Controller and Auditor-General
Tumuaki o te Mana Arotake

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# Central government: Results of the 2016/17 audits

Photo acknowledgement:
Chris Tse, Office of the Auditor-General

# Central government: Results of the 2016/17 audits

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# Contents

# Overview

This report sets out the results of my audit of the *Financial Statements of the Government of New Zealand for the year ended 30 June 2017* (the Government's financial statements) and of carrying out the Controller function. Both are essential components of New Zealand's public financial management system which, in my view, remains one of the best in the world.

My role is to provide assurance to Parliament that the way the Treasury has reported in the Government's financial statements fairly reflects the Government's financial performance and position. The Government's financial statements give an account of what the New Zealand Government earns, spends, owns, and owes.

I am pleased to report that I have issued an unmodified audit opinion on the Government's financial statements.

The Controller work complements the audit of the Government's financial statements. As the Controller, I check that government departments do not spend more money than Parliament has approved and that they have spent money for its intended purposes.

## Challenges for government in 2016/17

The 2016/17 financial year saw major disruption to government services and transport infrastructure resulting from the severe Kaikōura earthquake in November 2016 (the Kaikōura earthquake). Costs are estimated to be $0.6 billion for EQC claims, $0.2 billion has been recognised so far (to 30 June 2017) on restoring rail and road transport links, and further costs are anticipated.

The Government also identified external risks to New Zealand's economy from overseas events and trends, including slow global economic growth and political shifts such as Brexit and uncertainty about global trade developments.

Policy initiatives (such as the Better Public Services programme and the activities supporting the achievement of the Government's targets) can often involve cross-agency delivery, which can present operating challenges for agencies and also challenges in their financial and performance reporting and, consequently, for our audits of those reports.

## Key audit matters

In 2016, the then Auditor-General included within their audit report for the first time a section on "key audit matters". Key audit matters are those that, in our view, are complex, have a high degree of uncertainty, or are otherwise important to the public because of their size or nature. Accounting for and reporting on the key audit matters is not straightforward, not least because of the judgements, estimates, and assumptions involved.

The key audit matters for 2016/17 were:

- recognising tax revenue;
- valuing the rail network assets, the State highway network, electricity generation assets, and the social housing portfolio;
- valuing the Accident Compensation Corporation's outstanding claims liability and the Government employees' superannuation liability; and
- valuing financial assets and liabilities.

Overall, I was satisfied that the balances and disclosures in the Government's financial statements relating to these key audit matters are reasonable.

I made three recommendations that relate to the key audit matters. I have recommended that Inland Revenue continue to improve its methods for estimating income tax revenue and support its efforts to do so as part of its work within its Business Transformation project.

I have also recommended that the Treasury review the valuation of that portion of the rail network dedicated to freight, taking into account the progress (or outcome) of the current review of rail.

My third recommendation was for the Treasury to consider the recommendations in our review of the Treasury's methodology that supports the valuation of long-term liabilities.

I include in the Appendix to this report my full report on the Government's financial statements, including the key audit matters.

## Significant matters in the financial statements of the Government

As well as the key audit matters, I reported to the Minister of Finance on two other important audit matters: accounting for the proposed Crown contribution to the City Rail Link development in Auckland, and the treatment of income-related rent subsidies, which the Ministry of Social Development treats differently from Housing New Zealand Corporation and Tāmaki Regeneration Limited.

I made a further recommendation that the Treasury, along with the Ministry of Social Development, Housing New Zealand Corporation, and Tāmaki Regeneration Limited, review the documentation relating to income-related rent subsidies and clarify who the intended recipient of the subsidy is. Whether the intended recipient is best characterised as the tenant or the social housing provider affects the accounting treatment.

## Controller perspective

In some instances, the incurring of unappropriated expenditure demonstrates the flexibility of the Government's financial management system to respond to extraordinary events that cannot be anticipated. In other instances, unappropriated expenditure could have been anticipated and planned for. We have encouraged public agencies over the last few years to better identify their needs for previously unanticipated expenditure, so they can seek early approval for expenditure over and above the appropriation.

Since 2009/10, there has been an overall downward trend in incidences of unappropriated expenditure.

In 2016/17, the amount of unappropriated expenditure was $124 million (2015/16: $78 million), which is less than 0.14% of the Government's total appropriations for all Votes authorised through the Budget 2016 process (2015/16: less than 0.10%).

The total amount of expenditure incurred without prior Cabinet authority, as reported in the Government's financial statements for 2016/17, was $90 million (2015/16: $73 million). This was 0.10% of the Government's budgeted expenditure for 2016/17 (2015/16: 0.08%).

We noted that several central government agencies' offices in Wellington were affected by the Kaikōura earthquake. Consequently, those agencies incurred unanticipated expenditure during the year ended 30 June 2017. This expenditure was incurred either within the appropriations provided by Budget 2016 or incurred under imprest supply and appropriated for in the Appropriation (2016/17 Supplementary Estimates) Act 2017. No expenditure was incurred under the emergency or disaster expenditure provisions of the Public Finance Act 1989.

However, a significant amount of expenditure relating to the restoration of transport links damaged by the Kaikōura earthquake was unappropriated and will need to be validated by Parliament.

## Continued changes and challenges to financial reporting

In last year's report on the results of the audits of central government, the then Auditor-General commented on the constant change in the operating environment and externally, and the challenges this had brought over the previous seven years. With the potential for further natural disasters, and with current international developments, there will undoubtedly continue to be changes and challenges for central government agencies to respond to. These may require central government agencies to respond in an agile and timely manner.

It is important that agencies continue to provide quality reporting in a timely manner to ensure that their financial and performance reports continue to be of a standard that promotes transparency and accountability to Parliament and the public of New Zealand.

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

Greg Schollum
Deputy Controller and Auditor-General

6 December 2017

# The operating environment for central government

1

1.1 In this Part, we describe the operating environment for central government agencies in 2016/17. The description provides some context for this report – in particular, for our audit of the financial statements of the Government of New Zealand (the Government's financial statements). We set out the situation as it was in the last full financial year of the 51st New Zealand Parliament. The policies and programmes described are those of the Government at the time, and some or all of these may change as the new Government implements its own priorities.

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

## Government priorities during 2016/17

1.3 The Government changed one of its four priorities from previous years to include its response to the Kaikōura earthquake. Its fiscal strategy remained unchanged from the previous year.[2] The four priorities were as follows:

- responsibly managing the Government's finances;
- building a more productive and competitive economy;
- delivering better public services within tight financial constraints; and
- rebuilding of Christchurch (from the 2010/11 earthquakes) and responding to the Kaikōura earthquake.[3]

1.4 Shorter term fiscal priorities were:

- maintaining rising OBEGAL[4] surpluses over the forecast period so that cash surpluses are generated and net debt begins to reduce in dollar terms;
- reducing net debt to around 20% of gross domestic product (GDP) by 2020;
- if economic and fiscal conditions allow, beginning to reduce income taxes; and
- using any further "fiscal headroom" – including from unanticipated revenue – to reduce net debt faster.

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

2 New Zealand Government (2016), *Budget Policy Statement 2017*, page 5. Available at www.treasury.govt.nz.

3 New Zealand Government (2016), 2016, *Budget Policy Statement 2017*, page 6. Available at www.treasury.govt.nz.

4 OBEGAL is Operating balance before gains and losses. It represents total Crown revenue less total Crown expenses.

## Events and changes affecting financial and performance reporting

### Fiscal situation

1.5 The Government continued its focus on reducing net debt, and to limiting increases in core Crown expenditure, through an annual operating allowance of $1.5 billion. Although there were a number of cost pressures in 2016/17, including the effects of the Kaikōura earthquake, the OBEGAL result for the year was an surplus of $4.069 billion.[5]

1.6 The Government identified external risks to the economy from overseas events, trends, and developments. The global economy is experiencing low growth, and there is uncertainty about the potential effect on New Zealand of events such as Brexit, imbalances in the Chinese economy, and other global trade developments.[6]

### A policy environment of greater expectations and scrutiny

**Better Public Services**

1.7 The Government launched the Better Public Services programme (BPS) in March 2012 with the expectation that public entities would improve their service delivery and change the way they operate. As part of the BPS agenda, the Government set targets for 10 "results", which were grouped into result areas.

1.8 The Government published a report on its BPS targets and released a set of "refreshed" targets in March 2017. The report stated that four of the first set of results were expected to be reached by the target date, and four were progressing well but with changes still to be embedded. The Cabinet paper proposing changes to the targets classified six of the set of 10 results adopted in March 2017 as new, while four of the results continued (with updated descriptions, targets, and measures).

1.9 Figure 1 shows the updated BPS targets, with new results in bold.

5 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*, Wellington, page 28.

6 New Zealand Government (2016), *Budget Policy Statement 2017*, page 3. Available at www.treasury.govt.nz.

**Figure 1**
**Better Public Service results and targets, as updated in March 2017**

| | Result | Target |
|---|---|---|
| 1 | Reduce long-term welfare dependence | By June 2018, a 25% reduction of the number of people receiving main benefits. |
| 2 | **Healthy mums and babies** | By 2021, 90% of pregnant women are registering with a Lead Maternity Carer in the first trimester. |
| 3 | **Keeping kids healthy** | By 2021, a 25% reduction in the number of hospitalisations of children for preventable conditions.<br>(directly linked to Result 8) |
| 4 | Reduce the number of assaults on children | By 2021, a 20% reduction in the number of children experiencing a substantiated incidence of physical or sexual abuse. |
| 5 | **Improve mathematics and literacy skills** | By 2021, 80% of year 8 students are achieving at or above the National Standard in writing, or at Manawa Ora or Manawa Toa in Ngā Whanaketanga Rumaki Māori tuhituhi.<br>By 2021, 80% of year 8 students are achieving at or above the National Standard in mathematics, or at Manawa Ora or Manawa Toa in Ngā Whanaketanga Rumaki Māori pāngarau. |
| 6 | Upskill the New Zealand workforce (renamed) | By 2018, 60% of 25–34 year olds will have a qualification at Level 4 or above. |
| 7 | **Reduce serious crime** | By 2021, reduce the number of serious crime victimisations by 10,000. |
| 8 | **Better access to social housing** | By 2021, a 20% reduction in the median time to house for priority A clients on the social housing register. |
| 9 | Easy and seamless services for business | By 2020, business costs from dealing with government will reduce by 25%, through a year-on-year reduction in effort required to work with agencies. |
| 10 | **People have easy access to public services** | By 2021, 80% of the twenty most common transactions will be completed digitally. |

Note: For a more detailed explanation of these results and targets, see the State Services Commission's website at ssc.govt.nz.

