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# Central government: Results of the 2015/16 audits





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# Auditor-General's overview

Throughout my career, the financial statements of the Government have been a key feature. As an Assistant Auditor-General (AAG) in the 1990s, I was involved in the audit of the new accrual-based financial statements. As the responsible AAG, it was a long night on 30 September 1992 when the Auditor-General signed the first audit opinion on a full set of accrual financial statements for a sovereign nation. During the last seven years, these accounts were a big part of my role as Auditor-General, involving the oversight of the planning and performance of the audit and the reporting thereon.

This report discusses the 2016 audit findings and the opinion I issued. As far as I know, the new form of audit opinion including key audit matters issued on 30 September 2016 is the first of its kind for a sovereign nation. The report also traces the changes and events that have occurred during my time as Auditor-General together with the recurring audit findings.

## A period of constant change and challenge

The last seven years has been a period of considerable change, resulting from financial legislative reforms, governmental reforms, changes in public sector accounting standards, and the major economic shocks from the global financial crisis and the Canterbury earthquakes from 2010/11 onwards. Some of these factors have significantly affected the Government's resources. The implications of all of these factors have been reflected in the financial statements, with each year presenting new complexities and challenges.

In 2016, the economy had recovered from the major economic shocks of the previous seven years. The Government's balance sheet also shows that its net worth has been restored, increasing slightly since 2010 (from \$95.0 billion to \$95.5 billion), and the financial performance is in surplus.

## Key audit matters

For the first time this year, I have reported on "key audit matters" – matters I consider significant in forming the audit opinion. I have voluntarily applied a new requirement under international auditing standard ISA (NZ) 701 to the audit of the financial statements because I consider the introduction of reporting key audit matters to be another step in the evolution of good public sector auditing practice.

The key audit matters for 2016 are those that are complex, have a high degree of uncertainty, or are otherwise important to the public, such as the cost of rebuilding Canterbury. Accounting for and reporting on the above matters

is not straightforward, not least because of the judgements, estimates, and assumptions underpinning the measurement of value.

The key audit matters for 2016 relate to:

- recognition of tax revenue;
- valuing the state highway network, electricity generation assets, and rail network assets;
- valuing the Accident Compensation Corporation's outstanding claims liability and the Government employees' superannuation liability;
- valuing financial assets and liabilities; and
- accounting for the effects of the Canterbury earthquakes.

Overall, I was satisfied that the estimates and judgements were reasonable. I made two recommendations to the Treasury that relate to the key audit matters. These were to support Inland Revenue on improving the processes for estimating tax revenue receivable at 30 June in each accounting period and to review the accounting treatment for the freight part of the rail network.

### **Financial statements of the Government**

I am pleased to report that I issued an unmodified audit opinion on the Government's financial statements. As well as the key audit matters, I reported to the Minister of Finance on three other important audit matters: valuing New Zealand Defence Force assets, valuing housing stock, and accounting for the proposed Crown contribution to the City Rail Link development in Auckland.

I was disappointed to note that the Defence Force did not adequately assess material changes in the fair value of its assets on a timely basis. Without enough assurance on this matter, both the Defence Force and my appointed auditor had to carry out substantial additional work, which led to significant delays. This is unacceptable. I stress that it is important for entities to prepare accounts in a timely manner and to an appropriate level of quality.

### **Controller perspective**

In 2015/16, there were 12 reported cases of unauthorised expenditure, compared with 19 in 2014/15. The total amount of unauthorised expenditure reported in the Government's financial statements for 2015/16 was \$72.5 million (2014/15: \$55.8 million). Unauthorised expenditure reported in 2015/16 was 0.08% of the total appropriations for all Votes authorised through the Budget 2015 process (2014/15: 0.07%). I am pleased to note an overall decline in the frequency of

unappropriated expenditure during the last seven years, and the low level of unappropriated expenditure relative to the total appropriations.

### **A seven-year perspective**

For this report, my staff and I have considered changes and trends affecting the operating environment, the main matters and themes arising from our audits of the financial statements, and trends from our work through the Controller function during my seven-year term. Some of the recurring matters arising from the audits are the same as this year's key audit matters. Our analysis showed that the Government's net worth, although declining sharply between 2010 and 2012, has increased slightly overall.

The financial statements of the Government are the pinnacle of the public sector's financial reporting. They are something we should take considerable pride in. As I leave the role of Controller and Auditor-General, I encourage the Treasury to continue to innovate in the development of these statements, public entities to commit to quality reporting in a timely manner, and auditors to continue to challenge public entities to continue improving and providing better information to the readers of the financial statements.

I thank the hundreds of preparers and auditors who commit to high-quality financial reporting in the public sector.



Lyn Provost  
Controller and Auditor-General

7 December 2016

# 1

## The operating environment for central government

- 1.1 This Part describes the operating environment for central government agencies in 2015/16. It provides some context for this report – in particular, for the audit of the financial statements of the Government of New Zealand (the Government’s financial statements).
- 1.2 The Government’s financial statements consolidate financial information from all the organisations that are part of central government.<sup>1</sup> We audit each of these organisations each year. We need to understand the operating environment for these different organisations because the Government’s priorities and expectations drive how organisations plan, prioritise, spend, and report the funding approved by Parliament.

### An environment of continued changes

- 1.3 Constant change has been the main characteristic of the last seven years. The current operating environment for government reflects developments and the culmination of considerable changes during the last seven to eight years. The timeline in Figure 1 shows some of the significant events and changes in that period, including the Government’s response to the global financial crisis in 2008 and the Canterbury earthquakes in 2010 and 2011. We discuss these in more detail below.
- 1.4 Alongside these unexpected major events, the Government has introduced reforms that affect how entities conduct their business, deliver policy, and, importantly for our work, report financial and service performance. New accounting standards introduced specifically for the public sector have also affected the accounting and reporting of many public entities.
- 1.5 This period has also been characterised by a re-balancing of centralised and devolved decision-making and delivery of public services. On the one hand, the central agencies now have a stronger “corporate centre” role and some other entities have new functional leadership roles. Also, changes to the State Sector Act 1988 in 2013 established a legal obligation on departmental chief executives to be responsive to the collective interests of government.
- 1.6 On the other hand, the Government is using a changing mix of ways to deliver services, including by contracted organisations from the private and non-government sectors. New ways of contracting for outcomes, including social bonds, are being piloted. Shared service initiatives have also affected accounting, reporting, and auditing, with third parties or subsidiaries increasingly managing corporate functions such as finance and procurement. This can result in confusion in entities about where accountability for decision-making and expenditure resides.

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



- 1.7 Adverse external events have also led to significant government interventions. The global financial crisis created significant economic risks for New Zealand, one of which was a loss of confidence in local financial institutions, potentially leading to a flight of funds from the country. In response to this, the Government intervened directly by establishing the Crown Retail Deposit Guarantee Scheme (the Scheme). Ultimately, the Crown guaranteed up to \$133 billion through the Scheme and paid out more than \$2 billion under the Scheme for institutions that failed, most notably South Canterbury Finance Limited.
- 1.8 As a consequence of payments made to depositors of failed finance companies under the Scheme, the Crown inherited the beneficial interest in the proceeds from the secured assets of the receiverships. The Crown subsequently recovered proceeds of \$1.2 billion from these receiverships. After taking account of the fees the Crown earned from the Scheme of about \$0.5 billion, the net cost to the Crown was about \$0.3 billion.
- 1.9 We examined the Scheme in 2011 (the year it was closed)<sup>2</sup> and noted in a follow-up review in 2014 that the Treasury was applying a more carefully considered and controlled response to unexpected events.<sup>3</sup> An example of this was when Allied Mutual Insurance (AMI) requested financial assistance in dealing with the volume of claims from the Canterbury earthquakes.
- 1.10 The Government also established the Financial Markets Authority (FMA) to provide closer controls and regulation of New Zealand's capital markets to restore investor confidence after the global financial crisis. This directly affects public entities such as state-owned enterprises and mixed-ownership model companies and their auditors, because the FMA's mandate includes regulating some activities of state-owned enterprises and mixed-ownership model companies.
- 1.11 The other significant events that led to major government interventions were the Canterbury earthquakes of 2010 and 2011. We discuss the effects and response to these events in more detail below.

2 *The Treasury: Implementing and managing the Crown Retail Deposit Guarantee Scheme*. Available at [oag.govt.nz](http://oag.govt.nz).

3 *The Treasury: Learning from managing the Crown Retail Deposit Guarantee Scheme*. Available at [oag.govt.nz](http://oag.govt.nz).

**Figure 1**  
**Timeline of events affecting public service delivery, reporting, and auditing**

Date	Change
2008	Global financial crisis. Government intervention to support institutions. Beginning of period of government deficits. Change of government with new priorities.
2010	Auckland Council established. Methodology for discount rates agreed for all entities.
2010-11	Earthquakes in Canterbury. Canterbury Earthquake Recovery Authority established with budget of \$5.5 billion for Christchurch rebuild.
2011	Auditor-General issues <i>AG-4 (Revised): The Audit of Service Performance Reports</i> . Establishment of Financial Markets Authority. Inland Revenue Department reviews tax recognition policies. Government department mergers: Department of Internal Affairs (incorporating Archives New Zealand and the National Library); Ministry of Science and Innovation (replacing Foundation for Research, Science and Technology and the Ministry of Research, Science and Technology). Productivity Commission established. Social sector trials.
2011	External Reporting Board established as a Crown entity responsible for accounting and auditing assurance standards in New Zealand (July).
2012	External Reporting Board issues new Accounting Standards Framework. Better Public Services launched, identifies 10 key results. The Budget introduces four government priorities (see paragraph 1.12). Departments required to produce four-year plans combining strategic direction, medium-term delivery, financial planning, organisational capability, and workforce strategy. Ministry of Business, Innovation and Employment established (merging Building and Housing, Labour, Economic Development, and Ministry of Science and Innovation). Functional leadership introduced. Investing in services for outcomes – social investment approach.
2012	Public Finance (Mixed Ownership Model) Amendment Act 2012 establishes new class of entity.
2013	The Treasury issues its long-term fiscal statement, <i>Affording our future</i> . State sector legislative reforms (see Figure 2).
2014	Public Benefit Entity standards (including International Public Sector Accounting Standards) come into effect for public sector entities (July).

Date	Change
2015	<p>State Services Commission establishes new role of Deputy Commissioner, Auckland (March).</p> <p>Cabinet grants Ministers and departments increased flexibility in allocating resources.</p> <p>Reporting on key audit matters new requirement under ISA (NZ) 701 for certain entities.</p> <p>Auditor-General issues <i>AG-4: The audit of performance reports</i>, incorporating legislative changes from state sector reforms.</p>
2016	<p>Canterbury Earthquake Recovery Authority disestablished and functions distributed to several entities; Ōtākaro Limited and Regenerate Christchurch established.</p> <p>Changes to income tax recognition applied.</p> <p>New Zealand Health Strategy launched. National Health Board disestablished.</p> <p>Social Housing Reform Programme legislation enacted (Housing Corporation (Social Housing Reform) Amendment Act 2016).</p> <p>Establishment of <i>Investing in Children</i> Programme.</p> <p>Announcement of new Ministry for Vulnerable Children (August).</p>

## Government priorities

1.12 The Government's four priorities are:

- to responsibly manage the Government's finances;
- to build a more competitive and productive economy;
- to deliver better public services to New Zealanders; and
- to support the rebuilding of Christchurch.

1.13 These four priorities have been in place since 2012. The two priorities most relevant to our audit of the Government's financial statements are the management of the Government's finances and rebuilding Christchurch. The Government has estimated that the cost to the Crown for rebuilding Christchurch will be \$17.1 billion. Not surprisingly, given high public interest, the continuing effect of the work to rebuild Christchurch on the Government's financial statements remains a focus of our audits.

## Managing finances

1.14 In its first term (2008-11), the Government signalled that the negative effects of the global financial crisis on the economy would result in a period of deficits. The Government aimed to return to surplus as soon as possible, initially by 2015/16, and then after forecasts in 2011 had indicated an earlier improvement, by 2014/15. This would be achieved in part by constraining government spending,

with the consequence that baseline funding for many public entities had limited or no increases for several years. A modest surplus, measured by the total Crown operating balance before gains and losses (OBEGAL), was reported in 2014/15. In 2015/16, the OBEGAL was a surplus of \$1.8 billion, against a budgeted surplus of \$668 million.

- 1.15 This climate of financial constraint has played an important part in the individual and collaborative decisions entities have made in recent years, as they look for greater efficiencies to deliver the Government's expectations for improved service delivery as expressed through the Better Public Services goals (see paragraph 1.21).

