



MINISTRY OF DEFENCE ANNUAL REPORT

for the year ended 30 June 2018

Presented to the House of Representatives pursuant to section 44(1) of the Public Finance Act 1989



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This page: The base of HMNZS *Aotearoa* is assembled at the HHI dockyard in Ulsan, Republic of Korea for the Maritime Sustainment Capability project

Coverpage: HMNZS *Hawea* assists with fisheries and customs patrols in Fiji as part of Operation WASAWASA

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PART 1: OVERVIEW

BY THE SECRETARY OF DEFENCE

During the year the Ministry of Defence has continued to deliver across its responsibilities. We delivered a significant capability programme, supported a demanding programme of Defence engagements, and provided advice on deployments of New Zealand Defence Force personnel.

Since the change of Government in 2017, the Ministry has been working actively with the Defence Force to support the new Minister of Defence implement the Government's priorities.

The Ministry prepared a *Strategic Defence Policy Statement 2018*, for the Government that sets out an assessment of New Zealand's challenging strategic environment. The Statement establishes updated policy settings for Defence and a set of principles that guide how the Government makes decisions about Defence.

It is against this strategic assessment that the decision to procure four P-8 maritime patrol aircraft was made. Officials carefully examined a wide range of options and demonstrated that the P-8 was the most cost effective maritime patrol aircraft option available.

A Review of Defence Procurement Policies and Practices for Major Capability Projects by Sir Brian Roche determined that Defence now has a robust Capability Management System, but noted the changes as part of the Defence Capability Change Action Programme are still relatively new, and that ongoing leadership is required to embed and sustain them.

The recent Treasury-sponsored Investor Confidence Index A rating result for the Defence capability portfolio also reaffirms that the investment in the Ministry since 2015 has resulted in a significant uplift in project and programme management performance.

We have systematically reviewed our approach to the development and delivery of military capability across the board. This has included reviewing our project management disciplines, procedures, processes, policies and practices in line with international best practice. We have built specialist expertise in the areas of commercial project management, financial management and risk management. Governance arrangements and management oversight arrangements have been strengthened.

This work was done in partnership with the Chief of Defence Force and the New Zealand Defence Force.

During the year we obtained Government approval to progress seven capability projects. We delivered new individual weapons and Special



Operations Vehicles to the Defence Force, commenced installation under the Frigate Systems Upgrade project, and completed design work for the Maritime Sustainment Capability.

We have also continued to support the Government's key decisions on a range of deployments to the Middle East, Pacific and Africa. This included for the first time deploying a New Zealand Defence Force officer to Mali in support of the United Nations Multi Dimensional Integrated Stabilization Mission. These operational deployments reflect New Zealand's global interests and our commitment to international rules based order.

The Ministry was rated second in the public service for the quality of its policy advice and received a Policy Advice Excellence Award from the New Zealand Institute of Economic Research in December 2017.

A major, continued focus is to shift the Ministry's results in respect of gender and diversity. The Ministry pays men and women the same remuneration for the same work. At 30 June 2018, women made up 54 per cent of staff (against 36 per cent in 2013) and 38 per cent of managers (against 19 per cent in 2013). While the Ministry has made a lot of progress since 2013, work to reduce the Ministry's gender pay gap is ongoing and remains the primary focus.

The Ministry will later this year finalise the 2018 Defence Capability Plan update. The Defence Capability Plan will provide the Government's capability investment intentions.

I am confident we can continue to deliver on an ambitious programme of work to continue to support the Government's priorities for Defence and security.



Helene Quilter
Secretary of Defence

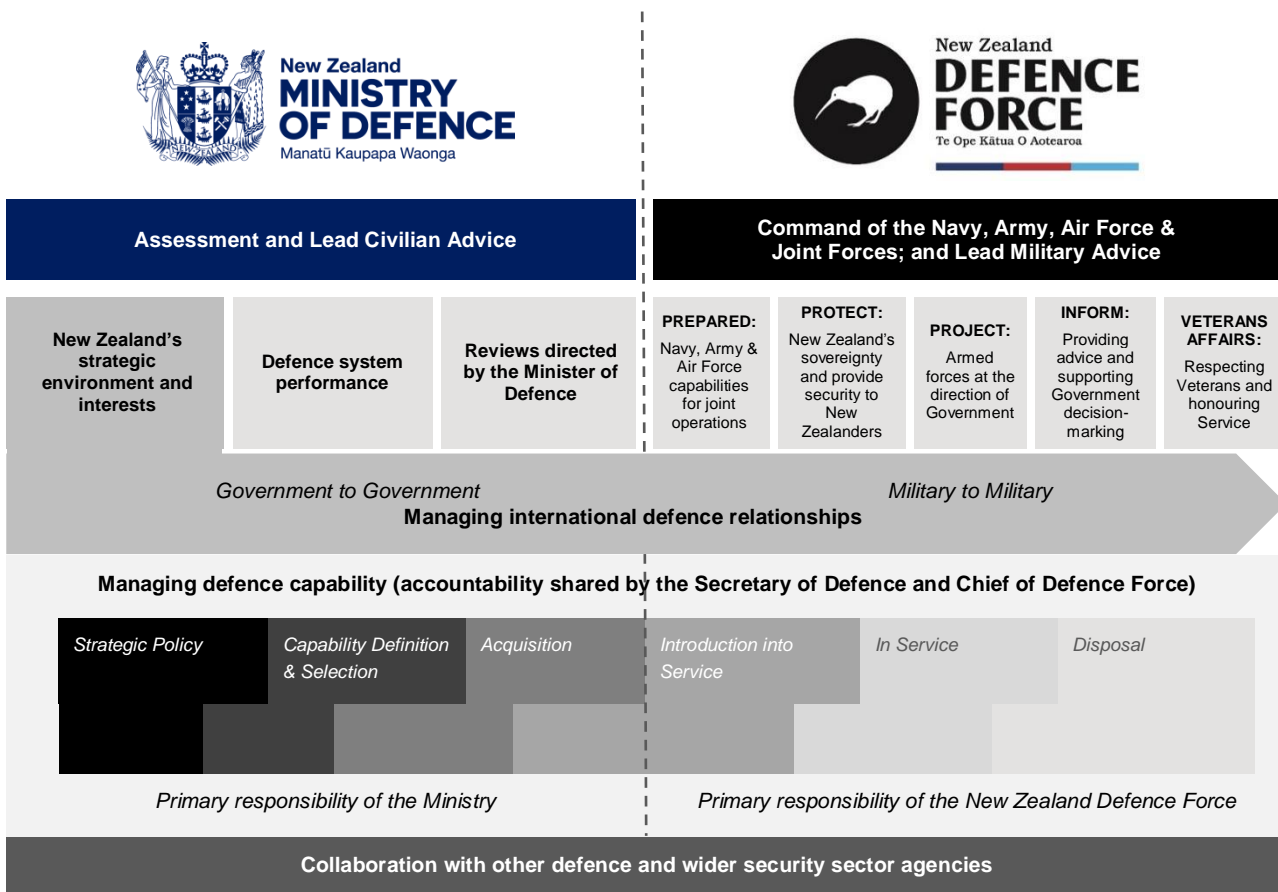
PART 2: THE MINISTRY'S PERFORMANCE AND OPERATIONS

THE MINISTRY OF DEFENCE

The Ministry of Defence is the Government's lead civilian advisor on defence. Its purpose is to give civilian advice on defence matters to enhance the security and interests of New Zealand and its people. The Ministry also purchases major items of defence equipment which becomes a capability when it is used by the service men and women of the New Zealand Defence Force.¹

Defence is made up of two agencies: the Ministry of Defence and the New Zealand Defence Force. The agencies work very closely together; drawing on their strong, separate civilian and military perspectives. The separation between the two agencies is part of New Zealand's constitutional arrangements. Under the Defence Act 1990, the Secretary of Defence is the lead civilian advisor on defence matters and the Chief of Defence Force is the lead military advisor and senior military officer.

Figure 1: Respective roles of the Ministry of Defence and New Zealand Defence Force



¹ In the Defence context, 'capability' refers to the personnel, equipment, platforms, and/or other resources that affect the capacity to undertake military operations.

The Ministry is responsible for the development of defence policy, international defence relationships and engagements, deployments, systemic reviews on behalf of the Minister of Defence, and the development and delivery of capability projects. In this context, capability means platforms, equipment, systems, technologies and materiel with a whole of life capital and operating cost of more than \$15 million.

To carry out these functions, the Ministry works closely with the Defence Force, the Ministry of Foreign Affairs and Trade and other agencies. The Ministry also builds and maintains strong defence connections with other governments, including our ally Australia, so New Zealand can contribute to the security of the Asia-Pacific region, as well as understand and respond to defence and security challenges internationally.

