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Parliamentary paper

Central  
government:  
Results of the  
2010/11 audits  
(Volume 2)

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# Contents

Auditor-General's overview	3
Part 1 – Results of Crown entity audits	5
About Crown entities	5
Audit results	6
Environment, systems, and controls	9
Our focus for 2011/12 and beyond	18
Part 2 – Results of State-owned enterprise audits	19
About State-owned enterprises	19
Audit results	23
Environment, systems, and controls	23
Part 3 – Reporting alternative performance measures such as “underlying profit”	27
Why we were uneasy	27
Our expectations for reporting underlying profit	28
Underlying profit disclosures by State-owned enterprises in 2011	29
What next?	29
Appendix – Crown entities audited in 2010/11 and covered in this report	31
Figures	
1 – Grading scale for assessing Crown entities' environment, systems, and controls	9
2 – Summary of Crown entities' grades for 2010/11, as percentages	10
3 – Grades for Crown entities' management control environment, 2006/07 to 2010/11, as percentages	11
4 – Grades for management control environment, 2010/11, by type of entity, as percentages	12
5 – Grades for Crown entities' financial information systems and controls, 2006/07 to 2010/11, as percentages	13
6 – Grades for financial information systems and controls, 2010/11, by type of entity, as percentages	14
7 – Grades for Crown entities' service performance information and associated systems and controls, 2008/09 to 2010/11, as percentages	15
8 – Grades for service performance information and associated systems and controls, 2010/11, by type of entity, as percentages	16
9 – Total staff, revenue, assets, liabilities, and equity of each SOE (excluding ECNZ and Timberlands but including Air New Zealand)	21
10 – Grading scale for assessing SOEs' environment, systems, and controls	23
11 – Summary of grades for the 15 SOEs and Air New Zealand for 2010/11	24
12 – Grades for SOEs' management control environment, 2006/07 to 2010/11, as percentages	25
13 – Grades for SOEs' financial information systems and controls, 2006/07 to 2010/11, as percentages	25

## Auditor-General's overview

This is my fourth and final report on the central government audits for 2010/11. In December 2011, I published *Central Government: Results of the 2010/11 audits (Volume 1)* and *Education sector: Results of the 2010/11 audits*. This year, I complete my reporting with *Health sector: Results of the 2010/11 audits* and this report, *Central Government: Results of the 2010/11 audits (Volume 2)*.

This fourth report summarises the audit findings for Crown entities other than the education and health sector entities, and for State-owned enterprises. I also comment on the practice of some State-owned enterprises reporting alternative performance measures such as “underlying profit”.

Overall, the results for 2010/11 show that Crown entities and State-owned enterprises have generally sound management control environments and financial information systems and controls.

The management control environment of an entity is especially important in times of change and restructuring. With an emphasis now on shared “back office” functions, entities need to maintain a sound control environment to ensure that risks are well managed.

There were many changes for Crown entities during 2010/11. For 11 Crown entities, the financial statements were prepared on a disestablishment basis. Six were disestablished during the year, and five were due to be disestablished.

We issued 68 unmodified audit opinions and one modified opinion on the 69 existing and disestablishing Crown entities in 2010/11. The modified opinion was because 2010/11 performance information could not be directly compared to the 2009/10 data.

We issued unmodified audit opinions on all 17 State-owned enterprises and Air New Zealand Limited for the year ended 30 June 2011, and drew attention to the impending winding up of Timberlands West Coast Limited.

We drew attention to several matters in our audit letters to the managers of Crown entities, from breaches of legislation to the need to prepare or implement asset management plans.

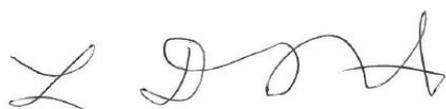
Crown entities have continued to improve their service performance information and reporting, with 53% of Crown entities graded “Good” in 2010/11 (compared to 43% in 2009/10). State-owned enterprises are not required to report service performance in the same way. In practice, State-owned enterprises also provide additional information in their annual reports, including reporting against their statement of corporate intent and providing information on corporate social responsibility and sustainability matters.

Many Crown entities were affected by the Canterbury earthquakes. Those effects included reduced revenue and/or increased expenditure, and damaged buildings, equipment, or other assets. There was a significant effect on the Earthquake Commission, including a much expanded role and major financial implications, such as outstanding claims liabilities and associated reinsurance recoveries.

Last year, we reported our unease about the practice of disclosing alternative performance measures, such as underlying profit, by some State-owned enterprises. This year, we reviewed all the underlying profit disclosures made in the 2011 annual reports of State-owned enterprises.

About half of the State-owned enterprises reported underlying profit in their annual reports. They did a reasonably good job of disclosing how they calculated underlying profit and how that profit related to the information in the financial statements. However, in our view, there is room for greater clarity. We will continue to work with State-owned enterprises and our auditors where we consider improvements can be made to such disclosures.

In all four reports about the 2010/11 audits in central government, I have commented on the ongoing importance for public entities to continue improving their reporting. I am pleased to note the improvements to date, and will continue to encourage simpler and more meaningful reporting, of both financial and performance information.



Lyn Provost  
Controller and Auditor-General

2 March 2012

# Part 1

## Results of Crown entity audits

- 1.1 In this Part, we discuss the results of our 2010/11 audits of 69 Crown entities (see the Appendix).<sup>1</sup>
- 1.2 We also report our assessments and grades of the management control environments, financial information systems, and service performance information and associated systems and controls for 63 of the Crown entities. Six Crown entities were disestablished in 2010/11, and we do not grade disestablished entities.

### About Crown entities

- 1.3 There are more than 2700 Crown entities, including 2460 school boards of trustees. Crown entities have a wide range of roles, functions, and responsibilities, and different degrees of autonomy. The Auditor-General is the statutory auditor of all Crown entities and their subsidiaries.
- 1.4 The Crown Entities Act 2004 provides a framework for the establishment, governance, accountability, and operation of Crown entities.<sup>2</sup> It sets out five categories of Crown entities:
- statutory entities:
    - Crown agents, such as the Accident Compensation Corporation and DHBs;
    - autonomous Crown entities, such as the Standards Council of New Zealand and the New Zealand Symphony Orchestra; and
    - independent Crown entities, such as the Law Commission;
  - Crown entity companies, including Crown research institutes (CRIs);
  - Crown entity subsidiaries;
  - school boards of trustees; and
  - tertiary education institutions (polytechnics, universities, and wānanga).
- 1.5 There have been several structural changes for Crown entities during 2010/11, in response to Government priorities, including disestablishing and establishing entities (see paragraph 1.9).

1 District health boards and Crown research institutes are also Crown entities, but we have discussed them separately in other reports. It makes sense to compare district health boards to one another, but little sense to compare them with other Crown entities. The same applies to Crown research institutes.

2 Many Crown entities also have their own enabling legislation.

## Audit results

### 2010/11 audit reports

- 1.6 We audited 69 Crown entities<sup>3</sup> in 2010/11, including final audits for six entities that were disestablished during the year. We issued 68 unmodified audit opinions and one modified opinion.
- 1.7 We issued the New Zealand Fire Service Commission with a modified audit opinion because its 2010/11 performance data was not comparable to its 2009/10 data. Industrial action in 2009/10 meant that the Commission's non-financial performance information for 2009/10 was incomplete. The 2010/11 data was complete, but could not be directly compared to the 2009/10 data.
- 1.8 We included "emphasis of matter" paragraphs in our audit reports in 2010/11 to draw attention to:
- uncertainties associated with the Canterbury earthquakes (two emphasis of matter paragraphs for the Earthquake Commission);
  - disclosures about the grounding of the container vessel *Rena* (the New Zealand Oil Pollution Fund);
  - a high degree of uncertainty about the value of unlisted investments that could have a material effect on the financial statements (Public Trust and Group, and New Zealand Venture Investment Fund Limited and Group); and
  - the "going concern" assumption appropriately not being used because the public entity was disestablished (six Crown entities were disestablished during the year) or expected to be disestablished in the near future (Crown Health Financing Agency, Health Sponsorship Council, Charities Commission, Mental Health Commission, and Alcohol Advisory Council of New Zealand).

