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Central  
government:  
Results of the  
2012/13 audits  
(Volume 2)



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(Volume 2)

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# Auditor-General's overview

This report presents the aggregate results from my audits of central government agencies for 2012/13. It also sets out my observations on those results for government departments, tertiary education institutions, and Crown entities. I will publish separate reports on the health sector, schools, and State-owned enterprises later this year.

My auditors issued 669 audit reports for central government agencies. Of these, 557 were standard reports, which means that the auditors were able to obtain reasonable assurance that the audited information is free from material misstatement. The other 112 were non-standard audit reports (containing a modified opinion or an explanatory paragraph, or both), the reasons for which varied widely.

Central government agencies sought better ways of delivering public services under ongoing financial constraint. Some agencies have continued to adjust to new systems and structures from mergers in recent years.

When organisations' structures change, the management and financial control environments are often at increased risk, especially when functions from different organisations are brought together. We have looked at the treatment of assets, liabilities, and business-critical information, and how public entities subject to structural change manage the risks of fraud. Overall, public entities are appropriately identifying and managing risks associated with organisational change.

The size and investment in physical assets throughout the public sector is significant. The Crown owns \$110 billion of property, plant, and equipment. Our audits have found that the performance of public entities in managing assets is mixed. Public entities need to better manage the risks of deferred maintenance and improve how they report the condition of assets to decision-makers.

Problems with the security and management of private and sensitive information were highlighted in 2012/13 by some high-profile breaches of information security. This report also includes a section on observations arising from our auditing of information systems throughout central government. The audit work is carried out as part of our annual audits. The purpose is to test and provide assurance on the underlying systems and controls necessary to produce the information that appears in the financial statements.

This report also describes our analysis of the financial statements of selected central government agencies. It shows that government departments, Crown research institutes, and other Crown entities are planning and aligning their

financial resources to help ensure that services are stable, resilient, and sustainable. Crown entities and government departments show the greatest consistency over time, which could be because of the greater number of entities, the stability of their operating environments, and/or ongoing consequences for Crown research institutes that followed a taskforce review in 2010.

Generally, central government agencies are responding to the range of challenges facing them by maintaining the systems and controls necessary to ensure that they manage public expenditure well.

A handwritten signature in black ink, appearing to read 'Lyn Provost', written in a cursive style.

Lyn Provost  
Controller and Auditor-General

14 April 2014



# Part 1

## Introduction

- 1.1 This report discusses the results of our 2012/13 audits of central government agencies – public entities in the central (rather than local) government sector. They include:
- government departments (and their subsidiaries);
  - Crown entities (and their subsidiaries);
  - companies that are partly owned by the Crown and partly in private ownership (called “mixed ownership model” companies);
  - public entities that do not fall neatly into other categories, such as the New Zealand Police and the Parliamentary Service; and
  - the Student Loans Scheme and the Financial Statements of the Government.
- 1.2 There are different types of public entities, with different governing legislation. They include State-owned enterprises, Crown research institutes (CRIs), school boards of trustees, Māori trust boards, district health boards (DHBs), and tertiary education institutions (TEIs). In this report, we sometimes discuss the wider group of central government agencies. At other times, we focus on a subset (such as CRIs).
- 1.3 Because of the size and significance of DHBs, schools, and State-owned enterprises, we will be reporting more fully on their audit results in separate reports.

### **The operating context for central government entities**

- 1.4 The operating environment for central government agencies in 2012/13 was marked by ongoing fiscal constraint, a strong focus by the Government on better public sector performance, significant changes to governance arrangements, and the implementation and consolidation of structural changes.
- 1.5 As well as a drive for greater effectiveness and efficiency, we also saw a trend towards greater centralised guidance and monitoring. Privacy and security, and associated issues with information management and sharing, have gained prominence, and we expect this to continue.

### **The Government’s stated priorities**

- 1.6 The Government has set, and repeatedly confirmed, four priorities for its term:
- responsibly managing the Government’s finances;
  - building a more productive and competitive economy;
  - delivering better public services within tight fiscal constraints; and
  - supporting the rebuilding of Christchurch.

- 1.7 The Government has remained committed to posting a surplus in 2014/15 and to reducing its debt. In May 2013, the total Crown operating balance before gains and losses (sometimes called OBEGAL) was forecast to improve from a deficit of \$6.3 billion in 2012/13 to a deficit of \$2.0 billion in 2013/14.
- 1.8 The 2012 Budget outlined the Government's spending priorities and expectations for 2012/13 within the context of these financial constraints. Central government agencies were expected to implement significant new initiatives that covered health services, early childhood education, school funding to lift students' achievement, welfare reforms, new justice sector programmes, tertiary education initiatives, and social housing reform.
- 1.9 In support of the economy, the Government has also put a focus on investment in research and innovation. During the year, a number of thematic Business Growth Agenda progress reports set out how the Government intended to support businesses to deliver more and higher-paying jobs for New Zealanders.
- 1.10 Rebuilding Christchurch and support for Canterbury has continued to be a focus for the Government. The most recent estimate is that the Canterbury earthquake recovery will cost the Crown about \$14.9 billion.<sup>1</sup> The Economic Recovery Programme for Greater Christchurch, which was launched in December 2012, laid out a "roadmap" for economic recovery in the region. Public and private investment in 20 projects, identified as the most important for the recovery, was estimated at \$20 billion to \$30 billion.

### **Focus on reform – the Better Public Services programme**

- 1.11 The operating environment for government departments changed significantly in 2012/13 as a consequence of the Better Public Services (BPS) programme.
- 1.12 The BPS programme was launched by the Prime Minister in March 2012. The Government is expecting public entities to improve their service delivery and transform the way they operate. Major components include:
- a focus on results;
  - people-centred service design and delivery;
  - delivering effective spending and efficiencies; and
  - building capability to deliver services in the best way.

1 New Zealand Treasury, *Budget Policy Statement 2014*, page 11.

- 1.13 Three months after the launch, the Government announced specific outcomes that government departments were expected to achieve by 2017. The outcomes were focused on:
- reducing long-term welfare dependence;
  - supporting vulnerable children;
  - boosting skills and employment;
  - reducing crime; and
  - improving interaction with the Government.
- 1.14 In May 2012, Cabinet also made decisions about a range of institutional and governance matters related to the BPS programme. Amendments were made to the Public Finance Act 1989, the State Sector Act 1988, and the Crown Entities Act 2004, and they took effect in July 2013. The changes will affect how public entities covered by these Acts account for their performance.

### **Stronger guidance and monitoring from the centre**

- 1.15 The Treasury, the State Services Commission (SSC), and the Department of the Prime Minister and Cabinet (DPMC) aim to act as a “corporate centre”, to help ensure successful implementation of the BPS programme (and, more generally, overseeing public sector performance and improvements). A joint Treasury-SSC Performance Hub to carry out performance monitoring of the State sector<sup>2</sup> and provide advice on improving its performance was established in February 2013.
- 1.16 Also, Performance Improvement Framework (PIF) reviews of government departments are conducted to identify organisational strengths and areas for improvement. At least 26 PIF reviews or follow-up reviews were published in 2012 and 2013. An overview of insights from PIF reviews to date summarised best practice guidance and also drew attention to core weaknesses common to central government agencies, several of which were linked to efficiency.<sup>3</sup>
- 1.17 The Treasury also leads the “Optimise Finance” initiative to improve processes, enhance people capacity, and strengthen demand for better financial management in the State sector. The Department of Internal Affairs was the lead agency for a related initiative for human resources. The “Optimise HR” programme was a collaborative initiative by six agencies to develop shared human resource services. This has progressed to procurement of a common capability model. CRIs are also using a joint initiative – “Snaphire” – for recruitment.

<sup>2</sup> See the website of the State Services Commission ([www.ssc.govt.nz](http://www.ssc.govt.nz)) for *A guide to New Zealand's central government agencies*. There are many subsets of entities, and the terms used to describe the different groups of agencies are often similar (such as public service, State services, and State sector).

<sup>3</sup> State Services Commission (April 2013), *Core Guide 3: Getting to Great; Lead Reviewer insights from the Performance Improvement Framework*, Wellington.

## Continued focus on effectiveness and efficiency

- 1.18 Cabinet decided on 1 October 2012 to put in place functional leadership roles for information and communications technology (ICT), procurement, and property. According to one of the Cabinet papers, functional leadership is “aimed at securing economies or efficiencies across departments, improving services or service delivery, developing expertise and capability across the Public Service, and ensuring business continuity.”

### ICT – strong guidance from the centre

- 1.19 ICT functional leadership is exercised by the Government Chief Information Officer (GCIO). In June 2013, the Department of Internal Affairs published the *Government ICT Strategy and Action Plan to 2017*. The document emphasises the significance of ICT for transforming service delivery and outlines a programme of actions.
- 1.20 Also in 2013, Cabinet agreed to extend ICT functional leadership to ICT assurance. The GCIO has responsibility for co-ordinated oversight and delivery of system-wide ICT assurance. The assurance function was created after a number of security and privacy incidences at central government agencies in 2012/13 and a review of the Government’s ICT systems in December 2012. The review found that privacy and security processes within many agencies were under-developed and relied too much on the individual skills and capabilities of staff and suppliers.

### Procurement – an all-of-government approach

- 1.21 The reform of government procurement is intended to improve procurement capability and co-ordination and reduce cost. For example, all-of-government contracts establish a single supply agreement between the Crown and approved suppliers of selected goods and services. The contracts are intended to deliver a range of benefits, including saving costs to public entities and taxpayers and productivity gains for public entities and suppliers.
- 1.22 The first four all-of-government contracts started in July 2010 for office consumables, vehicles, laptop/desktop computers, and print devices. There are now all-of-government contracts for legal services, air travel, travel management, electricity, recruitment, advertising, and mobile voice and data services. The Ministry of Business, Innovation and Employment (MBIE) identified savings from the initiatives totalling \$92.6 million to September 2013. As at December 2013, the first four all-of-government contracts were taken up by between 67% and 95% of the 129 targeted agencies.

- 1.23 In March 2013, Cabinet directed MBIE to lead a three-year project called “Streamlined Contracting with NGOs”. The project aims to reduce variance in, and duplication of, contract management practices among central government agencies and reduce the compliance burden on non-governmental organisations.
- 1.24 There are other initiatives under way to change the approach to contracting between central government agencies and third parties. The Investment in Services for Outcomes initiative, led by the Ministry of Social Development, is designed to shift contracting with third parties from an output to an outcome basis.

### **Other measures to improve efficiency**

- 1.25 Many government departments’ four-year plans identify financial pressures, often linked to anticipated increases in personnel costs. Those pressures are also pushing the search for greater efficiencies, and some government departments are looking at significant changes to their business models.
- 1.26 There is a continued emphasis on reducing administration costs, building on the Better Administrative and Support Services initiative that was established in 2009. The initiative seeks to lower costs and strengthen the efficiency of State-sector administration and support services (such as finance, human resources, ICT, procurement, and corporate/executive services).

### **Structural changes**

- 1.27 Mergers and structural changes have been one means by which departments have sought to realise efficiencies and savings, although this tends to be only one of several objectives for amalgamations.
- 1.28 There have been several significant mergers in the past few years. The largest in 2012/13 was the creation in July 2012 of MBIE. MBIE brought together the functions of the previous Ministry of Economic Development, Ministry of Science and Innovation, Department of Labour, and Department of Building and Housing.
- 1.29 Mergers from previous years – such as the creation of the Ministry for Primary Industries (from the Ministry of Agriculture and Forestry, the Ministry of Fisheries, and the New Zealand Food Safety Authority) and the Department of Internal Affairs’ integration with the National Library and National Archives – continued to be a focus for the departments concerned. They are working to unify their operations, and some have made significant redundancy payments in recent years.

## Managing assets

- 1.30 In 2013, we published a report called *Managing public assets*. In it, we highlighted the importance of having and following asset management plans, understanding the need for maintenance and renewals, and of reporting to decision-makers about these matters.
- 1.31 Raising productivity in the public sector by better asset management is an important part of the Government's economic plan. The Crown owns \$110 billion of property, plant, and equipment.<sup>4</sup>
- 1.32 The Government has established a specialist infrastructure unit, the National Infrastructure Unit, within the Treasury. The Unit takes a national overview of infrastructure priorities – providing cross-government co-ordination, planning, and expertise.
- 1.33 The Unit's responsibilities include monitoring progress on a 20-year National Infrastructure Plan and establishing cross-government frameworks for appraising infrastructure projects and managing capital assets. The 2011 National Infrastructure Plan, released on 4 July 2011, provides a framework for infrastructure development, sets out guiding principles to respond to infrastructure challenges, and outlines a programme of action to drive change.

## Expectations of public entities' behaviour

### Stronger focus on system-wide stewardship

- 1.34 Changes to the State Sector Act 1988 include provisions that emphasise the concept of "stewardship" – the responsibility to look after the Crown's medium- and long-term interests, not just agencies' particular portfolio responsibilities. This means that chief executives will be expected to focus on performance throughout the State sector and on maximising their collective effect.

### Collaboration and sector leadership

- 1.35 There is an increasing expectation of sector-level co-ordination and collaboration to ensure that central government agencies jointly focus on planning, resourcing, and delivering sector outcomes. Examples of structures for sector leadership include:
- the Justice Sector Leadership Board and the Justice Sector Fund, a mechanism that allows the transfer of savings between agencies;
  - the Social Sector Forum, where the Ministry of Social Development's chief executive is mandated by Cabinet to lead the forum of relevant chief executives (including the chief executives of the Ministries of Health and Education); and

<sup>4</sup> As at 30 June 2013. *Investment Statement: Managing the Crown's Balance Sheet*, the Treasury, 26 March 2014, page 24.

- the Border Sector Governance Group, which shares the governance of border security matters.

- 1.36 There is a clear expectation that collaboration among central government agencies should support joined-up front-line services. An example is the cross-agency approach outlined in the 2012 White Paper for Vulnerable Children and associated Children's Action Plan, which envisages joint service delivery in New Zealand's regions.
- 1.37 Public entities in the science and innovation sector are expected to work closely together to optimise their effectiveness and be more efficient. Lincoln University and three CRIs (AgResearch Limited, Landcare Research (New Zealand) Limited, and New Zealand Institute for Plant and Food Research Limited) are working with DairyNZ Limited in developing a new "innovation hub" at Lincoln, while Callaghan Innovation is developing a high-value manufacturing sector innovation precinct at its Gracefield site in Lower Hutt.

### **More medium-term strategic planning**

- 1.38 Financial constraints have led to a greater emphasis on prioritisation. The preparation of four-year plans (known in 2012 as four-year Budget plans) has become an integral part of the annual budget process. Public entities are required to outline their medium-term priorities and spending intentions, resourcing needs, any funding gaps, and areas where they envisage efficiency gains.

### **Centralisation of planning but devolution of service delivery**

- 1.39 The trend to greater centralisation and more co-ordination in areas such as information technology and procurement exists alongside initiatives that devolve decision-making to the local and community level. A range of innovative approaches to working with communities are under way, including social sector trials and Whānau Ora, which have in common the intention that communities have greater influence on the provision of government services.





## Part 2

# Overview of the audit results

- 2.1 The Auditor-General is responsible for auditing all entities in the public sector. This supports Parliament’s function of holding public entities accountable for their performance, in accordance with Parliament’s intentions. Under the Public Audit Act 2001, our Office is required to audit and report the findings of those audits to Parliament.
- 2.2 This Part provides a summary of the audit results of the central government agencies, including the number and types of audit reports that we issued. The main distinction is between “standard” and “non-standard” audit reports. Appendix 1 contains an outline of the different types of audit report and how they are decided.
- 2.3 A standard audit report means that the auditor was able to obtain reasonable assurance that the audited information was free from material misstatement and presented in accordance with relevant accounting principles.
- 2.4 A non-standard audit report is one that contains a modified opinion and/or an “emphasis of matter” (or an “other matter”) paragraph.
- 2.5 A modified opinion indicates:
- a misstatement about the treatment or disclosure of a matter in the financial and/or service performance information; or
  - that the auditor was unable to obtain sufficient appropriate audit evidence to conclude that the financial and/or service performance information is free from material misstatement.
- 2.6 An “emphasis of matter” paragraph or “other matter” paragraph in the audit report indicates a matter that, although it may be appropriately presented or disclosed in the financial and service performance information, is considered to be sufficiently important that it is fundamental to a reader’s understanding of the information or the audit. In such instances, the auditor draws readers’ attention to matters such as fundamental uncertainties, breaches of law, or concerns about probity or financial prudence.

### Summary of audit reports issued

- 2.7 During the year ended 31 December 2013,<sup>5</sup> we issued 669 audit reports for central government agencies, excluding school boards of trustees (schools). Of these 669 audit reports, 557 reports (including the report on the Government’s financial statements) were standard and 112 were non-standard.

<sup>5</sup> Our audit reports were issued between 1 January and 31 December 2013. Most of these audit reports relate to 2012/13, except where we explain otherwise. We note where balance dates differ from 30 June.

## Financial Statements of the Government

- 2.8 We issued a standard audit report on the Government's financial statements, which we reported on in December 2013. In our 2011 and 2012 audit reports, we drew attention to the uncertainties arising from the Canterbury earthquakes with the inclusion of an "emphasis of matter" paragraph in our audit report. For 2013, we concluded that it was no longer necessary to include this paragraph.