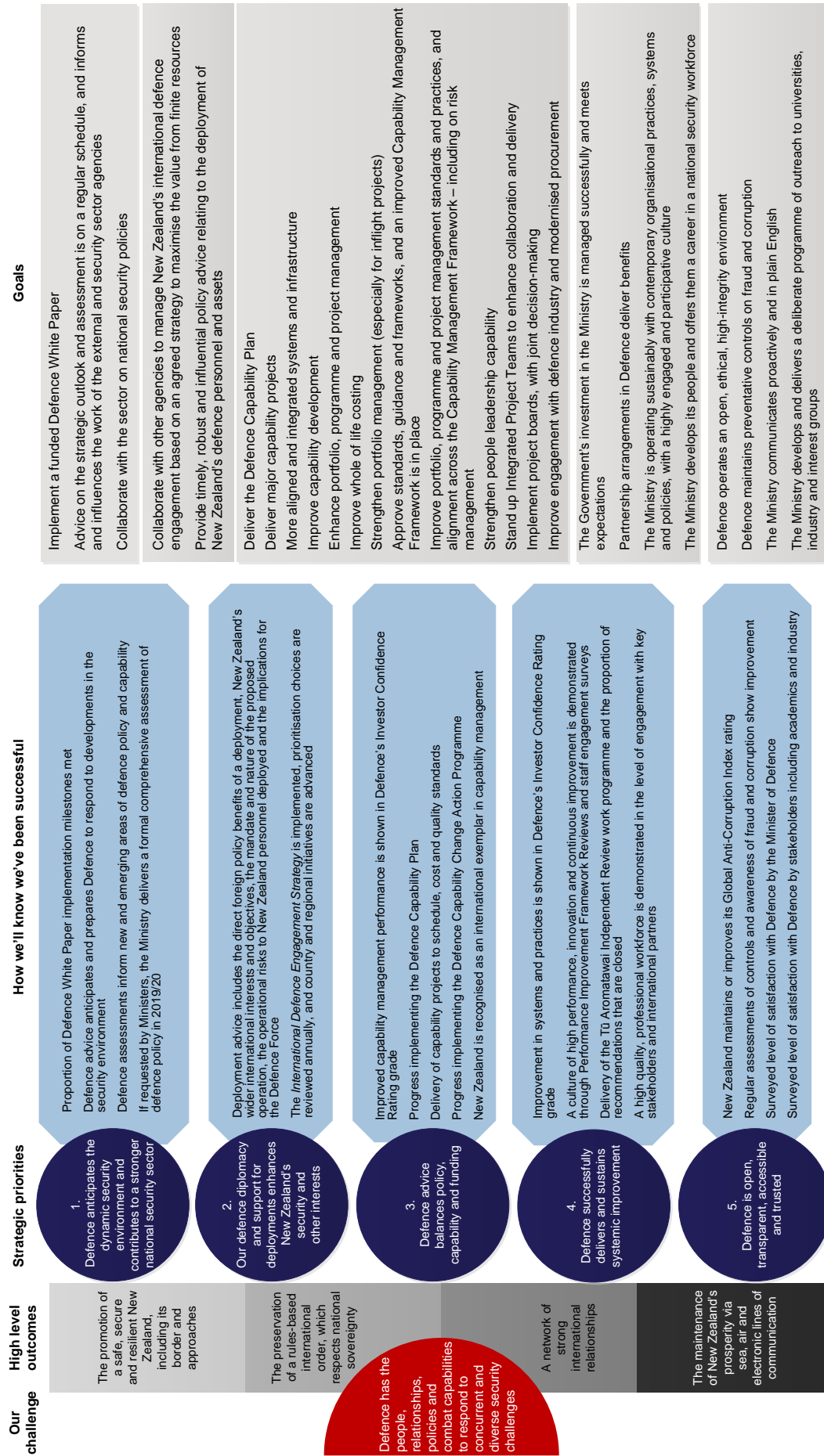
THE MINISTRY'S PRIORITIES AND OUTCOMES FRAMEWORK

The Ministry's objectives and performance indicators are based on the Vote Defence *Estimates of Appropriations for 2017/18* and the Ministry's *Statement of Intent 1 July 2017 – 30 June 2021*.² Divisions regularly evaluate their performance against these during the year.

The Ministry's outcomes framework for this period is set out over the page, showing how the Ministry's outcomes, business activities and success factors reinforce each other.

² The Ministry's Statement of Intent is available from its website at www.defence.govt.nz/publications.

Figure 2: The Ministry of Defence's Strategic Outcomes Framework



THE SECURITY ENVIRONMENT

Defence is a key part of the broader New Zealand security system, and works alongside other government agencies to protect and advance New Zealand's security interests.

The Ministry contributes to New Zealand's security through four high-level outcomes:

- the promotion of a safe, secure and resilient New Zealand, including its border and approaches
- the preservation of a rules-based international order, which respects national sovereignty
- a network of strong international relationships
- the maintenance of New Zealand's prosperity via sea, air and electronic lines of communication.

The Ministry constantly monitors the security environment. A summary of developments is provided below.

HOW DOES THE MINISTRY CONTRIBUTE TO THE ACHIEVEMENT OF THESE OUTCOMES?

The Ministry contributes to the primary outcomes in three ways:

1. providing the Government with policy advice concerning defence and security issues, including the security environment, the military capabilities of the Defence Force, the deployment of military forces and the conduct of international defence relations
2. undertaking the acquisition of major platforms and items of military equipment for use by the Defence Force undertaking defence and security tasks
3. undertaking evaluations, audits and assessments of the Defence Force and the capability delivery function of the Ministry to examine and help improve their efficiency and effectiveness.

NEW ZEALAND'S STRATEGIC ENVIRONMENT: SHIFTING FOUNDATION OF SECURITY

The *Strategic Defence Policy Statement 2018* – launched by the Minister of Defence on 6 July 2018 – sets out an assessment of New Zealand's challenging strategic environment. The contents of this assessment were developed over the course of 2017/18 both as part of the Ministry's enhanced Defence Assessment programme established by the *Defence White Paper 2016* and directly for inclusion in the Policy Statement.

New Zealand is navigating an increasingly complex and dynamic international security environment. We will face compounding challenges of a scope and magnitude not previously seen in our neighbourhood. While there may be noteworthy effects on New Zealand's interests from singular developments, New Zealand's security outlook may be shaped most powerfully by a combination of forces increasing pressure on the international rules-based order, which will play out in newly potent ways close to home.

The three key forces, and their dynamic interactions, pressuring the order are:

- The increasing importance of **spheres of influence**, with some states pursuing influence in ways that, at times, challenge international norms;
- **Challenges to open societies**, driven by increasing disillusionment with existing arrangements within these societies, threatening to reduce the willingness of these states to champion the rules-based order; and
- A collection of **complex disruptors**, including an array of impacts from climate change, new technologies changing the nature of conflict, extremist ideologies, and transnational organised crime. Many of these disruptors disproportionately affect open societies and weak states. They are forces for disorder.

New Zealand will face increasing disruptors close to home. Climate change, transnational organised crime, resource competition, together with the increasing influence and presence of non-traditional partners, will disrupt our neighbourhood (encompassing the area from Antarctica through to the South Pacific), including our extensive maritime area, in complex and compounding ways.

Supporting stability in the Asia-Pacific will increase in importance. Groupings of like-minded nations are emerging to balance challenges to rules and norms, and to reinforce the rules-based order across this region.

As challenges to the international rules-based order intensify, it will remain in New Zealand's vital interest to act in support of this order. While the New Zealand Defence Force will conduct some missions on its own, most deployments will be undertaken alongside other government agencies and international partners. It is therefore critical for the Defence Force to maintain and develop capabilities that effectively support operating with others.

Defence will have to act in new ways and at new levels to protect New Zealand's values and interests.

DELIVERING ON THE MINISTRY'S STRATEGIC INTENTIONS

The Ministry sets out five strategic priorities in its *Statement of Intent 1 July 2017 – 30 June 2021*.

Defence has the people, relationships, policies and combat capabilities to respond to concurrent and diverse security challenges



Below is the progress made against each priority over the year to 30 June 2018, including the associated critical success factors.



PRIORITY 1: DEFENCE ANTICIPATES THE DYNAMIC SECURITY ENVIRONMENT AND CONTRIBUTES TO A STRONGER NATIONAL SECURITY SECTOR

Over 2017–2021 this work will involve the following critical success factors:

- A funded Defence White Paper is implemented.
- Advice on the strategic outlook and assessment is on a regular schedule, and informs and influences the work of the external and security sector agencies.
- Collaborating with the sector on national security policies.



On 6 July 2018, the Government launched the *Strategic Defence Policy Statement 2018*. The Policy Statement presented an assessment of New Zealand’s challenging strategic environment and updated the policy settings contained in the *Defence White Paper 2016* to reflect Government’s foreign policy (including the Pacific Reset) and national security priorities. The Ministry developed the Policy Statement in consultation with the Defence Force and other key government agencies, and in so doing drew on the enhanced programme of Defence Assessments and Defence policy development that had been directed by the *Defence White Paper 2016*.

Advice on the strategic outlook and assessment

Over 2017 the Ministry developed and delivered the first set of Defence Assessments within the enhanced Defence Assessment programme. This first set included a number of in-depth assessments on issues of particular Defence policy interest as well as the first annual strategic Defence Assessment. These assessments provided a strong basis for the Ministry to deliver the *Strategic Defence Policy Statement 2018*, as directed by Government early in 2018. The Ministry will continue to deliver Defence Assessments as part of this programme to ensure Government is well placed to identify and respond to emerging and evolving Defence policy issues.

