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Parliamentary paper

# Central government: Results of the 2005/06 audits





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# Central government: Results of the 2005/06 audits

Presented to the House of  
Representatives pursuant to section 20  
of the Public Audit Act 2001

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Hon Margaret Wilson MP  
Speaker  
House of Representatives  
WELLINGTON

Madam Speaker

I am pleased to forward this report to you for presentation to the House of Representatives pursuant to section 20 of the Public Audit Act 2001.

Yours sincerely

A handwritten signature in black ink, appearing to be 'K B Brady', written on a light background.

K B Brady  
Controller and Auditor-General

Wellington

29 March 2007

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# Introduction

This report serves two broad purposes:

- It constitutes our “annual report” on the 2005/06 audits of the Government reporting entity and its subentities – mainly as reflected in the *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2006* (the Government financial statements), parliamentary paper B.11 2006.
- It brings to attention a number of other matters (related both directly and indirectly to events occurring in the financial year 2005/06) that we believe warrant consideration by Parliament.

Part 1 (pages 7-18) deals with the Government financial statements as audited and presented to the House. It discusses the significant matters arising from the 2005/06 audit.

Part 2 (pages 19-24) deals with the results of our audits of government departments for the year ended 30 June 2006. We include our usual:

- discussion of the audit opinions we issued on departments’ financial reports; and
- assessments of departments’ financial and service performance management, and this year note the progress made over the 13-year period that we have applied this framework.

Part 3 (pages 25-29) deals with changes we have made to our reporting to entities, Ministers, and select committees. These changes reflect our new framework for assessing departments’ financial and service performance management.

Part 4 (pages 31-45) sets out details of the non-standard audit reports we issued during the period 1 January 2006 to 31 December 2006 on the annual financial reports of entities that are part of the Government reporting entity. We also report on non-standard audit reports issued on the annual financial reports of school boards of trustees.

Part 5 (pages 47-54) outlines the effect of the Public Audit Act 2001 – in particular, the identification of new public entities under the test for “control”.

Part 6 (pages 55-61) outlines the public finance principles relating to the “Controller” function, summarises the unappropriated expenditure for 2005/06, and reports on some of the issues we have considered over the year.

Part 7 (pages 63-75) assesses the progress made by the Ministry of Education in reducing the incidence of unlawful expenditure by schools, which is a matter that we have reported on twice before.

Part 8 (pages 77-80) describes the work we intend to undertake in 2007/08 on service performance reporting by departments and most Crown entities, and explains how this work relates to the changes we have made to our reporting explained in Part 3.

Part 9 (pages 81-88) provides an update on progress made by the central government sector towards the transition to New Zealand equivalents to International Financial Reporting Standards.

Part 10 (pages 89-100) discusses the use of derivative financial instruments in central government.

Part 11 (pages 101-112) discusses the legislation and policy frameworks, and the activity by central and local government, relating to hazardous waste management.

Part 12 (pages 113-123) provides an overview of the Defence Sustainability Initiative, including its background, objectives, and governance, and discusses the current progress towards achieving its objectives.



## Part 1

# The 2005/06 audited financial statements of the Government

1.101 The Auditor-General issued the audit report on the *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2006* (the Government financial statements) on 29 September 2006. This is the same date on which the Minister of Finance and the Secretary to the Treasury signed their Statement of Responsibility.

### Unqualified opinion issued

1.102 The audit report appears on pages 24-25 of the Government financial statements. The report includes our unqualified opinion that those statements:

- comply with generally accepted accounting practice in New Zealand; and
- fairly reflect:
  - the Government of New Zealand’s financial position as at 30 June 2006; and
  - the results of its operations and cash flows for the year ended on that date.

1.103 As in previous years, the Treasury has provided a comprehensive commentary on the financial statements, which is presented on pages 6-22 of the Government financial statements.

1.104 The significant matters that arose during the 2005/06 audit of the Government financial statements are listed below and discussed in this Part:

- the Treasury and sector performance (paragraphs 1.105 to 1.111);
- student loans (paragraphs 1.112 to 1.127);
- tax revenue (paragraphs 1.128 to 1.135);
- fair value of receivables portfolios (paragraphs 1.136 to 1.141);
- the Kyoto Protocol provision (paragraphs 1.142 to 1.149);
- valuation of rail assets and land (paragraphs 1.150 to 1.154);
- Financial Reporting Standard No. 37: *Consolidating Investments in Subsidiaries* (FRS-37) (paragraphs 1.155 to 1.159);
- New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) (paragraphs 1.160 to 1.162);
- funding of Alpurtt B2 motorway extension (paragraphs 1.163 to 1.164);
- related party disclosures (paragraphs 1.165 to 1.167); and
- Public Finance Amendment Act 2004 (paragraph 1.168).

## Significant matters arising from the 2005/06 audit

### The Treasury and sector performance

- 1.105 Last year we raised concerns about the performance of the Treasury in preparing the draft Government financial statements – in particular, that the draft of the Government financial statements was not fully prepared by the statutory deadline and had not been subject to the level of quality assurance that we expected. We recognised that the Treasury’s performance had been affected by the performance of some entities included in the Government reporting entity.<sup>1</sup> We made a few recommendations to the Treasury. The recommendations were aimed at improving the process for 2005/06.
- 1.106 We are pleased to report that, overall, the audit of the Government financial statements went well this year. The close liaison between Treasury staff and our Government financial statements audit team, and changes to some procedures, have helped improve the process.
- 1.107 The Treasury produced the first draft of the Government financial statements on 31 August. We agreed with the Treasury that three important items should be omitted from that first draft, given that the auditors had not given clearance on the issues and that they were therefore still subject to change. The items omitted from the draft were Note 9 (on student loans), Note 10 (on disclosures on some receivables), and Note 15 (on the Kyoto Protocol provision).
- 1.108 The delay in finalisation largely reflects the complex nature of these issues and therefore the amount of effort required by both the entity and the auditor. Auditor clearance was subsequently given on all three areas, and the Government financial statements were amended to include the three notes. These three items are discussed below.
- 1.109 While we are satisfied with the Treasury’s performance in producing the Government financial statements this year, the coming year will pose challenges, being the transitional year for implementation of NZ IFRS. The Treasury will need to continue to work closely with the entities within the Government reporting entity and our Office to ensure that the 2007 Government financial statements are prepared within the agreed deadlines and to the appropriate standard.

### Date of audit sign-off

- 1.110 This year, the audit opinion on the Government financial statements was issued two weeks later than last year (29 September this year, compared to 16

1 From 1 July 2005, the Public Finance Amendment Act 2004 changed the reporting entity from “the Crown” to the “Government reporting entity”. The Government reporting entity is defined to include the Sovereign and the legislative, executive, and judicial branches of the Government. The revised definition clarifies that all three branches of government are to be included within the Government financial statements. Section 27(3) of the amended Public Finance Act 1989 requires the annual financial statements of the Government to include the Government reporting entity’s interests in various entities, including Offices of Parliament.

September last year).<sup>2</sup> The later date of sign-off this year allowed more time to consider some significant issues such as student loans valuation, tax revenue recognition changes, and Kyoto Protocol provision. The later date also meant that the audit sign-off of the Government financial statements was at the same time as some major entities within the Government reporting entity.<sup>3</sup>

- 1.111 We recognise that timely publication is important to users of the Government financial statements. We will discuss the timetable for next year with the Treasury, taking into consideration all these factors as well as the availability of the Minister of Finance.

### Student loans

- 1.112 In November 2005, the Government agreed that (with effect from 1 April 2006) interest would not be charged on student loans if certain criteria, largely related to living in New Zealand, were met. To better reflect the value of student loans under this no-interest policy, the accounting policy for reporting student loans was changed in 2005/06.
- 1.113 The accounting policy is to initially recognise student loans at their fair value and to subsequently report them at amortised cost. This accounting policy applies from 2005/06 and is consistent with the “loans and receivables” designation under NZ IAS 39: *Financial Instruments: Recognition and Measurement*.
- 1.114 The major effects of the change in accounting policy were:
- a one-off write-down of \$1,415 million of the existing loan book to fair value;
  - recognition of a further \$328 million as an expense, being the write-down to fair value of new loans made during 2005/06; and
  - a write-on of \$358 million to income to recognise the interest “unwind” during the year.<sup>4</sup>
- 1.115 Note 9 of the Government financial statements shows the analysis of the movement in student loans during the 2005/06 year, and provides further information about the book value and fair value.
- 1.116 Last year, we recommended an external peer review of the methodology used to determine the fair value, given the complexity of the calculation and the sensitivity to the key assumptions. This review was completed by independent

2 Under section 30 of the Public Finance Act 1989, the Auditor-General has 30 days after receiving the Government financial statements from the Treasury to issue the audit opinion. However, in recent years we have generally agreed an earlier date for audit sign-off in the interests of timely reporting.

3 The earlier date of sign-off of the Government financial statements does pose some risks, as the statutory audit opinions for some major entities have not been issued at that time. However, audit sign-off for consolidation audit purposes has been received.

4 The initial fair value write-down will be unwound (that is, recognised as income) over the maturity of the loan. The value will be adjusted for any impairment (for example, non-repayments caused by death or bankruptcy of the borrowers).

actuarial consultants during 2005/06. We acknowledge the significant amount of effort applied this year in determining the closing balance of student loans at 30 June 2006.

1.117 We are satisfied with the work done to determine the value of student loans. However, despite the significant effort, there are still three uncertainties that could significantly affect the student loans valuation. These are:

- the age of data;
- forecast future cash flows; and
- voluntary repayments.

#### **Age of data**

1.118 The data used for the initial fair value (calculated at 31 October 2005) was 39 months old as at 30 June 2006,<sup>5</sup> and the same data was used for the valuation in 2004/05. We understand that, for 2006/07, integrated student data to 2005 and 31 March 2006 tax data will be available. This will reduce the time gap between the age of the dataset and the year-end valuation date to 15 months, which we consider will improve the soundness of the valuation.

#### **Forecast future cash flows**

1.119 The student loans valuation model uses the “minimum obligation” repayments placed on the borrower to assess the future cash flows, and therefore assess the fair value (and amortised cost).

1.120 An independent actuary has analysed the forecast future repayments used in the model for years up to and including 2005/06 and compared these to the actual repayments made in those years. This comparison has indicated that the actual repayments could be lower than forecast for more than 17% of borrowers (in the dataset used by the actuaries valuing the scheme).

1.121 A conservative approach would treat these differences as “real” and adjust the valuation accordingly. However, the valuation has not been adjusted, because the actual level of underpayments, if any, is not at this stage fully understood.

1.122 The student loans valuation model is currently based on data with a short time horizon, and as such the fair value is sensitive to changes in the underlying assumptions.

1.123 The Inland Revenue Department (IRD) is currently investigating this matter by reviewing the data. This work is part of the integration and data testing required under the Memorandum of Understanding between the agencies involved in the collection of the dataset.

<sup>5</sup> The data is up to 31 March 2003.

- 1.124 The Ministry of Education considers it valid to assume that the IRD will ensure that all borrowers meet their minimum obligations. We agree with the approach being taken.

#### **Voluntary repayments**

- 1.125 The no-interest policy change will affect the level of voluntary repayments received. Before the policy change, about 30% of all repayments were voluntary. It has been assumed that, because of the policy of not charging interest on student loans for New Zealand residents, the percentage of voluntary repayments will reduce steadily over time.
- 1.126 As there is a lack of history about the level of voluntary repayments under the new policy, there is a degree of risk about the soundness of this assumption. We note that, since the new policy took effect on 1 April 2006, the actual decrease in repayments is consistent with the assumption that voluntary repayments will reduce.
- 1.127 We have recommended that the Treasury work closely with the IRD during the coming months to ensure that the work on student loans progresses as planned, and that the effect of any changes to the valuation as a result of the three uncertainties discussed above are thoroughly tested. The Treasury has also advised us that it is working with agencies to devise a reporting protocol that will address issues such as frequency of recalculation of the discount rate.

#### **Tax revenue**

- 1.128 Last year we recommended that the IRD and the Treasury review the tax revenue recognition policies for provisional tax payments in two particular areas – **revenue recognition** and **provisional tax pooling accounts** – to ensure that they remained appropriate and in accordance with New Zealand generally accepted accounting practice (NZ GAAP).

#### **Revenue recognition**

- 1.129 Our main concern about tax revenue recognition was that the practice of recognising provisional tax when “payment is due” was, in substance, cash accounting rather than accrual accounting.
- 1.130 After a review of the provisional tax estimation method, the IRD formed the view that provisional tax revenue can be reliably estimated when it is incurred or earned (accruals basis), rather than when payment is due. The transition to the new estimation method has resulted in a significant one-off adjustment to the Government financial statements for taxation revenue and taxes receivable of \$1.8 billion. We concurred with this treatment.

**Tax pooling**

- 1.131 Tax pooling was introduced in 1 April 2003 to allow taxpayers to manage provisional tax payment risk by reducing interest payable on underpaid tax and increasing interest receivable on overpaid tax.
- 1.132 The balance of the pooling account has increased significantly again this year to \$2.3 billion as at 30 June 2006 (\$1.2 billion in 30 June 2005 and \$0.6 billion in 30 June 2004). This increase is because more taxpayers are now using the pooling account for provisional tax payments.
- 1.133 The IRD has sought independent advice as to the correct accounting treatment of payments to the pooling account. That advice is that these payments do not meet the revenue recognition criteria and that they should be treated as taxes refundable. We have reviewed this advice and concur with the treatment.
- 1.134 However, we note that provisional tax payments into the pooling account are not recognised in the taxpayer's account. As a result, provisional tax payments are not recognised as revenue, as they would have been if they had been paid into the taxpayer's account. When the pooling account is used, revenue is only recognised based on a provisional tax assessment. Therefore, tax revenue will be recognised later in the year if a taxpayer uses tax pooling. However, provided that an appropriate tax assessment is made by the IRD before the end of the year, the amount of tax revenue recognised by the IRD is the same, regardless of whether the taxpayer uses tax pooling or not.
- 1.135 We have recommended that the IRD conduct an exercise comparing payments into the pooling account with the corresponding provisional tax assessments in the individual taxpayers' accounts and consider the implication of the results for monthly and year-end financial reporting. This will provide further understanding of the materiality of the timing difference caused by the tax pooling recognition treatment of provisional tax.

**Fair value of receivables portfolios**

- 1.136 The Government financial statements include \$14,474 million of receivables debt. As disclosed in Note 10 of the Government financial statements, the balance includes \$8,720 million of taxes receivable administered by the IRD, \$424 million of debt administered by the Ministry of Justice and \$413 million administered by the Ministry of Social Development (MSD).<sup>6</sup>
- 1.137 The Ministry of Justice and the MSD debt have lengthy collection periods and do not accrue interest. The fair value of these receivables is likely to be less than the carrying value. We have therefore, in previous years, recommended that the fair

<sup>6</sup> These amounts are net of provisions for doubtful debts. The Ministry of Justice receivables largely relate to outstanding court and enforcement fines, and associated filing and enforcement fees. The MSD receivables largely relate to benefit overpayments, advances on benefits, and recoverable special needs grants.

value of these receivables be disclosed in the Government financial statements (like student loans), and that the Treasury provide some guidance to departments on this matter.

- 1.138 The Ministry of Justice engaged an external provider to carry out a calculation of fair value as at 30 June 2006. The fair value figure was initially disclosed in the draft Government financial statements. However, on closer scrutiny, it was decided that further work was required on the fair value. The fair value disclosure was therefore removed from the Government financial statements. It is disappointing that work had not progressed as far as planned to allow this receivable to be disclosed in a note.
- 1.139 The fair value of the MSD receivable was determined but not disclosed in the Government financial statements, as it would have been the only receivable for which fair value was disclosed.
- 1.140 The fair value of all debt portfolios will need to be determined for the Government financial statements opening NZ IFRS balance sheet as at 1 July 2006. This includes the \$8,720 million tax receivable debt.
- 1.141 We have recommended that the Treasury work closely with the departments to ensure that fair values will be available for the opening NZ IFRS balance sheet. Our auditors will also need to be closely involved at a sufficiently early stage (see Part 9).

### The Kyoto Protocol provision

- 1.142 New Zealand ratified the Kyoto Protocol in December 2002. The protocol came into force on 16 February 2005, as a result of Russia's decision to ratify. This international agreement commits New Zealand to reducing its net emissions of greenhouse gases during 2008-12 (the first commitment period, otherwise called CP1) to 1990 levels or take responsibility for the difference.
- 1.143 A provision for New Zealand's net deficit position under the Kyoto Protocol for CP1 was first recognised in the 2005 Government financial statements. This year a provision of \$656 million (\$310 million in 2005) has been recognised. Detailed disclosure about the Kyoto Protocol provision is provided in Note 15 of the 2006 Government financial statements. The Treasury has not recognised any provision or contingent liability for periods beyond 2012, as New Zealand currently has no specific obligations beyond CP1.
- 1.144 The provision is the Treasury's best estimate at this time. However, provisions by their nature are more uncertain than most other items in the statement of financial position. It is likely that successive estimates will change as updated

information becomes available, better systems are implemented, or some uncertainties are reduced. Some of the main aspects of the Kyoto Protocol provision that are subject to fluctuation through time include:

- the price for a tonne of carbon;
- the exchange rate with the United States dollar; and
- the various assumptions underlying the calculation of the emissions and sinks (for example, forecasts of gross domestic product, oil prices, and availability of more updated statistics).

- 1.145 The provision in the Government financial statements is based on 21 million tonnes for estimated deforestation. This estimate assumes policy interventions to implement the Government's policy to cap its liability at this amount. This estimate was made in the knowledge that there was likely to be a policy decision on the deforestation cap by the Government in the near future and policy interventions designed to achieve that cap.
- 1.146 We note that, without such policy interventions (and assuming current market conditions prevail), a deforestation intentions survey carried out in 2005 indicated likely deforestation to be around 38.5 million tonnes, which would increase the provision by around \$279 million.
- 1.147 The determination of the net position is an extremely complex process involving a number of models across a range of government departments. An independent expert has assessed the reasonableness of the assumptions and methodologies underpinning the emissions projections and found them to be sound and reasonable.
- 1.148 We have reviewed the work done (including the annual Kyoto stocktake undertaken in May 2006) to estimate the provision, and are satisfied that it represents the best estimate of New Zealand's liability.
- 1.149 We have recommended that the Treasury continue to work with the relevant agencies to develop their methodologies, models, and data for determining the net Kyoto position and to ensure that the recommendations in the 2005 experts' report are addressed. We have also recommended that a follow-up independent report be commissioned in 2007 to give assurance for the 2007 Government financial statements that there have been no significant changes in the environment, good practice, or international thinking that would change the overall approach.



### Valuation of rail assets and land

- 1.150 The Crown purchased the national rail infrastructure and related assets from Toll Holdings Limited (Toll) for \$1 in 2004 and entered into a track access agreement with Toll to the year 2070. On 1 September 2004, the rail assets were transferred from the Treasury to ONTRACK (New Zealand Railways Corporation).
- 1.151 In the 2004 and 2005 Government financial statements, the Treasury assessed the track access agreement as a finance lease and accounted for the rail infrastructure as a lessor's interest in a finance lease. Under this accounting treatment, the Treasury expensed, rather than capitalised, the expenditure the Crown incurred on replacing and upgrading the national rail network and the Auckland commuter network. We disagreed with this accounting treatment as, in our view, the agreements with Toll did not amount to a finance lease.
- 1.152 We are pleased to report that the Treasury has reconsidered the accounting treatment for rail assets. The 2006 Government financial statements do not account for the rail agreements as a finance lease. Expenditure of \$119 million on upgrade and renewals work has been capitalised.
- 1.153 As we reported last year, in our view, more meaningful information would be provided if the rail assets were revalued to depreciated replacement cost (DRC). This would be consistent with the approach taken in the Government financial statements for other major infrastructural assets, such as the state highway network.
- 1.154 The determination of the DRC would also provide useful information for asset management. However, we have agreed with the Treasury and ONTRACK that, because of the complex nature of the valuation, it would not be possible to complete a valuation of rail assets at 30 June 2006. However, the valuation has been completed for the NZ IFRS opening balance sheet at 1 July 2006 (see Part 9).

### Financial Reporting Standard No. 37: *Consolidating Investments in Subsidiaries (FRS-37)*

- 1.155 Since 2003, the Treasury has used equity accounting for tertiary education institutions (TEIs) in the Government financial statements based on a 100% interest, rather than consolidating on a line-by-line basis. This approach is based on a view that the control test in FRS-37 is not satisfied, as the Crown does not have the ability to determine the financing and operating policies of TEIs, but that the Crown's relationship meets the "significant influence" test necessary for equity accounting. The approach and the reasons for it are set out in Note 13 to the Government financial statements.

- 1.156 Since 2003, we have expressed our view that line-by-line consolidation remains the treatment that best reflects the substance of the relationship between the Crown and TEIs, and the intent of FRS-37. However, we have accepted equity accounting for TEIs, as the treatment does arguably comply with a strict interpretation of the mandatory elements within FRS-37, and because of the additional disclosures provided in Note 13. With these additional disclosures, we have accepted that the Government financial statements remain fairly stated.
- 1.157 Last year we recommended that the Treasury continue discussions with accounting standard-setters on the application of the control test in the Crown context where entities have some autonomy and independence.
- 1.158 The Treasury has communicated with the standard-setters to clarify the treatment. In August 2005, the Financial Reporting Standards Board (FRSB) issued a discussion paper on control of public benefit entities that have autonomy and independence. The Treasury completed a joint submission, with the New Zealand Vice-Chancellor's Committee, on the discussion paper to the FRSB recommending criteria for defining when autonomous public benefit entities should be consolidated.
- 1.159 In July 2006, Exposure Draft 109<sup>7</sup> was issued, which proposed that TEIs should be consolidated into the Government financial statements as if they were wholly owned subsidiaries of the Government for the purposes of FRS-37. However, the FRSB has decided not to adopt the changes proposed in the exposure draft. We will be discussing the consequences of that decision with the Treasury. At this stage, it is likely that equity accounting for TEIs, based on a 100% interest, will continue.

### **New Zealand equivalents to International Financial Reporting Standards (NZ IFRS)**

- 1.160 The Government will be implementing NZ IFRS in the Government financial statements as part of Budget 2007. This means that the first audited Government financial statements under NZ IFRS will be for the year ending 30 June 2008.
- 1.161 In order to comply with the requirements of NZ IFRS 1: *First-time Adoption of New Zealand Equivalents to International Financial Reporting Standards*, the 2008 Government financial statements will need to include comparative figures as at 30 June 2007 restated in accordance with NZ IFRS, and some detailed reconciliations explaining the effect of the transition to NZ IFRS. To meet these requirements, the Treasury will need to produce an opening balance sheet at 1 July 2006 in accordance with NZ IFRS.

<sup>7</sup> Exposure Draft 109 proposed amendments to FRS-37 and NZ IAS 27: *Consolidated and Separate Financial Statements*.

- 1.162 We will be providing assurance on the NZ IFRS provisional opening balance sheet as at 1 July 2006 and NZ IFRS accounting policies. We have discussed with the Treasury its progress towards the adoption of NZ IFRS and how it is dealing with key NZ IFRS issues, and monitoring progress of significant entities within the Government reporting entity to ensure that timetables will be met (see Part 9).

### Funding of Alpur B2 motorway extension

- 1.163 The motorway extension north of Auckland (Alpur B2) is planned to be built by 2009. Transit NZ will fund the construction of the motorway partly from the national land transport fund and partly through funds raised from infrastructure bonds issued by the New Zealand Debt Management Office.
- 1.164 The financing arrangements for Alpur B2 have now largely been finalised. The accounting treatment of the arrangements is expected to be complex. We have recommended that the Treasury, in conjunction with Transit NZ, consider the appropriate accounting treatment and discuss it with us, so that the accounting treatment can be agreed.

### Related party disclosures

- 1.165 Related party disclosures in the Government financial statements have historically been limited to aggregate information on salaries and allowances paid to Ministers of the Crown.
- 1.166 Last year, we raised the issue of related party transactions in the context of the change from the Crown to the Government reporting entity from 1 July 2005 arising from the Public Finance Amendment Act 2004. We recommended that the Treasury consider further the application to the Government financial statements of SSAP-22: *Related Party Disclosures*, and whether present systems and processes are enough to identify and allow all related party transactions to be reported on. While this work has not been completed, we accept that, given the introduction of NZ IFRS, the focus should be on compliance with NZ IAS 24: *Related Party Disclosures* together with any changes that result as a consequence of Exposure Draft 108.<sup>8</sup>
- 1.167 We have recommended that the Treasury consider this issue further when the requirements under the new standard are known, to ensure that appropriate systems and processes are in place to comply with the NZ IFRS reporting requirements.

<sup>8</sup> Exposure Draft 108: *Omnibus Amendments* addressed minor matters relating to a number of standards, including NZ IAS 24: *Related Party Disclosures*.

### Public Finance Amendment Act 2004

- 1.168 Last year we referred to the changes that would be needed to the Government financial statements as a result of the Public Finance Amendment Act 2004. We mentioned two specific changes. The first was the need to reincorporate the Offices of Parliament into the 2006 Government financial statements because of the change in the reporting entity. The second was that the Government financial statements would no longer have to disclose all guarantees and indemnities entered into by the Minister of Finance, but only those that met the definition of a contingent liability under NZ GAAP. The Treasury made both these changes in the 2006 Government financial statements.

## Part 2

# Government departments – results of the 2005/06 audits

- 2.101 In this Part, we report on the results of the 2005/06 audits of 39 government departments and two Offices of Parliament.<sup>1</sup> Our purpose is to inform Parliament of the assurance given by the audits on:
- the quality of financial reports; and
  - aspects of the financial and performance management of government departments.

### Audit opinions issued

- 2.102 The Public Finance Act 1989 (PFA) sets out departments' responsibilities for general purpose financial reporting. Section 45 sets out the required contents of the annual report. Section 45A sets out the requirements for the **statement of service performance** and section 45B for the **annual financial statements** – two key statements within the annual report. Both statements need to be prepared in accordance with generally accepted accounting practice.<sup>2</sup>
- 2.103 Section 45D(2) of the PFA and section 15 of the Public Audit Act 2001 set out the responsibility of the Auditor-General to audit the annual financial statements, statement of service performance, and any other information that the Auditor-General has agreed to audit.
- 2.104 To form an audit opinion on the relevant sections of departments' annual reports, our audits are conducted in accordance with *The Auditor-General's auditing standards*,<sup>3</sup> which incorporate the auditing standards issued by the New Zealand Institute of Chartered Accountants. The audits are planned and performed to gather all the information and explanations considered necessary to obtain reasonable assurance that the financial statements do not have material misstatements caused by fraud or error.
- 2.105 The audit also involves procedures to test the information presented in the financial statements. In forming our opinion, we assess the results of those procedures, and evaluate the overall adequacy of the presentation of information in the financial statements.
- 2.106 None of the 41 departments audited received an audit report containing a qualified audit opinion (see Figure 2.1).