### **Leadership from the centre**

- 1.16 The State Services Commission (SSC), the Treasury, and the Department of the Prime Minister and Cabinet (DPMC) exercise leadership as the central agencies. As part of this, the SSC uses a Performance Improvement Framework programme to analyse performance challenges at an agency and system level.
- 1.17 The Treasury carries out an annual Benchmarking Administrative and Support Services analysis. This provides information on the cost, efficiency, and effectiveness of administrative and support services in the state sector.
- 1.18 Two government departments have continued their functional leadership roles for the whole of the public sector – the Ministry of Business, Innovation and Employment for procurement and property management and the Department of Internal Affairs for information and communications technology (ICT Strategy and Action Plan).
- 1.19 The objective of functional leadership is to improve the overall effectiveness of common business functions and reduce their overall costs. As part of our 2016/17 work on information, we are examining the Department of Internal Affairs-led Infrastructure as a Service model. The model is a vendor-managed and vendor-hosted solution that allows agencies access to shared storage, computing, and data-centre facilities on a self-service, pay-as-you-use basis.
- 1.20 The Treasury and the SSC share oversight of the four-year plans that government departments prepare annually. The purpose of the plans is to set out a medium-term view of the departments and how they will move closer to achieving their longer-term vision. As part of our 2015/16 work on investment and asset management, we reviewed selected four-year plans and will be reporting on them in 2016/17.

## Public sector transformation

- 1.21 The Government launched the Better Public Services programme (BPS) in March 2012. This programme set 10 measurable targets in 2012, which were reset with some changes in February 2015. The SSC provides regular reports of the aggregated results on its website. Results for some of the measures are reported in individual departments' annual reports.
- 1.22 However, the focus on BPS results is only one component of a broader agenda for public sector change. The SSC has outlined four guiding principles for reform to support improvement of service delivery and transformation of the way the public service operates. These principles are "Citizen-Centric" (as opposed to focusing on the agency's needs), "Results Focus", "Leadership", and "Kaitiaki/Stewardship".
- 1.23 The last two principles emphasise the aspiration to work in a more connected way throughout the public sector, and for public sector leaders to take a longer-term view that recognises their responsibility for looking after assets that have been entrusted to their care.
- 1.24 Aligned with this is the "investment approach", led by the Treasury, to achieving social outcomes. This approach emphasises using quality information and technology to better understand the people who need public services and what works, and then adjusting services accordingly.
- 1.25 Quality data also supports investment decisions and the measurement of return on investment. The approach emphasises making early investments aimed at reducing the number of New Zealanders relying on social services in the longer term and reducing the overall cost for taxpayers. Elements of this approach are visible in some BPS results, which use actuarial techniques to measure the present value of savings achieved over time.
- 1.26 Supporting this direction were changes made in 2013 to the three Acts that govern the management of the state sector and public finances. Figure 2 describes the main effects of these changes. We then outline how they are shaping changes in the central government sector.

**Figure 2**  
**State sector reforms and changes to legislation**

In 2013, Parliament enacted changes to the State Sector Act 1988, the Public Finance Act 1989, and the Crown Entities Act 2004. These changes were aimed at enabling more collaborative behaviour by public entities, strengthening leadership in the state sector, improving reporting, and encouraging better services and value for money.

The amendments were significant changes to the Acts that govern the management of the state sector and public finances. The main changes to each Act and their effect are summarised below.

<b>State Sector Act 1988</b>	<b>Public Finance Act 1989</b>	<b>Crown Entities Act 2004</b>
<p>Establishes State Services Commissioner as leader of state services.</p> <p>Strengthened the role of SSC to ensure that government agencies work collectively as a system.</p> <p>Broadened responsibilities of public service chief executives, including for collective interests of government and long-term stewardship.</p> <p>Allows delegation of functions and powers between agencies and to non-government providers.</p> <p>Established new organisational arrangement – departmental agency.</p>	<p>Multi-category appropriations established.</p> <p>Use and administration provisions – allowing one department to use an appropriation administered by another.</p> <p>Statements of Intent no longer required annually – three-year cycle.</p> <p>Requirement to report what has been achieved with appropriation.</p> <p>Specifies the financial responsibilities of departmental chief executives – financial sustainability for the long term and responsibility for managing and advising on non-departmental appropriations.</p> <p>New class of entities – Schedule 4A companies.</p>	<p>Crown entities required to collaborate with other public entities where practicable.</p> <p>Enhances ability to give directions to Crown entities to support a whole-of-government approach, including through functional leadership.</p> <p>Statements of Intent no longer required annually – three-year cycle.</p> <p>Statements of performance expectations annually.</p> <p>Focuses reporting and auditing on the group rather than each entity within the group.</p>

### Change in the social sector

- 1.27 In April 2016, the Government responded to the recommendations of the Expert Advisory Panel tasked with modernising the Child, Youth and Family division of the Ministry of Social Development by establishing the Investing in Children Programme. The Panel recommended system-wide changes to a “child-centred” approach and a social investment approach to meet the needs of vulnerable children and young people. The programme takes a cross-sector, social investment approach.
- 1.28 In August 2016, the Government announced the establishment of a new Ministry for Vulnerable Children, Oranga Tamariki, to begin operating from 1 April 2017.

This will involve the transition of core Ministry functions that relate to supporting vulnerable children and young people to the new entity, which is intended to provide a whole-of-sector, child-centred approach to working with vulnerable children and young people. It will also mean organisational changes for the rest of the Ministry of Social Development.

### **Social housing**

- 1.29 Housing has become a prominent issue in recent years. Social housing cannot be separated from wider housing supply and affordability issues, and interacts with other components of the housing market. These interdependencies, and the need to plan for and match supply and demand, are reflected in the Social Housing Reform Programme and in the way government agencies have organised the provision of housing services, with the Treasury in the lead policy role, the Ministry of Business, Innovation and Employment providing regulatory functions for community housing, the Ministry of Social Development as the single purchaser for government-funded social housing, and Housing New Zealand as the major provider of social housing.
- 1.30 In February 2016, the objectives of the reform programme were given legislative status through the passing of the Housing Corporation (Social Housing Reform) Amendment Act 2016.<sup>4</sup> The new legislation also provided powers to transfer Housing New Zealand properties to registered community housing providers. The transfer of significant numbers of properties out of the public sector has required careful consideration of the value of the assets and the effect on the Government's financial statements.

### **Changes in government arrangements for supporting the rebuilding of Christchurch**

- 1.31 The Canterbury Earthquake Recovery Authority (CERA) was a public service department that carried out functions under the Canterbury Earthquake Recovery Act 2011. CERA's role was to provide leadership and co-ordination for the ongoing recovery effort. On 1 February 2015, it became the first (and so far only) departmental agency. It sat within DPMC.
- 1.32 The Greater Christchurch Regeneration Act 2016 confirmed the expiry of the Canterbury Earthquake Recovery Act and the disestablishment of CERA in April 2016. The emphasis of government intervention in Christchurch has shifted from leading the recovery to establishing long-term, locally led recovery and regeneration arrangements.

4 Initially the Social Housing Reform (Transactions Mandate) Bill but renamed.

- 1.33 Two new entities were established for this purpose. Regenerate Christchurch will operate until 30 June 2021 and was set up to lead regeneration activities throughout greater Christchurch. It is governed by a seven-member board, with four members appointed by the responsible Minister and the remainder appointed by Christchurch City Council.
- 1.34 The other new entity is Ōtākaro Limited, a Schedule 4A company under the Public Finance Act 1989. It is charged with delivering Crown “anchor projects” and investments in Christchurch and ultimately support the Crown’s exit from these interests on favourable terms. DPMC and the Treasury have joint monitoring responsibility for Ōtākaro Limited. As a Crown company, Ōtākaro Limited should have a greater degree of flexibility and autonomy to pursue commercial options than CERA did, either as a department or as a departmental agency.
- 1.35 DPMC retains overall responsibility for policy and oversight of the two new Christchurch-based entities. Land Information New Zealand has assumed responsibility for demolitions and clearances, and interim land-use management in the residential red zones. The Ministry of Health has taken on responsibility for psycho-social recovery.
- 1.36 The changes that took place in 2015/16 will begin to have their real effect from 2016/17. Given the importance of the regeneration work in Christchurch, high public interest, and the significant financial investment in this work, it will remain a focus for our annual audits of these entities.

### **New working arrangements in Auckland**

- 1.37 Similarly to Christchurch, significant organisational changes have occurred at the local level since the creation of the Auckland “super-city” in 2010. The importance of Auckland to New Zealand’s economy was reflected in the establishment in 2015 of the Deputy State Services Commissioner role for Auckland.
- 1.38 The Government’s efforts to address housing and transport issues in Auckland have included changes to how central government and Auckland Council work together. Examples of new arrangements targeted at achieving specific outcomes include the Tāmaki Redevelopment Company Limited and its subsidiaries, the Auckland Transport Alignment Project, and the recently announced establishment of a special-purpose entity to deliver the City Rail Link.



## Other changes in government

- 1.39 Several government entities have implemented or are currently implementing significant change programmes.
- 1.40 Inland Revenue continued the implementation of its Business Transformation Programme. Initial work on this programme began in July 2011, and it has a planned roll-out through to 2024. This programme will change most aspects of the way that Inland Revenue carries out its work and how people and businesses interact with the tax system.
- 1.41 The Government launched the updated New Zealand Health Strategy in April 2016. The updated strategy notes that maintaining services as they are currently provided will probably become unaffordable and that an increased emphasis on maintaining health and illness prevention is needed.
- 1.42 The Government had previously signalled that there is no planned change to the structure or governance arrangements for district health boards (DHBs). However, the National Health Board, which co-ordinated DHB planning and funding, was disestablished and its functions mainstreamed into the Ministry of Health, which has also been reorganised to position it to lead implementation of the strategy.
- 1.43 New Zealand Health Partnerships, which replaced Health Benefits Limited as the lead shared services entity for the DHBs, began operations on 1 July 2015. New Zealand Health Partnerships is owned by the 20 DHBs and is continuing four programmes begun by Health Benefits Limited, including a shared financial and procurement system and a national infrastructure platform for information technology storage and applications.
- 1.44 The New Zealand Customs Service and the Ministry for Primary Industries are developing the Joint Border Management System. The new system is intended to modernise the border systems of these agencies and enable them to share processes, data, and technology, providing a single customs and biosecurity information system.
- 1.45 The Ministry of Justice is working to improve and modernise the Court system. The changes will result in changes for the Ministry and the way it supports the courts and tribunals. We are carrying out a performance audit on courts modernisation and expect to report during 2016/17.

## Fraud awareness and detection

- 1.46 Overall, the number of incidents our auditors have reported of actual or suspected fraud has been relatively stable when compared with the previous year.
- 1.47 However, we have seen an increase in the value of procurement-related fraud, mirroring the experience of other jurisdictions. This includes fraud related to one-off construction contracts or project work, or general procurement that has mainly involved employees with delegated authority entering false, amended, or overstated invoices for payment.
- 1.48 We have also seen an increase in cyber-fraud affecting the entire public sector, including email scams, ransom-ware, and spear-phishing, requiring entities to become more alert and more sophisticated in their approach to cyber-security.

## Reputation for integrity

- 1.49 Transparency International published its 2015 Corruption Perceptions index in January 2016. Having held the number one spot on seven previous occasions, in 2015, New Zealand slipped for the second year in succession. New Zealand is now in fourth position.
- 1.50 New Zealand's public sector has an enviable reputation for integrity and transparency, which has been described as this country's greatest competitive advantage. Although New Zealand remains in good company in the index, the fall from first to fourth position serves as a reminder that maintaining the highest standards of transparency and accountability requires continual effort. An ever-changing operating context will always present new challenges and risks that will need to be identified and addressed.

## Governance and accountability

- 1.51 From our work this year, we have confirmed that good governance and clear accountability are essential to ensuring that the public sector stays strong and effective. In our report *Reflections from our audits: Governance and accountability*,<sup>5</sup> we noted some common issues and challenges for entities, along with examples of good and emerging practice that public entities can use to help improve their governance and accountability arrangements.
- 1.52 It is vital that the public sector continues to focus on these areas to ensure that we maintain and continue to improve our strong public management system.

# Our audit of the Government's financial statements

# 2

- 2.1 In this Part, we report the results of our audit of the financial statements of the Government of New Zealand (the Government's financial statements) for 2015/16.
- 2.2 We discuss matters arising from our audit, including the audit opinion and our first year of including "key audit matters" in our audit report on the Government's financial statements.
- 2.3 We issued a standard audit report, which included an unmodified audit opinion, on the Government's financial statements for 2015/16.
- 2.4 We issued our audit report on 30 September 2016.

## Our audit opinion

- 2.5 The audit report appears on pages 25 to 31 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 2016;
    - financial performance and cash flows for the year ended on that date;
    - borrowings as at 30 June 2016; and
    - unappropriated expenditure, emergency expenses and capital expenditure, and trust money administered by departments for the year ended on that date; and
  - comply with generally accepted accounting practice in New Zealand, in accordance with public sector public benefit entity accounting standards.