1.10 Figure 2 shows the six result areas that were replaced.

**Figure 2**
**Results replaced in the March 2017 update of Better Public Services**

| | Result | Target |
|---|---|---|
| 2 | Increase participation in early childhood education | 98% of children enrolled in early childhood education. |
| 3 | Increase infant immunisation and reduce rheumatic fever | 95% of 8-month-olds are fully vaccinated.<br>Reduce from 4 first-episode rheumatic fever hospitalisations per 100,000 to 1.4 per 100,000 by June 2017. |
| 5 | Increase proportion of 18-year-olds with NCEA Level 2 | 85% of 18-year-olds have NCEA Level 2 by 2017. |
| 7 | Reduce rates of total crime, violent crime, and youth crime | From a June 2011 baseline:<br>Reduce violent crime rate by 20% by June 2017.<br>Reduce youth crime rate by 25% by June 2017.<br>Reduce total crime rate by 20% by June 2018. |
| 8 | Reduce re-offending | From a 2011 baseline, reduce re-offending by 25% by 2017. |
| 10 | New Zealanders can complete their transactions with the Government easily in a digital environment | By 2017, 70% of most common transactions with the Government will be completed in a digital environment. |

1.11 For each of the BPS targets they are responsible for, agencies are required to publish action plans on their websites that identify the Chief Executives accountable for delivering the result, the actions planned, and the agencies involved. In March 2017, Cabinet was asked to agree to agencies reporting six-monthly on progress to Cabinet and the public. Although the Auditor-General does not audit the results as a matter of course, some results that are included in a public entity's reported performance information (for example, the infant immunisation result reported in the Ministry of Health's annual report) are part of the information subject to the annual audit.

## Social investment approach

1.12 The Government further developed and embedded its social investment and "life course" approach in 2016/17. The Government defined social investment as an approach that puts the needs of people who rely on public services at the centre of decisions about planning, programmes, and resourcing. It includes setting goals, measuring effectiveness of services, and purchasing outcomes rather than inputs. The expectation is that effective interventions at early life stages can reduce the need for more expensive and less effective interventions later in life. Social investment, taking this life course approach, relies on agencies working collaboratively and taking joint responsibility for addressing major issues facing New Zealanders at each life stage.

## Structural change in the social sector

1.13 There were a number of organisational changes in 2016/17 for social sector agencies, including:

- A new public service department, the Ministry for Vulnerable Children, Oranga Tamariki started its work in April 2017. This was a significant re-organisation, extracting the former Child, Youth and Family unit, along with other related functions, from the Ministry of Social Development (MSD). The establishment of the new ministry was part of a major overhaul of government functions supporting children and young people. It followed recommendations by the Expert Advisory Panel that was tasked with reviewing the care and protection system, and the establishment of the Investing in Children Programme in 2016. The establishment of the new ministry included the transfer of more than 3000 staff from MSD, which reduced the size of MSD by about one-third. The functions of the new ministry are supported by changes to the principal legislation, which was also renamed: the Oranga Tamariki Act 1989 or the Children's and Young People's Well-being Act 1989.
- The Government established the Social Investment Agency (the SIA), which began operations as a departmental agency of the State Services Commission on 1 July 2017. The SIA replaces the Social Investment Unit, which was a cross-agency unit. The SIA is responsible for supporting the social sector to take a social investment approach, provide whole-of-system advice, and test and trial new approaches. The Social Investment Board was also set up on 1 July 2017. This is made up of the Chief Executives of the Ministries of Education, Health, Justice, and Social Development, with an independent chairperson. The Social Investment Board is charged with providing strategic direction and oversight of investments for achieving joint results in the social sector.
- The decision was made to disestablish Superu (the Social Policy Evaluation and Research Unit, formerly the Families Commission). Disestablishment will require legislative changes that have yet to be worked through. Some functions are likely to be incorporated into the SIA, MSD, and other social sector entities.

### Other agency changes

1.14 Another significant change under way is the implementation of the Business Transformation Programme by the Inland Revenue Department (Inland Revenue). Work on this programme began in July 2011, and it will continue through to 2021. This programme will change most aspects of the way that Inland Revenue carries out its work and how people and businesses interact with the tax system.

1.15 The programme achieved an important milestone in February 2017 with the introduction of new goods and services tax online services. Subsequent phases will include changes to the way individuals and businesses deal with Inland Revenue on income tax matters, and the integration of Inland Revenue's core tax system with the accounting software used by businesses.

### Continued effect of earthquakes

1.16 The Government's efforts in rebuilding Christchurch after the 2010/11 earthquakes have been a focus for our audits in the last few years. Responsibility for the different aspects of the rebuilding effort is now distributed between several different entities since the disestablishment in April 2016 of the Canterbury Earthquake Recovery Authority (CERA).

1.17 The Kaikōura earthquake affected the North Canterbury, Marlborough, and Wellington regions in different ways. Earthquake damage to infrastructure, particularly roading and rail in the South Island, has required greater maintenance of secondary roads that are now used for a much greater volume of freight transport.

1.18 In Wellington, many government offices experienced disruption, and some government agencies needed to arrange alternative accommodation during the initial disruption and in the months that followed. At the time of writing, several government departments, including the Ministry of Transport, New Zealand Defence Force, the Ministry of Defence, and Statistics New Zealand, continue to operate in temporary premises.

1.19 The Treasury forecast that the cost of the Kaikōura earthquake would be about $2-3 billion "over time". The Earthquake Commission (EQC) has estimated claims will cost nearly $0.6 billion, and another $0.2 billion has been recognised so far (to 30 June 2017) on restoring the rail and road transport links. More spending will be needed on transport infrastructure in 2017/18. The economic impact is also expected to be significant. A modelling report prepared for the Ministry of Transport in February 2017 assessed the loss to GDP as between $465 million and $513 million over 24 months from November 2016.[7]

7 m.e. environment (2017) *Economic impact of the 2016 Kaikōura earthquake – A report prepared for the Ministry of Transport*, Auckland, page 46. Available at www.transport.govt.nz.

1.20 Financial reporting for damage and disruption from the Kaikōura earthquake has been a challenge for some government departments in 2016/17. The unexpected nature of earthquake events and their damage and disruption can lead to unplanned public expenditure, which can have consequent implications for financial reporting and the proper authorising of new expenditure. (We discuss this further in Part 3.)

## Changes to legislation and standards affecting the audits of public entities

**Key audit matters**

1.21 Changes to auditing standards in 2016 mean that auditors are now required to include key audit matters in the audit report of certain entities. Key audit matters are the matters that, in the auditor's professional judgement, are of most significance in the audit of the financial statements.

1.22 At this stage, public entities covered by the requirement include mixed-ownership model companies, Auckland Council, and some port companies. The requirement extends to all "FMC reporting entities"[8] considered to have a higher level of public accountability for reporting periods ending on or after 31 December 2018.

1.23 Although not required to do so by the new standard, the previous Auditor-General decided, as a matter of good practice, to include key audit matters in the audit report on the Government's financial statements. We have continued this approach for this year. We also included key audit matters in the audit report of the Reserve Bank of New Zealand.

## Leadership from the centre

1.24 The State Services Commission (SSC), the Treasury, and the Department of the Prime Minister and Cabinet (DPMC) exercise leadership roles as the central agencies. The State Services Commissioner appoints public service chief executives and manages the process for certain other State sector appointments.

1.25 The SSC is responsible for overseeing the conduct of public servants and the integrity of the system. The SSC has recently investigated matters relating to CERA and the Ministry of Transport. It has also issued new standards designed to support staff on speaking up about wrongdoing that could damage the integrity of the State sector.

1.26 "Functional leadership" aims to improve the effectiveness and reduce the overall costs to government of common business functions. Functional leadership roles continued in 2016/17 for two public service Chief Executives: the Chief Executive of the Ministry of Business, Innovation and Employment continued to be

8 FMC reporting entities are those with reporting obligations under the Financial Markets Conduct Act 2013.

responsible for Government procurement reform and the Government National Property strategy; and the Chief Executive of the Department of Internal Affairs/Chief Government Information Officer continued to be responsible for the ICT Strategy and Action plan.

1.27 In 2016/17, a new functional leadership role for Health and Safety was established. The role is currently held by the Chief Executive of the Department of Corrections.

## Changes ahead

1.28 The September 2017 General Election resulted in a change of government. We expect to see the environment that public entities operate in start to change as new policies and priorities are put in place, and as agencies adapt to those new policies and priorities.

# Our audit of the financial statements of the Government

2

2.1 In this Part, we report the results of our audit of the financial statements of the Government (the Government's financial statements) for 2016/17.

2.2 We discuss matters arising from our audit, including the audit opinion and the key audit matters in our audit report on the Government's financial statements.

2.3 We issued an audit report that included an unmodified audit opinion on the Government's financial statements for 2016/17.