## Audit results for government departments

- 2.9 Figure 1 summarises the number of standard and non-standard audit reports issued for government departments, the Student Loan Scheme, which is the subject of an audit that is separate from those of individual entities, and for the subsidiaries of government departments (which include trusts).

**Figure 1**  
**Government departments – number and type of audit reports issued during 2012/13**

	Number of standard audit reports issued	Number of non-standard audit reports issued
Government departments	34	3
Student Loan Scheme	1	0
Subsidiaries	21	2
<b>Total</b>	<b>56</b>	<b>5</b>

- 2.10 Of the 61 audit reports we issued, five were non-standard audit reports. Three of these were reports for government departments and two for government departments' subsidiaries.
- 2.11 We issued a qualified opinion on the Ministry of Health's service performance information. The Ministry relies on performance information from third parties and we could not obtain enough evidence to provide an audit opinion over many service performance measures (including some of the six key national health targets). The measures are reported by DHBs and aggregated in the Ministry's reporting. We could not get the assurance because the DHBs' annual reporting, and their respective audits, had not been completed when we completed our audit of the Ministry.
- 2.12 We also issued non-standard audit reports for two other government departments for 2012/13. The reports included unmodified opinions but

contained “emphasis of matter” paragraphs drawing attention to particular disclosures:

- by the Ministry of Education about matters arising from the new payroll service, Novopay; and
- by the Canterbury Earthquake Recovery Authority about uncertainties after the Canterbury earthquakes.

2.13 We reported last year that we had issued two modified (adverse) opinions for two trusts (which are a type of subsidiary) because of their failure to recognise and depreciate museum collection assets. We have again issued modified opinions for these trusts because the matters we raised in previous years have not been addressed.

## Audit results for Crown entities

2.14 Figures 2 to 9 summarise the types of audit reports we issued for different types of Crown entities. Crown entities comprise statutory entities (including DHBs), Crown entity subsidiaries, Crown entity companies (including CRIs), TEIs, and school boards of trustees. Given their specific business and sector focus, we have decided to separate DHBs, CRIs, and TEIs from “other Crown entities” (such as Crown agents and independent Crown entities). The results for school boards of trustees will be reported separately.

### District health boards

**Figure 2**

**District health boards – number and type of audit reports issued during 2012/13**

	Number of standard audit reports issued	Number of non-standard audit reports issued
District health boards	0	20
Subsidiaries	16	10
<b>Total</b>	<b>16</b>	<b>30</b>

2.15 We issued modified audit reports for all 20 DHBs, which included:

- unqualified opinions on each DHB’s financial statements; and
- qualified opinions on each DHB’s service performance information.

2.16 DHBs generally have limited controls over much of the performance information from third-party health providers, and we were not able to obtain the evidence needed to express an audit opinion on all the performance information reported by each DHB. This issue affected our audits of all DHBs and the Ministry of Health.

- 2.17 We also qualified our opinion on other performance information reported by Lakes District Health Board and Wairarapa District Health Board.
- 2.18 We will discuss the reasons why we qualified our audit opinions on the service performance reporting by DHBs and the Ministry of Health in a forthcoming report on the results of the 2012/13 audits of entities in the health sector.

### Crown research institutes

**Figure 3**  
Crown research institutes – number and type of audit reports issued during 2012/13

	Number of standard audit reports issued	Number of non-standard audit reports issued
Crown research institutes	7	0
Subsidiaries	24	2
<b>Total</b>	<b>31</b>	<b>2</b>

- 2.19 We issued two non-standard audit reports for two CRI subsidiaries for 2012/13. The reports included unmodified opinions but contained “emphasis of matter” paragraphs drawing attention to disclosures about:
- the disestablishment or expected disestablishment of Paraco Technology Limited (a subsidiary of AgResearch); and
  - the appropriate use of the going-concern assumption<sup>6</sup> for AgResearch (Meat Biologics Consortia) Limited.

### Tertiary education institutions

**Figure 4**  
Tertiary education institutions – number and type of audit reports issued during 2012/13

	Number of standard audit reports issued	Number of non-standard audit reports issued
Tertiary education institutions	27	2
Subsidiaries	93	21
<b>Total</b>	<b>120</b>	<b>23</b>

Note: The balance date for TEIs was 31 December 2012.

<sup>6</sup> The going-concern assumption means that financial statements are prepared assuming that the entity will continue to operate in the foreseeable future.

- 2.20 We issued non-standard audit reports for two TEIs and 21 TEI subsidiaries.
- 2.21 We issued an unmodified opinion for the University of Canterbury. We included an “emphasis of matter” paragraph in the audit report, drawing attention to disclosures outlining the effect of the Canterbury earthquakes and appropriate use of the going-concern assumption.
- 2.22 We issued an unmodified opinion for the University of Auckland. The audit report included an “emphasis of matter” paragraph drawing attention to disclosures outlining the accounting treatment used by the University for Partnerships for Excellence funding (see paragraph 3.16).
- 2.23 Of the 21 non-standard audit reports issued for TEI subsidiaries, 12 included unmodified opinions but contained “emphasis of matter” paragraphs drawing attention to disclosures about:
- uncertainties about using the going-concern assumption;
  - disestablishment or expected disestablishment; and
  - uncertainties in the valuation of investments.
- 2.24 We issued modified (qualified) opinions for nine TEI subsidiaries:
- We issued a qualified opinion for the New Zealand Vice-Chancellors Committee because the group financial statements were not consolidated with that of a subsidiary that the Committee controls.
  - We issued a qualified opinion for WaikatoLink Limited and Group for the years ended 31 December 2010 and 31 December 2011 because WaikatoLink and Group included unaudited financial information about its associate, ZyGEM Corporation Limited. The associate is not a public entity and it was uncertain when its audit would be completed.
  - We issued a qualified opinion for Massey Ventures Limited and Group because we could not verify that the financial information about the company’s associates was properly recorded and disclosed in the financial statements. These associates are not public entities and, as decided by their directors, are not audited.
  - We issued qualified opinions for Ivey Hall and Memorial Hall 125th Anniversary Appeal Gifting Trust Limited and Ivey Hall and Memorial Hall 125th Anniversary Appeal Taxable Activity Trust Limited for the years ended 30 June 2011 and 30 June 2012 because we could not get enough assurance about the completeness of revenue.
  - We also issued a qualified opinion for Te Tapuae O Rehua Limited for the year ended 31 December 2010 because we could not verify that expenditure was properly recorded or classified correctly (see paragraph 3.41).

## Other Crown entities

**Figure 5**  
Other Crown entities – number and type of audit reports issued during 2012/13

	Number of standard audit reports issued	Number of non-standard audit reports issued
Other Crown entities	62	4
Subsidiaries	73	4
<b>Total</b>	<b>135</b>	<b>8</b>

- 2.25 Of the 143 audit reports for other Crown entities, eight were non-standard. Seven included unmodified opinions but contained “emphasis of matter” paragraphs drawing attention to disclosures about:
- disestablishment or expected disestablishment;
  - uncertainties in the value of unlisted investments for New Zealand Venture Investment Fund Limited and Group and for a subsidiary of New Zealand Venture Investment Fund Limited;
  - uncertainty in the value of unlisted mortgage-backed securities for Public Trust; and
  - uncertainties in the outstanding claims liability after the Canterbury earthquakes and the appropriate use of the going-concern assumption for the Earthquake Commission.
- 2.26 We again issued a modified (qualified) opinion for the New Zealand Fire Service Commission. This is a consequence of industrial action a few years ago that has reduced the usefulness of comparative service performance information.

## Other central government entities

- 2.27 Figure 6 summarises our audit reports for other types of central government agencies, including those listed in Schedule 4 of the Public Finance Act 1989.

**Figure 6**  
Other central government agencies – number and type of audit reports issued during 2012/13

	Number of standard audit reports issued	Number of non-standard audit reports issued
Central government other*	58	28
Subsidiaries	16	0
<b>Total</b>	<b>74</b>	<b>28</b>

\* This group includes entities such as Air New Zealand, the Reserve Bank, the National Provident Fund, Producer Boards, and Health and Medical Councils.

- 2.28 The non-standard audit reports included “emphasis of matter” paragraphs drawing attention to disclosures outlining:
- the disestablishment or expected disestablishment of:
    - Ngai Tahu Ancillary Claims Trust;
    - Road Safety Trust; and
    - Learning State Limited;
  - uncertainties about the provision of secretariat and office functions in the future for 16 health regulatory entities and two secretariats;<sup>7</sup> and
  - uncertainties involved in estimating the insurance claims liability and reinsurance receivables for Southern Response Earthquake Services Limited.
- 2.29 Three audit reports included modified (qualified) opinions:
- Ngati Whakaue Education Endowment Trust Board, because the value of land was not recognised in a way that was in keeping with generally accepted accounting practice;
  - the Māori Trustee and Group, because we were unable to confirm the financial information of an associated company; and
  - New Zealand Māori Arts and Crafts Institute, because we could not get enough assurance that the comparative information about revenue was complete.

## Māori trust boards

**Figure 7**

**Māori trust boards – number and type of audit reports issued during 2012/13**

	Number of standard audit reports issued	Number of non-standard audit reports issued
Māori trust boards	6	6*
Subsidiaries	0	0
<b>Total</b>	<b>6</b>	<b>6</b>

\* This number includes four audit reports for a previous year.

- 2.30 We issued five audit reports that included “emphasis of matter” paragraphs drawing attention to disclosures outlining the disestablishment or expected disestablishment of:
- Aupouri Māori Trust Board and Group (for the four years ended 30 June 2008, 30 June 2009, 30 June 2010, and 30 June 2011); and
  - Tuhoe-Waikaremoana Māori Trust Board (for the year ended 31 March 2013).

7 Four audit reports were issued for 2012 for four of the 16 health regulatory entities discussed in this section.

- 2.31 For the Tuhoe-Waikaremoana Māori Trust Board (for the year ended 31 March 2012), our audit report included an “emphasis of matter” paragraph drawing attention to disclosures outlining the Board’s intention to significantly change the nature of its operations. The Board was proposing to transfer certain assets to a separate charitable trust.

### State-owned enterprises and entities with a mixed ownership model

**Figure 8**

**State-owned enterprises and entities with a mixed ownership model – number and type of audit reports issued during 2012/13**

	Number of standard audit reports issued	Number of non-standard audit reports issued
State-owned enterprises and entities with a mixed ownership model	15	3
Subsidiaries	89	7
<b>Total</b>	<b>104</b>	<b>10</b>

- 2.32 We issued non-standard audit reports for Solid Energy New Zealand Limited and its three subsidiaries:
- Solid Energy Land Holdings Limited;
  - Solid Energy Renewable Fuels Limited; and
  - Spring Creek Mining Company.
- 2.33 The reports included “emphasis of matter” paragraphs to draw attention to:
- the appropriate use of the going-concern assumption;
  - the group’s capital restructure agreed by its shareholder, the Crown, and some bank creditors after balance date; and
  - the assumptions used in the discounted cash flow projections for the Stockton mine.
- 2.34 We issued a non-standard audit report for Spring Creek Mine Holdings Limited. The “emphasis of matter” paragraph drew attention to:
- the group’s capital restructure agreed by its shareholder, the Crown, and a number of its principal bank creditors after balance date; and
  - the assumptions used in the discounted cash flow projections for the Stockton mine.



- 2.35 We issued a non-standard audit report for Biodiesel New Zealand Limited. The “emphasis of matter” paragraph drew attention to:
- the company appropriately not using the going-concern assumption;
  - the group’s capital restructure agreed by its shareholder, the Crown and some bank creditors after balance date; and
  - the key assumptions used in the discounted cash flow projections for the Stockton mine.
- 2.36 We issued three non-standard audit reports that included “emphasis of matter” paragraphs. The paragraphs drew attention to disclosures outlining the disestablishment or expected disestablishment of:
- Electricity Corporation of New Zealand;
  - Learning Media Limited and Group; and
  - Air Post Limited, a subsidiary of New Zealand Post Limited.
- 2.37 We issued a modified (qualified) opinion for New Zealand Post Recycle Centre Limited because we could not get enough assurance about the completeness of revenue information.

## Rural Education Activities Programmes

**Figure 9**

**Rural education activities programmes – number and type of audit reports issued during 2012/13**

	Number of standard audit reports issued	Number of non-standard audit reports issued
Rural Education Activities Programmes	14	0

- 2.38 We issued standard audit reports for each of the 14 Rural Education Activities Programmes.

## Detailed audit findings

- 2.39 The following Parts of this report contain a more detailed discussion of non-standard audit reports (Part 3) and of our audit findings for different groups of entities. We discuss non-standard audit reports for government departments in Part 5, for Crown entities in Part 6, and for CRIs, as a separate sub-category, in Part 7.

- 2.40 This report does not contain a detailed discussion of DHBs, either on their own or as part of Crown entities, because we will publish a separate report on entities in the health sector later in 2014. We will do the same for State-owned enterprises. We have already published a report focused on entities in the social sector (December 2013).

## Part 3

# Non-standard audit reports issued

3.1 In this Part, we detail the nature of the 112 non-standard audit reports that we issued during the year ended 31 December 2013.

### Unmodified opinions with “emphasis of matter” paragraphs

- 3.2 A standard audit report is issued when an auditor is able to reasonably conclude that the information is free from material misstatement and is presented in accordance with generally accepted accounting principles. It is not a guarantee that there are no misstatements present within the information, regardless of their size or significance. The opinion provides only reasonable assurance about the information that is within the scope of the engagement. It not indicative of a positive assessment of the entity’s overall activities.
- 3.3 An unmodified opinion with an “emphasis of matter” paragraph is used when the auditor is largely satisfied that the financial and service performance information is fairly reflected in the financial statements but the reader’s attention needs to be drawn to certain matters.
- 3.4 The following section summarises the matters that led to some public entities receiving audit reports that included unmodified opinions but also included “emphasis of matter” paragraphs.<sup>8</sup>

### Novopay

- 3.5 We drew attention to disclosures in the Ministry of Education’s financial statements about:
- the significant issues that arose when the new payroll service, Novopay, went live in August 2012;
  - the Ministry not achieving its service performance target for accurately calculating payments to teachers;
  - the uncertainty of a claim that has been lodged in the High Court alleging breach of statutory duty due to the Novopay service failures; and
  - the uncertainty about when and how much of the salary overpayments to teachers would be recovered.

### Canterbury earthquakes

- 3.6 We drew attention to disclosures about the effects of the Canterbury earthquakes that resulted in uncertainties involved in estimating the insurance claim liability of the Earthquake Commission (EQC).

<sup>8</sup> There were no “other matter” paragraphs included in the 2012/13 audit reports for central government agencies.

- 3.7 For EQC, we confirmed that, for the year ended 30 June 2013, the going-concern assumption had been appropriately used.
- 3.8 We drew attention to disclosures about the effects of the Canterbury earthquakes that resulted in uncertainties involved in estimating the insurance claims liability and reinsurance receivables for Southern Response Earthquake Services Limited.
- 3.9 We also drew attention to disclosures in Canterbury Earthquake Recovery Authority's financial statements about:
- the uncertainty associated with the Government's share of local authority costs in response to the earthquakes and its share for restoring local authority water infrastructure damaged by the earthquakes; and
  - the uncertainties involved in estimating the Government's offer to purchase properties in the Christchurch residential red zone.
- 3.10 We also drew attention to disclosures in the University of Canterbury's financial statements for the year ended 31 December 2012 about:
- the impairment estimates for buildings damaged in the earthquakes, the significance of the estimates, and the inherent uncertainties in the information on which the estimates have been based; and
  - the going-concern assumption being appropriately used in preparing the financial statements and the relevant factors that the Council considered.

### **Solid Energy New Zealand Limited's capital restructure and assumptions about coal prices**

- 3.11 We drew attention to disclosures in the financial statements for Solid Energy New Zealand Limited and its group about:
- the financial statements being prepared using the going-concern assumption;
  - the company and group restructuring its business and agreeing to a capital restructure with its shareholder, the Crown, and a number of its principal bank creditors (this happened after the balance date, and the final settlement and documentation were expected to be finalised during October 2013); and
  - the material uncertainty about future coal prices that will determine the group's ability to generate enough cash to repay or refinance its debt when that debt falls due. This uncertainty arises because of the assumptions used in the discounted cash flow projections for the Stockton mine and the sensitivity of that assumption.
- 3.12 We also drew attention to disclosures in the financial statements of the subsidiaries of Solid Energy New Zealand Limited about the financial statements

being appropriately prepared using the going-concern assumption. Some of the matters disclosed were about:

- the parent and group being able to fund the company and not require repayment until the company was able to do so;
- the company being a guarantor under a new capital restructure of the group, which was being challenged by one of the principal bank creditors; and
- the material uncertainty about future coal prices that would determine the group's ability, in the absence of selling assets, to generate enough cash to repay or refinance debt when it falls due.

3.13 The subsidiaries are:

- Solid Energy Land Holdings Limited;
- Solid Energy Renewable Fuels Limited; and
- Spring Creek Mining Company.