## Our reporting on "key audit matters"

- 2.6 This year we included in our audit report, for the first time, a section on "key audit matters". Key audit matters are those matters that, in the auditor's professional judgement, are of most significance in the audit of the financial statements. We have reproduced the complete audit report, including the "key audit matters", in the Appendix.
- 2.7 Reporting on key audit matters is a new requirement under a new international auditing standard. It is mandatory only for:
- listed issuers – those with a statutory meaning under the Financial Markets Conduct Act 2013 (FMC) – for periods ending on or after 15 December 2016; and
  - FMC reporting entities considered to have a higher level of public accountability (other than listed issuers) for periods ending on or after 31 December 2018.<sup>6</sup>

6 ISA (NZ) 701: *Communicating Key Audit Matters in the Independent Auditor's Report*, available at [www.xrb.govt.nz](http://www.xrb.govt.nz).

- 2.8 The Auditor-General decided to apply this standard to the audit of the Government's financial statements for the year ended 2015/16 because she considered the introduction of reporting key audit matters to be of use to the readers of these accounts. It is another step in the evolution of good public sector auditing practice. We have produced what we believe is the world's first audit report on government financial statements to include a section on key audit matters.
- 2.9 In determining the key audit matters, we considered matters that were complex, had a high degree of uncertainty, or were otherwise important to the public. The key audit matters were:
- recognition of tax revenue;
  - valuing physical assets (property, plant, and equipment);
  - valuing long-term liabilities;
  - valuing financial assets and liabilities; and
  - accounting for the effects of the Canterbury earthquakes.<sup>7</sup>
- 2.10 Accounting for and reporting these matters was not straightforward, not least because of the judgements, estimates, and assumptions underpinning their measurement. These included assumptions and judgements about the future, particularly the service benefits and cash flows that could be expected from existing assets and liabilities. They could also include assumptions about market prices, interest rates, foreign exchange rates, inflation rates, and discount rates.<sup>8</sup>
- 2.11 Although relatively small in terms of amount, we included the outstanding Canterbury earthquake liabilities as a key audit matter because of the continuing public interest in them.

### **Other significant matters arising from the audit**

- 2.12 Other significant matters arising from the audit were about:
- valuing New Zealand Defence Force (Defence Force) assets;
  - valuing the Government's housing stock; and
  - accounting for the proposed Crown contribution to the City Rail Link development in Auckland.

<sup>7</sup> The Treasury (2016), *Financial Statements of the Government of New Zealand for the year ended 30 June 2016*, Wellington, pages 27-29.

<sup>8</sup> The Treasury (2016), *Financial Statements of the Government of New Zealand for the year ended 30 June 2016*, Wellington, Note 2 to the financial statements, pages 48-49.

## Key audit matters for 2015/16

### Recognition of tax revenue

- 2.13 Tax revenue from income tax and goods and services tax, at \$63.1 billion for the year ended 30 June 2016, was the main source of funding for the Government. Inland Revenue needed to estimate some components of tax revenue, and the associated receivables and payables, as at 30 June 2016. This was due to timing differences between the reporting date for the Government's financial statements and when taxpayers file tax returns.
- 2.14 The most significant estimates were those related to tax revenue flow from companies and income tax from other taxpayers. We carried out detailed audit work on these estimates, because errors in the underlying judgements could result in significant inaccuracies in the Government's financial statements. Overall, we were satisfied that these estimates were reasonable.
- 2.15 Inland Revenue's Business Transformation programme is expected to improve the accounting for tax revenue. As work progresses on this programme, we have recommended that Inland Revenue, with the Treasury's support, refine and improve the processes for estimating tax revenue receivable in each accounting period.

### Valuing physical assets (property, plant and equipment)

- 2.16 Certain assets are more difficult than other assets to value. We identified the following significant assets where there were inherent uncertainties involved in the valuations:
- state highway network;
  - electricity generation assets; and
  - rail network assets.
- 2.17 Overall, we were satisfied that the valuations for these assets were reasonable and consistent with valuation practices. The disclosures appropriately outlined the basis of valuation and the uncertainties associated with valuations of the assets.

### State highway network

- 2.18 The valuation of the state highway network (excluding land), of \$22.3 billion at 30 June 2016, was carried out by an independent external valuer. The valuation was based on information from several of the New Zealand Transport Agency's (the Agency's) databases that identify the asset components that make up the network, and their expected useful lives.

- 2.19 The Agency's data is primarily used for asset management purposes rather than financial reporting. Therefore, it is possible that some of the data could be incomplete or indexed using assumptions that cannot be easily verified. This includes data about "brownfield" costs, such as traffic management costs. Including such costs in the valuation better recognises the reality of roading work, particularly in urban areas.
- 2.20 Since 1 July 2013, the Agency has estimated brownfield costs for work carried out on the network from that time, and incorporated those costs in the valuation of the network. The cumulative amount of such costs recognised at 30 June 2016 is \$1.1 billion. Over time, brownfield costs will be progressively recognised in the valuation of the network.

#### **Electricity generation assets**

- 2.21 Electricity generation assets are majority-owned by the Government (at least 51%). The valuation of those assets, of \$15.7 billion at 30 June 2016, was carried out by specialist valuers. Specialist valuers are used because of the complexity and significance of assumptions about the future prices of electricity, the generation costs, and the generation volumes that these assets will create.
- 2.22 Small changes to assumptions, such as the forecast prices of electricity and discount rates, could significantly change the reported value of these assets.
- 2.23 As set out in Note 18 to the Government's financial statements, the specialist valuers of each of the electricity generation companies had different assumptions and made different disclosures about the valuation of their generation assets. Although there were differences, we were satisfied that the differences were reasonable.
- 2.24 We accepted the differences because:
- each company used the best information available, based on its circumstances and expectations, which was supported by the specialist valuers the company engaged; and
  - the information in the Government's financial statements was consistent with other information available in the market.

#### **Rail network assets**

- 2.25 The rail network was valued at \$959 million at 30 June 2016. The freight and metro passenger transport parts of the network were valued on different bases, reflecting the commercial nature of the freight part of the network and public benefit nature of the metro passenger transport part of the network.

- 2.26 The extent to which the freight part of the network is commercial is open to debate, given the expected government funding required in future. If it was not considered commercial, the freight part of the network would be valued to reflect a public benefit nature. This would increase the reported value of the rail network by \$4.2 billion.
- 2.27 The Government's accounting policy choice for the valuation of the freight part of the network was a difficult accounting matter to consider during our audit. That part of the network continues to be valued on a commercial basis, taking into account the net cash flows it generates.
- 2.28 As in past years, we considered the evidence supporting a commercial or public benefit valuation of the freight part of the network. The evidence showed mixed results. Some evidence, such as the requirements of the State-owned Enterprises Act 1986, clearly points to KiwiRail's commercial nature. And KiwiRail continues to behave commercially. However, evidence about long-term forecast results raises questions about the realistic prospect of generating a commercial return in the long term. KiwiRail's current financial projections show a continuing dependency on the Government for funding.
- 2.29 The decision to continue to accept the basis of valuation for the freight part of the rail network was marginal. We have recommended that the Treasury carry out a robust review of the accounting treatment for the year ending 30 June 2017, given KiwiRail's dependence on the Government for ongoing financial support.

### **Valuing long-term liabilities**

- 2.30 The valuation of the Government's long-term liabilities is complex and requires actuaries to estimate the value, based on assumptions about the future. The two significant long-term liabilities at 30 June 2016 were the \$36.6 billion outstanding claims liability of the Accident Compensation Corporation (ACC), and the Government employees' superannuation liability of \$12.4 billion. These liabilities were significant by value and there were inherent uncertainties in valuing them, due to a high degree of judgement and estimation.
- 2.31 The assumptions used to calculate the value of ACC's outstanding claims liability included estimating the length of rehabilitation from injuries, amounts of cash payments and when they will occur, and inflation and discount rates.
- 2.32 The assumptions used to calculate the value of the Government employees' superannuation liability for past and current members of the Government Superannuation Fund included estimating the return on assets owned by the

Fund, expected rates of salary increases for members of the Fund, and inflation and discount rates.

- 2.33 Note 2 to the Government's financial statements sets out the sensitivity of assumptions. There can be a large effect on the amount of these liabilities where there are changes in the assumptions, which also affects the amount of actuarial gains and losses.
- 2.34 We evaluated the appropriateness of the key assumptions used in valuing the long-term liabilities. For discount rates and inflation assumptions, the Treasury determines a table of risk-free discount rates and inflation assumptions each year using an agreed methodology. These are required to be consistently applied to valuations of long-term liabilities. We reviewed the table of risk-free discount rates and inflation assumptions as at 30 June 2016, and concluded they had been calculated in keeping with the agreed methodology.
- 2.35 Overall, we were satisfied that the valuations of the ACC outstanding claims liability and the Government employees' superannuation liability were reasonable and that appropriate disclosures had been made about them.

### **Valuing financial assets and liabilities at fair value**

- 2.36 According to the Government's financial statements, the Government had financial assets of \$125.8 billion, of which \$71.8 billion was measured at fair value. It also had financial liabilities of \$127.2 billion, of which \$12.3 billion was measured at fair value. The financial assets and financial liabilities measured at fair value included marketable securities, share investments, advances, and derivatives (which had a principal value of \$221.5 billion).
- 2.37 The fair value of some of the financial assets and financial liabilities (less than 5%) could not be measured using quoted market prices, and instead were estimated by applying an appropriate valuation approach, such as a valuation model. Inputs into the models use market data when available or inputs derived from non-market data, which requires significant judgement. We paid particular attention to evaluating the appropriateness of inputs to models that had been derived from non-market data.
- 2.38 We were satisfied that the fair values for financial assets and financial liabilities were reasonable and that the disclosures were appropriate.

### **Accounting for the effects of the Canterbury earthquakes**

- 2.39 The outstanding Canterbury earthquake insurance liabilities, although now only \$2.1 billion at 30 June 2016, continue to be of significant public interest.



- 2.40 The calculations of the remaining liabilities were complex, partly because of significant uncertainties, and they were carried out by independent actuaries. The calculations took into account estimates of the extent of damage, which was often not clearly known, uncertainties arising from changing land policies, engineering requirements arising from issues such as liquefaction and flooding, and associated legal claims.
- 2.41 We evaluated whether the actuaries used the latest information about the effects of the earthquakes, including damage, claims paid, and repairs carried out. We were satisfied that the earthquake insurance liabilities were reasonable and that the disclosures appropriately outlined the uncertainties about their valuation.

## Other significant matters arising from the audit

### Valuing New Zealand Defence Force assets

- 2.42 The Defence Force manages assets valued in excess of \$5 billion. These assets include land, buildings, and specialised military equipment, which were recognised in the financial statements at fair value. To comply with accounting standards, the Defence Force needs to ensure that the carrying values of assets remain materially consistent with fair value. Where there are indicators of material changes in value, a revaluation needs to be done and the carrying values adjusted.
- 2.43 The Defence Force did not do a good job of assessing whether there had been a material change in the fair value of its assets, compared with their carrying value. In particular, the Defence Force did not make enough use of subject-matter specialists. The appointed auditor could not obtain assurance that the carrying value was materially consistent with fair value. When Defence Force senior leadership became aware that the Defence Force's initial assessment required further testing, it acted immediately to rectify the situation. The Defence Force carried out substantial additional work, with support from the Treasury. However, we did not gain assurance about these balances until 27 September 2016, which is unacceptable.
- 2.44 As a result of the additional work, it was concluded that fair values had moved materially since the last valuation in 2013, and a late adjustment was made to the Government's financial statements. This adjustment increased the asset values by about \$500 million. The evidence provided by the Defence Force to support the movement was sufficient for the Government's financial statements. However, further work was performed by the Defence Force in support of its own financial statements.

- 2.45 We have recommended that entities responsible for managing significant assets that are recognised in the financial statements at fair value be reminded of the importance that asset carrying values are materially consistent with fair values. Regular valuations need to be complemented by robust assessments of carrying values between valuation years. Asset management in the public sector is an important element of good public management and timely and regular asset valuations are a vital part of that management.

### **Valuing the Government's housing stock**

- 2.46 The valuation of the Government's investment in its social housing portfolio (primarily held by Housing New Zealand) is based on the highest and best use and on comparable market sales data for each individual property. In the year ended 30 June 2016, the value of the social housing stock increased by \$3.2 billion, largely as a result of increases in the value of Auckland properties.
- 2.47 As part of the Social Housing Reform Programme, the Government announced that it is taking steps towards transferring ownership of some Housing New Zealand houses and tenancies to registered community housing providers. This has raised some specific accounting issues.
- 2.48 We identified this matter because of the judgement involved in determining the appropriate accounting treatment for social houses proposed to be transferred to community housing providers, either sold or redeveloped as part of the Government's social housing reform programme.
- 2.49 The social houses designated for ownership transfer in Tauranga and Invercargill were written down by \$237 million, a 60% write-down from their original carrying value of \$397 million. The value of these properties has reduced because they are "encumbered" – they can be used only for social housing. The write-down is charged against the revaluation reserve, and therefore did not change the operating balance.
- 2.50 A gain or loss on sale of the social houses with encumbrances will be recognised when transfers of state houses are completed, based on the difference between their written down value and sale price.

