Controller and Auditor-General
Tumuaki o te Mana Arotake

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Observations from our central government audits: 2020/21

Photo acknowledgement:
Lynley Jenkins

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December 2021

Contents

Auditor-General's overview

E ngā mana, e ngā reo, e ngā karangarangatanga maha o te motu, tēnā koutou.

The public sector is under significant and sustained pressure. The response to, and recovery from, Covid-19 is creating new and additional expectations on the public service, while restrictions due to the pandemic make it harder to meet those expectations. The Government is also introducing major reforms across the public sector, including to the health sector, the tertiary education sector, water management, and resource management, as well as increasing its response to climate change.

The public sector has responded well to this pressure. It has, for the most part, delivered what is expected of it, helped mitigate the effects of Covid-19, and actively progressed implementation of the various reforms. As a country, we can be proud of what our public sector has achieved since Covid-19 first emerged.

However, this work comes at a cost. Public servants continue to be under significant pressure, particularly those who have worked relentlessly on leading the Covid-19 response and the reforms. There is also a significant financial cost to the Government's response to Covid-19 and its reform agenda.

Increased risk is an inevitable result of the current environment. High-trust policies, new policies prepared at speed, and urgent and high-value procurement processes all come with risks to probity and, ultimately, risks to value for money. We have seen some of these risks play out. In my view, the Government and the public sector need to more actively manage these risks while tackling both the ongoing challenges that Covid-19 presents and the Government's extensive reform agenda.

In this context, it is pleasing that New Zealand's world-class financial management system has performed well despite the pressures it is under. The financial statements of the Government were completed and received an unmodified audit opinion by their normal statutory reporting deadline of 30 September 2021. Completing this on time was a considerable achievement for finance teams throughout the public sector and in the Treasury, and for my auditors.

There was the lowest occurrence of unappropriated expenditure in 2020/21 than in any year this century. This is a credit to the Treasury and finance teams in government departments. Public organisations operating within the spending authority provided by Parliament is a cornerstone of our public financial management system.

However, I do have some concerns with how government is accountable to Parliament and the public. In a time of significantly increased public spending and rising levels of debt, Parliament and the public will quite reasonably want to know how well the public sector is performing and whether public spending represents good value for money.

I would like to see increased transparency about performance and value as a feature of the major reforms currently under way. For example, I see a need for:

- a whole-of-government performance report. This would set out what has been achieved with the Government's spending (about $130 billion in 2020/21) and be an independently assured companion report to the financial statements of the Government;
- more insightful reporting of performance at an organisation level and where organisations are working together to achieve common outcomes (for example, the joint venture on family violence and sexual violence, and cross-agency initiatives such as the Provincial Growth Fund); and
- public organisations better understanding what information Parliament and the public need and tailoring their reporting to meet those needs.

The current reforms affecting the public sector provide a rare opportunity to enhance accountability to Parliament and the public. Parliament could also play a role in this by making meaningful improvements to public accountability when considering legislation to enact those reforms and in setting accountability expectations of public organisations.

Our work

My Office has continued to engage early on matters of high public interest so that our recommendations can have a more immediate impact. Our performance audits of the Wage Subsidy Scheme, the vaccination roll-out, and the joint venture on family violence and sexual violence are good examples of this. So too is our inquiry work on matters such as the procurement of saliva testing services and the national immunisation system.

However, annual audits remain the foundation for all of our work. In 2020/21, across 195 of the larger public organisations, including district health boards, tertiary education institutions, government departments, and councils, more than 900 of our annual audit recommendations were implemented. This, together with our reporting to Parliament and the public, underscores the importance of independent assurance about the integrity of New Zealand's public financial management system.

In my view, the importance of our role in supporting trust and confidence in New Zealand's system of government has never been more apparent.

There are challenges ahead for the audit profession. A severe shortage of senior auditors in New Zealand and Australia, caused by border closures, has meant audits have been deferred in both the public and private sectors. A challenge for me as Auditor-General will be to ensure that we maintain our capacity to help Parliament and the public to hold public organisations accountable for their performance by completing timely audits.

Acknowledgements

I thank all public servants for their work to keep New Zealanders safe and for continuing to deliver services that are critical to every community. I thank my staff and the private sector auditors who work in the public sector on my behalf. They too have continued to show dedication, perseverance, and resilience in carrying out their work in difficult circumstances.

I also thank Parliament for its ongoing interest in the work we do and, in particular, for extending some reporting deadlines to help alleviate the extraordinary pressures that Covid-19 has put on the audit profession in New Zealand.

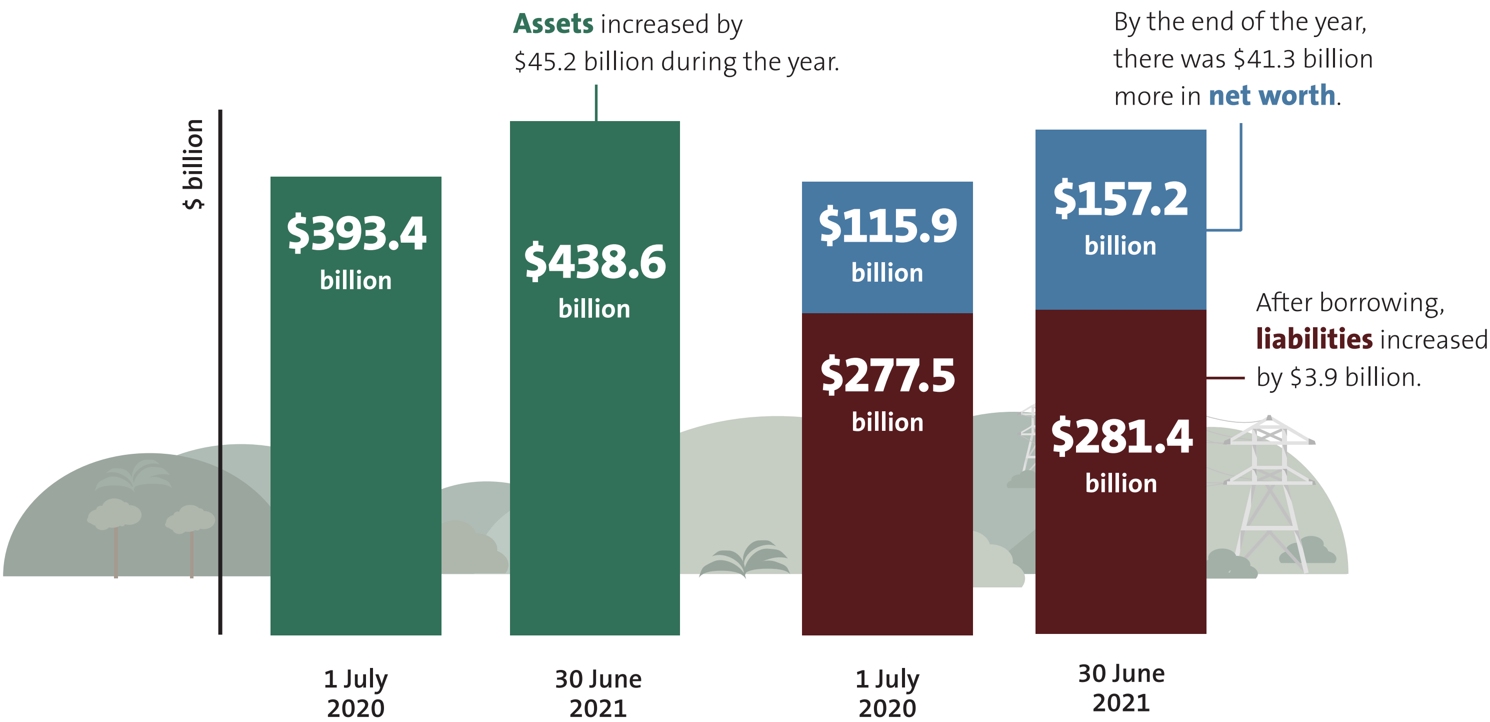
Nāku noa, nā

John Ryan
Controller and Auditor-General

7 December 2021

SNAPSHOT

Auditing the Government's financial statements



Net worth

If we look at it for each person...

The increases in total net worth (or "equity") is significant. This is mainly due to the Government's land and buildings and share portfolio increasing in value.

Based on a population of 5 million, each of us started the year with a "share" of the Government's net worth of about $23,200 – and it has increased by about $8,200 to $31,400.

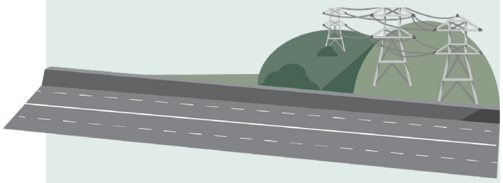
This is a notable recovery, considering the net worth per person had dropped by about $5,400 last financial year.

Government's assets increased in value

Government ***assets have increased significantly*** since 2019/20.

The ***value of housing stock*** (land and buildings) has increased significantly, mainly due to market conditions.

The Government also acquired $10 billion of new assets. These were mostly improvements to schools, hospitals, and the state highway network.



The ***value of shares increased*** by $15 billion. This was mainly due to the share market recovering after the initial outbreak of Covid-19.

Government's liabilities increased a little

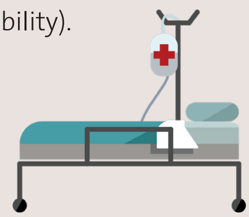
Government borrowings increased during the year, but by significantly less than in 2019/20.

The increase in borrowing was mostly related to Covid-19. It was offset by a decrease in insurance and retirement liabilities.

Retirement liabilities decreased because of better returns on investments and changes to the underlying assumptions used in the calculations.

Many district health boards and schools have still not calculated how much they ***need to pay their staff*** for money owed under the Holidays Act 2003. The uncertainty is considerable, and the ongoing delay is concerning.

The amount ACC estimates it might need to ***pay in the future*** for injuries decreased (because of changes in the assumptions used to calculate the liability).



1 The operating environment for central government

1.1 In this Part, we discuss:

- the significant pressure the central government operating environment is under;
- the Government's continued response to Covid-19; and
- the significant reform agenda under way.

1.2 Taken together, the pressure on the public sector from delivery of business-as-usual services, responding to Covid-19 and implementing various reforms has been significant and sustained.

An operating environment under significant pressure

1.3 A key feature of the central government operating environment in 2020/21 was the pressure that public organisations and their staff were under.

1.4 Responding to Covid-19 has placed significant demands on public servants. For many, this pressure has been relentless since Covid-19 emerged. Despite this pressure, the public sector has demonstrated its resilience and ability to adapt and deliver services.

