Controller and Auditor-General
Tumuaki o te Mana Arotake

B.29 [15r]

Central government: Results of the 2014/15 audits

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Auditor-General's overview

This report sets out the results of my audit of the *Financial Statements of the Government of New Zealand for the year ended 30 June 2015* (the Government's financial statements) and of carrying out the Controller function. Both are essential components of New Zealand's public financial management system.

I am pleased to report that I have issued an unmodified audit opinion on the Government's financial statements. The financial statements give an account of what the New Zealand Government earns, spends, owns, and owes.

My role is to provide assurance to Parliament that the way the Treasury has reported in the Government's financial statements fairly reflects the Government's financial performance and position. The Controller work complements that. As the Controller, I check that government departments do not spend more money than Parliament has approved and that they have spent money for its intended purposes.

These are not trivial matters. Establishing that the Government's books are trustworthy is fundamental to public accountability, as is the principle that the Government spends only what Parliament has approved.

The Government's financial statements do not exist in isolation. This report draws on the many individual audits of central government organisations. That said, many specific issues covered in individual audits are not significant enough to feature in this report.

Some of the issues that I highlight in this report are of interest not only from a financial reporting perspective. They indicate the complexity of issues that concern a large number of New Zealanders – assessing the cost of the Canterbury rebuild is one example.

Investing in, and managing, the Crown's assets

The Government's financial statements record the Crown's assets, as at 30 June 2015, at $278.7 billion. This is a $21.9 billion (9%) increase on the previous year. Financial assets make up 49% of the Crown's asset base, with property, plant, and equipment making up 45% of total assets.

One of the more interesting challenges in preparing and auditing the Government's financial statements involves deriving and verifying the values of property, plant, and equipment assets (fixed assets), many of which are large, complex, and specialised. Particular areas of focus in our 2014/15 audit included the valuations of the state highway network, Solid Energy's assets, railway network assets, and the Government's social housing stock (see Part 2).

We note with interest the Treasury's work to improve investment decisions and asset management practices across the State sector. Recent Treasury initiatives include its *Investment Statement*, *Thirty Year New Zealand Infrastructure Plan 2015*, and development of Cabinet Office Circular (15) 5 – *Investment Management and Asset Performance in the State Services* (see Part 1). The latter requires investment-intensive agencies to produce long-term investment plans (covering at least 10 years) and asset management performance measures.

We will play a complementary role in our audit work, which will be driven by my 2015/16 work programme theme, *Investment and asset management*. As part of this theme, my Office is looking at the Government's investment strategy and will examine the four-year plans of selected asset-intensive or investment-intensive agencies. We are taking a special interest in the extent and maturity of long-term asset planning and management practices, including financial forecasts.

Given the significance of financial assets to the Crown's balance sheet, I will report on how the financial assets are managed, governed, and monitored.

Rebuilding Canterbury

The net annual operating costs incurred by the Crown for the Canterbury earthquake recovery continue to decline, while capital expenditure increases as the Government invests more heavily in rebuilding assets and infrastructure. Some challenges continue with how the costs are accounted for and reported (see Parts 2 and 3).

Since 2011, my reports on the audits of the Government's financial statements have identified significant uncertainties with the estimated costs of the Canterbury rebuild. My reports have given reassurance that the Treasury has reasonably estimated the total cost and associated liabilities. However, significant uncertainties still remain, particularly for the valuation of liabilities and associated insurance recoveries (see Part 2).

These uncertainties have challenged accounting and reporting practice. This, in turn, has led to some appropriation breaches (see Part 3).

Financial management and reporting

The preparation and audit of the Government's financial statements relies on a finely tuned financial management and reporting system, run by the Treasury. The publicly owned entities whose financial results are sent to the Treasury and included in the Government's financial statements must also present their annual statements to my auditors in a timely manner. My auditors provide assurance on both the financial statements of the individual reporting entities and the whole-of-government financial statements. I issued my audit report on the 2014/15 Government's financial statements on 30 September 2015, as required.

The Public Finance Act 1989 (section 45D) requires government departments to provide the Auditor-General with all information for audit by 31 August. Considerable pressure can be placed on my auditors when government entities are late in providing satisfactory draft financial and performance statements to my auditors.

For the 2014/15 audits, some government departments provided annual report information to my auditors that was late or, if provided on time, was incomplete or inadequate. The lateness and poor quality of information and draft reports initially provided not only created more work for my auditors but that work also needed to be completed in a tighter time frame.

I would like to see more attention being committed to good quality financial and performance reporting to ensure that entities provide a robust and transparent account of themselves to Parliament and the public in a timely manner.

Lyn Provost
Controller and Auditor-General

4 December 2015

1 The operating environment for central government

1.1 This Part describes the operating environment for central government agencies in 2014/15. It provides some context for this report – in particular, for our audit of the financial statements of the Government of New Zealand (the Government's financial statements).

1.2 The Government's financial statements consolidate the many and varied organisations associated with central government.[1] We audit each of these organisations each year, which informs our work on the Government's financial statements. We need to understand the operating environment for these different organisations because the Government's priorities and expectations drive how organisations plan, prioritise, operate, spend, and report funding allocated through the Budget process and approved by Parliament.

Government priorities

1.3 The Government's four priorities are as follows:

- responsibly managing the Government's finances;
- building a more productive and competitive economy;
- delivering better public services within tight financial constraints; and
- supporting the rebuilding of Christchurch.

1.4 The two priorities most relevant to our audit of the Government's financial statements are the management of the Government's finances and the rebuilding of Christchurch. With the total cost of rebuilding estimated at $40 billion in 2014, and the Government's contribution forecast to be $16 billion, the continuing effect of Christchurch in the Government's financial statements continues to be a focus for our audit.

Focus on financial management

1.5 The Government set a target of returning to surplus in 2014/15, measured by the total Crown operating balance before gains and losses (OBEGAL). On 14 October 2015, the Government announced that it had achieved an operating surplus for 2014/15 of $414 million.

1.6 Knowing that the Government's financial statements fairly reflect the Government's financial performance and position allows Parliament to consider and debate the Government's financial performance and direction.

1.7 The expectations of tight fiscal management have affected how departments manage. Many agencies have faced demand, wage, and price pressures when

1 Including government departments, State-owned enterprises, Crown entities (including schools, Crown research institutes, and district health boards), mixed-ownership model companies, Offices of Parliament, Fish and Game Councils, the New Zealand Superannuation Fund, and the Reserve Bank of New Zealand.

their funding is static or declining because appropriations are capped. This has driven many to search for greater efficiencies.

Public sector transformation

1.8 The Government's agenda for public sector change continued in 2014/15. First launched in March 2012, the Better Public Services programme has a strong focus on results. The Government set 10 specific and measurable targets in 2012. In February 2015, it extended or reset the original targets for reducing long-term welfare dependence, boosting skills and employment, and reducing crime.

1.9 However, the results focus is only one component of a broader agenda for public sector reform. The Government expects the public sector to improve service delivery and transform the way it operates. In 2014, the State Services Commission outlined four guiding principles for reform, which highlight the aspiration of a citizen-centric and results-focused public sector and emphasise the importance of leadership and stewardship.

1.10 The expectation is for public agencies to work together more effectively. Stewardship obligations mean that government department chief executives are expected to contribute to the collective leadership of state services and deliver results in the medium term, making sure that organisations respond to New Zealanders' future needs.

1.11 Ministers have also been clear that they expect the public sector to make better use of data and create greater value from data that the Government holds. Greater focus on analysis and insights available within cross-agency data and work to expand Statistics New Zealand's Integrated Data Infrastructure have been part of the central agencies' work programme.

Change at system level – leadership from the centre

1.12 The State Services Commission, the Treasury, and the Department of the Prime Minister and Cabinet are exercising leadership as the "corporate centre" to oversee and improve state sector performance. The State Services Commission continued to use its Performance Improvement Framework (PIF) programme to analyse performance challenges at an agency and system level. In 2014/15, it completed 12 full PIF reviews, compared with six full PIF reviews in the previous year. Another initiative to lift state sector performance was the establishment of a new senior role in Auckland, responsible for leadership of state services there and improved engagement between central government and Auckland.

