

Introduction

- 1.001 In this article we analyse and comment on the financial condition of Hospital and Health Services (HHSs)¹ based on the information in their audited financial statements for the five years 1994-95 to 1998-99.
- 1.002 In 1997 and 1998² we reported on our analysis of the financial condition of Crown Health Enterprises over the three financial years from 1 July 1994 to 30 June 1997. That analysis highlighted significant losses, resulting in erosion of the equity base and the need for additional financial support from taxpayers.
- 1.003 Our analysis and comment is confined to financial condition because that (at present) is the limit of the Audit Office's mandate. However, as we said in both 1997 and 1998, financial measures alone are not a suitable basis for judging the "success" of HHSs. Appropriate attention needs to be given to establishing a suitable mix of financial and non-financial measures and standards that are publicly reported against.

Changes Affecting Hospital and Health Services

- 1.004 With effect from 1 July 1998 three significant changes have affected HHSs:
- a revised statutory requirement that HHSs operate in a "business-like and effective manner" and "on a not-for-profit basis", instead of as "successful and efficient businesses";
 - introduction of the "Deficit Switch"; and
 - introduction of a capital charge.

1 New Zealand Blood Service Limited (NZBS) was established as an HHS on 1 July 1998. We have not included data for NZBS in our analysis because of the range of services NZBS provides and the fact that its primary relationship is with other HHSs and health service providers rather than with the Health Funding Authority.

2 *First Report for 1997*, parliamentary paper B.29[97a], pages 121-140; *Second Report for 1998*, parliamentary paper B.29[98b], pages 11-36.

“Deficit Switch”

- 1.005 In 1998 we reported that capital contributions from the Crown were not, in some cases, being used to expand the Crown’s investment in HHSs. Rather, the contributions were being used to provide working capital because of previous operating deficits.³ To address this problem the Government agreed to what was called the “Deficit Switch”. The switch amounted to a transfer from Vote Crown Health Enterprises to Vote Health of the appropriations for what had been effectively a deferred payment for health services already delivered, rather than [genuine new capital] for the development of capital assets.⁴
- 1.006 To give practical effect to the switch:
- the Health Funding Authority (HFA) was required to redress price imbalances and volume requirements; and
 - for 1998-99 \$129.5 million was transferred from Vote Health Service Providers (formerly Vote Crown Health Enterprises) to Vote Health so that the HHSs could be funded to a level that appropriately covered the real and reasonable costs of the services they were contracted to provide.
- 1.007 The objective of those measures was to more appropriately reflect the price of health services and thereby halt the trend of annual operating deficits that HHSs had recorded up until 1998. An idea of the extent to which that objective was achieved in 1998-99 can be gained from Figure 1.1 on page 15. It was also intended that future capital contributions would be for financing capital projects and not for funding shortfalls in the cost of service delivery.

³ *Second Report for 1998*, paragraph 1.025.

⁴ *Ibid.*, paragraph 1.026.

Capital Charge

- 1.008 From 1 July 1998 all HHSs have been required to pay a capital charge to the Crown based on their actual shareholder's funds. The intention of the capital charge is to make explicit the true costs of the taxpayers' investment in the HHSs and, by requiring that those costs be recognised, encourage effective and efficient management of HHS assets and liabilities.
- 1.009 For 1998-99 HHSs were separately funded out of Vote Health Service Providers for the capital charge. For 1999-2000 the separate funding is being continued out of Vote Health. This separate funding is an interim arrangement for these two years. It is expected that, at some future date, the cost of the capital charge will be incorporated in the HHSs' pricing structure for their services.
- 1.010 The capital charge funding for each HHS is calculated on the basis of shareholder's funds at the beginning of the 1998-99 financial year, adjusted for the planned net operating result after tax for the year and any estimated asset revaluations. The HHSs pay the capital charge to the Crown monthly calculated at 11% of the month's balance of shareholder's funds. Thus the funding provided does not necessarily equal the charge paid.
- 1.011 In accordance with generally accepted accounting practice, the funding from the HFA is included as revenue in the HHSs' Statement of Financial Performance. However, the payment of the capital charge to the Crown is regarded as a distribution to the shareholder and as such is recorded "below the line". Thus, the effect of the capital charge transactions is to increase revenue and beneficially affect the net operating result, with a corresponding diminution in shareholder's funds.
- 1.012 For the reasons stated in paragraphs 1.010 and 1.011, readers should be aware that transactions relating to the capital charge are reflected in our data for 1998-99 and comparisons between that year and previous years need to be read accordingly.