1.5 However, there are consequences from this high-pressure environment. Some agencies report high staff turnover, significant vacancies in key areas, and staff leave balances are increasing. Opening borders might not immediately resolve workforce shortages. The reforms have also increased uncertainty for staff in some organisations. Agencies report staff salary pressures as organisations seek to recruit and/or retain key roles from a limited resource pool.

1.6 Capability and capacity gaps, other constraints caused by Covid-19, and the Government's reform agenda pose risks to probity and value for money of public spending. We have already seen instances where the pressure to deliver has resulted in poor processes being followed and high-trust policies not having the level of post-payment verification we would have expected.

1.7 There are risks not just in immediate service delivery but also in the medium to long-term capability and capacity of organisations to implement complex reforms, progress and deliver benefits from new investments and implement continuous improvements to their core activities.

1.8 Careful prioritisation and planning of activity, ensuring that key controls continue to operate, and maintaining staff well-being are critical for ongoing success.

Responding to Covid-19

1.9 In general, the public sector has responded well to the challenges of Covid-19 while continuing to deliver essential services to New Zealanders.

1.10 However, there are challenges ahead in ensuring that the significant new investments made to support the response to, and recovery from, Covid-19 deliver value for money. As well as continuing to respond to the immediate impacts of Covid-19, public organisations will also need to prepare and plan for the medium to longer term implications of the pandemic.

1.11 There have been significant changes to the revenue some agencies relied on to deliver services – for example, transport infrastructure funded through the national land transport fund and border services funded through cost-recovery. The effect of Covid-19 on areas such as tourism and international students has affected public and private organisations.

1.12 There are also emerging issues that might become longer-term trends, such as lower school attendance rates or less public transport patronage as people work from home. And there might also be longer-term issues, such as continuing to respond to new Covid-19 variants and the impact on demand for mental health services.

1.13 In March 2020, the Government established a $12.1 billion initial package that funded key initiatives such as the Wage Subsidy Scheme and business tax changes. In Budget 2020, the Government signalled increased funding of up to $50 billion for New Zealand's Covid-19 response and recovery through the Covid-19 Response and Recovery Fund, making a total of $62.1 billion available. As at 30 June 2021, the Government had allocated most of the Fund, with just $4.7 billion unallocated.

1.14 In June 2021, responding to calls for more visibility over the Covid-19 expenditure, the Treasury began to report periodically on this expenditure.[1] This includes expenditure incurred on initiatives announced in March 2020 and subsequent initiatives that have been funded through the Covid-19 Response and Recovery Fund. As at 30 June 2021, expenditure incurred against appropriations created as a result of the response to Covid-19 totalled $22.1 billion. The Wage Subsidy Scheme was the Government's largest area of spending in response to Covid-19 (more than $13 billion as at 30 June 2021).

1.15 In the first iteration of the Wage Subsidy Scheme, the Government used a "high-trust" approach so it could make payments to employers quickly. This was to help employees retain their connections to their employers during lockdown and maintain a level of income. However, a high-trust approach has greater risks of fraud and error. In our 2021 report on the Wage Subsidy Scheme, we made several recommendations. One recommendation was that, when using a high-trust

1 Some initiatives represented an extension of existing government activities and fell within existing appropriations. Expenditure incurred under pre-existing appropriations is not included in this data release.

approach, public organisations put in place a robust verification process for after payments are made.

1.16 When large amounts of public money are spent quickly, it is essential to have good-quality decision-making, strong processes, and effective assurance, monitoring, and reporting practices to prevent the risks of poor public spending. The Government and the public sector need to provide transparency to Parliament and the public on what has been spent and whether this has delivered what was expected.

The Government's reform agenda

1.17 The Government's reform agenda in 2020/21 was significant and further reforms have been signalled. The Government is introducing major reforms, including to the health sector, the tertiary education sector, water management, and resource management. The Government is also increasing its response to climate change, including requiring the public sector to be carbon neutral by 2025.

1.18 The health sector reform announced in April 2021 will disestablish all 20 district health boards and a new Crown entity, Health New Zealand, will be established. A new Māori Health Authority will work alongside Health New Zealand, with the aim of achieving equitable health outcomes for Māori. A new Public Health Agency will also be set up in the Ministry of Health. These reforms build on earlier changes in the health system including the establishment of the Mental Health and Wellbeing Commission in February 2021.

1.19 There are also proposed changes to the traditional roles and functions of local government. As well as the Three Waters Reform Programme, there are reforms of the resource management system and the Future for Local Government review is currently under way.

1.20 One of the most common themes to emerge from the initial work on the Future for Local Government review has been that the relationship between local and central government needs to improve. Some issues, such as addressing the impacts of climate change, require a collective response from all parts of government. There is an opportunity through the reforms and reviews under way to reset the relationship between central and local government.

1.21 To implement the Government's reform agenda, there is much to do in a short time frame. This presents increased risks to the delivery of services, the quality of the transition to new arrangements, and the effective use of public funds. The loss of capability and capacity, including institutional knowledge, is also a risk that needs to be managed.

1.22 The various reforms under way present a rare opportunity to improve the accountability of the public sector, to both Parliament and the public.

1.23 Public organisations of the scale of Health New Zealand and Te Pūkenga will provide critical services and use significant public resources. Ensuring that accountability arrangements for these organisations and others in the Government's reforms are fit for the 21st century will be an area of interest for my Office and, I hope, a key focus for Parliament as it passes legislation to enable the reforms.

2 Our audit of the Government's financial statements

2.1 Our audit report on the Government's financial statements provides independent assurance that the financial statements present fairly the Government's financial performance and position. Confidence in the reliability of this information allows Parliament, the public, and the international community to confidently scrutinise the Government's financial performance and position.

2.2 The audit report included an unmodified opinion and a description of the key audit matters arising during the audit.

2.3 Each year we review whether the previous year's key audit matters remain relevant and consider any new matters that should be included in the audit report.

2.4 The key audit matters highlighted in our audit report for the year ended 30 June 2021 were:

- calculating the value of other persons' and corporate tax revenue;
- valuing property, plant, and equipment:
  - state highways;
  - electricity generation assets;
- valuing financial assets where market data is not available:
  - student loans;
- valuing insurance liabilities, superannuation liabilities and veterans' disability entitlements liabilities:
  - Accident Compensation Corporation's (ACC) outstanding claims liability;
  - Government Superannuation Fund's unfunded liability;
  - Veterans' Disability Entitlements liability; and
- entitlements under the Holidays Act 2003.

2.5 Overall, we were satisfied that the balances and disclosures in the Government's financial statements about these matters were reasonable and appropriate.

Recognising other persons' and corporate tax revenue

2.6 The Government recognised other persons' tax revenue of $8.8 billion and corporate tax revenue of $15.8 billion for the year ended 30 June 2021.

2.7 Other persons' and corporate tax revenue for the year needs to be estimated because the final income tax owed for a year is known only when a tax return is filed. Filing could happen more than a year after the end of the tax year.

2.8 The estimation process relies on macro-economic forecasts about how the economy will perform. It also relies on assumptions about how these macro-economic forecasts relate to taxable profits.

2.9 As a result of Covid-19, there is increased uncertainty about how the New Zealand economy will perform. Therefore, judgements were made about the performance of the economy and they were used to estimate tax revenue for the year ended 30 June 2021.

2.10 We reviewed the systems, processes, and controls for receiving and reviewing provisional and final tax returns, tax assessments, and tax revenue. This included understanding Inland Revenue's information technology system for managing tax. We also:

- assessed the controls for significant reconciliation processes;
- tested the underlying data used in the tax revenue estimation models;
- reviewed the main assumptions and judgements used to estimate tax revenue from other persons and corporates; and
- assessed the reasonableness of the most important variables in the models, given the economic impact of Covid-19.

2.11 We used independent economic experts to assess the main assumptions about the future (such as economic growth) and tested how sensitive the estimates were to changes in the main assumptions. The independent experts also considered alternative macro-economic indicators that could reliably estimate tax revenue from other persons and corporates. We were satisfied that the macro-economic indicator used was reasonable.

2.12 We also:

- performed a retrospective review of the 2020 tax estimation compared to actual information received from taxpayers to assess the robustness of the methodology used for the estimation of tax revenue. (Information is available up to the March 2020 tax year only and that means limited information for the period affected by Covid-19);
- reviewed the accounting adjustments to tax revenue processed by Inland Revenue;
- reviewed the year-end procedures and testing performed by Inland Revenue for significant taxpayers, and any adjustments arising from this review by Inland Revenue; and
- reviewed the relevant disclosures.

2.13 As a result of the audit work, we were satisfied that other persons' and corporate tax revenue for the year ended 30 June 2021 are reasonable and that the disclosures are appropriate.

Valuing property, plant, and equipment

2.14 The Government owned physical assets of $213.2 billion at 30 June 2021. Considerable judgement is needed to determine the value of some of these assets because there are inherent uncertainties in valuing them.

2.15 Valuers have considered the economic effects of Covid-19 on significant estimates and judgements. These include economic indicators for interest rates and inflation, cash flow forecasts, any changes in levels of service, and replacement costs.

2.16 Assets that needed significant judgement to determine their value at 30 June 2021 included state highways and electricity generation assets. We discuss each in more detail below.

State highways

2.17 The state highways (excluding land) were valued at $42.7 billion at 30 June 2021 by an independent valuer. The value of the state highways cannot be measured precisely. Significant estimates and assumptions are made, including assumptions about quantities and rates used to construct the state highways, the remaining useful life of the assets, and the unit costs to apply. Changes to the underlying estimates and assumptions can cause a material movement in the valuation of the state highway network.

2.18 Work done over the last four years has improved the quality of the data used in the valuations, but uncertainties remain.

2.19 We examined how the state highways are valued, the significant estimates and assumptions used, and their reasonableness. We confirmed the competence, capabilities, and objectivity of the valuer, considered the valuer's main assumptions, and assessed the valuation procedures.

2.20 We considered whether there were any limitations placed on the valuer and whether centrally calculated assumptions applied to the valuation were appropriate.

2.21 We confirmed that key controls were operating over the systems and processes used to record costs and other asset information about the state highways.

2.22 We also considered how the valuer took the economic effects of Covid-19 into account and the effect of any estimation uncertainties on the final valuation. There was no significant impact at 30 June 2021.

2.23 As a result of the audit work, we were satisfied that the value of the state highways at 30 June 2021 is reasonable and that the disclosures are appropriate.

