Controller and Auditor-General
Tumuaki o te Mana Arotake

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Parliamentary paper

Central government: Results of the 2004-05 audits

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Central government: Results of the 2004-05 audits

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

March 2006

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Hon Margaret Wilson MP

Speaker

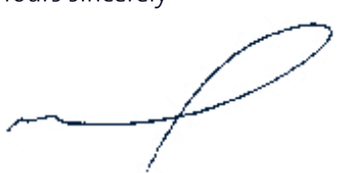
House of Representatives

WELLINGTON

Madam Speaker

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

Yours sincerely



K B Brady

Controller and Auditor-General

Wellington

28 March 2006

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Introduction

This report serves 2 broad purposes:

- it constitutes our "annual report" on the audits for 2004-05 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 2005* (the Government financial statements), parliamentary paper B.11, 2005; and
- it brings to attention a number of other matters (related both directly and indirectly to events occurring in the financial year 2004-05) that we believe warrant consideration by Parliament.

Part 1 (pages 7-21) deals with the Government financial statements as audited and presented to the House. Specific topics addressed include:

- significant matters arising from the 2004-05 audit;
- issues that affect future financial statements; and
- the resolution of matters raised previously.

Part 2 (pages 23-27) deals with the results of our audits of government departments for the year ended 30 June 2005. We include our usual:

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

Part 3 (pages 29-39) sets out details of the non-standard audit reports we issued during the period 1 January 2005 to 31 December 2005 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.

Part 4 (pages 41-50) outlines the results of our review of how well public entities are meeting the requirements of parts of the Crown Entities Act 2004, and the Public Finance Amendment Act 2004.

Part 5 (pages 51-60) describes our experience with the reformed "Controller" function performed by the Auditor-General, which changed from 1 July 2005.

Part 6 (pages 61-68) discusses the arrangements Crown Research Institutes and tertiary education institutions have in place to share the benefits of commercialising intellectual property with employees. We provide some recommendations on identifying, managing, and commercialising intellectual property.

Part 7 (pages 69-75) describes the Managing for Outcomes and Managing for Results initiatives, and why we are interested in them. We discuss the effectiveness to date of the Managing for Outcomes initiative in improving departments' statements of intent, and describe where further work may be warranted. (The Managing for Results initiative is being implemented in the Crown entities sector from 2006-07.)

Part 8 (pages 77-84) discusses the accountability framework for Māori Trust Boards. Although we have previously expressed concerns about the audit and accountability arrangements for those Māori Trust Boards governed by the provisions of the Māori Trust Boards Act 1955, the legislative framework for the sector remains largely unchanged. We considered it timely to report on this again, because we continue to believe that a review of the Māori Trust Boards Act 1955 is urgently required.

Part 9 (pages 85-87) discusses the Register of Pecuniary Interests of Members of Parliament, and the functions of the Auditor-General in relation to the register.

Part 10 (pages 89-97) describes the results of a review we carried out after a taxpayer asserted that Instant Kiwi players were being deliberately disadvantaged by the way the Instant Kiwi games are administered by the New Zealand Lotteries Commission.

Part 11 (pages 99-106) provides an update on progress made by the central government sector in moving towards accounting and reporting in accordance with the New Zealand equivalents of International Financial Reporting Standards. We also highlight some of the implications for the sector of using the New Zealand equivalents of International Financial Reporting Standards.

Part 1
The 2004-05 audited financial statements of the Government

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 2005* (the Government financial statements) on 16 September 2005. This is the same date on which the Minister of Finance and the Secretary to the Treasury signed their Statement of Responsibility.

Unqualified opinion issued

1.2 The audit report appears on pages 22-23 of the Government financial statements. The report includes our unqualified opinion that those statements:

- comply with generally accepted accounting practice in New Zealand; and
- fairly reflect:
  - the Government of New Zealand's financial position as at 30 June 2005; 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 statements, which is presented on pages 6-19 of the Government financial statements.

1.4 The significant matters that arose during the 2004-05 audit of the Government financial statements are listed below and discussed in this Part:

- Treasury and Crown sector performance (paragraphs 1.7 to 1.12);
- rail assets (paragraphs 1.13 to 1.23);
- student loans valuation (paragraphs 1.24 to 1.31);
- fair value of other debtor portfolios (paragraphs 1.32 to 1.38);
- the Kyoto Protocol provision (paragraphs 1.39 to 1.48);
- Financial Reporting Standard No. 37: *Consolidating Investments in Subsidiaries* (paragraphs 1.49 to 1.55); and
- tax revenue recognition (paragraphs 1.56 to 1.58).

1.5 We also discuss 3 matters that will affect future Government financial statements:

- applying New Zealand equivalents to International Financial Reporting Standards (paragraphs 1.59 to 1.64);
- the Public Finance Amendment Act 2004 (paragraphs 1.65 to 1.68); and
- related party transactions (paragraphs 1.69 to 1.75).

1.6 The Part concludes with a discussion of the resolution of matters we have raised previously.

Significant matters arising from the 2004-05 audit

Treasury and Crown sector performance

1.7 Section 27(4)[1] of the Public Finance Act 1989 states in relation to the annual financial statements of the Crown –

> *The Treasury shall forward the annual financial statements to the Auditor-General no later than the 31st day of August following the end of the financial year.*

1.8 Under section 30[1] of the Public Finance Act 1989, the Auditor-General has 30 days after receiving the Government financial statements from the Treasury to issue the audit opinion. However, in recent years we have generally agreed an earlier date for issuing the audit opinion with the Treasury in the interests of timely reporting. This year we agreed to sign the audit opinion on 16 September.

1.9 The Treasury provided the first draft of the Government financial statements to us on 31 August 2005. However, this draft was not of a satisfactory standard. A number of the detailed schedules and notes did not tie in to the primary statements, and other detailed disclosures were not provided (for example, commitments, contingencies, financial instrument disclosures, statement of trust money). Because of time pressures, the Treasury had not been able to fully complete the financial statements by the statutory deadline and the draft financial statements had not been subject to the level of quality assurance that we would expect.

1.10 It was not until 9 September that we received a draft set of financial statements that we considered to be of a good standard. This was only 7 days before we signed our audit opinion. This meant that the consolidation audit team were under significant pressure to complete the consolidation audit within the remaining timeframe. The deadline was met, but not without difficulty.

1.11 We note that the performance of the Treasury in producing the draft Government financial statements was affected by the performance of some entities in the Crown sector. A number of these entities were late in submitting their financial information to the Treasury, and the quality of some of the information submitted to the Treasury did not meet our expectations. In particular, we were disappointed that a number of entities were not able to agree on the amounts of funding that had flowed between them during the year, before submitting their financial information for consolidation.

1.12 We have recommended that the Treasury:

- review, in consultation with the entities in the Crown sector and our Office, the

1 Sections 27(4) and 30 continued to apply for the year ended 30 June 2005, in accordance with the transitional provisions in Part 8 of the Public Finance Amendment Act 2004.

timetable for producing the 2006 Government financial statements, to ensure that a draft set of financial statements that has been subject to appropriate quality assurance can be provided to the audit team within the statutory deadline;

- identify and take the steps necessary to ensure that the Treasury produces the Government financial statements within agreed deadlines and to the appropriate standard;
- follow up with the chief executives of those entities that did not meet the agreed timetable for submitting consolidation information for the 2005 Government financial statements and those that submitted consolidation information with significant errors, as to the importance of timely and accurate information;
- ensure that all entities are provided with clear guidance on how to complete the reporting schedules necessary for the Crown consolidation; and
- remind entities of the importance of agreeing funding flows with other entities in the Crown sector, and specifically of the requirements under the Government financial statements elimination framework, to seek written confirmation of all intra-group flows in excess of $10 million.

Rail assets

1.13 The Crown entered into a number of agreements with Toll Holdings Limited (Toll) on 30 June 2004, including the purchase of the national rail infrastructure for one dollar and a track access agreement out to the year 2070. In our report at the end of the 2004 Government financial statements audit, we raised our concerns about the accounting treatment adopted by the Treasury for the rail assets.

1.14 In the 2005 Government financial statements, the Treasury has again assessed the rail access agreement with Toll as a finance lease and accounted for the rail infrastructure as a lessor's interest in a finance lease. Under this accounting treatment, the Treasury has expensed the approximately $91 million of capital expenditure that the Crown has incurred on the rail network since 2004. The costs that the Treasury has expensed, rather than capitalised, include the expenditure to date from the $200 million that the Crown has committed to spend on replacement and upgrade of the national network, plus the capital expenditure on the Auckland commuter network (primarily the $23 million spent on double tracking).

1.15 We disagree with the accounting treatment adopted by the Treasury for the rail infrastructure assets. We do not consider it appropriate for the Crown to treat the significant capital expenditure incurred to date and planned for the future on the

rail network as an operating expense. However, we have not qualified our audit opinion on the Government financial statements this year, because we do not consider the $91 million of capital expenditure incurred to date to be material to the Government financial statements as a whole. This may not be the case next year, as the Crown continues to invest in the rail network.

1.16 We have discussed this issue at length with the Treasury. The Treasury's accounting treatment is based on its assessment that the agreements entered into with Toll are a finance lease, and, as there is no net income to the Crown from the rail assets (after considering the access fee revenue from Toll and the capital and operating expenditure to be incurred), the value of the Crown's interest in the finance lease is nil.

1.17 A finance lease is defined by Statement of Standard Accounting Practice No. 18: Accounting for Leases and Hire Purchase Contracts (SSAP-18) as a lease that transfers substantially all the risks and rewards incident to ownership of an asset to the lessee. We have considered carefully the requirements of SSAP-18 and we are satisfied that the agreements entered into with Toll do not amount to a finance lease over the rail infrastructure.

1.18 Some of the factors that have contributed to our view that the agreements do not amount to a finance lease are:

- The exposure of the Crown to funding unexpected and emergency expenditure, as occurred during 2004-05 in relation to the Nuhaka bridge failure and the Bay of Plenty floods.
- The ability of Toll to walk away from some sections of the network through the "use it or lose it" clauses in the access agreement, in relation to both freight and passenger services.
- The Crown's decision-making powers in relation to maintenance and capital investment, including the ability to make additional investment on public policy grounds.
- The term of the access agreement not being, in our view, for a major proportion of the useful life of the rail network taken as a whole, given the requirement in the access agreement to maintain the rail network "to standards and conditions equal to or better than those at the commencement date".
- The collectability of the minimum payments under the access agreement not being considered "reasonably predictable", and being subject to further negotiations between the parties.
- The inability to ascertain with reasonable certainty the amount of unreimbursable costs to be incurred by the Crown.

- The difficulty of 2 different parties having a finance lease over the Auckland rail network, where there are access agreements with both Toll and the Auckland Regional Transport Authority (who have contracted with Connex to provide the Auckland passenger rail services).

1.19 On 31 August 2004, the rail infrastructure assets held by the Treasury were transferred to ONTRACK (New Zealand Railways Corporation). It is of note that the accounting treatment adopted by ONTRACK in its annual statutory financial statements is consistent with the views of this Office – that is, it has not accounted for the agreements as a finance lease; instead it has capitalised the replacement and upgrade expenditure on the national and Auckland rail networks. The Treasury has reversed ONTRACK's accounting treatment as a consolidation adjustment in producing the 2005 Government financial statements.

1.20 In summary, we are of the view that the Treasury has incorrectly accounted for rail capital expenditure in the Government financial statements. This has resulted in an understatement of assets and an understatement of the Crown's net surplus by approximately $91 million (less any related depreciation).

1.21 As well as capitalising future capital expenditure, we are of the view that more meaningful information would be provided in the Government financial statements if the rail infrastructure assets were revalued to their depreciated replacement cost. This would be consistent with the approach taken by the Crown to other major infrastructural assets, such as the state highway network. Determination of the depreciated replacement cost may also provide useful information for asset management of this major asset.

1.22 We understand that, after we completed the audit of the 2005 Government financial statements, the Treasury has reconsidered its position on this matter and does not intend to account for the rail agreements as a finance lease in future Government financial statements.

1.23 We have recommended that the Treasury continue to discuss the accounting treatment for rail infrastructure assets with our Office to ensure that these assets are appropriately accounted for in the 2006 Government financial statements.

Student loans valuation

1.24 Note 9 to the Government financial statements discloses the fair value for the student loan portfolio as $5,994 million. This is $471 million lower than the carrying value (after provisions) of $6,465 million. In the 2004 Government financial statements, the fair value of student loans was $261 million lower than the carrying value.

1.25 We agreed with the Treasury's view that the carrying value of the student loan portfolio did not need to be written down to fair value at 30 June 2005. The reasons for our view are, first, that generally accepted accounting practice in New Zealand (NZ GAAP) is not clear as to the appropriate accounting treatment in these circumstances and, secondly, that the fair value determination remains, at this stage, only an approximation.

1.26 This is the third year that a fair value has been disclosed in the Government 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 determined by actuaries based on their professional experience and the data available. Some of these assumptions will become more accurate as the loan scheme matures and further data is available.

1.27 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 NZ GAAP is not clear as to the accounting treatment to be adopted when the fair value disclosed is less than the carrying value of the assets.

1.28 Since we completed our audit, legislation has been passed[2] to implement an interest-free student loan policy that will apply to new and existing loans (subject to some conditions about residency in New Zealand).

1.29 The removal of interest from student loans will significantly reduce the fair value of the student loan scheme. Because of this, we have agreed with the Treasury that it will be appropriate to write down the carrying value of the student loan scheme to its revised fair value, with effect from the date of passing of the legislation necessary to implement the new policy.

1.30 As the fair value calculation will become the basis on which the student loan scheme is recorded in the Crown's statement of financial position, we expect the fair value determination to be appropriately robust. Given the complexity of the fair value calculation and its sensitivity to the key assumptions, we are of the view that an external peer review of the methodology used to determine the fair value would be beneficial.

1.31 We have therefore recommended that the methodology for determining the student loan fair value be subject to a peer review to ensure that the methodology and assumptions are appropriate, and in compliance with the requirements of authoritative financial reporting pronouncements (NZ IAS 39: *Financial Instruments: Recognition and Measurement*).

2 The Student Loan Scheme Amendment Act received royal assent on 21 December 2005.

Fair value of other debtor portfolios

1.32 A number of Government departments are responsible for significant debtor portfolios (that is, assets of the Crown) where the debts are of such a nature that collection takes place over a significant period of time. Student loan debt is one example of this and, as discussed above, a fair value of the student loan portfolio has been determined and disclosed. There are, however, other significant debtor portfolios in the Government financial statements for which the fair value is not disclosed.

1.33 These include some debtor portfolios 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 – $791 million gross Crown debt, including benefit overpayments, advances on benefits, and recoverable special needs grants ($396 million after provisions);
- Ministry of Justice – $498 million gross outstanding court costs, fines, and enforcement fees ($382 million after provisions).

1.34 For some years, we have been recommending to the Treasury that fair value disclosures for these other debtor portfolios be included in the Government financial statements, and that the Treasury provide some guidance to departments on this matter.

1.35 On 9 September 2005, we were informed that fair values of the above debtor portfolios had been determined and would be disclosed in the 2005 Government financial statements. Our auditors for the Ministry of Social Development and the Ministry of Justice were requested to audit the fair values in a very limited timeframe.

1.36 Given the very limited time available, our auditors were not able to conclude whether the fair values for these 2 debtor portfolios were materially correct. We therefore requested the Treasury to remove these fair value disclosures from the 2005 Government financial statements.

1.37 As with student loans, our current expectation is that, under NZ IFRS (see paragraph 1.59), these debt portfolios will need to be initially recognised at fair value.

1.38 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 2006 Government financial statements and for the transition to NZ IFRS.

We have also asked the Treasury to ensure that our auditors are involved at a sufficiently early stage in the process, so that the methodology can be agreed by all parties and the fair values audited in a realistic timeframe.

The Kyoto Protocol provision

1.39 New Zealand is a signatory to the Kyoto Protocol, which imposes binding emission reduction targets on New Zealand over the First Commitment Period (CP1) from 2008 to 2012. The Protocol came into force on 16 February 2005, when the required threshold of ratification was reached.

1.40 In June 2005, the Treasury informed us that it had an updated forecast net position for New Zealand under the Kyoto Protocol, and that it was of the view that a provision for this net position should be recognised in the June 2005 Government financial statements. The determination of the net position is an extremely complex process involving a number of models across a range of government departments. It was a significant challenge for us to complete the audit of the provision in the short period of time that was available before signing the audit opinion.

1.41 The current timing of the annual review of the Kyoto stocktake in May will cause ongoing challenges for this Office in gaining adequate audit assurance over the various drivers that make up the liability, within the timetable for the audit of the Government financial statements. We have therefore recommended that the Treasury, together with the other relevant government agencies, review the timetable for the annual Kyoto stocktake to ensure that sufficient time is available for robust audit assurance. We note that an earlier date for completion of the Kyoto stocktake may also be beneficial in providing an updated Kyoto position in time for the annual Government Budget.

1.42 The Crown has recognised a provision of $310 million in the 2005 Government financial statements for the Kyoto net position. The Crown's net surplus for the year was therefore affected by $310 million. Detailed disclosure about the Kyoto Protocol provision is provided in Note 15 to the 2005 Government financial statements.

1.43 It should be noted that, although the provision is the Treasury's best estimate at this time, provisions by their nature are more uncertain than most other items in the statement of financial position. It is likely that successive projections will change as more updated information becomes available, better systems are implemented, or some uncertainties are reduced. Some of the key aspects of the Kyoto provision which are subject to fluctuation through time include:

- the price for each tonne of carbon;

- the exchange rate with the US dollar; and
- the various assumptions underlying the calculation of the emissions and sinks (for example, forecasts of Gross Domestic Product, energy prices, availability of more updated statistics).

1.44 Our audit work in relation to the Kyoto Protocol provision included reviewing models and assumptions, testing data where possible, and detailed discussions with various departments, peer reviewers, and independent experts. Overall, we are satisfied that the provision represented the Treasury's best estimate of New Zealand's liability as at 30 June 2005, and that it meets the criteria in Financial Reporting Standard No. 15: *Provisions, Contingent Liabilities and Contingent Assets* to be recognised as a provision.

1.45 As part of our audit assurance, we discussed the Kyoto Protocol provision with the independent experts from the United Kingdom that the Ministry for the Environment (MfE) engaged to review the determination of New Zealand's net CP1 Kyoto position. These experts confirmed to us that they had identified no major concerns or issues with the methodologies used, and that the CP1 net forecast position is a reasonable best current estimate, given current information, understanding, and methodological tools.

1.46 Since signing our audit opinion, these experts have provided a draft report to the MfE that is consistent with their discussions with us. This report also makes a number of recommendations, and highlights areas where further improvements should be made.

1.47 We have recommended that the Treasury, together with the relevant agencies, continue to develop their methodologies, models, and data for determining emissions, sinks, and the net Kyoto position, and that these agencies address the recommendations in the recent international experts' review report.

1.48 The Treasury has not recognised any provision or contingent liability for periods beyond 2012, because New Zealand currently has no specific obligations beyond CP1. The architecture of any obligations in future commitment periods has yet to be negotiated by the Kyoto signatories.

Financial Reporting Standard No. 37: *Consolidating Investments in Subsidiaries*

1.49 Financial Reporting Standard No. 37: *Consolidating Investments in Subsidiaries* (FRS-37) came into effect for the 2003 Government financial statements. A significant aspect of FRS-37 was a revised set of tests to determine which entities are controlled and hence subject to consolidation within the Government financial statements.

1.50 The application of the control test to the Crown is difficult, particularly in cases where legislation provides entities with a degree of statutory independence, such as tertiary education institutions (TEIs).

1.51 The accounting treatment adopted by the Treasury for the Government financial statements since 2003 has been not to consolidate TEIs on a line-by-line basis, but to equity account for them based on a 100% interest. The accounting treatment in the 2005 Government financial statements has remained unchanged from previous years.

1.52 This approach is based on a 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 Government financial statements.

1.53 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. However, we have accepted equity accounting for TEIs, as the treatment could arguably be regarded as complying with a strict interpretation of the mandatory elements within FRS-37, and because of the additional disclosures provided in Note 13, which enable readers to see the effect on the Government financial statements if a line-by-line treatment had been adopted for TEIs. With these additional disclosures, we have accepted that the Government financial statements are fairly stated.

