B.29[99a]

Report of the

Controller and Auditor-General

Tumuaki o te Mana Arotake

First Report for 1999

Presented to the House of Representatives pursuant to section 33 of the Public Finance Act 1977

Hon Doug Kidd
Speaker
House of Representatives
WELLINGTON

Mr Speaker

I am pleased to forward this report to you for presentation to the House of Representatives pursuant to section 33 of the Public Finance Act 1977.

Yours sincerely

D J D Macdonald
Controller and Auditor-General

Wellington
17 March 1999

Contents

Introduction

The articles in this report deal principally with the results of our audits of the 1997-98 financial statements of the Government and its departments, and with related matters arising in the course of those audits. The first six articles are in this category.

The sixth article in particular (on pages 49-62) addresses the important matter of departments maintaining the requisite standards of financial and service performance during organisational change. The article:

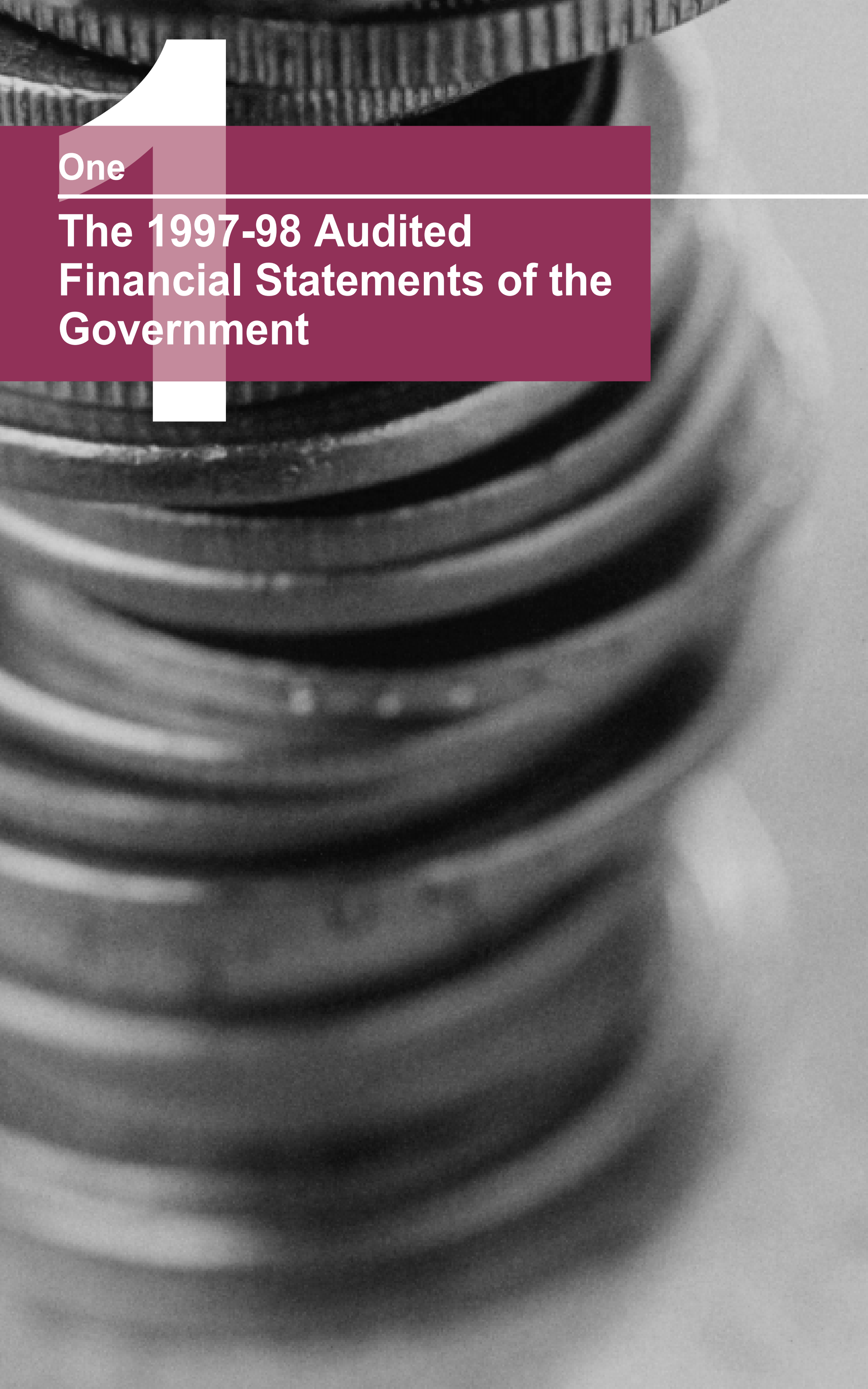
- describes and comments on organisational changes involving the Ministries of Agriculture and Forestry, the Department of Conservation, and Land Information New Zealand; and
- draws conclusions from our observations about some key requirements for future restructuring arrangements.

The seventh article (on pages 63-86) sets out the results of our follow-up review of how ready public sector organisations are to meet the potential risks arising from their computer chip-controlled electronic equipment being adversely affected by the Year 2000 problem. Our overall findings are that – while much progress has been made since we last reported in December 1997 – two essential tasks that many entities have yet to address are:

- drawing up a programme for testing systems and applications; and
- developing business continuity plans for Year 2000 contingencies.

Our analysis indicates that many entities have continued to under-estimate the extent of the problem and the work involved to address it. This applies in particular to a significant proportion of Hospital and Health Services (formerly Crown Health Enterprises) and regional and territorial local authorities.

The final article (on pages 87-104) reports the results of a special review we carried out of how – in these times of difficult international trading conditions and fluctuating exchange rates – state-owned enterprises (SOEs) were managing the foreign exchange risk that they face from those factors. Generally, we found that those SOEs most affected were managing their risks as we expected them to. The notable exception, however, was Solid Energy New Zealand Limited, which is reliant on exports for a significant proportion of its annual revenue. In our view, the company had not managed its foreign exchange risk at all well and is facing the prospect of having to bear substantial losses on that account.



One

The 1997-98 Audited Financial Statements of the Government

1.001 The Audit Office issued its audit report on the *Financial Statements of the Government of New Zealand for the year ended 30 June 1998*[1] (the *Financial Statements*) on 11 September 1998. This is the same date on which both the Treasurer and Minister of Finance and the Secretary to the Treasury signed their Statement of Responsibility for the *Financial Statements*.

Unqualified Audit Opinion Issued

1.002 The audit report appears on pages 28-29 of the *Financial Statements*. The report includes our unqualified opinion that those statements:

- *comply with generally accepted accounting practice; and*
- *fairly reflect:*
  - *the results of operations and cash flows for the year ended 30 June 1998; and*
  - *the financial position as at 30 June 1998.*

Issues Arising

1.003 We have identified a few issues that relate directly to the *Financial Statements* and other issues that relate only to individual entities that are part of the Crown. We accept that the Treasury is not responsible for either the application of accounting policies or the resolution of issues within those individual entities. However, we raise these issues here because:

- Some issues have a material or significant impact on the *Financial Statements*.
- Some issues are common to a number of entities combined in the *Financial Statements*.
- We see this report as an appropriate and timely means of communicating significant common findings from our audits of individual entities.

1 Parliamentary paper B.11, 1998.

Accident Rehabilitation and Compensation Insurance Corporation – Unfunded Liability

1.004 The Accident Rehabilitation and Compensation Insurance Corporation (ARCIC) does not recognise as a liability in its own Statement of Financial Position what is commonly referred to as the "unfunded liability". This liability comprises the obligation for future payments in respect of claims notified to and accepted by it in the current and previous years – but which will not be paid until future years.

1.005 Consequently, the liability is not recognised in the Crown's Statement of Financial Position – although the liability is disclosed in Note 9 on page 83 of the *Financial Statements*.

1.006 Recognition of this liability in the *Financial Statements* has been an issue for some time. We drew attention to the matter in our report on the previous year's financial statements of the Government.[2]

1.007 We are pleased to report that ARCIC will recognise the unfunded liability – and report it as a liability in its Statement of Financial Position – as at 30 June 1999. Therefore, the unfunded liability will be reported as a liability in the Crown's Statement of Financial Position at the same date.[3]

1.008 The estimated liability as at 30 June 1998 was $7,672 million (1997, $8,267 million). Recognising this liability in the Crown's Statement of Financial Position will have a significant impact on the Crown's net worth, which stood at $9,921 million at 30 June 1998. Had the liability been recognised at that date, the Crown's net worth would have been reduced to $2,249 million.

1.009 As can be seen from Note 9, significant movement can occur between years in the balance of the outstanding claims obligation. Once the liability is recognised as at 30 June 1999, these annual fluctuations will directly impact on the Crown's future operating balances as reported in its Statement of Financial Performance.

---

2 *Third Report for 1997*, parliamentary paper B.29[97c], pages 13-14.

3 This position has been endorsed by Parliament and is required by section 456 of the Accident Insurance Act 1998.

Full Consolidation

1.010 The Crown currently uses the modified equity method to combine state-owned enterprises (SOEs) and Crown entities into the *Financial Statements*. Although we have accepted the existing policy – subject to inclusion in the *Financial Statements* of the now-comprehensive disclosures in Note 9 – our view remains that full consolidation is more appropriate. Full consolidation is what generally accepted accounting practice requires, but the existing policy is allowed by a specific exemption given to the Crown.

1.011 The Institute of Chartered Accountants of New Zealand (ICANZ) exposure draft for a proposed financial reporting standard on consolidation[4] would remove the Crown's exemption from full consolidation – although it does provide for transitional arrangements for the Crown.

1.012 As part of the 1997-98 audit, we asked our auditors to give preliminary consideration to the issues that full consolidation is likely to raise. The issues that have been identified to date include:

- Resolving the "ownership" question for a number of entities. This will entail determining which entities (or parts thereof, such as in the case of the Legal Services Board) are "owned" by the Crown and therefore would need to be fully consolidated under the proposed ICANZ financial reporting standard.
- The treatment of deferred tax assets. For example, some SOEs recognise deferred tax liabilities but the Crown recognises no corresponding assets.
- The current *Financial Statements* treatment of SOEs and Crown entities as one class of asset. As a result, movements in the values of the Crown's investment in SOEs and Crown entities are all taken to account in the one asset revaluation reserve. Under full consolidation this treatment would no longer be appropriate – separate reserves would be required.

4 ED-84 – *Consolidating Investments in Subsidiaries.*

- ICANZ exposure draft ED-82 – *Accounting for Property, Plant and Equipment* requires that, for all assets that are revalued, the valuation is to be made or reviewed by an independent valuer. This may have implications for valuing assets – such as land improvements, infrastructural assets, and specialised military equipment – and ensuring consistency in valuations for the purpose of consolidated reporting in the *Financial Statements*.
- Considering multi-level elimination. An example is the range of inter-entity transactions that take place between the Crown, the Ministry of Health, the Health Funding Authority, and Hospital and Health Services.
- The use of discounting in valuing some assets and liabilities. There may be a need to review the various discounting methodologies for consistency.

1.013 We acknowledge that the Treasury is currently working through the issues that will affect future consolidated financial reporting by the Crown, and we will continue to work with the Treasury to ensure that all potential issues are identified and resolved.

Appropriation for Diminution in Value of Crown Investments and Other Assets

1.014 We expressed the view in our report on the 1996-97 financial statements of the Government that a diminution in the value of the Crown's investment in an entity or other Crown asset appears to give rise to an "expense" requiring appropriation under the Public Finance Act 1989 (the Act).[5]

1.015 The Act defines "Expenses" to mean *expenses measured in accordance with generally accepted accounting practice*, and section 4(2) requires an appropriation for all expenses. On the other hand, sections 4(3) and 9(2) of the Act specify what types of transactions require separate appropriation, but Crown expenses arising from diminution in value of Crown investments or other assets are not among them.

5 *Third Report for 1997*, parliamentary paper B.29[97c], pages 16-17.

1.016 In 1997-98, the value of the Crown's investment in Crown entities decreased by $231 million as a result of deficits incurred by the entities (see Note 9 to the *Financial Statements*). We continue to hold the view that these deficits are expenses of the Crown in terms of generally accepted accounting practice and should be subject to an appropriation (together with the associated parliamentary scrutiny).

1.017 The Treasury has told us that the Act was drafted with the intention that the authority of Parliament would be sought only where diminution in value arose through some action being taken by the Crown. However, we believe that the current practice reflects an inconsistency in the scheme of appropriation and that the Act should be amended to provide certainty about Parliament's requirements.

Financial Statement Disclosure of Non-departmental Transactions

1.018 Government departments undertake activities on their own account – resulting in departmental transactions, and on account of the Crown – resulting in non-departmental transactions. The former are comprehensively reported in departments' financial statements as required by Part IV of the Act.