2.4 We issued our audit report on 29 September 2017.

## Our audit opinion

2.5 The audit report appears on pages 136 to 142 of the Government's financial statements. It includes our opinion that those statements:

- present fairly, in all material respects, the Government's:
  - financial position as at 30 June 2017;
  - financial performance and cash flows for the year ended on that date;
  - borrowings as at 30 June 2017;
  - unappropriated expenditure for the year ended 30 June 2017;
  - expenses or capital expenditure incurred in emergencies for the year ended 30 June 2017; and
  - trust money administered by departments for the year ended 30 June 2017; and
- comply with generally accepted accounting practice in New Zealand, in accordance with Public Benefit Entity accounting standards.

## Key audit matters and other significant matters

2.6 This is the second year in which we have included key audit matters in our audit report. Key audit matters are those matters that, in the auditor's professional judgement, are of most significance in the audit of the financial statements.

2.7 In determining the key audit matters, we considered matters that, in our view, were complex, had a high degree of uncertainty, or were otherwise important to the public because of their size or nature. The key audit matters for 2016/17 were:

- recognising tax revenue;
- valuing property, plant, and equipment;
- valuing insurance and superannuation liabilities; and
- valuing financial assets and liabilities.[9]

9 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*, Wellington, pages 137-140.

2.8 Accounting for and reporting these matters was not straightforward, not least because of the judgements, estimates, and assumptions underpinning their measurement. These included assumptions and judgements about the future, particularly the service benefits and cash flows that could be expected from existing assets and liabilities. They could also include assumptions about market prices, interest rates, foreign exchange rates, inflation rates, and discount rates.[10]

2.9 We have reproduced the complete audit report, including the key audit matters, in the Appendix.

### Other significant matters arising from the audit

2.10 Other significant matters arising from the audit were related to:

- the Crown's obligation to City Rail Link Limited; and
- income-related rent subsidy.

## Key audit matters for 2016/17

### Recognising tax revenue

2.11 The main sources of revenue for the Government are income tax and goods and services tax. These revenue sources total $68.3 billion for the year ended 30 June 2017. The calculation of revenue from income tax is subject to significant assumptions and judgements caused by the timing differences between the reporting date and when taxpayers file tax returns.

2.12 Judgement was applied to estimating tax revenue, and the associated receivables and payables as at 30 June 2017, where taxpayers are yet to file their returns, or where payments have been received but no provisional or final tax return has been filed.

2.13 We carried out detailed audit work on these estimates because errors in the underlying assumptions and judgements could result in significant inaccuracies in the Government's financial statements. Our audit work included:

- obtaining an understanding of the systems, processes, and controls in place over tax revenue;
- the testing of underlying data; and
- assessing the reasonableness of estimation models by checking revenue received relating to previous years against estimates made in those years.

2.14 We continue to recommend that Inland Revenue improves its methods for estimating income tax revenue in the year to which it relates. To date, Inland Revenue has determined that its options are limited by the cost and feasibility of

10 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*, Wellington, Note 2 to the financial statements, pages 43-45.

making such improvements in its current system. However, we understand that Inland Revenue's management team plans to use the opportunities afforded by work on a new system, as part of its Business Transformation project, to develop more accurate and robust revenue estimation approaches. We support ongoing efforts to improve Inland Revenue's processes for estimating tax revenue.

2.15 Overall, we are satisfied that the assumptions and judgements applied in estimating tax revenue were reasonable.

## Valuing property, plant, and equipment

2.16 The Government's physical assets total $144.6 billion at 30 June 2017. Some assets are more difficult than others to value because of the uncertainties inherent in the valuation of these assets, the quality of data available, and the benefits these assets provide. We identified the following significant assets where there were inherent uncertainties involved in the valuations:

- rail network assets;
- the State highway network;
- electricity generation assets; and
- social housing.

2.17 Overall, we are satisfied that the valuations for these assets were reasonable and consistent with valuation practices. The disclosures appropriately outline the basis of valuation and the uncertainties associated with valuation of the assets.

### Rail network assets

2.18 One of the key assumptions used in preparing the Government's financial statements is that assets will continue to be held for their intended purpose. For accounting purposes, this determines the basis on which these assets are valued, either on a for-profit basis or a public benefit basis.

2.19 Assets that are held with the primary purpose of making a profit are valued commercially, based on the income that can be generated from the asset or what the asset can be sold for. Assets that are held for public benefit purposes are generally valued at optimised depreciated replacement cost. This is the cost of replacing all the components of the asset, less an amount that reflects the age and condition of those components.

2.20 Since 2012, as part of the restructuring of New Zealand Railways Corporation, the Rail Freight Network assets transferred to KiwiRail Holdings Limited have been valued on the basis that their intended use is to generate a commercial return. The Rail Freight Network assets had a value of $96 million at 30 June 2017. The network not used for freight (including metropolitan rail services), with a value of $724 million at 30 June 2017, is valued on a different basis because these assets are considered to provide a broader public benefit.[11]

2.21 The extent to which the Rail Freight Network is commercial is open to debate. If it were not considered commercial, the basis for valuing the Rail Freight Network would change to reflect a public benefit nature. This would result in the overall rail network increasing in value by up to $4.3 billion.

2.22 We considered the evidence for the commercial treatment against that supporting a public benefit treatment of the Rail Freight Network. As in past years, this showed mixed results. The evidence included the State-owned Enterprises Act 1986, KiwiRail strategy documents, forecast results, correspondence setting out Ministers' expectations, and KiwiRail Board minutes. We also considered the terms of reference for the current review of rail in New Zealand, the objective of which is to consider KiwiRail's operating structure, capital requirements, and funding mechanisms. The outcome of this review will be important in deciding whether valuing the Rail Freight Network on a commercial basis remains appropriate.

2.23 We have accepted the status quo for the valuation of the Rail Freight Network at 30 June 2017, largely because of the current review. We will continue to monitor the progress of the review to inform our position at 30 June 2018 about whether valuing the Rail Freight Network on a commercial basis remains appropriate.

2.24 We have recommended that the Treasury review the accounting treatment for 2017/18, taking into account the progress (or outcome) of the review.

### State highway network

2.25 The valuation of the State highway network (excluding land), $23.8 billion at 30 June 2017, is carried out by an independent external valuer.

2.26 The valuation is based on information from several of the New Zealand Transport Agency's (the Agency's) databases that identify the asset components that make up the network and their expected useful lives. There remain some uncertainties about the values assigned to different components (such as bridges), because of limited information on quantities and useful lives.

2.27 We are pleased to note that, since 1 July 2013, the Agency has estimated the additional costs associated with road construction in urban areas (such as for traffic management), commonly referred to as "brownfield" costs. The Agency incorporated those costs in the valuation of the network. The cumulative amount of such costs recognised at 30 June 2017 is $1.2 billion. Over time, brownfield costs will be progressively recognised in the valuation of the network. We agree

11 The rail network assets include the rail freight network, the network not used for freight, buildings, and capital work in progress.

with the Agency and its valuers that, given the uncertainty and lack of data to reasonably quantify the costs, it is reasonable that the brownfield costs incurred before 1 July 2013 are not included in the State highway network valuation.

**Electricity generation assets**

2.28 Electricity generation assets are majority owned by the Government (at least 51%). The valuation of those assets, $15.9 billion at 30 June 2017, is carried out by specialist valuers. Specialist valuers are used because of the complexity and significance of assumptions about the future prices of electricity, the generation costs, and the generation volumes that these assets will create.

2.29 Small changes to assumptions, such as for the forecast prices of electricity and discount rates used to determine the present value of these prices, could significantly change the value of these assets.

2.30 The specialist valuers of each of the generation companies have different assumptions and make different disclosures about the valuation of generation assets. Although there are differences, we are satisfied about the reasonableness of the differences.

2.31 Differences have been accepted because:

- each generation company has used the best information available, based on its circumstances and expectations, which are supported by the specialist valuers it engages; and
- the information in the Government's financial statements is consistent with other information available in the market.

**Social housing**

2.32 The social housing portfolio has been valued at $26.8 billion as at 30 June 2017. The portfolio is valued on a "highest and best use" basis, as required by accounting standards, which is aligned to market prices for properties of a similar size and condition in the same geographical location. In the year ended 30 June 2017, the value of social housing increased by $2.5 billion, mainly as a result of an increase in land values in Auckland (where 44% of the housing units are located).

2.33 A small portion of the social housing portfolio has been, or is being, disposed of to community housing providers, as part of the Social Housing Reform Programme (the Reform Programme). The Reform Programme is aimed at meeting the needs of social housing tenants by providing houses through a greater range of providers than just Housing New Zealand Corporation (HNZC).

2.34 As part of the disposal of properties to third-party social housing providers, encumbrances are placed on the properties to ensure that their social housing purpose is maintained. Encumbrances affect the highest and best use of the properties and therefore reduce their fair value. This reduction in value has been calculated using a valuation model that includes a series of assumptions about future income and expenditure for the properties.

2.35 Based on three transactions in the last two financial years, the average reduction in fair value is about 60%. The reduction in value is charged against the revaluation reserve. It has no effect on the operating balance in the Government's financial statements.

2.36 As part of these transactions, the Crown, through the Ministry of Social Development (MSD), enters into long-term agreements with the social housing provider to make houses available to people seeking social housing through MSD. In addition, as part of the disposal of the properties, the Crown protects its interest in the difference between the purchase price offered by the social housing provider and the unencumbered fair value (highest and best use value) of the property.

### Valuing insurance and superannuation liabilities

2.37 The valuation of the Government's long-term liabilities is complex and requires actuaries to estimate their fair value, based on assumptions about the future. The two significant long-term liabilities at 30 June 2017 are the Accident Compensation Corporation's (ACC's) outstanding claims liability of $37.7 billion and the Government employees' superannuation liability of $11.0 billion. These liabilities are significant by value, and there are inherent uncertainties in valuing them that require a high degree of judgement and estimation.