### **Accounting for the proposed Crown contribution to the City Rail Link development in Auckland**

- 2.51 On 15 September 2016, the Government and Auckland Council signed a Heads of Agreement under which the Government intends to fund 50% of the City Rail Link. The cost of the project is still to be determined.
- 2.52 This matter was appropriately disclosed in the Government's financial statements as an event that occurred after 30 June 2016.

# The last seven years of the Government's financial statements

# 3

- 3.1 In this Part, we look back on our auditing of the Government's financial statements during the current Auditor-General's term. We reflect on the main matters and themes that arose during those seven years.
- 3.2 In the last seven years, global and national economies have experienced major economic shocks. As part of this, the resources of governments have changed, and some of these changes are reflected in the financial statements – for example, in the composition and complexity of the Government's assets.<sup>9</sup>
- 3.3 We discuss how the revenue earned, assets owned, and liabilities owed by the Government have changed, as reported in the last seven years of the Government's financial statements.
- 3.4 When discussing the Government's financial results in this Part, our figures include the amount attributable to minority interests. This is because our audit covers all of the assets and liabilities on the Government's balance sheet. We are interested in the values and performance of economic resources under the Crown's control, whether they are wholly owned by the Government or partly owned by minority shareholders. (Some of the financial data reported in the Government's financial statements are shown net of minority interests to emphasise the amount attributable to the Crown. The difference between those figures and the gross amounts discussed here are usually immaterial.)

## Main matters affecting our audits

- 3.5 We have reported annually on our audits of the financial statements and, in the last seven years, we have reported on 30 matters that have been of great importance in forming our audit opinions on the financial statements.<sup>10</sup>
- 3.6 Figure 3 shows the number of matters we have reported on and the number of times they have been reported on. For example, in the past seven years, 10 different matters were reported on only once, and four matters were reported on seven times – every year from 2009/10. One other matter was reported on six times during the seven years.
- 3.7 The five matters that were reported on six or seven times concerned the recognition of tax revenue, valuation of state highways, discount rates used

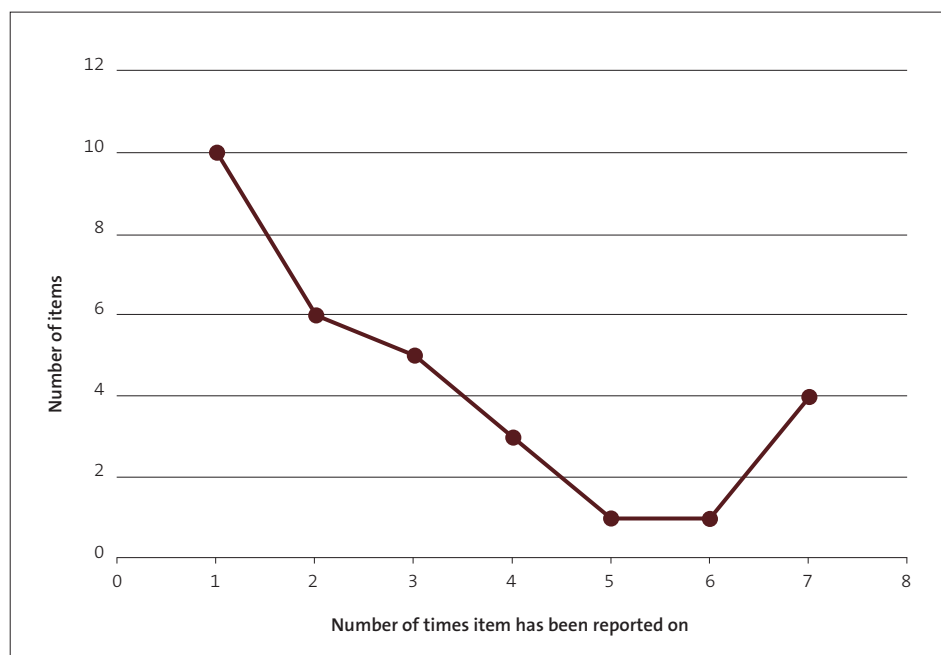
<sup>9</sup> We have published several reports on managing government assets. See *Insuring public assets* (June 2013), *New Zealand Transport Agency: Maintaining and renewing the state highway network – follow-up report* (October 2014), *Governance and accountability for three Christchurch rebuild projects* (December 2015), *District health boards' response to asset management requirements since 2009* (June 2016), and *A review of public sector financial assets and how they are managed and governed* (March 2016). All of these reports are available at [oag.govt.nz](http://oag.govt.nz).

<sup>10</sup> We also recently published a separate report, *Improving financial reporting in the public sector* (February 2016), in which we reported positive changes to accounting standards in the last six to seven years. We expect those changes to lead to improvements in financial reporting.

in valuing long-term liabilities, accounting for the costs of the Canterbury earthquakes, and accounting for liabilities under the Treaty of Waitangi settlements.

- 3.8 Perhaps unsurprisingly, four of those five matters have featured as “key audit matters” in our 2015/16 audit report on the financial statements (see Part 2).

**Figure 3**  
The number of specific matters we have reported on from 2009/10 to 2015/16 and frequency of reporting



- 3.9 In the following sections, we discuss briefly how the Government's financial performance and position have changed in the past seven years, some of the challenges for the Government's financial reporting, and some of the areas of audit interest that have arisen.

## Government revenue

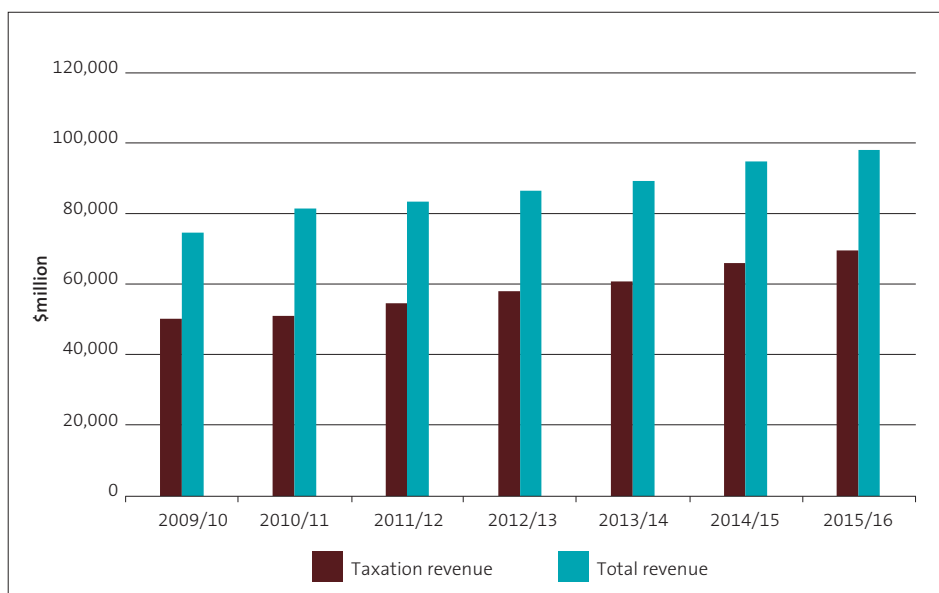
- 3.10 Most government revenue is from taxes.<sup>11</sup> The Government's tax revenue declined for two consecutive years during the last decade – in 2008/09 and 2009/10. The reduction in tax revenue was mostly due to reductions in corporate and personal income tax rates, declining profits resulting from the worsening economic climate (following the global economic crisis), and declining interest rates.
- 3.11 Figure 4 begins with the low point in 2009/10, after which government revenue has increased for each consecutive year. By 2012/13, tax revenue (\$58.1 billion)

11 Total tax revenue comprises individual and corporate income tax, GST, and other indirect taxes.

had surpassed the previous high point of 2007/08 (\$57.4 billion). In 2015/16, tax revenue was \$69.7 billion. It constituted 71% of total Crown revenue of \$98.2 billion (up from 67% of total Crown revenue in 2009/10).

- 3.12 Non-tax revenue<sup>12</sup> earned during the same seven-year period remained fairly constant.

**Figure 4**  
**Tax revenue and total revenue from 2009/10 to 2015/16**



- 3.13 Tax revenue is generally recognised in the financial statements when assessable income has been earned. Some estimation is required to account for tax revenue from taxpayers who have not filed income tax returns by the end of the financial year.
- 3.14 When reporting on our audits of the financial statements during the past seven years, we have regularly drawn readers' attention to the calculation of income tax revenue. This is because of the significant judgements and estimations involved. Tax revenue featured as a key audit matter in our 2015/16 audit of the Government's financial statements (see paragraphs 2.13-2.15).

### The Government's balance sheet – net worth

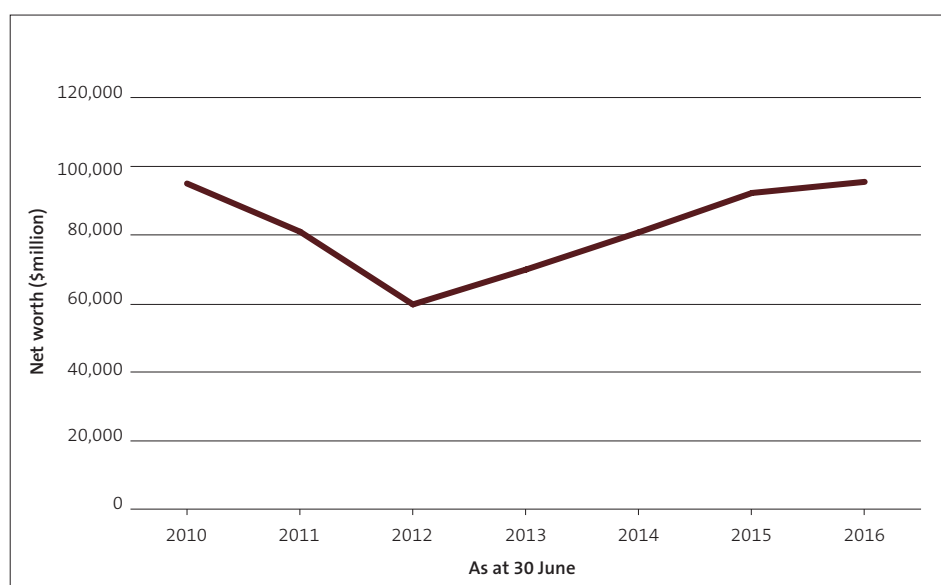
- 3.15 When the first consolidated Government financial statements were published in 1992, the Government's net worth was in deficit. This means that, when applying generally accepted accounting practice, its reported liabilities exceeded its

12 Non-tax revenue includes fees, levies, revenue from operations, and interest and dividends received.

reported assets – by \$10.35 billion. It therefore reported “negative equity”.<sup>13</sup> Despite several national and global economic and financial shocks in recent decades, the financial statements report a positive equity situation as at 30 June 2016 of \$95.5 billion.<sup>14</sup>

- 3.16 Figure 5 shows that the Government's net worth (including net worth attributable to minority interests) as at 30 June 2016 (\$95.5 billion) is about the same as it was at 30 June 2010 (\$95.0 billion). It decreased steeply from 2010 to 2012 (\$59.8 billion) before recovering steadily from 2013 onward.

**Figure 5**  
**Net worth from 2010 to 2016 (including minority interests in listed companies)**

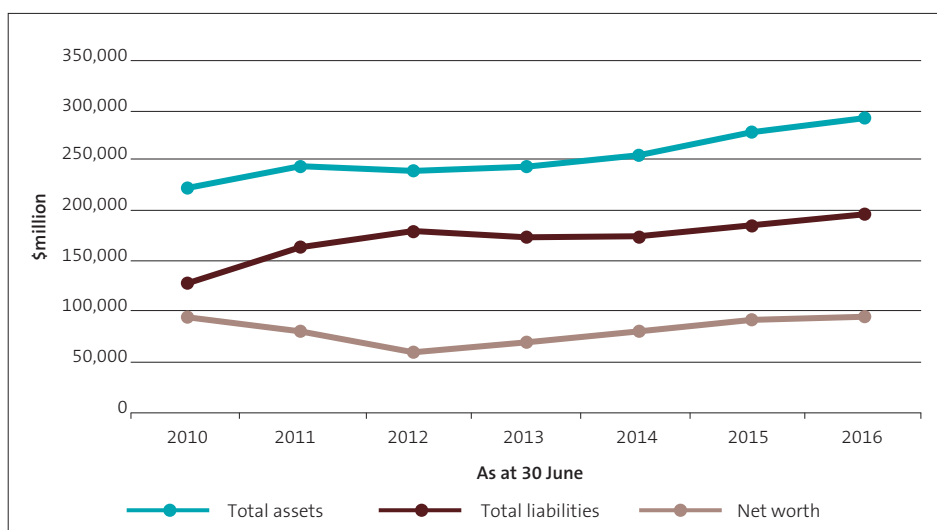


- 3.17 Figure 6 shows the relative movement in what the Government owns (assets), owes (liabilities), and equity (net worth) from the Government's financial statements for the last seven years. It shows a gradual increase in Government net worth since 2012, as the gap between assets and liabilities has gradually widened.

