Controller and Auditor-General
Tumuaki o te Mana Arotake

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Central government: Results of the 2018/19 audits

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Chris Tse, Office of the Auditor-General

Central government: Results of the 2018/19 audits

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Auditor-General’s overview

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

Government spending in New Zealand is about 37% of gross domestic product. How the Government manages its finances is therefore a significant determinant of the financial state of our nation.

The Government’s financial statements draw on the financial information of more than 2000 public organisations. Together, they provide an account of what the Government collected in revenue (largely, people’s taxes), what it spent, and how much we collectively own (the Crown’s assets) and owe (the Crown’s debt).

The accountability of the Government is critical to Parliament and to the people of New Zealand for the taxes it collects and spends. Independent audit assurance is fundamental to this accountability.

Importantly, behind the numbers are matters that make a real difference in all our lives – the taxes we pay, hospitals, schools, and the highways on which we drive. In the Government’s financial statements, there is a line called “Transfer Payments and Subsidies”, which covers New Zealand Superannuation, working benefits, and accommodation assistance. These government expenses have real implications for the New Zealanders entitled to them, because they help with day-to-day living costs and affect the quality of life for these New Zealanders.

When we report on the Government’s financial statements, we also highlight the main judgement areas as key audit matters. For example, my auditors examine the valuation of the state highway network. It matters, not because it is a complex accounting question (although it certainly is), but because it compels those in charge of the network to tell the public what they have assumed about required life spans and when components of our state highways will need to be replaced or rebuilt.

The key audit matters that we have highlighted also involve issues that directly affect people. The Government’s financial statements include salaries paid to New Zealanders employed in the public service. I draw attention to ongoing problems with calculating and paying people what they are entitled to under the Holidays Act 2003. I acknowledge the amount of work done on this matter, and that the provisions of the Holidays Act are complicated, but all public employees deserve to be paid their legal entitlements when they are due. This has not been the case.

Although New Zealand operates a sound and transparent financial management system, we need to always look for improvements. I would, for example, like to see more performance-related information reported together with the Government’s financial statements. This would tell a richer overall story of what the public are receiving for the taxes they pay.

I want New Zealanders to have assurance that the money Parliament allocated to particular activities has been spent as intended. In my role as the Controller, I work with the Treasury to provide that assurance. It is a strength of our financial management system that breaches to what has been approved by Parliament are very much the exception. For 2018/19, there were few breaches. These amounted to 0.2% of government expenditure. However, when they did happen, such as the Winter Energy Payments, they remind us of important rules for sound financial management. Parliament approves funding – it is not for public organisations to decide whether they can go beyond or outside Parliament's approval.

It is important, as Parliament considers future changes to the public management system, that accountability of government to Parliament for the money it has approved to spend remains a central focus.

I thank those involved in preparing and auditing the Government's financial statements. They are a significant and important component of the financial management system of our country, and they remain, in many ways, world leading.

Nāku noa, nā

John Ryan
Controller and Auditor-General

11 December 2019

The operating environment for central government

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1.1 This Part describes the operating environment for central government agencies in 2018/19. Government priorities and expectations direct how public organisations plan, operate, spend, and report their spending to account for the funding they have been allocated through the Budget process. Therefore, the Government's financial management objectives provide an important context for our audit of the *Financial Statements of the Government of New Zealand for the year ended 30 June 2019* (the Government's financial statements).

Budget 2018 settings and the Government's priorities

1.2 The Budget allows the Government to propose the allocation of funding towards its policy objectives. This is an important step in the public management and accountability cycle. The funding approved by Parliament, based on the Government's Budget, determines how much can be spent on different functions and services. The first full year the Government could set priorities was 2018/19.

1.3 In its 2018 Budget, the Government set out how much funding would be available in 2018/19 for New Zealand's health services, employment measures, school funding, and many other items of government expenditure. Out of total proposed spending of $102 billion, social development ($24 billion), health ($18 billion), and education ($12 billion) together accounted for more than half of the total. Capital expenditure accounted for about $12 billion.

1.4 In Budget 2018, the Government allocated investment towards five high-level priorities:

- rebuilding critical public services;
- promoting economic development and supporting the regions;
- taking action on child poverty, housing, and homelessness;
- enhancing and protecting our natural resources; and
- enriching New Zealand's culture and identity.

1.5 Most new operating spending allocated through the Budget was directed at "rebuilding critical public services".

1.6 The Government's financial statements provide an account of government spending and, as spending shifts over time between different areas, offers information about how government decisions and prioritisation translate into funding for different services or investments. For example, readers of the Government's financial statements can see that total Crown expenses for social security and welfare, health, and education all increased between 2017/18 and 2018/19, as did their share of gross domestic product (GDP).

1.7 Although not a large percentage of total spend, another example of funding shaping the operating environment was the focus on supporting the regions as part of the Government's economic strategy. An announcement was made in December 2017 of a $1 billion investment each year for three years through the Provincial Growth Fund. A Provincial Development Unit was established in 2018 in the Ministry of Business, Innovation and Employment (MBIE) to support the delivery of government funding to enhance economic development opportunities in New Zealand's regions.

1.8 New Zealanders will have an interest in knowing whether the funding was used for the regions as intended. We intend to report separately on our work looking at the Provincial Growth Fund. Spending through the Provincial Growth Fund is separately identified in the Government's financial statements (see Part 2).

Change in the central government sector

1.9 In the past 18 months, the Government initiated several in-depth reviews or institutional changes that cover wide-ranging sectors such as welfare, health, education, justice, tax, housing, and environmental areas such as water reform. The sectors under review affect significant numbers of New Zealanders, their entitlements, or the services provided to them. These sectors are also associated with a large percentage of central government spending.

1.10 For that reason, we take a close interest in how well key policy changes are implemented. Significant changes to policy and the structure of the central government sector are usually reflected in Budget allocations and subsequent reporting in the Government's financial statements.

1.11 Although some fundamental decisions have already been made, their financial implications are not yet visible in 2018/19 reporting. For example:

- the establishment of a single New Zealand Institute of Skills and Technology from 1 April 2020, which brings together the 16 current institutes of technology and polytechnics; and
- the Provincial Growth Fund, where funding and policy implementation crosses portfolios and financial implications stretch into out-years.

1.12 Institutional, policy, and legislative changes to the housing sector are also continuing. The Ministry of Housing and Urban Development was created on 1 October 2018. Public housing is a significant Crown asset, with housing stock valued at $30.2 billion at 30 June 2019. This is almost a third of the Government's total land and buildings assets (valued at $96.1 billion).

1.13 Other reviews are complete but still have work under way on subsequent policy changes (such as the report by the Welfare Expert Advisory Group). Some reviews might bring significant changes but are still in draft stages (health), others are being consulted on (such as the discussion document *Shaping a Stronger Education System with New Zealanders*), or are still under development (such as Hāpaitia te Oranga Tangata: Safe and Effective Justice).

1.14 Arguably, the most far-reaching review is the New Zealand Health and Disability System Review. Its intention was to identify opportunities to improve the performance, structure, and sustainability of the health and disability system. The Government Inquiry into Mental Health and Addictions, a more narrowly focused review, reported in late 2018.

1.15 We continue to take an interest in the financial, reporting, performance, and accountability implications of reviews such as these.

The pending transformation of the public sector – implications for reporting

1.16 In September 2018, the Government began to consult on reforms to the public sector – in particular, changes to the State Sector Act 1988 to make public services more responsive to New Zealanders. It is proposed that the State Sector Act will be repealed and replaced with a new Public Service Act.