1 The 39 departments are those listed on page 102 of the *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2006*, excluding the Government Communications Security Bureau and the Security Intelligence Service. The two Offices of Parliament included in the results are the Office of the Ombudsmen and the Parliamentary Commissioner for the Environment. For the purposes of this Part, our use of the term "departments" includes these two Offices of Parliament.

2 Generally accepted accounting practice is defined in section 2(1) of the Public Finance Act 1989.

3 ISBN 0-478-18131-0, May 2005.

**Figure 2.1**  
Analysis of audit opinions from 2001/02 to 2005/06

Year ended 30 June	2002	2003	2004	2005	2006
Unqualified opinions	42	41	40	41	41
Qualified opinions	1	2	1	0	0
Total audit opinions issued	43	43	41	41	41

## Financial and service performance management

- 2.107 As part of the audit, our auditors examine aspects of financial and service performance management. These are sometimes referred to as the “five management aspects” (see paragraphs 2.109 and 2.110). Where applicable, we identify specific areas of weakness, and make recommendations to eliminate those weaknesses.
- 2.108 In Part 3, we explain the changes to our reporting to Ministers and select committees that we are making from 2006/07. These changes mean that this is the last year that we will be reporting ratings for departments under the five management aspects. We have reported under the current framework for 13 years starting from 1993/94.

### Financial management

- 2.109 We assess and report on the following aspects of financial management:
- *Financial control systems* – the individual systems that process financial data – for example, processing of payments (expenditure and creditors). This covers controls surrounding the processing of these transactions to ensure that the data is complete and accurate.
  - *Financial management information systems* – the systems for recording, reporting, and protecting financial information. This includes the information systems and information technology (IS/IT) control environment, and, for example, IS/IT strategic planning, data integrity, access controls, and the physical security of hardware and software.
  - *Financial management control environment* – this covers management’s attitude, policies, and practices for overseeing and controlling financial performance. It includes financial management policies and procedures, self-review procedures (including internal audit), and budgeting processes.

## Service performance management

2.110 We assess and report on the following aspects of service performance management:

- Service performance information systems – the systems to record service performance (non-financial) data, and the internal controls (manual and computer) to ensure that the data is complete and accurate.
- Service performance management control environment – this covers the planning processes, the existence of quality assurance procedures, the adequacy of operational policies and procedures, and the extent to which self-review of non-financial performance is taking place.

**Figure 2.2**

### Our rating system for aspects of financial and service performance

Assessment term	Further explanation
Excellent	Works very well. No scope for cost-beneficial improvement identified.
Good	Works well; few or minor improvements only needed to rate as excellent. We would have recommended improvements only where benefits exceeded costs.
Satisfactory	Works well enough, but improvements desirable. We would have recommended improvements (while having regard for costs and benefits) to be made during the coming year.
Just adequate	Does work, but not at all well. We would have recommended improvements to be made as soon as possible.
Not adequate	Does not work; needs complete review. We would have recommended major improvements to be made urgently.
Not applicable	Not examined or assessed. Comments should explain why.

## Reporting of results

2.111 We report our assessment of certain aspects of financial and service performance management to the chief executive of, and to stakeholders (such as the responsible Minister and the select committee that conducts the financial review of the department) in, each department.

2.112 Departments vary greatly in size and organisational structure, and sometimes undergo restructuring. For these reasons, we advise all readers to exercise caution when comparing departments.

## The results

- 2.113 We assessed financial and service performance management in each of the 41 departments. A summary of the assessments (205 in total – 5 for each department) is given in Figure 2.3.<sup>4</sup>
- 2.114 There were 67 (33%) assessments of “Excellent”, and a combined total of 184 (90%) assessments were either “Excellent” or “Good”. This compares with assessments of 35% and 88% respectively in the previous year.
- 2.115 No assessments of “Just adequate” or “Not adequate” have been issued in the past four years.

**Figure 2.3**

**Summary of assessments of aspects of financial management and service performance management in departments for 2005/06**

Aspect assessed	Excellent		Good		Satisfactory		Just adequate		Not adequate		Total
	No.	%	No.	%	No.	%	No.	%	No.	%	
FCS	14	34	24	59	3	7	0	0	0	0	41
FMIS	13	32	26	63	2	5	0	0	0	0	41
FMCE	16	39	20	49	5	12	0	0	0	0	41
SPIS*	9	22	24	59	8	20	0	0	0	0	41
SPMCE	15	37	23	56	3	7	0	0	0	0	41
<b>Totals 2006</b>	<b>67</b>	<b>33</b>	<b>117</b>	<b>57</b>	<b>21</b>	<b>10</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>205</b>
<i>2005</i>	<i>72</i>	<i>35</i>	<i>109</i>	<i>53</i>	<i>24</i>	<i>12</i>	<i>0</i>	<i>0</i>	<i>0</i>	<i>0</i>	<i>205</i>

\* The percentage figures add to 101% as a result of rounding.

Key:

FCS	Financial control systems
FMIS	Financial management information systems
FMCE	Financial management control environment
SPIS	Service performance information systems
SPMCE	Service performance management control environment

- 2.116 We compared our assessments for 2005/06 with those for 2004/05. The results are summarised in Figure 2.4.

<sup>4</sup> For two departments, we have issued separate additional ratings for aspects relating to non-departmental performance. These additional ratings are excluded from this analysis.



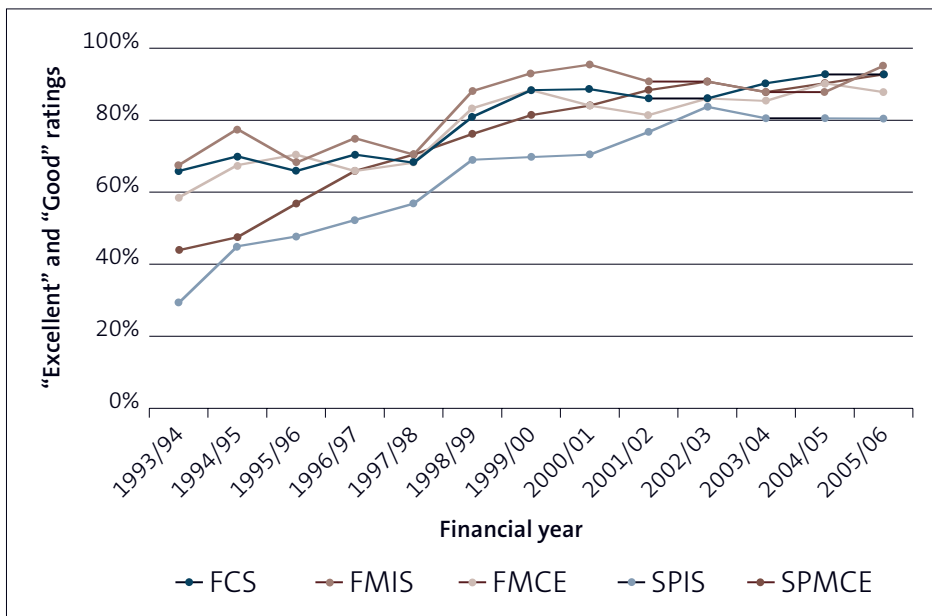
**Figure 2.4**  
Assessment ratings for 2005/06 compared to 2004/05

Aspect assessed	Higher rating	Same rating	Lower rating	Total
FCS	1	37	3	41
FMIS	3	35	3	41
FMCE	2	36	3	41
SPIS	0	40	1	41
SPMCE	1	40	0	41
Totals	7	188	10	205
%	3%	92%	5%	100%

- 2.117 Figure 2.4 shows that:
- a high proportion (92%) of ratings remained unchanged from the previous year;
  - seven ratings (3%) improved from the previous year; and
  - 10 ratings (5%) were lower than the previous year.

2.118 The proportion of departments assessed as “Excellent” or “Good” during the 13-year period that we have been reporting on the five management aspects is shown in Figure 2.5.

**Figure 2.5**  
Percentage of “Excellent” and “Good” ratings from 1993/94 to 2005/06



- 2.119 Figure 2.5 shows that the proportion of departments rated “Excellent” or “Good” has increased during the period. For those departments rated “Excellent” or “Good”, the consistency between the individual aspects ratings has increased, as indicated by the narrowing of the spread between the individual aspects at the start and the end of the period.
- 2.120 The Service Performance Information Systems aspect has consistently had the lowest proportion of departments rating “Excellent” or “Good”.

## Part 3

# Changes to our reporting to entities, Ministers, and select committees

- 3.101 During the past 13 years, we have reported to government departments, Crown entities, and State-owned enterprises (referred to collectively as “entities” in this Part) our assessment ratings of aspects of financial and service performance management (which we have referred to as the “five management aspects”). We have also reported our assessment ratings to responsible Ministers and select committees.
- 3.102 This is the last year that we will be reporting ratings under the current five management aspects framework (see Part 2 for the results of the 2005/06 government department audits).
- 3.103 In 2006/07, we will begin reporting under a new assessment framework, which is designed to be simpler and, in our view, clearer and easier to understand. Our new reporting will address the same subject matter as the previous framework – the areas of the management control environment, information systems, and controls necessary to produce the audited financial statements, including Statements of Service Performance (SSPs).
- 3.104 Our shorthand term for the new assessment framework is “ESCO”, which emphasises that the assessment is of the **e**nvironment, **s**ystems, and **c**ontrols underlying the financial statements.

### Why we are changing our assessment framework

- 3.105 We have reviewed our terminology to help avoid the implication that our assessment covers overall management performance. The assessment is a by-product of the financial statements audit (including SSPs), and we consider that our new terminology reflects this more accurately.
- 3.106 We have also reviewed and refreshed our assessment framework to provide greater transparency about how grades under the new framework are assigned. We have made substantive changes to our assessment and reporting model, which we expect will improve the understandability and usefulness of our reporting to Ministers, select committees, and the entities that we audit.
- 3.107 During the last couple of years, entities have expressed some concerns that the basis for their five management aspects ratings was not clear. They were uncertain whether auditor expectations were the same for all entities, and about how any particular concern identified by the auditor might affect their rating for any specific aspect. This means they did not always understand why they received their rating, and were not certain what action might be required to improve it.

- 3.108 We have also been concerned that users' perceptions of the five management aspects assessment sometimes differed from that intended. Our changes are aimed at improving the clarity and transparency of our assessment so that users can better understand what the commentary and grades in the new framework are based on, and what they do and do not provide information about.
- 3.109 In addition, we have sought to ensure that our revised ESCO framework aligns with our obligations under international auditing standards that are likely to come into effect in the next couple of years.

### The new assessment framework

- 3.110 The most substantive change is to the basis on which grades will be assigned. Grading will now be based purely on any deficiencies observed by auditors and their corresponding recommendations for improvement. We expect that the reasons for the auditor's choice of grade will be clearer than under the current framework, and the commentary will support continual improvement by entities.

### We will report audit conclusions on three "aspects"

- 3.111 The new framework will cover the same areas in the simpler form of three aspects:<sup>1</sup>
- management control environment;
  - financial information systems and controls; and
  - service performance information and associated systems and controls.
- 3.112 The management control environment will now cover the organisational context for the production of the financial statements and, if applicable, the SSP.<sup>2</sup> It includes attitudes, policies, and practices relating to strategic planning; ethics; governance and management styles; organisational structure and the assignment of authority and responsibility; human resources; risk management; and key entity-level control policies, procedures, information systems, and communication.
- 3.113 The two other aspects represent the information systems and controls that underlie the two main areas to which the audit opinion relates – the financial statements and the SSPs (if applicable).

1 The current five management aspects are (1) Financial Control Systems, (2) Financial Management Information Systems, (3) Financial Management Control Environment, (4) Service Performance Information Systems, and (5) Service Performance Management Control Environment.

2 The ESCO report will encompass the Statements of Service Performance (SSPs) of government departments and Crown entities (other than Crown Research Institutes). Crown Research Institutes and State-owned enterprises are not required by legislation to produce SSPs; accordingly, we will not cover information systems and controls relating to service performance for these entities.

### Our commentary will emphasise areas for improvement

- 3.114 Under each of the three aspects, auditors will identify any significant deficiencies observed during the annual audit. For each deficiency identified, they will recommend improvement. The recommendations for improvement, individually and collectively, will determine which grade the auditor assigns for the aspect. In addition to focusing on areas for improvement, auditors will use their discretion to provide brief general comments to place their discussion of deficiencies in a proper context.

### We will use a four-point grading scale

- 3.115 The previous five management aspects framework had a five-point scale.<sup>3</sup> We have reduced the points on the scale by one for ESCO, with our deficiency-and-recommendations-based scale offering a simpler and clearer explanation of why entities receive the grades they get.

**Figure 3.1**

#### Our four-point grading scale in the new assessment framework

Grade	Explanation of grade
Very good	We recommend that <i>no improvements</i> are necessary.
Good	We recommend that <i>improvements would be beneficial</i> and that the entity addresses these.
Needs improvement	We recommend that <i>improvements are necessary</i> and should be addressed <i>at the earliest reasonable opportunity</i> .
Poor	We recommend that <i>major improvements are required</i> , to which the entity should give <i>urgent attention</i> .

- 3.116 We expect that the majority of entities will fall within the two middle grades, which offer distinctly different signals about the importance and urgency of the improvements recommended.

### We will provide better explanatory notes

- 3.117 To enhance users' understanding of what is covered in the ESCO assessment and how the grades are derived, the notes in our reporting to entities, Ministers, and select committees will explain each aspect, as well as the assumptions underlying the auditors' assessments.
- 3.118 The most important point to note is that the auditor's conclusions on deficiencies (that is, the gap between "how things are" and "how they should be"), and the associated recommendations for improvement, are based on the auditor's assessment of how far short things are from "best practice". The auditor's notion of "best practice" is based on their professional expertise and judgement, taking

3 (1) Excellent, (2) Good, (3) Satisfactory, (4) Just adequate, and (5) Not adequate.

into account what is deemed appropriate for each entity, given its size, nature, and complexity.

- 3.119 Another important assumption relates to the cost-benefit of introducing improvements. Auditors will recommend improvements only when they consider (in their professional judgement) that the benefit of the improvement will justify its cost.
- 3.120 Our explanatory notes will also explain why grades may fluctuate from year to year. This could happen even if nothing has changed within the entity. Some of the factors that may cause the “goalposts to move” include changes in the operating environment, standards, best practice expectations, or auditor emphasis. This suggests that the long-term trend in grade movement will be a more useful indicator of progress than the shorter term, year-to-year grade changes.

### **A greater emphasis on the appropriateness of service performance information**

- 3.121 To coincide with the introduction of the new ESCO assessment framework, we will be placing a greater emphasis on the appropriateness of the service performance information reported in SSPs. This is necessary because, unlike financial statements, SSPs do not have prescribed standards that govern their content, measurement, disclosure, and presentation requirements. We therefore need to review Statements of Intent (SOI) to determine the context for SSP performance measures, as well as entities’ processes and rationale for selecting them, to form our conclusions on their appropriateness. Our review of SOIs is discussed further in Part 8.
- 3.122 Our shift in emphasis takes into account the recent changes in the Public Finance Act 1989 and the new Crown Entities Act 2004, reflecting the Managing for Outcomes and Managing for Results initiatives. Last year, we reported to Parliament that the relationship between the outcomes a department seeks to achieve and the outputs it delivers in order to contribute to those outcomes (Parts A and B of the SOI) has generally not been well enough developed, and considerable improvement is required.
- 3.123 We expect that departments should now have adapted more to the new requirements for SOIs and their outcome-to-output links. Service performance reporting, in particular the “appropriateness” of the service performance measures used, will be an area of emphasis in our 2006/07 annual audits. This emphasis will be reflected in the assessments we provide in our ESCO reports to entities, Ministers, and select committees.

## When the new assessment framework will take effect

- 3.124 We will begin reporting under the new assessment framework from 2006/07, issuing grades for the first two aspects (management control environment, and financial information systems and controls). We will not assign grades for the service performance aspect in 2006/07, but we will provide comments on where improvements can be made.
- 3.125 We expect that shortcomings identified in our reviews of service performance reporting will, in future, affect entities' grades more significantly than they have to date, for two reasons – our move to a deficiency-and-recommendations-based grading system, and our auditors giving greater emphasis in their reports to the appropriateness of performance measures. Our transitional approach will allow entities time to adjust to this change of emphasis. We will grade the service performance aspect for the first time in the 2007/08 ESCO assessment.<sup>4</sup>

4 This will cover the 2008/09 SOI and the 2007/08 SSP.





## Part 4

# Non-standard audit reports issued

- 4.101 In this Part, we report on the non-standard audit reports issued on the annual financial reports of entities that are part of the Government reporting entity.<sup>1</sup>
- 4.102 We report on the non-standard audit reports issued during the year 1 January 2006 to 31 December 2006 on the annual financial reports of:
- school boards of trustees; and
  - other public entities.

### Why are we reporting this information?

- 4.103 An audit report is addressed to the readers of an entity's financial report. However, all central government public entities are ultimately accountable to Parliament, including for their use of public money and their use of any statutory powers or other authority given to them by Parliament. We therefore consider it important to draw Parliament's attention to the range of matters that give rise to non-standard audit reports.
- 4.104 In each case, the issues underlying a non-standard audit report are drawn to the attention of the entity and discussed with its governing body.

### What is a non-standard audit report?

- 4.105 A non-standard audit report<sup>2</sup> is one that contains:
- a qualified opinion; and/or
  - an explanatory paragraph.
- 4.106 The auditor expresses a qualified opinion, as opposed to an unqualified opinion (which is issued when the auditor is satisfied, in all material respects, with the matters outlined in the financial report), because of:
- a disagreement between the auditor and the entity about the treatment or disclosure of a matter in the financial report; or
  - a limitation in scope because the auditor has been unable to obtain enough evidence to support, and accordingly is unable to express, an opinion on the financial report or a part of the financial report.
- 4.107 The types of qualified opinions are an "adverse" opinion (explained in paragraphs 4.111-4.112), a "disclaimer of opinion" (paragraph 4.113), or an "except-for" opinion (paragraphs 4.114-4.115).

<sup>1</sup> We report separately on entities that are within the local government portfolio, in our yearly report on the results of audits for that sector.

<sup>2</sup> A non-standard audit report is issued in accordance with the Institute of Chartered Accountants of New Zealand Auditing Standard No. 702: *The Audit Report on an Attest Audit*.

- 4.108 The auditor will include an explanatory paragraph (see paragraphs 4.116-4.117) in the audit report in order to emphasise a matter such as:
- a breach of law; or
  - a fundamental uncertainty.
- 4.109 Auditors are required to ensure that an explanatory paragraph is included in the audit report in such a way that it cannot be mistaken for a qualified opinion.
- 4.110 Figure 4.1 outlines the different types of audit reports that auditors can issue.

### Adverse opinion

- 4.111 An adverse opinion is expressed when there is disagreement between the auditor and the entity about the treatment or disclosure of a matter in the financial report and, in the auditor's judgement, the treatment or disclosure is so material or pervasive that the report is seriously misleading.
- 4.112 Expression of an adverse opinion represents the most serious type of non-standard audit report.

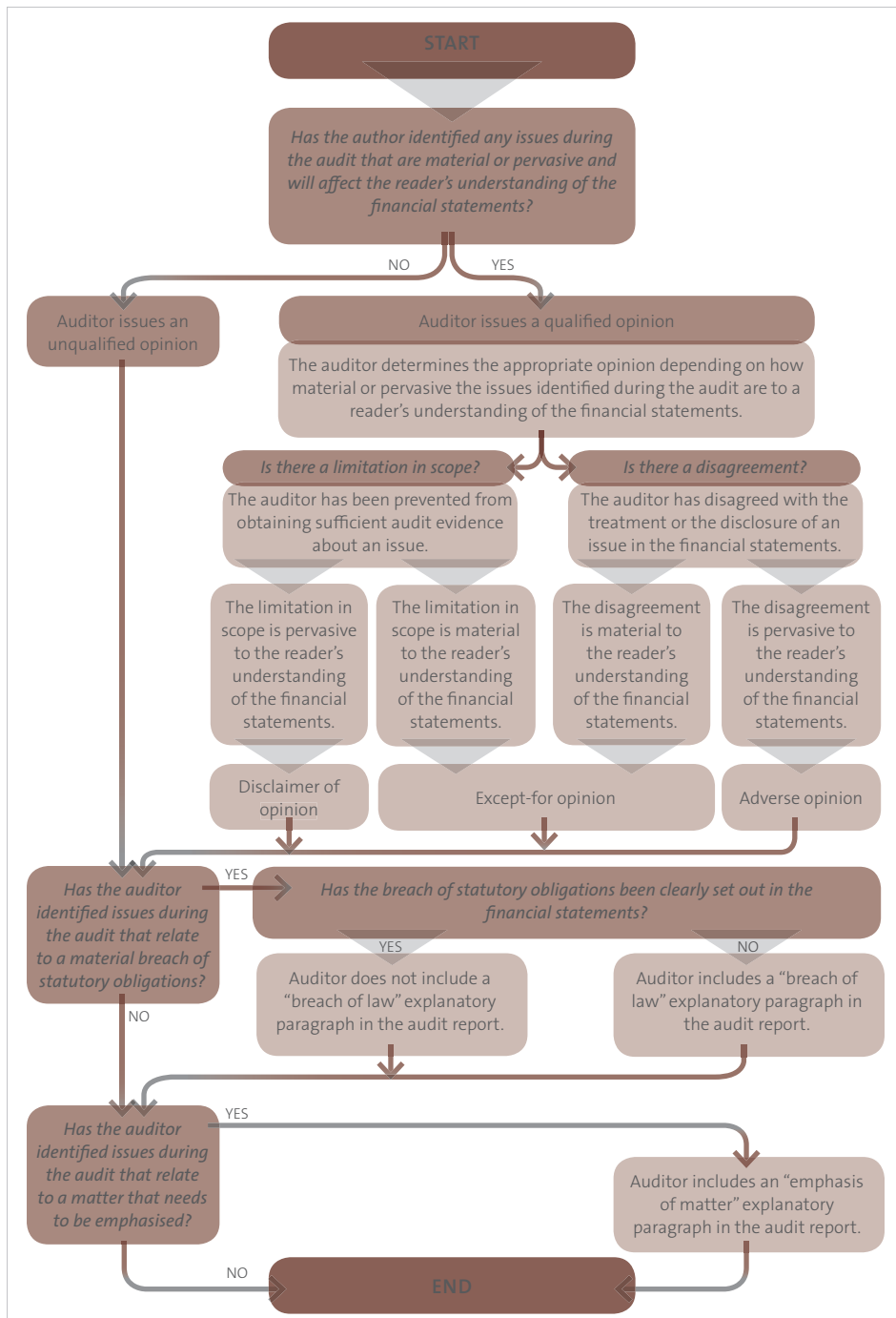
### Disclaimer of opinion

- 4.113 A disclaimer of opinion is expressed when the possible effect of a limitation in the scope of the auditor's examination is so material or pervasive that the auditor has not been able to obtain sufficient evidence to support, and accordingly is unable to express, an opinion on the financial report.

### Except-for opinion

- 4.114 An except-for opinion is expressed when the auditor concludes that either:
- the possible effect of a limitation in the scope of the auditor's examination is, or may be, material but is not so significant as to require a disclaimer of opinion – in which case the opinion is qualified by using the words "except for the effects of any adjustments that might have been found necessary" had the limitation not affected the evidence available to the auditor; or
  - the effect of the treatment or disclosure of a matter with which the auditor disagrees is, or may be, material but is not, in the auditor's judgement, so significant as to require an adverse opinion – in which case the opinion is qualified by using the words "except for the effects of" the matter giving rise to the disagreement.
- 4.115 An except-for opinion can be expressed when the auditor concludes that a breach of statutory obligations has occurred and that the breach is material to

**Figure 4.1**  
Audit report options



the reader's understanding of the financial report. An example of this is where a Crown entity has breached a requirement of the Crown Entities Act 2004 by not including budgeted figures in its financial report.

### Explanatory paragraph

- 4.116 In certain circumstances, it may be appropriate for the auditor to include in the audit report additional comment, by way of an explanatory paragraph, to emphasise a matter that they regard as relevant to a reader's proper understanding of an entity's financial report.
- 4.117 For example, it could be relevant to draw attention to an entity having breached its statutory obligations in respect of certain matters where that breach may affect or influence a reader's understanding about the entity. In this situation, the audit report would normally draw attention to the breach only when the entity has not clearly set out the breach in its financial report.

### School boards of trustees

- 4.118 This is the first time that we are reporting on the non-standard audit reports issued on the financial reports of school boards of trustees. Consequently we are not identifying schools by name. We may identify schools in a similar report next year.
- 4.119 There are about 2450 state schools governed by boards of trustees, which are made up of members of the local community (usually parents of children attending the school). The board of each school is a Crown entity in its own right and, as such, has legal obligations.
- 4.120 One of these legal obligations is to prepare annual financial statements in accordance with "generally accepted accounting practice". These are accounting standards that apply to all entities that are obliged to prepare annual financial statements.
- 4.121 We are pleased to report that it was not necessary for any adverse opinions or disclaimer of opinions (which are the most serious forms of qualified opinion) to be issued on schools' financial statements in the year ending 31 December 2006.

### Except-for opinions

- 4.122 The following except-for opinions were issued on schools' financial statements in the year ending 31 December 2006.

- 4.123 Because of the number of schools, we have reported the types of except-for opinions that were issued and the number of schools that received each type, rather than list each school for which an except-for opinion was expressed and the reason for each school's except-for opinion. In some cases, an audit report was qualified for more than one reason.

### Figure 4.2

#### Except-for opinions for schools by type and number

##### Limitation in scope because of limited controls over income (10 schools)

Schools receive income from government grants and other sources. We must satisfy ourselves that the income reported in the financial statements is complete. In some schools the controls operated over the receipt of income from other sources are not sufficiently strong for us to give an assurance that the figures in the financial statements are materially correct. In these circumstances, our audits have a "limitation of scope", which we report in our opinion.

Our audits of 10 schools were limited because we were unable to satisfy ourselves that the controls operated over income received were sufficiently strong to verify the completeness of the income figures included in the financial statements.

