indicates

Capital Class	Life Expectancy
The original cost of land is not amortized	
Buildings:	20 to 30 years
Machinery and equipment:	5 to 15 years
Works and infrastructure:	20 to 40 years
Informatics hardware:	3 to 5 years
Informatics software	1 to 10 years
Arms and weapons for defence:	5 to 10 years
Motor vehicles:	3 to 10 years
Military vehicles	3 to 20 years
Ships and boats:	10 to 25 years
Aircraft:	10 to 20 years

The implications of this change are profound in terms of the re-capitalization crisis in the Department of National Defence.

They mean that in future years only the annual depreciation of major capital equipments will be charged to Vote 5 of the defence budget, a development which has a short run leveraging effect on capital purchases, and which can massively increase the de facto capital budget. We can see this in terms of a simple thought experiment.

For example, the Medium Support Vehicle System (MSVS) project is a desperately needed *Support, Sustainment, and Mobility* project. The existing MLVW fleet to be replaced is now 24 years old, 4 years beyond the end of it’s life expectancy according to the Treasury Board Guidelines.

The MSVS acquisition is a $956,900,000 project. The *Strategic Capabilities Investment Plan* (*SCIP 2004*) showed a slow five year ramp-up in spending on it, with a total of only $125 million or 13.1 per cent spent to the 2008-09 point and the remainder to be spent in the years following.[7]

Its inclusion in Vote 5 expenditures was impossible before that time because there simply wasn’t enough money in Vote 5 to accommodate it before then. In 2008-09 the fleet will be 26 years old, with good prospects of being 30 years old by the time

actual replacement takes place.

The use of accrual based accounting would allow the new MSVS fleet to be taken onto the DND balance sheet immediately, and to be amortized over its 20 year life at the approved Treasury Board guideline rate of "Military vehicles: 3 to 20 years." As such, instead of a $957 million charge in Vote 5 of the year of purchase, the cost would only be one-twentieth of that, or $48 million.

If we extend the thought experiment a bit further we could hypothesize that the average life expectancy, or amortization schedule for all DND capital equipment assets might be about 14 years. That would mean that we would have to charge amortization at rate of 7% of the original cost annually to Vote 5.

If we took Budget 2005's Vote 5 total of about $1.6 billion as the total amortization to be charged, we would find that that amount of amortization would be the appropriate charge for a total capital acquisition of about $22.4 billion. And the Vote 5 increases promised by both the Liberal government in years 3, 4, and 5 of Budget 2005 would very substantially increase that figure.[8]

If the government actually plans to do as it says it plans to do in terms of the adoption of accrual accounting, we can make a strong case that there is no longer any re-capitalization problem for the Defence Department from a financial perspective. Accordingly, there is no longer any "Zero-Sum Game" implicit assumption in Defence recapitalization.

The Acquisition Process Problem: The 15 Year Cycle

Given the end of the "Zero Sum Game," the focus must now shift to the ponderous Acquisition process. The Minister's Advisory Committee on Administrative Efficiency identified internal DND procedures as a significant part of the problem, noting that:

> The Committee finds that Defence's *internal* process for defining requirements and approving capital projects takes too long (nine years out of the average 15-16 year process required to procure major equipment), involves too many successive reviews, occupies too much senior management time for little added value, and fails, from a process perspective, to distinguish between common goods and complex weapons systems.[9]

A key element in this lethargy is that the current Canadian government procurement decision model is intendedly "Risk Averse." Unfortunately, the primary focus of this "Risk Aversion" seems to be on things like the "Financial Risk" of contract over-runs, or the "Contract Risk" involved in contractors not meeting contract specifications, and the "Legal Risk" of not observing the requirements for open, transparent, and fair competitive bidding processes mandated by our obligations with respect to the provisions of the World Trade Organization (WTO), North American Free Trade Area (NAFTA), and the intra-Canadian Agreement on Internal Trade (AIT).

There is, as well, the problem of "Political Risk" within the Canadian context—of politicians imposing non-defence objectives on top of, and sometimes in place of legitimate defence objectives. This can range from the very costly decision taken by Prime Minister Chrétien to cancel the EH-101 contract entered into by Prime Minister Mulroney's previous administration, and thereby to set back the Maritime Helicopter replacement project by two decades, to political interventions into the Industrial and Regional Benefits (IRBs) aspects of major equipment projects, which may be playing a role in the delay in getting out an RFP for the Fixed-Wing Search and Rescue project, even though Treasury Board provided for an acceleration of the project in Budget 2004.