1.13 Each year, government departments have to prepare four-year plans. The purpose of the plans is to set out a medium-term view of the sector the departments work with or are responsible for, and set out how the departments will move closer to achieving their longer-term vision. This reflects chief executives' stewardship obligation. We are examining selected four-year plans as part of our 2015/16 work on investment and asset management. Other initiatives to improve performance include the Treasury's work to improve the State sector's strategic financial management capability through setting up the Office of the Government Accountant.

1.14 The Treasury carries out an annual Benchmarking Administrative and Support Service (BASS) analysis. It provides information on the cost, efficiency, and effectiveness of administrative and support services in the State sector. The State Services Commission also monitors the size of the public sector. As at 31 December 2014, there were 36,107 full-time equivalent positions in core government administration, below the cap of 36,475 in place since 2012.

1.15 Also, the Ministry of Business, Innovation and Employment, Department of Internal Affairs, and Ministry of Social Development have continued to progress their respective functional leadership roles for procurement, information and communications technology (ICT), and property management. The objective of functional leadership is to improve the effectiveness of common business functions and reduce their overall costs.

1.16 There has also been an increased focus on investment and asset management from a system perspective. In 2014, the Treasury published the 2014 Investment Statement, a blueprint for improving the effectiveness and efficiency of the Crown's balance sheet. In August 2015, it released the *Thirty Year New Zealand Infrastructure Plan 2015*, which includes actions to achieve better use of existing infrastructure and the better allocation of new investment.

1.17 In 2014/15, the Treasury led the development of *Investment Management and Asset Performance in the State Services*, a Cabinet Office Circular that sets out Cabinet's expectations for managing investments and both physical and intangible assets. A group of Ministers (Investment Ministers) has been designated to give effect to the objectives of the investment system, with the Treasury assigned the lead role for the Government's investment management system.

1.18 The *Government Investment Strategy* was released in August 2015. It outlines the principles that the Government wants to apply to the selection, decision making, and management of the Government's investment portfolio.

Change at agency and sector level

1.19 The Government's expectations for public sector transformation are reflected in a significant number of change initiatives at an agency level. Several large organisations have implemented, or are in the process of implementing, significant change programmes. For example:

- The Inland Revenue Department (Inland Revenue) is implementing a Business Transformation programme. The programme has progressed well through the year and has moved into a detailed design stage. We carried out a performance audit in 2014/15 of the governance of the programme. We found that, overall, the governance arrangements for the programme to date had been broadly fit for purpose.
- The Ministry of Business, Innovation and Employment began a "High Performing MBIE" programme to improve its operations. Changes to the Ministry's business structure were announced in May 2015.
- The Ministry of Social Development is progressing a Simplification Programme to modernise transactional services to the benefit of both the Ministry (through efficiency savings) and service users. The Ministry is also supporting an Expert Advisory Panel, tasked with making recommendations to modernise the Child, Youth and Family division. The changes are expected to have a significant effect on Child, Youth and Family's work programme and operations.
- The Ministry of Justice is implementing a court modernisation programme, which is expected to provide modern, accessible, and people-centred justice services.
- AgResearch Limited has continued with its Future Footprint project. The project aims to ensure that the right infrastructure and staff are located at the most appropriate locations in New Zealand to deliver improved scientific support to the agricultural sector.
- Health Benefits Limited was preparing for the transfer of its shared services programme. The Government confirmed on 2 June 2015 that Health Benefits Limited would be wound up on 30 June and a new company owned by district health boards would be set up to implement the shared-services programme previously led by Health Benefits Limited. In October 2015, we issued a report on the costs and benefits of aspects of Health Benefits Limited's work in the health sector.
- Also, reflecting a different phase of efforts to rebuild Christchurch, the Canterbury Earthquake Recovery Authority (CERA) became a departmental agency (from 1 February 2015), hosted by the Department of the Prime Minister and Cabinet.

1.20 Our audit of the Government's financial statements does not cover these changes unless they significantly affect assumptions about the assets or liabilities of the Crown. However, because change increases the risk of internal controls not operating effectively, our annual audits consider the effect of significant change programmes on the control environment.

1.21 There are also some significant strategy reviews. The New Zealand Health Strategy is being reviewed and updated. This strategy will set the vision for, and could significantly change, the health sector during the next three to five years. Exercising its sector leadership, the Ministry of Transport also completed three strategy projects (Transport and Economics, Future Demand, and Future Funding).

1.22 The Government has indicated that it will expand its social investment approach, first used in the 2012/13 welfare reform, to the justice sector and social housing. Also, public sector agencies are exploring and implementing different models for service delivery to meet the Government's expectations of an innovative approach to delivery. Examples include:

- The Ministry of Health is leading cross-government work to pilot social bonds in New Zealand. Social bonds see private and not-for-profit organisations enter into partnerships to fund and deliver services to improve social outcomes.
- The Department of Corrections is implementing a public-private partnership for designing, building, financing, operating, and maintaining a new prison, the Auckland South Corrections Facility.
- The Ministry of Social Development is changing how it purchases social services for vulnerable people, based on its Community Investment Strategy. The Strategy is intended to be a more results-focused and evidence-based approach.

1.23 The Government could change its approach to providing social services further as it considers a response to the wide-ranging recommendations in the Productivity Commission's report on social service contracting.

Changes in institutional arrangements – implications for reporting

1.24 Requirements for public sector planning and reporting, and the accountabilities of chief executives, changed with the 2013 amendments to the Public Finance Act 1989, the State Sector Act 1988, and the Crown Entities Act 2004. Among other goals, the amendments were designed to lead to more meaningful reporting on what has been achieved with funding from appropriations and facilitate more collaboration between agencies. For example, the amendments to the Public Finance Act provide greater flexibility by allowing end-of-year reporting to be grouped by sector or topic.

1.25 Performance reporting is an integral part of our parliamentary accountability system and helps demonstrate effectiveness, efficiency, and value for money in the public sector. Our annual audits of central government entities examine information about service performance. However, this is reported on an entity basis, not in the Government's financial statements.

2 Our audit of the Government's 2014/15 financial statements

2.1 In this Part, we report the results of our audit of the Government's financial statements for 2014/15, and discuss the significant and other matters arising from this audit. The significant matters relate to:

- continuing uncertainties due to the Canterbury earthquakes;
- the effect of new accounting standards for the public sector;
- how tax revenue is recognised; and
- discount rates used to value long-term liabilities.

2.2 The other matters arising from our audit relate to:

- valuation of the state highway network;
- valuation of Solid Energy New Zealand Limited's assets and liabilities, given its uncertain financial situation;
- accounting for the Government's Treaty of Waitangi settlement obligations;
- accounting for KiwiRail Holdings Limited in the Government's financial statements;
- Accident Compensation Corporation residual levies;
- consolidation of the financial results of schools;
- valuation of the Government's social housing stock;
- accounting for and disclosure of minority interests; and
- reduction in disclosures.

Our audit report

2.3 We issued a standard audit report, which included an unmodified audit opinion on the Government's financial statements for the year ended 30 June 2015.

2.4 We issued our audit report on 30 September 2015.

2.5 The audit report appears on pages 28 to 30 of the Government's financial statements. It includes our opinion that those statements:

- present fairly, in all material respects:
  - the Government's financial position as at 30 June 2015;
  - the Government's financial performance and cash flows for the year ended 30 June 2015; and
  - the Government's borrowings as at 30 June 2015, unappropriated expenditure and expenses or capital expenditure incurred in emergencies for the year ended on that date, and trust money administered by departments and Offices of Parliament as at 30 June 2015; and
- comply with generally accepted accounting practice in New Zealand.

Significant matters arising from the audit

Continuing uncertainties due to the Canterbury earthquakes

2.6 We are satisfied that the effects of the Canterbury earthquakes have been appropriately accounted for in the Government's financial statements.

2.7 The Crown's earthquake-related obligations at 30 June 2015 totalled $3.9 billion, which was about 2% of the Crown's total liabilities. These earthquake-related amounts were considerably less material to the whole-of-government position than they were to the individual entities that manage the liabilities.

Significant uncertainties remain

2.8 However, significant uncertainties remain in the valuation of liabilities and associated insurance recoveries, as explained in Note 32 to the Government's financial statements. Broadly, the uncertainties are:

- uncertainty in estimating the earthquake-related outstanding claims liabilities and reinsurance receivables for the two insurance entities – the Earthquake Commission and Southern Response Earthquake Services Limited (Southern Response);
- uncertainty relating to the Crown's obligation to provide a support package to local authorities for repairing damaged infrastructure (the "three waters" – waste water, stormwater, and drinking water systems); and
- uncertainty about the red zone and, in particular, the insurance receivables assumed by the Crown as part of the Crown's offer to acquire property in the red zone.