### Final audits for disestablished Crown entities

- 1.9 We carried out final audits for six Crown entities<sup>4</sup> that were disestablished during 2010/11:
- The Electoral Commission was disestablished on 30 September 2010 and its functions were transferred to the new Electoral Commission, established on 1 October 2010.
  - The Electricity Commission was disestablished on 31 October 2010 and its functions were transferred to the new Electricity Authority, established on 1 November 2010.

3 The Financial Markets Authority was established on 1 May 2011. Its first audit will be for the 14 months to 30 June 2012.

4 On 1 July 2011, the Accounting Standards Review Board transitioned to the External Reporting Board. The Accounting Standards Review Board was not disestablished and did not require a final audit.

- The Environmental Risk Management Authority was disestablished on 30 June 2011 and its functions were transferred to the Environmental Protection Authority, established on 1 July 2011.
- The Foundation for Research, Science and Technology was disestablished on 31 January 2011, along with the Ministry of Research, Science and Technology, and the two were merged on 1 February 2011 to form the new Ministry of Science and Innovation.
- The Legal Services Agency was disestablished on 30 June 2011 and its functions were transferred to the Ministry of Justice on 1 July 2011.
- The Securities Commission was disestablished on 30 April 2011 and its functions were transferred to the new Financial Markets Authority, established on 1 May 2011.

1.10 For all six final audits, our audit reports included “emphasis of matter” paragraphs highlighting that the financial statements were appropriately prepared on a disestablishment basis.

1.11 We did not assess the environment, systems, and controls of the disestablished entities when we carried out the final audit. This is because the grades we give reflect our recommendations for improvement, and deficiencies identified during the final audit of a disestablished entity may or may not be relevant to any new or ongoing entity.

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

1.13 Overall, our auditors found that, for all six disestablished entities, the management control environment and internal controls continued to operate effectively during the year. Other matters our auditors reported included that:

- one entity had difficulty in retaining staff in the months leading to disestablishment, including finance staff, which affected its ability to respond to the audit in a timely way; and
- another entity had limited reporting of its progress towards desired outcomes and a lack of clear reporting of actual activity and achievement during the year.

### **Matters of audit interest**

1.14 The Government’s focus on lifting the performance of the public sector, while reducing the rate of spending, includes an expectation that Crown entity boards deliver improved performance and greater value for money.

1.15 In 2010/11, our auditors focused on a range of risks for Crown entities, including the need for them to effectively govern and manage change and improvement processes while maintaining effective controls and core services in a fiscally constrained environment.

#### **Financial sustainability**

1.16 Ongoing financial sustainability was a risk for six Crown entities. Reasons for financial pressures included reduced fee revenue, exchange rate pressures, and increasing operating costs within static funding. For all six, our auditors concluded that the going concern assumption was appropriate for 2010/11. This means that the auditor concluded that the entity could continue operating within its means, without additional government support, for at least the next 12 months.<sup>5</sup> We drew this heightened risk to the attention of the entity and to the respective Ministers and monitoring departments.

1.17 We will continue to monitor the financial performance of Crown entities to ensure that the going concern assumption is appropriately used in 2011/12.

#### **Canterbury earthquakes**

1.18 Many Crown entities were affected by the Canterbury earthquakes. Those effects included reduced revenue and/or increased expenditure, and damaged buildings, equipment, or other assets. There was a significant effect on the Earthquake Commission, including a much expanded role and major financial implications, such as outstanding claims liabilities and associated reinsurance recoveries.

#### **Other matters**

1.19 Other matters of interest that our auditors reported to the managers of Crown entities, and the number of Crown entities that each applied to, included:

- **legislative compliance** – seven entities breached legislation and, in each instance, had responded to the incident appropriately and planned action to avoid re-occurrence, while a further eight entities needed to improve their compliance monitoring systems and processes;
- **related-party transactions** – eight entities needed to ensure that all interests of board members and senior staff members are identified and disclosed so that potential conflicts can be monitored and appropriately managed;
- **sensitive expenditure** – seven entities needed to improve policies and/or processes (for example, to ensure that there is appropriate approval or more consistent application of policies throughout the entity);
- **risk management** – seven entities needed to prepare, improve, or fully implement an appropriate risk management policy and/or framework;

<sup>5</sup> AG ISA (NZ) 570: *Going Concern*, page 3-4302 of *The Auditor-General's Auditing Standards* (March 2011), available at [www.oag.govt.nz](http://www.oag.govt.nz).

- **fraud awareness** – four entities needed to update fraud policies or carry out fraud risk assessments;
- **asset management** – four entities needed to prepare or implement asset management plans;
- **business continuity** – three entities needed to prepare or implement business continuity and disaster recovery plans; and
- **procurement** – three entities needed to update and/or consistently implement appropriate procurement policies and practices.

## Environment, systems, and controls

- 1.20 As part of the annual audit, we examine, assess, and grade Crown entities' environment, systems, and controls for managing and reporting financial and service performance information.
- 1.21 Our auditors recommend improvements to ensure that there are effective internal controls for sound management and good governance, and to help entities to manage risks (such as errors and potential fraud).
- 1.22 This is the fifth year that we have used our current assessment framework to support the continued improvement of public entities. We assess three aspects:
- the management control environment;
  - financial information systems and controls; and
  - service performance information and associated systems and controls.
- 1.23 If auditors identify deficiencies in any of these aspects, they will recommend improvements. The grades assigned reflect the recommendations for improvement as at the end of the financial year (see Figure 1).
- 1.24 Fluctuations in grades can occur from year to year – for example, because of changes in the operating environment, organisational structure, good practice expectations, or auditor emphasis. How an entity responds to the auditor's recommendations for improvement is more important than the grade change from year to year. Consequently, the long-term trend in grade movement is a more useful indicator of progress than year-to-year grade changes.

**Figure 1**  
Grading scale for assessing Crown entities' environment, systems, and controls

Grade	Explanation of grade
Very good	No improvements are necessary.
Good	Improvements would be beneficial and we recommend that the entity address these.
Needs improvement	Improvements are necessary and we recommend that the entity address these at the earliest reasonable opportunity.
Poor	Major improvements are required and we recommend that the entity urgently address these.