Overall Picture of Financial Condition

1.013 The financial condition of the HHSs is a function of their financial position and performance over time. In order to provide a concise and (we hope) informative picture of HHS financial condition we have compiled two sets of data⁵:

- Table 1.1 on page 21 shows selected financial statistics on an aggregate basis for HHSs for the five years 1994-95 to 1998-99.
- Table 1.2 on pages 22-23 shows the same financial statistics for each individual HHS for 1998-99 – the latest financial year we have audited.

1.014 Key aspects of the trends in the aggregate financial condition of HHSs over the five years are:

- net operating deficits in all years, but a significant reduction in the deficit for 1998-99;
- as a result –
 - a major turn round in the erosion of the equity base caused by operating deficits; and
 - much reduced reliance on capital contributions from the Crown in 1998-99;
- shareholder's funds have nevertheless declined over the period, and would have been considerably lower without the capital contributions from the Crown.

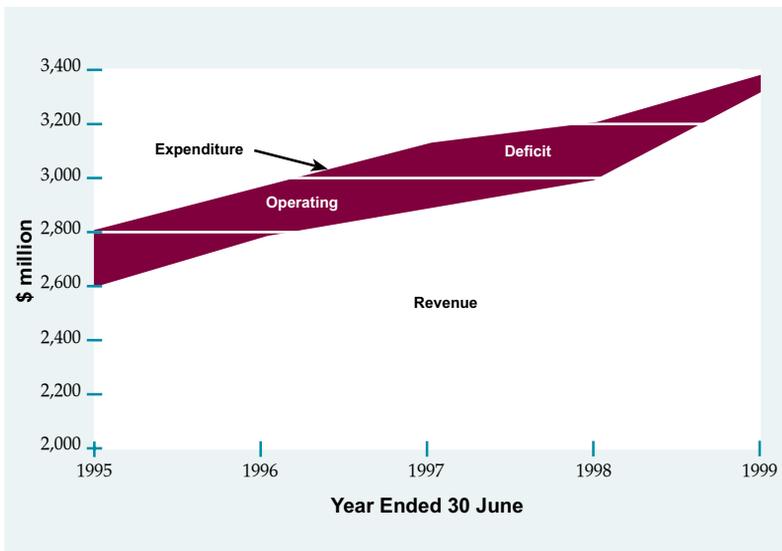
1.015 We comment on these trends in the following paragraphs.

⁵ The source of the data is the audited annual financial statements of the HHSs. Consequently, figures used are all in current dollars as reported in those statements.

Operating Results

1.016 The aggregate annual operating results over the five years 1994-95 to 1998-99 are presented graphically in Figure 1.1 below.

Figure 1.1
Aggregate Operating Results
1994-95 to 1998-99



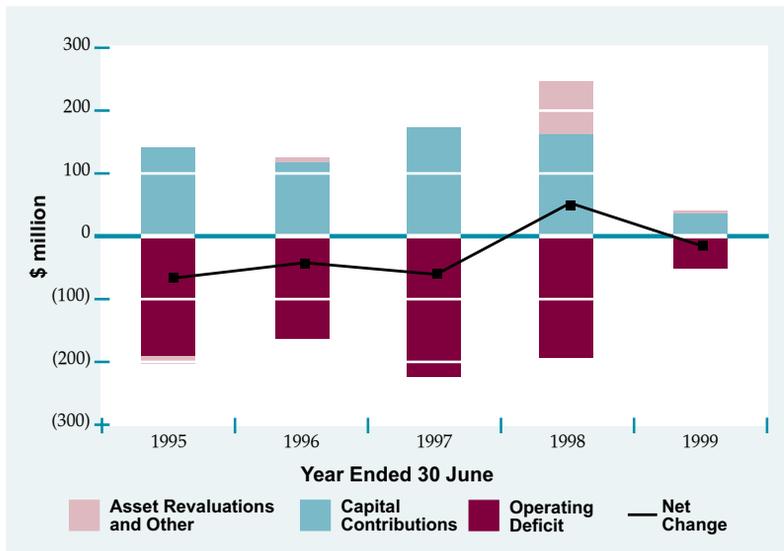
1.017 While revenue rose steadily over the five years expenditure also rose, although the rate of increase in expenditure declined in the last two years. Expenditure always exceeded revenue but the gap narrowed appreciably in 1998-99.



