Central Government: Results of the 2003-04 Audits

Report of the Controller and Auditor-General

Tumuaki o te Mana Arotake

ISBN 0-478-18130-2

Office of the Auditor-General
Private Box 3928, Wellington
Telephone: (04) 917 1500
e-mail: reports@oag.govt.nz
web site: www.oag.govt.nz

B.29[05a]

Report of the

Controller and Auditor-General

Tumuaki o te Mana Arotake

on

Central Government: Results of the 2003-04 Audits

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

Hon Margaret Wilson MP
Speaker
House of Representatives
WELLINGTON

Madam Speaker

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

Yours sincerely

K B Brady
Controller and Auditor-General

Wellington
16 March 2005

Contents

Introduction

This report serves two broad purposes:

- it constitutes our "annual report" on the audits for 2003-04 of the Crown and its sub-entities – mainly as reflected in the *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2004* (the Financial Statements), parliamentary paper B.11, 2004; and
- it brings to attention a number of other matters (related both directly and indirectly to events occurring in the financial year 2003-04) that we believe warrant consideration by Parliament.

Part One (pages 9-18) deals with the Government's *Financial Statements* as audited and presented to the House. Specific topics addressed include:

- consolidation issues;
- valuation issues;
- issues with significant impacts on future financial statements; and
- resolution of issues raised previously.

Part Two (pages 19-25) deals with the results of our audits of government departments for the year ended 30 June 2004. We include our usual:

- commentary on the audit opinions on the departments' financial reports; and
- assessments of the departments' financial and service performance management.

Part Three (pages 27-39) sets out details of the non-standard audit reports we issued during the period 1 July 2003 to 31 December 2004 on the annual financial statements of:

- entities that are part of the Crown reporting entity; and
- other public entities not within the local government portfolio.

INTRODUCTION

Part Four (pages 41-49) outlines the adoption of International Financial Reporting Standards in New Zealand, and comments on the impacts this will probably have on both the preparation of financial statements by public entities and our auditing of those statements.

Part Five (pages 51-57) describes the "Controller" function performed by the Auditor-General, and examines changes in that function resulting from the Public Finance Amendment Act 2004.

Part Six (pages 59-73) reports on the results of our examination of expenses incurred by the chairpersons of the boards of 98 public entities. We set out our expectations for proper control over different classes of expenditure.

Part Seven (pages 75-78) sets out our planned work programme for examining issues relating to contract and other funding arrangements between government and non-government organisations.

Part Eight (pages 79-82) describes the responsibility of public entity management to minimise fraud – we mention key elements in a fraud policy – and the duties of public entity management in the event of fraud being detected or suspected.

Part Nine (pages 83-92) reports on the assessments made by our auditors in their annual audit of school Boards of Trustees, on the extent of their compliance with certain legislative financial provisions.

Part Ten (pages 93-98) describes the establishment of the Electricity Commission in September 2003, and the new responsibility of the Auditor-General to conduct an assurance audit and report to the House of Representatives on the Commission's annual performance report.

Part Eleven (pages 99-121) gives the current status of follow-up action on reports we have presented to the House during the past financial year.

Part One

1

The 2003-04 audited financial statements of the Government

B.29[05a]

1.1 The Auditor-General issued the audit opinion on the *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2004* (the *Financial Statements*) on 17 September 2004. This is the same date on which the Minister of Finance and the Secretary to the Treasury signed their Statement of Responsibility for the *Financial Statements*.

Unqualified opinion issued

1.2 The audit report appears on pages 20-21 of the *Financial Statements*. The report includes our unqualified opinion that those statements –

- *comply with generally accepted accounting practice in New Zealand; and*
- *fairly reflect:*
  - *the Government of New Zealand's financial position as at 30 June 2004; and*
  - *the results of its operations and cash flows for the year ended on that date.*

1.3 As in previous years, the Treasury has provided a comprehensive commentary on the financial performance and position, which is presented on pages 6-17 of the *Financial Statements*.

1.4 In addition to that commentary, we draw attention to the following significant matters.

Consolidation issues

ONE

Financial Reporting Standard No. 37: Consolidating Investments in Subsidiaries

1.5 This was the second year that the *Financial Statements* had been prepared on a fully consolidated basis. Financial Reporting Standard No. 37: *Consolidating Investments in Subsidiaries* (FRS-37) came into effect for the 2003 *Financial Statements* and was one of the drivers behind the switch to full consolidation.

1.6 The significant issue that arose from FRS-37 was in relation to determining the appropriate accounting treatment for tertiary education institutions (TEIs) within the *Financial Statements*. This remained an issue for the 2004 *Financial Statements*.

1.7 A significant aspect of FRS-37 was a revised set of tests to determine which entities were "controlled" and hence subject to consolidation within the *Financial Statements*.

1.8 The application of the "control" test to the Crown is difficult, particularly in cases where legislation provides entities such as TEIs with statutory autonomy and independence.

1.9 The accounting treatment that the Treasury adopted in the 2003 *Financial Statements* was not to consolidate TEIs line-by-line, but to equity account them based on a 100% interest. This accounting treatment has again been adopted for the 2004 *Financial Statements*.

1.10 This approach is based on the view that the "control" test is not satisfied, as the Crown does not have the ability to determine the financing and operating policies of TEIs, but that the Crown's relationship with TEIs does meet the "significant influence" test necessary for equity accounting. As the Crown's interest in the TEIs' residual assets is 100%, the somewhat unusual accounting policy adopted is 100% equity accounting for TEIs. This approach and the reasons for it are set out in Note 13 to the *Financial Statements*.

1.11 In our view, line-by-line consolidation remains the treatment that best reflects the substance of the relationship between the Crown and the TEIs and the intent of FRS-37. We have accepted equity accounting for TEIs as it can be argued that the treatment complies with a strict interpretation of the mandatory elements of FRS-37, and because of the additional disclosures

provided in Note 13. These enable readers to see the impact on the *Financial Statements* if a line-by-line treatment had been adopted for TEIs. With these additional disclosures, we have accepted that the *Financial Statements* remain fairly stated.

1.12 This issue demonstrates the difficulties of the "control" test in the Crown context. The Treasury has communicated with the bodies responsible for setting Financial Reporting Standards in New Zealand to seek clarification of the "control" test in the Crown context. In future, the adoption of New Zealand equivalents to the International Financial Reporting Standards (NZ IFRS) (see paragraphs 1.49-1.51 on pages 17-18) may again affect the "control" test to be applied.

1.13 We have recommended that the Treasury continue its discussions with standard setters on the application of the "control" test in the Crown context. The timeframe for any amendments to FRS-37 is not yet clear or certain. We will continue to monitor developments in this area.

Sub-consolidations: Ministry of Health and Ministry of Education

1.14 The Ministry of Health (MOH) and the Ministry of Education (MOE) are responsible for collecting, consolidating, and reporting to the Treasury the consolidated financial results of district health boards (DHBs) and tertiary education institutions (TEIs) respectively. Neither Ministry met the agreed timetable for producing these sub-consolidations for audit.

1.15 Last year, we highlighted the problems of ensuring that the consolidated results of DHBs were accurate. This year, we are pleased to see a considerable improvement in the MOH's performance in that area, but the Ministry was late in providing the audit team with its consolidated information. We acknowledge that the consolidation timeframe is tight (being only 3 days), but the delays affected the ability of our auditors to achieve the level of review envisaged.

1.16 There were also issues this year with the timeliness of the MOE's TEI sub-consolidation, and with its response to our auditor's queries on that matter.

1.17 Given that the deadlines governing the overall *Financial Statements* audit were tight, the inability of these two Ministries to achieve them posed significant challenges to our audit teams.

1.18 We have recommended:

- that the Treasury work with the MOH, the MOE, and ourselves to agree on a timetable for the sub-consolidations that provides sufficient time for audit; and
- that all parties commit the resources that will ensure that these deadlines can be met in the future.

Valuation issues

Rail assets

1.19 On 30 June 2004, the Crown signed a number of agreements with Toll Holdings Ltd (Toll), including agreements on the purchase of the rail infrastructure and a track access agreement out to the year 2070. The accounting treatment for these agreements had to be determined, particularly the valuation of the Crown-owned land associated with the rail network and capital expenditure on the rail infrastructure.

1.20 In the *Financial Statements*, the rail access agreement with Toll has been accounted for as a finance lease, and the rail infrastructure and land as a lessor's interest in a finance lease. Under this treatment, capital expenditure incurred by the Crown on the rail network is expensed, and the fair value of the land is discounted for the term of the access agreement.

1.21 During the audit, we discussed with the Treasury the appropriateness of this accounting treatment. The Treasury's view is based on the criteria for a finance lease under SSAP-18 *Accounting for Leases and Hire Purchase Contracts*, specifically:

- the agreements being effectively non-cancellable;
- the collectibility of the access payments being assessed as reasonably predictable; and
- the lease term being assessed as for a major portion of the useful life of the asset.

1.22 It is arguable whether the access agreement is a finance lease that passes substantially all the risks and rewards of ownership to Toll, or whether the term of the access agreement is for the majority of the life of the rail network asset as a whole.

1.23 The agreements between the Crown and Toll are complex, and a number of elements need to be considered. They include:

- the "use it or lose it" clauses in the access agreement in relation to both freight and passenger services;
- the other operators that will use the network, including the Auckland metro operator and small-scale heritage operators;
- the Crown's decision-making powers in relation to maintenance and capital investment in the network, including the ability to make additional investment on public policy grounds; and
- the commercial property rights passed to the Crown with the surrender of the old core lease.

1.24 An alternative accounting treatment would be to capitalise as property, plant, and equipment the capital expenditure incurred on the rail network, and to record the rail land at fair value (subject to further consideration of the relatively small amounts of land retained by Toll under the revised core lease).

1.25 As at 30 June 2004, we were satisfied that the differences between the accounting treatment adopted by the Treasury and the alternative described above were not material to the *Financial Statements*. This may not be the case in future years, as the Crown meets its capital investment commitments under the agreements with Toll.

1.26 For future years, our current view is that depreciated replacement cost would be the most meaningful method of accounting for the rail infrastructure assets in the Crown Statement of Financial Position. This would be consistent with the approach adopted for some of the Crown's other major infrastructural assets, such as the State highway network. The determination of depreciated replacement cost may also provide useful information for the management of this major asset.

1.27 We have recommended that the Treasury, together with the New Zealand Railways Corporation, review the accounting treatment of the rail assets during 2004-05. This is to ensure that it reflects the nature of the rail network assets and the substance of the rail agreements, taking into account all relevant guidance and international precedents.

Fair value of land and buildings

1.28 Crown accounting policy is that land and buildings are recorded at fair value. The Treasury has advised entities included in the Crown reporting entity, on the grounds of materiality, that they are not required to revalue land and buildings with a book value of less than $50 million.

1.29 Last year, we noted that some entities (including Air New Zealand Limited) had not revalued their land and buildings for the purposes of the *Financial Statements*, despite the disclosed rating valuations being significantly greater than the carrying values. In Air New Zealand's case, the carrying value of land and buildings was greater than the $50 million threshold.

1.30 Although rating valuations are not acceptable as fair valuations under FRS-3, they indicate that the fair value of these assets is likely to be significantly greater than the carrying value.

1.31 This year, we again noted that the land and buildings of Air New Zealand had not been revalued to fair value for the purposes of the *Financial Statements*. It was agreed that a consolidation adjustment would be made in the *Financial Statements* to reflect the rating valuation of Air New Zealand's land and buildings as an approximation of fair value.

1.32 The Treasury reviewed the reasonableness of the $50 million threshold for the revaluation of land and buildings, and concluded that it was unlikely that any other entities had land and buildings with a fair value significantly different to the carrying value.

1.33 For the purposes of the *Financial Statements*, we have recommended that the Treasury ensure that all entities comply with the requirement to revalue land and buildings holdings with a value greater than $50 million to fair value for the purposes of the *Financial Statements*.

Student loans valuation

1.34 Note 9 to the *Financial Statements* discloses the fair value of student loan balances as $5,734 million. This is $261 million lower than the carrying value (after provisions) of $5,995 million. In the 2003 *Financial Statements*, the disclosed fair value of the student loan balances was $222 million greater than the carrying value.

1.35 We have agreed with the Treasury's view that the difference between fair value and carrying value does not represent an impairment of the asset and that no write-down was required in the 2004 *Financial Statements*. The reasons for this are, firstly, that the fair value determination at this stage is only an approximation and, secondly, that generally accepted accounting practice in New Zealand (NZ GAAP) is not clear about the appropriate accounting treatment in these circumstances.

1.36 This is only the second year that a fair value for student loan balances has been disclosed in the *Financial Statements*. The fair value exercise is highly complex and requires collaboration between the Ministry of Education, the Inland Revenue Department, and the Ministry of Social Development. The fair value model contains a number of significant assumptions based on the professional experience of the actuaries and the data available. Some of these assumptions will become more accurate as the loan scheme becomes more mature and further data is available.

1.37 The model will also become more accurate as the quantity and quality of data improves. This year, significant problems were encountered in attempting to refresh the historic data in the model with an additional year's student loan data. The additional data could not be extracted, and so the model has used the previous data rolled forward an extra year with updated assumptions.

1.38 NZ GAAP currently requires the disclosure of the fair value of financial assets such as the student loan scheme (subject to constraints of timeliness and cost), but does not require that such assets be accounted for at fair value. NZ GAAP for financial assets will change in coming years with the move to NZ IFRS. However, it is not yet clear whether NZ IFRS will require a change to account for the loan scheme at fair value, and therefore whether recognition of an impairment loss will be required in circumstances such as this.

1.39 We have recommended that the Treasury continue to work with the appropriate Government departments to develop the student loan fair value model, and that particular efforts be made to resolve the issues that prevented the model being updated this year. We have also recommended that the Treasury continue to monitor developments in International Financial Reporting Standards with respect to accounting for similar financial assets.

Fair value of other debtor portfolios

1.40 A number of Government departments are responsible for debt portfolios (i.e. assets of the Crown) where the debts are collected over a significant period of time. Student loan debt is one example of this and, as discussed above, a fair value for the student loan portfolio has been determined and disclosed. However, there are other significant debt portfolios in the *Financial Statements* for which the fair value is not disclosed.

1.41 These portfolios include some that have lengthy collection periods and do not accrue interest on outstanding balances. In these cases, the fair value is likely to be less than the carrying value of the debt. Examples of such debtor portfolios are:

- Ministry of Social Development – $769 million gross ($445 million after provisions) Crown debt (e.g. benefit recoveries); and
- Ministry of Justice – $482 million gross ($321 million after provisions) unpaid fines.

1.42 In the case of the Ministry of Justice, an attempt was made to determine a fair value for the unpaid fines balance. However, because of significant errors in the Ministry's methodology, this was not disclosed in the *Financial Statements*.

1.43 We have recommended that the Treasury provide guidance on determining fair values of debtor portfolios to ensure that fair value disclosures are available for the 2005 *Financial Statements* and beyond.

Issues with significant impacts on future financial statements

Public Finance Amendment Act 2004

1.44 The Public Finance Amendment Act 2004 came into force on 25 January 2005. It has a number of impacts on future *Financial Statements*, including changing the reporting entity from the "Crown" to the "Government reporting entity". The Public Finance Act 1989 (the Act) now defines the "Government reporting entity" as follows –

Government reporting entity *means:*

(a) the Sovereign in right of New Zealand; and

(b) the legislative, executive, and judicial branches of the Government of New Zealand.

1.45 The revised definition clarifies that the three branches of government are to be included within the Government's financial statements under the Act. As a result, the Offices of Parliament will be re-incorporated into the Government's financial statements. Currently, these Offices are not included in the *Financial Statements* because they are instruments of the House of Representatives rather than of the Crown.

1.46 The Treasury will therefore need to plan for re-incorporating the Offices of Parliament into the Government's financial statements in future.

Foreshore and seabed

1.47 Section 13(1) of the Foreshore and Seabed Act 2004 states –

On and from the commencement of this Act, the full legal and beneficial ownership of the public foreshore and seabed is vested in the Crown, so that the public foreshore and seabed is held by the Crown as its absolute property.

1.48 We have recommended that the Treasury consider how the Crown's ownership of the foreshore and seabed should be accounted for in future *Financial Statements*.

Application of New Zealand equivalents to International Financial Reporting Standards

1.49 In August 2003, the Government announced that NZ IFRS would be implemented in the *Financial Statements* as part of the 2007 Budget. This means that the first audited *Financial Statements* under NZ IFRS will be for the year ending 30 June 2008 (with comparatives to 30 June 2007 restated in accordance with NZ IFRS).

1.50 In Part 4 of this report (pages 41-49), we discuss the progress made to date towards transition to NZ IFRS and highlight some of the issues and impacts (to the extent known at this stage) for the *Financial Statements* and the central government sector.

1.51 We have recommended that the Treasury continue to provide the necessary leadership and guidance to entities within the Crown sector on the move to NZ IFRS.

Resolution of issues raised previously

Ministry for the Environment (MfE) – Assets and liabilities

1.52 Last year, we highlighted an issue in relation to certain MfE land holdings that were not recognised in the Crown Statement of Financial Position, and possible associated environmental liabilities that were also not accounted for. Although the financial impact of the issue was not material to the *Financial Statements*, it resulted in a qualification of our 2003 audit opinion on MfE.

1.53 We are pleased to note that MfE has appropriately valued these land holdings in 2004, and that they are now included in the Crown Statement of Financial Position. We also note that plans are now in place to appropriately manage these assets.