Electricity generation assets

2.24 The electricity generation assets were valued at $18.0 billion at 30 June 2021. Valuing electricity generation assets is complicated and relies on significant assumptions about the future prices of electricity, generation costs, and how much electricity will be generated. Each of these assumptions affects the others.

2.25 These assumptions are sensitive to small changes that can have a significant effect on the value of the electricity generation assets.

2.26 We examined how electricity generation assets are valued. We confirmed the competence, capabilities, and objectivity of the valuers, tested their procedures for carrying out the valuations (including the information they used), and considered their main assumptions and judgements.

2.27 We tested the sensitivity of the main assumptions to confirm that they were reasonable. We compared the forecast prices of electricity to the expected longer-term wholesale prices and market data, where it was available.

2.28 We considered how the valuers took the economic effects of Covid-19 into account in the valuations and the effect of any estimation uncertainties on the value of electricity generation assets. There was no significant impact in 2020/21.

2.29 We also considered whether the valuers considered the future of the aluminium smelter at Tiwai Point to estimate the value of electricity generation assets.

2.30 As a result of the audit work, we were satisfied that the value of electricity generation assets at 30 June 2021 is reasonable and that the disclosures are appropriate.

Valuing financial assets where market data is not available

2.31 The Government had financial assets that were valued, where market data is not available, at $20.5 billion at 30 June 2021. These financial assets include loans, including student loans (which we discuss separately in paragraphs 2.35-2.40), investments, deposits, private equity investments, and small business cashflow loans.

2.32 When there is no quoted market price for a financial asset, the value of the asset is estimated using an appropriate technique, such as a valuation model. These models are usually complex, using inputs from market data when available. Otherwise, inputs are derived from non-market data, which requires greater judgement.

2.33 Based on a sample, we reviewed the valuation techniques, controls, and inputs used to determine the value of financial assets where market data is not available. We tested the internal controls over data entered into financial systems for these assets and assessed the controls and valuation approaches applied where a fund manager carried out the valuation. We compared the fair value of financial assets to independent information, investigated any significant variances, and assessed the appropriateness of the inputs used in the valuation where market data is not available.

2.34 As a result of the audit work, we were satisfied that the value of financial assets where market data is not available at 30 June 2021 is reasonable and that the disclosures are appropriate.

Student loans

2.35 At 30 June 2021, student loans were valued at $10.8 billion. Student loans are measured using actuarial and predictive models, which reflect current student loan policy and macro-economic assumptions. The value is sensitive to changes in several assumptions, including future income levels, repayment behaviour, inflation, and discount rates.

2.36 There is added uncertainty now about how Covid-19 might affect student loan repayments.

2.37 We tested a sample of student loan applications during the year to ensure that they were correctly paid out. We tested the internal controls over student loans entered into financial systems and actuarial models used by the valuer, checked that the underlying information used in the valuation was correctly extracted from the system, and assessed the controls and valuation approaches applied by the valuer.

2.38 We performed a retrospective review of the actual repayments of student loans in previous years against prior year cash flow forecasts, to consider whether there was any estimation bias.

2.39 We used an independent expert to review the main assumptions in the student loans model. That review included a review of the cash flow forecasts, the use of the risk-free discount rate and the risk premium used to determine the fair value of loans, and adjustments for employment and overseas non-compliance due to Covid-19.

2.40 As a result of the audit work, we were satisfied that the value of student loans at 30 June 2021 is reasonable and that the disclosures are appropriate.

Valuing insurance liabilities, superannuation liabilities, and veterans' disability entitlements liabilities

2.41 The Government has significant insurance liabilities from Accident Compensation Corporation (ACC) claims, public servants' superannuation liabilities, and veterans' disability entitlements liabilities at 30 June 2021.

2.42 Estimating the values of these liabilities is complicated and there are inherent uncertainties in the valuations. Actuaries estimate the amounts based on assumptions about the future (including the economic effects of Covid-19).

2.43 The calculations use risk-free discount rates information and CPI assumptions, which the Treasury publishes.

2.44 We had an independent expert consider the appropriateness of the risk-free discount rates and CPI assumptions that are published by the Treasury. This review included assessing the appropriateness of the methodology, including the reasonableness of the Treasury's conclusions about the ongoing reviews of selected aspects of the methodology.

2.45 We tested the application of the methodology in determining the risk-free discount rates and CPI assumptions.

2.46 As a result of the audit work, we were satisfied that the risk-free discount rates and CPI assumptions are appropriate for use in valuing these liabilities at 30 June 2021.

ACC's outstanding claims liability

2.47 ACC's outstanding claims liability has been valued at $55.4 billion at 30 June 2021.

2.48 The assumptions used to determine the value of ACC's outstanding claims liability include assumptions about discount rates, risk margin, the effects of inflation and innovation on future medical costs, and how long it will take people to recover from injuries.

2.49 We examined how ACC's outstanding claims liability is valued by assessing the reasonableness of the approach. We also reviewed ACC's main assumptions about each significant type of claim to see whether these were appropriate. The impact of Covid-19 on these assumptions and estimation uncertainties was considered minimal.

2.50 We tested the systems and controls and, in particular, tested the process for recording claims in detail. We tested the main assumptions by considering past claims. We assessed the reasonableness of forecasts that differed from past experience by looking at the evidence supporting the forecasts.

2.51 We used an independent actuary to review the scope, approach, and reasonableness of the estimated liability.

2.52 We tested the reconciliations of the underlying claims data with ACC's systems, examined the sensitivity analysis for movements in the main assumptions, and reviewed the related financial statement disclosures.

2.53 As a result of the audit work, we were satisfied that ACC's outstanding claims liability at 30 June 2021 is reasonable and that the disclosures are appropriate.

Government Superannuation Fund's unfunded liability

2.54 The Government's unfunded liability for public servants' superannuation entitlements for members of the Government Superannuation Fund (the Fund) was valued at $11.0 billion at 30 June 2021 by an independent actuary.

2.55 The value of the unfunded liability is sensitive to the value of the Fund's assets, expected rates of salary increases for members of the Fund, and estimated inflation and discount rates. The Fund's assets, which are mainly shares and bonds, are traded in markets. Changes in the prices of these shares and bonds affect the amount of the unfunded liability.

2.56 We examined how the unfunded liability for public servants' superannuation entitlements is valued.

2.57 We engaged our own actuary to review the main assumptions, judgements, and procedures used to value the unfunded liability.

2.58 We tested the main controls that ensure that membership data used in the actuary's valuation is reliable. We assessed the appropriateness of the main assumptions used to estimate the value of the unfunded liability, including the expected rates of salary increases, against external benchmarks.

2.59 We tested the design and implementation of key controls over investments. We obtained an understanding of the valuation techniques and inputs used by the respective fund managers to value the investments. The value of the funds was reconciled to the latest valuation reports. Any movements between the last valuation date and the year-end data were checked against supporting documentation. We also considered the estimated return on assets owned by the Fund.

2.60 As a result of the audit work, we were satisfied that the unfunded liability for public servants' superannuation entitlements at 30 June 2021 is reasonable and that the disclosures are appropriate.

Veterans' disability entitlements liability

2.61 The Government recognised a veterans' disability entitlements liability of $3.0 billion at 30 June 2021.

2.62 Working out the value of the veterans' disability entitlements liability is subject to uncertainty, because of possible deficiencies in the underlying data used to make the estimate, the extent to which veterans will take up their full entitlement, the discount rate, the inflation rate, and changes in mortality rates.

2.63 We examined how the veterans' disability entitlements liability is valued. We reviewed the method used to calculate the liability and confirmed the competence, capabilities, and objectivity of the actuary. We also tested the valuation procedures.

2.64 We used an independent actuary to review the main assumptions, judgements, and procedures used to value the liability.

2.65 We tested key controls over the reliability of veterans' data used in the actuary's valuation.

2.66 As a result of the audit work, we were satisfied that the veterans' disability entitlements liability at 30 June 2021 is reasonable and that the disclosures are appropriate.

Entitlements under the Holidays Act 2003

2.67 The provision for employee entitlements in the Government's financial statements includes a provision relating to historical non-compliance with the Holidays Act 2003. Some public organisations need to do more work to finalise the amounts owed to each individual, resulting in uncertainty in the value of the provision. A number of organisations have started or completed a review of current and historical payroll calculations to ensure that they have complied with the legislation. Where possible, provision has been made in the Government's financial statements for obligations arising from these reviews, where settlement has not been made.

2.68 For certain organisations, particularly district health boards and schools, complexities mean it is taking longer to calculate the amounts owed to each individual. District health boards and schools employ many people and the amounts needed to settle these obligations remain uncertain. For the organisations most significantly affected, we considered the progress made in resolving the historical payroll calculation issues.

2.69 For those organisations that had a provision, we assessed the approach used to calculate the provision. We also reviewed the processes followed for calculating a provision and tested a sample of transactions. We considered the completeness of the data used for calculating a provision. We assessed the competence, capabilities, and objectivity of independent experts who were involved in the calculations and considered the reasonableness of the main assumptions and judgements made in calculating the provision, including consideration of the impact of Covid-19 on the valuation.

2.70 For those organisations that did not have a provision, we made sure that they could not reasonably quantify an amount. We also reviewed the disclosures made.

2.71 As a result of the audit work, we were satisfied that the provision for entitlements under the Holidays Act 2003 at 30 June 2021 is reasonable, and that where a liability cannot be reliably measured, the contingent liability disclosures are appropriate.

Other audit matters

Electricity network assets

2.72 The electricity network assets comprising the national grid are currently recorded at cost, which differs from the valuation approach for all other classes of assets. As with the rail network assets, we have accepted a different valuation approach at an entity and Government financial statements level. Rail infrastructure assets are valued on a for-profit basis for the purposes of KiwiRail's statutory financial statements and on an optimised depreciated replacement cost basis for inclusion in the Government's financial statements. In our view, a similar approach should be taken for this class of assets. It is the only major class of assets in the Government's financial statements not valued at fair value.

2.73 During the audit we looked for, and did not identify, any significant changes to the valuation approach.

2.74 We will continue to talk with the Treasury about this matter.

Emissions Trading Scheme liability

2.75 The valuation of the Emissions Trading Scheme liability presents a risk due to its level of public interest, its accounting impact, the degree of judgement involved, and the inherent uncertainty due to the many governance and co-operation agreements between agencies.

2.76 We have reviewed the governance and co-operation arrangements between the agencies with administrative responsibilities for parts of the Emissions Trading Scheme.