1.17 The intention is to enshrine the purpose, values, and principles of the New Zealand public service in the new Public Service Act. Principles like political neutrality, free and frank advice, and merit-based appointments will be embedded in legislation. The new Act is intended to strengthen agencies' collective responsibility. The new Act will also set out the public service responsibility in relation to the Treaty of Waitangi (te Tiriti o Waitangi).

1.18 We will follow with interest how these changes are implemented. We have an enduring interest in the public's trust and confidence in the public sector. As part of our work, we will seek to influence and support future public sector management reforms to strengthen the accountability system, further encourage public organisations to be open and transparent, and provide reliable, meaningful, and timely information in an accessible way. This is because accountability to Parliament and the public cannot be compromised even as new ways of working are established.

1.19 New institutional arrangements have already been created to encourage a different way for sectors to work together. For example, a Joint Venture Unit for Family Violence and Sexual Violence has been set up to tackle the long-standing issue of family violence. Although the Ministry of Justice is hosting it, the arrangement is deliberately designed to link relevant agencies such as Oranga Tamariki, the Ministry for Social Development, and the New Zealand Police. These new types of institutional arrangements also require new accountability and reporting arrangements.

1.20 Related changes to how central government agencies plan and report are also already under way as part of the implementation of the Government's wellbeing approach. The idea is for the government of the day to select particular wellbeing objectives as priorities to inform its fiscal policy, spending, and other decisions. Under proposed legislation (at the time of writing), the Treasury would report annually on wellbeing indicators that track long-term trends in wellbeing throughout New Zealand. We would like to see the report gain general acceptance and credibility with readers. Appropriate standards and independent assurance processes would assist that objective.

1.21 The Treasury has advanced work on its Living Standards Framework. It released a dashboard in December 2018 that contains data measures for the main components of the Living Standards Framework that determine inter-generational wellbeing (natural, human, social, financial, and physical). The Treasury will use the Living Standards Framework to advise successive governments about the likely effects of their policy choices on New Zealanders' living standards and wellbeing over time. One example of this was the Government's 2019 Wellbeing Budget setting priorities for 2019/20 (which this report does not cover).

1.22 The Treasury also has a Public Finance System modernisation programme of work that looks to lift long-term resilience through applying a wellbeing approach to agency reporting and improvements to strategic asset management. The programme also looks for smarter regulation and value creation through reviews of budget process, appropriations structure, and accountability mechanisms.

1.23 Although the wellbeing approach and associated reviews were still forming during the 2018/19 reporting period covered by this report, we will consider how we can best account for it in our work as it evolves, including in our auditing of the Government's financial statements and the underlying financial and performance reporting of government agencies.

Our audit of the Government's financial statements

2

2.1 A main focus for our report on the audit of the Government's financial statements is to provide assurance that the Government's financial statements present fairly its financial performance and position. Confidence in the reliability of government reporting allows Parliament to properly scrutinise the Government's financial performance and direction.

2.2 The Government's financial statements allow the reader to track overall spending. At the time of the 2018 Budget, the Government forecast a surplus in the operating balance for 2018/19 of $3.7 billion, measured by the total Crown operating balance before gains and losses. It also forecast net core Crown debt (excluding the New Zealand Superannuation Fund and advances) at $64.2 billion (21.1% of GDP).

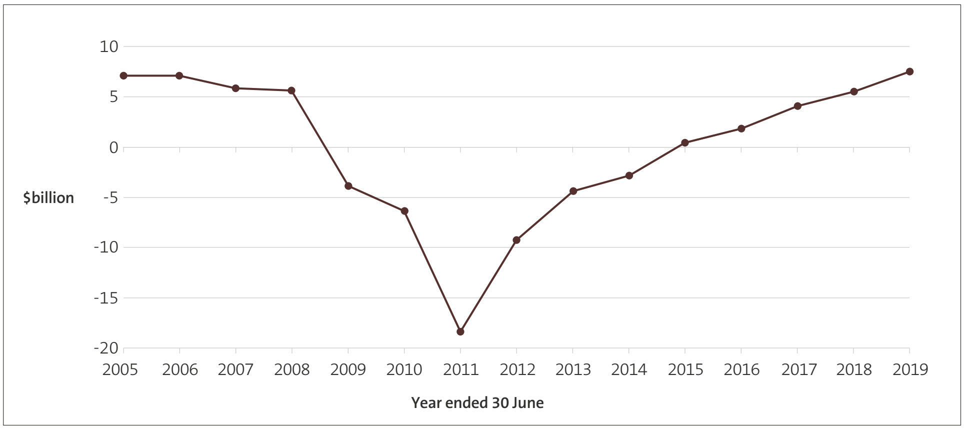
2.3 At the end of the reporting period, the Government's financial statements showed a surplus in the operating balance (before gains and losses) of $7.5 billion. This can be explained, in part, by a one-off effect of KiwiRail accounting changes of $2.6 billion. The Government's financial statements reported net core Crown debt of $57.7 billion (19.2% of GDP) – that is, an improved debt position compared with the forecast.

2.4 The Government's net worth at 30 June 2019 was $146.3 billion (2018: $135.6 billion).

2.5 Not all countries have the systems and controls in place to accurately record operating balances or the value of the Government's assets and liabilities. Figure 1 shows the operating balance before gains and losses (which is the difference between revenue and expenses before adding in any changes to the valuation of certain assets).

Figure 1
The Government's operating balance before gains and losses, from 2005 to 2019

The figure shows the operating balance before gains and losses. There was a drop for three years from 2008, but it has gone up each year from 2011.

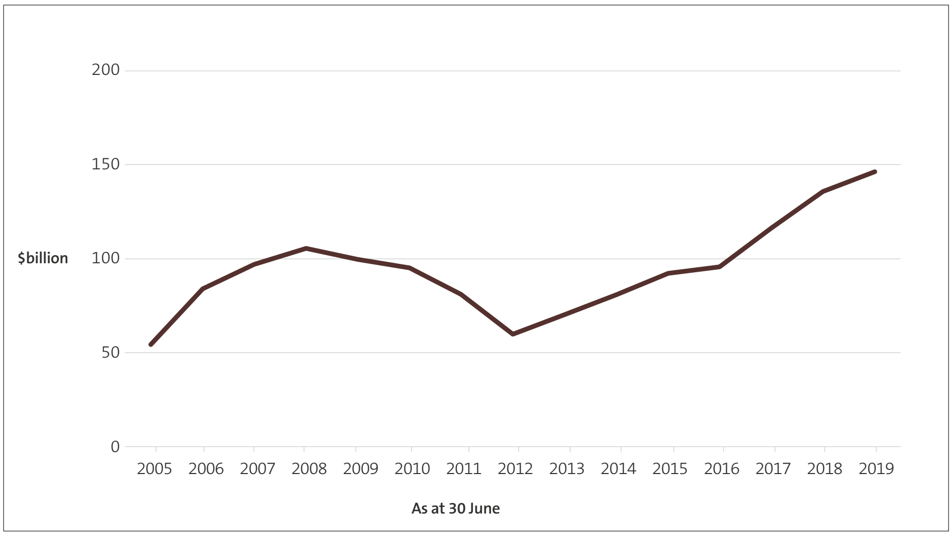


Source: Adapted from The Treasury (2019) *FSG Basics* and (2010) *Financial Statements of the Government of New Zealand for the year ended 30 June 2010*, at treasury.govt.nz.