##### Limitation in scope because of limited controls over expenditure (8 schools)

Schools incur expenditure on matters that contribute to their educational objectives. We must satisfy ourselves that the expenditure reported in the financial statements is lawful, and has been properly authorised by the board of trustees. In some schools, not all expenditure has been properly authorised, and so we are unable to give an assurance on the validity of all the expenditure included in the financial statements. In these circumstances, our audits have a "limitation of scope", which we report in our opinion.

Our audits of eight schools were limited because we were unable to verify the validity of all the expenditure that the schools had incurred because approval to incur the expenditure was not recorded in the boards of trustees' minutes.

##### Disagreement over cyclical maintenance provisions (5 schools)

Boards have an obligation to the Ministry of Education to maintain their school buildings in good repair. Accounting standards require boards to include a provision for cyclical maintenance in their financial statements to represent the amount of maintenance that is estimated will be required in the future (Financial Reporting Standard No. 15: *Provisions, Contingent Liabilities and Contingent Assets*).

We disagreed with five schools because they did not comply with the accounting standard, in that they did not include provisions for cyclical maintenance in their financial statements.

##### Disagreement over consolidated financial statements (3 schools)

Accounting standards require schools to prepare consolidated financial statements that incorporate their subsidiaries (Financial Reporting Standard No. 37: *Consolidating Investments in Subsidiaries*). Only a few of the 2450 schools have subsidiaries, and most of these schools prepare consolidated financial statements.

We disagreed with three schools because they did not comply with the accounting standard, in that they did not prepare consolidated financial statements.

##### Disagreement over the application of Financial Reporting Standards (3 schools)

We disagreed with three schools because they did not comply with an applicable Financial Reporting Standard.

**Other reasons (6 schools)**

The audit opinions of six other schools were qualified for other reasons:

- We disagreed with one school because budget figures were not included in its financial statements.
- We disagreed with one school because its financial statements did not reflect the expenditure incurred by the board to paint the school buildings and the borrowing that had taken place.
- We disagreed with one school because expenditure incurred on planning for the construction of a building that did not proceed had not been written off.
- Our audit of one school was limited because there was insufficient evidence to confirm the amount of adjustments made to the value of the school's assets and liabilities to reflect a misappropriation of funds in previous years.
- Our audit of one school was limited because we were unable to obtain sufficient evidence to support the provision for cyclical maintenance that the school included in its financial statements.
- Our audit of one school was limited because we were unable to confirm whether the school had complied with an applicable Financial Reporting Standard.

**Explanatory paragraphs**

- 4.124 The following explanatory paragraphs were issued on schools' financial statements during the year ended 31 December 2006.
- 4.125 Because of the number of schools, we have reported the types of explanatory paragraphs that were issued and the number of schools that received each type, rather than list each school for which an explanatory paragraph was noted and the reason for each school's explanatory paragraph.
- 4.126 Some explanatory paragraphs concern a breach of law. In most cases, boards have a choice of disclosing a breach of law in their financial statements. Where a board decides to make a voluntary disclosure, we would not normally include an explanatory paragraph in the audit report. Figure 4.3 does not include such breaches, voluntarily disclosed in the financial statements.

**Figure 4.3****Explanatory paragraphs (breach of law) for schools by type and number****Not reporting by 31 May 2006 (80 schools)**

Boards have a statutory obligation to issue their audited financial statements by 31 May. We noted that 80 schools had breached the law by failing to meet this statutory reporting deadline.

**Statements of performance (14 schools)**

Schools are obliged by the Education Act 1989 to include, in their annual reports, statements comparing their performance against their objectives.

We noted that 14 schools had breached the law by not including such statements in their annual reports.

**Expenditure by integrated schools on buildings (12 schools)**

Integrated schools are not permitted to incur expenditure on buildings owned by proprietors without the approval of the Ministry of Education and the proprietor's written recognition of the board's financial interest.

We noted that 12 schools had breached the law by using their funds to pay for improvements to buildings on land owned by the schools' proprietors. A large number of schools made voluntary disclosure of this inadvertent breach of the law in their financial statements. Part 7 in this report titled "Unlawful expenditure by schools" gives further detail on this matter.

**Borrowing without approval (10 schools)**

Boards are not permitted to borrow above a prescribed limit without the approval of the Ministers of Education and Finance.

We noted that 10 schools had breached the law by not seeking authority from the Ministers for borrowing above the limit.

**Investing in non-approved institutions (8 schools)**

In order to safeguard public money, schools may invest their surplus funds only in approved banking and other institutions.

We noted that eight schools had breached the law by making investments in non-approved banking institutions without the authority of the Ministers of Education and Finance.

**Banking arrangements (9 schools)**

Boards are obliged to deposit their income in a bank account under their direct control and authority.

We noted that nine schools had breached the law by depositing income in the bank accounts of third parties.

**Figure 4.4****Explanatory paragraphs (emphasis of matter) for schools by type and number****Closures (31 schools)**

During the last few years, a number of schools have been closed. Accounting standards require schools that have been or are being closed to prepare their financial statements on the basis that they are not a “going concern”, that is, that they are not continuing.

We noted that 31 closed schools had prepared their financial statements correctly.

**Payments in advance to staff (19 schools)**

Schools are not permitted to pay their staff in advance without the approval of the Ministry of Education.

We noted that 19 schools had paid some of their staff in advance, in order to make use of government grants that would otherwise have been lost. This was in anticipation of the staff working without pay in the future.

We understand that the schools did not realise that they did not have the authority to make such payments and we expect that this issue will not recur.

**Serious financial difficulties (16 schools)**

A small number of schools are in serious financial difficulty, mainly because of large working capital deficits.

We noted that 16 schools had included disclosures in their financial statements that outlined their financial difficulties and the actions they are taking to address the factors that had resulted in those difficulties.

**Allegations of irregularities in the award of contracts (14 schools)**

A number of schools had employed a company to assist with the award of building contracts. Allegations of irregularities concerning an employee of that company are being investigated by the Serious Fraud Office.

We noted that 14 schools had included disclosures in their financial statements, and that the result of those enquiries and whether they affected the schools’ contracts was not known. There was no suspicion of impropriety on the part of the boards of trustees.

**Other reasons (6 schools)**

Our audit reports included explanatory paragraphs for other reasons:

- We noted one school was not charging sufficient fees to overseas students.
- We noted two schools had made payments of additional remuneration to teachers without the approval of the Ministry of Education.
- We noted one school had made a loan to staff without the approval of the Ministry of Education.
- We noted two schools had enrolled overseas students without being a signatory to the relevant Code of Practice.



## Other public entities

**Figure 4.5**

### Adverse opinions for other public entities

#### **Royal New Zealand Navy Museum Trust Incorporated**

*Financial statements year ended: 30 June 2005*

We disagreed with the Trustees not recognising the museum collection assets of the Museum Trust, nor the associated depreciation expense, in the Museum Trust's financial statements. These are departures from Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment*, which requires museum collection assets not previously recognised to be recognised at fair value and depreciated. In addition, we were unable to verify some cash sales and donations because of limited control over those revenues.

#### **Queen Elizabeth II Army Memorial Museum**

*Financial statements year ended: 30 June 2006*

We disagreed with the Trustees not recognising the museum collection assets of the Museum, nor the associated depreciation expense, in the Museum's financial statements. These are departures from Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment*, which requires museum collection assets not previously recognised to be recognised at fair value and depreciated. In addition, we were unable to verify some cash sales and donations because of limited control over those revenues.

#### **RNZAF Museum Trust Board**

*Financial statements year ended: 30 June 2006*

We disagreed with the Board not recognising the museum collection assets of the Trust Board, nor the associated depreciation expense, in the Board's financial statements. These are departures from Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment*, which requires museum collection assets not previously recognised to be recognised at fair value and depreciated.

#### **Christchurch Polytechnic Institute of Technology and Group**

*Financial statements year ended: 31 December 2005*

We issued an unqualified opinion on the parent entity's financial statements. However, we disagreed with the CPIT Council's decision not to prepare consolidated financial statements. In our opinion, this was a departure from Financial Reporting Standard No. 37: *Consolidating Investments in Subsidiaries*.

**Figure 4.6**

### Disclaimer of opinion for other public entities

#### **Ngati Whatua O Orakei Health Clinic Limited\***

*Financial statements year ended: 31 March 2005*

Our audit was limited because we were unable to form an opinion on the validity of the use of the going concern assumption. The Board believed that the Company was a going concern, having adopted a financial recovery plan to address the Company's financial difficulties. However, the Board had not prepared forecasts or budgets of future operating results to support the financial recovery plan; therefore, there was insufficient information for us to be able to form an opinion.

\* A subsidiary company of Ngati Whatua O Orakei Māori Trust Board.

**Figure 4.7**  
**Except-for opinions for other public entities**

**Auckland District Health Board and Group**

*Financial statements year ended: 30 June 2006*

We disagreed with the value at which the Board had recorded land, buildings, and associated fit out and services in the Statement of Financial Position of the Board and Group. The Board had recorded those assets revalued based on a valuation that excluded those parcels of land subject to restrictive covenants. This is a departure from Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment*, which requires the revaluation of all assets within a class of assets to be recorded at fair value. The value of the Board and Group's property, plant, and equipment was understated by excluding those parcels of land subject to restrictive covenants.

**University of Auckland**

*Financial statements year ended: 31 December 2005*

We disagreed in the previous accounting period with the accounting treatment to incorporate the net assets of the Auckland College of Education into the University as an unusual item in the University's Statement of Financial Performance. In our opinion, the net assets should have been treated as a contribution from the Crown in the University's Statement of Movements in Equity. Because we had previously disagreed with the accounting treatment, we disagreed with the comparative information disclosed in the 31 December 2005 financial statements that related to transactions undertaken in the previous accounting period.

**Victoria University of Wellington and Group**

*Financial statements year ended: 31 December 2005*

We disagreed with the accounting treatment to incorporate the net assets of the Wellington College of Education into the University as an unusual item in the University's Statement of Financial Performance. In our opinion, the net assets should have been treated as a contribution from the Crown in the University's Statement of Movements in Equity.

**Te Arawa Maori Trust Board**

*Financial statements year ended: 30 June 2005*

Our audit was limited because we were unable to confirm the value of the Board's fixed assets. The Board has an accounting policy to revalue land and buildings to reflect their fair value. However, the Board had not revalued its land and buildings since 30 June 1999. This is a departure from Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment*, which requires revaluations to be undertaken on a systematic basis with sufficient regularity to ensure that no individual item of property, plant, and equipment within a class is included at a valuation that is materially different from its fair value, and at a minimum every five years. In addition, the Board did not revalue its investment properties as at 30 June 2005 in accordance with Statement of Standard Accounting Practice No. 17: *Accounting for Investment Properties and Properties Intended for Sale*, which requires investment properties to be valued at net current value on an annual basis. We also drew attention to the fact that legislation was being drafted that, if enacted, would result in the Board being vested in a new entity, the Te Arawa Lakes Settlement Trust. Because the legislation was still being drafted, the Board had prepared the financial statements on a going concern basis.

**Auckland District Health Board Charitable Trust\***

*Financial statements years ended: 30 June 2005 and 30 June 2006*

Our audit was limited because we were unable to verify certain revenue because of limited control over the receipt of that revenue.

**Three Harbours Health Foundation\*\***

*Financial statements year ended: 30 June 2005*

Our audit was limited because we were unable to verify certain revenue because of limited control over the receipt of that revenue.

**Wanganui City College Hostel Trust\*\*\***

*Financial statements year ended: 31 December 2002*

Our audit was limited because we were unable to obtain confirmation of the value of the accounts receivable at 31 December 2001. Any misstatements of the accounts receivable would affect the results for the year ended 31 December 2002. We were unable to satisfy ourselves as to the value of the accounts receivable by any other audit procedures.

**Wilson Home Trust\*\*\*\***

*Financial statements year ended: 31 December 2005*

Our audit was limited because we were unable to verify certain revenue because of limited control over the receipt of that revenue.

**Australian Study of Parliament Group (New Zealand Chapter)**

*Financial statements years ended: 30 June 2004 and 30 June 2005*

Our audit was limited because we were unable to verify certain revenue because of limited control over the receipt of that revenue.

**Ngati Whakaue Education Endowment Trust Board**

*Financial statements year ended: 31 December 2005*

Our audit was limited because we were unable to confirm the value of the Trust Board's land that was classified as investment property. The land had not been revalued but instead was recognised at its rating value. This is a departure from Statement of Standard Accounting Practice No. 17: *Accounting for Investment Properties and Properties Intended for Sale*, which requires the investment property to be revalued annually to net current value.

\* A trust controlled by Auckland District Health Board.

\*\* A trust controlled by Waitemata District Health Board.

\*\*\* A trust controlled by Wanganui City College.

\*\*\*\* A trust controlled by Waitemata District Health Board.

**Figure 4.8****Explanatory paragraphs (emphasis of matter) for other public entities****Parliamentary Service**

*Financial statements year ended: 30 June 2006*

We noted the disclosures in the Statement of Unappropriated Crown Expenditure that referred to the Controller and Auditor-General examining whether advertising expenditure incurred in the three months before the 2005 General Election was within the legal authority provided by Parliament.

**Western Institute of Technology at Taranaki**

*Financial statements year ended: 31 December 2005*

We noted the disclosures in the financial statements that referred to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the Crown in the form of loans and guarantees until December 2007.

**New Zealand Institute for Crop and Food Research Limited**

*Financial statements year ended: 30 June 2006*

We noted the disclosures in the group financial statements that referred to the uncertainty about the outcome of the plan for a wholly owned subsidiary to raise capital to finance the development of products in the future. The viability of the subsidiary is dependent on the success of its plan in generating the necessary capital and on the commercial success of its products.

**Gracelinc Limited\***

*Financial statements year ended: 31 December 2005*

We noted the disclosures in the financial statements that referred to the uncertainty about the outcome of the company's plans to raise new capital to finance the development of its products in the future. The viability of the company is ultimately dependent of the success of the company's plans in generating the necessary capital, and thereafter on the commercial success of the company's products.

**Woodville Windfarm Limited\*\***

*Financial statements year ended: 30 June 2005*

We noted the disclosures in the financial statements that referred to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent company.

**Enzedair Tours Limited\*\*\***

*Financial statements year ended: 30 June 2005*

We noted that the financial statements were appropriately prepared on the going concern basis because the parent company had confirmed that it would provide adequate support to ensure that the company could meet its debts as they fall due.

**Ansett Australia and Air New Zealand Engineering Services Limited \*\*\***

*Financial statements year ended: 30 June 2005*

We noted that the financial statements were appropriately prepared on the going concern basis because the parent company had confirmed that it would provide adequate support to ensure that the company could meet its debts as they fall due.

**Travelseekers International Limited\*\*\***

*Financial statements year ended: 30 June 2005*

We noted that the financial statements were appropriately prepared on the going concern basis because the parent company had confirmed that it would provide adequate support to ensure that the company could meet its debts as they fall due.

**Jetaffair Holidays Limited\*\*\***

*Financial statements year ended: 30 June 2005*

We noted that the financial statements were appropriately prepared on the going concern basis because the parent company had confirmed that it would provide adequate support to ensure that the company could meet its debts as they fall due.

**Air New Zealand Associated Companies (Australia) Limited\*\*\***

*Financial statements year ended: 30 June 2005*

We noted that the financial statements were appropriately prepared on the going concern basis because the parent company had confirmed that it would provide adequate support to ensure that the company could meet its debts as they fall due.

**Tasman Empire Airways (1965) Limited\*\*\***

*Financial statements year ended: 30 June 2005*

We noted that the financial statements were appropriately prepared on the going concern basis because the parent company had confirmed that it would provide adequate support to ensure that the company could meet its debts as they fall due.

**Freedom Air Limited\*\*\***

*Financial statements year ended: 30 June 2005*

We noted that the financial statements were appropriately prepared on the going concern basis because the parent company had confirmed that it would provide adequate support to ensure that the company could meet its debts as they fall due.

**Air New Zealand Travel Business Limited\*\*\***

*Financial statements year ended: 30 June 2005*

We noted that the financial statements were appropriately prepared on the going concern basis because the parent company had confirmed that it would provide adequate support to ensure that the company could meet its debts as they fall due.

**Eagle Air Maintenance Limited\*\*\***

*Financial statements year ended: 30 June 2005*

We noted that the financial statements were appropriately prepared on the going concern basis because the parent company had confirmed that it would provide adequate support to ensure that the company could meet its debts as they fall due.

**PIERC Education**

*Financial statements year ended: 31 December 2005*

We noted the disclosures in the financial statements that referred to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing successful implementation of a recovery plan and the ongoing support of the Tertiary Education Commission.

**NIWA Natural Solutions Limited\*\*\*\***

*Financial statements year ended: 30 June 2005*

We noted the disclosures in the financial statements that referred to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent company.

**Quotable Value Australia Pty Limited<sup>†</sup>**

*Financial statements year ended: 30 June 2004*

We noted the disclosures in the financial statements that referred to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent company.

**Egan Australasia Pty Limited (formerly Quotable Value (NSW) Pty Ltd)<sup>†</sup>**

*Financial statements year ended: 30 June 2004*

We noted the disclosures in the financial statements that referred to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent company.

**Department of Child, Youth and Family Services**

*Financial statements year ended: 30 June 2006*

We noted the disclosures in the financial statements that appropriately referred to the going concern assumption not being used in preparing the financial statements because the Department was disestablished and merged with the Ministry of Social Development on 1 July 2006.

**ComOne Joint Venture<sup>††</sup>**

*Financial statements year ended: 31 March 2005*

We noted that the financial statements had been prepared on a realisation basis because the joint venture was expected to be wound up within 12 months.

**West Coast Transport Network Group**

*Financial statements year ended: 31 December 2005*

We noted the disclosures in the financial statements that the Network Group had a working capital and net asset deficit because costs exceeded income, and that the Trustees were attempting to improve this financial situation.

**The Patriotic and Canteen Funds Board**

*Financial statements year ended: 16 May 2005*

We noted the disclosures in the financial statements that appropriately referred to the going concern assumption not being used in preparing the financial statements because the entity was disestablished on 16 May 2005.

**Kings Hostel Trust<sup>†††</sup>**

*Financial statements year ended: 31 December 2005*

We noted the disclosures in the financial statements that appropriately referred to the going concern assumption not being used in preparing the financial statements because the Trust was wound up on 31 December 2005.

**New Zealand High Performance Sports Centre Trust<sup>#</sup>**

*Financial statements year ended: 14 July 2004*

We noted the disclosures in the financial statements that appropriately referred to the going concern assumption not being used in preparing the financial statements because the Trust was wound up on 14 July 2004.

**Fishing Industry Development Trust<sup>##</sup>**

*Financial statements year ended: 31 March 2003*

We noted the disclosures in the financial statements that appropriately referred to the going concern assumption not being used in preparing the financial statements because the Trust would be disestablished shortly.

**Open Mind Journals Limited<sup>###</sup>**

*Financial statements years ended: 31 December 2003 and 31 December 2005*

We noted the disclosures in the financial statements that appropriately referred to the going concern assumption not being used in preparing the financial statements because the Company had ceased trading.

\* A subsidiary controlled by New Zealand Institute for Crop and Food Research Limited.

\*\* A subsidiary controlled by Meridian Energy Limited.

\*\*\* A subsidiary company of Air New Zealand Limited.

\*\*\*\* A subsidiary company of National Institute of Water and Atmospheric Research Limited.

† A subsidiary company of Quotable Value Limited.

†† A joint venture between the University of Otago, Agresearch Limited, and a private sector entity.

††† A trust controlled by Kings High School (Dunedin).

# A trust controlled by Sport and Recreation New Zealand.

## A trust controlled by New Zealand Fishing Industry Board.

### A subsidiary company of the Open Polytechnic of New Zealand.





## Part 5

# Effect of the Public Audit Act 2001 – new public entities

- 5.101 The Public Audit Act 2001 (the Act) resulted in a clearer definition of the Auditor-General’s mandate. The Auditor-General is the auditor of every public entity, and of any entity controlled by one or more public entities under the test for “control” contained in the Act (the control test).
- 5.102 We have examined and made a decision on the status of about 700 entities since the Act was passed. The application of the control test has increased the number of entities audited by the Auditor-General by about 500. Many of these new public entities are trusts associated with public entities. This has caused concerns for some trusts that have not previously been subject to public audit.
- 5.103 In this Part, we highlight some issues that have arisen in applying the control test in the central government sector. A small number of trusts have not yet accepted that they are public entities subject to the Auditor-General’s mandate. We consider it important to advise Parliament that we are not auditing a small number of entities that we consider should be subject to public audit.

### The control test

- 5.104 Under section 5 of the Act, the Auditor-General is the auditor of every public entity and of every entity that is controlled by one or more public entities.
- 5.105 The Act uses both legal and accounting definitions of control. Section 5(2) says that an entity is controlled by one or more other entities if:
- (a) *the entity is a subsidiary of any of those other entities; or*
  - (b) *the other entity or entities together control the entity within the meaning of any relevant approved financial reporting standard; or*
  - (c) *the other entity or entities can together control directly or indirectly the composition of the board of the entity within the meaning of sections 7 and 8 of the Companies Act 1993 (which, for the purposes of this paragraph, are to be read with all necessary modifications).*
- 5.106 The two legal limbs of the control test in paragraphs (a) and (c) above are reasonably straightforward. The definition in paragraph (a) applies where a public entity owns a majority of shares of an incorporated subsidiary and/or has the right to appoint a majority of directors. The definition in paragraph (c) applies where one or more public entities have the right, directly or indirectly, to appoint a majority of the governing body of an entity (whether incorporated or not).
- 5.107 Analysis of control under the accounting test in paragraph (b) is often more difficult. This Part focuses on some of the issues that have arisen in applying the accounting test for control.

## Control under the accounting test

- 5.108 The relevant approved financial reporting standard, for the purpose of the control test, is Financial Reporting Standard No. 37: *Consolidating Investments in Subsidiaries* (FRS-37).<sup>1</sup> We have used this standard to determine whether an entity is a subsidiary of another public entity (that is, a controlled entity).
- 5.109 The effects of being assessed as a controlled entity under FRS-37 are that the controlled entity must be consolidated into the parent entity's group financial statements, and the Auditor-General is the auditor of the controlled entity.
- 5.110 For financial reporting periods beginning on or after 1 January 2007, a New Zealand equivalent to an international financial reporting standard (NZ IAS 27: *Consolidated and Separate Financial Statements*) will apply for the purpose of the control test. That standard also uses the concepts of control, power, and benefit that apply under FRS-37, and refers to FRS-37 as a source of additional guidance when applying NZ IAS 27. FRS-37 is, therefore, still relevant to determining control for New Zealand public entities. We do not anticipate major changes to the Auditor-General's portfolio arising from the adoption of New Zealand equivalents to international financial reporting standards.
- 5.111 We discuss in paragraphs 5.112-5.127 how we have applied FRS-37 in determining whether a public entity controls another entity since the enactment of the Public Audit Act.
- 5.112 The approach under FRS-37 is to consider the *substance* of the relationship between two entities to determine whether one controls another. Control is defined in FRS-37 as:

*“Control” by one entity over another entity exists in circumstances where the following parts (a) and (b) are both satisfied:*

- (a) *the first entity has the capacity to determine the financing and operating policies that guide the activities of the second entity, except in the following circumstances where such capacity is not required:*
- (i) *where such policies have been irreversibly predetermined by the first entity or its agent; or*
  - (ii) *where the determination of such policies is unable to materially impact the level of potential ownership benefits that arise from the activities of the second entity.*
- (b) *the first entity has an entitlement to a significant level of current or future ownership benefits, including the reduction of ownership losses, which arise from the activities of the second entity.*

<sup>1</sup> The standard was issued in October 2001 and applies to general purpose financial reports covering periods ending on or after 31 December 2002.

5.113 Part (a) of the definition is referred to in FRS-37 as the “power” element, and part (b) is the “benefit” element. These elements are linked, as ownership benefits are derived from the policies that guide the activities of a subsidiary. Both elements must be present for control to exist, unless one of the exceptions to the power element in subparagraphs (i) or (ii) applies.

### Power element

5.114 Under FRS-37, an entity is presumed to control another entity if it appoints a majority of members of the second entity’s governing body or controls a majority of voting rights at a meeting.<sup>2</sup> FRS-37 overlaps with the legal limbs of the control test in this respect. However, FRS-37 goes further than the legal tests by setting out other indicators of power that are not solely related to appointment of the governing body or voting rights. Examples of other indicators of power include where an entity has a direct or indirect ability to:

- determine the revenue raising, expenditure, and resource allocation policies of another entity, including an ability to modify or approve the entity’s budget; and
- veto, overrule, or modify decisions of the governing body other than for the purpose of protecting existing legal or contractual rights or restrictions.

5.115 The exceptions to the power element (subparagraphs (i) and (ii) in the FRS-37 definition of control) are also a significant extension of the legal tests of control. These are discussed in paragraphs 5.119 and 5.120.

### Benefit element

5.116 The benefit element requires the parent entity to be entitled to a significant level of ownership benefits from the subsidiary’s activities, or to have a greater entitlement to benefits than any other parent entity. Ownership benefits are benefits that give a return on an investment.

5.117 Types of ownership benefits include:

- benefits from the distribution of earnings or net assets (for example, a right to a significant level of the net assets of an entity in liquidation); or
- other benefits from control over net assets (for example, synergistic benefits from a parent and subsidiary combining their activities); or
- benefits from an entity undertaking activities that are complementary to those of the parent.

5.118 In our experience, the activities of trusts formed by public entities often complement those of the public entity. FRS-37 states:

<sup>2</sup> Paragraph 5.10 of FRS-37 sets out other circumstances that establish “rebuttable presumptions” that control exists.

*A parent's entitlement to other ownership benefits may also arise in circumstances where there is a supply of goods or services to a third party by the possible subsidiary, which meets an operating objective of the parent. For example, it is common for special entities such as trusts to be established to provide certain services to support the operating objectives of another entity. In such circumstances, a parent may benefit from complementary activities. Because it can be difficult to identify clearly whether a given circumstance establishes an entitlement to receive the benefits resulting from complementary activities, this Standard takes the position that such entitlement arises when all three of the following conditions apply:*

- *the supply of goods or services by the possible subsidiary is directly consistent with, and is likely to enhance, the operating objectives of the parent, and*
- *determination of the nature of the goods or services to be supplied is a direct consequence of the exercise of the parent's decision-making ability over the activities of the possible subsidiary, and*
- *the parent is relieved, as a result of the activity of the possible subsidiary, of an actual or constructive obligation to provide such supply; or the parent has a right to receive a future service delivery from the possible subsidiary that is not subject to additional funding to be provided by the parent.*

### Exceptions to the power element

- 5.119 FRS-37 identifies two circumstances where it is not necessary to have the power element to satisfy the definition of control (see subparagraphs (i) and (ii) of the FRS-37 definition of control in paragraph 5.112).
- 5.120 We have found that the first circumstance often applies to trusts formed by public entities. This is where the policies that guide the activities of an entity have been predetermined and are unable to be modified. In such cases, a power element is not necessary, although the benefit element is still required. Any party that has established such an entity, and has ownership benefits, has control. These arrangements are sometimes described as “irreversible predetermined mechanisms” or “autopilots”. This is discussed further in paragraphs 5.122-5.127.