3.14 We also drew attention to disclosures in the financial statements of Biodiesel New Zealand Limited about:

- the financial statements being appropriately prepared not using the going-concern assumption because the parent company ceased operating during the year;
- a capital restructure (after the balance date) where the company is a guarantor and which is being challenged by one of the principal bank creditors; and
- the material uncertainty about future coal prices that would determine the group's ability, in the absence of selling assets, to generate enough cash to repay or refinance debt when it falls due.

3.15 We also drew attention to disclosures in the financial statements of Spring Creek Mine Holdings Limited about:

- a capital restructure (after the balance date) where the company is a guarantor and which was being challenged by one of the principal bank creditors; and
- the material uncertainty about future coal prices that would determine the group's ability, in the absence of selling assets, to generate enough cash to repay or refinance debt when it falls due.

### **Capital contributions from the Crown**

3.16 We drew attention to the accounting treatment used by the University of Auckland for Partnerships for Excellence funding. In our view, this funding should have been recognised as equity. (The Crown has an in-substance ownership interest in the University, and the University was given the funds as a capital contribution to increase the capability of the University.)

### **Uncertainties arising from, or from the prospect of, structural change**

- 3.17 Both planned and actual structural changes create uncertainties that need to be considered in reading the financial and service performance statements of the organisations undergoing change.
- 3.18 We drew attention to the uncertainties arising from structural changes or expected future changes for Tuhoe-Waikaremoana Māori Trust Board for the year ended 31 March 2012. We drew attention to the uncertainty about the outcome of a transfer of certain assets to a separate charitable trust, which depends on the Trust Board obtaining the approval of the High Court.
- 3.19 We included “emphasis of matter” paragraphs that drew attention to disclosures about the appropriate use of the going-concern assumption and an impending decision about the future of the company in the audit reports of:
- AgResearch (Meat Biologics Consortia) Limited (a subsidiary of AgResearch Limited) for the year ended 30 June 2013; and
  - Kiwi Innovation Network Limited (a consortium of universities and CRIs) for the year ended 31 December 2012.
- 3.20 In our audit reports for the 16 health regulatory authorities and the two secretariats in 2012/13, we drew attention to uncertainty about the delivery of office functions of authorities because of a proposal to combine their secretariats and office functions. We will discuss this further in our forthcoming report on audit results for the health sector.

### **Uncertainties over aspects of the entity’s obligations**

- 3.21 We drew attention to uncertainties about tax on the profits of New Zealand Institute of Highway Technology Limited (a subsidiary of Western Institute of Technology at Taranaki) for the year ended 31 December 2012. It was not clear whether the company was liable for income tax on its profits since 2008 and what the company was doing to remedy the situation.
- 3.22 We drew attention to the uncertainties faced by Polytechnics International New Zealand Limited for the year ended 31 December 2012. There was uncertainty about a contractual dispute over project costs and recoveries for a client in Saudi Arabia. The dispute might result in the company providing a performance bond in favour of this client.

## Not using the going-concern assumption to prepare financial statements

3.23 In a number of audits, we drew attention to the fact that entities had, appropriately, not used the going-concern assumption. Entities did this because they had been disestablished or were expected to be disestablished in the near future. The following public entities' audit reports included such an "emphasis of matter" paragraph:

- Paraco Technology Limited (a subsidiary of AgResearch Limited);
- Ngai Tahu Ancillary Claims Trust;
- Canterprise Nominees Limited (a subsidiary of University of Canterbury) for the year ended 31 December 2012;
- Canterprise Trustees (No. 2) Limited (a subsidiary of University of Canterbury) for the year ended 31 December 2012;
- Canterprise Trustees ArcActive Limited (a subsidiary of University of Canterbury) for the year ended 31 December 2012;
- iPredict Limited and Group (a subsidiary of Victoria University of Wellington) for the year ended 31 December 2012;
- Predictions Clearing Limited (a subsidiary of Victoria University of Wellington) for the year ended 31 December 2012;
- Unitec Recreation Trust (a trust controlled by Unitec Institute of Technology) for the year ended 31 December 2012;
- iLink Apps Limited (a subsidiary of University of Waikato) for the year ended 31 December 2012;
- South Island Shared Service Agency Limited (shared by Canterbury District Health Board, Nelson Marlborough District Health Board, South Canterbury District Health Board, and West Coast District Health Board) for the year ended 30 June 2013;
- District Health Boards New Zealand Incorporated for the year ended 30 June 2012;
- Manukau Health Trust (a trust controlled by the Counties Manukau District Health Board) for the year ended 30 June 2013;
- Aupouri Māori Trust Board and Group, for the years ended 30 June 2008, 30 June 2009, 30 June 2010, and 30 June 2011;
- Tuhoe-Waikaremoana Māori Trust Board for the year ended 31 March 2013;
- Road Safety Trust for the period ended 31 May 2013;
- Electricity Corporation of New Zealand;
- Learning State Limited (disestablished on 8 March 2013);

- Learning Media Limited and Group;
- Air Post Limited (a subsidiary of New Zealand Post Limited);
- Public Trust Group Investment Funds – Australian Equity Fund (No 8), New Zealand Cash Fund (No 9) and International Equity Fund (No 10) – for the year ended 15 March 2013;
- Public Trust Group Investment Funds – New Zealand and Australian Equities Investment Fund (No 67) and International Equities Investment Fund (No 68) – for the year ended 31 March 2013; and
- Balanced Income Funds (Public Trust Investment Fund No 13) for the year ended 31 March 2013.

### Uncertainties about the value of investments

- 3.24 Uncertainties about the value of unlisted investments can have a material (that is, big enough to make a difference worth noting) effect on the statement of financial performance and the statement of financial position.
- 3.25 For University of Otago Holdings Limited and Group and a subsidiary, Otago Innovation Limited and Group (all subsidiaries of Otago University), we included an “emphasis of matter” paragraph drawing attention to the uncertainties in measuring the fair value of investments. The uncertainties are to do with the forecast future cash flows of an investment.
- 3.26 For New Zealand Venture Investment Fund Limited and Group and for a subsidiary, NZVIF Investments Limited, we included an “emphasis of matter” paragraph drawing attention to the uncertainties in measuring the fair value of unlisted venture capital investments. These uncertainties could, in turn, create uncertainties about the carrying amount of related-party loans recorded in the parent entity’s financial statements.
- 3.27 For Public Trust and Group, we included an “emphasis of matter” paragraph drawing attention to the uncertainty in measuring the value of unlisted mortgaged backed securities due to the absence of an active, liquid market and quoted market prices. This uncertainty could have a material effect on the statement of profit and loss and statement of financial position.



## Modified opinions

### Adverse opinions

- 3.28 During 2013, we issued an adverse opinion for two public entities that did not recognise their museum collection assets nor the associated depreciation expense that is a requirement of generally accepted accounting practice. The two public entities were:
- Royal New Zealand Navy Museum Trust Incorporated; and
  - RNZAF Museum Trust Board.

### Qualified opinions

- 3.29 We also issued qualified opinions on the financial or the service performance information of 13 public entities.
- 3.30 A qualified opinion is issued if there is a disagreement with the treatment or disclosure of an issue in the financial statements or when we cannot get enough audit evidence about an issue.
- 3.31 We issued a qualified opinion on the Ministry of Health's statement of service performance for the year ended 30 June 2013 because we could not get enough assurance about some significant service performance measures (including the six national health targets) that were provided by the DHBs and are aggregated by the Ministry in its annual report. This was because no annual reporting by DHBs, nor their respective audits, had been completed at the time we completed our audit of the Ministry.
- 3.32 We issued a qualified opinion because we disagreed with the accounting treatment used by the New Zealand Vice Chancellors Committee for the year ended 30 June 2012. We disagreed with the Committee not preparing group financial statements to consolidate the financial statements of its controlled entity, the New Zealand Universities Academic Audit Unit.
- 3.33 We issued a qualified opinion because we disagreed with the accounting treatment used by Ngati Whakaue Education Endowment Trust Board (for the year ended 31 December 2012). We disagreed with how the Trust recognised the value of land because the accounting treatment departed from generally accepted accounting practice.
- 3.34 We issued a qualified opinion for Te Tumu Paeroa (the Māori Trustee and Group) for the year ended 31 March 2013 because we were unable to confirm the financial information for an associated company. This was because the associated company has a balance date of 31 July, which is three months after the Te Tumu

Paeroa balance date. The equity accounted financial statements for the associated company included unaudited information for the eight month period from 1 August 2011 to 31 March 2012.

- 3.35 We issued a qualified audit report for New Zealand Fire Service Commission, related to its comparative performance information. Industrial action by fire fighters in 2011 and 2012 meant that data was not collected for some performance measures. This affected the performance data reported for the year ended 30 June 2012, and the comparative performance data for the year ended 30 June 2013.
- 3.36 We issued a qualified audit report for Massey Ventures Limited and Group for the year ended 31 December 2012 because we could not verify that the financial information about the company's associates is properly recorded and disclosed in the financial statements. The associates, which are not public entities within the Auditor-General's mandate, are not audited. This was a decision made by the company's shareholders.
- 3.37 We issued a qualified audit report for WaikatoLink Limited and Group for the years ended 31 December 2010 and 31 December 2011 because we could not verify that the financial information about the company's associate, ZyGEM Corporation, for the years ended 31 March 2010 and 31 March 2011 is properly recorded and disclosed in the financial statements. The associate is not a public entity within the Auditor-General's mandate, and its audit is yet to be completed.
- 3.38 We issued a qualified audit report for Tairāwhiti Laundry Services Limited, which is a subsidiary of Tairāwhiti District Health Board, for the years ended 30 June 2009, 30 June 2010, 30 June 2011, and 30 June 2012. We could not get enough assurance about the completeness of the revenue of an associate of Tairāwhiti Laundry Services Limited or its investment in that associate.
- 3.39 We issued a qualified opinion for New Zealand Māori Arts and Craft Institute. Our audit was limited in relation to comparative information because, for the year ended 31 March 2012, we were unable to get assurance about completeness of revenue. The Institute implemented systems and procedures to provide assurance that its revenue was properly recorded for the year ended 31 March 2013.
- 3.40 We issued qualified opinions for the following entities because we could not get enough assurance to confirm that their revenue information was complete:
- New Zealand Post Recycle Centre Limited (a subsidiary of New Zealand Post Limited);

- Ivey Hall and Memorial Hall 125th Anniversary Appeal Gifting Trust (a trust controlled by Lincoln University);<sup>9</sup> and
- Ivey Hall and Memorial Hall 125th Anniversary Appeal Taxable Activity Trust (a trust controlled by Lincoln University).<sup>9</sup>

3.41 We issued a qualified opinion for Te Tapuae O Rehua Limited for the year ended 31 December 2010 because we could not get enough assurance about the completeness of expenditure information, including payroll information. The accounting records were in areas cordoned off and inaccessible after the Canterbury earthquakes.

**Reasons for the greater number of non-standard audit reports issued in 2012/13**

- 3.42 Overall, there has been an increase in non-standard audit reports issued in 2012/13 compared to 2011/12.
- 3.43 There has been a minor increase in the number of non-standard audit reports issued in the tertiary sector because some TEI subsidiaries were disestablished in 2012 or expected to be disestablished. We previously reported the audit results for TEIs and Rural Education Activities Programmes separately in an education report.
- 3.44 We issued non-standard audit reports for all DHBs as a result of limited assurance on performance information for the year ended 30 June 2013.
- 3.45 Within the overall increase, there was a decrease in the number of non-standard audit reports for some Crown entities, because there were fewer disestablishments during 2012/13.

<sup>9</sup> Audits for the years ended 31 December 2011 and 31 December 2012.



## Part 4

# Government departments' audit results

- 4.1 In this Part, we report on the audit results of government departments in 2012/13, including our assessments of their management control environments, financial information systems and controls, and service performance information and associated systems and controls.

### Audit reports for 2012/13

- 4.2 We audited 37 government departments in 2012/13, and issued 34 unmodified opinions for the year ended 30 June 2013.

### Observations and matters arising from the audits

- 4.3 During our audit work, we gain insights and perspectives on the various factors and challenges facing public entities and about the initiatives for responding to these and driving improvement. In this Part, we set out some of our observations and matters raised by auditors working with government departments.

### Restructuring and business transformations

- 4.4 A large number of government departments have undergone significant restructuring or business transformations in recent years. Restructuring and business transformations include:
- mergers of departments, such as the creation of the Ministry of Business, Innovation and Employment (MBIE) out of the former Department of Building and Housing, the Ministry of Economic Development, the Department of Labour, and the Ministry of Science and Innovation;
  - combining the back-office functions of more than one department into shared services, such as Central Agencies Shared Services (CASS), which provides finance, information systems, and human resources support to the Treasury, the SSC, and DPMC;
  - internal restructuring of departments to align with new business models, such as the Modernisation Programme conducted by the Ministry of Foreign Affairs and Trade (MFAT); and
  - the introduction of new systems and processes within a department, such as the new Joint Border Management System being implemented by the New Zealand Customs Service (Customs).
- 4.5 There are a number of risks associated with organisational restructure and business transformations. These include the risk of fraud, errors, and the loss of core capability. The areas we focused on during our 2012/13 audits included:
- ensuring that the entity has maintained an effective control environment,

which includes having robust internal controls and processes that are consistently applied, especially where there is loss of significant personnel or where there are changes in staff morale;

- ensuring that appropriate delegations are in place through the transition period;
- ensuring that there is appropriate management and execution of the change programme, including risk identification, management and reporting;
- reviewing severance, redundancy, and retention payments for any indication of waste and lack of probity or financial prudence; and
- ensuring that the implications of the restructure or business transformation are correctly treated in the financial statements, including any restructuring provisions.

4.6 Generally, we found that restructures and business transformations had been reasonably well managed by departments in ensuring that appropriate systems and controls were maintained during the change process.

4.7 The most significant restructure in 2012/13 was the formation of MBIE, established on 1 July 2012 by the merger of four departments:

- the Ministry of Economic Development;
- the Ministry of Science and Innovation;
- the Department of Labour; and
- the Department of Building and Housing.

4.8 Our audit of the first year of operations for MBIE found that a number of issues needed to be addressed. We assessed MBIE's management control environment, financial information systems and controls, and service performance information and associated systems and controls as "Needs improvement".

4.9 Many of these issues are attributable to the speed of the merger, which meant that MBIE used the underlying systems and controls from the four legacy departments rather than having one coherent and consistent system. Having consistent policies and procedures is important for maintaining an effective control environment, and MBIE is committed to making the changes required to address these issues.

4.10 Restructuring and business transformations are generally intended to either improve service delivery or produce savings. Departments need to ensure that the outcomes from restructures and business transformations can be measured through robust systems that allow for timely and accurate reporting.

## Governance and accountability

- 4.11 Governance and accountability arrangements are important to the decision-making and risk management processes of an entity. Weaknesses in governance and accountability systems can result in a breakdown in systems and controls, an increase in the risk of fraud, and expose the entity to significant reputational risk. Maintaining strong governance and accountability systems is particularly important during times of significant structural change and transformation, which many departments are currently experiencing.
- 4.12 Risk management is an essential part of good governance and accountability. Good risk management policies and procedures help departments identify the risky areas and develop an appropriate approach to mitigating the risks. We found that many departments need to reassess and formalise their risk management policies, which includes the process for reporting risks to management.
- 4.13 In 2008, we produced a good practice guide, *Audit Committees in the Public Sector*, on the benefits of audit and risk committees for good governance and accountability. Accountability for good governance in a department lies with the chief executive, but audit and risk committees can provide independent advice on strategic, performance, assurance, and compliance matters. We continue to recommend that departments consider whether an audit and risk committee would help with their governance and accountability.
- 4.14 Governance and accountability will be a focus for us during 2014/15. This will involve understanding the strengths and weaknesses of governance arrangements and accountability systems within government departments, including systems and processes that support good decision-making, delegations of authority, and risk-management processes.

## Security and privacy issues

- 4.15 There were several high-profile security and privacy issues in the public sector in 2012/13. Auditors have found that, in general, security and privacy policies in departments are not well developed.
- 4.16 Through the Better Public Services programme, the Government wants to see an improvement in the way New Zealanders interact with the Government by increasing the number of transactions that can be completed in a digital environment. It is within this context that departments are moving more information into the digital environment – but this comes with significant risks to information security. We have found that many government departments have poor password settings and password policies, which are an important control for information security.

- 4.17 Part 8 contains more commentary on security and privacy issues – it sets out our observations from information systems work carried out as part of our annual audits.

### **Asset management**

- 4.18 The size and level of investment in assets is significant to the Financial Statements of the Government. (The Crown owns \$110 billion of property, plant, and equipment.) We found that there is scope to improve asset management policies and practices in the public sector.
- 4.19 In June 2013, we published *Managing Public Assets*. We reported that, for many public entities, asset condition was not being regularly reported to decision-makers. Good information about assets and future asset needs is essential for managing maintenance and renewal needs and future asset investments.
- 4.20 Financial constraints in the public sector have put pressure on departments' ability to ensure that assets are well maintained – even though maintaining assets is essential to departments' service delivery. For example, the New Zealand Defence Force needs to manage risks that have arisen from deferred maintenance, compounded by tight financial pressures. We understand that the New Zealand Defence Force now has a plan in place to deal with this.
- 4.21 We will continue to monitor asset management during 2013/14 and encourage good asset management practice in government departments and in the public sector generally.