Part Two

2

Government departments – Results of the 2003-04 audits

B.29[05a]

Introduction

2.1 This part reports on the results of the 2003-04 audits of 41 government departments.[1] Its purpose is to inform Parliament of the assurance given by the audits in relation to:

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

Audit opinions issued

2.2 The Public Finance Act 1989 (the Act) specifies departments' responsibilities for general purpose financial reporting. Sections 34A(3) and 35(3) of the Act[2] required departments to prepare their financial statements for the 2003-04 financial year in accordance with generally accepted accounting practice.[3]

2.3 Section 38(1) of the Act[4] and section 15 of the Public Audit Act 2001 set out the responsibility of the Auditor-General to issue an audit opinion on the financial statements of each department.

2.4 To form an opinion on the financial statements of departments, our audits are conducted in accordance with the Auditor-General's Auditing Standards, which incorporate the Auditing Standards issued by the Institute of Chartered Accountants of New Zealand. The audits are planned and performed to obtain all the information and explanations considered necessary in order to obtain reasonable assurance that the financial statements do not have material mis-statements, whether caused by fraud or error.

1 The 41 departments are listed on page 88 of the *Financial Statements*.
2 These sections have since been repealed by the Public Finance Amendment Act 2004, and replaced by new sections 41(1)(a) and 45B(1).
3 "Generally accepted accounting practice" is defined in section 2(1) of the Public Finance Act 1989.
4 This section has since been repealed by the Public Finance Amendment Act 2004, and replaced by new section 45D(2).

2.5 The audit also involves performing procedures to test the information presented in the financial statements. In forming our opinion, we assess the results of those procedures, and evaluate the overall adequacy of the presentation of information in the financial statements.

2.6 Of the 41 government departments audited, one received an audit report containing a qualified audit opinion (see Figure 2.1 below).

Figure 2.1
Analysis of audit opinions 2000-04

Year ended 30 June	2000	2001	2002	2003	2004
Unqualified opinions	43	44	42	41	40
Qualified opinions	-	-	1	2	1
Total audit opinions issued	**43**	**44**	**43**	**43**	**41**

The total number of departments reduced to 41 in 2004. The Department for Courts merged with the Ministry of Justice, and the Ministry of Youth Affairs became part of the Ministry of Social Development.

Qualified audit opinion

2.7 The Ministry for the Environment received a qualified audit opinion. A qualified audit opinion was issued in 2003[5], and the matter was corrected in the financial statements for the year ended 30 June 2004. The qualification for the latest year related only to comparative information (i.e. figures for the previous year).

Financial and service performance management

2.8 Our auditors examine aspects of financial management and service performance management. Where applicable, we identify specific areas of weakness, and make recommendations to eliminate those weaknesses.

5 See our detailed explanation in *Central Government: Results of the 2002-03 Audits*, parliamentary paper B.29[04a], pages 26-27.

Reporting to Parliament

2.9 We report our assessment of certain aspects of management to the chief executive, and to stakeholders in each department (such as the responsible minister, and the Select Committee that conducts the financial review of the department).

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

Financial management

2.11 We assess and report on the following aspects of financial management:

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

Service performance management

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

- *Service performance information and information systems* – the systems to record service performance (non-financial) data, and the internal controls (manual and computer) to ensure the completeness and accuracy of the data.

- *Service performance management control environment* – this covers the planning processes, the existence of quality assurance procedures, the adequacy of operational policies and procedures, and the extent to which self-review of non-financial performance is taking place.

The rating system

2.13 The rating system we use is:

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

2.14 We assessed financial and service performance management in each of the 41 departments. A summary of the assessments (205 in total – 5 for each department) is given in Figure 2.2 on the next page.

2.15 The 80 assessments of "Excellent" (39%), and the combined total of 177 assessments (86%) that were either "Excellent" or "Good", shows a slight decrease on the previous year. There were fewer "Excellent" assessments, due mainly to departmental restructuring, and, in particular, the integration of organisations with different control environments, requirements, and systems.

Figure 2.2
Summary of assessments of aspects of financial management and service performance management in departments for 2003-04

Aspect Assessed	Excellent		Good		Satisfactory		Just Adequate		Not Adequate	Total
	No.	%	No.	%	No.	%	No.	%	No.	No.
FCS	17	*41*	20	*49*	4	*10*	0	*0*	0	41
FMIS	17	*41*	19	*46*	5	*12*	0	*0*	0	41
FMCE	18	*44*	17	*41*	6	*15*	0	*0*	0	41
SPIS	12	*29*	21	*51*	8	*20*	0	*0*	0	41
SPMCE	16	*39*	20	*49*	5	*12*	0	*0*	0	41
Totals 2004	**80**	***39***	**97**	***47***	**28**	***14***	**0**	***0***	**0**	**205**
2003*	83	*41*	99	*48*	23	*11*	0	*0*	0	205

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

* The 2003 totals are included to enable comparisons to be made (results for the Department of Courts and the Ministry of Youth Affairs have been removed from the 2003 figures).

2.16 No assessments of "Just Adequate" or "Not Adequate" were issued in the last two years.

2.17 We compared our assessments for 2002-03 and 2003-04 for each of the 41 departments. The results are summarised in Figure 2.3 below.

Figure 2.3
Assessment ratings for 2004, compared to 2003

Aspects assessed*	Higher rating	Same rating	Lower rating	Total
FCS	3	36	2	41
FMIS	1	38	2	41
FMCE	2	37	2	41
SPIS	1	38	2	41
SPMCE	0	37	4	41
Totals	**7**	**186**	**12**	**205**
%	*3.4*	*90.7*	*5.9*	*100.0*

* See Figure 2.2 for key to abbreviations.

2.18 Figure 2.3 shows:

- a very high proportion (90.7%) of the assessment ratings were maintained at the level of the previous year;
- 7 of the assessment ratings (3.4%) were higher in 2004 than in 2003; and
- 12 of the assessment ratings (5.9%) were a lower rating than in 2003.

2.19 The 7 assessment ratings that were higher in the 2003-04 year confirm that some departments continue to make improvements. The 12 rating assessments that were lower than the previous year were due to:

- departmental restructuring, and in particular the integration of organisations with different control environments, requirements, and systems; and
- other significant issues that had an adverse effect on the management control environment.

2.20 The possibility of all departments attaining a rating assessment of "Excellent" is, for a variety of reasons, unlikely. The reasons for this include:

- periodic restructuring;
- the complexity of departmental operations; and
- the sheer size of some departments' operations.

2.21 Our auditors will, nevertheless, continue to assist and encourage departments to make improvements.

Part Three

3

Non-standard audit reports issued

B.29[05a]

Introduction

3.1 We report in this part on the non-standard audit reports issued on the annual financial statements of entities that are part of the Crown reporting entity and other public entities not within the local government portfolio.[1]

3.2 This article covers non-standard audit reports issued during the period 1 July 2003 to 31 December 2004 on entities' financial statements for:

- balance dates between 1 July 2003 and 30 June 2004; and
- balance dates before 1 July 2003 (audits in arrears).

3.3 Last year, we reported our intention to name the public entities for which we issued a non-standard audit report from this year onwards. Accordingly, all entities falling into the first category above have been named, but not those in the second category. From next year, we will name all public entities.

Why are we reporting this information?

3.4 An audit report is addressed to the readers of an entity's financial statements. However, all public entities are ultimately accountable to Parliament. We therefore consider it important to draw Parliament's attention to the range of matters that give rise to non-standard audit reports.

3.5 In each case, the issues underlying a non-standard audit report have been drawn to the attention of the entity and discussed with its governing body.

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

What is a non-standard audit report?

3.6 A non-standard audit report[2] is one that contains:

- a **qualified audit opinion**; and/or
- an **explanatory paragraph**.

3.7 The auditor expresses a **qualified audit opinion** because of a disagreement or a limitation on scope. The type of opinion will be either an "adverse" opinion (explained in paragraph 3.10), or a "disclaimer of opinion" (paragraph 3.12), or an "except-for" opinion (paragraph 3.13).

3.8 The auditor will include an **explanatory paragraph** (see paragraphs 3.14-3.15) in the audit report in order to draw attention to:

- a breach of law; or
- a fundamental uncertainty.

3.9 An explanatory paragraph is included in the audit report in such a way that it cannot be mistaken for a qualification of the opinion.

"Adverse" opinion

3.10 An "adverse" opinion is expressed when there is disagreement between the auditor and the entity about the treatment or disclosure of a matter in the financial statements and, in the auditor's judgement, the treatment or disclosure is so material or pervasive that the statements are seriously misleading.

3.11 Expression of an "adverse" opinion represents the most serious type of non-standard audit report.

"Disclaimer of opinion"

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

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

"Except-for" opinion

3.13 An "except-for" opinion is expressed when the auditor concludes that either:

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

Explanatory paragraph

3.14 In certain circumstances, it may be appropriate for the auditor to include in the audit report additional comment, by way of an explanatory paragraph, to draw attention to a matter that is regarded as relevant to a proper understanding of the basis of opinion on the financial report.

3.15 For example, it could be relevant to draw attention to the entity having breached its statutory obligations, or to a fundamental uncertainty that might make the going concern assumption inappropriate. The most common type of non-standard audit report tends to include an explanatory paragraph.

Non-standard audit reports issued for balance dates between 1 July 2003 and 30 June 2004

3.16 The table on the next page outlines the nature of the non-standard audit reports issued for balance dates between 1 July 2003 and 30 June 2004.

Full "adverse" opinions

Name of Entity	Financial Statements Period Ended	Reason for Opinion
New Zealand Railways Corporation	30 June 2004	We disagreed with the recognition of provisions for claims and litigation relating to the previous operations of the business. In our opinion, these provisions did not constitute a liability of the Corporation.
Queen Elizabeth II Army Memorial Museum	30 June 2004	The Board did not recognise the museum collection assets it owns; nor the associated depreciation expense in its financial statements. These are departures from Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment* (FRS-3), which requires museum collection assets not previously recognised to be recognised at fair value and depreciated. In addition, we were unable to verify some material revenues due to limited control over those revenues. We also reported that we were unable to express an opinion as to whether the comparative information in the Statements of Financial Performance and Position was fairly stated, due to a qualification expressed on the prior year's financial statements.
RNZAF Museum Trust Board	30 June 2004	The Board did not recognise the museum collection assets it owns; nor the associated depreciation expense in its financial statements. These are departures from Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment* (FRS-3), which requires museum collection assets not previously recognised to be recognised at fair value and depreciated. We also reported that, if it were not for the departure from FRS-3, the financial statements would have fairly reflected the Board's financial position, results of operations and cash flows.

NON-STANDARD AUDIT REPORTS ISSUED

Partial "adverse" opinions

Name of Entity	Financial Statements Period Ended	Reason for Opinion
Christchurch Polytechnic Institute of Technology and Group	31 December 2003	We issued an unqualified opinion on the parent entity's financial statements. However, we disagreed with the Council's decision not to prepare consolidated financial statements. In our opinion, this was a departure from Financial Reporting Standard No. 37: *Consolidating Investments in Subsidiaries.*
Broadcast Communications Limited	30 June 2004	We disagreed with the Board of Directors' decision to recognise a fundamental error relating to a payment made in 2000 under a non-compete settlement agreement that had the effect of writing down the non-compete asset. In our opinion, this decision was incorrect and mis-stated the company's Statement of Financial Performance and Statement of Financial Position. We issued an unqualified opinion on the company's statement of cash flows.

Partial "disclaimers of opinion"

Name of Entity	Financial Statements Period Ended	Reason for Opinion
Morrinsville College Educational Trust	31 December 2003	The financial statements of the Trust had not previously been audited. We were therefore unable to form an opinion as to whether the Statement of Financial Performance was fairly stated. We also did not give an opinion about the comparative information. However, in our opinion, the financial position of the Trust was fairly stated.

"Except-for" opinions

Name of Entity	Financial Statements Period Ended	Reason for Opinion
Ministry for the Environment	30 June 2004	We disagreed with the Ministry's decision not to recognise its non-departmental land in the 2003 comparative information. In our opinion, this was a departure from Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment*.
Transmission Holdings Limited and Group	30 June 2004	We disagreed with the write-down of the non-compete settlement asset of Broadcast Communications Limited, a subsidiary of Transmission Holdings Limited (THL), and the recognition of goodwill by the THL Group. In our opinion, this decision was incorrect and mis-stated the financial statements.
Ngati Whakaue Education Endowment Trust Board	31 December 2003	We disagreed with land being recorded at the value used for rating purposes. In our opinion, this was a departure from Statement of Standard Accounting Practice No. 17: *Accounting for Investment Properties and Properties Intended for Sale*.
New Zealand Army Singapore Fund	31 December 2003	The financial statements of the Fund had not previously been audited. We therefore did not form an opinion about the comparative information. The lack of assurance about the comparative information meant that adjustments may have been necessary for the Statement of Financial Performance to be fairly stated. However, in our opinion, the financial position of the Fund was fairly stated.

… continued on page 33.

NON-STANDARD AUDIT REPORTS ISSUED

Name of Entity	Financial Statements Period Ended	Reason for Opinion
RNZAF Sports Association	30 June 2004	The financial statements of the Association had not previously been audited. We therefore did not form an opinion about the comparative information. The lack of assurance about the comparative information meant that adjustments may have been necessary for the Statement of Financial Performance to be fairly stated. However, in our opinion, the financial position of the Association was fairly stated.
Auckland District Health Board Charitable Trust	30 June 2004	We were unable to verify certain revenue because of limited control over the receipt of this revenue.
He Huarahi Tamariki CharitableTrust	31 December 2003	We were unable to verify certain revenue because of limited control over the receipt of this revenue.
McAlister Holdings Limited[3]	31 December 2003	We were unable to verify certain revenue because of limited control over the receipt of this revenue.

Explanatory paragraphs

Name of Entity	Financial Statements Period Ended	Reason for Opinion
Northland Polytechnic and Group	31 December 2003	We highlighted that the validity of the going concern assumption depended on the results of a strategic review of the Polytechnic.
Auckland College of Education and Group	31 December 2003	We drew attention to the uncertainty over the future status of the College as an entity. The validity of the going concern assumption depended on the Minister of Education's decision on the proposal to amalgamate the College into the University of Auckland.

… continued on page 34.

3 Subsidiary of Te Whare Wananga o Awanuiarangi.

NON-STANDARD AUDIT REPORTS ISSUED

THREE

Name of Entity	Financial Statements Period Ended	Reason for Opinion
Western Institute of Technology at Taranaki and Group	31 December 2003	We highlighted that the going concern assumption depended on the continuing financial support of the Crown and/or the Institute's bankers.
Treaty of Waitangi Fisheries Commission and Group	30 September 2003	We drew attention to the uncertainty over the future status of the Commission as an entity. The validity of the going concern assumption depended on the outcome of the Māori Fisheries Bill, which was at that time being considered by Parliament. If enacted, the Bill would result in the Commission being dissolved and its activities being vested in a new corporate structure.
Building Industry Authority	30 June 2004	We highlighted that the going concern assumption had not been used in the preparation of the financial statements, because the Authority was to be disestablished on 30 November 2004. We also highlighted the uncertainty over the outcome of litigation on the weathertightness of buildings.
Pacific Education Centre	31 December 2003	We drew attention to a note in the financial statements regarding the Centre's financial difficulties, its business recovery plan, and the support provided by stakeholders.
Department for Courts	30 September 2003	We highlighted that the going concern assumption had not been used in the preparation of the financial statements, because the Department was to be merged with the Ministry of Justice on 1 October 2003.
Manukau Pacific Markets Limited	30 June 2004	We highlighted that the going concern assumption had not been used in the preparation of the financial statements, because the company was winding down its operations.

… continued on page 35.

Name of Entity	Financial Statements Period Ended	Reason for Opinion
Transfund New Zealand	31 December 2003	We highlighted that the going concern assumption had not been used in the preparation of the financial statements, because the entity was to be disestablished on 30 November 2004.
TP Holdings Limited[4]	31 December 2003	We highlighted that the going concern assumption had not been used in the preparation of the financial statements, because the company was to be liquidated within 12 months.
Casino Control Authority	30 June 2004 and 29 September 2004	We highlighted that the going concern assumption had not been used in the preparation of the financial statements, because the Authority was required to be dissolved 3 months from 1 July 2004.
Land Transport Safety Authority	30 June 2004	We highlighted that the going concern assumption had not been used in the preparation of the financial statements, because the Authority was to be disestablished on 30 November 2004.

Non-standard audit reports issued for balance dates before 1 July 2003 (audits in arrears)

3.17 In June 2004, we reported on the non-standard audit reports issued during the period 1 July 2002 to 31 March 2004. The following table updates and outlines the number and nature of non-standard audit reports issued during the period 1 July 2003 to 31 December 2004 for balance dates before 1 July 2003.

4 Subsidiary of the Western Institute of Technology.

NON-STANDARD AUDIT REPORTS ISSUED

Full "adverse" opinions

Class of Entity	No. of Entities	Reason for Opinion
State Owned Enterprise	1	We disagreed with the recognition of provisions for claims and litigation relating to the previous operations of the business. In our opinion, these provisions did not constitute a liability of the entity.

Partial "adverse" opinions

Class of Entity	No. of Entities	Reason for Opinion
Education – Polytechnic	1	We issued an unqualified opinion on the parent entity's financial statements. However, we disagreed with the Council of the Polytechnic not preparing consolidated financial statements. In our opinion, this was a departure from Financial Reporting Standard No. 37: *Consolidating Investments in Subsidiaries*.

Partial "disclaimers of opinion"

Class of Entity	No. of Entities	Reason for Opinion
State Owned Enterprise Subsidiary	1	The financial statements of the company had not previously been audited. We were therefore unable to form an opinion as to whether the comparative information in the Statement of Financial Performance was fairly stated.
Statutory Body Subsidiary	2	The financial statements of the entity had not previously been audited. We were therefore unable to form an opinion as to whether the Statement of Financial Performance was fairly stated. We also did not give an opinion about the comparative information. However, in our opinion, the financial position of the entity was fairly stated.