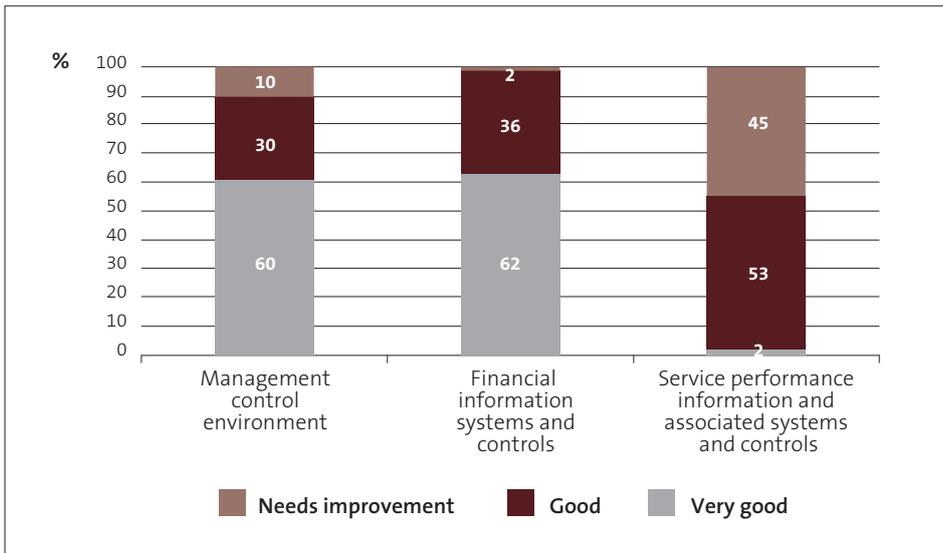
1.25 We report our assessments to the entity, the responsible Minister, the relevant select committee, and relevant monitoring agency. We also advise the central agencies – the Treasury, the State Services Commission, and the Department of the Prime Minister and Cabinet.

1.26 There have been changes to the size of the Crown entity group in recent years, with entities established and disestablished. The data in Figures 3, 5, and 7 below is for the group as it was constituted each year. We also compare Crown entities’ grades for 2010/11 with those of other types of central government entities in Figures 4, 6, and 8.

**Grades for 2010/11**

1.27 We assessed and graded 63 Crown entities in 2010/11. We did not grade the six disestablished Crown entities (see paragraph 1.11). Figure 2 sets out a summary of the grades for 2010/11 for the three aspects that we assess.

**Figure 2**  
Summary of Crown entities’ grades for 2010/11, as percentages



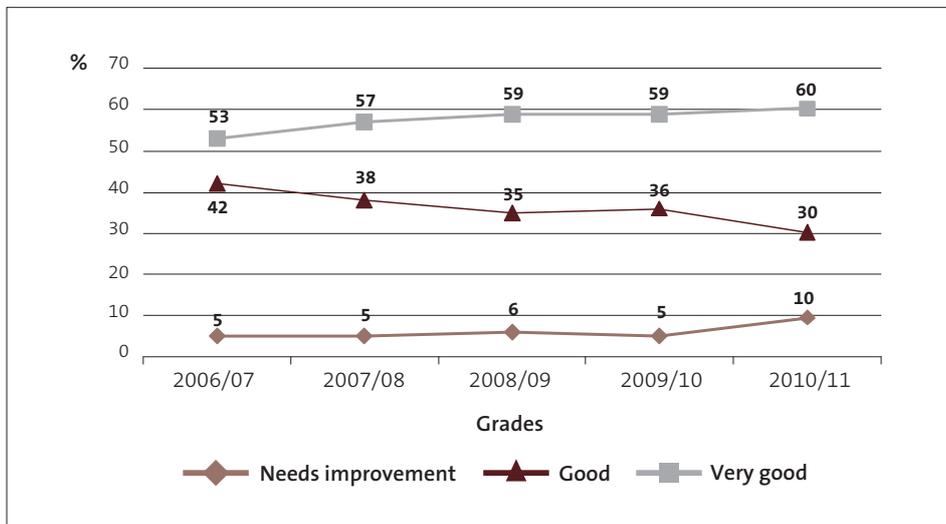
1.28 The results for 2010/11 show that almost all Crown entities have sound management control environments and financial information systems and controls.

1.29 However, we recommended that 45% of Crown entities improve their service performance information and reporting. Crown entities have been focused on improving this aspect, and eight entities improved their grades from “Needs improvement” in 2009/10 to “Good” in 2010/11.

**Management control environment**

- 1.30 The management control environment of an entity is especially important in times of change and restructuring. With an emphasis now on shared “back office” functions, entities need to maintain a sound control environment to ensure that risks are well managed.
- 1.31 Figure 3 shows grades for Crown entities’ management control environment for the five years to 2010/11.

**Figure 3**  
**Grades for Crown entities’ management control environment, 2006/07 to 2010/11, as percentages**



- 1.32 We graded the management control environment of 90% of the Crown entities as “Very good” or “Good”. A “Very good” grade means that the appointed auditor did not recommend any improvements. A “Good” grade indicates that we did not have any significant concerns but that the appointed auditor recommended improvements that would be beneficial.
- 1.33 Four entities improved their grades from “Good” in 2009/10 to “Very good” in 2010/11.
- 1.34 The number of entities we graded as “Needs improvement” increased from three in 2009/10 to six in 2010/11.
- 1.35 Three of the entities that we graded as “Needs improvement” in 2010/11 had also been graded as “Needs improvement” in 2009/10. These entities had only partially

resolved the deficiencies we identified in 2009/10. We expect entities to address the matters raised by our auditors and make the necessary improvements. We will continue to monitor how these entities respond to our recommendations for improvement.

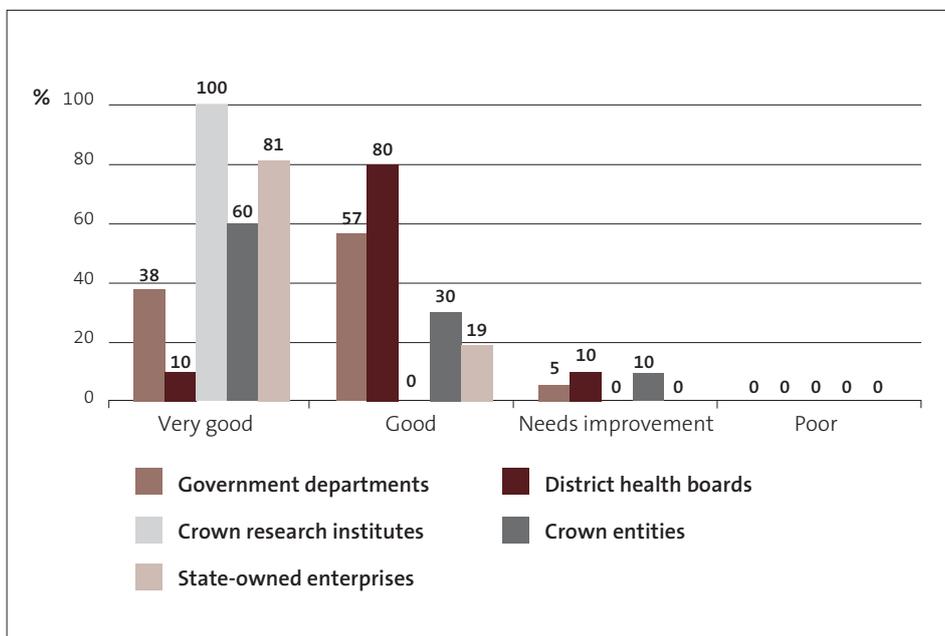
1.36 The other three entities that we graded “Needs improvement” in 2010/11 included:

- A new entity that was still implementing its systems and processes, and an entity that underwent significant organisational change during the year. A “Needs improvement” grade in these circumstances is not unusual. We expect to see progress in responding to our recommendations for improvement in 2011/12 as new policies, systems, and controls are prepared and embedded.
- An entity where, although it had addressed some of our recommendations from previous years, there were still some outstanding issues. We will continue to monitor its response to our recommendations for improvement.

### Comparing grades between types of entities

1.37 Figure 4 compares the 2010/11 management control environment grades of the 63 Crown entities with the grades for other types of central government entities (37 government departments, eight CRIs, 20 DHBs, and 16 State-owned enterprises).

