Central government: Results of the 2011/12 audits
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Auditor-General’s overview

This report presents the aggregate results from our audits of central government entities for 2011/12. I also present in-depth results of our audits of government departments, Crown entities, and State-owned enterprises. We have already published our reports on Crown research institutes, local government, and the education, transport, and health sectors.

I have also included a section examining the use of memorandum accounts by central government entities, as well as an analysis of the financial statements of entities in the sector.

My auditors issued 481 audit reports in the central government portfolio. Of these, 400 were standard and 81 were non-standard. Three reports included emphasis of matter paragraphs that drew attention to uncertainties associated with the effects and recovery from the Canterbury earthquakes. We also drew attention to uncertainties associated with the response to the oil spill from the grounding of the container vessel MV Rena, as well as uncertainties arising from structural changes in a range of organisations. We issued adverse opinions for two public entities and qualified the opinions on the financial or non-financial information of eight entities. The reasons for these opinions are detailed in this report.

As the analysis of our environment and systems controls grades in this report shows, the management controls and financial systems controls of both government departments and Crown entities continue to strengthen. And I am pleased to see that the positive momentum towards better reporting of non-financial performance continues across the sector.

Change and consolidation has been a feature in the central government portfolio. We carried out final audits for four government departments that were disestablished with effect from 1 July 2012 and amalgamated to form the new Ministry of Business, Innovation and Employment. During our audits of these entities, we considered the monitoring and control environment, paying particular attention to the risk of fraud and errors; the appropriate treatment of assets, liabilities, and provisions; and compliance with relevant legislation. We also monitored financial prudence around severance, redundancy, and retention payments. Overall, I am pleased to report that the four disestablished entities maintained sound systems and controls until their disestablishment.

We have noticed that, in an environment of fiscal constraint, some departments are considering alternative revenue streams to fund service delivery, including cost recovery through user charges for some services. In 2011/12, non-tax revenue
from departments was $7.5 billion. This is an area I intend to watch closely, and my staff will be working with entities to ensure that they understand the requirements and guidelines for setting charges and fees for public services. Part 11 describes some of the main memorandum accounts that record the accumulated surplus or deficit arising from these types of third-party funding of services.

Our audit of the Government’s financial statements showed that there is uncertainty in estimating the costs associated with the recovery from the Canterbury earthquakes. Our report also included consideration of the accounting for KiwiRail after the Government’s decision to restructure KiwiRail and create a new company called KiwiRail Holdings Limited. I am satisfied that the accounting treatment was appropriate, and I am pleased that the accounting for metropolitan-only rail infrastructure means that the recent financial investment made by the Government is not written off in the Government’s financial statements, which is good for accountability.

I am pleased to report that almost all government expenditure during 2011/12 was authorised by appropriations in the usual way. However, there were 17 instances of expenditure that were not authorised. In 12 instances, the Government had spent more than was authorised. In total, this amounted to over $262 million. The biggest individual instance was just over $175 million, which was incurred by Canterbury Earthquake Recovery Authority. This arose from the Government’s decision to extend the red zone offer to owners of 285 severely at risk or largely destroyed houses in the Port Hills area of Christchurch.

There were five instances where expenditure was outside the scope of, or without any, appropriation. This amounted to a total of $10 million, mostly associated with expenditure related to the Canterbury recovery. I continue to encourage departments to pay close attention to whether they have authority before incurring expenditure.

The State Sector and Public Finance Reform Bill is before the Finance and Expenditure Committee. The proposed changes to the Public Finance Act 1989 are intended to improve financial flexibility and provide more meaningful information to Parliament about what the Government is spending and achieving. My Office has been consulted on those aspects of the reforms that affect public sector accountability, and my staff have been providing advice to the select committee while it has been considering the Bill.

This report also highlights changes to financial reporting in New Zealand, which introduce a new multi-standards approach. This new approach recognises that financial and non-financial information should meet the information needs
of users of financial reports, so financial reporting standards will now be more tailored to particular classes and sizes of entities. Broadly, I support these changes. They provide a sound platform for financial reporting by public benefit entities in the public sector. However, the changes do not resolve all the issues with financial reporting, and my staff will continue to contribute to work aimed at strengthening financial reporting in the public sector.

Lyn Provost
Controller and Auditor-General
15 April 2013
Part 1
The operating environment of central government

1.1 Last year, we reported that public entities in the central government sector were faced with a challenging environment, with pressure to reduce operating costs while improving levels of service delivery. We also noted greater collaboration and cross-agency working, and greater outsourcing of public service delivery to non-government organisations. In 2011/12, we observed similar challenges and trends for public entities, including a focus on:

- fiscal constraint;
- ongoing change and reform;
- priorities;
- more leadership from the three “central agencies”;
- greater collaboration across sectors and between entities;
- more emphasis on medium- and long-term planning;
- recovery and rebuilding after the Canterbury earthquakes;
- managing information and communication technology (ICT) and security issues; and
- outsourcing of service delivery.

Fiscal constraint

1.2 Public entities are operating under ongoing fiscal constraint. At the same time, the public and the Government expect that public services will be more effective and easier to access.

1.3 The Financial Statements of the Government of New Zealand for the year ended 30 June 2012 (the Government’s financial statements) reported $84 billion of revenue and expenditure of $93 billion, resulting in a deficit of $9 billion. The Government has a target to reduce the deficit and return to surplus in 2014/15.¹

1.4 The 2012 Budget included few increases in expenditure, with most entities expected to operate within existing and, in some cases, reduced levels of funding. Public entities are also experiencing increasing costs, particularly insurance costs. In its Half Year Economic and Fiscal Update, the Treasury forecast that:

> With this forecast pace of growth [in government spending] lagging behind that of overall [Gross Domestic Product, or GDP], government spending on goods and services’ share of real GDP falls from 18.5% at present to 16.7% in the June 2017 quarter.²

¹ New Zealand Treasury, Half Year Economic and Fiscal Update, 18 December 2012.
1.5 Within this context, public entities are seeking new and improved ways of delivering public services so that services continue to improve without increases in expenditure. These include:

- more collaboration between entities to address complex, long-term social and economic issues;
- greater use of providers from the private and non-government sectors to deliver services; and
- initiatives to improve the efficiency of back-office services across entities, such as through shared services arrangements and all-of-government procurement.

**Ongoing change and reform**

1.6 There was extensive change to public entities in the central government sector during 2011/12, with a range of initiatives to improve performance, effectiveness, and efficiency.

1.7 In November 2011, the Government’s Better Public Services Advisory Group (the Advisory Group) reported that New Zealand’s public services:

- respond reasonably well to Ministers’ needs;
- provide reasonable services to citizens;
- are trusted to be impartial and ethical; and
- can respond well in times of crisis.³

1.8 However, the Advisory Group’s report also described significant scope for improvement in the system and capacity of public services. In particular, it noted scope for:

- greater focus on results;
- strengthened leadership; and
- more focus on improvement, innovation, and value for money.

1.9 The State Services Commission (SSC) led a review of the findings from individual departments’ Performance Improvement Framework (PIF) reviews. It found that, although public entities are generally strong in delivering the Government’s immediate objectives, there are weaknesses in resolving longer-running issues.⁴ On the basis of its analysis, the SSC will be looking for departments to improve their capability to:

- provide robust policy advice that stands the test of time;

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• develop a stronger understanding about the relationship between expenditure and the effect of that expenditure, which requires having better information on the effectiveness of programmes and services, and using that information to make investment and improvement decisions;
• work across agency boundaries to improve outcomes; and
• manage people better to more effectively communicate the vision, develop appropriate cultures and capability, and manage poor performance.

1.10 In response to the Advisory Group’s report, the Government has begun a wide-ranging programme of reforms to the public sector, including some proposals for legislative changes that are now being scrutinised by Parliament.

1.11 The State Sector and Public Finance Reform Bill includes proposals for legislative amendments to the State Sector Act 1988, the Public Finance Act 1989, and the Crown Entities Act 2004. With these reforms, the Government intends to:
• encourage government agencies to work more closely together;
• support government agencies to share functions and services, and purchasing of goods and services;
• provide for greater financial and reporting flexibility; and
• promote stronger leadership across the public service.5

1.12 A range of structural changes were implemented in 2011/12, most notably the creation of the Ministry of Business, Innovation and Employment (MBIE) by bringing together the functions of the Department of Building and Housing, the Department of Labour, the Ministry of Economic Development, and the Ministry of Science and Innovation. During 2011/12, other departments continued to implement new systems and structures as a result of previous changes, mergers, and transitions. These included the Department of Internal Affairs (DIA) and the Ministry for Primary Industries.

1.13 This ongoing and extensive change presents risks to management and financial control environments in entities. We found that, in the context of such change, entities were mostly managing risks to their core systems and controls reasonably well. However, we advised continued vigilance as agencies continue their change programmes and embed new systems and processes. We will continue to focus on how these risks are being managed in our 2012/13 audits.

5 New Zealand Government, Pre-introduction Parliamentary Briefing.
A focus on priorities

1.14 The Government has established four main priorities for the public sector. These are to:

- responsibly manage government finances;
- build a more productive and competitive economy;
- deliver better public services within tight financial constraints; and
- rebuild Christchurch.6

1.15 In March 2012, the Prime Minister also announced the establishment of 10 “Key Result Areas” that are grouped under the five themes of:

- reducing long-term welfare dependency;
- supporting vulnerable children;
- boosting skills and employment;
- reducing crime; and
- improving interaction with government.

More leadership from the State Services Commission, the Treasury, and the Department of the Prime Minister and Cabinet

1.16 The SSC, the Treasury, and the Department of the Prime Minister and Cabinet (the central agencies) are working more closely together with the intention of becoming more like a corporate head office.7

1.17 These agencies have also joined up their “back office” functions, such as ICT support, finance, payroll, and human resources, into the Central Agencies Shared Services (CASS).

1.18 The Government has made arrangements for “functional leadership” in three areas of government business activity: property, ICT, and procurement (see Figure 1). The aim of these arrangements is to achieve more efficiency across entities, improve service delivery, develop expertise and capability across entities, and ensure business continuity.

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The operating environment of central government

Part 1

1.19 To address the Government’s priorities and targets, public entities are working collaboratively. New governance arrangements are being implemented to support working across sectors and between entities.

1.20 For example, in the justice sector, the Ministry of Justice, Department of Corrections, New Zealand Police (the Police), Serious Fraud Office, Crown Law Office, and Ministry of Social Development (for youth justice) are working together to reduce crime and numbers in the “criminal justice pipeline”. In 2012, this collaboration was formalised with the establishment of a Justice Sector Leadership Board comprising the Chief Executives of the Ministry of Justice, the Police, and the Department of Corrections.
More emphasis on medium- and long-term strategic planning

1.21 There is more focus on medium- and long-term planning. Entities are now required to prepare four-year plans. This is a joint SSC and Treasury initiative that replaces the previous requirement to submit separate four-year Budget plans and workforce strategies. Four-year plans combine, in one document, a discussion of strategic direction, medium-term delivery, financial planning, organisational capability, and workforce strategy. Four-year plans are aimed at providing Ministers and the central agencies with a clear view of an agency’s:
- medium-term strategy;
- financial performance; and
- workforce.

1.22 Four-year plans are also aimed at providing Ministers with a more comprehensive picture of how agencies and sectors intend to deliver government priorities, and reducing reporting requirements on agencies.

The recovery and rebuild after the Canterbury earthquakes

1.23 Rebuilding after the Canterbury earthquakes is one of the Government’s four main priorities, and it therefore remains a strong feature of the work of many public entities. In our report *Roles, responsibilities, and funding of public entities after the Canterbury earthquakes*, we noted the complex nature of the recovery and rebuild, and identified the risks and challenges for public entities involved in the recovery. Our report stressed the importance of good co-ordination among all those involved.

1.24 For the public sector, the financial consequences of the earthquakes are still uncertain. The cost to the Crown is likely to be more than $13 billion.

1.25 Because of the uncertainties with the eventual net costs of the Canterbury earthquakes, our appointed auditors included “emphasis of matter” paragraphs in the audit reports for the Canterbury Earthquake Recovery Authority (CERA), the Earthquake Commission (EQC), Southern Response Earthquake Services Limited (Southern Response, formerly AMI Insurance Limited), and the Government’s financial statements.
Managing information and communication technology and security issues

1.26 In line with government priorities, public entities are increasingly employing digital technology to deliver public services. ICT has become essential for delivering many of these services, such as collecting taxes, paying benefits, and recording land titles.

1.27 Within DIA, the Government Chief Information Officer (GCIO) is accountable for leading more effective use of ICT across agencies by implementing the Government’s programme of projects, Directions and Priorities for Government ICT. The GCIO also advises on the use of all-of-government ICT, such as the use of cloud computing and all-of-government ICT procurement.

1.28 Effective use of ICT can reduce costs and help meet what people and businesses expect in their dealings with government. Two of the 10 outcome targets in the Better Public Services for New Zealanders (BPS) initiative (results 9 and 10) are related to delivering services in a digital environment. By 2017, the target is to deliver about 300% more digital service interactions with the public than there are now.

1.29 In addition, the Service Transformation Programme (led by the Office of the Government Chief Information Officer) aims to design and build public services around customer needs rather than around the structure of government agencies. This programme includes more than 20 different public entities that cover about 90% of citizens’ transactions with government.

1.30 In June 2012, we published a report describing six public sector projects that used technology as a means of delivery (Realising benefits from six public sector technology projects). We identified six themes and lessons from the projects:

- understanding the environment and making the most of circumstances;
- using a business-led, flexible, and agile approach;
- having strong support from leaders and senior managers;
- working effectively with the right people, including end users;
- using the right technology tools; and
- monitoring and understanding the benefits.

1.31 Ageing ICT legacy systems remain a concern for public entities. In our information services audit assurance work, we have found that, generally, entities are aware of the risks associated with older ICT systems and are taking step to mitigate these risks.
1.32 Mergers between departments have also created challenges, particularly in integrating systems from entities that have been operating independently for a number of years. If ICT systems are not successfully merged, there is a risk that anticipated efficiency savings may not be realised as soon as forecast or at all.

1.33 The unintentional release of data about more than 6500 Accident Compensation Corporation clients in March 2012, and the information breach of the Ministry of Social Development’s kiosks, highlighted the importance of good controls, risk management, and governance around the use of information. Greater cross-agency working, particularly in case management, is testing the public sector’s approach to handling private information, and the shift towards greater use of cloud computing also raises risks with information management that will need careful management.

**Outsourcing of service delivery**

1.34 The increasing trend towards outsourcing the delivery of services continued. This included piloting different ways of delivering public services, such as the Social Sector Trials (specifically for youth services) and contracting for outcomes (for social services more widely), the Whānau Ora programme, and more use of the private sector in general.

1.35 Greater contracting and commissioning of services can require more relationship-based approaches and developing mutual capability to deliver outcomes. This may require different types of skills for public servants.
Part 2
Our audit of the Government’s 2011/12 financial statements

2.1 In this Part, we report the results of our audit of the Government’s financial statements and discuss the significant matters arising from this audit. These matters relate to:
- the Canterbury earthquakes;
- the restructuring of New Zealand Railways Corporation (KiwiRail);
- fewer homeowners entering the scheme to help fix leaky homes;
- reviewing accounting policies for recognising tax revenue;
- reviewing how state highway and rail networks are valued;
- changes related to the Kyoto Protocol and the Emissions Trading Scheme;
- the Government’s investment in ultra-fast broadband;
- the Government’s Treaty of Waitangi settlement obligations;
- accounting for goodwill (for Air New Zealand and other entities); and
- inaccurate reporting of commitments.

Our audit report

2.2 The Auditor-General issued the audit report on the Government’s financial statements on 28 September 2012.

2.3 The audit report appears on pages 30 to 32 of the Government’s financial statements. It includes our audit opinion that those statements:
- comply with generally accepted accounting practice in New Zealand; and
- fairly reflect:
  - the Government’s financial position as at 30 June 2012;
  - the results of the Government’s operations and cash flows for the year ended 30 June 2012; and
  - the Government’s borrowings as at 30 June 2012, and unappropriated expenditure, expenses, or capital expenditure incurred in emergencies, and trust money managed by the Government, for the year ended on that date.

2.4 As was the case in 2010/11, our audit report emphasised the uncertainties in the Government’s financial statements because of the Canterbury earthquakes.

2.5 The most significant effects of the earthquakes related to:
- EQC;
- the support package for Southern Response;
- the Canterbury residential red zone support package; and
• the Government’s share of local authority costs in response to the earthquakes and its share for restoring local authority infrastructure damaged by the earthquakes.

2.6 We drew readers’ attention to:
• the inherent uncertainties involved in estimating EQC’s and Southern Response’s earthquake-related outstanding claims liabilities and reinsurance receivables, using actuarial assumptions;
• the inherent uncertainties involved in estimating the provision and associated insurance recoveries resulting from the Government’s offer to purchase properties in the Canterbury residential red zone, using actuarial assumptions; and
• the high level of uncertainty associated with the Government’s share of costs for restoring local authority water infrastructure damaged by the earthquakes.

2.7 In our view, the disclosures in the Government’s financial statements about the uncertainties related to the Canterbury earthquakes are adequate.

Significant matters arising from the 2011/12 audit

Continuing uncertainties because of the Canterbury earthquakes

2.8 The costs associated with the Canterbury earthquakes are again significant to the Government this financial year, and there is still a lot of uncertainty associated with many of the cost estimates included in the Government’s financial statements.

2.9 We were satisfied that:
• the effects of the Canterbury earthquakes have been appropriately recognised and disclosed in the Government’s financial statements; and
• the Government’s financial statements provide a clear overview of the effects of the Canterbury earthquakes.

2.10 The most significant effects of the earthquakes related to insurance claims managed by EQC and Southern Response and the obligations managed by CERA. These obligations are the Canterbury residential red zone support package and the Government’s share of costs for restoring local authority infrastructure damaged by the earthquakes.

2.11 In Note 30 of the Government’s financial statements, the Treasury disclosed the uncertainties related to the Canterbury earthquakes. In related notes, it disclosed details about the assumptions and the sensitivities of the assumptions. The Treasury has also completed an analysis to ensure that the major assumptions for
EQT, Southern Response, and CERA have been consistently applied and that the base data used is comparable.

2.12 Note 30 describes:

- the inherent uncertainties involved in estimating EQC’s and Southern Response’s earthquake-related outstanding claims liabilities and reinsurance receivables, using actuarial assumptions;
- the inherent uncertainties involved in estimating the provision resulting from the Government’s offer to purchase properties in the Canterbury residential red zone, using actuarial assumptions; and
- the high level of uncertainty associated with the Government’s share of costs for restoring local authority infrastructure damaged by the earthquakes.

2.13 We considered it essential to draw readers’ attention to these uncertainties in the audit report issued on the Government’s financial statements, given the significance of the effects of the Canterbury earthquakes to the Government’s financial statements.

2.14 Note 30 also includes the total costs of the earthquakes to the Crown based on the best information available when the Government’s financial statements were prepared. Costs of $11 billion have been recognised in 2010/11 and 2011/12.

2.15 Although the net costs are less for the Government this financial year – $1.9 billion compared with $9.1 billion last year – in some respects, the uncertainties have increased. For example:

- the provision for the Crown’s contribution to local authority infrastructure costs is based on a report that includes a margin of error of plus or minus 25%; and
- the risk margin for EQC’s outstanding claims has increased to 14.3% from 10.4% last year.

Accounting for the Government’s share of costs to repair Canterbury infrastructure assets

2.16 Under the Civil Defence Emergency Management Plan and Guide, the Government has an obligation to provide financial support for response and recovery costs after a local or national emergency. This includes up to 60% of the recovery costs arising from natural disasters for water infrastructure assets (freshwater, stormwater, and waste water) and river management systems owned by local authorities.

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2.17 Last year, a liability was not recognised in the Government’s financial statements because the uncertainties were too great to reliably estimate a provision. However, although significant uncertainties still remain, both CERA and the Treasury considered that a provision could be reasonably estimated this year.

2.18 CERA’s approach to calculating the liability was to work with the four local authorities involved – Christchurch City Council, Waimakariri District Council, Selwyn District Council, and Environment Canterbury – to determine the costs that they expect to recover from CERA. For Christchurch City Council, which has the most significant damage, the best available information at the time of our audit was a September 2011 report. The estimates were detailed enough to identify the Government’s potential contribution to Christchurch City Council’s costs. The costs are still to be confirmed, and it was difficult to assess the extent of damage to underground assets. These uncertainties contributed to Christchurch City Council estimating a margin of error on its estimates of plus or minus 25%.

2.19 Despite the level of uncertainty, we were comfortable that an estimate has been made and an amount recognised for the Crown’s obligation for recovery of local authority water infrastructure in Canterbury.