1.54 This issue demonstrates the difficulty 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. The Financial Reporting Standards Board issued a discussion paper on control of public benefit entities that have autonomy and independence in August 2005, but it is not yet clear when this issue will be finally resolved.

1.55 We have recommended that the Treasury continue discussions with standard setters on the application of the control test in the Crown context, to enable these issues to be resolved.

Tax revenue recognition

1.56 Direct income taxation revenue for the year to 30 June 2005 totalled $31,974 million. Our review of the accounting policies and their application in relation to taxation revenue identified 2 areas where the revenue recognition policies and

processes in relation to provisional taxation payments should be reviewed to ensure that they remain appropriate:

- *Recognition point*. Currently, provisional tax revenue is recognised at the earlier of the payment receipt date and the payment due date, rather than on a full accruals basis.
- *Provisional tax pooling*. Since April 2003 taxpayers have been able to take advantage of provisional tax pooling accounts run through tax intermediaries to reduce exposure to use of money interest. The appropriateness of the accounting treatment for this is becoming more significant as the use of pooling accounts grows. The balance in the pooling accounts grew from $603 million at 30 June 2004 to $1,215 million at 30 June 2005.

1.57 Given the value of taxation revenue, any amendment to the tax revenue recognition policies has the potential to have a significant effect on the Crown's financial performance, particularly in the year when the policy is changed.

1.58 We have recommended that the Treasury and the Inland Revenue department review the provisional tax revenue recognition policies (including the accounting treatment adopted for the pooling accounts), to ensure that they remain appropriate and in line with NZ GAAP.

Issues that affect future Government financial statements

Application of New Zealand equivalents to International Financial Reporting Standards

1.59 In August 2003, the Government announced that the New Zealand equivalents of International Financial Reporting Standards (NZ IFRS) will be implemented in the Government financial statements as part of the 2007 Budget. This means that the first audited Government financial statements under NZ IFRS will be for the year ending 30 June 2008 (with the comparative figures to 30 June 2007 restated in accordance with NZ IFRS).

1.60 Over the past year, we have had a number of discussions with Treasury officials about their planning for the transition to NZ IFRS. The Treasury has completed an initial impact assessment to identify the key areas of change, difficulty, or uncertainty. In addition, the Treasury has produced a draft set of Government accounting policies under NZ IFRS, which have been circulated for comment to entities within the Government reporting entity.

1.61 FRS-41: *Disclosing the Impact of Adopting New Zealand Equivalents to International Financial Reporting Standards* encourages all entities to disclose in their annual report information about the entity's planning for the transition to NZ IFRS, any key differences in accounting policies that are expected to arise on the adoption of NZ IFRS, and any known or reliably estimable information about the effects on the financial report had it been prepared using NZ IFRS.

1.62 Although compliance with FRS-41 was not mandatory for the 2005 Government financial statements, we were pleased that the Treasury chose to make disclosures about the transition to NZ IFRS (see page 19 of the 2005 Government financial statements). Given the limited level of impact assessment available at that time, the disclosures provided were necessarily at a fairly high level. The disclosures highlight that the biggest effects are expected in the area of financial instruments, including the need under NZ IFRS to initially recognise long-term receivables and advances that do not earn a market rate of return at fair value.

1.63 At this stage, we are satisfied with the progress made by the Treasury towards the transition to NZ IFRS, but there remains much work to be done.

1.64 We will continue to liaise closely with the Treasury on the implications of the change to NZ IFRS for the Government financial statements.

Public Finance Amendment Act 2004

1.65 The Public Finance Amendment Act 2004 (the PFAA) received assent on 21 December 2004. The PFAA changes the reporting entity from "the Crown" to the "Government reporting entity" from the year commencing 1 July 2005.

1.66 The Government reporting entity is defined to include the Sovereign and the legislative, executive, and judicial branches of the Government. The revised definition clarifies that all 3 branches of government are to be included within the Government financial statements. Section 27(3) of the amended Public Finance Act 1989 requires the annual financial statements of the Government to include the Government reporting entity's interests in various entities, including Offices of Parliament. As a result, the Offices of Parliament will need to be re-incorporated into the 2006 Government financial statements.

1.67 One other change arising from the PFAA is that the Government financial statements will no longer have to disclose all guarantees and indemnities entered into by the Minister of Finance. However, those that meet the definition of a contingent liability under NZ GAAP will still need to be disclosed.

1.68 The Treasury will need to continue to plan to implement the changes required under the PFAA for the 2006 Government financial statements.

Related party transactions

1.69 Related party disclosures in the Government financial statements have historically been limited to aggregate information on salaries and allowances paid to Ministers of the Crown. With the change in reporting entity to the Government reporting entity from 1 July 2005, we consider it an opportunity to reconsider the issue of related party disclosures.

1.70 Statement of Standard Accounting Practice No. 22: *Related Party Disclosures* (SSAP-22) sets out the criteria for identifying related parties and states that related parties would normally include "those persons having authority and responsibility for planning, directing and controlling the activities of the reporting entity ... and close members of the families of such individuals".

1.71 We have given some preliminary consideration to the requirements of SSAP-22 in the context of the revised definition of the Government reporting entity (as set out in paragraph 1.66 above). In our view, related parties of the reporting entity include Ministers of the Crown, their close family members, and entities in which Ministers or their close family have a substantial interest or over which they are able to exercise significant influence. We also consider it possible that the Speaker of the House of Representatives and the Governor-General and their close family and interests would be related parties.

1.72 SSAP-22 also sets out the disclosure requirements for transactions with related parties. These disclosures are required for "material" related party transactions. In determining whether a transaction is material, it is necessary to consider both the amount and nature of the transaction. Although the above possible related parties will regularly transact with government entities (for example, paying postage, electricity, or car registration costs), we would not consider transactions of that nature to be material related party transactions.

1.73 The Register of Ministers' Interests administered by the Cabinet Office provides information relevant to the identification of related parties but does not (and was not intended to) capture related party transaction information to comply with SSAP-22 requirements. In addition, a change to the Standing Orders of the House of Representatives established a Register of Pecuniary Interests of Members of Parliament that will also hold some relevant information (see Part 9).

1.74 If it is determined that there are additional related party transaction disclosures that should be provided to comply fully with SSAP-22, it may be considered more appropriate for public disclosure to be made via other reporting mechanisms that could be referred to in the Government financial statements.

1.75 We have recommended that the Treasury consider further the application of SSAP-22 to the Government financial statements, and whether present systems and processes are sufficient to identify all related party transactions.

Resolution of significant matters raised previously

Foreshore and seabed

1.76 Last year, we highlighted the proposals in the Foreshore and Seabed Bill and recommended that, if the Bill was passed, the Treasury consider whether, and if so at what value, the foreshore and seabed should be incorporated into the Government financial statements.

1.77 The Foreshore and Seabed Act 2004 (FSA) received assent on 24 November 2004. Section 13(1) of the FSA states –

> *On and from the commencement of this section, 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.*

1.78 We discussed at length with the Treasury the nature of the Crown's interests in the foreshore and seabed, in order to determine whether the foreshore and seabed should be recognised as an asset or disclosed as a contingent asset in the Government financial statements. In the end, we agreed with the Treasury that no asset should be recognised and that detailed disclosure of the issue should be made in the notes to the 2005 Government financial statements. This disclosure (at page 77) included the following comment –

> *The FSA codifies the nature of the Crown's ownership interest in the public foreshore and seabed on behalf of the public of New Zealand. Although full legal and beneficial ownership of the public foreshore and seabed has been vested in the Crown, there are significant limitations to the Crown's rights under the FSA. As well as recognising and protecting customary rights, the FSA significantly restricts the Crown's ability to alienate or dispose of any part of the public foreshore and seabed and significantly restricts the Crown's ability to exclude others from entering or engaging in recreational activities or navigating in, on or within the public foreshore and seabed. Because of the complex nature of the Crown's ownership interest in the public foreshore and seabed and because we are unable to obtain a reliable valuation of the Crown's interest, the public foreshore and seabed has not been recognised as an asset in these financial statements.*

Fair value of land and buildings

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

1.80 Last year, we noted that some entities, including Air New Zealand, had not revalued their land and buildings because the carrying value of the land and buildings at that date was slightly less than $50 million, despite these having a disclosed government valuation greater than $50 million (in Air New Zealand's case, a valuation of $162 million).

1.81 We are pleased to report that, for the 2005 Government financial statements, Air New Zealand revalued its land and buildings to fair value in accordance with Crown accounting policies.

Ministry of Health – Consolidation of District Health Boards

1.82 The Ministry of Health is responsible for collecting, consolidating, and reporting to the Treasury the consolidated financial results of the District Health Boards (DHBs). For the past 3 years we have highlighted the problems we encountered in obtaining assurance over the accuracy of the consolidated results of the DHBs. A key issue has been the Ministry of Health's inability to meet the agreed timeframes for producing the consolidated information.

1.83 We are pleased to report a significant improvement in the performance of the Ministry of Health in preparing the 2005 consolidated results of the DHBs, enabling the auditor of the Ministry of Health to complete the sub-consolidation audit within the agreed timeframe.

Ministry of Education – Consolidation of Tertiary Education Institutions

1.84 The Ministry of Education is responsible for collecting, aggregating, and reporting to the Treasury the aggregated financial results of the Tertiary Education Institutions (TEIs). Last year, we encountered issues with the timeliness of the TEI exercise by the Ministry of Education and with the timeliness of response by the Ministry of Education to our auditor's queries. No such issues arose this year.

Part 2
Government departments – results of the 2004-05 audits

Introduction

2.1 This Part reports on the results of the 2004-05 audits of 39 government departments and 2 Offices of Parliament.[1] Its purpose is to inform Parliament of the assurance given by the audits on:

- the quality of financial reports; 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. Section 35 of the Act[2] requires departments to prepare financial statements in accordance with generally accepted accounting practice.[3]

2.3 Section 38(1)[4] of the Act 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 New Zealand Institute of Chartered Accountants. The audits are planned and performed to obtain all the information and explanations considered necessary to obtain reasonable assurance that the financial statements do not have material mis-statements caused by fraud or error.

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

1 The 39 departments are those listed on page 98 of the *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2005*, excluding the Government Communications Security Bureau and the New Zealand Security Intelligence Service. The 2 Offices of Parliament included in the results are the Office of the Ombudsmen and the Parliamentary Commissioner for the Environment. For the purposes of this Part, our use of the term "departments" includes reference to these 2 Offices of Parliament.

2 This section has been repealed by the Public Finance Amendment Act 2004 and replaced by new sections 45 and 45B. However, the former section remains in effect for a transitional period – see section 33 of the Public Finance Amendment Act 2004.

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), but the former section remains in effect for a transitional period – see section 33 of the Public Finance Amendment Act 2004.

2.6 None of the 41 departments audited received an audit report containing a qualified audit opinion (see Figure 2.1).

Figure 2.1
Analysis of audit opinions 2001-05

Year ended 30 June	2001	2002	2003	2004	2005
Unqualified opinions	44	42	41	40	41
Qualified opinions	0	1	2	1	0
Total audit opinions issued	**44**	**43**	**43**	**41**	**41**

Financial and service performance management

2.7 Our auditors examine aspects of financial management and service performance management. These are sometimes referred to as the "five management aspects" (see paragraphs 2.8 and 2.9). Where applicable, we identify specific areas of weakness and make recommendations to eliminate those weaknesses.

Financial management

2.8 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

2.9 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 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

2.10 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.

Reporting of results

2.11 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).

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

The results

2.13 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.

2.14 There were 72 assessments of "Excellent" (35%), and a combined total of 181 assessments (88%) that were either "Excellent" or "Good", which shows a similar pattern to the previous year.

2.15 No assessments of "Just adequate" or "Not adequate" were issued in the last 3 years.

Figure 2.2

Summary of assessments of aspects of financial management and service performance management in departments for 2004-05

Aspect assessed	Excellent		Good		Satisfactory		Just adequate	Not adequate	Total
	No.	%	No.	%	No.	%	No.	No.	No.
FCS	16	39	22	54	3	7	0	0	41
FMIS	15	37	21	51	5	12	0	0	41
FMCE	16	39	21	51	4	10	0	0	41
SPIS	10	24	23	56	8	20	0	0	41
SPMCE*	15	37	22	54	4	10	0	0	41
Totals 2005	**72**	**35**	**109**	**53**	**24**	**12**	**0**	**0**	**205**
2004	*79*	*39*	*99*	*48*	*27*	*13*	*0*	*0*	*205*

* The percentage figures add to 101% due to rounding.

Key:

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

2.16 We compared our assessments for 2003-04 and 2004-05. The results are summarised in Figure 2.3.

Figure 2.3

Assessment ratings for 2005 compared to 2004

Aspect assessed*	Higher rating	Same rating	Lower rating	Total
FCS	2	37	1	40
FMIS	0	39	1	40
FMCE	1	38	1	40
SPIS	0	39	1	40
SPMCE	1	39	0	40
Totals	**4**	**192**	**4**	**200**
%	**2**	**96**	**2**	**100**

Note: This table compares the ratings of 40 entities. The 2004 ratings for the former Ministry of Housing and the 2005 ratings for the Department of Building and Housing are excluded from the analysis because the former Ministry is only one of the constituent parts of the department.

* See Figure 2.2 for key to abbreviations.

2.17 Figure 2.3 shows:

- a very high proportion (96%) of the assessment ratings were maintained at the 2004 level;
- 4 of the assessment ratings (2%) were higher in 2005 than in 2004; and
- 4 of the assessment ratings (2%) were lower in 2005 than in 2004.

2.18 The 4 assessment ratings that were higher in the 2004-05 year confirm that some departments continue to make improvements.

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

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

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

Part 3
Non-standard audit reports issued

Introduction

3.1 In this Part, we discuss the non-standard audit reports issued on the annual financial reports of entities that are part of the Crown reporting entity, and other public entities not within the local government portfolio.[1]

3.2 Our discussion covers non-standard audit reports issued during the period 1 January 2005 to 31 December 2005.

Why are we reporting this information?

3.3 An audit report is addressed to the readers of an entity's financial report. However, all public entities are in one sense or another creatures of statute, and are therefore 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.

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

What is a non-standard audit report?

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

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

3.6 The auditor expresses a *qualified opinion*, as opposed to an unqualified opinion (which is issued when the auditor is satisfied, in all material respects, with the matters outlined in the financial statements), because of:

- a disagreement between the auditor and the entity about the treatment or disclosure of a matter in the financial report; or
- a limitation in scope because the auditor has been unable to obtain sufficient evidence to support, and accordingly is unable to express, an opinion on the financial report or a part of the financial report.

3.7 The types of qualified opinions are either an "adverse" opinion (explained in paragraph 3.11), or a "disclaimer of opinion" (paragraph 3.13), or an "except-for" opinion (paragraphs 3.14-3.15).

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.

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

3.8 The auditor will include an *explanatory paragraph* (see paragraphs 3.16-3.17) in the audit report in order to emphasise a matter such as:

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

3.9 Auditors are required to ensure that an explanatory paragraph is included in the audit report in such a way that it cannot be mistaken for a qualified opinion.

3.10 Figure 3.1 outlines the different types of audit reports that auditors can issue.

Adverse opinion

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

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

Disclaimer of opinion

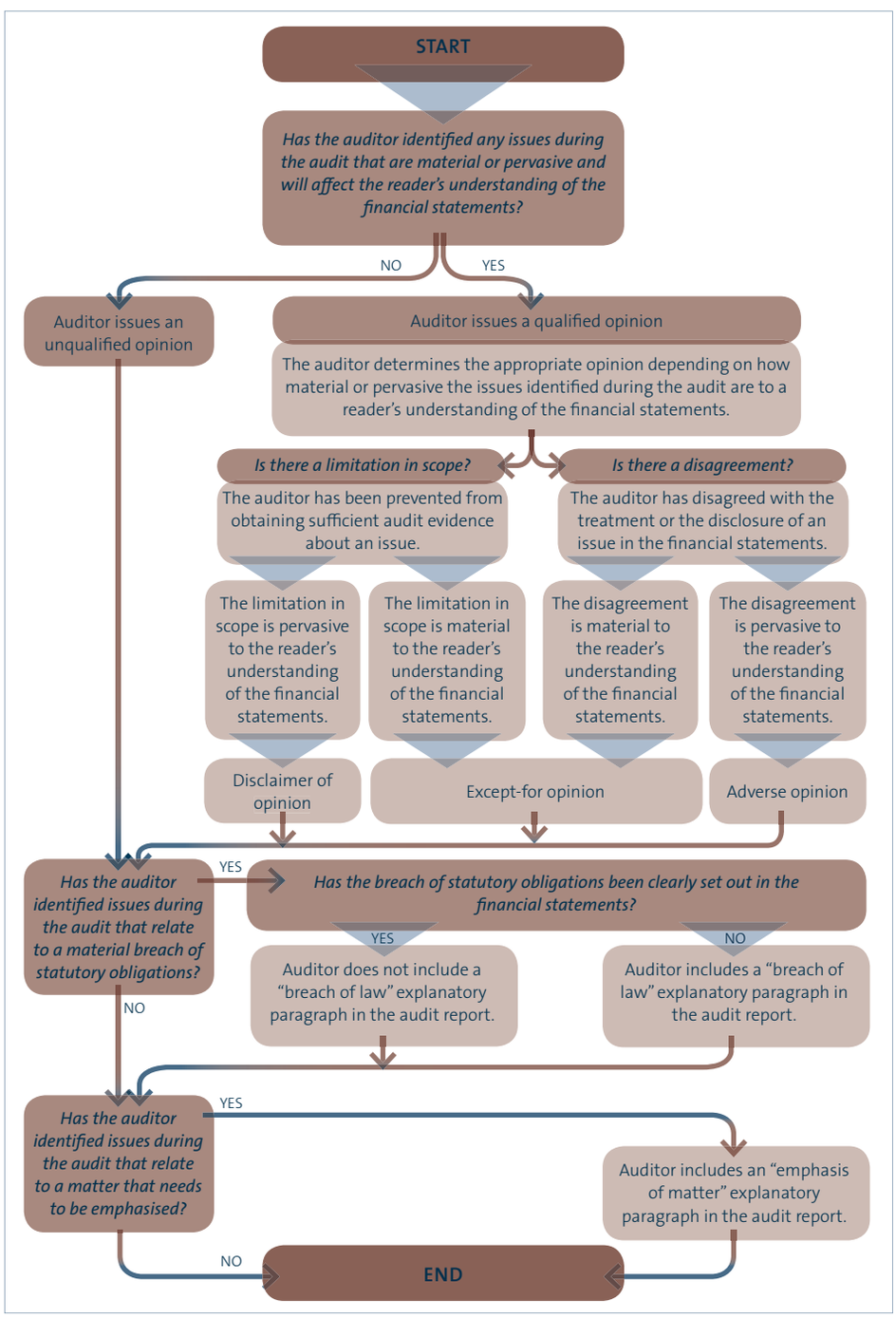
3.13 A disclaimer of opinion is expressed when the possible effect of a limitation in the scope of the auditor's examination is so material or pervasive that the auditor has not been able to obtain sufficient evidence to support, and accordingly is unable to express, an opinion on the financial report.

Except-for opinion

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

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

Figure 3.1
Audit report options



3.15 An except-for opinion can be expressed when the auditor concludes that a breach of statutory obligations has occurred and that the breach is material to the reader's understanding of the financial statements. An example of this is where a Crown entity has breached a requirement of the Crown Entities Act 2004 by not including budgeted figures in its financial statements.

Explanatory paragraph

3.16 In certain circumstances, it may be appropriate for the auditor to include in the audit report additional comment, by way of an explanatory paragraph, to emphasise a matter that is regarded as relevant to a reader's proper understanding of an entity's financial report.

3.17 For example, it could be relevant to draw attention to an entity having breached its statutory obligations in respect of certain matters where that breach may affect or influence a reader's understanding about the entity. In this situation, the audit report would normally draw attention to the breach only when the entity has not clearly set out the breach in its financial statements.

Full adverse opinions

Royal New Zealand Navy Museum Trust Incorporated

Financial statements period ended: 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*, 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 controls over those revenues.