**Figure 4**  
**Grades for management control environment, 2010/11, by type of entity, as percentages**

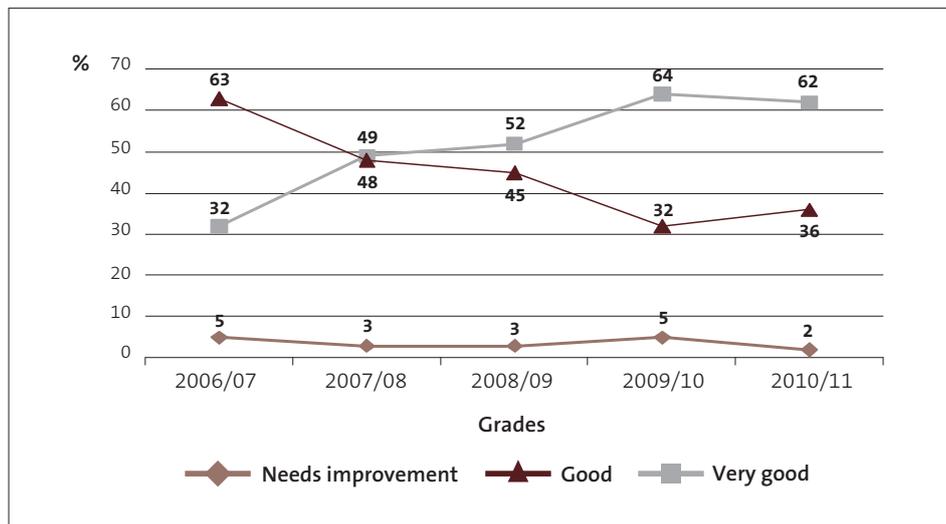


1.38 Figure 4 shows that, of all the entities where we graded the management control environment, at least 90% were graded as either “Very good” or “Good”. Overall, central government entities have sound management control environments. CRIs stand out, with all eight CRIs receiving “Very good” grades in 2010/11. Crown entities other than DHBs and CRIs are toward the middle of the range for the number of those graded as “Very good”.

**Financial information systems and controls**

1.39 Figure 5 shows grades for Crown entities’ financial information systems and controls for the five years to 2010/11.

**Figure 5**  
**Grades for Crown entities’ financial information systems and controls, 2006/07 to 2010/11, as percentages**



1.40 Figure 5 shows that, in the past five years, we have graded the financial information systems and controls of at least 95% of Crown entities as either “Very good” or “Good”. We have consistently found that the financial information systems and controls of most Crown entities are sound. In 2010/11, 98% were graded “Very good” or “Good”.

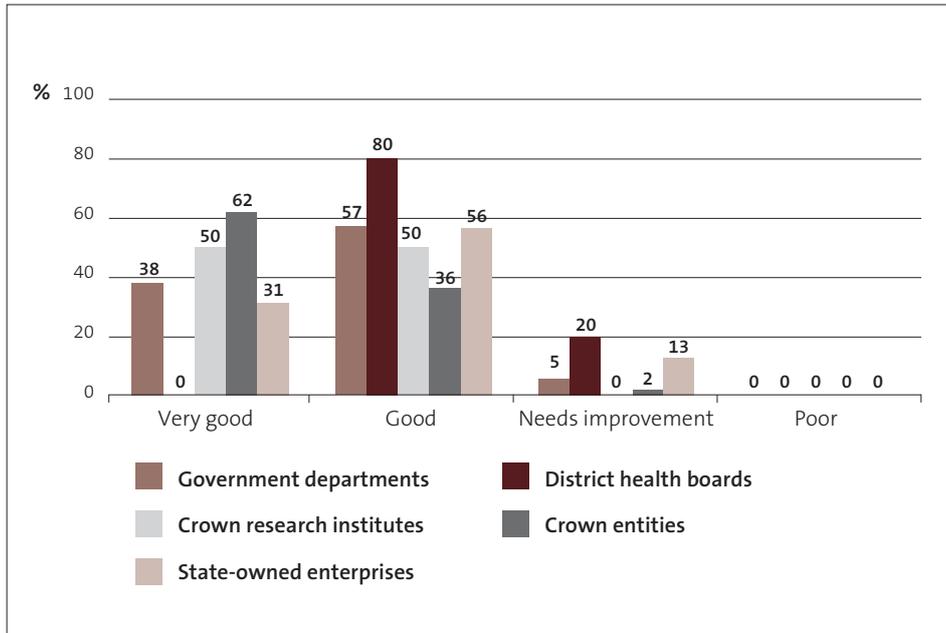
1.41 Between 2009/10 and 2010/11, three entities moved from “Very good” to “Good” and three entities improved their grades from “Good” to “Very good”. We expect fluctuations between the “Very good” and “Good” grades and are not concerned, as they tend to reflect changes in the operating environment, organisational structure, good practice expectations, or auditor emphasis.

1.42 We graded only one entity as needing to improve its financial information systems and controls in 2010/11. This was the new entity that was still implementing its systems and processes. It was also graded as “Needs improvement” for its management control environment. We expect to see improvements as its systems and processes become fully established and embedded.

**Comparing grades between types of entities**

1.43 Figure 6 compares the 2010/11 financial information systems and controls grades of the 63 Crown entities with the grades for other types of central government entities (37 government departments, eight CRIs, 20 DHBs, and 16 State-owned enterprises).

**Figure 6**  
**Grades for financial information systems and controls, 2010/11, by type of entity, as percentages**



1.44 Figure 6 shows that most central government entities have sound financial information systems and controls. We recommended that improvements were necessary for two of the 16 State-owned enterprises (13%) and four of the 20 DHBs (20%).

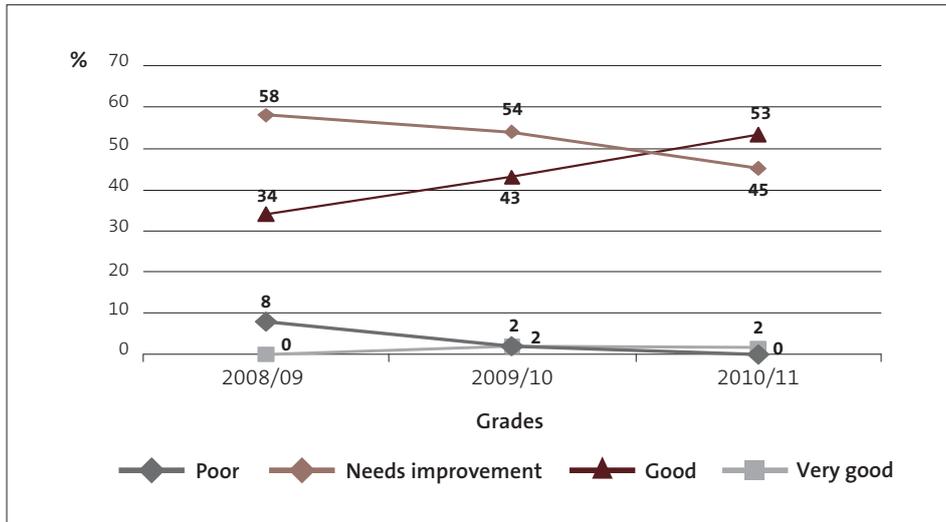
1.45 We graded 39 of the Crown entities (62%) as “Very good”, which means that our auditors did not recommend any improvements. This result shows a strong

performance by Crown entities compared to the other types of entities in the central government sector.