### Trusts controlled by public entities

- 5.121 Since the Act was passed, we have identified a number of charitable trusts in the central and local government sectors as being controlled by one or more public entities in terms of FRS-37. In the central government sector, the majority of such

trusts are in the health and education sectors. The most common circumstances of control include:

- a public entity where, given its right to appoint all or a majority of the trustees, control under FRS-37 is presumed to exist in the absence of evidence to rebut that presumption. The presumption is generally not rebuttable where the public entity receives significant ownership benefits from the charitable trust.
- a charitable trust established by a public entity where the public entity does not appoint a majority of trustees but:
  - where the objects or purposes have been determined by the public entity and cannot be changed; and
  - where complementary activities provide benefits to the public entity (such arrangements are referred to under FRS-37 as autopilots, discussed in paragraphs 5.122-5.127).

## Autopilots

- 5.122 In the case of a trust established for charitable purposes, it is reasonably common to find either that the objects or purposes specified in the trust deed cannot be changed or that substantive changes to the terms of the trust cannot be made. In some cases, substantive changes could be made only if it is no longer possible or practicable to achieve the objects and if approved by the High Court.<sup>3</sup> Trustees of charitable trusts often have a power to make amendments to procedural or technical aspects of trust deeds in order to better give effect to the purposes of the trust, provided that any such changes do not affect the status of the trust for income tax purposes.
- 5.123 Such trust deeds can be an “irreversible predetermined mechanism” or “autopilot”, in terms of the first exception to the power element in FRS-37. Where that is the case, the power element under the standard does not have to be present and the parent entity does not need to have an ongoing power to appoint trustees or some other form of power.
- 5.124 We have found that many trusts controlled by public entities are in this category – that is, the policies that guide the activities of the trust have been irreversibly predetermined by the public entity at the time the trust was established. Where the public entity is entitled to receive benefits from the trust’s activities, and where the trustees cannot make substantive changes to the objects of the trust that would have an effect on the public entity’s entitlement to receive those benefits, the significant policy direction of the trust is unlikely to change and the public entity therefore controls the trust under FRS-37.

<sup>3</sup> The Charitable Trusts Act 1957 contains a regime for the variation of charitable trusts where the trust fails in some way.

- 5.125 In many cases, public entities have established trusts at arm's length from the public entity so that the trust would be able to perform its functions independently. Examples that we have considered include fundraising foundations established by schools and universities, and trusts established to operate facilities such as libraries or hostels. In some cases, entities have established the trusts in order to avoid the restrictions that apply to the parent entity.<sup>4</sup>
- 5.126 Many public entities and trusts have found it surprising to be told that many such trusts are controlled for accounting purposes under FRS-37 and are therefore public entities. In part, this is because the standard did not apply when the trusts were established. The concept of control is not seen as appropriate for a trust, as the trustees are under a legal duty to act independently in accordance with the objects of the trust and do not consider themselves to be controlled in any sense by the organisation that established the trust.
- 5.127 In general trust law, once a settlor has given property to trustees, the settlor has divested themselves of the asset and the trustees must act independently. The trustees do not receive ongoing funding from the settlor and must act independently. The accounting standard does not sit easily with trust law in this respect, but it does acknowledge that entities often form trusts to provide services that support their objectives. The standard-setters were clearly aware of the accounting standard's possible application to trusts.

### Disputes with controlled entities

- 5.128 We have had protracted debates with trustees of a small number of trusts about whether the trusts are in fact controlled by public entities under FRS-37. The matters that are usually contested are discussed in paragraphs 5.129-5.132.
- 5.129 One issue is whether the objects and purposes of a trust are “the financing and operating policies that guide the activities of the entity” within the meaning of FRS-37.<sup>5</sup> In the case of a charitable trust, we consider that the policies that guide the activities of the trust are the objects or purposes of the trust rather than day-to-day administrative matters, such as the particular powers applying to the operational, borrowing, or investment activities of the trust (which, in any case, must be exercised in furtherance of the trust's objects or purposes).
- 5.130 Another issue is whether the policies that guide the activities of the subsidiary can be modified – that is, whether the trustees can make substantive changes to the objects or purposes of the trust. In our view, it is not possible for trustees to make substantive changes to the terms of the trust in a way that affects the

<sup>4</sup> The Crown Entities Act 2004 has introduced requirements for a Crown entity (not including a tertiary education institution or a school) that wishes to settle, or be or appoint a trustee of, a trust – see section 100.

<sup>5</sup> The definition of control in FRS-37 refers to “the financing and operating policies that guide the activities of the second entity”.

parent entity's entitlement to ownership benefits. For example, the trustees of a charitable trust established to raise funds for the benefit of a particular entity would be likely to be in breach of their duty if they were to change the objects and purposes of the trust to benefit another entity.

- 5.131 In some instances, trustees have contested whether the public entity established the trust. This is partly a question of fact, and often the trusts and public entities have not been willing or able to make records or evidence of the facts of establishment available to us. In some cases, we have been told that the person such as the chairperson or chief executive of a public entity settled a trust associated with the public entity in their private capacity rather than on behalf of the public entity.
- 5.132 Whether the public entity derives ownership benefits from the activities of the trust is another issue that trustees have contested. In most cases, we consider that the activities of the subsidiary trust are complementary to those of the parent where the three requirements in FRS-37 for complementary benefits apply and the benefit test is met.
- 5.133 In many cases, the real concern of trustees is with the idea that they are controlled by another entity when in legal terms and in practice they are independent. They are also concerned about the possible effect of being consolidated into the group financial statements of a public entity. Some trustees have told us that they believe that consolidation would affect their ability to raise funds from members of the public and other funding organisations, as they would be perceived to be part of a publicly funded entity.
- 5.134 We do not know whether this concern has eventuated for those trusts that have already been consolidated. This would be an unintended consequence of the application of the control test if the trustees' concern were realised. In our view, being subject to public audit and the greater accountability associated with that may enhance a trust's appeal to the public and funding organisations.
- 5.135 Trustees tend to be less concerned about the Auditor-General appointing their auditor than about the potential effect of consolidation. The concern about consolidation has proved to be an obstacle to our appointing an auditor in a small number of cases, and some trusts have not been willing to accept that they are subject to the Auditor-General's mandate.
- 5.136 Where the activities of a subsidiary entity are material to the activities of a parent entity, generally accepted accounting practice requires the parent to consolidate the subsidiary entity into its group financial statements. Where the parent

entity is not willing to do so, or is unable to do so because the subsidiary will not provide the necessary information, then the audit opinion on the group financial statements of the parent entity may need to be qualified.

- 5.137 In some cases, the trustees have considered winding up the trust to avoid consolidation and public audit, or resettling the trust fund on a new trust that would not be subject to public audit. We think this is an extreme response to the application of the control test in the Act, and it is one that has involved cost for the trusts concerned. In some cases, trustees have found that they do not have the ability to resettle the trust in the way they seek if the trust deed does not contain an express power to resettle.
- 5.138 We have resolved most disagreements with controlled entities and they have eventually accepted our view that they are controlled under FRS-37. We have explained that the test for control under FRS-37 is relevant for accounting purposes only, and has no effect on the role or independence of the trustees. In many cases, we have been able to appoint the trust's existing auditor to conduct the audit on our behalf.
- 5.139 We can appreciate why our conclusions are sometimes contentious for trustees who regard themselves as completely independent from the settlor entity, and who are concerned about the implications of control.
- 5.140 The Auditor-General is bound by the Act and the scheme of the Act, which is to ensure that there is public accountability for all public entities, including controlled public entities. We have explained that, in determining control under the Act, we are applying the accounting standard as we understand it. We have suggested to entities that they should raise their concerns about the application of the standard to trusts with the standard-setters.<sup>6</sup>
- 5.141 If we reach the point where a controlled public entity refuses to accept that the Auditor-General is its auditor, we consider that it would be important to advise Parliament of that fact, including the name of the controlled entity concerned. We do not yet need to take this step, but will do so as necessary in the future.



## Part 6

# Operation of the Controller function

- 6.101 The Public Finance Amendment Act 2004 (the Amendment Act) made significant changes to the Controller function of the Controller and Auditor-General. These changes took effect from 1 July 2005, so this is the second year of the operation of the function since the Amendment Act.
- 6.102 Last year we reported on the work that has been done to bring the function into operation and discussed the issues that arose between 1 July 2005 and 31 December 2005. We also advised of our intention to report annually to Parliament on the significant issues arising from the operation of the Controller function.
- 6.103 In this Part, we outline the public finance principles and main features of the Controller function, summarise the unappropriated expenditure in 2005/06, and report on some notable matters we have had to consider during the past year.

### Public finance principles

- 6.104 Public expenditure occurs within a framework dominated by two important principles:
- the principle of appropriation; and
  - the principle of lawfulness of purpose.
- 6.105 The system of appropriations is the primary means by which Parliament authorises the Executive to use public resources. Expenses and capital expenditure can be incurred only in accordance with an appropriation or other statutory authority.
- 6.106 There are three elements to an appropriation. It specifies:
- the maximum amount of expenses or capital expenditure that can be incurred;
  - the scope (that is, what the amount can be used for); and
  - the date on which the appropriation lapses.
- 6.107 Unappropriated expenditure occurs when expenses or capital expenditure are incurred:
- without an appropriation;
  - in excess of the amount of an appropriation;
  - for a purpose outside the scope of an appropriation; or
  - after an appropriation has lapsed.
- 6.108 The principle of lawfulness of purpose includes, but is wider than, the principle of appropriation. To be lawful, expenses or capital expenditure must be incurred in accordance with an appropriation, but also in keeping with the lawful authority

provided to the department<sup>1</sup> to engage in the activity concerned, if such lawful authority exists.

## The Controller function and the appropriation audit

- 6.109 The legislative provisions for the Controller function are set out in sections 65Y to 65ZB of the Public Finance Act 1989.<sup>2</sup>
- 6.110 The main features of the Controller function are:
- The Treasury is required to supply monthly reports to the Controller, to enable the Controller to examine whether expenses and capital expenditure have been incurred in accordance with an appropriation or other authority (section 65Y).
  - The Controller can direct a Minister to report to the House of Representatives if the Controller has reason to believe that any expenditure has been incurred that is unlawful or not within the scope, amount, or period of any appropriation or other authority (section 65Z).
  - The Controller can stop payments from a Crown or departmental bank account, to prevent money being paid out that may be applied for a purpose that is not lawful or not within the scope, amount, or period of any appropriation or other authority (section 65ZA).
- 6.111 The Auditor-General's appointed auditors must carry out an appropriation audit as part of the annual audit of a department.<sup>3</sup>
- 6.112 Departments provide information to the Treasury on the expenses and capital expenditure incurred against the statutory authority available. The Treasury collates this information and provides a monthly report to the Office of the Auditor-General (OAG).<sup>4</sup> Each month the OAG and appointed auditors operate the Controller function under certain standard procedures. These procedures are carried out in accordance with the Auditor-General's Auditing Standard 2: *The Appropriation Audit and the Controller Function* (AG-2) and the Memorandum of Understanding between the Office of the Auditor-General and the Treasury.<sup>5</sup> As part of the annual audit, appointed auditors carry out the appropriation audit work in accordance with the requirements in AG-2.

1 The references to "departments" in this article mean government departments and Offices of Parliament.

2 As amended by the Public Finance Amendment Act 2004.

3 Section 15 of the Public Audit Act 2001, as amended by the Public Finance Amendment Act 2004.

4 Monthly reporting is not required for July and August.

5 The joint understanding and expectations of the OAG and the Treasury of the role and procedures associated with the Controller function are set out in the Memorandum of Understanding between the Treasury and the Office of the Auditor-General: Controller Function (MOU), which is available on the Treasury website ([www.treasury.govt.nz](http://www.treasury.govt.nz)). The MOU is currently being updated to take into account current practice and matters requiring emphasis or further clarification.

- 6.113 All appropriations are audited to:
- determine whether expenses or capital expenditure have been incurred within the amount, scope, and period of an appropriation or other statutory authority;
  - ensure that expenses incurred have been for lawful purposes; and
  - ensure that any unappropriated expenditure is reported in the financial statements of each department.

### Unappropriated expenditure in 2005/06

- 6.114 There were 84 instances (within 21 departments) where unappropriated expenditure was reported during the 2005/06 year.<sup>6</sup>
- 6.115 A summary of the amount of expenses or capital expenditure in excess of appropriation, outside of scope, or incurred without an appropriation, and breaches of net asset limits, is presented on pages 89 to 98 of the Financial Statements of the Government (Government financial statements) for the year ended 30 June 2006. Unappropriated expenditure is also reported in the financial statements of the relevant department in the Statement of Unappropriated Expenses and Capital Expenditure, together with an explanation of the reasons for such expenditure.
- 6.116 Seven instances of unappropriated expenditure occurred because of “in-principle expense transfers”. We reported on in-principle expense transfers last year.<sup>7</sup> The Treasury subsequently revised procedures so that, before the end of the financial year, an explicit (rather than an in-principle) authority is given under imprest supply to incur the transferred expenses in the next financial year up to a particular amount. We were pleased to see that there were no further breaches of appropriation as a result of in-principle expense transfers at the start of the 2006/07 year.
- 6.117 In October 2006, for the first time, the Auditor-General exercised the power under section 65Z of the Public Finance Act to direct a Minister to report to the House of Representatives. A direction was issued to the Speaker, as Minister responsible for Vote Parliamentary Service, to report breaches of the scope of appropriations identified after an inquiry into advertising expenditure incurred by the Parliamentary Service in the three months before the 2005 General Election. Our expectation is that this power is likely to be used rarely.

<sup>6</sup> This number includes each breach of appropriation for each year. Where breaches of appropriation were identified for previous years but the amount of the breach could not be separately identified for each year, these have been counted as one breach. There were seven breaches of the Party and Member Support appropriations in Vote Parliamentary Service in 2005/06 and five in 2004/05. The Government financial statements do not separately list each breach, but show these as one line because the inquiry of the Auditor-General was not complete at the time the Government financial statements were issued.

<sup>7</sup> *Central Government: Results of the 2004-05 audits*, parliamentary paper B.29[06a], “The operation of the Controller function”, pages 51-60.

- 6.118 During the year, the Treasury issued two Treasury circulars relating to unappropriated expenditure:
- 2006/4: *Unappropriated Expenditure – Avoiding Unintended Breaches*. This circular emphasised that departments must have an existing appropriation or other authority (or authority for use of imprest supply) in advance of incurring expenses or capital expenditure. Departments should seek authority in advance for any expenditure they anticipate may be in excess or outside the scope of an appropriation, or any breach of the net asset balances.
  - 2006/6: *Unappropriated Expenditure 2005/06*. This circular provided information and templates for the 2005/06 unappropriated expenditure process.
- 6.119 The 79 instances of unappropriated expenditure in 2005/06 within 21 departments compare with 45 instances in 2004/05 within 16 departments, and a similar number in 2003/04 within 12 departments. This indicates that the new monthly process has been effective, and has identified breaches of appropriation earlier. We encourage all departments to pay particular attention to ensuring that all expenses and capital expenditure stay within appropriation throughout the year. We found instances where departments could have avoided unappropriated expenditure through better forecasting of expenditure for each output class, and more timely requests for imprest supply to deal with potential unappropriated expenditure.

## Scope of appropriations

- 6.120 The Public Finance Act provides that the authority to incur expenses or capital expenditure provided by an appropriation is limited to the scope of the appropriation and may not be used for any other purpose.
- 6.121 In September 2005, the Treasury issued a paper entitled “Scoping the Scope of Appropriations”,<sup>8</sup> to provide guidance for departments in developing the scope description of appropriations in the Estimates of Appropriation.
- 6.122 The paper notes that:
- The objective of the scope description in the Estimates should be to provide an appropriately balanced description of the scope of expenses or capital expenditure being incurred so that:*
- *the wording acts as an effective constraint against non authorised activity;*
  - *the wording does not inappropriately constrain activity intended to be authorised.*

8 See [www.treasury.govt.nz/appropriations/scoping/default.asp](http://www.treasury.govt.nz/appropriations/scoping/default.asp).

- 6.123 We have seen examples where the scope of an appropriation is so broad that it is not possible to get a clear understanding from the scope description what activities are actually being funded within an appropriation. This affects the effectiveness of Parliamentary scrutiny, and approval of expenditure within Votes. We recommend that departments review the scope of the appropriation definitions before they are included within the Estimates of Appropriation.

### Net asset holdings

- 6.124 Four departments breached their net asset limits in 2005/06.
- 6.125 We considered some issues relating to the provisions in the Public Finance Act about net asset holdings and remeasurements when carrying out our Controller function work.
- 6.126 Section 22(3) of the Public Finance Act states: “The amount of net asset holding in a department must not exceed the most recent projected balance of net assets for that department at the end of the financial year, as set out in an Appropriation Act in accordance with section 23(1)(c).” This is subject to section 22(2), which provides authority for the reported net asset holdings of a department to increase as a result of a remeasurement of an asset or liability.
- 6.127 An issue that arose, for the purposes of determining whether a department’s net asset balance is within the limit set out in section 22(3), is whether planned capital withdrawals that have not yet occurred should be taken into account when determining whether net asset balances have been exceeded.
- 6.128 For example, a department’s net assets at 30 September 2006 were in excess of the projected 30 June 2007 balance because a capital withdrawal proposed to occur during the financial year ended 30 June 2007 had not yet taken place. The withdrawal subsequently occurred during October 2006. We considered whether this timing difference would cause the department to be in breach of section 22(3) at 30 September 2006.
- 6.129 We accepted the Treasury’s view that, for the purposes of interpreting section 22(3), departments can recognise a liability for a capital withdrawal that will be paid in the current financial year (either a provision for payment of surplus or a debt to the Crown) whenever their net assets would otherwise exceed the projected year-end balance. We therefore formed the view that the department was not in breach of section 22(3) at 30 September 2006.
- 6.130 Recognition of a liability to the Crown for capital withdrawals that will be paid in the current financial year in the Statement of Financial Position is appropriate on the basis that the first Appropriation Act for the year creates a legal requirement

to make a repayment of equity during the year. Therefore, departments may show capital withdrawals that will be paid in the current financial year in the Statement of Financial Position as a liability to the Crown with a corresponding reduction in equity, until such time as the capital withdrawal has occurred.

6.131 It is important to note that:

- A provision is required only in those situations where a department's net assets are in excess of the projected year-end balance because of a timing difference arising from a capital withdrawal.
- The earliest point at which such a provision would be recognised would be when the first Appropriation Act for the year is passed (for example, 3 August 2006 for the year ending 30 June 2007).
- The requirement to make a provision for the capital withdrawal will be incorporated into Treasury Instructions with effect from 1 July 2007. This will include a requirement for departments to agree with the Treasury the date for the capital withdrawal; this will need to be agreed before the passing of the first Appropriation Act for the year.

## Remeasurements

6.132 The Amendment Act introduced the concept of remeasurements, defined in section 2 of the Public Finance Act as meaning: "revisions of prices or estimates that result from revised expectations of future economic benefits or obligations that change the carrying amount of assets or liabilities". Section 2 also sets out what remeasurements do not include. In particular, it does not include revisions that result from transactions or events directly attributable to actions or decisions taken by the Crown.

6.133 Remeasurements are not included in the meaning of expenses in section 4, and therefore do not require an appropriation.

6.134 As mentioned in paragraph 6.105, a fundamental principle to be applied to expenses or capital expenditure is that it must be incurred in accordance with appropriation or statutory authority. However, the remeasurement provision in the Public Finance Act provides an exception to this principle. Where remeasurements cause a reduction in the value of assets or increase the liabilities, the Public Finance Act does not require an appropriation for the expenses related to such transactions or events. This recognises that Parliament does not require prior approval for a reduction in net assets resulting from changing expectations of future economic benefits or obligations and transactions or events not under the control of the Crown.

- 6.135 As part of our Controller function work, we have considered whether certain transactions or events arising result in a remeasurement as defined. We found that determining what is a remeasurement is often a matter of judgement. The key factors have usually been assessing whether the revision to prices or estimates is caused by changing expectations about future economic benefits or obligations, and whether the revision results from a transaction or event directly attributable to actions and decisions taken by the Crown. In our view, assessing an expense as a remeasurement needs careful consideration because it does not need an appropriation.
- 6.136 In July 2006, the Treasury issued a paper entitled “Measuring Remeasurements” to provide guidance for making judgements as to whether an item is a remeasurement or an expense requiring an appropriation. Examples of remeasurements are provided in the paper.<sup>9</sup>
- 6.137 Given the careful judgement needed for an expense to be assessed as a remeasurement, as well as the risk of an appropriation being exceeded if the transaction or event is not assessed as a remeasurement, we encourage departments to discuss any possible remeasurements with their appointed auditor.

## Summary

- 6.138 In our view, the nature of the issues that have arisen through the operation of the Controller function in the first and second year of its operation reinforces the value of the changes made to modernise and enhance that function.
- 6.139 The new monthly reporting process identifies breaches of appropriation earlier, and has improved accountability by reinforcing the need for departments to ensure that there is appropriate authority for all expenses and capital expenditure that they incur, and all departmental net assets that they hold.
- 6.140 Breaches of appropriation have also come to our attention through annual audits and inquiries.
- 6.141 We have worked closely with the Treasury in resolving issues as they have arisen. Further issues may arise as the full effects of the new legislation continue to emerge.
- 6.142 Departments are encouraged to pay particular attention to ensuring that all expenses and capital expenditure stay within appropriation throughout the year. Departments should review the scope of appropriations carefully before they are included in the Estimates of Appropriation for approval by Parliament. We encourage early communication between departments and appointed auditors on any potential issues, such as remeasurements.

<sup>9</sup> See [www.treasury.govt.nz/appropriations/remmeasurements/mr-tag-v1-1.pdf](http://www.treasury.govt.nz/appropriations/remmeasurements/mr-tag-v1-1.pdf).





## Part 7

# Unlawful expenditure by schools

- 7.101 In July 2004, we reported on the results of an audit exercise carried out to assess whether payments to school principals for additional duties were lawful and in accordance with any relevant Ministry of Education (the Ministry) requirements.<sup>1</sup>
- 7.102 We found examples of unlawful payments to principals made through the Ministry's central payroll system and paid locally by schools. As a result of our findings, the Ministry agreed to take action to reduce the incidence of unlawful payments and to consider whether it was possible and appropriate for such payments to be recovered.
- 7.103 Since our July 2004 report, we have not examined the payments made to principals in detail. However, given the action taken by the Ministry to strengthen the arrangements, we consider that the current incidence of unlawful payments is likely to be substantially lower than when we reported in 2004.
- 7.104 In March 2005, we reported on the extent to which schools complied with the law on a number of financial matters.<sup>2</sup> The report noted that most schools complied with the law, but that the Ministry needed to take further action to reduce the incidence of non-compliance, particularly by integrated schools.
- 7.105 In this Part, we assess the progress the Ministry has made on reducing the incidence of unlawful expenditure since our two earlier reports. It also describes the unlawful remuneration paid by a board to its principal in 2005. We address what further action might be appropriate to reduce the likelihood of unlawful payments, and recommend strengthening the arrangements for recovery of such payments.
- 7.106 While the Ministry has taken action on some of the matters raised in our two previous reports, it needs to consider further action to ensure public accountability on the part of school boards for unlawful payments.
- 7.107 In summary, we consider that the Ministry should:
- review the approvals for additional remuneration that have been given to ensure that payments are not being made locally;
  - conclude its consideration of how best to address issues of enforcement and recovery in relation to unlawful payments made to principals;
  - request on a regular basis a statement from each proprietor of an integrated school of all money paid directly to all school staff, the amounts involved, and the reasons for the payments;

1 *Central Government: Results of the 2002-03 Audits*, parliamentary paper B.29[04a], pages 45-65.

2 *Central Government: Results of the 2003-04 Audits*, parliamentary paper B.29[05a], pages 83-92.

- issue simple and accessible guidance, directed at inexperienced trustees, on the major financial constraints on the operation of schools – for integrated schools as well; and
- attach a higher priority to regularising the \$30 million of possibly unlawful expenditure incurred by integrated schools on buildings owned by proprietors.

## Summary of our report on principals' remuneration

### Summary of the system for remunerating principals

- 7.108 A school board of trustees is a Crown entity in its own right and, as such, has legal obligations. A principal is responsible for the overall management and professional leadership of the school.
- 7.109 The terms and conditions of employment for school principals are contained in a collective or individual employment agreement. The Ministry approves all such agreements, which set the amount of remuneration to be paid for normal duties.
- 7.110 A principal might also have other responsibilities for which extra remuneration can be paid. Legislation requires that the Ministry approves all such additional remuneration before it is paid, and that it is paid through the Ministry's central payroll system rather than locally by a board. Some of the reasons that the Ministry would usually consider an acceptable basis for granting approval include:
- management of, and responsibility for, a residential/boarding hostel;
  - recruitment and management of large intakes of foreign fee-paying students;
  - management of, and responsibility for, a significant initiative that earns extra revenue for the school and is in addition to the principal's normal role;
  - management of a school that is considered an exemplar of practice that results in other schools seeking information and advice; and
  - management of, and responsibility for, implementing a significant change process.
- 7.111 The main determinant the Ministry looks for when assessing an application for additional remuneration is that the principal has responsibilities over and above those that normally form part of a principal's job. Payments recognising performance, or for recruitment and retention, are unlikely to be approved, as the Ministry considers these aspects to be covered by the standard agreements.

### Summary of the audit findings on principals' remuneration

- 7.112 In July 2004, we reported on the payments made to principals through the Ministry's central payroll system and directly by boards.