2.6 Understanding the value of the Government's assets and liabilities helps with asset management over the lifecycle of those assets. Figure 2 shows how the Government's net worth (the total value of the Government's assets minus the total value of its liabilities) has changed over time. Note the effect of the Global Financial Crisis in 2008 in both Figures 1 and 2.

Figure 2
The Government's net worth, from 2005 to 2019

The figure shows how the Government's net worth has changed over time. There was a drop from 2008 but it has gone up from 2012.



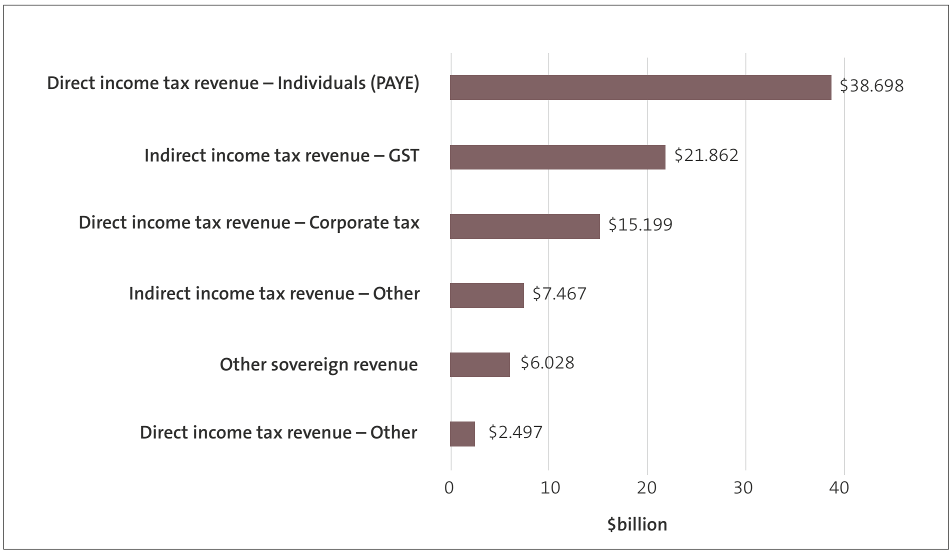
Source: Adapted from The Treasury (2019) *FSG Basics* and (2010) *Financial Statements of the Government of New Zealand for the year ended 30 June 2010*, at treasury.govt.nz.

Recognising tax revenue

2.7 The largest source of tax revenue for the Government is direct income tax (see Figure 3). It generated $56.4 billion (the total of direct income tax categories in Figure 3) for the year ended 30 June 2019.

Figure 3
Breakdown of types of income tax and other revenue for the year ended 30 June 2019

The figure shows the types of income tax and other revenue. Direct income tax revenue – Individuals (PAYE) generates the most revenue.



Source: Adapted from The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*.

2.8 The calculation of revenue from direct income tax is subject to significant assumptions and judgements because of the timing differences between the reporting date (30 June 2019) and when taxpayers file their tax returns.

2.9 Direct income tax revenue and the associated receivables and payables at 30 June 2019 were estimated for taxpayers yet to file their returns, and where payments had been received but no provisional or final tax return had been filed.

2.10 Inland Revenue implemented a new tax system during the year, which changed the process for estimating income tax revenue. It is now based on individual taxpayer information, rather than macro-economic cash flow forecasts. The change in process for estimating income tax revenue means that some different assumptions and judgements had to be used this year.

2.11 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 the recording of tax revenue, testing underlying data, assessing the reasonableness of key assumptions and judgements applied in the new process, and testing the sensitivities of the estimate to changes in key assumptions.

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

Valuing property, plant, and equipment

2.13 The Government's physical assets total $178 billion at 30 June 2019. Some assets are more difficult than others to value because of the inherent uncertainties in their valuation, 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:

- state highway network;
- electricity generation assets; and
- rail network assets.

State highway network

2.14 The state highway network (excluding land) was valued at $37.2 billion at 30 June 2019 by an independent valuer.

2.15 The valuation is based on information from several of the New Zealand Transport Agency's databases that identify the asset components that make up the network and their expected useful lives.

2.16 Because of the unique nature of the state highway network, the value of the assets cannot be measured with precision. Significant estimates and assumptions have been applied to the valuation, which include assumptions on quantities used in the construction of network components, the remaining life of the assets, and the unit costs to apply. Changes to the underlying estimates and assumptions can cause a material movement in the state highway valuation.

2.17 There continue to be uncertainties over the valuation of the state highway network. As part of the continuing valuation improvement programme, the costs relating to the formation component have been updated. The New Zealand Transport Agency continues work on improving the quality of the data that underpins the valuation.

2.18 Some of the costs associated with road construction (for example, traffic management) in urban areas have been assessed as a significant part of the network that might be undervalued. An allowance to recognise these costs has been included since 2014 where a reliable estimate can be made. This year a unit rate was determined for these costs and included in the valuation.

2.19 We obtained an understanding of the valuation of the state highway network, the significant estimates and assumptions used, and their reasonableness. This involved confirming the competence, capabilities, and objectivity of the valuer; challenging the valuer's key assumptions; and assessing the valuation procedures, including the information extracted from databases. We also considered whether there were any limitations placed on the valuer and the appropriateness of centrally calculated rates that were applied to the valuation.

2.20 We have recommended that the New Zealand Transport Agency continue to improve the valuation process, and, if required, refine the disclosures in the Government's financial statements in relation to the resulting changes and the Treasury work with the New Zealand Transport Agency to achieve this.

2.21 Overall, we are satisfied that the value of the state highway network at 30 June 2019 is reasonable and consistent with valuation practices, and the disclosures outlining the inherent uncertainties in the valuation are appropriate.

Electricity generation assets

2.22 The electricity generation assets, which are at least 51% owned by the Government, were valued at $17.2 billion at 30 June 2019. The valuation of these assets is carried out by specialist valuers 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.

2.23 The specialist valuers of each generation company have different assumptions and make different disclosures about the valuation of electricity generation assets.

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

2.25 We will continue to assess the appropriateness of using different valuation approaches and assumptions in the Government's financial statements for the valuation of electricity generation assets, as well as the related disclosures.

2.26 To enhance the disclosure, we recommended that the Treasury work at standardising the valuations for the Government's financial statements, especially for common assumptions used by the different electricity generation companies.

2.27 Overall, we are satisfied that the valuation of electricity generation assets at 30 June 2019 is reasonable and that the disclosures appropriately outline the sensitivity and the complexity of the valuation of these assets.

Rail network assets

2.28 The rail network assets were valued at $6.4 billion at 30 June 2019. In arriving at this value, the entire rail network (used for both freight and metro transport) has been valued on the basis of its public benefit nature.

2.29 In previous years, the freight part of the network was valued on a commercial basis. The extent to which the Government views the freight part of the network as commercial has been a matter we have considered carefully over a number of years.

2.30 The Government is currently reviewing rail to define its purpose, determine the appropriate structure and capital requirements, and determine how to fund it in the future.

2.31 Cabinet received the first of three review reports in May 2019. The paper noted that all rail, including freight, contributes to national and regional economic growth and reduces emissions and congestion, reduces road deaths and injuries, facilitates wider social benefits, and provides resilience and connection between communities.

2.32 Cabinet agreed in principle to the objective of having a resilient and reliable rail system to deliver the outcomes for transport and wider benefits the Government seeks, and budget decisions were made on this basis.