2.38 The assumptions used to calculate the value of ACC's outstanding claims liability include estimating the length of rehabilitation from injuries, estimating amounts of cash payments and when they will be made, and estimating inflation and discount rates.

2.39 The assumptions used to calculate the value of the Government employees' superannuation liability for past and current members of the Government Superannuation Fund include estimating the return on assets owned by the Fund, expected rates of salary increases for currently employed members of the Fund, inflation and discount rates, and mortality rates.

2.40 Note 2 of the Government's financial statements sets out the sensitivity of these assumptions. There can be a large effect on the amount of these liabilities when there are changes in the assumptions, which also affects the amount of actuarial gains and losses.

2.41 We evaluated the appropriateness of the main assumptions (such as inflation and discount rates) used in valuing the long-term liabilities. For discount rates and inflation assumptions, the Treasury determines a table of risk-free discount rates and inflation assumptions each year, using an agreed methodology. These are required to be consistently applied to valuations of long-term liabilities. We reviewed the table of risk-free discount rates and inflation assumptions as at 30 June 2017 and concluded that they had been calculated in keeping with the agreed methodology.

2.42 We have recommended that the Treasury consider the recommendations from our review of the methodology as part of its annual review process.

2.43 Overall, we are satisfied that the ACC outstanding claims liability and the Government employees' superannuation liability are reasonable and that the disclosures outlined the sensitivity of the valuations to changes in assumptions.

### Valuing financial assets and liabilities

2.44 The Government has financial assets of $133.4 billion, of which $75.3 billion are measured at fair value. It also has financial liabilities of $128.3 billion, of which $7.6 billion are measured at fair value. The financial assets and liabilities measured at fair value include marketable securities, share investments, advances, and derivatives.

2.45 The fair value of some of the financial assets and liabilities cannot be measured using quoted market prices and, instead, must be estimated by applying an appropriate valuation model. Market data are used when available, otherwise non-market data are used, which require the exercise of significant judgement. We paid particular attention to evaluating the appropriateness of inputs to models that had been derived from non-market data.

2.46 We are satisfied that the fair values for financial assets and financial liabilities were reasonable and that the disclosures were appropriate.

## Other significant audit matters

### The Crown's obligation to City Rail Link Limited

2.47 The Government's financial statements for 2015/16 included a note disclosing the Crown's commitment to fund 50% of the costs relating to the City Rail Link in Auckland. We considered whether the Crown had an obligation at 30 June 2017 for the costs incurred to date that should be recognised in the Government's financial statements.

2.48 We noted that several agreements had been concluded between the Crown and Auckland Council before 30 June 2017, as well as the establishment of City Rail Link Limited (CRLL), which is the entity that is responsible for carrying out the project and owning the rail link assets.

2.49 We concluded that the Crown had no obligation that should be recognised in the Government's financial statements because the Crown's involvement in CRLL will be as a shareholder. At 30 June 2017, CRLL had not issued shares to the Crown nor had the Crown paid in advance for them.

2.50 We are satisfied that this matter has been appropriately disclosed in the Government's financial statements.

### Income-related rent subsidy

2.51 The amounts paid by MSD to HNZC and Tāmaki Regeneration Limited (TRL) for income-related rent subsidies are treated as income by HNZC and TRL and as non-departmental output expenses by MSD. The Government's financial statements reflect these transactions as both income and expenditure, on the basis that the subsidy is equivalent to a benefit payment to the tenant. This results in the Government's financial statements recognising rental income at market levels, even though the rents received from tenants may not be at a market rate.

2.52 The underlying documentation used to support the accounting treatment – the agreement between MSD and HNZC/TRL, the tenancy agreement, and scope of the appropriation – is not clear that the subsidy should be viewed as a benefit payment to the tenant. Rather, the subsidy appears to be simply the moving of money from one government agency to another, which, at the Government reporting level, should be off-set.

2.53 We have recommended that the Treasury review support for the current accounting treatment for the income-related rent subsidy paid to HNZC and TRL. In doing this, the Treasury, along with MSD, HNZC, and TRL, should review the documentation, clarify who the intended recipient of the subsidy is, and consider whether the subsidy is best characterised (and accounted for) as a benefit payment to the tenant or a purchase of tenancies from a social housing provider.

# 3 The Controller function

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

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

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

3.3 Parliament's approval to incur expenditure is mainly provided through appropriations, which are authorised in advance through the annual Budget process and annual Acts of Parliament. Expenditure can also be authorised in advance through "permanent" legislation and can also be approved retrospectively.

3.4 We have explained in previous years what the Controller and Auditor-General does to help ensure that government spending stays within the limits approved by Parliament.[12]

3.5 Our discussion in this Part includes:

- why the Controller work is important;
- who is responsible for ensuring that public money is spent correctly;
- how much unappropriated expenditure was incurred with authority in 2016/17; and
- how much public expenditure was incurred without prior authority in 2016/17.

## Why is the Controller work important?

3.6 In their role as Controller, the Controller and Auditor-General helps maintain the transparency and legitimacy of the State sector financial management system. The Controller provides an important check on the system on behalf of Parliament, taxpayers, and the New Zealand public.

3.7 The appropriation part of the State sector financial management system ensures that Parliament, on behalf of New Zealanders, has adequate control over how the Government uses public resources. It also ensures that the Government can be held to account for how it has used those resources.

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

12 See *Central government: Results of the 2014/15 audits*, Part 3, and *About the Controller and Auditor-General*, Part 3. Available at oag.govt.nz.

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

3.9 Departmental chief executives are responsible under the Public Finance Act 1989 for the financial management and performance of their department.[13] This includes ensuring that they have both the funds and the necessary legal authority before incurring expenses or capital expenditure.

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

3.11 The Treasury is then required to compile a monthly report (from September to June) to the Controller and Auditor-General that sets out all expenditure incurred compared with the appropriation (or other authority)[14] and all expenditure incurred without authority or in excess of the authority given.

### Who checks whether departments are spending money lawfully and responsibly?

3.12 This is where the function of the Controller comes in.[15] To check and verify the spending, the Controller and Auditor-General's appointed auditors:

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

3.13 For government departments, as well as auditing the financial statements, the Controller and Auditor-General is responsible for auditing the appropriations administered by each department (the appropriation audit).[16]

3.14 Through the appropriation audit, our auditors look at systems and some transactions to ensure that public money was spent as intended by Parliament. If an auditor appointed by the Controller and Auditor-General detects spending outside authority through the appropriation audit work, then the auditor will discuss the matter with the department's chief executive, advise the department

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

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

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

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

about reporting the matter and taking corrective action, and inform the Auditor-General. The auditor will also check whether the department properly reports the matter in its financial statements.[17]

3.15 The appropriation audit for 2016/17 was carried out as part of the audit of the financial statements of all government departments on behalf of the Controller and Auditor-General. The Controller and Auditor-General's staff have also carried out assurance work on the data underlying the Government's appropriation reports for 2016/17. This was carried out in conjunction with the Treasury and helped to identify whether any unappropriated expenditure had been incurred during the year.

## Expenditure above or beyond the appropriation limits

3.16 The State sector financial management system provides flexibility to enable lawful spending above or beyond the limits specified by each appropriation. (Those limits comprise the type of expenditure, the scope of what the expenditure can cover, the amount, and the timing.)

3.17 In limited circumstances, expenditure can be legally incurred outside the bounds authorised by the Appropriation (Main Estimates) Act or the Appropriation (Supplementary Estimates) Act. For example, there is flexibility in the Public Finance Act 1989 for small amounts of expenditure (sections 26A and 26B) and for emergencies (section 25). Imprest Supply Acts also provide flexibility to enable the Government to incur expenditure not covered at the time by Appropriation Acts. In practice, Cabinet approval is required to incur expenditure under the provisions of an Imprest Supply Act.

3.18 We have urged government departments to seek early approval as soon as they have identified the need for previously unanticipated expenditure, so that any expenditure over and above the appropriation can be authorised before the event.

3.19 However, some events cannot be anticipated, such as expenses incurred from damage to assets caused by the Kaikōura earthquake in November 2016.

3.20 When approval for unappropriated expenditure is not obtained before the event, it is unlawful. Ministers need to report the matter to Parliament, and they must seek Parliament's retrospective approval of the expenditure through the Appropriation (Confirmation and Validation) Act.

3.21 Expenditure outside the bounds of the appropriations tends to be relatively small. In 2016/17, it was less than 0.14% of the Government's budgeted expenditure for 2016/17 as set out in the Main Budget 2016 (2015/16: less than 0.10%).

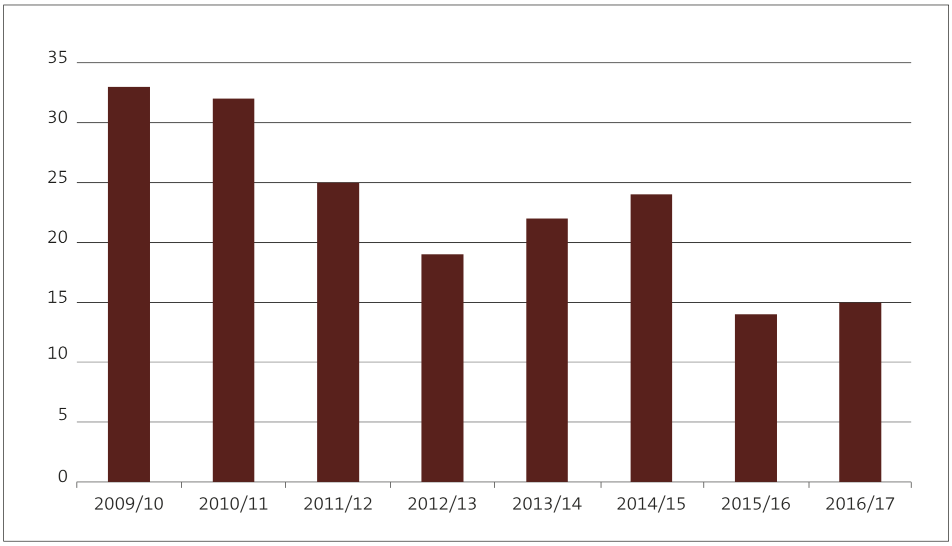
17 Within the Statements of Appropriations and Statement of Unappropriated Expenses and Capital Expenditure.