- 7.113 We took a targeted sample of 70 payments made through the central payroll system and found that nine cases of additional remuneration totalling \$63,217 had been made without the Ministry's approval. The largest amount was \$10,600 for renting a house.
- 7.114 Our school auditors reviewed payments made locally by secondary school boards and identified 119 separate instances of possible additional remuneration that had been made without Ministry approval. These payments involved 72 of the 402 secondary principals and were for amounts ranging from under \$500 to more than \$20,000. The two largest payments were \$23,000 for implementing a video conferencing project and a \$10,000 performance bonus.
- 7.115 In our opinion, 62 of the 119 payments were additional remuneration requiring Ministry approval. The total value of these payments was at least \$210,000 and involved 46 school boards. In our view, many of the payments potentially had tax implications that not all of the boards appeared to have addressed.
- 7.116 The Ministry and we were concerned about the extent to which unapproved additional remuneration had been paid outside the central payroll system. That 11% of secondary schools made these payments was significant.
- 7.117 As a result of our findings, we considered the adequacy of the guidance the Ministry issues to boards on principals' remuneration. We found that advice to boards was contained in seven documents. In our view, however, the guidance on the need for boards to obtain Ministry approval for additional remuneration could have been clearer.

### **Action taken on the principals' remuneration report**

- 7.118 Our 2004 report noted a number of actions for the Ministry to take and that it had given us firm assurances that it would appropriately address our concerns.
- 7.119 We are pleased to report that the Ministry has:
- reminded payroll centres of the need to have the Ministry's approval before paying additional remuneration through the central payroll system;
  - stopped all additional remuneration that was made through the central payroll system and informed school boards that new approvals are needed before any further additional remuneration is paid;
  - set up a routine where all approvals are ceased in January each year, requiring boards to review and seek renewal of approvals;
  - introduced in August 2006 new monitoring reports to check the correctness of additional remuneration paid through the central payroll system. The

Ministry is confident that its controls have been sufficiently strengthened to substantially reduce the incidence of unlawful payments made centrally;

- followed up with the relevant schools the examples of unlawful expenditure that we identified and confirmed our conclusions for the majority of cases. Schools have been recommended to seek the Ministry's approval if they wish to continue to pay additional remuneration; and
- reminded schools generally of the requirement for its approval of additional remuneration. This has been by issuing Circular 2004/19 in November 2004 and repeating that guidance in the Ministry's *Funding, Staffing and Allowances Handbook*. The New Zealand School Trustees Association has also issued advice on the need to obtain the approval of the Ministry for additional remuneration.

- 7.120 As a result of our findings, the Education Review Office (the ERO) sought additional assurances from school boards during its regular reviews. The further assurances related to obtaining the approval of the Ministry for additional remuneration and making local payments.
- 7.121 These further assurances have been sought since July 2004 and, in more than 2000 reviews carried out since then, no board chairperson or principal has attested that they have not complied with the requirements. This gives considerable comfort that the majority of schools now understand the legal requirements on these matters.
- 7.122 We have not examined the Ministry's systems and processes in the same detail as in the special audit exercise that formed the basis for our July 2004 report. However, we noted that 14 of the 90 applications for additional remuneration approved by the Ministry in 2006 did not appear to have been paid through the central payroll system. In most of these cases, there was no obvious reason why a board should seek and obtain approval for additional remuneration and then decide not to make the payments through the central payroll system. We recommend that the Ministry review approvals that have been given, as a matter of routine, to ensure that boards are not making payments locally.
- 7.123 We have not required our school auditors to examine local payments to principals in detail since our special audit exercise. However, except for the specific example mentioned in paragraphs 7.136-7.148, our school auditors have not brought any significant cases of unlawful remuneration to our attention.

## Payment of remuneration by proprietors of integrated schools

- 7.124 Our July 2004 report noted that we had also become aware that the principals of some integrated schools receive remuneration from the proprietors of the schools (the owners of the school buildings) in addition to the normal salary payable from public funds. We considered that such arrangements might breach section 7(4) of the Private Schools Conditional Integration Act 1975, which prohibits the payment of additional remuneration by proprietors for normal duties. Therefore, we recommended that the Ministry consider the extent of the remuneration received by the principals of some integrated schools from the school proprietors, whether such payments are lawful, and, if so, how they may be stopped.
- 7.125 The Ministry considers that it has limited ability to identify payments made by proprietors directly to a principal. Any such payments would not be included in a school's annual reporting on its principal's remuneration (which is restricted to remuneration paid by the school) and would be outside the scope of the audit of a school (which does not include reviewing payments made by a proprietor or income received by a principal from third parties).
- 7.126 The Ministry also notes that payments made directly by a proprietor for activities outside the scope of a principal's normal duties and responsibilities (for example, managing a boarding hostel) would not usually be subject to its approval and might also fall outside the requirements of the legislation mentioned above.
- 7.127 Consequently, we conclude that the current arrangements do not allow compliance with the above legislation to be monitored. If a principal is receiving additional remuneration from a proprietor in relation to the normal duties of a principal, this would not be detected.
- 7.128 Therefore, we recommend that the Ministry request on a regular basis a statement from each proprietor of all money paid directly to all school staff, the amounts involved, and the reasons for the payments. This would allow the Ministry to assess whether any unlawful payments have been made. The Ministry has confirmed that it will consider whether it may be appropriate to include a provision to this effect in integration agreements.

## Recovery of unlawful payments to principals

- 7.129 In response to the recommendation in our July 2004 report that the Ministry consider whether recovery of the unlawful payments is possible or appropriate, the Ministry obtained a legal opinion in December 2005.

- 7.130 In summary, that legal opinion said:
- The Ministry is the appropriate agency to consider how to prevent and recover unlawful payments. The State Service Commissioner has an interest in such matters, and therefore any action proposed might usefully be the subject of appropriate consultation with the State Services Commission.
  - A school board may take action to recover an unlawful payment. However, whether such action would be successful would depend on the facts of the particular case.
  - The Ministry has no power to require a board to apply for approval of a payment of additional remuneration or to cease making an unlawful payment. Also it is unable to direct a board to take action to recover an unlawful payment. The Minister is unlikely to be able to use his statutory powers of intervention in schools to require a board to take recovery action against an employee, or to replace a board with a Commissioner if a board was not prepared to seek recovery of an unlawful payment.
  - Board trustees might be personally liable for an unlawful payment they had made if it can be demonstrated that they did not act in good faith – for example, if they made the payment knowing it to be unlawful.
- 7.131 The Ministry has considered the legal opinion and remains concerned that the principle of equality of remuneration for all state schools is capable of being undermined by the lack of compliance by boards of current legislative arrangements. It recognises that there is a policy issue on the balance to be struck between the principle that unlawful payments should not be paid, but if they are paid then they should be recovered, and avoiding excessive intrusion into the affairs of school boards as separate entities in their own right.
- 7.132 We note that, before the Education Act 1989 (the Act) was changed in 2001, one of the provisions gave the Minister the power to dissolve a board and replace it with a Commissioner if satisfied that it had taken or intended to take an unlawful action, or had failed or refused or intended to fail or refuse to take an action required by law.
- 7.133 Since 2001, the grounds for appointing a Commissioner have been restricted to circumstances where there is a risk to the operation of the school, or to the welfare or educational performance of its students. Arguably, some types of mismanagement or other unlawful or improper acts that might have allowed the appointment of a Commissioner under the previous provisions of the Act are no longer permitted.

- 7.134 In our view, the current arrangements are unsatisfactory. A school board may make an unlawful payment to its principal, continue to make such an unlawful payment, and not be required either by legislation or the Ministry to consider recovery. The only recourse that appears to be available to the Ministry in these circumstances is to take action against trustees personally if it may be demonstrated that they did not act in good faith.
- 7.135 The Ministry is currently considering how best to address enforcement and recovery issues, and notes that this may require a change in legislation to strengthen its ability to promote compliance with the current legislation. In this context, we note that the legislation that existed before 2001 allowed a board to be replaced by a Commissioner in wider circumstances than currently.

### **Te Wharekura O Rakaumangamanga – unlawful remuneration**

- 7.136 Te Wharekura o Rakaumangamanga is a decile 1 school established under section 155 of the Education Act 1989. It is located in Huntly with a roll of about 400 students. It has an annual income of \$3 million. It has had stable governance, with the same chairperson, deputy chairperson, principal, and senior staff for the last 15 years. The school has a reputation for strong educational performance, and has been responsible for the development of a range of programmes in the primary and secondary area. It is in a very strong financial position.
- 7.137 Our audit report on the board's financial statements for 2005 will contain a breach of law paragraph, drawing attention to unlawful remuneration provided by the board to its principal. As the scale of the remuneration is exceptional in comparison with the examples we identified in our July 2004 report, we considered that reporting the breach of law in the audit report would not be sufficient to give a full public account of the matter. Therefore we decided to give a summary of the unlawful remuneration in this article.
- 7.138 We consider that this case adds further weight to the need for the Ministry to strengthen the arrangements for reducing the incidence of unlawful payments, and to enable recovery action where they occur.
- 7.139 In May 1999, the board gave its principal an interest-free loan of \$270,000 to assist with purchasing a house. This was because the board considered that the principal had transformed the performance of the school and been instrumental in obtaining substantial additional income for the school from contracts for

services. It wished to retain the services of the principal for the following years, to lead the school through a further period of development, and saw the loan as a means of retaining the principal. The board has advised us that the principal was contracted to remain for a period of eight years in consideration of the loan facility.

- 7.140 The Ministry concluded that the loan was unlawful and that it should be repaid. This was achieved by the board purchasing the house from the principal in June 2000 for \$238,000. The board believes that the housing market dropped between May 1999 and June 2000. The remaining \$32,000 of the loan was written off by the board. The Ministry also gave approval for the board to rent the house to the principal at \$5,000 a year less than the market rent, to compensate for the additional duties he carried out.
- 7.141 As part of the repayment of the loan, the board proposed that it enter into an agreement with the principal so that he had the first option to repurchase the house during the next 10 years. The Ministry's agreement to the board's purchase of the house was conditional on the option for the principal to repurchase the house being removed from the sale agreement.
- 7.142 The board's annual report for 2004 shows that the principal received remuneration in the range of \$110,000 to \$120,000, which is in accordance with the collective agreement. It also noted that the principal was living in a school house, that the market rent and consequent subsidy was yet to be determined, and that tax would be required to be paid on the subsidy.
- 7.143 The board's draft annual report for 2005 shows that a performance bonus of \$120,000 gross was paid to the principal, being \$20,000 a year for the previous six years. The principal paid PAYE tax on this sum when he received payment. The payment was made locally in February 2005. The board told us that it did not know that it was required to seek the Ministry's approval for the performance bonus or that it was not permitted to make payments outside the central payroll system.
- 7.144 In April 2005 the board sold the house to the principal for \$238,000, the same value as the house was purchased for five years previously. This was \$89,000 below the market value of \$327,000 at the date of sale. The board says that it believed that it was holding the house in trust for the principal for it to be returned to him at a future date. The board told us it was not aware that the benefit to the principal was deemed to be remuneration and accordingly it did not seek any advice on possible tax liability.



- 7.145 In the period between the purchase of the house by the board in June 2000 and the sale back to the principal in April 2005, the board allowed the principal to occupy the house without paying rent. This constituted additional remuneration of about \$85,000 for the five-year period. The board had Ministry approval for about \$25,000 of this remuneration (\$5,000 a year), so the unlawful remuneration was about \$60,000.
- 7.146 The total unlawful remuneration received by the principal amounted to \$269,000. The total cost to the board, including tax and possibly penalties and interest on unpaid tax, could be nearly \$400,000. The board says that it feels very strongly that it has moral and equitable obligations to the principal over and above the legal obligations it has under the employment agreement. The board has also told us that the penalties and interest on unpaid tax are a consequence of these other management failures, in particular the failure to require payment of rent by the principal and the failure to realise that the benefits for the principal attracted a tax liability. We note in this regard that taxpayers generally have a legal obligation to disclose fully all benefits received for tax purposes.
- 7.147 Since these matters were brought to the attention of the board, it has acknowledged that it has not complied with the relevant legislation and confirmed that it now fully understands its obligations. It has given the Ministry an assurance that there will be no further breaches.
- 7.148 The Ministry has recommended to the board that it take steps to recover the unlawful remuneration. The board has decided not to take any action, on the grounds that there is no reasonable prospect of recovery. Given the legal advice it has received, as referred to above, the Ministry will be considering what action to take on receipt of the 2005 audit report.

### Summary of our report on legal compliance by schools

- 7.149 There are about 2450 state schools governed by boards of trustees, which are made up of members of the local community (usually parents of children attending the school), the principal of the school, a staff representative, and, in secondary schools, a student representative. The board of each school is a Crown entity in its own right and, as such, has legal obligations. Many schools are relatively small; some have a single employee, and expenditure of only \$100,000 a year.
- 7.150 There are about 18,000 trustees, and about 45% (8000) will turn over at each triennial election. Many of the elected trustees may have little or no experience of governing a public entity when they first join a board. If they do not use the material made available to them, or the training opportunities that are on offer,

they may not be aware of the requirements of public accountability and the many different pieces of legislation that constrain the operation of schools.

- 7.151 The Ministry performs an important role for schools. It seeks to support good governance and management, develop clear expectations of quality, and provide core infrastructure in the schools sector.
- 7.152 An important aspect of our annual audit work is assessing whether public entities, including school boards, have complied with the financial legislation that affects their operations. The Act regulates the financial operations of schools in a number of ways, to ensure that they behave in a publicly accountable manner, and requires schools to seek the prior approval of the Ministry in certain circumstances. As part of our school audits, we assess compliance with the financial provisions on:
- *Borrowing*: Schools may borrow up to a prescribed limit, which gives them some flexibility in their financial affairs. Schools may also borrow above their limits, but only with the approval of the Ministers of Education and Finance. This helps the Ministry to control the amount borrowed and address any financial difficulties at an early stage.
  - *Investing money*: Schools may invest their surplus funds with banks and other approved institutions. Any other investment needs the approval of the Ministers of Education and Finance. This protects public funds, by requiring schools to invest in sound institutions.
  - *Purchasing land*: Schools may acquire or occupy land or premises only with the Minister's approval. This is to ensure that public funds are not spent on land and buildings without the Minister being satisfied of the need to do so.
  - *Conflicts of interest*: School trustees who have a financial interest in a matter, or any interest that may be regarded as likely to influence them, are required to exclude themselves from participating in board discussions or voting on the matter. Also trustees are disqualified from holding office if they have a financial interest in contracts with the school above \$25,000 a year, without the approval of the Ministry.
  - *Funding other organisations*: Like any other public entity, a school board may use its resources only for the proper exercise of its statutory functions. It cannot commit its funds or assets to activities that are not reasonably connected to its role in managing the school, providing education for its students, or other activities allowed by its charter. A transfer of money or other property from a board to another organisation may be unlawful.

7.153 We were pleased to report in March 2005, based on the results of the audits we carried out in 2004, that most schools complied with the financial provisions relating to the matters we examined. Some schools did not comply with all aspects of the legislation that we examined. Our report provided examples. Many of the breaches of legislation that we found were minor. However, some were significant. We made a number of recommendations for improvement, which we address in the following paragraphs.

### Guidance to boards on legislative matters

- 7.154 Our March 2005 report noted that the Ministry recognised the need to provide simple guidance for schools, directed at inexperienced trustees, on important aspects of the financial legislation that governs their operations.
- 7.155 We also recommended that the Ministry consider providing simple advice to integrated schools, and their proprietors, on specific aspects of the legislation relating to the financial relationship between schools and proprietors.
- 7.156 The Ministry has issued a number of additional pieces of guidance on legislation during 2005 and 2006:
- School Bank Accounts – Circular 2005/7 in June 2005;
  - Crown Entities Act – Circular 2005/16 in September 2005;
  - Governance – Circular 2005/17 in September 2005;
  - Integrated Schools' Fundraising – letter of February 2006; and
  - Conflicts of Interest – Circular 2006/7 in May 2006.
- 7.157 We commend the Ministry for providing this relevant and timely advice to boards on some of the aspects of legislation that govern their operations.
- 7.158 We have also reviewed the guidance issued by the New Zealand School Trustees Association (NZSTA), which has a contract with the Ministry for training trustees. The guidance issued by the NZSTA is in four main forms:
- *A Trustee Handbook* provides comprehensive guidance on relevant aspects of the role of trustees, including legislation.
  - *Guidelines* are issued on specific topics, to supplement the *Handbook*.
  - Electronic memoranda on topical issues are issued to boards of trustees and principals on a regular basis.
  - A helpdesk advisory service is available to respond to specific queries.

- 7.159 The guidance issued by the Ministry and the NZSTA on legislative matters is comprehensive and up to date. However, we remain concerned that it may not be sufficiently accessible for many of the 18,000 trustees who may have little or no experience in managing a public entity when they first join a board and who may be in office for only three years. The NZSTA notes that training cannot be imposed on boards of trustees, and accordingly there is no guarantee that all boards or individual trustees will achieve the same level of knowledge during their time in office.
- 7.160 In this context, we note that the Ministry's recent report on its review of Schools' Operational Funding identified that its communications might be difficult and time-consuming for schools to digest and follow, and that there was room for considerable improvement in terms of clarity and accessibility.
- 7.161 We therefore recommend that the Ministry consider whether it would be useful to issue simpler and more accessible guidance, directed at inexperienced trustees, on the major financial constraints on the operation of schools. The Ministry concurs with our view on simpler communication of legislation to schools.
- 7.162 Such simple accessible guidance would also be useful for integrated schools and their proprietors, as our audits continue to identify examples where the financial relationship between schools and proprietors is blurred.

### Integrated schools

- 7.163 One specific issue mentioned in our March 2005 report related to some of the 325 integrated schools, where the distinction between the board of trustees (a public entity) and the proprietor (a private entity and generally the owner of the land on which the school is based) is not always fully understood and has become blurred. The consequence is that public funds have sometimes been used to provide financial support to private entities.
- 7.164 The boards of many integrated schools have used public funds to pay for constructing or improving buildings on land owned by the school's proprietor. However, boards do not have the legal power to use their funds to pay for buildings that will be owned by the proprietor. A board may use its funds only for its own proper purposes, and cannot be used for matters that are the responsibility of the proprietor. The board of an integrated school should fund a building only if it obtains the approval of the Ministry and secures the proprietor's written agreement recognising the board's financial interest in the building.

- 7.165 Despite these requirements, the boards of about 200 integrated schools appear to have provided a total of about \$30 million of public funds in previous years for the construction or improvement of buildings on proprietors' land. Early in 2004, the Ministry agreed to carry out an exercise to make this expenditure lawful.
- 7.166 At that time, the Ministry also planned to issue guidance to boards of integrated schools. Some initial guidance was issued in February 2005. It reminded schools to seek the Ministry's approval, and to have a written agreement protecting the Crown's interest, where they wished to provide public funds to pay for constructing or improving buildings on land owned by the proprietor. The Ministry intended to issue more detailed guidance.
- 7.167 We have asked the Ministry whether the issue of its initial guidance in February 2005 has been effective. A register has not been kept of the individual applications from schools, but all of the Ministry's local offices report an increase in the number of applications received since the initial guidance was issued.
- 7.168 The Ministry is preparing a *Property Management Handbook* for integrated schools. The objective of the *Handbook* is to provide comprehensive guidance, in one publication, on all property management policies and processes that apply to the sector, including board-funded capital works. The Ministry plans to publish the *Handbook* in July 2007.
- 7.169 Three years later, the Ministry is still considering the most appropriate method of regularising the \$30 million of possibly unlawful expenditure. We recommend that the Ministry attach a higher priority to resolving this issue.



## Part 8

# Statements of Intent and service performance information

- 8.101 In our report last year, *Central government: Results of the 2004-05 audits*, we discussed the Managing for Outcomes (MfO) initiative put in place to support government departments' planning for, management of, and reporting on how they use public resources to fulfil their functions.<sup>1</sup> The experiences from this initiative subsequently informed the Managing for Results (MfR) initiative for Crown entities. We noted the importance of the Statement of Intent (SOI) as the public accountability document that sets out the result of planning for how government departments and most Crown entities use public resources.
- 8.102 Although the Auditor-General does not have a statutory audit role for SOIs, the State Services Commission (the SSC) and the Treasury's guidance for departments advises that entities:
- ... engage early with the Appointed Auditor on the draft SOI. The appropriateness of measures chosen and the auditability of systems used to record performance data are both of major interest to the auditor. Involvement of the Appointed Auditor at this initial stage may also assist departments in improving the quality of the SOI, and to identify and address appropriate risks.<sup>2</sup>*
- 8.103 Similar guidance is provided to Crown entities. This guidance reflects the Auditor-General's statutory role in auditing the Statement of Service Performance (SSP) as part of the annual audit of government department and Crown entity financial statements, and advising select committees as part of the Estimates of Appropriations and financial review processes.
- 8.104 Last year, we reported that the quality of departmental 2005/06 SOIs in general was variable and that government departments had made only small, incremental improvements in quality on the 2004/05 SOIs. There are three particular areas where we consider that they need to make more substantial improvement:
- setting out the logic and evidence that links the key outputs produced to the outcomes worked toward;
  - comprehensively identifying the risks faced by departments and providing more detail on how these risks are managed; and
  - refining the output and outcome indicators and gradually introducing outcome reporting in SSPs.
- 8.105 In the past, we have sought to provide feedback on draft SOIs to government departments. However, this has not always happened consistently, or in time for us to provide, and departments to respond to, substantial feedback. The effect of

1 Parliamentary paper B.29[06a], "Part 7 – Planning and managing for better public sector performance".

2 *Guidance and Requirements for Departments Preparing the Statement of Intent*, the Treasury and the State Services Commission, March 2007, pages 5-6.

this has been that departments often cannot consider auditor feedback on areas for improvements until the next year.

- 8.106 The Crown Entities Act 2004 required most Crown entities to prepare an SOI for 2006/07. For some entities, this was the first time they had to prepare an SOI. For other entities, it was the first time they had to meet the broader, outcome-focused requirements of the new Act. Therefore, we have not yet formed overall views about the extent to which these SOIs reflect Parliament's intentions.
- 8.107 Our report last year indicated that we would consider what further work we could undertake to provide assurance to Parliament about the effectiveness of the MfO initiative, and what, if any, lessons may be learned for implementing the MfR initiative in the Crown entities sector.
- 8.108 We also note that, under our annual assessments for aspects of financial and service performance management by government departments, the Service Performance Information Systems aspect<sup>3</sup> has consistently had the lowest proportion of "Excellent" or "Good" ratings between 1993/94 and 2005/06 (see Part 2 of this report).
- 8.109 While we are concerned about this finding, it is important that entities consider the outcome and output information they are most likely to need to effectively manage their performance. They should then set up service performance information systems to support the collection, monitoring, and use of the "right" information.
- 8.110 In this Part, we describe the work we intend to undertake in 2007/08 on service performance reporting by government departments and most Crown entities. We also describe how the work relates to changes in our reporting to entities, Ministers, and select committees, as outlined in Part 3.
- 8.111 This work is a component of a wider programme within the Office intended to improve the depth of our service performance information audit work. By undertaking this work, we hope to better position the Office to contribute to improving the meaningfulness and usefulness of service performance information reported by public entities.

## Our intended work on service performance information in 2007/08

- 8.112 Every public sector jurisdiction that uses planning and reporting systems to help assess the effectiveness of public entities' performance is concerned to ensure that such information is meaningful and useful. We acknowledge that public sector entities vary enormously in their size, governance arrangements, services,

<sup>3</sup> *Service performance information systems* are the systems to record service performance (non-financial) data, and the internal controls (manual and computer) to ensure that data is complete and accurate.



and functions. The nature of public services means that the desired results and outcomes can vary over time and according to the needs and interests of different stakeholders. This complexity and diversity has meant that, unlike with financial statements, standards have not yet emerged for the content, measurement, disclosure, and presentation requirements of service performance statements.

- 8.113 We have been mindful that government departments and Crown entities needed time to develop outcome reporting and associated outcome-related measures, and to relate these to their output service performance information, as required by recent legislative changes. However, we have observed that there has been little development in departments' 2006/07 SOIs compared with 2004/05 and 2005/06.
- 8.114 In our view, there has now been enough time since the 2004 amendments to the Public Finance Act 1989 and the Crown Entities Act 2004 were passed for entities to develop outcome reporting and associated outcome-related measures and link them logically to output reporting.
- 8.115 Service performance reporting, in particular the "appropriateness" of the service performance measures used, will therefore be an area of emphasis in 2006/07 annual audits.
- 8.116 This emphasis will involve reviewing 2007/08 SOIs for government departments and most Crown entities<sup>4</sup> to understand the strategic and outcome context for annual SSP performance measures, as well as entities' processes and rationale for including these in the SOI. This means they will need to:
- determine and review service performance information needs, and choose what to report (that is, the quality of the SOI in relation to the entity's vision, mission, and strategic intent, and the links to reported outputs and activities);
  - choose performance measures; and
  - choose levels of planned performance (the standards or targets forecasted or aimed for).
- 8.117 Our expectations for these matters are aligned with the guidance and instructions issued by the SSC and the Treasury.<sup>5</sup>
- 8.118 We expect to review many SOIs in draft form, and have sought the assistance of entities to allow us to do this. However, if we do not receive SOIs within enough time to provide feedback on the draft, we will undertake our review against the final SOI.

4 Those required by legislation to produce a Statement of Intent.

5 *Guidance and Requirements for Departments: Preparing the Statement of Intent*, the Treasury and the State Services Commission, March 2007, and *Preparing the 2006/07 Statement of Intent – guidance and requirements for Crown entities*, the Treasury and the State Services Commission in consultation with the Department of the Prime Minister and Cabinet, September 2005.

- 8.119 Our reporting to entities, Ministers, and select committees will reflect the findings from our review of service performance information. However, for the 2006/07 year, this will be only in the form of commentary on the direction the auditor believes any improvement in service performance information should take. From the 2007/08 annual audits, we will report a grading for entities on their service performance aspect.
- 8.120 We will incorporate the lessons learned from our reviews of SOIs into our audit methodology for future service performance audit work.
- 8.121 We expect service performance information and reporting to be an element of a continued focus by the Office, working with central agencies and entities to improve the effectiveness and use of SOIs to better meet Parliament's intentions. It is likely that we will, in the future, focus on the collection, management, and use of service performance information.

## Part 9

# Transition to New Zealand equivalents to International Financial Reporting Standards

9.101 In this Part, we provide an update on the progress made by the central government sector towards the transition to accounting and reporting in accordance with the New Zealand equivalents to International Financial Reporting Standards (NZ IFRS).

### Background

9.102 In December 2002, the Accounting Standards Review Board (ASRB) announced its decision that New Zealand entities producing general-purpose financial statements would be required to apply new standards, based on IFRS, for reporting periods beginning on or after 1 January 2007. Entities were given the option to apply the new standards from reporting periods beginning on or after 1 January 2005.

9.103 In August 2003, the Government announced that NZ IFRS would be implemented in the financial statements of the Government as part of Budget 2007<sup>1</sup> and that the first set of audited financial statements of the Government reported under NZ IFRS would be for the year ending 30 June 2008.