1.019 However, in our view the quality of reporting of the latter in departments' financial statements leaves much to be desired. Our concerns include:

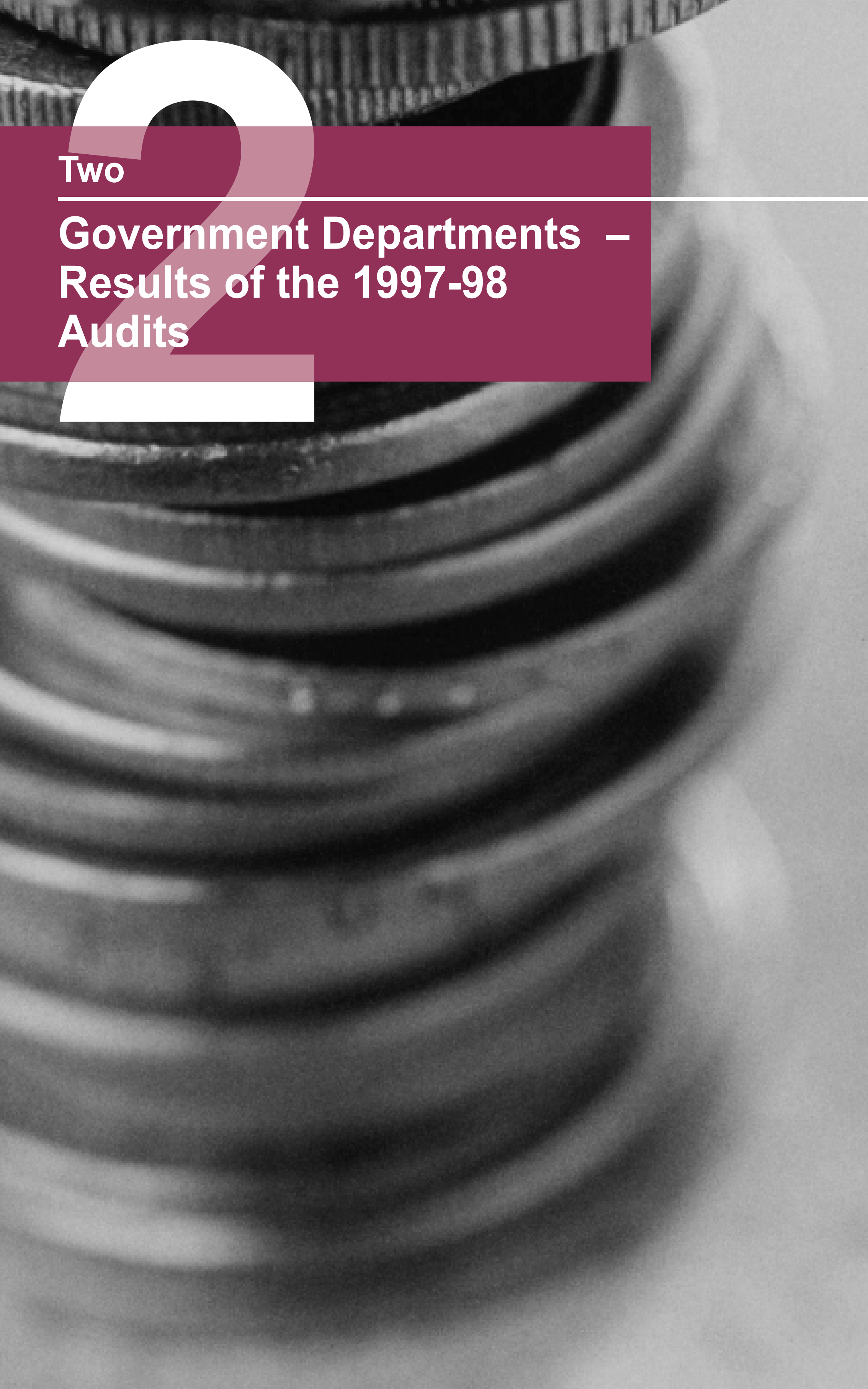
- Departments have no guidance or accepted method for them to report non-departmental transactions. Some departments make full disclosure of those transactions in their financial statements, some make partial disclosure, and others make no disclosure. We believe that all departments should consistently report non-departmental transactions to a standard of disclosure that enables adequate accountability.

- Crown investments in other entities reported by departments (for example, the investment through the Ministry of Health in the Health Funding Authority) are accounted for at cost, with no adjustment being made for movements in equity reported by the entity itself. However, such movements are accounted for in the *Financial Statements*. We believe that there should be consistency of reporting of these movements as between the *Financial Statements* and departmental financial statements.

1.020 We encourage the Treasury to consider developing appropriate policy and guidance for reporting non-departmental transactions in departments' financial statements.

Two

Government Departments – Results of the 1997-98 Audits



Introduction

2.001 This article reports on the results of the 1997-98 audits of 44 government departments. Its purpose is to inform Parliament of the assurance given by the audit in relation to:

- the quality of financial reports; and
- the financial and performance management of departments.

Audit Opinions Issued

2.002 The Public Finance Act 1989 (the Act) specifies departments' responsibilities in fulfilling the requirements for general purpose financial reporting. Sections 34A(3) and 35(3) of the Act require departments to prepare their financial statements in accordance with generally accepted accounting practice .[1]

2.003 The Act also sets out the responsibility of the Audit Office to issue an audit opinion on the financial statements of each department (section 38).

2.004 To form an opinion on the financial statements of departments, our audits are conducted in accordance with generally accepted auditing standards together with our own additional standards appropriate to public sector audits. The audits are planned and performed so as to obtain all the information and explanations considered necessary in order to provide sufficient evidence to give reasonable assurance that the financial statements are free from material mis-statements, whether caused by fraud or error. In forming our opinion, we also evaluate the overall adequacy of the presentation of information in the financial statements.

2.005 We are pleased to report that in 1998 for the first time in five years all of the 44 government departments audited received audit reports containing an unqualified audit opinion. See figure 2.1 on the next page.

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

Figure 2.1
Analysis of Audit Opinions 1994-1998

Year Ended 30 June	1998	1997	1996	1995	1994
Unqualified opinions	44	42	45	42	40
Qualifications regarding statements of service performance	-	1	1	1	4
Qualifications regarding cost allocation	-	-	-	2	-
Qualifications regarding other issues	-	3	-	-	-
Total audit opinions issued	**44**	**46**	**46**	**44***	**44**

* One department received a qualification on two separate matters in 1995.

2.006 While no audit reports were issued with any form of qualification in 1998, notes were included in the reports for three departments as further explained in paragraph 2.009 (referring to certain matters affecting their financial statements).

Going Concern

2.007 The three qualifications regarding other issues in 1997 related to the basis of valuation underlying the financial statements for the Ministry of Agriculture, the Ministry of Forestry and Valuation New Zealand. The accounting issue involved related to whether these departments could properly be treated as going concerns, in view of their impending disestablishment within the period of 12 months following 30 June 1997.[2]

2 *Third Report for 1997*, parliamentary paper B.29[97c], pages 23-24.

2.008 Now that the disestablishments have taken place, the financial effects (which could not previously be known with certainty) have been ascertained. Immediately following the respective disestablishment dates – 28 February 1998 in the case of the Ministries of Agriculture and Forestry, and 30 June 1998 in the case of Valuation New Zealand – all assets and liabilities were transferred at net book values. These transfers were to the new Ministry of Agriculture and Forestry in the case of the two defunct ministries, and to the Crown in the case of Valuation New Zealand.

2.009 Our 1998 audit report on each of the three disestablished departments noted that:

- because of the disestablishment, the financial statements had not been prepared using the going concern assumption; but
- there had been no change to the measurement basis for assets and liabilities as they were all transferred to their successors at net book value.

Financial and Service Performance Management

Financial Management

2.010 Our auditors examine aspects of financial management while conducting the annual audit. In 1994, we began reporting our assessments of aspects of financial management to the chief executive and to stakeholders in the department (such as the responsible minister and the select committee which conducts the financial review of the department).

2.011 We assess the following aspects of financial management:

- *Financial control systems* – the systems for monitoring expenditure and the management of assets.
- *Financial management information systems* – the systems for recording, reporting and protecting financial information.
- *Financial management control environment* – management's attitude, policies and practices for overseeing and controlling financial performance.

2.012 The purpose of this exercise is to identify specific areas of management where there are weaknesses, and to make recommendations to eliminate those weaknesses.

Service Performance Management

2.013 The aspects of managing service performance that we assess and report to chief executives fall into two broad areas:

- *Service performance information and information systems* – This covers the adequacy of monitoring and control systems for service performance information, the accuracy of the information produced by those systems, and whether the performance measures in the statement of service performance are being used as a management tool.
- *Service performance management control environment* – This covers the existence of quality assurance procedures, the adequacy of operational policies and decisions, and the extent to which self-review of non-financial performance is taking place.

The Rating System

2.014 The rating system we use is as follows:

Assessment Term	*Further Explanation*
Excellent	Works very well; no scope for cost-beneficial improvement identified.
Good	Works well; few or minor improvements only needed to rate as excellent. We would have recommended improvements only where benefits exceeded costs.
Satisfactory	Works well enough, but improvements desirable. We would have recommended improvements (while having regard for costs and benefits) to be made during the coming year.
Just Adequate	Does work but not at all well. We would have recommended improvements to be made as soon as possible.

Not Adequate Does not work; needs complete review. We would have recommended major improvements to be made urgently.

Not Applicable Not examined or assessed; comments should explain why.

The Results

2.015 We assessed management performance in each of the 44 departments. A summary of the assessments (220 in total – 5 for each department) is given in Figure 2.2 on page 24.

2.016 The highlights of the results are as follows:

- No assessments of "Not Adequate" were issued – the same as in the previous three years.
- Only three assessments of "Just Adequate" were issued – markedly reduced from nine in 1997[3] and 11 in 1995 and 1996. Two of the "Just Adequate" assessments were for service performance information systems, and the other was for financial control systems.
- Seventy assessments of "Satisfactory" were issued. This is 32% of all assessments, slightly higher than in 1997. The assessments of "Satisfactory" were fairly evenly distributed across four of the five management aspects, but were 39% of the assessments for service performance information systems. This is a reflection of the fact that there were fewer ratings of "Excellent" or "Good" for that aspect.
- One hundred and forty-seven assessments (67%) were either "Excellent" or "Good", representing a continuation of the gradual improvement noted last year. Twenty-one percent of the ratings were "Excellent" in 1998, compared with 18% in 1997.

Figure 2.2
Summary of Assessments of Aspects of Financial Management and Managing Service Performance in Departments for 1997-98

Aspect Assessed	Excellent		Good		Satisfactory		Just Adequate		Not Adequate	Total
		%		%		%		%		
FCS	12	*27.3*	18	*40.9*	13	*29.5*	1	2.3	0	44
FMIS	8	*18.2*	23	*52.3*	13	*29.5*	0	*0.0*	0	44
FMCE	8	*18.2*	22	*50.0*	14	*31.8*	0	*0.0*	0	44
SPIS	7	*15.9*	18	*40.9*	17	*38.6*	2	*4.5*	0	44
SPMCE	11	*25.0*	20	*45.5*	13	*29.5*	0	0.0	0	44
Totals 1998	**46**	***20.9***	**101**	***45.9***	**70**	***31.8***	**3**	***1.4***	**0**	**220**
1997	*39*	*17.7*	*106*	*48.2*	*66*	*30.0*	*9*	*4.1*	–	*220*

Key:
FCS - Financial Control Systems
FMIS - Financial Management Information Systems
FMCE - Financial Management Control Environment
SPIS - Service Performance Information Systems
SPMCE - Service Performance Management Control Environment

2.017 We compared our assessments for 1997 and 1998 for each of the 43 departments where the comparison is possible. The overall results for those 43 departments are summarised in Figure 2.3 below.

Figure 2.3
Assessments for 1998 Compared to 1997

	Higher	Same	Lower	Total
FCS	3	37	3	43
FMIS	3	36	4	43
FMCE	4	35	4	43
SPIS	8	32	3	43
SPMCE	11	28	4	43
Totals	**29**	**168**	**18**	**215**
%	***13.5***	***78.1***	***8.4***	***100.0***

See Figure 2.2 for key to abbreviations.

2.018 The noteworthy features of these results are:

- Over three-quarters of the assessments did not change between 1997 and 1998.
- About 13% of the assessments were higher in 1998 than in 1997.
- About 8% of the assessments were lower in 1998.

2.019 The fact that more assessments were higher in 1998 than lower is an indication of improvement, which has continued at about the same rate as in 1997.

2.020 To explore these changes a little more, we further examined results for departments which had been assessed as "Satisfactory" or worse in 1997 and for which assessments were also made in 1998.

2.021 Seventy assessments of either "Satisfactory" or "Just Adequate" had been given in 1997. The 1998 assessments were better in 18 cases, and worse in only one case. The corresponding figures last year were 79 assessments of

3 The contrast with 1997 is affected by the fact that a department which was disestablished in 1998 accounted for five of the nine "Just adequate" assessments in 1997.

"Satisfactory" or worse in 1996, of which 22 were higher in 1997 and two lower.

2.022 We have now reported our assessments of management performance to Parliament and its select committees for each of the last five years. Our assessments have often been of considerable interest to select committees when conducting their financial reviews of departments.

2.023 Departments vary greatly in terms of size and organisational structure. When we first reported results of the assessments to select committees, we took care to alert committees to these differences and urged them not to make comparisons between departments without being mindful of considerations, such as size and structure, which could explain reported differences in performance. Caution should continue to be exercised in using these assessments.

Three

Cost Allocation and Appropriation

3.001 In this article we set out our views on the circumstances when it is reasonable, and not reasonable, to make changes to cost allocation models. In general, we expect departments to determine and report actual expenditure in their year-end financial statements using the same cost allocation models as were used when the *Estimates of Appropriations* were prepared.

3.002 In preparing the *Estimates* for each financial year, departments forecast the amount of expenditure that will be needed for each class of outputs. Some of the costs that will be incurred in producing a particular output class can be directly attributed to that class. Other costs (such as administration overheads) are more general and must be allocated between two or more output classes.

3.003 Costs that must be allocated are split up among the different output classes by means of a "cost allocation model". The model applies one or more items of information (often information relating to specific costs) according to some formula that is believed to produce a fair allocation. For example, a department producing two output classes might record the number of working hours staff devoted to each output class in order to allocate direct labour costs between the two. And then allocate administrative overhead costs in the same proportion.

3.004 The purpose of appropriation is to set limits on the amount of expenditure that can be incurred in each category of expenditure, including each class of outputs. Any change to a cost allocation model on which an estimate of expenditure has been prepared may bring about a breach of the limits which Parliament has set.

3.005 The two circumstances where it might be appropriate to change a cost allocation model are:

- recognition during the course of the year that the model is seriously flawed and its continuing use would lead to unintended and undesirable results; and
- authorisation of significant changes in policy or operational procedures after the *Estimates* have been finalised that change the logical basis of the model or require the collection of different cost allocation information (or both).

3.006 Occasionally we encounter examples of changes to cost allocation models, especially at the end of the financial year, which do not fall into either of the above categories. These changes may have the effect of appearing to improve the department's compliance with Parliament's appropriations.

3.007 For example, in 1995 a department unexpectedly found itself having to meet the cost of staff redundancies, payment of which would have caused expenditure in excess of appropriation on some output classes. However, it had estimated that it was going to underspend on other output classes. It therefore proposed to seek fiscally neutral transfers in the *Supplementary Estimates* from the underspent output classes to those that would otherwise be overspent. Unfortunately, due to an administrative oversight, the transfers were not made. Instead, the department made adjustments to its cost allocation model that had the effect of achieving 'unofficial' fiscally neutral transfers.

3.008 Departments that make unwarranted changes to their cost allocation models that materially affect their reported expenditure risk receiving a qualified audit opinion on their annual financial statements. The department in the example described above received a qualified audit opinion principally for other reasons – including generalised problems with cost allocation. However, the audit opinion could (and would) have been qualified solely on the grounds of the changes to the cost allocation model itself.

Four

Validating Expenditure in Excess of Appropriation

4.001 When approving or validating unappropriated expenditure, two separate legislative devices are on occasion being used to validate over-expenditure on the same Vote item. We believe this is unnecessary.

4.002 The Constitution Act 1986 and the Public Finance Act 1989 both provide that no expenditure of public money shall be made other than in accordance with an appropriation by an Act of Parliament. The general intention is that executive government should not lawfully be able to expend public money unless Parliament has first agreed to that expenditure (by means of an Appropriation Act that sets limits on the amount that may be spent). However, the practicalities of passing legislation may create timing issues at the start and end of the financial year.