2.33 Because of the above points, the rail network assets are recorded at Optimised Depreciated Replacement Cost in the Government's financial statements, in keeping with Public Benefit Entity accounting standards, because it is no longer appropriate for the Government to value the rail freight network on a commercial basis given the Government's broader objectives for rail. This has resulted in a $5.2 billion net increase in the carrying value of the rail network from the previous year, in the most part due to the reversal of impairment previously expensed of $2.6 billion and a net revaluation increase of $2.3 billion during the year.

2.34 We obtained an understanding of how the rail network is valued, the significant estimates and assumptions used, and the reasonableness of them. This involved confirming the competence, capabilities, and objectivity of the valuer, challenging the valuer's key assumptions, and assessing the valuation procedures, including the information extracted from databases.

2.35 We confirmed that the revaluation movements and reversals of previous impairments were correctly accounted for.

2.36 We are satisfied that the value of the rail network at 30 June 2019 is reasonable and consistent with valuation practices and that the adjustments to reflect the change in the valuation are appropriate.

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 2019 are the Accident Compensation Corporation's (ACC) outstanding claims liability of $53.3 billion and the Government employees' superannuation liability of $13.2 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 relate to claims incurred before the valuation date, 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. ACC also includes a risk margin due to inherent uncertainties in valuing the liability because of the high degree of judgement and estimation applied.

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 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. The Government's financial statements set out some of the sensitivities of those assumptions and the effect of them.

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 at 30 June 2019 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 assumptions and judgements applied in estimating the Government's long-term liabilities at 30 June 2019 are reasonable and that the disclosures outline the sensitivity of the valuation to changes in assumptions.

Valuing financial assets and liabilities

2.44 The Government had financial assets of $145.1 billion, of which $89.6 billion was measured at fair value and $55.5 billion was measured at amortised cost. It also has financial liabilities of $128.7 billion, of which $8.4 billion was measured at fair value and $120.3 billion was measured at amortised cost. The financial assets and financial 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 financial 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 The fair value of financial assets and financial liabilities that are valued using non-market inputs are valued at $15.4 billion and $0.2 billion respectively.

2.47 We obtained an understanding of the valuation techniques, controls, and inputs used to determine the fair value of financial assets and liabilities. We also carried out a range of audit procedures that reflected the nature of the financial assets and liabilities being valued, the valuation techniques adopted, and the uncertainties in determining their fair values.

2.48 We are satisfied that the fair values for financial assets and financial liabilities at 30 June 2019 are reasonable and that the disclosures outline the significant judgements.

Entitlements under the Holidays Act 2003

2.49 We had previously raised concerns that some public organisations have not fully worked through issues of non-compliance with the Holidays Act 2003 and the accounting for potential liabilities. In particular, we were concerned with progress made by large employers, such as the Ministry of Education, Department of Corrections, and district health boards (DHBs), to resolve these issues.

2.50 Several public organisations, including the Ministry of Education and Department of Corrections, have already started or completed a review of current and historical payroll calculations to ensure compliance with the Holidays Act and other relevant legislation.

2.51 Where possible, provision has been made in the Government's financial statements for obligations arising from those reviews and where settlement has not been made.

2.52 To the extent that an obligation cannot reasonably be quantified at 30 June 2019, an unquantified contingent liability has been disclosed. Public organisations continue to calculate the potential liability required to remediate the issues associated with these entitlements. In certain sectors, in particular DHBs, there are complexities and the calculation of the liability is taking longer than expected to resolve. Public organisations in these sectors employ thousands of staff and the liabilities to settle these obligations remain uncertain.

2.53 The Government has noted that the indicative potential liability for DHBs could be between $550 million and $650 million. This is largely based on selecting a small, non-statistical sample of former and current employees, applying several assumptions agreed to by the sector, and then calculating an indicative liability by extrapolating the result over the known population. A significant amount of work is still required to finalise the liability and, therefore, there remains a high level of uncertainty over this liability, which could fall outside the indicative liability range.

2.54 A provision of $621 million has been included in the Government's financial statements for outstanding holiday pay obligations of DHBs.

2.55 For those public organisations most affected, we obtained an understanding of the progress made in resolving the payroll calculation issues, and we assessed the reasonableness of the approach to the financial reporting of these issues.

2.56 We carried out a range of procedures to audit the liabilities recognised, which included reviewing processes followed for valuing the liabilities; testing a sample of transactions; assessing the competence, capabilities, and objectivity of independent experts involved in the valuation; challenging critical assumptions and judgements made in the valuation; and reviewing the disclosures made.

2.57 We are satisfied that the liabilities recognised for entitlements are materially correct and that, where a liability cannot be reliably measured, the disclosures are appropriate.

Accounting and appropriation implications of the Provincial Growth Fund

2.58 The Provincial Growth Fund enables investment of $3 billion over three years to encourage regional economic development. The Provincial Development Unit in MBIE administers the Provincial Growth Fund, but several public organisations are involved in managing projects within their remit, including the Ministry of Transport, the Ministry for Primary Industries, and the Department of Conservation.

2.59 There are risks associated with the Provincial Growth Fund, including having appropriate systems and controls between the different public organisations and determining the appropriate accounting treatment to apply depending on whether funding is a grant, debt, or capital injection.

2.60 We reviewed the allocation of grants and funding to third parties based on evaluations by the Provincial Development Unit. We reviewed the recognition criteria and accounting treatment of a sample of the awards made during the year to confirm that the accounting treatment matches the underlying contracts.

2.61 We are satisfied that, at a whole-of-government level, the Provincial Growth Fund has been appropriately accounted for during the financial year, but we have more detailed work under way on the operation of this Fund.

Outcomes from reviews currently under way

2.62 As noted in Part 1, the Government has initiated several reviews in the past 18 months. Some of these reviews propose significant changes to the structure and funding of government. If recommendations from these reviews are implemented, there might be a significant effect on the Government's financial statements.

2.63 At the time of signing the audit report, the policy decisions arising from many reviews had not yet been approved by Cabinet. We will continue to monitor the progress with the reviews currently under way. We will consider the effect on the Government's financial statements if and when decisions to implement the recommendations from these reviews are made.

Changes to the Crown Financial Information System

2.64 The consolidation of the Government's financial statements is managed electronically through a system known as the Crown Financial Information System. This system has been updated several times since its introduction in 1999.

2.65 Changes to the system this year include collecting information for the adoption of PBE IFRS 9: *Financial Instruments* and adding a new department (the Ministry of Housing and Urban Development).

2.66 We assessed the Treasury's process for ensuring the integrity of the system through changes made during the year. We were satisfied that we could continue to rely on the system for our 2018/19 audit.

2.67 We were satisfied that the changes made to the Crown Financial Information System were appropriate and all required information recorded.

Changes to accounting standards

2.68 The Treasury adopted PBE IFRS 9: *Financial Instruments* early when preparing the Government's financial statements. This standard introduced a number of changes to the recognition and measurement of financial instruments, mainly affecting the measurement of student loans.

2.69 The early adoption of PBE IFRS 9 resulted in an increase of $628 million in the valuation of student loans at 1 July 2018.

2.70 The financial reporting standard PBE IPSAS 39: *Employee Benefits* is effective for reporting periods beginning 1 January 2019, with early adoption permitted. We considered the accounting for veteran support entitlements under the Veterans' Support Act 2014 as part of our submission to the External Reporting Board on this standard. The New Zealand Defence Force (NZDF) is still continuing to assess the effect of adopting the new accounting standard. We will monitor NZDF's assessment and the Treasury's work in assessing the effect of PBE IPSAS 39 on the Government's financial statements.