Over 2017/18 the Ministry has worked to deliver a set of Defence capability planning scenarios to link strategic policy development with capability planning. Once complete, these will cover the full range of Defence Force roles, including consideration of emerging areas of Defence activity alongside more traditional tasks.

Working across government and with academia

The Ministry has continued to work closely with a range of government agencies, particularly those in the wider national security sector, to contribute to broader policy development work. Over 2017/18 the Ministry has focused in particular on contributing to sector-wide initiatives that concern emerging technologies (notably cyber and space), issues of particular national security interest (such as maritime security, climate change and terrorism), and responses to significant changes in New Zealand's strategic environment.

Developing the *Strategic Defence Policy Statement 2018* provided a useful mechanism for deepening and broadening the Ministry's engagement with a range of New Zealand academics with expertise relevant to New Zealand's defence and security policy. This engagement helped to ensure we accessed a broad set of perspectives.

The Ministry also participates and provides advice on a number of sector and cross-agency initiatives including:

- input into development of a national risk register
- the ongoing development of policy and response planning for irregular migration
- provision of advice and input into whole-of-government counter-terrorism initiatives
- development of policy for Defence support to youth development and youth not involved in education or training
- participation in planning the conduct of Southern Ocean patrols for illegal, unregistered and unregulated fishing
- support to the Ministry of Foreign Affairs and Trade and Antarctica New Zealand for planning of logistic support to Scott Base and the United States of America and Italy under the Joint Logistics Programme
- facilitating cross sector work on Maritime Security Policy
- contribution to the development of New Zealand's cyber policy and space policy
- contributing to the South Pacific Defence Ministers' Meeting group on climate change and its security impacts.



PRIORITY 2: OUR DEFENCE DIPLOMACY AND SUPPORT FOR DEPLOYMENTS ENHANCES NEW ZEALAND'S SECURITY AND OTHER INTERESTS

Over 2017–2021 this work will involve the following critical success factors:

- Provide timely, robust and influential policy advice relating to the deployment of New Zealand's defence personnel and assets.
- Collaborate with other agencies to manage New Zealand's international defence engagement based on an agreed strategy to maximise the value from finite resources.



International defence engagement

The Ministry of Defence and New Zealand Defence Force's approach to international defence engagement is guided by a comprehensive *International Defence Engagement Strategy* (IDES). The Ministry completed a comprehensive refresh of this document in late 2017. The updated version clearly identifies and prioritises relationships that support broad defence, security and foreign policy objectives. The Strategy provides guidance on how the Ministry and Defence Force should focus resources, including high level visits, in order to maximise the value to New Zealand.

Over the reporting period Defence achieved a number of key initiatives or objectives as identified in the Strategy. Ministry-led bilateral defence talks with a wide range of partner countries continued to afford key opportunities for conveying New Zealand views on international security issues and New Zealand's priorities. Bilateral defence consultations remained a key vehicle for advancing key bilateral defence initiatives as articulated and prioritised in the IDES. The Ministry worked jointly with the Defence Force on this defence engagement, and in close consultation with the Ministry of Foreign Affairs and Trade.

Over 2017/18 the Ministry supported travel by the Minister of Defence, including bilateral visits to Papua New Guinea, Fiji and the United Arab Emirates; operational visits to Iraq and Afghanistan; and to multilateral meetings in Rome, Brussels and Singapore. This travel encompassed formal counterpart meetings, commemorations and a number of multilateral engagements including a Defeat-ISIS Defence Ministers' Meeting and the Shangri-La Dialogue. Such bilateral counterpart visits and engagement in multilateral fora are a useful tool for strengthening defence relationships with key partners and for sharing New Zealand's perspectives on security issues and our defence priorities.

The Ministry also supported the Minister in hosting visits to New Zealand by his Australian and Singaporean counterparts and in a number of meetings with foreign ambassadors following the change of Government in late 2017.

Working with the New Zealand Defence Force, the Ministry organised and ran a defence policymakers course in New Zealand for civilian defence officials from foreign counterpart militaries. This included personnel from the United Arab Emirates, Papua New Guinea and Fiji. Similar courses have been run in the past and are tailored to the recipient's needs or areas of focus.

The Ministry and Defence Force led an inter-agency assessment of a proposal from Singapore to base F-15 fighter jets at Ohakea Air Base for training on a long term basis. This was the first opportunity for this Government to consider this proposal, and Defence has been asked to carry out further work and report the results to Cabinet later in 2018.

Representing New Zealand and advancing our security interests on the international stage

In addition to supporting the Minister in his overseas engagements, the Ministry worked closely with partner agencies to support overseas visits by the Secretary of Defence, Chief of the Defence Force and other senior officials, as well as visits by their counterparts to New Zealand.

Overseas engagements have been particularly important following the release of the *Strategic Defence Policy Statement 2018* as they provide the opportunity to share and promote New Zealand's revised defence policy settings with partners.

The Policy Statement highlights the important role of multilateral forums in fostering stability, peace and security in the region through promoting understanding, entrenching habits of dialogue and facilitating practical cooperation.

Central to the Ministry's participation in regional fora, is participation and membership of the ASEAN Defence Ministers' Meeting-Plus (ADMM-Plus) framework that remains New Zealand's principal forum for multilateral defence engagement in Asia. The Ministry coordinated New Zealand's role as co-chair, with the Philippines, of the Experts' Working Group on Cyber Security and will continue to do so out to 2020. In addition, the Ministry hosted ADMM-Plus members for a cyber security legal seminar in November 2017.

For the first time since 2006, the Ministry, with support from the Defence Force, hosted the 27 member countries of the ASEAN Regional Forum Defence Officials' Dialogue in Auckland with Singapore as co-host. Support was also given to the Minister of Defence who opened the Dialogue. The Dialogue included discussions on regional responses to major security threats, including terrorism.

The Ministry continues to work closely and provide support to the New Zealand Defence Force as they prepare to host the major multinational annual conference of the International Association of Peacekeeping Training Centres in October 2018. The annual conference will be the culmination of many years of planning and preparation.

Deployment of New Zealand's defence personnel and assets

The Ministry provides comprehensive advice to the Government on the deployment of the New Zealand Defence Force, in collaboration with the Ministry of Foreign Affairs and Trade. This advice outlines the strategic rationale for New Zealand's participation in a deployment, including how it contributes to New Zealand's security, national or international strategic intentions and foreign policy goals. The advice also importantly sets out risks to the New Zealand Defence Force personnel and how these would be managed.

Figure 3: New Zealand Defence Force deployments³



The Government approved a series of commitments to Maritime Security and Support Operations in the Middle East, Royal New Zealand Navy deployments to Asia and the Southwest Pacific. These included:

- offshore and inshore patrol vessels to Fiji in 2018
- the deployment of HMNZS *Te Kaha* and *Te Mana* to the Asia-Pacific in 2017 and 2018 respectively
- deployment of New Zealand Defence Force (NZDF) personnel to the Combined Air Operations Centre in Qatar
- deployment of NZDF personnel to the United Nations Command in South Korea
- deployment of an NZDF Officer to the United Nations Multidimensional Integrated Stabilization Mission in Mali
- deployment of an NZDF Officer to the Chief of Staff role for the United Nations Mission in South Sudan, and
- regular updates are also provided to Ministers on a particular security situation or where a mission is evolving to ensure decision makers remain well informed.

³ Up to date details about New Zealand deployments are available from the Ministry's website at www.defence.govt.nz/what-we-do/diplomacy-and-democracy/deployments/deployment-map/.

PRIORITY 3: DEFENCE ADVICE BALANCES POLICY, CAPABILITY AND FUNDING

Over 2017–2021 this work will involve the following critical success factors:

- Deliver the Defence Capability Plan.
- Deliver major capability projects.
- Implement the Defence Capability Change Action Programme.



The Defence Capability Management System

The Capability Management System (CMS) enables the Government’s defence policy through cost-effective design, delivery, operation, maintenance and eventually disposal of military capability. The CMS was developed as part of the Defence Capability Change Action Programme to guide the approach towards capability investments and provides mechanisms and structures used to support other areas of investments. It has been rigorously tested, with best practice investment and defence procurement practices embedded into it. The foundation of the CMS is the principle of Total Picture Thinking – each phase of the investment cycle is undertaken with full consideration of the entire cycle. Integration and change management is incorporated into early thinking, as is through-life-support and ultimately disposal of the investment in question.



The Capability Management Framework

The Capability Management Framework sets out the roles and responsibilities, guidance, standards, frameworks, enablers, tools, processes and procedures of how the Ministry and Defence Force jointly deliver capability. It ensures Defence processes are implemented in a consistent, repeatable way. The Framework is a living, online tool launched in November 2017. This ensures total accessibility to practitioners from both Defence agencies to one source of the truth. The Framework embodies the responsibility our organisations undertake to achieve excellence in capability management through partnership.

Capability Based Planning

Consistent with international military best practice, Defence subscribes to a Capability Based Planning approach. This methodology involves a functional analysis of operational requirements. It is policy driven, and asks “what do we need to do” rather than “what equipment are we replacing”. Capabilities are identified based on the tasks required to meet Government policy. One of the key benefits of Capability Based Planning is its ability to properly articulate choices in the face of economic constraints.