4.003 Section 12 of the Public Finance Act 1989 provides that the Minister of Finance may approve the spending of public money in excess of appropriation in the last three months of any financial year, where the Minister considers that the spending of that money should be approved. This provision is to help manage year-end timing issues. The Minister's approval is limited to 1% of the total of the appropriations made to the Vote in question in the financial year in which the expenditure or expenses or liabilities were incurred.

4.004 The Public Finance Act 1989 also provides that a statement of expenditure or expenses or liabilities incurred under the authority of section 12 is to be included in an Appropriation Bill for the next financial year, for confirmation by Parliament.

4.005 Parliament's authority is also required to validate expenditure or expenses or liabilities not appropriated in the financial year in which they were incurred that:

- exceed 1% of the total appropriations to the Vote; or
- have not been approved by the Minister of Finance.

4.006 Although it need not be so, one Appropriation Bill has always been used for both of the purposes described in paragraphs 4.004 and 4.005.

4.007 Where unappropriated expenditure exceeds 1% of the total of all appropriations to the Vote, it has become the practice that the Minister of Finance approves the unappropriated expenditure up to 1% of total appropriations. The balance is then subject to separate validation.

4.008 It seems to us that there is little benefit to be gained from the Minister giving approval to that part of the unappropriated expenditure which is allowed to be incurred under section 12. The relevant Appropriation Bill will make reference to *all* the unappropriated expenditure – either in the clause that provides confirmation of the Minister's section 12 approvals, or in a separate clause seeking validation of the balance of the unappropriated expenditure, or in a separate clause dealing with both matters.

4.009 In our view, transparency and parliamentary accountability would be better served if validation of any unappropriated expenditure that in total exceeds 1% of total appropriations to that Vote should be sought only by means of a specific clause in the relevant Appropriation Bill. The only exception to this rule would occur when a section 12 approval had been sought before the end of the financial year and was given before it was realised that total unappropriated expenditure had unexpectedly exceeded 1% of total appropriations.

Five

Management of Appropriations for Non-departmental Transactions

Principles of Responsibility

5.001 It is a fundamental principle of parliamentary control of government expenditure that no expenditure can be made unless Parliament has made an appropriation for the purpose. This principle is established in law by section 22 of the Constitution Act 1986 and section 4(1) of the Public Finance Act 1989.

5.002 To assist in ensuring compliance with that principle, Parliament makes appropriations to nominated ministers – who are thereby responsible for use of the appropriations. As a means of enforcing this responsibility, Parliament has established (by section 9 of the Public Finance Act 1989) two more key principles:

- for any one vote, only one minister is responsible for the appropriations in that vote; and
- for any one department administering a vote (or votes), only one minister is responsible for the department's administration of that vote (or votes).

5.003 The majority of departments administer only one vote, so that the one minister is responsible for both the vote and the department. The remaining departments administer between two and six votes – resulting in a corresponding number of ministerial relationships.

5.004 However, for those votes that include appropriations for non-departmental transactions[1] two other dimensions of relationship are created:

- between the minister responsible for the vote and the Crown entity or other third party involved; and
- between the department administering the vote and the Crown entity or other third party involved.

1 The principal types of non-departmental transactions are the funding of Crown entities and other third parties for the supply of classes of outputs, and the payment of benefits and other unrequited expenses (see pages xi-xii in the Introduction to the *Estimates of Appropriations 1998/99*).

5.005 These additional relationships arising from appropriations for non-departmental transactions – especially for the supply of outputs by the third party – call for special consideration as to how the appropriations are managed. We have reported on this subject twice in recent years:

- In 1994 we reported on the results of a major review we had carried out of how a total of 139 appropriations were being managed.[2]
- In 1996 we reported on the results of a follow-up review, and suggested a "variable management model" by which to determine management arrangements best suited to the category of appropriation.[3]

5.006 In the course of the 1997-98 audits of government departments and related Crown entities we identified two instances of problems arising from the particular management arrangements being applied to appropriations for non-departmental transactions. In both instances the appropriations were for classes of outputs to be supplied by the third party concerned.

2 *Fifth Report for 1994*, parliamentary paper B.29[94e], pages 35-63.

3 *First Report for 1996*, parliamentary paper B.29[96a], pages 27-33.

Ministry of Foreign Affairs and Trade and the New Zealand Trade Development Board

5.007 The Ministry of Foreign Affairs and Trade (MFAT) is the department responsible for administering Vote Foreign Affairs and Trade. In that vote Parliament appropriates money for three classes of outputs to be supplied by the New Zealand Trade Development Board (Trade NZ).

5.008 The Minister of Foreign Affairs and Trade is the responsible minister for Vote Foreign Affairs and Trade and for the MFAT's administration of that vote. The Minister for International Trade is the responsible minister for Trade NZ and, accordingly, the minister who agrees with Trade NZ what outputs it is to supply in exchange for the funds Parliament has appropriated.

Responsibility Relationships Created

5.009 These circumstances give rise to a set of relationships that are inconsistent with the principles of responsibility reflected in the law and described in paragraphs 5.002-5.004. That is:

- Trade NZ's use of the appropriated funds for the outputs it is to supply is under the control of the Minister for International Trade, rather than the Minister of Foreign Affairs and Trade who is responsible to Parliament for Vote Foreign Affairs and Trade; and
- MFAT is responsible for disbursing the appropriations to Trade NZ but has no relationship basis against which it can be held to account by the Minister of Foreign Affairs and Trade, who is responsible to Parliament for MFAT's administration of Vote Foreign Affairs and Trade.

5.010 The involvement of two ministers in the spending of money from Vote Foreign Affairs and Trade raised issues about MFAT's obligations for:

- releasing appropriated funds to Trade NZ only in accordance with the purposes of the appropriations; and
- monitoring Trade NZ's use of the funds.

4 See our *Third Report for 1997*, parliamentary paper B.29[97c], pages 37-42.

5.011 Similar obligations were the subject of legal opinions obtained in 1997 in connection with other votes.[4] The minimum position is that:

- Public money must be used only to purchase the outputs for which it has been appropriated.
- Accordingly, a government department should ensure that the relevant purchase agreement is consistent with the appropriation(s) and the description of the output class(es) given in the *Estimates of Appropriations*.
- The department must spend money only in accordance with appropriations. Therefore, if the money it pays out is for the supply of outputs of a class other than those for which Parliament made the appropriation, the department breaches appropriation and acts illegally.

5.012 Since Trade NZ was set up in 1988 successive Ministers for International Trade have not requested advice from MFAT about the outputs purchased from Trade NZ – he has obtained advice, when required, from other sources. Nor has MFAT carried out any monitoring of the purchase agreement between the Minister for International Trade and Trade NZ – a position which MFAT has always been open and explicit about.

5.013 As a result of the legal opinions referred to in paragraph 5.011, the Treasury stipulated that for the 1997-98 financial year payments for non-departmental output classes could be made only when purchase agreements were in place. MFAT met that obligation by noting, before making payments to Trade NZ, that a purchase agreement was in place between the Minister for International Trade and Trade NZ. However, that step alone was insufficient to meet the second and third requirements listed in paragraph 5.011.

5.014 The terms of the purchase agreement between the Minister for International Trade and Trade NZ for 1998-99 were not finalised until some months after the contents of the *Estimates* for the year were settled. Although the total expenditure covered by the purchase agreement does not exceed the total in the *Estimates* for the three output classes taken together, the terms of the purchase agreement are nevertheless not consistent with the output classes and appropriations set out in the *Estimates*. We have pointed out this discrepancy to both Trade NZ and MFAT, and they have undertaken to seek to remedy the matter by alteration of either the appropriations or the purchase agreement.

5.015 However, assuming that the Minister for International Trade continues to be the responsible minister for Trade NZ, the two more important steps that need to be taken are:

- The appropriations for classes of outputs to be supplied by Trade NZ should be put in a separate vote for which the Minister for International Trade can be made responsible.
- The Minister of Foreign Affairs and Trade, the Minister for International Trade, MFAT, and Trade NZ should agree on and enter into the appropriate management arrangements contemplated by our "variable management model". Those arrangements are –
  - a supply contract between the Minister for International Trade and Trade NZ for each output class appropriation; and
  - one or more management services agreements specifying the roles, responsibilities, and relationships of the two ministers, MFAT, Trade NZ, and (if MFAT is not to monitor Trade NZ's use of the appropriated funds) the monitoring agent.

Taking Account of Goods and Services Tax

5.016 Trade NZ supplies some of its outputs overseas, and the Crown funding of the expenditure relating to these outputs is zero-rated for GST purposes. Nevertheless:

- The amounts of the appropriations in Vote Foreign Affairs and Trade have been set on the basis that Trade NZ was paying GST on the value of the outputs it supplied overseas.
- Trade NZ, until the end of its 1997-98 financial year, did pay GST on the value of the outputs it supplied overseas. (The effect of doing so, of course, was that part of its Crown funding was being returned to the Crown in the form of GST.)

5.017 However, in August 1997 Trade NZ lodged an application with the Commissioner of Inland Revenue to recover the GST it had paid in respect of the expenditure it had incurred outside New Zealand since 1 July 1996. Trade NZ disclosed the fact that it had made the application in the Notes to its 1996-97 financial statements, but did not quantify the amount it expected to recover. The 1997-98 financial statements report a recovery of $6 million.

5.018 An argument can be made that the $6 million should be returned to the Crown because:

- the money was provided by the Crown in the first place; and
- the cost to Trade NZ of supplying the outputs in question is now effectively $6 million less than the funding paid to it to meet that cost.

5.019 The Government, after considering Trade NZ's latest business plan, has agreed that:

- Trade NZ has to repay $2 million; and
- with effect from the 1998-99 financial year, Trade NZ will be funded only for output prices that include GST payable in respect of outputs supplied in New Zealand.

5.020 Two lessons can be learned from these events:

- Both those who set the amounts of appropriations for non-departmental transactions – especially to pay for outputs to be supplied – and those who receive the appropriated funds should be clear about what cost elements the amount being paid is intended to cover. Once the amount has been agreed (for outputs, on the basis of quantity and unit price), liability for GST should no longer be of any concern to the Crown since – consistent with the scheme of the Goods and Services Tax Act 1985 – liability rests with the party carrying out the taxable activity for which it is being paid.
- A properly functioning monitoring arrangement should have noted Trade NZ's decision to try and recover the GST it had paid on its zero-rated activities and at least put those responsible for setting the appropriations on enquiry as to the need for corrective action. The failure to

do so reinforces the need (referred to in paragraph 5.015) to institute a management services agreement providing for monitoring Trade NZ's use of the appropriations.

5.021 We will continue to pursue with the relevant parties resolution of the matters raised in paragraphs 5.015 and 5.020.

Ministry of Health, the Health Funding Authority, and the Waiting Times Fund

Our Concerns

5.022 We have two concerns about the management arrangements applied to the money appropriated in Vote Health to the Waiting Times Fund:

- the adequacy of those arrangements to ensure that the amount of money being spent by the service providers is being monitored (with the objective that the amount spent does not exceed the amount of the appropriation in any year); and
- whether the nature of the funding agreements entered into by the Minister of Health (the Minister) with the Health Funding Authority (HFA)[5], together with the contracts for services between the HFA and the service providers, may have put the Crown at risk of incurring a liability without appropriation – contrary to section 4(2) of the Public Finance Act 1989.

Background to the Waiting Times Fund

5.023 For the three years 1996-97 to 1998-99 Vote Health has included an appropriation for a non-departmental output class called ***Elective Services Backlog Reduction***. The money appropriated constitutes the "Waiting Times Fund".

5.024 The most recent description of the output class is given in the *Estimates of Appropriations 1998/99*:

> *This output class will be used to purchase additional specialist assessments and elective diagnostic treatment services (the Waiting Times Fund). The Fund is specifically targeted at clearing the backlog in elective services as at 7 May 1996. This is so that, with the establishment of booking systems based on clinical assessment criteria, people requiring additional first specialist assessments and elective diagnostic and treatment services can be either booked for a procedure to occur within six months, or*

5 For convenience, references to the HFA include (as necessary) reference to its predecessors – the relevant regional health authority or the Transitional Health Authority.

be directed back to their referrer for continuing care and management of their condition. The appropriation for the 1998/99 financial year is the third part of a four-year (1996/97 to 1999/2000) initiative.[6]

5.025 As the service provider performs the agreed services it invoices the HFA, whereupon the service provider is entitled to be paid. When the HFA has paid the service provider the HFA looks to the Ministry of Health (the Ministry) to cover the payment under its funding agreement with the Minister. The Ministry can respond to the HFA to the extent that the terms of the funding agreement and the unspent portion of the current appropriation allow.

What Caused Our Concerns

5.026 In 1997-98, the value of services performed by service providers – for which the HFA had paid or was liable to pay the providers – exceeded by approximately $23 million the appropriation of $96 million for the Waiting Times Fund for the year. As a result, at 30 June 1998:

- the HFA was in debt to the service providers for the excess (and therefore had to report a liability in its financial statements);
- the HFA could report a counterbalancing asset because (in accordance with generally accepted accounting practice) it had a reasonable expectation of receiving an equivalent sum from the Ministry within the next financial year; but
- the Ministry could not contemplate reporting a corresponding liability to the HFA because it had no power to pay or commit money in excess of the $96 million appropriated for the year.

5.027 One of the criteria for administering the Waiting Times Fund is that *all contracts with providers will be written and monitored to ensure delivery of the services as agreed*. Nevertheless, the contracts entered into by the HFA with service providers before 1 January 1998 contained no provisions:

6 Parliamentary paper B.5 Vol.II, 1998, page 303.

- as to when the services were expected to be performed; or
- for monitoring progress against the contract by the HFA (although it can be argued that monitoring could be effected without an explicit contractual right[7]).

5.028 Similarly, the related funding agreements made before 1 January 1998 between the Minister and the HFA provided for payment to the HFA for the full value of the services to be performed by the service providers, without express regard for the implicit limit of the annual amount appropriated for the Waiting Times Fund.

5.029 However, the 1997-98 principal funding agreement between the Minister and the HFA contained provisions that effectively made the separate funding agreements part of, and subject to, the principal funding agreement. This means that the principal funding agreement requires the HFA:

- to operate a financially sound and sustainable business within appropriated funding levels, and be able to assure the Government of this; and
- to track expenditure, ensure it operates within the limits of funding provided, and report to the Crown findings of any excess likely to be incurred.

5.030 With effect from 1 January 1998, the separate funding agreements for payments to the HFA from the Waiting Times Fund have been consolidated into the principal funding agreement between the Minister and the HFA. Concurrently, the rights and obligations of the Crown under the separate funding agreements have been transferred to the HFA with effect from that date.

5.031 The obligations on the HFA set out in paragraph 5.029 apply to expenditure of the Waiting Times Fund.Never-the-less, the HFA failed to meet those obligations for 1997-98, as demonstrated by the situation described in paragraph 5.026.