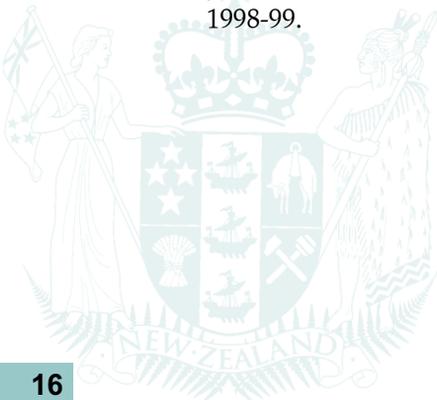
Changes in Shareholder's Funds

1.018 The changes in shareholder's funds each year for the five years to 1998-99 are shown graphically in Figure 1.2 below.

Figure 1.2
Changes in Shareholder's Funds
1994-95 to 1998-99

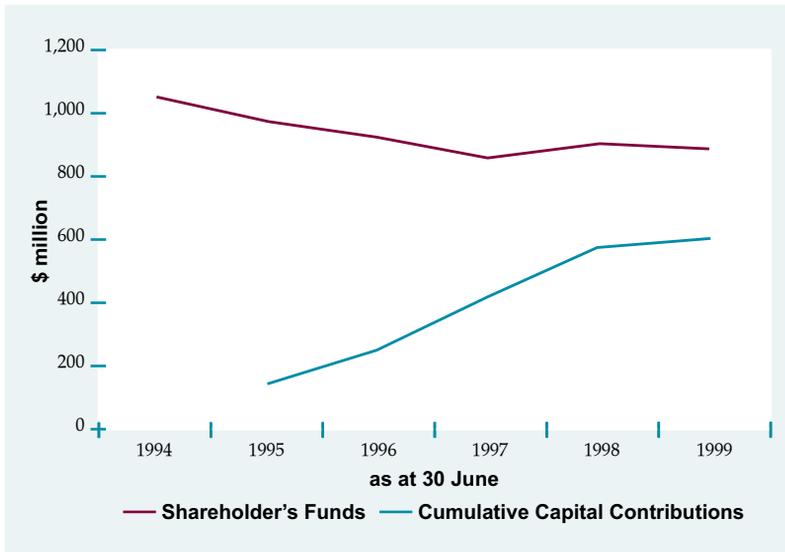


1.019 The two features that stand out are the amounts of capital contributions from the Crown – as positive contributions to changes in shareholder's funds – and the amounts of operating deficits that have the opposite effect. In both cases the amounts were substantial in the four years from 1994-95 to 1997-98 but dropped dramatically in 1998-99.



1.020 The relationship between the amounts of shareholder's funds at the end of each of the five years and the cumulative effect on those amounts of the Crown's capital contributions is illustrated in Figure 1.3 below. The picture is clear: but for the additional capital provided by the Crown the amount of shareholder's funds would have dropped over the five years to about 27% of what it stood at on 1 July 1994.

Figure 1.3
Shareholder's Funds and Cumulative Capital Contributions 1994-95 to 1998-99