Capability portfolio planning is a structured approach to analyse, prioritise, and manage Defence capability requirements based on strategic drivers and the balance of benefits and risks. It is the mechanism by which the portfolio of capability development and disposal programmes and projects is aligned to Defence policy and strategy.

Capability management planning is undertaken at a discrete capability level (capability sets and assets) and is the method by which Defence analyses the gap between current and future capabilities which determines the pathways that will achieve the future capability sets outlined in the Defence Capability Plan.

Life cycle management structure

The Capability Life Cycle represents the whole life of a capability from conception through to disposal and is a key driver for the way in which Defence manages capabilities. The New Zealand Defence Force and the Ministry must collaborate closely across all phases of the Life Cycle in order to successfully deliver Defence capabilities.

There is significant overlap between these stages – for example, planning for capability integration is expected to start in the Capability Definition phase, with the plan typically being finalised within the Capability Delivery phase.

To effectively deliver the Capability Life Cycle, each phase has been broken up into one or many stages that are aligned, in a tailored manner, to the Better Business Case pathway.⁴

Figure 4: The Capability Life Cycle



⁴ All phases must be followed; however, based on the scale and complexity of a project, some stages may be combined. Further information about the Better Business Cases Framework is available from the Treasury website at <https://treasury.govt.nz/information-and-services/-state-sector-leadership/investment-management/better-business-cases-bbc>.

Policy reviews

The Labour-New Zealand First Coalition Agreement outlined a commitment to re-examine the defence procurement programme within the context of the Defence Capability Plan budget. At the direction of the Minister of Defence, Defence officials have in 2018 undertaken a series of reviews related to strategic policy settings and capital investments.

The *Strategic Defence Policy Statement 2018* presented an assessment of New Zealand's challenging strategic environment and updated the policy settings contained in the *Defence White Paper 2016* to reflect Government's foreign policy and national security priorities.

A *Review of Defence Procurement Policies and Practices for Major Capability Projects* by Sir Brian Roche concluded that the Defence Capability Change Action Programme (DCCAP) has addressed the structural, operations and information deficiencies of the previous system; and the new Capability Management System now provides decision-makers with a strong level of confidence and assurance to support informed decision-making.

Sir Brian found that the Defence CMS:

- is well led by aligned and motivated leaders
- has a number of inbuilt checks and balances to mitigate risk
- operates within a well-defined structure and governance regime
- has clear delegations and accountabilities, and
- is making strong inroads into embedding a new way of working within an environment that historically had challenges with transparency, alignment and resourcing.

Although DCCAP is still early in its lifecycle, the foundations have been well established. The programme is found to have delivered a CMS that has substantially changed and improved the acquisition process. The core components of the system together with the quality of leadership and culture operating within the new CMS has demonstrably mitigated the risks associated with the process of military acquisition.

The *Investor Confidence Rating Index* assesses Defence's investment management and asset performance against nine measures employed across the government sector. The Defence capability portfolio has in 2018 been rated A in the *Investor Confidence Rating Index* process. The capability portfolio demonstrated an improvement on benefit delivery performance, project delivery, and change management maturity. Defence was also the first agency to be awarded an 'excellent' (10/10) for its Long Term Investment Plan. This reaffirms that the investment in the Ministry since 2015 has resulted in a significant uplift in project and programme management performance.

The Defence capability portfolio equivalent Investor Confidence Rating of A, is a positive improvement over the 2015 B rating. There has been a noticeable uplift in portfolio, programme and project maturity.

Review of the Defence Capability Plan

The Ministry will later this year present to Government, a review of the Defence Capability Plan. The purpose of the Review is to present options to the government for planned investments in future New Zealand Defence Force military capability. The review will enable the Government to take decisions on capability choices and ensure these decision are aligned with Government defence policy and its fiscal strategy.

Defining and selecting military capability

Over the reporting period, business cases and/or Cabinet papers have been developed and submitted to Ministers for the following defence capabilities:

- NH90 Simulator, single stage business case (July 2017)
- Aircrew Training Capability, Cabinet paper (July 2017)
- Future Air Mobility Capability, indicative business case (agreed July 2017)
- Frigate Systems Upgrade, Cabinet paper (December 2017)
- Network Enabled Army: procurement of radios and associated equipment and software for the Mobile Tactical Command Systems, single stage business case (August 2017)
- Fixed High Frequency Radio Capability, single stage business case (June 2018)
- Dive and Hydrographic Vessel, single stage business case (June 2018)
- Defence Force Future Air Surveillance: Approval to Purchase the Boeing P-8A Poseidon Aircraft, project implementation business case (July 2018).

Acquiring and upgrading military capability

During the 2017/18 financial year, the Ministry has undertaken negotiations for military capability contracts worth over \$2,819 million. Highlights include contracts and/or Letters of Offer and Acceptance to:

- lease four King Air KA350 aircraft to deliver multi-engine conversion training and light transport tasks, as well as specialist aircrew training
- acquire a contemporary dive and hydrographic vessel to replace HMNZS' *Manawanui* and *Resolution*
- acquire from CAE an NH90 flight training device, as well as supporting infrastructure, training systems, and support services, and
- acquire from the United States Government four Boeing P-8A Poseidon aircraft, training systems, and other support and services to replace the aging P-3K2 Orion maritime patrol aircraft.

Project closure

During 2017/18 the following major projects were closed during the year:

- ANZAC Frigates Platform Systems Upgrade
- P-3K Orion Missions Systems Upgrade
- Pilot Training Capability
- Protector Remediation
- Training/Light Utility Helicopter.

Project summaries for major defence equipment currently being acquired or introduced into service

This section summarises the background and 2017/18 performance of all significant defence projects that the Ministry is currently acquiring or supporting introduction into service by the New Zealand Defence Force.

The Ministry's foreign exchange policy requires the Ministry to manage currency risk arising from future transactions and recognised liabilities, by entering into foreign exchange forward contracts to hedge 100% of the foreign exchange exposure.

The approval by Cabinet to commit to total project costs uses foreign exchange rates obtained through hedging. The subsequent recording of project expenditure uses exchange rates prevailing at the date of the transaction and creates a difference between the estimated costs included in the Cabinet approval and the amounts recorded in ledgers as project expenditure.

The project cost summaries show the financial effect of foreign exchange movements between Cabinet approval and recorded expenditure as at 30 June 2018: (favourable) / unfavourable.

During 2017/18 the Ministry managed the following major projects:

| Projects in definition phase | Projects in pre-acquisition phase |
|--|--|
| Future Air Surveillance Capability <i>Project was funded for acquisition phase by Cabinet on 2 July 2018.</i> | NH90 Simulator <i>Project was funded for acquisition phase by Joint Ministers on 25 July 2018.</i> |
| Future Air Mobility Capability Garrison and Training Support | Dive and Hydrographic Vessel <i>Project was funded for acquisition phase by Joint Ministers on 19 August 2018.</i> |
| HMNZS Canterbury Communications Upgrade Offshore Patrol Vessels Communications Upgrade Network Enabled Army – Tranche 2 Protected Mobility Communication, Navigation System, Air Traffic Management | Fixed High Frequency Radio Refresh |
| Projects in acquisition phase | Projects managed by the Ministry on behalf of the New Zealand Defence Force |
| 81mm Mortar Replacement ANZAC Frigate Systems Upgrade Individual Weapons Replacement Maritime Sustainment Capability Network Enabled Army – Tranche 1 Special Operations Vehicles Strategic Bearer Network Underwater Intelligence, Surveillance and Reconnaissance | Aircrew Training Capability <i>The Ministry-managed aspects of this project were completed in June 2018.</i> Counter Explosive Hazards |
| | Projects awaiting closure |
| | C-130 Hercules Life Extension Defence Command and Control System Medium-Heavy Operational Vehicles Medium Utility Helicopter |
| Selected projects in phases other than acquisition phase | |

Since the 2017 Annual Report the following projects have reached significant project lifecycle milestones.

Future Air Surveillance

This project was funded for acquisition phase by Cabinet on 2 July 2018

This project is to replace the Royal New Zealand Air Force's six aging P-3K2 Orion aircraft with four Boeing P-8A Poseidon maritime patrol aircraft. The project will also acquire the associated training systems and equipment, and the infrastructure and other components required to bring the P-8As into service. The project's overall budget is \$2.346 billion.

NH90 Simulator

This project was funded for acquisition phase by Joint Ministers on 25 July 2018

This project will acquire a flight simulator for the Royal New Zealand Air Force's fleet of eight NH90 helicopters, along with associated infrastructure and training systems. Currently training is provided through a combination of offshore simulator training, which reduces pilot availability in New Zealand, and training flights using the helicopters, which reduces available operational flying time. The simulator is expected to reduce cost and increase available operational use of the NH90 fleet. The Ministry is managing all of the project's budget of \$42.7 million.

Dive and Hydrographic Vessel

This project was funded for acquisition phase by Joint Ministers on 19 August 2018

This project will replace the Royal New Zealand Navy's dive and hydrographic capabilities, previously provided by the ships HMNZS *Resolution* and *Manawanui*. The Norwegian built multi-role offshore support vessel MV *Edda Fonn* will be purchased and modified for to meet the Navy's requirements. From November 2019 the vessel will undergo a phased process of implementing capabilities until full operational capability is achieved in mid-2020. The project's overall budget is \$103.4 million, with the Ministry managing \$98.4 million of this.