9.104 The first set of NZ IFRS financial statements must include comparative figures presented on the same accounting basis. Therefore, the comparative figures for the year ending 30 June 2007 and an opening balance sheet at 1 July 2006 need to be restated in accordance with NZ IFRS.

9.105 Government departments, State-owned enterprises (SOEs), and most Crown entities will also first report under NZ IFRS for the year ending 30 June 2008. Tertiary education institutions (TEIs) and schools have 31 December balance dates, so their transition to NZ IFRS is six months earlier. This means that their first set of audited financial statements under NZ IFRS will be for the year ending 31 December 2007 and that their opening balance sheets need to be restated under NZ IFRS at 1 January 2006.

### Preparation of preliminary NZ IFRS opening balance sheets

9.106 The opening balance sheet date has now passed for all entities within the central government sector, and many entities have now completed preliminary NZ IFRS opening balance sheets.

9.107 Government departments, SOEs, and Crown entities (except TEIs and schools) were required to provide their preliminary NZ IFRS opening balance sheets to the Treasury<sup>2</sup> within two weeks of their 2006 statutory reporting deadline. This was

<sup>1</sup> Budget 2007 will set out the Estimates of Appropriations for the Government for the year ending 30 June 2008.

<sup>2</sup> District Health Boards (DHBs) were required to provide their opening NZ IFRS balance sheets to the Ministry of Health, where a subconsolidation was performed to enable the Ministry to submit the consolidated DHBs' NZ IFRS opening balance sheet to the Treasury.

mid-October 2006 for government departments and SOEs, and mid-November for Crown entities. For other than the smaller of these entities, the preliminary NZ IFRS opening balance sheet then needed to be audited and resubmitted to the Treasury in late December 2006.

- 9.108 For TEIs, the timetable was slightly different, with their audited 1 January 2006 preliminary NZ IFRS opening balance sheets being due at the Ministry of Education by 30 November 2006. The Ministry of Education was then required to consolidate the TEI preliminary NZ IFRS opening balance sheets and return the consolidated position to the Treasury.
- 9.109 The Treasury is working towards consolidating all the entity-level preliminary NZ IFRS opening balance sheets into a preliminary NZ IFRS opening balance sheet of the Government reporting entity.<sup>3</sup> Achieving this consolidation has required remapping the Treasury's Crown Financial Information Systems (CFIS) consolidation system, and preparing consolidation journals to work with the new NZ IFRS reporting pack and accounting policies. This has been a significant piece of work for the Treasury.
- 9.110 In general, we are pleased with the progress that the sector has made on their preliminary NZ IFRS opening balance sheets. However, a significant minority of entities did not meet the Treasury's timetable for completion of their preliminary NZ IFRS opening balance sheets, so the production and the audit of the consolidated preliminary NZ IFRS opening balance sheet of the Government reporting entity is some weeks behind schedule.
- 9.111 The main reasons for the delays in entities completing their preliminary NZ IFRS opening balance sheets appear to be a combination of the challenges of applying NZ IFRS to the public sector, and entities not addressing the NZ IFRS transition early enough to be able to meet the Treasury timetable. Some of the issues that entities have been dealing with have been very complex, and some of these are described in more detail later in this Part.
- 9.112 The Treasury also has a role in facilitating implementation of NZ IFRS throughout the central government sector, although individual entities are responsible for ensuring their own preparedness for reporting under NZ IFRS. In carrying out its role, the Treasury's approach has been to provide the sector with the Government's NZ IFRS accounting policies and to provide guidance on some sector-wide issues, such as accumulating sick leave and the treatment

<sup>3</sup> From 1 July 2005, the Public Finance Amendment Act 2004 changed the reporting entity from "the Crown" to the "Government reporting entity". The Government reporting entity is defined to include the Sovereign and the legislative, executive, and judicial branches of the Government. The revised definition clarifies that all three branches of government are to be included within the Government financial statements. Section 27(3) of the amended Public Finance Act 1989 requires the annual financial statements of the Government to include the Government reporting entity's interests in various entities, including Offices of Parliament.

of the capital charge. The Treasury has supplemented this with individual discussions and advice to entities on particular issues with effects material to the Government financial statements. In providing this advice, the Treasury has consulted regularly with our Office.

- 9.113 The Treasury has told us that its approach to the provision of guidance to the sector is that where implementation issues are considered unlikely to have a material effect on the Government financial statements or where there is not likely to be significant saving from taking a centralised approach, the Treasury has refrained from providing guidance, believing that these issues are best handled by the organisation responsible for its own financial management.
- 9.114 While the guidance that the Treasury has provided has been very useful, in our view there are other challenging aspects of NZ IFRS applicable to multiple central government agencies, and for which the sector would have benefited from more guidance (for example, valuation of debt portfolios and how to determine appropriate discount rates).
- 9.115 Many entities have had to obtain professional advice on NZ IFRS transition matters. In some cases, the engagement of professional advice occurred too late to meet the Treasury timetable.
- 9.116 A number of the entities that were significantly late in providing an audited preliminary NZ IFRS opening balance sheet for consolidation are in the TEI sector. This could be a reflection of the complex relationship between the Crown and the TEI sector.

### **The significant changes to central government sector preliminary NZ IFRS opening balance sheets**

- 9.117 Entities within the Government reporting entity are involved in a wide range of activities, and the accounting issues in the sector are diverse. For some entities, the production of the preliminary NZ IFRS opening balance sheet was reasonably straightforward, but for other entities the NZ IFRS transition process has been very complex. Some of these complex issues are still not fully resolved.
- 9.118 One of the most significant challenges has been accounting for the Government's non-commercial debtors. A number of Government agencies have significant amounts of non-commercial debt owed to them. This debt includes:<sup>4</sup>
- taxes receivable;
  - unpaid fines;

4 Another example of the Government's non-commercial debt is student loans. The Government decided to account for student loans using NZ IFRS principles in the financial statements of the Government for the year ended 30 June 2006 because of the significant effect on the fair value of student loans from the introduction of the Government's interest-free policy.

- benefit recovery debt;
- child support debt;
- legal aid debt; and
- residential care loans.

9.119 Under current generally accepted accounting practice (GAAP), these debtors have been accounted for at the principal amount of the debt less any provision for amounts considered uncollectable. Under NZ IFRS, all debts need to be initially recognised at fair value, which, in the absence of a market price for these types of debt, needs to be determined using discounted cash flow techniques.

9.120 In most cases, the interest, if any, charged on these debts is less than a commercial interest level, and determination of the initial fair value has resulted in a write-down in the carrying value of the debt. The write-down primarily reflects the time value of money.

9.121 The determination of the initial fair values of these debt portfolios has in some cases proved very complex, with the major challenges being forecasting the future cash flows and determining an appropriate discount rate to apply to these cash flows.

9.122 Forecasting the future cash flows for these debts requires the use of complex models, which use a number of assumptions and estimates about the timing and amount of future payments and in some cases about the population of debtors (for example, mortality rates and income levels).

9.123 Under NZ IFRS, the discount rate applied to the forecast future cash flows must be a prevailing market rate for similar instruments with similar credit risk. As there is no market for debt of this type, determining an appropriate discount rate has also proved a challenge. Most of the agencies involved have needed to engage professional advisors to assist them in valuing these debt portfolios in accordance with the requirements of NZ IFRS.

9.124 Issues such as non-commercial debt portfolios of government agencies have not been specifically considered by standard-setters when developing and approving financial reporting standards relating to financial instruments. Given the significance of such financial instruments, particularly in the central government sector, it would have been helpful if the standard-setter in New Zealand had considered this issue and provided guidance material for public benefit entities. Such guidance material could have assisted Government agencies with how to determine the fair value of such debt portfolios, including guidance around how to determine appropriate discount rates.

- 9.125 Looking forward, we consider that it is essential for the credibility of financial reporting standards applying to the public sector that:
- specific consideration is given to such public sector issues;
  - appropriate changes are made to the international standards (which are written for application by large profit-oriented entities) so that the public sector is able to apply them; and
  - guidance is prepared to assist the public sector with application of the standards.
- 9.126 Other areas that have been challenges to entities within the Government reporting entity, or that have led to significant preliminary NZ IFRS opening balance sheet adjustments, are:
- determining how to account for the pension liabilities of the Government Superannuation Fund and the National Provident Fund;
  - determining how to account for the Accident Compensation Corporation claims liability, including the increase to the provision necessary to meet the requirement in NZ IFRS 4: *Insurance Contracts* to add an appropriate risk margin to the estimate of the claims liability;
  - determining whether land and buildings should be accounted for as property, plant, and equipment or investment property or land intended for sale. NZ IFRS transition work to date indicates that there will be significant reclassifications from property intended for sale to property, plant, and equipment, as the criteria under NZ IFRS for use of the intended for sale classification will not be met.<sup>5</sup> This will generally result in increases to the carrying value of these assets as they will need to be revalued to fair value;
  - valuing and accounting for derivative financial instruments, such as forward exchange contracts, interest rate swaps, and electricity and commodity derivatives. In most cases, these derivative financial instruments were previously off balance sheet;
  - categorising other financial instruments (such as investments and borrowings) in accordance with the requirements of NZ IAS 39: *Financial Instruments: Recognition and Measurement* and, dependant on this categorisation, then valuing the instruments in accordance with the complex rules in the standard;
  - establishing provisions for accumulating sick leave; and
  - calculating deferred tax balances. The whole approach to accounting for deferred tax is changing, and will result in more deferred tax assets and liabilities being recognised by those central government entities that pay tax – for example, SOEs. However these deferred tax assets and liabilities are eliminated in producing the consolidated financial statements of the Government.

<sup>5</sup> NZ IFRS 5: *Non-current Assets Held for Sale and Discontinued Operations* establishes the requirements for a property to be classified as held for sale.

- 9.127 As we have stated above, the audit of the consolidated preliminary NZ IFRS opening balance sheet of the Government reporting entity is currently in progress. A number of the issues discussed above have yet to be fully resolved, and the financial effect on the preliminary NZ IFRS opening balance sheet of the Government reporting entity and some individual entities is not yet finalised.
- 9.128 There is no specific requirement for entities to publish their preliminary NZ IFRS opening balance sheets. However, we are aware that some entities are considering publishing them and an explanation of the major adjustments in their 30 June 2007 annual report. This is one way of an entity meeting the requirements of Financial Reporting Standard 41: *Disclosing the Impact of Adopting New Zealand Equivalents to International Financial Reporting Standards* (FRS-41).<sup>6</sup> We support this approach.

### Effect on auditors

- 9.129 The transition to NZ IFRS has continued to be a significant challenge for us and the auditors appointed to audit entities on behalf of the Auditor-General.
- 9.130 During the past year, we have put all our professional staff through “refresher” training on NZ IFRS (having carried out full training the year before), and we continue to develop the resources and support tools for auditors to ensure that they are fully prepared to audit in an NZ IFRS environment.
- 9.131 The audit of the preliminary NZ IFRS opening balance sheets has been additional to our normal work programme, and has required careful management of our staff resources.
- 9.132 The responsibility for production of the preliminary NZ IFRS opening balance sheets lies with the entities that we audit. In many cases, these entities have done an excellent job in dealing with challenging issues and preparing a well-supported preliminary NZ IFRS opening balance sheet within agreed timeframes. For these entities, the audit of the preliminary NZ IFRS opening balance sheet will generally have been efficient and trouble-free.
- 9.133 However, some entities have struggled to meet the expectations of them in relation to the preliminary NZ IFRS opening balance sheet, and a number of them have not yet resolved all of the issues more than two months after the agreed date for completion of their audit. For these entities, the audit process will not have been efficient, and in some cases this will have implications for the audit fee charged.
- 9.134 In our view, the factors that have led to some entities not meeting our expectations include inadequate prioritisation or resourcing of the task, or

<sup>6</sup> FRS-41 requires the annual report of issuers to disclose information about planning for, and the effects of, the transition to NZ IFRS. Although most entities within the central government sector are not issuers as defined in section 4 of the Financial Reporting Act 1993, FRS-41 encourages other entities to also provide these disclosures.



underestimating the complexity of the issues to be addressed. Some entities have looked to us to advise them on how to carry out aspects of the NZ IFRS transition, and to assist them in determining their preliminary NZ IFRS opening balance sheet adjustments. However, our primary role is that of auditor, and we have had to carefully balance our willingness to work with the sector to achieve the transition to NZ IFRS as smoothly as possible with the need to maintain our independence as auditors.

- 9.135 A number of entities have stated to us that they would have appreciated further guidance from the Treasury on the transition to NZ IFRS. In our view, there would be merit in the Treasury providing guidance to entities on some of the key areas of difficulty that apply to multiple central government agencies (for example, valuation of debt portfolios and determining discount rates).

### The challenges ahead

- 9.136 In the coming year, there will be further challenges for central government entities and their auditors as the transition to NZ IFRS continues.
- 9.137 The Treasury will produce Budget 2007 as its first Budget under NZ IFRS. This will require entities to provide NZ IFRS-compliant 2007/08 budget figures to the Treasury.
- 9.138 All central government entities will need to report under both current GAAP and NZ IFRS for the year to 30 June 2007. The existing standards will apply to annual reports for the year ending 30 June 2007. However, entities will also need to restate their results in accordance with the requirements of NZ IFRS. These restated results will form the comparative figures for the first annual financial statements under NZ IFRS. Some entities may need to maintain accounting records under two different accounting bases to meet these requirements.
- 9.139 The restated NZ IFRS-compliant financial information for the year ending 30 June 2007 will also need to be audited. This will again create challenges for us as auditors, in terms of resourcing and scheduling this work.
- 9.140 Similarly, the ongoing transition to NZ IFRS will continue to be a challenge for some central government entities, in terms of workloads of finance teams, transition-related costs (such as professional advice and audit fees), and complexity of the issues to be addressed.
- 9.141 Although many of the complex NZ IFRS transition issues have been dealt with in the creation of the preliminary NZ IFRS opening balance sheets, some of these issues will require significant further work to determine the effect on the statement of financial performance. In addition, we are expecting the amount

and complexity of financial statement note disclosures to increase under NZ IFRS, and entities will need to produce these note disclosures for the first time to support the restated NZ IFRS-compliant 30 June 2007 financial information.

## Summary

- 9.142 The preliminary NZ IFRS opening balance sheets of most central government entities have now been completed and audited.
- 9.143 A minority of entities did not meet the deadline for completion of their preliminary NZ IFRS opening balance sheets, and this has delayed the completion and audit of the consolidated preliminary NZ IFRS opening balance sheet of the Government reporting entity.
- 9.144 The reasons for the delay are a combination of the complexity of the issues to be addressed and some entities not adequately planning and resourcing the transition.
- 9.145 We will continue to encourage the standard-setter in New Zealand to provide appropriate guidance to public benefit entities to assist entities such as Government agencies to implement standards that were not designed for them.
- 9.146 There have been many complex issues to address when applying NZ IFRS to the central government sector for the first time. One of the most challenging issues has been valuing the Government's non-commercial debt portfolios using discounted cash flow techniques.
- 9.147 In our view, there would be merit in the Treasury providing more guidance to entities on some of the particularly challenging NZ IFRS issues that apply to multiple central government agencies.
- 9.148 We have trained our professional staff and provided support tools to enable them to audit in an NZ IFRS environment. We have balanced the desire to work co-operatively with the sector to achieve the transition to NZ IFRS as smoothly as possible with the need to maintain our independence as auditors.
- 9.149 During the coming year, there will be further challenges for the sector and for us as auditors, particularly arising from the need to be able to report the financial results for the year ending 30 June 2007 under both the current financial reporting standards and NZ IFRS.
- 9.150 We are confident that we will fully meet the challenges for us as auditors, and we will continue working towards our overriding objective of supporting the change to NZ IFRS at least cost, with minimum fuss, and in a constructive, co-operative manner.

## Part 10

# Use of derivatives in central government

- 10.101 The area of financial instruments, and more specifically derivative financial instruments (derivatives), has an inherent degree of complexity. A natural consequence of this complexity is risk.
- 10.102 Some submissions to the Finance and Expenditure Committee during its review and consideration of the Public Finance (State Sector Management) Bill (the Bill) in 2004 specifically raised the issue of fiscal risk associated with financial market activity of the Crown, including the use of derivatives. We provided advice to the Committee on the use of derivatives by the Crown.
- 10.103 The new public sector legislation resulting from the Bill in December 2004 introduced clearer parameters within which both government departments (departments) and Crown entities could enter into derivative transactions. The legislation applied from 1 April 2005 and comprised the following Acts:
- the Crown Entities Act 2004 (the Crown Entities Act);
  - the Public Finance Amendment Act 2004 (the Public Finance Amendment Act);
  - the State Sector Amendment Act (No. 2) 2004; and
  - the State Owned Enterprises Amendment Act 2004.
- 10.104 The main restrictions around derivative use are in the Crown Entities Act and the Public Finance Act 1989.
- 10.105 The term “derivative transaction” is defined widely in section 136(1) of the Crown Entities Act and section 2 of the Public Finance Act. The definition lists many types of transactions, and allows for developments as financial markets continue to evolve. It includes foreign exchange transactions, which might not ordinarily be recognised as derivative transactions.
- 10.106 Common derivative transactions include “swaps”, “futures contracts”, “options”, and “forward agreements”.
- 10.107 Section 164 of the Crown Entities Act establishes a general rule that Crown entities are prohibited from entering into (or amending the terms of) derivative transactions, other than as provided under section 160 of the Crown Entities Act – that is, unless:
- the Crown entity is permitted to do so by regulation;
  - approval is granted by the Crown entity’s Responsible Minister and the Minister of Finance;
  - the Crown entity’s own Act provides for derivative use; or

- one of the exemptions contained in either of Schedule 1 or Schedule 2 of the Crown Entities Act<sup>1</sup> applies.
- 10.108 The Crown Entities (Financial Powers) Regulations 2005 (the Regulations) were made by Order in Council on 21 March 2005 under section 173 of the Crown Entities Act.
- 10.109 Regulation 15 of the Regulations permits a Crown entity to undertake specified derivative transactions without further authority. The regulation permits classes of transaction that tend to arise in the ordinary course of business, and that fit with the general policy objective of limiting potential fiscal risk to the Crown and Crown entities. The permitted transactions include foreign exchange transactions and related futures contracts.
- 10.110 The Public Finance Act provides that the Crown must not enter into derivative transactions except as expressly authorised by any Act (section 65F). However, on behalf of the Crown, the Minister of Finance may enter into a derivative transaction if it appears to be necessary or expedient in the public interest to do so (section 65G).
- 10.111 The Minister of Finance has delegated to the New Zealand Debt Management Office (the NZDMO)<sup>2</sup> the operational aspects of managing the Crown's borrowing, investing, and derivative activities. The NZDMO is responsible for the efficient management of the Crown's debt and associated assets within an appropriate risk management framework. Derivatives are used as a tool to protect the Crown from the interest rate risk associated with its borrowing and investment activities.
- 10.112 Departments have no ability, in their own right, to enter into derivative transactions. However, under delegations from the Minister of Finance and the Secretary to the Treasury, and subject to the Treasury having oversight through the *Guidelines for the Management of Crown and Departmental Foreign-Exchange Exposure* (the Guidelines),<sup>3</sup> departments are able to enter into derivatives to manage their foreign exchange risk.

## Scope

- 10.113 To gain a more thorough understanding of the level of risk borne by the Crown from the use of derivatives, we asked our appointed auditors to collect information from some public sector entities as part of the 2005/06 annual audits. We wanted to find out more about the level of derivative use, and about current policies and procedures to manage such use.

1 The various Crown entities are differently affected by the new derivative requirements. The Treasury provides guidance at [www.treasury.govt.nz/notindexed/cerrfp-table-jan05v3.xls](http://www.treasury.govt.nz/notindexed/cerrfp-table-jan05v3.xls) to help determine how individual Crown entities are affected.

2 The NZDMO is a branch of the Treasury. However, for the purposes of this Part, it has been treated as a separate department.

3 The Guidelines were last updated in November 2003 and can be found on the Treasury website at [www.treasury.govt.nz/publicsector/fxexposure/default.asp](http://www.treasury.govt.nz/publicsector/fxexposure/default.asp).

- 10.114 We sought to obtain assurance that derivatives were used to manage and reduce existing risk for the Crown, as opposed to increasing the Crown's risk through speculation. We also wanted to assess whether the control environment surrounding derivative use was adequate.
- 10.115 Further, we sought assurance that the use of derivatives was within the parameters set out in the Crown Entities Act, the Public Finance Act, the Regulations, the Guidelines, and other relevant legislation.
- 10.116 Accordingly, we collected information from 165 public sector entities about:
- their exposure to foreign exchange, interest rate, or commodity price risk;
  - their use of derivatives to manage each risk mentioned above, including quantification of the value, volume, and type of the derivative instruments being used, and the entities' approach to managing the risks;
  - the controls, policies, and procedures in place surrounding derivative use – appointed auditors were asked to provide an overall assessment of the effectiveness of these controls, policies, and procedures;
  - departments' foreign exchange policy;
  - Crown entities' compliance with Part 4 of the Crown Entities Act and the associated regulations on derivatives; and
  - planning for, and implementation of, New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) – in particular, the new hedge accounting requirements introduced under NZ IAS 39.
- 10.117 The 165 public sector entities surveyed are classified in Figure 10.1.

**Figure 10.1**  
Classification of public sector entities

Entity type	Number of entities
Crown entity	95
Government department*	41
State-owned enterprise	20
Other entities**	9
Total	165

\* Includes Offices of Parliament.

\*\* Other entities are entities that do not legally or logically fall under one of the first three categories. They include the New Zealand Superannuation Fund (the Guardians of New Zealand Superannuation is a Crown entity), the Government Superannuation Fund (the Government Superannuation Fund Authority is a Crown entity), the Reserve Bank of New Zealand, Air New Zealand, New Zealand Government Property Corporation, Leadership Development Centre Trust, New Zealand Fish and Game Council, New Zealand Game Bird Habitat Trust Board, and Road Safety Trust.

10.118 In the rest of this Part, we summarise then discuss our findings from the information we collected, and provide suggestions as to how the control environment surrounding derivative use in the public sector can be further enhanced to decrease potential risk to the Crown.

## Findings and commentary

### Foreign exchange risk

- 10.119 Eighty-six entities we obtained information from have exposure to foreign exchange risk, which is the risk that an entity is exposed to when it enters into a transaction denominated in a currency other than its functional currency. Foreign exchange risk could arise, for example, from purchasing goods or services from an overseas location.
- 10.120 Of those entities with exposure to foreign exchange risk, 58 had entered into derivative transactions to mitigate that risk.
- 10.121 Although it was more common for State-owned enterprises (SOEs) (13) and other entities (4) to enter into derivative transactions to manage foreign exchange risk, a significant portion of both departments (16) and Crown entities (25) also used derivatives to manage foreign exchange risk.
- 10.122 Figure 10.2 shows the estimated typical value and volume of derivative transactions used by entities in managing foreign exchange risk.

**Figure 10.2**  
Value and volume of derivative use to manage foreign exchange risk

Estimated typical transaction value (\$)	Number of entities
0-5,000	3
5,001-100,000	11
100,001-1,000,000	22
1,000,001+	22
Total	58

Estimated number of transactions each year	Number of entities
0-20	33
21-100	14
101+	11
Total	58

- 10.123 Thirty-six entities entered into relatively low-value transactions (less than \$1 million for each transaction) that also happened to be low-volume (fewer than 100 transactions each year).
- 10.124 The remaining 22 entities had a typical transaction value of more than \$1 million. Of these 22 entities, 15 carried out a relatively low volume of transactions annually. The seven remaining entities had both an estimated typical transaction value of more than \$1 million, and entered into more than 100 derivative transactions each year. We consider these entities to be high users of foreign exchange derivative transactions. These entities included departments, an SOE, and other entities.
- 10.125 The relatively frequent use of larger value foreign exchange derivative transactions for particular entities is in line with our expectations. Without exception, the entities undertake transactions in foreign currency as part of their day-to-day operations. It therefore follows that they would be high users of derivative transactions to help manage their exposure to foreign exchange risk.
- 10.126 We noted no particular preference for one entity type to use foreign exchange transactions as a tool to manage foreign exchange risk. Rather, the activities and needs of the entity seemed to determine the level of use of foreign exchange derivatives.

#### **Instruments used**

- 10.127 The most common form of derivative instrument used to manage foreign exchange risk was forward foreign currency contracts, which were used relatively evenly by all entity types.
- 10.128 Forward foreign currency contracts are one of the two transaction types that departments are permitted to use under the Guidelines to cover foreign exchange exposure, the other being spot foreign exchange contracts.<sup>4</sup>
- 10.129 Forward foreign currency contracts are also one of the least complex forms of derivative transactions, and are therefore relatively easy to use.

#### **Risk management policy**

- 10.130 We sought information about entities' foreign exchange risk management policy. Information provided about such policies varied according to the size and nature of the business of the entity.
- 10.131 A common approach was for entities to hedge a certain percentage of individual purchases and/or commitments of more than a pre-set limit. For example, the Guidelines require departments to state the transaction exposure limit for each

<sup>4</sup> Spot foreign exchange contracts are used for not more than two-business-day settlement. This is used where a department needs to buy or sell currencies immediately (for example, to pay an invoice) – see paragraph 35(i) of the Guidelines.

individual currency, and says that the limit must not exceed \$100,000. Therefore, the policy could require hedging of all exposures of more than \$100,000.

- 10.132 We noted that many entities have differing limits for committed exposures and budgeted exposures, individual commitments and aggregate commitments, and types of transaction – for example, whether the exposure resulted from borrowing, capital expenditure, or operating expenditure.
- 10.133 Entities dealing frequently in currencies or with high levels of currency exposure have detailed hedging policies with specific details and limits relevant to the entity.

### Interest rate risk

- 10.134 Fifty-seven entities we obtained information from had borrowed or invested.
- 10.135 Twenty-nine entities had also entered into derivative transactions to manage the associated interest rate risk.
- 10.136 It was more common for entities to enter into derivative transactions associated with borrowing than investing.
- 10.137 Further analysis by entity type revealed that nine SOEs that had invested or borrowed also used derivative transactions to manage the associated interest rate risk. However, at the other end of the scale, only one department (the NZDMO) used derivative transactions for this purpose.
- 10.138 The frequent use of derivative transactions by SOEs was expected (more so than other types of entities), given that SOEs are required to operate successfully as profitable businesses in the same way as privately owned companies.
- 10.139 There are no laws or regulations that prevent an SOE from entering into derivative transactions. Accordingly, if an SOE Board sees the use of derivatives as supporting its quest to make a profit, then such instruments may be used by the SOE at its discretion.
- 10.140 Departments, on the other hand, have no ability, in their own right, to enter into derivative transactions, except in specific circumstances to manage their foreign exchange risk. This means we would expect to see less use of derivatives from this type of entity. As discussed above, the NZDMO is an exception.
- 10.141 Figure 10.3 shows the estimated typical value and volume of derivative transactions used by entities in managing interest rate risk.