2.9 The main sources of the uncertainty in estimating outstanding claims liabilities are:

- severe land damage and a complex land claims environment from both an engineering and legal perspective (the land aspect affects only the Earthquake Commission);
- the effect of multiple earthquakes on the Earthquake Commission's insurance cover and associated reinsurance cover (with consequential effects on other insurers, such as Southern Response); and
- estimating the time to repair or rebuild and inflation in building costs.

2.10 For the Earthquake Commission, the volatility of these claims is partly mitigated by the maximum settlement amounts for dwellings ($100,000) and contents ($20,000). However, claims made for residential land are not subject to a monetary limit and are therefore subject to greater volatility.

2.11 To take account of the inherent risk in estimating outstanding claims liabilities, a margin is added to the expected cost of fulfilling the claims to increase the probability that the provisions in the Government's financial statements will be enough. For 2015, despite the decrease in the overall liability, there has been a small increase in the total risk margin for the Earthquake Commission and Southern Response.

2.12 In December 2014, at the Earthquake Commission's request, the High Court made a ruling (a declaratory judgment) that confirmed that "Increased Liquefaction Vulnerability" and "Increased Flooding Vulnerability" were forms of land damage covered by the Earthquake Commission.

2.13 The declaratory judgment also confirmed that the Earthquake Commission could settle certain claims on a diminution of value approach (that is, to compensate owners for the loss of value in their homes arising from the increased risk). This judgment has helped to reduce some of the uncertainty associated with land claims.

2.14 Increased Liquefaction Vulnerability and Increased Flooding Vulnerability claims make up most land claims. More than 98% of the properties eligible for cover because of an increased vulnerability to liquefaction have been identified, but the settlement process had yet to be confirmed by the 2014/15 year end. The number of properties more vulnerable to flooding is less certain.

Provision for water infrastructure costs

2.15 After the Canterbury earthquakes of 2010 and 2011, the Government had an obligation to provide financial support for response and recovery under the Civil Defence Emergency Management Plan and Guide (CDEM Plan and Guide). This included 60% of the repair (recovery) cost for water infrastructure assets (drinking water, stormwater, and waste water) owned by local authorities.

2.16 In May 2011, a permanent legislative authority was put in place to replace the obligation under the CDEM Plan and Guide. This committed the Crown to funding 60% of the water infrastructure costs for Christchurch City Council, Waimakariri District Council, Selwyn District Council, and Environment Canterbury.

2.17 After this decision, the Crown entered into cost-sharing agreements with Christchurch City Council and Waimakariri District Council in 2013. The purpose of the cost-sharing agreements was to establish a value that the Crown would commit to, so the previous permanent legislative authority was able to be removed.

2.18 The most significant costs are for horizontal infrastructure, with a cap of $1.8 billion agreed as the total Crown obligation. This obligation includes not only the obligation of CERA for the recovery of horizontal infrastructure (water infrastructure assets) but also the initial response costs under the CDEM Plan and Guide, which have been settled with the Department of Internal Affairs, and the repair costs for local roading to be funded by the New Zealand Transport Agency.

2.19 In May 2015, an independent assessor reviewed the eligible costs for the cost-sharing agreement with Christchurch City Council. After considering the independent assessor's report, CERA has not changed its original estimate of eligible costs.

2.20 At 30 June 2015, there was uncertainty over policy decisions for the funding of land drainage and work to renew the horizontal infrastructure.

Crown announcement on the revised red zone offers

2.21 A group of uninsured and commercial property owners took legal action against the Crown about the initial red zone offers made. A Supreme Court decision directed CERA to reconsider several offers. In doing this, CERA prepared a draft Residential Red Zone Offer Recovery Plan, which set out five main criteria for new Crown offers to buy vacant insured commercial properties and uninsured improved properties in the red zone and the Crown's preliminary views on new offers. The Plan was approved by Cabinet after 30 June 2015, and new offers were then made.

2.22 Because the offers were approved after 30 June 2015, a contingent liability of $48 million was disclosed in the Government's financial statements.

Treatment of local roading costs for the Canterbury earthquakes

2.23 For accounting purposes, repairs to local roads are recognised in the year of repair. There is no provision in the Government's financial statements for costs associated with future repairs of local roads, which differs from the water infrastructure assets described above. This exclusion reflects that the first call for funding these future expenses will be from dedicated revenue in the form of road user charges, fuel excise duties, and registration fees paid into the National Land Transport Fund.

2.24 Although the Government is committed to repairing local roads in Canterbury, the effect of the earthquakes has been to increase the priority of the work in the Canterbury region, rather than create an additional obligation to be recognised in the Government's financial statements. The Government has a continuing programme of funding the repair and development of local roads throughout New Zealand.

2.25 If the Government's share of the costs associated with the future repair of local roads exceeds the amount available in the National Land Transport Fund, then the Government has several options to allocate future revenue to help fund this expense.

2.26 Based on information about the Government's funding decisions to date, we are satisfied that it is appropriate to continue to not recognise a liability (because the effect of the earthquakes has been to increase the priority of the local roading work in the Canterbury region and future expenses are expected to be funded primarily through future funding).

Effect of new accounting standards for the public sector

2.27 We are satisfied that the Government's financial statements have been appropriately prepared in keeping with new accounting standards for public benefit entities (PBE standards).

2.28 The Government's financial statements for 2014/15 were the first to be prepared using the newly introduced PBE standards. Previously, the Government's financial statements were prepared using NZ IFRS (PBE) accounting standards.

Sovereign revenue

2.29 One of the significant effects of the new standards related to the recognition of "sovereign revenue", such as taxes, fines, and penalties. The relevant accounting standard now requires the initial recognition of revenue and related receivables at fair value. Under the previous standard, such revenue was initially recorded at its nominal value.

2.30 For fines and penalties, revenue was recognised at its fair value in the statement of financial performance (consistent with a revised accounting policy wording), with the nominal amounts, and initial allowance for impairment, disclosed in the notes.

2.31 However, no fair value adjustment was made to the nominal value of tax revenue. We accept that initially recognising tax receivables at nominal value is materially in keeping with both the accounting policy for the Government's financial statements and the applicable new standard. Determining the fair value of tax revenue requires estimation to determine whether the amount outstanding that is not collected is because of events in place at the time the taxable event occurred or because of events that occur later.

Sub-consolidation of tertiary education institutions

2.32 The Ministry of Education carries out a consolidation of 30 June financial returns of tertiary education institutions (TEIs) so that their consolidated financial performance and position can be included in the Government's financial statements. For 2014/15, this was required to be completed using the newly introduced PBE standards.

2.33 TEIs will publish their first financial statements in compliance with the new PBE standards for the 31 December 2015 financial year. Few of the TEIs had adequately considered the effect of the new PBE standards as at 30 June 2015. Furthermore, the Ministry of Education had not taken any significant steps to provide guidance or collect additional information to enable an accurate assessment of the effect of the new PBE standards for the purpose of the sector consolidation. This raised concerns about whether the consolidation had been prepared based on a full understanding of the TEI funding streams supported by adequate evidence from the sector.

2.34 Our own analysis raised questions about whether TEIs should not have recognised several liabilities as at 30 June 2015. The most material component of this was deferred revenue arising from full-year course fees. We accepted the decisions made about those liabilities because the effect of including them was not material for the Government's financial statements.

Accounting for the Crown's interest in TEIs

2.35 The Government's financial statements continue to reflect the Crown's ownership interest in TEIs as 100% equity accounted investments under the new PBE standards.

2.36 We agreed with the Treasury that the previous judgement that the Crown does not control TEIs should continue to apply. The accounting standard on control has not changed with the adoption of the new PBE standards. However, this judgement will need to be reviewed when the new standard on control, which is currently being developed, is introduced.

2.37 We also agreed that it is reasonable to continue to equity account TEIs rather than consolidating their results on a line-by-line basis.