2.77 We obtained an understanding of the Emissions Trading Scheme systems and processes, and tested controls over the Emissions Trading Scheme systems at both the Ministry for Primary Industries and Environmental Protection Authority.

2.78 We performed substantive audit procedures to gain assurance over Emissions Trading Scheme transactions and balances.

2.79 We reviewed the appropriateness of the methodology, data, and assumptions used by the Ministry for Primary Industries to make material estimates for inclusion in the Government's financial statements.

2.80 As a result of the audit work, we were satisfied that the Emissions Trading Scheme liability is fairly stated in the Government's financial statements.

Outcomes from reviews currently under way

2.81 The findings of the Health and Disability System Review were released in March 2020. The recommendations of the review included creating two new agencies and reducing the number of district health boards from 20 to between eight and 12.

2.82 During 2020/21, the Government announced the disestablishment of all district health boards with effect from 30 June 2022 and the establishment of the two new agencies, Health New Zealand and the Māori Health Authority.

2.83 We have considered the impact of these changes on the Government's financial statements. Although the use of the going concern assumption in the preparation of the district health boards' financial statements will be affected, there is no effect at the level of the Government's financial statements.

Management of appropriations

2.84 The Statement of Unappropriated Expenditure, included in the Government's financial statements, is an important summary of all unappropriated expenditure incurred in the financial year.

2.85 There was a significant improvement noted in the management of appropriations in 2020/21. There were decreases in both the number of instances of unappropriated expenditure and the amount of unappropriated expenditure. This year is the least number of unappropriated expenditure items we have had so far this century.

2.86 Instances of unappropriated expenditure identified by public organisations, rather than by the Treasury or auditors, have increased as well. This points to a greater understanding amongst public organisations about the Controller function.

2.87 During our audit, we assessed the accuracy and completeness of the disclosure of unappropriated expenditure. This included confirming that the final listing of unappropriated expenditure and any expenditure incurred under section 25 of the Public Finance Act 1989 is correctly reported in the Government's financial statements. It also included confirming the completeness and accuracy of all disclosed unappropriated expenditure with the relevant public organisations and confirming with those with no unappropriated expenditure disclosed that no unappropriated expenditure has been identified during the year.

2.88 We identified no areas of concern to report. We acknowledge the progress made in managing appropriations and the collaborative manner in which the Treasury has worked with us on this.

2.89 As a result of the audit work, we were satisfied that the Statement of Unappropriated Expenditure is accurate, complete, and consistent with what will be reported in the individual organisations' annual reports.

Ongoing improvement in note disclosures

2.90 One of the benefits of work completed last year (to better understand the effects of Covid-19 on the Government's financial statements) was improvements made to the note disclosures about key assumptions and judgements. In 2019, disclosures about the state highway valuation were also enhanced. These enhanced disclosures should greatly assist the readers of the Government's financial statements to understand the basis and risks inherent in this valuation process.

2.91 We reviewed the note disclosures in the Government's financial statements to ensure that they conveyed appropriate information to readers in a way that is accessible and adds to the overall understanding of the financial statements.

2.92 We also reviewed the Covid-19 commentary and disclosures to ensure that they were relevant and understandable to the readers of the Government's financial statements and focused on key assumptions and judgements.

2.93 We have previously indicated that we would consider in turn the note disclosures in the Government's financial statements in more depth for all areas of the financial statements to ensure they continue to convey the appropriate information to readers in a way that is accessible and adds to the overall understanding of the financial statements. This year, our focus was on the insurance note disclosures, particularly the ACC claims insurance liability. We were pleased to see a more refined disclosure in this note.

2.94 As a result of the audit work, we were satisfied that the effects of Covid-19 are adequately disclosed in the Government's financial statements. We are also satisfied with the progress that has been made with other disclosures.

Large-scale asset purchase programme

2.95 In response to the economic impact of Covid-19, the Reserve Bank of New Zealand (the Reserve Bank) implemented a large-scale asset purchase (LSAP) programme. This programme involves the repurchase of New Zealand Government Bonds and Local Government Financing Agency Bonds. The Reserve Bank halted additional asset purchases under the LSAP programme on 23 July 2021.

2.96 The Reserve Bank had purchased $52.9 billion (at fair value) of New Zealand Government Bonds (NZGBs) and $1.6 billion of Local Government Funding Agency (LGFA) bonds on the secondary market up to 30 June 2021. The LSAP programme's impact on the Government's financial statements can broadly be summarised as follows:

- A loss of $4.0 billion is reported in the financial statements. The loss represents the difference between the price paid by the Reserve Bank to acquire the NZGBs and the carrying value of the bonds at the date of repurchase.
- The benefit of lower borrowing costs (interest expenses) in the current year and possibly for the future as the fixed interest rate payable on the NZGBs is replaced by the lower floating Official Cash Rate (0.25% at 30 June 2021) payable on bank settlement deposit account borrowings.

2.97 A model was prepared when the LSAP programme was introduced to calculate the difference between the price paid to re-purchase the bonds and the value of the bonds at the date of each transaction. A "first in first out" method was applied, which assumes that the bonds purchased first were the bonds issued earliest.

2.98 On a sample basis, we agreed the bond information in the model to the Treasury and Reserve Bank systems, tested the accuracy of key calculations in the model, and assessed whether the first-in-first-out method was correctly applied.

2.99 As a result of the audit work, we were satisfied that the loss recognised for the year ended 30 June 2021 was reasonably calculated and that the disclosures are appropriate.

Overriding of internal controls

2.100 There is an inherent risk in every organisation of fraud resulting from management override of internal controls. People in management positions are in a unique position to perpetrate fraud because of their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

2.101 We examined the controls for collecting financial information from public organisations included in the Government Reporting Entity and the adjustments to that information for consolidation purposes. We also tested the appropriateness of journal entries and other adjustments made in the preparation of the Government's financial statements through review of journals and disclosures.

2.102 We reviewed significant accounting estimates for bias, and engaged specialists to assist with those reviews, where appropriate.

2.103 As a result of the audit work, we were satisfied that the risk of management override of internal controls for the Government's financial statements has been adequately mitigated.

The Controller function

3

3.1 The Controller function is an important part of the Auditor-General's work. It supports the fundamental principle of Parliamentary control over government expenditure.

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

- make laws;
- impose taxes on people to raise public funds;
- borrow money; and
- spend public money.[2]

3.3 Parliament's approval to incur expenditure is mainly provided through appropriations,[3] which are authorised in advance through the annual Budget process and annual Acts of Parliament. When the Government wants to incur expenditure not yet authorised in an Appropriation Act, it can draw on the Parliamentary authority provided in an Imprest Supply Act. Expenditure can be authorised in advance through permanent legislation. Some expenditure can also be approved retrospectively.

3.4 In 2020/21, there was a significant decrease in the number of instances of unappropriated expenditure. The Government's financial statements report 12 instances for 2020/21, which is the lowest occurrence of unappropriated expenditure so far this century.[4]

3.5 In this Part, we discuss:

- why the Controller work is important;
- how much public expenditure was unappropriated in 2020/21;
- how 2020/21 compared with previous years; and
- a summary of work we carried out in 2020/21 to discharge the Controller function.

Why the Controller work is important

3.6 Appropriations ensure that Parliament, on behalf of the public, has adequate control over how the Government plans to spend public money. It also ensures that the Government can be held to account for how it has used that money.

2 Section 22 of the Constitution Act 1986.

3 Appropriations are authorities from Parliament that specify what the Crown may incur expenditure on (specific areas of expenditure). Most appropriations specify limits in terms of the type of expenditure (the nature of the spending), scope (what the money can be used for), dollar amount (the maximum that can be spent), and period (the time frame for which the authority is given).

4 We have surveyed the Government's financial statements for each year, as far back as the statements for the year ended 30 June 2000.

3.7 Most of the Crown's funding is obtained through taxes. The public is entitled to assurance that the Government is spending public money as authorised by Parliament.

3.8 As the Controller, the Auditor-General helps maintain the transparency and legitimacy of the public finance system. The Auditor-General provides an important check on the system on behalf of Parliament and the public by providing independent assurance that the spending is within authority. The Auditor-General also provides assurance that any government spending without authority has been identified and dealt with appropriately. As an Officer of Parliament, the Auditor-General is independent of the Government.

3.9 In the Appendix, we explain how public expenditure is authorised, who is responsible for managing it, and the Controller's role in checking it.

How much public expenditure was unappropriated in 2020/21?

3.10 The Government's financial statements for the year ended 30 June 2021 report 12 instances of unappropriated expenditure (2019/20: 29). Expenditure incurred above or beyond appropriation for the 2020/21 year was $133 million (2019/20: $925 million). Figure 1 shows a breakdown of unappropriated expenditure categories.[5]

Figure 1
Unappropriated expenditure incurred for the year ended 30 June 2021

Category	Unappropriated expenditure by category	2020/21 Number	2020/21 $million*	2020/21 Votes
A	Approved by the Minister of Finance under section 26B of the Public Finance Act 1989.	-	-	
B	With Cabinet authority to use impress supply but in excess of appropriation prior to the end of the financial year.	-	-	
C	With Cabinet authority to use imprest supply but without appropriation prior to the end of the financial year.	-	-	
D	In excess of appropriation and without prior Cabinet authority to use imprest supply.	5	82	Defence Force, Internal Affairs

5 New Zealand Government (2021), *Financial Statements of the Government of New Zealand for the year ended 30 June 2021*, Wellington, pages 143-149.

Category	Unappropriated expenditure by category	2020/21 Number	2020/21 $million*	2020/21 Votes
E	Outside scope of an appropriation and without prior Cabinet authority to use imprest supply.	3	15	Business, Science and Innovation; Education; Revenue
F	Without appropriation and without prior Cabinet authority to use imprest supply.	4	36	Arts, Culture and Heritage; Business, Science and Innovation; Housing and Urban Development; Tertiary Education
	Total	**12**	**133**	

* Amounts are rounded to the nearest million.

3.11 The unappropriated expenditure categories shown in Figure 1 fall into three broader categories:

- **Approved by the Minister of Finance** (Category A): Small overruns of expenditure in the last three months of the financial year (that is, within $10,000 or 2% of the appropriation) may be approved by the Minister of Finance under section 26B of the Public Finance Act. Although unappropriated, expenditure approved under section 26B is lawful.

  No instances of unappropriated expenditure were recorded under this section for 2020/21 (2019/20: one instance).