Aircrew Training Capability

As this project involves managing a lease agreement, any capital costs are covered by Vote Defence Force.

The Ministry has provided support to the New Zealand Defence Force Aircrew Training Capability project, managing the new lease and acceptance of King Air KA350 aircraft to replace the expiring lease of King Air B200s. The upgraded platform will allow multi-engine pilot training, air warfare officer training, light transport operations, specialist support capabilities and support the development of a short-range maritime patrol capability. The new lease was signed in April 2018 with the new aircraft being accepted into service from April 2018 through 2019.

The T-6 Texan aircraft, introduced under the Pilot Training Capability project, now allows pilots to undertake the advanced training which was previously performed on the Royal New Zealand Air Force's leased King Air B200 aircraft. This has in turn allowed this fleet to be used for Air Warfare Officer training which is currently conducted in Australia.

Projects in acquisition phase

81mm Mortar Replacement

This project is to replace and enhance the Defence Force's 81mm medium mortar capability in order to improve its operational effectiveness, reliability and sustainability. There are three equipment components that form the mortar capability: the mortar weapon, the sighting system and the weapons locating radar. In March 2017 the Minister of Defence approved the single stage business case for the sole source acquisition of the following components:

- 81mm mortars and weapons locating radars – via separate United States Foreign Military Sales cases
- sighting systems – direct commercial sales contract with Hall & Watts, United Kingdom.

| Objectives | Performance |
|--|--|
| <ul style="list-style-type: none"> • Develop letter of request for mortars and radars | <ul style="list-style-type: none"> • Letter of Offer and Acceptance for mortars received May 2018. Cost increase since 2016 Price and Availability letter means alternative mortar supplier are being investigated⁵ • Letter of Offer and Acceptance for three AN/TPQ-49 Lightweight Counter Mortar Radars signed July 2018. Delivery is scheduled for the second quarter of 2021 |
| <ul style="list-style-type: none"> • Develop contract for sights | <ul style="list-style-type: none"> • Contract for mortar sights awarded October 2017. The first 25 sights were delivered April 2018, with the remainder scheduled for delivery in November 2018 • Offer includes buy-back option of existing sights |

At 30 June 2018 actual and expected project costs were:

| | Total costs to 30 June 2017 \$000 | Project costs in 2017/18 \$000 | Estimated remaining costs to complete \$000 | Estimated total project costs \$000 |
|--------------------------------------|--------------------------------------|-----------------------------------|--|--|
| Cabinet approved budget | | | | 10,560 |
| Effect of foreign exchange movements | | | | 176 |
| | | | | 10,736 |
| Project expenditure | 35 | 534 | 9,955 | 10,524 |
| Estimated project variation | | | | 212 |

⁵ Under the United States Foreign Military Sales process, the Price and Availability letter provides initial indicative pricing. This is followed by the Letter of Offer and Acceptance which is the formal contract offer.

ANZAC Frigate Systems Upgrade

This project is upgrading the ANZAC frigates' combat capabilities to counter contemporary threats and to replace obsolescent systems.

In April 2014, Cabinet approved the Project Implementation Business Case, including capital expenditure of up to \$446.2 million between the Ministry and Defence Force. Contracts were awarded to Lockheed Martin Canada as the Prime System Integrator and 11 others for the provision of equipment and services.⁶

The design phase for the frigates was completed in May 2017. In December 2017, Cabinet approved the additional \$148 million in funding required to complete the installation of equipment. The installation for the first frigate, HMNZS *Te Kaha*, commenced in May 2018.

| Objectives | Performance |
|---|--|
| <ul style="list-style-type: none"> Prepare HMNZS <i>Te Kaha</i> for transfer to Victoria, Canada in February 2018 and the start of the installation phase Commence installation phase in accordance with schedule Manage installation phase to schedule Complete all preparations required for commencement of initial crew training in July 2018 | <ul style="list-style-type: none"> All requirements for transfer and preparation for installation were achieved on time The installation phase commenced on schedule, in May 2018 Installation is tracking in accordance with the approved schedule All preparations were completed on time. Initial crew training will commence on schedule, in July 2018 |

At 30 June 2018 actual and expected project costs were:

| | Total costs to 30 June 2017 \$000 | Project costs in 2017/18 \$000 | Estimated remaining costs to complete \$000 | Estimated total project costs \$000 |
|--------------------------------------|--------------------------------------|-----------------------------------|--|--|
| Cabinet approved budget | | | | 623,537 |
| Effect of foreign exchange movements | | | | (31,028) |
| Project expenditure | 313,877 | 70,996 | 207,636 | 592,509 |
| Estimated project variation | | | | - |

⁶ The appropriation was subsequently increased through a non-cash technical adjustment to the approved budget, reflecting the effect of hedged foreign exchange movements.

Individual Weapons Replacement

This project is replacing the existing Defence Force individual weapon (the Steyr rifle) with a new Modular Assault Rifle System – Light manufactured by Lewis Machine and Tools, along with necessary spares and ancillaries. Following Cabinet approval of the Project Implementation Business Case authorising the acquisition (in December 2015), the following contracts were signed:

- Individual Weapon and associated equipment – Lewis Machine and Tools USA
- Advanced Combat Optical Gunsights – Trijicon USA
- Combat Torches – Quality Imports NZ.

| Objectives | Performance |
|---|--|
| <ul style="list-style-type: none"> • Complete delivery of weapons (across four tranches), gunsights (seven tranches), and torches • Progressive introduction into service across New Zealand Defence Force units • Complete the initial series of the train-the-trainer training | <ul style="list-style-type: none"> • All equipment has been delivered • First unit converted to new weapon in April 2017 • All units expected to be converted to new weapon by December 2018 • Phase one was completed before 30 June 2017. Phase two planned to complete by 31 October 2018 |

At 30 June 2018 actual and expected project costs were:

| | Total costs to 30 June 2017 \$000 | Project costs in 2017/18 \$000 | Estimated remaining costs to complete \$000 | Estimated total project costs \$000 |
|--------------------------------------|--------------------------------------|-----------------------------------|--|--|
| Cabinet approved budget | | | | 59,234 |
| Effect of foreign exchange movements | | | | (1,062) |
| Project expenditure | 41,310 | 7,573 | 8,284 | 57,167 |
| Estimated project variation | | | | 1,005 |

Maritime Sustainment Capability

This project replaces the naval tanker HMNZS *Endeavour* with a vessel with capacity to maintain an afloat sustainment capability for the Defence Force and its partners, to support New Zealand's civilian presence at Scott Base in Antarctica and the nation's Southern Ocean interests.

2017/18 saw the project progress from the design phase to the production phase. The preliminary design review was completed on 20 October 2017 with the detailed design review meeting following in December 2017 and formally closed in June 2018. Sea Quest Marine was contracted to provide Superintendent Services in support of the Integrated Project Team with their onsite project team being stood up at steel cutting in January 2018.

| Objectives | Performance |
|--|--|
| <ul style="list-style-type: none"> Let the contract for superintendent services of ship production and acceptance Ship production commencement Completion of detailed design review | <ul style="list-style-type: none"> Superintendent services contract signed in 26 August 2017 Steel cutting, the formal commencement of production, was undertaken on 29 January 2018 The detailed design review was completed on 15 June 2018 |

At 30 June 2018 actual and expected project costs were:

| | Total costs to 30 June 2017 \$000 | Project costs in 2017/18 \$000 | Estimated remaining costs to complete \$000 | Estimated total project costs \$000 |
|--------------------------------------|--------------------------------------|-----------------------------------|--|--|
| Cabinet approved budget | | | | 477,130 |
| Effect of foreign exchange movements | | | | 6,441 |
| Project expenditure | 101,452 | 110,089 | 272,018 | 483,559 |
| Estimated project variation | | | | 12 |

Network Enabled Army – Tranche 1

In April 2015, Cabinet approved Network Enabled Army – Tranche 1, including capital expenditure of up to \$106 million. Tranche 1 will deliver modern communications to Special Operations Forces, and an Enhanced Infantry Task Group and its headquarters, comprised of around 200 personnel.

| Objectives | Performance |
|---|--|
| <ul style="list-style-type: none"> Request for Proposal for the provision of a Mobile Tactical Command System, for core radios, their ancillaries, network and engineering integration Acquire specialist communication devices for Special Operations Forces Command Post combined capability realised Communication Access Nodes, supporting common universal bearers designed and procured Implementation of wide band communication devices Commence construction Test, Reference and Evaluation Capability Engineering Centre Commence construction for Capability Integration Centre | <ul style="list-style-type: none"> Approval to enter in to negotiations with Industry Partner for supply of core radios, network design and radio integration for the delivery of Tranche 1 capability and provision for future tranches Delivery of introduction into service commenced Contract signed for equipment to commence introduction into service Acquisition strategy confirmed for communication access nodes, with approach to market expected early 2018/19 Commenced introduction into service Construction underway with handover to the New Zealand Defence Force in early 2018/19 Design Consultant and Quantity Surveyor procured; concepts and requirements agreed; and site confirmed |