**Accounting for the Government’s share of future costs to repair local roads in Canterbury**

2.20 The current year’s earthquake costs do not include costs associated with the future repair of local roads in Canterbury. These costs were excluded because the first call for funding these future expenses will be from dedicated ring-fenced revenue in the form of road user charges, fuel excise duties, and registration fees paid to the New Zealand Land Transport Fund. Should the Government’s share of the costs associated with the future repair of local roads in Canterbury exceed the amount available from that ring-fenced revenue, the Government has several options to allocate future revenue to fund this expense. The Crown’s share of the costs for local roads in Canterbury remains uncertain, as is the range of funding options available to the Government.

2.21 The Crown has agreed to meet its share of the cost for repairing Canterbury roads above the $50 million for each year that the New Zealand Transport Agency has agreed to fund from the New Zealand Land Transport Fund. Although the Government has yet to fully consider its options for providing additional funding, the two options being assessed would result in the costs being ultimately funded through the New Zealand Land Transport Fund.

2.22 Based on the known information on the Government’s funding decisions to date, we were satisfied that it is appropriate to continue to not recognise a liability (because future repair costs are expected to be met by future funding).
Accounting for the rail assets as a result of a Government announcement about restructuring KiwiRail

2.23 KiwiRail is a State-owned enterprise and therefore expected to be a profitable business. However, KiwiRail has not been profitable in the past and has required a lot of investment from the Government. As a result, for financial reporting purposes, KiwiRail has been designated as a public benefit entity. This has meant that its assets have been valued on the basis of their service potential rather than the net cash flows the assets could generate.

2.24 The Government has been looking at what changes could be made to KiwiRail to turn it into a profitable business. We were asked to look at draft proposals for the restructure of KiwiRail. There were two main parts to the restructure:
  • New Zealand Railways Corporation would continue to hold the 18,000 hectares of rail network land, from which no financial return would be expected; and
  • KiwiRail’s freight, passenger, and ferry businesses, including rolling stock, rail infrastructure, and plant and equipment, would be transferred to a new State-owned enterprise, KiwiRail Holdings Limited, which would be expected to be profitable during the medium to long term.

2.25 The KiwiRail Board asked for our opinion on whether it would be appropriate for KiwiRail Holdings Limited to account as a profit-oriented entity if the proposed restructure proceeded. We found this a challenging matter to consider, and it took us some time to work it through. It was challenging and time consuming because:
  • on one hand, the Government wanted to restructure KiwiRail to create a profit-oriented business that owns the entire rail network; and
  • on the other hand, the Government is committed to using the part of the rail network that provides metropolitan passenger services in Auckland and Wellington to provide benefits to the community, including reduced congestion and reduced travel times, regardless of the profitability of that part of the network.

2.26 If we agreed that KiwiRail Holdings Limited could account as a profit-oriented entity, the assets of KiwiRail Holdings Limited would be valued on the basis of the net cash flows those assets could generate. This was expected to result in a very significant impairment to the value of the assets.

2.27 We advised the KiwiRail Board in April 2012 that, although KiwiRail Holdings Limited would be an entity with mixed objectives (because it would incorporate both metropolitan and freight rail infrastructure), on balance we accepted that the Board designating KiwiRail Holdings Limited as a profit-oriented entity was not unreasonable but marginal.
2.28 The main considerations in reaching that view were:

- although the intentions of the shareholder, the Board, and management were clearly aligned, it was difficult to assess how realistic those intentions were over the medium to long term;
- as an asset-intensive business, KiwiRail Holdings Limited would continue to incur significant renewal and replacement capital expenditure, which would need to be appropriately accounted for;
- KiwiRail Holdings Limited is more than a commercially focused freight business— it has responsibility for significant metropolitan infrastructure assets; and
- the rail infrastructure assets (metropolitan and freight) represent a significant asset management challenge for KiwiRail Holdings Limited irrespective of how those assets are valued.

2.29 We noted concerns that:

- a very significant recent financial investment in a public good asset (metropolitan rail infrastructure) would effectively be written off and dilute accountability for those assets; and
- it would not sit comfortably that KiwiRail Holdings Limited was a commercially focused business if, in future years, much of what would normally be accounted for as capital expenditure needed to be expensed.

2.30 We noted the importance of continuing to reassess the appropriateness of KiwiRail Holdings Limited continuing to account as a profit-oriented entity.

2.31 On 27 June 2012, the Government announced the restructure referred to in paragraph 2.24. This resulted in KiwiRail providing for impairing the value of the rail assets, based on the expected cash flows that the assets would generate for KiwiRail Holdings Limited. The provision for impairment of the rail assets reflected by KiwiRail in its financial statements was $7.1 billion.

2.32 When it came to the Government’s financial statements, it was important that the rail assets were accounted for in keeping with the Government’s underlying drivers for the different parts of the rail network.

2.33 As a result, the part of the rail network that provides only metropolitan passenger services (the metropolitan-only rail infrastructure) has been accounted for on a different basis in the Government’s financial statements than in KiwiRail’s financial statements. KiwiRail treated the assets on a purely commercial basis because that was consistent with the Government’s expectations of KiwiRail Holdings Limited generating a commercial return from the use of the rail network.
2.34 However, in the Government’s financial statements, the metropolitan-only rail infrastructure has continued to be accounted for on the basis of the service potential provided by those assets rather than the net cash flows they could generate. This is because, despite the Government’s expectations of KiwiRail, the primary purpose for the metropolitan-only rail infrastructure at an all-of-government level is a public benefit purpose, such as reduced congestion on roads and reduced travel times, rather than the Government generating a commercial return from those assets.

2.35 The different accounting treatment of the metropolitan-only rail infrastructure in the Government’s financial statements has resulted in these assets being valued $0.5 billion higher than they were in KiwiRail’s own financial statements. Therefore, the provision for impairment of the rail assets reflected in the Government’s financial statements was $6.6 billion. That total amount reflects an impairment of the rail network of $6.3 billion and an impairment of other rail assets, such as rolling stock, of $0.3 billion.

2.36 Of the $6.6 billion total impairment provision, $4.9 billion was accounted for by writing it off against the revaluation reserve. The balance of $1.7 billion was treated as an expense in the Government’s financial statements.

2.37 We were satisfied that the carrying value of the rail assets in the Government’s financial statements was appropriate and that the impairment provision of $6.6 billion was appropriately accounted for. We are also pleased that the accounting treatment of the metropolitan-only rail infrastructure means that the recent financial investment in those assets is not written off in the Government’s financial statements, providing some degree of accountability.

2.38 We note that further work needs to be carried out during 2012/13 to ensure that all rail infrastructure assets used for both the freight business and metropolitan passenger services (dual-use assets) are necessary for the freight business. We expect that those assets that are not necessary for the freight business will be valued on the same basis as the metropolitan-only rail infrastructure in the Government’s financial statements, rather than on the basis of expected cash flows.
Other matters from the audit

Significant decrease in the Government’s provision for repairing leaky homes

2.39 We were satisfied that the provision of $189 million for the Government’s weathertightness financial assistance scheme was appropriately recognised and disclosed in the Government’s financial statements. The provision has decreased significantly from the 2010/11 valuation of $567 million.

2.40 After a year’s experience of operating the financial assistance scheme, the underlying assumptions were modified. The most significant modification was to the take-up rate by affected homeowners entering the scheme. In calculating the provision this year, it has been assumed that 3544 homeowners will enter the scheme compared with the 2010/11 assumption of 11,040.

2.41 There is still considerable uncertainty about the assumptions used in measuring the provision because of the limited claims experience to date. The three most critical assumptions used in measuring the provision are the number of eligible homes, the take-up rate for the scheme, and the average cost of repair. However, we were satisfied that the nature of the uncertainties and the sensitivities of the assumptions have been satisfactorily disclosed in the Government’s financial statements.

Discount rates used for valuing long-term liabilities

2.42 We were satisfied with the discount rates and consumer price index (CPI) assumptions used to value the Government’s significant long-term liabilities.

2.43 We reviewed the Treasury’s table of risk-free discount rates and CPI assumptions as at 30 June 2012 and concluded that they had been determined in keeping with the Methodology for Risk-free Discount Rates and CPI Assumptions for Accounting Valuation Purposes\(^\text{10}\) (the Methodology) and that they were appropriate for the Government to use.

2.44 We followed up our observations from the review we carried out last year, and we were satisfied with the outcome. We will continue to monitor these observations next year because they may be subject to future technical developments or different market conditions.

The review of accounting policies for tax revenue recognition

2.45 We were satisfied that the recognition of taxation revenue under current policies materially complies with generally accepted accounting practice. However, in previous years, we have suggested that a thorough review of taxation revenue
recognition policies be carried out with a view to fine-tuning the recognition of taxation revenue, where appropriate. This is an important review because of the complexities involved and the potential effect on the way the Government recognises its tax revenue.

2.46 The Inland Revenue Department (Inland Revenue) is currently part-way through reviewing its Crown revenue accounting policies and methodologies for each of the main tax types it administers: PAYE, GST, and income tax (for individuals and companies). The PAYE and GST components were completed during 2011/12, and the income tax component is expected to be completed in 2012/13. It was originally planned that a review of all three tax types would be completed by December 2011.

2.47 The overall conclusion from the completed reviews of PAYE and GST was that the current accounting policies and methodologies were reliable and fit for purpose. However, to improve the accuracy of estimations, some enhancements to year-end processes were agreed. The enhanced processes have been implemented in the Government’s financial statements.

2.48 In addition to the above, we also noted that Inland Revenue needs to strengthen the robustness of its year-end processes. This year, a late year-end adjustment of $109 million, which related to a tax case that has been in dispute for several years, decreased the estimated recoverable amount of a tax receivable.

2.49 We have recommended that the Treasury closely monitor the progress of the income tax component of the review. It will be important that the review is completed within the revised time frame to enable early consideration of any potential changes to revenue recognition policies, their financial reporting effect, and disclosure requirements (if any) in the Government’s 2012/13 financial statements.

Review of the approach to valuing the state highway and rail networks

2.50 During 2011/12, the Treasury commissioned a review of the valuation approach to network assets, including the state highway network and the rail network. The purpose of the review was to determine whether consistent methods were being applied and, if not, whether differences between methods reflected differences in substance between the state highway and rail networks.

2.51 As a result of the review, the Treasury decided to classify all land into a new asset class rather than retain it within each of the networks as a component.
In 2010, we recommended that the New Zealand Transport Agency (NZTA) review the reasonableness and validity of the assumptions used in the methodology to value state highways and update the valuation methodology to incorporate “brownfield”\textsuperscript{11} costs, such as the cost of traffic management.

We have agreed to continue discussions about these costs to determine the appropriateness of making any adjustments to future state highway valuations. Unfortunately, work to date has not provided reliable enough information to adjust the state highway valuation for such costs.

**Changes to the net position under the Kyoto Protocol**

Under the Kyoto Protocol, New Zealand is committed to reducing its average net emissions of greenhouse gases during 2008-12 (the “first commitment period”) to 1990 levels or to take responsibility for the difference.

The best estimate of New Zealand’s position under the Kyoto Protocol at 30 June 2012 was a net asset of $202 million (based on 35.4 million forecast surplus tonnes of emission units at a carbon price of NZ$5.70 for each unit). In 2010/11, the net asset was $291 million (based on 21.8 million forecast surplus tonnes of emission units at a carbon price of NZ$13.31 for each unit).

Although surplus units have increased by 13.6 million, the value of the Kyoto Protocol asset has decreased. This is primarily because of the significant drop in the carbon price.

We were satisfied that the estimated asset of $202 million has been recognised in keeping with accounting standards. However, there is a degree of uncertainty with the asset because fluctuations can occur in forecast surplus emission units and the carbon price.

The Ministry for the Environment is considering the valuation implications of a second commitment period (beyond 2012). However, no liability for periods beyond 2012 has been recognised in the Government’s financial statements because New Zealand currently has no specific obligations.

There remains uncertainty about what international agreements will come into effect after 2012. This creates uncertainty about the future use and value of any surplus emission units held by public entities. We have accepted that the market takes this uncertainty into account in determining a price for emission units and that this is reflected in the year-end net asset.

\textsuperscript{11} “Brownfields” in the NZTA context are where highways have been built through built-up areas, resulting in movement of buildings and services.
Reduction of the Emissions Trading Scheme provision

2.60 The Emissions Trading Scheme was set up to encourage a reduction in New Zealand’s greenhouse gas emissions. It currently operates in the forestry, stationary energy, industrial processes, and liquid fossil fuels sectors. No new sectors entered the Emissions Trading Scheme during 2011/12. Waste and synthetic gases entered the Emissions Trading Scheme on 1 January 2013.

2.61 We were satisfied with the accounting treatment and disclosures in the Government’s financial statements for the Emissions Trading Scheme provision of $375 million. The Emissions Trading Scheme provision has reduced from $612 million as at 30 June 2011 to $375 million as at 30 June 2012. The main reason for the reduction is the significant drop in the carbon price, which was offset to some extent by an increase in the number of New Zealand units.

2.62 We note that there is currently no authoritative guidance on accounting for the Emissions Trading Scheme and that the International Accounting Standards Board project on emissions trading is on hold. Therefore, the current accounting policy may be subject to change.

Accounting issues associated with the Government’s investment in ultra-fast broadband

2.63 We were satisfied with the accounting treatment for the investments by Crown Fibre Holdings Limited (Crown Fibre Holdings) in local fibre companies and Chorus Limited (Chorus).

2.64 Crown Fibre Holdings has been established to manage the Government’s $1.5 billion investment in ultra-fast broadband infrastructure. Crown Fibre Holdings has established three local fibre companies and entered into agreements with Chorus to progress the Government’s ultra-fast broadband initiative.

2.65 The nature of the local fibre companies’ arrangements presents some challenging accounting issues. Crown Fibre Holdings has reviewed the control status of the three local fibre companies and determined that, on balance, they are currently controlled by Crown Fibre Holdings for accounting purposes. Therefore, the three local fibre companies have been consolidated in Crown Fibre Holdings’ and the Government’s financial statements. Private sector partners also have shares in each of the local fibre companies, which means that a non-controlling interest is also accounted for in Crown Fibre Holdings’ and the Government’s financial statements. The control status of each of the local fibre companies will need to be carefully considered in future years as the share ownership mix of the local fibre companies’ changes and the network build nears completion.
Accounting for the Government’s Treaty of Waitangi settlement obligations

2.66 We were satisfied that the Crown’s obligations as a result of relativity clauses in two previous Treaty of Waitangi settlements have been appropriately accounted for and disclosed in the Government’s financial statements. That includes disclosure of an unquantifiable contingent liability for payments that may be required under the relativity clauses.

2.67 The deeds of settlement negotiated with Ngai Tahu and Waikato-Tainui included relativity clauses. The clauses provide that, when the total redress amount for all historical Treaty settlements exceeds $1 billion in 1994 present-value terms, the Crown is liable to make payments to maintain the real value of Ngai Tahu’s and Waikato-Tainui’s settlements as a proportion of all Treaty of Waitangi settlements.

2.68 We will continue to liaise with the Ministry of Justice and the Treasury on this issue.

Accounting for goodwill

2.69 We were satisfied that the balance of goodwill from the Crown’s acquisition of Air New Zealand (Air NZ) has been appropriately accounted for.

2.70 The Crown continues to recognise goodwill of $258 million from the Air NZ acquisition, which is tested for impairment annually. An impairment loss must be recognised if the recoverable amount of the Air NZ investment (the higher of value-in-use and fair value less costs to sell) is less than its carrying amount, including goodwill.

2.71 The Treasury prepared a model to calculate value-in-use using inputs (such as revenue growth rates) provided by Air NZ. The value-in-use model produced a valuation that showed goodwill was not impaired.

2.72 During the year, New Zealand Post Group acquired Gareth Morgan Investments Limited, Express Couriers Limited, and Couriers Please Holding Limited. The total goodwill arising from these transactions was $275 million. The Government’s financial statements disclose that the amount of goodwill on these transactions is provisional because a full fair-value analysis has not been performed. We were satisfied that the balances were not impaired as at 30 June 2012.

2.73 We will check that a full fair-value assessment and impairment test for the New Zealand Post acquisitions is performed for the Government’s 2012/13 financial statements.
2.74 We have recommended that the Treasury continue to monitor Air NZ’s value-in-use and market capitalisation, and the rationale for differences, for future impairment tests.

Inaccurate reporting of commitments

2.75 The reporting of commitments has been an area of concern in previous years because of the number and size of adjustments required as a result of our audit.

2.76 In 2010/11, the biggest problem was the disclosure of other operating commitments. The Treasury decided to remove these disclosures for 2011/12 because they are not required by accounting standards and did not provide useful additional information to a reader of the financial statements. We agreed that removing these disclosures did not materially affect the Government’s financial statements.

2.77 Last year, we recommended that the Treasury provide guidance to public entities about disclosure of commitments. We emphasised the need for accuracy in the disclosure of commitments. The Treasury provided this guidance in July 2012.

2.78 Even with this guidance, we identified several errors, primarily with capital commitments. These errors were corrected before the Government’s financial statements were finalised.

2.79 We will continue to discuss with the Treasury ways to further improve reporting of commitments.
Part 3
The Controller function and the appropriation audit

3.1 The Controller function and appropriation audit are important aspects of the Auditor-General’s work. They support the fundamental principle of Parliamentary control over government expenditure.

3.2 In this Part, we outline the system of appropriation then discuss:
• authorised expenditure;
• unauthorised expenditure;
• net asset holdings (which are breaches of appropriations); and
• the upcoming changes to the public accountability regime that will affect the Controller function and appropriation audit.

The system of appropriation

3.3 The Public Finance Act 1989 (the Act) defines the system of appropriation, which is the primary means by which Parliament authorises the Executive to use public resources. Under this system, expenses and capital expenditure should be incurred only within an appropriation or other statutory authority. The net assets of government departments should not exceed the limits set in the relevant Appropriation Act.

3.4 The Controller function is a way of checking that the Government is operating within the financial authorities that Parliament has approved.

3.5 Audit work carried out on appropriations supports the formal operation of the Controller function. Section 15(2) of the Public Audit Act 2001 explicitly recognises this audit work as part of the basic functions of the Auditor-General.

3.6 Our appointed auditors must carry out an appropriation audit in conjunction with the annual audit of each government department, to confirm that:
• expenses and capital expenditure have been incurred within the amount, scope, and period of an appropriation or other statutory authority;
• expenses have been incurred for lawful purposes; and
• any unappropriated expenditure is reported in the Government’s financial statements and submitted to Parliament for validation in the Appropriation (Financial Review) Bill.

3.7 The Treasury provides useful guidance on the system of appropriations on its website (www.treasury.govt.nz). This guidance includes:
• Guide to the Public Finance Act;
• Guide to Appropriations;
• Treasury Circular 2007/05: Multi-year, Revenue Dependent and Department to Department Appropriations – 11 May 2007;
• Treasury Circular 2006/04: Unappropriated Expenditure – Avoiding Unintended Breaches; and
• Treasury Instructions.

Authorised expenditure in 2011/12

Almost all government expenditure during 2011/12 was authorised by appropriations in the usual way.

Section 26B of the Public Finance Act

There were seven uses of section 26B of the Act, which enables the Minister of Finance to approve expenses that exceed an appropriation in the last three months of the financial year if those additional expenses are within the scope of the appropriation and do not exceed the greater of $10,000 or 2% of the total appropriation. The additional expenditure approved in this way totalled $21.903 million. The largest instance was $12.327 million of additional spending on early childhood education over the authorised amount of $1.312 billion.

In one instance, the Government used imprest supply\(^\text{12}\) to authorise expenditure too late in the year to be incorporated into Supplementary Estimates. This expenditure had to be validated in the Appropriation (Financial Review) Act for 2011/12. The instance related to additional write-downs of debt, totalling $2.379 million, incurred for “deemed values” of fish taken in excess of quota by the fishing industry.

Unauthorised expenditure in 2011/12

Seventeen instances of expenditure were not authorised by an appropriation or any other approval process. The total of this expenditure was about $273 million.

In 12 of these instances, there was an appropriation authorising that type of expenditure, but the Government spent more than was authorised. For these 12 instances, the total expenditure in excess of authority was more than $262 million. The biggest individual instance was just over $175 million, incurred by CERA. This unappropriated expenditure arose from the Government’s announcement that the red zone residential offer will be extended to the owners of 285 severely at-risk or largely destroyed residential properties in Christchurch’s Port Hills. This announcement was made before the relevant authority was adjusted to accommodate this additional expenditure.

\(^\text{12}\) Imprest supply is a statutory mechanism that allows Parliament to provide the Government with the authority to incur expenses or capital expenditure in advance.
3.13 The other five instances involved expenditure that was outside the scope of, or without any, appropriation. The total expenditure in these instances was just over $10 million and mainly related to activities associated with the Canterbury recovery.

3.14 Overall, expenditure in excess of or outside appropriation, and therefore without any parliamentary authority, is a very small proportion of overall government expenditure.

3.15 We continue to encourage departments to pay closer attention to ensuring that they have authority before incurring any expenditure. Departments should seek the necessary authority and approval as soon as they become aware that they have incurred unappropriated expenditure.

Net asset holdings

3.16 The Act sets a limit on the net assets that departments may hold. Section 22(3) 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).