Kippenberger Trust Fund*

Financial statements period ended: 31 March 2004

The Trustees did not recognise the value of military books and archive 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*, which requires museum collection assets not previously recognised to be recognised at fair value and depreciated. In addition, as the financial statements of the Trust had not previously been audited, we were unable to form an opinion as to whether the statement of financial performance was fairly stated, and we also did not give an opinion about the comparative information.

RNZAF Museum Trust Board

Financial statements period ended: 30 June 2005

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*, which requires museum collection assets not previously recognised to be recognised at fair value and depreciated.

Queen Elizabeth II Army Memorial Museum

Financial statements period ended: 30 June 2005

The Board did not recognise the museum artefacts and 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*, 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.

* A trust controlled by the New Zealand Defence Force.

Partial adverse opinions

Christchurch Polytechnic Institute of Technology and Group

Financial statements period ended: 31 December 2004

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

Financial statements period ended: 30 June 2005

The company restated a settlement asset that had been written off in the prior year. We disagreed with the write-off of the asset in the prior year and, as a result, the restatement of that asset in the current year should not have been required. The restatement of the settlement asset has resulted in a fundamental mis-statement of the current year's Statement of Financial Performance. We issued an unqualified opinion on the current year's Statements of Financial Position and Cash Flows. We also drew attention to our qualified audit report for the year ended 30 June 2004 and noted that the comparative information in the financial statements for the year ended 30 June 2005 should be read in conjunction with that qualified audit report.

Except-for opinions

Auckland District Health Board and Group

Financial statements period ended: 30 June 2005

We disagreed with the amount at which land, buildings, and associated fit outs and services was recorded in the Board's Statement of Financial Position. The Board had obtained from an independent valuer the fair value of the assets and, at the Board's request, a valuation of the assets excluding land that was subject to restrictive covenants, which resulted in a value less than fair value. The Board decided to record the assets in the Statement of Financial Position at the value less than fair value. In our opinion, this was a departure from Financial Reporting Standard No. 3: *Accounting for Property, Plant and Equipment*, which requires assets that are revalued to be recognised at their fair value.

University of Auckland

Financial statements period ended: 31 December 2004

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

Ngati Whakaue Education Endowment Trust Board

Financial statements period ended: 31 December 2004

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*.

Te Arawa Māori Trust Board

Financial statements period ended: 30 June 2004

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. In addition, we were unable to confirm the value of the Board's investment properties, as it did not revalue them in accordance with Statement of Standard Accounting Practice No. 17: Accounting for Investment Properties and Properties Intended for Sale. We were also unable to confirm payroll expenditure due to inadequate supporting documentation. The Trust Board also breached section 37(2) of the Māori Trust Boards Act 1955, as it did not obtain Ministerial approval for a payment made to a Board member for work performed outside his capacity as a member of the Board.

Te Arawa Māori Trust Board

Financial statements period ended: 30 June 2003

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*. In addition, we were unable to confirm the value of the Board's investment properties, as it did not revalue them in accordance with Statement of Standard Accounting Practice No. 17: *Accounting for Investment Properties and Properties Intended for Sale*. We were also unable to confirm payroll expenditure due to inadequate supporting documentation.

Electricity Commission

Financial statements period ended: 30 June 2005

We did not agree that the information contained in the Statement of Service Performance enabled an informed assessment to be made of the performance of the Commission against the objectives and outcomes of the Government Policy Statement on Electricity Governance and the performance standards in the statement of intent for the year ended 30 June 2005. Our reason for this view was that the performance standards were largely task-oriented and short-term in focus, when we expected them to be more outcome-based.

West Auckland Catholic Transport Group

Financial statements period ended: 31 December 2004

The financial statements of the Group 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.

Tasman Aviation Enterprises (Queensland) Pty Limited*

Financial statements period ended: 30 June 2003

The financial statements of the Company 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.

Three Harbours Health Foundation**

Financial statements period ended: 30 June 2004

We were unable to verify certain revenue due to limited control over the receipt of this revenue.

Wilson Home Trust***

Financial statements period ended: 30 June 2004

We were unable to verify certain revenue due to limited control over the receipt of this revenue.

McAlister Holdings Limited****

Financial statements period ended: 31 December 2004

We were unable to verify certain revenue due to limited control over the receipt of this revenue.

* A subsidiary company of Air New Zealand Limited.

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

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

**** A subsidiary company of Te Whare Wānanga o Awanuiarangi.

Explanatory paragraphs

Transmission Holdings Limited and Group

Financial statements period ended: 30 June 2005

We highlighted that we disagreed with an adjustment in the financial statements for the year ended 30 June 2004 and that we qualified our audit report for that year accordingly. In addition, we highlighted that the comparative information in the financial statements for the year ended 30 June 2005 should be read in conjunction with the qualified audit report for the year ended 30 June 2004.

Northland Polytechnic

Financial statements period ended: 31 December 2004

We drew attention to the uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the Crown.

Western Institute of Technology at Taranaki

Financial statements period ended: 31 December 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the Crown in line with the Institute's business recovery plan.

Building Industry Authority

Financial statements period ended: 29 November 2004

We drew attention to uncertainties over the potential outcome of lawsuits alleging negligence on the part of the Authority regarding its performance on weathertightness issues. In addition, we highlighted that the going concern assumption appropriately had not been used in preparing the financial statements because the Authority was disestablished on 29 November 2004.

Meridian Limited*

Financial statements period ended: 30 June 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent company.

ComOne Joint Venture**

Financial statements period ended: 31 March 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the joint venture partners.

Aupouri Māori Trust Board and Group

Financial statements period ended: 30 June 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the outcome of negotiations with the Board's bankers over the recovery plan and its implementation.

NIWA Natural Solutions Limited***

Financial statements period ended: 30 June 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent company.

Geological Surveys (New Zealand) Limited****

Financial statements period ended: 30 June 2005

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent company.

Air New Zealand Associated Companies (Australia) Limited[§]

Financial statements period ended: 30 June 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent entity.

Travelseekers International Limited[§]

Financial statements period ended: 30 June 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent entity.

Eagle Air Maintenance Limited[§]

Financial statements period ended: 30 June 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent entity.

Air New Zealand Travel Business Limited[§]

Financial statements period ended: 30 June 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent entity.

Jet Affair Holidays Limited[§]

Financial statements period ended: 30 June 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent entity.

Enzedair Tours Limited[§]

Financial statements period ended: 30 June 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent entity.

Ansett Australia & Air New Zealand Engineering Services Limited[§]

Financial statements period ended: 30 June 2004

We drew attention to uncertainties surrounding the going concern assumption. The validity of the going concern assumption was dependent on the continuing financial support of the parent entity.

Auckland College of Education and Group

Financial statements period ended: 31 August 2004

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the College was disestablished and its net assets were incorporated into the University of Auckland on 1 September 2004.

Wellington College of Education

Financial statements period ended: 31 December 2004

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the College was disestablished and its net assets were incorporated into the Victoria University of Wellington on 1 January 2005.

Land Transport Safety Authority

Financial statements period ended: 30 November 2004

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the Authority was disestablished on 30 November 2004.

Wanganui Regional Community Polytechnic

Financial statements period ended: 31 December 2001, 31 March 2002

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the Polytechnic was disestablished on 1 April 2002.

NZVIF (IOM) Limited

Financial statements period ended: 30 June 2004

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the Directors intended to realise the investment in the Company after 30 June 2004.

Early Childhood Development Board

Financial statements period ended: 6 April 2004

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the Board was disestablished on 6 April 2004.

Transfund New Zealand

Financial statements period ended: 30 November 2004

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the entity was disestablished on 30 November 2004.

Open Mind Journals Limited[§§]

Financial statements period ended: 31 December 2004

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the Company had ceased trading on 30 June 2004.

Auckland University of Technology Move Dance Foundation[§§§]

Financial statements period ended: 31 December 2002, 31 December 2003, 31 December 2004

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the Foundation was disestablished on 31 December 2004.

Patriotic and Canteen Funds Board

Financial statements period ended: 30 September 2004

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the Board was disestablished on 17 May 2005.

Te Ohu Kai Moana (Treaty of Waitangi Fisheries Commission)

Financial statements period ended: 28 November 2004

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the Commission was dissolved on 29 November 2004.

The Bay of Plenty Provincial Patriotic Council

Financial statements period ended: 30 September 2004

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the Council had declared its intention to wind up its operations, subject to approval from the Minister of Veterans' Affairs.

Northern Region Health Consortium Limited¶

Financial statements period ended: 30 June 2005

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the entity was disestablished on 30 June 2005.

Ngai Tahu Ancillary Claims Trust

Financial statements period ended: 30 June 2004, 30 June 2005

We highlighted that the going concern assumption appropriately had not been used in preparing the financial statements, because the Trust had received Ministerial consent to be disestablished on 30 June 2005.

Aupouri Māori Trust Board and Group

Financial statements period ended: 30 June 2005

We drew attention to a note in the financial statements regarding the Board's financial difficulties and its business recovery plan.

Pacific Education Centre

Financial statements period ended: 31 December 2004

We drew attention to a note in the financial statements regarding the Centre's financial difficulties and its business recovery plan.

Innes House Hostel¶¶

Financial statements period ended: 31 December 2004

We highlighted that the Board breached the law by failing to meet its statutory reporting deadline.

* A subsidiary company of Meridian Energy Limited.

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

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

**** A subsidiary company of Institute of Geological and Nuclear Sciences Limited.

§ Subsidiary companies of Air New Zealand Limited.

§§ A subsidiary company of The Open Polytechnic of New Zealand.

§§§ A controlled foundation of the Auckland University of Technology.

¶ A subsidiary company of Treaty Relationship Limited, itself a controlled company of the Auckland District Health Board and Te Rūnanga o Ngati Whatua.

¶¶ A joint venture between Marlborough Boys' College and Marlborough Girls' College.

Part 4
Meeting the requirements of the Crown Entities Act and the Public Finance Act

Introduction

4.1 In this Part, we set out the results of our review of how well public entities are meeting the requirements of parts of the new public sector legislation – namely, the Crown Entities Act 2004 (CEA) and the Public Finance Amendment Act 2004 (PFAA) – which are of particular interest to us. Both Acts were enacted on 16 December 2004.

4.2 The new legislation has moved nearly all financial management and accountability provisions in respect of Crown entities into the CEA, which contains:

- new provisions regarding bank accounts, which came into effect on 25 January 2005, with a 6-month period of grace ending on 25 July 2005;
- new financial powers[1] provisions, which came into effect on 1 April 2005;
- conflict of interest disclosure provisions requiring entities to keep an interests register, which came into effect on 25 January 2005; and
- planning and reporting provisions, in particular as regards the statement of intent (SOI), which will take effect for the 2006-07 financial year.

4.3 The PFAA:

- introduced changes to the financial powers provisions for departments and Offices of Parliament;
- inserted a new Schedule 4 naming organisations that (with one exception)[2] were formerly Crown entities and to which specified financial and reporting provisions of the CEA are applied as if the organisation were a Crown entity; and
- also introduced changes to *ex ante* accountability requirements; relating, in particular, to SOIs and the Estimates of Appropriations.

4.4 The new legislative provisions take effect at various times, some within the last financial year, and others in 2005-06, or 2006-07. The planning and reporting provisions for Crown entities, for example, do not take effect until 2006-07.

4.5 We were concerned to assess whether entities had complied with some of the new legislative requirements where these were already in effect, and their preparedness for those requirements that had yet to come into effect. We

1 The financial powers relate to the acquisition of securities, borrowing, giving of guarantees and indemnities, and use of derivatives, and are supplemented by the Crown Entities Financial Powers Regulations 2005. Financial powers provisions for one class of Crown entity – tertiary education institutions – remain under the Education Act 1989.

2 Pacific Co-operation Foundation.

therefore asked our appointed auditors to report on compliance and preparedness in the course of the 2004-05 annual audit.

4.6 The public entities we examined were:

- all Crown entities as defined under the CEA, except Crown entity subsidiaries, school boards of trustees, and tertiary education institutions; and
- all departments and Offices of Parliament, except the Auditor-General, the New Zealand Security Intelligence Service, and the Government Communications Security Bureau.

4.7 We did not examine the organisations named in Schedule 4 of the Public Finance Act 1989 (the "as if" Crown entities).

Crown entities' meeting of requirements of the Crown Entities Act

4.8 The CEA contains 3 main groups of provisions that are of particular interest to us (see paragraph 4.2 above):

- new provisions regarding bank accounts and financial powers;
- conflict of interest provisions requiring entities to keep an interests register; and
- planning and reporting provisions.

Compliance with the banking and financial powers requirements

What the legislation requires

4.9 The CEA provides a regime for bank accounts held by Crown entities. Accounts that fall outside the provisions of the CEA require the permission of the Minister of Finance. The requirements came into effect on 25 January 2005, with a 6-month period of grace ending on 25 July 2005.

4.10 The CEA also contains a framework for acquisition of securities, borrowing, giving of guarantees and indemnities, and use of derivatives by Crown entities, which came into effect on 1 April 2005.[3]

What we asked our auditors to do

4.11 Our appointed auditors were asked to:

- review the entity's banking arrangements to assess compliance with the new requirements that took effect on 25 July 2005 (just after balance date); and

3 A guide to the financial powers provisions of the CEA (covering bank accounts, acquiring securities, giving guarantees and indemnities, and using derivatives) is available on the Treasury website at www.treasury.govt.nz/crownentities/.

- assess whether or not the entity had complied with the new requirements regarding securities, borrowing, guarantees and indemnities, and derivatives, for the period 1 April (when the provisions took effect) to 30 June 2005 (balance date).

Findings

4.12 All Crown entities complied with the legislation regarding permitted types of bank accounts (section 158).

4.13 All Crown entities complied with the legislation regarding acquisition of securities (section 161); new borrowing (section 162); new guarantees and indemnities (section 163); new derivatives (section 164); and existing securities, borrowing, guarantees, indemnities, and derivatives that have been amended or options taken up on or after 1 April 2005 (section 197).

Disclosure of interests

What the legislation requires

4.14 The CEA (sections 62-72) requires that entities keep an interests register, and that members of boards[4] disclose interests in the interests register and to the chairperson or, if the chairperson is unavailable or has an interest in the matters, the deputy or temporary chairperson, or, failing that, to the responsible Minister. The requirement came into effect on 25 January 2005. The Act also contains provisions that require prospective members to disclose interests to the responsible Minister.

4.15 In respect of the disclosure requirement, we expect that an entity would proactively ask new members if they are aware of any potential interests and to record the details in the register. In addition, we would expect there to be a regular process – we suggest at least 6-monthly – where members are asked to review and update the interests register. We note that a number of entities have a "conflict of interest" question as a standing item on the agenda for every meeting. That practice is encouraged.

What we asked our auditors to do

4.16 We asked our appointed auditors to report whether or not the entities kept an interests register as required in sections 64-65 of the CEA.

4.17 The CEA requirements in respect of interests do not apply to District Health Boards, but there is a similar requirement in those entities' own Act. Auditors of District Health Boards were asked to report whether or not the entity had complied with the relevant requirement in its own Act.

4 As defined in section 10 of the CEA.

Findings

4.18 Most of the entities that were required to have an interests register did have one. Nine did not. Three of the 9 entities were in the process of setting up registers. We advised the other 6 entities that they were required to implement a register.

4.19 Failure to disclose an interest is a serious matter of probity where public management is concerned, and the statutory entity's board must advise the Minister when there is a failure to disclose. In the 2005-06 audit, we will ensure that all these entities have implemented a register as required, or initiate appropriate reporting action.

Preparedness for impact of the CEA, in particular the new planning requirements, on the entity

What the legislation requires

4.20 Under previous legislation, only some individual Crown entities and Crown entity groups had to prepare an SOI. The CEA extends this requirement to all Crown entities except schools, tertiary education institutions, and Crown Research Institutes,[5] and changes the focus of the SOI in line with the new emphasis in public management on managing for outcomes and results.[6] Section 139 of the CEA requires that, before the start of the financial year, Crown entities prepare an SOI covering at least the next 3 financial years. The SOI is required to include the scope of the entity's functions and intended operations, the specific impacts, outcomes, or objectives that the entity seeks to achieve or contribute to, and financial and non-financial measures and standards by which the future performance of the Crown entity may be judged.

4.21 Sections 150 and 151 of the CEA require entities to present an annual report, which includes reporting against the financial and non-financial service performance measures set out in the SOI.

4.22 These provisions of the Act do not come into force until the 2006-07 financial year.[7] Guidance on applying the provisions is available on the SSC website at www.crownentities.ssc.govt.nz.[8]

5 Schools, tertiary education institutions, and Crown Research Institutes have to meet planning requirements in their own governing legislation.

6 See Part 7.

7 Some reporting requirements, specifically in respect of remuneration disclosures, took effect for the 2004-05 annual report.

8 In particular the 2 papers *Planning and Managing for Results: Guidance for Crown Entities*, and *Preparing the 2006/07 Statement of Intent: Guidance and Requirements for Crown Entities*.

What we asked our auditors to do

4.23 We asked our appointed auditors to assess whether the entity had analysed the effect on it of the changes to legislation.

4.24 Auditors were asked to exercise their judgement, taking into account the size and complexity of the entity and the risk of non-compliance. Examples of actions which could demonstrate that the entity had sufficiently analysed the effect of the legislation on it include:

- discussing the legislation in governance or management meetings;
- going through the Act and assessing the effect on the entity;
- seeking legal advice, external or in-house, where appropriate;
- engaging with the entity's monitoring department or the Treasury or the State Services Commission regarding the legislation;
- providing training or education for staff on the effect of the legislation; and
- changing its procedures and processes in line with the new legislation.

4.25 We also asked our appointed auditors to report on whether entities had a plan for meeting the statutory requirements identified in the assessment process. While auditors were asked to consider whether the entity had a formalised plan, and whether it had allocated resources to implementing the plan, this level of planning was not considered necessary in all entities. Auditors were asked to exercise their judgement as to what constituted a suitable plan for a given entity.

Findings

4.26 Almost all the audited Crown entities had analysed the impact of the legislation changes. However, in our auditors' opinion, 4 entities had either not done any analysis or had not done sufficient analysis.

4.27 Most entities had instituted some form of appropriate planning for meeting their statutory obligations. In our auditors' view, 7 entities did not have a sufficient level of planning.

4.28 Of these 7 entities, one did not have a plan because it considered that it already complied with all its statutory obligations. We have advised this entity that we intend to follow up its compliance during the 2005-06 audit. We advised the other 6 entities of the need to plan to meet their statutory obligations.

4.29 A further 2 entities did not have a plan, but in our opinion a detailed plan was not necessary, as the new legislation will have only minimal impact on these entities.

4.30 We noted that, for some Crown entities, the requirement to have an SOI was new. But even where the entity had an SOI before the requirement was introduced,

several felt the need to refocus their SOI to meet the requirements of the new legislation. Others were reshaping their SOI to respond to new reporting focuses (such as triple bottom line reporting), even though it was not required in the legislation.

4.31 We also noted that non-financial measurement of outcomes is an area that several entities need to develop further in future SOIs.

Compliance of departments[9] with the Public Finance Act

4.32 We focused on 2 main areas of changes introduced to the Public Finance Act 1989 (PFA) by the PFAA:

- changes to the financial powers requirements for departments and Offices of Parliament; and
- changes to the *ex ante* accountability requirements, relating, in particular, to SOIs and the Estimates of Appropriations.

Compliance with financial powers requirements

What the legislation requires

4.33 The financial powers provisions of the PFA concerning banking, investing, borrowing, guarantees, and indemnities remain broadly the same as they were, but changes have been made regulating use of derivatives. The changes to the provisions took effect from 1 April 2005.

What we asked our auditors to do

4.34 We asked our appointed auditors to assess whether or not the department had complied with the financial powers provisions in the period 1 April 2005 (when the provisions took effect) to 30 June 2005 (balance date).

Findings

4.35 Most departments had complied with the financial powers aspects of the new legislation.

4.36 There were 3 instances of minor technical breaches of the borrowing provisions, which we have brought to the attention of the departments concerned. The technical breaches were in the nature of accounts overdrawn as a result of dishonoured payments.