At 30 June 2018 actual and expected project costs were:

| | Total costs to 30 June 2017 \$000 | Project costs in 2017/18 \$000 | Estimated remaining costs to complete \$000 | Estimated total project costs \$000 |
|--------------------------------------|--------------------------------------|-----------------------------------|--|--|
| Cabinet approved budget | | | | 106,000 |
| Effect of foreign exchange movements | | | | 924 |
| Project expenditure | 20,173 | 15,656 | 70,594 | 106,423 |
| Estimated project variation | | | | 501 |

Special Operations Vehicles

Replacing the Pinzgauer Special Operations Vehicle, the project will acquire a mixed fleet, consisting of four vehicle types matched to the core requirements of the Special Operations Forces.

| Objectives | Performance |
|--|---|
| <ul style="list-style-type: none"> Award contracts for the supply of the Mobility Heavy, Protected Heavy, Low Profile Protected, and Low Profile Utility vehicles, and necessary spares and ancillary equipment Monitor contract deliveries in accordance with the contracted milestone delivery schedules | <ul style="list-style-type: none"> All contracts awarded: <ul style="list-style-type: none"> Mobility Heavy: August 2016 Protected Heavy: May 2017 Low Profile Protected and Utility combined contract: December 2016 Infrastructure: June 2017 All contracted milestones and deliveries up to 30 June 2018 have been met, including delivery of all four categories of vehicles, associated spares and ancillary equipment and new build infrastructure |

At 30 June 2018 actual and expected project costs were:

| | Total costs to 30 June 2017 \$000 | Project costs in 2017/18 \$000 | Estimated remaining costs to complete \$000 | Estimated total project costs \$000 |
|--------------------------------------|--------------------------------------|-----------------------------------|--|--|
| Cabinet approved budget | | | | 29,279 |
| Effect of foreign exchange movements | | | | (73) |
| | | | | 29,206 |
| Project expenditure | 16,241 | 9,845 | 3,120 | 29,206 |
| Estimated project variation | | | | - |

Strategic Bearer Network

Strategic Bearer Network – Phase 1 will deliver global satellite communications services to the New Zealand Defence Force through the United States Department of Defense Wideband Global Satellite System. The Ministry is responsible for acquiring the infrastructure (mobile land based terminals, maritime terminals and fixed anchor stations) required to access the satellites. On 11 July 2016, Cabinet approved an increase in appropriation of \$11.7 million to complete equipment acquisition.

Delivery of all capability is expected to be completed by the end of 2018 but the installation of some equipment may not occur until later in 2019.

| Objectives | Performance |
|---|--|
| <ul style="list-style-type: none"> Commence delivery of five maritime terminals for installation on HMNZS <i>Te Mana</i>, <i>Te Kaha</i>, <i>Canterbury</i>, <i>Wellington</i> and <i>Otago</i> Delivery of second anchor station | <ul style="list-style-type: none"> HMNZS <i>Canterbury</i> and <i>Otago</i> are in the final stages of Interim Operational Release.⁷ <i>Wellington</i> is on track for completion in the third quarter of calendar year 2018 HMNZS <i>Te Mana</i> and <i>Te Kaha</i> have been delayed to 2019 as this is dependent on the completion of the ANZAC Frigate Systems Upgrade project Delivery was deferred to the third quarter of 2018. This is on track for completion |

At 30 June 2018 actual and expected project costs were:

| | Total costs to 30 June 2017 \$000 | Project costs in 2017/18 \$000 | Estimated remaining costs to complete \$000 | Estimated total project costs \$000 |
|--------------------------------------|--------------------------------------|-----------------------------------|--|--|
| Cabinet approved budget | | | | 43,610 |
| Effect of foreign exchange movements | | | | 184 |
| | | | | 43,794 |
| Project expenditure | 32,413 | 4,560 | 6,137 | 43,110 |
| Estimated project variation | | | | 684 |

⁷ Interim Operational Release allows the New Zealand Defence Force to use the equipment in a limited manner, referred to as Interim Operational Capability. Full Operational Capability is achieved following completion of all training and integration into Defence Force systems and processes.

Underwater Intelligence, Surveillance and Reconnaissance

This project seeks to replace the underwater intelligence, surveillance and reconnaissance capability of the existing P-3K2 Orion fleet. In June 2014, Cabinet directed the Secretary of Defence to issue a Request for Tenders for the project. In June 2016 Cabinet approved the project implementation business case and issued an Approved to Commit Funds to the Secretary of Defence. In July 2016, a contract was signed with Boeing for the delivery of the upgrade.

| Objectives | Performance |
|--|---|
| <ul style="list-style-type: none"> Manage the project and prime contractor, Boeing, in accordance with the project plans Complete upgrade of ground systems and first aircraft Complete design acceptance and accept first aircraft Accept second aircraft | <ul style="list-style-type: none"> The project continues to be managed in accordance with the project plans Upgrade of ground systems and first aircraft were completed in December 2017 Design acceptance and the first aircraft accepted in June 2018 Second aircraft accepted in June 2018 |

At 30 June 2018 actual and expected project costs were:

| | Total costs to 30 June 2017 \$000 | Project costs in 2017/18 \$000 | Estimated remaining costs to complete \$000 | Estimated total project costs \$000 |
|--------------------------------------|--------------------------------------|-----------------------------------|--|--|
| Cabinet approved budget | | | | 36,601 |
| Effect of foreign exchange movements | | | | 116 |
| | | | | 36,717 |
| Project expenditure | 17,456 | 13,283 | 5,723 | 36,462 |
| Estimated project variation | | | | 255 |

PRIORITY 4: DEFENCE SUCCESSFULLY DELIVERS AND SUSTAINS SYSTEMIC IMPROVEMENT

Over 2017–2021 this work will involve the following critical success factors:

- The Government's investment in the Ministry is managed successfully and meets expectations.
- Partnership arrangements in Defence deliver benefits.
- The Ministry is operating sustainably with contemporary organisational practices, systems and policies, with a highly engaged and participative culture.
- The Ministry develops its people and offers them a career in a national security workforce.



The Government's investment in the Ministry

The Budget 2015 investment increased the Ministry's annual baseline from \$11.2 million in 2014/15 to \$19.7 million in 2018/19. The Ministry's increased baseline has enabled it to invest in becoming a more sustainable organisation, able to support a highly skilled workforce.

The Ministry believes in continuous improvement. We embed this in our own organisation; jointly with the Defence Force through the Defence Capability Change Action Programme; and across Defence through the activities of our Tū Aromatawai Independent Review Division.

A Review of Defence Procurement Policies and Practices for Major Capability Projects by Sir Brian Roche determined that Defence now has a robust Capability Management System, but noted the changes as part of the Defence Capability Change Action Programme are still relatively new, and that ongoing leadership is required to embed and sustain them. A number of observations were made that largely align with Defence's ongoing continuous improvement programme.

The recent Investor Confidence Index A rating result for the Defence Capability Management System also reaffirms that the investment in the Ministry since 2015 has resulted in a significant uplift in project and programme management performance.

We have systematically reviewed our approach to the development and delivery of military capability across the board. This has included reviewing our project management disciplines, procedures, processes, policies and practices in line with international best practice. We have built specialist expertise in the areas of commercial project management, financial management, and risk management. Governance arrangements

The foundations have been well established with a result of having delivered a system that has substantially changed and improved the acquisition process

Sir Brian Roche April 2018



have also been strengthened. This work was done in partnership with the Chief of Defence Force and his people.

Each year, the Ministry provides a sample of its policy advice to the New Zealand Institute of Economic Research for independent quality assessment. Observations on strengths or weaknesses of the product and, if appropriate, recommendations for improvement are provided. In December 2017 the Ministry was rated second in the public service for the quality of its policy advice and received a Policy Advice Excellence Award from the New Zealand Institute of Economic Research.

Partnership arrangements in Defence

Ministry and Defence Force personnel work together to provide joint advice to Ministers on a full range of defence matters including defence capability, international engagement and defence deployments.

This collaboration is supported by our working arrangements, whereby the Ministry is co-located within the Defence Force Headquarters and its property footprint is managed by the New Zealand Defence Force under a shared services agreement.

Co-location is particularly important in respect of major defence capability projects, delivered by integrated project teams led by the Ministry but including team members from both the Defence Force and Ministry. These projects are managed and governed under the joint Defence Capability Management System. Reflecting the shared responsibilities of the Secretary of Defence and Chief of Defence, capability governance and management board meetings are co-chaired by Ministry and New Zealand Defence Force representatives.

Partnered working between the agencies is supported by a shared system for programme and project management and reporting of capability projects. In addition, a combined Defence document management system has been introduced that both agencies are implementing and using together. This system has been rolled out to all Ministry teams.

A sustainable and contemporary Ministry of Defence

The Ministry has grown from 64 people in June 2015 to 127 people at 30 June 2018. The Defence Capability Change Action Programme provided opportunities to enhance our capability delivery workforce with increased skills and expertise in portfolio and programme management; industry engagement; governance; and policy development for major capabilities. Most staff increases have been in the Capability Delivery Division, which has increased from 15 to 56 people since 2015.

In January 2018 a Governance, People and Executive Services Division was established to bring together and consolidate teams working on governance and assurance, ministerial and chief executive services, people management, information and records management and office support. The new Division provides organisation support and governance functions that are designed to meet the Ministry's current and future priorities.

Ministry policies are regularly reviewed and updated to ensure they are based on contemporary best practice.