NON-STANDARD AUDIT REPORTS ISSUED

"Except-for" opinions

Class of Entity	No. of Entities	Reason for Opinion
Government Department[5]	1	We disagreed with the Department's valuation of visitor assets. We also disagreed with the fact that the Department did not recognise fencing assets and the associated depreciation expense and capital charge in the prior year's comparative information. In our opinion, the matters on which we disagreed were departures from Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment*.
Government Department[5]	1	We disagreed with the Department's decision not to recognise its non-departmental land and any associated liabilities. In our opinion, this was a departure from Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment* and Financial Reporting Standard No. 15: *Provisions*, *Contingent Liabilities and Contingent Assets* respectively.
Māori Trust Board	1	We were unable to confirm the value of the Board's fixed assets as it did not revalue them in accordance with Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment*. We were also unable to confirm the value of the Board's investment property as it did not revalue its investment properties in accordance with Statement of Standard Accounting Practice No. 17: *Accounting for Investment Properties and Properties Intended for Sale*.
Māori Trust Board	3	We disagreed with the Board not consolidating a subsidiary in the group financial statements. In our opinion, this was a departure from Statement of Standard Accounting Practice No. 8: *Accounting for Business Combinations*.

… continued on page 38.

5 Audit reports covered the year ended 30 June 2003.

NON-STANDARD AUDIT REPORTS ISSUED

Class of Entity	No. of Entities	Reason for Opinion
Māori Trust Board	1	We were unable to confirm the value of an investment held by the Board, and were unable to satisfy ourselves as to this balance by other audit procedures.
District Health Board Subsidiary	2	We were unable to verify certain revenue because of limited control over the receipt of this revenue.
Health – Health Miscellaneous	1	We were unable to verify certain revenue because of limited control over the receipt of this revenue.
Education – University and Wananga Subsidiary	1	We were unable to verify certain revenue because of limited control over the receipt of this revenue.
Education – Other Crown Entity	1	The entity did not complete a Statement of Intent for the year as required by the Public Finance Act 1989. As there were no formal performance targets, we were unable to assess the entity's service performance.
Statutory Body Subsidiary	1	The financial statements of this entity had not previously been audited. We therefore did not form an opinion about the comparative information. The lack of assurance about the comparative information meant that adjustments may have been necessary for the Statement of Financial Performance to be fairly stated. However, in our opinion, the financial position of the entity was fairly stated.

Explanatory paragraphs

Class of Entity	No. of Entities	Reason for Opinion
Government Department[6]	2	We highlighted that the going concern assumption had not been used in the preparation of the financial statements.
Crown Entity	2	We highlighted that the going concern assumption had not been used in the preparation of the financial statements.
Crown Entity Subsidiary	1	We highlighted that the going concern assumption had not been used in the preparation of the financial statements.
District Health Board Subsidiary	2	We highlighted that the going concern assumption had not been used in the preparation of the financial statements.
Education – Polytechnic Subsidiary	1	We highlighted that the going concern assumption had not been used in the preparation of the financial statements.
Education – Other Crown Entity	2	We highlighted that the going concern assumption had not been used in the preparation of the financial statements.
Statutory Body	1	We drew attention to the uncertainty over the future status of the entity. The validity of the going concern assumption on which the financial statements are prepared depended on both the potential outcome of litigation and the potential dissolution of the entity.
Statutory Body Subsidiary	8	We drew attention to the uncertainty over the future status of the entity.

6 Audit reports covered the year ended 30 June 2003.

Part Four

4

Planning for conversion to the New Zealand equivalents of International Financial Reporting Standards

B.29[05a]

4.1 Last year, we reported on the decision to convert to reporting in accordance with International Financial Reporting Standards (IFRS[1]), and the consequent issues emerging for central government. In this part, we provide an update on the progress made towards the transition to the New Zealand equivalents of IFRS (NZ IFRS[2]), and highlight some of the implications for the central government sector.

Background

4.2 In December 2002, the Accounting Standards Review Board (ASRB) announced its decision that New Zealand reporting entities would be required to apply new standards, based on IFRS, for reporting periods beginning on or after 1 January 2007. Reporting entities have the option to apply the new standards from periods starting on or after 1 January 2005.

4.3 In August 2003, the Government announced that NZ IFRS would be implemented in the financial statements of the Government as part of Budget 2007. This means that the first set of audited financial statements of the Government reported under NZ IFRS will be for the year ending 30 June 2008. However, as comparative figures must be presented on the same basis of accounting, the comparative figures for the year ending 30 June 2007, and an opening balance sheet at 1 July 2006, will need to be restated in accordance with NZ IFRS. For those central government entities with 31 December balance dates (for example, tertiary education institutions and schools), the transition comes six months earlier. Their opening balance sheets will therefore need to be restated at 1 January 2006.

---

1 The term IFRS is used to refer to International Accounting Standards Board (IASB) standards. The standards comprise:
- International Accounting Standards (IASs), inherited by the IASB from its predecessor body, the International Accounting Standards Committee (IASC), and the interpretations of those standards.
- International Financial Reporting Standards (IFRS) – the new standards being issued by the IASB, and the interpretations of those standards.

2 NZ IFRS will comprise:
- New Zealand International Accounting Standards (NZ IASs), and the interpretations of those standards.
- New Zealand International Financial Reporting Standards (NZ IFRSs), and the interpretations of those standards.

4.4 We understand that some state-owned enterprises (SOEs) and Crown entities are considering adopting NZ IFRS at an earlier date than the Crown. If any of these entities choose to adopt NZ IFRS earlier than the Crown, they will have to maintain two sets of information. One set would be in accordance with the policies that they adopt under NZ IFRS (for their own reporting). The other would be in accordance with the current New Zealand FRS (for reporting to the Crown for consolidation purposes, until the Crown financial statements are also prepared on an NZ IFRS basis).

ASRB approval of the NZ IFRS "stable platform"

4.5 On 24 November 2004, the ASRB approved the initial suite of standards for NZ IFRS. The adoption of these standards is the culmination of 2 years' intensive work by standard setters and those few parties (including the Office of the Auditor-General) that have been providing submissions on the exposure drafts of NZ IFRS.

4.6 The initial group of approved NZ IFRS is described as the "stable platform". This term is used by the International Accounting Standards Board to describe the standards to be applied by countries moving to adopt IFRS from 2005. The approved NZ IFRS "stable platform" is the New Zealand equivalent of the IASB's "stable platform".

4.7 It should be noted, however, that some aspects of the "stable platform" are still being developed by the IASB (particularly accounting for financial instruments), and that the "stable platform" will not be stable for long. The IASB has a number of projects in progress that are likely to lead to changes to IFRS, and consequently NZ IFRS, before NZ IFRS are adopted by the central government sector in the year to 30 June 2008.

One set of standards for all reporting entities

4.8 The current set of standards in New Zealand has been described as "sector-neutral", in that the standards have been developed for all reporting entities, and the same standards apply to both profit-oriented and public benefit entities[3]. IFRS, on the other hand, have been developed with a focus on profit-oriented entities. NZ IFRS have preserved the format, language, and structure of IFRS, but the ASRB has decided that a single set of standards should continue in New Zealand, applying to both profit-oriented and public benefit entities.

3 Public benefit entities are entities whose primary objective is to provide goods or services for a community or a social benefit, and where any risk capital has been provided with a view to supporting that primary objective rather than for a financial return to equity shareholders. They include most public sector entities.

4.9 In our view, there are a number of benefits in retaining a single set of standards, including efficiency in applying the standards (preparers and auditors can achieve a better understanding of a single set of standards), and more clarity and cross-sector comparability for readers of financial statements. However, it is important to appreciate that, while the standard setters in New Zealand have been able to preserve one set of standards, those standards can no longer be considered sector-neutral. This is because the adaptions made to IFRS (in accordance with the ASRB's guidelines – see paragraph 4.10) have resulted in differing requirements for public benefit entities and profit-oriented entities in some circumstances.

Guidance for public benefit entities

4.10 In June 2003, we raised concerns with the ASRB that inadequate consideration was being given to the effects of changes to standards on public sector reporting. After discussion, the ASRB established the following guidelines[4] to be used in adapting IFRS in New Zealand:

- The IFRS disclosure requirements cannot be reduced for profit-oriented entities.
- Additional disclosure requirements can be introduced for all entities.
- The IFRS recognition and measurement requirements for profit-oriented entities cannot be changed.
- Recognition and measurement requirements can be amended for public benefit entities, with a rebuttable presumption that amendments are based on existing International Public Sector Accounting Standards (IPSAS)[5] or existing New Zealand FRS.
- The introduction of guidance materials for public benefit entities should be based on the same principles as those applying to the amendment of recognition and measurement requirements (as outlined above).
- The elimination of options in IFRS is permitted for all entities, on a case-by-case basis. Where an IFRS permits options that are not allowed in an existing FRS, a strong argument would need to be made in order for the ASRB to agree to the retention of such options in the NZ IFRS. In reaching a view on this issue, the ASRB will be mindful of the approach adopted by the Australian Accounting Standards Board[6].

4 Accounting Standards Review Board Release 8, paragraph 27.
5 IPSAS are developed and issued by the international Public Sector Accounting Standards Board of the International Federation of Accountants, for application to public sector entities.
6 One of the functions of the ASRB is to liaise with the Australian Accounting Standards Board, with a view to harmonising New Zealand and Australian financial reporting standards (section 24, Financial Reporting Act 1993).

4.11 In our view, the provision of additional guidance on the application of NZ IFRS to public benefit entities is crucial to ensure that NZ IFRS are relevant and appropriate for the New Zealand public sector environment. We are concerned that valuable guidance, built up over a decade and based on our experience as the first country to apply accrual accounting in the public sector, could disappear. We have worked closely with the Treasury on this issue over the past year, and we will continue to do so.

4.12 A number of the recently approved NZ IFRS include some additional requirements, options or guidance that apply to public benefit entities. However, we believe that further guidance is required, and that this needs to be addressed as a priority. In our view, the main areas where additional guidance should be provided are:

- How to distinguish a public benefit entity from a profit-oriented entity – A number of public sector entities exist both for the benefit of the public and to make a profit, and it is debatable whether they fall within the definition of a public benefit entity. In addition, we note that most public sector entities are ultimately controlled by a public benefit entity (usually the Crown or a local authority). This creates issues where consolidated groups contain a mix of public benefit entities and profit-oriented entities. In such circumstances, there will be a temptation for all subsidiary entities to be treated as public benefit entities, which may not be appropriate. We acknowledge that the Financial Reporting Standards Board of the Institute of Chartered Accountants of New Zealand is currently developing such guidance.

- The application of NZ IAS 16: *Property, Plant and Equipment* to public benefit entities, particularly in relation to infrastructural assets – Much of the guidance needed is already contained in the current standard on property, plant and equipment (FRS-3), and could be supplemented by the knowledge gained in the public sector from applying that standard. The guidance should address such issues as componentisation, component accounting, classification of assets into classes, and calculating depreciated replacement cost (e.g. guidance on optimisation).

- How to determine whether a public benefit entity controls another entity – The current consolidation standard (FRS-37) includes extensive guidance that has been built up, through the experience of applying consolidation principles in the public sector, over the last decade. The nature of relationships and arrangements between entities frequently differs markedly between the public sector and the private sector. In paragraphs 1.8-1.12 (see pages

10-11), we discuss the difficulties of applying this guidance in some circumstances (particularly where entities have statutory autonomy and independence. Notwithstanding this, the guidance in FRS-37 has proven to be very useful in seeking to apply the standards.

- The application of non-financial performance reporting – NZ IFRS appear to have carried foward most of the guidance in terms of reporting non-financial performance information. In our view, however, NZ IFRS have not gone far enough regarding non-financial performance reporting. It is debatable whether any of the carried-forward material has any standing, given that NZ IFRS state that they are developed for application to financial statements, and acknowledge that statements of service performance are not financial statements but rather part of a financial report. There are statutory requirements for some public sector entities to report non-financial performance, and, in some cases, that information is required to be prepared in accordance with generally accepted accounting practice (GAAP). Reporting of non-financial performance is important to the public sector because of these requirements. To ensure that non-financial performance reporting remains at a level consistent with current New Zealand FRS, it is essential, in our view, that changes be made to NZ IFRS to remove room for debate about the authority of non-financial reporting requirements in NZ IFRS.

4.13 We will continue to raise the issue of guidance for public benefit entities with those parties responsible for setting standards in New Zealand. Our strong preference is for such guidance to form an integral part of the new standards, rather than be seen as an "add on" for the public sector.

Impact of the new standards

4.14 The approval of the "stable platform" of NZ IFRS provides a degree of certainty, enabling entities to plan for the transition and assess the implications for their financial reporting. We are currently analysing the changes between the approved NZ IFRS and current NZ GAAP. We have been working closely with the Treasury, who are also assessing the likely effect on the central government sector and the financial statements of the Government.

4.15 In general terms, we expect that:

- there will be changes to the values at which some assets and liabilities are measured;

- there will be some assets and liabilities recognised for the first time (for example, derivative financial instruments); and
- some assets will no longer be recognised (for example, internally generated intangibles).

There will also be increased disclosures in the notes to the financial statements.

4.16 One area of significant change is in the accounting for financial instruments, an area where the New Zealand FRS sets out only disclosure requirements. The new NZ IFRS establish rules for the recognition and measurement of financial assets and liabilities. There will be an increased requirement to account for financial instruments at fair value, including derivative financial instruments. This is likely to increase the volatility of reported financial performance, and, while there are options to reduce this volatility through the adoption of hedge accounting, the criteria that need to be met for adopting hedge accounting are onerous (for example, in terms of hedge effectiveness, and in record keeping). As a result, such options will not be worthwhile for some entities.

4.17 Other areas where the requirements of NZ IFRS are significantly different from current FRS requirements, and which may significantly affect entities within the Crown reporting entity, include:

- deferred tax (the whole approach to accounting for deferred tax is changing, and will result in more deferred tax assets and liabilities being recognised by those central government entities that pay tax – for example, State-owned enterprises);
- business combinations (including a prohibition on goodwill amortisation, which is replaced by an annual impairment test);
- intangible assets (including a prohibition on the recognition of internally generated intangibles such as brands);
- property, plant and equipment (including increased disclosures, and a requirement for profit-oriented entities to account for asset revaluations on an asset-by-asset basis rather than the current class of assets basis); and
- related parties (including disclosures of compensation for "key management personnel").

4.18 The degree to which individual entities are affected will depend on the types of assets and liabilities that they have, and the transactions that they enter into. For some government departments and Crown entities, the impact is likely to be limited, and managing the transition to NZ IFRS is therefore likely to be uncomplicated. However, this will not be the case for all entities.

4.19 The Financial Reporting Standards Board has issued an exposure draft, ED-96: *Disclosing the Impact of Adopting New Zealand Equivalents to International Financial Reporting Standards*. ED-96 proposes mandatory disclosure in the annual report of issuers[7] of information about the implications of adopting NZ IFRS, and planning for the transition to NZ IFRS. Although most entities within the central government sector are not issuers, ED-96 encourages other entities to also provide the disclosures. In our view, such disclosures are helpful. They demonstrate that entities are planning for the transition to NZ IFRS, and provide an early indication to stakeholders of the likely impacts of the transition.

4.20 We agree that appropriate communication with stakeholders on the transition to NZ IFRS is important. This will include bankers and lenders, in relation to loan covenants and the financial measures used to assess credit worthiness and credit ratings. Other stakeholders include the users of financial statements, including employees (possibly with elements of remuneration linked to reported financial performance), and Parliament, including the Select Committees responsible for the financial reviews of government departments, State-owned enterprises, and Crown entities.

4.21 We have outlined above some of the implications for accounting and financial reporting (to the extent they are known at this stage). The workload and training requirements for finance teams in some public sector entities may need to increase, if the transition to NZ IFRS is to progress smoothly. New policies and procedures will need to be determined in some areas, and systems may need adapting (for example, in entities with complex financial instrument transactions, to meet fair value and hedge accounting requirements). The transition to NZ IFRS is likely to result in additional costs through the transition period.

4.22 In general, we would expect central government entities, with appropriate guidance from the Treasury, to have the capability and resources to cope with the challenges of the transition to NZ IFRS. However, the central government sector does include some groups of entities that have limited capability (for example, schools and reserve boards). The effect of NZ IFRS on the generally fairly simple financial statements of these entities is expected to be limited (but this is dependent on the form of the differential reporting framework to be established for small entities under NZ IFRS). Nevertheless, there is a need for specific consideration of their ability to cope with the transition, and we will continue to work with the Treasury to ensure that the effect NZ IFRS will have on these entities is appropriately considered.

7 ED-96 uses the concept of an "issuer" as defined in section 4 of the Financial Reporting Act 1993.

4.23 The local government sector is planning to adopt NZ IFRS a year earlier than central government. We are working closely with the local government sector, and we expect the lessons from the local government transition experience to be extremely helpful for the central government transition.

Effect on auditors

4.24 The transition to NZ IFRS is also a significant challenge for the Office of the Auditor-General, and the auditors appointed to audit entities on behalf of the Auditor-General.

4.25 Auditors need to be trained in the requirements of the new standards, and audit approaches will have to be reviewed and adapted, to meet the revised reporting requirements. There will be additional audit work required, in relation to restated opening balance sheets and comparative figures, and in assessing revised accounting policies and processes (such as those required for hedge accounting). This additional work will need to be included within an already tight work programme, and will have some implications for audit fees.

4.26 We fully expect to be able to meet these challenges, and we have established a major project in the Office of the Auditor-General to ensure that our auditors are ready to audit in an NZ IFRS environment.