13 *Report of the Controller and Auditor-General on the Audit of the Crown and Government Departments for the year ended 30 June 1992*, pages 25, 27, and 50.

14 The Treasury (2016), *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2016*, Wellington, page 18.

**Figure 6**  
**Growth in the Government's assets, liabilities, and net worth (including minority interests in listed companies)**



- 3.18 Net worth increases when the Government's assets gain in value, its liabilities fall in value, or its revenues exceed expenses (which results in a positive OBEGAL).
- 3.19 Between 2010 and 2012, the Government's net worth decreased, as shown in Figures 5 and 6. The main reason for the decrease in 2010/11 was the significant negative OBEGAL (that is, expenses exceeded revenue). In that year, the OBEGAL was minus \$18.4 billion. A major factor in that deficit was the expense resulting from the Canterbury earthquakes.
- 3.20 Three major reasons for the further decline in 2011/12 were a continuing negative OBEGAL, increases in the values of the long-term liabilities of ACC and the Government Superannuation Fund (GSF)<sup>15</sup>, and a significant write-down of KiwiRail assets. The write-down of rail assets followed the decision to value some assets on a commercial basis for the purpose of the Government's financial statements. Deteriorating market conditions also affected the valuation.
- 3.21 From 2011/12, the Government's net worth has steadily increased, largely because of gains in asset values, and the OBEGAL has steadily improved. After 2010/11, the gap between expenses and revenue declined each year to 2014/15, when the Government recorded a small OBEGAL surplus (\$0.7 billion including the minority interest share) – the first time government revenue had exceeded expenses since 2008. The gradual narrowing of the gap between expenses and revenue was largely driven by increases in tax revenue as the economy improved

<sup>15</sup> The ACC and GSF liabilities increased as a result of "actuarial losses" caused by the decrease in interest rates. The decrease in interest rates led to a decrease in the discount rate, which increases the present value of the future payments obligations (that is, the long-term liabilities).

and some tax policy changes took effect, with the growth in revenue outpacing the growth in government spending. During this period, government borrowing continued to increase to fund the Government's continuing cash deficits.

3.22 The biggest factors affecting the changes in net worth from 2012/13 to 2015/16 were the changes in values of the Government's assets and liabilities. Net worth increased because of the upwards valuations of Government assets (or downward valuation of liabilities). The items that had the most significant effects on net worth in this period were:

- investment gains – primarily in the asset portfolios of ACC and the New Zealand Superannuation Fund;
- fluctuations in the values of the ACC and GSF long-term liabilities, mainly driven by changes in discount rates; and
- upward revaluations of the Government's physical assets.

3.23 In 2013/14, a significant increase in net worth (\$3.3 billion) resulted from the Government's share offers in the partial sale of the state-owned energy companies. Although the cash received for the sale of shares increased the Government's asset base, it had no effect on the *net worth attributable to the Crown* because the \$3.3 billion received was reflected instead in the *net worth attributable to minority interests*.<sup>16</sup>

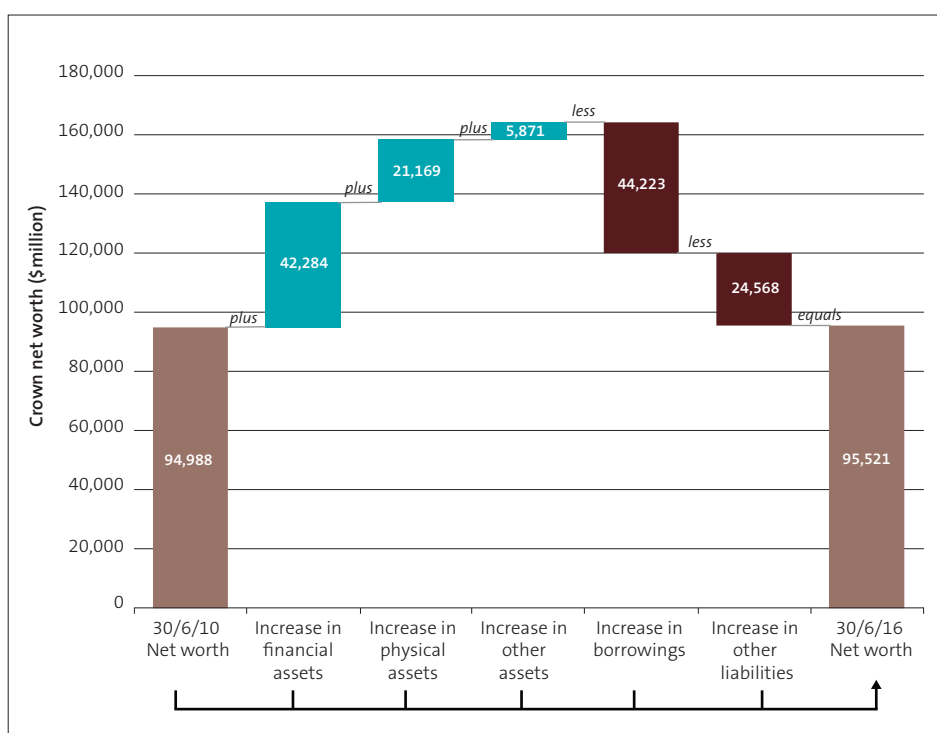
3.24 A notable point, shown in Figures 5 and 6, is that the Government's net worth at the end of the period shown (\$95.5 billion) is about the same as it was at the beginning of the period (\$95.0 billion). Figure 7 presents the net changes in the Government's balance sheet items between 2010 and 2016 and shows that reported assets have increased by \$69 billion – and its liabilities have increased by about the same amount.

3.25 Figure 7 shows that the increase in the value of the Government's financial assets has been significantly greater than the increase in physical and other assets during this period. Government borrowing is \$44 billion higher in 2016 than in 2010. The increase in borrowings was slightly larger than the increase in the value of financial assets.

<sup>16</sup> Minority interests is the portion of the Government's net worth attributable to the minority shareholders in the Crown-owned, listed companies, which mainly comprise Mercury NZ Limited (formerly Mighty River Power Limited), Meridian Energy Limited, Genesis Energy Limited, and Air New Zealand Limited.



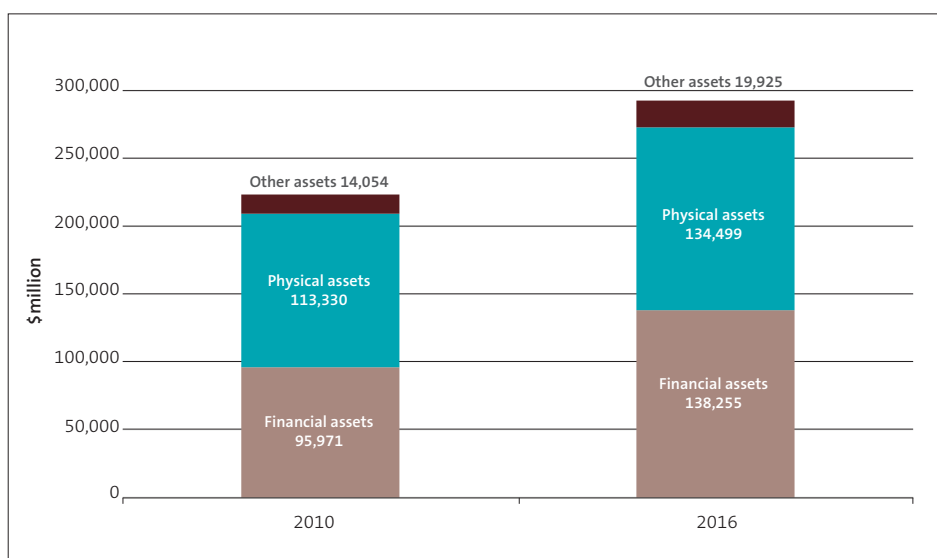
**Figure 7**  
Changes in the net worth of the Government between 2010 and 2016



- 3.26 In Figure 8, we look more closely at the Government's asset base – financial assets, physical assets, and other assets. We compare the composition of government assets as at 30 June 2010 with the composition as at 30 June 2016. Figure 8 shows the growth in the value of physical assets on the Government's balance sheet and highlights the even greater growth in the amount and proportion of financial assets.
- 3.27 A significant proportion of government assets are reported at "fair value" as opposed to what they cost. Fair values are generally based on notions of market values or other economic value, which provide more relevant measures of an asset's worth than the historical cost of the asset.
- 3.28 Accounting at fair value has a degree of subjectivity. Measuring fair value often requires management judgement about market assumptions, likely future inflation rates, likely future cash flows, and an appropriate rate at which to discount the cash flows.<sup>17</sup>

<sup>17</sup> Future cash flows need to be discounted to arrive at their present value.

**Figure 8**  
Crown asset composition as at 30 June in 2010 and 2016



## Physical assets

- 3.29 The value of physical assets (property, plant, and equipment) reported in the financial statements rose by \$21.2 billion (19%) between 2010 and 2016. The increase in this class of assets, as shown in Figure 8, is partly due to increased land values.
- 3.30 When physical assets such as land are reported at fair value, the upward movement in the market values of those assets are reflected in higher asset values in the Government's balance sheet.
- 3.31 On the equity side of the balance sheet, the valuation increase is usually reflected in the "property, plant, and equipment revaluation reserve". That revaluation reserve has, over time, become a larger component of the Government's net worth. In 2016, the revaluation reserve makes up 85% of net worth (having peaked at 94% in 2012). Because the revaluation reserve is a more significant part of the Government's balance sheet than it was in the past, the assumptions and judgements that go into reporting physical asset fair values have become more important.
- 3.32 A significant and constant factor in the rising value of physical assets during this period was the increasing value of the state housing portfolio, driven by rising Auckland property prices.
- 3.33 Another asset that we have reported on frequently in the past seven years is the state highway network. Upward revaluations of state highway land also contributed to the increases in Government net worth between 2010 and 2016.

- 3.34 This state highway network valuation is particularly complex and provides different measurement challenges. Challenges relate to identifying and including all of the components that make up the network and estimating their useful lives. We have previously noted that there are uncertainties with the quality of some underlying data used in the valuation, including the quantity, cost, and life of some components. The state highway network has also been identified as a key audit matter in our 2015/16 audit report of the financial statements (see paragraphs 2.18-2.20 and the Appendix).

### Financial assets

- 3.35 Figures 7 and 8 show that the value of financial assets increased by \$42.3 billion (a 44% increase) compared with \$21.2 billion (19% increase) for physical assets, and \$5.8 billion (42% increase) for other assets. The significant increase in financial assets during the period has increased the complexity and volatility of the Government's asset base.
- 3.36 In the past, the holdings of financial assets were relatively small and usually based on managing short-term cash needs and supporting debt requirements. Today, they are also used to increase liquidity, flexibility, and risk management in the delivery of public services.<sup>18</sup>
- 3.37 The larger asset classes in the financial asset portfolio are marketable securities, deposits, and derivatives in gain (39% of financial assets); share investments (18%); and advances (20%). Most financial assets are held by the New Zealand Superannuation Fund, ACC, and the Reserve Bank of New Zealand. Nearly 60% of the value of advances are Kiwibank loans and advances, with student loans making up more than 30%.
- 3.38 The valuation of securities and share investments is relatively straightforward when their fair values can be determined by reference to observable and objective data, such as quoted market prices. For unlisted shares and securities for which there is no active market, the value arrived at for financial reporting purposes is more subjective because more reliance is placed on assumptions and other judgements (such as cash flow forecasts and the selection of an appropriate discount rate to determine the asset's present value). Similar challenges apply to valuing student loans.
- 3.39 We reported on public sector financial assets in our 2016 report, *A review of public sector financial assets and how they are managed and governed*. In our report, we recommended that the financial assets (and associated liabilities) of central government should be considered together, with a clear understanding of the risks being taken, how they are managed, and the opportunities and challenges

<sup>18</sup> We discuss this in our 2016 report, *A review of public sector financial assets and how they are managed and governed*. Available at [oag.govt.nz](http://oag.govt.nz).

they create. This is especially so since the Treasury's projections suggest that financial assets will increasingly dominate the Government's balance sheet.