People Development

At the Ministry, each staff member has a development plan as part of their individual performance agreement. Depending on the individual and their role, this plan may vary from on the job learning opportunities to more formal courses such as Machinery of Government training. The Ministry explores development opportunities for each individual to allow them every opportunity to be successful in their role.

The Ministry has a comprehensive induction programme, consisting of a two-day Ministry orientation and a tailored individual programme to help set employees up for success in their roles. We are also introducing a 'Foundation Programme' which is aimed at those joining the public service, or new to working in the defence and security sector.

At the Ministry we utilise the 70:20:10 approach to learning and development; meaning that 70 per cent of learning is on the job, 20 per cent is learning through others and 10 per cent is formal training.

The Ministry is an active participant in National Security Workforce activities. The Ministry has engaged in the mentor/mentee programme offered through the National Security Workforce. This is aimed at females, enabling them to see progression in the wider security sector.

The Ministry offers a range of development opportunities for its leaders, and those aspiring to be leaders. Most of these are accessed through Leadership Development Centre and State Services Commission, examples include the Leadership Insight, Management in Action and Leadership In Practice programmes. We also utilise the Leadership Development Centre's coaches for those in the Ministry who require this.

Each financial year, the Human Resources team work with the Leadership Team to establish what the organisational development focus needs to be for the year ahead. For the previous two financial years this has been the 'leaderless coach' and 'unconscious bias' training.

Ministry staff also participate in training and development opportunities organised through the New Zealand Defence Force. Joint training of the new Capability Management System has been a major focus this year.

PRIORITY 5: DEFENCE IS OPEN, TRANSPARENT, ACCESSIBLE AND TRUSTED

Over 2017–2021 this work will involve the following critical success factors:

- The Ministry operates an open, ethical, high integrity environment.
- The Ministry maintains preventative controls on fraud and corruption.
- The Ministry communicates proactively and in plain English.
- The Ministry develops and delivers a deliberate programme of outreach to universities, industry and interest groups.



High integrity environment

The Ministry regularly communicates to its staff the importance of always acting ethically, with integrity and honesty. Staff are required in particular to demonstrate probity and good judgement when committing funds.

The requirement to behave in accordance with the Ministry and State Services Commission Codes of Conduct have been incorporated into Ministry annual Individual Performance Agreements to raise awareness of the requirement to act with integrity and also provide an avenue to hold staff and managers to account, should behaviour not meet the required standards.

Fraud control framework

The Leadership Team provides governance of the Ministry's multi-layered set of policies and actions to prevent, detect and respond to fraud and corruption. Vulnerabilities relating to fraud and corruption are considered as part of the Leadership team's consideration of the Ministry's strategic risk. Internal control policies are regularly reviewed to ensure they are based on contemporary best practice and communication to staff on these has been increased during the 2017/18 year. The Ministry engages with external agencies and partners to develop better practice in fraud and corruption control. For example, the Ministry attends the annual Five Country Defence Fraud and Anti-Corruption Network meeting.

Outreach and communication

The Ministry's website www.defence.govt.nz is the main channel used by the Ministry for communicating information on Defence activities. In addition to providing access to major defence policy documents such as the Strategic Defence Policy Statement, we have proactively released on the website copies of Cabinet papers, Ministerial submissions and other documents on defence deployments, and international defence engagement activities.

Developing the *Strategic Defence Policy Statement 2018* provided a useful mechanism for deepening and broadening the Ministry's engagement with a range of New Zealand academics with expertise relevant to New Zealand's Defence and security policy. This engagement helps to ensure we access a broad set of perspectives, and the Ministry will continue to seek opportunities to engage with academia, including via initiatives such as the Massey University-led Multi-Agency Research Network and by presenting at academic meetings and to students. The development of a new climate change policy portfolio has provided an

opportunity to engage with a wide range of environmental and Pacific specialists and to develop new links with the environmental science academics in New Zealand.

Working with Industry

The Ministry's website provides a first point of reference for information about capability. In 2017/18 new functionality in the form of an Industry Portal has been added to the website. The Portal is an industry-specific channel for regular and targeted updates for Defence industry as capability projects move from definition to delivery.

The Portal also links Prime suppliers with New Zealand industry. This is an important function for industry. Changes to the Ministry's Requests for Tenders and Proposals now require Prime suppliers to submit an activity report that sets out and describes the steps that have been taken to identify goods and services which can be supplied by New Zealand industry. The assumption is that there is value for money to Defence in proximity, readiness, and convenience, as well as cost and high quality. The Portal provides Prime suppliers access to New Zealand industry so that they can develop comprehensive activity reports.

The review by Sir Brian Roche of *Defence Procurement Policies and Practices for Major Capability Projects* identified an "area of opportunity" for industry engagement between project initiation and the release of a Request for Tender or Proposal. Historically, engagement of Ministry project staff was constrained by an operating model that appointed procurement and project management specialists to projects only after Cabinet approval of the Detailed Business Case.

Under the new operating model, Ministry staff are now engaged much earlier. This provides an opportunity to work with industry in identifying and mitigating commercial risks, as well as supporting New Zealand industry to build partnerships with overseas suppliers. More targeted early engagement will lead to better responses to the Ministry's Requests for Tenders or Proposals, more thoughtful commercial frameworks, and better choices for solutions, including through life support. In summary, it will lead to Defence becoming a smart customer; and industry becoming smart suppliers.



These initiatives are being welcomed by industry. The 2017 customer satisfaction survey reported just under 80 per cent of industry respondent were 'somewhat satisfied' or 'very satisfied' with the Ministry. The highest satisfaction scores were for 'knowledge of personnel', 'information on upcoming projects' and 'access to personnel'.

Reviewing Defence activities

Within the Ministry, Tū Aromatawai (Independent Review) undertakes assessments and audits to assist improvement across key areas for Defence:

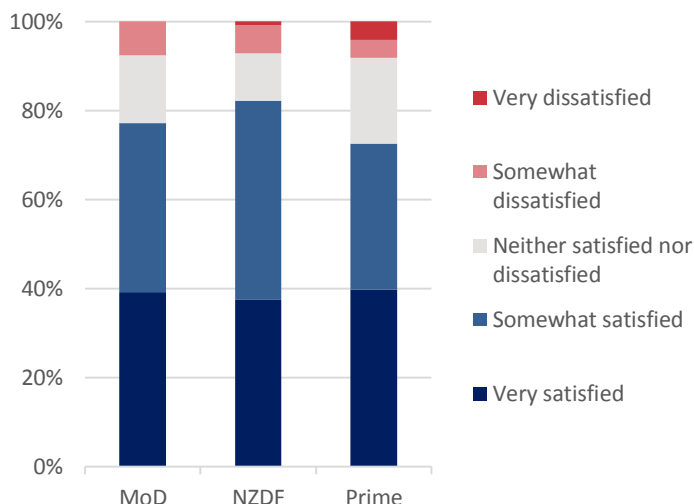
- operational readiness
- people and organisation
- military capability projects and support systems.

In 2017 the Ministry concluded a review of the establishment and early operation of the offshore project team for the new naval tanker, HMNZS *Aotearoa* (the Maritime Sustainment Capability being built in South Korea). The Review found that the Maritime Sustainment Capability project office was well set up. It made a number of recommendations for procedural improvements in a variety of areas including financial, ICT, security and health and safety. The project was completed in November 2017 and the Ministry has implemented its recommendations.

The Division also produced a report on *Retaining Personnel in Strategically Significant Trades*. This report focuses on the factors that influence the retention of personnel in strategically significant trades. It recommends the New Zealand Defence Force consider factors that may influence stay or go decisions, build their insights into people capability planning as appropriate, and that it adopt a consistent, tri-service definition for strategically significant trades and systematically collect data on them for monitoring and management purposes.

The Division is also conducting reviews into the Military Justice system and an assessment of how the Limited Service Volunteer programme addresses barriers to employment and training outcomes for participants. Stocktake reports of military women and recruit training will also be undertaken.

Figure 5: Industry satisfaction with Defence's engagement



ORGANISATIONAL HEALTH AND CAPABILITY

STAFF ENGAGEMENT

The Ministry carried out a staff engagement survey in November 2017. The survey results showed an engagement index score of 75 per cent, which was 9 per cent higher than the 2017 Core State Sector Benchmark.

In the year under review the Ministry has undergone a significant transformation. The organisation has almost doubled in size which meant that the survey captured a much larger audience and reflected the fact that 76 per cent of the staff within the Ministry have only worked for the organisation for two years or less.

The Kaikoura earthquake of November 2016 also had an impact in the overall way that staff perceived their physical working environment and this was reflected in the engagement survey results.

MANAGING GROWTH

During 2017/18 the Ministry ran 40 recruitments. Most of this recruitment was for positions created as part of the Defence Capability Change Action Programme and for new major capability projects.

The growth in headcount over the past years has changed our staff profile. Over the year to 30 June 2018, the Ministry's average length of service reduced from 10 years to two. Because of this, an important part of the change continues to be preserving the best aspects of the Ministry's culture, while acknowledging that our culture will change.

The Ministry has made sure every new staff member attends an induction programme that is focused on the Ministry's values. Each programme includes content on the Ministry's work and way of working, the perspectives of partners and key stakeholders, and is led by the Ministry's Leadership Team.