Summary

4.27 Significant progress has been made over the past year towards the implementation of NZ IFRS, but much work remains to be done. A major achievement has been the ASRB's approval of the "stable platform" of NZ IFRS.

4.28 We have some concerns that, to date, insufficient priority has been given to guidance on applying NZ IFRS to public benefit entities. However, we are pleased to see progress on the most pressing area where guidance is required; that is, in determining when an entity is a public benefit entity. We will continue to liaise with standard setters over the other matters identified in paragraph 4.12 (see pages 44-45).

4.29 The approval of the "stable platform" means that there is now some certainty from which to assess the impacts of the transition to NZ IFRS. However, all the implications of the transition are not yet fully clear. As well as affecting financial reporting, the transition may require amendments to processes and

systems. The changes will be significant for some central government entities, but less so for others.

4.30 The conversion to NZ IFRS will affect the workload and training requirements of finance teams in some central government entities. We will continue to work closely with the Treasury in its planning for the transition to NZ IFRS by the central government sector.

4.31 In addition, the Office of the Auditor-General has a significant project under way, to ensure that our auditors are ready to audit in an NZ IFRS environment.

Part Five

5

Changes to the Controller function

B.29[05a]

5.1 The Public Finance Amendment Act 2004 ("the Amendment Act") makes significant changes to the Controller function of the Controller and Auditor-General.

5.2 In this part, we explain the Controller function, and the changes that will occur.

Background

5.3 Parliament passed the Amendment Act on 16 December 2004. It is the first substantial revision of the Public Finance Act 1989 for a decade. The Amendment Act, among other changes, reforms the system of parliamentary appropriations, and changes and enhances the Controller function.

5.4 We worked closely with Treasury and State Service Commission officials during the Bill's development, and advised the Finance and Expenditure Committee on its examination of the Bill. We provided independent advice to the Committee on several aspects, including changes to the Controller function.

What is the Controller function?

5.5 The office of Controller originated centuries ago in the United Kingdom, and became an important element in the Westminster system of parliamentary supremacy. The original purpose of the office was to receive and hold public revenues until they were issued, under the authority of Parliament, for the service of the State.[1] The role later evolved into one of verifying that any release of public money to the Executive was lawful and in accordance with an appropriation by Parliament.

1 See Jennings, *Parliament*, 2nd Edition, 1961, page 323.

5.6 The New Zealand Parliament adopted the role in 1865. Since then, the Controller's primary function has been to certify, before the event, that all payments of public money from the Crown bank account into a departmental bank account are in accordance with a warrant issued by the Governor-General, and that there is an appropriation or other statutory authority against which each payment can be charged. If the Controller refuses certification, no money can be released into the departmental bank account.[2]

5.7 The constitutional importance of the role is reflected in section 22(c) of the Constitution Act 1986, which provides that –

> *It shall not be lawful for the Crown, except by or under an Act of Parliament, … to spend any public money.*

5.8 The system of appropriations is the means by which Parliament gives effect to the principle set out in section 22(c). An appropriation is a particular form of statutory authorisation by Parliament, which authorises the Crown (or an Office of Parliament) to incur public expenditure. The system of appropriations enables Parliament to control the ability of the executive branch of government to incur expenditure, and to hold it to account for its performance in doing so.

Why the Controller function needed changing

5.9 Until 1989, all appropriations were expressed in terms of an authority to spend public money. Thus, a certification by the Controller was a pre-condition for any expenditure under an appropriation. However, with the introduction of accrual accounting by the Public Finance Act 1989, most appropriations came to be expressed in terms of an authority to incur expenses or liabilities.

5.10 Under the accrual approach, expenditure is charged against an appropriation at the time the expenditure (operating or capital, measured in accounting terms) is incurred. The lawfulness of the expenditure is also judged, against the terms of the appropriation, with reference to that event. Yet the spending of public money to meet the expense or liability (for example, payment of a contractual obligation entered into some time previously) may not happen until some time afterwards. The Controller's certification addresses only that payment.

5.11 In this way, accrual appropriations reduce the Controller's ability to act as a check on the lawfulness of public expenditure.

2 Public Finance Act 1989, old section 22 (repealed by the Amendment Act, but in force until 30 June 2005).

5.12 To address this problem, the Controller and Auditor-General's other function – that of the auditor of public accounts – evolved during the 1990s through what has become known as an audit of appropriations. Although undertaken substantially after the event, the audit involves obtaining assurance that a department has met all the requirements of each appropriation during a financial year. We describe this process in greater detail in paragraphs 5.19-5.25 on pages 54-55.

5.13 In the meantime, the Treasury recognised the need to change the Controller function to meet the requirements of the accrual accounting environment.[3] The move to fully accrual-based appropriations under the Amendment Act gave Parliament an opportunity to modernise and strengthen the function.

Changes to the Controller function from 1 July 2005

5.14 The changes to the Controller function and how it will operate are explained below. The changes take effect from 1 July 2005.

Removal of warrant and certification procedures

5.15 The Public Finance Act required:

- periodic certification by the Controller and Auditor-General to the Governor-General that payments to be made out of the Crown bank account (under a warrant signed by the Governor-General) could lawfully be made; and
- regular (in practice, daily) certification that amounts to be paid out of the Crown bank account were pursuant to a warrant by the Governor-General, and that there was an appropriation or other authority against which each payment could be charged.

5.16 The Amendment Act does away with the system of warrants and certification procedures.

3 See, for example, *Towards a Reconfiguration of the Controller Function*, a paper prepared for the Treasury in April 1993 by Rt Hon Sir Geoffrey Palmer.

Power to direct a Minister to report to the House of Representatives

5.17 The Amendment Act introduces a new power for the Auditor-General to direct a Minister to report to the House of Representatives if the Auditor-General has reason to believe that any expenditure has been incurred that is unlawful or not within the scope, amount or period of any appropriation, or other authority (section 65Z).

Power to stop payments from bank accounts

5.18 The Auditor-General's power to stop payments from the Crown bank account is unchanged. However, there is an additional power to stop payments out of departmental bank accounts (section 65ZA). This amendment recognises that incurring expenditure, and the payment of expenditure, also occurs at a departmental level.

The audit of appropriations – Now a statutory requirement

5.19 As mentioned in paragraph 5.12, the function of Controller is most substantially exercised in the audit of appropriations as part of the departmental annual financial audit. In practice, this is how most appropriation issues are detected. The relevant auditing standard (published by the Auditor-General under section 23 of the Public Audit Act 2001) is AG-2: *The Appropriation Audit and the Controller Function*. This standard requires our appointed auditors of government departments, as part of the annual audit, to audit all appropriations to:

- determine whether expenditure is within an appropriation;
- test whether expenditure charged against an appropriation has actually been incurred for the purposes for which it was appropriated; and
- ensure that expenses incurred are for lawful purposes.

5.20 Under the standard, appointed auditors must perform audit procedures to gain assurance that the requirements of the appropriation have been adhered to. Particular areas of interest in an appropriation audit include departmental budgetary procedures, systems and procedures for monitoring performance against appropriation, and cost allocation systems.

5.21 Appointed auditors must perform this audit work during the financial year. Specific reporting to the Office of the Auditor-General (OAG) is required. The appointed auditor must advise the OAG whenever a breach of appropriation has occurred, or is likely to occur, or where any unlawful action has been identified. If any unlawfulness is identified, this enables the OAG to raise the matter with the department. If necessary, the Auditor-General will consider whether, acting in "Controller" mode, he should exercise the power to stop payments out of the Crown bank account.

5.22 The Amendment Act amends section 15 of the Public Audit Act 2001, to ensure that the appropriation audit will be carried out as a matter of statutory duty in future, rather than as an aspect of the financial report audit that the Auditor-General currently chooses to require by his auditing standards.

5.23 The audit of appropriations also ensures that any breach of appropriation will be disclosed in the financial statements and, if necessary, reported:

- in the audit report (and/or the management letter to the department following the audit);
- in our report to the Minister on the results of the audit; and
- to the Select Committee conducting the financial review.

5.24 The Auditor-General may also choose to report to Parliament on matters arising from the appropriation audit, and the Controller function.

5.25 Unlike other aspects of an annual audit, the audit of appropriations is not subject to any threshold of materiality. This means that any breach of appropriation, however small, will be the subject of a report.

Monthly reports by the Treasury

5.26 There is a new requirement for the Treasury to supply monthly reports to the Controller and Auditor-General, to enable the Auditor-General to examine whether expenses and capital expenditure have been incurred in accordance with an appropriation or other authority (section 65Y).

5.27 There is also an explicit recognition in section 65Y of the Auditor-General's powers, under Part 4 of the Public Audit Act 2001, to access such information as the Auditor-General may require to independently verify the Treasury report.

5.28 The requirement for the Treasury to supply monthly statements expands an existing practice, whereby statements are provided to the OAG for the months of March to June, inclusive, of each financial year.

5.29 The monthly statements will generally reveal information only about a breach of the financial amount of an appropriation. Appointed auditors and the OAG will continue to rely on other information, obtained in the course of the appropriation audit, to detect breaches of appropriation arising from expenditure that may be for an unlawful purpose or inconsistent with an appropriation or other authority.

Our view of the changes

5.30 As we advised the Finance and Expenditure Committee during its consideration of the changes to the Controller function, the periodic certification function in respect of the Governor-General's warrant is largely symbolic and has little practical value as a check on public expenditure.

5.31 Similarly, although the daily certification carried out by the Controller and Auditor-General provides an independent check on Treasury procedures, it is in effect an internal control check in addition to the Treasury's own procedures. It has limited use in relation to the Controller and Auditor-General's function of safeguarding the integrity of appropriations, because the incurring of expenditure (operating and capital, departmental and non-departmental) against appropriation occurs at a departmental level.

5.32 We therefore advised the Committee that we were comfortable with the abolition of the Governor-General's warrant and the daily certification procedures – despite their time-honoured constitutional significance. But, in our view, the Controller function remains significant in constitutional terms even without those procedures. Indeed, the changes to the Controller function under the Amendment Act significantly enhance it.

5.33 Two of the changes help to preserve the constitutional importance of the role. Both were made on our recommendation. The first is the statutory confirmation, in section 65Y, that the Auditor-General's powers under Part 4 of the Public Audit Act can be used to independently verify the Treasury's monthly reports (see paragraph 5.27). This provision removes any inference that the Auditor-General relies on the Executive for accurate information upon which to exercise a constitutionally independent function. Secondly, the amendment to section 15 of the Public Audit Act (see paragraph 5.22)

elevates the appropriation audit to having a statutory base, instead of being based merely on a requirement of the Auditor-General's auditing standards.

5.34 Although the Controller function will no longer exist as a prior check on expenditure, its effectiveness in the accrual accounting environment was always questionable. The power to stop release of funds from the Crown bank account, although infrequently exercised, remains as a valuable deterrent – and is enhanced by its extension to include funds being paid from departmental bank accounts. The new power to direct a Minister to report to the House of Representatives on an appropriation breach is another significant enhancement of the function.

Summary

5.35 In our view, the changes coming into effect on 1 July 2005 will maintain the constitutional significance of the Controller function as a statutory safeguard on the integrity of appropriations, as well as enhance its operation in practice.

Part Six

6

Board chairpersons' expenses

B.29[05a]

Background

6.1 Recent inquiries we have undertaken – in particular, the inquiry into expenses incurred by the former board chairperson of New Zealand Post, TVNZ Limited, and Industrial Research Limited[1] – identified weaknesses in controls over the expenses incurred by members of some boards of public entities.

6.2 Given those concerns, we asked our appointed auditors, as part of the annual audits for 2003-04, to review the systems, policies and procedures applying to board members' expenses. The entities in which this audit work was undertaken are listed in the Appendix to this article on pages 70-73.

6.3 We asked our auditors to examine the expenses incurred by each board chairperson ("the chairperson") to ensure that all such expenditure was appropriate, reasonable, and in accordance with the entity's policies and procedures. We asked our auditors to report on the results of their work to the Office of the Auditor-General, as well as to the appropriate entities. We report on these results in this part.

Why the board chairperson?

6.4 All board members incur a range of expenses in the course of their duties. We decided to focus on chairpersons' expenditure for the following reasons:

- In general, the chairperson is most heavily involved in representing the interests of the board and the entity to stakeholders, and is therefore likely to incur the majority of board expenditure.
- Given the chairperson's key leadership position in the entity, it is important that their expenditure is subject to processes for approval and authorisation that provide the necessary independent scrutiny and transparency.

1 *Inquiry into Expenses Incurred by Dr Ross Armstrong as Chairperson of Three Public Entities*, ISBN 0-478-18113-2, December 2003.

- Chairpersons are in a position of authority and influence, and as such should be setting an example of appropriate standards of accountability for their entity's expenditure.
- Good policies and procedures protect chairpersons from allegations that public funds may have been spent wastefully or dishonestly.

6.5 In our 2004-07 Strategic Plan (issued in January 2004), we signalled our intention to enhance the level of work done in annual audits in the areas of waste, probity, and governance. The work done by our auditors as part of the 2003-04 annual audits is the first step in this development.

Appropriateness and reasonableness of expenditure – Our expectations

6.6 In reaching a view as to whether the chairperson's expenditure was reasonable and appropriate, we required our auditors to have regard to the following principles:

- *Compliance with relevant policies and procedures.* All expenditure should be incurred in accordance with approved policies. Policies should be approved by the board and be reasonable.
- *Appropriately authorised.* The chairperson's expenses should be authorised by the chair of the audit committee, or a director of similar standing, or by 2 other members of the board. The chairperson's expenses should not be authorised by a subordinate.
- *Reasonableness.* Business expenditure should be necessary and reasonable in the context of public sector expectations and the entity's business. Wasteful or excessive expenditure is not acceptable.
- *Supporting documentation showing clear business purpose.* All claims for payment should be supported by GST receipts or other validating documentation, and submitted as soon as possible after the expenditure is incurred. Supporting documentation should clearly state the business purpose of such expenditure, ensuring that no private benefit was derived from it.

6.7 Our auditors were also asked to have regard to the following:

- the *Directors' Fees and Reimbursement Guidelines* prepared by the Crown Company Monitoring Advisory Unit (CCMAU) and issued by the various responsible Ministers to companies in February 2004. The guidelines cover the payment of directors' fees and reimbursement of directors' expenditure for all State-owned enterprises and Crown-owned companies that CCMAU monitors on behalf of shareholding Ministers. The guidelines pull together a range of best practice already widely accepted in the governance community, and which CCMAU believes should already have been reflected in entities' policies and procedures. However, in issuing the guidelines, CCMAU noted that the policies and procedures adopted by individual boards for the control of board expenditure were an operational matter for each board to determine.
- the Institute of Internal Auditors' 1996 publication *A Management Guide to Discretionary Expenditure.*
- Annex 5 of the Cabinet Office Circular CO(03)4 *Allowances under the Fees and Travelling Allowances Act*, which applies to all statutory bodies, non-statutory bodies and committees in which the Crown has an interest. Such bodies comprise most Crown entities (including tertiary education institutions and district health boards), trust boards, advisory bodies and committees, Royal Commissions and commissions of inquiry, statutory tribunals, individuals appointed as statutory bodies that are not covered by the Remuneration Authority, and subsidiary bodies of statutory entities.

6.8 We expected our auditors to use their judgement when reviewing and assessing chairpersons' expenditure. In particular, we expected them to take into account the specific requirements of the Auditor-General's Auditing Standard (AG-3): *The Auditor's Approach to Issues of Performance, Waste and Probity.*

6.9 Our expectations in relation to each category of expenditure are set out below. We developed those expectations from the above publications, as well as from the inquiries we have undertaken, taking into account what we believe to be current best practice.

6.10 We intend to publish comprehensive guidance on sensitive expenditure in the public sector. The audit work we have undertaken will contribute to the development of that guidance.

6.11 Types of expenditure incurred by the chairperson differed from entity to entity. However, we categorised this expenditure into the following general categories:

- domestic and international travel;
- accommodation;
- entertainment and hospitality; and
- other expenditure, covering items such as communications and telephones (including cellphones), vehicle use, car parking, airline membership, gifts, and the use of laptop computers.

6.12 Expectations specific to each category are set out below, as well as some generally applicable expectations regarding authorisation and credit card use.

Domestic and international travel

6.13 We expected entities to have a policy for both domestic and international travel covering all types of travel undertaken by the entity, including board members' travel. Unless it is impracticable to do so, all travel arrangements should be approved in advance.

6.14 Proposals for significant travel should be accompanied by the following details (usually in the form of a business case for significant international travel):

- persons travelling;
- business purpose (what benefits are to be achieved);
- entity and people to be visited;
- class of travel;
- dates of travel; and
- estimated cost.

6.15 All travel should be justifiable as entity business, and expenditure should be economical and efficient, having regard to purpose, distance, time and urgency. Methods of travel (air, train, motor vehicle) should be appropriate to the circumstances.

6.16 The business purpose of the travel should be clear from the documentation accompanying approvals or claims for reimbursement. Travel should be by economy or business class, with first class travel to be chosen in exceptional circumstances only. Economy class should be chosen for air travel of up to 4 hours, except where the distance/hours travelled and work schedule on arrival make a business class fare necessary.

6.17 Only in exceptional circumstances should the entity meet the costs of a spouse/partner or other family member(s) travelling with the chairperson. For example, an entity would meet the travel cost of the spouse/partner of a chairperson attending a significant function where the spouse/partner was expected to accompany the chairperson.

6.18 Travel rewards (for example, frequent-flyer points) accumulated on business travel should not be used for personal benefit. Entities should monitor and control the rewards accumulated by board members from business travel and ensure that they are available to reduce the cost of future business travel by board members or staff.

6.19 Claims for meals and daily allowances should comply with the entity's policies. Travel claims should also comply with those policies, and be completed in a timely manner.

