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.