## How much unappropriated expenditure was incurred in 2016/17?

3.22 The Government's financial statements report 15 instances of unappropriated expenditure. Expenditure incurred without appropriation in 2016/17 was $124 million (2015/16: $78 million).

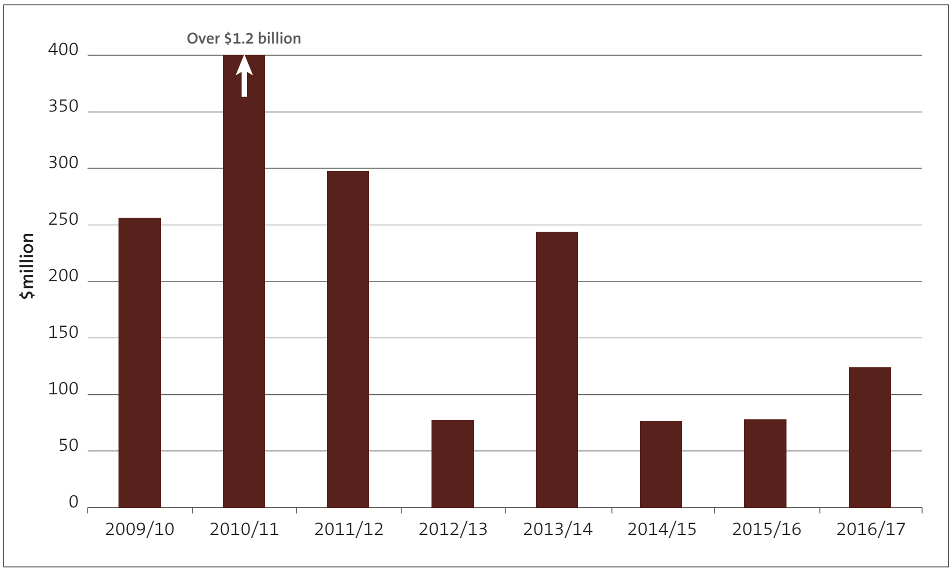
3.23 Figure 3 shows that the number of times that government departments have incurred unappropriated expenditure has fluctuated in recent years. However, since 2009/10, there has been an overall downward trend in incidences of unappropriated expenditure. More than 30 instances were reported in 2009/10 and 2010/11. By contrast, less than half of that has been reported in the last two years (14 in 2015/16 and 15 in 2016/17).

**Figure 3**
**Instances of unappropriated expenditure, from 2009/10 to 2016/17**




3.24 The dollar amount of unappropriated expenditure since 2009/10 is shown in Figure 4. After the extraordinary circumstances in 2010/11, in which unappropriated expenditure exceeded $1.2 billion (a figure that is literally off the chart) because of the Canterbury earthquakes, unappropriated expenditure fell to $298 million in 2011/12 and has fallen further still since then. In the last three years (2014/15 to 2016/17), unappropriated expenditure has averaged less than $100 million.

**Figure 4**
**Dollar amount of unappropriated expenditure, from 2009/10 to 2016/17**



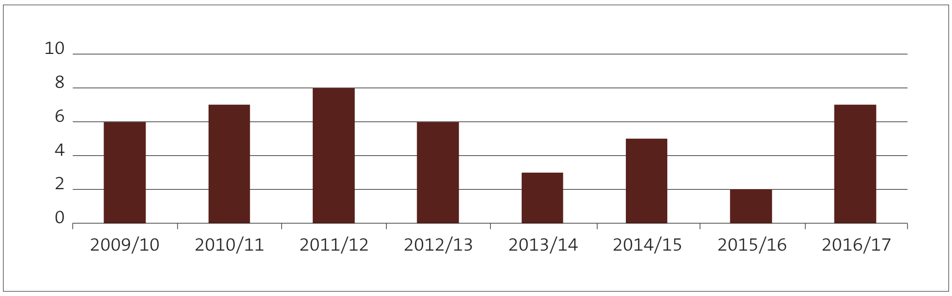

Note: The upper limit shown in Figure 4 is $400 million. Actual unappropriated expenditure for 2010/11 was more than $1.2 billion; most of this was authorised expenditure for the purchase of residential red zone properties in Canterbury after the February 2011 earthquake.

## How much unappropriated expenditure was incurred with authority?

3.25 As mentioned in paragraph 3.17, the Public Finance Act 1989 provides for some flexibility in how public expenditure is authorised. This is necessary to allow Government to function in the new financial year before the Appropriation (Main Estimates) Bill has been enacted, to allow for unanticipated expenditure during the year as circumstances change, to allow for immediate expenditure in emergencies, and to provide for the approval of relatively small amounts of expenditure in excess of appropriation without needing prior approval from Parliament.

3.26 In 2016/17, prior authority was obtained for seven instances of unappropriated expenditure (2015/16: two instances). Figure 5 shows the relatively low number of times in recent years that expenditure not covered by appropriations has been incurred with authority.

**Figure 5**
**Instances of authorised expenditure beyond appropriation limits, from 2009/10 to 2016/17**




3.27 The dollar amounts involved for the instances shown in Figure 5 are shown in Figure 6. In 2016/17, the Government's financial statements reported $34 million of unappropriated expenditure incurred with authority, compared with $5 million in 2015/16.[18] (As with Figure 4, the amount involved in 2010/11 is not fully represented here because, at over $1 billion, it is literally off the chart.)

3.28 During 2016/17, the Minister of Finance used his powers under the Public Finance Act 1989 to authorise six instances of unappropriated expenditure for a total of $4 million. All six instances related to Vote Police. The excess expenditure resulted from the New Zealand Police correcting a previously understated employee leave liability.[19] Six approvals were required because the increase in the liability exceeded the spending limit of six different appropriations. This expenditure is lawful but will need to be confirmed by Parliament in a subsequent Appropriation Act.

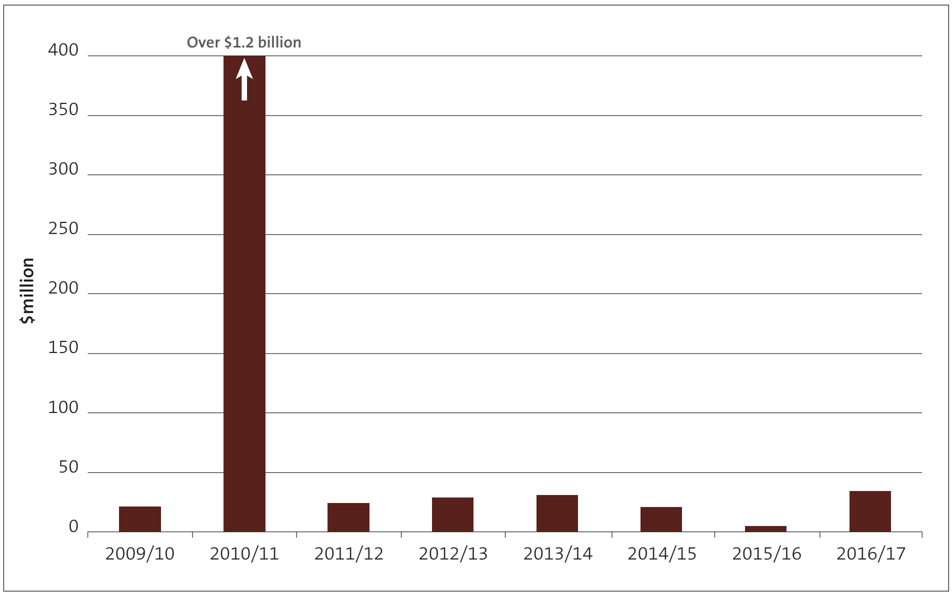
3.29 The unappropriated expenditure incurred with Cabinet authority during the year, amounting to $30 million, was under Vote Transport. The Main North Line (rail) between Picton and Christchurch was damaged during the Kaikōura earthquake. The cost to replace the Line was expected to be mainly funded by KiwiRail Limited's insurers; however, as part of Budget 2017, a tagged capital contingency was established to fund the costs of reinstating the Line that are not covered by insurance.

3.30 The contingency funding was forecast to be used in 2017/18. However, $30 million of the funding was approved for use in late June 2017 and, therefore, constituted unappropriated expenditure in 2016/17.

18 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*, Wellington, page 118.

19 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*, Wellington, page 119.

**Figure 6**
**Dollar amount of authorised expenditure beyond appropriation limits, from 2009/10 to 2016/17**




Note: The upper limit shown in Figure 6 is $400 million. Actual authorised expenditure beyond appropriation limits for 2010/11 was more than $1.2 billion; most of this was spent on purchasing residential red zone properties in Canterbury after the February 2011 earthquake.

## How much unappropriated expenditure was incurred without prior authority?

3.31 All unappropriated expenditure incurred without prior Cabinet authority is unlawful unless and until it is validated by Parliament through a subsequent Appropriation Act.