### Long-term liabilities

- 3.40 Significant judgements apply not only to establishing the reported value of government assets but also to the reported value of its long-term liabilities.
- 3.41 Measuring and reporting on the Government's long-term liabilities also involves testing assumptions about the amount and timing of cash flows, projected inflation rates, and the calculation of risk-free discount rates. Actuarial expertise is relied on for much of this work.
- 3.42 Several entities whose accounts are consolidated into the financial statements use discounted cash flow models to value various assets and liabilities. Before 2009, different entities whose component financial elements are included in the financial statements used different risk-free rates and Consumer Price Index assumptions to calculate their respective liabilities. During 2010, the Treasury completed a substantial project to establish an acceptable methodology for deriving risk-free discount rates and inflation assumptions for use in certain accounting valuations for the financial statements.
- 3.43 The effect of changes in the risk-free rate or Consumer Price Index assumptions on the financial statements is significant. For example, a 1% increase in the risk-free discount rate would decrease the ACC claims obligation by \$5.2 billion, or the obligation would increase by \$6.9 billion should the rate decrease by 1%.
- 3.44 As auditors, we need to satisfy ourselves that appropriate risk-free discount rates and Consumer Price Index assumptions have been used in the valuation models. This is especially important for the Crown's two significant long-term liabilities, which can be significantly affected by changes in discount rates – ACC's outstanding claims liability (which constitutes 20% of the Government's total liabilities) and the retirement plan obligations for the members of the GSF (which constitutes about 6% of the Government's total liabilities).
- 3.45 Fluctuations in the values of the ACC and GSF liabilities, mainly because of changes to discount rates, have significantly affected movements in the Government's net worth during the seven years discussed in this Part.
- 3.46 Upward fluctuations (actuarial gains), including for ACC, helped offset negative OBEGAL results in 2010/11 and 2012/13. However, in 2011/12 actuarial losses of about \$6.8 billion for these liabilities added significantly to a negative OBEGAL of \$9.2 billion. And in 2015/16, ACC and GSF actuarial losses of over \$7 billion more than offset the small OBEGAL surplus. The Government's net worth increased

in 2015/16 nonetheless because the resulting negative operating balance (that is, OBEGAL minus losses) was more than offset by revaluation gains on physical assets.

- 3.47 Estimating and valuing liabilities stemming from the Canterbury earthquakes has also posed major challenges for the Government; accounting for the effects of, and responses to, the Canterbury earthquakes has featured in our audit reports on the financial statements since 2010/11.
- 3.48 After the September 2010 earthquake, the 2009/10 financial statements included a "subsequent event" note about the earthquake. We concluded that the event did not require the financial statements to be adjusted (that is, it was a "non-adjusting event") but that the costs would be significant.<sup>19</sup>
- 3.49 A year later, the combined effect of the September 2010 and February 2011 events was a significant matter for the financial statements. With net costs of \$9.1 billion, the earthquakes affected both the preparation and the audit of the financial statements. A separate note on the Canterbury earthquakes has been included in each set of financial statements since 2011.
- 3.50 Matters stemming from the earthquakes that needed careful consideration from 2011 to 2016 included:
- quantifying the Earthquake Commission's insurance liabilities and expenses;
  - the effect of acquiring the Canterbury-related business of AMI and managing its earthquake liabilities through the Crown-owned company, Southern Response Earthquake Services Limited;
  - accounting for red zone properties by CERA; and
  - the Government's share of the cost of restoring local authority infrastructure in the region.
- 3.51 In the absence of historical data or experience, the inherent uncertainties in the estimates and underlying assumptions about the various asset and liability balances presented many challenges for the public entities affected. Entities and their auditors needed to use experts, such as actuaries and engineers, to test entities' assumptions and judgements about the values, and changes in values, of balance sheet items. Specifically, this included assessing the number and amount of outstanding claims, estimating the time expected to repair or rebuild, and making judgements about the effect of inflation on future costs.
- 3.52 We worked with the Treasury and the separate government entities to better understand the assumptions and related sensitivities for the financial figures and to agree the accounting treatment for various transactions. Our work with

<sup>19</sup> The Treasury (2016), *Financial Statements of the Government of New Zealand for the Year Ended 30 June 2010*, Wellington, page 153. Available at [www.treasury.govt.nz](http://www.treasury.govt.nz).

the Treasury also included ensuring that entities made adequate annual report disclosures about the costs and associated liabilities arising from the earthquake events.

- 3.53 We have given special attention in our audits to the outstanding insurance liability. Although the size of the liability has decreased, the level of uncertainty about the amount remains high, particularly for Earthquake Commission claims where there has been severe land damage. We have included the outstanding earthquake liabilities in our key audit matters for 2015/16 because of the continuing public interest in these liabilities (see paragraphs 2.39-2.41).
- 3.54 Another audit matter that has featured regularly in our reports in the past seven years concerns the long-term liability associated with Treaty of Waitangi settlements. The Treaty settlements affect several balances in the financial statements. For financial reporting purposes, considerable judgement is required in recognising obligations to iwi, payments due to Waikato Tainui and Ngāi Tahu triggered by the relativity mechanism clause, and related disputed items.

### **Audit opinions during the last seven years**

- 3.55 We have been able to issue unmodified audit opinions on the Government's financial statements for each of the seven years discussed in this Part.
- 3.56 We have issued "standard" audit reports for five of the seven years. The exceptions were 2010/11 and 2011/12, for which we included an "emphasis of matter" in those audit reports to draw readers' attention to uncertainties in the financial statements arising from the Canterbury earthquakes.
- 3.57 Without needing to modify our audit opinion, we pointed out that there were significant uncertainties underpinning estimates in the Government's financial statements about the Earthquake Commission, the AMI/Southern Response Earthquake Services Limited support package, the Canterbury residential red zone support package, and the Government's share of local authority costs in response to the earthquakes and its share for restoring local authority water infrastructure damaged by the earthquakes.

# The Controller function and the appropriation audit

- 4.1 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.
- 4.2 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.
- 4.3 Parliament's approval can be given in advance or retrospectively.
- 4.4 We have explained in previous years what the Controller and Auditor-General does to help ensure that government spending stays within the limits approved by Parliament.<sup>20</sup>
- 4.5 Our discussion covers:
- How much unappropriated expenditure was authorised in 2015/16?
  - How much public expenditure was incurred without prior authority in 2015/16?
  - A seven-year overview of appropriation issues.
- 4.6 Details of how the Controller function works can be found in Part 3 of our 2015 report, *Central government: Results of the 2014/15 audits*.

## **Expenditure above or beyond the appropriation limits**

- 4.7 We have explained in past reports that the public finance system provides flexibility to enable lawful spending above or beyond the limits specified by each appropriation (that is, type of expenditure, scope, amount, and timing).
- 4.8 In limited circumstances, expenditure can be incurred outside the bounds authorised by the Appropriation (Main Estimates) Act or the Appropriation (Supplementary Estimates) Act. For example, flexibility is provided by the Public Finance Act 1989 for small amounts of expenditure (sections 26A and 26B) and for emergencies (section 25). Imprest Supply Acts, which delegate approvals to Cabinet, also provide flexibility to enable the Government to incur expenditure not covered at the time by Appropriation Acts.

<sup>20</sup> See *Central government: Results of the 2014/15 audits*, Part 3, and *All about the Controller and Auditor-General*, Part 3. Available at [oag.govt.nz](http://oag.govt.nz).

- 4.9 We have urged government departments to seek early approval as soon as they have identified the need for previously unanticipated expenditure, so that any expenditure over and above the appropriations can be authorised before the event.
- 4.10 When authority for unappropriated spending is not obtained before the event, it is unlawful. Ministers need to report the matter to Parliament<sup>21</sup> and seek retrospective approval of the expenditure from Parliament, through the Appropriation (Confirmation and Validation) Act.
- 4.11 Expenditure outside the bounds of the appropriations tends to be relatively small. In 2015/16, it was less than 0.1% of the Government's total budget (2014/15: less than 0.1%).

### How much unappropriated expenditure was authorised in 2015/16?

- 4.12 In both of the following instances, expenditure beyond the appropriation limits was approved through the correct channels.
- 4.13 The Minister of Finance used his powers under section 26B of the Public Finance Act to authorise one instance of unappropriated expenditure of \$2.2 million during 2015/16.<sup>22</sup> The overspending was in Vote Social Development for recoverable assistance payments to low-income earners and beneficiaries. The level of spending is driven by demand, and in 2015/16 the number of grant recipients exceeded what was initially budgeted.
- 4.14 In 2015/16, Cabinet provided authority to the Ministry of Justice to use imprest supply for a \$2.5 million "ex gratia" payment for wrongful conviction and imprisonment. This was necessary because the timing of the payment lay outside the time frame for inclusion in Vote Justice appropriations approved by Parliament in that year.

### How much expenditure was incurred without prior authority in 2015/16?

- 4.15 Figure 9 shows the number of instances for which public expenditure was not only unappropriated but also spent without the authority to do so.<sup>23</sup>
- 4.16 In 2015/16, there were 12 reported cases of unauthorised expenditure, compared with 19 in 2014/15. The total amount of unauthorised expenditure reported

21 Section 26C of the Public Finance Act 1989. Section 26D requires that unauthorised expenditure is disclosed in the Government's financial statements, and government departments must disclose the unauthorised expenditure in their annual reports.

22 *Financial Statements of the Government of New Zealand for the year ended 30 June 2016*, page 143.

23 *Financial Statements of the Government of New Zealand for the year ended 30 June 2016*, pages 145-146.



in the Government's financial statements was \$72.5 million (2014/15: \$55.8 million).<sup>24</sup> Unauthorised expenditure reported in 2015/16 was 0.08% of the total appropriations for all Votes authorised through the Budget 2015 process<sup>25</sup> (2014/15: 0.07%).

**Figure 9**  
**Unappropriated expenditure incurred without authority during the year ended 30 June 2016**

Unauthorised expenditure by category	2015/16 Number	2015/16 \$million	2015/16 Votes
Expenses and capital expenditure incurred in excess of appropriation and without prior Cabinet authority to use imprest supply	6	51.7	Conservation; Business, Science and Innovation; Arts, Culture and Heritage; Education; Social Development; Finance
Expenses and capital expenditure incurred outside scope of an appropriation and without prior Cabinet authority to use imprest supply	1	10.8	Justice
Expenses and capital expenditure incurred without appropriation and without prior Cabinet approval to use imprest supply	5	10.0	Business, Science and Innovation; Health
<b>Total</b>	<b>12</b>	<b>72.5</b>	

4.17 For six of the 12 instances in 2015/16, the Government spent \$51.7 million more than the amount that was authorised within existing appropriations. In another (in Vote Justice), expenditure of \$10.8 million was outside the scope of existing appropriations. In five instances, expenditure totalling \$10 million was not covered by any of the appropriations in the two Votes concerned (Business, Science and Innovation; and Health).

4.18 The most significant instances of unauthorised expenditure in 2015/16, in terms of the amounts involved, were in Votes Education, Social Development, and Justice. Between them, they constitute \$57.4 million of the \$72.5 million of unappropriated expenditure incurred without authority.

<sup>24</sup> The Treasury, (2015), *Financial Statements of the Government of New Zealand for the year ended 30 June 2015*, pages 141-143. Some of the unauthorised spending reported in 2015/16 related to previous years.

<sup>25</sup> The Budget 2015 appropriations for all Votes totalled \$88.9 billion.

### Vote Education

- 4.19 In the Government's financial statements for 2014/15, the Government reported unappropriated expenditure of just over \$16 million. This was due to the demand for early childhood education exceeding forecast. This excess spending was authorised by the Minister of Finance under section 26B of the Public Finance Act.<sup>26</sup>
- 4.20 However, during 2015/16, the Ministry of Education identified a further \$23.4 million of expenditure incurred under the *Early Childhood Education* appropriation. The Ministry identified an accounting classification error that, when corrected, increased further the expense under the appropriation for 2014/15.
- 4.21 With the appropriation limit already exceeded for 2014/15, the addition to expenses identified during 2015/16 increased the excess even further. The total amount in excess for 2014/15 rose to \$39.4 million, with the more recently identified amount of \$23.4 million also being unauthorised.<sup>27</sup>

### Vote Social Development

- 4.22 In 2015/16, the Ministry of Social Development discovered a miscalculation error that dated back to 1993. The error related to the assessment and payment system for Accommodation Assistance payments. At the end of the financial year, the Ministry of Social Development recognised a \$29 million expense to account for the underpayments, which resulted in \$23 million of expenditure in excess of the appropriation limit for 2015/16.<sup>28</sup>

### Vote Justice

- 4.23 Another instance of unauthorised expenditure from past years came to light in 2015/16 in Vote Justice. In 2011, the Ministry of Justice created a provision for expenses against the *Recovery from February 2011 Christchurch Earthquake* appropriation. During 2015/16, and after a detailed review of the earthquake provision following an earthquake-related settlement, we and the Treasury advised the Ministry of Justice that the expenditure was compensatory in nature and therefore outside the scope of the appropriation. The Ministry has sought approval for the payment. The expenditure outside scope amounted to \$10.8 million.<sup>29</sup>

<sup>26</sup> *Financial Statements of the Government of New Zealand for the year ended 30 June 2015*, page 140.