How tax revenue is recognised

2.38 In previous years, we have recommended to Inland Revenue that a thorough review of taxation revenue recognition policies be carried out with a view to fine-tuning the recognition of taxation revenue, where appropriate. This is an important project because of the complexities involved and the potential effect on the way the Government recognises its tax revenue. The PAYE and GST components of the review were concluded in 2012.

2.39 A pilot project, which was to be completed by the end of 2014, was being run to assess the effect of some proposed changes against the current revenue recognition policy. However, Inland Revenue has now decided it should not continue with changes to its income tax recognition policy because of:

- the significant costs involved in making changes to its current tax management system;
- the expected changes to systems and processes as a result of the Business Transformation project, which is expected to take place in the next few years; and
- the need to maintain a stable core operating environment during the Business Transformation project.

2.40 In our view, there are other approaches that could be implemented, independently of the Business Transformation programme, to help Inland Revenue refine its revenue recognition policy and produce better year-end estimates of taxes receivable. Two such refinements were made to tax accruals as at 30 June 2015, and we look forward to further refinements in 2015/16.

Discount rates for long-term liabilities

2.41 We are satisfied that appropriate assumptions about risk-free discount rates and the consumer price index (CPI) have been used to value the Crown's two significant long-term liabilities that can be materially affected by changes in discount rates. Those two liabilities are ACC's outstanding claims obligations and the retirement plan obligations of the Government Superannuation Fund.

2.42 The Treasury used its Methodology for Risk-free Discount Rates and CPI Assumptions for Accounting Valuation Purposes (the Methodology) to prepare a 30 June 2015 table of risk-free discount rates and CPI assumptions used to value the significant long-term liabilities of the Government. The risk-free rates are used as a "building block" for deriving a market interest rate for discounting student loan advances.

2.43 The long-term interest rate remained at 5.5% and the long-term CPI inflation rate was kept at 2.5%. However, because of generally lower interest rates at the shorter end of the yield curve since last year, there were significant discount rate losses this year ($4.7 billion for ACC and the Government Superannuation Fund combined).

Other matters arising from the audit

Valuation of the state highway network

2.44 We are satisfied that the $30 billion valuation of the state highway network, including underlying land, is based on the best information available to the New Zealand Transport Agency at the time of the valuation.

2.45 The state highway valuation is complex and involves numerous data sources from several different parties (both external and internal to the New Zealand Transport Agency). There is a high degree of reliance on the expertise and experience of the external valuer. The valuation of the state highway network is based on valuing each of the various components (such as land, formation, and bridges) and adding these together.

2.46 We note that "brownfield" costs, such as the cost of traffic management, are not fully incorporated as part of the valuation. Also, we note that there are uncertainties with the quality of some of the underlying data used in the valuation.

2.47 In 2010, we recommended that the New Zealand Transport Agency review the reasonableness and validity of the assumptions used to value state highways and that brownfield costs be incorporated into the valuation.

2.48 In 2013/14, the New Zealand Transport Agency began to estimate, and progressively include, brownfield costs. Historical costs cannot be reliably measured, so brownfield costs will be recognised over time in the Government's financial statements. The current year's brownfield costs included in the state highway valuation are $702 million. Last year's estimate of $251 million was reduced to $176 million this year after an estimation error was identified.

2.49 Because judgements in estimating brownfields costs are particularly challenging, the New Zealand Transport Agency is planning how to better capture such costs in future valuations of the state highway network.

2.50 As in previous years, there are uncertainties about whether the underlying data include the right quantity of some components, account for all the costs of some components, and record the right life of some components based on their condition. The valuer's final report also noted some significant errors identified by our auditors that required adjustment.

2.51 Our previous understanding was that the New Zealand Transport Agency had a plan to improve the accuracy of the asset data, including carrying out a stocktake of all state highway assets during the three years to 30 June 2016. However, we understand that the New Zealand Transport Agency's focus is to have good data on the condition of the roads (such as smoothness) that is regularly updated and used to prioritise maintenance. There are also clauses about uploading network data in contracts with maintenance firms, which specify that asset data be updated whenever work is done.

2.52 We will continue to monitor the New Zealand Transport Agency's work on these matters as part of our audit. As better information becomes available, it needs to be used in future valuations of the state highway network.

Valuation of Solid Energy New Zealand Limited's assets and liabilities, given its uncertain financial situation

2.53 We are satisfied that the Government's financial statements reflect the assumption that there is no residual value in Solid Energy and that appropriate disclosure has been included in the subsequent events note (Note 34).

2.54 On 13 August 2015, the Board of Solid Energy placed that company and all associated companies into voluntary administration. On 17 September 2015, creditors approved a deed of company arrangement. It will allow the company to continue to trade while it carries out an orderly and managed sale of its assets during the next 2.5 years.

2.55 The Crown will continue to take responsibility for site rehabilitation costs associated with Solid Energy's historical mining activity. On execution of the deed of company arrangement, existing Crown indemnities were restructured to make them available to any purchasers of the company's mining assets.

Accounting for the Government's Treaty of Waitangi settlement obligations

2.56 The deeds of settlement negotiated with Waikato-Tainui and Ngāi Tahu included relativity clauses. Those clauses mean that the Crown is liable to make payments to maintain the proportion of Waikato-Tainui's and Ngāi Tahu's settlements at 17% and 16.1% respectively of all Treaty settlements.

2.57 We are satisfied that the Crown's obligation as a result of those relativity clauses have been appropriately accounted for and disclosed in the Government's financial statements. That includes disclosure of an unquantifiable contingent liability for payments that might be required in future under the relativity clauses. In October 2012, the Crown advised that the relativity mechanism had been triggered, after which Waikato-Tainui and Ngāi Tahu made claims under their relativity clauses and received an initial payment. We expect that the reliability of the estimate of the claims under the relativity mechanism will continue to increase as disputed items between the parties are progressively settled.

2.58 We will continue to liaise with both the Ministry of Justice and the Treasury on this issue.

Accounting for KiwiRail Holdings Limited in the Government's financial statements

2.59 We are satisfied that, despite facing financial difficulties, it is still appropriate for KiwiRail Holdings Limited (KiwiRail) to designate itself as a for-profit entity[2] for financial reporting purposes. As such, we are satisfied with the accounting treatment and disclosures, noting the different treatment of non-freight rail infrastructure at the whole-of-government level (see below).

2.60 In our view, the Board's decision to consider KiwiRail a for-profit entity continues to be not unreasonable, but it is marginal because the group is likely to continue to depend on the Government for funding in the medium term.

2.61 Information that helps to determine whether an entity is a public benefit entity includes the entity's founding documents, the nature of the benefits provided by the entity, the amount of expected financial surplus, the nature of the equity interest, and the nature of the entity's funding.

2.62 In our view, there are conflicting indicators when assessing the designation of the group. For some indicators, such as the founding documents, the group would clearly be "for-profit". To be "for-profit", an entity needs to have both a clear intention and the realistic prospect of generating a commercial return over the long term. Both the KiwiRail Board and the Government appear committed to delivering a sustainable business and the entity continues to behave commercially, consistent with being a for-profit entity. However, KiwiRail's current financial projections show a continuing dependency on the Government for funding in the medium term.

2.63 Given the group's financial performance during the past few years and its projected financial performance, we will continue to monitor the appropriateness of the for-profit designation.

Valuation of railway network assets not required for freight services

2.64 We are satisfied with the valuation and disclosure in the Government's financial statements of railway network assets not required for freight services (including rail infrastructure assets used solely for metro passenger services).

2.65 The "non-freight" portion of the network continues to be accounted for in the Government's financial statements on a different basis from KiwiRail's financial

2 For-profit entities are entities that are not public benefit entities.

statements. KiwiRail accounts for this part of the network on a purely commercial basis because that is consistent with the Government's expectations of the company (to generate a commercial return from the use of the rail network).

2.66 However, in the Government's financial statements, the portion of the network not necessary to run the freight operation is accounted for on the basis of the service potential provided by those assets, rather than the net cash flows they are forecast to generate. This is because, despite the Government's expectations of KiwiRail generally, the primary purpose for the non-freight portion of the network at a whole-of-government level is a public benefit purpose, such as reduced congestion on roads and reduced travel times, rather than the Government generating a commercial return from those assets.

2.67 The different accounting treatment of the non-freight portion of the network in the Government's financial statements has resulted in this portion being valued $0.8 billion higher at 30 June 2015 than in KiwiRail's own financial statements.