3.17 Net asset holdings in excess of a department’s net asset authority are treated as breaches of appropriation. These are listed on page 167 of the Government’s financial statements.

3.18 Four departments breached their net asset authority during 2011/12. The breaches (amounting to $16.694 million) were without the authority of an Imprest Supply Act.

3.19 This aspect of appropriations is complex from a legal and an accounting perspective. A number of breaches continue to occur because of administrative errors. Accordingly, departments need to continue taking care in applying the net asset requirements of the Act. We are working with the Treasury to prepare additional guidance to departments before the net asset rules are changed, as described below.

Changes to the public accountability regime

3.20 The State Sector and Public Finance Reform Bill is currently before Parliament’s Finance and Expenditure Committee. The proposed changes to the Act are intended to:

• improve financial flexibility to facilitate different ways of working between the various agencies within the Executive branch of government; and
3.21 The changes include:

- clarifying departmental chief executives’ responsibilities for financial management and financial stewardship;
- shifting the emphasis from reporting by departments to reporting against appropriation, sharpening the focus on what is achieved with public resources;
- removing the existing one-size-fits-all approach to reporting requirements by providing flexibility for how performance is specified and where it will be reported;
- replacing the net assets rule with a requirement for Parliament to authorise capital injections made to departments; and
- specifying the governance regime for companies that are currently listed in Schedule 4 of the Act.

3.22 The Bill will affect some aspects of the Auditor-General’s audit and Controller functions. The Government consulted with the Office of the Auditor-General when developing the reform proposals that affect public sector accountability, and the Office will also provide advice to the select committee while it considers the Bill.
Part 4
Overview of audit results for the central government entities

4.1 In Parts 4 to 8, we provide an overview of the audit results for government departments, Crown entities (excluding tertiary education institutions (TEIs) and schools), Crown research institutes, district health boards (DHBs), State-owned enterprises (SOEs), and other central government entities such as Air NZ, regulatory bodies, and Māori Trust Boards.

4.2 Under the Public Audit Act 2001, our Office is required to audit and report the findings of those audits to Parliament.

4.3 During the year ended 31 December 2012, we issued 481 audit reports for entities in our central government portfolio (excluding TEIs, Rural Education Activity Programmes, and schools). Of these 481 audit reports, 400 were standard and 81 were non-standard.

4.4 Figure 2 sets out a summary of the results of our audit work.

Figure 2
Summary of central government portfolio 2011/12 audit results

<table>
<thead>
<tr>
<th>Description and type of non-standard audit report/s issued</th>
<th>Number of standard audit reports issued</th>
<th>Number of non-standard audit reports issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Government’s financial statements</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Description and type of non-standard audit report/s issued</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The audit report included an unmodified opinion and an “emphasis of matter” paragraph drawing attention to the uncertainties arising from the Canterbury earthquakes.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government departments</td>
<td>35</td>
<td>5</td>
</tr>
<tr>
<td>Student Loan Scheme</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>10</td>
<td>3**</td>
</tr>
<tr>
<td>Total</td>
<td>46</td>
<td>8</td>
</tr>
</tbody>
</table>

*We issued five non-standard audit reports for government departments. The reports included unmodified opinions and “emphasis of matter” paragraphs drawing attention to the disclosures of four departments about their disestablishment on 1 July 2012 and disclosures by CERA about the uncertainties following the Canterbury earthquakes.

**We also issued two modified (adverse) opinions for two trusts (which are a type of subsidiary) because of their failure to recognise and depreciate museum collection assets.

13 Our audit reports were issued between 1 January and 31 December 2012. Most of these reports relate to 2011/12 except where we explain (arrears). We note where balance dates differ from 30 June.
### Overview of audit results for the central government entities

<table>
<thead>
<tr>
<th></th>
<th>Number of standard audit reports issued</th>
<th>Number of non-standard audit reports issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>Crown research institutes</td>
<td>7</td>
<td>1</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>26</td>
<td>4*</td>
</tr>
<tr>
<td>Total</td>
<td>33</td>
<td>5</td>
</tr>
</tbody>
</table>

**Description and type of non-standard audit report/s issued**

Our audit report for Industrial Research Limited included an unmodified opinion and an “emphasis of matter” paragraph drawing attention to disclosures outlining uncertainties over the company’s future.

We issued four non-standard audit reports for three subsidiaries for 2011/12. The reports included unmodified opinions and “emphasis of matter” paragraphs drawing attention to disclosures related to:

- the disestablishment or expected disestablishment of:
  a. Paraco Technology Limited (a subsidiary of AgResearch); and
  b. Phytagro LLC New Zealand Branch, a subsidiary of Phytagro New Zealand Limited; and
- the appropriate use of the “going concern” assumption for AgResearch (Meat Biologics Consortia) Limited for two years ended 30 June 2011 and 30 June 2012.

<table>
<thead>
<tr>
<th></th>
<th>Number of standard audit reports issued</th>
<th>Number of non-standard audit reports issued</th>
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</thead>
<tbody>
<tr>
<td>District health boards</td>
<td>17</td>
<td>4*</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>17</td>
<td>4*</td>
</tr>
<tr>
<td>Total</td>
<td>34</td>
<td>8</td>
</tr>
</tbody>
</table>

**Description and type of non-standard audit report/s issued**

We issued an unmodified opinion for Whanganui DHB. The audit report included an “emphasis of matter” paragraph drawing attention to disclosures outlining some financial difficulties.

We issued an unmodified opinion for Hutt Valley DHB, which included an “emphasis of matter” paragraph drawing attention to disclosures outlining the uncertainties about the carrying value of buildings given earthquake-strength issues.

We issued two modified (qualified) opinions for Counties Manukau DHB (for the two years ended 30 June 2011 and 30 June 2012) because we disagreed with how some funding from the Ministry of Health had been recognised.

We issued three non-standard reports for two subsidiaries of DHBs:

- South Island Shared Service Agency Limited (for the two years ended 30 June 2011 and 30 June 2012); and
- District Health Boards New Zealand Incorporated.

The reports included unmodified opinions and “emphasis of matter” paragraphs drawing attention to disclosures outlining the disestablishment or expected disestablishment of the subsidiaries.

We issued a modified (qualified) opinion for Auckland DHB Charitable Trust because we were unable to obtain enough assurance over the completeness of revenue.
### Number of standard audit reports issued

<table>
<thead>
<tr>
<th></th>
<th>Number of standard audit reports issued</th>
<th>Number of non-standard audit reports issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other Crown entities</td>
<td>59</td>
<td>10*</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>76</td>
<td>12</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>135</strong></td>
<td><strong>22</strong></td>
</tr>
</tbody>
</table>

**Description and type of non-standard audit report/s issued**

Nineteen audit reports included unmodified opinions and “emphasis of matter” paragraphs drawing attention to disclosures outlining:

- the disestablishment or expected disestablishment of:
  - a. Charities Commission;
  - b. Alcohol Advisory Council of New Zealand;
  - c. Health Sponsorship Council;
  - d. Crown Health Financing Agency;
  - e. Mental Health Commission;
  - f. Public Trust Investment Funds – New Zealand and Australian Equities Investment Fund (No. 67), International Equities Investment Fund (No. 68); and
  - g. Balanced Income (Public Trust Investment Fund No. 13).
- uncertainties about the value of unlisted investments for
  - a. the Public Trust and Group; and
  - b. New Zealand Venture Investment Fund Limited and Group (including nine subsidiaries); and
- uncertainties following the Canterbury earthquakes and the appropriate use of the going concern assumption for the Earthquake Commission.

We issued a modified (qualified) opinion for the New Zealand Fire Service Commission (for the two years ended 30 June 2011 and 30 June 2012) because performance information had not been collected on some outcome and performance measures.

Our audit report for the New Zealand Oil Pollution Fund (which is a subsidiary of Maritime New Zealand) included an “emphasis of matter” paragraph drawing attention to disclosures outlining the uncertainties associated with the responses to the oil spill after the grounding of the container vessel MV *Rena*. 
Overview of audit results for the central government entities

<table>
<thead>
<tr>
<th>Number of standard audit reports issued</th>
<th>Number of non-standard audit reports issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Government Other**</td>
<td>43</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>19</td>
</tr>
<tr>
<td>Total</td>
<td>62</td>
</tr>
</tbody>
</table>

Description and type of non-standard audit report/s issued

Of the non-standard reports, 22 included “emphasis of matter” paragraphs drawing attention to disclosures outlining:

- the disestablishment or expected disestablishment of:
  - a. Learning State Limited;
  - b. Ngai Tahu Ancillary Claims Trust; and
  - c. Road Safety Trust;
- uncertainties about the provision of secretariat and office functions in the future for 16 health regulatory entities and two secretariats; and
- uncertainties after the Canterbury earthquakes and the appropriate use of the “going concern” assumption for Southern Response.

Three audit reports included modified (qualified) opinions:

- the Māori Trustee and Group because we were unable to confirm the financial information of an associated company;
- Ngati Whakaue Endowment Trust because we disagreed with the recognition of the value of land; and
- New Zealand Maori Arts and Crafts Institute because we were unable to obtain enough assurance over the completeness of revenue.

Māori Trust Boards

<table>
<thead>
<tr>
<th>Number of standard audit reports issued</th>
<th>Number of non-standard audit reports issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>14***</td>
<td>3</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>2****</td>
</tr>
<tr>
<td>Total</td>
<td>16</td>
</tr>
</tbody>
</table>

Description and type of non-standard audit report/s issued

We issued three audit reports that included “emphasis of matter” paragraphs drawing attention to disclosures outlining the disestablishment or expected disestablishment of:

- Te Runanga o Ngati Porou and Group;
- Treaty Relationship Company Limited and Group (year ended 30 June 2011); and
- Northern Region Health Consortium Limited (year ended 30 June 2011).

For the Maniapoto Māori Trust Board, our audit report included an “emphasis of matter” paragraph drawing attention to disclosures outlining uncertainties over the trust board’s future.

We also issued a modified (qualified) opinion for the Tauranga Moana Māori Trust Board (year ended 30 June 2011) because we were unable to confirm the valuation of the Board’s investment in a joint venture.
Overview of audit results for the central government entities

<table>
<thead>
<tr>
<th>State-owned enterprises</th>
<th>Number of standard audit reports issued</th>
<th>Number of non-standard audit reports issued</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>16</td>
<td>0</td>
</tr>
<tr>
<td>Subsidiaries</td>
<td>58</td>
<td>7*****</td>
</tr>
<tr>
<td>Total</td>
<td>74</td>
<td>7</td>
</tr>
</tbody>
</table>

**Description and type of non-standard audit report/s issued**

We issued non-standard audit reports for one SOE and five SOE subsidiaries. The reports included “emphasis of matter” paragraphs drawing attention to disclosures outlining:

- the disestablishment or expected disestablishment of:
  - PropertyInsight Limited;
  - Whisper Tech Limited;
  - Terrace Coal Mine Limited; and
  - Biodiesel New Zealand Limited; and
- the appropriate use of the “going concern” assumption for The ECN Group Limited.

We issued a modified (qualified) opinion for New Zealand Post Recycle Centre Limited (for the two years ended 30 June 2011 and 30 June 2012) because we were unable to obtain enough assurance over the completeness of revenue.

**Total**

| Total | 400 | 81 |

* Including one audit report that related to a prior year.
** This group of miscellaneous entities includes those that do not neatly fit into other categories. It includes entities such as Air New Zealand, the Reserve Bank, the National Provident Fund, Producer Boards, and Health and Medical Councils.
*** The number includes five audit reports for previous years.
**** The number includes two audit reports for previous years.
***** The number includes one audit report for a prior year.

4.5 We have already discussed our audit of the Government’s financial statements in Part 2. In the following Parts, we discuss our other audit findings in more detail. Part 5 discusses non-standard reports. Part 6 looks at our audits of government departments. Part 7 discusses our audits of Crown entities (excluding TEsIs, schools, and DHBs). Part 8 discusses our audits of SOEs.

4.6 We encourage those readers unfamiliar with the concepts and frameworks applied to our audit work to read Appendix 1. This Part and later Parts presume a working knowledge of the concepts and frameworks.

4.7 Our Office has published more-detailed sector reports on entities in the education, transport, and health sectors and has also provided a more-detailed overview of our findings for Crown research institutes.
Part 5
Non-standard audit reports issued

5.1 We issued 481 audit reports in our central government portfolio during the year ended 31 December 2012 (excluding entities in our education portfolio). Of these, 400 were standard audit reports and 81 were non-standard audit reports. In this Part, we detail the nature of the non-standard reports that we issued.

Unmodified opinions with “emphasis of matter” paragraphs

5.2 The following section summarises the matters relevant to understanding the financial and non-financial information for those public entities with audit reports that included unmodified opinions but also included “emphasis of matter” paragraphs.15

Uncertainties associated with disaster response/recovery

Uncertainties associated with the Canterbury earthquakes

5.3 We drew attention to disclosures in the Government’s financial statements about the effects of the Canterbury earthquakes. In particular, we drew attention to disclosures about:

• the uncertainties involved in estimating EQC’s and Southern Response’s support packages;
• the uncertainties involved in estimating the Government’s offer to purchase properties in the Canterbury residential red zone;
• the uncertainty associated with the Government’s share of local authority costs in response to the earthquakes and its share for restoring local authority water infrastructure damaged by the earthquakes.

5.4 At an entity level, these disclosures resulted in the inclusion of “emphasis of matter” paragraphs for:

• EQC;
• CERA; and
• Southern Response and Group.

5.5 For EQC and Southern Response and Group, we confirmed that, for the year ended 30 June 2012, the “going concern” assumption had been appropriately used.

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14 Our audit reports were issued between 1 January and 31 December 2012. Most of these reports relate to 2011/12 except where we explain (arrears). We note where balance dates differ from 30 June.

15 No “other matter” paragraphs were included in audit reports.
Uncertainties associated with the response to the oil spill from the grounding of the container vessel MV Rena

5.6 The audit report for the New Zealand Oil Pollution Fund (for the year ended 30 June 2012) included an “emphasis of matter” paragraph to draw attention to disclosures about the availability of Crown funds to cover the costs of response to the oil spill that occurred after the grounding of the container vessel MV Rena on 5 October 2011. The Crown had made further funds available to cover the costs of responding to the oil spill, which were expected to exceed the reserves in the fund at the time the audit report was issued.

Uncertainties arising from, or from the prospect of, structural change

5.7 Structural change continues within central government and the entities covered in this report. Both planned and actual changes create uncertainties that need to be considered in reading the financial and non-financial statements of entities subject to change.

5.8 We drew attention to the uncertainties arising from structural changes or expected future changes for:

- Industrial Research Limited (IRL) for the year ended 30 June 2012 – we drew attention to the uncertainty about IRL’s future, with the proposal that IRL become a subsidiary of Callaghan Innovation, a new Crown entity that was established on 1 February 2013. At the time the audit report was issued, the Bill establishing Callaghan Innovation and confirming the future of IRL had not been passed.

- Maniapoto Māori Trust Board for the year ended 30 September 2012 – we drew attention to the uncertainty about the Trust Board’s future given its intention to establish tribal entities to perform its functions.

5.9 We included “emphasis of matter” paragraphs in the audit reports of AgResearch (Meat Biologics Consortia) Limited (which is a subsidiary of AgResearch Limited) for the two years ended 30 June 2011 and 30 June 2012. The “emphasis of matter” paragraphs drew attention to disclosures about the appropriate use of the “going concern” assumption and an impending decision about the future of the company.

5.10 We drew attention to an agreement to change the ownership of The ECN Group Limited (which was a subsidiary of New Zealand Post Limited) for the year ended 30 June 2012 and that the “going concern” assumption had been used.

5.11 Our audit reports for 16 health regulatory entities and two secretariats for the year ended 30 June 2012 drew attention to the uncertainties over the outcome of
a proposal for shared secretariat and office functions across the group. The health entities were:

- Nursing Council of New Zealand;
- Midwifery Council of New Zealand;
- Pharmacy Council of New Zealand;
- New Zealand Psychologists Board;
- New Zealand Chiropractic Board;
- Optometrists and Dispensing Opticians Board;
- Physiotherapy Board of New Zealand;
- Medical Sciences Council of New Zealand;
- Occupational Therapy Board of New Zealand;
- Osteopathic Council of New Zealand;
- Podiatrists Board of New Zealand;
- Psychotherapists Board of Aotearoa New Zealand;
- Dietitians Board;
- Medical Radiation Technologists Board;
- Dental Council of New Zealand;
- Medical Council of New Zealand;
- Medical Sciences Secretariat; and
- Health Regulatory Authorities Secretariat Limited.

Not using the going concern assumption to prepare financial statements

5.12 In a number of audits, we drew attention to the fact that entities had appropriately not used the “going concern” assumption because they had been disestablished or were expected to be disestablished in the near future. The following public entities’ audit reports included such an “emphasis of matter” paragraph:

- Ministry of Economic Development (diseestablished on 1 July 2012);
- Department of Labour (diseestablished on 1 July 2012);
- Ministry of Science and Innovation (diseestablished on 1 July 2012);
- Department of Building and Housing (diseestablished on 1 July 2012);
- Paraco Technology Limited (a subsidiary of AgResearch Limited);
- PropertyInsight Limited (a joint venture between Geological and Nuclear Sciences Limited and Quotable Value Limited);
• Phytagro LLC New Zealand Branch (a subsidiary of Phytagro New Zealand Limited) for the year ended 31 December 2011;
• Charities Commission (disestablished on 1 July 2012);
• Alcohol Advisory Council of New Zealand (disestablished on 1 July 2012);
• Health Sponsorship Council (disestablished on 1 July 2012);
• Crown Health Financing Agency (disestablished on 1 July 2012);
• Mental Health Commission (disestablished on 1 July 2012);
• Road Safety Trust (expected to be disestablished by 1 July 2013);
• Public Trust Investment Funds – New Zealand and Australian Equities Investment Fund (No. 67); Public Trust Investment Funds – International Equities Investment Fund (No. 68);\textsuperscript{16}
• Balanced Income Fund (Public Trust Investment Fund No. 13);\textsuperscript{17}
• Te Runanga o Ngati Porou and Group, which was dissolved on 7 April 2012;
• Treaty Relationship Company Limited and Group (a subsidiary of Te Rūnanga o Ngāti Whātua and Auckland District Health Board) for the year ended 30 June 2011 with an expectation of disestablishment within 12 months;
• Northern Region Health Consortium Limited (a subsidiary of Te Rūnanga o Ngāti Whātua and Auckland District Health Board) for the year ended 30 June 2011, after which it was amalgamated with its parent company;
• Ngāi Tahu Ancillary Claims Trust;
• South Island Shared Service Agency Limited, for the two years ended 30 June 2011 and 30 June 2012;\textsuperscript{18}
• District Health Boards New Zealand Incorporated, for the year ended 30 June 2011;
• Whisper Tech Limited (a subsidiary of Meridian Energy Limited);
• Terrace Coal Mine Limited (a subsidiary of Solid Energy New Zealand Limited);
• Biodiesel New Zealand Limited (a subsidiary of Solid Energy New Zealand Limited); and
• Learning State Limited (ceased to operate September 2012).

Uncertainties about the value of unlisted investments

Uncertainties about the value of unlisted investments can have a material effect on the statement of financial performance and the statement of financial position.

The audit report for Public Trust and Group drew attention to disclosures about the value of some mortgage-backed securities. There is no comparable security

\textsuperscript{16} Audits for the year ended 31 March 2012. The expectation is for the entities to be disestablished within 12 months.
\textsuperscript{17} Audit for the year ended 31 March 2012. Disestablishment is expected within 12 months.
\textsuperscript{18} South Island Shared Service Agency Limited ceased operations on 1 December 2011.
to benchmark value and, as such, the Public Trust has adopted a discounted cash flow approach to valuation. The new approach to valuation was applied as at 31 December 2011 and resulted in a $10.1 million fair value gain at that time. Although we concur with the approach taken, we nevertheless wanted to acknowledge the uncertainties around the value of these securities given the number of judgements underpinning the valuation.

5.15 For New Zealand Venture Investment Fund Limited and Group and each of its nine subsidiaries, we included an “emphasis of matter” paragraph drawing attention to the uncertainties in measuring the fair value of unlisted venture capital investments. These uncertainties could, in turn, create uncertainties about the carrying amount of related-party loans recorded in the parent entity’s financial statements.

Uncertainty in the carrying value of buildings given earthquake-strength issues

5.16 The audit report for Hutt Valley District Health Board included an “emphasis of matter” paragraph related to the uncertainty in the carrying value of certain buildings resulting from earthquake-strength issues and drawing attention to the fact that the Board has not made any adjustments to the carrying value of those buildings. The Board is gathering information, including estimates to strengthen buildings, and is expected to make decisions in 2013 about affected buildings.

Financial viability

5.17 The audit report for Whanganui District Health Board included an “emphasis of matter” paragraph that acknowledged the financial challenges faced by the DHB and the steps it is taking to improve its financial position. We also noted support from the Crown to meet cash-flow requirements.