What seems less apparent, unfortunately, in the Canadian government procurement decision model, is a willingness to accept the existence of "Operational Risk"—the risk that a critical capabilities platform won't be able to do its job, especially under adverse conditions, because it is either simply inappropriate for the circumstances, too old physically, and/or its critical technologies are too out of date—with the result that the platform becomes of greater danger to its crew than to any possible enemy.

In contrast to this ponderous system has been the procurement of critical equipments urgently needed for the deployment in Afghanistan, which has bypassed the cumbersome acquisition system.

A case in point has been the acquisition of the M-777 lightweight medium howitzers currently in action in Afghanistan. These were acquired from the US Marine Corps through the United States Foreign Military Sales programme to meet the very clear operational necessity of providing effective and responsive indirect fire support to the Canadian force deployed in Afghanistan.

From a defence policy viewpoint this was also a most fortuitous development, since it allowed the Royal Canadian Artillery to continue to use 155mm projectiles, the calibre for which there has been extensive research and development work done in terms of highly accurate terminally guided projectile such as those in the US *Excalibur* programme.

What is required is a similar methodology to bypass the turgidity of the acquisition cycle for other critically needed capabilities.

The National Security Exception and TB Life Expectancies

Fortunately, such a tool already exists in the form of the National Security Exception (NSE). The purpose of the NSE is clearly identified in the Guidelines issued by Treasury Board to assist Departments in determining when to invoke the NSE:

> "The NSE provided for in trade agreements allows Canada to remove a procurement from some or all of the obligations of the relevant trade agreement where Canada considers it necessary to do so in order to protect its national security or other related interests specified in the text of the national security exceptions."[10]

Treasury Board notes that the NSE provides for considerable flexibility in approach, and may impact upon such perennial practices as the much loved IRBs:

> "The term 'NSE' is self defining and as such, signatories to the trade agreements made a conscious decision to ensure considerable discretion in complying with the trade agreements in the context of their own domestic security requirements."[11]

> "In general, protecting national security is not meant to preclude work being performed by international firms. In this vein, invoking NSE does not mean that Industrial and Regional Benefits (IRBs) are in or out of a procurement

strategy. IRBs may or may not arise in the context of NSE. As well, invoking NSE is not meant by definition to restrict competition to Canadian suppliers unless for example, there is a legitimate need to maintain or establish a Canadian source of supply. Depending on what is being purchased, there may be situations where only foreign suppliers are able to bid on those goods and services deemed essential to Canada's security interests." [12]

The adoption of accrual accounting has effectively solved the problem of generating enough money to solve the re-capitalization dilemma of the Canadian Forces. The combination of the use of the NSE together with the use of Treasury Board Capital Asset Amortization Guidelines may be the way of solving the problem of acquisition process rigidity by providing an operating heuristic as to when the NSE should be used to bypass the normal procurement process, and when the normal process can be followed without danger to the operational needs of the Canadian Forces.

Put simply, we could adopt the following decision rules:

1 If purchasing normal commodity goods and supplies to be consumed within one year, use the existing PWGCS acquisition process.

2 For the acquisition of major equipments, compare the Acquisition cycle length to the remaining years of life in the equipments to be replaced, according to Treasury Board guidelines. If the cycle is less than the life remaining, use the normal competitive bidding process.

3 If the major equipment service life remaining, according to Treasury Board guidelines, is less than the acquisition cycle length, invoke the National Security Exception, and bypass the normal acquisition process.

4 Where new, rather than replacement, capabilities are required to eliminate operational risk, invoke the National Security Exception, and bypass the normal acquisition process.

The Project Management Expertise Challenge

The adoption of the proposed NSE decision rules, together with the availability of funds under accrual accounting, and the advanced ages of the Canadian Forces major equipment fleets could potentially result in the greatest surge in defence re-capitalization since the Korean War, but would also raise the question as to whether the existing procurement organizations are up to the task. Indeed the Minister's Review Committee has commented:

"The Committee believes that the split accountability for the procurement of military unique requirements is fundamentally wrong. It weakens accountability and creates inefficiency by requiring the two departments to work on the acquisition of the same goods and services. The Committee recognizes that there is a definite benefit to a common procurement organization for common goods and services; this is PWGSC's specialty. However, the acquisition of specialized military equipment is unique to DND, large in