Accommodation

6.20 We expected the entity to have a policy providing guidance on the quality and type of accommodation considered acceptable. Hotels or other accommodation should not be of an extravagant standard. All payments should be supported by receipts and evidence of business purpose.

6.21 The choice of accommodation or hotels should be made in accordance with the entity's list of prescribed or recommended hotels (if applicable).

Entertainment and hospitality

6.22 Entertainment is a contentious area of expenditure. For that reason, entertainment expenditure (such as hosted dinners and other forms of hospitality) must accord with approved policies, represent value for money, meet standards of probity, and have a legitimate business purpose. Claims for reimbursement of entertainment expenses should be accompanied by receipts and documentary evidence of business purpose. As a general rule, the most senior person at the function (dinner, etc.) should pay.

Other expenditure

Communications and telephones

6.23 Communications and telephone policies should include the use of mobile phones, claiming for business use of a personal phone, and private calls when away on business.

6.24 If board members use their private phones or other personal communication equipment for business use, claims for reimbursement should be supported by evidence of business use.

Vehicle use (including company vehicles, taxis, rental cars and private vehicles)

6.25 Different methods of transport can be used for business purposes, but they should be appropriate to the circumstances.

6.26 We expected entities to have policies specifying the circumstances and conditions under which private or corporate vehicles, taxis and rental cars, may be used, including cost/benefit, convenience, and whether feasible alternatives were available.

6.27 Private vehicles should be used only where travel by other means is impractical. Taxis or corporate vehicles should not be used for private purposes. The class of rental car used should be appropriate to its intended use and not be unnecessary or extravagant.

6.28 Claims for the use of taxis, corporate and personal vehicles should be supported by evidence of business use. Private vehicle expenditure claims should be reimbursed at approved rates in line with those paid in the public sector (by reference to Cabinet Office guidance) or at the rate set by the individual entity. Claims should be matched against supporting documentation (such as taxi chits, petrol purchase receipts, or evidence of distances travelled).

Other benefits

6.29 We expected policies to make it clear that that all gifts, gratuities, prizes, credits (such as frequent-flyer points), or other tangible benefits received by the chairperson, or their spouses or partners, or members of their households, in the exercise of their business roles, are the property of the entity.

Generally applicable expectations

Prior authorisation of significant expenditure

6.30 We expected all significant expenditure to be authorised in advance of any expenses incurred.

Credit card expenditure

6.31 While credit cards are a convenient means of paying for business expenses, they must be subject to appropriate controls and limits. We expected entities to have a policy governing the use of credit cards.

6.32 All expenditure charged to a credit card should be for a clear business purpose and be reconciled against receipts and the supplier's invoice, or other appropriate external supporting documentation. Authorisation of credit card expenditure should include the purchase receipt, as well as credit card and EFTPOS record slips. If the business purpose of the expenditure is not clear, a written reason for it should be attached to the credit card statement or attached receipts.

6.33 Credit cards should not be used for personal expenditure, or for obtaining cash advances.

The audit work we undertook

6.34 Our auditors examined the expenses of chairpersons for the 2003-04 year to assess whether their expenditure was appropriate, reasonable, and incurred in accordance with the entity's policies and procedures. Auditors reviewed chairpersons' expenses in all State-owned enterprises and Crown companies (including Crown Research Institutes), and certain Crown entities – 98 entities in total. The entities are listed in the Appendix on pages 70-73.

6.35 In the 2003-04 year, the total expenditure incurred by the chairpersons of those 98 entities was $1.37 million, of which our auditors specifically examined expenses totalling $875,000.

6.36 Our audit covered only the expenses of chairpersons, and not fees paid to them for their services.

Our findings

6.37 Expenditure incurred by chairpersons for 2003-04 is shown in the table below.

Total Chairperson Expenditure 2003-04	Number of Chairpersons
Greater than $50,000	4
Between $20,000 and $50,000	18
Between $10,000 and $20,000	22
Less than $10,000	58
Total	**102***

* *Because there was a change of chairperson for 4 entities during the year, the table includes 4 more chairpersons than the number of entities examined.*

6.38 In 43 of the 98 of the entities reviewed (i.e. just under half), our auditors identified no exceptions or concerns about controls over the expenditure incurred by the chairperson.

6.39 In the remaining 55 entities, our auditors identified one or more exceptions where practice diverged from our expectations relating to the control of chairpersons' expenditure. These exceptions involved control weaknesses or breakdowns, or non-compliance with the entities' policies and procedures.

6.40 Most exceptions identified by our auditors involved minor amounts in relation to the total expenditure examined, and arose from a relatively small number of transactions proportionate to the total number examined.

Exceptions identified

Lack of appropriate authorisation

6.41 We identified 46 exceptions where some of the chairperson's expenditure had not been appropriately authorised. Most of those exceptions related to expenditure authorised by the chief executive officer or chief executive officer's personal assistant.

6.42 We believe that it is inappropriate for the chief executive officer to approve the chairperson's expenditure, as this would be likely to create a situation

where each one is signing off the other's expenditure claims. It is also unacceptable for a personal assistant, or any other employee in a subordinate role to the chief executive officer, to approve the chairperson's expenditure claims.

6.43 As noted in paragraph 6.6 on page 60, we expected the chairperson's expenses to be authorised by the chair of the audit committee or a director of similar standing, or by 2 other members of the board. The CCMAU guidelines also have the same best-practice expectation.

6.44 An example of expenditure not properly authorised was identified in a Crown entity, where a personal assistant used a travel agent to arrange travel for all members of the board. While the travel was booked in advance, the arrangements were not subject to further scrutiny within the organisation to ensure that the expenditure was appropriate and complied with its travel policies.

6.45 A second example of expenditure not appropriately authorised was identified in a Crown Research Institute. In this example, our auditor noted that the chairperson's entertainment and hospitality expenditure was generally booked directly by the personal assistant to the chief executive officer. In this situation, the chairperson's expenses should have been authorised by the chair of the audit committee or a director of similar standing, or by 2 other board members.

Supporting documentation not showing clear business purpose

6.46 We identified 34 exceptions where supporting documentation for some expenditure was inadequate. Most of these involved insufficient explanation of the business purpose of the expenditure incurred.

6.47 A Crown entity provided one example of such expenditure. In this case, supporting documentation consisted of the proper GST invoices, but there were no further details on the business purpose. As a result, the auditor was unable to assess the reasonableness of the expenditure in terms of business need.

6.48 A State-owned enterprise provided a second example of the problem. In this case, no documentation was attached to an expense claim to explain the business purpose of 2 nights' accommodation in Melbourne. Our auditors requested this information, but the entity was unable to provide any supporting documentation or explanation.

6.49 The exceptions have been raised in the auditor's management letter to the entity concerned, so that appropriate corrective action can be taken.

Lack of, or non-compliance with, relevant policies and procedures

6.50 We identified 15 exceptions where the entity's policies and procedures relating to the chairperson's expenditure failed to provide adequate guidance for proper control over that expenditure. Most of the exceptions involved entities whose policies and procedures did not specify the authorisation process, or provide guidance on the level of expenditure considered reasonable.

6.51 We also identified 12 exceptions where the entity did not comply with its own policies and procedures relating to the chairperson's expenditure.

6.52 These exceptions have been raised in the auditor's management letter to the entities concerned.

6.53 A Crown entity provided one example of policies and procedures that had failed to properly control its chairperson's expenditure. In this case, the chairperson was leasing a laptop computer and a cellphone from the entity. The entity did not have a specific policy covering such a situation.

6.54 A second example came from a Crown company, where the chairperson was accruing for personal use frequent-flyer points earned on business trips. Although this was in line with the company's policies and procedures, it did not meet our expectation that frequent-flyer points accrued on business trips should be retained and used for the entity's benefit (notwithstanding that these points can be accrued only by individuals, not by entities).

6.55 A third example concerned a State-owned enterprise that did not follow its own policies and procedures. In this case, the chairperson was paid an accommodation allowance on a daily basis, which was approved by the board and the chair of its audit committee. However, the entity's policy at that time was that on no occasion would daily accommodation allowances be paid to directors, even if they were staying in private accommodation. The entity has since updated its policies and procedures.

Our conclusions

6.56 Our audit found that controls over chairpersons' expenditure were satisfactory for just under half the entities examined. No exceptions were noted in these entities.

6.57 Most of the exceptions identified by our auditors involved inappropriate authorisation and inadequate supporting documentation. In a number of cases, the entity's policies provided insufficient guidance for the proper control of the chairperson's expenditure.

6.58 In many cases, the exceptions involved minor amounts, which made up a small proportion of the total expenditure examined. However, they concern us, particularly because of the key position the chairperson holds in a public entity.

6.59 It is important that public entities ensure that all expenditure incurred by chairpersons (and all persons) is appropriately authorised. Many of the exceptions identified by our auditors occurred in entities whose policies and procedures had not been updated to incorporate best practice.

6.60 Although the CCMAU guidelines were issued only part-way through the year under review, the best practice they advocate should already have been reflected in the entities' policies and procedures. Best practice is constantly evolving, and public entities need to ensure that their policies and procedures are updated to reflect current expectations.

6.61 Our expectation (based in part on the CCMAU guidelines) is that all expenditure incurred by a chairperson should be authorised by the chair of the entity's audit committee or a director of similar standing, or by 2 other members of the board. We often found that the chief executive officer or a personal assistant had authorised the chairperson's expenditure. These arrangements are inappropriate.

6.62 Adequate supporting documentation should accompany all expense claims. This documentation is critical in linking the expenditure incurred to the business purpose for which it was incurred. Often the supporting documentation provided little or no explanation of the business purpose of the expenditure.

6.63 Where our auditors identified exceptions, they formally advised the entities concerned of the issues involved. Many of those entities were already updating their policies and procedures to meet our expectations and/or the CCMAU guidelines, or had undertaken to do so. Our auditors will follow up these issues in the 2004-05 audit, to ensure that the necessary corrective action has been taken and that the practice of these entities has improved.

6.64 We intend to continue to enhance the level of work done in annual audits in the areas of waste, probity, and governance. As board expenditure is an area of sensitive expenditure, it will continue to be scrutinised as part of our annual audits, and we will pay close attention to the areas for improvement.

Appendix – Entities whose chairperson's expenses were examined

SIX

Companies monitored by CCMAU

State-owned Enterprises

AgriQuality New Zealand Limited
Airways Corporation of New Zealand Limited
ASURE New Zealand Limited
Electricity Corporation of New Zealand Limited
Genesis Power Limited
Landcorp Farming Limited
Meridian Energy Limited
Meteorological Service of New Zealand Limited
Mighty River Power Limited
New Zealand Post Limited
New Zealand Railways Corporation
Solid Energy New Zealand Limited
Timberlands West Coast Forestry Limited
Transmission Holdings Limited
Transpower New Zealand Limited

Crown Research Institutes

AgResearch Limited
Industrial Research Limited
Institute of Environmental Science and Research Limited
Institute of Geological and Nuclear Sciences Limited
Landcare Research New Zealand Limited
National Institute of Water and Atmospheric Research Limited
New Zealand Forest Research Institute Limited
New Zealand Institute for Crop and Food Research Limited
The Horticulture and Food Research Institute of New Zealand Limited

Crown Companies

Animal Control Products Limited
Learning Media Limited
New Zealand Venture Investment Fund Limited
Quotable Value Limited
Radio New Zealand Limited
Television New Zealand Limited

Crown Entities

New Zealand Lotteries Commission
Public Trust

Other entities (not monitored by CCMAU)

Crown Entities

Accident Compensation Corporation
Alcohol Advisory Council
Arts Council of New Zealand Toi Aotearoa
Auckland District Health Board
Bay of Plenty District Health Board
Building Industry Authority
Canterbury District Health Board
Capital and Coast District Health Board
Career Services
Civil Aviation Authority
Commerce Commission
Counties Manukau District Health Board
Earthquake Commission
Electricity Commission
Energy Efficiency and Conservation Authority
Environmental Risk Management Authority
Foundation for Research, Science and Technology
Government Superannuation Fund Authority

Guardians of New Zealand Superannuation
Hawke's Bay District Health Board
Health Research Council of New Zealand
Housing New Zealand Corporation
Human Rights Commission
Hutt Valley District Health Board
Lakes District Health Board
Land Transport Safety Authority of New Zealand
Legal Services Agency
Maritime Safety Authority of New Zealand
MidCentral District Health Board
Museum of New Zealand – Te Papa Tongarewa
Nelson Marlborough District Health Board
New Zealand Antarctic Institute
New Zealand Artificial Limb Board
New Zealand Blood Service
New Zealand Film Commission
New Zealand Fire Service Commission
New Zealand On Air
New Zealand Qualifications Authority
New Zealand Symphony Orchestra Limited
New Zealand Teachers Council
New Zealand Tourism Board
New Zealand Trade and Enterprise
Northland District Health Board
Otago District Health Board
Pacific Islands Business Development Trust
Pharmaceutical Management Agency (Pharmac)
Residual Health Management Unit
Securities Commission
South Canterbury District Health Board
Southland District Health Board
Sport and Recreation New Zealand
Standards Council of New Zealand

BOARD CHAIRPERSONS' EXPENSES

Tairawhiti District Health Board
Takeovers Panel
Taranaki District Health Board
Te Mangai Paho (Māori Broadcasting Commission)
Te Taura Whiri I Te Reo Māori (Māori Language Commission)
Tertiary Education Commission
Testing Laboratory Registration Council of New Zealand
Transfund New Zealand
Transit New Zealand
Waikato District Health Board
Wairarapa District Health Board
Waitemata District Health Board
West Coast District Health Board
Whanganui District Health Board

Part Seven

7

Funding arrangements with non-government organisations

B.29[05a]

Introduction

7.1 In this article, we provide some background to the issues relating to contract and other funding arrangements between government and non-government organisations (NGOs), and set out our planned work programme intentions in relation to these issues over the next few years.

Background

7.2 We live in an era of collaboration and partnership between the Government and communities, where the Government makes policy choices on the spending of public money and the services are increasingly delivered by NGOs in the private and voluntary sectors. There is broad consensus about the involvement of NGOs in publicly funded service delivery, and the importance of values such as collaboration and mutual trust between the Government and NGOs. This has been reflected in a number of developments, including an agreed statement of government intentions towards the voluntary sector.

7.3 Nevertheless, there are expectations of transparency and accountability, and the best use of public money. A collaborative approach does not, on its own, ensure either transparency or accountability. There are tensions between collaboration and mutual trust on the one hand, and control and strict enforcement of contractual performance on the other hand.

7.4 With justifiably high expectations of accountability over the use of public funds, more relaxed controls create substantial risks for both the Government and NGOs.

7.5 Since 2000, when a range of issues were raised relating to the Waipareira Trust[1], we have been extensively involved in issues relating to contract and other funding arrangements between the Government and NGOs.

1 Central Government: Results of the 1999-2000 Audits, parliamentary paper B.29[00c]), pages 52-55.

7.6 In our 2003 report of an inquiry into the management of funding arrangements with several NGOs connected with Donna Awatere Huata MP[2] ("the Huata inquiry"), we outlined some of our expectations of how public entities contracting with NGOs, or providing funding to them, should ensure proper accountability, transparency, and best use of public money. Parts of the inquiry report have been used as a *de facto* best-practice guide, although it was not written to be so.

7.7 Based on our experience from this and other studies, we have identified several risk areas, including particularly:

- scrutiny of the governance and management capability of the potential provider;
- monitoring of the arrangements with the provider; and
- review of whether the arrangements have the desired impact.

7.8 We have advocated a risk-management approach. Policies and standard procedures should be designed to mitigate risks that are systemic and common to this type of funding arrangement. This should be done in ways that are most cost effective for the funding entity, and most efficient in terms of transaction and compliance cost for the NGO. Key and critical risks in the funding arrangements should be identified and mitigated, with resources being re-allocated where necessary to ensure that the higher level of risk is mitigated.

7.9 Since the Huata inquiry, we have continued to be involved in NGO issues across a range of government agencies, particularly in the health, social services and education sectors, including providing best-practice advice. We have also contributed to several forums on this issue.

Treasury guidelines

7.10 The Treasury has issued *Guidelines for Contracting with Non-Government Organisations for Services Sought by the Crown* (the Guidelines). The Guidelines are intended to encourage better contracting practices by all departments and Crown entities involved in negotiating arrangements with NGOs for services that support the Government's objectives. The Guidelines were first issued in 2001, and were updated in 2003.

2 *Inquiry into Public Funding of Organisations Associated with Donna Awatere Huata MP*, ISBN 0-478-18111-6, November 2003.

7.11 The Guidelines cover the following aspects of the contract lifecycle:

- planning;
- selecting a provider;
- negotiating the contract;
- managing the contract;
- review and evaluation; and
- starting over.

7.12 The Guidelines do not diminish the need for government agencies to exercise informed judgement about the arrangements that may be appropriate in their own circumstances. The Treasury is clear that the Guidelines are not a manual on how to write contracts.

What we plan to do

7.13 During our recent cycle of strategic audit planning, we further developed and refined our work programme in relation to the issues surrounding NGOs. We have identified the NGO area as one that would benefit from an integrated audit approach. We set out our intentions below.

2004-05

7.14 During 2004-05, we intend to continue to provide wider assurance to public entities on their NGO-funding activities where appropriate.

7.15 We will continue to highlight NGO issues with our appointed auditors through the audit briefs we issue. Our auditors have been asked to ensure that public entities within the Crown reporting entity that contract with NGOs are fully aware of our best-practice recommendations arising from the Huata inquiry, and the Treasury guidelines.

7.16 We have asked our auditors to review the quality of departments' and Crown entities' contract management systems in the course of the 2004-05 annual audit, to ensure that they are consistent with the Treasury guidelines – with a particular focus on the adequacy of the monitoring and audit arrangements in place to ensure that services purchased are properly delivered. Any audit

concerns will be reported to the public entity in the management letter, and, where appropriate, to the Minister and the relevant Select Committee as part of the financial review.