Modified opinions

Adverse opinions

5.18 During 2012, we issued an adverse opinion for two public entities that did not recognise their museum collection assets nor the associated depreciation expense that is a requirement of generally accepted accounting practice:19

- Royal New Zealand Navy Museum Trust Incorporated (for the two years ended 30 June 2011 and 30 June 2012); and
- RNZAF Museum Trust Board.

19 A modification to the audit report of a subsidiary may not affect the audit report of its parent entity if, in our judgement, the misstatement would not materially influence readers’ overall understanding of the financial statements of the group.
Qualified opinions

5.19 We also issued qualified opinions on the financial or non-financial information of eight public entities.

5.20 A qualified opinion is issued if there is a disagreement with the treatment or disclosure of an issue in the financial statements or when we cannot get enough audit evidence about an issue.

5.21 We issued qualified opinions because we disagreed with the accounting treatment used by the following two entities:

- Counties Manukau District Health Board (for the two years ended 30 June 2011 and 30 June 2012). We disagreed with the DHB’s accounting treatment of certain funding from the Ministry of Health.
- Ngati Whakaue Endowment Trust (for the year ended 31 December 2011). We disagreed with how the Trust recognised the value of land on the basis that it departed from generally accepted accounting practice.

5.22 We issued a qualified opinion for the New Zealand Fire Service Commission for the two years ended 30 June 2011 and 30 June 2012 because industrial action prevented performance data being collected during part of the audit period.

5.23 In the case of the Tauranga Moana Māori Trust Board, we issued a qualified opinion for the year ended 30 June 2011 because we could not get enough audit evidence to confirm the valuation of the Board’s investment in a joint venture. The joint venture operated kiwifruit orchards affected by the PSA virus, which caused a significant decrease in the rating valuation of the joint venture’s land and buildings.

5.24 We issued a qualified opinion for the Māori Trustee and Group for the year ended 31 March 2012 because we were unable to confirm the financial information for an associated company.

5.25 We issued qualified opinions for the following entities because we could not get enough assurance to confirm the completeness of revenue:

- Auckland DHB Charitable Trust (a trust controlled by Auckland District Health Board);
- New Zealand Māori Arts and Craft Institute; and
- New Zealand Post Recycle Centre Limited, for the two years ended 30 June 2011 and 30 June 2012.

20 New Zealand Post Recycle Centre Limited is a subsidiary of New Zealand Post Limited.
Part 6
Results of government department audits

6.1 In this Part, we report on the audit results of government departments in 2011/12, including our assessments of their management control environments, financial information systems, and service performance information and associated systems and controls.

Audit reports for 2011/12

6.2 We audited 40 government departments in 2011/12. These included:

- 32 public service departments (four of the audits were final audits for departments disestablished on 1 July 2012);
- six non-public service departments; and

6.3 The 40 audits included the final audits for four departments that were disestablished on 1 July 2012.

6.4 We issued unmodified opinions for all 40 government departments for the year ended 30 June 2012.

6.5 We also issued opinions for 12 trusts and funds overseen by government departments. We expressed an adverse opinion for two of these entities on the basis that they did not recognise their museum collection assets or the associated depreciation expense:

- Royal New Zealand Navy Museum Trust Incorporated (for the two years ended 30 June 2011 and 30 June 2012); and
- RNZAF Museum Trust Board.

6.6 These opinions did not affect the opinion we issued for the New Zealand Defence Force.

Observations and matters arising from the audits

6.7 During our audit work, we gain insights and perspectives on the various factors and challenges facing public entities and about the initiatives for responding to these and driving improvement. In this Part, we set out some of our observations and matters raised by auditors working with government departments.
Final audits for departments that were disestablished

6.8 We carried out final audits for four departments that were disestablished on 1 July 2012 and amalgamated to form the new MBIE. The four departments were the:

- Ministry of Economic Development;
- Ministry of Science and Innovation;
- Department of Labour; and
- Department of Building and Housing.

6.9 For all four departments, our audit report included an explanatory paragraph highlighting that the financial statements were prepared on a disestablishment basis.

6.10 Our main considerations for disestablishment audits included:

- monitoring the control environment to identify emerging risks or issues, such as the loss of significant personnel and the effect of changes on staff morale, because risk of fraud, errors, and loss of core capability is often heightened during significant change processes and needs to be managed well;
- understanding and ensuring that appropriate delegations are in place through the transition period and for signing the statement of responsibility in the annual report;
- checking that relevant legislation was complied with, including the requirements associated with the disestablishment of the entities; and
- the appropriate treatment of assets, liabilities, and provisions.

6.11 Auditors also monitored for any indication of waste and lack of probity or financial prudence around severance, redundancy, and retention payments.

6.12 We did not assess the entities’ environments, systems, and controls when we carried out the final audits. This is because the grades we give reflect our recommendations for improvement, and deficiencies identified in the final audit of an entity to be disestablished may or may not be relevant to any new entity.

6.13 However, we did report our audit findings and any significant issues to the responsible Minister, and we commented on the operation of the environment, systems, and controls during the disestablishment period.

6.14 Overall, our appointed auditors found that the four disestablished government departments maintained sound systems and controls until disestablishment.
Results of government department audits

6.15 The 2011/12 year saw continued structural and organisational change within government departments. Our findings from disestablishment audits are discussed in paragraphs 6.8-6.14. Other organisational change has included executive team changes, national office restructures, and/or regional management changes. This work has continued through into 2012/13. Change has been driven by a range of factors, including:

- demand for improved results as signalled under BPS and the need to manage within existing financial baselines;
- changed business models and approaches to delivery; and
- mergers, both of functions and/or entities.

6.16 A number of departments are investing in modernising service delivery. In other cases, fiscal constraints have challenged and exposed issues around business models and pricing of services resulting in substantive reviews.

6.17 The Crown Law Office (CLO) and the Ministry of Justice are examples of entities that are currently implementing organisational change. In 2011/12, the CLO responded to a number of organisational reviews that were carried out during the previous year. There has been restructuring of the organisation and other initiatives aimed at improving financial management and overall governance. The Ministry of Justice has been working to refocus its national office structure, capability, and resources to better support delivery of a new business strategy and frontline services. This is discussed in the next section.

6.18 Periods of significant organisational change pose a risk to the maintenance of management systems and controls, and management needs to be vigilant to avoid potential slips in controls. Generally, we found that entities’ controls were sound throughout their change processes.

6.19 If restructuring is expected to lead to savings, we have recommended that departments develop and implement systems to report on savings and where savings have been re-applied.

Structural and organisational change

6.20 A number of departments are in the process of developing and implementing significant business transformation programmes. These often underpin organisation restructures discussed above. For example:

- Inland Revenue’s Business Transformation Programme, if approved and funded by Cabinet, will involve major changes to the way Inland Revenue conducts its
business, how or when it interacts with customers and associated parties, and how its technology platform performs to support operations.

- The Statistics New Zealand 2020 Te Kāpehu Whetū programme is an organisation-wide change programme to ensure that Statistics New Zealand can effectively lead the Official Statistics System in the future, get more value from official statistics by connecting more closely with users, and modernise the systems used by Statistics New Zealand to produce and disseminate statistics.

- The Ministry of Justice is implementing a number of programmes designed to modernise how it delivers court services – through greater use of technology (electronic operating model), better processes (Criminal Procedure Act 2011), and using its scale and resources more effectively (regional service delivery). These changes will have implications for the major players within the criminal justice sector: judiciary, constabulary, legal profession, court staff, and other users of court services.

6.21 Business transformation programmes can often involve developing and implementing core information systems that have inherent risks. These include, but are not limited to, the potential for significant cost overruns, system “bugs”, and security breaches.

6.22 We monitor and stay abreast of developments through our audit work. The SSC monitors significant programmes.

**Cost recovery through user charges**

6.23 Fiscal constraints are challenging some departments to consider alternative revenue streams to fund service delivery. Cost recovery through user charges for some services is an option that some departments are considering. We intend to watch this area closely and will work with entities to ensure that they understand the requirements. We will also check on compliance with guidelines for setting charges and fees for public sector goods and services.

6.24 If government departments provide services on a full cost recovery basis, the department is required to operate a memorandum account to record the accumulated surplus or deficit arising from providing the service. The balance of each memorandum account should trend to zero over time.

6.25 We noted in our 2011/12 audit work that some departments’ memorandum accounts have significant surpluses and others have significant deficits. For a more detailed overview of the issues, see Part 11. In 2012/13, we plan to review the processes that departments have in place to monitor the balances of memorandum accounts and to enquire into departments’ plans to address significant deficits or surpluses.
Implications of the Canterbury earthquakes and other strengthening work

6.26 In Part 5, we noted how the uncertainties arising from the Canterbury earthquakes need to be considered when reviewing the financial and non-financial statements of CERA and EQC.

6.27 Beyond Canterbury, the vulnerability of government buildings to future earthquakes has been considered, with many public entities carrying out seismic strength assessments. This has seen earthquake-strengthening programmes put in place, the closure of some properties (some permanently), and property revaluation.

6.28 The financial statements of the Ministry of Education reflect the wider effect that the Canterbury earthquakes have had on government departments. The Ministry increased its provisions for impairments to the value of school buildings, increasing its provision for defective buildings by $94.6 million, bringing the total of the provision to $1.025 billion at 30 June 2012. However, unlike CERA and EQC, the Ministry received a standard audit report. This is because, although damage and future seismic strengthening costs have adversely affected its financial position:
- there is relative certainty over the expected future costs; and
- the associated provisions do not affect the “going concern” assumption.

6.29 The potential accounting implications associated with the Canterbury earthquake recovery include asset write-offs and recognition of impairment losses. Our appointed auditors will remain alert to these potential issues to ensure that the appropriate accounting treatment occurs.

Procurement

6.30 Our audit work confirms that procurement and the need to ensure that processes and systems are robust and fit for purpose was front of mind for many government departments. Those departments with significant procurement programmes carried out, or were in the process of implementing, reviews of procurement systems and processes.

6.31 For example, auditors have noted the reviews and subsequent changes that have been and are being carried out by the Ministry of Health, Inland Revenue, and the Ministry of Social Development.

6.32 The Ministry of Health’s review of procurement and contracting processes has led to a number of recommendations to improve consistency in how its
procurement and contracting processes are applied. An action plan to address recommendations arising from the review has been put in place.

6.33 Inland Revenue is implementing recommendations laid out in the PMMS Consulting Group’s Procurement Capability Review Report, released in August 2010. We noted that Inland Revenue was making good progress and is well placed to implement changes to strengthen its procurement function.

6.34 The Ministry of Social Development has now introduced a standardised process across the unified procurement team. Templates and a procedures manual to support this are due to be finalised in the first quarter of 2013.

6.35 With fiscal constraints and a focus on better public services and value for money, procurement will continue to be an area of audit interest. Appointed auditors will assess entities’ procurement processes by reviewing procurement policies and large contracts.

6.36 As part of our 2012/13 work programme, we are carrying out a performance audit to examine how effectively and efficiently CERA, NZTA, and the Christchurch City Council are managing to rebuild Christchurch’s horizontal infrastructure through the Stronger Christchurch Infrastructure Rebuild Team. We are examining whether:

- the entities have appropriate strategic arrangements in place that promote effective and efficient procurement (in the context of post-disaster recovery); and
- operational project delivery is effective and efficient in the circumstances and, where trade-offs are necessary, they are made with the intent to support recovery from the Canterbury earthquakes.

Environment, systems, and controls

6.37 We assessed and graded the environment, systems, and controls for managing and reporting financial and service performance information for 34 government departments in 2011/12. We did not assess the four departments disestablished with effect from 1 July 2012, and the summary excludes the assessments for both the Government Communications Security Bureau and the New Zealand Security Intelligence Service. Figure 3 sets out a summary of the grades for departments from 2006/07 to 2011/12. See Appendix 1 for an explanation of the grading scale.
Management control environment

Figure 3
Management control environment – grades for the departments assessed from 2006/07 to 2011/12

Overall, the results for 2011/12 show that government departments have generally sound management control environments. Except for CERA, which was assessed as “Needs improvement”, all other departments were assessed as either “Good” or “Very good”. CERA’s grade largely reflects its status as a newly established entity (15 months at the time of audit) that is setting up robust and consistently applied controls.

Over time, across government departments, controls have strengthened overall. The number of departments assessed as “Needs improvement” dropped to zero for established departments, and 41% of departments are now assessed as “Very good” compared with 13% in 2006/07.

However, it is useful to look at the assessment of individual entities over time because grades can move up and down. Grades fluctuate from year to year depending on several factors, such as changes in the operating environment, in standards, in good practice expectations, and in auditor emphasis. For example, a downward shift might not indicate deterioration. Instead, the entity might not have kept pace with best practice expectations for similar entities. Consequently, how an entity responds to the auditor’s recommendation for improvement is important, and the long-term trend in grade movements is a more useful indication of progress than year-to-year movements.
Financial information systems and controls

6.41 Overall, our assessment of government departments’ financial information systems and controls is positive (see Figure 4). In 2011/12, all but three departments were assessed as “Good” or “Very good”.

Figure 4
Financial information systems and controls – grades for the departments assessed from 2006/07 to 2011/12

6.42 The three entities assessed as “Needs improvement” were:

- CERA – As noted in paragraph 6.37, CERA was still working to establish robust systems and processes at the time of audit.

- Parliamentary Service – The implementation process for the new financial information management system (FMIS) in 2010/11 was not as effective as expected. Therefore, we assessed Parliamentary Service’s control environment as “Needs improvement”. Although some progress has been made in addressing issues raised during the 2010/11 audit, there is further work to embed the system. On this basis, the grade remained “Needs improvement” in 2011/12.

- New Zealand Defence Force – The audit identified a number of areas with control deficiencies, including payroll, delegations, and accounting for property, plant, and equipment.
Service performance information and associated systems and controls

6.43 Figure 5 shows the results of our assessment of government departments’ service performance information and associated systems and controls during the past four years. For the year ended 30 June 2012, 22 (65%) departments received a “Good” grade. For the first time, we can report that two departments, Inland Revenue and the Ministry for the Environment, received “Very good” grades for their service performance information and associated controls. “Needs improvement” grades were received by 10 (29%) departments compared with 21 (57%) for the previous year. No departments were graded “Poor”.

Figure 5
Service performance information and associated systems and controls – grades for the departments assessed from 2008/09 to 2011/12

6.44 We noted the improvement in reporting performance information in our analysis of the 2010/11 audit results. We are pleased to see that departments have continued to work to improve their performance measurement frameworks and reporting in 2011/12.
Part 7

Results of Crown entity audits

7.1 In this Part, we report on the results of our 69 audit reports issued for Crown entities in 2011/12. In this report, we do not consider the results for TEIs, schools, Crown research institutes, or DHBs, nor do we provide any comment on the results of the audit reports for Crown entity subsidiaries for 2011/12 other than to note non-standard reports issued. For a list of the entities we considered, see Appendix 2.

7.2 We also report on our assessments of the management control environments and financial information systems for 62 Crown entities, and the service performance information and associated systems and controls for 61 Crown entities. Five Crown entities were disestablished in 2011/12, and we do not grade disestablished entities.

About Crown entities

7.3 There are more than 2700 Crown entities, including 2460 school boards of trustees. Crown entities have a wide range of roles, functions, and responsibilities and different degrees of autonomy. By law, the Auditor-General is the auditor of all Crown entities and their subsidiaries.

7.4 The Crown Entities Act 2004 provides a framework for the establishment, governance, accountability, and operation of Crown entities. It sets out five categories of Crown entities:

• statutory entities:
  – Crown agents, such as ACC and the DHBs;
  – autonomous Crown entities, such as the Standards Council of New Zealand and the New Zealand Symphony Orchestra; and
  – independent Crown entities, such as the Law Commission;

• Crown entity companies, including Television New Zealand and the Crown research institutes (CRIs);

• Crown entity subsidiaries;

• school boards of trustees; and

• TEIs (polytechnics, universities, and wānanga).

7.5 In 2011/12, there have been some structural changes (including disestablishing and establishing entities) for Crown entities in response to the Government’s priorities (see paragraph 1.14).

21 For the results of our audits of other entities, see our reports: Education sector: Results of the 2011 audits, Crown research institutes: Results of the 2011/12 audits, and Health sector: Results of the 2011/12 audits.

22 Many Crown entities also have their own enabling legislation.
Audit reports for 2011/12

7.6 We issued standard audit reports for 59 Crown entities and 10 non-standard reports (nine for the year ended 30 June 2011/12 and one for a prior year).

7.7 We issued a qualified opinion for the New Zealand Fire Service Commission (NZFSC), for the two years ended 30 June 2011 and 30 June 2012, because industrial action prevented performance data being collected during part of the period audited.

7.8 “Emphasis of matter” paragraphs (see Part 4) drew readers’ attention to:
- disclosures relating to the disestablishment or pending disestablishment of entities;
- uncertainties about measuring the fair value of unlisted venture capital investments; and
- uncertainties relating to the response to the MV Rena oil spill and the appropriate use of the “going concern” assumption for EQC because of uncertainties around the response to the Canterbury earthquakes.

7.9 We also audit a number of Crown entity subsidiaries. Our audits drew attention to the disestablishment of some of the Public Trust’s subsidiaries and uncertainties in measuring the fair value of unlisted venture capital investments for the New Zealand Venture Fund and subsidiaries.

Observations and matters arising from the audits

7.10 During our audit work, we gain insights and perspectives about the various factors and challenges facing public entities and about the initiatives being advanced to respond to these and drive improvement. In this Part, we discuss some of our observations and matters raised by auditors working with Crown entities.

Final audits for Crown entities that were disestablished

7.11 We carried out final audits for five Crown entities that were disestablished with effect from 1 July 2012. The five entities were the:
- Health Sponsorship Council;
- Alcohol Advisory Council of New Zealand;
- Crown Health Financing Agency (CHFA);
- Charities Commission; and
- Mental Health Commission.
We did not assess the entities’ environments, systems, and controls when we carried out the final audits. This is because the grades we give reflect our recommendations for improvement, and deficiencies identified in the final audit of an entity to be disestablished may or may not be relevant to any new entity.

However, we did report our audit findings and any significant issues to the responsible minister. We also commented on the operation of the environment, systems, and controls during the disestablishment period.

Overall, we found that the five disestablished entities maintained sound systems and controls until disestablishment.

Managing the implications of the Canterbury earthquakes

A number of Crown entities are continuing to face issues caused by the Canterbury earthquakes. These issues range from the role that entities are required to play in the Christchurch rebuild to damaged premises and future costs of seismic strengthening.

NZTA has the important role of rebuilding the Canterbury transport network in partnership with CERA and Christchurch City Council. The estimated cost of this project is $816 million.23

Housing New Zealand Corporation (HNZC) and NZFSC have both been adversely affected by the Canterbury earthquakes and the resulting review of building standards. In 2011/12, HNZC recognised $56 million of impairment on properties damaged during the earthquakes and a further $15 million impairment to reflect the costs of seismically strengthening its earthquake-prone buildings. NZFSC had similar issues with a number of properties requiring seismic strengthening or rebuilding at an estimated cost of $39.7 million as at 30 June 2012.

The implications of the Canterbury earthquakes will continue to affect Crown entities into the foreseeable future, whether it is through costs associated with damages and seismic strengthening or a change in the entities’ objectives.

Our appointed auditors will remain vigilant with regard to the funding constraints and the value of capital commitments. They must also ensure that particular attention is paid to the assumptions used in calculating impairment losses and provisions to gain assurance that the values reported accurately reflect the future costs of earthquake strengthening.

Structural and organisational change

Structural and organisational change continues to be a trend across Crown entities. The changes take many forms, including:

23 For more results about our audit of NZTA, see our sector report: Transport sector: Results of the 2011/12 audits.
Part 7 Results of Crown entity audits

7.21 These changes have been driven by a number of factors, the most significant of which is fiscal constraints. With pressure from the Government to reduce costs while also providing better public services, entities have reassessed their structures and business models.

7.22 The back-office functions of the Civil Aviation Authority (CAA) and the Aviation Security Service have been combined to reduce costs. Other entities, such as the Public Trust, are in the process of reviewing their business structure and operations to identify the most effective and efficient business model for delivering their desired outputs.

7.23 The Health and Disability Commissioner has had to prepare for taking on functions of the Mental Health Commission, which was disestablished with effect from 1 July 2012.

7.24 Appointed auditors need to remain alert to a number of unintended adverse effects caused by structural and organisation change. With changes in senior management personnel, there is a risk that the internal control environment might be weakened because the new management changes control procedures. Restructuring announcements can cause staff to become disgruntled, which in turn increases the risk of fraud and inappropriate sensitive expenditure. Reduction in staff numbers can also reduce organisational capability, which can have a detrimental effect on an entity’s ability to achieve its major outcomes.

Business transformation programmes and projects

7.25 Several Crown entities have begun to prepare and implement business transformation programmes or projects. These include planning and/or procurement of major information management systems and review, and subsequent streamlining of business processes. Once again, the driving force behind these initiatives is to reduce costs and provide better services to service users.