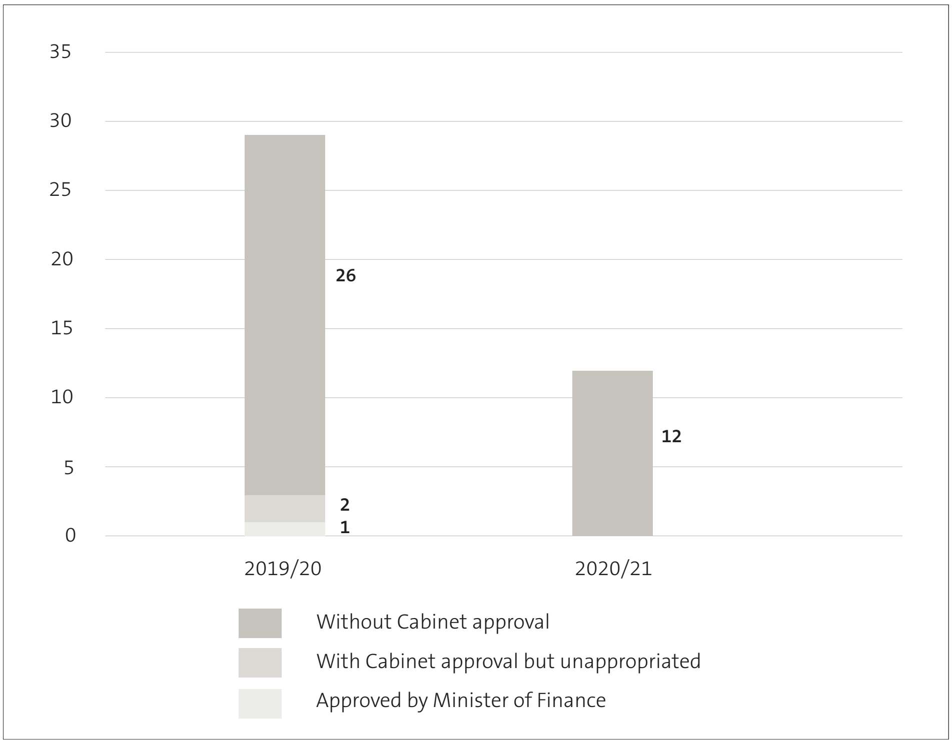
- **With Cabinet approval** (Categories B and C): When it is anticipated that expenditure will be incurred above or beyond the appropriation limits, departments should seek prior Cabinet approval to use imprest supply for the spending not covered by appropriations. Sometimes Cabinet's approval to use imprest supply is obtained, but the extra spending is not included in an Appropriation Act before the end of the financial year, so the spending remains unappropriated.

  There was no expenditure in this category in 2020/21, meaning that every dollar of expenditure authorised under imprest supply in 2020/21 was subsequently appropriated through the Supplementary Estimates Act (2019/20: two instances).

- **Without prior Cabinet approval** (Categories D, E, and F): For 2020/21, the Government's financial statements report 12 instances of expenditure incurred above or beyond the appropriation limits without any authority at the time it was incurred, that is, without Parliamentary appropriation and without Cabinet's prior approval to use imprest supply (2019/20: 26 instances).

3.12 Figure 2 shows the considerable decrease in the reported instances of unappropriated expenditure in 2020/21 compared with 2019/20. Instances of expenditure without prior Cabinet approval were less than half that for the previous year.[6]

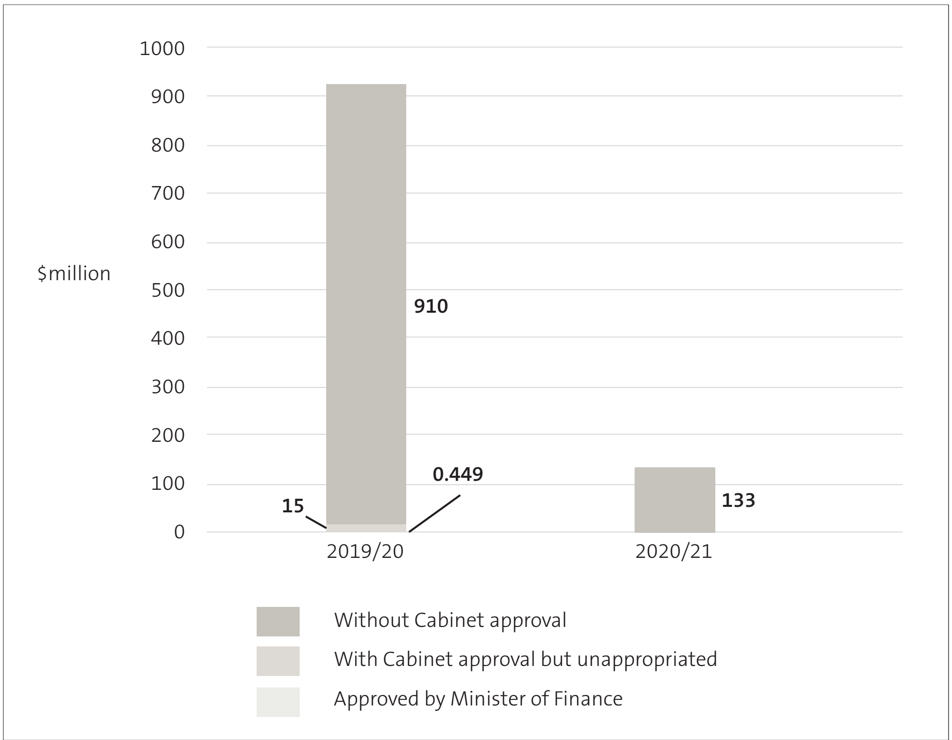
Figure 2
Number of instances of unappropriated expenditure for the year ended 30 June 2021



6 New Zealand Government (2021), *Financial Statements of the Government of New Zealand for the year ended 30 June 2021*, Wellington. One of the 12 instances recorded for 2020/21 relates to unappropriated expenditure incurred in earlier years that was identified, but not incurred, in 2020/21.

3.13 Figure 3 compares the dollar amounts of unappropriated expenditure for 2019/20 and 2020/21. The amount of unappropriated expenditure decreased from just over $925 million for 2019/20 to $133 million for 2020/21 although, as shown in Figure 6, 2019/20 was an outlier compared with recent years.[7]

Figure 3
Amount of unappropriated expenditure for the year ended 30 June 2021



3.14 Expenditure outside the bounds of the appropriations tends to be relatively low. Unappropriated expenditure of $133 million for 2020/21 was 0.09% of the Government's final budgeted amount for that year, compared with 0.61% in 2019/20.

7 New Zealand Government (2021), *Financial Statements of the Government of New Zealand for the year ended 30 June 2021*, Wellington.

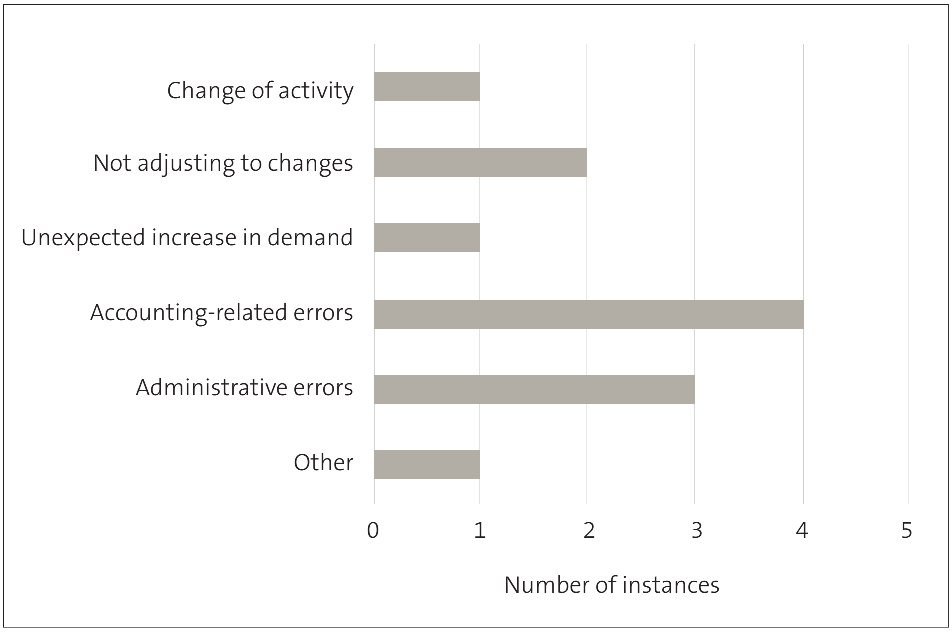
Why was the expenditure unappropriated?

3.15 Of the $133 million of expenditure unappropriated in 2020/21, almost all was due to the following reasons:

- 61% by value was because of departments not adjusting to changes in customer entitlements;
- 23% by value was because of administrative errors; and
- 10% by value was because a public organisation changed its operations to an activity not covered by its appropriation.

3.16 Figure 4 assigns the instances of unappropriated expenditure into six categories that describe why the unappropriated expenditure came about. The most common reasons were accounting-related errors (four instances) and administrative errors (three instances).

Figure 4
Reasons for unappropriated expenditure in 2020/21, by number of instances



Change of activity

3.17 During the first Covid-19 lockdown, the Minister of Tourism endorsed Tourism New Zealand redirecting its efforts from marketing New Zealand overseas to promoting tourism to the domestic market. This was in response to the effect of the pandemic on global tourism and, specifically, the sudden halt in overseas tourists visiting New Zealand. Tourism New Zealand used its resources to promote New Zealand to New Zealanders through a "Do Something New, New Zealand" campaign. The campaign's intention was to stimulate tourism and therefore support the domestic tourism industry.

3.18 Parliament had authorised the funding of Tourism New Zealand's activities through an appropriation in Vote Business, Science and Innovation that is "limited to the promotion of New Zealand as a visitor destination in key overseas markets". Promoting tourism to the domestic market was outside the scope of what Parliament had approved.

3.19 Approval to change the scope of the appropriation was not sought before Tourism New Zealand embarked on its domestic marketing. As a result, a little over $2 million of spending was unappropriated in 2019/20 and a further $13.5 million was unappropriated in 2020/21, before the correct authority was put in place in December 2020.[8]

Not adjusting to changes

3.20 In two instances, government departments did not seek adjustments to their appropriations in time for implementing changes to customer entitlements.

3.21 In 2020/21, the Defence veterans' entitlement for qualifying service was widened. The Government's decision and announcement led to an increase in the Veterans' Entitlements obligation and a commensurate expense increase. This resulted in expenses exceeding appropriation in Vote Defence Force by $78.9 million.