### **Procurement and contract management**

- 4.22 With financial constraints and a focus on better public services and value for money, procurement continues to be an area of audit interest.
- 4.23 The quality of procurement practices continues to vary in government departments. There is progress towards improving procurement practices, but there is still room for improvement. Examples of progress include:
- The Inland Revenue Department has made good progress in adopting recommendations made by an external reviewer in 2010, with increased procurement capability and capacity, a new procurement policy, and the development of a new contract management system.
  - The New Zealand Defence Force commissioned a comprehensive review of the effectiveness and maturity of its procurement process and has prepared a plan to address the issues identified.
  - The Ministry of Justice has established a National Procurement Team to provide policy advice and lead the procurement strategy. The team is new and yet to



prepare a procurement framework and plan but the introduction of the team and focus is encouraging.

- 4.24 An issue for some departments has been consistently applying procurement processes. For example, testing performed at the Ministry of Social Development found examples of excellent procurement record-keeping for some projects but also found some inconsistency in record-keeping, and that it was not always evident how a process had been carried out. The Ministry intends to improve its processes, which will include updating its procurement manual and providing better training.
- 4.25 The Ministry of Defence has a significant procurement function in purchasing large items of specialist military equipment for the New Zealand Defence Force. Although its procurement systems are sound and its procurement employees competent, our review of its procurement function found that it was lean on staff, considering the scale and value of procurement carried out. This is not uncommon – other government departments have a shortage of skilled and experienced procurement practitioners and under-resourced procurement functions. MFAT has implemented the recommendations of a procurement review, which has included recruiting procurement specialists to support its procurement function.
- 4.26 As part of our 2012/13 work programme, we carried out a performance audit to examine how effectively and efficiently the Canterbury Earthquake Recovery Authority (CERA), New Zealand Transport Agency, and the Christchurch City Council are managing to rebuild Christchurch's horizontal infrastructure through the Stronger Christchurch Infrastructure Rebuild Team (SCIRT). We found that the operational design of SCIRT created efficiencies that facilitated good oversight and reduced costs. SCIRT had a consistent approach to pricing, sound risk management, and used the collective experience and expertise of the various entities that make up SCIRT.<sup>10</sup>
- 4.27 We also carried out an inquiry into the Government's decision to negotiate with SkyCity Entertainment Group Limited for an international convention centre. The inquiry highlighted the importance of having sound procedures and policies for procurement, and the requirement for good documentation to support decisions. Although there was no evidence that the final decision to negotiate with SkyCity was influenced by any inappropriate considerations, the quality of support by MBIE for decisions fell short of what we would expect, especially considering that it is the lead government department on procurement and commercial matters.<sup>11</sup>

10 Controller and Auditor-General (2013), *Effectiveness and efficiency of arrangements to repair pipes and roads in Christchurch*, Wellington.

11 Controller and Auditor-General (2013), *Inquiry into the Government's decision to negotiate with SkyCity Entertainment Group Limited for an international convention centre*, Wellington.

- 4.28 A public-private partnership (PPP) is a form of procurement that some public entities use as an alternative to traditional methods of procurement. The Department of Corrections is using a PPP for the construction of Wiri Prison. Our auditors noted that accounting for this asset is complex, and encouraged the Department to review and confirm the accounting treatment for the recognition of the Prison asset and liability during and after its construction, the borrowing costs relating to the liability, and unitary payments on the contract.
- 4.29 The New Zealand Transport Agency has received support from the Government to proceed with a PPP for construction of the Transmission Gully section of the Wellington Northern Corridor. Although this is still in the early stages of procurement, our auditors will continue to monitor this to ensure that there is strong project management and that the project is correctly accounted for.

### Service performance reporting

- 4.30 Performance reporting is an integral part of our parliamentary accountability system. It enables Parliament to hold ministers and departments to account, and allows Parliament and the public to assess the performance of departments and how effectively they have used public funds.
- 4.31 We continue to see improvements in the quality of departments' performance reports. Paragraphs 4.43 to 4.46 set out more information on the service performance information and associated systems and control assessment for government departments.
- 4.32 There are a number of common reporting issues that we have identified from our audits. These include:
- Clarity and specificity of measures and targets. For example, we noted that CERA needed to improve its measures and targets so that it is clear on "what we will do, why we will do it, when we will do it, how we will do it". This includes the need to provide clear definitions for certain terms, to ensure that they can be easily understood.
  - The need to rationalise measures to make the reporting on performance useful to the reader. For example, MBIE has a complex vote structure, which had led to it creating many measures. We recommended that MBIE rationalise its measures and focus on important ones, such as quality. We also found that the Ministry of Education has too many measures, which diminish their value to the reader.

- Having robust systems and controls to ensure that performance data is accurate and complete. For example, we recommended that MFAT continue to improve its business processes and information systems, to ensure that service performance results can be reported through a systematic process rather than requiring manual collection and collation.

4.33 The Ministry of Social Development is moving towards contracting with third parties to achieve outcomes, rather than just producing outputs. The aim is to bring together multiple funding agreements into one document and create a “whole-of-Ministry” way of thinking. We will continue to monitor progress on contracting for outcomes.

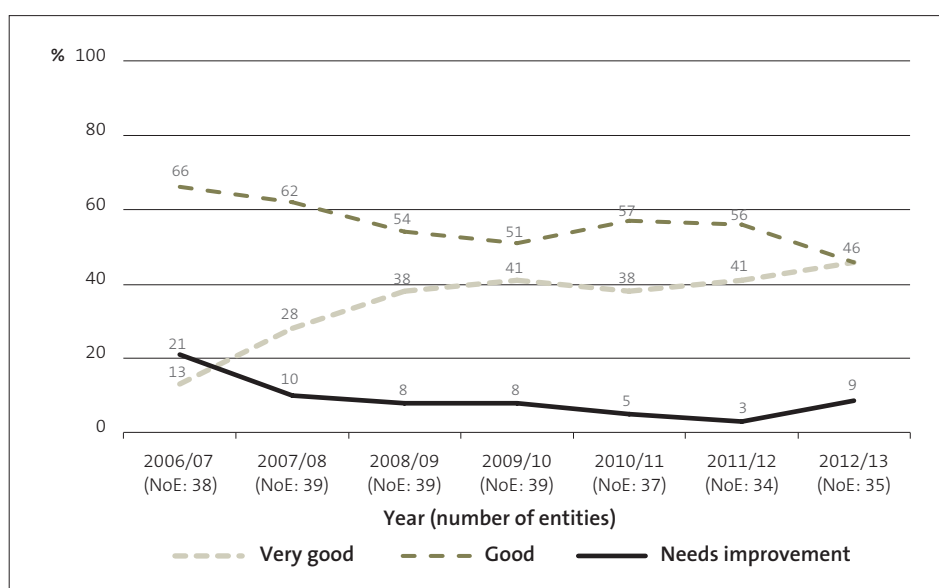
4.34 Amendments to the Public Finance Act 1989 were passed in July 2013. The amendments give greater reporting flexibility to government departments for reporting on service performance, such as removing the need to define performance in terms of outcomes, impacts, and outputs, and to encourage reporting as a sector on common goals. These amendments come into force on 1 July 2014, and we will be working with the Treasury and other government departments to help them with this transition.

### **Environment, systems, and controls**

4.35 We assessed and graded the environment, systems, and controls for managing and reporting financial and service performance information for 35 government departments in 2012/13. The summary excludes the assessments for both the Government Communications Security Bureau and the New Zealand Security Intelligence Service. We explain the grading scale in Appendix 2.

## Management control environment

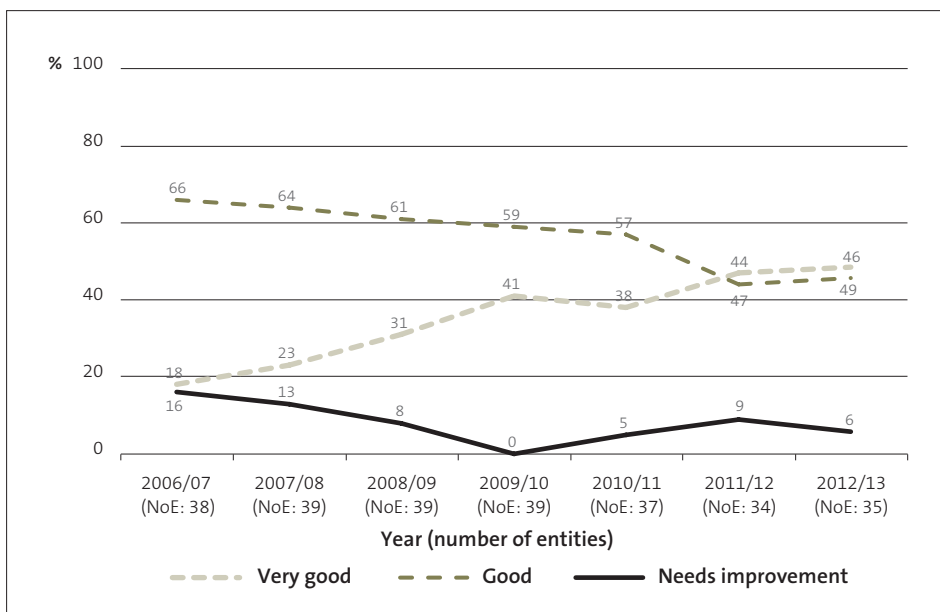
**Figure 10**  
Government departments – grades for management control environment, 2006/07 to 2012/13



- 4.36 The overall trend for government departments is positive. Generally, departments are maintaining good management control environments (see Figure 10), especially those experiencing significant changes in organisational structure and strategy. The Ministry of Women's Affairs improved from "Good" to "Very good". Statistics New Zealand also improved its grade after implementing a business continuity plan and improving its asset management planning.
- 4.37 Although the trend is positive, there has been an increase in the percentage of entities with "Needs improvement" grades:
- MBIE – 2012/13 was the first year of operation for MBIE. This assessment reflects the transitional state of its systems and processes, particularly as it looks to prepare consistent policies.
  - Te Puni Kōkiri (the Ministry of Māori Development, or TPK) – TPK was undergoing a strategic review at the time of the audit, which affected the Ministry's ability to set a meaningful performance framework. This is a downgrade from "Good" in 2011/12.
  - CERA – Improvements have been made on 2011/12 but more improvements need to be made, including improvements to the management of information systems.

### Financial information systems and controls

**Figure 11**  
**Government departments – grades for financial information systems and controls, 2006/07 to 2012/13**



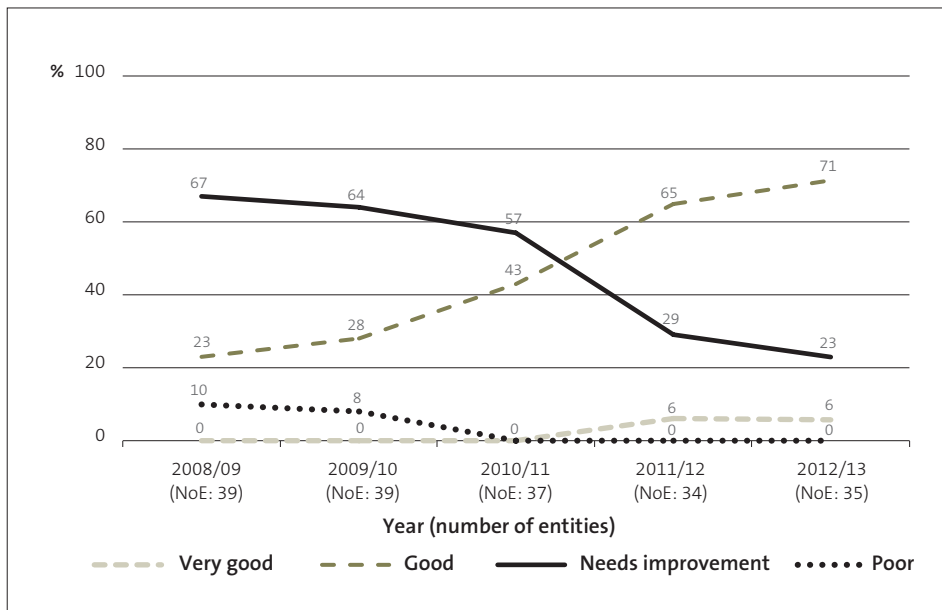
- 4.38 As Figure 11 shows, 2012/13 saw a significant improvement in our assessment of government departments' financial information systems and controls.
- 4.39 The SSC and Customs have improved from "Good" to "Very good". The SSC has increased its grade as a result of improvements to reporting and budgeting processes and appropriate financial training for managers. The New Zealand Defence Force and Parliamentary Service also improved their grade in 2012/13 from "Needs improvement" to "Good". Although these entities require additional improvements to their financial systems and controls, this grade shows that they are resolving system deficiencies identified in previous periods.
- 4.40 MBIE has been assessed as "Needs improvement" in its first year of operation. This grade reflects the difficulty of merging four systems, inherited from the four departments that became MBIE, into one coherent and consistent system.
- 4.41 The Ministry of Education was downgraded from "Good" to "Needs improvement" in 2012/13. The primary reason for this is the significant issues with the new payroll service, which has resulted in inaccurate payments.

4.42 TPK's grade moved from "Very good" to "Good". This was as a result of difficulties in delivering good quality and timely financial information for the audit.

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

4.43 Figure 12 shows the results of our assessment of departments' service performance information and associated systems and controls during the past five years.

**Figure 12**  
**Government departments – grades for service performance information and associated systems and controls, 2008/09 to 2012/13**



4.44 The Inland Revenue Department and the Ministry for the Environment maintained the grade of "Very good" that they achieved in 2011/12 (the first departments to achieve this grade). Inland Revenue had strong links between all levels of its performance measurement framework, resulting in clear and logical reporting.

4.45 MBIE was graded as "Needs improvement", reflecting its first year of operations. MBIE has a large number of votes, which makes its reporting complicated and administratively demanding. We recommended that it rationalise this complex vote structure and the performance measures, focusing on the measures that target quality.

- 4.46 The Ministry for Culture and Heritage, Office of the Clerk of the House of Representatives, and Parliamentary Service all improved from “Needs improvement” to “Good”. It is pleasing to see that departments were continuing to work on their performance measurement frameworks and reporting in 2012/13.





## Part 5

# Crown entities' audit results

- 5.1 In this Part, we report on the audit reports issued for Crown entities in 2012/13.
- 5.2 During our audit work, we gain insights and perspectives about the various factors and challenges facing public entities and about the initiatives being advanced to respond to these and drive improvement. This Part also sets out some of our observations and matters raised by auditors working with Crown entities.
- 5.3 Technically, schools and DHBs are also Crown entities, but we do not discuss them in any depth here. We are publishing reports later this year that will set out the audit results for these types of entities.<sup>12</sup> Also, we do not comment here on the results of the 2012/13 audits for subsidiaries of Crown entities, other than to note the non-standard reports that we issued.

### About Crown entities

- 5.4 There are more than 2700 Crown entities, including 2486 school boards of trustees. Crown entities have a wide range of roles, functions, and responsibilities and different degrees of autonomy. By law, the Auditor-General is the auditor of all Crown entities and their subsidiaries.
- 5.5 The Crown Entities Act 2004 provides a framework for the establishment, governance, accountability, and operation of Crown entities.<sup>13</sup> It sets out five categories of Crown entities:
- statutory entities:
    - Crown agents, such as the Accident Compensation Corporation and DHBs;
    - autonomous Crown entities, such as the Standards Council of New Zealand and the New Zealand Symphony Orchestra; and
    - independent Crown entities, such as the Law Commission;
  - Crown entity companies, including Television New Zealand and CRIs;
  - Crown entity subsidiaries;
  - school boards of trustees; and
  - TEIs (polytechnics, universities, and wānanga).
- 5.6 In July 2013, significant amendments to the Crown Entities Act were passed into law. The amendments aim to improve collaboration in the public sector by encouraging entities to work together to achieve the Government's priorities. It also changes requirements for accountability documents and service performance reporting.

<sup>12</sup> For the results of our audits of other entities, see our forthcoming reports on the audit results for the health sector, for schools, and for State-owned enterprises.

<sup>13</sup> Many Crown entities also have their own enabling legislation.

## Audit reports for 2012/13

- 5.7 For the Crown entities included in this report, we issued 102 audit reports. Of those, the reports for six Crown entities were non-standard audit reports (see Figure 13).

**Figure 13**  
**Number of standard and non-standard audit reports issued, by type of Crown entity, for 2012/13**

	Standard audit reports	Non-standard audit reports
Crown research institutes	7	0
Tertiary education institutions	27	2
Crown entities (other)	62	4
<b>Total</b>	<b>96</b>	<b>6</b>

- 5.8 We used “Emphasis of matter” paragraphs (see Part 4) to draw readers’ attention to:
- disclosures about the disestablishment or pending disestablishment of entities;
  - uncertainties about measuring the fair value of unlisted venture capital investments;
  - uncertainties about measuring the value of unlisted mortgage-backed securities; and
  - the appropriate use of the going-concern assumption for EQC and uncertainties relating to the calculation of the outstanding claims liability from the Canterbury earthquakes.
- 5.9 We also audit a number of Crown entity subsidiaries. Our audits drew attention to the disestablishment of some of the Public Trust’s controlled nominee companies. They also drew attention to uncertainties in measuring the fair value of unlisted venture capital investments for the New Zealand Venture Investment Fund Limited and subsidiaries.