Accident Compensation Corporation residual levies

2.68 We are satisfied that the Government's decision to stop collecting residual ACC levies has been correctly reflected in the Government's financial statements.

2.69 Until 1999, ACC operated under a "pay as you go" basis, collecting only enough levies each year to cover the cost of claims for that particular year. In 1999, the Government decided to change ACC to a fully funded way of operating. As a result, a "residual levy" has been collected to meet the continuing cost of claims incurred before 1999 and to move this part of the scheme to a fully funded position.

2.70 Under legislation in force as at 30 June 2015, the residual levy was required to be collected until 1 April 2019. An amendment Act, the Accident Compensation (Financial Responsibility and Transparency) Amendment Act 2015, received Royal Assent on 23 September 2015. The amendments in this Act give the Government the option to stop collecting residual levies before 1 April 2019.

2.71 On 21 September 2015, Cabinet agreed that ACC should stop invoicing and collecting residual levies from 1 April 2016. This meant that ACC would no longer charge residual levies on liable earnings from 1 April 2015 onwards.

2.72 To recognise this as an event that happened after 30 June 2015 but that affected the 2014/15 financial statements, we had previously agreed with the Treasury and ACC that there were three criteria to be satisfied:

- the Cabinet decision noted above;
- a public announcement of the decision in enough detail so levy payers have a

valid expectation that they will not have to pay the levy (this took place on 22 September and was widely reported in the media); and

- a likelihood that a Bill would be passed into law in enough time to put into effect the Cabinet decision to discontinue the residual levy from 1 April 2016. (As noted in paragraph 2.70, the Bill has now been passed into law.)

2.73 The effect of this is that accrued revenue and unearned levy liability recorded for residual levies at 30 June 2015 are no longer considered to be collectable and are therefore no longer recorded in the Government's financial statements as at 30 June 2015. Also, as a result of removing residual levies, a deficiency in the work account arises, which led to the recognition of an unexpired risk liability as at 30 June 2015.

Consolidation of the financial results of schools

2.74 For 2014/15, there was a significant improvement in the timeliness of information included in the schools sub-consolidation. We therefore have greater confidence in the robustness of information that has been included in the Government's financial statements this year.

2.75 The information included in the schools' consolidation incorporated the actual 2014 results for 92% of schools. The other 8% of schools results were estimated, based on the previous year's results (2014: 62% and 38% respectively). This is getting close to the levels achieved before the Novopay issues affected schools' financial reporting.

Valuation of the Government's social housing stock

2.76 We are satisfied that the Government's social housing reform programme does not have a significant effect on the Government's financial statements for 2014/15.

2.77 The Government has continued to progress its social housing reform programme. During August 2015, the Social Housing Reform (Transaction Mandate) Bill had its first reading in Parliament. This Bill will enable the Government to transfer state houses to third-party providers. No significant transfers of assets took place in 2014/15.

2.78 In our view, the valuation of the social housing stock within the Housing New Zealand Corporation appropriately remains at fair value, assessed using current market values of individual properties.

Accounting for, and disclosure of, minority interests

2.79 We are satisfied that the presentation and disclosure of minority interests are materially correct.

2.80 The Treasury's presentation of minority interests in the statement of financial performance is consistent with the previous year. However, in our view, the presentation does not fully comply with generally accepted accounting practice. We have previously reported this concern to the Treasury. The applicable standard requires:

- all figures in the statement of financial performance to include minority interests; and
- the operating balance to be allocated between that which is attributable to minority interests and that which is attributable to owners of the parent (that is, the bottom line should be allocated).

2.81 We accepted how the information was presented in the Government's financial statements because minority interest figures are not a material amount in the context of the Government's financial statements as a whole.

Reduction in disclosures

2.82 Overall, we consider that the changes to disclosures in the Government's financial statements achieve the Treasury's aim of making the financial statements more accessible to readers, while complying with generally accepted accounting practice.

2.83 With the transition to the new PBE standards, the Treasury has considered how it can reduce the disclosures in the Government's financial statements, to make the information more accessible to readers. Another aim is to tell more of a whole-of-government story and remove some of the individual entity disclosures that readers can get from other annual reports.

2.84 Clearly immaterial notes, such as inventory, have been removed, along with additional details of limited usefulness. One example is the removal of the breakdowns of each note by source (Core Crown, Crown entities, State-owned enterprises).

2.85 The Treasury has made the most significant reduction in its disclosures about financial instruments in Note 30. This note was previously complex, and the Treasury felt that it did not tell a succinct story of the Government's financial instruments. The summarised information for each disclosure also helps readers to more easily navigate this note.

2.86 The new note removes several disclosures that are required by a particular PBE standard because, in the Treasury's view, the disclosures were either not relevant to the Government's financial statements or not material. We identified and considered each of the required disclosures that were not presented and were satisfied with the Treasury's judgements.

3 The Controller function and the appropriation audit

3.1 The Controller function and appropriation audit are important aspects of the Auditor-General's work. They support the fundamental principle of Parliamentary control over government expenditure.

3.2 Under New Zealand's constitutional and legal system, the Government needs Parliament's approval to:

- make laws;
- impose taxes on people to raise public funds; and
- spend public money.

3.3 Parliament's approval can be given in advance or retrospectively.

3.4 In this Part, we explain what the Controller and Auditor-General does to help ensure that government spending stays within the limits approved by Parliament. Our discussion includes:

- Why is the Controller work important?
- Who approves the spending of public money and how?
- Who is responsible for ensuring that public money is spent correctly?
- How great is the risk that public money might be spent above or beyond the appropriation limits?
- How does the Controller deal with breaches of appropriation?
- How much public money was spent without proper authority in 2014/15?
- What are the emerging Controller issues and themes?

Why is the Controller work important?

3.5 In her role as Controller, the Controller and Auditor-General helps maintain the transparency and legitimacy of the public financial management system.

3.6 The appropriation system ensures that Parliament, on behalf of the New Zealand people, has adequate control over how the Government uses public resources. It also ensures that the Government can be held to account for how it has used those resources.

3.7 Most of the Crown's funding is obtained through taxes. New Zealanders want assurance that the Government is spending public money as intended.

3.8 The Controller and Auditor-General provides an important check on the public financial management system on behalf of Parliament, taxpayers, and the New Zealand public.

Who approves the spending of public money, and how?

3.9 Each year, the Government puts forward its spending proposals for the coming financial year in the Budget (usually in May). It formally presents its proposed budget to Parliament in the form of a Bill, called the Appropriation (Main Estimates) Bill, along with various explanatory documents. This is the first appropriation Bill for the financial year.

3.10 The Bill sets out estimates of what will be spent under each ministerial portfolio – in general, every ministerial portfolio has a corresponding "Vote" in the budget (for example, Vote Health sets out all the spending in the Health portfolio). Each Vote is made up of several more specific "appropriations", which are descriptions of a particular area of activity and the spending approval sought for that area. Each appropriation has to set out:

- the maximum amount of spending being approved;
- the scope (that is, what the money can be used for); and
- the date on which the appropriation lapses (most appropriations last for one year).

3.11 Once Parliament has considered and passed the Bill, it becomes law as an Act. In general, any spending outside what has been approved in this Act of Parliament will be unlawful. There are some exceptions. For example, under a "permanent legislative authority" appropriation (PLA), the appropriation authority does not need to be sought from and approved each year by Parliament. With PLAs, the Estimates figure represents forecast expenditure, not an upper limit.

3.12 The Budget generally does not become law until several weeks into the fiscal year.

If the Budget Bill is not passed before the financial year begins, how can the Government spend money lawfully in the meantime?

3.13 The Appropriation (Main Estimates) Bill is usually passed in August. From 1 July until the Bill becomes law, the Government must continue to operate and spend public money. To cover this period, interim authority is provided through an Imprest Supply Act, which is enacted before the financial year begins. The spending authority under this Imprest Supply Act is repealed when the Appropriation (Main Estimates) Act comes into force.

3.14 Imprest Supply Acts authorise the Government to incur expenses and capital expenditure – up to a specified amount – in advance of Parliament passing an Appropriation Act. This helps ensure that the Government has enough funds for general purposes (up to a specified amount) throughout the financial year. There are usually at least two Imprest Supply Acts in a financial year. Cabinet requires that any use of imprest supply must be authorised by a specific Cabinet decision or, in some instances, by delegated authority to joint ministers.