<sup>27</sup> *Financial Statements of the Government of New Zealand for the year ended 30 June 2016*, page 144, and Ministry of Education, *Annual Report 2016*, page 133.

<sup>28</sup> *Financial Statements of the Government of New Zealand for the year ended 30 June 2016*, page 145, and Ministry of Social Development, *Annual Report 2015/2016*, page 142.

<sup>29</sup> *Financial Statements of the Government of New Zealand for the year ended 30 June 2016*, page 145, and Ministry of Justice, *Annual Report 1 July 2015 to 30 June 2016*, page 107.

- 4.24 Further details of other unauthorised and unappropriated expenditure are provided in the annual reports of the departments responsible for administering their Votes and in the Government's financial statements for 2015/16.

### **How did the Controller address the issues that arose during 2015/16?**

- 4.25 The auditors for the affected departments carried out the actions necessary to provide assurance that unauthorised expenditure was accurately reported. Those actions included discussing the matter with the departments and agreeing the facts and the corrective action required. This involved confirming that the expenditure was unappropriated, the amount of the unappropriated expenditure, and the amount to be disclosed in the Government's and individual departments' financial statements, as well as reviewing the explanation given for the unappropriated expenditure.

### **A seven-year overview of appropriation issues**

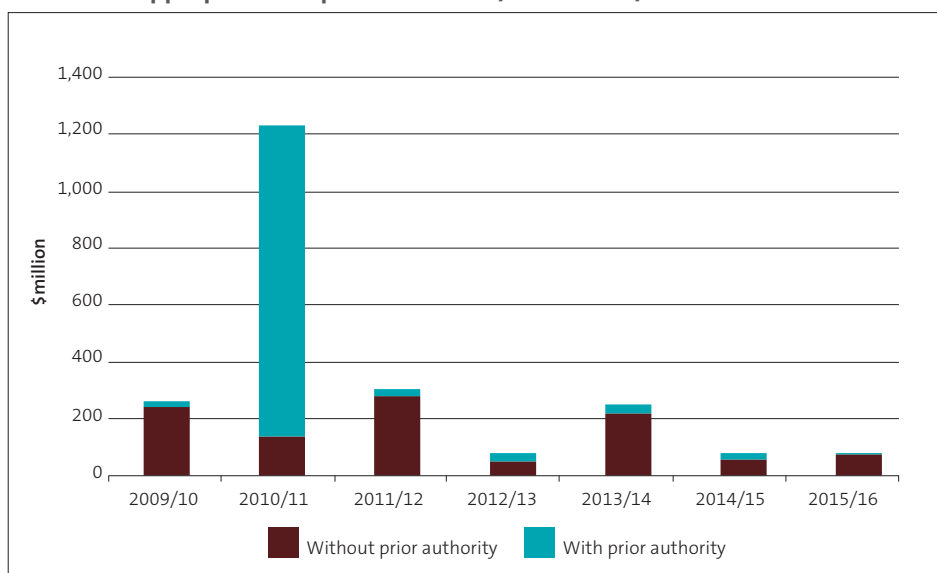
- 4.26 In the last seven years, we have seen a decline in the frequency of unappropriated expenditure. At the beginning of the period shown in Figure 10, there were 33 instances of unappropriated expenditure reported in the financial statements. There have been fewer instances of unappropriated expenditure every year since then.
- 4.27 The number of unappropriated expenditure items incurred *with prior authority* (the top section of the bars in Figure 10) has fluctuated in the last seven years. In 2015/16, in two instances departments obtained prior authority for the expenditure, despite that expenditure not being covered by the appropriation as described in the Budget or Supplementary Estimates.

**Figure 10**  
Instances of unappropriated expenditure 2009/10 to 2015/16



- 4.28 By contrast, there has been an overall reduction in the number of instances of unappropriated spending *without prior authority* in the same period (the bottom section of the bars in Figure 10). The number has fallen from 27 in 2009/10 and 25 in 2010/11 to 12 in 2015/16.
- 4.29 Figure 11 shows the amount of unappropriated expenditure incurred in the last seven years *with prior authority* (the top section of the bars) and *without prior authority* (the bottom section of the bars), as reported in the financial statements.

**Figure 11**  
Value of unappropriated expenditure 2009/10 to 2015/16



- 4.30 Figure 11 shows that, aside from 2010/11, the amount of unappropriated spending for which *prior authority had been obtained* (the top section of the bars) has ranged from \$31 million (2013/14) to \$4.7 million (2015/16). In 2010/11, more than \$1 billion of expenditure was authorised for the purchase of residential red zone properties in Canterbury, after the February 2011 earthquake.
- 4.31 In each year except 2010/11, most unappropriated expenditure was unauthorised at the time it was incurred. Although Figure 10 shows the frequency of unauthorised expenditure trending down (the bottom section of the bars), Figure 11 shows no noticeable trend in the amount of unauthorised expenditure. The amount has fluctuated in the last seven years, and the values for three of the past four years are at the lower end. The value has decreased noticeably from \$273.3 million in 2011/12 to \$55.8 million in 2014/15 and \$72.5 million in 2015/16.
- 4.32 A common cause of unappropriated expenditure was underestimating public expenditure in specific areas. A significant case was the expenditure required for the Canterbury earthquake recovery, most of which resulted from unpredictability of the costs involved.
- 4.33 Other reasons have related to underestimating the demand for services. Higher than expected uptake in early childhood education resulted in expenditure exceeding appropriation for Vote Education in several years. Similarly, in Vote Justice, the greater than forecast demand for legal aid services resulted in unappropriated expenditure in two instances.

- 4.34 In response to the number of unauthorised expenditure instances shown in Figure 10, the Controller and Auditor-General and the Secretary to the Treasury wrote to department chief executives in October 2014, encouraging them to ensure that their staff are familiar with any legislation that underpins the department's authority to incur public expenditure.
- 4.35 We have continued to urge departments to be more vigilant about their expenditure and the limits that Parliament has set for them. If there is an early indication that demand will exceed initial forecasts, then departments should act quickly to arrange prior authority to use imprest supply or seek adjustments through the supplementary estimates process.
- 4.36 We have also urged departments to anticipate and think through the possible accounting and appropriation implications of changed circumstances or unusual events. This will help ensure that they are not taken by surprise through incurring expenditure that is not yet authorised.

# Appendix

## Our audit report on the Government's financial statements

*To the Readers of the Financial Statements of the Government of New Zealand for the Year Ended 30 June 2016*

### Opinion

I have audited the financial statements of the Government of New Zealand (the financial statements of the Government) for the year ended 30 June 2016 using my staff, resources and appointed auditors and their staff. The financial statements of the Government on pages 34 to 151 comprise:

- the annual financial statements that include the statement of financial position as at 30 June 2016, the statement of financial performance, analysis of expenses by functional classification, statement of comprehensive revenue and expense, statement of changes in net worth, and statement of cash flows for the year ended on that date, a statement of segments, and notes to the financial statements that include accounting policies, borrowings as at 30 June 2016, and other explanatory information;
- a statement of unappropriated expenditure for the year ended 30 June 2016;
- a statement of expenses or capital expenditure incurred in emergencies for the year ended 30 June 2016; and
- a statement of trust money, administered by departments, for the year ended 30 June 2016.

In my opinion, the financial statements of the Government on pages 34 to 151:

- present fairly, in all material respects the Government's:
  - financial position as at 30 June 2016;
  - financial performance and cash flows for the year ended on that date;
  - borrowings as at 30 June 2016;
  - unappropriated expenditure for the year ended 30 June 2016;
  - emergency expenses and capital expenditure for the year ended 30 June 2016; and
  - trust money administered by departments for the year ended 30 June 2016.
- comply with generally accepted accounting practice in New Zealand, in accordance with Public Sector Public Benefit Entity Accounting Standards.

### Basis for Opinion

The audit has been carried out in accordance with the Auditor-General's Auditing Standards, which incorporate the International Standards on Auditing (New Zealand) (ISAs (NZ)). My responsibilities under those standards are further

described in the *Auditor's responsibilities for the audit of the financial statements of the Government* section of this report.

While carrying out this audit, my staff, and appointed auditors and their staff followed my independence requirements, which incorporate the independence requirements of Professional and Ethical Standard 1 (Revised) *Code of Ethics for Assurance Practitioners* issued by the New Zealand Auditing and Assurance Standards Board and the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code), and we have fulfilled our other ethical responsibilities in accordance with my independence requirements.

As an Officer of Parliament, I am constitutionally and operationally independent of the Government and, in exercising my functions and powers under the Public Audit Act 2001 as the auditor of public entities, I have no relationship with or interests in the Government.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion.

### **Key Audit Matters**

Key audit matters are those matters that, in my professional judgement, were of most significance in my audit of the financial statements of the Government of the current period. In applying my professional judgement to determine key audit matters, I considered those matters that could be complex, have a high degree of uncertainty, or are important to the public.

Because of the nature of the Government's activities, I recognise that key audit matters may be long-standing, and therefore, may not change significantly from one year to the next. These matters were addressed in my audit of the financial statements of the Government as a whole, and in forming my opinion thereon.



Recognition of tax revenue	
Key audit matter	What we did
<p>The Government recognised tax revenue of \$63.1 billion for the year ended 30 June 2016. Tax revenue is the main source of revenue for the Government.</p> <p>As outlined in note 2, it is necessary to estimate some components of tax revenue at 30 June 2016 because of timing differences between the reporting date for the financial statements of the Government and when taxpayers file tax returns.</p> <p>At 30 June 2016, the most significant estimates were those about companies' and other persons' income tax revenue totalling \$14.4 billion (net of refunds).</p> <p>Estimating income tax revenue is complex and relies on judgement. The recognition of income tax revenue is a key audit matter because it is a significant source of the Government's revenue, and is subject to significant uncertainties, complexities, and judgements.</p>	<p>We obtained an understanding of the systems, processes, and controls in place over the receipt of tax revenue, and assessed significant reconciliation processes.</p> <p>We carried out audit procedures to confirm the value of tax revenue as at 30 June 2016. This involved testing the data used in the estimation models to ensure that it was relevant and was used appropriately, checking the evidence to support the reasonableness of underlying assumptions applied in the models, and testing the sensitivity of the underlying assumptions used in the models.</p> <p>We also reviewed the historical accuracy of the estimation models to ensure that they had previously provided reasonably accurate estimates, and we checked receipts after year end to confirm the validity of some estimates.</p> <p>I am satisfied that the estimates included in tax revenue at 30 June 2016 are reasonable, and that the disclosures about the key estimates and judgements are appropriate.</p>

Valuing property, plant and equipment	
Key audit matter	What we did
<p>The Government owns a number of significant assets that can be difficult to value because of the nature of the assets. I have identified the following specific asset types where such difficulties are considered key audit matters because of the significance of those assets, and the uncertainties inherent in making the valuations.</p>	

Valuing property, plant and equipment	
Key audit matter	What we did
<p><b><i>State highway network</i></b></p> <p>As outlined in note 18, the state highway network has been valued at \$22.3 billion at 30 June 2016 by an independent external valuer. The valuation is based on information from a number of databases that identify the asset components that make up the network (roads, bridges, culverts, etc.), and their expected useful lives. These asset components exclude land which is separately recorded, as set out in note 18.</p> <p>It is possible that some of the information in the databases could be incomplete or has been indexed using assumptions that cannot be easily verified. This includes additional brownfields costs, such as traffic management, that cannot be applied to historic road construction because of incomplete records about these costs. As a result, there are uncertainties about the valuation of the state highway network.</p>	<p>We obtained an understanding of how the state highway network is valued. This involved confirming the competence, capabilities, and objectivity of the valuer, testing the valuer's valuation procedures, including the information they extracted from databases, and challenging the valuer's critical assumptions and judgements.</p> <p>We also carried out audit procedures to confirm that key controls were operating over the state highway network systems. This involved testing a sample of asset components to check whether appropriate approval had been obtained for expenditure on the components and whether there was adequate supporting documentation.</p> <p>We also reviewed the valuer's estimates of known brownfields costs, and in particular brownfields costs associated with roading components constructed or acquired during the year.</p> <p>I am satisfied that the value of the state highway network is reasonable and consistent with valuation practices, and that the disclosures appropriately outline the uncertainties about the valuation of the state highway network.</p>