7 By reason of the HFA's statutory function *[T]o monitor the performance of service agreements or other arrangements by persons with whom it has entered into such agreements or arrangements.*

What Issues Are Raised?

5.032 This case highlights the care that needs to be given to the administrative arrangements in circumstances where:

- the Government decides to fund a programme of services over a multi-year period; and
- the Crown enters into contracts to give effect to the programme over the whole period; but
- the Crown seeks appropriation from Parliament to fund the necessary expenditure only on a year-by-year basis.

5.033 What is not at issue here is the Government's power to determine policy or the Crown's power to enter into long-term contracts. Nevertheless, exercise of the latter power ought not to have the effect of diminishing Parliament's right to control government spending. The potential for that effect appears to be the principle of section 4(2) of the Public Finance Act prohibiting the Crown incurring a liability other than in accordance with an appropriation by Act of Parliament. Whether a liability has been incurred is to be judged by reference to generally accepted accounting practice.[8]

5.034 One option for reducing the potential for conflict between long-term contracting by the Crown and the rules on appropriation is to consider using the provision in section 4(6) of the Public Finance Act for multi-year appropriations. In our view an appropriation of that kind would have been well suited to the Waiting Times Fund – providing a basis for funding the expenditure that is compatible with the multi-year nature of the initiative.

What Should Happen Next

5.035 It may be too late to conveniently change the formal management arrangements applied to the Waiting Times Fund to overcome their intrinsic shortcomings. Nonetheless (and without ascribing "blame" to any party), we think that the Ministry and the HFA should recognise their respective responsibilities for the good management of the

8 See the definition of "liability" in section 2 of that Act.

public money involved. To that end they need to find a way to ensure that the Government's objectives for the Fund are achieved effectively and in a manner that is consistent with the rules for appropriations.

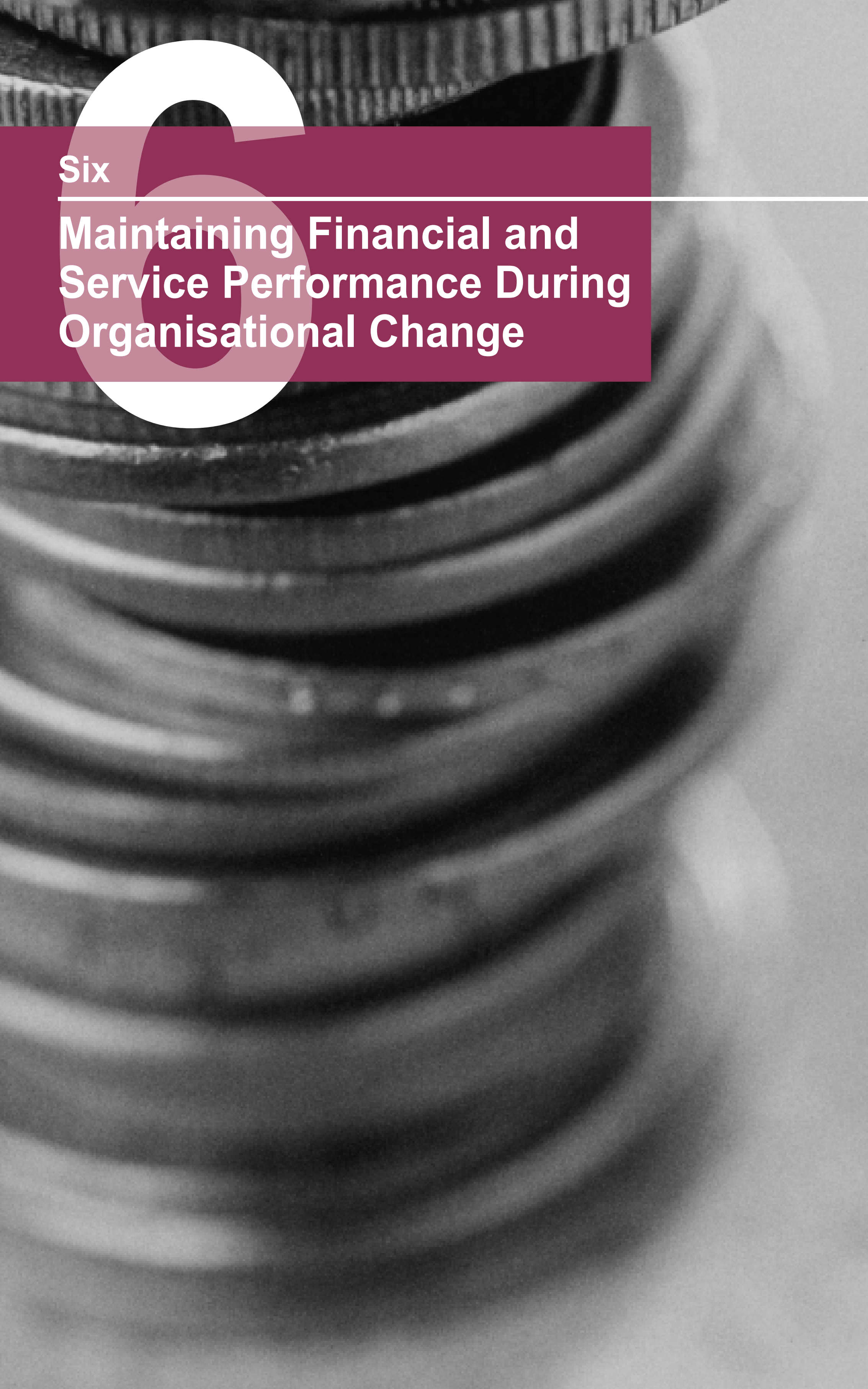
5.036 We suggest that the Treasury consider the provisions of the Public Finance Act relating to incurring liabilities with a view to reconciling the benefits of long-term contracting with Parliament's right to control government expenditure. The Treasury may also wish to consider greater use of multi-year appropriations in suitable cases.[9]

5.037 We would be pleased to assist the Ministry, the HFA, and the Treasury in those endeavours.

9 The provision allowing multi-year appropriations appears to have been used only once – in Vote Treaty Negotiations for ***Historical Treaty of Waitangi Settlements***.

Six

Maintaining Financial and Service Performance During Organisational Change



Introduction

6.001 Organisational change and the management of that change continue to be important features of public sector administration. Our interest in the subject stems from considerations such as whether:

- the intended results have been achieved;
- physical assets and other resources have been properly managed; and
- control systems continued to operate.

6.002 We have observed a number of types of organisational change during the course of our 1997-98 audits of government departments, including:

- the disestablishment of an agency, and the creation of a new agency with different management and accountability arrangements;
- the merger of existing agencies to create a new agency;
- the realignment of functions within an agency, and the transfer of functions to other agencies; and
- major strategic reorientation.

6.003 The demands placed on public sector agencies for increased efficiency and effectiveness, and changes in the services that the Government provides and how these are provided, mean that the management of change is likely to continue to be a feature of public sector administration in the future.

Risks

6.004 The risks to financial and service performance most likely to be associated with significant organisational change – such as restructuring or merger – include increased potential for:

- Inability to report accurately on financial and non-financial performance due to a breakdown in information and reporting systems.

- Failure of compliance systems – allowing the possibility of serious legislative breach.
- Unappropriated expenditure.
- Non-delivery or under-delivery of key outputs, or non-fulfilment of statutory obligations – resulting from a loss of staff, reduced staff morale, or lesser commitment to the provision of quality services. We recognise that in times of major restructuring some outputs may not be delivered to the standard anticipated, but the need remains to ensure that core critical work is completed.
- Breakdown in financial control systems, increasing the possibility of fraud or theft going undetected.

Major Organisational Changes in 1997-98

6.005 Illustrative of the major organisational changes that took place in 1997-98 were:

- the merger of the Ministry of Agriculture and the Ministry of Forestry into the Ministry of Agriculture and Forestry, and its subsequent restructuring;
- restructuring in the Department of Conservation; and
- the restructuring of Land Information New Zealand.

Merger and Restructuring of the Ministries of Agriculture and Forestry

6.006 The reorganisation of government departments related to primary industries has been lengthy, involving a series of structural changes – the more recent changes each occurring within a short time.

6.007 In 1994-95, the former Ministry of Agriculture and Fisheries was split into the Ministry of Agriculture and the Ministry of Fisheries (with fisheries research transferred to the National Institute of Water and Atmospheric Research). The new Ministry of Agriculture had thus only recently 'bedded-in' when it was merged with the Ministry of Forestry on 1 March 1998, to create the present Ministry of Agriculture and Forestry (the Ministry).

6.008 Two other factors had an impact on the merger:

- The restructuring that also took place within the Ministry of Agriculture.

- The uncertainty that had surrounded the disposition of MAF Quality Management (MQM) for a long time before the merger. The potential to corporatise MQM was recognised in earlier restructuring, and further steps were taken during the course of the merger to prepare for corporatisation. However, the potential impacts of further restructuring MQM were not fully quantifiable.

6.009 On 1 March 1998, the meat verification and agricultural quarantine services of MQM were incorporated into the Ministry's Operations Group established from that date. The key surveillance and emergency response capabilities were also transferred back into the Ministry from MQM. After the merger, the decision was taken to corporatise MQM, and on 1 November 1998 its residual functions were transferred to two state-owned enterprises – Asure New Zealand Limited and Agriquality New Zealand Limited.

6.010 Other changes were prepared for during 1997-98. From 1 July 1998 the Animal Health Board became an incorporated society set up under the Biosecurity Act 1993 as a Pest Management Agency. Further structural changes are now being implemented for the delivery of food, biosecurity and forest health services. Several major and minor reviews of structure and function are under way.

6.011 A review of border control machinery has been commissioned for 1999, the terms of reference for which require the review to address the viability of a single border control agency.

6.012 The Ministry's view is that the scope of changes since the merger has been significantly greater than could have been projected at the time of the merger.

6.013 We have been particularly concerned with the effects of time constraints, ongoing change, and loss of human resource capability on:

- the accuracy of the budget; and

- the ability to address deficiencies in reporting service performance.

Effects of Time Constraints

6.014 Time constraints meant that, in some instances, there was insufficient opportunity to consider issues and risks associated with the proposals of the establishment group (Transition Unit). One result was the occurrence of errors affecting the overall budget on an ongoing basis. These errors were:

- the omission of funding for irrigation schemes and biosecurity risk assessment in forestry; and
- the assumption that some functions were to be funded from Crown revenue when they were supposed to be wholly or partly funded by cost-recovery.

6.015 The Ministry informed the Primary Production Committee in the course of its 1997-98 financial review of the Ministry that budget shortfalls of $2.1 million in 1998-99, $2.2 million in 1999-2000, and $2.3 million in 2000-01 and 2001-02 had to be addressed.

6.016 These budget shortfalls have had two particular effects:

- delaying set-up work until the situation could be sorted out; and
- "freezing" positions in, for example, the policy area.

6.017 It is still uncertain what efficiency savings – in addition to those already planned – will need to be made to offset these budget errors, and what effect this may have on service performance in 1998-99 and future years.

6.018 Time constraints were compounded to some extent by the requirement for neutrality in the merger environment and its inhibiting effect on consultation with the incumbents.

Ongoing Change

6.019 Ongoing change has placed pressure on senior management. The chief executive and his new management group have had to concentrate on managing changes in the structure and resources at the expense of addressing some significant policy issues facing the Ministry. Strategic planning was begun in a timely fashion, but its completion has been held back by the pressures of ongoing change.

6.020 Another effect of the continual change has been a reduced capability to maintain good management information and control environment systems, or to address identified deficiencies in them. Change issues have taken precedence over the review of existing systems, and a review of the internal control systems is not scheduled for completion until March 1999.

6.021 We rated the former Ministry of Agriculture's financial control systems[1] "Satisfactory"[2] for the period ended 28 February 1998 (final audit). This rating had not improved in the merged Ministry by 30 June 1998. Financial management information systems that had been rated "Good"[3] in both of the predecessor Ministries were rated only "Satisfactory" in the merged Ministry.

6.022 At the time of our audit of the merged Ministry an estimated 80% of the systems were not Year 2000 compliant. This was confirmed by completion in October 1998 of the inventory and risk assessment phase of the Ministry's Year 2000 project. The position now is that the Ministry expects all of its critical systems to be tested and verified as Year 2000 compliant by the end of September 1999.

6.023 We also noted problems with the non-financial (service performance) aspects of the Ministry's information systems. The systems were rated "Just Adequate"[4] in the former Ministry of Agriculture and since the merger. The statement of service performance was incomplete and untimely, and there was uncertainty in the Ministry over what should be reported against in the four-month period between the merger and the end of the financial year.

Loss of Human Resource Capability

6.024 We noted resource pressures in a number of areas during the merger and restructuring – due to either actual staff shortages or larger than anticipated demand for outputs.

1 Financial Control Systems are the individual systems that process financial data. For example, processing payments (expenditure and creditors). They include controls surrounding the processing of these transactions to ensure the completeness and accuracy of data.

2 "Satisfactory" means works well enough, but improvements are desirable.

3 "Good" means works well, with few or minor improvements only needed to rate as excellent.

4 "Just Adequate" means does work, but not well at all.

6.025 In connection with its financial review by the Primary Production Committee, the Ministry gave the committee details of staff reductions that totalled 488 between 1996-97 and 1997-98. The Ministry has since acknowledged that the figures provided were incorrect. The correct total is 92.3 full-time-equivalent staff, including 83 redundancies.

6.026 The Ministry says that providing incorrect information was symptomatic of the difficulties of bringing together the three different reporting systems of the predecessor organisations. The figures first provided did not differentiate between numbers of people and numbers of full-time-equivalent staff, and were compounded by the omission from the latest count of temporary and seasonal staff.

6.027 The Ministry has not indicated the extent to which the staff reductions represent a loss of critical expertise. However, it has acknowledged that its capability in the policy advice area was considerably reduced as a consequence of the merger. Matching the new policy group structure with the merged functions and outputs resulted in a smaller group and an inevitable loss of institutional knowledge.

6.028 Effecting the merger part-way through a financial year meant that three sets of financial statements had to be produced in a four-month period. The Ministry told the Primary Production Committee in the course of its financial review that capability problems in the finance area affected debt management, cost recovery, invoicing, and data processing – although not to an extent sufficient for us to issue a modified audit report on the financial statements.

6.029 Post-merger functions need to be aligned with new needs, and reviews of functions need to be in step with the change process. For example, we have suggested to the Ministry that (when planning for any future restructuring) the finance function should be reviewed concurrently to ensure that it aligns with future financial service needs. However, because several major and minor reviews are under way, the Ministry has told the Primary Production Committee that it is not possible at this stage to ensure that its financial capability and structure are aligned to business needs.