> scope and complex in nature. Therefore, accountability, responsibility and authority for that activity should, more logically, be assigned to a single agency. Such a move would eliminate the current high costs of maintaining up-to-date knowledge levels in two groups of personnel, assigned to executing similar aspects of a shared task."[13]

The Minister's Review Committee had in mind an expansion of the responsibilities of the office of ADM (Materiel). An alternative, given the size of the potential re-armament of the Canadian Forces after so many years of structural disarmament through rustout, might be the restoration of the Department of Defence Production, which was abolished by Prime Minister Pearson in 1963, though it was revived for a single year by Prime Minister Trudeau in 1968, before being abolished once again.

The restoration of the Department of Defence Production might also imply the restoration of a number of its original responsibilities, which have been shifted to other departments in the intervening years, and whose focus has morphed in other directions. It might be that the management of IRBs should be shifted exclusively to the new DDP, with a special focus on using these as a means of enhancing the Canadian Defence Industrial Base.

The new DDP mandate would logically include the revitalization of the Defence Production Sharing Arrangement (DPSA), which effectively committed to a balance in defence trade between Canada and the US over the long terms, and which allowed Canadian companies to be treated effectively as American companies in terms of competing for contracts with the American Government (and vice-versa), or for sub-contracts with American prime contractors. Central to this would also be a focus on the mitigation of the effects of the US ITAR regulations upon Canadian suppliers to US primes.

This would, of course, lead to the restoration of the de facto Canadian strategic preference for US equipment which the then Deputy Minister of Defence Production, Reginald M. Brophy, described in a 1952 address to the US Industrial College of the Armed Forces:

> "Another important difference was the result of a major change in Canadian policy, which was to change over to United States-type equipment so that our armed forces and yours might fight together using the same equipment and the same supply lines. Large requirements against United States production developed rapidly and Canadian production facilities were required to manufacture to United States designs and specifications."

Given that the United States civilian research and development investments in information and communications technology (ICT) accounts for about 50% of global investment in ICT, and the heavy R&D investments of the US DOD, and the longer production runs for US equipments, it seems that the Canadian Forces would be likely to achieve "better equipment at a better price" by returning to the Defence Production strategy described by Mr. Brophy, a strategy which was largely the product of the man whose name the *C.D. Howe Institute* bears.

Footnotes

1. Department of Finance Canada, *Backgrounder - Implementation of Full Accrual Accounting in the Federal Government's Financial Statements (2004)*, at: http://www.fin.gc.ca/toce/2001/fullacc_e.html
2. Department of Finance Canada, *Budget 2004 – Budget Plan,* Chapter 4.5 - Moving Forward on the Priorities of Canadians -The Importance of Canada's Relationship to the World, at: http://www.fin.gc.ca/budget04/bp/bpc4ee.htm
3. There has been some confusion about whether the fixed wing SAR project would actually be treated in accrual budgeting terms, since there have been reported statements that DND would be "loaned" the money, and would have to "pay back" the loan out of future Vote 5 funds. Whether this implies a real delay in the adoption of accrual budgeting, or simply a "flexibility" in language in case the accrual budgeting adoption date is delayed, is unclear at this time.
4. http://www.fin.gc.ca/budget05/bp/bpc6e.htm#defence
5. Department of Finance Canada, *Budget Plan 2006: Focusing on Priorities,* p. 136
6. http://www.tbs-sct.gc.ca/pubs_pol/dcgpubs/accstd/capasset1_e.asp
7. National Defence, Strategic Capabilities Investment Plan, Capital Equipment Annex 2004 Update, Capability Thrust 2, Support, Sustainment, and Mobility, at: http://www.vcds.forces.gc.ca/dgsp/pubs/rep-pub/ddm/scip/annex04-05/ctdyn_e.asp?ct=2
8. Note that this "Thought Experiment" does not make allowances for the amortization of the existing capital asset inventory.
9. *Minister's Efficiency Study*, *Section 1 – Management Enhancements*, at: http://www.forces.gc.ca/site/Focus/AE/report/toc_e.htm
10. Guidelines to Assist Departments in Invoking the National Security Exception (NSE) in Procurement Trade Agreements http://www.tbs-sct.gc.ca/cmp/guide/nse-esn_e.asp
11. *Ibid.*
12. *Ibid.*
13. *Minister's Efficiency Study, op. cit.*

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