2005-06

7.17 In 2005-06, we intend to develop a best-practice guide on our audit expectations of NGO contracting and funding arrangements. We will use the knowledge and expertise built up over recent years to develop our audit expectations. In developing those expectations, we expect to have discussions with central agencies, and we will take account of the Treasury guidelines.

7.18 We also intend to establish the specific work we could usefully carry out on NGO issues as part of annual audits. We expect that this work will link closely to our best-practice expectations.

2006-07 onwards

7.19 In 2006-07 and future years, we intend to reflect the outcomes of our research and development work in annual audits. We also intend to institute a rolling performance audit programme examining different agencies' management of NGO contracting arrangements, using our best-practice expectations as audit criteria.

Part Eight

8

Fraud – The responsibilities and duties of public entities

B.29[05a]

Introduction

8.1 There have been a number of instances of fraud in the public sector in recent years. Two of the more high-profile, and high-value, instances were:

- a fraud of $1.9 million at the Ministry of Social Development (identified in July 2003); and
- a fraud of $2.3 million at the Ministry of Health (identified in September 2004).

8.2 We thought it timely to reiterate our expectations in respect of the:

- responsibility of public entity management to minimise fraud; and
- duties of public entity management in the event of fraud.

Background

8.3 Fraud always attracts a great deal of interest, irrespective of its scale. Questions are asked about how the fraud was perpetrated, and whether the controls designed to stop fraudulent activity were operating effectively. In the public sector, the interest in fraud is heightened, because public money is involved, and because those individuals entrusted with public money are expected to exhibit the highest standards of honesty and integrity.

8.4 The high standards of behaviour expected of individuals entrusted with public money mean that, when a fraud is committed, the same high standards must be applied to ensure that the perpetrators are brought to justice, and that there is an accompanying level of accountability and disclosure.

EIGHT

Responsibility of public entity management to minimise fraud

8.5 Responsibility for preventing and detecting fraud rests with the management teams of public entities, through the implementation and continued operation of adequate internal control systems (appropriate to the size of the public entity), supported by written policies and procedures.

8.6 In general, the potential for fraud is affected by a number of factors, including the:

- quality of the entity's financial information systems, financial controls, and financial control environment (which includes an awareness of the possibility of fraud and active measures to combat it);
- competence, experience, and focus of management teams and staff handling financial transactions;
- frequency with which the organisational structure changes:
- level of staff turnover;
- amount of money being managed by the entity; and
- number of people employed by the entity to manage its money.

Minimising employee fraud

8.7 Because of the ingenuity of people determined to commit fraud, and because internal controls need to be cost effective, it is effectively impossible to prevent all fraud. We also recognise that the risk of fraud will vary according to the size of the entity, the complexity of its operation, and other factors as noted above.

8.8 Public entities can take a number of steps to minimise fraud.

8.9 Management must make it clear that fraudulent behaviour is unacceptable, and make employees and those who deal with the entity aware of that attitude and the consequences of transgressing. The only satisfactory way of communicating that attitude is by issuing formal policies and procedures to everyone in the entity – covering the prevention, detection and investigation of fraud.

8.10 We therefore expect every public entity to have a policy on how to minimise fraud, and how it will be dealt with if it occurs.

8.11 In an article published in 2000, we stated that a fraud policy should include, as a minimum, these key elements[1]:

- a system for undertaking regular reviews of transactions, activities or locations that may be susceptible to fraud;
- specifications for fully documenting what happened in a fraud, and how it is to be managed;
- the means for ensuring that every individual suspected of committing fraud (whether they are an employee or someone external to the entity) is dealt with in the same manner;
- the principle that every effort is to be made to gather sufficient reliable evidence to support a prosecution, and that every case of fraud will be referred to the appropriate law enforcement agency with a view to prosecution; and
- the principle that recovery of the lost money or other property will be pursued wherever possible and practicable.

8.12 Other steps that public entities can take to minimise fraud include:

- Having clear ethical standards that are understood by all employees, and complied with. Managers should demonstrate these standards.
- Thorough recruitment processes – checking not only nominated referees but also, with the consent of the applicant, previous direct managers. Gaps in employment history should be explained. Criminal checks should be undertaken before new employees are hired into key positions.
- Enforcement of mandatory holidays. In addition to being sound business practice for the welfare of staff, this is an important internal control.
- Effective budget setting and monitoring procedures.
- An understanding by management teams of the roles of their staff, an appropriate and sensible level of oversight, and a balance of segregation of duties and aggregation or concentration of unsupervised duties.
- Active risk management, including an ongoing assessment of fraud risk through important areas of the organisation. This should include an effective internal audit function.

1 "Managing Employee Fraud", *Central Government: Results of the 1999-2000 Audits*, parliamentary paper B.29[00c], pages 46-51.

EIGHT

Duties of public entity management in the event of fraud

8.13 The managers of public entities, whether elected or appointed to office, have a duty to conduct the entity's affairs in a fair, businesslike manner, with reasonable care, skill, and caution, and with due regard to the interests of taxpayers, ratepayers, and others whom they serve. Managers should not shield a person from the possible institution of proceedings for a criminal offence (even though managers may believe that they do so on valid grounds).

8.14 In the event of suspected fraud, we expect the Board or Chief Executive to report the matter to the appropriate law enforcement agency, which will decide whether proceedings should be instituted for a criminal offence. We also expect public entities to immediately inform their Appointed Auditor of any suspected fraud.

8.15 It is for the law enforcement agencies, not public entity managers, to decide whether or not a person should be prosecuted.

8.16 It is the Auditor-General's policy that, if a public entity does not report fraud to the appropriate law enforcement agency, the Auditor-General will consider doing so – for the purpose of protecting the interests of the public.

8.17 We also expect that recovery of the lost money or other property will be pursued wherever possible and practicable.

Part Nine

9

Legal compliance by school boards

B.29[05a]

Introduction

9.1 There are about 2500 state schools. Many are relatively small; some have a single employee, and expenditure of only $100,000 a year. Schools are governed by Boards of Trustees, made up of members of the local community (usually parents of children attending the school). Trustees may have little or no experience of governing a public entity. They may not be aware of the many different pieces of legislation that apply to schools, and the requirements of public accountability.

9.2 While the Board of Trustees of each school is a Crown entity in its own right and, as such, has legal obligations, the Ministry of Education (the Ministry) also performs an important role in relation to schools. The Ministry seeks to support good governance and management, develop clear expectations of quality, and provide core infrastructure in the schools sector.[1]

9.3 The Auditor-General is the statutory auditor of all state schools, and appoints auditors to carry out the audits on his behalf. An important aspect of our audit work is assessing whether public entities, including schools, have complied with the legislation that affects their operations. The stakeholders of public entities are interested in whether the legislation has been complied with. The audit process provides a degree of assurance on this.

9.4 We assess compliance with legislation of a financial nature, which is contained mainly in the Education Act 1989 (the Act). The Act regulates the financial operations of schools in a number of ways, to ensure that they behave in a publicly accountable manner, and requires schools to seek the prior approval of the Ministry in certain circumstances. As part of our audit, we assess compliance with the financial provisions on:

- borrowing money;
- investing money;

1 Ministry of Education Statement of Intent 2004-2009, parliamentary paper E.1 SOI (2004).

- purchasing land;
- conflicts of interest; and
- funding other organisations.

9.5 This article presents our findings from the school audits we carried out for the year ended 31 December 2003, and makes some observations on those findings.

9.6 After we completed those audits, the financial legislation relating to schools was changed by the Crown Entities Act 2004. Some of the legal requirements described here will be different in the future.

What did we find?

9.7 We are pleased to report that most schools complied with the financial provisions relating to the matters listed in paragraph 9.4 above.

9.8 Some schools did not comply with all aspects of the legislation that we examined. We provide some examples, without identifying individual schools, in paragraphs 9.18 onwards.

9.9 Many of the breaches of legislation that we found were minor. Some breaches were significant.

9.10 Two specific issues arose:

- Current legislation does not prohibit schools from entering into commercial contracts with their employees.
- In some integrated schools, the distinction between the Board of Trustees (a public entity) and the proprietor (a private entity) is not fully understood, and has become blurred. The consequence is that public funds have sometimes been used to provide financial support to private entities.

9.11 In most cases, it appears that the schools were not aware of the legal constraints on their financial operations. However, in a few cases, the schools may have sought to operate on the boundary of the law, and in so doing went too far.

How may compliance be improved?

9.12 The majority of schools comply with the legislation. However, we remain concerned about those schools that transgressed. Breaches of legislation are reported in the schools' financial statements or, if necessary, in our audit reports on those statements. We also refer to breaches of legislation in the management letters to school boards that accompany our annual audit reports, and notify the Ministry of all significant breaches.

9.13 We are also interested in helping to reduce the future incidence of cases where schools do not comply with the legislation. This is a challenge, given the number of schools, the relative inexperience of some trustees, and the range of legislation to which schools are subject.

9.14 The Ministry helps schools meet their legal obligations by:

- providing advice to schools on the legislation they need to comply with;
- arranging for the training of Boards of Trustees;
- reviewing the annual financial statements of schools, and providing feedback;
- monitoring specific cases where breaches have occurred; and
- in exceptional cases, intervening in the management of schools.

9.15 With the introduction of the Crown Entities Act 2004, the Ministry also recognises the need to provide simple guidance for schools, directed at inexperienced trustees, on important aspects of the new financial legislation that governs their operations.

9.16 We recommend that the Ministry also consider:

- providing simple advice to integrated schools, and their proprietors, on specific aspects of the legislation relating to the financial relationship between schools and proprietors; and
- whether schools should be allowed to enter into commercial contracts with their employees.

9.17 We will continue to assess legal compliance by schools, and assist the Ministry in its efforts to help schools comply.

Breaches of legislation found during our audits

NINE

Borrowing money

9.18 Schools receive grants from the Ministry to fund their everyday expenses. The Act (sections 67 and 67A) allows schools to borrow up to a prescribed limit, giving them some flexibility in their financial affairs. The current limit is that annual repayments of principal and interest of any borrowing may not exceed 10% of a school's annual operational grant.

9.19 Schools may borrow above their limits, but only with the approval of the Ministers of Education and Finance. This helps the Ministry to control the amount borrowed, and address any serious financial difficulties at an early stage. The Ministry told us that limits are in place so it can check the robustness of any borrowing proposal and to make sure that the loan will not adversely affect the day-to-day financial operation of the school.

9.20 Borrowing may take many different forms. The simplest is a bank overdraft. Other forms of borrowing include loans, finance leases (for example, on computer equipment), and hire purchase arrangements.

9.21 We are pleased to report that only 32 schools (less than 1.5% of the total) had borrowed above the prescribed limit without the necessary approval.

9.22 Most of the unauthorised borrowing was for less than $10,000. However, some of the breaches were for more substantial amounts:

- A school had used an overdraft of $385,000, without approval. The need for an overdraft of that size was not apparent. The school also had a long-term investment of $321,000.
- An integrated school had unauthorised borrowing, from its proprietor, of $300,000 – incurred to help finance the development of a school hall on the proprietor's land.
- A school entered into a number of finance leases to acquire computers. The extent of the unauthorised borrowing was assessed at $260,000.
- An integrated school had unauthorised borrowing, assessed at $200,000, at the same time as it was owed $163,000 by its proprietor. The audit management letter noted that the proprietor appeared to be funding its own operations at the expense of the school, and suggested that consideration be given to recompensing the school for this cost.

- A school had an overdraft of $650,000, substantially over its borrowing limit, without Ministerial approval. The overdraft was converted to a "flexible finance facility", reducing the amount borrowed by $50,000 a year. This change in the loan agreement removed the breach of the borrowing restriction.

9.23 The Crown Entities Act 2004 provides an opportunity to review the borrowing rules. This Act amends the borrowing provisions in the Education Act 1989 by providing that the regime in the Crown Entities Act applies. Borrowing by schools will not be permitted, except in accordance with any regulations made under the Crown Entities Act, or any approval given jointly by the Ministers of Education and Finance. We understand that the Ministry is carrying out a review of the current arrangements. We will be pleased to contribute to that review.

9.24 The Ministry could also provide the registered banks and other approved lenders with a copy of the new regulations. This would ensure that the lender is aware of the legal requirement for the Ministry's approval, where necessary. The Ministry has agreed to consider this suggestion.

Investing money

9.25 The Act (section 73) allows schools to invest their funds with registered banks, or in public securities such as government stock. Any other investment currently needs the approval of the Minister of Education. This protects public funds, by requiring schools to invest in sound institutions.

9.26 We are pleased to report that, in 2003, only 22 schools (less than 1% of the total) had made an unapproved investment. (This figure excludes the integrated schools funding buildings – see paragraphs 9.41 to 9.46 on pages 91-92.)

9.27 Most of the breaches of legislation were for less than $10,000 (for matters such as loans to staff, and holding company shares), and the breaches appeared to be inadvertent. However, some of the breaches were for more substantial amounts:

- An integrated school advanced $250,000 to its proprietor, who owns the land and buildings from which the school operates. The loan does not incur interest, is unsecured, and is to be repaid over 10 years. The "interest free" element of the loan represents a substantial benefit to the proprietor, at the expense of the school, in the region of $100,000.

- An integrated school invested $100,000 with a private company, for a period of 6 months. The same school had also agreed to advance $125,000 for a project to upgrade some of the proprietor's buildings. The proprietor's representative organisation intends to repay these funds in 2008, but repayment is conditional and is therefore not guaranteed.
- Many years ago a school invested $100,000 with a trust, to assist with the provision of a hostel for the school's students. The school applied, some years later, for the Minister's retrospective approval. The Ministry has told us that such an investment would not be approved. It appears that the Ministry has not informed the school of this decision.
- Another integrated school gave an interest-free loan of $69,000 to its proprietor some years ago for 2 classrooms. The loan will be repaid in a few years.
- A school provided resources to help a private company arrange an activity programme for overseas students. There was no written contract, but the school spent $55,000 of public funds in anticipation of a return, without any certainty that its funds would be repaid or that any returns would be made.
- A school made advances of $34,000 to a number of its employees during 2003. At the end of 2003, about $15,000 had not been repaid.

9.28 The serious cases of investment without approval are isolated. Nevertheless, some of these examples are not consistent with the legislative intent of protecting public funds from unnecessary risk. Funds that have been entrusted to public entities for the provision of services should be handled with great care.

Purchasing land

9.29 The Act (section 69) prohibits schools from acquiring or occupying land or premises without the Minister's approval. This is to ensure that public funds are not spent on land or buildings without the Minister being satisfied of the need to do so.

9.30 Only 4 schools (less than 0.2% of the total) had breached this legislative requirement. The acquisitions were mainly of land or houses adjacent to the school premises. The schools and the Ministry are discussing whether the transactions will be approved retrospectively, in some cases by transferring the interest in the land to the Crown.

Conflicts of interest

9.31 In the public sector, a conflict of interest exists where a person's duties or responsibilities to a public entity could be affected by some other separate (usually private) interest or duty that he or she may have. Impartiality and transparency in administration are essential to maintaining the integrity of the public sector. Where activities are paid for by public funds, or are undertaken in the public interest, taxpayers will have strong expectations of probity. Members of the public take a strong interest when they think taxes are being spent irresponsibly, or misused for private gain.

9.32 The Act (clause 8(8) of the Sixth Schedule) prohibits Trustees who have a financial interest in a matter, or any interest that may reasonably be regarded as likely to influence them in carrying out their duties and responsibilities, from participating in Board discussions or voting on the matter. The Act (section 103A) also disqualifies a Board member from holding office if they have a financial interest in contracts with the Board, under which the total payments made by or on behalf of the Board exceed $25,000 in any financial year, unless approval has been obtained from the Secretary for Education. This provision ensures that Board members are not able to award contracts to themselves, which may not be in the interests of the school.

9.33 However, managing conflict of interest issues in the public sector often involves more than consideration of only the legal requirements. The ethics of the situation must also be considered.[2]

9.34 We are pleased to report that only 5 schools (0.2% of the total) had awarded contracts of more than $25,000, where a Board member had an interest, without obtaining the prior approval of the Secretary. We recommended to the relevant schools that they seek the retrospective approval of the Secretary. We understand that such approval has been given in 4 of the cases, and further consideration is being given to the fifth.

Specific issues

9.35 In September 2004, we announced our inquiry into possible conflicts of interest in the relationship between a school and a private training establishment. We will report on that matter in due course.

2 A full discussion on conflicts of interest is contained in a report we published in November 2004 – Christchurch Polytechnic Institute of Technology's management of conflicts of interest regarding the Computing Offered On-line (COOL) programme, ISBN 0-478-18123-X. This report is available on our website ***www.oag.govt.nz*** under Reports/2004.

9.36 Another issue relating to conflicts arose during the year. A principal and deputy principal established a private company. The private company carried out many of the school's functions relating to its overseas students programme (for example, organising home-stay accommodation). There was no written contract for the arrangement, which involved the company charging a management fee for each overseas student for the services it provided. During 2003, the company charged management fees of $145,000. We are pleased to report that the arrangement was terminated early in 2004. However, these two employees had already obtained a significant financial gain.

9.37 This form of contracting arrangement does not appear to have been unlawful. However, in our view, the arrangement was inappropriate because of the conflict of interest involved. Public sector employees should not be able to use their position to enter into commercial contracts with their employers, thereby obtaining financial benefit from their employment over and above that provided by their employment agreement. In our view, the Ministry should consider whether schools should be allowed to enter into commercial contracts with their employees.