3.15 To continue to receive Parliamentary authority, all expenditure incurred under an Imprest Supply Act must later be approved by Parliament under an Appropriation Act. This approval is typically gained through a second appropriation Bill, the Appropriation (Supplementary Estimates) Bill, which is usually enacted in June.

3.16 If expenditure under the authority of an Imprest Supply Act is incurred too late in the financial year to have received authorisation through the Appropriation (Supplementary Estimates) Bill, then as at 30 June it becomes "unappropriated expenditure". It must also be validated later by Parliament through a third appropriation Bill, the Appropriation (Confirmation and Validation) Bill.

What happens if things change during the year?

3.17 The changing nature of government activities and unexpected demands means that it is rarely possible to foresee all future expenses and capital expenditure. The system recognises the need for some flexibility to respond to changing events:

- A second Imprest Supply Act for the year is provided, usually at the same time as the Appropriation (Main Estimates) Act. This provides authority for spending that might not have been envisaged when the budget Estimates were finalised.
- The second appropriation Bill during the financial year – the Appropriation (Supplementary Estimates) Bill – allows the Government to update the initial estimates in the Budget and to get approval for those changes (including expenditure already incurred under imprest supply).
- The second Imprest Supply Act remains in force until the end of the financial year to provide authority for unexpected spending after the Supplementary Estimates are finalised.
- The Public Finance Act 1989 includes several other mechanisms for approving minor changes to the spending authorities approved by Parliament. For example, there is limited scope for the Governor-General to approve, by Order in Council, transfers between appropriations within a Vote.[3] To provide further flexibility during the final three months of the financial year, the Public Finance Act authorises the Minister of Finance to approve a limited amount of extra spending within the scope of an existing appropriation.[4] Flexibility under these mechanisms is subject to confirmation by Parliament through the Appropriation (Confirmation and Validation) Act.

3 Section 26A of the Public Finance Act 1989.

4 Section 26B of the Public Finance Act 1989.

- Section 25 of the Public Finance Act authorises the Government to spend public money outside appropriations in emergency situations, subject to confirmation by Parliament through the Appropriation (Confirmation and Validation) Act.

So, does that mean that any spending that is outside the revised budget (Supplementary Estimates) is unlawful?

3.18 Not necessarily. Expenditure incurred over and above the revised Estimates could still be lawful if it is incurred under a proper authority (for example, if it is within imprest supply or in keeping with the provisions of the Public Finance Act or any other Act). However, expenditure incurred under proper authority, but not included in an Appropriation Act as at the financial year end, remains "unappropriated" until it is validated by Parliament.

3.19 In contrast, expenditure incurred without appropriation, or other authority, by or under an Act remains both unappropriated and unlawful unless and until it is validated by Parliament in an Appropriation Act.[5]

3.20 The Appropriation (Confirmation and Validation) Act, which is introduced after the end of the financial year, allows Parliament to retrospectively confirm or validate all unappropriated expenditure incurred during the year, whether it was incurred with or without the proper authority.

Does the Controller and Auditor-General have a role in the Budget process?

3.21 No. The Government prepares the Budget. The Minister of Finance and the Treasury co-ordinate the work of the various government departments and individual Ministers to put together a set of spending proposals for the Government as a whole. The Auditor-General is not part of the Government or answerable to Ministers, so has no role in this process.[6] Some people believe that the Auditor-General audits the Budget, but she does not.

3.22 Once the Government has presented its proposed budget to Parliament, individual select committees consider the proposals in the various Votes. The Auditor-General's staff provide advice to the select committees to assist their scrutiny of the spending proposals in the budget Estimates.

3.23 Parliament then votes on whether to pass the Appropriation (Main Estimates) Bill. Votes on budget and spending matters are automatically regarded as confidence matters. That means that, if a Government cannot persuade a majority of

5 Section 26C of the Public Finance Act 1989.

6 There is a special process for working out the budget for Officers of Parliament, such as the Auditor-General, to ensure that the funding decisions are made by Parliament and not the Government.

Parliament to support its spending plans, then it does not have enough support to continue as the Government.

Who spends the money, and how?

3.24 All public money must be held in a Crown or departmental bank account. The Treasury is responsible for managing Crown bank accounts unless it delegates responsibility to a department to operate as an agent of the Crown. Government departments are responsible for managing departmental bank accounts.

3.25 Each department forecasts its cash requirements based on its budget and agrees cash payment schedules with the Treasury. The Treasury is responsible for disbursing cash to departments during the year in keeping with those schedules. Responsibility for how that cash is applied rests with the departments.

3.26 The departments are responsible for paying non-departmental providers (for example, Crown entities within their Votes) and for their own departmental spending.

3.27 The public financial management system operates on an “accrual” rather than a cash basis of accounting. To keep within budget limits, departments need to manage expenditure on an “accrual” basis. This means that expenditure is accounted for when it is incurred (that is, when there is an obligation to pay, as opposed to when the payment is made).

Who is responsible for ensuring that public money is spent correctly?

3.28 Departmental chief executives are responsible under the Public Finance Act for the financial management and performance of their department.[7] This includes ensuring that they have both the funds and the necessary legal authority before incurring expenses or capital expenditure.

3.29 Departments are required to report to the Treasury (usually monthly) the expenses and capital expenditure incurred by the department against the appropriation or other statutory authority provided.

3.30 The Treasury is then required to compile a (usually) monthly report to the Controller and Auditor-General that sets out all actual expenditure incurred compared with the appropriation (or other authority)[8] and all expenditure incurred without authority or in excess of the authority given.

7 Section 34(1)(a) of the Public Finance Act 1989.

8 Such as imprest supply and Cabinet or ministerial decisions made within delegated authorities.

Who checks whether the departments are actually spending the money lawfully and responsibly?

3.31 This is where the function of the Controller comes in.[9] To check and verify the spending, the Controller and Auditor-General's auditors:

- review the Treasury's monthly report;
- carry out some tests on the financial information (provided by the Treasury from the Crown Financial Information System);
- report back to the Treasury highlighting any issues (including any breaches), comment on actions needed to validate any unappropriated expenditure, and advise on any further action that the Treasury or the department needs to take to resolve outstanding issues; and
- inform the auditors of the issues affecting the departments they audit.

3.32 As well as her responsibilities under the Public Finance Act, the Controller and Auditor-General is responsible under the Public Audit Act 2001 for auditing the financial statements of every public entity. For government departments, as well as auditing the financial statements, her auditors are responsible for auditing the appropriations administered by the department ("the appropriation audit").[10]

3.33 Through the appropriation audit, the auditors look at systems and some transactions to ensure that public money was spent as intended by Parliament. If an auditor appointed by the Controller and Auditor-General detects spending outside authority through the appropriation audit work, then the auditor will discuss the matter with the department's chief executive and advise the department about reporting the matter and taking corrective action. The auditor will also check to ensure that the department reports the matter in its financial statements.[11]

How great is the risk that public money might be spent above or beyond the appropriation limits?

3.34 Expenditure outside the bounds of the appropriations tends to be relatively small, less than 0.1% of the Government's total budget in 2014/15 (2013/14: less than 1%).

3.35 When the proper authority for unappropriated spending is not obtained, it constitutes a breach of appropriation and is unlawful. Not all unappropriated expenditure is unlawful, because the appropriations system provides some flexibility.

9 The Auditor-General exercises her Controller function under sections 65Y to 65ZA of the Public Finance Act 1989.

10 Section 15(2) of the Public Audit Act 2001.

11 Within the Statement of Appropriations and Statement of Unappropriated Expenses and Capital Expenditure.

3.36 Some of the more common reasons for exceeding the spending limit set out in the appropriations include under-estimating expenditure that is demand-driven, write-downs of asset values, and the write-off or write-down of Crown receivables. (For the latter two, there is no cash outflow but they are nonetheless expenses for appropriation and accounting purposes.)