## Observations and matters arising from the audits

- 5.10 In the last two years, some Crown entities have received a high level of media coverage and public interest about security and privacy breaches. When an internal spreadsheet with Canterbury earthquake claims progress and personal details was mistakenly sent by an EQC employee to an external person in March

2013, it highlighted the growing importance of security in a digital environment. This followed the accidental release of claimant details by the Accident Compensation Corporation in 2011.

- 5.11 The increasing trend to more online delivery of government services comes with significant risk to protecting sensitive information. Some Crown entities had poor password settings, while others needed to improve their policies for user access to key information management systems. A recent PricewaterhouseCoopers report, *The Global State of Information Security 2014*, highlights that information security is an issue facing entities world-wide, stressing the importance of having effective security strategies and policies.
- 5.12 We have provided further commentary on security and privacy issues in Part 8, where we describe our observations from information systems audits carried out as part of our annual audits.

### Structural and organisational change

- 5.13 An ongoing theme for Crown entities is structural and organisational change. Examples of this include:
- shared services (the merging of back-office functions such as financial services, human resources and information technology);
  - the expansion of an entity's functions;
  - creating one entity out of several disestablished entities;
  - the introduction of new business processes; and
  - internal restructuring by disestablishing and creating new positions to align with new business strategies.
- 5.14 The Civil Aviation Authority and the Aviation Security Service underwent a change programme called "One Organisation", with the intent of creating a single organisation with two legislative responsibilities. This has seen their back-office services combined into shared services, along with structural changes and operational reviews of their regulatory functions. The New Zealand Productivity Commission is another Crown entity in a shared services agreement, with its core corporate support services provided by Inland Revenue. We encourage entities in shared service arrangements to agree the nature of their relationship and the services to be delivered, to ensure that sharing services provides value for money.
- 5.15 The Health Promotion Agency is a new Crown entity, established on 1 July 2012. It has taken over the functions of Alcohol Advisory Council, Health Sponsorship Council, and some health promotion functions previously delivered by the Ministry of Health. With any new entity there is a risk of an ineffective control

environment, which can lead to fraud or error. The Health Promotion Agency has managed the change period well, developing a new governance and management structure to support its new identity and brand. It had an effective change management programme that prioritised the review and alignment of policies and processes. The Health Promotion Agency received a “Very good” grade when we assessed its management control environment.

- 5.16 Although most organisational change and restructuring is a result of financial pressure, two Crown entities are changing as a result of expansion and increased funding:
- The Pharmaceutical Management Agency (Pharmac) increased its role to incorporate managing the national immunisation schedule and establishing the national hospital medicines list. No negative effects from the expansion of functions were found, although we encouraged Pharmac to review its performance framework to ensure that it captures the new responsibilities.
  - Education New Zealand is expanding its functions as it matures, and its total revenue for 2012/13 was \$11.7 million higher than for 2011/12. We encouraged Education New Zealand to closely monitor how this expansion will affect its operational capacity and to plan effectively to mitigate any risks from this.
- 5.17 Generally, we found that organisational change and restructuring had been well managed by Crown entities, with no significant issues arising. However, there will be further organisational change and restructuring. Managers and auditors will need to remain alert to a number of unintended adverse effects caused by these changes, such as risks to the internal control environment, disgruntled staff, and the effect on organisational capability, which can reduce an entity's ability to achieve its major outcomes.

### **Governance and accountability**

- 5.18 In times of significant organisational and environmental change, maintaining strong governance and accountability systems is important. Strong governance and accountability arrangements improve the decision-making and risk management processes of an entity. Weaknesses in governance and accountability can cause a breakdown in systems and controls, an increase in the risk of fraud, and expose the entity to significant reputational risk.
- 5.19 Having appropriate policies and procedures is essential for good governance and accountability. This year, Education New Zealand prepared its finance and administration policies and had them independently reviewed to ensure that they were appropriate and reflected good practice. It is also implementing an internal

assurance programme, which will help improve its governance and accountability arrangements. We commend Education New Zealand on these improvements, and note that it went from “Needs improvement” grades in 2011/12 to “Good” grades for 2012/13.

- 5.20 The Museum of New Zealand Te Papa Tongarewa (Te Papa) has experienced change in senior management roles and at the board level, including a new board chairperson. There are risks to the internal control environment with these changes. However, the changes also provide Te Papa with an opportunity to improve on its management control environment, especially by improving the quality of internal reporting to support senior management and board decision-making.
- 5.21 We continue to encourage Crown entities to consider audit and risk committees. We produced a good practice guide, *Audit Committees in the Public Sector*, in 2008, which highlights the benefits of audit and risk committees. Those benefits include strong accountability and independent advice on strategic, performance, assurance, and compliance matters. For example, Te Māngai Pāho has established an audit and risk committee this year, but needs to set up an annual work plan for the committee.
- 5.22 Governance and accountability will be a focus for our work in 2014/15. This will involve understanding the strengths and weaknesses of governance arrangements and accountability systems within entities, including systems and processes that support good decision-making, delegations of authority, and risk management processes.

### Service performance reporting

- 5.23 Performance reporting is an essential part of public sector accountability for Crown entities, just as it is for government departments. It allows Parliament and the public to assess the performance of Crown entities and ensure that they are using public funds effectively to provide the services they have been established to provide.
- 5.24 Appointed Auditors will modify their audit opinion if the performance information in the annual report does not, in their opinion, fairly reflect the Crown entity's performance for the year.
- 5.25 In general, Crown entities are improving the quality of their performance reports. Paragraphs 5.46 to 5.47 set out more information on the service performance information and associated systems and control assessment for Crown entities.

5.26 Some common issues were highlighted during the audits of Crown entities. These common reporting issues were:

- The clarity and specificity of measures. In particular, many Crown entities were not providing enough context for their measures, which includes having relevant comparative and trend information. We recommended that both Sport New Zealand and the Health Quality and Safety Commission consider introducing international comparative information to give a clearer picture of their performance. Being clear with measures also includes providing specific definitions for words that may help the reader of the annual report understand what is being measured.
- A number of Crown entities have overly complex performance frameworks that need to be refined so that they are better balanced, more concise, and accurate. For example, Maritime New Zealand's performance framework includes outcomes, intermediate outcomes, strategic objectives, impacts, and outputs. While we assessed the overall framework and associated performance information as good, a simpler framework would be easier for the reader to understand and for Maritime New Zealand to administer.
- There is a general need for systems and controls to be strengthened so that they support the accuracy and completeness of performance data. This includes having an appropriate audit trail to allow us to verify the reported performance. For example, we recommended that EQC implement stronger controls over the information supporting output figures, including a review by management of the underlying data.

5.27 We have also encouraged Crown entities to use performance information as an internal reporting tool, not just as a compliance exercise at the end of the financial year. If a performance measure or target is useful to an external reader of the annual report, then it should be important to management for monitoring the entity's performance. Internal reporting of performance measures allows the entity to support decision-making and "fine-tune" its performance to meet targets and achieve outcomes.

5.28 Amendments to the Crown Entities Act 2004 were passed in July 2013. The amendments give greater reporting flexibility to Crown entities for reporting on service performance, such as removing the need to define performance in terms of outcomes, impacts, and outputs, and to encourage reporting as a sector on common goals. These amendments come into force on 1 July 2014, and we will be working with the Treasury and the Crown entities to help with this transition.

## Financial sustainability

- 5.29 Crown entities continue to deal with issues of long-term financial viability and sustainability, especially in the context of static funding and changing demands.
- 5.30 The New Zealand Blood Service (the Blood Service) and the Office of Film and Literature Classification (OFLC) are being challenged by a decrease in demand for their services. The Blood Service is grappling with this decrease while redeveloping major facilities in Auckland and Christchurch and minimising price increases for DHBs. Similarly, OFLC is receiving significantly fewer submissions from the Film and Video Labelling Body Incorporated, which directly affects OFLC's revenue. Both entities are actively managing these challenges and we will continue to monitor their performance.
- 5.31 Financial pressure can also come when demand increases but funding remains static. The Office of the Privacy Commissioner's funding has remained static for a number of years despite increasing demand. In this instance, the Office of the Privacy Commissioner has managed the growth in demand and largely maintained service performance standards.

## Tertiary education institutions

- 5.32 The main themes and/or risks that our auditors identified and focused on during the 2012 audits of TEIs were:
- financial viability, sustainability, and reputational risk, in particular how revenue diversification, cost, and performance pressures affected service delivery and reputation;
  - improvements to service performance reporting;
  - capital asset expansion, in particular, procurement, project management and cost control, finance, and sustainability;
  - governance and management of subsidiaries; and,
  - for some affected TEIs, accounting for the Canterbury earthquakes.
- 5.33 We will continue to focus on this same range of themes in our 2013 audits of TEIs.

## Our reporting on service performance

- 5.34 In December 2013, we sent out to TEIs and published on our website a document entitled *Continuing to improve how you report on your TEI's service performance*.<sup>14</sup> This document noted that, although there was a range in quality and scope, there was an encouraging and positive trend toward improvement in service performance reporting. Good points included:
- the gradual broadening of reporting to include all dimensions of the TEI's

<sup>14</sup> See [www.oag.govt.nz/2013/tei-reporting](http://www.oag.govt.nz/2013/tei-reporting).

services, beyond the mandatory reporting against Educational Performance Indicators; and

- management teams' and governance bodies' increased ownership of performance information.

### Improving governance and management of subsidiaries

- 5.35 In December 2012, our report entitled *Education sector: Results of the 2011 audits* was presented to Parliament. Part 4 of that report noted our views about the need to improve assessment of the business need for, and reporting on, subsidiaries. We are aware that the Ministry of Education and the Tertiary Education Commission are considering these issues.

### Environment, systems, and controls

- 5.36 In this section, we discuss our assessment and grading of the environment, systems, and controls for managing and reporting financial information for 63 Crown entities and service performance information for 61 Crown entities in 2012/13.<sup>15</sup> We discuss the grades for CRIs in Part 6, and the grading scale in Appendix 2.
- 5.37 Two new Crown entities were assessed for the first time:
- Health Promotion Agency, which received grades of “Very good” for its management control environment and “Good” for its financial information systems and controls and service performance information and associated systems and controls; and
  - Callaghan Innovation, which was assessed on its management control environment (“Very good”) and its financial information systems and controls (“Very good”).

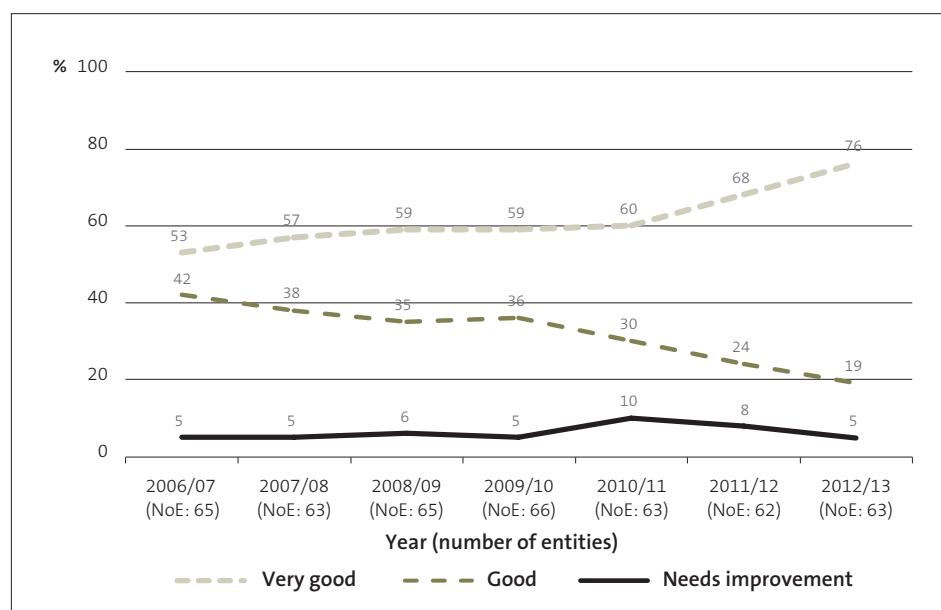
### Management control environment

- 5.38 Figure 14 shows the results of our assessment of Crown entities' management control environment from 2006/07 to 2012/13. The trend in the last three years is positive, with a significant increase in the number of Crown entities with a grade of “Very good”. Of the 63 Crown entities, 48 (76%) were assessed as having “Very good” management control environments, with another 12 (19%) graded as “Good”.

<sup>15</sup> The Standards Council of New Zealand does not prepare a statement of service performance because it has a reporting exemption under section 143 of the Crown Entities Act 2004. We did not assess the service performance information and associated systems and controls for Callaghan Innovation because it was transitioning from the reporting requirements of a former CRI to those of a non-CRI Crown entity.



**Figure 14**  
**Crown entities – grades for management control environment, 2006/07 to 2012/13**

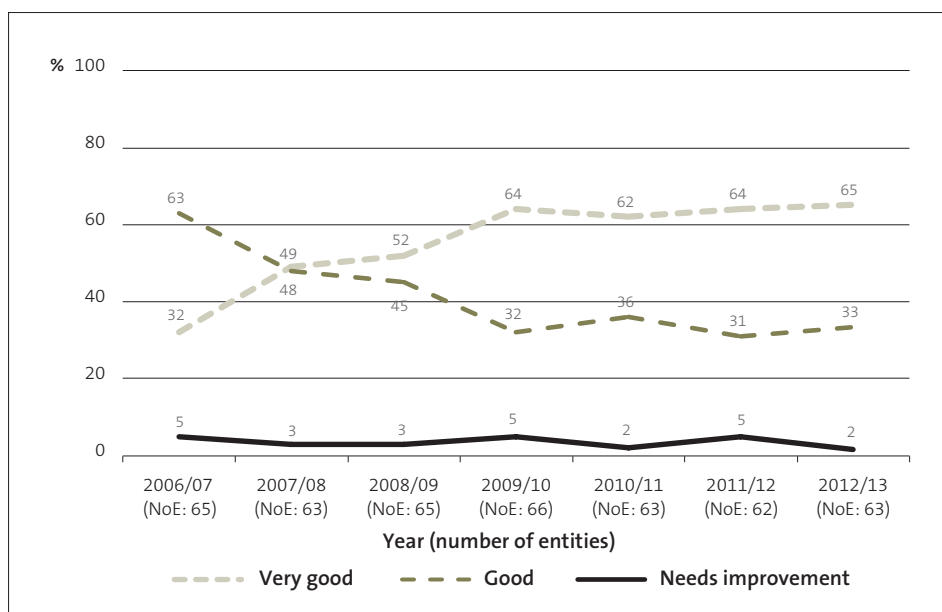


- 5.39 Seven entities improved from “Good” to “Very good” grades in 2012/13. These entities were:
- External Reporting Board;
  - Health Quality and Safety Commission;
  - Independent Police Conduct Authority;
  - New Zealand Historic Places Trust;
  - New Zealand Productivity Commission;
  - New Zealand Transport Agency; and
  - Social Workers Registration Board.
- 5.40 Some of the reasons that Crown entities improved their grade included:
- improved strategic planning;
  - implementing important policies, including risk management, fraud, and procurement;
  - improving systems to comply with legislation; and
  - using an audit and risk committee to help with governance and accountability or implementing an internal assurance programme.

- 5.41 Three entities were assessed as “Needs improvement”. This is an improvement on 2011/12, when five entities were assessed as “Needs improvement”. The reasons why the three entities have remained on this grade vary:
- EQC – The consequences of the Canterbury earthquakes continue to affect the management control environment of EQC. Although our auditors found an appropriate level of governance, and improvements such as expanding the internal audit function, a number of recommended improvements have yet to be addressed. They include establishing or updating important policies, proper staff handover when there is restructuring, and formalising processes for IT controls.
  - Te Papa – Changes to the board and senior management have increased risks to maintaining adequate controls. Some recommended improvements from last year were still to be addressed at the time of the audit. We note that the change in management is an opportunity to make these changes.
  - Real Estate Agents Authority – We noted improvements from 2011/12, but systems and controls were not in place for the whole year. Also, a board-initiated review of a significant project identified weaknesses in project management and the development of business requirements. The board is acting on the recommendations from the review.

## Financial information systems and controls

**Figure 15**  
Crown entities – grades for financial information systems and controls, 2006/07 to 2012/13



5.42 Figure 15 shows the results for our assessments of Crown entities' financial information systems and controls from 2006/07 to 2012/13. There has been some improvement in 2012/13, with 41 (65%) of Crown entities assessed as "Very good" and 21 (33%) as "Good".

5.43 The following entities improved their grade from "Good" to "Very good" in 2012/13 by resolving last year's recommendations (as well as Callaghan Innovation, which was graded "Very good" in its first year):

- Broadcasting Standards Authority;
- Civil Aviation Authority;
- Electricity Authority; and
- Environmental Protection Agency.