Funding other organisations

9.38 Sometimes we find that a school board has given money, or other property, to another organisation. Boards need to be careful here. Like any other public entity, a Board may use its resources only for the proper exercise of its statutory functions. It cannot commit its funds or assets to activities that are not reasonably connected to its role in managing the school, providing education for its students, or other activities allowed by its charter.[3]

9.39 Similarly, a Board should not try to use its assets in an attempt to avoid its legal obligations. This can arise where the Board tries to establish another organisation, often a trust, with broader legal powers than the Board. In this situation, a transfer of money or other property from the Board to the other organisation might be regarded as an unlawful attempt to avoid the requirements of the Act. This risk is particularly high where the gift is used for a purpose that the Board is not permitted to undertake itself (or that the Board could undertake only if it complied with specific statutory restrictions, such as those relating to investment, borrowing, or property acquisition).

3 This principle is reinforced by clauses 1A and 1B of the Sixth Schedule to the Education Act.

9.40 One example involved a school that set up an educational trust with wider powers than the school. The school routinely donated a portion of its income from foreign students to the trust. We considered this an improper use of funds that rightfully belonged to the Board, and that should have been spent by the Board on the school. At our suggestion, the money was refunded to the Board.

Integrated schools

9.41 About 325 of the 2500 state schools are integrated. They have the same governance arrangements as other schools, with a Board of Trustees responsible for running the school. They differ in that their proprietors (which are private organisations), rather than the Crown, generally own the land and buildings on which the schools are sited. Many of these schools have a religious character.

9.42 The Boards of Trustees of many integrated schools have used public funds to pay for the construction or improvement of buildings on land owned by the school's proprietor. However, Boards do not have the legal power to use funds to pay for buildings that will be owned by the proprietor. A Board's funds can only be used for its own proper purposes, and cannot be used for matters that are the responsibility of the proprietor. The Board of an integrated school should fund a building only if the Board obtains all necessary Ministerial approvals, and also secures a written agreement with the proprietor to make it clear that the Board or the Crown – not the proprietor – will own the building.

9.43 Despite these requirements, the Boards of Trustees of about 200 integrated schools appear to have provided a total of up to $30 million of public funds to proprietors in previous years for this purpose.

9.44 We decided not to report this matter to the individual schools for 2003, but have reported it to the Ministry instead, to allow the Ministry to consider a co-ordinated and centralised response.

9.45 The Ministry agreed early in 2004 to carry out an exercise to regularise this expenditure or make it lawful. The Minister of Education will give retrospective approval, and the Boards of Trustees are to obtain the written agreement of the relevant proprietors to the Crown's interest in the buildings that have received the public funds. However, we understand that there has been a delay in starting this process. We will continue to closely monitor progress until the appropriate action has been taken.

9.46 The Ministry also planned, early in 2004, to issue guidance to Boards of Trustees of integrated schools. Again, there was a delay, but the Ministry issued some initial guidance to integrated schools in February 2005. The guidance reminds schools to seek Ministerial approval, and to have a written agreement protecting the Crown's interest, where they wish to provide public funds to pay for the construction or improvement of buildings on land owned by the proprietor. This should help to minimise future instances of such unlawful expenditure. The Ministry intends to issue more detailed guidance, which we hope will be published as soon as possible.

Part Ten

10

Electricity Commission – Audit of performance information

B.29[05a]

The Electricity Commission

10.1 The Electricity Commission (the Commission) is a new Crown entity established under the Electricity Act 1992 to oversee New Zealand's electricity industry and markets. The Commission began operating in September 2003.

10.2 The objectives of the Commission are –

> *(a) to ensure that electricity is produced and delivered to all classes of consumers in an efficient, fair, reliable, and environmentally sustainable manner; and*
> *(b) to promote and facilitate the efficient use of electricity.*[1]

10.3 The Commission is a public entity under the Public Audit Act 2001, and is therefore audited by the Auditor-General.

The Auditor General's role

10.4 As well as being the statutory auditor of the Commission, the Auditor-General has a specific role under the Electricity Act 1992 in relation to the Commission's performance information.

10.5 There are 2 parts to this role:

- The Commission must agree performance standards with the Minister of Energy. Before agreeing the performance standards, the Minister of Energy must consult with the Auditor-General on whether the proposed performance standards meet certain requirements specified in the Act.
- The Commission must provide an annual performance report to the Minister of Energy, and submit that report to the Auditor-General for an assurance audit.

1 Section 172N(1) of the Electricity Act 1992 (as amended by the Electricity Amendment Act 2004).

10.6 This article describes how we have undertaken this role in the 2003-04 year, and also explains the legislative background.

TEN

Amendments to the Electricity Act 1992

10.7 The Electricity Amendment Act 2001 ("the Amendment Act") was passed into law in August 2001.

10.8 The Amendment Act was, in part, designed to encourage the electricity industry to develop its own responses to issues in the energy sector through industry governance organisations.[2] The Amendment Act also provided for the establishment of a statutory Electricity Governance Board, if the electricity industry failed to meet the Government's objectives for the electricity sector and agree on self-regulatory arrangements.

10.9 The Amendment Act also provided for the accountability of electricity governance organisations, by requiring the Auditor-General to undertake the two-part role described in paragraph 10.5.[3]

10.10 Because the industry failed to establish a self-regulatory model, the Government moved to implement its own governance arrangements for the sector, using sections in the Amendment Act.

10.11 On 20 May 2003, the Government announced the establishment of the Electricity Governance Board, operating under the name "the Electricity Commission", and the Electricity (Commencement of Electricity Governance Board) Order 2003[4] formally established the Commission on 15 September 2003.

10.12 The Electricity and Gas Industries Bill was then introduced to the House of Representatives, in October 2003. Among other things, the Bill reflected the establishment of the Electricity Commission, and updated the Electricity Act 1992 accordingly.

---

2 The Electricity Governance Establishment Committee was formed in October 2000. The Committee had been working to establish a single industry electricity governance organisation known as the industry Electricity Governance Board.

3 If the statutory Electricity Governance Board was established under the Electricity Amendment Act 2001, which it subsequently was, the Auditor-General was required to undertake only the second part of the two-part role (that is, an assurance audit). The requirement for performance standards to be agreed with the Minister, and for consultation to occur with the Auditor-General on those performance standards, applied only to electricity governance organisations *other than* the statutory Electricity Governance Board. This was subsequently changed in the Electricity Amendment Act 2004, to require the Auditor-General to undertake both parts of the role.

4 SR 2003/200.

10.13 The Bill was divided into 4 pieces of legislation at the time of its final reading in the House. One of these, the Electricity Amendment Act 2004, carried forward the provisions from the 2001 Amendment Act, and the Electricity and Gas Industries Bill, relating to the Auditor-General's role.

Performance standards

10.14 Section 172ZL of the Electricity Act 1992 states –

> *(1) The Commission must, within 3 months after the commencement of each reporting period beginning on or after 1 July 2004, agree performance standards with the Minister for that reporting period.*
>
> *(2) The performance standards –*
> *(a) must include the performance targets and other measures by which the performance of the Commission may be judged; and*
> *(b) must be matters against which the Commission's actual performance may be reported and audited; and*
> *(c) must relate to all of the GPS objectives and outcomes.*
>
> *(3) Before agreeing the performance standards, the Minister must consult with the Auditor-General on whether the proposed performance standards meet the requirements in sub-section (2)(b) and (c).*

10.15 The Commission developed a set of performance standards for the period 1 July 2004 to 30 June 2005, and provided them to the Auditor-General for review.[5]

10.16 Our review of the Commission's performance standards largely focused on the 2 matters (sub-section (2)(b) and (c)) that the Minister is required to consult the Auditor-General about.[6]

10.17 In relation to the first matter, we were satisfied that the standards can be reported against, and that they are auditable.

10.18 In relation to the second matter, we saw this as a "completeness test". We were looking for close alignment between the performance standards

5 While the legislation requires the Minister of Energy to consult with the Auditor-General, in practice we worked with the Electricity Commission to be satisfied that its performance standards met the requirements specified in the legislation. We then provided assurance to the Ministry of Economic Development, as the agent of the Minister of Energy, that the performance standards met the legislative requirements.

6 When we carried out our work, the Electricity Amendment Act 2004 had not been passed. We were therefore undertaking our role based on the proposals in the Electricity and Gas Industries Bill.

and the draft Government Policy Statement (GPS).[7] We were satisfied that the standards developed by the Commission were aligned with the GPS.

10.19 The Commission's performance standards will evolve over time. We will work with the Commission to enhance the standards for future reporting periods.

Annual performance report

10.20 Section 172ZM of the Electricity Act 1992 states –

> *(1) The Commission must, within 3 months after each of the Commission's report dates on and after 30 June 2004, deliver to the Minister a report on its operations during the last reporting period, and submit that annual report to the Auditor-General for an assurance audit under section 172ZO.*
>
> *(2) The annual report –*
> *(a) must contain the information that is necessary to enable an informed assessment to be made of the performance of the Commission against the GPS objectives and outcomes and against the performance standards; but*
> *(b) need not contain information on the Commission's financial performance.*

10.21 Section 172ZO of the Electricity Act 1992 states –

> *(1) The Auditor-General –*
> *(a) must examine the annual report provided to the Auditor-General under section 172ZM and report to the Minister and the House of Representatives as soon as practicable after receiving the annual report:*
> *(b) may, at any time, examine the information to be contained in the annual report and the systems of the Commission, and report on that examination to the Minister and the House of Representatives.*
>
> *(2) The Auditor-General's report under subsection (1) must provide assurance on –*
> *(a) the appropriateness, adequacy, and accuracy of the information contained, or to be contained, in the annual report; and*
> *(b) whether the annual report enables, or is likely to enable, an informed assessment to be made of the matters stated in section 172ZM(2)(a).*

10.22 The Commission prepared a performance report for the period 15 September 2003 to 30 June 2004, which was approved by the Chair of the Commission in December 2004. In terms of section 172ZO, we then carried out an assurance

7 The final Government Policy Statement was published on the same day as the Electricity and Gas Industries Bill was passed. When we reviewed the Commission's draft performance measures, we were using a draft version of the Government Policy Statement.

audit on that report, and submitted our report to the Minister of Energy and the House of Representatives in February 2005.

10.23 The Commission's annual performance report noted –

> *The requirement that performance measures be agreed with the Auditor-General at the start of each year was amended in the Electricity Amendment Act 2004, and only applies from 30 June 2004. As such, no performance measures were agreed with the Auditor-General covering the 2003/04 reporting period.*
>
> *Therefore in preparing this report the Commission has focussed on providing an overview of the Commission's establishment and reported against the performance measures in the 2003/04 Statement of Intent.*[8]

10.24 In our audit opinion on the Commission's annual performance report, we reiterated the observations quoted in the previous paragraph. The Commission was established on 15 September 2003, and was not required to establish performance standards against which the Commission would be assessed until the year commencing 1 July 2004. Instead, in the annual performance report, the Board reported its service performance achievement against the Statement of Corporate Intent for the period 15 September 2003 to 30 June 2004.

10.25 Our opinion was therefore expressed on those service performance achievements that were reported by the Commission. We noted that the service performance information fairly reflected the Commission's service performance achievements, as measured against the performance targets adopted in the Commission's Statement of Intent, for the period 15 September 2003 to 30 June 2004.

Change to the Auditor-General's role for future reporting periods

10.26 The House of Representatives passed the Public Finance (State Sector Management) Bill on 16 December 2004. The 4 resulting pieces of legislation are the:

- Public Finance Amendment Act 2004;
- State Sector Amendment Act 2004;
- Crown Entities Act 2004; and
- State-owned Enterprises Amendment Act 2004.

8 Paragraphs 2 and 3 from the *Annual Performance Report to the Minister of Energy 15 September 2003 Electricity Commission Establishment to 30 June 2004.*

10.27 The Crown Entities Act amends the sections in the Electricity Act 1992 that deal with the Auditor-General's role (see paragraphs 10.4-10.5 on page 93), to align that role more closely with the existing statutory accountability requirements of the Commission – the Statement of Intent and the Annual Report.

10.28 In relation to the development of performance standards that are now required to be included in the Commission's Statement of Intent, the new timeframe for finalising the Statement of Intent is earlier than the current timeframe (in which the Commission has 3 months after the commencement of each reporting period to agree performance standards). The requirement for the Minister to consult with the Auditor-General remains.

10.29 Concerning the annual performance report of the Commission, the information that was required to be included in this report is now required to be included in the Commission's Annual Report.

10.30 There is also a change to our reporting of the audit of that information – we may either report on it in the audit report on the Commission's Annual Report, or continue to report separately to the Minister and the House of Representatives.

10.31 These amendments will take effect from the first year the Commission prepares a Statement of Intent under the Crown Entities Act. This will be for the year commencing 1 July 2006.

Part Eleven

11

Status of follow-up action on previous reports

B.29[05a]

11.1 The Auditor-General reports on a broad range of topics and issues within the public sector. Parliament is the primary audience for these reports. By their nature, however, these reports are usually focussed on the Executive. This focus may be on:

- single agencies; or
- multiple agencies; and/or
- central agencies (the Treasury, the State Services Commission, and the Department of the Prime Minister and Cabinet).

11.2 For formal consideration of our reports by the House, we rely on relevant select committees taking the opportunity to consider the reports and deciding whether they want to ask for a Government response.

11.3 The Officials Policy Committee (comprising the chief executives of the three central agencies) has also considered the need for a Government response to our reports.

11.4 Both of these mechanisms have been informal. Nevertheless, they formed a basis to complete the "accountability loop" between:

- the Auditor-General's reports;
- Parliamentary scrutiny of the reports; and
- Government responses.

11.5 This part gives a brief analysis of each of our performance audit reports published since June 2003. It follows a similar format to the comments that we have published in each of the past 3 years[1] about follow-up action on our previous reports, with updated comments as appropriate.

11.6 Our reports on local government issues and one-off inquiries are not included in this article.

1 *Central Government: Results of the 2002-03 Audits*, parliamentary paper B.29[04a], pages 77-103; *Central Government: Results of the 2001-02 Audits*, parliamentary paper B.29[03a], pages 95-128; and *Central Government and Other Issues 2001-02*, parliamentary paper B.29[02b], pages 99-126.

Title of report

ELEVEN

Management of Hospital-acquired Infection

Date presented

25 June 2003

Brief description

Hospital-acquired infection (HAI) is recognised nationally and internationally as a serious problem. Here, and in other developed countries, it is estimated that about 10% of patients admitted to hospital will acquire an infection as a result of their hospital stay. The costs of dealing with hospital-acquired infections in this country's public hospitals are estimated to be more than $137 million a year. The extent of HAI can be reduced through effective infection control practices.

The purpose of our performance audit was to describe and assess systems for managing hospital-acquired infection in public hospitals. The performance audit was reported in two volumes.

Key findings and recommendations

We found that some dimensions of infection control are working particularly well – such as collaboration between infection control staff and laboratory staff. Others require more attention – for example, auditing of infection control practice, which provides a vital source of assurance about compliance by hospital staff.

We made 39 recommendations about areas such as:

- the national framework for infection control;
- national surveillance of hospital-acquired infection;
- improving planning, resourcing, reporting and oversight of infection control by District Health Boards (DHBs); and
- scope and co-ordination of hospital infection control arrangements and staff compliance with infection control polices and practices.

ELEVEN

Impact of our report

In October 2003, we presented our report to the Health Committee. We also presented our report to the National Infection Control conference in Dunedin, and our input has been sought by DHBs on the issue.

As a result of the performance audit, the Health Committee carried out an inquiry, the results of which were reported to Parliament on 6 May 2004. In its report, the Committee said that it considered the implementation of our report's recommendations to be essential to reassure the public about the safety and quality of public health in New Zealand. It supported a national surveillance programme for HAI, and sought consistency in collation and reporting of blood stream infection data, as well as better public information about HAI in their hospitals.

The Ministry of Health has put in place a response plan that is being monitored by the Select Committee and by us. We are continuing to monitor the work occurring to improve infection control practices in hospitals.

Title of report

ELEVEN

Inland Revenue Department: Performance of Taxpayer Audit

Date presented

6 August 2003

Brief description

Each year the Inland Revenue Department (the IRD) audits thousands of taxpayers to detect non-compliance with tax laws, and to deter potential non-compliance in the future. This report examined the IRD's taxpayer audit function in the context of the IRD's Taxpayer Compliance Model. We wanted to establish whether taxpayer audit is in a position to deliver the IRD's vision to improve taxpayer compliance.

Key findings and recommendations

We found that the taxpayer audit function was under-developed. The IRD agreed, and has initiated a number of projects to improve the situation.

We recommended that the IRD's strategy for taxpayer audit needed to be further developed. Other particular recommendations included:

- implementing best practice case management techniques;
- improving formal ongoing training of investigators;
- reviewing the availability and use of information technology; and
- improving the measuring and reporting of performance to Parliament.

Impact of our report

The Finance and Expenditure Committee decided not to inquire into the matters raised in our report.

The IRD acknowledged that there were a number of changes to be made in the area of taxpayer audits. Many of these changes had been progressed by the time our report was published. The IRD has an extensive Audit Strategy Programme in place to fully implement all our recommendations. We meet with the Programme Manager regularly to assess progress made in implementing our recommendations. We also attend meetings of the Business Initiative Governance Board, which is overseeing the changes to taxpayer audit, as an observer when required.

We are satisfied with the progress made, and intend to conduct a follow-up audit in 2 years' time.

Title of report

ELEVEN

Co-ordination and Collaboration in the Criminal Justice Sector

Date presented

9 October 2003

Brief description

The criminal justice sector is a complex network of discrete but procedurally connected agencies. The four core criminal justice agencies are the Ministry of Justice (the Ministry), the Police, the Department for Courts[2], and the Department of Corrections.