3.37 Examples of unappropriated expenditure in recent years include:

- Increased demand from New Zealanders for the SuperGold card in 2009/10 led to increased government spending on public transport concessions. The amount spent was $327,000 greater than anticipated, leading to spending in Vote Transport in excess of the appropriation limit.[12]
- Unappropriated expenditure can occur because of spending not envisaged at the time the Budget was prepared. In 2010/11, the New Zealand Defence Force overspent $990,000 of Vote Defence Force money in the appropriation for funding Naval Helicopter Forces. This happened because damage to three Seasprite helicopter rotor blades was beyond repair and the blades needed to be replaced.[13]
- Sometimes, financially neutral transfers are made between appropriations during the year and, if the amount transferred is miscalculated, it can result in under-expenditure in one appropriation and over-expenditure in the other. This happened in Vote Prime Minister and Cabinet in 2011/12, when too much funding was transferred from an existing appropriation into a newly created appropriation for Support Services to the Governor-General and Maintenance of Residences.[14] In that instance, the over-spending in the existing appropriation was incurred without the proper authority.
- Incorrect financial forecasting led to spending in excess of a Vote Statistics appropriation in 2012/13. Statistics New Zealand forecast under-expenditure when the budget was revised during that financial year (that is, in the Supplementary Estimates). Accordingly, the Official Statistics appropriation was reduced by $1.937 million. The appropriation should not have been reduced, and the adjustment resulted in over-spending of $1.03 million.[15]
- In 2013/14, CERA incurred $130.6 million without an appropriation and authorisation. The expenses that caused the breach related to movement in the provision for vesting in land, losses on the valuation of land, and land-related transaction and demolition costs. Most of the amount reflected

12 Ministry of Transport, *Annual Report 2009/10*, page 52. The excess spending was authorised by the Minister of Finance under section 26B of the Public Finance Act 1989.

13 New Zealand Defence Force, *Annual Report 2011*, pages 94 and 149. The excess spending was authorised by the Minister of Finance under section 26B of the Public Finance Act 1989.

14 Department of the Prime Minister and Cabinet, *Annual Report for the year ended 2012* [sic], page 33.

15 Statistics New Zealand, *Annual Report of Statistics New Zealand for the year ended 30 June 2013*, page 79. The excess spending was authorised by the Minister of Finance under section 26B of the Public Finance Act 1989.

changes in assumptions underlying the accounting for land. A further $9.1 million was incurred through Vote Canterbury Earthquake Recovery without appropriation but with Cabinet authority to use imprest supply.[16]

How much unappropriated spending was incurred with the proper authority?

3.38 The Minister of Finance used his powers under the Public Finance Act to authorise five instances of unappropriated expenditure during 2014/15, for $21 million.[17] Most of that, just over $16 million, was in Vote Education and related to early childhood education. The Ministry of Education says this was because of higher than expected growth in attendance at early childhood education centres on non-school days and higher than expected growth in home-based care for under two-year olds.[18] (This follows unappropriated expenditure of $21.5 million for early childhood education in 2013/14 where the authority was limited to $1.5 billion, which the Ministry also attributed to higher than expected costs.)[19]

3.39 Expenditure in Vote Police exceeded appropriation by $4.9 million because expenses were transferred between different output appropriations. The expenditure related to payroll costs and the transfers affected three appropriations. Although the transfers were fiscally neutral, the re-allocation of expenditure to different appropriations meant that some appropriation limits were exceeded.[20]

3.40 The five instances of expenditure in excess of appropriation were authorised by the Minister of Finance under section 26B of the Public Finance Act and will need to be confirmed in the next Appropriation (Confirmation and Validation) Act.

How often is expenditure incurred without proper authority?

3.41 Figure 1 shows the number of appropriation breaches – the instances of unappropriated expenditure incurred without authority – in the last five years, as reported in the Government's financial statements. The Figure shows a combined total for expenses and capital expenditure.

16 Canterbury Earthquake Recovery Authority, *Annual Report 2014*, page 106 and the *Financial Statements of the Government of New Zealand for the year ended 30 June 2015*, pages 160-162.

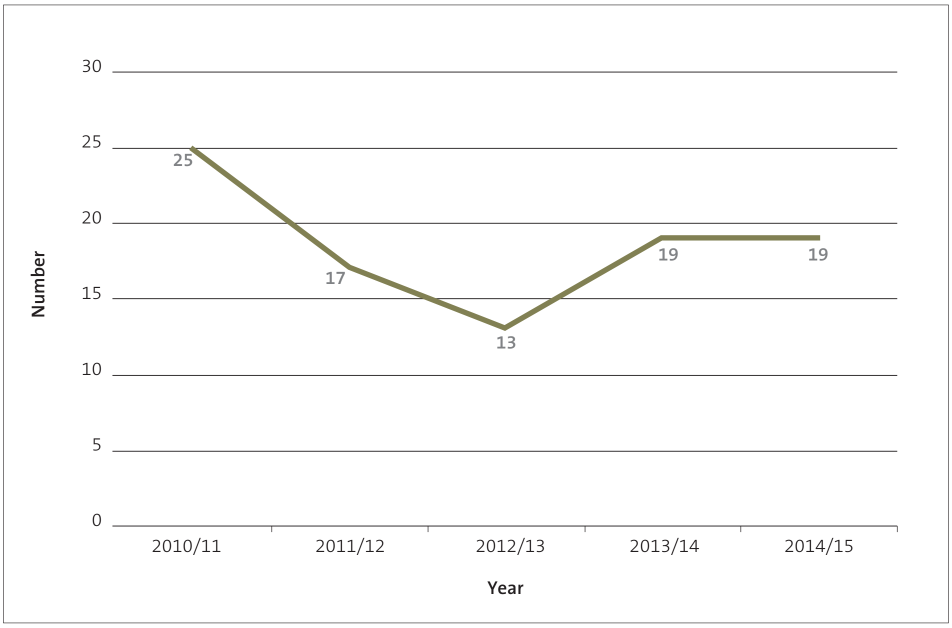
17 *Financial Statements of the Government of New Zealand for the year ended 30 June 2015*, page 140.

18 Ministry of Education, *Annual Report 2015*, page 117.

19 Ministry of Education, *Annual Report 2014*, page 156.

20 New Zealand Police, *Annual Report 2014/15*, page 74.

Figure 1
Number of instances of unappropriated expenses and capital expenditure incurred without authority



Source: The Government's financial statements for 2010/11 to 2014/15.
Note: Some of the expenditure without authority reported in 2014/15 related to expenditure incurred in 2013/14.

3.42 The fluctuations between years are relatively minor.

3.43 The total amount of public money reported as spent without proper authority has fallen significantly in 2014/15: $55.8 million compared with $213 million in 2013/14.[21]

How does the Controller deal with breaches of appropriation?

3.44 When departments become aware of an appropriation breach or a potential breach, they are expected to immediately tell their auditor, the Treasury, and their Minister (who will need to seek additional authority for the expenditure). The department should provide the Treasury with an explanation of the breach as well as an explanation of actions being taken to resolve the issue – for example, to gain additional authority in advance to avoid a potential breach or to validate any already unappropriated expenditure through an Appropriation (Confirmation and Validation) Bill.

21 *Financial Statements of the Government of New Zealand for the year ended 30 June 2015*, pages 141-143 and *Financial Statements of the Government of New Zealand for the year ended 30 June 2014*, pages 160-162.

3.45 The Treasury then collates the reports from the departments and provides a single, monthly report to the Office of the Auditor-General, highlighting actual, expected, and potential breaches. The Controller then carries out the work we describe in paragraphs 3.31 to 3.33.

3.46 Auditors might detect breaches through their audit process, as might the Treasury through its financial management and budgeting work.

3.47 However detected, the facts of the situation are reviewed and the nature and amount of the breach is confirmed. If the department has not acted already, the Auditor-General's staff advise the department to immediately inform the Treasury. They also advise on the corrective action that needs to be taken – for example, seeking further authority for spending[22] and/or seeking to legitimise the expenditure after the event, usually through validating legislation.[23]

3.48 The Controller monitors all matters reported to her or detected by her staff until they are resolved. If the department does not take the required action, then the Controller can write to the department's chief executive and the relevant Minister instructing that no further expenditure can be incurred under the affected appropriation until approval has been obtained.

3.49 If the department continues to fail to obtain the correct approval, then the Controller can direct the Minister, the Treasury, and the department to stop payments from the relevant bank account and direct the Minister to report to the House of Representatives. Such measures would be a last resort.

How much public money was spent without proper authority in 2014/15?