5.44 However, three entities dropped from "Very good" to "Good":

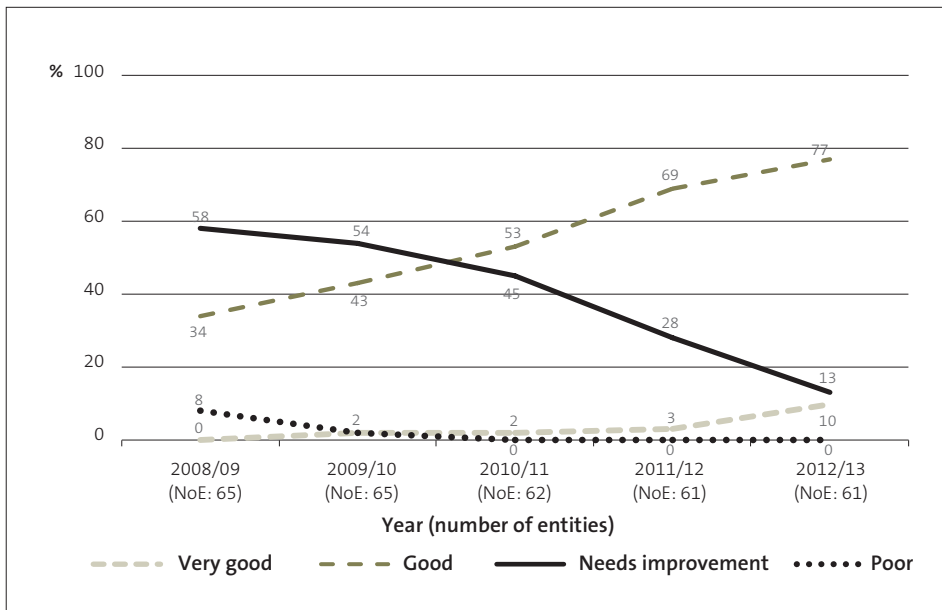
- Drug Free Sport New Zealand – we recommended improvements to some formal processes for contract income and payroll reconciliations;
- Te Māngai Pāho – we recommended some improvements to processes for expenditure coding and approval; and

- Transport Accident Investigation Commission – we made recommendations about the independent review of journals and general ledger reconciliations.

5.45 We provide a briefing to management and the relevant boards if our auditors identify deficiencies or recommend improvements to financial information systems and controls. We will review the entities' progress with addressing issues and we expect those issues to be addressed during 2013/14.

### Service performance information and associated systems and controls

**Figure 16**  
**Crown entities – grades for service performance information and associated systems and controls, 2008/09 to 2012/13**



5.46 As Figure 16 shows, we continue to see significant improvements in service performance information and associated systems and controls in 2012/13. The percentage of Crown entities assessed as “Needs improvement” has dropped from 28% in 2011/12 to 13% in 2012/13. Six Crown entities are now assessed as “Very good”, up from two in 2011/12. This improvement is positive, especially considering this was the first year the Auditor-General’s revised standard for auditing service performance reports was applied to the audits in all Crown entities.

5.47 The following four entities have improved to join the New Zealand Artificial Limb Service and the New Zealand Blood Service with a “Very good” grade in 2012/13:

- Broadcasting Standards Authority;
- Guardians of New Zealand Superannuation and New Zealand Government Superannuation Fund;
- New Zealand Transport Agency; and
- Office of Film and Literature Classification.



## Part 6

# Crown research institutes' audit results

6.1 In this Part, we report on the results of our audits of CRIs for 2012/13. We set out our assessments of their management control environments and financial information systems, particular observations from the audits, and discuss the financial performance of CRIs.

### About Crown research institutes

6.2 The seven CRIs were established under the Crown Research Institutes Act 1992 to carry out research for the benefit of New Zealand. The CRIs also provide a range of scientific and advisory services.

6.3 The CRIs are:

- AgResearch Limited (AgResearch);
- Institute of Environmental Science and Research Limited (ESR);
- Institute of Geological and Nuclear Sciences Limited (GNS);
- Landcare Research (New Zealand) Limited (Landcare);
- National Institute of Water and Atmospheric Research Limited (NIWA);
- New Zealand Institute for Plant and Food Research Limited (Plant and Food);
- and
- New Zealand Forest Research Institute Limited (Scion).

6.4 We also audited Callaghan Innovation Research Limited (CIRL). CIRL is now a subsidiary company of a new Crown entity, Callaghan Innovation. CIRL used to be called Industrial Research Limited, and it was the eighth CRI before it was absorbed into Callaghan Innovation on 1 February 2013.

6.5 For the year ended 30 June 2013, the seven CRIs and CIRL reported combined total revenue of about \$710 million (2011/12: about \$707 million) and total assets of just over \$738 million (2011/12: \$733 million). The aggregate equity of the seven CRIs and CIRL was just over \$547 million (2011/12: just under \$527 million).<sup>16</sup> Together, the seven CRIs employed about 3500 full-time equivalent staff.<sup>17</sup>

### Audit reports for 2012/13

6.6 We issued standard audit reports for all seven CRIs for the year ended 30 June 2013. We also issued a standard audit report for CIRL.

<sup>16</sup> According to data from the audited financial statements of the CRIs and CIRL.

<sup>17</sup> According to annual reports and figures provided by the Ministry of Business, Innovation and Employment.

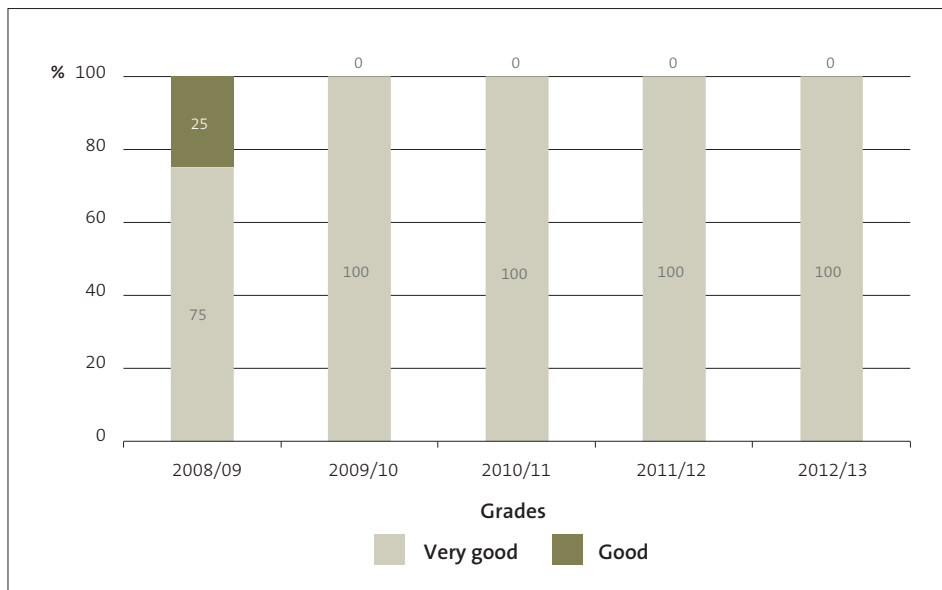
## Environment, systems, and controls

- 6.7 We again assessed the systems and controls of CRIs as being of a high standard.
- 6.8 As part of the annual audits, our auditors assess and grade the management control environment of CRIs and their financial (but not their service performance) information systems and controls.<sup>18</sup> We report our assessments of each CRI to its management and board, the Minister of Science and Innovation, the Ministry of Business, Innovation and Employment (as the monitoring department), and the Treasury.
- 6.9 In 2012/13, we graded all seven CRIs as having “Very good” management control environments. This is consistent with the grades we issued in the preceding three years.
- 6.10 We graded all seven as either “Good” (three) or “Very good” (four) for financial information systems and controls. A “Very good” grade means that the appointed auditor did not recommend any improvements. A “Good” grade indicates that we do not have any significant concerns but that the appointed auditor recommended some improvements.
- 6.11 This is an improvement on 2011/12, when four were rated “Good” and three were rated “Very good”.
- 6.12 These results compare well with the results for other groups within the central government sector (see Parts 4 and 5).
- 6.13 Figures 17 and 18 summarise the last five years' assessments.

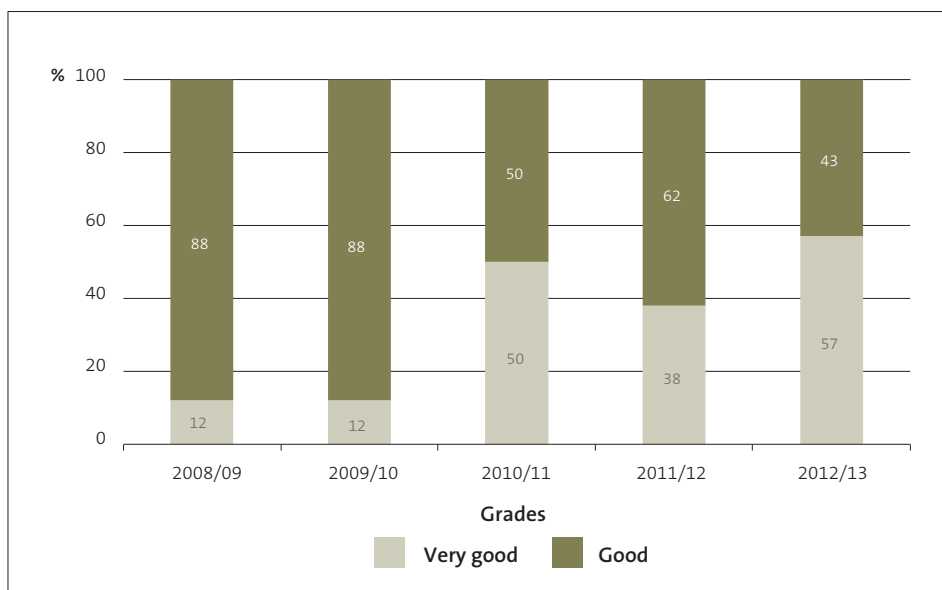
<sup>18</sup> Industrial Research Limited is included in the Figure 17 and Figure 18 graphs for 2008/09 to 2011/12. CIRL, as a subsidiary company, was not graded.



**Figure 17**  
 Crown research institutes – grades for management control environment, 2008/09 to 2012/13



**Figure 18**  
 Crown research institutes – grades for financial information systems and controls, 2008/09 to 2012/13



## Observations and matters arising from the audits

- 6.14 In our reports on our audit work with CRIs in 2012/13, we made the following observations or raised the following matters.

### Restructuring and business transformations

- 6.15 We noted that there were a number of significant business and organisational changes under way:
- AgResearch will be undergoing significant restructuring with its Future Footprints project.
  - Landcare restructured its subsidiaries on 1 July 2013 to improve its financial performance.
  - Scion sold its software brand, ATLAS Technology, on 1 January 2014.
  - ESR's core laboratory operating systems have been replaced.
  - There has been a review of Plant and Food (the first of the four-year rolling reviews of the CRIs), which could affect the way the CRI carries out its business.

### Performance reporting

- 6.16 We do not audit or grade the performance reporting of CRIs. However, we indicated in our report on CRIs in 2013<sup>19</sup> that we had a particular interest in the reporting of performance against the statement of core purpose. Improvements to service performance reporting were suggested for AgResearch and GNS in our reports on their 2012/13 audits. We intend to report further on this topic after the 2013/14 audits of the CRIs.

### Valuation of heritage assets

- 6.17 We again noted the ongoing issue with CRIs in valuing heritage assets. Because of their nature, it is not easy to reliably place a value on heritage assets. Such assets are usually irreplaceable, and a value is therefore difficult to assess.

### Financial results for 2012/13

- 6.18 The aggregate net profits of the seven CRIs and CIRL<sup>20</sup> showed a 29% decline from \$21.5 million (in 2011/12) to \$15.3 million (in 2012/13). All CRIs made a profit, of between 0.6% and 5.7% of their revenue. CIRL made a loss of \$1.9 million.
- 6.19 Most CRIs retained these profits within their businesses rather than making a return to the shareholder.

19 Controller and Auditor-General (2013), *Crown Research Institutes: Results of the 2011/12 audits*, Part 4, Wellington.

20 The results for IRL (later CIRL) have been included for comparative purposes.

- 6.20 Two CRIs provided a dividend to shareholders for 2012/13: GNS (\$0.25 million) and NIWA (\$2 million). The latter was declared after the balance date.
- 6.21 Figure 19 shows the CRIs' and CIRL's group financial results for 2012/13, comparative results for 2011/12, and retained earnings for 2012/13.

**Figure 19**  
**Financial results for Crown research institutes and Callaghan Innovation Research Limited, 2011/12 and 2012/13**

CRI	Revenue		Net profit(loss)			Retained earnings
	2012/13 \$million	2011/12 \$million	2012/13 \$million	% of revenue	2011/12 \$million	2012/13 \$million
AgResearch	162.9	157.8	5.7	3.5	4.2	5.7
ESR	62.3	58.8	1.3	2.0	2.4	1.3
GNS	72.2	74.9	1.1	1.6	4.0	1.1
IRL/CIRL	70.1	68.3	(1.9)	(2.7)	1.2	N/A
Landcare	55.6	59.3	0.6	1.1	1.3	0.6
NIWA	120.8	121.4	4.6	3.8	5.5	4.6
Plant and Food	120.4	122.3	2.2	1.9	1.3	2.2
Scion	45.6	44.1	1.7	3.7	1.6	1.7
<b>Total</b>	<b>709.9</b>	<b>706.9</b>	<b>15.3</b>		<b>21.5</b>	

Note: All results have been rounded to one decimal place, and have then been totalled. Revenue figures have been adjusted where necessary so that the treatment of "other gains and losses" and finance income is consistent.

## Analysis of the financial statements

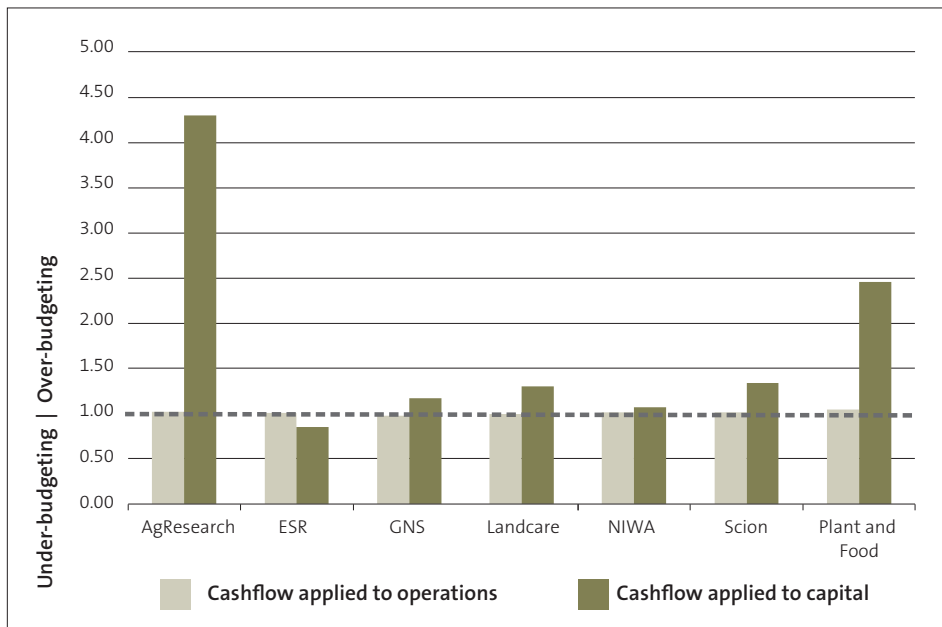
- 6.22 In Part 7, we present our analysis of the audited financial statements of central government entities, and contrast the financial health of government departments, CRIs, and most other Crown entities. The following summarises the findings for CRIs and provides some more detail.

### Ability to operate as planned

- 6.23 In terms of their ability to operate as planned, we found that, comparatively, CRIs as a group are at low risk of over-forecasting or under-forecasting their operational spending needs. However, as with the other central government entities, there is a high risk that they will over-budget (or under-spend) on capital assets.

- 6.24 We looked in detail at CRIs' audited financial statements for 2012/13.<sup>21, 22</sup> Figure 20 shows that, in four of the CRIs, actual spending varied by more than 20% from the budgeted capital amount. The most variance was in AgResearch (330%) and Plant and Food (145%).

**Figure 20**  
Ratio of Crown research institutes' budget to actual spending, for 2012/13



- 6.25 This trend of the capital budget being higher than actual spending has been consistent in the last six years, and is common to other Crown entities.<sup>23</sup> To see whether this trend extended beyond the parent company, we also looked at the financial statements of one material CRI subsidiary and found the opposite of the parent company's trend. That is, during the last three years, the subsidiary consistently spent considerably more on both operations and capital than its budget.
- 6.26 We intend to carry out further analysis in 2014/15 to understand better the relationship between planned and actual spending by the CRIs.

21 We did not include CIRL in this section because its budget figures for 2012/13 were not available.

22 We used parent data for this financial analysis and, where parent budget data was unavailable, we used prorated group budgets. Doing so lets us separately analyse the interactions of larger subsidiaries with the parent.

23 See paragraphs 7.14 and 7.15 for a discussion of possible reasons for this. See also our 2013 report, *Crown Research Institutes: Results of the 2011/12 audits*.

### Ability to manage uncertainty

- 6.27 As a sector, CRIs are at low risk of being unable to cover their current liabilities with current assets, if needed. However, the nature of their activities means that ongoing or fixed costs are moderately high and the ability to adjust and adapt in times of change could be limited. We do not consider this represents a high risk in CRIs as a group.