Our audit examined the way in which the four core agencies were working together to achieve the Government's goals for the criminal justice sector.

Key findings and recommendations

We identified many examples of good practice across the sector, and a strong commitment to sharing information and collaboration. At the same time, the impact of one agency's plans or activities on the other agencies in the sector had not always been well understood.

Our recommendations included:

- In the area of strategic planning, the criminal justice agency chief executives should support the Chief Executives Forum by attending all meetings.
- Agencies should improve collaboration in policy development and between research units.
- A key role for the Ministry should be to oversee the status of information technology systems in the sector, and to evaluate sector-wide impacts of any planned changes.

2 The Department for Courts was merged into the Ministry of Justice from 1 October 2003.

- All justice sector agencies should consider establishing Māori advisory groups.
- The criminal justice sector agencies should draw lessons from the events and processes surrounding development of the sentencing and parole legislation for the future management of projects with sector impacts.

Impact of our report

The Law and Order Committee considered our report in October 2003.

Our report was accepted by the entities concerned, and the Treasury and the Department of the Prime Minister and Cabinet have both found it useful.

The Ministry of Justice completed an analysis of our report, highlighting the recommendations and action taken by sector departments. Justice sector chief executives have considered the analysis. We understand that, while the chief executives generally found the comments in the report useful to reflect on, not all of the recommendations were agreed to.

Title of report

ELEVEN

Managing Threats to Domestic Security

Date presented

30 October 2003

Brief description

Threats to domestic security include threats from terrorism, cyber attack on major information or business systems, attacks against critical physical infrastructure (such as the public water supply), and events which are likely to threaten the country's economic and social well-being (for example, an outbreak of foot and mouth disease).

Our audit set out to provide assurance to Parliament and the public that threats to the country's domestic security were being adequately managed.

Key findings and recommendations

We found that New Zealand has taken, and is continuing to take, steps to ensure that it is meeting current "international best practice" in relation to domestic security. However, our audit identified the following issues that needed to be addressed:

- there was no single document or collection of documents that sets out a whole-of-government Domestic Security Strategy;
- a cross-agency information/intelligence system was in the early stages of development;
- reporting on the preparedness of domestic security arrangements supported individual agency accountability, but did not provide a whole-of-government picture of preparedness;
- while the traditional domestic security response elements were well-practised and planned, the requirements of the recovery phase have not received as much attention.

ELEVEN

Impact of our report

The Foreign Affairs, Defence and Trade Committee considered our report on 20 November 2003.

Over the last 12 months, the Department of the Prime Minister and Cabinet has been working to address the issues that it identified from our report. We have had six-monthly meetings with the Director of the Domestic and External Security Group, and we are satisfied that appropriate action continues to be taken to address these issues.

Title of report

ELEVEN

Ministry of Health: What Further Progress Has Been Made To Implement the Recommendations of the Cervical Screening Enquiry?

Date presented

8 December 2003

Brief description

Organised cervical screening was established in New Zealand in 1990. In April 2001 a Committee of Inquiry, set up to look into the under-reporting of cervical smear abnormalities in the Gisborne region, made 46 recommendations to the Minister of Health. This was our second report in relation to the implementation of those recommendations.

Our first report[3] – published in February 2002 – concluded that good progress was being made to implement the recommendations in a number of areas, but that effective monitoring, evaluation, and audit of the National Cervical Screening Programme (the Programme) still required action.

Our report of 8 December 2003 commented on what progress the Ministry of Health (the Ministry) has made since the January 2003 independent review of the implementation of the Committee of Inquiry recommendations.

Key findings and recommendations

We found that:

- 31 of the 46 recommendations had been implemented or were expected to be implemented by June 2004;
- work had been planned or begun on 8 recommendations;

3 *Ministry of Health: Progress in Implementing the Recommendations of the Cervical Screening Inquiry*, ISBN 0-477-02890-X.

- work had begun on a further 4 recommendations relating to ethics committees, but it was unclear whether they would be implemented;
- 2 of the recommendations would not be implemented; and
- the Ministry was still to decide whether the last recommendation would be implemented.

We also reported on the need:

- to ensure that appropriate assurance processes are in place around the quality aspects of the Programme;
- for the National Screening Unit to be more open and collaborative with stakeholders, and to ensure that all key staff positions are filled; and
- for an independent expert to continue to review implementation of the Committee of Inquiry recommendations, and to focus on the effectiveness of the whole Programme.

Impact of our report

Our report gave assurance in respect of public concern over the status of some of the recommendations as well as the time being taken to implement them, e.g. the audit of invasive cervical cancer.

The Health Committee considered our report in December 2003. The Committee indicated that the review was timely, given its consideration of the Health (National Cervical Screening Programme) Amendment Bill (subsequently enacted, and assented to on 7 March 2004). This legislation provides, among other things, for independent review of the Programme at least once every 3 years.

We maintain contact with the National Screening Unit regarding the implementation of our recommendations. We were pleased to note that the audit of invasive cervical cancer has now been completed and did not identify evidence of systematic failings in New Zealand cytology laboratories.[4]

4 *Cervical Cancer Audit Report – Screening of Women with Cervical Cancer, 2000-2002*, Ministry of Health, 2004.

Title of report

ELEVEN

Social Security Benefits: Accuracy of Benefit Administration

Date presented

10 December 2003

Brief description

In 2002-03, the Ministry of Social Development (the Ministry) paid $11,743 million to over 800,000 beneficiaries. Given the very large sums involved, it is clearly important to ensure that payments are made accurately.

Inaccurate benefit payments can result in direct costs to the Ministry from the administrative actions associated with identifying and correcting any errors. Opportunity costs also arise from Ministry staff having to spend time and effort on correcting benefits instead of undertaking other work. In addition, beneficiaries can suffer hardship when payments are made incorrectly.

We sought to provide Parliament with assurance that the Ministry has effective systems and methods for ensuring benefit accuracy, and that Parliament can place reliance on the performance data that the Ministry reports.

Key findings and recommendations

The Ministry's obligation is to pay benefits correctly on the basis of the information available to it. It measures accuracy in terms of this obligation. It does not currently collect information in other areas that we think are relevant to the general issue of accuracy.

Our report identified a number of areas in which we believe the information on benefit accuracy currently collected and published by the Ministry could be extended and improved, and we made a number of recommendations. These include that the Ministry:

- learns more about the extent and causes of under- and over-payments;
- continues to promote internal sharing of information on approaches to staff development and managing caseloads;
- explores the possibility of allocating more case managers to regions with large numbers of clients with complex circumstances;
- requires all regions to assess the performance of staff consistently, with accuracy being accorded an appropriately high priority;
- provides all Regional Commissioners and Regional Operations Managers with training on the appropriate interpretation of the Accuracy Reporting Programme's results;
- regularly performs a risk-sizing exercise to estimate the amount of over-payments;
- continues to explore the collection and analysis of information on errors and their size and causes; and
- periodically undertakes exercises to estimate the number of people who are potentially eligible for social security assistance but who have not applied.

Impact of our report

The Social Services Committee considered our report in February 2004, and questioned Ministry staff about various matters identified in the report.

The Ministry has formally responded to us setting out the progress that it has made in addressing the recommendations in our report. The Ministry's view is that it has made good progress in addressing the recommendations. We will maintain an active interest in the issues raised in our report, and intend to assess the Ministry's progress in implementation of the report's recommendations in the coming year.

Title of report

ELEVEN

The State Services Commission: Capability to Recognise and Address Issues for Māori

Date presented

30 January 2004

Brief description

Part of the role of the State Services Commission (the Commission) is to provide assurance to the Government on the strategy, capability and performance of Government departments – including in relation to departments' Māori capability.

The objective of our audit was to assess the capability of the Commission to recognise and address issues for Māori in the advice it provides to other departments and Ministers.

Key findings and recommendations

We reported that the Commission has positioned itself well to work alongside departments to build a Public Service that produces more effective outcomes for Māori. We noted some areas where we think the Commission could further enhance its capability, and we made some recommendations in this regard.

Our recommendations included:

- clarifying the respective roles of the Commission and Te Puni Kōkiri to resolve any potential confusion;
- that the Commission consider evaluating the impact of its overall coherent strategy in this area; and
- that the Commission take steps to clarify and formalise its relationships with chief executives and their departments.

ELEVEN

Impact of our report

The Māori Affairs Committee considered our report in February 2004, and the Government Administration Committee considered it in April 2004.

The Minister of Māori Affairs has displayed an interest in the extent to which the State Services Commission has addressed the findings of our report.

We will maintain an active interest in the issues raised in our report. We are conducting a similar performance audit in respect of the Treasury, with the intention that this will be published in 2005-06.

Title of report

ELEVEN

Māori Land Administration: Client Service Performance of the Māori Land Court Unit and the Māori Trustee

Date presented

26 March 2004

Brief description

We investigated the effectiveness of the client service provided by:

- the Māori Land Court Unit (an administrative unit of within the Ministry of Justice *Tahu o te Ture*, that provides support for the Judges of the Māori Land Court, as well as information and advisory services for Māori land owners); and
- the Māori Trustee *Te Kaitiaki Māori* (who works within the Māori Land system to manage Māori Land on behalf of owners who engage the Trustee's services through the Māori Trust Office, which is part of the Ministry of Māori Development *Te Puni Kōkiri*).

Key findings and recommendations

We reported that, overall, the Māori Land Court Unit has provided a good level of service to its clients through strategic planning based on client surveys, the appointment of Advisory Officers, and the introduction of the Māori Land Information System. Areas where improvements could be made include:

- management and reporting of applications;
- training of case managers; and
- standardisation of practices and processes between registries.

We also found that the Māori Trustee has provided his clients with a good level of client service. However, we noted that the Trustee's client service could be improved in the following areas:

- establishing more qualitative land management performance measures – particularly in relation to rent collection and review;
- developing a set of criteria to determine which owners should receive written Reports to Owners, and which should be delivered in a formal meeting;
- a strategy for reducing the backlog in processing Court orders and correspondence; and
- implementing a time-recording system that allocates staff time to individual clients.

We identified areas of risk to the Trustee's future client service performance, including the ongoing delay in the government review of the Trustee's role and functions. We also noted some opportunities to increase the amount of interaction between the Māori Land Court Unit and the Trustee, so that clients receive a more seamless service.

Impact of our report

We will follow up with both the Māori Trustee and the Māori Land Court Unit to see what improvements have been made as a result of our report.

We will maintain an active interest in the issues raised in our report; in particular, the completion of the government review of the Māori Trustee.

Title of report

ELEVEN

Accident Compensation Corporation: Case Management of Rehabilitation and Compensation

Date presented

29 April 2004

Brief description

The Accident Compensation Corporation (ACC) was established when New Zealand introduced a comprehensive no-fault accident compensation scheme in 1974. The private rights of individuals to sue for personal injury were replaced with a public scheme of universal coverage that aimed to provide compensation for all accidents, wherever they occurred.

An audit of the efficiency and effectiveness of ACC's case management processes and procedures was proposed in our 2002-03 Annual Plan. After preliminary scoping work at ACC, the audit was focused on ACC Branches (as opposed to the Service and Contact Centres), because this is where case management occurs for the most seriously injured and long-term claimants.

Key findings and recommendations

Our report represented an independent view of the compliance of ACC's operational structures, systems, and processes with key legislative requirements. The report also provided Parliament and the general public with information on ACC's activities.

During our audit we encountered polarised views of ACC's performance, although there was a consistently strong theme that the organisation was performing better then than it had in the past. Overall, we found no systemic failings in ACC's case management practices. However, we identified areas where improvements could be made for the benefit of both ACC and claimants. We made 17 recommendations, based mainly around:

- better use of tools to assist case managers;
- tailoring of Individual Rehabilitation Plans;
- reporting of Key Performance Indicators;
- case manager induction, monitoring and assessment;
- communication with claimants, particularly former Catalyst claimants;
- analysing the outcomes of complaints, reviews and appeals with a view to improving policies and procedures; and
- accurate reporting of claimant satisfaction rates and differences between groups of claimants (e.g. short-term and long-term).

Impact of our report

After the report's publication, members of the Transport and Industrial Relations Committee considered our report. We also met with the ACC Ministerial Advisory Group, and asked various other stakeholders to gauge the report's impact.

Soon after publication of the report, ACC provided us with a memorandum detailing its response to each of the report's recommendations. ACC indicated that, with the exception of several actions to be completed during the 2004-05 year, all recommendations had been implemented. We remain in contact with ACC to follow progress with the outstanding actions from the audit.

Title of report

ELEVEN

New Zealand Trade and Enterprise: Administration of grant programmes

Date presented

7 December 2004

Brief description

New Zealand Trade and Enterprise (NZTE) was established in July 2003 as a result of a merger between Industry New Zealand (the Government's economic development agency) and Trade New Zealand (the Government's trade promotion agency). NZTE administers a range of grants and awards to firms, sectors and regions in order to promote economic development in New Zealand.

Our audit examined whether the following grant programmes were being administered effectively and efficiently, and in keeping with the policy parameters set by Cabinet:

- Growth Services Fund;
- Enterprise Development Grants;
- Enterprise Network Grants;
- Major Events Fund; and
- Strategic Investment Fund.

Key findings and recommendations

During the course of our audit, we found:

- variable data collection and reporting practices;
- variable standards of documentation;

- an inconsistent approach to the assessment of risk; and
- inconsistent approaches to monitoring.

We recommended that NZTE review all its grant programmes to ensure that it is administering them appropriately. For all grant programmes, this includes ensuring that a sound set of administrative principles and standards are applied.

Impact of our report

NZTE undertook a number of initiatives to improve its administration of grant programmes during the course of our audit.

The Foreign Affairs, Defence and Trade Committee considered our report in February 2005.

We will maintain an active interest in the issues raised in this report. We have agreed to meet with NZTE on a regular basis to discuss the progress being made to address the matters raised in our report.

We intend to conduct a follow-up audit of NZTE in two years' time to determine if our recommendations have been implemented and to what effect.

We also intend to undertake, every year, a similar audit of grant programmes that are administered by other public entities.

Title of report

ELEVEN

New Zealand Trade and Enterprise: Administration of the Visiting Investor Programme

Date presented

7 December 2004

Brief description

The Visiting Investor Programme (VIP) is a managed visit programme for companies and individuals who are considering New Zealand as a location for establishing all or part of their operations. It targets investment that will create jobs (particularly higher value jobs), provide profitable and sustainable export market access, and introduce new technology and management expertise in specific sectors.

We examined NZTE files to determine whether:

- robust and appropriate policies and procedures were in place;
- these policies and procedures were being followed; and
- there was appropriate monitoring and evaluation of payments.

Key findings and recommendations

Investment New Zealand did not have comprehensive and clearly established policies and procedures for administering the VIP.

We expected that all expenditure incurred under the VIP would comply with appropriate policies, be well documented, and be approved by the relevant authority. However, there were no policies governing what types and levels of expenditure were appropriate under the VIP as a whole, and no procedures for applying the policies when preparing itineraries for specific visits.

ELEVEN

We recommended that New Zealand Trade and Enterprise create guidance that sets out clearly the types and levels of expenditure acceptable under the Visiting Investor Programme, and enable expenditure to be incurred on a basis that is appropriate in each particular case, having regard to the purpose of the visit and the desired investment outcome. Such guidance should also specify the appropriate expenditure for officials when accompanying visiting investors.

Impact of our report

NZTE has told us that it is reviewing and updating its guidelines for the VIP to include guidance on the types of expenditure that will be approved under the VIP and what costs are eligible.

The Foreign Affairs, Defence and Trade Committee considered our report in February 2005. The Commerce Committee has indicated that it will consider our report in March 2005.

We will maintain an active interest in the issues raised in this report. We have agreed to meet with NZTE on a regular basis to discuss the progress being made to address the matters raised in our report.

Recent Publications by the Auditor-General

Other publications issued by the Auditor-General in the past 12 months have been:

- Progress in implementing key recommendations of the 1996 Transport Committee inquiry into truck crashes
- Assurance audit of the Annual Performance Report of the Electricity Commission for the period ended 30 June 2004
- Department of Conservation: Administration of the Conservation Services Programme – Follow-up audit
- Ministry of Defence and NZDF: Further report on the acquisition and introduction into service of Light Armoured Vehicles
- New Zealand Trade and Enterprise: Administration of grant programmes
- New Zealand Trade and Enterprise: Administration of the Visiting Investor Programme
- Christchurch Polytechnic Institute of Technology's management of conflicts of interest regarding the Computing Offered On-Line (COOL) programme
- Annual Report 2003-04 (including Summary Report insert) – B.28
- Inquiry into the Ministry of Education's monitoring of scholarships administered by the Māori Education Trust
- Conflicts of Interest – *A Guide to the Local Authorities (Members' Interests) Act 1968 and Non-pecuniary Conflicts of Interest*
- Central Government: Results of the 2002-03 Audits – B.29[04a]
- Local Government: Results of the 2002-03 Audits – B.29[04b]
- Annual Plan 2004-05 – B.29AP(04)
- Local Authorities Working Together
- Accident Compensation Corporation: Case Management of Rehabilitation and Compensation
- Good Practice for Managing Public Communications by Local Authorities
- Māori Land Administration: Client Service Performance of the Māori Land Court Unit and the Māori Trustee

Web Site

All these reports are available in PDF form on our web site ***www.oag.govt.nz***. They can also be obtained in hard copy on request – ***reports@oag.govt.nz***. A cost may apply for hard copies.

Subscription for Notification of New Reports

We offer a subscription facility for people to be notified by e-mail when new Reports and Latest News are added to the web site. The link to this subscription service is on our Home Page and also in the Reports section of the web site.

The Controller and Auditor-General
Tumuaki o te Mana Arotake

Central Government: Results of the 2003-04 Audits

ISBN 0-478-18130-2