6.030 In the Ministry's own words, *the extent and duration of the capability loss is extended if restructurings follow one on the other with no period of stability to develop and rebuild systems.*[5]

6.031 The various papers considered by the Cabinet gave several reasons for the merger and restructuring of the agriculture and forestry sectors. The reasons included:

- Improved biosecurity capability (through operational synergies).
- Improved consistency in approach to policy advice issues.
- Improved management of tensions between forestry and farming land use (e.g. ensuring competitive neutrality between sectors).
- More efficient international trade representation and negotiations.
- Improved co-ordination and interaction with local government.
- Efficiencies and economy of scale gains of $4.6 million annually – with total costs of the merger estimated to be $8.1 million.

6.032 Except for the last of those reasons, no indicators have been given by which to judge their successful achievement. We consider that – as a first step – the purpose of the change and the results sought should be clearly articulated, if Parliament is to be assured that the change is in the public interest, and the effects of change are to be measured. We are concerned that there should at least be milestones against which to measure progress toward the desired outcome(s). The milestones should be established before 2001 when the post-implementation review of the merger is planned to take place. The Ministry has indicated that there is some work to be done to develop the desired measures, and has targeted 1998-99 to achieve this.

5 *Response to the Primary Production Committee Financial Review Questionnaire, 1998 Financial Review of Ministry of Agriculture and Forestry*, page 2.

Restructuring in the Department of Conservation

6.033 The restructuring in the Department of Conservation (the Department) was an internal reorganisation that took place over two years. In 1996-97 the Department established the foundations for a new structure, a stated objective of which was to strengthen accountability within the Department.[6]

6.034 The key features of the restructuring were to develop:

- A system for formal monthly operating reviews at all levels.
- Improved quality management systems.
- A new general management team – including three Regional General Managers appointed in March 1997. (The new head office divisions and regional offices came into operation on 1 May 1997. Restructuring of conservancies occurred during 1997-98.)

6.035 The loss of key personnel and their institutional knowledge during the restructuring had an impact on our assessments of the Department's financial controls. One reason for downgrading our assessments from "Good" to "Just Adequate" was the lack of documented systems and procedures available for new staff to follow. For example, during our audit we noted a general lack of appreciation of the distinction between Crown and departmental activities. Certain assets in the fixed assets register appear to bear little relationship to the expected range of departmental activities.

6.036 Our 1997 assessment of "Good" anticipated an improvement in the quality, timeliness, and accuracy of financial information at both conservancy and head office level. This did not occur. The comprehensiveness and quality of financial information at the end of the financial year was not of a good standard, and there was a lack of systems to ensure quality information.

6 *Report of the Department of Conservation for the year ended 30 June 1997*, parliamentary paper C.13, 1997, page 8.

6.037 The Department is upgrading its present financial management system. The upgrade is being carried out to achieve Year 2000 compliance; but it will also result in training for staff, better documentation, and a separate accounts receivable system for Crown revenue.

6.038 The new operating and management structure is now in place. Nevertheless, it is evident that further work is required to fully realise the benefits of the new structure by extending the advances in operational management disciplines to year-end financial reporting.

Restructuring of Land Information New Zealand

6.039 The recent creation of Land Information New Zealand (LINZ) involved the merger of functions from two predecessor sources, with the associated management and restructuring of inherited staff and systems. At the same time contestable functions were transferred to other organisations. The merger effectively took place in two steps.

6.040 In October 1995, the Land Titles Office (LTO) was transferred from the Department of Justice and attached to the Department of Survey and Land Information (DOSLI), without being functionally integrated. LINZ was created on 1 July 1996, taking over the non-contestable functions of DOSLI and the functions of LTO. The contestable work previously undertaken by DOSLI was taken over at the same time by state-owned enterprise Terralink NZ Limited.

6.041 Like the Ministry of Agriculture and Forestry, LINZ started out in circumstances of considerable staff uncertainty and, to some extent, of dysfunctional management information systems. LINZ had the added disadvantage of a large titles backlog to reduce within the first six months. It also had major industrial relations negotiations to conduct.

6.042 LINZ has also been undertaking ongoing restructuring, some of which has required changes in staff skills. It has made a major shift to outsourcing of services, requiring new staff skills in contract management.

6.043 During 1996-97 and 1997-98 LINZ concentrated on a fundamental review and restructuring of the functions which it took over. Survey and land title services were integrated, and a major project begun for automating this information. Crown property services were restructured with effect from 1 July 1998. Also on that date the Office of the Valuer-General was established within LINZ, having previously been a function of the Valuation Department.

6.044 There are several points in which the establishment process for LINZ was distinctive:

- ***Achievable time targets***. LINZ's formation and subsequent major structural shifts have been timed for the start of the financial year. Planning timetables were achievable. Hand-over by the establishment unit to the chief executive occurred three-and-a-half months before the set-up date.
- ***Clarity of objectives***. The policy framework and the Government's desired outcomes from the new entity were pre-established, by the establishment unit, for the (new) incoming chief executive. There was a clear focus in the post-establishment period on establishing a vision, together with a strategy and rules of operation to support this vision. In 1997-98, the focus was on the development of the Strategic Business Plan, and on confirming and adjusting the plan's links with Government-desired outcomes.
- ***Clarity of internal systems objectives***. The inherited management information systems were known to be poor, and an independent in-depth study of the systems was carried out before LINZ began operations to identify future needs. The development of adequate internal systems was a specific focus of change management from the establishment date.[7] This included review and development of risk and information management, and management controls.

  For 1996-97, for instance, we assessed financial management information systems as "Satisfactory", and service performance information, and systems and management

7 LINZ Annual Report for the year ended 30 June 1997, parliamentary paper C.14, 1997, pages 10-11.

control environment, as "Just Adequate". For 1997-98, we assessed service performance information and systems as "Satisfactory", and all other aspects of financial and non-financial management and control systems as "Good".

- ***Integration of human resource strategy***. The overall human resource strategy was integrated with the restructuring strategy; in particular:
  - retention and succession planning; and
  - an emphasis on developing human resource policies and procedures *to enable the department to proceed with its proposed business strategies with confidence.*[8]

Conclusions

6.045 In our view, the degree of success in maintaining financial and service performance during organisational change within the public sector has been variable. This view is expressed from our perspective as auditor, and is our assessment of the impact that restructuring has had on financial and service performance reporting.

6.046 It is not for us to question the purpose or intention behind an organisational change. However, the purpose of the change and the results sought should be clearly articulated. In addition, so that Parliament can be assured that change resulting in significant restructuring and cost is in the public interest, an evaluation should be made at an appropriate time to assess whether the results sought have been achieved.

6.047 From our observations we conclude that restructuring arrangements need to:

- Be based on achievable time targets that minimise any adverse impact on the quality of the decisions made and services provided.
- Take into account at the outset the totality of the anticipated changes – especially in terms of human resource planning – in order to maximise senior management capability and minimise the impact on organisational capability.

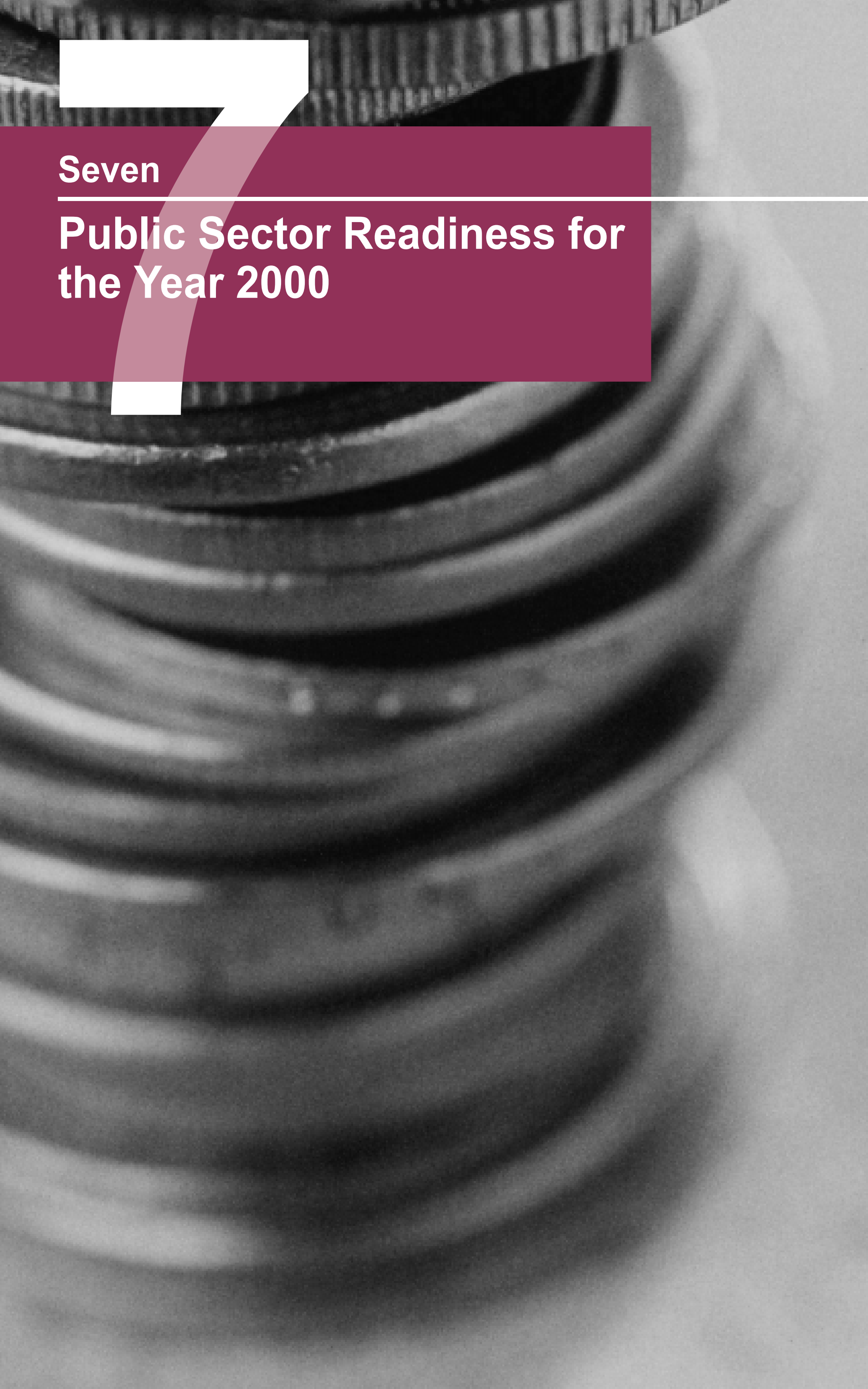
8 Ibid, page 17.

- Ensure that key staff have been identified, and that arrangements are in place at the outset to ensure that they are retained wherever possible through the transition phase.
- Ensure that sufficient capability is in place to review and address key management issues within the organisation throughout the restructuring process, so as to –
  - Maintain sound financial and service performance management control environments. Restructuring by its very nature is likely to lead to some deterioration in the control environment. However, control systems should be managed in such a way as to ensure that agencies are able to continue to rely on them to produce financial and non-financial information that is complete, timely and accurate.
  - Minimise disruption to existing information and management systems.
- Ensure that roles and responsibilities in the new structure are clear, and that policies and procedures are put in place as a priority.
- Ensure that any required new skills or processes are developed (e.g. contract management skills, in the case of outsourcing).

6.048 Monitoring, measuring and reporting systems should be in place to ensure that:

- milestones in the restructuring process are met;
- expected efficiencies and other objectives are achieved; and
- a post-implementation review is carried out that will (in part) ensure that feedback occurs in a timely fashion on lessons learned in the implementation process.

6.049 We expect that restructuring of varying scope and nature will continue to be a feature of public sector organisations in the future. As the auditor of these entities we will continue to monitor and report to Parliament on how organisational changes affecting them are being managed.



7

Seven

Public Sector Readiness for the Year 2000

Executive Summary

7.001 The Year 2000 problem represents one of the most serious management challenges currently facing public sector entities. The results of our most recent survey – carried out between August and December 1998 – indicate that encouraging progress has been made, particularly in identifying critical systems and setting priorities for fixing identified problems. Nevertheless, reports from our auditors highlighted two essential tasks which many entities had yet to address:

- drawing up a programme for testing systems and applications; and
- developing business continuity plans for Year 2000 contingencies.

7.002 We surveyed six groups of public sector entities:

- government departments;
- Hospital and Health Services (formerly Crown Health Enterprises);
- State-owned enterprises;
- Crown Research Institutes;
- local authorities[1]; and
- a selection of other public bodies.

7.003 In evaluating the progress made by individual entities we considered three factors:

- the entity's assessment of when it will have completed planning;
- when the entity's critical systems will be ready for the Year 2000; and
- whether key risk management processes have been followed.

1 Regional and territorial local authorities under the Local Government Act 1974.

7.004 Our analysis indicates that many entities have continued to underestimate the extent of the problem and the work involved to address it. A significant proportion of Hospital and Health Services and local authorities, in particular, still have a lot of essential tasks to complete, placing them at risk of missing their deadlines.

7.005 Local authorities are responsible for managing important items of community infrastructure – including water supply and sewage disposal. Disruption to the operation of hospitals may endanger lives. Many Hospital and Health Services and local authorities are large and complex, making the task of addressing the Year 2000 problem a difficult one. Nonetheless, given that health, safety and welfare are at stake, and deadlines are fast approaching, there is no margin for error.

Further Monitoring of Progress

7.006 We will continue to take a close interest in the efforts which the public sector is making to address the Year 2000 problem. In particular, we will be watching the progress of those entities that, at the time of our 1998 survey, were not meeting our expectations for being ready for the Year 2000.

7.007 Our auditors are required to alert us to any information which gives rise to doubt that, as a consequence of the Year 2000 problem, an entity will be able to continue as a going concern, or deliver essential services. We will also seek special reports through our auditors and, if necessary, direct assurance from individual entities wherever we have reason to believe that governing bodies and senior management may not be making satisfactory progress.

7.008 The ongoing responsibility for monitoring progress in managing the Year 2000 problem rests with central government agencies and sector groups. We are aware of the leadership role played by the Y2K Readiness Commission set up by the Government last year. We are also aware that the Ministry of Health and the State Services Commission, and Local Government New Zealand are monitoring progress in the health sector and in local government respectively, providing ongoing assessment, guidance and co-ordination. Each of these monitoring agencies has an important role to play in promoting good practice, and in facilitating the sharing of information.

7.009 We have briefed each monitoring agency on the general findings from our survey. Some of our findings differ from those reached by the State Services Commission and other monitoring agencies, the reasons for which we have discussed with them.

2 See our *Fourth Report for 1997*, parliamentary paper B.29[97d], pages 9-42. We summarised the results of the local authorities we surveyed in our *First Report for 1998*, parliamentary paper B.29[98a], pages 99-109.