### Ability to invest for the future

- 6.28 None of the CRIs currently have ratios of liabilities to assets that suggest the level of liabilities could adversely affect their ability to invest for the future.
- 6.29 However, the two CRIs that are under-spending their capital expenditure budget have, on average, been spending less on assets in the last three years than the level of depreciation and amortisation, that is below what accounting judgements would suggest is reasonable for the long term. If this level of capital spending were to continue, it could begin to adversely affect the sustainability of services.

### Our focus

- 6.30 We will continue our interest in whether CRIs' reporting against their statements of core purpose meets the relevant reporting requirements. We will also continue to include, in our reporting, the results of our analyses of the financial performance of CRIs.
- 6.31 We have recently reported on *Maintaining a future focus in governing Crown-owned companies* (February 2014). CRIs were included in the study. Among other matters, we found that Crown-owned companies that innovate and communicate to a wide range of stakeholders are more likely to be preparing well for the future. We saw evidence of:
- better asset planning and condition than in the rest of the state sector;
  - longer-term thinking, such as Scion extending wood-processing technology to help sewage disposal; and
  - increases in Crown-owned companies' financial resources, allowing them to better manage uncertainty or invest in the future.
- 6.32 Future audit work will focus, within CRIs and other public entities, on:
- the level of deferred maintenance and capital expenditure;
  - the nature and status of asset management plans, and the extent to which entities are delivering on their asset management plans; and
  - governance and accountability, including audit and risk at the governance level.



## Part 7

# Analysis of the audited financial statements

- 7.1 In this Part, we discuss our analysis of what the audited financial statements can tell us about the financial health of central government entities and their ability to deliver on their objectives.
- 7.2 The analysis used information presented in the financial statements of the parent entity to better understand the adequacy and alignment of the entities' financial resources – a fundamental component in the ability of public entities to deliver on their objectives.
- 7.3 We carried out this analysis for all CRIs and all government departments. For Crown entities, we excluded DHBs and schools because they will be the subject of forthcoming separate reports that will feature a similar analysis of their financial statements. We included the largest of the remaining Crown entities (about 70% of those remaining). Because of the nature of their activities, we have also excluded entities whose activities have a significant financial services element (such as the Accident Compensation Corporation, the Reserve Bank of New Zealand, and the New Zealand Superannuation Fund).

### Overview of government expenditure

- 7.4 Public entities have been operating in an environment of financial constraint for a number of years, particularly since the global financial crisis in 2008. The growth in total operating revenue and in operating and capital spending has slowed significantly since 2007. In recent years, these amounts have actually declined.
- 7.5 These trends have meant that the need for financial restraint has changed not only the way that entities are working (doing more with less) but also the structure of central government activities.

### The financial health of central government entities

- 7.6 Our analysis covered the main groups of central government entities (Crown entities, government departments, and CRIs). We have analysed data from seven years of audited financial statements.
- 7.7 To consider the financial health of the entities, we assessed the:
- **ability to operate as planned.** This relates to the stability of entities' services. We examined the relationship between planned expenditure and actual expenditure for operational and capital spending. We also examined the likelihood of entities spending more than they receive;
  - **ability to manage uncertainty.** This relates to the resilience of entities' services. We examined the ability of entities to cover their current liabilities and adjust their operations in times of change; and

- **ability to invest for the future.** This relates to the sustainability of entities' services. We examined the general level of expenditure on capital assets and the level of total liabilities the entity is responsible for.

7.8 Figure 21 summarises the accounting relationships we analysed to better understand the financial health of public entities.

**Figure 21**  
**Accounting relationships examined to better understand the financial health of public entities**

Ability to operate as planned (stable services)	Ability to manage uncertainty (resilient services)	Ability to invest for the future (sustainable services)
Variance of operational spending from budget	Current assets to current liabilities. (working capital)	Spending on capital compared to depreciation
Variance of capital spending from budget	Ongoing or fixed operating expenses* and total operating expenses	Total liabilities to total assets
Net operating cash flow (excluding depreciation and amortisation) to total cash flow received		

\* By ongoing or fixed operating expenses, we mean employee benefits, interest, depreciation, and amortisation.

- 7.9 We use our analysis to better understand how the adequacy and alignment of financial resources can affect the risk posed to the different types of entities' ability to operate as planned, manage uncertainty, and invest for the future.
- 7.10 Generalisations need to be made in collecting and analysing the data from financial statements, similar to the generalisations required for any large and complex data set. The findings drawn from our analysis are of a general nature and can be used to identify matters or trends that might require further investigation.
- 7.11 The rest of this Part considers each of the three "abilities" and what our analysis shows about the financial health of the three groups of entities. We have used "traffic light" colours to help convey our assessment of relative risk.



## The ability to operate as planned

### Are entities over-forecasting or under-forecasting their operational spending?

- 7.12 The difference between budgeted and actual operational spending has been consistently small for most entities within all three groups. As Figure 22 shows, CRIs and government departments have improved their forecasting accuracy in recent years.

**Figure 22**

**Over or under percentage difference between entities' budgeted and actual operational spending, by type of central government entity, 2006/07 to 2012/13**

	2006/07 to 2010/11	2011/12	2012/13
Crown entities	5 to 10%	5 to 10%	5 to 10%
CRIs	5 to 10%	Less than 5%	Less than 5%
Government departments	5 to 10%	5 to 10%	Less than 5%

- 7.13 These small variances of less than 10% suggest a low or very low risk that entities will not be able to operate as planned in their day-to-day operations. Factors contributing to this could include good short-term forecasting procedures and/or a tighter monitoring environment.

### Are entities over-forecasting or under-forecasting their capital spending?

- 7.14 The difference between budgeted and actual capital spending has been consistently large for most entities within all three groups (see Figure 23).

**Figure 23**

**Over or under percentage difference between entities' budgeted and actual capital spending, by type of central government entity, 2006/07 to 2012/13**

	2006/07 to 2010/11	2011/12	2012/13
Crown entities	20 to 50%	20 to 50%	20 to 50%
CRIs	20 to 50%	10 to 20%	20 to 50%
Government departments	20 to 50%	20 to 50%	20 to 50%

- 7.15 These large variances, mostly greater than 20%, suggest a high risk that entities will not be able to operate as planned in their capital-related activities. Factors contributing to the over-budgeting (or under-spending) on capital assets could include poor short-term forecasting, inadequate monitoring, and/or a generally uncertain capital project environment.

### Are entities spending more than they receive on their operations?

- 7.16 In most instances, the difference between what is received and what is spent on entities' operations has ranged from a 5% surplus to a 2% deficit (excluding depreciation and amortisation funding received). Figure 24 shows that CRIs and government departments are slightly more likely to spend more than they receive on their operations than they were in earlier years. The pattern for Crown entities has not changed.
- 7.17 In Figure 24, 0% would mean that operational spending is equal to operational revenue, and negative amounts indicate spending more than what is received.<sup>24</sup>

**Figure 24**

**Proportion of entities' net operating cash flow to cash flow received, by type of central government entity, 2006/07 to 2012/13**

	2006/07 to 2010/11	2011/12	2012/13
Crown entities	-2% to 2%	-2% to 2%	-2% to 2%
CRIs	2 to 5%	2 to 5%	-2% to 2%
Government departments	2 to 5%	2 to 5%	-2% to 2%

- 7.18 Our findings showed that Crown entities have had only small differences between what they receive and what they spend. The results for CRIs and government departments could indicate generally tighter budgetary controls and monitoring environments. Overall, this suggests a low to moderate risk of entities not being able to operate as planned with little held back as reserves. However, we also note that, for most years, about 8% of central government entities showed cash flow operating deficits of more than 10%.
- 7.19 Overall, the financial statements show that central government entities' ability to operate as planned is supported by good operational planning and forecasting.

<sup>24</sup> We excluded depreciation and amortisation because the associated revenue is related to capital.

Net operating cash flows appear to be managed appropriately without generating large surpluses, but some entities have significant deficits.

- 7.20 For all three groups, capital planning and forecasting needs to improve. The consistent over-budgeting suggests that there is scope for improvement in longer-term financial management practices. This aligns with the findings in our 2012 report on financial management, where we found that public entities were focused on providing (short-term) financial control budget management and external reporting. There was a need for stronger strategic financial management, including enhancing the quality, analysis, and usability of financial information to better understand financial performance.<sup>25</sup>

## The ability to manage uncertainty

### Could entities find it difficult to cover their current liabilities, with current assets, if needed?

- 7.21 Figure 25 shows that, for all three groups, levels of current assets are mostly sufficient to cover current liabilities if required. In Figure 25, 100% means that the value of current assets equals the value of current liabilities.

**Figure 25**

**Percentage of entities' current assets to their current liabilities, by type of central government entity, 2006/07 to 2012/13**

	2006/07 to 2010/11	2011/12	2012/13
Crown entities	100 to 200%	100 to 200%	over 200%
CRIs	50 to 100%	100 to 200%	100 to 200%
Government departments	100 to 200%	100 to 200%	100 to 200%

- 7.22 For all three groups, our findings suggest a low risk that levels of current liabilities could be onerous in times of uncertainty. This is a positive indication of the ability of entities within these three groups to manage uncertainty. We also note that Crown entities and CRIs have shown some improvements in the past seven years.

### Could entities find it difficult to adjust operations in times of change?

- 7.23 Where entities have a high proportion of non-discretionary (ongoing or fixed) expenses (employee benefits, interest, depreciation and amortisation), the ability to adjust and adapt in times of change can be limited. Figure 26 shows that, for all three groups, the average proportion of ongoing or fixed costs is between 30%

<sup>25</sup> Controller and Auditor-General (2012), *Reviewing financial management in central government*, Wellington.

and 70% of total expenses. In Figure 26, 100% would mean that all expenses are ongoing or fixed.

**Figure 26**  
**Proportion of entities' current operational expenses that are ongoing or fixed, by type of central government entity, 2006/07 to 2012/13**

	2006/07 to 2010/11	2011/12	2012/13
Crown entities	30 to 50%	30 to 50%	30 to 50%
CRIs	50 to 70%	50 to 70%	50 to 70%
Government departments	50 to 70%	50 to 70%	50 to 70%

- 7.24 Our findings suggest a low to moderate level of risk that entities' ability to manage uncertainty could be adversely affected by these levels of ongoing or fixed costs.
- 7.25 Overall, the financial statements indicate that, in all three groups, levels of current assets, current liabilities, and fixed costs are not onerous, and would not adversely affect the entities' ability to manage uncertainty in times of change.

## The ability to invest for the future

### Are entities investing in their assets adequately?

- 7.26 Maintaining the operational capacity of assets is fundamental to the long-term sustainability of public services. Comparing an entity's capital expenditure to what accounting estimates suggest is reasonable (for example, to cover depreciation) is one way of understanding the adequacy of investment in an entity's capital assets.
- 7.27 The percentages shown in Figure 27 suggest some under-investment in capital assets for Crown entities and government departments (because their spending on capital is not quite equal to, or above, the amount set aside for depreciation). The investment in capital assets for CRIs appears adequate. In Figure 27, 100% means that levels of capital expenditure are equal to depreciation estimates.

**Figure 27**  
**Percentage difference between entities' capital spending and their depreciation estimates, by type of central government entity, 2006/07 to 2012/13**

	2006/07 to 2010/11	2011/12	2012/13
Crown entities	80 to 100%	80 to 100%	80 to 100%
CRIs	100 to 150%	100 to 150%	100 to 150%
Government departments	80 to 100%	80 to 100%	80 to 100%

Note: We would expect a result of more than 100% because capital expenditure also includes spending on new assets.

- 7.28 Our analysis suggests that, for Crown entities and government departments, there is a moderate risk that these levels of capital investment could be inadequate to maintain operational capacity in the longer term. Although CRIs' investment appears adequate, variability in all three groups was high, with a significant proportion of very high risk and very low risk entities.

### Are total liabilities becoming onerous?

- 7.29 Too many liabilities can reduce future funding options and distract management from a focus on the long-term assets of the entity. The percentages in Figure 28 suggest that, in all three groups, there is a low risk that the level of liabilities could adversely affect entities' ability to invest for the future.
- 7.30 In Figure 28, 100% would mean that total liabilities are equal in value to total assets.

**Figure 28**  
**Proportion of total liabilities to total assets, by type of central government entity, 2006/07 to 2012/13**

	2006/07 to 2010/11	2011/12	2012/13
Crown entities	30 to 50%	30 to 50%	30 to 50%
CRIs	30 to 50%	30 to 50%	30 to 50%
Government departments	30 to 50%	30 to 50%	30 to 50%

- 7.31 Overall, the financial statements indicate that, in all three groups, levels of total liabilities and capital investment should not adversely affect the ability of entities to invest for the future. However, further work is needed to understand the levels of capital investment for Crown entities and government departments.

## Our conclusions

- 7.32 Overall, our analysis of financial statements shows that the planning and alignment of financial resources in CRIs, government departments, and Crown entities are sufficient to support stable, resilient, and sustainable services. Crown entities and government departments show the greatest level of consistency over time, which could be due to the stability of their operating environments and/or the ongoing consequences for CRIs resulting from the 2010 taskforce review.
- 7.33 Our analysis of financial statements indicates that there are risks in the forecasting and management of capital expenditure.

## Part 8

# Our observations about information systems

- 8.1 In this Part, we describe the trends, risks, and issues in the use of information systems by public entities. The comments are based on our observations during the annual audits in 2013.
- 8.2 We are seeing greater central direction for the management of information communications technology, greater use of shared services, an increase in the use of cloud computing services, and more staff wishing to use their own technology devices in their workplace. We note that government departments and Crown entities are aware of risks posed by their legacy systems and are taking steps to manage those risks. There is scope to better align business continuity plans with IT disaster recovery plans, and we also note that steps are being taken to strengthen the management of information security.

### The scope of information systems audit work

- 8.3 The work carried out during an annual audit includes considering the information technology controls that affect the reliability of financial statements and service performance reporting. The work is carried out according to international auditing standards, in particular ISA (NZ) 315: *Identifying and assessing the risk of material misstatement through understanding the entity and its environment*. ISA (NZ) 315 gives auditors a framework to understand how entities operate and whether they have adequate controls in place to manage risks.
- 8.4 ISA (NZ) 315 states that the auditor should:
- carry out a risk assessment, including assessing the entity's internal controls;
  - assess the risks of material misstatement within the financial statements;
  - understand the entity and its environment, including its internal controls;
  - communicate with those charged with governance; and
  - document the understanding and the risks.
- 8.5 The auditors we appoint have teams of specialist information systems auditors. These teams perform audits of general information technology controls, business application controls, and data analysis. The work is not a comprehensive review of all information system controls. What gets audited depends on the results of an initial risk assessment, as well as an understanding of how the use of information systems affects the business processes that, in turn, have a material effect on financial statements.

### General information technology controls

- 8.6 The specialist auditors draw on a range of frameworks to assess control risks. For example, Audit New Zealand uses an international framework published by the Information Systems Audit and Control Association called CoBIT.
- 8.7 An audit of general controls for information technology is split into two groups of work. First, a risk assessment is made of:
- governance and strategic planning;
  - processes, organisation, and relationships;
  - assessment and management of risks;
  - how performance is monitored and evaluated; and
  - the monitoring and evaluation of internal controls.
- 8.8 Secondly, the operational effectiveness of management controls (those that affect the reliability of financial statements and service performance reporting) is tested. This might include:
- systems acquisition and project management;
  - security (network and applications);
  - the management of physical hardware;
  - change management;
  - management of third-party services;
  - management of data;
  - management of operations;
  - management of the configuration of the information communications and technology system; and/or
  - management of problems and incidents.

### Observations and matters arising from our audits

- 8.9 Information systems audits often identify areas for improvement and these are communicated in the auditor's report to the management of public entities. We have collated the audit reports for the central government sector to get a broader view of technology trends and risks.
- 8.10 As we noted in Part 1, public entities continue to maintain or improve services to the public in an environment of financial constraint. In response, many public



entities have been looking at their use of technology to see how improvements and savings can be achieved.

### **Central direction for information communications and technology**

- 8.11 There is an environment of change, driven by central direction and leadership from the Office of the Government Chief Information Officer (GCIO) in the Department of Internal Affairs. The role and influence of the GCIO continues to have a significant effect on the sector, with a strong emphasis on compliance and security as well as data classification and management.
- 8.12 The uptake rate for all-of-government contracts for Infrastructure as a Service<sup>26</sup> is steadily increasing. It is not clear yet whether the anticipated cost savings will eventuate, and we expect entities to maintain a focus on benefits realisation.

### **Shared services**

- 8.13 Public entities are increasingly sharing support services, such as financial management information systems or human resources systems. For example, the Treasury and the SSC are sharing a financial management information system, and the Inland Revenue Department is extending its financial management information system to deliver shared transactional services for the Department of Internal Affairs.

### **Cloud computing**

- 8.14 Cloud computing means computer services provided remotely by suppliers through the Internet. One advantage of cloud computing is that users do not have to buy or invest in hardware, such as servers.
- 8.15 Cloud computing has been an increasingly important topic within technology departments as public entities look to deliver services in a more effective and efficient manner. This is actively encouraged in central government, with Infrastructure as a Service agreements in place with some suppliers. Our auditors have seen a significant increase in the use of Infrastructure as a Service by government departments, with others planning to move to it during the next 12-18 months.
- 8.16 Cloud computing is a service-based procurement model. Arrangements can be complex, with business structures that include overseas third-party organisations, which can be a challenge for establishing robust controls.