7.26 HNZC’s business transformation exercise progressed significantly during the year. The aim of this exercise is to develop a new service delivery model to better deliver services to tenants. The initiative is supported by the replacement of major information technology (IT) applications, including the implementation of
a financial management application and a property management application. These applications were implemented, after balance date, on 5 August 2012.

7.27 To reduce costs and provide better public services, many Crown entities have started business transformation programmes or projects. Initiatives focused on streamlining business processes and modernising systems are essential if savings are to be made without reducing the quality of service provided.

7.28 For entities implementing IT systems involving migration, storage, and capture of sensitive information, it is important that both the entity and the auditor pay particular attention to the security measures used by the entity.

Procurement

7.29 With several Crown entities managing assets of significant value and strategic importance, procurement remains an area of audit focus. It is important for entities to have clear and effective procurement policies. This helps to ensure that the procurement process is transparent and that entities receive the best value for money. The need for transparency and value for money stems from the public sector’s commitment to accountability and fiscal constraint.

7.30 In 2011/12, our auditors noted a higher than expected proportion of closed tenders to initiate procurement decisions by HNZC. The major drivers for this were earthquake-related matters and HNZC’s Enterprise Transformation Programme, which generated an increased level of procurement activity. Our auditors have recommended that entities apply increased scrutiny when using closed tender processes so as to confirm that it is the only approach or most economic approach available.

7.31 Previous reviews of NZTA’s procurement policies have concluded that they are consistent with good practice. In 2011/12, our audit of NZTA did not identify any specific issues worthy of disclosure.

7.32 Although we have discussed only two specific entities, procurement remains a focus for many Crown entities. Appointed auditors will continue to review entities’ procurement policies to ensure that they have robust processes in place and will continue to review significant contracts to test that they have been awarded within the guidelines set out in the entity’s policy.

24 The main sources of guidance are the Mandatory Rules for Procurement by Departments, which were endorsed by Cabinet on 18 April 2006, our good practice guides (especially Public sector purchases, grants, and gifts: Managing funding arrangement with external parties (2008) and Procurement guidance for public entities (2008)), and Mastering procurement: A structured approach to strategic procurement (2011, available at www.business.govt.nz).
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Part 7 Results of Crown entity audits

Financial sustainability

7.33 We note that some entities, such as CAA and the Office of Film and Literature Classification (OFLC), continue to grapple with concerns about long-term financial viability and sustainability.

7.34 A proposal resulting from the review of the Aviation Security Service (which addressed issues about charging for passenger security) that will enable CAA’s operation to continue on a sustainable basis was put to the Government in mid-2012. Cabinet agreed to implement proposals from 1 November 2012.

7.35 Auditors noted the challenges facing OFLC given a reported loss of $41,000 in 2011/12 and budgeted losses of $185,000, $188,000, and $195,000 for the three years 2012/13 to 2014/15. With fewer submissions from the Film and Labelling Body Inc, its revenue is adversely affected. OFLC is actively working to manage its operating costs and looking to realise efficiencies. We will continue to monitor OFLC’s financial performance.

Environment, systems, and controls

7.36 We assessed and graded the environment, systems, and controls for managing and reporting financial information for 62 Crown entities and service performance information for 61 Crown entities in 2011/12.25 See Appendix 1 for an explanation of the grading scale.

7.37 A number of new Crown entities were assessed for the first time:
• the Financial Markets Authority (FMA);
• the External Reporting Board (XRB);
• the Environmental Protection Authority (EPA); and
• Education New Zealand.

7.38 Against the three aspects, three of the four new entities were assessed as “Very good” or “Good”. We note in other Parts the challenges and risks arising from change, including structural change. The challenges of integrating systems and processes also carry risks. For the EPA and FMA, the establishment processes were able to build on existing systems and processes of predecessor organisations, which may have helped to maintain systems and controls.

7.39 Education New Zealand, established on 1 September 2011, was graded “Needs improvement” across all aspects. The issues identified by the auditor reflect the transitional issues associated with establishing an organisation and relate to staffing, systems, and organisational structure. The entity inherited systems, staff,

25 Note that the Standards Council of New Zealand does not prepare a Statement of Service Performance because the Council has obtained a reporting exemption under section 143 of the Crown Entities Act 2004. Therefore, we assess only the Council’s management control environment and financial information systems and controls.
assets and liabilities, and intellectual property from the Education New Zealand Trust, the Ministry of Education, and New Zealand Trade and Enterprise.

7.40 We continue to be interested in the effects and management of change within the public sector. Our appointed auditors will consider the risks and issues associated with change and reflect that in their audit work and reporting.

Management control environment

7.41 Figure 6 shows the results of our assessment of Crown entities’ management control environment from 2006/07 to 2011/12. Overall, the results for 2011/12 show that Crown entities have generally sound management control environments. Of the 62 Crown entities, 42 (68%) were assessed as having “Very good” management control environments, with another 15 (24%) graded as “Good”.

Figure 6
Management control environment – grades for the Crown entities assessed from 2006/07 to 2011/12

7.42 In terms of trends, controls have strengthened, with six entities moving from “Good” to “Very good” grades in 2011/12. These entities were:

• the Broadcasting Standards Authority;
• the Electoral Commission;
• the New Zealand Film Commission;
• the New Zealand Walking Access Commission;
• OFLC; and
• Public Trust.
Five entities were assessed as “Needs improvement”. Looking at the recommendations supporting the assessment, we note that the issues and recommendations for each entity vary:

- **EQC** – Although the auditors found that an appropriate level of governance existed, a number of recommended improvements still have to be addressed. We acknowledge that both 2010/11 and 2011/12 were extraordinary years for EQC, requiring a number of pragmatic responses and structural changes to address pressing issues. In our audit, we have advised management and the Board of the need to improve IT controls, and processes for the Housing Repair Programme.

- **Education New Zealand** – As noted in paragraph 7.39, the auditor’s assessment and recommendations reflect the fact that the entity was established on 1 September 2011 and that many of its policies and procedures require further work to ensure that they are relevant and appropriate. Internal controls are also underdeveloped. We have briefed Education New Zealand’s Audit and Risk Committee and Board on our major recommendations and will monitor progress during the next financial year.

- **Museum of New Zealand Te Papa Tongarewa (Te Papa)** – A number of recommended improvements have yet to be addressed to strengthen management systems and controls, including:
  - preparing an asset management plan;
  - preparing and adopting a collections stocktake policy; and
  - implementing recommendations for procurement policy.

- **Real Estate Agents Authority** – Areas for improvement include the need to enhance the reporting capability of the Authority’s complaints and licensing system.

- **Te Taura Whiri i Te Reo Māori (the Māori Language Commission)** – Work is required to improve expenditure policies and guidance.

We note that, in the last two years, the slight increase in the proportion of Crown entities being assessed as “Needs improvement” simply reflects the addition of the newly established Education New Zealand.

### Financial information systems and controls

Figure 7 shows the results for our assessments of Crown entities’ financial information systems and controls from 2006/07 to 2011/12. In 2011/12, 40 (64%) Crown entities were assessed as “Very good” and 19 (31%) as “Good”.
The decline in “Good” grades last year mainly reflects the improvement in grade from “Good” to “Very good” for the:

- Arts Council of New Zealand Toi Aotearoa (Creative New Zealand);
- Electoral Commission;
- Independent Police Conduct Authority;
- New Zealand Blood Service;
- New Zealand Film Commission;
- New Zealand Historic Places Trust; and
- Takeovers Panel.

However, it also reflects the downward movement from “Good” to “Needs improvement” for two entities:

- Real Estate Agents Authority – The Authority was still working through issues related to its financial management system and the calculation of operating levies and deferred revenue; and
- Te Papa – The auditors identified weaknesses in some major financial controls in the early part of the year and noted that major controls were reinstated for the year-end audit.
Part 7 Results of Crown entity audits

7.48 For completeness, it is also useful to note that some entities’ grades moved from “Very good” to “Good” - for example:

- CAA – auditors reviewed the effect of CAA’s change programme on systems and controls, and found issues regarding reconciliations, masterfile changes reviews, and the timely review of journals. CAA also had difficulty obtaining payroll reports from its replaced payroll system.
- The Electricity Authority – auditors noted weaknesses in the approval of journals and asset additions.

7.49 The Health Quality and Safety Commission improved its grade from “Needs improvement” to “Good”.

7.50 We brief management and the relevant Boards if our auditors identify deficiencies or recommend improvements. We will review the entities’ progress with addressing issues and expect those issues to be addressed during 2012/13.

7.51 As noted in paragraph 7.11, we did not grade the five entities disestablished with effect from 1 July 2012. For similar reasons, we did not assess the Road Safety Trust, which is to be wound up by 30 June 2013. Assessing fewer entities affected the trends noted above.

Service performance information and associated systems and controls

7.52 Figure 8 shows the trends for the grades for Crown entities’ service performance information and associated system and controls since 2008/09. In 2011/12, 42 (69%) Crown entities were graded as “Good” against this aspect and 17 (28%) as “Needs improvement.” In 2010/11, we reported that 28 Crown entities were assessed as “Needs improvement”.

7.53 For the year ended 30 June 2012, two (3%) Crown entities, the New Zealand Artificial Limb Board and the New Zealand Blood Service, were graded “Very good”, marking an improvement on previous assessments. In 2010/11, we reported that CHFA was assessed as “Very good” against this aspect. However, because CHFA was disestablished with effect from 1 July 2012, we did not grade it in 2011/12.

7.54 We are encouraged by the continued progress of entities that are working to improve their service performance information. In 2012/13, we will apply the Auditor-General’s revised auditing standard for auditing service performance reports to the remaining, generally smaller, departments and Crown entities.

7.55 For more information on the quality of performance reporting as we have continued to phase in the Auditor-General’s revised auditing standard, see Part 9.
Figure 8
Service performance information and associated systems and controls – grades for the Crown entities assessed from 2008/09 to 2011/12
Part 8

Results of State-owned enterprise audits

8.1 In this Part, we provide background information about SOEs and report the results of our 2011/12 audits of SOEs,26 including our assessments of their management control environment and financial systems and controls.

About State-owned enterprises

8.2 SOEs are established under the State-Owned Enterprises Act 1986 (the Act), are registered as companies, and are bound by the provisions of the Companies Act 1993.27 The Auditor-General is the statutory auditor of all SOEs and their subsidiaries. In this role, she is responsible for the annual audit and other aspects of the Auditor-General’s mandate provided for by the Public Audit Act 2001.

8.3 The principal objective of an SOE is to operate as a successful business and to be as profitable and efficient as comparable businesses that are not owned by the Crown. SOEs are also required to be good employers and to show a sense of social responsibility.

8.4 SOEs have some similarities. For example, they are all part of the Crown’s commercial portfolio and they are all subject to the same monitoring framework. The Crown Ownership Monitoring Unit (COMU) within the Treasury monitors SOEs on behalf of the shareholding Ministers, as outlined in the Owner’s Expectations Manual. However, other than their governance arrangements, there are few similarities among SOEs because of the many and varied nature of their businesses.

8.5 We audited 15 SOEs and Air NZ in 2011/12. These are listed below with a brief description of each:

- Airways Corporation of New Zealand Limited (Airways) – commercial provider of air navigation services and associated aviation infrastructure services;
- Animal Control Products Limited (Animal Control Products) – manufacturer and seller of pest management products;
- AsureQuality Limited (AsureQuality) – provider of a wide range of services to the food and primary industries in New Zealand and other countries;
- Genesis Power Limited (Genesis) – generator, wholesaler, and retailer of electricity;
- Kordia Group Limited (Kordia) – telecommunications and media business, which provides network and technology solutions;
- Landcorp Farming Limited (Landcorp) – pastoral farming, including dairy, sheep, beef, and deer;

26 We include Air NZ with SOEs for the purpose of reporting audit results.
27 Except for KiwiRail, which is a statutory corporation established by the New Zealand Railways Corporation Act 1981. It is an SOE but not a company.
8.6 At 30 June 2012, SOEs and Air NZ had a combined total equity of $18.776 billion (2010/11: $27.707 billion). In 2012, KiwiRail decided to change the basis of its asset valuations to one that reflects the commercial returns generated by those assets. The change in KiwiRail’s valuation approach resulted in a $7.1 billion reduction in asset value and a commensurate reduction in equity. This accounts for most of the drop of $9 billion in the combined total equity of SOEs and Air NZ in 2011/12.

8.7 Figure 9 shows the size of each SOE with total staff, revenue, assets, liabilities, and equity.29

28 For more information, see Transport sector: Results of the 2011/12 audits, available at www.oag.govt.nz.
Figure 9
Summary financial tables for State-owned enterprises, 2011/12

<table>
<thead>
<tr>
<th>State-owned enterprise</th>
<th>Total staff** (FTE)</th>
<th>Total revenue*** $million</th>
<th>Total assets $million</th>
<th>Total liabilities $million</th>
<th>Total equity $million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Airways</td>
<td>730</td>
<td>164.2</td>
<td>143.0</td>
<td>96.2</td>
<td>46.9</td>
</tr>
<tr>
<td>Animal Control Products</td>
<td>12</td>
<td>6.3</td>
<td>6.9</td>
<td>1.3</td>
<td>5.6</td>
</tr>
<tr>
<td>AsureQuality</td>
<td>1549</td>
<td>154.4</td>
<td>73.9</td>
<td>39.0</td>
<td>35.0</td>
</tr>
<tr>
<td>Genesis</td>
<td>931</td>
<td>2,270.2</td>
<td>3,635.5</td>
<td>1,835.1</td>
<td>1,800.4</td>
</tr>
<tr>
<td>Kordia</td>
<td>1112</td>
<td>398.5</td>
<td>259.2</td>
<td>167.5</td>
<td>91.7</td>
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<tr>
<td>Landcorp</td>
<td>573</td>
<td>210.5</td>
<td>1,662.9</td>
<td>330.9</td>
<td>1,332.0</td>
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<tr>
<td>Learning Media</td>
<td>133</td>
<td>27.5</td>
<td>12.6</td>
<td>8.0</td>
<td>4.6</td>
</tr>
<tr>
<td>Meridian</td>
<td>775</td>
<td>2,570.2</td>
<td>8,692.8</td>
<td>3,867.1</td>
<td>4,825.7</td>
</tr>
<tr>
<td>MetService</td>
<td>253</td>
<td>42.2</td>
<td>39.8</td>
<td>25.1</td>
<td>14.7</td>
</tr>
<tr>
<td>Mighty River Power</td>
<td>802</td>
<td>1,520.6</td>
<td>5,877.4</td>
<td>2,863.2</td>
<td>3,014.2</td>
</tr>
<tr>
<td>NZ Post</td>
<td>8326</td>
<td>1,309.4</td>
<td>15,851.0</td>
<td>14,891.6</td>
<td>959.5</td>
</tr>
<tr>
<td>KiwiRail</td>
<td>4175</td>
<td>888.1</td>
<td>4,262.4</td>
<td>802.3</td>
<td>3,460.2</td>
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<tr>
<td>QV</td>
<td>312</td>
<td>46.0</td>
<td>32.8</td>
<td>12.2</td>
<td>20.6</td>
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<td>Solid Energy</td>
<td>1656</td>
<td>980.7</td>
<td>1,165.9</td>
<td>742.6</td>
<td>423.4</td>
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<td>Transpower</td>
<td>747</td>
<td>785.4</td>
<td>4,905.3</td>
<td>3,396.1</td>
<td>1,509.2</td>
</tr>
<tr>
<td>Air NZ*</td>
<td>7631</td>
<td>3,272.6</td>
<td>3,985.1</td>
<td>2,752.8</td>
<td>1,232.2</td>
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<td>**</td>
</tr>
<tr>
<td>Total</td>
<td>29,717</td>
<td>14,646.8</td>
<td>50,606.5</td>
<td>31,831.0</td>
<td>18,775.9</td>
</tr>
</tbody>
</table>

* Numbers for Air NZ are expressed in proportion to the Crown’s ownership interest in the company.
** Crown Ownership Monitoring Unit, 2012 Annual Portfolio Report, page 118.

Governance and accountability

As noted, each SOE has two shareholding Ministers who hold the SOE shares on behalf of the Crown and are responsible to Parliament for the SOE’s performance. The shareholding Ministers appoint the board of directors, which is accountable for the performance of the SOE. COMU monitors SOEs on behalf of the shareholding Ministers.
8.9 The main accountability documents for SOEs are the statement of corporate intent (SCI), the annual report, and the half-yearly report.

8.10 The SCI must be finalised before the start of each financial year and must include specified information, including information about objectives, activities, targets and measures, and dividends.

8.11 The annual report, which is required to be finalised within three months of the end of each financial year on 30 June, must include audited financial statements and any information that is necessary to enable an informed assessment of the SOE’s operations, including a comparison of its performance with the relevant SCI.

Changes in the State-owned enterprises sector

8.12 The SOE sector is, and continues to be, influenced by the challenges faced by global market uncertainties. For example, the downturn in the New Zealand economy has resulted in the three energy generator and retailer SOEs (Genesis, Meridian, and Mighty River Power) experiencing a period of low demand for growth in electricity generation. Although there has been significant capital investment by these companies in the past five years, their forecast capital programmes have been scaled back or put on hold until such time as demand increases. COMU notes that it will be important for the companies to translate the high levels of earlier investment into stronger performance in the years ahead. This will continue to challenge all SOEs.

8.13 In the 2012 Budget, the Government announced its intention to sell up to 49% of the shares in the State-owned energy companies Genesis, Meridian, Mighty River Power, and Solid Energy. An ownership structure of at least 51% Crown ownership and up to 49% private ownership is commonly referred to as a mixed ownership model. Air NZ currently operates under a mixed ownership model in which the Crown owns most of the shares as well as the special rights convertible share (the Kiwi Share).

8.14 In July 2011, the Treasury appointed financial advisors to do preparatory work on applying the mixed ownership model to the four State-owned energy companies and on reducing the Crown’s shareholding in Air NZ. It was proposed that the Crown would retain a 51% stake in all the companies. As a result, the entities would remain public entities and continue to be within the mandate of the Auditor-General.

8.15 The sales of shares in SOEs are proving to be a matter of significant public interest. Therefore, we are monitoring the preparatory work and considering how it affects or may affect our role.
8.16 Financial information will be included in any prospectus documents, and our auditors are likely to be asked to provide assurance over this financial information.

**Audit reports 2011/12**

8.17 We issued standard audit reports for 15 SOEs and for Air NZ for the year ended 30 June 2012.

8.18 Our audits of SOE subsidiaries resulted in modified (qualified) opinions on New Zealand Post Recycle Centre Limited (for the two years ended 30 June 2011 and 30 June 2012) because we were unable to obtain enough assurance over the completeness of revenue.

8.19 Other non-standard audit reports included the recognition of the disestablishment or pending disestablishment of subsidiaries and comment on the appropriate use of the “going concern” assumption by The ECN Group Limited, a subsidiary of NZ Post.

**Environment, systems, and controls**

8.20 As part of the annual audit, we consider the SOE’s management control environment as well as the financial information systems and controls that support the management and reporting of financial information. Based on our observations, we assign grades for these.

8.21 Our appointed auditors identify deficiencies in each of these aspects and recommend improvements. The grades assigned reflect the recommendations for improvement as at 30 June 2012. See Appendix 1 for an explanation of the grading scale.

8.22 SOEs report a range of information in their annual reports. They are required by the Act to report against their SCI, and they also provide information on corporate social responsibility and sustainability matters, some of which is reported against international frameworks. The Act does not require such additional information to be audited. However, auditors will consider the information reported against the SCI (in particular, the performance measures and targets) to ensure that it is consistent with other information disclosed in the annual report.

8.23 Some of the reported information on corporate responsibility and sustainability is also subject to independent assurance, provided at the SOE’s request.

31 The Auditor-General is not required to attest to an SOE’s service performance. Therefore, we do not grade this aspect.
Grades for 2011/12

8.24 Figure 10 sets out a summary of the grades for the 15 SOEs and Air NZ for 2011/12.

Figure 10
Summary of grades for the 15 State-owned enterprises and Air New Zealand for 2011/12

<table>
<thead>
<tr>
<th>Number of entities graded</th>
<th>Management control environment</th>
<th>Financial information systems and controls</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>VG G NI P</td>
<td>VG G NI P</td>
</tr>
<tr>
<td>16</td>
<td>13 3 0 0</td>
<td>7 9 0 0</td>
</tr>
</tbody>
</table>

Grades used are: VG – Very good, G – Good, NI – Needs improvement, P – Poor.

8.25 Overall, the results for 2011/12 show that SOEs have sound management control environments and financial information systems and controls. The grades we issued for management control environment remain as high as they were in 2010/11. For financial information systems and controls, we assigned a “Very good” grade to seven entities (2010/11: five), with no entities receiving the “Needs improvement” grade (2010/11: two). Six of the 16 entities received a “Very good” grade for both their management control environment and financial information systems and controls. These results suggest that SOEs have made good progress during the past year in responding to our recommendations for improvement.