2.71 We are satisfied that adjustments made as a result of the adoption of new accounting standards were appropriate and disclosures met requirements.

Reporting of unappropriated expenditure

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

2.73 During our audit, we assessed the accuracy and completeness of the disclosure of the unappropriated expenditure. This included:

- confirming that the final listing of unappropriated expenditure is correctly reported in the Government's financial statements;
- confirming the completeness and accuracy of all disclosed unappropriated expenditure with Appointed Auditors of the relevant departments and ministries; and
- confirming with Appointed Auditors of those departments with no unappropriated expenditure disclosed that no unappropriated expenditure was incurred during the year.

2.74 We are satisfied that the Statement of Unappropriated Expenditure is complete, and consistent with reporting entities' own annual reports. More detail on the Controller function and how it supports Parliamentary control over government expenditure is provided in Part 3.

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;
- borrow money; and
- spend public money.[1]

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 Our website explains what the Controller and Auditor-General does to help ensure that government spending stays within the limits approved by Parliament.[2]

3.5 In this Part, we discuss:

- why the Controller work is important;
- who is responsible for ensuring that public money is spent correctly;
- how much unappropriated expenditure was incurred in 2018/19;
- how 2018/19 compares with previous years; and
- recent developments.

Why the Controller work is 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 and the public.

3.7 The appropriation part of the State sector financial management system ensures that Parliament, on behalf of the public, has adequate control over how the Government plans to use 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. The public can expect assurance that the Government is spending public money as intended.

1 Section 22 of the Constitution Act 1986.

2 For example, in Part 3 of our 2015 report, *Central government: Results of the 2014/15 audits*, Wellington.

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. This includes ensuring that they have both the funding authority and the necessary legal authority before incurring expenses or capital expenditure.[3]

3.10 Departments are required to report to the Treasury the expenses and capital expenditure incurred by the department against the appropriation or other statutory authority provided. The first report for the financial year is provided in October (covering the previous July to September period) and then monthly after that.[4]

3.11 The Treasury is then required to report to the Controller and Auditor-General in October (for July to September) and then monthly after that. The Treasury's reports set out all expenditure incurred compared with the appropriation (or other authority) and all expenditure incurred without authority or in excess of the authority given.

Who checks whether departments are spending money lawfully?

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

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

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

3.14 Through the appropriation audit of each department, our auditors look at systems and some transactions to check that public money was spent as Parliament intended. If an appointed auditor detects spending outside authority through the appropriation audit work, then the auditor will discuss the matter with the

3 This is set out in section 79 of the Public Finance Act and Treasury Instructions.

4 The Treasury and the Office of the Auditor-General (2008), *Memorandum of understanding between the Controller and Auditor-General and the Secretary to the Treasury: Controller Function*.

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

Expenditure above or beyond the appropriation limits

3.15 Through the Appropriation (Estimates) Act and the Appropriation (Supplementary Estimates) Act, Parliament imposes limits on government spending. Spending is authorised through appropriations. Appropriations are specific areas for expenditure that are usually restricted by type (the nature of the spending), scope (what the money can be spent on), dollar amount (the maximum that can be spent), and period (the time frame for which the authority is given).

3.16 The public finance management system provides some flexibility in some circumstances to enable lawful spending above or beyond the limits specified by each appropriation. In limited circumstances, expenditure can be legally incurred outside the limits authorised by the Appropriation Acts. For example, there is flexibility in the Public Finance Act 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.

3.17 The first annual Imprest Supply Act allows the Government to incur expenditure before the Budget for that year is enacted in legislation (through the Appropriation (Estimates) Act). In practice, Cabinet approval is required to incur expenditure under the provisions of the second annual Imprest Supply Act. To remain lawful, any expenditure incurred under imprest supply must be appropriated by Parliament within that financial year (usually under an Appropriation Act).

3.18 When government departments do not get approval for unappropriated expenditure before it is incurred, it is unlawful. Expenditure approved by Cabinet under imprest supply will also be unlawful if Parliament has not validated it before the end of the financial year. We have urged government departments to seek early approval as soon as they have identified the need for previously unanticipated expenditure, so that any expenditure over and above that authorised in the Appropriation (Estimates) Act can be authorised by Cabinet before the event and subsequently authorised by Parliament in the Appropriation (Supplementary Estimates) Act.

3.19 Ministers need to report unappropriated expenditure to Parliament, and they must seek Parliament's retrospective approval of the expenditure through an Appropriation (Confirmation and Validation) Act.

3.20 Expenditure outside the bounds of the appropriations tends to be relatively small. In 2018/19, it was 0.20% of the Government's budgeted expenditure for 2018/19 as set out in Budget 2018 (2017/18: less than 0.13%).

How much unappropriated expenditure was incurred in 2018/19?

3.21 The Government's financial statements for the year ended 30 June 2019 report 14 instances of unappropriated expenditure (2017/18: 21). Expenditure incurred without appropriation in 2018/19 was $205 million (2017/18: $128 million). Figure 4 shows a breakdown of unappropriated expenditure categories.[5]

Figure 4
Unappropriated expenditure incurred during the year ended 30 June 2019

Unappropriated expenditure by category	2018/19 Number	2018/19 $million*	2018/19 Votes
In excess of existing appropriation and approved by the Minister of Finance under section 26B of the Public Finance Act 1989	4	11	Conservation, Foreign Affairs and Trade, Health
In excess of appropriation and without prior Cabinet authority to use imprest supply	4	161	Building and Housing, Environment, Defence Force
Outside scope of an appropriation and without prior Cabinet authority to use imprest supply	2	6	Education, Social Development
Without appropriation and without prior Cabinet authority to use imprest supply	4	27	Building and Housing; Business, Science, and Innovation; Health; Prime Minister and Cabinet
Total	**14**	**205**	

* Amounts are rounded to the nearest million.

5 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 142.

Unappropriated expenditure approved by the Minister of Finance

3.22 As mentioned in paragraph 3.16, the Public Finance Act provides some flexibility in how public expenditure is authorised. This is necessary to:

- allow the Government to function in the new financial year before the Appropriation (Estimates) Bill has been enacted;
- allow for unanticipated expenditure during the year as circumstances change;
- allow for immediate expenditure in emergencies; and
- provide for the approval of relatively small amounts of expenditure in excess of appropriation without needing approval from Parliament.

3.23 The Public Finance Act allows the Minister of Finance to approve excess spending of up to the greater of $10,000 or 2% of the appropriation if it is incurred between April and June (inclusive). During 2018/19, the Minister of Finance used his powers under the Public Finance Act to authorise four instances of unappropriated expenditure for a total of $11.4 million (2017/18: three instances for $16 million).[6]

3.24 Under this provision, the Ministry of Health received approval to exceed its appropriations to meet increased costs and growing demand for national disability support services ($6.7 million).[7] The Department of Conservation also received approval to exceed appropriations to cover asset write-off costs resulting from the March 2019 West Coast storm event ($2.9 million).[8] The Ministry of Foreign Affairs and Trade gained approval to cover excess expenses from increasing its liability under the Holidays Act ($1.8 million across two appropriations).[9]

3.25 Because $11.4 million of unappropriated expenditure was authorised under section 26B of the Public Finance Act, the spending was lawful. However, it remains unappropriated until confirmed by Parliament in the next Appropriation (Confirmation and Validation) Act.

6 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 142.

7 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 143.

8 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 143.

9 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 143.