<sup>26</sup> One of the main categories of cloud computing service. A model in which entities pay an external provider to supply the equipment used to support operations, including storage, hardware, servers, and networking components.

### **Bring your own device**

- 8.17 Staff in many public entities are asking whether they can bring their own technology devices (such as mobile phones and tablets) to use in the workplace. This is referred to as “bring your own device”. Strong policies and practices are needed before staff can bring their own devices, to cover compatibility as well as security.

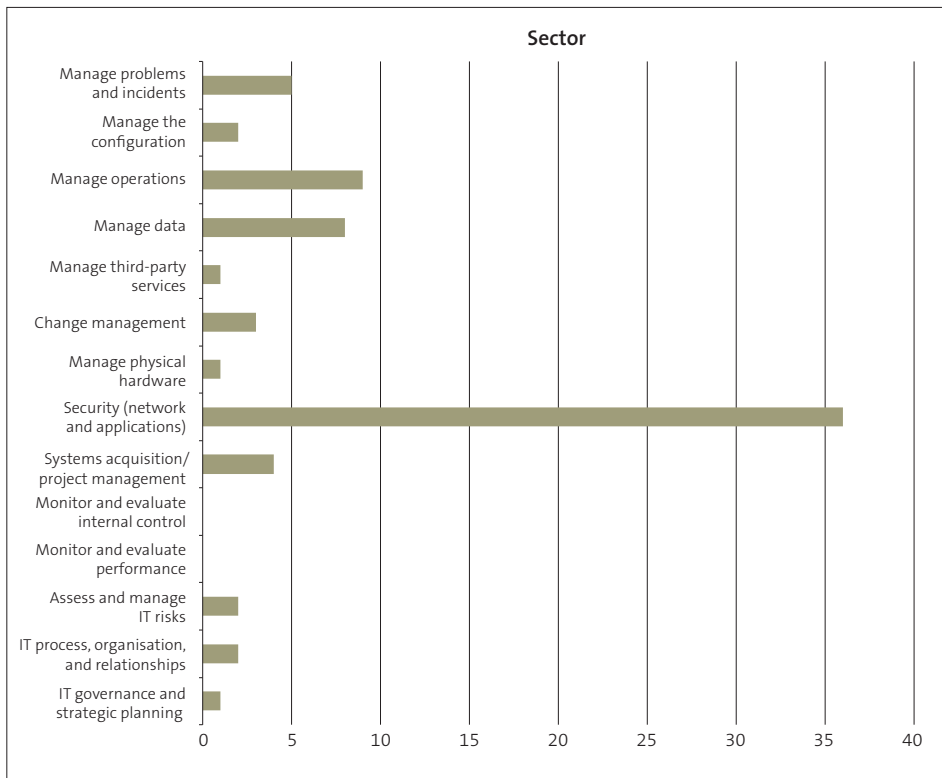
### **Anytime, anywhere access**

- 8.18 With the uptake of ultrafast and mobile broadband, there is a greater expectation that users of government services will be able to access their information and transact at any time of the day from any location in the world using any device they choose. There continues to be pressure on infrastructure and applications to be available 24 hours a day, seven days a week.

### **Risks for public entities in their use of information technology**

- 8.19 Figure 29 shows the audit exceptions from Audit New Zealand’s information systems audit work, which is carried out as part of the annual audits. Audit exceptions are matters that the auditor notes that warrant asking the entity about. The Figure shows how often audit exceptions were identified during information systems audits. It covers only the public entities that Audit New Zealand is appointed to audit on behalf of the Auditor-General.
- 8.20 The high number of audit exceptions for security is, in part, because of the focus and time that the audits tend to devote to security issues. There are a high number of security tests.
- 8.21 Our other audit service providers have noted audit exceptions for change management controls, system developer access, and issues with legacy systems where entities rely on a small number of staff with historical knowledge to operate those systems.
- 8.22 The following sections discuss the main technology risks that we identified during our annual audits.

**Figure 29**  
**Number of audit exceptions noted during Audit New Zealand’s information systems audits, 2012/13**



**Information security**

- 8.23 Information security remains the area where most of our recommendations for improvement are made. Weak password settings, failure to promptly terminate system access, and periodic user access rights review are the most prevalent deficiencies identified.
- 8.24 Information security is inherently risky. This risk is likely to increase as systems become more complicated and more unsupported devices, such as devices owned by staff, are used in the work place.
- 8.25 Responsibility for security processes and controls is often spread throughout public entities rather than with a small group of individuals with clear accountability. This can increase the likelihood of controls failing. We have also observed that risk management principles and accountabilities are often not connected to information systems security-related activities.

- 8.26 Public concern about information security increased after inadvertent releases of private information at the Ministry of Social Development and EQC. More focus has already been given to improvement as a result.
- 8.27 The Government Communications Security Bureau is implementing a work programme to improve its information security. Its focus is on four primary controls – patching applications, patching operating systems, minimising the number of users with administrative privileges, and whitelisting<sup>27</sup> applications.

### Legacy systems

- 8.28 Legacy systems are older computer systems or programs that continue to be used, often because of the costs of replacing or redesigning them.
- 8.29 If legacy software runs only on antiquated hardware, the cost of maintaining it could eventually outweigh the cost of replacing both the software and the hardware – unless some form of backward compatibility allows the software to run on new hardware.
- 8.30 Legacy systems remain a concern for some public entities. We have found that the government departments with legacy systems are aware of the risks and taking steps to mitigate them. There is often a need for significant investment to change the legacy systems because they are often important operational systems. Examples include the Inland Revenue Department's tax system, FIRST; the Ministry of Social Development's payment system, SWIFTT; and the payment applications at the Ministry of Health.
- 8.31 Government departments continue to investigate the options available. Currently, the trend is to keep the legacy systems while any further changes are developed in new applications that interface with the legacy systems.

### Business continuity and IT disaster recovery

- 8.32 Business continuity and disaster recovery remain an inherent risk to all government departments. There needs to be close alignment between the disaster recovery plans and business expectations set out in the business continuity plans. Government departments making use of Infrastructure as a Service also need to consider how these systems can be recovered in the event of vendor failures.

<sup>27</sup> A whitelist is a list of applications for which permission has been granted by the user or an administrator. Applications that are not on the list will not run.

### **Mergers, amalgamations, and changes to structures of public entities**

- 8.33 From an IT perspective, mergers often present several challenges to integrating systems from entities that have been operating independently for several years. Efficiencies anticipated from these mergers are not always realised as soon as forecast, or at all, if the IT systems cannot be successfully merged. There is often a dependence on the organisation redesigning its processes to ensure success.

### **Formalising the strategic direction of IT architecture and expenditure**

- 8.34 Most departments have documented their IT direction and spending for the medium term (3-5 years) in their ICT strategies. However, there is scope for better strategic planning that takes into account the current all-of-government initiatives under way, such as procurement, shared services, and cloud computing options. Information systems are also significant assets for public entities, and we have found varying levels of benefits realisation management to maximise the value of information systems architecture and expenditure.
- 8.35 We are observing the spread of new technology trends, such as cloud computing and “bring your own device” policies, as government departments better understand the effect these technologies have on them.

### **Dependence on key skills**

- 8.36 Public entities are under pressure to keep adequate numbers of skilled staff to maintain their systems. This is due to having legacy systems for which support skills have dwindled over time and competing with other employers in other sectors and countries.

### **Managing the services of vendors**

- 8.37 As more public entities enter outsourcing arrangements for their IT infrastructure and services, there is a greater need to ensure that they are clear on what services they expect to receive. As the trend towards contracting the operation of IS systems, processes, and controls to third parties increases, the issues of who is accountable and who is responsible for what needs to be clearly defined. Public entities remain accountable for managing risks, and should have formal vendor management processes in place to monitor service levels and obtain assurance that the reported service levels are accurate.



# Appendix 1

## Types of audit reports

This appendix provides an overview of the different types of audit report and how the appropriate form is decided.

### Audit reports

An audit report is addressed to the readers of an entity's financial and non-financial information. All public entities are accountable to Parliament for their use of public money and their use of any statutory powers or other authority given to them by Parliament.

### Non-standard audit reports

A non-standard audit report<sup>28</sup> is one that contains:

- a modified opinion; and/or
- an “emphasis of matter” or an “other matter” paragraph.

A modified opinion is given because of:

- a misstatement about the treatment or disclosure of a matter in the financial and/or non-financial information; or
- a limitation in scope. This may occur when the appointed auditor has been unable to obtain sufficient appropriate evidence to support, and accordingly is unable to express, an opinion on the financial or non-financial information or a part of the financial or non-financial information.

There are three types of modified opinion (which are discussed below):

- an “adverse” opinion;
- a “disclaimer of opinion”; and
- a “qualified opinion”.

The appointed auditor will include an “emphasis of matter” paragraph (see below) or “other matter” paragraph (see below) in the audit report to draw attention to matters such as:

- fundamental uncertainties;
- breaches of law; or
- concerns over probity or financial prudence.

The appointed auditor has to include an “emphasis of matter” paragraph or an “other matter” paragraph in the audit report in such a way that it cannot be mistaken for a modified opinion.

<sup>28</sup> A non-standard audit report is issued in accordance with the requirements of the New Zealand equivalents to the International Standards on Auditing: No. 700: *Forming an Opinion and Reporting on Financial Statements*; No 705: *Modifications to the Opinion in the Independent Auditor's Report*; and No. 706: *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

Figure 30 outlines the decisions that an appointed auditor has to make when considering the appropriate form of the audit report.

### **Adverse opinions**

An adverse opinion is the most serious type of non-standard audit report.

An adverse opinion is expressed when the appointed auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial and/or non-financial information.

### **Disclaimers of opinion**

A disclaimer of opinion is expressed when the appointed auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion (that is, a limitation in scope), and the appointed auditor concludes that the possible effects on the financial and/or non-financial information of undetected misstatements, if any, could be both material and pervasive.

A disclaimer of opinion is also expressed when, in extremely rare circumstances involving multiple uncertainties, the appointed auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements and/or non-financial performance information because of the potential interaction of the uncertainties and their possible cumulative effect on the financial and/or non-financial information.

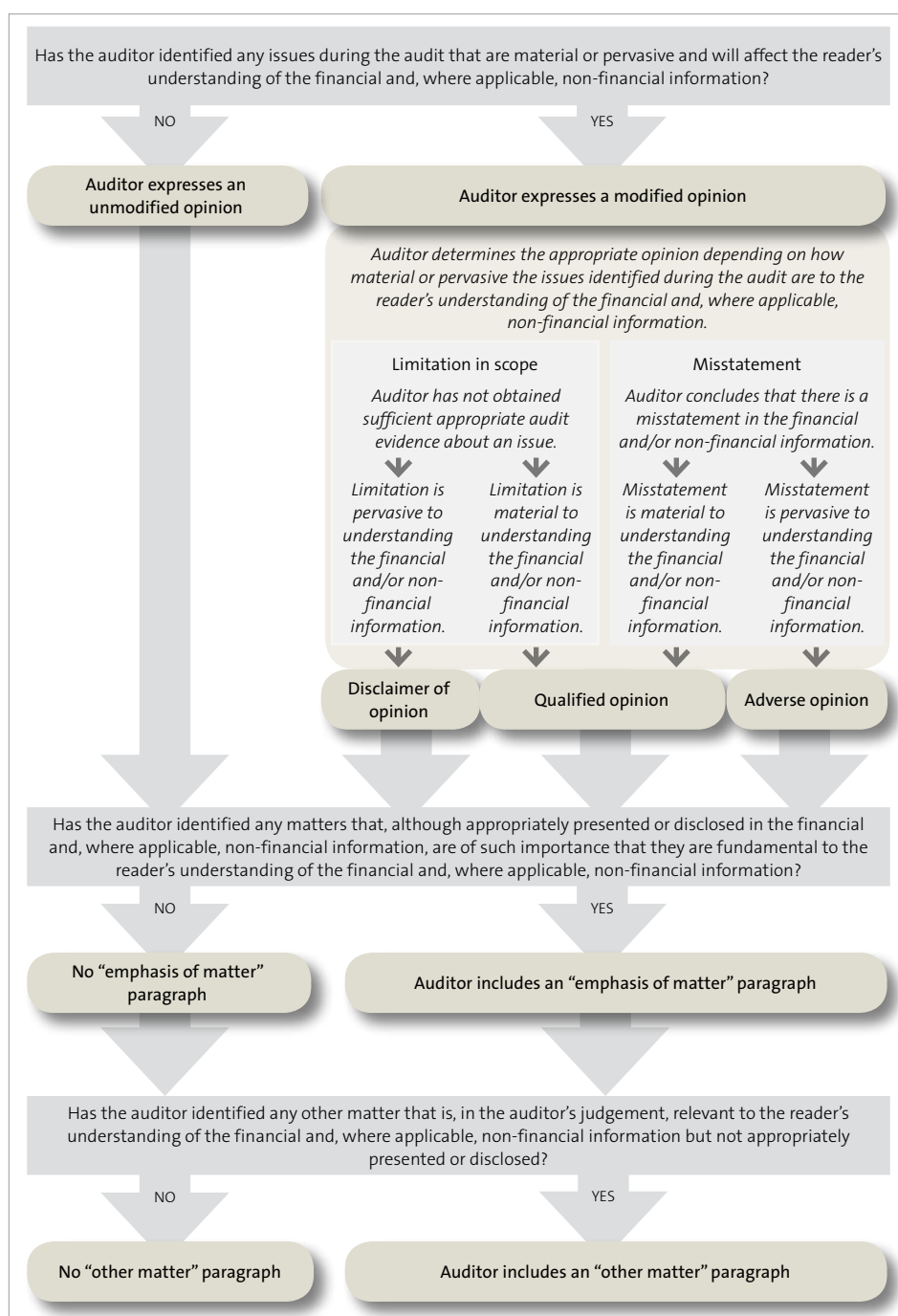
We are pleased to report that it was not necessary for us to express a disclaimer of opinion on the financial and/or non-financial information of any entity in the central government portfolio covered by this report.

### **Qualified opinions**

A qualified opinion is expressed when the appointed auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in aggregate, are material, but not pervasive, to the financial and/or non-financial information.



**Figure 30**  
Deciding on the appropriate form of the audit report



Note: This flowchart is based on the requirements of the New Zealand equivalents to the International Standards on Auditing No. 700: *Forming an Opinion and Reporting on Financial Statements*; No. 705: *Modifications to the Opinion in the Independent Auditor's Report*; and No. 706: *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

A qualified opinion is also expressed when the appointed auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the appointed auditor concludes that the possible effects on the financial and/or non-financial information of undetected misstatements, if any, could be material but not pervasive.

In addition, a qualified opinion is expressed when the appointed auditor concludes that a breach of statutory obligations has occurred and that the breach is material to the reader's understanding of the financial and/or non-financial information. An example of this is where a Crown entity has breached the requirements of the Crown Entities Act 2004 because it has not included budgeted figures in its financial statements.

### **“Emphasis of matter” paragraphs**

In certain circumstances, it may be appropriate for the appointed auditor to include additional comments in the audit report to draw readers' attention to a matter that, in the appointed auditor's professional judgement, is fundamental to their understanding of the financial and/or non-financial information. The additional comments will be included in the audit report in an “emphasis of matter” paragraph, provided the appointed auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial and/or non-financial information.

### **“Other matter” paragraphs**

In certain circumstances, it may be appropriate for the appointed auditor to communicate a matter that is not adequately presented or disclosed in the financial and/or non-financial information because, in the appointed auditor's professional judgement, the matter is relevant to readers' understanding of the financial and/or non-financial information. The additional comments will be included in the audit report in an “other matter” or similarly titled paragraph.

## Appendix 2

# Our framework for assessing environment, systems, and controls

This appendix outlines the framework we use for assessing environment, systems and controls in the entities we audit.

### Environment, systems, and controls

As part of the audit process, we separately examine, assess, grade, and report on central government entities' environment, systems, and controls for managing and reporting financial and service performance.

Our auditors recommend improvements to ensure that there are effective internal controls for sound management and good governance, and to help entities to manage risks (such as errors and potential fraud).

This is the sixth year we have used our current assessment framework to support entities in their effort to strengthen systems and controls and to report more meaningful information on their financial and non-financial performance. Accordingly, we assess these three aspects:

- the management control environment;
- financial information systems and controls; and
- service performance information and associated systems and controls.

If auditors identify deficiencies in any of these aspects, they will recommend improvements. The grades reflect the recommendations for improvement as at the end of the financial year (see Figure 31).

Fluctuations in grades can occur from year to year – for example, because of changes in the operating environment, organisational structure, good practice expectations, or auditor emphasis. How an entity responds to an auditor's recommendations is more important than the grade change from year to year. Consequently, the long-term trend is a more useful indicator of progress than year-to-year changes.

**Figure 31**  
**Grading scale for assessing public entities' environment, systems, and controls**

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

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

Given that our assessments and grades are focused on encouraging improvements, we do not grade entities that are, or will subsequently be, disestablished.



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