3.32 The Government's financial statements report eight instances of unappropriated expenditure incurred without prior Cabinet authority in 2016/17 (2015/16: 12 instances). The amount of expenditure incurred without prior authority was $90 million (2015/16: $73 million).[20] This was 0.10% of the Government's budgeted expenditure for 2016/17 as set out in the Main Budget 2016 (2015/16: 0.08%).

3.33 Figure 7 provides a breakdown of public expenditure that was not only unappropriated but also incurred without prior Cabinet authority.[21]

20 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*, Wellington, page 118.

21 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*, Wellington, page 118.

**Figure 7**
**Unappropriated expenditure incurred without prior Cabinet authority during the year ended 30 June 2017**

| Unauthorised expenditure by category | 2016/17 Number | 2016/17 $million* | 2016/17 Votes |
|---|---|---|---|
| Expenses and capital expenditure incurred in excess of appropriation and without prior Cabinet authority to use imprest supply | 4 | 12 | Arts, Culture and Heritage; Building and Housing; Conservation; Labour Market |
| Expenses and capital expenditure incurred outside the scope of an appropriation and without prior Cabinet authority to use imprest supply | 2 | 5 | Internal Affairs |
| Expenses and capital expenditure incurred without appropriation and without prior Cabinet authority to use imprest supply | 2 | 73 | Business, Science and Innovation; Transport |
| **Total** | **8** | **90** | |

* Figures are rounded to the nearest $million.

3.34 In four of the eight instances shown in Figure 7, the Government spent $12 million more than the amount that was authorised by existing appropriations. In other instances (Vote Internal Affairs), expenditure of $5 million was outside the scope of existing appropriations. In two further instances, expenditure totalling $73 million was not covered by any of the appropriations in the two Votes concerned (Business, Science and Innovation; and Transport).

3.35 The more significant instances of unauthorised expenditure reported in the Government's financial statements, in terms of the amounts involved, were in Votes Arts, Culture and Heritage; Internal Affairs; and Transport. Between them, they constitute more than $86 million of the $90 million of unappropriated expenditure incurred without authority.

## Vote Arts, Culture and Heritage

3.36 The Ministry for Culture and Heritage has leased the Dominion Museum Building to house the Great War Exhibition. The Ministry has recognised an expense for decommissioning costs of $8.9 million to reflect its obligations should the exhibition be discontinued. The expense for the possible future expenditure was not anticipated in 2016/17, and this has resulted in the Ministry incurring expenditure in excess of appropriation and without prior authority of $8.6 million.[22]

22 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*, Wellington, page 120; Ministry for Culture and Heritage (2017), *2016/17 Annual Report*, Wellington, page 94.

### Vote Internal Affairs

3.37 In Budget 2015, the scope of the appropriation for Members of the Executive – Travel was changed. One of the effects of the change was to exclude ministerial office staff's travel expenses from the scope of the appropriation. However, the Department of Internal Affairs continued to charge ministerial staff travel against this appropriation in 2015/16 and 2016/17. This resulted in unappropriated and unauthorised expenditure of $5.1 million over the two years.[23] In its annual report, the Department describes the effect as an unintended consequence of the change in the scope wording.[24]

### Vote Transport

3.38 Of the $90 million of unappropriated expenditure incurred without authority in 2016/17, $72.7 million was incurred by the Ministry of Transport.

3.39 In response to damage caused by the Kaikōura earthquake to State Highway 1 between Picton and Christchurch, Cabinet approved $812 million in capital expenditure for its restoration.[25] For 2016/17, $69 million of capital expenditure had been authorised through the Supplementary Estimates.[26] The total amount incurred during 2016/17 on the restoration of State Highway 1 was $93 million, most of which was outside the scope of appropriation because the nature of the expenditure was operating expenditure.[27]

3.40 Appropriations that are strictly for capital expenditure (that is, for purchasing or developing assets) cannot be used for operating expenditure (that is, for expenses). However, after the project started, a large portion of the expenditure was determined to be operating expenditure and outside the scope of the appropriation.[28] The Ministry of Transport sought and received Cabinet approval in June 2017 for a change in appropriation so that it now covers operating expenditure.

3.41 The Ministry of Transport notes in its annual report that it has re-examined the appropriations required for future years to ensure that they are split correctly between operating expenses and capital expenditure. A new, multi-category

23 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*, Wellington, page 121.

24 Department of Internal Affairs (2017), *2016-2017 Annual Report*, Wellington, page 128.

25 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*, Wellington, page 121.

26 *The Supplementary Estimates of Appropriations 2016/17*, B7, page 692. Available at www.treasury.govt.nz.

27 Ministry of Transport (2017), *Annual Report 2016/17*, Wellington, page 53.

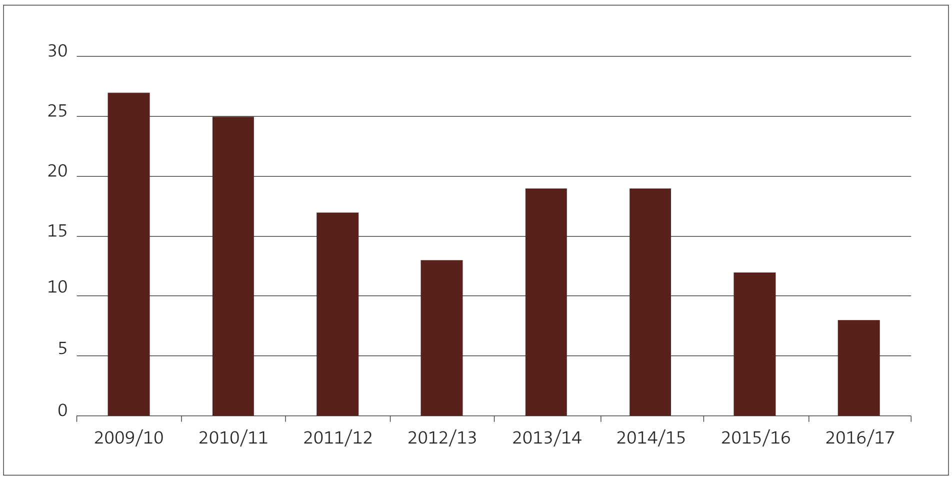
28 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017*, Wellington, page 121.

appropriation has been approved by Cabinet to ensure that this problem will not recur.

## Trend in unauthorised expenditure

3.42 Figure 8 shows that the number of times that expenditure was incurred without authority has declined overall in recent years. In 2016/17, there were only eight instances of expenditure incurred without prior authority, less than a third of the number that occurred in 2009/10 (27 instances).

**Figure 8**
**Instances of unappropriated expenditure incurred without authority, from 2009/10 to 2016/17**

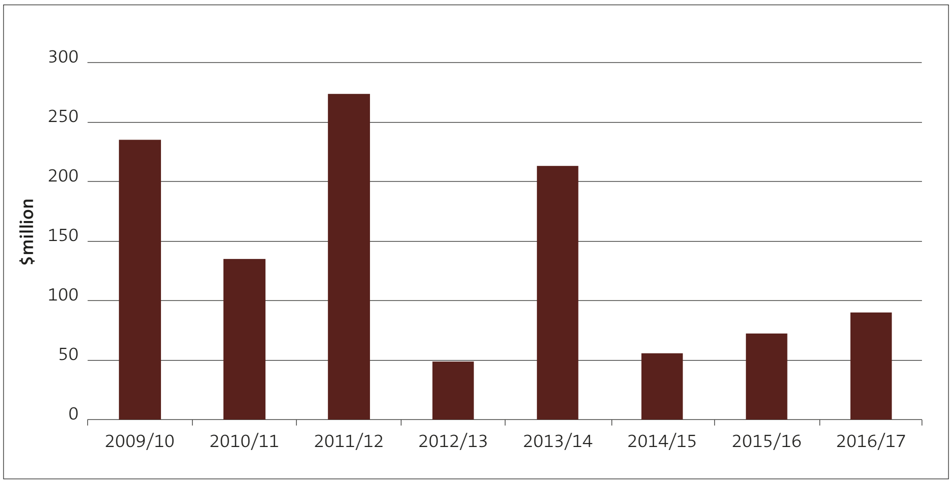



3.43 Figure 9 shows the dollar amount of unappropriated expenditure incurred without authority from 2009/10 to 2016/17. There appears to be no discernible pattern to the dollar amount of unauthorised expenditure in the past eight years.

3.44 We certainly expect the number of instances of unauthorised expenditure to decrease as government departments improve their budgeting and become better at anticipating the accounting implications of near-future events and their consequences for appropriations. Whether that translates into a decrease in the dollar amount of unauthorised expenditure is yet to be seen.

3.45 Over time, we might expect to see a loose correlation between the number of instances and the dollar amount of unauthorised expenditure as departments improve their management of appropriations, better anticipate events, and make better use of the flexibility provisions already provided in the Public Finance Act 1989. But the very nature of unanticipated expenditure might also see fluctuations between years in the dollar amount of unauthorised expenditure.

**Figure 9**
**Dollar amount of unappropriated expenditure incurred without authority, from 2009/10 to 2016/17**




## Effects of the Kaikōura earthquake

3.46 The town of Kaikōura and the surrounding region were significantly affected by the earthquake in November 2016. The effects spread further, as trade and travel were affected by damage to State Highway 1 and the Main North Rail Line between Picton and Christchurch.

3.47 The earthquake's effects extended to Wellington, which suffered significant damage. Several central government agencies' offices were affected by the earthquake and incurred unplanned expenditure as a result. Unplanned expenditure included the cost of alternative accommodation, hiring temporary office equipment, other costs incidental to working offsite, and the write-off of assets that were damaged or unable to be recovered from damaged property.

3.48 Because unexpected events such as earthquakes can lead to unplanned expenditure, there is a risk that government departments might incur expenditure over and above the budgeted appropriations. Two such examples are discussed in paragraphs 3.29 and 3.38-3.39.