4.37 Section 65S of the PFA requires departments to have the authorisation of the Minister or the Treasury to operate bank accounts. We found one instance of a department operating an unapproved bank account. We brought this to the attention of the department concerned.

9 Offices of Parliament (except the Auditor-General) are included with this group, as the same requirements apply to them.

4.38 One department had received approval from the Minister of Finance to continue 4 existing finance leases that, without permission, would have constituted borrowing on behalf of the Crown, which departments cannot lawfully do.

Planning for, and compliance with, the new *ex ante* accountability requirements

What the legislation requires

4.39 The amendment to the legislation introduced changes to the *ex ante* accountability requirements for departments, which apply to the 2005-06 financial year (that is, they needed to be in place before 1 July 2005). These included:

- a change to the GST basis of appropriations;
- changes to the information regarding future operating intentions (SOIs); and
- changes in the way the authority given by an appropriation is described – in particular, from specifying the purpose of the expenditure to specifying the scope within which expenditure may be incurred.

4.40 Under the PFA, all appropriations are GST-exclusive for the 2005-06 Estimates, with the exception of existing multi-year appropriations (all new multi-year appropriations are presented on a GST-exclusive basis).

4.41 Information regarding future operating intentions (SOI) replaces the Departmental Forecast Report (DFR), but the information previously published in the DFR continues to be published as part of the SOI. The required information is detailed in sections 38-42 of the PFA. Departments' SOIs must cover at least the next 3 years, and include the scope of the department's functions and intended operations, and the specific impacts, outcomes, or objectives that the department seeks to achieve or contribute to. These provisions give effect to the focus in public sector management on managing for outcomes.[10]

4.42 In addition, section 40(d) of the PFA requires the department to set out and explain the main measures and standards that it intends to use to assess and report on matters relating to its future performance, including the following matters:

- the impacts, outcomes, or objectives achieved or contributed to by the department (including possible unintended impacts or negative outcomes);
- the cost-effectiveness of the interventions that the department delivers or administers; and
- the department's organisational health and capability to perform its functions and conduct its operations effectively.

10 Guidance is given to the departments by the Treasury and SSC at www.treasury.govt.nz/publicsector/sois/.

4.43 The amended PFA clarifies the requirements as regards description of the appropriation. It provides that the authority to incur expenses or capital expenditure provided by an appropriation is limited by the "scope" of the appropriation. The scope describes what activities are allowed using the funding available, rather than the purpose for which the expenditure could be incurred.

4.44 There was relatively little movement by departments in the 2005-06 appropriations descriptions in response to the "scope" provision. The Treasury gave general direction to departments regarding the "scope" provision in its Circular 2005/2 on 7 February 2005, and has since issued more specific guidance (*Scoping the Scope of Appropriations*, August 2005, available on the Treasury website). We expect to see improvement in the description of appropriations in the 2006-07 Main Estimates.

What we asked our auditors to do

4.45 We asked our appointed auditors to assess:

- whether departments had planned adequately for the impact of the changes in *ex ante* accountability reporting;
- whether departments had complied with the *ex ante* accountability requirements for 2005-06 – our auditors were instructed to bear in mind that the legislation had been very recently introduced, and that the SOIs were likely to be "works in progress", in terms of fully complying with all the new requirements of the amended PFA; and
- whether departments were aware of their statutory obligations in respect of specifying the scope of the appropriations and that further changes would be required in the 2006-07 year. We also asked our auditors to assess whether departments had a plan in place to meet these statutory obligations.

Findings

4.46 In our view, all departments had planned adequately for the impact of the changes required in *ex ante* accountability reporting.

4.47 Most departments had a plan for meeting their statutory obligations. Those that did not have a formal plan intended to read and follow relevant Treasury circulars and obtain further advice as needed.

4.48 Most departments had made some moves towards compliance with the new *ex ante* accountability requirements. However, 7 departments were considered not to have complied with the requirements for 2005-06.

4.49 We noted in particular that:

- Almost all departments need to refine future SOIs in order to fully comply with section 40(d) of the PFA.

- In our view, departments need to work on mechanisms to establish the cost-effectiveness of interventions. Mechanisms to establish cost-effectiveness need to be clear, and able to show that the interventions chosen by the department were more cost-effective than other possible interventions.
- Departments need to improve their outcome indicators. While most departments had some indicators, these were not always clear enough to assess the impact of departments' interventions on the outcomes they wish to achieve.

4.50 With one exception, departments were aware of their statutory obligation to include a description of scope of each appropriation in the Estimates. The one department that was not aware of the forthcoming changes was awaiting Treasury guidance, which has now been issued.[11]

Conclusions

Crown entities' compliance with the CEA

4.51 Crown entities have generally done a good job of complying with the financial powers and conflict of interest disclosure aspects of the new public sector legislation.

4.52 We note that the full planning and reporting requirements of the CEA have not yet come into effect. Thus, while entities have been preparing for the impact of the new legislation, full compliance is still work-in-progress.

4.53 In particular, entities need to ensure that they develop non-financial outcome performance measures, in accordance with Treasury and SSC guidance,[12] that are:

- valid and meaningful;
- sensitive and specific to the underlying phenomenon;
- grounded in research;
- intelligible and easily interpreted;
- able to be disaggregated, and
- timely.

4.54 Entities should pay particular attention to the performance information (for example, quality, quantity, timeliness, and cost). The auditor will review the forecast measures and standards for appropriateness. This will involve using the standard audit criteria of relevance, completeness, and understandability.

11 See www.treasury.govt.nz/appropriations/scoping.

12 Guidance on performance measures can be found at www.treasury.govt.nz/publicsector/sois/sois-guidance-depts and www.ssc.govt.nz/display/document.asp?navid=215&docid=4859&pageno=7#P130_14612.

These measures and standards provide the basis for end-of-year reporting in the statement of service performance contained in the annual report and the basis on which that statement is audited.

Departments' compliance with the PFA

4.55 While the *ex ante* reporting requirements of the PFA had already come into force at the time of our audit, we considered that almost all departments' SOIs were also works-in-progress in relation to the new requirements of the PFA.

4.56 In particular, departments need to ensure – as required in section 40(d) of the PFA – that the SOI includes the main measures and standards that the department intends to use to assess and report on its future performance, including:

- the impacts, outcomes, or objectives achieved or contributed to by the department (including possible unintended impacts or negative outcomes);
- the cost-effectiveness of the interventions that the department delivers or administers; and
- the organisational health and capability of the department to perform its functions and conduct its operations effectively.

4.57 In the 2005-06 Main Estimates, departments tended to produce scope descriptions that were essentially the same as the statements of purpose that were appropriate to the former legislative requirement. Specific Treasury guidance to departments to describe the scope of their appropriations was available in August 2005, after the presentation of the 2005-06 Estimates. The guidance is now available on the Treasury website, at www.treasury.govt.nz/appropriations/scoping/.

4.58 The description of the appropriation is important for the audit scrutiny of whether or not the entity is using public funding in the way that Parliament intended. In his Controller role, the Auditor-General needs to be satisfied that the entity is using the resource within the limits described in the scope.

4.59 In the next annual audit, we will ask our appointed auditors to assess whether each department has complied with the Treasury guidance on preparation of the scope descriptions of the appropriations, and to report on the quality of those descriptions.

Part 5
The operation of the Controller function

5.1 The Public Finance Amendment Act 2004 (the Amendment Act) made significant changes to the Controller function of the Controller and Auditor-General. Last year we described the Controller function and explained the changes that occurred from 1 July 2005.[1]

5.2 In this Part, we summarise the changes to the Controller function, discuss the work that has been done to bring the function into operation from 1 July 2005, and discuss the issues that have arisen to date.

Changes to the Controller function from 1 July 2005

5.3 The legislative provisions for the Controller function are set out in sections 65Y to 65ZB of the Public Finance Act 1989 (the PFA).[2]

5.4 The move to fully accrual-based appropriations under the Amendment Act gave Parliament an opportunity to modernise the Controller function to meet the requirements of the accrual accounting environment, and to strengthen the Controller function.

5.5 The key changes to the Controller function are:

- abolishing the Governor-General's warrant and certification procedures;
- a new requirement for the Treasury to supply monthly reports to the Controller, to enable the Controller to examine whether expenses and capital expenditure have been incurred in accordance with an appropriation or other authority (section 65Y); and
- a new power for the Controller to direct a Minister to report to the House of Representatives if the Controller has reason to believe that any expenditure has been incurred that is unlawful or not within the scope, amount, or period of any appropriation, or other authority (section 65Z).

5.6 The Controller'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 also occurs at a departmental level.

5.7 The Controller function and the Auditor-General's auditing functions have been intertwined for many years. Each year the Auditor-General's appointed auditors must carry out an appropriation audit as part of the annual financial audit of a government department or Office of Parliament.[3] The Amendment Act amended

1 *Central Government: Results of the 2003-04 Audits* (parliamentary paper B.29[05a]), "Changes to the Controller function", pages 51-57.

2 As amended by the Public Finance Amendment Act 2004.

3 See *Central Government: Results of the 2003-04 Audits*, "Changes to the Controller function", pages 54-57 for a brief explanation of the audit of appropriations.

section 15 of the Public Audit Act 2001 to ensure that the appropriation audit is carried out as a matter of statutory duty, rather than as an aspect of the financial report audit that the Auditor-General, under the previous regime, chose to require by his auditing standards.

Bringing the reformed Controller function into operation

5.8 After the Amendment Act was passed, we worked closely with the Treasury to bring the reformed Controller function into operation from 1 July 2005.

Auditor-General's auditing standards

5.9 We are currently updating the Auditor-General's Auditing Standard 2: *The Appropriation Audit and the Controller Function* (AG-2) for the changes to the function.

5.10 AG-2 is the basis for the appropriation audit work that appointed auditors of departments and Offices of Parliament must carry out. It:

- provides appointed auditors with an understanding of responsibilities of the Controller and Auditor-General for auditing appropriations made by Parliament and the function of the Controller; and
- sets out the standards appointed auditors apply when auditing appropriations and doing Controller work.

5.11 AG-2 requires our appointed auditors, as part of the annual audit, to audit all appropriations to:

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

Memorandum of Understanding

5.12 The Auditor-General has signed a Memorandum of Understanding (MOU) with the Secretary to the Treasury that sets out the joint understanding and expectations of the Office of the Auditor-General (OAG) and the Treasury of the role and procedures associated with the Controller function. The MOU can be accessed on the Treasury website http://www.treasury.govt.nz/controller/default.asp.

5.13 The MOU sets out the procedures for:

- providing information by departments to the Treasury;
- providing information by the Treasury to the Controller;
- breaches of appropriations or other statutory authority (where this has occurred or is likely to occur) or where there is reason to believe that expenditure has been or is likely to be incurred for unlawful purposes;
- making directions under section 65Z by the Controller, directing a Minister to report a breach of appropriation to the House of Representatives (see paragraph 5.5);
- stopping payments out of bank accounts; and
- the general operation of the Controller function.

Monthly reports by the Treasury

5.14 All departments are responsible for setting up and maintaining a system of internal controls to provide reasonable assurance that the transactions recorded are within statutory authority and properly record the use of all public resources by the Crown.

5.15 Treasury instructions require departments to provide information to the Treasury on the expenses and capital expenditure incurred against the statutory authority available. This information must be provided by the seventh working day of the next month.[4]

5.16 The Treasury is responsible for collating this information and providing a monthly report to the OAG within 3 working days of receiving the information from the departments. The Treasury has agreed (through the MOU) to provide, before the end of September each year, a schedule of the dates on which the monthly reports will be provided to the OAG during the financial year.

5.17 The monthly reports provide information on:

- all actual expenses and capital expenditure incurred against an appropriation, or other authority (which includes approvals under imprest supply);
- all actual expenses and capital expenditure incurred in excess of or without an appropriation or other authority; and
- the balance between the amount of expenses and capital expenditure authorised to be incurred and the amount that was actually incurred.

4 Monthly reporting is not required for June, July, and August. In the case of December, the report must be provided by the Tuesday immediately following Wellington Anniversary Day.

Standard operating procedures for the Controller function

5.18 We have prepared standard operating procedures that the OAG and appointed auditors carry out to give effect to the Controller function. These procedures are carried out in accordance with AG-2 and the MOU.

5.19 The procedures require the OAG to obtain assurance about the systems and controls that the Treasury uses to prepare the monthly report.[5] The procedures also specify the work that needs to be carried out centrally when these reports are received. Under the MOU, the OAG will write to the Treasury within 7 working days of receiving the Treasury monthly report to either confirm no issues have come to our attention from the work carried out centrally or provide advice of the issues arising and the action to be taken.

5.20 The monthly reports are provided to appointed auditors to use when auditing appropriations. The confirmations we provide are subject to any further action required as a result of the work carried out by appointed auditors.

5.21 In June each year, after receiving the May monthly report, appointed auditors are also required to assess whether the department is operating and will operate within appropriation, and to report the outcome of that work to the OAG. Appointed auditors are required to assess whether the department has adequate internal control systems and procedures to enable effective monitoring of expenditure against appropriation.

Breaches of scope of appropriation

5.22 The monthly report provides a formal process for identifying breaches of the amount of an appropriation. But an appropriation may be breached in another way – for example, if the activities for which expenditure is incurred are outside the scope of the appropriation. We expect to continue to receive information on such breaches through the appropriations audit.

Operation of the Controller function from 1 July 2005

5.23 We outline in this section the key issues that have arisen in the operation of the Controller function from 1 July 2005 to 31 December 2005. We also report on the instances where expenditure in excess of the amount of appropriation has been incurred during this period, and the corrective action that has been taken or is proposed.

5.24 We received 4 monthly reports from the Treasury during this period – for the months ended September, October, November, and December 2005. The Treasury has met the statutory deadlines (see paragraph 5.16) for providing these reports

5 Section 65Y explicitly recognises 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 reports.

in all cases. We have also met the agreed timeframes (see paragraph 5.19) for advising the Treasury on the outcome of the work we have carried out centrally, the issues arising, and the action to be taken.

In-principle expense transfers

5.25 The first monthly report we received from the Treasury for 2005-06, which was for the 3 months ended 30 September 2005, identified 7 instances where expenditure exceeded the amount of the appropriation (a breach of appropriation) because of "in-principle expense transfers". We list the instances in Figure 5.1 and discuss the issues raised in paragraphs 5.26 to 5.32.

5.26 During the baseline update process in March each year, Joint Ministers can approve expense and capital transfers between financial years when these are fiscally neutral (Cabinet Circular CO(02)17). These expense and capital transfers can be in 2 forms:

- explicit transfers; or
- in-principle transfers.

5.27 Ministers approve an explicit transfer as part of the March baseline update process. The legal authority for the transfer is the Crown's imprest supply authority, which is subject to the expenditure being validated by an Appropriation Act at a later date.

5.28 An in-principle transfer is an agreement between Joint Ministers to a transfer, but with the final amount of the transfer being determined only after the 30 June financial statements have been completed. Formal approval for the transfer is not given by Ministers until the following October – well into the next financial year – as part of the baseline update process.

5.29 In our view, an in-principle transfer does not constitute the necessary authority to incur expenses under the imprest supply system. Accordingly, the expenditure is unlawful to the extent that it exceeds the amount or scope of an existing appropriation for the financial year in question. The Treasury has agreed with our view.

5.30 The lack of authority for the 7 cases listed in Figure 5.1 is to a large extent a timing issue, with approval expected as part of the October 2005 baseline update process. The Treasury therefore advised departments that had incurred expenditure in excess of an existing appropriation solely on the basis of an "in-principle" approval that it was unnecessary to seek immediate approval. We accepted that position on the basis that it was a newly identified problem and that steps would be taken to ultimately validate the expenditure. However, we recommended that action be taken to ensure that these issues do not recur in future years.

Figure 5.1

Expenditure in excess of appropriation – in-principle transfers

2005-06 Appropriation* Name	Type	Amount ($000)	Actual expenditure for 4 months to 31 October 2005# ($000)
Vote: Arts Culture and Heritage			
National Memorial Park in Wellington	Capital expenditure	(846)†	4,952
Vote: Economic, Industry and Regional Development			
Large Budget Screen Production Fund	Other expenses to be incurred by the Crown	35,556	44,682
Vote: Economic, Industry and Regional Development			
NZ's Participation at Expo 2005, Aichi, Japan	Non-departmental output class	971	1,285
Vote: Energy			
Development of Reserve Electricity Generation Capacity	Capital expenditure	0	9
Vote: Health			
Health Sector Projects	Capital expenditure	1,112	3,314
Vote: Health			
Response to Significant Health Emergencies	Capital expenditure	0	16,512
Vote: Justice			
Contribution to Foreshore and Seabed Negotiation Costs	Other expenses to be incurred by the Crown	0	90
Ministers agreed "in-principle" transfers for all of these instances as part of the March 2005 baseline update process.			
All of the breaches were authorised by Joint Ministers under imprest supply authority delegated by Cabinet on 14 November 2005 as part of the October 2005 baseline update process.			

* As reflected in the Appropriation (2005/06 Estimates) Act 2005, or in Cabinet/Ministerial approvals given under imprest supply.

\# These figures are not audited.

† The original appropriation for 2005-06 was nil. Cabinet authority was later provided to reduce the appropriation to ($846,000) under imprest supply before the in-principle transfer was authorised in the October 2005 baseline update process.

5.31 Formal approval for the transfers was subsequently given by Joint Ministers on 5 November 2005. The October 2005 monthly report therefore continued to reflect the expenditure in excess of appropriation.

5.32 Treasury officials have advised us that action has been taken to ensure that breaches of appropriation amount due to in-principle transfers do not occur in future years. The procedures for these transfers are to be revised so that, before the end of the financial year, an explicit (rather than an in-principle) authority is given under imprest supply to incur the transferred expenses in the next financial year up to a particular amount.

Expenditure in excess of appropriation amount

5.33 The monthly monitoring process has also identified expenditure incurred in excess of the amount of appropriation (breaches of appropriation) that are not due to in-principle transfers. Figure 5.2 lists the instances identified in the monthly monitoring reports during the 6 months ended 31 December 2005. The corrective action that has been taken or is proposed is also described.

Figure 5.2
Expenditure in excess of appropriation – other

2005-06 Appropriation* Name	Type	Amount ($000)	Actual expenditure for the period ($000)*
September 2005, Vote: Labour			
Bad Debt Expense	Other expenses to be incurred by the Crown	0	2
Joint Ministers authorised the breach under imprest supply authority delegated by Cabinet as part of the October 2005 baseline update process.			
November 2005, Vote: Community and Voluntary Sector			
Community Organisation Grants Scheme	Other expenses to be incurred by the Crown	11,394	11,730
The department believes it has overestimated the GST component of the appropriation in removing GST as part of the 2005 Budget. The department is still assessing the correct amount of GST. Joint Ministers have provided imprest supply authority as part of the March 2006 baseline update process.			
December 2005, Vote: Courts			
Care of Children Act Costs	Other expenses to be incurred by the Crown	3,120	4,314
Joint Ministers authorised a fiscally neutral transfer from the "Family Court Counselling and Professional Services" appropriation to the "Care of Children Act Costs" appropriation under imprest supply authority as part of the March 2006 baseline update process.			

* As reflected in the Appropriation (2005/06 Estimates) Act 2005, or in Cabinet/Ministerial approvals given under imprest supply.

Net asset holdings and imprest supply

5.34 We identified some issues relating to the new provisions in the PFA about net asset holdings and the Imprest Supply (Second for 2005/06) Act 2005 (the Imprest Supply Act) when we received the September 2005 monthly report and carried out our Controller function work.

5.35 Parliament approves the incurring of public expenditure through Appropriation Acts and Imprest Supply Acts. Appropriation Acts provide the Executive with statutory authorisation to incur expenses or capital expenditure. Imprest Supply Acts provide the Executive with authority to incur expenditure up to a specified amount and for any purpose in advance of an appropriation and as if an appropriation existed.

5.36 Section 22(3) of the PFA states "The amount of net asset holding in a department must not exceed the most recent projected balance of net assets for that department at the end of the financial year, as set out in an Appropriation Act in accordance with section 23(1)(c)." This is subject to section 22(2), which establishes a permanent legislative authority for "reported net asset holdings" to increase as a result of a remeasurement of an asset or liability.