8.26 Figures 11 and 12 show the grades for SOEs for the six years from 2006/07 to 2011/12.

Figure 11
Management control environment – grades for State-owned enterprises, 2006/07 to 2011/12
8.27 Figure 11 shows the steady climb in the percentage of entities achieving a “Very good” grade for management control environment, which means we had no major recommendations for improvement for these entities. This rise was accompanied by a commensurate fall in the percentage of entities graded as “Needs improvement” or “Good”.

**Figure 12**
Financial information systems and controls – grades for State-owned enterprises, 2006/07 to 2011/12

8.28 Similarly, Figure 12 shows a steady rise in the percentage of entities with “Very good” financial information systems and controls, although most remain at the “Good” standard. After some “blips” in 2008/09 and 2010/11, there are no SOEs in the “Needs improvement” category.
Improving service performance reporting

9.1 In this Part, we report on improvements in the quality of performance reporting as we continue to phase in the Auditor-General’s revised auditing standard for auditing service performance reports. Our efforts will continue as we apply the revised auditing standard to more public entities in 2012/13. In particular, we discuss:
• the importance of performance information and reporting;
• how we are phasing in our revised auditing standard;
• results of audit reports for 2011/12 using the revised auditing standard;
• trends in entities’ quality of performance reporting; and
• our future work to phase in the revised auditing standard.

Why performance information and reporting is important

9.2 Performance reporting is an integral part of our parliamentary accountability system, enabling Parliament to hold ministers and central government entities to account. Parliament is required to make decisions about the funds to be voted through the annual Budget process and to review the performance of the entities that have used those funds. Parliament and the public rely on accountability documents to assess the performance of public entities and how effectively they use public funds.

9.3 If public entities are clear on why they exist, what changes they are seeking to influence, and how their services contribute to those desired changes, then they can build a sound framework for planning, measuring, managing, and reporting their performance. When public entities have good performance systems for running their organisations and making informed decisions, they should more easily produce external accountability reports that are relevant, reliable, and in keeping with legislation and generally accepted accounting practice. Within these reports, we expect public entities to:
• clearly explain what they are trying to achieve;
• clearly explain the services they are accountable for providing;
• present a framework that shows the cause-and-effect relationships and assumptions underpinning the spending of taxpayer funds on public services to achieve public benefit;
• report targets and results through a well-rounded suite of appropriate performance measures; and
• report externally in a way that is integrated with the information they use to manage their business.

9.4 We continue to witness significant improvements in the quality of government departments’ and Crown entities’ performance reports.

**Phasing in our revised auditing standard and accompanying support**

9.5 We are phasing in a revised standard for auditing service performance reports. Our revised standard requires our auditors to modify their audit opinion if the performance information in the annual report does not, in their opinion, fairly reflect performance for the year. Under the previous auditing standard, there was very little scope for appointed auditors to modify their audit opinion if the content of the performance report was inadequate.

9.6 Before implementing our revised auditing standard, we have endeavoured to prompt and help public entities to raise the standard of their performance reporting through our Office’s support initiatives, combined with regular evaluation and feedback to entities from appointed auditors. To help make the improvement programme manageable and to provide a concentrated effort on our support initiatives, we phased in the application of the revised standard.

9.7 In 2010/11, 28 of the larger and more complex entities were audited using the revised standard.

9.8 In 2011/12, we applied the revised standard to the audit of a further 34 (mainly medium-size) departments and Crown entities.

9.9 We will apply the revised standard to our audits of the remaining (generally smaller) departments and Crown entities in 2012/13.

9.10 We provided entities with advance notice about the revised auditing standard to allow time and to provide support for them to up-skill and improve their performance information and reporting. In the lead-up to applying the revised standard to our audits, we placed greater emphasis on performance information in the audit, provided clear signals and specific advice to entities about continual improvement in this area, and provided guidance and other support to help entities improve.

9.11 We have supported public entities by:
- giving feedback on performance documents;
- holding one-on-one conversations about business objectives and how to reflect these in performance information systems;
- providing guidance and advice, seminars, and workshops; and
- giving other forms of support, such as online resources to support an emerging community of practice.
Audit reports for 2011/12

9.12 We issued just one modified opinion for poor performance reporting for those entities we audited using the revised standard in 2011/12. We modified our opinion for NZFSC because of the absence of results data (see Figure 2 and paragraphs 5.22 and 7.7). However, the quality of NZFSC’s performance reporting framework has been of a high standard for several years.

9.13 In Figure 13, we list the 28 departments and Crown entities that were first audited using the revised auditing standard in 2010/11 and the 34 departments and Crown entities that were audited using the revised auditing standard for the first time in 2011/12.

**Figure 13**
Entities audited using the revised auditing standard for service performance reporting

<table>
<thead>
<tr>
<th>Entities audited using the revised auditing standard for the first time in 2010/11 (first phase – Category A)</th>
<th>Entities audited using the revised auditing standard for the first time in 2011/12 (second phase – Category B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government departments</td>
<td>Government departments</td>
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<tr>
<td>Department of Conservation</td>
<td>Crown Law Office</td>
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<tr>
<td>Department of Corrections</td>
<td>Department of Building and Housing</td>
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<tr>
<td>Department of Labour</td>
<td>Department of Internal Affairs</td>
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<tr>
<td>Inland Revenue Department</td>
<td>Department of the Prime Minister and Cabinet</td>
</tr>
<tr>
<td>Land Information New Zealand</td>
<td>Education Review Office</td>
</tr>
<tr>
<td>Ministry of Agriculture and Forestry/ Ministry for Primary Industries</td>
<td>Ministry of Culture and Heritage</td>
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<td>Ministry of Economic Development</td>
<td>Ministry of Defence</td>
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<td>Ministry of Education</td>
<td>Ministry of Pacific Island Affairs</td>
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<td>Ministry of the Environment</td>
<td>Ministry of Science and Innovation</td>
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<td>Ministry of Fisheries</td>
<td>Ministry of Transport</td>
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<td>Ministry of Foreign Affairs and Trade</td>
<td>Parliamentary Service</td>
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<td>Ministry of Health</td>
<td>State Services Commission</td>
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<tr>
<td>Ministry of Justice</td>
<td>Statistics New Zealand</td>
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<tr>
<td>Ministry of Social Development</td>
<td>New Zealand Customs Service</td>
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<td>New Zealand Defence Force</td>
<td>New Zealand Police</td>
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<tr>
<td>New Zealand Police</td>
<td>Te Puni Kōkiri</td>
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<tr>
<td>The Treasury</td>
<td></td>
</tr>
</tbody>
</table>
During the last year, appointed auditors maintained contact with the medium-size “second phase” entities, offered advice on critical deficiencies and where to make improvements, monitored progress, and reviewed draft performance frameworks and accountability documents. Entities in this group have responded well and continued to make significant improvements to their performance frameworks, choice of performance measures, and presentation of those frameworks and measures in their annual reports.
Assessing the quality of performance reporting

9.15 As well as attesting to an entity’s service performance in their audit opinions, appointed auditors assign a grade for service performance information and its associated systems and controls (see Appendix 1). The grade for the service performance aspect can be “Poor”, “Needs improvement”, “Good”, or “Very good”. (See Figure 27, Appendix 1, for explanations of these grades.)

Entities audited using the revised audit standard for the first time in 2010/11 (first phase – Category A entities)

9.16 In Figures 14 and 15, we present a time-series of the grades for performance reporting that our appointed auditors have assigned to 24 government departments and Crown entities since 2008/09. These 24 entities are those to which we applied our revised auditing standard from 2010/11 and for which we issued a performance information grade for all four years.33

9.17 Figure 14 presents results by grade value and highlights a significant reduction in “Poor” and “Needs improvement” grades during the four years, with a related rise in “Good” grades and the emergence of entities attaining “Very good” grades.

Figure 14
Performance reporting grades by grade value (Category A entities), 2008/09 to 2011/12

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33 We applied our revised auditing standard to 26 entities from this group in 2011/12, two less than in 2010/11, because of the disestablishment of the Ministry of Fisheries and the Legal Services Agency in the previous year. We issued grades to 24 of the 26 remaining entities because of the disestablishment of the Department of Labour and the Ministry of Economic Development at the 30 June 2012 year-end.
Figure 15 highlights the movement in the distribution of grades from year to year. The shape of the grade clusters shows a distinct move to the right (that is, improvement) during the last four years.

Both graphs show that the largest improvement took place during 2010/11, which was the year in which we first applied our revised auditing standard to these 24 entities. Since then, entities have continued to improve, with grades skewing more towards the higher end of the scale.

**Figure 15**
Performance reporting grades by year (Category A entities), 2008/09 to 2011/12

This year is the first time we have identified “Very good” performance reporting within this larger group of entities (Inland Revenue and Ministry for the Environment). Those receiving a “Good” grade have more than trebled during the past four years. The incidence of the “Needs improvement” grade has reduced to less than a third of what it was, and the “Poor” grades disappeared during the year that we first applied our revised auditing standard to these entities (that is, 2010/11).

Entities audited using the revised auditing standard for the first time in 2011/12 (second phase – Category B entities)

In Figures 16 and 17, we present a four-year time-series of the grades for performance reporting for those entities to which we applied our revised auditing standard for the first time in 2011/12. This group comprises 30 (mainly) medium-
size government departments and Crown entities for which we have issued a performance information grade for all four years.34

9.22 Figure 16 presents results by grade value and highlights a considerable reduction in “Poor” and “Needs improvement” grades over the four years, with a related rise in “Good” grades and one entity achieving a “Very good” grade.

**Figure 16**
Performance reporting grades by grade value (Category B entities), 2008/09 to 2011/12

9.23 Figure 17 highlights the movement in the distribution of grades from year to year. As with the group of larger entities (Category A), the grade clusters for Category B entities also show a distinct move to the right during the last four years, signalling considerable improvement.

9.24 The grades set out in Figures 16 and 17 show little improvement to 2009/10 but a marked improvement beginning in 2010/11, with improvement continuing at similar pace in 2011/12. This group of entities responded, in 2010/11, with improved performance reporting one year before we first applied our revised auditing standard to them and continued the pace of change during the year we first applied the revised standard (2011/12). The grades are now clearly skewed towards the higher end of the scale.

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34 We applied our revised auditing standard to 34 entities from this group in 2011/12. We have issued grades to 30 of these 34 entities. We did not issue grades for three disestablished entities (Charities Commission, Department of Building and Housing, and Ministry of Science and Innovation). The New Zealand Symphony Orchestra is excluded from our figures because of its later balance sheet date.
9.25 One entity within this group has achieved a “Very good” grade (New Zealand Blood Service). Those entities receiving a “Good” grade have more than doubled during the past four years. The incidence of the “Needs improvement” grade is less than half of what it was in 2008/09, and the “Poor” grades among this group of entities disappeared early on.

9.26 The extent of genuine improvement may be understated by the graphs, because we have seen examples of improved performance reporting that has not resulted in an increased grade. In the short term, we encourage entities and the users of performance reports to focus on how the entities have responded to our specific recommendations for improvement and how they are resolving the current deficiencies in their reporting frameworks and practices.

9.27 In the medium term, we expect to see reporting improvements reflected in grade increases, and that is what we are seeing now. As we have phased in our revised auditing standard during the past two years, we have made a concerted effort to support entities, and many entities have made a concerted effort to improve the quality of their performance reports. These improvements are evident in the significant grade increases issued for performance reporting in 2010/11 and 2011/12.
Future intentions

9.28 In 2012, we ran workshops to support the third group of entities (Category C) to which we will apply our revised auditing standard in 2012/13. Our aim was to help this group of entities to improve their performance information frameworks, systems, and reports as they prepared their 2012-15 Statements of Intent, which they will report against in 2012/13. We also helped establish a community of practice for this group and provided them with a secure website where they could access tools, guidance, and advice as well as share ideas and documents.

9.29 In 2013, appointed auditors will concentrate efforts on monitoring the progress of this third group as these entities prepare their 2012/13 annual reports, which we will then audit using our revised auditing standard.
Part 10
Financial reporting changes

10.1 In this Part, we highlight changes to financial reporting in New Zealand during the past 12 months, including strategic changes to the financial reporting framework and proposed changes to financial reporting standards. We comment on how these changes are likely to affect central government entities, and we provide some concluding comments.

Strategic changes to New Zealand’s financial reporting framework

10.2 Since 1 July 2011, the XRB\textsuperscript{35} has had responsibility for both preparing and issuing financial reporting standards. The XRB determined a proposed strategy for different classes of entities and for tiers of financial reporting within those classes, which it consulted on in September 2011.\textsuperscript{36} After consultation, the strategy was finalised and approved by the Minister of Commerce on 2 April 2012.

10.3 The strategy establishes what has become known as a “multi-standards approach” to financial reporting. The approach distinguishes three classes of entities:
- for-profit entities in the public and private sectors;
- public benefit entities in the public sector; and
- public benefit entities in the not-for-profit sector.

10.4 The approach also distinguishes different tiers of reporting for classes of entities, with each tier having different financial reporting requirements.

10.5 At the heart of the multi-standards approach is a recognition that financial and non-financial information should meet the information needs of users of general purpose financial reports. In future, those needs are expected to be best met by having financial reporting standards tailored to particular classes and particular sizes of entity.

10.6 The multi-standards approach is also expected to better align the costs of producing general purpose financial reports with the benefits realised by the users of those reports. For some entities, this should mean that the cost of preparing their general purpose financial reports reduces.

10.7 The XRB has established a transition plan that takes into account proposed legislative changes. That plan aims to have the new financial reporting framework fully operational within the next two to three years.

\textsuperscript{35} The XRB was previously the Accounting Standards Review Board. The previous Board had a narrower role than the XRB.  
\textsuperscript{36} This consultation followed consultation about similar matters carried out by the Accounting Standards Review Board in 2009.
10.8 The new financial reporting framework will affect how public sector entities report. It will mean that public entities could report under one of six categories, depending on the nature and size of the entities.

10.9 The categories for public benefit entities in the public sector are:
- full reporting (tier 1);
- reduced disclosure reporting (tier 2);
- simple format accrual reporting (tier 3); and
- simple format cash reporting (tier 4).

10.10 The categories for for-profit entities in the public sector are:
- full reporting (tier 1); and
- reduced disclosure reporting (tier 2).

10.11 There are also two temporary categories for for-profit entities, which will be removed once changes are made to financial reporting legislation. The temporary categories are:
- differential reporting (tier 3); and
- old standards, referred to as “old GAAP” (tier 4).

10.12 Entities that are “publicly accountable”\(^{37}\) will report fully (tier 1) regardless of size. This will include all “issuers”.\(^{38}\) All other entities will be allocated to a category based on their size, and can elect to report in keeping with the requirements that correspond to that category.

10.13 The size criteria for allocating public benefit entities in the public sector to tiers are:
- tier 1 – operating expenditure of more than $30 million;
- tier 2 – operating expenditure between $2 million and $30 million;
- tier 3 – operating expenditure of less than $2 million; and
- tier 4 – only if permitted by legislation and expected to be for very small entities.

10.14 The size criteria for allocating for-profit entities in the public sector to tiers are:
- tier 1 – operating expenditure of more than $30 million; and
- tier 2 – operating expenditure of $30 million or less.

10.15 Central government entities include public benefit entities and for-profit entities. Therefore, we expect central government entities to be in at least five of the six different categories. For example, government departments and Crown entities are expected to report in keeping with public benefit entities tier 1 or tier 2.

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\(^{37}\) As defined in the XRB’s exposure draft ED XRB A1 (FP Entities + PS PBEs).

\(^{38}\) As defined in section 4 of the Financial Reporting Act 1993.
Entities such as some smaller schools and fish and game councils will be eligible to report in keeping with public benefit entities tier 3. State-owned enterprises and any other central government entities that are for-profit entities are expected to report in keeping with for-profit entities tier 1 or 2, depending on whether they are “publicly accountable” and their size.

**Proposed changes to New Zealand’s financial reporting standards**

10.16 The XRB has established a sub-board called the New Zealand Accounting Standards Board (NZASB). The XRB has delegated responsibility to NZASB to develop the financial reporting requirements for the classes of entities and the tiers that the XRB has determined. At present, the NZASB is doing a lot of work to prepare the financial reporting standards that will be used when the new financial reporting framework is fully operational.

**Public benefit entities**

10.17 The new financial reporting framework will result in new standards and requirements being put in place for all public benefit entities in the public sector. The NZASB has recently consulted on a new suite of financial reporting standards for public benefit entities in tiers 1 and 2. The new suite of financial reporting standards for public benefit entities is largely based on International Public Sector Accounting Standards (IPSAS) and is proposed to apply for reporting periods beginning on or after 1 July 2014.

10.18 At present, IPSAS are generally aligned to the current financial reporting standards applied by most public benefit entities in the public sector, which, in turn, are based on International Financial Reporting Standards (IFRS). The alignment is because most IPSAS were developed using IFRS as a starting point. However, over time, we expect the level of alignment to reduce because the approaches taken by the two international standard-setters diverge.

10.19 Although generally aligned at present, there are a few significant differences and a number of more subtle differences in the proposed new suite of standards. Therefore, as part of the recent consultation process, we carefully reviewed the proposed new standards and we provided comments to NZASB to help it finalise the new suite of standards.

10.20 NZASB is currently consulting on its proposals for reporting by public benefit entities in the public sector in tiers 3 and 4. We expect to provide comments to NZASB on the proposals for tiers 3 and 4 shortly.
For-profit entities

10.21 The new financial reporting framework retains the existing suite of financial reporting standards for for-profit entities that are based on IFRS but changes some of the requirements for for-profit entities at tier 2. For many years, smaller for-profit entities could apply a differential reporting regime that included some different accounting requirements and fewer disclosure requirements. That regime was replaced with a new reduced disclosure reporting regime at the end of 2012.

10.22 The reduced disclosure reporting regime for tier 2 for-profit entities requires those entities to follow the same accounting requirements as tier 1 entities but has a lot fewer disclosures than the previous regime. The reduced disclosure reporting regime aligns with the requirements in Australia for smaller for-profit entities.

10.23 Apart from the change to a reduced disclosure reporting regime, for-profit entities will have the usual ongoing changes to deal with as new standards are developed or existing standards revised. In that regard, a number of new standards were issued recently that will need to be applied in the next year or two.

10.24 Appendix 3 contains a guide to the new financial reporting standards framework for entities in the public sector.

Effect on central government entities

10.25 In the next two to three years, the changes to financial reporting standards referred to above will affect all central government entities to some extent. Although many central government entities will qualify to report as public benefit entities tier 2 or tier 3, and others as for-profit entities tier 2, some central government entities may be required to provide more detailed information than that reported under those tiers for the purpose of producing consolidated financial statements, such as the Government’s financial statements.

Concluding comments

10.26 We support the strategic changes and the broad direction of the proposed financial reporting standards that are starting to take shape. In future, we expect to see greater divergence of the international financial reporting standards. The expected divergence would have made it increasingly difficult to have one cohesive set of financial reporting standards based on IFRS that were suitable for application by all entities in New Zealand. We therefore consider that the new suite of financial reporting standards for public benefit entities in the public sector will be a more appropriate base from which future changes are made.
10.27 Although we support the new suite of financial reporting standards for public benefit entities in the public sector, we do not regard it as a “silver bullet” that resolves all the various concerns that have been previously raised about financial reporting. Nevertheless, in our view, the change is necessary, and it provides the best platform for future financial reporting by public benefit entities in the public sector.
Part 11
Memorandum accounts in central government

11.1 In this Part, we examine what memorandum accounts are and their role in ensuring public accountability. We discuss entities with significant memorandum accounts and the business risks facing those entities. We then look at the historical trends and the future use of memorandum accounts by entities.

What are memorandum accounts?

11.2 A number of public sector entities provide services that are not funded by the Crown but by third-party users of those services. Sometimes, this is referred to as “user pays”. If entities provide services on a full cost-recovery basis and the revenue and expenses will not necessarily agree in each financial year, the entity must operate a memorandum account that records the accumulated surplus or deficit arising from providing the service.

11.3 The 2012 Treasury Instructions state that “full cost-recovery ... applies where departments supply services to third parties in the absence of competition or under a statutory monopoly”. The balance of each memorandum account is expected to trend to zero over a realistic period of time, with temporary deficits being met either from the entity’s balance sheet or by a capital injection from the Crown.

11.4 The use of memorandum accounts was implemented in 1995 to improve transparency around outputs for which costs are fully recovered through fees, levies, and other charges from third parties. Memorandum accounts also provide assurance from entities that they do not gain from over-recovery – that is, they do not make a profit. Requiring entities to prepare memorandum accounts ensures that they are accountable to those purchasing the services and wider stakeholders.

11.5 From 1 July 2011, departmental memorandum accounts changed from being “notional” to “real” accounts. This change means that entities are required to separately recognise memorandum accounts in their financial statements as opposed to a note disclosure that is mandatory for notional accounts. The accounting effect of this, as described in the Treasury Circular, is that:

... the portion of surpluses in any financial year from those departmental services subject to memorandum accounts are no longer required to be paid to Treasury as part of the department’s surplus. The amount equivalent to deficits recorded on services subject to memorandum accounts needs to be added back to the net surplus that a department would be otherwise required to pay to Treasury for that financial year.