3.49 Not all unplanned expenditure leads to unappropriated expenditure. In most instances, expenses relating to asset write-offs and additional costs resulting from the earthquake were covered by existing appropriations or through imprest supply. Because the earthquake was in November, affected departments were able to seek appropriations for some costs through the Government's budget revision exercise, known as the Supplementary Estimates, which passed into law as the

Appropriation (2016/17 Supplementary Estimates) Act 2017. New appropriations were provided through the Supplementary Estimates for writing off, or making good the damage to, departmental assets and re-establishing departmental operations after the earthquake.

3.50 The Public Finance Act 1989 has additional provisions that could be used in some instances for incurring unplanned expenditure outside appropriation. For example, if the Government declares an emergency, the Minister of Finance may then approve expenditure to be incurred to meet the costs of responding to the emergency or disaster under section 25 of the Public Finance Act 1989. However, no expenditure was incurred under this provision of the Act in response to the Kaikōura earthquake or for any other reason during 2016/17.[29]

3.51 It is also possible that some unplanned expenses could be exempted from requiring any express authority from Parliament. Under section 4(2)(a) of the Public Finance Act 1989, expenses that meet the definition of a "remeasurement" can be incurred without requiring any further Parliamentary authority. Although no earthquake-related expenses were treated as remeasurements for 2016/17, the Controller and the Treasury agreed in September 2017 that some expenses resulting directly from earthquake damage might, in future, qualify for treatment as remeasurements. Because remeasurements avoid the need to be expressly authorised by appropriation or other legislated authority, it is important that they are clearly identified and disclosed in departments' annual reports.

29 The Treasury (2017), *Financial Statements of the Government of New Zealand for the year ended 30 June 2017,* Wellington, page 122.

# Appendix
# Our audit report on the financial statements of the Government

CONTROLLER AND AUDITOR-GENERAL
Tumuaki o te Mana Arotake

**INDEPENDENT AUDITOR'S REPORT**

**TO THE READERS OF THE FINANCIAL STATEMENTS OF THE GOVERNMENT OF NEW ZEALAND FOR THE YEAR ENDED 30 JUNE 2017**

**Opinion**

I have audited the financial statements of the Government of New Zealand (the financial statements of the Government) for the year ended 30 June 2017 using my staff, resources and appointed auditors and their staff. The financial statements of the Government on pages 28 to 125 comprise:

- the annual financial statements that include the statement of financial position as at 30 June 2017, the statement of financial performance, analysis of expenses by functional classification, statement of comprehensive revenue and expense, statement of changes in net worth, and statement of cash flows for the year ended on that date, a statement of segments, and notes to the financial statements that include accounting policies, borrowings as at 30 June 2017, and other explanatory information;
- a statement of unappropriated expenditure for the year ended 30 June 2017;
- a statement of expenses or capital expenditure incurred in emergencies for the year ended 30 June 2017; and
- a statement of trust money, administered by departments, for the year ended 30 June 2017.

In my opinion, the financial statements of the Government on pages 28 to 125:

- present fairly, in all material respects the Government's:
  - financial position as at 30 June 2017;
  - financial performance and cash flows for the year ended on that date;
  - borrowings as at 30 June 2017;
  - unappropriated expenditure for the year ended 30 June 2017;
  - expenses or capital expenditure incurred in emergencies for the year ended 30 June 2017; and
  - trust money administered by departments for the year ended 30 June 2017.
- comply with generally accepted accounting practice in New Zealand, in accordance with Public Benefit Entity accounting standards.

My audit was completed on 29 September 2017. This is the date on which my opinion is expressed.

The basis for my opinion is explained below and I outline the key audit matters addressed in my audit. In addition I outline the responsibilities of the Treasury and the Minister of Finance and my responsibilities relating to the financial statements of the Government, I comment on other information, and I explain my independence.

**Basis for Opinion**

I carried out my audit in accordance with the Auditor-General's Auditing Standards, which incorporate the Professional and Ethical Standards and the International Standards on Auditing (New Zealand) issued by the New Zealand Auditing and Assurance Standards Board. My responsibilities under those standards are further described in the *Auditor's responsibilities for the audit of the financial statements of the Government* section of this report.

I have fulfilled my responsibilities in accordance with the Auditor-General's Auditing Standards.

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

**Key Audit Matters**

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

These matters were addressed in my audit of the financial statements of the Government as a whole, and in forming my opinion thereon.

| Recognising tax revenue | How we addressed this matter |
| --- | --- |
| The largest sources of revenue for the Government are income tax and goods and services tax. These revenue sources total $68.3 billion for the year ended 30 June 2017.<br><br>As outlined in note 2, income tax is subject to significant assumptions and judgements due to the timing differences between the reporting date and when taxpayers file tax returns.<br><br>In order to record tax revenue, judgement is applied to estimating:<br>- the amount of tax revenue to be collected from provisional taxpayers who have not yet filed their final tax return;<br>- the amount of tax revenue where payments have been received but no provisional or final tax return has been filed; and<br>- the amount of tax revenue to be collected from, or refunded to, taxpayers who are not subject to provisional tax.<br><br>I considered the recognition of tax revenue to be a key audit matter because of the significant assumptions and judgements applied. | We obtained an understanding of the systems, processes and controls in place over the receipt and review of provisional and final tax returns, tax assessments, and tax revenue receipts.<br><br>We assessed controls in place over significant reconciliation processes.<br><br>We tested the underlying data used in the various tax revenue estimation models to ensure that it was relevant and was used appropriately. This was performed by reviewing evidence to support key assumptions. The sensitivity of key assumptions was also tested.<br><br>We tested the reasonableness of the estimation models by checking actual revenue received related to previous financial years against estimates made in those years.<br><br>I am satisfied that the assumptions and judgements applied in estimating tax revenue are reasonable. |

| Valuing property, plant and equipment | How we addressed this matter |
| --- | --- |
| The Government owns significant physical assets totalling $144.6 billion.<br><br>The valuation of some of these assets requires significant judgement due to the uncertainties inherent in the valuation of these assets, the quality of data available and the benefits these assets provide. I have identified some specific assets where such judgements are evident. | |
| *State highway network* | |
| As outlined in note 16, the state highway network has been valued at $23.8 billion at 30 June 2017 by an independent external valuer. The valuation is based on information from a number of databases that identify the asset components that make up the network (roads, bridges, culverts, etc.), and their expected useful lives. These asset components exclude land which is separately valued.<br><br>There are some uncertainties about the values assigned to different components (formation, bridges, etc.) of the state highway network due to limited information on quantities and useful lives within some databases and incomplete information relating to certain cost components. | We obtained an understanding of how the state highway network is valued. This involved confirming the competence, capabilities, and objectivity of the valuer, challenging the valuers' key assumptions and assessing the valuation procedures, including the information extracted from databases.<br><br>We also carried out audit procedures to confirm that key controls were operating over the systems and processes used to record cost and other asset information related to the state highway network.<br><br>I am satisfied that the value of the state highway network at 30 June 2017 is reasonable and consistent with valuation practices, and that the disclosures outline the uncertainties about the valuation. |

Some of the costs associated with road construction (e.g. traffic management) in urban areas are assessed as being a significant part of the network that may potentially be undervalued. An allowance to recognise these costs has been included since 2014. However, such costs before then cannot be reliably measured and are currently excluded from the valuation.

*Rail network*

As outlined in note 16, the rail network has been valued at $939 million at 30 June 2017. In arriving at this value the freight and the metro transport parts of the network have been valued on different bases, reflecting the commercial nature of the freight part of the network and public benefit nature of the metro transport part of the network.

The extent to which the freight part of the network is commercial is open to debate. The Government is currently conducting a review of rail in New Zealand to consider KiwiRail's operating structure, capital requirements and funding mechanisms. This review is expected to be completed by 30 June 2018, and is likely to result in changes that could affect the valuation of the freight part of the network.

As outlined in note 16, the valuation of the rail network could increase by up to $4.3 billion if the entire rail network was not considered commercial, and it was valued on an optimised depreciated replacement cost basis.

We considered the evidence around the commercial nature versus the public benefit nature of the freight part of the rail network. The evidence included reviewing:

- the State-owned Enterprises Act 1986;
- strategy documents;
- forecast results;
- correspondence setting out the Ministers' expectations; and
- minutes from Board meetings.

As in past years, the evidence showed mixed results for the commercial nature versus the public benefit nature of the freight part of the rail network.

We also considered the terms of reference for the review of rail in New Zealand. The outcome of the current review will be key in deciding whether valuing the freight network on a commercial basis remains appropriate.

Due largely to the current review of rail, I am satisfied that the judgement to value the freight part of the network on a commercial basis for the current year, although marginal, is reasonable, and that the disclosures outline the significant judgements.

*Electricity generation assets*

As outlined in note 16, the electricity generation assets, which are at least 51% owned by the Government, are valued at $15.9 billion at 30 June 2017.The valuation of these assets is carried out by specialist valuers because of the complexity and significance of the assumptions about the future prices of electricity, the generation costs, and the generation volumes that these assets will create.

As a result, small changes to these assumptions, in particular the forecast prices of electricity and the discount rates used to determine the present value of these prices, could significantly change the value of these assets.

We obtained an understanding of how electricity generation assets are valued. This involved confirming the competence, capabilities, and objectivity of the valuers, testing the valuers' procedures for carrying out the valuations, including the information they used to carry them out, and challenging the valuers' critical assumptions and judgements. We also used our own valuation specialists to assess the valuers' procedures.

We tested the sensitivity of the key underlying assumptions used by the valuers to ensure that they were reasonable, and we compared the forecast prices of electricity to the expected longer-term wholesale prices and market data where it was available.