5.37 Section 9(1) of the Imprest Supply Act states "The amount of net asset holding in departments (other than intelligence and security departments) and Offices of Parliament during the 2005/06 year must not exceed in the aggregate the sum of $16,000 million."

5.38 As at 30 September 2005, the net assets of such departments were $16,496 million. We examined whether this was a breach of section 9(1) of the Imprest Supply Act. We accepted the Treasury's interpretation that section 22(2) of the PFA applies alongside the Imprest Supply Act provision. This means that the level of net asset holdings for the purpose of determining compliance with the Imprest Supply Act limit can be adjusted for remeasurements.

5.39 After excluding the remeasurements (largely revaluations as at 30 June 2005), the $16 billion limit was not exceeded ($14.761 billion as at 30 September 2005).

5.40 We were accordingly of the view that the Imprest Supply Act had not been breached.

5.41 Another issue that arose was whether section 9 of the Imprest Supply Act gave authority for the asset holdings of individual departments to exceed the projected net asset balances set out in the Main Estimates and the Appropriation Act, as long as the aggregated total was below $16,000 million. The Treasury's view was that it did. We agreed that the side-by-side effect of the Imprest Supply and PFA means that the Treasury's view was correct.

5.42 However, we were of the view that the wording of the Imprest Supply Act provision needed to be improved so that the statement that "the amount of net asset holdings ... must not exceed $16,000 million" is open to being read, not as an unequivocal statement that supplants the amounts of individual asset holdings set out in the Appropriation Act, but as an authority for those net asset holdings to increase within a certain limit, subject to later validation in an Appropriation Act.

5.43 We were subsequently consulted on the wording for section 10 of the Imprest Supply (Third for 2005/06) Act 2005. We are satisfied that the revised wording addressed the issues we had raised.

Summary

5.44 In our view, the nature of the issues that have come to our attention through the operation of the Controller function from 1 July 2005 already show the value of the changes made to modernise and enhance that function.

5.45 The new monthly reporting process has identified breaches of appropriation amounts earlier than the previous system. The previous system did not require monthly reporting to the Auditor-General against appropriation or other authority. Also, the daily Controller certification required under the previous system had limited use in an accrual accounting environment where departments incur expenditure. The audit of appropriations that evolved during the 1990s to address the limitations of the certification procedures generally focuses on reporting towards the end of the financial year. Therefore, the monthly reporting is providing more timely information on breaches of the amount of the appropriation.

5.46 It is important to note, though, that breaches of the scope of an appropriation are still more likely to come to our attention through the appropriation audit work carried out by our auditors.

5.47 The monthly reports contain information about expenditure incurred either under an appropriation or by some other authority (which includes an Imprest Supply Act). This means that more information is provided about expenditure funded under imprest supply than has previously been the case.

5.48 The reformed Controller function has also brought to light some processes, such as in-principle expense transfers, that do not provide the appropriate statutory authority to incur expenditure. These deficiencies have existed for some time but were not visible under the previous system. This is further evidence that the changes made have enhanced the Controller function.

5.49 We intend to report annually to Parliament on the significant issues arising during the previous year from the operation of the Controller function. This will ensure that Parliament and the public can be suitably informed about this important constitutional function of the Auditor-General.

Part 6
Intellectual property

6.1 Intellectual property is a generic term for a range of property rights that protect creations of the mind. The term "intellectual property" is defined[1] as including rights for:

- literary, artistic, and scientific works;
- performances of performing artists, sound recordings, and broadcasts;
- inventions in all fields of human endeavour;
- scientific discoveries;
- industrial designs;
- trademarks, service marks, and commercial names and designations;
- protection against unfair competition; and
- all other rights resulting from intellectual activity in the industrial, scientific, literary, and artistic fields.

6.2 Intellectual property rights provide creators and innovators with the exclusive right, for a limited time, to control what others may do with their work. This exclusive right is justified on the grounds that it gives creators and innovators an opportunity to make a return on their investment, and provides an incentive for creative or innovative activity that might not otherwise take place. The benefits of this additional creativity and innovation are generally considered to outweigh the costs imposed on society by intellectual property rights.

6.3 The importance of scientific endeavour and innovation to New Zealand's prosperity was emphasised in the most recent Speech from the Throne, in which the Governor-General referred to the Government's intention to accelerate the commercialisation of research generated from within the public sector.[2]

6.4 The protection of intellectual property is governed by national and international intellectual property regimes. These regimes employ a variety of means, including copyright, patents, trademarks, design rights, plant variety rights, and layout design rights.[3]

6.5 The Auditor-General has an interest in the manner in which public entities protect their resources, including intellectual property.[4] In particular, we

1 See Article 2(viii) of the Convention Establishing the World Intellectual Property Organisation 1967.

2 November 2005 Speech from the Throne.

3 A useful reference site on intellectual property is www.med.govt.nz.

4 The term "public entities" is defined in section 5 of the Public Audit Act 2001.

note that intellectual property can represent a significant asset for tertiary education institutions[5] (TEIs) and Crown Research Institutes[6] (CRIs).

6.6 During the 2003-04 annual audits,[7] we noted that some TEIs and CRIs were developing practices to share the benefits of commercialising intellectual property with employees.

6.7 We decided to find out more about these practices to better understand the issues, to provide some reassurance that any sharing of the benefits of commercialisation was being done with due probity, and to ensure that public entities had adequate policies for identifying, managing, and commercialising intellectual property. For example, the procedures for awarding benefits to staff should ensure that conflicts of interest are avoided and that staff do not receive benefits that should rightfully be owned by the public entity.

6.8 We therefore asked our appointed auditors of all TEIs and CRIs, during the 2004-05 annual audits,[8] to obtain copies of each TEI's and CRI's policies and procedures for identifying, managing, and commercialising intellectual property.

6.9 We also asked our auditors to identify up to 3 examples where employees or contractors shared in the benefits of commercialising intellectual property. For each example, we asked the auditor to outline how the commercialisation of the intellectual property took place, the value of the arrangement, and the nature of the benefits shared with the employee or contractor. We asked auditors to identify and report whether the transactions in each example complied with the entity's intellectual property policies and procedures.

6.10 In this Part we provide some background, report our findings from the 2004-05 audit returns, and provide some commentary and recommendations on identifying, managing, and commercialising intellectual property.

Background

6.11 Each year shareholding Ministers produce an annual *Operating Framework for Crown Research Institutes*, which conveys their expectations for the CRI sector and for individual CRIs.

6.12 The 2005 Framework discusses intellectual property (IP) and contains a statement of obligations on directors, including –

> *The IP policy of the company should be kept under active review. For the avoidance of doubt, Ministers are comfortable with policy that allows an*

5 TEIs include the universities, polytechnics, colleges of education, and wānanga.

6 The CRIs are the 9 research-based companies established under the Crown Research Institutes Act 1992.

7 These audits cover the year ended 31 December 2003 for TEIs, and the year ended 30 June 2004 for CRIs.

8 The returns cover the year ended 31 December 2004 for TEIs, and the year ended 30 June 2005 for CRIs.

individual or group of employees to benefit materially from their intellectual contribution.

6.13 The Tertiary Advisory and Monitoring Unit of the Ministry of Education is preparing a set of best practice principles for TEIs to use as guidance when commercialising intellectual property. We understand that these principles are likely to outline the need for a TEI to have clear policies on who owns intellectual property generated by staff, and what kind of sharing with staff might be appropriate.

Findings – Crown Research Institutes

6.14 All 9 CRIs have policies for identifying and managing intellectual property, and for commercialising intellectual property. Each CRI also has supporting procedures for identifying, managing, and commercialising intellectual property.

6.15 Most policies and procedures define intellectual property and make it clear that such property arising from the duties of an employee belongs to the CRI. The documents typically remind employees of the need to exercise caution and to seek approval for articles, presentations, and other activities that might reveal confidential information or inadvertently assign ownership. The documents generally specify that staff need to obtain approval before they can seek to register intellectual property (for example, by applying for a patent).

6.16 A number of CRIs provide a clearly documented process that is used to commercialise ideas. This is typically a staged process (for example, conceptualisation, screening, selection, development, and investment) with a specified process for senior management, committee, and Board decision-making. The processes usually specify that legal and other advice must be obtained.

6.17 While these policies and procedures provide useful background on intellectual property generally, the focus of our study was on the sharing of benefits with employees. Our examination of the 9 CRI policies supplied shows that:

- Two clearly state that intellectual property is not shared with staff.[9]
- One is silent on the matter.
- Three mention that intellectual property could be shared with staff, but the documents supplied gave no details of the policies or procedures for such sharing.[10]
- Three contain details of sharing intellectual property with staff, as described in the next paragraph.

9 This means that there is no direct reward or sharing of the revenue from commercialising a particular identified piece of intellectual property. It does not preclude less direct recognition, for example in a performance assessment and annual salary review process.

10 One of these reported that a policy was being prepared.

6.18 The 3 CRI policies with some detail had these features in common:

- a definition of qualifying commercialisation (such as receiving royalties, setting up joint ventures or subsidiary companies, or selling a technology);
- a definition of eligible staff, in terms of contribution (such as inventing scientist, product champion, or support team) and duration of eligibility (such as being dependent on remaining in employment);
- a specified formula for sharing the benefits with staff (a set percentage or a sliding scale of percentage against total revenue) or a statement that it will be considered case by case; and
- reference to a decision-making process for sharing benefits (such as a committee or senior management), often with a higher-level approval for larger amounts.

6.19 The policies are reasonably clear in defining the total reward that would be provided for a particular item of commercialisation. They are less clear in defining the process for deciding which staff would be entitled to a share of the total reward, what their individual share would be, and whose judgement would be involved.

6.20 We received 6 examples of payments made to staff, all from the 3 CRIs that have detailed policies for sharing the benefit of commercialisation with staff.[11] All 6 examples are in accordance with the policies (albeit with one case being a retrospective application of the policy to an event that had occurred before the policy was adopted). None of the examples involved the staff member being given an equity shareholding in a subsidiary or other company, although some policies did provide for this option.

6.21 Five of the examples involve the ongoing payment of a share of royalties or licence fees received from a third party for the right to use a product commercially. Across all 5 examples, a total of fewer than 10 staff received individual benefits of between $1,000 and $3,000 each year, dependent on the level of sales. The other example was a one-off payment after an item of intellectual property was sold to a third party.

Findings – tertiary education institutions

6.22 We received returns relating to 8 universities, 3 colleges of education, 19 polytechnics, and 2 wānanga. At the date of the preparation of this report, we had not yet received information from the auditors of 2 TEIs.

11 We asked for up to 3 examples from each CRI but did not ask how many cases there were in total. It is therefore not possible to estimate how many cases there were.

6.23 We report the TEI findings in 2 groups because there is a marked difference in intellectual property practices between these groups. The 2 groups are:

- the universities (8 entities).
- the colleges of education, polytechnics, and wānanga (24 entities).

Universities

6.24 The 8 universities all have policies and procedures for identifying and managing intellectual property. Nearly all also have policies and procedures for commercialising intellectual property.

6.25 The policies define intellectual property and assert the university's ownership, with some clearly defined exceptions. In general, staff are able to retain ownership of scholarly publications and teaching materials (with some conditions), in keeping with academic traditions and scholarly activities. Students are not employees and own the intellectual property they create, with provision generally being made, through a written agreement, for shared ownership of intellectual property arising from the work of post-graduate students and their supervisors.

6.26 Most universities have established a subsidiary company to take responsibility for managing all cases of commercialisation of intellectual property. Seven policies refer to sharing the benefits with staff and students, while one is silent. There is limited reference to specific shares or any formula, but reference is made to principles (such as fairness and recognising relative contributions) and the need to negotiate on a case-by-case basis.

6.27 There are 3 ways in which the benefits could be shared with staff – a share of royalties or licence fees, an equity shareholding in a subsidiary or other company, or a share in the proceeds of a sale.

6.28 We received 15 examples of sharing intellectual property with staff.[12] Fourteen of these examples conform to the relevant entity's policy. The remaining example is an equity shareholding benefit not detailed in the policy. The auditor assessed this benefit as being reasonable on the basis of the supporting documentation and agreements drawn up between the parties involved.

6.29 Ten of the examples involve intellectual property that is licensed by the university to a third party to use. This third party pays royalties (dependent on the level of sales) to the university, which shares the benefit with eligible staff. The percentage received by staff was negotiated and varies from example to example, but we note that one-third shares (the university as a whole, the department, and individual staff) are common. While data is incomplete for 2 of these examples, the other 8 involve a total of fewer than 20 staff receiving varying individual amounts, with an average payment of $2,500 each year.

12 As with the CRIs, it is not possible to estimate how many cases there were in total.

6.30 The other 5 examples involve equity arrangements. The intellectual property was transferred into the ownership of a company (either existing or newly established) in exchange for a share of the equity in that company. The equity holding was then split between the university and the staff who had contributed to the development of the intellectual property. The value of these equity arrangements to individual staff is unknown as it depends on the commercial success of the company over time. This will be reflected in the future share price and any dividends paid. From the information available to us, we have formed the view that the financial benefit to individual staff in some of the university examples could be substantial.

Other tertiary institutions

6.31 The 24 non-university TEIs (colleges of education, polytechnics, and wānanga) reported significantly less established practices for identifying, managing, and commercialising intellectual property. In summary:

- Seven have no policies or procedures for either identifying and managing intellectual property or commercialising it.
- Two have some general policy, but have not prepared any procedures.
- Five have policies and procedures for identifying and managing intellectual property, but do not have a policy or procedures for commercialising it.
- Ten have policies and procedures for both identifying and managing intellectual property, and commercialising it.

6.32 We note that the policies vary considerably in their coverage and comprehensiveness. Some are rudimentary while some are comprehensive, including a number that appear to have been modelled on some of the university documents. Those that do refer to commercialising intellectual property generally say that the benefits will be shared between the creator(s) and the institution, without specifying any formula or details. A number of entities reported that they were working on their policy at the time of our audit.

6.33 None of the 24 entities have examples of staff receiving benefits from commercialising intellectual property. This was because most entities have not commercialised any intellectual property.

Commentary – CRIs and universities

6.34 In general, the CRIs and the universities have policies for commercialising intellectual property and, in some cases, for sharing the benefits with staff.

6.35 Whether individual institutions should share the benefits of commercialising intellectual property with staff is a policy decision for the institution to make, within the context of any government policy. Our interest is in ensuring that any such sharing arrangement is managed appropriately with due regard to the protection of public resources and assets, and to probity.

6.36 We are encouraged by the fact that all the examples (with one exception) have been in accordance with the relevant entity's policy, and that all examples have been supported by appropriate documentation.

6.37 We are also encouraged by the general presence of a decision-making group or process for exercising judgements (such as the relative shares and exactly who is entitled to participate in a particular case of sharing). These matters are properly for the judgement of management or the Board or Council (guided by the policies), as opposed to being decided by those who could potentially personally benefit.

Commentary – other tertiary institutions

6.38 For the other TEIs (colleges of education, polytechnics, and wānanga), the situation is less clear. It is not clear how much intellectual property such institutions create.

6.39 However, it is clear that there is currently little commercialisation of intellectual property. This may be because there is little intellectual property in the first place or it may be because the institutions are not taking advantage of opportunities to commercialise the intellectual property they do possess. We note that about 40% of these institutions have policies for commercialising intellectual property and assume that they have done so because they envisage there being opportunities to commercialise now or in the future. On this basis we also assume that most of the other 60% have similar opportunities.

6.40 We recommend that each institution first consider what intellectual property it generates and then make an assessment of the possibility of commercialisation. If there is a reasonable prospect of commercialisation, the institution should prepare (or enhance) a policy to govern this commercialisation for the benefit of the institution. Whether such a policy provided for any sharing of the benefits with staff would be a decision for the institution's governing Board.

Conclusions and recommendations

6.41 We chose to look at the management and commercialisation of intellectual property, and any sharing of benefits with staff, because we have an interest in

how public entities protect their resources and whether they act with due regard to probity.

6.42 We expect that public entities with opportunities to commercialise intellectual property will have clear policies and procedures, including procedures to ensure that decisions on the sharing of benefits with staff are made with due regard to the protection of public resources and to probity.

6.43 We found that CRIs and universities have policies that provide clear decision-making processes. There were no probity concerns in the examples we examined. The situation with other TEIs (polytechnics, colleges of education, and wānanga) is less clear because of the varied state of their policies and procedures. We recommend that each institution first consider what intellectual property it generates and then make an assessment of the possibility of commercialisation.

6.44 As with any corporate policy, we recommend that the universities and the CRIs monitor the operation of their policies and periodically review their policies based on their experiences and on developments in good practice.[13]

13 A number of agencies have an interest in good practices in managing intellectual property. We draw attention, for example, to reports published in 2005 by the New South Wales Auditor-General (*Follow-up of Performance Audit: Management of Intellectual Property*) and by the Victoria Auditor-General (*Managing intellectual property in government agencies*).

Part 7
Planning and managing for better public sector performance

7.1 The Managing for Outcomes (MfO) initiative was agreed by the Government in December 2001. This new initiative sought to improve how government departments planned, managed, and reported on their activities. MfO has been progressively implemented across the public service since 2002-03. All public service departments and Offices of Parliament are now part of the MfO initiative. A similar initiative, called Managing for Results (MfR), is being implemented in the Crown entities sector from 2006-07.

7.2 MfO is designed to bring about significant improvements in the performance of the New Zealand public service. The Auditor-General's statutory mandate includes consideration of the performance of public entities. The Auditor-General therefore has a strong interest in ensuring that the MfO initiative is effective in meeting its objectives.

7.3 This Part describes what the MfO initiative is, and the basis of the Auditor-General's interest in MfO. We outline what we know about MfO's effectiveness to date in bringing about improvements in departmental planning processes as reflected in statements of intent (SOI), and where further work may be warranted. We will be considering what work we might undertake in relation to MfO to enhance Parliament's and the public's understanding about the effectiveness of MfO as an important public sector management initiative.

What is managing for outcomes and managing for results?

Departments – Managing for Outcomes

7.4 MfO seeks to encourage a more strategic and outcome-based approach to departmental planning, management, and reporting. Ultimately, MfO is about Government initiatives achieving better results for New Zealanders.

7.5 MfO encompasses the full management cycle of setting direction, planning, implementing and delivering, and monitoring the impact or result of initiatives to inform future direction and plans. The aim is to ensure that departments' limited resources are deployed for the optimal public benefit. It also concerns departments developing their capability for the effective and efficient delivery of services. Departments tailor the components of the MfO process to their particular purpose, needs, and functions.

How is MfO co-ordinated?

7.6 In agreeing to the MfO initiative, the Government established a co-ordination and leadership role for the State Services Commission (SSC), the Treasury, the Department of the Prime Minister and Cabinet and Te Puni Kōkiri.

7.7 To implement MfO in the public service, these agencies initially formed an MfO Steering Group that met regularly and published both MfO and SOI guidance for departments. This guidance is accessible through both the Treasury and SSC websites.[1] Over the course of the last 4 years, this guidance has been revised and extended to take account of lessons learned along the way. Overseas experience has also been drawn on. More recently, the leadership and co-ordination of MfO has occurred through regular liaison between central agencies, particularly the Treasury and the SSC.

Statements of intent (SOI)

7.8 At the time MfO was implemented, Cabinet decided all departments were to prepare SOIs. Before then, departments were required to prepare a Departmental Forecast Report that had a strong focus on outputs. SOIs on the other hand require a strategic focus on outcomes promoted through MfO.

7.9 The requirement to prepare an SOI is now a legislative requirement in the 2004 amendment to the Public Finance Act 1989. All departments are to state their operating intentions at the beginning of the financial period and report against those intentions at the end of the period. Each department must prepare an SOI setting out its operating intentions and performance expectations for the ensuing financial year,[2] while taking a medium-term (3-5 year) approach. The SOI should provide a summary of a department's intentions as derived from its MfO thinking.

7.10 Broadly speaking, SOIs describe:

- the nature and scope of the department's functions;
- what the department is trying to achieve and why – and how it will go about doing this; and
- the main measures and standards (financial and non-financial) that the department intends to use to assess progress.