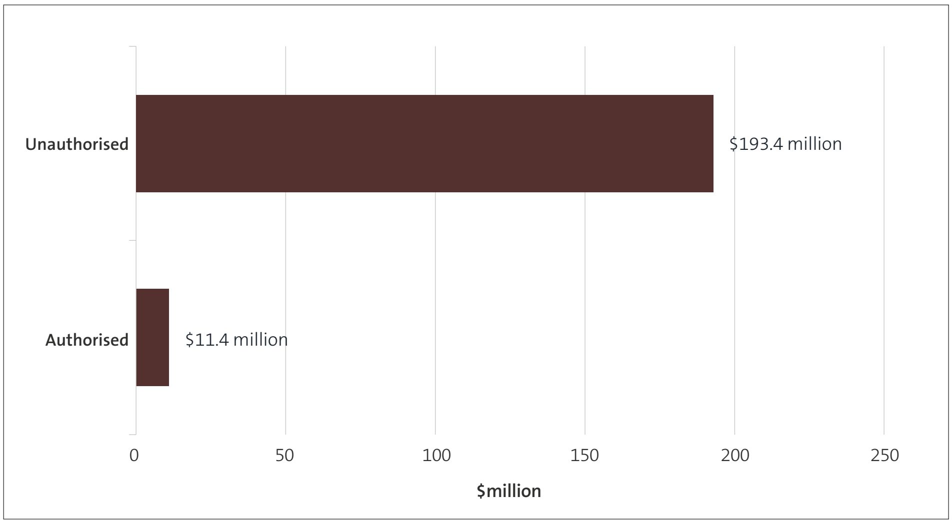
Unappropriated expenditure incurred without any authority

3.26 Of the appropriations where expenditure was outside the appropriation restrictions, the expenditure was incurred without authority in 10 of the 14 instances (as per the last three categories in Figure 4).

3.27 In terms of the amount of expenditure that was unappropriated, 95% was unauthorised (see Figure 5).

Figure 5
Proportion of unappropriated expenditure that was unauthorised for the year ended 30 June 2019

The figure shows that the amount of unauthorised unappropriated expenditure was $193.4 million. The amount of authorised unappropriated expenditure was $11.4 million.



3.28 Of the unappropriated expenditure in 2018/19 totalling just over $200 million, $193.4 million was incurred without authority (2017/18: $111 million). This expenditure was incurred across 10 appropriations (2017/18: 13 appropriations).

3.29 Although the number of instances of unauthorised expenditure fell from 13 in 2017/18 to 10 in 2018/19, the amount of expenditure incurred without any authority rose by 150% (from $77 million to $193 million). This expenditure is unlawful and will remain unappropriated until validated by Parliament in the next Appropriation (Confirmation and Validation) Act.

3.30 Two instances of unappropriated expenditure accounted for 90% of unauthorised expenditure: MBIE's expenditure under Vote Building and Housing ($151.9 million) and the Ministry of Health's expenditure under Vote Health ($22.6 million).[10] These

10 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, pages 144-148.

instances came about through the writing down, or writing off, of capitalised expenditure (that is, recognising impairment of asset book values, including following the accounting standards requirements for concessions on interest-free loans) in the absence of an appropriation to cover the expense.

Managing expenditure within the appropriation system

3.31 The two instances accounting for 90% of unauthorised expenditure are examples of departments not aligning the timing of the needed authority with the timing of the expenses; in particular, expenses resulting from accounting adjustments to the book values of assets.

3.32 The $151.9 million of unappropriated expenditure incurred under Vote Building and Housing is the largest single unappropriated expenditure in the last seven years. From 1 July to 30 September 2018, the Treasury signed Housing Infrastructure Fund loan agreements to provide interest-free loan facilities to local authorities. MBIE initially had an appropriation to cover the expense of writing down the loans to their fair value (the adjustment to fair value reflects the interest free nature of the loans). However, the accounting adjustment was made after 1 October 2018, when the appropriation was transferred to Vote Housing and Urban Development and administered by the Ministry of Housing and Urban Development. Therefore, MBIE wrote down the book values of the loans when it no longer had the authority within Vote Building and Housing to incur the expense.[11]

3.33 In the Ministry of Health's case, during year-end the Ministry reviewed several health-related items on the Crown balance sheet that had been accounted for as investments. It concluded that they needed to be written off. These investments included the capitalised costs for a joint-venture initiative that did not eventuate, historical payments made for housing modifications, and other costs that should have been accounted for as operating expenses originally. The expense caused by the combined write-offs ($22.6 million) was not covered by an existing appropriation under Vote Health, resulting in unappropriated expenditure.[12]

3.34 The public finance management system has flexibility to allow, under limited circumstances, amounts authorised for spending to be transferred between appropriations or between years. MBIE had requested an expense transfer from 2017/18 to 2018/19 for the remediation of facades and parapets of unreinforced

11 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 144.

12 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 148.

masonry buildings. However, MBIE incurred expenditure against the appropriation ($926,000) before the transfer had been approved.[13]

3.35 In August 2018, MBIE requested spending authority from Ministers under the Imprest Supply Act arrangements. The request was to create a new appropriation category and increase the amount of departmental expenditure for the "operational support of regional and sector investments". This was part of MBIE's administration of the Provincial Growth Fund, under Vote Business, Science and Innovation.

3.36 The Minister of Finance approved the operational funding for MBIE's Provincial Development Unit on 12 August 2018. However, an error in the paperwork led to the approval to establish the necessary new appropriation category to be overlooked. The error was discovered in September 2018 and the correction was made in October 2018, when the creation of a new appropriation category was approved. By that time, some money had already been spent on the basis of the August approval, before the proper authority was in place in October. This meant that expenditure before the October approval ($2.5 million) was unappropriated.[14]

Winter Energy Payments made to ineligible beneficiaries

3.37 From 1 July to 29 September, the Ministry of Social Development (MSD) applied public money to situations not covered by the law. A small proportion of payments under Vote Social Development for the Winter Energy Payment ($3.4 million) were outside the criteria set out in the Social Security Act 1964.

3.38 MSD had unlawfully made payments to recipients whose circumstances were expressly excluded from eligibility under the Social Security Act. The circumstances included:

- individuals receiving government funding for long-term residential care or residential care services but who are not eligible for Residential Care Subsidy or Residential Support Subsidy; and
- individuals who were absent from New Zealand for more than four weeks at a time during the eligibility period.

3.39 The Winter Energy Payments to these recipients were unlawful for two reasons: they were made outside MSD's legal mandate (under the Social Security Act), and they were made without Parliament's authority to spend (under the Public Finance Act). The payments of $3.4 million were therefore unappropriated expenditure.

3.40 The Controller told MSD that it must not make payments to people in those ineligible circumstances when the Winter Energy Payment resumed on 1 May

13 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 147.

14 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 147.

2019 unless Parliament had passed legislation in the meantime to allow for those payments. Subsequently, Parliament passed the Social Security (Winter Energy Payment) Amendment Act 2019 to allow for payments covering the above circumstances to be made from 1 May 2019 and retrospectively.

3.41 Although the amended social security legislation has legalised the payments to recipients who were previously ineligible for the Winter Energy Payment, the spending remains unappropriated and unlawful under the Public Finance Act because the Government did not have the authority to incur the expenditure at the time it was incurred. It will remain unappropriated until validated by Parliament in the next Appropriation (Confirmation and Validation) Act.[15]

Changes to accounting practices

3.42 In 2019, NZDF changed the way it accounts for cost recoveries (mainly related to service housing and barracks) and the related expenses. With the change in accounting practice, the reported expenses are now higher and exceed some of NZDF's appropriations.