We also confirmed the underlying information held about assets by verifying asset purchases and disposals in the current period. This included testing whether there was adequate supporting documentation for those purchases and disposals. It also involved confirming the opening assets balances, and evaluating the related financial statement disclosures.

I am satisfied that the valuation of electricity generation assets at 30 June 2017 is reasonable, and the disclosures outline the sensitivity and the complexity of the valuation of electricity generation assets.

*Social Housing*

As outlined in note 16, the portfolio of social housing was revalued at 30 June 2017 at a fair value of $26.8 billion. The portfolio is valued on a "highest and best use" basis which is aligned to market prices for properties of a similar size and condition in the same geographical location.

As part of the Social Housing Reform Programme, the Government has been disposing of properties to other social housing providers. Prior to transferring properties

We assessed the competence, capability and objectivity of the valuer and challenged the valuation and approach adopted, which was consistent with prior years.

We considered the extent to which the valuation appropriately took account of a wide range of significant factors, which included:

- underlying movements in market prices in places where houses are located;

to "held for sale", the Government places encumbrances on the properties to ensure their purposes for social housing is maintained.

Encumbrances of this nature limit the highest and best use of the properties and mean their fair value is reduced.

The reduction in value has been calculated using a discounted cash flow model based on a series of assumptions about income and expenditure for the properties.

- property acquisitions through to balance date;
- sales experience during the year to 30 June 2017; and
- the market implications of concentrations of social housing.

We reviewed the integrity of the data provided to the valuer on which its valuation has been based and assessed the appropriateness of the adjustments made to the valuation as a result of any timing differences between the date of the valuation and 30 June 2017.

We assessed the appropriateness of the methodology and assumptions used to calculate the value of the properties held for sale that have encumbrances placed on them.

We engaged our own valuation experts to review the methodology and calculations to assess the appropriateness of the approach.

I am satisfied that the valuation of social housing, including properties held for sale, at 30 June 2017 is reasonable and that disclosures about the valuation are adequate.

I considered the valuation of property, plant and equipment to be a key audit matter because of the significant amounts involved and the judgements applied.

| Valuing insurance and superannuation liabilities | How we addressed this matter |
|---|---|

The Government has insurance liabilities of $42.8 billion and public servants' superannuation liabilities of $11.0 billion as at 30 June 2017. The valuation of these liabilities is complex and requires actuaries to estimate the value, based on assumptions about the future. I have identified some specific liabilities because of the significance of the value of those liabilities, and the uncertainties inherent in the valuations.

***Accident Compensation Corporation's (ACC) outstanding claims liability***

As outlined in note 11, ACC's outstanding claims liability has been valued at $37.7 billion at 30 June 2017 by an independent actuary.

Key assumptions used to value the outstanding claims liability include:

- selecting an appropriate risk-free discount rate to present value future cash flows;
- selecting an appropriate risk margin for the inherent uncertainty in the estimate of the present value of future cash flows;
- estimating the impact of inflation and innovation on future medical costs; and
- estimating the length of rehabilitation from injuries.

The sensitivity of each assumption is analysed in note 11. This sensitivity analysis indicates that assumptions are closely linked, cannot be viewed in isolation and changes in assumptions can have a large impact on the value of the liability as well as the actuarial gain or loss recognised.

We obtained an understanding of how ACC's outstanding claims liability is valued by assessing the reasonableness of the approach taken to value the liability. We also reviewed the key assumptions adopted by ACC for each significant claim type to ensure these were appropriate.

We tested the systems, and controls and carried out detailed testing of the process for recording claims.

We tested key assumptions by evaluating them against past claims experience. We assessed the reasonableness of forecasts that diverged from past experience by looking at the evidence supporting the forecast.

We tested the reconciliations of the underlying claims data to ACC's systems, examined the sensitivity analysis for movements in key assumptions, and evaluated the related financial statement disclosures.

I am satisfied that the assumptions and judgements applied in estimating ACC's outstanding claims liability at 30 June 2017 are reasonable, and that disclosures outline the sensitivity of the valuation to changes in assumptions.

***Public servants' superannuation liability***

As outlined in note 20, the Government's liability for public servants' superannuation entitlements for past and current members under the Government Superannuation Fund has been valued at $11.0 billion at 30 June 2017 by an independent actuary.

The present value of the liability is sensitive to the estimated return on assets owned by the Fund, expected rates of salary increases for public servants who are members of the Fund and estimated inflation and discount rates.

We obtained an understanding of how the Government's liability for public servants' superannuation entitlements is valued. This involved confirming the competence, capabilities, and objectivity of the actuary, as well as testing the actuary's valuation procedures. We engaged our own valuation specialists to review the assumptions, judgements and procedures used to value the liability.

We tested key controls that ensure the completeness and accuracy of membership data, which was used in the actuary's valuation.

| | |
|---|---|
| The sensitivity of critical assumptions and judgements is analysed in note 20. This sensitivity analysis indicates that assumptions are closely linked, cannot be viewed in isolation and changes in assumptions can have a large impact on the value of the liability.<br><br>I considered the valuation of insurance and superannuation liabilities to be a key audit matter because of the significant amounts involved and the judgements applied. | We evaluated the appropriateness of key assumptions used in estimating the return on assets owned by the Fund and compared the expected rates of salary increases against external benchmarks.<br><br>I am satisfied that the Government's liability for public servants' superannuation entitlements at 30 June 2017 is reasonable, and that the disclosures outline the sensitivities of the valuation to changes in assumptions. |

| Valuing financial assets and liabilities | How we addressed this matter |
|---|---|
| As outlined in note 26, as at 30 June 2017, the Government has financial assets of \$133.4 billion, of which \$75.3 billion are valued at fair value (and \$58.1 billion are valued at amortised cost), and financial liabilities of \$128.3 billion, of which \$7.6 billion are valued at fair value (and \$120.7 billion are valued at amortised cost).<br><br>Financial assets and liabilities measured at fair value include derivatives (which have a principal value of \$232.5 billion), marketable securities, and share investments.<br><br>Where quoted market prices are not available to determine the value of financial assets and liabilities, fair value must be estimated. This is done by applying a valuation approach that is most appropriate for the asset or liability, such as using valuation models. Inputs into the models will use market data when available, otherwise inputs are derived from non-market data, which requires judgement.<br><br>The fair value of financial assets and financial liabilities that are valued using non-observable inputs are valued at \$3.3 billion and \$66 million respectively.<br><br>I considered the valuation of financial assets and liabilities to be a key audit matter because of the significant amounts involved and the judgements applied. | We obtained an understanding of the valuation techniques, controls and inputs used to determine the fair value of financial assets and liabilities.<br><br>We also carried out a range of audit procedures which reflected the nature of the financial assets and liabilities being valued, the valuation techniques adopted and the uncertainties that existed in determining their fair values. These audit procedures included:<br>- testing the internal controls in place over data relating to financial assets and liabilities that has been entered into financial and treasury systems;<br>- obtaining an understanding of the controls and valuation approaches applied, where a fund manager carries out the valuation;<br>- comparing the fair value of financial assets and liabilities to independent information and investigating any significant variances; and<br>- assessing the appropriateness of the inputs used for valuing financial assets and liabilities where the fair value was dependent on non-observable inputs.<br><br>I am satisfied that the fair values of financial assets and liabilities at 30 June 2017 are reasonable and that the disclosures outline the significant judgements. |

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

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

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

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

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

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

In carrying out their respective responsibilities for the financial statements of the Government, the Treasury and the Minister of Finance are responsible for assessing the Government's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting.

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

My objectives are to obtain reasonable assurance about whether the financial statements of the Government as a whole are free from material misstatement, whether due to fraud or error, and to issue an audit report that includes my opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the Auditor-General's Auditing Standards will always detect a material misstatement when it exists. Misstatements are differences or omissions of amounts or disclosures, and can arise from fraud or error. Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the decisions readers take on the basis of the financial statements of the Government.

For the budget information reported in the financial statements of the Government, my procedures were limited to checking that the amounts agree to the Government's relevant published budgets.

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

As part of an audit in accordance with the Auditor-General's Auditing Standards, I exercise professional judgement and maintain professional scepticism throughout the audit. Also:

- I identify and assess the risks of material misstatement of the financial statements of the Government, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- I obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the internal control used by the Treasury to prepare the financial statements of the Government.

- I evaluate the appropriateness of accounting policies used, and the reasonableness of accounting estimates and related disclosures made by the Treasury.

- I conclude on the appropriateness of the use of the going concern basis of accounting that has been used by the Treasury to prepare the financial statements of the Government, up to the date of my auditor's report based on the audit evidence I have obtained.

- I evaluate the overall presentation, structure, and content of the financial statements of the Government, including the disclosures, and whether the financial statements of the Government represent the underlying transactions and events in a manner that achieves fair presentation.

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

- eliminations of transactions between the organisations that are consolidated into the financial statements of the Government;

- application by those organisations of appropriate accounting policies and Treasury instructions to prepare the financial statements of the Government; and
- the risks of material misstatement of the financial statements of those organisations that may affect the financial statements of the Government.

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

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

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

**Other information**

The Treasury is responsible for the other information. The other information comprises the information included on pages 1 to 26 and 127 to 133, but does not include the financial statements of the Government, and my auditor's report thereon.

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

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

**Independence**

While carrying out this audit, my staff, and appointed auditors and their staff complied with the Auditor-General's independence requirements, which incorporate the independence requirements of Professional and Ethical Standard 1 (Revised) *Code of Ethics for Assurance Practitioners* issued by the New Zealand Auditing and Assurance Standards Board and the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants (IESBA Code)*.,

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

Greg Schollum
Deputy Controller and Auditor-General
Wellington, New Zealand

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