**Figure 10.3**  
Value and volume of derivative use to manage interest rate risk

Estimated typical transaction value (\$)	Number of entities
0-5,000	-
5,001-1,000,000	1
1,000,001- 10,000,000	11
10,000,001+	16
Total	28

Estimated number of transactions each year	Number of entities
0-20	17
21-100	5
101+	6
Total	28

- 10.142 Entities with an estimated typical transaction value of between \$1 million and \$10 million were mostly Crown entities, and they generally enter into a low volume of transactions each year.
- 10.143 Sixteen entities had a typical transaction value of more than \$10 million. Most of these entered into a low volume of transactions each year, with only 6 of those 16 entities entering into more than 100 transactions annually. These entities included Crown entities, other entities, and the NZDMO. We consider these entities to be high users of interest rate derivatives.
- 10.144 The high users are in line with our expectations. They each have high levels of borrowing and/or investment, and derivatives are used as a tool to protect the entity from the interest rate risk associated with its borrowing and/or investment activities.

#### **Instruments used**

- 10.145 We noted that a range of derivative instruments are being used to manage interest rate risk, and that the most common are interest rate swaps. Interest rate options and forward rate agreements were also relatively common.

#### **Risk management policy**

- 10.146 We sought information about interest rate risk management policy. A common approach taken with respect to liabilities was the establishment of hedging ranges for different maturity profiles, for example:
- Hedge x% (say 50-100%) of exposures maturing within 12 months;

- Hedge x% (say 40-80%) of exposures maturing within 12-36 months; and
- Hedge x% (say 0-60%) of exposures maturing within 36-60 months.

- 10.147 A common way of managing interest rate risk on assets was using short-term investments (that is, less than 12 months) to enable the entity to take advantage of high interest rates and maximise interest income.
- 10.148 Some entities use derivatives (in this case, interest rate based) as part of their core business or as investment tools, as opposed to risk management tools. The investment managers' policies for these entities varied, but the derivative activity always operated within the pre-set investment guidelines in question to balance the portfolio and/or manage interest rate exposure.

### Commodity price risk

- 10.149 We obtained information on each entity's exposure to other forms of risk, such as commodity price risk, which is the risk an entity is exposed to from fluctuating commodity prices. Examples of commodities are electricity, gas, and various forms of metal.
- 10.150 Commodity price risk exposure was less prevalent, with only 32 entities having had exposure at some point. Eight of the entities had managed this risk through the use of derivatives.
- 10.151 Further analysis of these entities revealed that, of the eight, five (including three SOEs) used derivatives to manage risk on electricity prices.
- 10.152 As expected, none of the departments surveyed had undertaken commodity derivative transactions.
- 10.153 Figure 10.4 shows the estimated typical value and volume of derivative transactions used by entities in managing commodity price risk.

**Figure 10.4**  
Value and volume of derivative use to manage commodity price risk

Typical transaction value (\$)	Number of entities
0-5,000	3
5,001-1,000,000	4
1,000,001-10,000,000	-
10,000,000+	1
Total	8

Number of transactions each year	Number of entities
0-20	4
21-100	1
100+	3
Total	8

10.154 Apart from one entity that enters into fewer than 20 commodity derivative transactions each year with an estimated typical transaction of more than \$10 million, entities had transactions with a relatively low value (up to \$1 million). Three of those entities with low-value transactions – two SOEs and one other entity – entered into more than 100 commodity derivative transactions each year.

#### **Instruments used**

10.155 Options and swaps were the most commonly used derivative transactions. Futures were also used to manage commodity price risk.

#### **Risk management policy**

10.156 The approach that entities took to the management of commodity price risk varied according to the industry each entity operated in.

10.157 In all cases, hedging of commodity price risk was carried out to manage risk by providing certainty of costs associated with the operations of the entity.

#### **Derivatives policy and procedures**

10.158 Most users of derivatives had a separate derivatives policy in place.

10.159 This finding is encouraging, as a specific policy for derivative use mitigates the associated risk by providing entities with clear parameters to follow when entering into such transactions. Interestingly, 10 entities that had not used derivatives had a derivatives policy in place anyway.

10.160 The main themes we noted in the various policy documents included:

- clearly defined authorisation procedures;
- clear documentation of staff responsibilities surrounding the use of derivative instruments – with a focus on segregation of duties (which means the initiator of the transaction is separate from the person approving the transaction and the person responsible for settling the transaction);
- pre-set transaction limits, above which governing body approval is required; and
- the requirement for regular (say, monthly) reporting of all open derivative positions to the governing body and senior management.

- 10.161 However, we noted that four entities that were users of derivative transactions (all of them Crown entities) did not have a separate policy on derivative use. In most cases, the use of derivatives was limited to the purchasing of forward foreign exchange contracts of a minor nature that were executed under the general disbursements policy of the entity.
- 10.162 We expect all entities that use or plan to use derivative instruments to prepare and adopt a specific derivatives policy that clearly outlines individual responsibilities, controls, and procedures to be followed when entering into derivative transactions.
- 10.163 We assessed the effectiveness of the combined controls, policies, and procedures (where in place) of each entity on derivatives activity, as we consider that it is the environment in which derivatives are used, rather than the actual use of derivative instruments, that determines the level of risk an entity is exposed to.
- 10.164 As we expected, we found that the controls, policies, and procedures for derivative activity to be effective in most entities. However, we identified three instances where controls and procedures for derivative use were not as specific as we would expect, particularly around authorisation of derivative transactions. These three instances related to entities that had only a few minor derivative transactions. Nevertheless, we would expect these entities to make the necessary changes to improve their controls and procedures.

### Government departments – foreign exchange policy

- 10.165 We questioned departments about foreign exchange policy documents. We were interested first in whether, in line with the requirements of the Guidelines, departments had a foreign exchange policy document in place and, if so, whether the policy complied with the Guidelines.
- 10.166 Of the departments, 56% did have a foreign exchange policy. In the other 44%, the lack of a foreign exchange policy was because the departments in question did not enter into foreign currency transactions or, if they did, had minimal exposure that was immaterial. This is in accordance with the Guidelines.
- 10.167 We identified five instances where the foreign exchange policy document did not comply with the Guidelines, and had not been approved by the Minister of Finance and the responsible Minister. In three of these cases, non-compliance was because the document had not been updated to take account of updates to the Guidelines. The remaining two cases were because the document was silent in areas where the Guidelines are not silent. In one of these two cases, the policy document is in the process of being updated to include the missing information.

### Crown entities – compliance with the Crown Entities Act 2004

- 10.168 We were encouraged to see that all Crown entities surveyed, with the exception of one, were aware of, and in compliance with, the requirements of Part 4 of the Crown Entities Act and the associated regulations on derivatives. The one exception noted was minor in nature and is awaiting Ministerial approval.

### New Zealand equivalents to International Financial Reporting Standards – planning and implementation

- 10.169 For financial reporting periods beginning on or after 1 January 2007, all New Zealand reporting entities, including public sector entities, will be required to apply New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) when preparing their financial statements.
- 10.170 Applying NZ IFRS will result in a change to a number of current accounting policies, with a resulting effect on the financial statements.
- 10.171 One such change relates to hedge accounting.<sup>5</sup>
- 10.172 Hedge accounting is where the related changes in fair value of a financial asset or financial liability are offset against each other. To use hedge accounting, an entity must meet and follow specific criteria, particularly around documentation and effectiveness testing.
- 10.173 As the criteria are somewhat onerous, we were not surprised to find that 85% of the entities we surveyed were not intending to adopt hedge accounting under NZ IAS 39. Many of these entities simply did not use derivatives, and those that did foresaw the costs of adopting hedge accounting as being more than the benefits to be derived.
- 10.174 It was reassuring to note that the 24 entities that do plan to adopt hedge accounting also expect to satisfy the criteria for doing so for their first set of financial statements under NZ IFRS.

### Conclusions

- 10.175 We examined the level of derivative use and the related policies and procedures of entities in the public sector, and are satisfied that the management and use of derivatives reduce risk to the Crown.
- 10.176 Entities identified as high users of derivatives clearly have specific business purposes for doing so, which centre on managing risk.

<sup>5</sup> NZ IAS 39: *Financial Instruments: Recognition and Measurement*, paragraphs 71-102.

- 10.177 We looked at the control environment surrounding derivative use, and found that most entities have a clear and concise derivatives policy in place as part of an effective overall control environment surrounding derivative use.
- 10.178 We identified four instances where an entity was a user of derivatives but did not have a derivatives policy in place. We expect those entities to develop and implement a detailed policy to be followed when entering into derivative transactions.
- 10.179 There were three instances where entities did have a derivatives policy, but the surrounding procedures and controls when entering into derivative transactions were not specific enough. We expect these entities to update their policies and procedures.
- 10.180 We were encouraged to see that all departments that had entered into foreign currency derivatives had a documented foreign exchange policy.
- 10.181 Five departments identified with an out-of-date or non-compliant foreign exchange policy document should update their policy to bring it into line with the requirements of the Guidelines.
- 10.182 All Crown entities, with one minor exception, complied with Part 4 of the Crown Entities Act and the associated regulations on derivatives.
- 10.183 Finally, we were reassured to note that the 24 entities that plan to adopt hedge accounting under NZ IAS 39 expect to satisfy the criteria for doing so for their first set of financial statements under NZ IFRS.
- 10.184 Because of the onerous requirements surrounding the adoption of hedge accounting under NZ IAS 39, we encourage those entities to obtain assurance over their hedging relationships, documentation, and effectiveness testing well in advance of their first reporting date under NZ IFRS.

## Part 11

# Hazardous waste management in New Zealand

- 11.101 Hazardous waste poses a risk to people and the environment if it is not stored, transported, treated, or disposed of properly. Hazardous waste includes waste materials (liquids, gases, or solids) that are explosive, flammable, corrosive, toxic, radioactive, or infectious, and it comes from many sources (for example, households, industry, small businesses, school laboratories, and hospitals).
- 11.102 Hazardous waste management was the subject of a number of reports during the 1990s that noted a range of concerns about the hazardous waste management framework in place at the time. We considered it timely to review the progress that had been made in managing hazardous waste since those earlier reports.
- 11.103 Our review looked at:
- the current legislative and policy framework and central government activity; and
  - local government activity.

### Overall conclusions

- 11.104 The New Zealand approach to the management of hazardous waste has three distinct elements:
- A number of Acts, regulations, and bylaws potentially apply, but no overarching legislation governs hazardous waste.
  - Our hazardous waste management system relies heavily on policy (largely in the form of strategies and guidelines) to inform, educate, and persuade local government, hazardous waste generators, and operators of treatment facilities to better manage hazardous waste.
  - Numerous parties are responsible for the management of hazardous waste.
- 11.105 These characteristics mean there are certain risks associated with the current management framework. These include:
- potential for overlapping roles;
  - potential for the management of hazardous waste to be fragmented and inconsistent throughout the country;
  - lack of co-ordination between the various policies and programmes developed for managing hazardous waste; and
  - lack of reliable information on which to make decisions and evaluate performance, especially at the national level.

- 11.106 The issues for managing hazardous waste are well known, and have been for the past 15 years. Some action plans and work programmes have been identified to address or scope the issues further. It is timely for both central government and local government to resolve these issues with some urgency.

## Background

### What is hazardous waste?

- 11.107 A waste is considered hazardous if it presents some degree of physical, chemical, or biological hazard to people or the environment.
- 11.108 A wide range of industries, commercial activities, and households generate hazardous waste. The types of waste also vary. For example, they include:
- hazardous residues of waste material that may contaminate and persist in water and soil (for example, sludge from re-refining used oil that contains a variety of contaminants); and
  - hazardous residues that are released into the atmosphere as products of combustion (for example, dioxins).

### Environmental effects of inappropriate disposal of hazardous waste

- 11.109 Like other types of waste, hazardous waste can be managed in a number of ways. It can be stored, treated to reduce hazardous properties, or disposed of.
- 11.110 In some cases, hazardous waste can be processed and disposed of at the place where it is generated. However, it usually needs to be transported to other places for further treatment or disposal.
- 11.111 While some hazardous waste is disposed of to landfills, the majority is disposed of to water through the wastewater treatment system. Hazardous waste can also be disposed of to the air through controlled incineration or direct emission into the atmosphere.
- 11.112 *The State of New Zealand's Environment* report<sup>1</sup> prepared in 1997 noted:
- The scale of hazardous waste generation in New Zealand is only beginning to be understood. Potentially hazardous wastes are released into streams and estuaries from sewers and stormwater drains, into the air from chimneys and car exhausts, and onto land from many sources. An estimated 8 percent of the waste entering our landfills is potentially hazardous.*
- 11.113 Landfills are the final receptacle for some hazardous waste, both treated and untreated. Generally, the lower the design and operating standard of a landfill, the

<sup>1</sup> *The State of New Zealand's Environment*, Ministry for the Environment, 1997, ISBN 0-478-09000-5, [www.mfe.govt.nz/publications/ser/ser1997/](http://www.mfe.govt.nz/publications/ser/ser1997/).



greater the risk that hazardous waste residues will contaminate the environment and endanger staff working there and the public.

- 11.114 Some of the potential adverse effects of inappropriate disposal of hazardous waste to landfills include:
- emissions to the atmosphere of gases from waste deposited in the landfill (there may be fire and other associated risks);
  - contamination caused by hazardous waste products leaching into soil, groundwater, and surface water at the landfill and surrounding areas; and
  - dust emissions to the atmosphere through wind-blown particles.

### Previous reviews of hazardous waste management

- 11.115 Hazardous waste management was the subject of various reports during the 1990s.<sup>2</sup> These reports noted a number of concerns about the hazardous waste management framework in operation at the time. Most of these concerns related to the lack of basic building blocks for an effective hazardous waste management framework. The reports noted the lack of:
- a clear and consistently used definition of hazardous waste;
  - incentives to reduce hazardous waste at its source; and
  - reliable information on quantities of hazardous waste disposed of (and to where).
- 11.116 These reports also highlighted capacity and capability issues within local government in terms of the ability of staff to manage hazardous waste. They also identified inconsistencies in how local authorities classified and managed hazardous waste.

### The current legislative and policy framework – central government activity

- 11.117 New Zealand's hazardous waste management framework is based on a mix of legislation and regulation, policy (largely in the form of strategies and guidelines), and non-regulatory methods (such as best practice guidelines, public awareness activities, and voluntary programmes and partnerships). While legislation and regulation are tools that are widely used to achieve improved environmental outcomes, non-regulatory methods also play an important role in changing behaviour.

2 *OECD Environmental Performance Reviews – New Zealand*, 1996, "Conclusions and recommendations, New Zealand", available on [www.oecd.org](http://www.oecd.org); *Review of Overseas Approaches to the Management and Landfilling of Hazardous Waste, Volumes 1 & 2*, 1997 – a study of hazardous waste management in five overseas countries, commissioned by the Ministry for the Environment; *Hazardous waste management*, 1998, Parliamentary Commissioner for the Environment – see the reports section of [www.pce.govt.nz](http://www.pce.govt.nz).

### Resource Management Act 1991

- 11.118 The Resource Management Act 1991 (the RMA) provides the legal structure for environmental management and policy. Its purpose is to promote the sustainable management of natural and physical resources.
- 11.119 However, the RMA does not directly address waste management (including reducing the amount of waste produced). If there are no adverse effects, or the effects of waste production and disposal are mitigated, the RMA cannot require waste to be reduced through consents or rules within a regional or district plan. Rather, it controls the environmental effects of waste management facilities through local policy, plans, and consent procedures. In this role, the RMA exercises influence over waste disposal facilities, and has helped improve the standards of landfills and wastewater treatment plants. The RMA also provides for the development of national policy statements and for the setting of national environmental standards, which can be relevant to managing and minimising hazardous waste.
- 11.120 The RMA also provides for rules (which have the effect of a regulation) to be included by regional authorities in their regional plans and by territorial authorities in their district plans. In both instances, if the rule is inconsistent with a regulation, the regulation will prevail.
- 11.121 These rules may require a resource consent to be obtained for any activity that causes, or that is likely to cause, adverse effects not covered by the plan.
- 11.122 The RMA also provides for territorial authorities to control uses of land by district plan rules and conditions on land use consents. This enables territorial authorities to control activities that are likely to involve generating, storing, or disposing of hazardous waste on land (including on the surface of water in lakes and rivers).

### Hazardous Substances and New Organisms Act 1996

- 11.123 The purpose of the Hazardous Substances and New Organisms Act 1996 (the HSNO Act) is to protect the environment, and the health and safety of people and communities, by preventing or managing the adverse effects of hazardous substances and new organisms. Broadly, the HSNO Act establishes nationwide performance-based requirements by regulating all hazardous substances (including their disposal), based on the degree of hazard of each substance. These controls apply to all users in all places.
- 11.124 The HSNO Act also provides for group standards that allow for obligations and restrictions to be imposed on an identified group of hazardous substances or products (including waste products or manufactured by-products that incorporate

or include a hazardous substance). Compliance requirements will apply to a group by way of conditions, which may cover the storage, transport, and disposal of the hazardous waste.

### Other legislation

11.125 There are numerous other pieces of legislation that deal with some aspects of hazardous waste management.

11.126 This legislation includes the:

- Local Government Acts of 1974 and 2002;
- Agricultural Compounds and Veterinary Medicines Act 1997, which prevents or manages risks (to trade in primary produce, animal welfare, and agricultural security) associated with the use of agricultural compounds (for example, herbicides, fungicides, and 1080 and cyanide poisons);
- Building Act 2004, which states that building work is to be constructed to the standards of the Building Code (this includes minimising the risks of hazardous waste substances);
- Civil Aviation Act 1990, which promotes safe air transport, including transporting hazardous or dangerous goods;
- Customs and Excise Act 1996, which provides for New Zealand Customs Service controls at the border (this covers border movements of hazardous waste);
- Environment Act 1986, which ensures that the management of natural and physical resources takes account of their sustainability and the values of ecosystems (this includes considering the adverse effects of hazardous waste);
- Fire Service Act 1975, which protects life and property from fire and other emergencies, including those involving hazardous substances and waste;
- Gas Act 1992, which provides for the regulation, supply, and use of gas – a hazardous substance;
- Health Act 1956, which aims to improve, promote, and protect public health (this includes knowing about the adverse effects of hazardous waste); and
- Land Transport Act 1998.

### Policy framework and other guidance

11.127 The hazardous waste management framework in New Zealand incorporates a variety of policy mechanisms. For example:

- national policy statements, which can guide subsequent decision-making under the RMA at the national, regional, and district levels;
- regional policy statements and regional plans, prepared by regional authorities;

- strategic policy directions – for example, the Hazardous Waste Management Programme (a three-year programme announced by the Minister for the Environment in 1997) and the *New Zealand Waste Strategy* (a national waste management strategy developed jointly by the Ministry for the Environment (the Ministry) and Local Government New Zealand, which was launched in March 2002);
- a policy framework released by the Ministry in December 2005, guiding future policy development and identifying current policy gaps, which has recently been updated; and
- Ministry guidance on aspects of hazardous waste management, including landfill waste acceptance criteria and record keeping.

## Discussion and conclusions

### Legislative and policy framework

- 11.128 While the legislative framework for hazardous waste is complex, we are not convinced that it is comprehensive. The RMA does not directly address hazardous waste management, but rather controls the environmental effects of waste management facilities through local policy, plans, and consent procedures.
- 11.129 In future, changes to the HSNO Act<sup>3</sup> may address managing the storage, transportation, and disposal of hazardous waste. The HSNO Act now provides for group standards that could be used as a means of attaching compliance requirements to hazardous waste (over storage, transportation, and disposal). The Ministry advised us that the Environmental Risk Management Authority intended to produce group standards covering hazardous waste by the end of 2006. It is therefore too early to comment on the effect that these standards will have. These standards will be in addition to existing RMA controls on appropriate disposal.
- 11.130 Other Acts, regulations, and bylaws also regulate some aspects of hazardous waste. The current legislation and regulatory arrangements for hazardous waste are therefore complicated, and do not provide a clear framework to manage hazardous waste.
- 11.131 One of the objectives of the *New Zealand Waste Strategy* was to review the institutional and legislative arrangements to ensure a sound base for implementation of the *Strategy*. The Ministry was to report on the progress of this review by January 2003. The hazardous waste stocktake that developed into the hazardous waste policy framework fulfilled the objective of a review for hazardous waste.

<sup>3</sup> The Hazardous Substances and New Organisms (Approvals and Enforcement) Amendment Act 2005, which came into effect on 22 December 2005.

11.132 We are concerned that central government is not using the current legislative framework to the best advantage, in that it has not yet made full use of some provisions contained in existing legislation. For example, responsibility for environmental management and policy has been largely devolved to local authorities, which are responsible for achieving environmental standards that are suited to their communities and that address the specific needs of their communities. However, the lack of national policy statements and national environmental standards makes it difficult for local authorities to gauge how local environmental initiatives compare nationally and, from a national point of view, whether the local environment management initiatives are at least providing a minimum level of protection of public health and the environment.

11.133 In response to the target set in the *New Zealand Waste Strategy* of establishing an “integrated and comprehensive” national hazardous waste policy covering the reduction, transportation, treatment, and disposal of hazardous waste by December 2005, the Ministry released its policy framework in December 2005. The framework provides a good benchmark in that it identifies the policy elements that have been completed and those that are still under development. To get maximum benefit from a policy framework of this sort, the Ministry will need to ensure that it:

- completes the elements that are still under development;
- monitors local government and industry compliance with the framework; and
- assesses the effectiveness of the framework to guide future policy development.

#### **Lack of information**

11.134 A significant issue is the lack of information about the quantities and types of hazardous waste produced, and how this waste is being disposed of. This also means that there is not enough information to monitor the effectiveness of the hazardous waste management system at both the local level and national levels.

11.135 The effectiveness of the hazardous waste management system must be monitored to ensure that it is achieving the desired results.

11.136 In conjunction with other agencies, the Ministry has tried various initiatives during the past 10 years to monitor the state of the environment. However, none of these initiatives has been pursued on a permanent basis.

11.137 The Ministry has recently begun implementing environmental standards. We consider that it would be difficult to establish whether the standards are comprehensive and whether they have been set at the appropriate level without the state of the environment being monitored.

- 11.138 Development of the hazardous waste management framework (through standard-setting and other mechanisms provided by legislation) and monitoring the effectiveness of the framework need to occur together. For example, the *New Zealand Waste Strategy* contains targets for reducing the amount of hazardous waste, but the Ministry is not able to determine whether improvements are occurring because there is not enough baseline data.

### **Tracking**

- 11.139 Effective policy development and monitoring require reliable information on the types and quantities of hazardous waste generated and disposed of.
- 11.140 We are pleased to note that the Ministry is looking at introducing a system for tracking hazardous waste called WasteTRACK. This is a web-based system that tracks waste from generation to final disposal.
- 11.141 Local authorities have told us that, in their view, voluntary systems will not allow the collection of data that accurately represent the volumes and types of hazardous waste produced, treated, and disposed of within their region. Some local authorities consider that generators of waste who do not record the quantities and types of hazardous waste they produce are more likely to require compliance testing. However, the WasteTRACK system, because of its voluntary nature, is unlikely to identify such generators of waste.
- 11.142 Record-keeping and recording rates will not improve, nor become established practice, while they remain voluntary. The Ministry has advised us that trade waste bylaws and group standards are two mechanisms by which tracking of certain hazardous waste can be made compulsory.
- 11.143 We consider that, in addition to undertaking tracking, waste generators need to be better educated about hazardous waste, in that tracking will not necessarily fix the problem of waste generators being unaware that they are producing hazardous waste. Waste generators need to understand what hazardous waste is in order to track it.
- 11.144 The Ministry has advised us that it is still working with local authorities and industry on data collection (focused on solid waste disposal) through the *Solid Waste Analysis Protocol*<sup>4</sup> and other audit tools. Although the Ministry is confident that this collaborative approach will provide data on general waste, it may not provide data on hazardous waste, given that hazardous waste is only a small percentage of the total waste and is predominantly disposed of as trade waste.

## Local government activity

- 11.145 Local government, made up of regional and territorial authorities, has an important role in the hazardous waste management framework.
- 11.146 Broadly, the role of regional authorities is to:
- prepare regional policy statements and regional plans that establish objectives, policies, and rules controlling the discharge of contaminants into the environment, and monitor and enforce those rules; and
  - grant resource consents for the discharge of contaminants, and monitor the conditions of those consents.
- 11.147 Broadly, the role of territorial authorities is to:
- prepare district plans that establish objectives, policies, and rules controlling the effects of uses of land, and monitor and enforce those rules;
  - grant resource consents for uses of land, and monitor the conditions of those consents;
  - make bylaws regulating the deposit, collection, and transportation of waste, and also charge for the use of waste facilities provided, owned, or operated by them; and
  - prepare waste management plans.

## Regional policy statements

- 11.148 The RMA provides for regional councils to produce regional policy statements, and sets out what the regional policy statements must include. The RMA requires regional policy statements to give effect to national policy statements. However, apart from the coastal policy statement, no national policy statements have been issued.

## Joint regional initiatives

- 11.149 Some regional and territorial authorities are working, or have worked, on joint strategies to improve the management of hazardous waste in their regions and districts. Currently, the main initiatives are still focused on collecting and disposing of hazardous waste. Territorial authorities, either independently or as a joint initiative with other local authorities, provide for either a periodic collection or a drop-off facility for disposing of household hazardous waste. However, hazardous waste – for example, paint – is recycled where possible.

### Rules and resource consents

- 11.150 The RMA prohibits the discharge of contaminants into the environment (unless the discharge is expressly allowed by a rule in a regional plan, resource consent, or regulations), and hazardous waste may be classed as a contaminant.<sup>5</sup>
- 11.151 The RMA also has provisions for hazardous waste substances. It provides for regional authorities to control the use of land and territorial authorities to control any actual or potential effects of using, developing, or protecting land, including for the purpose of preventing or mitigating any adverse effects of storing, using, disposing of, or transporting hazardous substances.
- 11.152 The effectiveness of the rule-making process is determined by the quality of the regional and district plans. We were therefore concerned to note that the Ministry prepared a Cabinet paper in September 2004 that reported:
- Most, but not all, regional councils had regional plans.
  - The quality of these plans varied considerably.
  - Some local authorities had spent a lot of time producing detailed plans that did not provide certainty or the environmental outcomes desired by the community, and were difficult to interpret or did not reduce the need for consent applications.
  - Fewer than half of the district plans required to be produced under the RMA had been completed and were operational.