**Service performance information and associated systems and controls**

- 1.46 Good-quality service performance information and reporting enables public entities to account for, and be held to account for, the effective and efficient use of resources and achievement of their objectives. It enables Parliament and the public to see what an entity said it would do, what it achieved, and the difference it made.
- 1.47 In Part 9 of *Central government: Results of the 2010/11 audits (Volume 1)*, we discuss our work to help public entities improve their performance information and reporting.
- 1.48 Figure 7 shows the grades for Crown entities for the three years to 2010/11.

**Figure 7**  
**Grades for Crown entities’ service performance information and associated systems and controls, 2008/09 to 2010/11, as percentages**



- 1.49 Crown entities have continued to make steady progress in improving their service performance reporting.
- 1.50 In 2010/11, we did not grade any Crown entities as “Poor”, compared to one graded “Poor” in 2009/10. We graded 33 of the 62<sup>6</sup> Crown entities (53%) as “Good”

6 For service performance information and associated systems and controls, we assessed one less entity. The Standards Council of New Zealand had an exemption, under the Crown Entities Act 2004, and did not need to include a statement of forecast service performance in its Statement of Intent. We therefore did not grade this aspect for that entity, and our audit opinion covered only the financial statements.

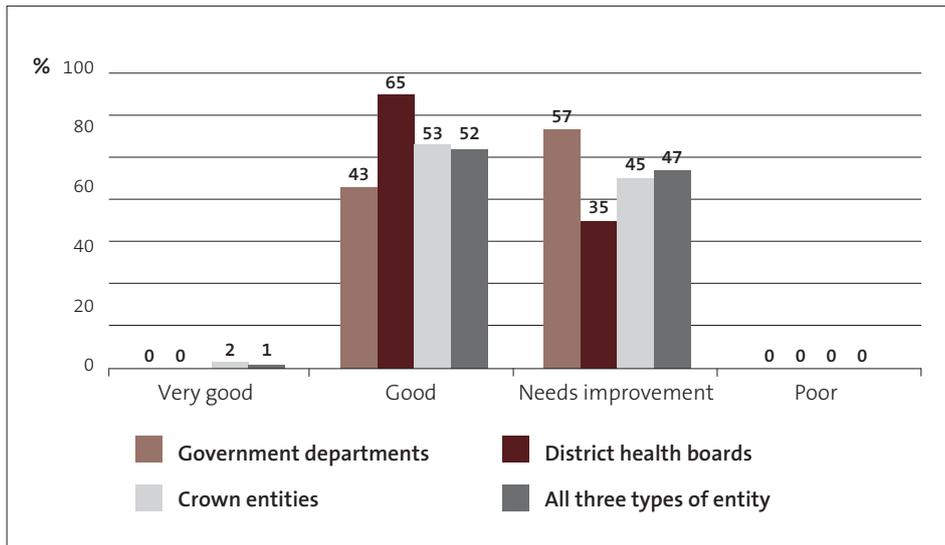
and one entity (2%) as “Very good” (the same entity as in 2009/10). We graded the remaining 28 entities (45%) as “Needs improvement”.

- 1.51 Eight entities improved their grades from “Needs improvement” in 2009/10 to “Good” in 2010/11, which reflects the progress that Crown entities are making in improving their service performance information and reporting.

**Comparing grades between types of entities**

- 1.52 Figure 8 compares Crown entities’ grades for service performance information and associated systems and controls in 2010/11 with the grades for 20 DHBs and 37 government departments, the other entities for which we assess this aspect.

**Figure 8**  
**Grades for service performance information and associated systems and controls, 2010/11, by type of entity, as percentages**



- 1.53 Figure 8 shows that we graded 52% of all these entities’ service performance information and reporting as “Good” (and one as “Very good”) in 2010/11. Crown entities’ performance information is similarly graded to that of the other groups, except DHBs.

- 1.54 The results for DHBs are particularly positive, because in 2009/10 all DHBs were graded either “Needs improvement” or “Poor”.<sup>7</sup> We discuss this significant improvement in greater detail in our separate report *Health sector: Results of the 2010/11 audits*.

<sup>7</sup> Central government: Results of the 2009/10 audits (Volume 2), page 8.

- 1.55 We graded the service performance information of 21 government departments (57%) as “Needs improvement” in 2010/11.<sup>8</sup>

### Phasing in a revised auditing standard

- 1.56 In Part 9 of *Central government: Results of the 2010/11 audits (Volume 1)*, we discussed the phased implementation of our revised standard for auditing service performance reports.
- 1.57 The revised standard requires auditors to modify their audit opinion if the performance information in the annual report does not, in their opinion, fairly reflect the entity’s performance for the year. This includes assessing the appropriateness of performance information and verifying key aspects of it. Under the previous standard, there was little scope for auditors to modify their audit opinion if the content of the performance report was inadequate.
- 1.58 In 2010/11, nine Crown entities were audited under the revised standard. They were:
- Accident Compensation Corporation;
  - Housing New Zealand Corporation;
  - Legal Services Agency;
  - New Zealand Fire Service Commission;
  - New Zealand Lotteries Commission;
  - New Zealand Trade and Enterprise;
  - New Zealand Transport Agency;
  - Public Trust; and
  - Tertiary Education Commission.
- 1.59 One year ago, we concluded that five of these entities were at risk of receiving a modified audit opinion if they did not improve their performance reporting in 2011. During the year, our auditors maintained contact with the five entities, offering recommendations for improvement, reviewing draft accountability documents, monitoring progress, and testing systems and controls for reporting non-financial performance information. The entities responded well and made significant improvements.
- 1.60 As a result, we were able to issue unmodified opinions on the service performance for eight of the nine entities. Only one entity received a modified opinion, and we have commented on this entity in paragraph 1.7.

<sup>8</sup> Although there has been an improvement in departments’ grades since 2009/10, the results for the other types of entities (both Crown entities and DHBs) show stronger performance in 2010/11. (See Figure 7 in *Central government: Results of the 2009/10 audits (Volume 2)*, page 20.)

## Our focus for 2011/12 and beyond

- 1.61 We are continuing to focus on improving the quality of service performance reporting. Our revised standard for auditing service performance reports applies to a further 21 Crown entities in 2011/12.
- 1.62 Our audit work and wider work programme in 2011/12 and 2012/13 will be underpinned by the theme *Our future needs – is the public sector ready?* We want our work on a range of issues and initiatives related to this theme to make a lasting difference to the public sector and to the public.

## Part 2

# Results of State-owned enterprise audits

- 2.1 In this Part, we provide background information about State-owned enterprises (SOEs) and report the results of our 2010/11 audits of SOEs,<sup>9</sup> including our assessments of their management control environment and financial systems and controls.

### About State-owned enterprises

- 2.2 SOEs are established under the State-Owned Enterprises Act 1986 (the Act), registered as companies, and bound by the provisions of the Companies Act 1993.<sup>10</sup> The Auditor-General is the statutory auditor of all SOEs and their subsidiaries. In this role, she is responsible for the annual audit and other aspects of the Auditor-General's mandate provided for by the Public Audit Act 2001.
- 2.3 The principal objective of an SOE is to operate as a successful business and to be as profitable and efficient as comparable businesses that are not owned by the Crown. SOEs are also required to be good employers and to show a sense of social responsibility.
- 2.4 We audited 17 SOEs and Air New Zealand Limited in 2010/11. These entities are listed below, with a brief description of each:
- Airways Corporation of New Zealand Limited (Airways) – commercial provider of air navigation services and associated aviation infrastructure services;
  - Animal Control Products Limited (Animal Control Products) – manufacturer and seller of pest management products;
  - AsureQuality Limited (AsureQuality) – provider of a wide range of services to the food and primary industries in New Zealand and other countries;
  - Electricity Corporation of New Zealand Limited (ECNZ) – a residual entity, left after assets were transferred in 1999 to the newly established electricity generator SOEs, which has been selling assets, settling liabilities, and winding down operations before its eventual disestablishment;
  - Genesis Power Limited (Genesis) – generator, wholesaler, and retailer of electricity;
  - Kordia Group Limited (Kordia) – telecommunications and media business that provides network and technology solutions;
  - Landcorp Farming Limited (Landcorp) – pastoral farming, including dairy, sheep, beef, and deer;
  - Learning Media Limited (Learning Media) – publisher, producer, marketer, and seller of education materials;

<sup>9</sup> We include Air New Zealand with SOEs for the purpose of reporting audit results.