7.11 The SOI is a public document that is presented to Parliament on Budget Day each year, along with the Estimates of Appropriations. Each SOI is signed by both the Chief Executive and Responsible Minister.[3]

7.12 The latest departmental SOI guidance issued by the SSC and the Treasury states that SOIs should set out both the key elements of a department's plans and the thinking behind that planning.[4] It notes that "...by its nature, the SOI provides a public window on a department's efforts...".[5]

1 See http://www.ssc.govt.nz/display/document.asp?navid=253 and http://www.treasury.govt.nz/publicsector/.

2 Section 39 of the Public Finance Act 1989.

3 Sections 39(2)(b)(i) and 42 of the Public Finance Act 1989.

4 *Guidance and Requirements for Departments: Preparing the Statement of Intent*, State Services Commission and the Treasury, December 2005, page 3.

5 Ibid, page 6.

7.13 The SSC and the Treasury state that MfO is about "much more than the production of a document for Parliament". They also state that MfO helps facilitate departments' reporting on their results, thereby promoting transparency to Parliament and the public.[6]

7.14 We consider the SOI to be an important accountability document. When the implementation of MfO began, we formally advised the SSC, the Treasury, and all public service chief executives of our interest in both the MfO process itself and the quality of content of SOIs. In providing feedback to departments on draft SOIs, our comments reflect our expectation that SOIs should adhere to the guidance provided by the Treasury and the SSC.

Crown entities – Managing for Results

7.15 A similar focus on results-focused planning and management has been introduced in the Crown entities sector – the Managing for Results (MfR) initiative – through the Crown Entities Act 2004 (the CEA).[7] The SSC and the Treasury are performing a key leadership role with MfR. They have issued both MfR and SOI guidance for Crown entities.

7.16 The implementation of MfR begins with the 2006-07 SOIs of Crown entities.[8] The Crown entities sector is not as homogenous as the public service. Crown entities vary considerably in both size and complexity of business. There are 5 categories of Crown entity and for 3 of those categories the CEA contains different planning and reporting provisions.[9]

7.17 Based on our experience as the auditor of all classes of Crown entities, we anticipate a varying degree of ease with which the sector as a whole will come to terms with the reporting requirements of the CEA. Some Crown entities produce SOIs that meet most (if not all) of the requirements set down in the CEA. For other Crown entities, the new legislation will require a different approach to planning and reporting.

7.18 The Office of the Auditor-General is working closely with the Treasury and the SSC as they consider what further guidance might be useful for the Crown entities sector. Similarly, the appointed auditors of Crown entities are working

6 Ibid, page 5.

7 Before the Public Finance Amendment Act 2004 and the Crown Entities Act 2000, the expression "outcome" was used synonymously with "results". The language of the 2 Acts has been expanded to include 3 related concepts of "outcomes", "impacts", and "objectives. "Results" is used to include all 3 concepts.

8 This provision of the CEA does not apply to tertiary education institutions or school Boards of Trustees.

9 Statutory Crown entities, Crown entity companies, and Crown entity subsidiaries.

constructively with Crown entities and their monitoring departments[10] as they start to prepare their first SOIs under the new regime.

What is the Auditor-General's interest in Managing for Outcomes?

7.19 The Auditor-General provides assurance to Parliament and New Zealand taxpayers and ratepayers that public resources are being applied for the public benefit by public entities.

7.20 The Auditor-General seeks to ensure, through the audit opinion or the entity's statements of account, that Parliament and other audiences are provided with:

- good quality information about the performance of public entities; and
- a fair representation of that performance.

7.21 SOIs set out critical forecast financial and service performance information that departments report against in their annual reports. In order for a public entity to demonstrate that it is applying public resources for the public benefit, it needs to state what outcomes it is trying to achieve (and, importantly, why), how its activities will contribute to those outcomes, and how it will measure those contributions. This should be set out in departmental SOIs. It is against this statement that departments are held to account in their annual reports, which contain the audited financial statements that Parliament scrutinises through its financial review examinations.

7.22 Although the Auditor-General does not have a statutory audit role in relation to departmental SOIs, the SSC and Treasury's guidance for departments notes that "it is good practice to ask [the] auditor to review the SOI".[11] This, in part, reflects the Auditor-General's statutory role in auditing the statement of service performance as part of the annual audit of departments' financial statements, and advising select committees as part of the Estimates of Appropriations process. Departmental SOIs form part of the accountability information presented to select committees for scrutiny.

Has Managing for Outcomes been effective in improving departmental statements of intent?

7.23 MfO has the potential to improve the quality of departmental planning, management, and reporting. The results of this improved process should be fully reflected in a department's SOI.

10 Monitoring departments provide support to a Minister in carrying out their role and responsibilities in relation to Crown entities. For example, the Ministry of Education is the monitoring department for the New Zealand Qualifications Authority, the Tertiary Education Commission, and other education sector Crown entities.

11 *Guidance and Requirements for Departments: Preparing the Statement of Intent,* State Services Commission and the Treasury, December 2005, page 17.

7.24 In our view, there have been some incremental improvements in the quality of some SOIs since the implementation of MfO in 2002-03. However, there is still room for improvement.

7.25 An evaluation of departmental SOIs completed in September 2004[12] found that government departments had done "a great deal of work in developing their SOIs" under MfO.[13] Some of the specific findings of the evaluation that are of relevance to this Part were that:

- On a scale from "developed" (high) to "basic" (low), only one of the 35 SOIs reviewed was rated as developed. Twenty-two were rated from moderate to just below developed. Ten were rated from fair to just below moderate. Three were rated somewhere between basic and fair.
- Of the 34 departments whose SOIs were reviewed to assess the level of improvement between 2003 and 2004, one had shown major improvement, 8 substantial improvement, 15 some improvement, and 10 between little improvement and just below some improvement.[14]
- Departments' identification of their capability needs and their environmental scans featured relatively strongly in their SOIs. These 2 areas scored highly in the evaluation.
- Departments could better articulate the output "trade-offs" they were making in their SOIs. Even though the evaluators acknowledged that alternative output analysis "is hard to include in an SOI because it is about the process of planning",[15] there is scope for the strategy behind the output choices to be properly outlined in the SOI.
- Departments' SOI commentaries on attribution (that is, the extent to which their outputs are contributing to the desired outcomes) needed to improve, as did departments' use of evaluation, research, and monitoring.

7.26 After reviewing the draft SOIs for 2005-06, we convened a meeting of the appointed auditors of all government departments. The purpose of the meeting was to share views on the overall quality of 2005-06 departmental SOIs, and identify any consistent themes as to how SOIs could be improved.

12 *Evaluation of New Zealand Government Departments' 2003 and 2004 Statements of Intent (SOIs)*, Dr Paul Duignan, Pat Duignan, and Sally Munro, September 2004.

13 Ibid, page 7.

14 Ibid, page 7.

15 Ibid, page 11.

7.27 Generally speaking, we consider that the quality of 2005-06 SOIs across the public service was variable. Again, we have noted only incremental change since 2004-05 in the overall quality of SOIs. We identify 3 particular areas where we consider that more substantial improvement needs to be made:

- There is a lot of scope for departments to better articulate in their SOIs the logic and evidence that links the key outputs they produce to the outcomes they are working towards.
- Departments could be more comprehensive in their identification of the risks that face their organisation, and provide more detail on how they are actively managing those risks. Some departments have told us that Parliamentarians' and the public's appetite for risk is set so low that this provides no incentive for departments to fully disclose the risks.
- Departments should seek to continually refine their output and outcome indicators. When SOIs were first introduced, we did not expect departments to include outcome reporting in their statements of service performance at the initial stages. However, we continue to see a distinct separation of outcome and output reporting in annual reports (with the audited financial statements almost exclusively containing output reporting). We expect the gradual introduction of some outcome reporting into departments' audited financial statements.

7.28 We recognise that the development of SOIs is an iterative process. However, we consider that the pace of change needs to be accelerated. It is important that the Treasury and the SSC pursue their co-ordination and leadership role in harmony and with the energy necessary to ensure that departments and Crown entities engage fully with the underlying intent of MfO and MfR.

Conclusions

7.29 MfO underpins departments' planning, management, and reporting for how they use the public resources they receive to fulfil their functions. A critical public accountability document is the SOI. The Auditor-General has a significant interest in both MfO and the SOI.

7.30 There was an independent evaluation in 2003 to assess the extent and quality of selected departments' uptake of the MfO initiative.[16] However, there has not been an overall evaluation to assess whether MfO is achieving its objectives. We have noted some incremental improvements in the quality of departmental planning and the quality of departments' core planning document with the introduction of

16 *Departmental Uptake of the Managing for Outcomes Initiative*, Economics and Strategy Group for the interdepartmental Managing for Outcomes Steering Group, August 2003, Wellington, New Zealand, ISBN 0-478-24436-3.

the MfO initiative. Generally speaking, the SOI provides a better quality and range of planning information than its predecessor, the Departmental Forecast Report.

7.31 We encourage departments to take a continuous improvement approach to the ongoing development of their MfO processes and SOIs. This is particularly so given that we are yet to see a demonstrable improvement in the quality of departmental performance reporting, which we might naturally expect as a positive flow-on effect from the quality of planning that MfO promotes.

7.32 We expect that Crown entities will look to their monitoring departments, as well as to the MfR and SOI guidance issued by the Treasury and the SSC, for support and guidance as they produce their results-oriented SOIs for the 2006-07 financial year. We consider that high quality departmental MfO processes and SOIs have the potential to act as a positive benchmark for Crown entities to try to meet as they respond to the enhanced planning requirements set out in the CEA.

7.33 It may be that further oversight mechanisms need to be put in place, or further steps need to be taken by the Treasury and the SSC, to provide the momentum that we consider is required to ensure that departments continuously improve the quality of their MfO processes and SOIs.

7.34 We are considering what further work we can undertake to provide assurance to Parliament as to the effectiveness of the MfO initiative, and what, if any, lessons may be learned for the implementation of the MfR initiative in the Crown entities sector. In the meantime, as far as is consistent with our audit independence, we will continue to work with the Treasury, the SSC, and those public entities producing SOIs (both departments and Crown entities) to try to enhance the quality of SOIs as a core public accountability document.

Part 8
The accountability framework for Māori Trust Boards

8.1 We have previously expressed concerns in 1993, 1995, and 1998[1] to Parliament about the audit and accountability arrangements for those Māori Trust Boards (MTBs) governed by the provisions of the Māori Trust Boards Act 1955 (the Act). As the legislative framework for the MTB sector remains largely unchanged since we last reported publicly in 1998, and the Auditor-General is still the auditor of all the MTBs that are subject to the Act, we considered it timely to report again to Parliament.

8.2 This Part outlines the accountability arrangements for MTBs under the Act, and our views on the shortcomings of these arrangements. In forming our views, we have drawn on our discussions with the 12 MTBs we have met with over the last year. We continue to believe that a review of the Act is urgently required.

8.3 We also set out the status of MTB annual audits for the last 4 years as at 31 December 2005.

What is the Māori Trust Board sector?

8.4 A significant number of Māori organisations, formed along both tribal and non-tribal lines, operate in the non-government sector. They exist for a wide range of commercial, social, and cultural purposes.

8.5 MTBs exist to manage tribal assets for the general benefit of their beneficiaries. They are able to provide money for the benefit or advancement of their beneficiaries and to apply money towards the promotion of health, social, and economic welfare, and education and vocational training.[2]

8.6 The Act defines a beneficiary as any person for whose benefit the assets of a MTB are administered under the Act.[3] Part 1 of the Act further defines who constitutes a beneficiary for each of the MTBs governed by the Act. Each definition is slightly different. Generally speaking, though, MTB beneficiaries are those persons who have genealogical links to the tribe(s) that the MTB represents.

8.7 Many MTBs are negotiating Treaty settlements with the Crown, or preparing to receive fisheries assets under the Māori Fisheries Act 2004. This means many MTBs are reconsidering their legal form (particularly because a MTB under the Act does not meet the criteria for receiving fisheries assets under the Māori Fisheries Act 2004). This has led to a gradual reduction in the number of MTBs – from 19 in 1993 to 16 by mid-2005.

1 *First Report for 1993* (parliamentary paper B.29[93a]), *First Report for 1995* (parliamentary paper B.29[95a]), and *Second Report for 1998* (parliamentary paper B.29[98b]).

2 Section 24.

3 Section 2.

8.8 Seventeen MTBs were governed by the provisions of the Act for all or part of the 2004-05 audit period.[4] They were:

- Aorangi;
- Hauraki;
- Maniapoto;
- Ngāti Whātua ki Orakei;
- Taranaki;
- Tauranga-Moana;
- Te Arawa;
- Te Aupōuri;
- Te Tai Tokerau;
- Te Rūnanga o Ngāti Awa;
- Te Rūnanga o Ngāti Porou;
- Te Rūnanga o Ngāti Whātua;
- Tūhoe-Waikaremoana;
- Tūwharetoa;
- Wairoa-Waikaremoana;
- Whakatōhea; and
- Whanganui River.

8.9 These MTBs are public entities under the Public Audit Act 2001, and are therefore audited by the Auditor-General. The Auditor-General is not the statutory auditor of any MTB subsidiary entities. However, he has accepted audit appointment requests for a number of MTB subsidiary entities under section 19 of the Public Audit Act.

8.10 The Act prescribes the responsibilities and obligations of the Minister of Māori Affairs (the Minister) for MTBs. However, and importantly, MTBs are not Crown entities; nor are they in any other way an institution of the Crown.

8.11 Over the years, MTBs' operations have become more sophisticated. Many of the MTBs operate subsidiary companies and trusts that conduct both non-profit and profit-based activities for the overall benefit of the MTBs and their beneficiaries. For example, one MTB that we audit owns a number of commercial properties, and is involved in (through its subsidiaries) retirement village businesses and a health clinic. Some MTBs also manage fishing quota, and operate significant education, training, and social services providers. It is the defined nature of MTBs' beneficiaries (MTB "benefits" not being distributed to all New Zealanders), and

4 By 30 June 2005, there were 16 MTBs – with the disestablishment of Te Rūnanga o Ngāti Awa as an MTB governed by the Act on 24 March 2005, as part of its Treaty settlement process with the Crown.

the very complex and modern nature of their activities, that led many of the representatives of MTBs that we have met with to question the relevance of the Act.

What is the accountability framework for Māori Trust Boards?

8.12 The Minister has a significant role in the governance of, and accountability arrangements for, MTBs. The specific details of the Minister's role are set out in the Act. Various aspects of the accountability framework are outlined below.

8.13 In planning their activities, MTBs need the Minister's approval for their annual statement of estimated receipts and proposed payments for the next financial year.[5] MTBs are then required to keep full and accurate accounts of all of their receipts and payments.[6] The Act also requires MTBs to prepare annual statements that set out their financial position and financial operations at the end of each financial year. These must be audited by the Auditor-General, who in turn forwards copies of the financial statements and audit report to the Minister.[7]

8.14 While the Act does not specify a statutory deadline for providing financial statements for audit and completing the annual audit, the Auditor-General requests that his auditors complete the annual audit on his behalf within 5 months of the balance date. For the most part, this means that MTB audits are due to be completed by 30 November each year. However, there are 4 MTBs with a 31 March balance date, which means that their audits are considered outstanding if they are not completed by 31 August each year. The current status of the 2004-05 audits for the MTB sector is discussed in paragraph 8.22.

8.15 The accountability framework also requires an MTB to seek the Minister's approval for the remuneration of an MTB's Secretary (equivalent, in some cases, to a general manager or chief executive),[8] and for any benefits paid to a Board member using Board funds that are not related to their capacity as a Board member. The prior approval of the Minister is also needed if an MTB proposes to make total payments in any year that would exceed by more than 10% the total of payments in the budget approved by the Minister (see paragraph 8.19).

8.16 While the Minister is a central figure in the present accountability framework provided for under the Act, an MTB's "books" may be inspected and copies taken free of charge by any beneficiary, any member or officer of the Board, or any

5 Section 32.

6 Section 30.

7 Section 31.

8 Section 19.

person authorised by the Minister.[9] Many of the MTBs are also governed by their own Act of Parliament (such as the Orakei Act 1991 and the Hauraki Māori Trust Boards Act 1988), which places other requirements on their activities. For example, 6 of the MTBs that were established in the late 1980s have an obligation in their own Acts to hold annual meetings to report to beneficiaries on their activities and their plans for the future. These meetings are publicly notified.

Are Māori Trust Boards meeting their accountability requirements?

8.17 There has been an improvement by MTBs in complying with some aspects of the accountability requirements set out in the Act, but certain other requirements, particularly relating to timeliness, are still not being met by many MTBs.

8.18 Generally speaking, most MTBs do not have the Minister's approval for their annual statement of estimated receipts and proposed payments (budget) for the next financial year before that year begins – by 1 July for those MTBs with a 30 June balance date, and by 1 April for those 4 MTBs with a 31 March balance date. Based on information provided by Te Puni Kōkiri,[10] none of the 16 MTBs[11] had their 2005-06 budgets approved before that financial year began. However, Te Puni Kōkiri advised us that 10 of the 16 MTBs had their 2005-06 budgets approved before 31 December 2005. The time taken to process some of these applications meant that, in some instances, there was a delay between the dates that the budgets were submitted to the Minister and the dates of Ministerial approval.

8.19 In addition, there were no instances in 2004-05 where an MTB sought the prior approval of the Minister for expenditure in terms of section 32(3). Neither were any retrospective applications made to the Minister during 2004-05 for this purpose.[12]

8.20 Where legislative breaches occur, we encourage MTBs to disclose them in the notes to their financial statements. If such disclosures are not made, we consider whether the audit opinion should draw attention to these breaches.

8.21 The Act requires MTBs to prepare annual statements that set out their financial position and financial operations at the end of each financial year. The Auditor-General requires the auditors he appoints to complete the annual audits of MTBs within 5 months. In each of our previous reports to Parliament in 1993, 1995, and 1998, we have expressed concern about the timeliness of MTBs' preparation

9 Section 30.

10 Te Puni Kōkiri is the Māori name of the Ministry of Māori Development – the agency that undertakes a number of tasks relating to MTBs on behalf of the Minister.

11 We have deliberately excluded Te Rūnanga o Ngāti Awa from this analysis, as it was disestablished as an MTB under the Act on 24 March 2005.

12 The information has been obtained from Te Puni Kōkiri because not all the 2004-05 audits are complete yet.

of their financial statements, and how this detracts from the purpose of having audited financial statements. As at 31 December 2005, our audits of financial statements for the 2004-05 year had been completed for only 7 MTBs.

8.22 Of the 10 MTBs that had outstanding audits for 2004-05, 6 of them also had audits still outstanding for earlier years. Two MTBs have yet to have an audit opinion issued for the 2001-02 financial year. The outstanding audits by year are show in Figure 8.1.

Figure 8.1

Status of Māori Trust Board audits as at 31 December 2005

Some audits are still outstanding for the 2002, 2003, 2004, and 2005 financial periods.

	2002	2003	2004	2005
Number of MTBs in audit portfolio	17	17	17	17
Number of audits completed	15	14	11	7
Number of audits in arrears	2	3	6	10

8.23 There are several reasons for these outstanding audits, including:

- delays by MTBs or their accountants in producing financial statements for audit;
- delays by MTBs or their accountants in making the necessary amendments after initial audit work has been completed;
- delays in the completion of MTB subsidiary audits that are needed for group consolidation purposes (as noted previously, the Auditor-General is not the statutory auditor of MTB subsidiary entities);
- difficulty in resolving technical accounting and auditing issues, such as the valuation of assets; and
- competing demands on audit resources when the initial timeframes set to complete the audit are not met due to the reasons outlined above.

8.24 At a sector level, MTBs also appear to have difficulty complying with some of the more minor aspects of the current accountability framework. For example, in 2004-05, the Minister's approval was never sought in advance for the remuneration of an MTB's Secretary. One application for retrospective approval was made (see footnote 12).

8.25 The Minister processed 4 requests to provide benefits from Board funds to an MTB member that were not related to their board membership, as required by section 37 of the Act.[13] All 4 of these requests were approved before the MTB provided the benefits to its Board member (see footnote 12).

13 These benefits are usually in the form of consultancy fees or loans. It should be noted that the Minister does not always grant retrospective approval to such applications.