### Monitoring

- 11.153 The RMA requires every local authority to monitor and keep records on:
- the state of the environment, to the extent necessary for the local authority to carry out its RMA functions;
  - the effectiveness and efficiency of policies, rules, or other methods in its policy statement or its plan; and
  - the exercise of the resource consents that have an effect in its region or district and, where necessary, to take appropriate action.
- 11.154 We understand that some local authorities (for example, Auckland Regional Council, Environment Bay of Plenty, and Environment Waikato) have conducted surveys to determine how much hazardous waste is being generated in their regions.

<sup>5</sup> A contaminant is defined as any substance (including gases, liquids, and solids) that, when discharged either by itself or in combination with other substances, is likely to change the physical, chemical, or biological condition of the land, water, or air onto or into which it is discharged.



## Discussion and conclusion

- 11.155 New Zealand has adopted a hazardous waste management system that relies heavily on policy, and gives local authorities a wide degree of autonomy to develop “local solutions for local needs”. We were therefore not surprised to find different approaches to managing hazardous waste within local government. While different approaches are acceptable, we note that, because of the lack of an overall national framework, local authorities give different priority to hazardous waste management depending on their particular circumstances. For example, some local authorities are energetically managing hazardous waste, whereas others – for a variety of reasons (for example, lack of resources, knowledge, or expertise) – have much scope to improve their performance.
- 11.156 Establishing joint strategies and initiatives between regional and territorial authorities is one way in which hazardous waste management can be improved at a local level. We saw examples of, and encourage, this type of co-operation.
- 11.157 At a local level, the RMA gives regional and territorial authorities wide powers to make rules (which have the force and effect of regulations) through their regional and district plans. However, it does not require those plans to address waste management in general and hazardous waste management in particular, apart from requiring the plans to state the local authority responsible for specifying the objectives, policies, and methods for controlling the use of land to prevent or mitigate the adverse effects of storing, using, disposing of, or transporting hazardous substances. The RMA covers only hazardous waste substances and the environmental effects of the release of contaminants (which may include hazardous waste). The RMA has no mechanisms that would avoid or minimise the creation of hazardous waste.
- 11.158 There needs to be rigorous monitoring to ensure that objectives, policies, and rules set out in the regional and district plans are actually operating effectively, and, if not, that the policies can be developed so that this does happen.
- 11.159 We note that the definition of hazardous waste drafted by the Ministry<sup>6</sup> should address previous concerns about a wide range of definitions being adopted and applied among local authorities. The lack of a national definition was identified as a major weakness of the hazardous waste management system in New Zealand in a number of earlier reports. For example, in 2002, the Ministry noted:<sup>7</sup>

*Current definitions of hazardous waste are done at a local level, and vary significantly throughout the country. Some wastes that are typically regarded as*

<sup>6</sup> Module 1 of the Ministry for the Environment’s guidance for managing hazardous waste at [www.mfe.govt.nz/publications/waste/haz-waste-guide-mod1-jun02/html/index.html](http://www.mfe.govt.nz/publications/waste/haz-waste-guide-mod1-jun02/html/index.html).

<sup>7</sup> Ministry for the Environment, *Policy Instruments for Waste Management in New Zealand – A Background Document to Implementation of the New Zealand Waste Strategy*, 30 September 2002.

*hazardous are labelled “special wastes” and continue to be disposed of in unlined refuse dumps. Liquid hazardous wastes are often tipped into stormwater drains, or dumped to sewer without a discharge permit.*

- 11.160 A national definition should ensure that hazardous waste is managed more consistently by local authorities. It will also mean that data on the type and quantities of hazardous waste collected will be comparable between local authorities as well as within the same local authority over time.
- 11.161 However, we consider that the draft definition alone will not decrease the likelihood that hazardous waste generators will unwittingly release hazardous waste or contaminants into the environment. Several studies undertaken in New Zealand suggest that a number of hazardous waste generators have a poor understanding of what hazardous waste is (especially in smaller industries).
- 11.162 Local authorities will need to educate waste generators about:
- the composition of the waste they produce;
  - regional and district plan conditions; and
  - resource consent requirements.
- 11.163 Ongoing information on both the type and quantity of hazardous waste produced is critical to the effective management of hazardous waste. Local authorities need to consider how best they can capture trends and data on hazardous waste volumes.

## Part 12

# Overview of the Defence Sustainability Initiative

- 12.101 In May 2005, the Government announced the \$4.6 billion Defence Funding Package. This is a 10-year programme of additional funding for the Ministry of Defence (the Ministry) and the New Zealand Defence Force (NZDF).
- 12.102 The Defence Sustainability Initiative (the Initiative) is a major component of the Defence Funding Package, and is aimed at rebuilding the NZDF and the Ministry by addressing shortages in personnel, equipment, and management capability.
- 12.103 The Auditor-General is interested in the Initiative because there is a significant level of funding involved, and because it aims to improve the performance of the Ministry and the NZDF.
- 12.104 In this Part, we set out the background to the Initiative, its main objectives, and the arrangements for monitoring and reporting progress. We also provide an outline of progress to date and the risks to achieving the Initiative's objectives.
- 12.105 The objective of this Part is to provide Parliament with an overview of the most important aspects of the Initiative, and to indicate the Auditor-General's ongoing interest in this subject. We have not done an audit, and this Part does not draw conclusions about the performance of the Initiative to date. To write this Part, we have discussed the Initiative with staff of the Ministry and the NZDF, and have relied on formal NZDF reporting for factual information.

### Background to the Defence Sustainability Initiative

- 12.106 The NZDF provides the Government with a range of military options that can be called on in response to unknown future security events. The NZDF's accountability documents set out the range of Army, Navy, and Air Force options (such as frigates, Special Air Service troops, or transport aircraft) that the Government requires, and report whether the NZDF has maintained enough personnel and equipment (quantity) at the required level of preparedness (quality) to do the tasks required.
- 12.107 In recent years, the NZDF has not been able to fully deliver the outputs set out in its accountability documents. This has been as a result of shortfalls in military and organisational capability (particularly because of declining personnel numbers), as well as a high number of active deployments.<sup>1</sup>
- 12.108 Since 2001, the Government has committed additional capital and operational funding to the Ministry and the NZDF. The Government's Defence Policy Statement of June 2000 announced that the NZDF would be reshaped and rebuilt to meet policy objectives, and that there would be a related capital investment programme for acquiring and upgrading essential equipment. Additional capital

<sup>1</sup> During the period from 1999 to 2007, NZDF personnel have been deployed to areas such as East Timor, the Solomon Islands, Afghanistan, Iraq, and Tonga.

funding is allocated towards the projects that are most important for achieving the Government's defence policy objectives (such as new vehicles for the Army or new ships for the Navy) through the Long Term Development Plan (LTDP).<sup>2</sup>

- 12.109 The Government Defence Statement, dated 8 May 2001, made a commitment of additional operating funding to provide the NZDF with financial certainty. In late 2003, the Government commissioned the Defence Capability and Resourcing Review (DCARR) to identify the operational resourcing required for the NZDF to be able to successfully deliver its outputs. The review also looked at management systems and capability in the NZDF and the Ministry. The main findings of the DCARR, issued in 2005, were:
- Personnel numbers in the three services and in the NZDF Headquarters were below the levels required, and could not be rapidly increased to the required levels.
  - The number and trained state of personnel in some trades was deficient.
  - Some major weapons platforms were not yet aligned with the Government's intentions, although the LTDP is intended to address this.
  - Some military equipment (other than major weapons platforms) was below the required standard.
  - Contingency reserve stocks were depleted.
  - There was a backlog of maintenance and capital expenditure in the defence estate,<sup>3</sup> which could not be fully addressed in the short term.
  - Aspects of corporate management capability were depleted.
- 12.110 The DCARR recommended a major improvement in strategic planning, resourcing of NZDF initiatives to improve corporate management, and an upgrade of the Ministry's policy capability.
- 12.111 The Initiative is a programme of work designed to address the DCARR's findings and recommendations.

### Objectives of the Defence Sustainability Initiative

- 12.112 The Defence Funding Package was announced as part of Budget 2005. It totals \$4.6 billion for the 10-year period to 2014/15. It includes \$4.4 billion in additional operating expenditure for the NZDF, a permanent \$0.844 million baseline increase for the Ministry, and \$209 million in extra capital funding for the LTDP. The extra capital is additional to the \$1 billion for major capital projects allocated to the NZDF through the LTDP.

<sup>2</sup> The LTDP was first released in 2002 with a 10-year timeframe. It committed about \$1 billion dollars in capital injections for major new equipment and infrastructure (such as new vessels for the Navy). In 2006, this figure was increased to \$1.3 billion.

<sup>3</sup> The "defence estate" refers to the various real estate holdings of the NZDF.

- 12.113 There are three main phases to the Defence Funding Package – the “foundations” phase (currently under way), the “construction” phase (2008-10), and the “consolidation” phase (2010-15).
- 12.114 The objectives for the foundations phase are:
- recruiting and retaining personnel;
  - developing corporate capability;
  - implementing Project Protector;<sup>4</sup>
  - reviewing the optimal configuration of the Army; and
  - maintaining current levels of operational capability.
- 12.115 The objectives for the construction phase are:
- eliminating the backlog of deferred maintenance and expenditure;
  - recruiting and retaining personnel;
  - implementing the future structure of the Army;
  - restoring the defence estate;
  - developing military and corporate capability; and
  - increasing levels of operational capability.
- 12.116 The objectives for the consolidation phase are:
- creating depth of talent in personnel;
  - consolidating Air Force operations at Ohakea;
  - upgrading the defence estate;
  - extending corporate capability;
  - consolidating increased levels of operational capability; and
  - rebalancing the NZDF to achieve simultaneous operations.
- 12.117 The Initiative addresses those areas of the Defence Funding Package associated with addressing personnel shortages and issues of personnel retention, rebuilding corporate capability in the NZDF and the Ministry, and improving defence management systems and processes.
- 12.118 In June 2005, the NZDF comprised about 10,600 military and civilian personnel. Through the Initiative, the NZDF expects to increase personnel numbers by at least 1600 over a 10-year period (a 15% increase), as well as reduce rates of personnel turnover.
- 12.119 The Initiative is also intended to increase levels of operational readiness in the NZDF. To assess these levels, the NZDF has developed a system of measuring and scoring the readiness of its various outputs. This Operational Preparedness

4 “Project Protector” is a major capital acquisition under the LTDP that involves acquiring new vessels for the Navy.

Reporting System (OPRES), measures the NZDF's ability to perform its main operational roles. The OPRES score is underpinned by assessments of the NZDF's actual or predicted readiness, combat viability, ability to prepare for deployment within a specified time, and sustainability.

- 12.120 The first full year of the Initiative was 2005/06. The specific objectives for that year were to:
- identify, design, and implement improved organisations, systems, and processes for managing and developing NZDF capability;
  - enhance the Ministry's ability to conduct policy analysis and provide purchase advice; and
  - begin to address the immediate military and organisational capability priorities outlined in the Initiative.

## Monitoring and oversight of the Defence Sustainability Initiative

- 12.121 There have been two phases of governance over the Initiative. A temporary governance structure was set up to cover the implementation phase during the 2005/06 financial year. This was set up to see that new management systems and processes were developed and integrated into normal business.
- 12.122 From July 2006, the existing defence governance framework has overseen the Initiative. This is supplemented by specific arrangements for monitoring performance, and includes input from the central agencies.<sup>5</sup>
- 12.123 The original plans for the Initiative included a number of milestones for formal progress reports to Ministers. Since the Initiative was introduced, the Ministry is co-ordinating some additional evaluation work.

### Governance arrangements during the implementation of the Defence Sustainability Initiative

- 12.124 The Defence Sustainability Initiative Steering Group provided governance over the implementation phase of the Initiative. This was a joint committee that reported to the Ministers of Defence, Finance, and State Services (the joint Ministers). The Steering Group included the Chief of Defence Force (as chairman), the Secretary of Defence, and representatives from the Department of the Prime Minister and Cabinet, the State Services Commission (the SSC), and the Treasury.<sup>6</sup>

<sup>5</sup> The central agencies include the Department of the Prime Minister and Cabinet, the State Services Commission, and the Treasury.

<sup>6</sup> The Defence Sustainability Initiative Steering Group was also attended by the Vice Chief of Defence Force, the Deputy Secretary of Defence Policy and Planning, the NZDF Chief Financial Officer, and the Chiefs of the Army, Navy, and Air Force.

- 12.125 The Vice Chief of Defence Force (representing the NZDF) and the Deputy Secretary of Defence Policy and Planning (representing the Ministry) were the project directors of the Initiative. It was their role to monitor the progress of implementation and report back to the Defence Sustainability Initiative Steering Group.
- 12.126 A project team was established to co-ordinate the implementation of the Initiative. The team was headed by an NZDF project manager and included representatives from the NZDF, the Ministry, the Treasury, and the SSC. The role of the team was to identify the planning, performance management, systems, and structures needed to ensure that the Initiative's objectives were achieved, and to implement the necessary systems and processes.
- 12.127 The project team reported regularly to the project directors, who in turn reported to the Defence Sustainability Initiative Steering Group on close to a monthly basis. The deadline for the implementation phase of the Initiative was 30 June 2006. The Defence Sustainability Initiative Steering Group met for the final time on 28 June 2006.

### Ongoing governance of the Defence Sustainability Initiative as of 30 June 2006

- 12.128 With the dissolution of the Defence Sustainability Initiative Steering Group, the NZDF Executive Leadership Team<sup>7</sup> now has overall responsibility for monitoring the progress of the Initiative and directing the allocation of the Initiative's resources. The Ministry's Senior Management Team oversees areas that are specific to the Ministry, such as the project to enhance the Ministry's purchase advice.
- 12.129 The NZDF General Manager Organisational Support has been designated as the Initiative programme sponsor, and is now responsible for overseeing the ongoing Initiative programme and for co-ordinating major Initiative projects. The newly established NZDF Planning Branch is responsible for routine monitoring of progress against the 10-year Initiative targets. This information is reported to the NZDF Executive Leadership Team and to the Government. The central agencies retain a monitoring role through quarterly progress reports and meetings organised by the programme sponsor.

<sup>7</sup> The NZDF Executive Leadership Team is chaired by the Chief of Defence Force, and includes the Chiefs of the Army, Navy, and Air Force, as well as the General Manager Organisational Support, the Vice Chief of Defence Force, Commander Joint Forces, and the Corporate Finance Officer.

### Formal reports on Defence Sustainability Initiative progress

- 12.130 In addition to ongoing monitoring and reporting activities through the governance framework, there are formal reporting milestones for the Initiative. There were specific milestones for the implementation phase to 30 June 2006, and other milestones for the 10-year Initiative as a whole. Other external reviews and evaluations are planned or are already under way.
- 12.131 The first three milestone reports covered the implementation phase of the Initiative. The first report was made to the joint Ministers in June 2005, and addressed the planned changes to management systems and structures. This was followed by a progress report to the joint Ministers in November 2005.
- 12.132 The final report to joint Ministers for the implementation phase to 30 June 2006 summarised performance against Initiative targets for personnel numbers, retention rates, and levels of operational readiness. It also provided an update on the projects under way to improve the organisational capability of the defence agencies.

### Milestone reports from July 2006 onwards

- 12.133 With the integration of the Initiative into the defence agencies' normal business, progress reports are provided to the inter-agency group that meets quarterly to monitor the Initiative.<sup>8</sup> The joint Ministers will receive an annual Initiative update report during the Budget process, as the funding allocated to the Initiative forms part of the yearly appropriation to Vote Defence Force. In addition, the Minister of Defence is updated on Initiative progress in quarterly reports from the Chief of Defence Force. The accountability documents of the NZDF and the Ministry both include references to the Initiative, and the NZDF Annual Report for 2006 includes a report on Initiative progress.
- 12.134 The original Initiative timetable envisaged some major reports at important milestones. As the Initiative has developed, some additional reviews have been added. Major reports or reviews under way or scheduled include:
- a Ministry Evaluation Division report on the status of the Initiative's organisational capability projects, due to the Minister of Defence in early 2007;
  - a report on Initiative progress, due in November 2007;
  - a major mid-term review of Initiative progress, due in the 2009/10 financial year; and
  - a final completion report, due in the 2014/15 financial year.

<sup>8</sup> This inter-agency group comprises essentially the same membership as the Defence Sustainability Initiative Steering Group with the exception of the three Service Chiefs.



## Progress towards Defence Sustainability Initiative objectives

- 12.135 As at November 2006, the NZDF reported that it has met or exceeded aggregate personnel recruitment and retention targets for the Initiative. However, it has also reported that increasing the level of operational readiness has not been as successful. It reports that this is primarily because there are more operational deployments than were assumed for the purpose of planning the Initiative.

### Expenditure on the Defence Sustainability Initiative

- 12.136 The NZDF's current Statement of Intent reports that, in line with the original forecast Initiative funding, \$86.9 million was committed to the Initiative in its first full year (2005/06). The latest figures provided to us by the NZDF show that, of this sum, \$16.6 million was allocated to the NZDF's continuing contribution to Operation Enduring Freedom in Afghanistan, another \$4.7 million to fund allowances for operationally deployed personnel, and \$5.214 million to operating costs associated with Project Protector. This left a balance of \$59.763 million available for the Initiative in 2005/06. Of this balance, the NZDF's latest figures show that the largest funding allocations were \$25.2 million for pay and allowances, \$13.3 million for recruiting additional personnel, \$7.9 million for capability purchases, \$8.1 million for real estate, and \$4 million for enhancing corporate capability.
- 12.137 The NZDF Statement of Intent also reports that the estimated allocation for the Initiative in 2006/07 was \$72.8 million, again in line with the original forecast. The latest figures provided to us by the NZDF indicate that \$14.936 million was transferred to fund operationally deployed forces, leaving a balance of \$57.825 million available for the Initiative in 2006/07 for which finalised figures are not yet available.
- 12.138 For the purposes of this Part, we have not audited the breakdown of Initiative funding into its component parts. However, in our view, it is important that it be clear how the Initiative funding has been allocated, and we intend to carry out future audit work in this area.

### Personnel recruitment and retention targets

- 12.139 The Initiative aims to increase the overall number of defence personnel by at least 1600 in the 10-year period. Annual targets have been set for achieving this increase, and to date the NZDF has reported to Ministers that it has met those targets. At 1 June 2005, there were 10,602 military and civilian personnel employed in the defence agencies. The 30 June 2006 target under the Initiative was to increase this figure to 11,135.

- 12.140 The NZDF reported that, by 30 June 2006, it had exceeded its overall personnel target by seven. This included recruiting 165 more personnel than expected to the NZDF Headquarters and to the Army, and 141 fewer personnel than expected to the Navy and Air Force. The NZDF has reported to Ministers that, as at September 2006, the overall targets for recruitment were still being achieved, with total personnel numbers up to 11,254, and that the Army, Navy, and Air Force were closer to meeting their individual targets.
- 12.141 The NZDF reports that the new personnel are a mix of new recruits and experienced personnel. Some experienced personnel have chosen to re-enlist, while others have been “laterally recruited” from overseas (typically from the United Kingdom). The NZDF considers that, while these individuals are two to three times more expensive than new recruits, they bring experience that would otherwise take several years to develop.
- 12.142 The NZDF reports that improvements to pay and conditions have assisted in retaining staff. The NZDF reported to Ministers that, between September 2005 and September 2006, turnover rates dropped, and that the NZDF is on track to meet or exceed its targets for 30 June 2007. Figure 12.1, taken from the NZDF report to joint Ministers in December 2006, illustrates this performance.

**Figure 12.1**

**Rates of personnel turnover since the Defence Sustainability Initiative was introduced**

	30 September 2005	30 September 2006	Target 2006/07
Navy	13.8%	11.8%	12.5%
Army	19.0%	15.0%	14.5%
Air Force	9.0%	8.5%	10.0%

### Operational readiness targets

- 12.143 The Initiative has a scale and series of annual operational readiness targets based on the NZDF’s OPRES system. Specific OPRES scores and targets for operational readiness are classified information, and are not included in this Part. However, the NZDF expects to make a substantial increase in overall levels of operational readiness as a result of the Initiative.
- 12.144 As at December 2006, the NZDF was not achieving its overall OPRES targets. NZDF OPRES reporting for each of the individual services shows that, while the Navy and the Air Force are meeting their readiness targets, the Army is not. The NZDF has reported to Ministers that this is primarily because the Army continues to be deployed beyond the levels planned for the initial period of the Initiative. This

means that the NZDF's current operational deployments are affecting its ability to meet its Initiative targets.

### Developing corporate capability

- 12.145 During the implementation phase of the Initiative to 30 June 2006, the NZDF identified a range of projects that it considered necessary for developing its corporate capability. Many of these, such as developing a new NZDF Strategic Plan, were scheduled to be completed and integrated into the NZDF's normal business by 30 June 2006.
- 12.146 Of the organisational capability projects that were initiated within the NZDF Headquarters, some have been delivered, others have merged with other projects or been superseded, and others remain in progress. To deliver these projects, the NZDF has made structural changes by setting up the Planning Branch and the Organisational Support Branch. The NZDF reported to Ministers in November 2006 that the bulk of the Initiative projects had been completed and that the outstanding projects were on schedule to be completed in 2007.
- 12.147 Each project has a plan for its transition to normal business, and a project sponsor who has responsibility for managing milestones. The General Manager Organisational Support has responsibility for ongoing major projects. The Initiative projects have been prioritised and grouped into tiers according to their priority.
- 12.148 The NZDF has reported that the main results for the highest priority items in Tier 1 as at November 2006 are:
- The Interim Strategic Plan was completed by June 2005. The subsequent NZDF Strategic Plan 2007-11 is due to be completed by the end of March 2007. Strategic planning within the Army, Navy, and Air Force is now aligned with overall NZDF strategy.
  - An interim Corporate Planning Framework is in place. The project ends in June 2007.
  - The Organisational Structure Review has been completed, and its implementation is due to be reviewed in December 2007.
  - The new NZDF Corporate Planning Branch was established in November 2005.
  - An interim Defence Performance Management System is in place. It provides performance information on achievement of the NZDF Strategic Plan. The project ends in June 2007.
  - The Strategic Human Resource Planning Framework project has been completed.

- Human Resource Capability: Recruitment and Retention initiatives are under way.

12.149 The main results for the high priority items in Tier 2 as at November 2006 are:

- The rewrite of the Capability Management Framework is complete. It will be amended to include the relevant recommendations of the Defence Capital Asset Management Practice Review completed in October 2006.
- The Risk Management Framework project is on time, and is due to be completed in May 2007. Risk management training is under way.
- Phase 1 of the Information Management and Exploitation project is under way. New systems will be incorporated into the new Defence Headquarters building.
- A draft Defence Estate Strategic Plan is in place. The timing of future major real estate decisions and opportunities for efficiency gains have been identified.
- After the provision of policy guidance from the NZDF Executive Leadership Team, the Housing and Accommodation Assistance project is due to be reported back to the NZDF Executive Leadership Team in March 2007.
- The Army Configuration Review project has been completed and reported to the Minister of Defence. The Army is now preparing an Army Transformation Plan to implement the configuration review.
- Defining the nature and protocols of the Ministry's purchase advice role is due to be completed in March 2007.

12.150 The main results for the lower priority items in Tier 3 as at November 2006 are:

- The Knowledge Management Framework project is being reconsidered and refocused to position the NZDF as "a knowledge edge force". It is due to be completed in December 2007.
- The Management of Shared Functions project has been incorporated into the NZDF Efficiency and Innovation Programme that is currently in its design phase.
- The New Strategy and Capability Analysis Team has been set up.

## Risks to achieving the Defence Sustainability Initiative objectives

12.151 In June 2006, the NZDF identified a risk to achieving the Initiative's objectives. This was that conclusion of the Initiative's implementation phase and dissolution of the Defence Sustainability Initiative Steering Group would have a detrimental effect on progress. The NZDF has reported to Ministers that this risk has been successfully mitigated by introducing a new framework to oversee the Initiative and report to the NZDF Executive Leadership Team.

- 12.152 As at November 2006, the NZDF had identified two significant risks to achieving the Initiative's objectives that have not yet been successfully mitigated. The first of these is because of the ongoing operational commitments beyond those originally agreed with the Government. The NZDF considers it likely that the level of operational activity will remain high, as was highlighted in 2006 with deployments to the Solomon Islands and East Timor in response to unrest in those countries. It has reported to Ministers that these commitments will slow the recovery of the NZDF under the Initiative programme. The mitigation strategy suggested by the NZDF is that the effect on the Initiative's objectives be considered when taking deployment decisions.
- 12.153 The second area of risk relates to pressures on operating costs. The NZDF has reported to Ministers that the funding package for the Initiative was based on 2004 costs and has been affected by inflation, the competitive labour market, exchange rate fluctuations, and increasing fuel and ammunition costs. The NZDF reported that it will be difficult to manage cost pressures over the medium term, despite introducing cost-saving measures and other mitigation strategies.

### **Future involvement of the Auditor-General**

- 12.154 The Auditor-General intends to monitor the progress of the Initiative through the annual audit and through our regular liaison activities with the NZDF and the Ministry. Areas of particular interest include the allocation of annual funding increases, and the outcome of the various scheduled reports and reviews of the Initiative (detailed at paragraphs 12.128-12.134).
- 12.155 We will keep Parliament informed of progress on the Initiative through our briefing to the Foreign Affairs, Defence and Trade Committee during the annual financial review process, and the Initiative will be included in our annual Strategic Audit Planning process to identify appropriate topics and timing for discretionary audit work, such as a performance audit.
- 12.156 We look forward to seeing how the Initiative develops through its life. It is a major investment of public funds and has important objectives for the future of the NZDF. We are particularly interested in observing the continuing organisational development of the NZDF, and how the benefits of the Initiative in this area will be measured.

# Publications by the Auditor-General

Other publications issued by the Auditor-General recently have been:

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- Performance of the contact centre for Work and Income
- Residential rates postponement
- Allocation of the 2002-05 Health Funding Package
- Advertising expenditure incurred by the Parliamentary Service in the three months before the 2005 General Election
- Inland Revenue Department: Performance of taxpayer audit – follow-up audit
- Principles to underpin management by public entities of funding to non-government organisations
- Ministry of Education: Management of the school property portfolio
- Local authority codes of conduct
- Housing New Zealand Corporation: Effectiveness of programmes to buy and lease properties for state housing
- Local government: Results of the 2004-05 audits – B.29[06b]
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