<sup>10</sup> Except for the New Zealand Railways Corporation, which is a statutory corporation established by the New Zealand Railways Corporation Act 1981. It is an SOE but not a company.

- Meridian Energy Limited (Meridian) – generator, wholesaler, and retailer of electricity;
- Meteorological Service of New Zealand Limited (MetService) – provider of weather information services in the form of forecasting, advice, weather graphics, and data systems;
- Mighty River Power Limited (Mighty River Power) – generator and retailer of electricity;
- New Zealand Post Limited (NZ Post) – postal and courier business;
- New Zealand Railways Corporation (KiwiRail) – operator of New Zealand rail network and Interislander ferry services;
- Quotable Value Limited (QV) – valuation and property information company;
- Solid Energy New Zealand Limited (Solid Energy) – a company mining coking coal for export markets and New Zealand Steel Limited, and thermal coal for the Huntly power station and a number of industrial customers;
- Timberlands West Coast Limited (Timberlands) – ceased trading on 31 December 2008 after the sale of its forest and land assets to the Ministry of Agriculture and Forestry on 1 January 2009 and was disestablished on 30 June 2011;
- Transpower New Zealand Limited (Transpower) – operator of the National Grid, which links generators of electricity to distribution companies and major industrial users; and
- Air New Zealand Limited (Air New Zealand) – an international and domestic airline group that provides air passenger and cargo services.

2.5 At 30 June 2011, the SOEs and Air New Zealand had a combined total equity of \$27.7 billion. Figure 9 shows the size of each SOE (including Air New Zealand, but excluding ECNZ and Timberlands) with total staff, revenue, assets, liabilities, and equity.<sup>11</sup>

11. Crown Ownership Monitoring Unit, *2011 Annual Report Portfolio Report*, pages 112-114.

**Figure 9**  
**Total staff, revenue, assets, liabilities, and equity of each SOE (excluding ECNZ and Timberlands but including Air New Zealand)**

State-owned enterprise	Total staff (FTE)	Total revenue 2010/11 \$m	Total assets 2010/11 \$m	Total liabilities 2010/11 \$m	Total equity 2010/11 \$m
Airways	732	152.5	137.4	93.0	44.4
Animal Control Products	11	7.1	7.6	1.9	5.7
AsureQuality	1,597	116.9	67.8	32.6	35.2
Genesis	976	1,834.5	3,676.8	1,964.8	1,712.0
Kordia	905	294.5	238.6	157.0	81.6
Landcorp	599	229.7	1,663.0	311.3	1,351.6
Learning Media	126	23.5	15.1	9.1	6.0
Meridian	800	2,053.0	8,460.0	3,528.7	4,931.3
MetService	216	39.2	37.3	22.9	14.3
Mighty River Power	784	1,163.9	5,376.6	2,470.0	2,906.5
NZ Post	8,059	1,295.9	14,682.0	13,887.6	794.4
KiwiRail	4,190	1,012.0	13,570.2	931.9	12,638.3
QV	352	46.0	28.1	8.0	20.1
Solid Energy	1,428	831.3	1,131.5	612.1	519.4
Transpower	689	731.4	4,170.6	2,637.1	1,533.5
Air New Zealand*	8,037	3,212.0	3,628.2	2,515.7	1,112.5
<b>Totals</b>	<b>29,501</b>	<b>13,043.4</b>	<b>56,890.8</b>	<b>29,183.7</b>	<b>27,706.8</b>

\* Numbers for Air New Zealand are expressed in proportion to the Crown's ownership interest in the company.

### Governance and accountability

- 2.6 Each SOE has two shareholding Ministers, who hold the SOE shares on behalf of the Crown and are responsible to Parliament for the SOE's performance. The shareholding Ministers appoint the board of directors, which is accountable for the performance of the SOE.
- 2.7 The key accountability documents for SOEs are the statement of corporate intent (SCI), the annual report, and the half-yearly report.

- 2.8 The SCI must be finalised before the start of each financial year and must include specified information, including information about objectives, activities, targets and measures, and dividends.
- 2.9 The annual report, which is required to be finalised within three months of the end of each financial year on 30 June, must include audited financial statements and any information that is necessary to enable an informed assessment of the SOE's operations, including a comparison of its performance with the relevant SCI.
- 2.10 The Crown Ownership Monitoring Unit within the Treasury monitors SOEs on behalf of the shareholding Ministers.

#### **Changes in the SOE sector**

- 2.11 The Government announced in the 2011/12 Budget its intention to sell up to 49% of the shares in the State-owned energy companies Genesis, Meridian, Mighty River Power, and Solid Energy. An ownership structure of at least 51% Crown ownership and up to 49% private ownership is commonly referred to as a mixed ownership model. Air New Zealand currently operates under a mixed ownership model in which the Crown owns more than 51% of the shares.
- 2.12 In July 2011, the Treasury appointed financial advisors to do preparatory work on applying the mixed ownership model to the four State-owned energy companies and on reducing the Crown's shareholding in Air New Zealand. It was proposed that the Crown would retain a 51% stake in all of these companies. As a result, they would remain public entities and continue to be within the mandate of the Auditor-General.
- 2.13 We expect the sale of shares in any SOE to be a matter of significant public interest, so we are monitoring the Treasury's work.
- 2.14 We expect financial information to be included in any prospectus documents, and our auditors are likely to be requested to provide assurance over this financial information. To preserve the integrity of any sale process, we have considered what work our auditors can or cannot do in keeping with our independence policies. We have advised the companies that are intended to operate under the mixed ownership model about the work our auditors can complete.
- 2.15 We will continue to monitor the work being carried out on the mixed ownership model.

## Audit results

- 2.16 We issued unmodified audit opinions for all 17 SOEs and for Air New Zealand for the year ended 30 June 2011.
- 2.17 The audit report for Timberlands included an emphasis of matter paragraph. This paragraph drew readers' attention to the disclosures in the financial statements that referred to the going concern assumption appropriately not being used in preparing the financial statements because the company was working through the process of winding up at 30 June 2011.

## Environment, systems, and controls

- 2.18 As part of the annual audit, we examine, assess, and grade SOEs' environment, systems, and controls for managing and reporting financial information.
- 2.19 We assess two aspects: the management control environment and the financial information systems and controls.<sup>12</sup>
- 2.20 The auditors we appoint to audit public entities identify deficiencies in each of these aspects and recommend improvements. The grades assigned reflect the recommendations for improvement as at 30 June 2011. Figure 10 explains these grades.

**Figure 10**

### Grading scale for assessing SOEs' environment, systems, and controls

Grade	Explanation of grade
Very good	No improvements are necessary.
Good	Improvements would be beneficial and we recommend that the entity address these.
Needs improvement	Improvements are necessary and we recommend that the entity address these at the earliest reasonable opportunity.
Poor	Major improvements are required and we recommend that the entity urgently address these.