Composition of Shareholder's Funds

1.021 The composition of shareholder's funds at the end of each of the five years is shown in Figure 1.4 on page 18.

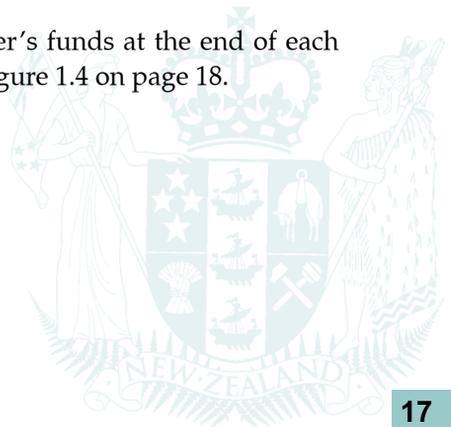
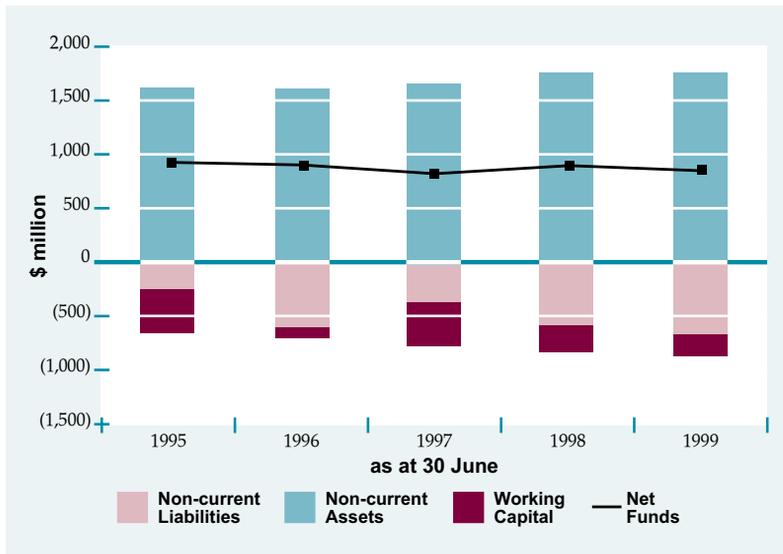


Figure 1.4
Composition of Shareholder's Funds
1994-95 to 1998-99



Note – “Working Capital” is calculated as the difference between current assets and current liabilities. “Current” means realisable within one year of the reporting date. Current liabilities therefore include that portion of term debt due to mature within the year.

“Non-current Assets” are assets (such as land, buildings, and plant) that are not expected to be realised in cash or sold or consumed within one year of the reporting date.

“Non-current Liabilities” are liabilities (such as term debts) that are not expected to be settled or extinguished within one year of the reporting date.

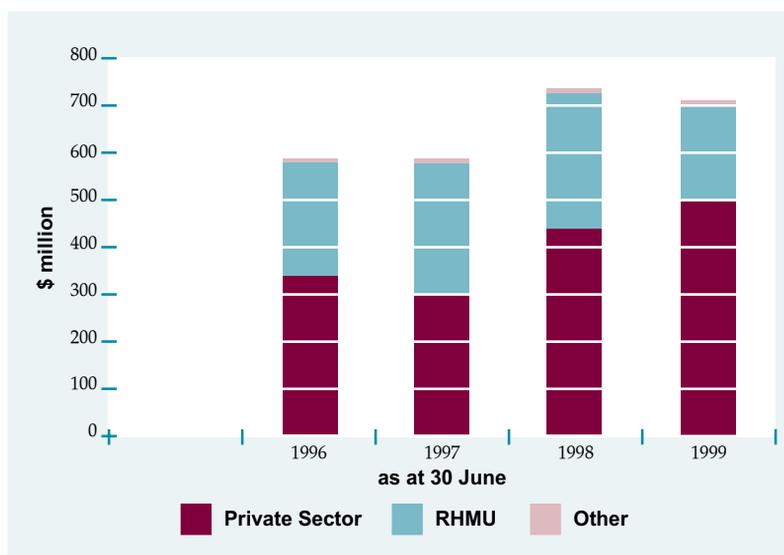
1.022 The “asset base” – in the form of land, buildings, plant, etc. – has been maintained over the five years. On the other hand, maintenance of the asset base has happened:

- at the expense of increased non-current liabilities (mainly term debt);
- by relying consistently on negative working capital; and
- with the benefit of asset revaluations (especially in 1997-98).