3.22 The Parental Leave and Employment Protect Act 1987 was amended during 2016. Amendments included changes to the entitlement criteria for recipients who had more than one employer. From April 2016 to February 2021, the calculations for some recipients were incorrect and, accordingly, some payments were incorrectly made. This resulted in $1.5 million of unappropriated expenditure for Vote Revenue in 2020/21. We have also confirmed the amount of unappropriated expenditure for each year from 2015/16. The Government will seek validation for each year's unappropriated expenditure through the next Appropriation (Confirmation and Validation) Act.

Unexpected increase in demand

3.23 The Department of Internal Affairs administers rates rebates for low-income ratepayers, under the Rates Rebates Act 1973. The demand for rebates under the scheme exceeded the Department's forecast for 2020/21, resulting in expenses exceeding the appropriation in Vote Internal Affairs by $1.6 million.

8 We first reported on this matter in March 2021, in our half-year Controller Update, *Controller update: July to December 2020*.

Accounting-related errors

3.24 Two departments had not sought appropriation to authorise the expenses that arose from writing down their loan values.

3.25 During 2019/20, in response to the economic effects of Covid-19, the Government decided to pay local media businesses in advance to run advertisements in 2020/21. Because the advanced payments were interest free, they needed to be accounted for as concessionary loans. As a result, the carrying value of the loans had to be written down to reflect their fair value. The Ministry for Culture and Heritage charged the expense ($121,000 for 2019/20 and $47,000 for 2020/21) against the Grants and Subsidies appropriation category, the scope of which does not authorise this type of expense.

3.26 In a similar case, the Energy Efficiency & Conservation Authority (EECA) administers the Crown Energy Efficiency Loan Scheme, which assists public organisations to implement energy efficiency and carbon emission reducing projects. The loans are funded through Vote Business, Science and Innovation, which is administered by the Ministry of Business, Innovation and Employment. The loan principal is repaid by third parties through EECA to the Ministry.

3.27 Because the loans are provided at below market interest rates, they need to be accounted for as concessionary loans. As such, the carrying value of the loans needed to be written down to reflect their fair value. The Ministry did not have an appropriation against which to charge the write-down expense of $37,000 for 2020/21.

3.28 We have also confirmed unappropriated expenses relating to write-downs for the five previous years for loans under this Loan Scheme. The Government will seek validation for each year's unappropriated expenditure through the next Appropriation (Confirmation and Validation) Act.

3.29 The Department of Internal Affairs incurred expenditure of $28,000 on a grant in 2019/20 but accounted for it in 2020/21, when the amount was not covered by the appropriation.

3.30 Unappropriated expenditure was confirmed in earlier years under Vote Education. The *School Support Project* appropriation authorises (non-property related) capital expenditure on school support and improvement projects. The Ministry of Education identified that some historical expenditure was recognised as being operating in nature, as opposed to capital, and was therefore outside the scope of the appropriation. We have confirmed unappropriated expenditure between 2016 to 2019, which will require validation through the next Appropriation (Confirmation and Validation) Act. There was no operating expenditure recorded against this appropriation in 2019/20 or 2020/21.

Administrative errors

3.31 Two departments incurred unappropriated expenditure because they did not properly manage the arrangements needed to seek additional authority for expenditure that was nonetheless anticipated.

3.32 The Royal Commission of Inquiry into Historical Abuse in State Care and in the Care of Faith-based Institutions required additional funding under Vote Internal Affairs to continue its work in 2020/21. The risk of costs exceeding appropriation was identified, but the Department of Internal Affairs did not secure the approvals for increased funding early enough. This led to expenses exceeding appropriation on two occasions during 2020/21: $638,000 in late 2020 and $331,000 in early 2021.

3.33 On 17 February 2021, the Ministry of Housing and Urban Development purchased land at Te Puke Tāpapatanga a Hape (commonly referred to as Ihumātao). To ensure that there was correct authority for the expenditure, the Ministry asked the Minister of Finance and the Minister of Housing to approve setting up a new appropriation, *Te Puke Tāpapatanga a Hape (Ihumātao)*, within Vote Housing and Urban Development. This was agreed on 9 February 2021.

3.34 Newly set up appropriations do not have any legal authority until they are appropriated by Parliament through inclusion in an Appropriation Act. The soonest opportunity was provided through the Appropriation (Supplementary Estimates 2020/21) Act 2021, scheduled for June 2021. In the interim, the only authority available to the Ministry on 17 February 2021 was under the Imprest Supply Act.[9] Due to an administrative oversight, the Ministry did not request Joint Ministers to approve the use of imprest supply for the purchase, in advance of receiving the appropriation through the Supplementary Estimates Act. As a result, the purchase price of $29.9 million was unappropriated expenditure.

Other

3.35 Tertiary education institutions (TEIs) can effectively own land and buildings, although the title to the land is with the Crown (this is known as "beneficial ownership"). On disposal, the standard arrangement is that the sale proceeds are repaid to the Crown and, under some circumstances, some or all of the sale proceeds may be returned to the TEI .

3.36 When a TEI retains the sale proceeds, it amounts to an equity injection from the Crown to the TEI, and that must be authorised through a capital expenditure appropriation in Vote Tertiary Education. Historically, some TEIs have retained the proceeds without the Ministry of Education having secured appropriation authority for the equity injection. This has resulted in unappropriated expenditure of $6.1 million for 2020/21. The Ministry identified the problem during 2020/21 and changed its approach to managing such sale proceeds to help prevent a

9 Imprest Supply (Second for 2020/21) Act 2020.

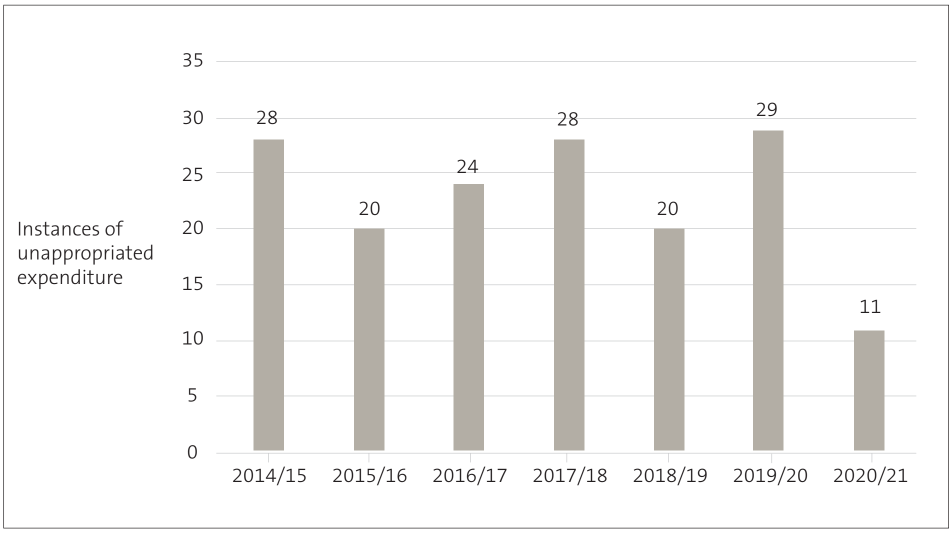
recurrence. In March 2021 it gained approval under imprest supply to correctly authorise further expenditure of this nature in the 2020/21 year, as well as approval to establish a new appropriation to cover such expenditure in future. We have also confirmed unappropriated expenditure back to 2016/17.

How does 2020/21 compare with previous years?

3.37 There was a significant decrease in the number of instances of unappropriated expenditure in 2020/21. The Government's financial statements for the year ended 30 June 2021 report 12 instances of unappropriated expenditure, and 11 of them were incurred during 2020/21 – the lowest number of occurrences at least as far back as the year ended 30 June 2000.

3.38 Figure 5 shows that the frequency of instances fluctuated between 20 and 29 for six of the last seven years, with a major dip in 2020/21.[10]

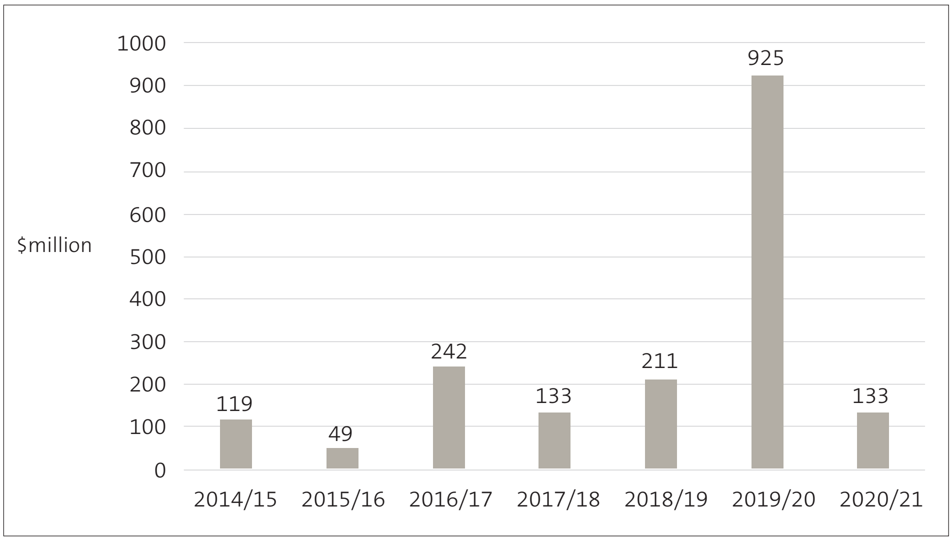
Figure 5
Number of instances of unappropriated expenditure, from 2014/15 to 2020/21



3.39 Figure 6 shows the dollar amount of unappropriated expenditure incurred during the last seven years. Last year, 2019/20, was an outlier, mostly attributable to one instance of excess expenditure ($676.8 million) incurred due to an administrative error. The value of unappropriated expenditure returned to the familiar, fluctuating pattern in 2020/21.

10 Figure 5 shows instances of unappropriated expenditure allocated to the financial year to which they relate.

Figure 6
Amount of unappropriated expenditure, from 2014/15 to 2020/21



Work carried out to discharge the Controller function

3.40 During the year, we carried out our core Controller work through our regular monitoring (with the Treasury) of expenditure against appropriations.[11] Other core Controller activity involves our audits of appropriations and audits of the Government's financial statements and of individual government departments.[12]

3.41 We periodically published website reports on observations and findings from our monitoring of government expenditure, including a half-year report on expenditure against appropriations and three reports during 2020/21 on the Government's Covid-19 expenditure. Since 30 June 2021, we have published a website report on how changes are made and approved to the Government's budget between the annual Budgets, how they are scrutinised and authorised through the Supplementary Estimates, and the Controller and Auditor-General's role in monitoring these approvals.