The prescribed accounting treatment is effective in that it allows entities to retain any surpluses derived from third-party revenue to meet any future deficits incurred for a particular service.

**Significant memorandum accounts**

**Department of Internal Affairs – Passport Products memorandum account**

The Department of Internal Affairs (DIA) has nine separate memorandum accounts disclosed in the notes to its financial statements for the year ending June 2012. Of these memorandum accounts, there is one balance significantly above zero. This is the Passport Products account, which had a surplus balance as at 30 June 2012 of $27.4 million. There are a number of factors that have resulted in this large surplus balance.

The Passport Products account, which includes all revenue and expenditure related to the issuing of passports and maintenance of the passport system, has had year-on-year account operating surpluses since 2007/08. The 2011/12 financial year was no different, with a surplus of $9.9 million recorded for the year, which was an increase from the 2010/11 surplus of $7.9 million. This increase in surplus can be attributed to systems enhancements that resulted in the ability to handle 2011/12 passport volume increases with only a modest increase in staff.

In the notes to its financial statements, DIA has disclosed that it will address the significant positive account balance and year-on-year surpluses through a passport fees review in 2012/13. Passport fees have not been reviewed since 2005 and a change in the fee should be effective in reducing the yearly surpluses.

**Department of Labour – Visas and Permits memorandum account**

The Department of Labour (now part of MBIE) had one memorandum account. This is the Visas and Permits memorandum account, which, as at 30 June 2012, had a deficit balance of $36.4 million. The account encompasses all revenue and expenditure related to the cost of visas and permits by the department on a full cost-recovery basis. As a result, there are various factors in the economic environment that affect the balance.

The deficit balance of $36.4 million as at 30 June 2012, disclosed in Note 27 to the financial statements, is the result of year-on-year deficits, including a $13.6 million deficit for 2011/12. The department attributes the deficit to lower than expected volumes of visa applications (particularly student visas) and the

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41 Department of Internal Affairs, 2011-12 Annual Report

42 Department of Labour, Annual Report for the year ended 30 June 2012.
effect of the Canterbury earthquake in February 2011 in reducing the number of people coming to New Zealand.

11.12 To address the current deficit on the memorandum account, Cabinet has approved an increase in immigration visa and permit fees, from 2 July 2012. Although the increase in fees is likely to be offset by the International Global Management System (IGMS)\textsuperscript{43} operating deficits from 2011/12 to 2016/17, it is expected that a net operating surplus will occur from 2017/18. This will reduce the account deficit and bring it closer to zero.

**Ministry of Economic Development – Vote Commerce: Registration and Provision of Statutory Information memorandum account**

11.13 The Ministry of Economic Development (MED), which is now part of MBIE, had seven memorandum accounts disclosed in the notes to MED’s financial statements for the year ended 30 June 2012. A number of these accounts have balances significantly above or below zero. The most significant of these is the Registration and Provision of Statutory Information memorandum account, which has a deficit balance of $5.1 million after a capital injection from the Crown of $6.0 million.\textsuperscript{44}

11.14 The Registration and Provision of Statutory Information memorandum account captures all revenue and expenditure related to the administration of companies in New Zealand. As a result, the amount of revenue and expenditure related to this service is heavily influenced by economic conditions. In the notes to the financial statements, MED discloses that the Companies Office has a strategy of maintaining the memorandum account in a balanced state over the long term. This allows for fluctuations in volumes because of changes in economic activity and other matters. MBIE will address surpluses and deficits through volume considerations and regular reviews of the pricing schedule.

11.15 The capital injection from the Crown to recover the 2012 deficit is repayable through projected future memorandum account surpluses.

**Department of Building and Housing – Occupational Licensing – Building Practitioners memorandum account**

11.16 The Department of Building and Housing (also now part of MBIE) provides a number of “user pays” services to third parties, the largest of which is the occupational licensing of building practitioners. The service was introduced from November 2007 and is the result of amendments to the Building Act 2004 that now require that all building practitioners must be licensed to carry out building work.

\textsuperscript{43} The IGMS is an online system for managing immigration applications. It will replace the current Application Management System.

\textsuperscript{44} Ministry of Economic Development (2012), Annual Report 2011/12.
11.17 As at 30 June 2012, the accumulated balance for this service’s memorandum account was negative $15.3 million. The memorandum account has been in existence since 2003/04, and it has recorded an operating surplus only once since that year. To reduce the account deficit, the department has disclosed in the notes to its financial statements that it will review the cost structures supporting the service.45

Other “user pays” accounts

11.18 There are other “user pays” accounts that central government entities use to disclose the revenue and expenditure attributed to services provided to third parties. CAA and NZTA are two such entities that provide “user pays” services. Although the Treasury Circular on memorandum accounts does not apply to these entities, it is considered good practice for entities to disclose revenue and expenses related to providing services to third parties to promote transparency.

Civil Aviation Authority – Aviation security charges

11.19 The Aviation Security Service, which is the operating arm of CAA, provides passenger security services to airlines and, in return, receives payment for these services on a per passenger basis. These services are administered on a full cost-recovery basis, and it is not intended for a profit to be made from their supply.46

11.20 As at 30 June 2010, CAA had an accumulated surplus balance of $49.8 million in its international and domestic passenger charges reserve. This was a result of a build-up of significant year-on-year operating surpluses for these services. To reduce the account balance surplus, the security fee was reduced by $5 per passenger effective from 1 April 2010. This led to operating deficits for passenger security services in 2010/11 and 2011/12 and reduced the reserve surplus to $23.1 million as at 30 June 2012.47

New Zealand Transport Agency – Driver licensing

11.21 NZTA is another entity that is not subject to the Treasury Circular on memorandum accounts but provides a number of “user pays” services related to the transport sector. These services include, but are not limited to, border inspections, certification reviews, driver licensing, and tolling.48 The revenue and expenditure as well as the accumulated account balance for each service are disclosed by NZTA in the notes to its financial statements.

45 Department of Building and Housing (2012), Annual Report 2011-2012.
46 Civil Aviation Authority of New Zealand (2012), 2011/12 Annual Report.
47 Civil Aviation Authority of New Zealand, 2009/10, 2010/11, and 2011/12 Annual Reports.
11.22 Of NZTA’s “user pays” services, driver licensing represents the biggest portion of third-party revenue. The amount of total revenue disclosed in the memorandum account for driver licensing for the year ending 30 June 2012 is $29.8 million. However, the actual amount received from third parties is $28.4 million because NZTA received $1.4 million from the Crown to subsidise driver tests. Therefore, if NZTA were subject to the Treasury Circular on memorandum accounts, this service would not be considered a memorandum account activity because the Treasury Circular requires that the service be fully funded by third parties.

Significant business risks for entities with memorandum accounts

Account balance monitoring systems

11.23 For entities with memorandum account balances, having effective monitoring systems in place is important. Entities should ensure that there is regular monitoring of account balances on either a monthly or quarterly basis. This will allow management to see how revenue and expenditure for a particular service is tracking against budget. Management will then be able to determine if the pricing and costing of the product is realistic and put in place plans to ensure that the account balance is kept stable.

11.24 Without regular and effective monitoring of account balances, there is a risk that memorandum account balances will run significant surpluses or deficits without management being aware. This could occur either through incorrect pricing or costing of the service. Appropriate monitoring also allows management to see how current economic conditions are affecting the provision of services to third parties.

Plans to reduce deficits/surpluses

11.25 Regular monitoring of account balances will allow management to put plans in place to reduce significant deficits and surpluses. To reduce the surpluses or deficits, management can implement regular service pricing reviews, perform sensitivity analysis for different economic conditions, and assess the viability of funding deficits from their balance sheet.

11.26 If clear plans are not put in place, entities run the risk that surpluses or deficits become uncontrollable. Deficits will require considerable capital contribution and surpluses will require major price cutting, leaving previous users of the service feeling as though they have paid for services provided to future users.
Cost allocation systems

11.27 A robust cost allocation system allows an entity with a memorandum account to accurately apportion direct and indirect costs to a particular service. Examples of this include the apportionment of staff costs where staff members are working in several different service areas, and the apportionment of premise costs where a premise is used to provide a number of services.

11.28 Accurate allocation of costs is important because it reduces the risk of third parties bearing the costs associated with other activities that should be funded by the Crown. It also ensures that the Crown is not inadvertently subsidising a service that should be paid for by third parties. As well as ensuring that costs are borne by the correct party, accurate cost allocation is a powerful tool for effective service costing and fair pricing of the service.

Historical trends and good practice

11.29 Our review of a number of memorandum accounts over time shows that surpluses and deficits fluctuate because of changes in economic and other conditions, pricing structures, and, in some cases, service cycles.

11.30 The Department of Labour Visas and Permits memorandum account shows the effect that economic and other conditions can have on memorandum account balances. From the year ending 30 June 2008, the accumulated account balance went from a surplus of $10.2 million to a deficit of $36.4 million in 2011/12. This was caused by a number of significant net memorandum account deficits, which can be attributed to the February 2011 Canterbury earthquake and volatile economic conditions in countries that would usually send their students to New Zealand for study.49

11.31 Other factors that can affect memorandum account balances can be seen by looking at the balance trend for DIA’s Passport Products memorandum account. Since 2007/08, there has been a steady increase in the net memorandum account surplus for Passport Products from $0.253 million in 2007/08 to $9.9 million in 2011/12. The result is that, as at 30 June 2012, the account has a surplus balance of $27.4 million. This is mainly because of the period of time that has passed since the last fee review in November 2005 and an increased passport volume (because of the change to a five-year passport cycle).50

11.32 The benefit of reviewing service pricing was shown in the case of CAA’s Passenger Security Services account (see paragraph 11.19). By reducing the service price, CAA reduced the account’s accumulated surplus by $26.7 million in just over two

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49 Department of Labour, Annual Reports 2007/08–2011/12.
50 Department of Internal Affairs, Annual Reports 2007/08–2011/12.
years.\textsuperscript{51} This is in line with our good practice guide, \textit{Charging fees for public sector goods and services}, which suggests that there should be regular reviews to ensure that fees remain appropriate and that the assumptions used continue to be relevant.\textsuperscript{52}

**Future use of memorandum accounts**

11.33 With the Government’s focus on achieving an operating surplus by 2014/15 and delivering better public services under tight financial constraints, it is possible that there will be an increase in the number of memorandum accounts in the coming years. Reduced levels of funding for entities may lead to a “user pays” approach for some services.

11.34 In times of fiscal constraint, memorandum accounts provide a useful accountability tool for both third-party users of services and wider stakeholders. They allow third parties to see whether services are being fairly priced and ensure that entities are not benefiting from overcharging for a service.

\textsuperscript{51} Civil Aviation Authority of New Zealand, Annual Reports 2008/09–2011/12

\textsuperscript{52} Controller and Auditor-General (2008), \textit{Charging fees for public goods and services}, page 12, paragraph 2.23.
Part 12
Developing our tool kit: Financial analysis framework and indicators

12.1 In this Part, we outline how we are developing our financial analysis framework, set out that framework, then present our initial findings from applying our analysis to government departments and Crown entities.

12.2 Government departments and Crown entities are grouped together simply based on legislative form, which does not necessarily render the most meaningful comparisons and aggregate view. However, our intention is to share the framework and to stimulate debate about how we can develop our framework and associated tools to enhance the value of our work.

Background

12.3 We have been working to develop and expand the tools we have available to improve our understanding and analysis of the entities we audit. The audited financial statements of the entities we audit are rich sources of information. This information is particularly useful if we can build up a picture of financial performance over time and can use this to provide independent assurance to Parliament and the public.

12.4 We have focused on developing a framework that we can apply across groups of entities or sectors, and a consistent agreed approach to collecting and analysing data. As we build the data set over time, we expect the value we can extract from our analysis to grow. We want to share our framework now so that we can test and fine-tune the framework before investing further in its development. We invite you to provide your thoughts on:

• the hypotheses or questions we could usefully test (for example, entities are maintaining their assets, entity Y is not typical of similar entities in the sector);
• the financial ratios and indicators we should focus on in our analysis of specific groups of entities or sectors;
• the groups of entities to which we could most usefully apply this analysis; and
• where, and in what contexts, you would expect us to apply this analysis.

12.5 The judgements we make may differ from other monitoring approaches and perspectives. As we develop our financial analysis framework and tools, we intend to engage closely with the Treasury, COMU, and monitoring departments to test our approach.

12.6 In this Part, we provide a brief overview of the analysis we can provide. Over time, as the data set grows and we integrate our financial analysis with our analysis of service performance and assessment of entities’ environment systems and

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53 Entities and monitoring agencies can provide this feedback to our sector managers. We can also be contacted by emailing info@oag.govt.nz.
controls, we expect to be able to provide a more comprehensive perspective on entity and sector performance.

**Our framework for analysing financial performance**

12.7 In general, performance is about achieving objectives in an uncertain environment. Measuring and analysing performance in a comprehensive way requires a good understanding of an organisation’s objectives, the risks to achieving those objectives, and the relationship between the two.

12.8 Audited financial statements play an important role in informing readers about the performance of public sector entities. Although objectives in the public sector are not always measurable in monetary terms, over a period of time, the financial statements can provide information on the risks of achieving public sector objectives.

12.9 Risks for central government entities arise from many different sources, including commercial, economic, political, and structural changes, both within and outside of an organisation. Our framework does not attempt to identify and understand the root causes of risk. Instead, it uses financial statements to assess how some of these risks are reflected through the financial activities of the entities. For example, we consider how well entities:

- apply their financial resources in the short term – we call this **stability**;
- respond to medium-term unanticipated events – we call this **resilience**; and
- deal with longer-term uncertainties – we call this **sustainability**.

12.10 To gauge the potential risk for a group of entities delivering on public sector objectives, we looked at, over a six-year period, various indicators (or ratios) relating to each of these three areas.

12.11 Figure 18 summarises the indicators we used to analyse government departments and Crown entities, as set out in paragraphs 12.20 to 12.39.

**Figure 18**

**Our indicators of financial performance for government departments and Crown entities**

<table>
<thead>
<tr>
<th>Stability</th>
<th>Resilience</th>
<th>Sustainability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Budget to actual cash flows applied to operations</td>
<td>Fixed costs to operating and investing cash outflows</td>
<td>Capital expenditure* to depreciation and amortisation</td>
</tr>
<tr>
<td>Budget to actual cash flows applied to asset-related activities</td>
<td>Current assets to current liabilities</td>
<td>Equity to assets</td>
</tr>
</tbody>
</table>

* Capital expenditure also includes expenditure on intangible assets.
12.12 Other indicators can be used for particular sectors. For example, total liabilities to total assets, and current assets to operating expenditure.

12.13 In terms of aggregating the analysis (for a group of entities), we look at each indicator and determine:

- whether the average values each year are within or outside what we consider to be a reasonable range;
- how these average values are trending over time (that is, direction); and
- the number of entities that lie outside the “typical” range. To understand what is typical for a sector, we use a standardised measure of variation on either side of the average (plus and minus one standard deviation). The number and distribution of these entities determines our assessment of low to high variability. If the number of entities outside a typical range is high, this suggests greater uncertainty or variability in the group’s or sector’s financial stability, resilience, and sustainability.

12.14 Because a degree of judgement is involved in the assessment of these areas, we use a traffic-light system to present the results of our analysis of each of the indicators (see Figure 19).

**Figure 19**
Traffic-light system to summarise the results of our assessments
By considering the three areas of stability, resilience, and sustainability, we get some insight into the financial risk involved in delivering on the Government’s objectives for a group of entities. In our model, the sustainability of a group, sector, or entity builds and depends on the stability and resilience of the entity or entities within the group or sector.

As with all financial analysis, there are limitations to what can be inferred from our analysis. Our approach does not provide a comprehensive assessment of a sector or indeed a group of entities’ performance. Importantly, any entities that fall outside what is considered typical for the sector may simply warrant further investigation and analysis. The value of the framework and application to our work will come not only from what we may be able to glean from the data but also from the follow-up questions and the broader discussion about the range of factors that may affect and drive sectors and other groups of entities.

Underlying data used in our analysis

We are drawing on data contained in the audited financial statements of public entities. The data used represents the financial activities of the parent organisations, and does not include any subsidiaries.

To build our data set for the past six years, we have had to capture the relevant data manually. Over time, we expect to build and develop the data set and will explore options to move to electronic data capture.

Applying the framework – government departments and Crown entities

We have applied our framework and reported the resulting analysis for local authorities, TEIs, CRIs, and DHBs. We will continue to develop our framework by further analysing all these sectors. For central government entities, we can apply the analysis to entity type – government departments and Crown entities. However, we realise that, although entities might have a similar organisational form in common, they might have little else in common. Therefore, some caution is needed when drawing inferences from our analysis. Our objective in this report is to demonstrate our framework and approach, and the potential inferences that can be drawn.

See: Matters arising from the 2012-22 local authority long-term plans (2012) and Local government: Results of the 2011/12 audits (2013); Education sector: Results of the 2011 audits (2012); Crown research institutes: Results of the 2011/12 audits; and Health sector: Results of the 2011/12 audits.
Part 12 Developing our tool kit: Financial analysis framework and indicators

Our overall analysis of government departments

12.20 Overall, our findings suggest that the potential financial risk to delivering on the various central government objectives is moderate. Government departments’ relatively high fixed-cost structures suggest that, without external intervention (such as additional government funding, changes in appropriations, or legislative change), they will require more time to adjust or respond to unforeseen or unplanned events.55

12.21 Our analysis indicates that, across government departments, there is consistent and sizeable over-budgeting and/or under-spending on assets. This, coupled with a declining trend in capital expenditure compared with depreciation and amortisation,56 suggests (among other things) that government departments may not be investing enough in major assets. As already noted (see paragraph 12.16), we intend to use the indicators as a means of identifying areas for further investigation. Alone, they are not enough to draw definitive conclusions.

12.22 Asset management and investment in capability in the public sector are areas we will continue to keep on our radar. In particular, we will continue to look at the:
• consistent and sizeable over-budgeting of capital expenditure; and
• declining trend in capital expenditure compared with depreciation and amortisation.

12.23 A summary of our underlying analysis about government departments’ stability, resilience, and sustainability follows.

Stability

12.24 The two indicators used show that, as a group, government departments over-budget for, and/or underspend on, both their operational and asset expenditure needs. Although over-budgeting is small for operations, it is sizeable for capital expenditure. The number and variability of those falling outside what is considered typical for the group suggests that the approaches to, or issues around, the application of financial resources across government departments are similar. Given a common funding model and governance and accountability frameworks, this is to be expected. However, it may be worth investigating this further to better understand what government departments can do to improve the application of financial resources.

12.25 Figure 20 sets out a traffic-light summary of the two indicators used to analyse government departments’ financial stability.

55 See Appendix 2 for a list of the entities we analysed.
56 Depreciation and amortisation are accounting estimates that can be used to indicate the amount of capital expenditure required to maintain the existing asset base.
Figure 20
Traffic-light summary of stability indicators for government departments

<table>
<thead>
<tr>
<th>Government departments: Budget to actual operating expenditure</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, there is a small but consistent trend of underspending. The average over the six-year period is 1.06.</td>
<td>Average value</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, the average has remained reasonably consistent.</td>
<td>Direction</td>
</tr>
<tr>
<td>Over the six-year period, there is low to moderate variability within the sector.</td>
<td>Variability</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Government departments: Budget to actual capital expenditure</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, there is a consistent and sizeable over-budget trend of 1.41 on average.</td>
<td>Average value</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, the direction is irregular and increasing.</td>
<td>Direction</td>
</tr>
<tr>
<td>Over the six-year period, there is moderate to high variability within the sector.</td>
<td>Variability</td>
</tr>
</tbody>
</table>

Resilience

12.26 The two indicators used suggest that government departments’ ability to respond to medium-term unanticipated events is supported by high current assets relative to current liabilities. However, government departments’ fixed-cost structure is also moderately high, indicating less operational flexibility in times of change. The number and variability of those falling outside what is considered typical for the group suggests that the ability to manage unanticipated events is similar across government departments.

12.27 Figure 21 sets out a traffic-light summary of the two indicators used to analyse government departments’ financial resilience.

57 Fixed costs are assumed to be any interest payable, personnel costs, and depreciation (as a proxy for renewal spending on assets).
Figure 21
Traffic-light summary of resilience indicators for government departments

<table>
<thead>
<tr>
<th>Government departments: Fixed costs to operating and investing cash outflows</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, the annual average of fixed costs to operating and investing cash flows ranges from 0.55 to 0.58.</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, the average has remained reasonably consistent.</td>
</tr>
<tr>
<td>Over the six-year period, there is low variability within the sector.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Government departments: Current assets to current liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, the annual average of current assets to current liabilities ranges from 1.43 to 1.70.</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, there is a consistent upward trend.</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, there is low variability within the sector.</td>
</tr>
</tbody>
</table>

Sustainability

12.28 Government departments’ ability to deal with longer-term uncertainty is mixed. Although there is a strong and consistent level of equity to assets, the average spending on assets for the last three years (2009/10, 2010/11, and 2011/12) is below the level that depreciation and amortisation would suggest is reasonable. The number and variability of those falling outside what is considered typical suggests that the ability to manage longer-term uncertainties is mixed across government departments.