3.43 Since NZDF's formation in 1990, it had offset cost recoveries (rent revenue) against the related expenses. NZDF states that it received advice from independent advisors that accounting for the expenses on a net basis was valid.

3.44 The cost recoveries are now correctly accounted for as revenue, and therefore the expenses are now reported at their gross amount. The change in accounting treatment was too late in the year to seek Cabinet's authority and an appropriation from Parliament for any of the resulting excess expense.

3.45 Consequently, appropriations in Vote Defence Force were exceeded by $8.6 million in 2018/19 for expenditure allocated to two appropriations: Army Capabilities Prepared for Joint Operations and Other Tasks and Protection of New Zealand and New Zealanders. We have also confirmed unappropriated expenditure as a result of applying the revised accounting treatment to historical expenses for the previous four years, amounting to $33.8 million.[16]

3.46 Since 1991, the Ministry of Education, under its School Risk Management Scheme, has operated an insurance scheme for schools that are unable to obtain contents insurance cover on their own. The Ministry retains a small portion of the schools' operational grants to buy collective insurance cover and manage the scheme.

15 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 146.

16 Unappropriated expenditure for previous years will be validated, along with unappropriated expenditure from 2018/19, in the next Appropriation (Confirmation and Validation) Act. The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 145.

3.47 The Ministry had been netting off the scheme expenses (mostly premiums and administration expenses) with revenue (such as insurance recoveries), and charging any net expense incurred against the Primary Education and Secondary Education appropriations in Vote Education.

3.48 Early in 2019, the Ministry sought clarification from the Treasury and the Controller on the correct accounting treatment. The advice was that the Ministry's treatment was incorrect – the expenses it incurred as an insurer needed to be accounted for in a new appropriation because the scope of the Primary Education and Secondary Education appropriations was not wide enough to cover these insurance expenses. After this problem was identified, the Ministry corrected its accounting practice. In April 2019, a new appropriation was approved for inclusion in the Supplementary Estimates to provide authority for insurance expenses for the remainder of 2018/19.

3.49 However, expenses of $2.4 million were incurred outside the scope of appropriations in 2018/19, up to the point at which authority was obtained in April. As a result of the correct accounting treatment now being applied, we have also confirmed unappropriated expenditure for the previous four years, amounting to $11.5 million.[17]

Obligations and increased demand

3.50 Some expenses are more challenging than others to manage within existing appropriations, as some departments experienced in 2018/19.

3.51 The Ministry for the Environment paid $489,000 more than was authorised to territorial local authorities, but this was necessary to meet a Crown obligation. The payment to councils was tied to revenue collected from the Waste Disposal Levy – because revenue collected was higher than expected, the obligation to pay the local authorities was higher than was authorised.[18]

3.52 The Department of the Prime Minister and Cabinet settled a legal dispute, which it inherited from the Canterbury Earthquake Recovery Authority. The Department considered the $500,000 cost to be a departmental expense; that is, an expense incurred in carrying out its operations. However, the Controller determined it to be a "non-departmental" expense. There was no non-departmental expense appropriation to authorise the expense, once reclassified, and so the expenditure was unappropriated.[19]

17 Unappropriated expenditure for previous years will be validated, along with unappropriated expenditure from 2018/19, in the next Appropriation (Confirmation and Validation) Act. The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 146.

18 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 144.

19 The Treasury (2019), *Financial Statements of the Government of New Zealand for the year ended 30 June 2019*, page 147.

The importance of thinking ahead and careful management

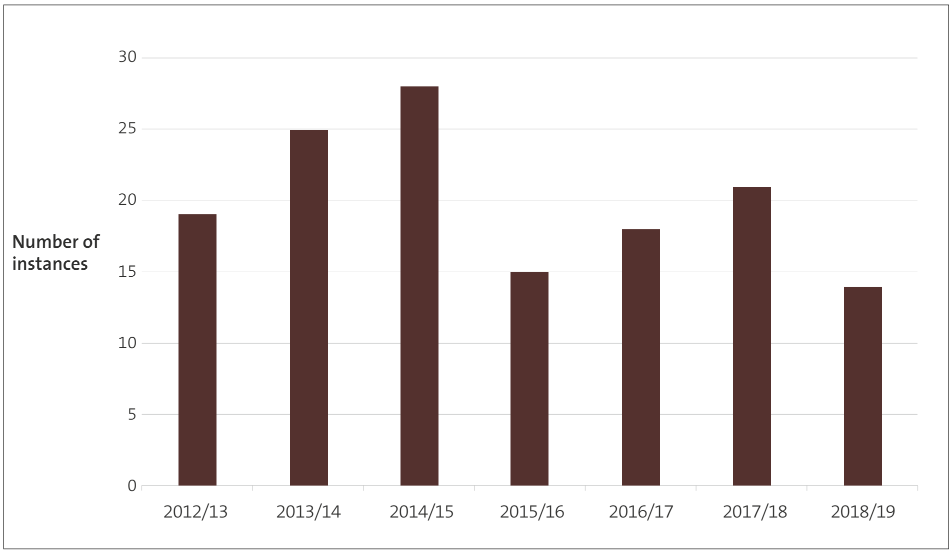
3.53 Several of the instances of unappropriated expenditure could have been avoided. We have been encouraging departments to try to anticipate when costs might be higher than expected and plan for that. Thinking ahead and careful management can often help ensure that spending not expected at Budget time can be incurred lawfully. When transfers are planned but not approved, departments need to take care to ensure that their spending remains within the approved limits. Particular care is needed to avoid spending before that spending has been authorised.

How does 2018/19 compare with previous years?

3.54 Figure 6 shows that the frequency of instances of unappropriated expenditure has fluctuated during the last seven years. Since 2014/15, when there was a peak of 28 instances of unappropriated expenditure, there have been notably fewer instances.

Figure 6
Number of instances of unappropriated expenditure, from 2012/13 to 2018/19

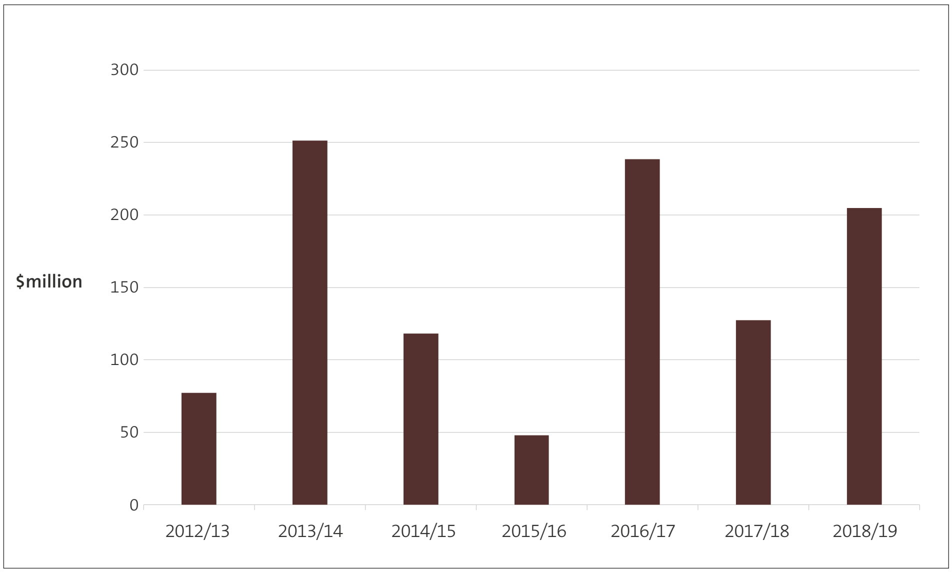
The figure shows the number of instances of unappropriated expenditure each year, from 2012/13 to 2018/19. The number of instances increased from 2012/13 to 2014/15. Since 2015/16, there have been fewer instances of unappropriated expenditure.