Introduction

7.010 In December 1997 we published a report *Is the Public Sector Ready for the Year 2000?*[2] That report was based on the findings from a survey we conducted of Year 2000 risk management practices among public sector entities.

7.011 The results of that survey provided us with a benchmark against which to monitor progress in each entity. We carried out a follow-up survey from August to December 1998, to provide Parliament with a further assessment of how well public sector entities are handling the issue. This report:

- outlines our role as auditors in respect of the risks posed by the Year 2000 problem;
- describes the initiatives we have taken to provide guidance and assessment through our auditors; and
- analyses the results of our recent survey.

Clarifying the Respective Responsibilities of Management and Auditors

7.012 Responsibility for addressing the risks associated with the Year 2000 problem lies with governing bodies and management. For the auditor the Year 2000 issue does not create any new responsibilities. In particular, the auditor is not responsible for ensuring that the entity is prepared for the Year 2000 date change.

> ***Responsibility for addressing Year 2000 risks lies with governing bodies and management.***

7.013 However, the Year 2000 issue may nonetheless merit our attention in the normal course of the audit where it constitutes a significant source of risk. The auditor may consider it appropriate to make enquiries of management about the entity's strategy for addressing the Year 2000 issue, and may make observations about the processes followed to identify and manage its Year 2000 project. The potential impact on the financial statements, and on the ability of the entity to continue carrying out its business, will be important considerations for the auditor in deciding what enquiries should be made of management.

7.014 Recognising the need to clarify the respective responsibilities of management and the auditor, in 1998, the Institute of Chartered Accountants of New Zealand (ICANZ) issued an Audit Guidance Statement *Implications for Management and Auditors of the Year 2000 Issue*. The objectives of that statement were to:

- assist in clarifying the respective responsibilities of the auditor and management;
- suggest inquiries for an auditor to make of management;
- suggest matters which might be reported to management;
- provide assistance in the application of the Auditing Standards and other Audit Guidance Statements to this issue;
- outline circumstances where an auditor may issue a modified audit report; and
- assist in overcoming the risk of an audit expectation gap arising.

7.015 All of our auditors are required to comply with the ICANZ guidance.

What Approach Have We Taken to the Year 2000 Issue?

7.016 Our objectives have been to:

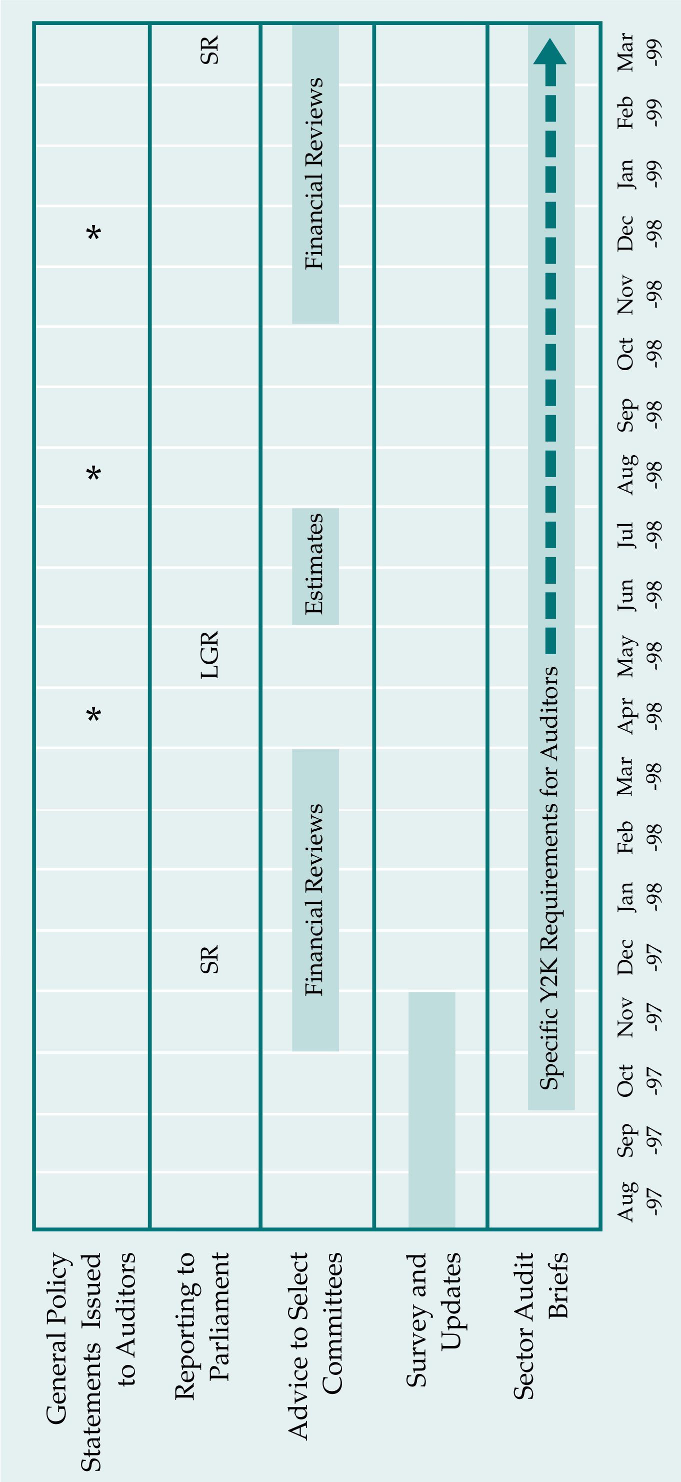
- raise awareness of the issue across the public sector, and provide general guidance where appropriate;
- encourage entities to make public disclosures about their handling of the Year 2000 issue in annual plans, financial statements, and other core public accountability documents;
- fulfil our reporting responsibilities to Parliament on any potential financial and non-financial performance consequences of the Year 2000 issue;
- encourage public sector entities to take a systematic risk management approach to the Year 2000 issue – which entails following a robust project management approach in tackling the issue, and directing efforts to fixing those systems critical to the delivery of essential services;
- ensure that Year 2000 issues are considered in the planning and conduct of audits, and that auditors raise concerns with management or the governing body where appropriate; and
- maintain regular contact with government agencies responsible for the co-ordination of Year 2000 work across sectors.

7.017 Figure 7.1 opposite shows the range of initiatives we have taken to bring Year 2000 issues to the attention of entities throughout the public sector, promote good practice, and inform Parliament of progress.

7.018 The public sector entities we surveyed in the second half of 1997 were made aware of the expectations we had of their risk management processes, and the report of our findings was widely distributed. Instructions to our auditors for the 1997-98 and 1998-99 audits required them to:

- monitor progress made by individual entities against the results of our 1997 survey;
- raise any significant concerns with management; and
- report those concerns to us.

Figure 7.1
Audit Office Initiatives to Date on the Year 2000 Issue



SR = Survey Results
LGR = Local Government Readiness

7.019 Where auditors considered it necessary, they were instructed to obtain representations from the entity's management about the steps taken, or plans in place, to address the Year 2000 issue.

7.020 We have encouraged all select committees (when carrying out financial reviews) to seek assurance from the management of government departments and agencies about progress in addressing the Year 2000 issue. In addition, we briefed the Government Administration Committee and the Prime Minister's Year 2000 Taskforce on the findings from our 1997 survey.

7.021 We have also maintained contact with those government agencies and relevant bodies with a direct interest in the issue. These include the State Services Commission, the Ministry of Commerce, and the Ministry of Health.

7.022 Where information obtained through our auditors gives rise to concern we have sought additional assurance from the entity concerned.

Specific Requirements for 1998-99 Annual Audits

7.023 In April 1998 we issued a general policy statement to our auditors on the accounting implications of the Year 2000 issue. The following August we issued a further policy statement outlining the audit approach which auditors should take in light of the Auditing Guidance Statement issued by ICANZ.

7.024 In December 1998 we issued a third policy statement, outlining our specific requirements for 1998-99 annual financial audits. During the interim audit all auditors are required to specifically consider whether the Year 2000 issue is likely to have an impact on the ability of the entity to continue to operate as a going concern or continue to provide essential services. The auditor must notify us immediately where there is doubt on either account.

> ***Every public sector entity should be able to demonstrate that it will continue to operate as a going concern, and continue to provide essential services.***

7.025 Our auditors have been told to encourage entities to disclose in their 1998-99 annual reports:

- the initiatives taken by the chief executive or the governing body to identify Year 2000 risks;
- the outcome of the risk identification process;
- the actions (or proposed actions) taken to minimise the risks identified; and
- any contingency plans that have been prepared in the event of systems failure.

7.026 Circumstances under which disclosure by an entity may be necessary include:

- where Year 2000 problems will result in the entity being unable to continue as a going concern;
- where Year 2000 problems will result in the entity being unable to continue to provide essential services (although the entity is still considered to be a going concern);
- where there is uncertainty attributable to the entity's operations or activities arising from the Year 2000 issue; and
- where the entity has identified a matter relating to the Year 2000 issue from which it is possible to identify and evaluate exceptional risks of operating.

We encourage every public sector entity to disclose publicly how it is handling the Year 2000 issue.

Our 1998 Survey

7.027 We surveyed the auditors of 195 public sector entities between August and December 1998. These entities comprised:

- government departments, Hospital and Health Services, State-owned enterprises and Crown Research Institutes;
- all regional and territorial local authorities; and
- a small number of other entities selected for their likely exposure to the effects of the Year 2000 factor.

7.028 We consulted with an external adviser in drawing up a guide to our expectations of good practice and a survey form. The survey form contained six questions which we considered particularly relevant as deadlines approach for entities to become Year 2000 compliant. Our auditors answered all survey questionnaires, after the necessary consultation with the entities concerned.

7.029 As we do not audit all energy companies we were not in a position to survey all companies operating in this sector. Nonetheless, we have impressed on our auditors the importance of the Year 2000 issue for the energy sector, given that it provides an essential service on which businesses and every community depends.

What Questions Did We Ask Our Auditors?

7.030 We sought our auditors' assessments in six areas:

- targeting effort where the impact of failure is likely to be most severe;
- meeting statutory and contractual obligations;
- quantifying and obtaining the necessary resources to fix problems;
- developing testing programmes;
- developing business continuity plans; and
- meeting deadlines for the completion of planning and correction of critical systems, and for Year 2000 compliance.

Targeting Effort

Our Expectations

7.031 Some entities may not be able to obtain the resources, or have the time, to fix all Year 2000 problems or address all areas of potential risk. They must direct their efforts – and often scarce resources – to critical areas of their business where systems failure is likely to have the most serious impact on clients and the community.

> ***Targeting effort is about directing scarce time and resources to critical areas of the business where Year 2000 problems will have the most serious impact on health, safety and welfare.***

7.032 Systems or processes can be defined as critical where their failure will affect the health, safety or welfare of individuals or the community. Other key systems or processes may have a serious impact on the effective functioning of the business, the amounts recognised and reported in the financial statements, and (in certain circumstances) the validity of the going concern assumption. We expected entities to have used a logical and systematic prioritisation process to rank their at-risk systems or processes in order of likely impact, consistent with the objectives of the business.

7.033 We put three questions:

- had the entity identified its most critical systems?;
- was the auditor satisfied that criteria used to differentiate between critical and non-critical systems reflected a logical and systematic process for setting priorities?; and
- was the entity focusing its remedial efforts on those areas of its business where the Year 2000 problem would have the greatest impact?

Our Findings

7.034 Figure 7.2 on the next page shows that almost all entities had identified their critical systems. This is vital where time is running out and resources more difficult to obtain.

Figure 7.2
Entities That Had Identified the Most Critical Systems

Group	Yes	No
Government departments	43	–
Hospital and Health Services	23	1
State-owned enterprises	14	–
Crown Research Institutes	9	–
Local authorities	81	6
Other public bodies	18	–
Totals	**188**	**7**

7.035 Similarly, in the judgement of our auditors, nearly all entities had used a logical and systematic process to set priorities (Figure 7.3 below), and were focusing remedial effort where the impact would be most serious (Figure 7.4 opposite).

Figure 7.3
Entities That Had Used a Logical and Systematic Process To Set Priorities

Group	Yes	No
Government departments	42	1
Hospital and Health Services	24	–
State-owned enterprises	14	–
Crown Research Institutes	9	–
Local authorities	82	5
Other public bodies	18	–
Totals	**189**	**6**

Figure 7.4
Entities That Had Focused Remedial Effort Where the Impact Would Be Most Serious

Group	Yes	No
Government departments	42	1
Hospital and Health Services	23	1
State-owned enterprises	14	–
Crown Research Institutes	9	–
Local authorities	83	4
Other public bodies	18	–
Totals	**189**	**6**

7.036 Those few entities that have failed to set priorities for risk assessment and action plans are, in effect, relying on their ability to remedy a range of problems to a number of different deadlines. We view this as a high-risk strategy when resources are becoming scarce and there is fundamental uncertainty about the likely impacts of the Year 2000 problem. For each entity some potential impacts from the Year 2000 problem will be more severe than others. Setting priorities for taking remedial action is an essential step in the risk management process if entities are to mitigate any such impacts.

Meeting Statutory and Contractual Obligations

Our Expectations

7.037 The entity's business impact assessment process should take into account its ability to meet statutory and contractual obligations. All public sector entities are required to comply with a range of statutory obligations. They may also have contractual obligations to parties such as clients, suppliers, funders and other stakeholders. Should key systems or processes fail entities may not be able to meet those obligations, placing them at risk of legal action and damaging their reputation.

All public sector entities must consider their ability to meet their legal obligations to stakeholders.

7.038 We asked auditors whether entities had identified their statutory and contractual obligations, and considered the possible impact of the Year 2000 problem on their ability to meet those obligations.

Our Findings

7.039 With the exception of a number of local authorities, nearly all entities had identified their statutory and contractual obligations, and considered their ability to meet those obligations (Figure 7.5 below).

Figure 7.5
Entities That Had Identified Their Statutory and Contractual Obligations and Considered Their Ability To Meet Those Obligations

Group	Yes	No
Government departments	43	–
Hospital and Health Services	23	1
State-owned enterprises	14	–
Crown Research Institutes	8	1
Local authorities	68	19
Other public bodies	18	–
Totals	**174**	**21**

Quantifying and Obtaining the Necessary Resources

Our Expectations

7.040 As deadlines approach, it is likely to become more difficult to find the necessary technical skills in the market. As entities compete for the same resources the necessary skills and expertise may not be available when most needed, and such skilled people as are available may be more expensive to retain or engage. This is likely to be particularly relevant to entities with large and complex in-house developed computer processing systems.

> ***Entities need to have enough skilled people on hand when needed.***

7.041 We asked auditors whether entities had quantified the necessary skills and resources to fix Year 2000 problems in time, and whether they would be able to obtain those skills and resources when required.