- 2.21 We report our assessments to the SOE, the responsible Minister, and the relevant select committee. We also advise the Treasury.
- 2.22 In practice, SOEs also provide additional information in their annual reports, including reporting against their SCI as required by the Act. They also provide a range of information on corporate social responsibility and sustainability matters, including some reporting against recognised international frameworks.
- 2.23 The Act does not require this additional information to be audited. However, auditors will consider the information reported against the SCI, particularly the

<sup>12</sup> The Auditor-General is not required to attest to SOEs' service performance. Therefore, we do not assess and grade this aspect.

performance measures and targets, to make sure that it is consistent with the rest of the information disclosed in the annual report.

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

### Grades for 2010/11

- 2.25 Figure 11 sets out a summary of the grades for 15 SOEs and Air New Zealand for 2010/11 for the two aspects we assess. We did not grade Timberlands (which was disestablished on 30 June 2011) or ECNZ (which is being wound up).

**Figure 11**

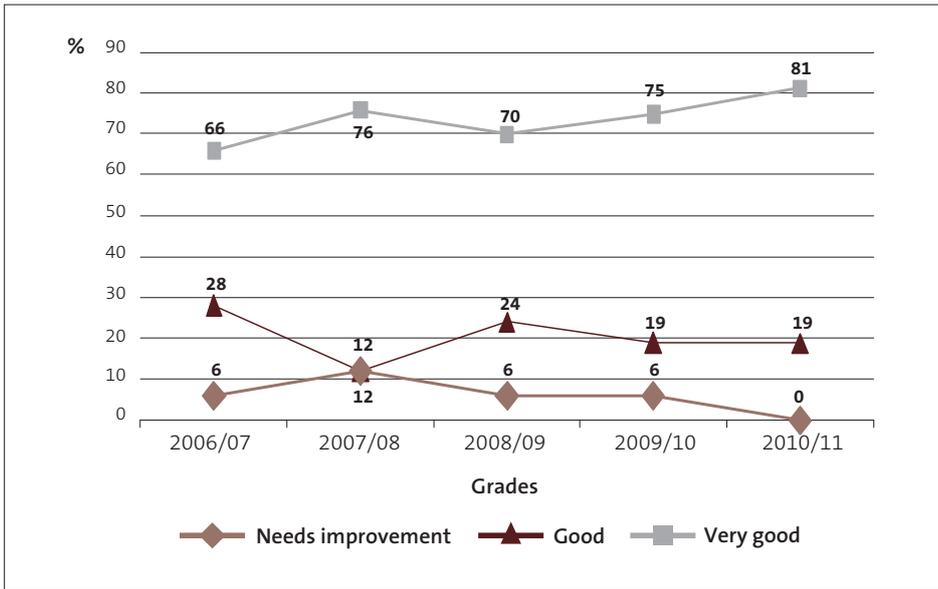
#### Summary of grades for the 15 SOEs and Air New Zealand for 2010/11

Number of entities graded	Management control environment				Financial information systems and controls			
	VG	G	NI	P	VG	G	NI	P
16	13	3	0	0	5	9	2	0

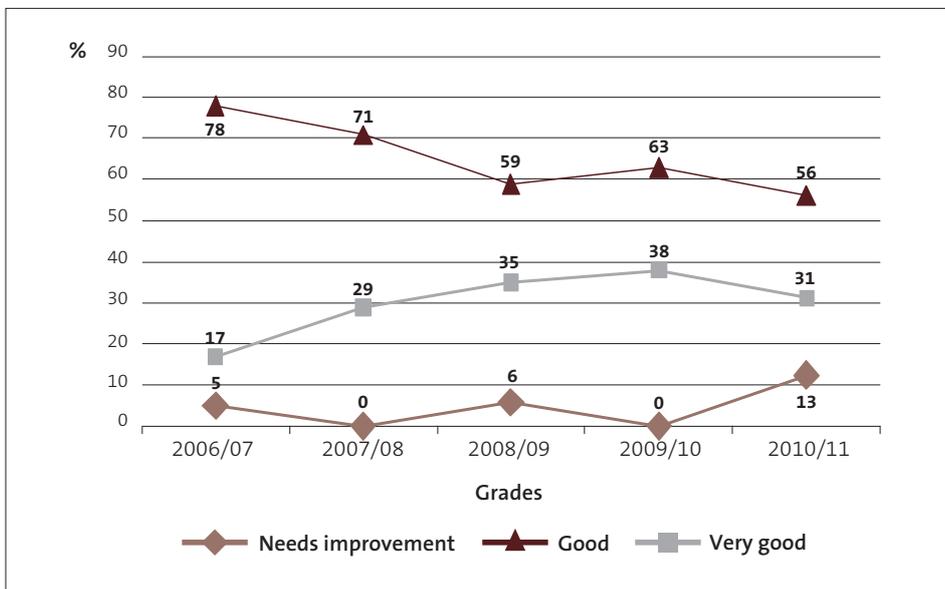
Grades used are: VG – Very good, G – Good, NI – Needs improvement, P – Poor.

- 2.26 Overall, the results for 2010/11 show that SOEs have sound management control environments and financial information systems and controls. More SOEs have a “Very good” grade for their management control environment than for their financial information systems and controls. Five SOEs received a “Very good” grade for both their management control environment and financial information systems and controls. This result reflects that SOEs have made good progress during the past year in responding to our recommendations for improvement.
- 2.27 The grade for two SOEs' financial information systems and controls dropped from “Good” in 2009/10 to “Needs improvement” in 2010/11. For these two SOEs, we identified significant deficiencies with their internal control systems and have assessed that improvements are necessary. No SOEs received a “Needs improvement” grade for their financial information systems and controls in 2009/10.
- 2.28 Figures 12 and 13 show the grades for SOEs for the five years from 2006/07.

**Figure 12**  
Grades for SOEs' management control environment, 2006/07 to 2010/11, as percentages



**Figure 13**  
Grades for SOEs' financial information systems and controls, 2006/07 to 2010/11, as percentages



- 2.29 Figure 12 shows a steady increase in the “Very good” grade for the management control environment aspect. Figure 13 shows deterioration in the “Very good” and “Good” grades for the financial information systems and controls grade. This is because of the two SOEs that received a “Needs improvement” grade in 2010/11.
- 2.30 We have included SOEs in our comparison of the 2010/11 grades for different types of central government entities in Part 1 (see Figures 4 and 6).
- 2.31 The comparison of grades for the management control environment in Figure 4 in particular shows that SOEs (and CRIs) are graded higher for this aspect than other types of entities in the central government sector. The reader needs to note the importance of considering the longer-term trends when making comparisons (see paragraph 1.24)

## Part 3

# Reporting alternative performance measures such as “underlying profit”

- 3.1 Last year, we reported our unease with SOEs in the electricity sector disclosing alternative performance measures in their 2010 annual reports. In this Part, we:
- briefly explain why we were uneasy;
  - set out our expectations for reporting “underlying profit”;
  - comment on underlying profit disclosures by SOEs in 2011; and
  - describe what we and others plan to do next.