Is the accountability framework for Māori Trust Boards appropriate?

8.26 We consider that there are a number of shortcomings in the current framework governing MTBs. The statute dates from 1955, and does not adequately encompass the usual characteristics of modern accountability frameworks; nor does it reflect the current operating environment for MTBs.

Accountability framework

8.27 In our recent meetings with MTBs, many of the Board members and Secretaries have expressed concern about aspects of the current framework. Some MTBs told us they consider that the compliance costs of meeting all of the legislative requirements in the Act outweigh the benefits of their (sometimes limited) receipt of public funds. Many of these MTB representatives also noted that each funding arrangement with a Crown agency often incurs its own specific reporting requirements in addition to the provisions in the Act.

8.28 The role of the Minister seems to give some MTBs comfort that they can demonstrate proper use of MTB resources. At the same time, MTBs seem to hold equal concerns about the relevance of the Minister's role, and about the practicality of meeting some of the provisions in advance.

8.29 In 1995, we noted that it was unclear why the Act places the Minister at the focus of the accountability framework for MTBs.[14] The legislation remains unchanged.

8.30 In 1998, we set out our view of the basic requirements of any revised accountability framework for MTBs. These remain relevant as general propositions in 2006. We consider that MTBs should be required to:

- consult with and advise their beneficiaries of their plans for the forthcoming year; and
- report against their plans to the beneficiaries each year at a general meeting and in an annual report (which includes audited financial statements) generally available to beneficiaries.

8.31 As a general principle, we consider that a trust's beneficiaries and their trustees should have a direct accountability relationship. Such an arrangement enables beneficiaries to hold trustees to account for their performance. In our view, Parliament and policy makers could usefully consider how this general principle could underpin any reform of the Act.

8.32 We also consider that any review of the Act should examine the appropriateness of Ministerial involvement in the activities of MTBs, the application of the Fees

14 *First Report for 1995* (parliamentary paper B.29[05a]), page 122.

and Travelling Allowances Act 1951 to payments to MTB members, and the auditing arrangements.

8.33 Another consideration in any review of the Act could be the currency of the election provisions set out in Part 3 of the Act, given that many MTB beneficiaries live away from their tribal areas, and the sophistication of digital technology. There could be a range of options for providing for a more efficient and flexible election process.

Remuneration arrangements

8.34 The remuneration of MTB members is governed by the Fees and Travelling Allowances Act 1951. Some resetting of the levels of fees paid to MTB members has occurred since we last reported to Parliament. However, given the largely non-public nature of MTB activities and the complexity and diversity of some MTBs' operations, we consider that the appropriateness of this framework for setting MTB member remuneration levels should be reconsidered.

Accounting and audit arrangements

8.35 In 1993, 1995, and 1998 we queried why the Auditor-General is the statutory auditor of MTBs. MTBs seem to prefer the current audit arrangements because the Auditor-General is independent. Some MTB staff told us that they feel that this helps them with any concerns about transparency that beneficiaries might have.

8.36 In the context of a review of the accountability framework, we continue to prefer a revised provision that allows for MTBs' beneficiaries to appoint an independent auditor at an annual general meeting. At the same time, the legislation could clarify MTBs' requirements to prepare financial statements that comply with generally accepted accounting practice in New Zealand. This is not explicit in the Act at present, but it is a requirement that we impose on MTBs because our audits must comply with the professional auditing standards set down by both the New Zealand Institute of Chartered Accountants and the Auditor-General. Setting a statutory timeframe within which an audit must be completed would also be desirable.

Conclusions

8.37 The most recent reform of the legislation governing the MTB sector occurred in 1996. A discussion paper proposing further reform was released by the Minister in June 1996. While several consultation meetings on this discussion paper were held with interested parties around New Zealand later in 1996, no further action has been taken on the proposals set out in the discussion paper.

8.38 Although the number of MTBs governed by the Act has been gradually reducing for the reasons set out in paragraph 8.7, this is a slow process. In our view, the accountability framework needs to be changed so that it meets modern standards for holding governing bodies to account for their performance and stewardship of an entity's operations. We again recommend that some legislative reform be given urgent attention by the Minister and Te Puni Kōkiri.

Part 9
Register of Pecuniary Interests of Members of Parliament

9.1 Amendments to the Standing Orders of the House of Representatives in 2005 established a Register of Pecuniary Interests of Members of Parliament (the register).[1] The Auditor-General has been given certain functions in relation to the register.

9.2 In this Part, we describe the register and, in particular, the Auditor-General's new functions.

Purpose and scope of the register

9.3 The new Standing Order requires members of Parliament to record and disclose certain personal financial interests. Members must disclose such things as business interests, employment, trusts, involvement in organisations seeking government funding, real estate, debts, overseas travel, and gifts.

9.4 In general, members of Parliament must file a return after being elected, and annually each February. The first returns were due to be filed in early 2006.

9.5 The register comprises all returns submitted by members.

9.6 Only the fact of a personal financial interest is required to be recorded in the register, not its value. The register is not designed to be a "register of wealth".

9.7 The purpose of the register is to promote greater transparency, openness, and accountability in the parliamentary process. It ought to strengthen public trust and confidence in the integrity of members of Parliament and, more broadly, the public sector. It brings Parliament into line with similar requirements that already exist for Ministers[2] and for members of legislatures in several other Commonwealth countries.

9.8 The register will be a useful tool to help identify and avoid possible conflicts of interest. However, by itself the register will not necessarily prevent or detect abuses of public office by members of Parliament; nor is it designed to do so. It only records interests. It does not record particular instances of conflicts of interest; nor does it address how a member should act when a conflict of interest does arise. Separate requirements for express disclosure where a financial conflict of interest arises in a specific situation in the House already exist for members of Parliament.[3]

9.9 Formally disclosing the personal financial interests of members of Parliament can help ensure that any conflicts of interest that arise are identified and carefully managed before they cause trouble. Such a disclosure minimises any temptation

1 See Standing Order 164 and Appendix B of the Standing Orders of the House of Representatives.

2 See the Cabinet Manual, paragraphs 2.52-2.55.

3 See Standing Orders 165-167.

for a member to use their office for personal pecuniary benefit, and also reduces the potential for false allegations of improper behaviour.

9.10 A registrar is appointed to compile and maintain the register, and to provide advice and guidance to members about their obligations. The inaugural registrar is a former Ombudsman, Judge Anand Satyanand.

9.11 The registrar publishes – on a website and in booklet form – a summary containing a description of the information in the returns.[4] The full returns themselves are not made public.

The Auditor-General's functions

9.12 The registrar supplies copies of members' returns to the Auditor-General. The Auditor-General has certain functions in relation to them. These functions are:

- review of returns (which is mandatory); and
- inquiry and report (which are discretionary).

9.13 The review function is –

> *The Auditor-General will review the returns provided* [by the registrar] *as soon as is reasonably practicable.*[5]

9.14 The inquiry and report functions are –

> *The Auditor-General may inquire, either on request or on the Auditor-General's own initiative, into any issue as to whether –*
>
> *(a) any member has complied, or is complying, with his or her obligations under* [the provisions relating to the register]*, or*
>
> *(b) the registrar has complied, or is complying, with his or her obligations under* [the provisions relating to the register].
>
> *The Auditor-General may, after he or she has completed an inquiry ..., report to the House the findings of the inquiry and any other matter that the Auditor-General considers it desirable to report on.*[6]

Review

9.15 We do not intend the regular review of returns to involve a detailed audit. Our review will not attempt to verify or certify that the details in every return are accurate and comprehensive, and we do not propose to investigate the interests or activities of members of Parliament beyond what is contained in returns. To do

4 The registrar also publishes explanatory notes and forms to assist members of Parliament to comply with their obligations. See http://www.clerk.parliament.govt.nz/Publications/Other/.

5 Clause 15(1) of Appendix B.

6 Clauses 15(2) and 15(3) of Appendix B.

this would involve obtaining separate information from each member to check the veracity of the interests disclosed (for example, proof of share ownership). To do this annually for every member would be time-consuming and unnecessarily invasive of personal privacy. It would be almost impossible to give positive assurance that every member had declared all applicable interests.

9.16 Our review of returns will enable us to check generally that all members have filed a return in the correct form and at the correct time, and whether the return appears to address all the necessary matters. Our knowledge of the contents of each member's return will help us decide when to exercise the inquiry function.

Inquiry

9.17 We will address serious questions about the truthfulness of a particular member's return on a case-by-case basis by conducting an inquiry. This is where we would, if necessary, verify precise details of a member's return. The primary focus of an inquiry would be on fact-finding. We would ordinarily report the findings of any such inquiry to the House of Representatives.

9.18 We can begin an inquiry on our own initiative or on request. For instance, we may begin an inquiry as a result of our review of returns, in response to concerns raised in the media, or after receiving a complaint from a member of the public or another member of Parliament.

9.19 We envisage that, in practice, our inquiry function will be exercised rarely.

Other consequences

9.20 The Standing Orders provide that a member of Parliament who knowingly fails to file a return when required, or who knowingly provides false or misleading information in a return, may be in contempt of the House. However, we would not be responsible for taking enforcement action against a member who has not complied with their obligations. As with most of our other functions, our role is simply to report our findings. Any further action against a member would be a matter for the House.

Summary

9.21 Our practice of reviews and inquiries is likely to develop over time. We expect to liaise closely with the registrar over the implementation of the register, especially in the early days as members of Parliament get used to these new requirements.

9.22 Sound processes and openness in managing conflicts of interest are essential to maintaining the integrity of Parliament. The register ought to assist this. We anticipate that our involvement will provide an additional measure of assurance over the operation of the register.

Part 10
Review of the New Zealand Lotteries Commission's "Instant Kiwi" game

Introduction

10.1 The Auditor-General decided to investigate issues raised by a taxpayer about a game of chance called Instant Kiwi and run by the New Zealand Lotteries Commission (the Lotteries Commission). The taxpayer asserted that Instant Kiwi players were being deliberately disadvantaged by the way the games are administered by the Lotteries Commission.

The New Zealand Lotteries Commission

10.2 The Lotteries Commission is a Crown entity. It was established in 1987 and is responsible for promoting and conducting lotteries to generate profits for the benefit of all New Zealand communities. Community funding is distributed by a separate organisation called the New Zealand Lottery Grants Board.

10.3 The Lotteries Commission's products include Lotto, Powerball, Keno, and Instant Kiwi, and are sold through more than 600 retail outlets throughout New Zealand. The Department of Internal Affairs administers the regulations that govern these games.

Instant Kiwi

10.4 Instant Kiwi is a ticket-based game that was introduced in September 1989. There are 12 different ticket streams on sale at any time, and about 60 new games are released each year. Tickets for Instant Kiwi games are in the form of a "scratch-to-win" card.

10.5 Prizes range from $2 to a maximum of $50,000 every year for 10 years, depending on the game being played. On average, between 2 and 3 players each week win $10,000 or more. There is a choice of $1, $2, $3, $4, $5, and $6 ticket prices. The prizes are printed on the tickets under strict security. Prizes are randomly distributed to ensure that no-one can detect where prizes are until a ticket is purchased and the latex covering is scratched off the prize area.

10.6 The Instant Kiwi game is a significant earner for the Lotteries Commission, with sales in 2004-05 of $105 million and prizes payable of $60 million.

Relevant legislation

10.7 The principal legislation that the Lotteries Commission operates under is the Gambling Act 2003. Operation of the Instant Kiwi game is regulated by the Instant Kiwi (Instant Game) Rules 1992 (the Rules).

10.8 In addition, the Lotteries Commission has internal policies and procedures that control how the games are managed and administered. These include a scheme of delegated operating authorities that is ratified by the Lotteries Commission on an annual basis.

How we conducted our review

10.9 Our review involved:

- detailed analysis of operational performance of games and prizes;
- discussion with senior officers;
- reviewing governing legislation, including the Rules;
- reviewing management arrangements, including policies and procedures;
- understanding and documenting systems and procedures;
- evaluating controls and testing compliance;
- testing the completeness and accuracy of the games summary to the prime record; and
- visiting selected Lotto retailer outlets.

10.10 The review was a limited scope inquiry and, accordingly, may not have identified all the matters that a more extensive investigation would.

Withdrawal of games

10.11 In considering whether the public has been disadvantaged by the way that the Instant Kiwi game is operated, we focused on the practice of withdrawing games before all tickets are sold. Under the Rules, the Lotteries Commission is permitted to close a game at any time before all tickets are sold. The question is whether this option is being fairly exercised.

10.12 Decisions to withdraw games are based on a recommendation by the Instant Kiwi product team for authorisation by the Chief Financial Officer (CFO) under delegated authority. The tickets are never completely sold out. Therefore, a game is closed and the remaining tickets cancelled when:

- all the top prizes for that game have been claimed;
- the warehouse ticket stock for that game is, or is about to be, exhausted; or
- a marketing decision is made based on a judgement about potential remaining sales on the existing game balanced with the cost of withdrawing unsold tickets, as compared to the revenues from the introduction of a replacement game.

10.13 The Instant Kiwi product team monitors the performance of current Instant Kiwi games and completes a template model that summarises the costs of

withdrawing an active game. This takes into account the wastage cost of tickets in stock and in trade, and expected sales up to the proposed date of withdrawal.

10.14 We tested a sample of game withdrawals and found documentation to confirm that the proper authority was exercised by the authorising officer – in these cases, the CFO.

10.15 The Lotteries Commission has a policy of stopping the sale of tickets in a game after all the top prizes have been claimed. This policy will tend to advantage the game-playing public in that the actual odds of winning a top prize will have exceeded the game design odds. However, in our review of the game summaries of 89 games closed between 2003 and 2005 inclusive, only 12 were withdrawn on the basis that all top prizes had been claimed.

10.16 The other games we examined were apparently closed for marketing reasons, based on either warehouse stock exhaustion or sales performance, with one or more top prizes remaining.

Duration of games and percentage of tickets sold

10.17 There is no fixed period for a game to remain on sale. The duration of the game will depend on its popularity as indicated by the rate of sales. It is in this context that the marketing decision is made on when to stop the game.

10.18 We analysed the duration of games closed during the years 2003 to 2005. The typical duration ranged from 60 to 100 days. At the extremes, the shortest duration was 39 days and the longest was 195 days.

10.19 There is also no minimum percentage of tickets that must be sold before the game is withdrawn. Accordingly, there was a wide variation in ticket sales for the 2003 to 2005 closed games. Ticket sales typically fall in the 60% to 85% range, though sales for individual games have been as low as 33% and as high as 99%.

10.20 One of the main issues we considered was whether withdrawing the game before all tickets are sold is detrimental to the public. While the Lotteries Commission may argue that games are being withdrawn because they are not selling, there is the risk, particularly given the Lotteries Commission's incentive to maximise profit, that games are withdrawn from sale when the potential revenue from unsold tickets is less than the outstanding prize liability.

10.21 There would clearly be a commercial advantage in withdrawing the game when the outstanding prize liability exceeds the potential revenue from unsold tickets. However, from our review of operating procedures and the information used to support the case for withdrawing a game, there is no evidence that this measure is used to influence (or even inform) the decision.

10.22 In 14 cases out of the total of 89 closed games in the sample period 2003 to 2005, the prize liability on unsold tickets exceeded the potential future revenues on these games (that is, a negative value).

10.23 The total negative value of these 14 cases was $812,621, compared with an overall positive value (where potential future revenues exceed the prize liability on unsold tickets) of $22.4 million across the other 75 cases. Accordingly, we can conclude that there is no evidence either procedurally or empirically that there is bias in terms of potential prize payout versus potential revenue when deciding to withdraw games.

Our findings

10.24 In our view, there is no intention to disadvantage the public through the early withdrawal of games – either before all major prizes have been claimed or when the remaining prizes exceed potential revenues from unsold tickets.

10.25 We found the majority of games were closed as a result of either ticket stock exhaustion or other marketing decisions.

10.26 The number of major prizes remaining should be explicitly taken into account when deciding to withdraw a game. The Lotteries Commission's policy to withdraw a game when all major prizes have been claimed will tend to advantage the public. Equally, there may be merit in deferring the withdrawal of a game when more than one top prize still remains to be claimed.

10.27 There are internal controls over the withdrawal of games and proper delegated authority was exercised. Nevertheless, there is scope for the Lotteries Commission to improve the transparency of the decision to withdraw games by defining policy and operating procedures, including criteria for judgement, and by recording the basis for the decision.

Game integrity

Game design

10.28 A design specification is prepared for each new Instant Kiwi game. In accordance with the Rules, each game design must be approved by the Auditor-General and the Department of Internal Affairs before the game can be released by the Lotteries Commission. The game design review confirms, among other things, that the design payout percentage and prize construction meets the legislative requirements.

Prize pool structure

10.29 Each game normally comprises a number of separate prize pools. The prize pools are structured in accordance with a defined multiple prize construction to give a specified number of winning tickets and, therefore, winning chances for each prize value.

10.30 The prize pool structure proves at the design stage that the required payout percentage will be achieved if all tickets in a given pool are sold. It also details the number of top prizes and the chances of winning those prizes.

10.31 The odds of winning a major prize, or indeed any prize, are determined at the outset of the game in accordance with the game design specification.

10.32 In theory, closing the game before all the ticket stock is sold makes no difference to the chances of winning. However, because Instant Kiwi is a game of chance and the prize pool is predetermined, in practice the opportunity to win future prizes is influenced by the pattern of prizes already won. This could be an advantage or disadvantage depending on when the game is closed and at what stage of the game the top prizes are claimed.

Our findings

10.33 The important question is whether the game design is affected by the performance of the game in practice. The only way to ensure that the prize pool as constructed in design is delivered to the playing public is by selling the entire ticket stock.

10.34 Although there are measures built into the ticket sequencing and multiple prize pools within a game to ensure an even distribution of prize opportunities, Instant Kiwi remains a game of chance. Therefore, the observed odds in play at any point may be different from the design intentions. The default position is that the difference between actual and expected prizes to achieve the design payout percentage is transferred to the Prize Reserve Fund (see paragraphs 10.43 to 10.54).

Payout percentages and unclaimed prizes

10.35 Applying the design payout prize percentage for each game to the actual sales will indicate the expected prize total for those sales. This expected prize total can be compared to the actual cash prize payout.

10.36 Comparing the actual prizes paid to gross sales turnover between 2003 and 2005 indicates actual prize payout percentages range from 42% to 72%.

10.37 In overall terms, the actual prizes paid as a percentage of sales were remarkably consistent for the 3 years – 52.5% in 2003, 52.7% in 2004, and 52.7% in 2005. But, at the level of individual games, the actual prize percentages were below the payout percentage specified in the game design in almost every case.

10.38 The overall scale of these differences is considerable. Instant Kiwi ticket sales on closed games examined for the period 2003 to 2005 totalled $183.9 million. The expected prize total on these sales based on game design payout percentages is $103.5 million. However, the total actual prizes paid out on these games was $96.7 million – being some $6.8 million, or 6.5%, less than that predicted.

10.39 Figure 10.1 provides a summary, although it should be noted that prizes may be claimed for 12 months after a game has closed. Additional claims on the 2005 games would reduce the margin of difference.

Figure 10.1
Expected versus actual prize totals for Instant Kiwi

Year ended 30 June	2003	2004	2005*	Total
Expected prize pool based on ticket sales	$40.6m	$32.4m	$30.5m	$103.5m
Total actual prizes paid	$38.1m	$30.6m	$28.0m	$96.7m
Difference between expected and actual	$2.5m	$1.8m	$2.5m	$6.8m
Difference as percentage of expected prize	6.2%	5.6%	8.2%	6.6%

* Figures have been updated to September 2005.

10.40 A comparison with other products within the Lotteries Commission range shows that Instant Kiwi has the highest percentage of unclaimed prizes in proportion to gross sales, as demonstrated in Figure 10.2.

Figure 10.2
Comparison of unclaimed prizes for New Zealand Lotteries Commission products in 2004-05*

	Lotto		Powerball		Strike		Keno		Instant Kiwi	
	($m)	(%)	($m)	(%)	($m)	(%)	($m)	(%)	($m)	(%)
Gross sales	312.9		122.2		66.8		23.2		105.3	
Prizes payable	162.7	52%	63.5	52%	36.7	55%	14.2	61%	59.7	57%
Unclaimed prizes	4.7	2%	1.7	1%	1.2	2%	0.2	1%	3.1	3%

* The figures are extracted from the Lotteries Commission's 2004-05 financial statements. Some caution is required when interpreting these numbers as the unclaimed prize totals relate to amounts transferred to the Prize Reserve Fund 12 months after game closure. Therefore, they are more a function of turnover in the prior year than the current year.