Our Findings

7.042 Over the survey population our auditors said 14% of entities had not quantified the necessary skills and resources – with local authorities again proportionately over-represented in this group (Figure 7.6 on the next page above). For 14 entities the auditors were not confident that the necessary skills and resources would be obtained when required (Figure 7.7 on the next page below).

Figure 7.6
Entities That Had Quantified the Necessary Skills and Resources

Group	Yes	No
Government departments	40	3
Hospital and Health Services	19	5
State-owned enterprises	13	1
Crown Research Institutes	8	1
Local authorities	70	17
Other public bodies	18	–
Totals	**168**	**27**

Figure 7.7
Entities That Expected To Be Able To Obtain the Necessary Skills and Resources

Group	Yes	No
Government departments	41	2
Hospital and Health Services	21	3
State-owned enterprises	14	–
Crown Research Institutes	9	–
Local authorities	78	9
Other public bodies	18	–
Totals	**181**	**14**

7.043 Some entities may assume that there is no need to plan for resourcing the Year 2000 project. Some have simple systems, and others may have assigned management of the Year 2000 project to a contractor whom they expect to be responsible for engaging the necessary staff when needed. Whatever the type of systems or project arrangements, we advise all entities to ensure that skilled staff will be on hand quickly should problems emerge without warning. This may occur through the failure of the entity's own systems or the systems of others.

Developing Testing Programmes

Our Expectations

7.044 The best way to secure some assurance that computer applications or other chip-controlled systems will handle the Year 2000 changeover is to test them. Testing:

- should be undertaken for diagnosis and to ensure that remedies have worked; and
- will take place at different levels – from individual applications or pieces of equipment to entire networks or systems.

7.045 Businesses potentially affected by the Year 2000 problem are looking at a period of 18 months or more during which a number of dates may cause problems. These problems may be triggered by:

- business process cycles, such as the beginning of a financial year, which involve date calculations;
- date processing practices, such as the use of special dates to signify the end of files; or
- a computer's failure to process correctly date formats, such as because of the character make-up of the date.

7.046 Testing programme managers need to determine which dates are likely to cause which types of date-related problems and are most likely to affect their business operations.

Testing is likely to be the most resource-intensive phase of a Year 2000 project. The testing phase should be well under way by now.

7.047 Every entity should have a tailored testing programme to confirm compliance, testing the most critical devices or systems first. We asked our auditors whether entities had developed a programme for testing the operation of critical systems for their ability to handle Year 2000 dates.

Our Findings

7.048 Only a small number of responses to our 1997 survey referred to testing strategies. Our 1998 survey showed that over a quarter of the entities surveyed had still not developed a testing programme (Figure 7.8 below).

Figure 7.8
Entities That Had Developed a Testing Programme

Group	Yes	No
Government departments	33	10
Hospital and Health Services	17	7
State-owned enterprises	14	–
Crown Research Institutes	8	1
Local authorities	55	32
Other public bodies	15	3
Totals	**142**	**53**

7.049 Testing is an integral part of any Year 2000 risk management programme, and failure to do so exposes the entity to unacceptable risk.

Developing Business Continuity Plans

Our Expectations

7.050 Few entities can be certain of having addressed every area of possible risk. In addition, a supposedly Year 2000 compliant system may fail, and system conversions may not work. Even with the best planning, unanticipated failures may occur. The vulnerability of key business systems to unforeseen failure makes business continuity planning a vital aspect of Year 2000 project planning.

> ***No entity can be certain that it will be unaffected by the Year 2000 problem. Business continuity planning recognises that not all risks can be eliminated, and should focus on the critical business processes.***

7.051 Business continuity plans should:

- identify the entity's core services and critical at-risk systems;
- identify the means by which the entity will continue its operations should key systems or processes fail; and
- outline the actions the entity needs to take (such as use of manual procedures or parallel processes) to resume normal operations as soon as possible, including the resources required.

7.052 Business continuity plans should be tested so that they can be implemented swiftly and smoothly when the need arises.

7.053 We asked auditors whether entities had drawn up business continuity plans which specifically reflected the risks associated with their exposure to the Year 2000 problem.

Our Findings

7.054 Less than one-third of the entities we surveyed had developed business continuity plans for Year 2000 contingencies (Figure 7.9 on the next page above).

Figure 7.9
Entities That Had Drawn Up a Business Continuity Plan for Year 2000 Contingencies

Group	Yes	No
Government departments	12	31
Hospital and Health Services	10	14
State-owned enterprises	6	8
Crown Research Institutes	2	7
Local authorities	25	62
Other public bodies	5	13
Totals	**60**	**135**

7.055 The reality is that no business can be certain that its operations will not be affected by unexpected events, however well it may be prepared. Preparing for contingencies through business continuity planning must be an integral part of the Year 2000 risk management programme. This is a vital task for those entities that deliver essential services.

Meeting the Deadlines

7.056 Effective project management is vital to ensure that problems will be fixed before the first impact occurs. Many entities are likely to have a range of target dates, distinguishing between critical and non-critical systems. The scale of the task and the growing scarcity of resources make meeting these deadlines a key issue.

Effective project management is the key to meeting Year 2000 deadlines. Entities need to know what their deadlines are, and allow enough time to complete tasks such as remediation, testing, and developing business continuity strategies.

7.057 For each entity we compared the completion dates specified in the returns for our 1997 and 1998 surveys. The results of this comparison showed that in 1997 many entities had under-estimated the extent of the problem and the work involved in addressing it.

7.058 In analysing the returns from the 1998 survey we used two main indicators to establish whether there was a potential problem in their ability to meet Year 2000 project deadlines:

- planning completion dates after 31 December 1998; and
- indications that the entity would not be ready before 1 July 1999.

7.059 We considered it reasonable to expect most entities to have completed planning by December 1998. Our survey showed that 77% of entities were likely to meet this date. We accept that, in a few cases, planning for correction or replacement may be continuing into early-1999. However, delays in completing planning may also indicate that the entity has not yet addressed key aspects of the Year 2000 risk management process.

7.060 Auditors reported that 69% of the entities in the survey expected to be ready for the Year 2000 by 30 June 1999. This would have left a significant number of entities with much work to complete in the final six months before 1 January 2000.

7.061 Taking that information together with the data on planning completion dates indicates that some entities will need to make significant progress to complete the tasks required within an acceptable time. We expect that all of the entities will have rescheduled their project timelines since our survey. Our auditors will be monitoring their ability to meet the deadlines for progress over the coming months.

Conclusions

7.062 The findings from our 1998 survey and information from our discussions with monitoring bodies show that a significant number of Hospital and Health Services and local authorities still had a number of essential tasks to complete – placing them at risk of missing their deadlines.

7.063 Our auditors will continue to monitor the progress of all public sector entities in being ready for the Year 2000, particularly those entities that, at the time of our 1998 survey, gave rise to the “No” responses in the various figures in this article. For those entities that we believe are not making enough progress, we will be seeking assurance directly from them about the steps they are taking to minimise this significant source of risk to their business.

7.064 We are aware that some of our findings differ from those reached by the State Services Commission and other monitoring agencies. These differences reflect:

- the time when the information was gathered;
- the methods used to gather the information;
- the type of information sought;
- the survey population; and
- the type of analysis undertaken.

7.065 We have discussed these differences with the Commission and other agencies to ensure that they fully understand the basis on which we have reached our findings. We encourage them to continue their efforts to promote responsible management of this key business risk.

7.066 In addition, we will be urging all public sector entities to disclose in their public accountability documents the progress they have made in addressing the issue.

Eight

How Are State-owned Enterprises Managing Foreign Exchange Risk?

EIGHT

Why Did We Look At the Subject?

8.001 The domestic economic problems experienced by various Asian countries have resulted in a significant downturn in New Zealand trade volumes to the Asian market. Coupled with the downturn in trade, from mid-1997 the New Zealand dollar experienced a rapid and unexpected fall in value against major trading currencies such as the British pound and the United States dollar.

8.002 Both of these two factors presented risks to entities that trade in international markets – among them the state-owned enterprises (SOEs) that buy and sell internationally.

8.003 In this article we look at how SOEs have protected themselves against those risks.

Why Take Out Foreign Exchange Cover?

8.004 When buying and selling goods on the domestic market the main concerns of traders are price and quantity. (This is not to say that the domestic market is unaffected by movements in the value of the New Zealand dollar as domestic sale prices can be driven by international market prices.) However, when trading internationally a third dimension – the prevailing foreign exchange rate – becomes a factor. Although traders may not be able to influence the price or the quantity of demand to any large degree, they are able to bring certainty to the exchange rate through purchasing foreign exchange cover.[1]

8.005 A forward exchange contract is an agreement to buy or sell a quantity of foreign currency at a fixed rate for delivery at an agreed date. The forward rate of exchange is set at the time of the agreement. It is not a forecast of expected future exchange rates but is a mathematically calculated adjustment to current exchange rates based upon the interest rate differential between the two currencies.

1 By "foreign exchange cover" we mean both forward exchange contracts and options to purchase foreign currency.

8.006 Establishing foreign exchange rates effectively eliminates foreign currency fluctuations, enabling traders to know with certainty what their receipts will be if they are able to achieve a predetermined level of sales at the forecast price. Nevertheless, there is a risk associated with the purchase of foreign exchange cover, which increases relative to the length and volume of cover purchased. In addition, normal business volatility means that sales volumes and prices will fluctuate over time. Therefore, the further out one seeks to predict future trading patterns the greater will be the uncertainty.

How Are the Business Risks of Taking Out Foreign Exchange Cover Reported?

8.007 One of the main risks in taking out foreign exchange cover is that if the sales projections are incorrect the trader may be left in a position of having insufficient sales to take advantage of the cover. Cover that is excessively greater than actual sales, and prevailing exchange rates that are lower than the forward exchange contract rate, may result in significant losses being realised.

8.008 Sales that have been made are accounted for as revenue in the Statement of Financial Performance in the period in which the sales occur.[2] The amount at which the sale will be recorded will be based on the exchange rate in the forward exchange contract. Therefore, if the forward rate at the date of sale differs from the rate in the forward exchange contract the result will be reflected in an increase or decrease in the revenue recorded.

8.009 Until the sale actually occurs, financial reporting standards require disclosure of the foreign exchange exposure by way of a note to the accounts.[3] The note to the accounts reports the amount of forward exchange contracts purchased and their fair value – that is, the amount the currency could be sold for at balance date (on the basis that there is no penalty for selling early).

2 SSAP-21, *Accounting for the Effects of Changes in Foreign Currency Exchange Rates*; Institute of Chartered Accountants of New Zealand.

3 FRS-31, *Disclosure of Information about Financial Instruments*; Institute of Chartered Accountants of New Zealand.

8.010 Understanding the implications of the note disclosure requires some knowledge of accounting and foreign exchange transactions.

What Did We Review?

8.011 We identified those SOEs that were purchasing foreign exchange cover, reviewed their foreign exchange risk management policies, and ascertained how the policies had been applied in the 1997-98 financial period. We did not review the management of foreign exchange risk in relation to the principal element of overseas debt.

8.012 We reviewed each SOE's annual report, and where we needed further information we obtained it by discussions with the appropriate staff of the SOE.

How Did We Judge the Foreign Exchange Risk Management Policies?

8.013 We were not concerned just with whether the SOEs had made losses on foreign exchange transactions because gains and losses will be made even when foreign exchange cover is in place. The reason for this is that it is extremely difficult for an organisation to match exactly the movement of the New Zealand dollar against other international currencies, and as a consequence gains and losses will occur even when hedging the exchange rate risk.

8.014 Rather, we were concerned that SOEs had adequate policies to minimise any long-term foreign exchange risk that they faced. Therefore, we sought to establish whether each Board:

- had clearly set out its objectives for managing foreign exchange risk;
- had established policies that gave effect to its objectives;
- was receiving adequate information on a regular basis to ensure that its policies were being complied with; and
- ensures that its treasury policies are regularly reviewed by a suitably qualified external party.

8.015 We did not review the SOEs' treasury management functions in detail.

What Did We Find?

8.016 Of the 15 SOEs we reviewed, four had no foreign exchange risk. Nine out of the remaining 11 SOEs were involved in managing foreign exchange risk to any significant degree.

8.017 Of the nine, seven had taken out foreign exchange cover that related to foreign borrowing costs or capital expenditure purchases. The practices adopted by these seven SOEs in relation to capital expenditure purchases were largely in line with our expectations.

8.018 We were interested most in the remaining two SOEs:

- one had entered into a foreign loan to partially hedge future revenue streams; and
- the other had taken out foreign exchange cover as a hedge against the effect of foreign exchange rate changes so as to give greater certainty of receipts from export sales.

Land Corporation Limited

8.019 The first of those SOEs was Land Corporation Limited (Landcorp), which met our expectations in managing foreign exchange risk in the context of the scope of our review. However, its foreign exchange management was unusual. Landcorp had converted a portion of its domestic debt to a United States dollar loan (of US$25 million) as a hedge against the effect of foreign exchange rate changes on prices for the majority of its products that are sold on the domestic market. It also takes out forward exchange contracts to cover the relatively small proportion of total revenue generated from sales of its products on the international market.

8.020 We accept that the Board entered into the United States dollar loan arrangement having been independently advised that a partial natural hedge does exist with the loan, due to domestic product prices achieved by Landcorp largely being determined on the international market (commonly fixed in United States dollars).

Solid Energy New Zealand Limited

8.021 The second SOE was Solid Energy New Zealand Limited (Solid Energy), which is directly involved in significant sales of its products in international markets ($94.8 million for the year ended 30 June 1998). We would therefore expect the Board of Solid Energy to have sound policies in place to manage foreign exchange risk. The balance of this article assesses the degree to which Solid Energy met our expectations as set out in paragraphs 8.013-8.014.

What Was Our Assessment of Solid Energy's Foreign Exchange Risk Management?

How Much Foreign Exchange Cover Did Solid Energy Have?

8.022 An analysis of Solid Energy's position is shown in Figure 8.1.

Figure 8.1
Solid Energy – Sales and Foreign Exchange Cover

	1997-98 $million	1996-97 $million
Total sales	187.3	208.8
International revenue	94.8	115.6
Total foreign exchange cover held at 30 June	468.0	165.2
Realised[4] (loss)/profit at 30 June	(3.6)	Nil
Unrealised[5] (loss)/profit at 30 June	(138.1)	8.2

4 In this instance when the contracts matured there were insufficient sales to match against the proceeds of the contract and an actual loss of $3.6 million was made.

5 This is unrealised in that a profit or a loss will only occur if all contracts existing at 30 June were closed out at 30 June at the current exchange rates. This is extremely unlikely to occur in the normal course of business but it does give an indication of the extent of risk in the event that no sales are achieved.