### Why we were uneasy

- 3.2 In our 2011 report to Parliament, *Local government: Results of the 2009/10 audits*, we noted that the electricity SOEs were disclosing an amount described as underlying profit in their annual reports.
- 3.3 Underlying profit is an alternative performance measure to the profit figure determined using approved financial reporting standards and included in the financial statements. Sometimes, different terms are used, such as “normalised profit” instead of “underlying profit”, but they are essentially the same type of measure. The term underlying profit is not defined in financial reporting standards, but it typically excludes changes in the fair value of financial instruments and non-recurring transactions.
- 3.4 By presenting an underlying profit figure, entities intend to provide information that readers can use to better assess ongoing financial performance.
- 3.5 Normally, we encourage public entities to include information in their annual reports that is likely to be relevant to users. However, we were uneasy about the practice of disclosing underlying profit because:
- there is no authoritative guidance about what “underlying profit” is or how to calculate it, so inconsistent practices are likely between different entities;
  - the underlying profit amount is often presented prominently in the annual report and could overshadow the financial information that was prepared in keeping with financial reporting standards; and
  - the underlying profit amount is not always clearly labelled as supplementary information that is additional to the information required by financial reporting standards.

## Our expectations for reporting underlying profit

- 3.6 In early 2011, we carried out some research about underlying profit disclosures and set our expectations for such disclosures by entities in the public sector. Our research included looking at how regulators address the reporting of underlying profit, locally and internationally. In particular, we looked at the work on underlying profit completed by:
- the Securities Commission (which was disestablished and replaced by the Financial Markets Authority in May 2011);
  - the Committee of European Securities Regulators; and
  - the Australian Securities and Investments Commission.
- 3.7 In March 2011, we provided our auditors with guidance about what they should expect when entities disclose alternative performance measures such as underlying profit. We said that, if entities in the public sector disclose alternative performance measures in their annual reports, then we expect those disclosures to:
- be understandable;
  - relate to information based on generally accepted accounting practice in New Zealand (NZ GAAP<sup>13</sup>), preferably by reconciling the amounts;
  - be neutral and not used to remove “bad news”;
  - be consistently calculated over time;
  - be less prominent than information based on NZ GAAP; and
  - include comparative information for the previous year.
- 3.8 For any alternative performance measure to be understandable, we said that we expect the disclosures to contain enough contextual information for a reader to understand what the alternative performance measure is (that is, the principles supporting it) and why it has been included in the annual report.
- 3.9 We generally expect the alternative performance measure to be disclosed outside the financial statements or in the notes to the financial statements, and for any commentary on the alternative performance measure to be balanced with commentary on information based on NZ GAAP.

13 NZ GAAP includes applicable financial reporting standards issued by the New Zealand Accounting Standards Board, which is a sub-board of the External Reporting Board. NZ GAAP establishes requirements for preparing financial statements in New Zealand.

## Underlying profit disclosures by State-owned enterprises in 2011

- 3.10 We reviewed the underlying profit disclosures made in the 2011 annual reports of SOEs.<sup>14</sup> Underlying profit disclosures are usually reported by entities with a commercial focus, and SOEs are the main entities in central government that have a commercial focus.
- 3.11 The purpose of our review was to gauge the level of reporting of underlying or “normalised” profit within the SOE sector and assess how clear those disclosures were.
- 3.12 About half of the SOEs reported underlying profit in their annual reports, using a range of reporting practices. Some included it in their financial statements, while others included that information in commentary accompanying the financial statements. In our view, these SOEs were trying to provide readers with some additional insight into how the SOEs’ performance should be judged.
- 3.13 These SOEs did a reasonably good job of disclosing how they calculated underlying profit and how that profit related to the information in the financial statements. However, in our view, there is room for greater clarity.

### What next?

- 3.14 We will continue to work with SOEs and our auditors, as appropriate, where we consider that improvements can be made to the disclosures about underlying profit (in keeping with the principles set out in paragraph 3.7).
- 3.15 We will watch developments with the reporting of alternative performance measures (such as underlying profit) in the private sector, where the practice is more widespread. If necessary, we will revise our expectations for “for-profit” entities in the public sector. We want to ensure that practice in the public sector is appropriately aligned to practice in the private sector, given that entities in the public sector making such disclosures have a commercial focus.
- 3.16 As well as keeping up with developments in reporting alternative performance measures in New Zealand, we will watch what is happening internationally, especially in Australia. We note that the Australian Securities and Investments Commission issued a regulatory guide (No. 230) in December 2011, entitled *Disclosing non-IFRS financial information*.
- 3.17 The Financial Markets Authority has said that it intends to consult on a draft regulatory guide on disclosing alternative performance measures and other information prepared other than in keeping with approved financial reporting standards. We look forward to seeing the draft regulatory guide.

<sup>14</sup> We included Air New Zealand with SOEs for the purposes of our review.



## Appendix

# Crown entities audited in 2010/11 and covered in this report

Autonomous Crown entities	Crown agents (DHBs excluded)
Alcohol Advisory Council of New Zealand	Accident Compensation Corporation
Arts Council of New Zealand Toi Aotearoa	Career Services
Charities Commission	Civil Aviation Authority
Commission for Financial Literacy and Retirement Income (former Retirement Commission)	Crown Health Financing Agency
Environmental Risk Management Authority*	Earthquake Commission
Families Commission	Electricity Commission*
Government Superannuation Fund Authority	Energy Efficiency and Conservation Authority
Guardians of New Zealand Superannuation	Foundation for Research, Science and Technology*
Health Quality and Safety Commission	Health Research Council of New Zealand
Mental Health Commission	Health Sponsorship Council
Museum of New Zealand – Te Papa Tongarewa	Housing New Zealand Corporation
New Zealand Artificial Limb Board	Legal Services Agency*
New Zealand Film Commission	Maritime New Zealand
New Zealand Historic Places Trust	New Zealand Antarctic Institute
New Zealand Lotteries Commission	New Zealand Blood Service
New Zealand Symphony Orchestra	New Zealand Fire Service Commission
New Zealand Teachers Council	New Zealand Qualifications Authority
NZ On Air	New Zealand Tourism Board
Public Trust	New Zealand Trade And Enterprise
Standards Council of New Zealand	New Zealand Transport Agency
Te Māngai Pāho	New Zealand Walking Access Commission
Te Taura Whiri i te Reo Māori	Pharmaceutical Management Agency
	Real Estate Agents Authority
	Social Workers Registration Board
	Sport and Recreation New Zealand
	Tertiary Education Commission

Independent Crown entities	Crown entity companies (CRIs excluded)
Broadcasting Standards Authority	New Zealand Venture Investment Fund Limited
Commerce Commission	Radio New Zealand Limited
Drug Free Sport New Zealand	Television New Zealand Limited
Electoral Commission (new)	
Electoral Commission* (old)	
Electricity Authority	
External Reporting Board	
Health and Disability Commissioner	
Human Rights Commission	
Independent Police Conduct Authority	
Law Commission	
New Zealand Productivity Commission	
Office of Film and Literature Classification	
Office of the Children's Commissioner	
Privacy Commissioner	
Securities Commission*	
Takeovers Panel	
Transport Accident Investigation Commission	

\* Disestablished.

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- Cleanest public sector in the world: Keeping fraud at bay
- Annual Report 2010/11
- Transpower New Zealand Limited: Managing risks to transmission assets
- The Treasury: Implementing and managing the Crown Retail Deposit Guarantee Scheme
- Managing freshwater quality: Challenges for regional councils
- Local government: Improving the usefulness of annual reports
- New Zealand Transport Agency: Delivering maintenance and renewal work on the state highway network
- Government planning and support for housing on Māori land
- Inquiry into the use of parliamentary travel entitlements by Mr and Mrs Wong
- The Emissions Trading Scheme – summary information for public entities and auditors
- Planning to meet the forecast demand for drinking water in Auckland
- Appointing public sector auditors and setting audit fees
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