10.41 The long-run average of unclaimed prizes on Instant Kiwi amounts to 1.5% of sales (see paragraph 10.52). The Lotteries Commission asserts that the value of unclaimed prizes for all product ranges also amounts to 1.5% of sales for the same period. Nevertheless, during the last 3 years, the unclaimed prize rate on Instant Kiwi, at 2.6% of sales, has been slightly higher than the long-run average.

10.42 The reasons for the apparent shortfalls in the actual prizes paid over those expected in Instant Kiwi are not entirely clear. The game design's complexity will affect the level of unclaimed prizes. In the case of some Instant Kiwi games, it is conceivable that game players are simply not aware that they have won and therefore discard the ticket without claiming the prize.

Prize Reserve Fund

10.43 Rule 13(1)(b) provides that the Lotteries Commission shall pay into the Prize Reserve Fund "any prize money from any game remaining unclaimed on the expiry of 12 months after the close of that game".

10.44 We identified an ambiguity in the Rules relating to the Prize Reserve Fund. The issue is how the "prize money remaining unclaimed" is measured.

10.45 Twelve months after each game is closed, the "prize money remaining unclaimed" is transferred to the Prize Reserve Fund. The "prize money remaining unclaimed" is measured by the Lotteries Commission as the difference between the expected prize liability (the design prize payout percentage applied to actual sales) and actual prizes claimed. In other words, the measure of "prize money remaining unclaimed" is based on actual ticket sales rather than the total prize pool.

10.46 The prize pool as defined under Rule 10 is determined by the Lotteries Commission, but must meet a minimum 56% of notional turnover assuming that all tickets are sold. In terms of game design, we are satisfied that the prize pools are structured to meet this minimum prize percentage. The game design specifies the total prize pool in percentage and cash values assuming all tickets are sold.

10.47 The "prize money remaining unclaimed" could be taken for the purposes of Rule 13(1)(b) to represent the prizes remaining in the entire prize pool after deducting prizes paid on actual ticket sales. In other words, the actual prize payout would be based on actual ticket sales but the prize pool would be that fixed in the game design assuming all tickets are sold. Using this measure of "prizes remaining unclaimed" the transfers to the Prize Reserve Fund would be substantially increased, as in the majority of closed games more than 20% of tickets remained unsold.

10.48 This issue has been discussed with the Lotteries Commission. It acknowledges the point as being open to interpretation, but asserts that its operational practice in this regard has been consistently applied since Instant Kiwi began. The Lotteries Commission's approach is based on the interpretation of Rule 13(1)(b) that prize money remaining unclaimed means that prizes must have been won rather than simply forming part of the total prize pool. The Lotteries Commission has since proposed an amendment to Rule 13(1)(b) to the Department of Internal Affairs to make clear that "prize money remaining unclaimed" applies only to prize money expected to be paid in respect of Instant Kiwi tickets that have been sold.

10.49 The combined balance of the Prize Reserve Fund across all game brands at 30 June 2005 was $11 million. The balance in the Prize Reserve Fund at 30 June 2005 in respect of Instant Kiwi was $30.6 million.

10.50 The Rules also provide that the Prize Reserve Fund may be used to supplement any of the prize pools. In practice, the Prize Reserve Fund is predominantly used to top up the jackpot prizes on Lotto, Powerball, and Strike, particularly in the week after a big payout when the jackpot may otherwise fall short of target.

10.51 Although there have been special prizes to be won through the Instant Kiwi game from time to time, such as cars or scooters, the opportunity to use the Prize Reserve Fund to supplement Instant Kiwi is more limited. The positive balance in the Prize Reserve Fund in respect of Instant Kiwi of $30.6 million compared to a negative balance of $33.4 million in respect of Lotto and Strike demonstrates that Instant Kiwi is a net contributor to other prize pools.

Our findings

10.52 The scale of unclaimed prizes in the Instant Kiwi range is significant both in terms of value and percentage of ticket sales. An analysis of the Prize Reserve Fund for Instant Kiwi reveals total unclaimed prizes of $27 million since it began. Sales of Instant Kiwi during this period total some $1,780 million. Therefore, the long-run unclaimed prize percentage is 1.5% of sales. More recently, the unclaimed prize rate has been higher than the long-run average, which may warrant some further research.

10.53 These unclaimed prizes in the Prize Reserve Fund are applied to supplement the main Lotto prize pool, rather than being recycled into the Instant Kiwi pool. This is permitted under legislation.

10.54 We have identified an ambiguity in the Rules governing transfers to the Prize Reserve Fund for which the Lotteries Commission is seeking an appropriate amendment.

Availability of information on games and remaining prizes

10.55 When a new game is launched, each retailer receives a game summary and promotional material. Retailers are also provided with information regarding the sales and remaining prizes of individual games.

10.56 In addition, the retail lottery terminals can, on request, print a prize summary for each Instant Kiwi game on sale. The printout for each selected game shows the prizes claimed and remaining for each prize denomination. These printouts were readily made available to us on casual enquiry at retail outlets.

10.57 While the availability of this information is not publicly advertised, it could be used by a discerning player to assess prize availability and therefore make a more informed choice about which ticket to buy.

Our findings

10.58 Information about the key features of games in play is made available to the public at retail outlets. In addition, summary information is available from Lotto terminals to the enquiring public on the numbers of prizes claimed and remaining on any game.

Conclusions

10.59 We conclude that there is no evidence to uphold the assertion that Instant Kiwi players are being deliberately disadvantaged by the way the games are administered by the Lotteries Commission.

10.60 The legislative requirements as set out in the Rules are being observed.

10.61 However, our review identified a number of areas worth reporting, and scope to improve procedures and practice to remove any perception that Instant Kiwi game players have been disadvantaged.

10.62 Our findings have been discussed with the Lotteries Commission's management. The Lotteries Commission has welcomed the review and has responded positively to the issues raised about securing continuous improvement in both product design and operating arrangements.

Part 11
Planning for the transition to the New Zealand equivalents to IFRS

11.1 In this Part, we provide an update on the progress made by the central government sector towards the transition to accounting and reporting in accordance with the New Zealand equivalents to IFRS[1] (NZ IFRS[2]), and highlight some of the implications of that transition for the sector.

Background

11.2 In August 2003, the Government announced that NZ IFRS would be implemented in the financial statements of the Government as part of Budget 2007.[3] 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.

11.3 As this first set of NZ IFRS financial statements must include comparative figures presented on the same accounting basis, 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.

11.4 For those central government entities with 31 December balance dates (for example, tertiary education institutions and schools), the transition to NZ IFRS is 6 months earlier, meaning their opening balance sheets need to be restated at 1 January 2006.

The new standards and their anticipated effects on the central government sector

11.5 On 24 November 2004, the Accounting Standards Review Board (ASRB) approved the initial suite of standards for NZ IFRS. This initial group of approved NZ IFRS was described as the "stable platform". This term is used by the International Accounting Standards Board (IASB) to describe the standards to be applied by countries adopting IFRS from 2005. The approved NZ IFRS "stable platform" is the New Zealand equivalent to the IASB's "stable platform".

11.6 Some aspects of the "stable platform" have already been amended, and the IASB is continuing to develop IFRS. The IASB's work programme will lead to further changes to IFRS, and consequently NZ IFRS, before NZ IFRS are adopted by the central government sector. This creates a risk that some aspects of the adoption of

1 The term IFRS is used to refer to International Accounting Standards Board (IASB) standards. The standards comprise International Accounting Standards (IAS) inherited by the IASB from its predecessor body, the International Accounting Standards Committee, and the interpretations of those standards; and 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 IAS), and the interpretations of those standards; New Zealand International Financial Reporting Standards (NZ IFRS), and the interpretations of those standards; and New Zealand Financial Reporting Standards (FRS), where there is no equivalent IFRS.

3 Budget 2007 will set out the Estimates of Appropriations for the Government for the year ending 30 June 2008.

NZ IFRS will not be fully resolved by the time the relevant information is required to be captured. Future developments at the IASB and the resultant changes to NZ IFRS will need to be monitored.

11.7 However, we are expecting the majority of the "stable platform" to mostly stay as it is now. There is, in our view, enough certainty to enable the sector to plan for the transition to NZ IFRS, assess the implications for financial reporting, and make the transition.

11.8 Over the past year, the Treasury has done a significant amount of work to plan for the transition, including identifying the major areas of change and the potential difficulty for the financial statements of the Government. The Treasury disclosed its plans for the transition, and its assessment of the likely significant effects of the transition, in the financial statements of the Government for the year ended 30 June 2005.[4]

11.9 We have continued to work closely with the Treasury in planning for the transition. Our auditors are also working closely with sector groups and individual agencies within the central government sector. While some agencies have made significant progress, the progress of others has so far been limited. We discuss this further in paragraphs 11.25-11.31.

11.10 As many agencies in the sector have yet to fully assess the likely effects of the transition on their financial statements, we are currently not in a position to comment definitively on the expected effects. However, we observe 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 accrued sick leave).
- Some assets will no longer be recognised (for example, internally generated intangibles to the extent they exist in the sector).
- There will be more disclosures in the notes to the financial statements.

11.11 Probably the most significant change is in accounting for financial instruments. Current New Zealand Generally Accepted Accounting Practice (GAAP) sets out only disclosure requirements. NZ IFRS set up new rules for recognising and measuring financial assets and liabilities. Derivative financial instruments will need to be accounted for "on balance sheet" at fair value. There will also be an increased requirement to account for other financial instruments at fair value. This may increase the volatility of reported financial performance. While there are options to reduce this volatility in some circumstances by adopting hedge

4 *Financial Statements of the Government of New Zealand for the year ended 30 June 2005*, parliamentary paper B.11, page 19.

accounting, the criteria that need to be met are quite onerous (for example, in terms of assessing hedge effectiveness and in record keeping).

11.12 We expect that accounting for financial instruments will be the most significant and complex NZ IFRS issue for the financial statements of the Government. These statements include a number of complex investment, borrowing, and derivative portfolios (for example, the New Zealand Debt Management Office and the Reserve Bank).

11.13 Another significant change will be for long-term receivables and advances that do not earn a market rate of return (such as the fines debtors and benefit recoveries). The current accounting policy is to record receivables and advances at amounts expected to be collected in cash, whereas under NZ IAS 39: *Financial Instruments: Recognition and Measurement* these assets will have a lower value, taking into account the time value of money.

11.14 Some of the other areas where the requirements of NZ IFRS are significantly different from current GAAP requirements, and are likely to significantly affect either the financial statements of the Government or individual entities within the central government sector, are:

- business combinations (including a prohibition on goodwill amortisation, which is replaced by an annual impairment test);
- 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);
- employee entitlements (particularly a requirement to account for accumulating non-vesting sick leave);
- property, plant, and equipment (particularly 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 information for "key management personnel").

11.15 There are some other areas of significance to the financial statements of the Government that need further consideration before the effects of NZ IFRS will be fully known (for example, accounting for the substantial liabilities for accident compensation and defined benefit pension obligations).

11.16 The degree to which individual entities are affected will depend on the types of assets and liabilities they have and the transactions that they enter into. For some central government entities, the effects are 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 central government entities.

11.17 In April 2005, the ASRB approved Financial Reporting Standard 41: *Disclosing the Impact of Adopting New Zealand Equivalents to International Financial Reporting Standards* (FRS-41). FRS-41 requires the annual report of issuers[5] to disclose information about planning for the transition to NZ IFRS, key differences in accounting policies that are expected to arise, and the estimated effects of adopting NZ IFRS on the financial report. Although most entities within the central government sector are not issuers as defined in section 4 of the Financial Reporting Act 1993, FRS-41 encourages other entities to also provide these disclosures. We support such voluntary disclosure.

11.18 Many entities in the sector provided some disclosures of this nature in their 2005 annual reports, although there was little detailed information on the expected effects. This was to be expected, given the state of progress towards the transition at that stage. However, we expect that there will be significantly more information about the effects of the transition included in annual reports for the year ending 30 June 2006.

Guidance for public benefit entities

11.19 IFRS 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, applying to both profit-oriented and public benefit entities,[6] should continue in New Zealand. In order for NZ IFRS to be appropriate for public benefit entities, some adaptation of IFRS has been necessary.

11.20 The ASRB set out guidelines[7] for 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)[8] or existing New Zealand FRS.

5 FRS-41 uses the concept of an "issuer" as defined in section 4 of the Financial Reporting Act 1993.

6 Public benefit entities are entities whose primary objective is to provide goods or services for a community or a social benefit where equity has been provided to support that primary objective rather than for a financial return to equity holders. They include most public sector entities.

7 Accounting Standards Review Board Release 8, paragraph 27.

8 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.

- 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. If an IFRS permits options that are not allowed in an existing FRS, a strong argument would need to be made for the ASRB to agree to retaining 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.[9]

11.21 We reported last year that, in our view, providing additional guidance on applying 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 have worked closely with the Treasury and the Financial Reporting Standards Board (FRSB) on this issue over the past year, and we will continue to do so.

11.22 We are pleased to report that some of the concerns that we raised last year about guidance for public benefit entities have now been addressed. In particular, standard setters have now issued useful guidance to assist entities to determine whether they are a profit-oriented entity or a public benefit entity.[10] This distinction is important because some of the requirements of NZ IFRS differ depending on the nature of the entity applying the standards.

11.23 The central government sector is made up of some entities that are clearly public benefit entities (such as government departments, district health boards, and schools) and some entities that are clearly profit-oriented entities (such as State-owned enterprises). However, there are some entities that have a mix of objectives (such as some Crown Research Institutes and other Crown entity companies). The guidance developed by the FRSB provides a framework for these entities to use to determine whether they should account under NZ IFRS as a public benefit entity or as a profit-oriented entity.

11.24 The FRSB has recently set up a public benefit entity working group on which we are represented. The working group is addressing topics that affect public benefit entities and that are not currently adequately addressed in NZ IFRS. We hope to continue our involvement in this working group. We will continue to raise the need for appropriate guidance for public benefit entities with those parties responsible for setting standards in New Zealand. We strongly prefer such guidance to form an integral part of the new standards, rather than be an "add-on" for the public sector.

9 One of the functions of the ASRB is to liaise with the Australian Accounting Standards Board to harmonise New Zealand and Australian financial reporting standards (section 24, Financial Reporting Act 1993).

10 NZ IAS 1 Appendix: New Zealand Application Guidance: When is an Entity a Public Benefit Entity?

Sector preparations for NZ IFRS

11.25 Over the past year, the Treasury has made significant progress in its planning for implementing NZ IFRS in the financial statements of the Government. This progress has included:

- assessing the options available under NZ IFRS both on transition and for the ongoing application of NZ IFRS accounting policies;
- preparing a preliminary set of NZ IFRS accounting policies for the financial statements of the Government and issuing these for consultation with the sector;
- setting out a timetable for collecting the information needed for the transition from entities within the Government reporting entity; and
- producing a draft NZ IFRS data pack to be used to collect NZ IFRS financial information from entities for the preliminary opening balance sheet at 1 July 2006, and for the NZ IFRS comparative information that will be collected during the 2006-07 financial year.

11.26 The Treasury's NZ IFRS timetable requires all entities within the Government reporting entity to provide it with a preliminary NZ IFRS opening balance sheet within 2 weeks of their 2006 statutory reporting deadline (mid-October for government departments and State-owned enterprises, and mid-November for Crown entities). In addition, all government departments, the larger Crown entities, and State-owned enterprises will be required to provide the Treasury with monthly interim financial results under NZ IFRS from December 2006 (so the Treasury can collate NZ IFRS comparative figures to use in the monthly financial statements of the Government to be published in the 2007-08 year).

11.27 In order to meet these requirements, entities will need to be able to report to the Treasury under both current New Zealand GAAP and NZ IFRS for the year ending 30 June 2007. This includes monthly reporting by government departments, the larger Crown entities, and State-owned enterprises. Entities may need to maintain accounting records under 2 different accounting bases to meet these requirements.

11.28 The transition to NZ IFRS is expected to affect both the workload and training requirements of finance teams in some public sector entities. The transition is also likely to result in some additional costs during the transition period.

11.29 We are pleased to note that there has been progress towards the transition to NZ IFRS by many individual entities within the Government reporting entity, although the degree of progress is variable. Most of the larger entities have set up NZ IFRS transition projects and have completed or are completing assessments of the

effects of NZ IFRS. However, some of the smaller entities have done limited NZ IFRS planning to date. For many of the smaller entities the transition to NZ IFRS will be straightforward, but this will not be so in all cases.

11.30 We are also pleased to note that the Treasury has undertaken some initiatives to assist entities in the transition, including issuing a guidance paper on accounting for sick leave under NZ IFRS and working with groups of entities on NZ IFRS issues that apply to a number of entities (for example, accounting for debt portfolios). These initiatives are a very effective means of assisting the sector in the transition. Another valuable initiative to support the transition has been the formation of a group of mainly government department finance personnel that is meeting regularly to discuss and address NZ IFRS issues.

11.31 Overall, we are satisfied with the progress made by the sector to date. However, there remains much to be done. The financial statements of the Government include some very complex accounting issues, and there are some entities within the Government reporting entity that are very significantly affected by NZ IFRS. Some of these entities have still to implement systems and business processes to enable them to account under NZ IFRS. For some entities, meeting the Treasury timetable for collecting preliminary NZ IFRS opening balance sheet information may be a challenge. To meet this challenge, it is important that the Treasury continues to be proactive in providing guidance on issues affecting the sector as a whole and that, where appropriate, entities share information on NZ IFRS transition issues and their resolution.

Effect on auditors

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

11.33 There will be additional audit work required for 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. Entities will need to ensure that such additional audit fees are incorporated into their budgets.

11.34 Over the past year, we have put all our professional staff through extensive training on NZ IFRS. We are continuing to develop resources for auditors to ensure that they are fully prepared to audit in an NZ IFRS environment. We are currently auditing the restated NZ IFRS opening balance sheets in the local government sector. This will prove useful in testing our knowledge and audit approaches under

NZ IFRS. We will continue to share our knowledge of the local government sector's experience of NZ IFRS with the central government sector.

11.35 The coming years will be a significant challenge for us and our appointed auditors as we change to auditing in an NZ IFRS environment. We are confident that we will fully meet these challenges, and that we will achieve our over-riding objective of supporting the change to NZ IFRS at least cost, and with minimum fuss, in a constructive, co-operative manner.

Summary

11.36 The central government sector has made significant progress over the past year towards the implementation of NZ IFRS.

11.37 Although NZ IFRS will continue to be subject to some change before they are adopted, there is enough stability within NZ IFRS to allow entities to plan for, and manage, the transition.

11.38 Accounting for financial instruments is expected to be the area of greatest challenge for the sector, although the effect on individual entities will vary depending on the nature of their assets, liabilities, and underlying transactions.

11.39 We are pleased with the progress made in providing guidance on NZ IFRS for public benefit entities, and consider that the formation of a public benefit entity working group by the FRSB is a positive step.

11.40 The Treasury has made significant progress in its planning for using NZ IFRS in the financial statements of the Government. A timetable for transition has been set up that will require entities to provide their preliminary NZ IFRS opening balance sheets to the Treasury within 2 weeks of their 2006 statutory reporting deadline.

11.41 There has also been good progress towards the transition to NZ IFRS by many individual entities within the Government reporting entity, although the degree of progress is variable, particularly for smaller entities.

11.42 We have worked closely with the Treasury in its planning for the transition and will continue to do so. The Treasury has undertaken some useful initiatives to assist the sector in the transition. In our view, it is important that the Treasury continues to be proactive in providing guidance on issues affecting the sector.

11.43 The transition remains a significant challenge for us. There will be additional audit work required, particularly on NZ IFRS accounting policies, restated opening balance sheets, and comparative figures. We are confident that we will fully meet these challenges.

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

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- Annual Report 2004-05 – B.28
- Electricity Commission: Contracting with service providers
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