3.42 One of the major objectives of the Controller function is to support Parliament in its exercising of control over the public purse. As part of this, we have continued to monitor the Government's "consolidation" of appropriations in Budget 2021, whereby it sought to combine separate appropriations into fewer, larger appropriations. We have observed that these changes have introduced more efficiency and flexibility in the authorising of public expenditure. We are supportive of such reforms so long as the transparency of, and accountability for,

11 Under section 65Y of the Public Finance Act 1989.

12 Under section 15 of the Public Audit Act 2001.

public spending is not unduly diminished, and Parliament's control of the public purse is not eroded.

3.43 During 2020/21, we worked with the Treasury on the question of whether the salary costs of seconded employees are properly authorised when the salary costs continue to be paid by the employee's home department. The question arises because all expenses incurred by a government department must be authorised by an appropriation that covers the activity undertaken. This important principle needs to be upheld to ensure that public money is not redirected away from the purposes that Parliament has authorised.

3.44 Covid-19 has highlighted this issue because many staff have been redeployed to support the Government's response. A potential problem arises when the home department continues to pay the salary of the secondee because the secondee's activities are likely to be outside the scope of the home department appropriations. This creates a risk of the home department incurring unappropriated expenditure.

3.45 We supported the Treasury in its development of guidance to government departments on the accounting and appropriation treatment of the salary costs of seconded staff. The Treasury guidance was issued in May 2021.

3.46 Through the Treasury's Finance Development Programme, we were given the opportunity to discuss with government department finance professionals the importance of Parliamentary control of Crown spending and how the Controller function supports New Zealand's constitutional arrangements. We highlighted:

- why it is important to avoid incurring public expenditure without the proper authority;
- what some of the more common pitfalls are that lead to unappropriated expenditure; and
- how government departments can avoid it.

Improving how the government reports on its performance

4

4.1 In this Part, we set out our observations about performance reporting across central government.

4.2 Performance reporting is about showing what has been achieved with public money. Effective performance reporting is essential to building and maintaining trust and confidence in the public sector and, arguably, its ongoing social licence to operate.

4.3 The Government spends about $130 billion[13] each year. Parliament and the public expect effective performance reporting that provides them with confidence that public money is spent well and that the Government is effectively and efficiently delivering services to achieve better outcomes for New Zealanders.

4.4 New Zealand's public accountability system currently rests on a strong **financial** reporting system, where:

- there is clear reporting at the beginning of the financial year on how the Government and government agencies intend to spend money, and at the end of the financial year on how the money has been spent;
- there are reports on the financial performance of each government entity and a consolidated view at an all-of-government-level; and
- we provide independent assurance about the reporting.

4.5 In our view, how the Government reports on and is held to account for its **performance** should exhibit the same strengths.

4.6 As we see with many key government programmes, such as the vaccination programme, the public can care more about how these programmes are performing than it does about how much money has been spent and whether it has been spent appropriately.

4.7 But as we commented in last year's report and in our recent report on performance reporting, how the public sector reports on its performance needs to significantly improve, if the Government wants to maintain the confidence of Parliament and the public.[14]

4.8 Too often, the reporting is focused on what is important to government agencies, instead of what the public or Parliament cares about. We continue to see annual reports that focus on describing all of the activities that an organisation has carried out, without enough focus on good quality reporting about its services and how these have made a difference to people's lives.

13 New Zealand Government (2021), *Financial statements of the Government of New Zealand for the year ended 30 June 2021*, Wellington, page 29.

14 Office of the Auditor-General (2021), *The problems, progress, and potential of performance reporting*, Wellington.

4.9 Our previous audits of major government initiatives, such as the Provincial Growth Fund, have noted that reporting, while compliant with statutory requirements, is also often fragmented. The reporting on major government priorities and initiatives is spread between the reporting by different organisations and it is left to Parliament and the public to piece together what has been achieved. In many cases, this is not possible from the information provided publicly.

4.10 These issues frequently make it hard to tell how well individual central government organisations and the public sector as a whole are performing and what value taxpayers are receiving from the spending of public money.

4.11 We acknowledge that reporting on performance is more complex and challenging than financial reporting. Care must be taken to improve how the public sector reports on its performance in a way that meets Parliament's and the public's expectation and supports ongoing performance improvement in the public sector.

4.12 However, public trust and confidence can be fragile, and there is a risk of losing it at any time. A concerted focus on how the public sector reports on its performance will contribute to improving the transparency of what is being achieved through the provision of public services and, through this, improving trust in government.

4.13 As outlined in more detail in our recent paper on performance reporting, there are likely no quick solutions given the many previous attempts to improve performance reporting.[15] Changes are likely needed at multiple levels at which the public sector is regulated and reports on its performance to make a substantive difference to how the public sector is held to account for its performance to Parliament and the public.

Reporting at an all-of-government level

4.14 In our view, to meet the public's expectations, there should be reporting on performance at an all-of-government level, on major cross-agency activities (such as joint ventures under the Public Service Act 2020), and for major initiatives delivered by single agencies, but this reporting is currently not required.

4.15 In our research on public accountability and performance reporting, we noted that the way in which the public sector is held to account and reports on performance often does not answer the questions that the public cares about.

4.16 Our research shows that the public wants to know answers to questions such as whether they and their families receive high-quality education and health services, what is being done to keep their communities safe, and what is being done to address climate change and poverty across New Zealand.

15 Office of the Auditor-General (2021), *The problems, progress, and potential of performance reporting*, Wellington.

4.17 In general, the public wants to know what progress the Government is making on its commitments, promises, and objectives to improve the lives and well-being of New Zealanders. People care less about the number of transactions a government department has processed (for example, how many contracts were approved in accordance with approved criteria), and more about impacts and outcomes (for example, whether their communities are safer).

4.18 In 2020, the Government amended the Public Finance Act 1989 to introduce an important element into the public accountability system. The Government is now required to set out its well-being objectives to guide the annual Budget.

4.19 This amendment to the public accountability system enables the public and Parliament to understand what the Government is setting out to achieve through the Budget at an all-of-government level. Knowing how much public money is spent is important, but it is not sufficient.

4.20 At any level of government, effective public accountability systems should enable the public and Parliament to understand what the Government has set out to achieve but – equally importantly – what progress is being made.

4.21 If the Government were to report on the core ways in which it is contributing to the key outcomes that matter to the well-being of New Zealanders, this would tell a rich, comprehensive, and cohesive whole-of-government story of what the public receives from government spending and what progress the Government is making on its core objectives.

4.22 Although the well-being amendment to the Public Finance Act also introduced a requirement for the Treasury to periodically produce a well-being report, neither the well-being report nor other reports produced by the Treasury (such as He Tirohanga Mokopuna or the investment statements) will report on what progress the Government is making on its well-being objectives.

4.23 Although a significant amount of effort goes into producing these reports, they are not independently assured, and it is unclear how they should be used and what role they serve in the overall accountability system.

4.24 The reform work that is happening across the public sector provides an opportunity to address this gap and to put in place a more comprehensive, integrated, and cohesive accountability system.

Reporting on major cross-agency and individual agency initiatives

4.25 In last year's report, we noted that the reporting on government initiatives involving multiple public organisations, such as the Covid response and recovery fund and the Provincial Growth Fund, is often siloed and focused on the activities and spending of individual organisations, rather than a report on the initiative as a whole.

4.26 We recommended that when significant, new initiatives are established, requirements be established to enable cohesive and comprehensive reporting across the initiative about what it is there to do, how the initiative is progressing (including spending), and what outcomes are being achieved.

4.27 Building on last year's comments, we examined what reporting requirements are established for initiatives that are approved as part of the Government's annual Budget.

4.28 We looked at a sample of initiatives under the budget priorities for mental health and family and sexual violence in Budget 2019, Budget 2020, and Budget 2021.

4.29 For many of the initiatives that we examined, we found it difficult to track, from publicly available documents, spending and how performance will be assessed for each of the individual initiatives and across the relevant priority area as a whole.

4.30 We found that the funding for each individual initiative and across the relevant priority area is often authorised across several existing, and at times new, appropriations and Votes administered by different departments.

4.31 This approach to authorising spending for new major government initiatives and priorities makes it difficult to track how much spending has been used for the specific initiative compared with the business-as-usual operational spending authorised under the appropriation. It also results in fragmented reporting on spending and performance for the initiatives and across the relevant priority area.

4.32 In examining the performance information attached to the appropriations, we also found that this information was often not modified to reflect the distinctive features of the initiative. For example, the budget initiatives to expand mental health services did not result in any changes to the performance information for the appropriations. There were no performance measures assessing to what extent the public has greater access to mental health services.

4.33 Currently, the statutory requirements for central government organisations simply require them to report on progress against their strategic intentions and their annual service performance expectations (such as end-of-year appropriations for departments and Statement of Performance Expectations for Crown entities). There is no statutory requirement for public organisations to report on the impacts of any major initiatives that are approved through the Budget.

4.34 Although some public organisations will report voluntarily on major policy initiatives in their annual report, this reporting is not required nor consistently available.

4.35 Although we examined just a sample of major budget initiatives and priorities, it indicates a broader issue in how the reporting requirements for major initiatives are established through each annual Budget. The current statutory reporting requirements and the process through which initiatives are approved and authorised through the Budget often does not enable meaningful reporting to Parliament and the public.

4.36 In our view, members of Parliament and the public should be able to track funding for major policy initiatives and priorities as announced by Ministers through to the appropriations that authorise them, the expenditure incurred under the appropriations, and performance information about what has been achieved with that public money.

4.37 Given that the Government typically announces between $2-4 billion in new spending each year, which includes spending for new budget initiatives as well as increased spending due to cost pressures, this is an important public accountability issue.

4.38 The Treasury is currently working on modernising the public finance system. This work provides an opportunity to put in place reporting requirements that can enable Parliament and the public to track funding for major policy initiatives and what has been achieved.

Reporting at an organisation level

4.39 Last year we noted that there are challenges inherent in good performance reporting and identified where substantive improvements are still needed.

4.40 Our recent paper on performance reporting describes in detail the issues that we are seeing in how public organisations report on their performance and areas for improvement.