Term Debt

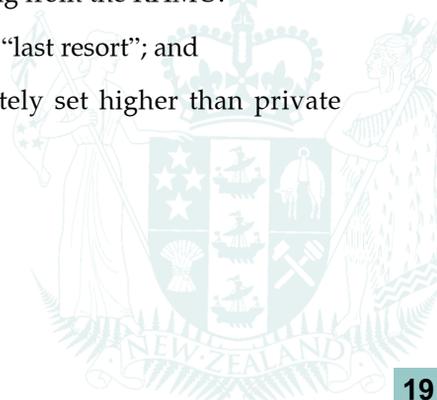
1.023 The sources of term debt – both current and non-current – at the end of each of the five years are shown graphically in Figure 1.5 below.

Figure 1.5
Sources of Term Debt
1995-96 to 1998-99



1.024 The principal feature shown by Figure 1.5 is that borrowing from the RHMU has remained a significant proportion of term debt that, overall, has increased. By 1999, RHMU debt still represented 29% of all term debt, notwithstanding that borrowing from the RHMU:

- is intended to be a matter of “last resort”; and
- is at interest rates deliberately set higher than private sector term debt rates.



Conclusion on Overall Financial Condition

1.025 The preceding analysis highlights the improved financial condition of HHSs since the “Deficit Switch” initiated in 1998-99 and the HFA’s redress of price imbalances and volume requirements. The financial performance of HHSs in that year was in marked contrast to the preceding four years. Those years were characterised by large operating deficits and reliance on the Crown providing a continuing flow of additional capital.

1.026 A number of factors could be involved in the improvement. These include:

- a more appropriate price paid for contracted services by the HFA, so that HHSs are closer to being funded for the costs they incur;
- additional Crown capital being used to improve buildings and facilities rather than fund day-to-day operations; and
- better matching of service delivery to contracted revenue, which may include delivery of fewer unfunded services.

1.027 We also believe that Parliament is now being given a clearer representation of the true cost of health and disability support services through the switching of appropriations from Vote Health Service Providers to Vote Health.



Table 1.1 – Aggregate Financial Statistics 1994–95 to 1998–99

	1994-95 \$000	1995-96 \$000	1996-97 \$000	1997-98 \$000	1998-99 \$000
Expenditure	2,800,168	2,952,254	3,130,096	3,205,241	(1)3,384,804
Revenue	2,601,768	2,783,567	2,902,025	3,007,661	(2)3,330,468
Net Operating Result	(198,400)	(168,687)	(228,071)	(197,580)	(54,336)
Movements in Equity					
Capital Contributions	135,351	113,276	168,436	157,726	32,819
Asset Revaluations	2,555	6,884	(124)	83,919	5,376
Other	(13,414)	(1,638)	(48)	2,907	(565)
Opening Shareholder's Funds	124,492	118,522	168,264	244,552	37,630
Net Change for the Year	1,045,609	971,701	921,536	861,729	908,701
Closing Shareholder's Funds	(73,908)	(50,165)	(59,807)	46,972	(16,706)
971,701	921,536	861,729	908,701	891,995	
Composition of Shareholder's Funds –					
Working Capital	(398,618)	(56,275)	(412,257)	(232,671)	(217,342)
Non-current Assets	1,622,472	1,604,616	1,649,621	1,735,707	1,763,083
Non-current Liabilities	(252,153)	(626,805)	(375,635)	(594,335)	(653,746)
Term Debt –	971,701	921,536	861,729	908,701	891,995
Private Sector	(3)	331,266	294,529	440,868	493,401
RHMU	(3)	254,261	280,068	285,248	204,573
Other	(3)	4,845	10,995	10,433	9,679
(3)	590,372	585,592	736,549	707,653	707,653

Note: a + b = c

Notes - (1) includes the cost of the capital charge.

(2) includes the funding received to meet the cost of the capital charge.

(3) We did not compile these figures when we first reported in 1997.