3.55 Figure 7 shows the dollar amount of unappropriated expenditure incurred during the last seven years. The fluctuations show there has been no discernible trend. The main factors for the unappropriated expenditure spike in 2013/14 were related to support for the Canterbury earthquake recovery.

Figure 7
Dollar amount of unappropriated expenditure, from 2012/13 to 2018/19

The figure shows the total dollar amount of unappropriated expenditure each year. The dollar amount fluctuates from year to year. There is no apparent trend.



3.56 The Government's financial statements disclose details of unappropriated expenditure under six categories. Figure 8 distils these into three broad categories:

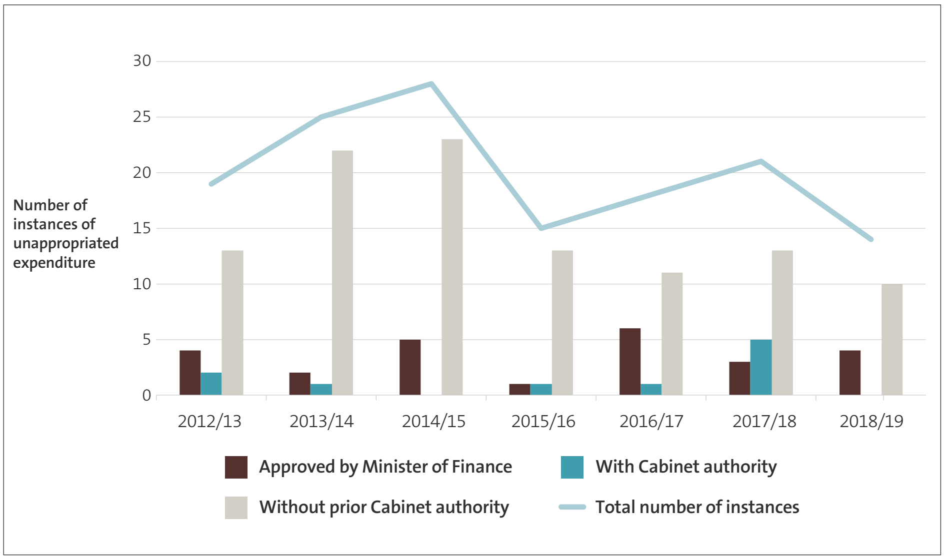
- **Approved by the Minister of Finance**: Small over-runs of expenditure in the final three months of the financial year, which was within $10,000 or 2% of the appropriation, and was approved by the Minister of Finance under section 26B of the Public Finance Act.
- **With Cabinet authority**: Expenditure incurred above or beyond the appropriation limits, with Cabinet authority to use imprest supply, but not authorised by Parliament in an Appropriation Act before the end of the financial year.

- **Without prior Cabinet authority**: Expenditure incurred above or beyond the appropriation limits without any authority at the time it was incurred.

3.57 Figure 8 provides a time series for the last seven years of the number of instances of unappropriated expenditure under these three broad categories.

Figure 8
Number of instances of unappropriated expenditure by category, from 2012/13 to 2018/19

The figure shows, from 2012/13 to 2018/19, the number of instances each year of three categories of unappropriated expenditure: unappropriated expenditure approved by the Minister of Finance, unappropriated expenditure with Cabinet authority, and unappropriated expenditure without prior Cabinet authority. The highest number of instances every year, from 2012/13 to 2018/19, was unappropriated expenditure without prior Cabinet authority.



3.58 Section 26B of the Public Finance Act provides some flexibility for small cost over-runs in the last three months of the financial year, when it is generally too late to have additional expenditure (incurred under imprest supply) included in the Appropriation (Supplementary Estimates) Act. Figure 8 shows that there are only a small number of exceeded appropriations approved by the Minister of Finance each year.

3.59 The second Imprest Supply Act for the year provides temporary authority for expenditure additional to that authorised in the Budget, within a specified spending limit. Expenditure under imprest supply must receive Cabinet approval before it is incurred. Because the authority is temporary, this expenditure must also be included in the Appropriation (Supplementary Estimates) Bill for the year in order to be appropriated before the end of the year, when the Bill is enacted. However, if such expenditure is not included in the Bill, then it is unappropriated and remains so until validated by Parliament in the next Appropriation (Confirmation and Validation) Act.

3.60 Figure 8, shows the number of instances where expenditure outside the appropriation limits received the required Cabinet authority but were not appropriated before the end of the year. After an increase in the number of such instances in 2017/18 (five instances), there were no instances in the next year. In 2018/19, all expenditure incurred under imprest supply was approved by Parliament and included in the Appropriation (2018/19 Supplementary Estimates) Act 2019.

3.61 Most instances of unappropriated expenditure are incurred without any prior authority. In rare instances, these result from unseen events (for example, costs of immediate responses to natural disasters or other emergencies). But in most instances, these can be avoided with better planning and management.

3.62 In 2018/19, there were 10 instances of departments incurring expenditure without any authority. These were in Votes Building and Housing; Business, Science and Innovation; Defence Force; Education; Environment; Health; Prime Minister and Cabinet; and Social Development (see Figure 4) and are discussed in paragraphs 3.26 to 3.52. This is lower than the about 23 instances in 2013/14 to 2014/15, but it is too soon to conclude that this constitutes a trend.

Recent developments

3.63 As part of a broader programme of public finance system reforms, the Treasury has been looking for ways to add more flexibility to, and reduce the compliance burden of, the system that annually authorises public spending – the appropriation system.

3.64 Recently, the Treasury introduced two initiatives aimed at increasing flexibility and/or reducing compliance: multi-category, multi-year appropriations (in Budget 2019) and, more recently, the requirement to consolidate small appropriations as of Budget 2020.

3.65 Both initiatives permit the merging of what were previously separate appropriations into one appropriation. Multi-category appropriations already allowed for flexibility of spending across different types of expenditure – this can now be extended to flexibility of spending across different years. The consolidation of appropriations will allow for more flexibility of spending across different scopes, that is, the scope of permitted expenditure will be widened by combining the scopes of previously separate appropriations.

3.66 Put simply, these changes to the rules allow more spending flexibility by removing barriers (such as type, scope, or time restrictions) that were there to control the amount of public money spent for a specific purpose. More flexibility also makes compliance easier because it becomes harder to overstep the barriers.

3.67 The Treasury consulted closely with the Controller before making the above changes. We agree in principle with moves to make the public finance system achieve its objectives more smoothly and at lower cost. However, we are mindful that the aggregation of spending can reduce the level of control Parliament has over aspects of government expenditure. That can also lead to less transparency when reporting what was done with the money if the reported information is more aggregated than before. Transparency in reporting is important to enable Parliament to hold executive government to account for its expenditure.

3.68 We are also mindful that any reforms to the authorising and accountability system should preserve Parliament's ability to authorise spending, and to hold the Government accountable for that spending, at an appropriate level of detail. Just what the optimal level of detail is will be a matter of judgement. We will monitor developments closely to help ensure that the transparency of, and accountability for, public spending is not unduly diminished.

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