12.29 Figure 22 sets out a traffic-light summary of the two indicators used to analyse government departments’ financial sustainability.
Figure 22
Traffic-light summary of sustainability indicators for government departments

<table>
<thead>
<tr>
<th>Government departments: Capital expenditure to depreciation and amortisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, the annual average of capital expenditure to depreciation and amortisation ranges between 0.92 and 1.46.</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, on average there is an irregular pattern with an overall small downward trend.</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, there is low variability within the sector.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Government departments: Equity to assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, the annual average of equity to assets is consistently around 0.57.</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, the average has remained consistent.</td>
</tr>
<tr>
<td>Over the six-year period, there is moderate to high variability within the sector.</td>
</tr>
</tbody>
</table>

Crown entities

12.30 Overall, we found that the potential financial risk is generally low to moderate for the group of Crown entities to which we applied the framework. As might be expected, because Crown entities are so diverse, there is greater variability across the group than for government departments. Therefore, it would be necessary to look at the underlying analysis for specific entities or apply the framework to "like" groups of Crown entities.58

12.31 Most of the indicators analysed show that Crown entities have a good ability to plan for their operations and are reasonably well placed for responding to uncertainties in the medium and longer term.

12.32 As for government departments, we noted consistent and sizeable over-budgeting of, and/or underspending on, assets, which may (among other things) indicate that Crown entities are not investing enough in major assets.

12.33 A summary of our underlying analysis about Crown entities’ stability, resilience, and sustainability follows.

58 See Appendix 2 for a list of the entities we analysed.
Stability

12.34 The ability of Crown entities to plan, budget, and deliver their financial resources is mixed, with good accuracy for operating expenses but consistent (and sizeable) over-budgeting for capital expenditure. The number and variability of entities falling outside what is considered typical suggests that the group’s ability to deal with uncertainties in the planning and budgeting of financial resources is mixed also.

12.35 Figure 23 sets out a traffic-light summary of the two indicators used to analyse Crown entities’ financial stability.

Figure 23
Traffic-light summary of stability indicators for Crown entities

<table>
<thead>
<tr>
<th>Crown entities: Budget to actual operating expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, the average for the sector is consistently around 1.00, indicating that Crown entities consistently spend what they budgeted for on operations.</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, the average has remained relatively consistent.</td>
</tr>
<tr>
<td>Over the six-year period, there is low variability for Crown entities.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Crown entities: Budget to actual capital expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, there is underspending on assets compared with budget within the sector, with an average ranging from 1.10 to 1.33.</td>
</tr>
<tr>
<td>From 2007/08 to 2011/12, there is a steady increase in over-budgeting.</td>
</tr>
<tr>
<td>Over the six-year period, there is moderate to high variability among Crown entities.</td>
</tr>
</tbody>
</table>

Resilience

12.36 The capability of Crown entities to respond to uncertain events without major structural or organisational change is supported by a reasonably flexible cost structure\(^{59}\) and high current assets compared with current liabilities. The number and variability of entities falling outside what is considered typical suggests that the ability to plan for and manage unexpected events varies across the group.

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\(^{59}\) Fixed costs are assumed to be any interest payable, personnel costs, and depreciation (as a proxy for renewal spending on assets).
12.37 Figure 24 sets out a traffic light summary of the two indicators used to analyse Crown entities’ financial resilience.

**Figure 24**

Traffic-light summary of resilience indicators for Crown entities

<table>
<thead>
<tr>
<th>Crown entities: Fixed costs to operating and investing cash outflows</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, the annual average of fixed costs to operating and investing cash flows ranges between 0.34 and 0.36.</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, the average has remained relatively consistent.</td>
</tr>
<tr>
<td>Over the six-year period, there is moderate to high variability among Crown entities.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Crown entities: Current assets to current liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, the annual average of current assets to current liabilities ranges between 1.94 and 2.10.</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, the average has remained relatively consistent.</td>
</tr>
<tr>
<td>Over the six-year period, there is moderate to high variability among Crown entities analysed.</td>
</tr>
</tbody>
</table>

**Sustainability**

12.38 Our findings suggest that the ability of Crown entities to deal with longer-term uncertainty is sound, but with some variability across the group. The amount of equity as a percentage of total assets is consistent and reasonable, and the level of capital expenditure is above what depreciation and amortisation assumptions suggest is sensible.\(^{60}\) The number and variability of entities falling outside what is considered typical suggests that the group’s ability to approach and manage sustainability is mixed.

---

\(^{60}\) Depreciation and amortisation are accounting estimates that can be used to indicate the amount of capital expenditure required to maintain the existing asset base.
12.39 Figure 25 sets out a traffic light summary of the two indicators used to analyse Crown entities’ financial sustainability.

**Figure 25**
Traffic-light summary of sustainability indicators for Crown entities

<table>
<thead>
<tr>
<th>Crown entities: Capital expenditure to depreciation and amortisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, the annual average of capital expenditure to depreciation and amortisation ranges between 1.04 and 1.40.</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, the average is variable and the direction is also variable.</td>
</tr>
<tr>
<td>Over the six years, there is low to moderate variability among Crown entities.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Crown entities: Equity to assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>From 2006/07 to 2011/12, the annual average of equity to assets ranges between 0.50 and 0.54.</td>
</tr>
<tr>
<td>From 2006/07 to 2011/12, the average is reasonably consistent.</td>
</tr>
<tr>
<td>Over the six years, there is moderate to high variability among Crown entities.</td>
</tr>
</tbody>
</table>

**Conclusions and next steps**

12.40 Audited financial statements are a rich source of information. When we can look at trends over time, the value of that information is greater. The framework presented in this Part and the underlying data will be developed based on the feedback from entities and interested monitoring agencies. Ultimately, we want to integrate the results of our financial analysis with the information and analysis generated from our audits and analysis of environment, systems, and controls across the public sector.

12.41 We plan to follow up with the central agencies and the main monitoring agencies for Crown entities to review the results of our analysis, then further refine and develop our approach.
Appendix 1
Audit reports and our framework for assessing environment, systems, and controls

This Appendix provides an overview of what an audit report contains. It also sets out the framework auditors use to assess an entity’s environment, systems, and controls.

Audit reports
An audit report is addressed to the readers of an entity’s financial and non-financial information. All public entities are accountable to Parliament for their use of public money and their use of any statutory powers or other authority given to them by Parliament.

Non-standard audit reports
A non-standard audit report is one that contains:
• a modified opinion; and/or
• an "emphasis of matter" or an "other matter" paragraph.

A modified opinion is given because of:
• a misstatement about the treatment or disclosure of a matter in the financial and/or non-financial information; or
• a limitation in scope. This may occur when the appointed auditor has been unable to obtain sufficient appropriate evidence to support, and accordingly is unable to express, an opinion on the financial or non-financial information or a part of the financial or non-financial information.

There are three types of modified opinion (which are discussed below):
• an "adverse" opinion;
• a "disclaimer of opinion"; and
• a "qualified opinion".

The appointed auditor will include an "emphasis of matter" paragraph (see below) or "other matter" paragraph (see below) in the audit report to draw attention to matters such as:
• fundamental uncertainties;
• breaches of law; or
• concerns over probity or financial prudence.

61 A non-standard audit report is issued in accordance with the requirements of the New Zealand equivalents to the International Standards on Auditing: No. 700: Forming an Opinion and Reporting on Financial Statements; No. 705: Modifications to the Opinion in the Independent Auditor’s Report; and No. 706: Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report.
The appointed auditor has to include an “emphasis of matter” paragraph or an “other matter” paragraph in the audit report in such a way that it cannot be mistaken for a modified opinion.

Figure 26 outlines the decisions that an appointed auditor has to make when considering the appropriate form of the audit report.

**Adverse opinions**
An adverse opinion is the most serious type of non-standard audit report.

An adverse opinion is expressed when the appointed auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial and/or non-financial information.

**Disclaimers of opinion**
A disclaimer of opinion is expressed when the appointed auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion (that is, a limitation in scope), and the appointed auditor concludes that the possible effects on the financial and/or non-financial information of undetected misstatements, if any, could be both material and pervasive.

A disclaimer of opinion is also expressed when, in extremely rare circumstances involving multiple uncertainties, the appointed auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements and/or non-financial performance information because of the potential interaction of the uncertainties and their possible cumulative effect on the financial and/or non-financial information.

We are pleased to report that it was not necessary for us to express a disclaimer of opinion on the financial and/or non-financial information of any entity in the central government portfolio covered by this report.

**Qualified opinions**
A qualified opinion is expressed when the appointed auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in aggregate, are material, but not pervasive, to the financial and/or non-financial information.

A qualified opinion is also expressed when the appointed auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but
Figure 26
Deciding on the appropriate form of the audit report

Note: This flowchart is based on the requirements of the New Zealand equivalents to the International Standards on Auditing No. 700: Forming an Opinion and Reporting on Financial Statements; No. 705: Modifications to the Opinion in the Independent Auditor's Report; and No. 706: Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report.
the appointed auditor concludes that the possible effects on the financial and/or non-financial information of undetected misstatements, if any, could be material but not pervasive.

In addition, a qualified opinion is expressed when the appointed auditor concludes that a breach of statutory obligations has occurred and that the breach is material to the reader’s understanding of the financial and/or non-financial information. An example of this is where a Crown entity has breached the requirements of the Crown Entities Act 2004 because it has not included budgeted figures in its financial statements.

“Emphasis of matter” paragraphs
In certain circumstances, it may be appropriate for the appointed auditor to include additional comments in the audit report to draw readers’ attention to a matter that, in the appointed auditor’s professional judgement, is fundamental to their understanding of the financial and/or non-financial information. The additional comments will be included in the audit report in an “emphasis of matter” paragraph, provided the appointed auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial and/or non-financial information.

“Other matter” paragraphs
In certain circumstances, it may be appropriate for the appointed auditor to communicate a matter that is not adequately presented or disclosed in the financial and/or non-financial information because, in the appointed auditor’s professional judgement, the matter is relevant to readers’ understanding of the financial and/or non-financial information. The additional comments will be included in the audit report in an “other matter” or similarly titled paragraph.

Environment, systems, and controls
As part of the audit process, we separately examine, assess, grade, and report on central government entities’ environment, systems, and controls for managing and reporting financial and service performance.

Our auditors recommend improvements to ensure that there are effective internal controls for sound management and good governance, and to help entities to manage risks (such as errors and potential fraud).

This is the sixth year we have used our current assessment framework to support entities in their effort to strengthen systems and controls and to report more
meaningful information on their financial and non-financial performance. Accordingly, we assess these three aspects:

- the management control environment;
- financial information systems and controls; and
- service performance information and associated systems and controls.

If auditors identify deficiencies in any of these aspects, they will recommend improvements. The grades reflect the recommendations for improvement as at the end of the financial year (see Figure 27).

Fluctuations in grades can occur from year to year – for example, because of changes in the operating environment, organisational structure, good practice expectations, or auditor emphasis. How an entity responds to an auditor’s recommendations is more important than the grade change from year to year. Consequently, the long-term trend is a more useful indicator of progress than year-to-year changes.

**Figure 27**

Grading scale for assessing public entities’ environment, systems, and controls

<table>
<thead>
<tr>
<th>Grade</th>
<th>Explanation of grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very good</td>
<td>No improvements are necessary.</td>
</tr>
<tr>
<td>Good</td>
<td>Improvements would be beneficial and we recommend that the entity address these.</td>
</tr>
<tr>
<td>Needs improvement</td>
<td>Improvements are necessary and we recommend that the entity address these at the earliest reasonable opportunity.</td>
</tr>
<tr>
<td>Poor</td>
<td>Major improvements are required and we recommend that the entity urgently address these.</td>
</tr>
</tbody>
</table>

We report our assessments to the entity, the responsible Minister, the relevant select committee, and relevant monitoring agency. We also advise the central agencies: the Treasury, the State Services Commission, and the Department of the Prime Minister and Cabinet.

Given that our assessments and grades are focused on encouraging improvements, we do not grade entities that are, or will subsequently be, disestablished.
## Appendix 2

List of entities discussed in particular Parts of this report

Government departments discussed in Parts 6 and 12

<table>
<thead>
<tr>
<th>Government department</th>
<th>In Part/s</th>
<th>Government department</th>
<th>In Part/s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Archives New Zealand (merged into DIA in 2012)</td>
<td>12</td>
<td>Ministry of Health</td>
<td>6, 12</td>
</tr>
<tr>
<td>Canterbury Earthquake Recovery Authority (established in 2011)</td>
<td>6</td>
<td>Ministry of Justice</td>
<td>6, 12</td>
</tr>
<tr>
<td>Crown Law Office</td>
<td>6, 12</td>
<td>Ministry of Pacific Island Affairs</td>
<td>6, 12</td>
</tr>
<tr>
<td>Department of Building and Housing (merged into MBIE in 2012)</td>
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<td>Ministry of Māori Affairs (Te Puni Kōkiri)</td>
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<td>Ministry of Agriculture and Forestry (merged into MPI in 2011)</td>
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<td>Ministry of Defence</td>
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<td>Serious Fraud Office</td>
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<tr>
<td>Ministry of Economic Development (merged into MBIE in 2012)</td>
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<td>State Services Commission</td>
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<td>Ministry of Education</td>
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<td>Statistics New Zealand</td>
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<td>Ministry of Fisheries (merged into MPI in 2011)</td>
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<td>The Treasury</td>
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<td>Ministry of Foreign Affairs and Trade</td>
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### Crown entities discussed in Parts 7 and 12

<table>
<thead>
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<th>Crown entities</th>
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<th>In Part/s</th>
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<td>Accident Compensation Corporation</td>
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<td>New Zealand Film Commission</td>
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<td>Arts Council of New Zealand Toi Aotearoa (Creative NZ)</td>
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<td>New Zealand Fire Service Commission</td>
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<td>Broadcasting Standards Authority</td>
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<td>New Zealand Historic Places Trust</td>
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<td>Career Services</td>
<td>7, 12</td>
<td>New Zealand Lotteries Commission</td>
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<td>Civil Aviation Authority</td>
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<td>New Zealand on Air</td>
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<td>Commerce Commission</td>
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<td>New Zealand Productivity Commission</td>
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<td>Commission for Financial Literacy and Retirement Income (former Office of</td>
<td>7, 12</td>
<td>New Zealand Qualifications Authority</td>
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<td>Retirement Commissioner)</td>
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<td>Drug Free Sport New Zealand</td>
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<td>New Zealand Symphony Orchestra</td>
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<td>Earthquake Commission</td>
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<td>New Zealand Teachers Council</td>
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<td>Education New Zealand</td>
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<td>New Zealand Tourism Board</td>
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<td>Electoral Commission (new)</td>
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<td>New Zealand Trade and Enterprise</td>
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<td>Electricity Authority</td>
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<td>New Zealand Transport Agency</td>
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<td>Energy Efficiency and Conservation Authority</td>
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<td>New Zealand Venture Investment Fund Limited</td>
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<td>Environmental Protection Authority (former Environmental Risk Management</td>
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<td>New Zealand Walking Access Commission</td>
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<td>Authority)</td>
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<td>External Reporting Board (former Accounting Standards Review Board)</td>
<td>7, 12</td>
<td>Office of Film and Literature Classification</td>
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<td>Families Commission</td>
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<td>Office of the Children's Commissioner</td>
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<td>Financial Markets Authority (established 2012)</td>
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<td>Office of the Privacy Commissioner</td>
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<td>Government Superannuation Fund and Government Superannuation Fund Authority</td>
<td>7, 12</td>
<td>Pharmaceutical Management Agency</td>
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<td>Guardians of New Zealand Superannuation and New Zealand Superannuation Fund</td>
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<td>Public Trust</td>
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<tr>
<td>Health And Disability Commissioner</td>
<td>7, 12</td>
<td>Radio New Zealand Limited</td>
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### Appendix 2  List of entities discussed in this report

<table>
<thead>
<tr>
<th>Crown entities</th>
<th>In Part/s</th>
<th>Crown entities</th>
<th>In Part/s</th>
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</thead>
<tbody>
<tr>
<td>Health Quality and Safety Commission (established 2010)</td>
<td>7</td>
<td>Real Estate Agents Authority</td>
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<tr>
<td>Health Research Council of NZ</td>
<td>7, 12</td>
<td>Social Workers Registration Board</td>
<td>7</td>
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<tr>
<td>Housing New Zealand Corporation</td>
<td>7, 12</td>
<td>Sport New Zealand</td>
<td>7</td>
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<tr>
<td>Human Rights Commission</td>
<td>7, 12</td>
<td>Standards Council of New Zealand</td>
<td>7, 12</td>
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<tr>
<td>Independent Police Conduct Authority</td>
<td>7</td>
<td>Takeovers Panel</td>
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<td>Law Commission</td>
<td>7, 12</td>
<td>Te Māngai Pāho (Maori Broadcasting Commission)</td>
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<tr>
<td>Maritime New Zealand</td>
<td>7, 12</td>
<td>Te Taura Whiri i te Reo Māori (Māori Language Commission)</td>
<td>7, 12</td>
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<tr>
<td>Museum of New Zealand Te Papa Tongarewa</td>
<td>7, 12</td>
<td>Television New Zealand</td>
<td>7, 12</td>
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<tr>
<td>New Zealand Antarctic Institute</td>
<td>7, 12</td>
<td>Tertiary Education Commission</td>
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<tr>
<td>New Zealand Artificial Limb Board</td>
<td>7, 12</td>
<td>Testing Laboratory Registration Council</td>
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<tr>
<td>New Zealand Blood Service</td>
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<td>Transport Accident Investigation Commission</td>
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### State-owned enterprises discussed in Part 8

<table>
<thead>
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<th>State-owned enterprises</th>
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<tbody>
<tr>
<td>Air New Zealand Limited</td>
<td>Meridian Energy Limited</td>
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<tr>
<td>Airways Corporation of New Zealand Limited</td>
<td>Meteorological Service of New Zealand Limited</td>
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<tr>
<td>Animal Control Products Limited</td>
<td>Mighty River Power Limited</td>
</tr>
<tr>
<td>AsureQuality Limited</td>
<td>New Zealand Post Limited</td>
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<tr>
<td>Genesis Power Limited</td>
<td>New Zealand Railways Corporation (KiwiRail)</td>
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<tr>
<td>Kordia Group Limited</td>
<td>Quotable Value Limited</td>
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<tr>
<td>Landcorp Farming Limited</td>
<td>Solid Energy New Zealand Limited</td>
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<tr>
<td>Learning Media Limited</td>
<td>Transpower New Zealand Limited</td>
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<tr>
<td>Tier</td>
<td>Public sector for-profit entities with reporting periods beginning on or after 1 December 2012</td>
</tr>
<tr>
<td>------</td>
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</tr>
<tr>
<td>Entities</td>
<td>Accounting Standards</td>
</tr>
<tr>
<td>Tier 1</td>
<td>Expenses &gt; $30m or publicly accountable†</td>
</tr>
<tr>
<td>Tier 2</td>
<td>Expenses ≤ $30m and not publicly accountable†</td>
</tr>
<tr>
<td>Tier 3</td>
<td>Not publicly accountable† and either all of its owners are members of the entity’s governing body or not large† if an entity’s parent or ultimate controlling party has the coercive power to tax, rate, or levy, it must satisfy the not large† criterion.</td>
</tr>
<tr>
<td>Tier 4</td>
<td>Applied “old GAAP” at 30 June 2011, not publicly accountable†, not required to file financial statements under section 19 of the Financial Reporting Act 1993, and not large†</td>
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</table>

* Transitional tiers will be removed when certain financial reporting legislative changes come into force. The timing of this is uncertain.
† Publicly accountable has a specific meaning within the framework that is narrower than its general meaning.
‡ Large – An entity is large if it exceeds two of total income of $20m, total assets of $10m, or 50 employees.
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Other publications issued by the Auditor-General recently have been:

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• Health sector: Results of the 2011/12 audits
• Transport sector: Results of the 2011/12 audits
• Local government: Results of the 2011/12 audits
• Draft statement of intent 2013–2016
• Crown Research Institutes: Results of the 2011/12 audits
• Inquiry into decision by Hon Shane Jones to grant citizenship to Mr Yang Liu
• Ministry for Primary Industries: Preparing for and responding to biosecurity incursions
• Inquiry into the Government’s decision to negotiate with SkyCity Entertainment Group Limited for an international convention centre
• New Zealand Police: Enforcing drink-driving laws
• New Zealand Defence Force: The civilianisation project
• Effectiveness and efficiency: Stories from the public sector
• Department of Conservation: Prioritising and partnering to manage biodiversity
• Auckland Council: Transition and emerging challenges
• Matters arising from the 2012-22 local authority long-term plans
• Education sector: Results of the 2011 audits
• Response of the New Zealand Police to the Commission of Inquiry into Police Conduct: Third monitoring report

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