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Table 1.2
Individual Financial Statistics 1998-99
(All amounts in \$000)

Hospital and Health Service	Operations			Movements in Equity		
	Expenditure (1)	Revenue (2)	Net Operating Result	Capital Contributions	Asset Revaluations	Other
Northland Health	100,670	104,008	3,338	-	-	-
Waitemata Health	206,256	203,615	(2,641)	-	3,922	-
Auckland Healthcare	562,321	556,832	(5,489)	-	-	-
Counties Manukau	255,215	255,463	248	-	-	17
Health Waikato	302,348	302,384	36	-	-	-
Lakeland Health	66,889	67,090	201	-	-	-
Western Bay Health (3)	49,238	49,268	30	-	-	(14,189)
Pacific Health (3)	77,850	78,143	293	-	-	14,189
Tairāwhiti Healthcare	48,405	44,035	(4,370)	2,500	-	-
Taranaki Healthcare	83,985	79,608	(4,377)	3,000	21	-
Health Care Hawkes Bay	121,421	113,228	(8,193)	5,500	-	-
MidCentral Health	165,603	165,776	173	2,000	-	-
Good Health Wanganui	69,514	69,582	68	-	-	(40)
Wairarapa Health	32,839	30,480	(2,359)	2,300	-	-
Hutt Valley Health	94,719	94,870	151	-	-	-
Capital Coast Health	266,032	244,270	(21,762)	10,000	323	(608)
Nelson-Marlborough Health	106,904	105,995	(909)	1,619	-	-
Coast Healthcare	44,883	40,803	(4,080)	1,400	-	-
Canterbury Health	296,818	298,490	1,672	-	-	-
Healthlink South	117,595	116,743	(852)	4,500	-	66
Health South Canterbury	47,034	44,880	(2,154)	-	-	-
Healthcare Otago	188,341	188,388	47	-	-	-
Southern Health	79,924	76,517	(3,407)	-	1,110	-
Totals	3,384,804	3,330,468	(54,336)	32,819	5,376	(565)

(1) Expenditure includes the cost of the capital charge (see paragraph 1.011).

(2) Revenue includes the funding received to meet the cost of the capital charge (see paragraph 1.011).

(3) Western Bay Health amalgamated with East Bay Health on 1 February 1999 and became Pacific Health.

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Changes in Shareholder's Funds			Composition of Closing Shareholder's Funds			Sources of Term Debt (5)		
Opening Shareholder's Funds	Net Change for Year (4)	Closing Shareholder's Funds	Working Capital	Non-current Assets	Non-current Liabilities	Private Sector	RHMU	Other
39,376	3,338	42,714	5,155	46,599	9,040	7,000	-	-
83,530	1,281	84,811	(4,832)	148,537	58,894	58,500	-	1,346
88,210	(5,489)	82,721	(48,786)	179,419	47,912	35,353	-	144
68,809	265	69,074	(26,994)	128,495	32,427	36,853	-	-
99,578	37	99,615	(8,903)	189,749	81,231	82,434	-	-
9,639	201	9,840	(4,250)	24,457	10,367	1,714	8,579	22
14,159	(14,159)	-						
8,206	14,482	22,688	(1,877)	46,695	22,130	2,000	14,984	4,140
14,715	(1,870)	12,845	464	26,633	14,252	5,000	8,543	3
20,396	(1,356)	19,040	(8,229)	42,613	15,344	15,000	-	30
37,068	(2,693)	34,375	(5,700)	83,276	43,201	-	40,508	2,080
31,072	2,173	33,245	(17,308)	60,173	9,620	22,700	-	-
24,813	28	24,841	136	42,114	17,409	-	17,000	-
7,672	(59)	7,613	(899)	16,394	7,882	-	7,150	406
36,395	151	36,546	(2,313)	65,216	26,357	-	23,545	100
77,179	(12,047)	65,132	(45,353)	193,929	83,444	89,664	30,167	83
22,818	710	23,528	1,217	45,321	23,010	-	17,461	90
10,504	(2,680)	7,824	(2,568)	20,561	10,169	900	8,866	355
117,769	1,672	119,441	(12,414)	193,838	61,983	57,915	-	589
19,297	3,714	23,011	(27,459)	50,861	391	8,632	8,123	-
10,826	(2,154)	8,672	(11,091)	21,329	1,566	861	10,541	-
39,110	47	39,157	8,246	91,270	60,359	59,575	-	158
27,559	(2,297)	25,262	(3,584)	45,604	16,758	9,300	9,106	133
908,701	(16,706)	891,995	(217,342)	1,763,083	653,746	493,401	204,573	9,679

(4) This is the sum of Net Operating Result and Movements in Equity.

(5) Current and non-current.