8.023 Our initial review of Solid Energy's financial statements raised the following four issues:

- There was a significant increase in the level of foreign exchange cover during the 1997-98 financial year – from $165.2 million at 30 June 1997 to $468.0 million at 30 June 1998. (Part of this increase can be attributed to the different exchange rates at 30 June. If both figures were expressed in United States dollars the increase would have been from US$112.9 million to US$242.4 million.)
- This increase in cover was not supported by an increase in international sales, which decreased from $115.6 million for the year ended 30 June 1997 to $94.8 million for the year ended 30 June 1998.
- A substantial adverse turnaround in the potential exposure of $146.3 million (if all the forward exchange contracts outstanding at 30 June had been closed out at the exchange rate at that date), resulting from turning a potential profit of $8.2 million as at 30 June 1997 into a potential loss of $138.1 million as at 30 June 1998.[6]
- Forward exchange contracts were in place for up to five years. Expected sales this far into the future were based on estimates only and were not underpinned by firm sales contracts.

What Was the Board's Objective in Managing Foreign Exchange Risk?

8.024 The Board's objective is stated to be:

… to protect CoalCorp [now Solid Energy New Zealand Limited] *from adverse exchange rate variations, by managing the Corporation's exposure.*

8.025 The foreign exchange exposures recognised in Solid Energy's policy document are:

- budgeted (and forecast) export sales; and
- import commitments of a capital and operational nature.

6 On the same basis the unrealised loss at 30 November 1998 would have been $75 million.

8.026 For Solid Energy this means protection of future income.

What Was the Board Policy for Managing Foreign Exchange Risk?

8.027 The Board's policy for determining the level of its foreign exchange cover is set out in Figure 8.2 below. The exposure is based on forecast export sales and foreign exchange cover is taken out in the ranges specified.

Figure 8.2
Policy for Foreign Exchange Cover

Export Sales Exposure	Forward Exchange Contracts		Option Cover	
	min %	max %	min %	max %
Forecast receipts up to 3 months	35	90	Nil	15
Forecast receipts 4 to 12 months	35	90	Nil	20
Forecast receipts 13 to 24 months	35	80	Nil	Nil
Forecast receipts 25 to 36 months	30	65	Nil	Nil
Forecast receipts 37 to 60 months	30	65	Nil	Nil

8.028 The policy was changed in August 1997 to extend the maximum period of cover from 36 months to 60 months.

How Did the Policy Compare With Others?

8.029 Our experience suggests that taking out foreign exchange cover for a period as long as five years, particularly when sales are uncertain, is unusual and not without cost or risk. We therefore compared the periods and lengths of cover in Solid Energy's policy with those of four Australian coal-mining companies.[7]

8.030 Solid Energy's treasury policy differed from the Australian companies in relation to both the wide degree of discretion given to management (i.e. the width of the bands) and the maximum period of cover. For coal sales, three out of the four Australian companies limited their foreign exchange cover to a three-year projection, and the fourth had a maximum five-year projection.

8.031 As for the level of cover, three out of the four had a maximum cover in the first year of between 70% and 75% and the fourth had a maximum of 100%. The maximum cover in the second and third years was between 50% and 60% for three companies. The fourth company retained a maximum of 100%. The company that takes cover out for up to five years has a maximum cover level of 35% for years four and five.

8.032 In summary, the policy adopted by Solid Energy, although not materially different in relation to the maximum period of cover, gave greater discretion to management in relation to the maximum level of permitted foreign exchange cover.

How Was the Policy Applied in Practice?

8.033 Solid Energy calculated its cover over both contracted sales and forecast other sales – without recognising the different levels of certainty inherent in the two categories.

8.034 Covering contracted sales makes sense because a sales contract establishes certainty over the sale transaction. Therefore, taking out cover over the total value of contracted sales results in the company attaining certainty of revenue for what are ostensibly certain sales.

7 The companies were Portman Mining Limited, Mount Isa Mines Holdings, QCT Resources Limited, and Broken Hill Proprietary Company Limited.

8.035 However, our review revealed that some of the reported "contracted sales" were, rather, estimates based on previous business relationships, and the longer-term projections included anticipated production. Latterly, contract expectations as to price and quantity have not been achieved. Therefore, the certainty that we would normally expect of "contracted sales" did not exist.

8.036 In relation to forecast other sales, we would expect the amount of cover to be lower due to the inherent uncertainty of sales being achieved. We would also expect that, as the sales projections become less reliable the longer the period, the amount of foreign exchange cover would reduce accordingly.

8.037 Solid Energy's policy did have the effect of reducing the level of foreign exchange cover but we would question whether the reduction was sufficient in view of the state of uncertainty of forecast sales.

What Did Management Report to the Board?

8.038 Management prepares a monthly *Foreign Exchange Position Report* for the Board. This report is an effective way of determining whether the Board's policy in relation to the maximum and minimum levels of cover is being complied with. However, in our view the report contains insufficient information for the Board to be aware of the extent of the foreign exchange risk to which Solid Energy is exposed.

8.039 We were told that a forecast revision of the expected result for the year was carried out each quarter. However, we were not able to establish how the revised forecasts of sales were carried through into the monthly reports to the Board and the amounts of foreign exchange cover held.

What Are Our Views on the Reporting?

8.040 We consider that, for the Board to ensure that its foreign exchange risk policy is being complied with, it needs to be provided with sufficient information to determine:

- Whether previously forecast sales have been achieved and future forecast sales are still achievable.

- If the forecasts are not being, or likely to be, achieved what is happening with the foreign exchange cover – is any excess being taken forward to match against future sales, or is it being reversed if too much cover is in place.

8.041 The Board recognised the need for additional information and, at a meeting on 27 August 1997, determined that:

> … *the Company should incorporate a sensitivity analysis in the forecasting to show the impact that a shift in the rate will have on the forecast* [value of the business].

8.042 We were told that the Board was given the information orally. We were not able to locate any formal advice to show that this was so.

8.043 Our analysis of forward exchange contracts outstanding at 30 June 1998 established that substantial purchases of foreign exchange cover – US$176 million (or 87% of the total cover of US$201 million purchased during the year) – were made in the period September to December 1997.[8] Of this amount, US$105 million was purchased for 37 to 60 months following the policy change the previous August (see paragraph 8.028).

8.044 We were surprised that the Board was not consulted before taking out these significant increases in cover. We would have thought that the increases were so substantial that management would first have discussed them with the Board.

8.045 In addition, we had the following concerns about the monthly reports submitted to the Board:

- The options purchased by Solid Energy were "2:1 single strike" options. These were valued in the monthly schedules at the value should Solid Energy exercise the "strike" option. However, if the exchange rate falls below that shown in the option the bank has the right to "strike" the option at twice the amount shown in the monthly reports to the Board.
- In the October 1997 report contracted sales for the 3-4 year and 4-5 year bands for the month of October 1997 were shown as US$45.9 million and US$31.8 million respectively. Yet in the reports for November and December 1997 there

8 September US$37 million, October US$89 million, November US$6.5 million, and December US$43.5 million.

were no contracted sales for these two periods. The January 1998 report showed contracted sales for the 3-4 and 4-5 year bands as US$6.6 million and US$2.2 million respectively. In the February 1998 report the corresponding figures fell to US$5.7 million and US$215,000. The March 1998 report showed contracted sales of US$3.8 million in years 3-4 and none in years 4-5. At 30 June 1998 the monthly report showed no contracted sales beyond 3 years. This situation continued after 30 June 1998.

- When we asked the reason for the changed figures management said that errors had occurred. Ignoring the split between contracted and projected sales, total forecast sales were relatively consistent. However, that left large fluctuations unexplained (i.e. a decrease in the 5-year forecast of $14 million between October and November 1997, and an increase of $57 million between November and December 1997).
- It was difficult to determine whether the percentage levels within the bands in the Board policy had been complied with. This was a result of the bands shown in the reports being different to those in the policy. In addition, the percentage calculations combined the forward exchange contracts and options, whereas the policy dealt with these categories separately.
- We noted significant fluctuations in the forecast sales figures between the bands from month to month. The report did not explain the fluctuations.

Was the Board's Policy Complied With?

8.046 The Board's policy on foreign exchange risk was often not complied with during the period March 1997 to November 1998.[9]

8.047 In relation to forward exchange contract cover, the maximum level of cover had been exceeded in some bands, in July, August, October and November 1997, and in January, February, April, June, July, August, September, October and November 1998.

9 The following reports were not available for this period: April, May, September 1997; March and May 1998.

8.048 In relation to option cover, both the level of cover within the bands as well as the period had been exceeded. The levels of cover were exceeded throughout the period January to December 1998 with the exception of June. The period of cover was also exceeded for the whole period we reviewed – March 1997 to November 1998. Cover for periods from 1 to 5 years ranged from $10 million to $40 million. This is contrary to the Board policy, which allows option cover for a maximum of 12 months.

8.049 Solid Energy's Chief Financial Officer told us that before February 1998, when the policy was breached, no formal report was made to the Board additional to the regular monthly report. We would have expected the Board to receive details of the extent to which it was exposed, and management's recommended path of action, if any, to return to compliance with the policy.

8.050 In February 1998 the Board considered closing out some forward exchange contracts but deferred action to await further developments in the market. In April 1998 the Board discussed the level of foreign exchange cover but again decided not to close out any contracts.

On What Basis Did Solid Energy Determine the Level of Foreign Exchange Cover?

8.051 Solid Energy calculated the amount of foreign exchange cover based on forecast export sales (both contracted and projected) in its five-year business plan, taking account of both the prevailing and likely forward exchange rate.

8.052 The forecast sales included significant growth in export revenues anticipating completion of the Mount Davy mine and the West Coast jetty. There were two problems in including revenue from these projects:

- the projects had not been approved at the time the cover was taken out; and
- as the projects were still being developed, there was a lack of certainty about their completion dates and, therefore, when they would start generating additional revenue.

8.053 We were advised that management decided in 1997 to increase the foreign exchange cover to the maximum levels permissible under the various categories in the policy. The reason given was that the quantity of coal that Solid Energy was selling at the price it was receiving was considered to be an adequate return on capital invested. The intention was to fix the exchange rate so that there was greater certainty of receipt of revenue from export sales.

8.054 In making that decision, management reduced the company's ability to accommodate a downward movement in either the quantity of coal sold or the price received before having an excess of foreign exchange cover. Foreign exchange cover is generally taken out because there is some certainty that the sale will be made and the cover will be fully utilised.

8.055 The downturn in the Asian economy during 1997 and 1998 meant that both the demand for and the price of coal has fallen. Solid Energy is now in a position where contracts are currently not always being fulfilled. Not only is it having difficulty meeting its "contracted sales" targets, but the downturn also means that it is not able to meet the level of projected sales on which the foreign exchange cover is based.

8.056 The monthly reports to the Board from June to November 1998 show the five-year forecast sales being revised downwards. The forecast international sales and the foreign exchange cover are shown in Figure 8.3 on the next page. In the November report, the foreign exchange cover for the first three years significantly exceeds the forecast sales.

Will Solid Energy Be Able To Make Use of the Foreign Exchange Cover?

8.057 Solid Energy is now in a position where it has purchased foreign exchange cover well in excess of the level of international sales it is currently expecting to attain. Over-optimistic sales targets have meant that Solid Energy is now facing the risk that it will incur substantial actual losses in the event that sales fall short of the level of cover taken out.

8.058 This risk is very real, especially since international coal sales are depressed. The year-to-date position in the 30 November 1998 management accounts showed a budget sales forecast of US$24.3 million yet only US$14.1 million had been achieved.[10]

Figure 8.3
Forecast International Sales and Foreign Exchange Cover

	Year 1 US$ million	Year 2 US$ million	Year 3 US$ million	Year 4 US$ million	Year 5 US$ million
Forecast international sales –					
as at June 1998	65	85	113	135	148
as at October 1998	50	74	111	128	135
as at November 1998	49	55	50	49	48
Foreign exchange cover –					
as at June1998	70	71	91	53	12
as at October 1998	75	87	62	50	Nil
as at November 1998	80	82	70	40	Nil

Has Solid Energy's Foreign Exchange Policy Been Regularly Reviewed?

8.059 An external review of Solid Energy's treasury policies (which include the foreign exchange risk management policy) has been undertaken only twice since the company was established as an SOE in 1987 – in 1995, and in 1997 when the company asked Southpac Limited (Southpac) to do a review.

10 The exchange rate that Solid Energy used to convert from New Zealand dollars to United States dollars was 0.63.

8.060 One of Southpac's recommendations was that Solid Energy adopts a benchmark[11] to assess performance. Southpac recommended that the benchmark comprise 50% of foreign exchange cover over contracted revenue with the remaining 50% being purchased at the time of the transaction. A different benchmark was to be applied for other non-contract revenue projections, which Southpac proposed should be the minimum cover levels in the company's current treasury policy. The Board did not accept Southpac's recommendation.

8.061 Separate advice was sought from Bancorp Treasury Services Limited (Bancorp), which had a differing view in relation to the benchmarking – it recommended a composite benchmark in excess of 50%.

8.062 Solid Energy's treasury policies require that:

- An annual audit of the treasury systems be undertaken. We were advised that internal audit has conducted two audits, so that the requirements of this policy have not been met. The Board determines the annual internal audit programme.
- The maximum and minimum levels of foreign exchange cover should be reviewed at least every 12 months. We found no formal evidence that the Board had made this annual review.

What Is Currently Being Done To Mitigate the Foreign Exchange Risk?

8.063 A new Board has been appointed.

8.064 The new Board has instituted a strategy to manage the foreign exchange risk over the next 12 months. The Board is currently reviewing its treasury policies with the assistance of a newly appointed adviser.

11 A "benchmark" is a measure against which the company's performance in relation to foreign exchange can be assessed. In this instance benchmarking means that the company would calculate the level of revenue from a benchmark foreign exchange policy and compare it to the actual revenue received using the actual policy.

Conclusions

How Are SOEs Managing Foreign Exchange Risk?

8.065 The majority of SOEs did not purchase foreign exchange cover to hedge future revenue streams to any significant degree. Of those that did, one (Solid Energy) did not meet all our expectations – particularly in relation to the adequacy of the information that was supplied to the Board.

What Are the Lessons for Others?

8.066 We believe that, when considering how to manage foreign exchange risk, Boards should:

- Set out their objectives as to what and why they are aiming to manage.
- Ensure that polices and procedures are sufficiently detailed to give effect to the objectives.
- Require that they receive sufficient information to enable them to understand clearly and fully the exposure that their company has to foreign exchange risk. This information should include known and anticipated changes in business conditions and the effect that these could have on the company's exposure.
- Require that, where the policies are not being complied with, the Board be advised immediately of the extent of the exposure as well as an action plan to ensure a return to compliance.
- Provide for a suitably qualified external party to periodically review the policies. This review should include a comparison with other participants in their industry, as well as current trends in foreign exchange management. Any changes to the policies should be subject to detailed analysis in light of any known or anticipated changes in business conditions.