3.50 Figure 1 showed that 19 instances of expenses and capital expenditure incurred without authority were reported in the Government's financial statements for 2014/15. Figure 2 provides more detail on the unauthorised expenditure reported for 2014/15, including the Votes and amounts involved.

3.51 During 2014/15, the total amount of public money identified as being in excess of, or without, appropriation and without proper authority was $55.8 million. This was 0.07% of the total appropriations for all Votes authorised through the Budget 2014 process.[24]

22 Additional authority may be obtained under the Public Finance Act 1989. Cabinet may approve the use of imprest supply as a source of temporary authority and agree to include the amounts in the next Appropriation (Confirmation and Validation) Bill.

23 Detailed information on seeking additional authority or validating unappropriated expenditure is provided on the Treasury's website, www.treasury.govt.nz.

24 The Budget 2014 appropriations for all Votes totalled $85.5 billion.

Figure 2
Unappropriated expenditure incurred without authority during the year ended 30 June 2015

	2013/14 No.	2014/15 No.	2014/15 $million	2014/15 Votes
Expenses and capital expenditure incurred in excess of appropriation and without prior Cabinet authority to use imprest supply	8	7	30.5	Canterbury Earthquake Recovery; Commerce and Consumer Affairs; Arts, Culture and Heritage; Justice; Parliamentary Service; Education; Tertiary Education
Expenses and capital expenditure incurred outside scope of an appropriation and without prior Cabinet authority to use imprest supply	3	3	10.9	Attorney General; Housing; Transport
Expenses and capital expenditure incurred without appropriation and without prior Cabinet authority to use imprest supply	8	8	14.3	Commerce and Consumer Affairs; Labour; Tourism; Canterbury Earthquake Recovery; Transport
Other	0	1	0.1	Social Development
Total	**19**	**19**	**55.8**	

Source: The Government's financial statements for 2014/15.

3.52 In seven of the 19 breaches in 2014/15, the Government spent more ($30.5 million in total) than the amount that was authorised within existing appropriations. In three instances, expenditure totalling $10.9 million was outside the scope of existing appropriations. Another eight breaches amounting to $14.3 million were from expenditure for which there was no appropriation.

3.53 The more significant instances of unauthorised expenditure in 2014/15, in terms of the amounts involved, were in Votes Justice, Transport, and Canterbury Earthquake Recovery.

Vote Justice

3.54 A small number of high-cost court cases contributed to a $4.8 million over-spending of the legal aid budget within Vote Justice. Other factors included a general increase in the number of applications and grants for legal aid.[25]

Vote Transport

3.55 Most of the "outside scope" expenditure of $10.9 million related to a technical oversight in Vote Transport. The Crown had provided loan finance to the New Zealand Railways Corporation (NZRC) to fund capital projects and provide working capital. The loan ($10.75 million) was due to mature and be renewed in 2014/15. In 2011/12, the Government restructured the rail sector, transferring network and operating assets, and all rail operations, to KiwiRail Holdings Limited (KiwiRail). The NZRC's function as a State-owned enterprise was then simply to hold rail land.

3.56 The Government had provided in Budget 2014 for the loan rollover of $10.5 million, but the appropriation (as expressed in the Budget estimates) limited the loan to the NZRC.[26] In April 2015, the loan was rolled over but, given the new entity structure, the loan recipient was KiwiRail, not the NZRC.[27] The funding was therefore outside the scope of the appropriation as authorised by Parliament. The scope statement was updated in the Supplementary Estimates for 2014/15.

Vote Canterbury Earthquake Recovery

3.57 Several accounting treatment changes agreed between CERA and its auditors during the 2013/14 audit resulted in appropriation issues in the early part of the 2014/15 year. All appropriation issues were rectified through the October baseline update and Budget 2015 processes.

3.58 CERA incurred $24.4 million of expenses over and above its appropriation for "impairment of improvements". This related to the purchase of land occupied by a building intended for demolition. The initial land purchase was authorised, but the amount needed to account for how much the asset (the building) was impaired was more than expected. Vote Canterbury Earthquake Recovery provided $51 million for such expenses, under a multi-year appropriation, but CERA exceeded this amount by $24.4 million during 2014/15.

3.59 Some accounting treatments and decisions made in 2013/14 had implications for 2014/15: CERA incurred a further $12.7 million on expenditure for which there was no appropriation within the Vote. More than a third of the breach ($4.6 million) resulted from a different accounting treatment of initial land acquisitions. An element of the cost of purchasing land for the Anchor Projects

25 Ministry of Justice, *Annual Report 1 July 2014 to 30 June 2015*, page 137.

26 *The Estimates of Appropriations 2014/15 – Economic Development and Infrastructure Sector* Vol.1, pages 315-316.

27 Ministry of Transport, *Annual Report 2014/15*, page. 74.

that had previously been expected to be capitalised (that is, added to the asset's recorded value) was appropriately treated as an expense instead. No appropriation existed for such expenses at the time they were incurred.

3.60 Another legacy from 2013/14 decisions concerns CERA's role in purchasing land, some of which must be vested to the Christchurch City Council. The obligation to vest land for no consideration constitutes an expense to CERA. In 2014/15, such transactions took place without an appropriation in the Vote to provide the authority for incurring the expenses. A total of $4.1 million was incurred without proper authority for this reason.

3.61 Capital expenditure on the Christchurch Bus Interchange was also without an appropriation in 2014/15. CERA had authority to incur operating expenditure on the construction of the Interchange but did not initially envisage having an ownership interest in the Interchange. With the assumption of ownership of the asset, $3.5 million needed to be treated as capital expenditure, but there was no capital expenditure appropriation in the Vote to cover this.[28]

3.62 All of the above-mentioned appropriation issues of Vote Canterbury Earthquake Recovery were rectified through the Supplementary Estimates process and will be validated in forthcoming legislation.

3.63 Further details of unauthorised (and other unappropriated) expenditure are provided in the annual reports of the departments responsible for administering their Votes and in the Government's financial statements for 2014/15.

How did the Controller address the issues that arose during 2014/15?

3.64 The auditors for the affected departments carried out the necessary actions described in this Part. Those actions included confirming that expenditure was unappropriated, the amount of the unappropriated expenditure, and the amounts to be disclosed in the Government's and individual departments' financial statements, as well as reviewing the explanation given for the unappropriated expenditure.

What are the emerging Controller issues and themes?

3.65 Recent reforms in state sector legislation have introduced more flexibility into the appropriation system, with the aim of helping government entities to work more effectively and efficiently.[29]

28 Department of the Prime Minister and Cabinet, *Annual Report for the year ended 30 June 2015*, pages 49-50.

29 The Treasury, State Sector Public Finance Reform Resources, at www.treasury.govt.nz/statesector/2013reform.

Administration and use

3.66 One of those reforms was to formally create a distinction between the "administration" and "use" of appropriations (under section 7C of the Public Finance Act). Distinguishing between the administration and use of appropriations formalises a system to make it easier for one department to spend public money from an appropriation administered by a different department (with the administering department's or Minister's agreement). This is designed to provide greater flexibility when several departments need to work together to share resources or work towards a common outcome.

3.67 So far, we have not seen much uptake of the administration-and-use provisions. From the little we have seen, we have detected instances in which the timing and/or amount of spending has not been reported consistently by both parties to the arrangement in the Crown Financial Information System. It is clear that departments will need to take better care to document and report spending under these arrangements, and the arrangements will need to be monitored carefully by the Treasury.

Multi-category appropriations

3.68 The introduction of multi-category appropriations (MCAs) has also afforded more flexibility in the appropriation system – for example, by allowing operating and capital expenditure to be covered in the one appropriation. An MCA is useful when the proportion of operating expenditure to capital expenditure for a project is inherently uncertain. As such, the introduction of an MCA has the potential to avoid appropriation breaches that can occur with single-category appropriations when the operating expenditure to capital expenditure proportions are misjudged. The use of MCAs is widespread.

Thinking ahead

3.69 It is especially important that departments anticipate the accounting and budget ramifications of future investments, asset transactions, and other events. This includes anticipating how much of the forecast expenditure (including expenses incurred through asset write-offs or write-downs) will need to be treated as operational and capital respectively and ensuring that there is sufficient authority to cover the expenditure.

3.70 We urge government departments to think ahead and try to ensure that future developments likely to affect their expenditure profile are reflected in their Vote structure.

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

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