Valuing property, plant and equipment	
Key audit matter	What we did
<p><b><i>Electricity generation assets</i></b></p> <p>As outlined in note 18, the electricity generation assets, which are at least 51% owned by the Government, are valued at \$15.7 billion at 30 June 2016. The valuation of these assets is carried out by specialist valuers because of the complexity and significance of the assumptions about the future prices of electricity, the generation costs, and the generation volumes that these assets will create.</p> <p>As a result, small changes to these assumptions, in particular the forecast prices of electricity and the discount rates used to determine the present value of these prices, could significantly change the value of these assets.</p>	<p>We obtained an understanding of how electricity generation assets are valued. This involved confirming the competence, capabilities, and objectivity of the valuers, testing the valuer's procedures for carrying out the valuations, including the information they used to carry them out, and challenging the valuer's critical assumptions and judgements. We also used our own valuation specialists to assess the valuer's procedures.</p> <p>We tested the sensitivity of the key underlying assumptions used by the valuers to ensure that they were reasonable, and we compared the forecast prices of electricity to the expected longer-term wholesale prices and market data where it was available.</p> <p>We also confirmed the underlying information held about assets by verifying asset purchases and disposals in the current period. This included testing whether there was adequate supporting documentation for those purchases and disposals. It also involved confirming the opening assets balances, and evaluating the related financial statement disclosures.</p> <p>I am satisfied that the valuation of electricity generation assets is reasonable and the disclosures appropriately outline the sensitivity and the complexity of the valuation of electricity generation assets.</p>

Valuing property, plant and equipment	
Key audit matter	What we did
<p><b>Rail network</b></p> <p>As outlined in note 18, the rail network has been valued at \$959 million at 30 June 2016. In arriving at this value the freight and the metro transport parts of the network have been valued on different bases, reflecting the commercial nature of the freight part of the network and public benefit nature of the metro transport part of the network.</p> <p>The extent to which the freight part of the network is commercial is open to debate, given the expected government funding required in future years. If it was not considered commercial, the basis for valuing the freight part of the network would change to reflect a public benefit nature. As outlined in note 18, if the freight part of the network had been valued based on a public benefit value rather than a commercial value, the rail network would increase in value by \$4.2 billion.</p>	<p>We considered the evidence around the commercial nature versus the public benefit nature of the freight part of the rail network. The evidence included reviewing:</p> <ul style="list-style-type: none"> <li>the State owned Enterprises Act 1986;</li> <li>strategy documents;</li> <li>forecast results;</li> <li>correspondence setting out the Minister's expectations; and</li> <li>minutes from Board meetings.</li> </ul> <p>As in past years, the evidence showed mixed results for the commercial nature versus the public benefit nature of the freight part of the rail network.</p> <p>It is a finely balanced judgement whether to value the freight part of the network on a commercial basis.</p> <p>On balance, I am satisfied that the judgement to value the freight part of the network on a commercial basis is once again marginal but reasonable, and that the disclosures are appropriate.</p>
Valuing long-term liabilities	
Key audit matter	What we did
<p>The valuation of the Government's long-term liabilities is complex and requires actuaries to estimate the value, based on assumptions about the future. I have identified the following specific liabilities where such complexities are considered key audit matters because of the significance of the value of those liabilities, and the uncertainties inherent in making those valuations.</p>	

Valuing long-term liabilities	
Key audit matter	What we did
<p><b><i>ACC's outstanding claims liability</i></b></p> <p>As outlined in note 22, ACC's outstanding claims liability has been valued at \$36.6 billion at 30 June 2016 by an independent actuary.</p> <p>The assumptions used to calculate the value of the outstanding claims liability include estimating the length of rehabilitation from injuries, estimating amounts of cash payments and when they will occur, and estimating inflation and discount rates.</p> <p>The sensitivities are demonstrated in note 2, which indicates that changes in the assumptions can have a large effect on the amount of the liability, which also effects the amount of the actuarial gain or loss on the liability.</p>	<p>We obtained an understanding of how ACC's outstanding claims liability is valued, which included considering the appropriateness of the assumptions adopted by ACC for each significant claim type.</p> <p>We tested the underlying process for recording claims, used our own actuarial specialists to assess the approach taken to valuing the liability, and assessed the significant assumptions used in the valuation by evaluating them against past claims.</p> <p>We also tested the reconciliations of the underlying claims data to ACC's systems, examined the sensitivity analysis for movements in key assumptions, and evaluated the related financial statement disclosures.</p> <p>I am satisfied that ACC's outstanding claims liability is reasonable, and that the disclosures appropriately outline the sensitivities of the valuation to changes in assumptions.</p>
<p><b><i>Valuing Government employees superannuation liability</i></b></p> <p>As outlined in note 23, the Government's liability for public servants superannuation entitlements for past and current members under the Government Superannuation Fund has been valued at \$12.4 billion at 30 June 2016 by an independent actuary.</p> <p>The assumptions used to calculate the value of the liability include estimating the return on assets owned by the Fund, estimating expected rates of salary increases for public servants who are members of the Fund, and estimating inflation and discount rates.</p> <p>As demonstrated in note 2, changes in the assumptions can have a large effect on the amount of the liability.</p>	<p>We obtained an understanding of how the Government's liability for public servants superannuation entitlements is valued. This involved, confirming the competence, capabilities, and objectivity of the actuary, as well as testing the actuary's valuation procedures. We used our own valuation specialists to assess the actuary's procedures, and we challenged the actuary's critical assumptions and judgements.</p> <p>We also tested key controls over the completeness and accuracy of membership data, which was used in the actuary's valuation and we evaluated the appropriateness of key assumptions on the return on assets and expected rates of salary increases, against external benchmarks.</p> <p>I am satisfied that the Government's liability for public servants superannuation entitlements is reasonable, and that the disclosures appropriately outline the sensitivities of the valuation to changes in assumptions.</p>

Valuing financial assets and liabilities at their fair value	
Key audit matter	What we did
<p>As outlined in note 29, the Government has financial assets of \$125.8 billion, of which \$71.8 billion are valued at their fair value, and financial liabilities of \$127.2 billion, of which \$12.3 billion are valued at their fair value. The financial assets and liabilities measured at fair value include derivatives (which have a principal value of \$221.5 billion), marketable securities, and share investments.</p> <p>Where quoted market prices are not available to determine the value of financial assets and liabilities, fair value must be estimated. This is done by applying a valuation approach that is most appropriate for the asset or liability, such as using valuation models. Inputs into the models will use market data when available, otherwise inputs are derived from non-market data, which requires judgement.</p> <p>We consider that valuing financial assets and financial liabilities at their fair value is a key audit matter, given their significance, including the principal value of derivatives, and the estimations required.</p>	<p>We obtained an understanding of the valuation processes used by entities to determine the fair value of financial assets and liabilities.</p> <p>Where a fund manager carries out the valuation, we obtained an understanding of the controls and valuation approaches applied.</p> <p>We also carried out a range of audit procedures which reflected the nature of the financial assets and liabilities being valued and the uncertainties associated in determining their fair value. These audit procedures included a mixture of:</p> <ul style="list-style-type: none"> <li>• testing the internal controls over data relating to financial assets and liabilities that has been entered into systems;</li> <li>• confirming the fair value of financial assets and liabilities to independently sourced valuations, and investigating any significant variances;</li> <li>• confirming the value of financial assets and liabilities to independent pricing sources; and</li> <li>• evaluating the appropriateness of the inputs used for valuing financial assets and liabilities where the fair value was dependent on significant non-market inputs.</li> </ul> <p>I am satisfied that the fair values for financial assets and liabilities are reasonable and that the disclosures are appropriate.</p>

Accounting for the effects of the Canterbury earthquakes	
Key audit matter	What we did
<p>The outstanding earthquake insurance liabilities for the Canterbury earthquakes, as outlined in note 31, are \$2.1 billion at 30 June 2016.</p> <p>The calculation of these liabilities is complex and is carried out by independent actuaries. The calculations have to take into account estimates of the extent of the damage, which is often not clearly known, uncertainties arising from changing land policies and engineering requirements in response to issues such as liquefaction and flooding, and associated legal claims.</p> <p>I have included the outstanding Canterbury earthquakes liabilities as a key audit matter because of the public interest in these liabilities.</p>	<p>We obtained an understanding of how the outstanding earthquake insurance liabilities for the Canterbury earthquakes were valued. This involved confirming the competence, capabilities, and objectivity of the actuaries, testing the actuaries' valuation procedures, including the information they used, and challenging the actuaries' critical assumptions and judgements.</p> <p>We evaluated whether the latest information about the effects of the earthquakes, including the damage, claims paid out, and repairs undertaken, had been used by the actuaries. We also used our own actuarial specialists to assess the actuaries' procedures.</p> <p>We tested a sample of claims and payments of claims during the year to ensure that appropriate controls were in place, they had been appropriately approved, they had supporting evidence, and they had been correctly incorporated into the information used by the actuaries.</p> <p>I am satisfied that the earthquake insurance liabilities are reasonable and that the disclosures appropriately outline the uncertainties over the valuation of the earthquake insurance liabilities.</p>

## Responsibilities of the Treasury and the Minister of Finance for the financial statements of the Government

The Treasury is responsible for preparing financial statements of the Government that:

- comply with generally accepted accounting practice in New Zealand in accordance with Public Sector Public Benefit Entity Accounting Standards;
- present fairly, in all material respects the Government's financial position, financial performance, and cash flows; and
- presents fairly, in all material respects the Government's:
  - borrowings;
  - unappropriated expenditure;
  - expenses or capital expenditure incurred in emergencies; and
  - trust money administered by departments.

The Minister of Finance is responsible for forming an opinion that the financial statements of the Government present fairly in all material respects the financial position and financial performance of the Government.

The responsibilities of the Treasury and the Minister of Finance arise from the Public Finance Act 1989.

The Treasury is also responsible for such internal control as it determines is necessary to enable the preparation of the financial statements of the Government that are free from material misstatement, whether due to fraud or error. The Treasury is also responsible for the publication of the financial statements of the Government, whether in printed or electronic form.

In preparing the financial statements of the Government, the Treasury is responsible for assessing the Government's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting.

### **Auditor's responsibilities for the audit of the financial statements of the Government**

I am responsible for expressing an independent opinion on the financial statements of the Government and reporting that opinion to you based on my audit. My responsibility arises from section 15 of the Public Audit Act 2001.

My objectives are to obtain reasonable assurance about whether the financial statements of the Government as a whole are free from material misstatement, whether due to fraud or error, and to issue an audit report that includes my opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (NZ) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the decisions users take on the basis of the financial statements of the Government. If material misstatements had been found that were not corrected, I would have referred to them in my opinion.

As part of an audit in accordance with ISAs (NZ), I exercised professional judgement and maintained professional scepticism throughout the audit. Also:

- I identified and assessed the risks of material misstatement of the financial statements of the Government, whether due to fraud or error, designed and performed audit procedures responsive to those risks, and obtained audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery,



intentional omissions, misrepresentations, or the override of internal control.

- I obtained an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the internal control used by the Treasury to prepare the financial statements of the Government.
- I evaluated the appropriateness of accounting policies used, and the reasonableness of accounting estimates and related disclosures made by the Treasury.
- I concluded on the appropriateness of the use of the going concern basis of accounting that has been used by the Treasury to prepare the financial statements of the Government, up to the date of my auditor's report based on the audit evidence I have obtained.
- I evaluated the overall presentation, structure, and content of the financial statements of the Government, including the disclosures, and whether the financial statements of the Government represent the underlying transactions and events in a manner that achieves fair presentation.

For the budget information reported in the financial statements of the Government, my procedures were limited to checking that the amounts agree to the Government's most recent forecast.

As part of my audit, I obtained information from my staff, and appointed auditors of the organisations that are consolidated into the financial statements of the Government, including information about:

- eliminations of transactions between the organisations that are consolidated into the financial statements of the Government;
- application by those organisations of appropriate accounting policies and Treasury instructions to prepare the financial statements of the Government; and
- relevant risks of material misstatement of the financial statements of those organisations that may affect the financial statements of the Government.

I have communicated with the Treasury, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that I identified during my audit.

From the matters communicated with the Treasury, I determined those matters that were of most significance in the audit of the financial statements of the Government of the current period and are therefore the key audit matters described in this report.

I did not evaluate the security and controls over the publication, whether in printed or electronic form, of the financial statements of the Government.

### **Other information**

In addition to preparing the financial statements of the Government, the Treasury is also responsible for preparing the other information on pages 3 to 24 and 153 to 162.

My opinion on the financial statements of the Government does not cover the other information. As a result, I do not express any form of audit opinion or assurance conclusion on that information.

In connection with my audit of the financial statements of the Government, my responsibility is to read the other information, and, in doing so, consider whether this information is materially inconsistent with the financial statements of the Government, or my knowledge obtained in the audit, or otherwise appears to be materially misstated. If, based on the work I have performed, I conclude that there is a material misstatement of this other information, I am required to report that fact. I have nothing to report in this regard.



Lyn Provost  
Controller and Auditor-General  
Wellington, New Zealand

30 September 2016

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