4.41 As part of our work to better understand public sector performance, we have started developing a database of the performance measures that are used by public organisations over the past five years (10 years for district health boards) and how successful they have been in achieving their targets.

4.42 As noted in our report on performance reporting,[16] we found that the performance information and measures presented by public organisations is overly complicated. We found that from 2016 and 2019, 109 annual reports had more than 100 output indicators and 28 annual reports had more than 200 output indicators. One public organisation had 340 output indicators in a single annual report.

4.43 We also found that the performance measures were continuously changing. For example, looking at the output indicators in the annual reports of 33 organisations between 2016 and 2019, we found that in 2016, the annual reports had a total of 1849 output indicators. By 2017, 30% of them were new or had changed their description. By 2018, almost 50% of them were new or had changed their description.

4.44 Looking ahead, the database can serve as a rich resource to analyse and identify trends in how the public is reporting on its performance and performing across different levels of government, from an individual entity level through to major government initiatives and at an all-of-government level.

4.45 During the next year, we intend to explore opportunities to analyse the performance data to see what it might tell us about the performance of government over time.

4.46 For example, the database provides an opportunity to examine trends, such as how well central government entities have succeeded in achieving their targets and comparing this against expenditure over time at an individual entity level, across different sectors, and throughout central government. This kind of analysis can serve as an important initial starting point for examining the performance of central government organisations.

16 Office of the Auditor-General (2021), *The problems, progress, and potential of performance reporting,* Wellington, pages 21-22.

Appendix
How appropriations work

Who approves the spending of public money and how?

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

The Bill sets out estimates of what will be spent under each ministerial portfolio. In general, every ministerial portfolio associated with a department has a corresponding "Vote" in the Budget (for example, Vote Health sets out all the spending in the health portfolio). Each Vote is made up of several specific appropriations. Each appropriation sets out:

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

Once Parliament has considered and passed the Bill, it becomes law as an Act. In general, any spending outside what has been approved in this Act of Parliament will be unlawful.

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

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

The Appropriation (Estimates) Bill needs to be passed within four months of Budget Day. From 1 July until the Bill becomes law, the Government must continue to operate and spend public money. To cover this period, interim authority is provided through an Imprest Supply Act, which is enacted before the financial year begins. The first annual Imprest Supply Act therefore allows the Government to incur expenditure before the Budget for that year is enacted in legislation. The spending authority under this Imprest Supply Act is repealed when the Appropriation (Estimates) Act comes into force.

There are usually at least two Imprest Supply Acts in a financial year.

What happens if things change during the year?

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

A second Imprest Supply Act for the year is enacted, usually at the same time as the Appropriation (Estimates) Act. This provides authority for spending that might not have been envisaged when the Budget estimates were finalised. It remains in force until the end of the financial year to provide authority for unexpected spending.

Cabinet requires that any use of imprest supply must be authorised by a specific Cabinet decision (or, in some instances, by approval of joint ministers under delegation from Cabinet). But Imprest Supply Acts provide only "interim" authority. To remain lawful, all expenditure incurred under an Imprest Supply Act must be approved by Parliament under an Appropriation Act passed before the end of the financial year. Expenditure under the second Imprest Supply Act is typically appropriated through a second appropriation Act, the Appropriation (Supplementary Estimates) Act, which is usually enacted in June. This allows the Government to update the initial estimates in the Budget and get legislative approval for those changes (which include expenditure already incurred under imprest supply).

If expenditure under the authority of an Imprest Supply Act is incurred too late in the financial year to be authorised through the Appropriation (Supplementary Estimates) Act, then as at 30 June it becomes "unappropriated expenditure". It must be validated by Parliament through a third appropriation Act, the Appropriation (Confirmation and Validation) Act, in the next financial year.[17]

The Public Finance Act includes several other mechanisms for approving minor changes to the spending authorities approved by Parliament. For example, there is limited scope for the Governor-General to approve, by Order in Council, transfers between appropriations in a Vote.[18] To provide further flexibility during the final three months of the year, the Public Finance Act authorises the Minister of Finance to approve a limited amount of extra spending within the scope of an existing appropriation.[19] Flexibility under these mechanisms is subject to confirmation by Parliament through the Appropriation (Confirmation and Validation) Bill.

Sections 25 and 25A of the Public Finance Act also authorise the Government to spend public money outside appropriations in emergency situations, subject to confirmation by Parliament through the Appropriation (Confirmation and Validation) Bill.

17 Section 26C of the Public Finance Act 1989. The Appropriation (Confirmation and Validation) Bill, which is introduced after the end of the financial year, allows Parliament to retrospectively confirm or validate all unappropriated expenditure incurred during the year.

18 Section 26A of the Public Finance Act 1989.

19 Section 26B of the Public Finance Act 1989.

Does that mean any spending outside the revised Budget (Supplementary Estimates) is unlawful?

Such expenditure can be unlawful, but not always. It could still be lawful if it is covered by some other authority, for example, a relevant section in the Public Finance Act or by another Act of Parliament. However, expenditure incurred under Cabinet authority to use imprest supply, but not included in an Appropriation Act at the end of the financial year, becomes unappropriated and remains unlawful until it is validated by Parliament.

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

No. The Government prepares the Budget. The Minister of Finance and the Treasury co-ordinate the work of the various government departments and individual Ministers to put together a set of spending proposals for the Government as a whole. The Auditor-General is not part of the Government nor are they answerable to Ministers, and so has no role in this process.[20] The Auditor-General does not audit the Budget.

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

Parliament then votes on whether to pass the Appropriation (Estimates) Bill. Votes on Budget and spending matters are automatically regarded as confidence matters. That means that, if a Government cannot persuade a majority of Parliament to support its spending plans, then it does not have enough support to continue as the Government.

Who spends the money and how?

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

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

20 There is a special process for working out the budget for Officers of Parliament (such as the Auditor-General) to ensure that the funding decisions are made by Parliament and not the Government. The Auditor-General is involved in this process in their capacity as the chief executive of their own Office.

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

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

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

Departmental chief executives are responsible under the Public Finance Act for the financial management and performance of their department. This includes ensuring that they have both the funding authority and the necessary legal mandate before incurring expenses or capital expenditure.[21]

Government departments are required to report regularly to the Treasury on the expenses and capital expenditure incurred by the department against the appropriation or other statutory authority provided. The first report for the financial year is provided in October (covering the previous July to September period) and then monthly after that. This and other financial information is used to compile the monthly financial statements of the Government.

The Treasury is also required to report to the Controller all expenditure incurred compared with the appropriation (or other authority) and all expenditure incurred without authority or in excess of the authority given. This is carried out monthly, beginning in October each year, in co-ordination with the requirements in the paragraph above.

Who checks whether government departments are spending money lawfully within authority?

This is where the role of the Controller comes in. To check and verify the spending, the Auditor-General's Controller team:

- reviews the Treasury's monthly reports;
- carries out tests on the financial information (provided by the Treasury from the Crown Financial Information System);
- checks that Cabinet's authority for changes to budgets are correctly applied;
- reports back to the Treasury highlighting any issues (including unappropriated expenditure), comments on actions needed to confirm or validate any unappropriated expenditure, and advises on any further action that the Treasury or the department needs to take to resolve outstanding issues; and

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

- confers with the relevant auditors about issues affecting the government departments they audit.

As well as auditing government departments' financial statements, the Auditor-General is responsible for auditing the appropriations administered by each department (the appropriation audit).

Through the appropriation audit of each department, our auditors look at systems and some transactions to check that public money was spent as Parliament has authorised. If an appointed auditor detects spending outside authority through the appropriation audit work, then the auditor will discuss the matter with the government department, advise the department about reporting the matter and taking corrective action, and inform the Controller. The appointed auditor will also check whether the department properly reports the matter in its financial statements.

Expenditure above or beyond the appropriation limits

The public finance system provides some flexibility to how public expenditure is authorised. This is necessary to:

- allow the Government to incur expenditure not covered at the time by Appropriation Acts, including to allow for unanticipated expenditure during the year as circumstances change (through imprest supply);
- allow for immediate expenditure in declared emergencies (sections 25 and 25A of the Public Finance Act); and
- provide for the approval of relatively small amounts of expenditure in excess of appropriation without needing approval from Parliament (sections 26A and 26B of the Public Finance Act).

However, in general, when government departments do not get approval for expenditure before it is incurred, it is unlawful. Expenditure approved by Cabinet under imprest supply will also be unlawful if Parliament has not appropriated it before the end of the financial year.

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 that authorised in the Appropriation (Estimates) Act can be authorised by Cabinet before the event and subsequently authorised by Parliament in the Appropriation (Supplementary Estimates) Act.

Ministers need to report unappropriated expenditure to Parliament and, for that spending to be lawful, must seek Parliament's retrospective approval of unappropriated expenditure through an Appropriation (Confirmation and Validation) Bill.

How does the Controller deal with expenditure incurred outside appropriation limits?

When government departments become aware of potentially unappropriated expenditure, they are expected to immediately tell their appointed auditor, the Treasury, and their Minister (who will need to seek additional authority for the expenditure). The department should provide the Treasury with an explanation of the issue as well as an explanation of actions taken to resolve it, for example, to gain additional authority in advance to avoid unappropriated expenditure or to seek validation of any already unappropriated expenditure through an Appropriation (Confirmation and Validation) Act.

Auditors might detect potentially unappropriated expenditure through their audit process, as might the Treasury through its financial management and budgeting work. After collating information from government departments each month, the Treasury provides its monthly report to the Controller highlighting actual, expected, and potentially unappropriated expenditure. The Controller then carries out the work we described earlier in this Appendix.

The Controller monitors all matters that come to their attention until they are resolved and will often, through their auditors, advise government departments on any corrective action required. For expenditure that is confirmed as being unappropriated, corrective action includes disclosing the facts in the affected departments' annual financial statements (and the Government's financial statements). After the end of the financial year, the Auditor-General audits the departments' and the Government's financial statements to ensure that all unappropriated expenditure is correctly disclosed.

If a government department does not take the action required to prevent continuing unauthorised spending, then the Controller can write to the department's chief executive or the relevant Minister directing that no further expenditure can be incurred under the affected appropriation until approval has been obtained.

If the government department still fails to obtain the correct approval, then the Controller can direct the Minister, the Treasury, and the department to stop payments from the relevant bank account and direct the Minister to report to the House of Representatives. This would be an unusual sanction and used only in exceptional circumstances.[22]

22 Sections 65Z and 65ZA of the Public Finance Act 1989.

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