THE KAIKOURA EARTHQUAKE

The November 2016 Kaikoura earthquake and subsequent demolition of Defence House continues to have an impact on the Ministry which is still in temporary premises in the Freyberg Building. Staff are required to work more flexibly as a result of reduced access to meeting rooms and collaborative spaces. Staff are also located across a number of floors of the building.

The Ministry will move to the new Defence Headquarters in the former Bowen State Building in the second half of 2019.

GENDER PAY

The Ministry pays men and women the same remuneration for the same work. At 30 June 2018, women made up 54 per cent of staff (against 36 per cent in 2013) and 38 per cent of managers (against 19 per cent in 2013).

The Ministry's Spirit and Character attributes are:

- Professional
- Integrity
- Courageous
- Pragmatic
- Influential
- Collaborative

The Ministry has taken a number of steps to support careers of all staff, particularly women:

- changes to human resources policies
- providing private sector secondments for high potential staff
- requiring shortlists for management roles to include at least one woman candidate
- progressive policies that include support with parental leave and flexible working arrangements
- reimbursing some childcare costs, including when staff have to travel
- being the first public service department to provide free flu vaccinations for dependent family members, and
- making sure that, where people have to pause their career or change hours, we help them to maintain pay and career advancement.

While the Ministry has made a lot of progress on gender pay since 2013, work to reduce the Ministry's gender pay gap is ongoing and remains the biggest challenge. The gender pay gap has reduced from 43 per cent in June 2015 to 37 per cent in June 2018.

The Ministry has developed a Gender Pay Gap Action Plan which sets specific targets to improve our performance further over the five years from 2017. The targets are:

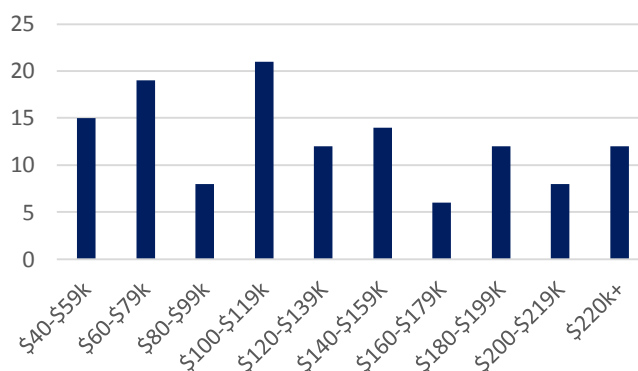
- to ensure that the gender makeup of the Ministry operates on a 40-40-20 basis: 40 per cent males, 40 per cent females, and 20 per cent either gender
- to ensure that the percentage of female managers in the Ministry is a minimum of 40 per cent
- that 50 per cent of appointments made to the Capability Delivery Division each year will be female and maintain 40-40-20 balance.

The Ministry supports the retention and recruitment of women through our progressive policies and practices. The Ministry is monitoring, measuring and analysing workforce data on a quarterly and yearly basis to measure change and show improvements. While we are committed to reducing the gender pay gap, we have been working on this for the past 18 months to two years and we know that turning this around will not be a quick process. Due to the small number of staff at the Ministry, it will take time to change the gender pay gap.

STAFF SALARY BANDS

The table to the right shows staff numbers by salary band as at 30 June 2018. The two main workforce groups, which reflect our major functions, are Policy and Project Management.

Figure 6: Number of Ministry staff in each \$20,000 salary band



HEALTH AND SAFETY

The Ministry takes its health and safety obligations seriously and participates in activities arranged by the Government Health and Safety Lead and through its membership of the Business Leaders' Health & Safety Forum. In February 2018, the Secretary of Defence signed the Business Leaders' Health & Safety Forum pledge committing the Ministry to a zero harm workplace. Engagement with workers is a focus of the Ministry's Health and Safety Committee. The Ministry's Leadership Team receives regular information on significant health and safety events.

The Ministry and New Zealand Defence Force have put in place a shared project safety and environmental assurance framework, which is available to staff as part of the Capability Management Framework. This provides guidance to capability project teams on delivering capabilities that are safe to operate, and are operated safely, in accordance with the Health and Safety at Work Act 2015.



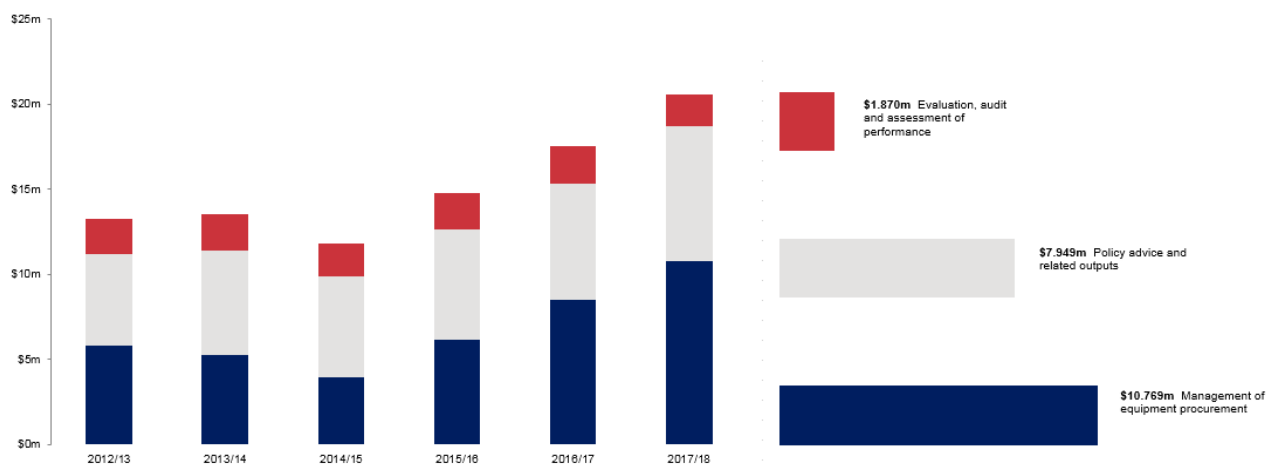
IMPLEMENTING THE NEW ZEALAND BUSINESS NUMBER

The Ministry has an internal group working on the Ministry's adoption of the New Zealand Business Number (NZBN). In 2018/19 the Ministry will introduce systems to make use of NZBNs provided by suppliers.

SUMMARY FINANCIAL INFORMATION

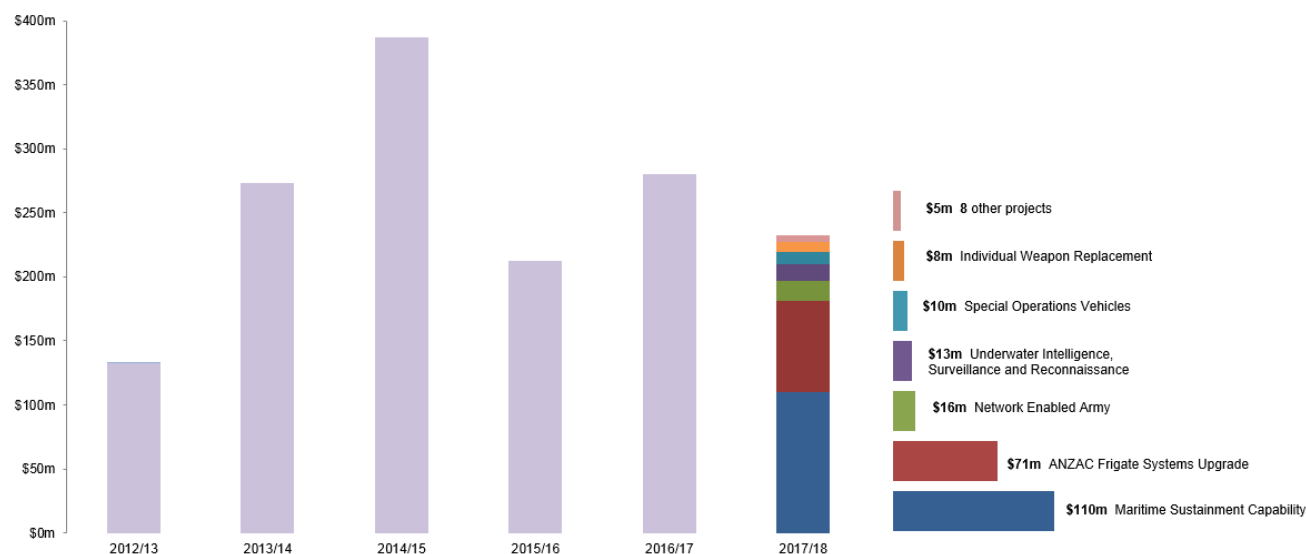
The Ministry's departmental expenditure

The Ministry meets departmental operating expenses through three appropriations⁸. Additional funding in Budget 2015 to enhance the Defence Capability Management System has seen the Ministry's departmental funding raise to a baseline of \$20.6 million in 2017/18.



The Ministry's non-departmental expenditure on Defence equipment

This appropriation is used for the purchase, modification or refurbishment of major items of defence equipment for the New Zealand Defence Force. The graph below shows the spending on significant projects in 2017/18.



Crown funding is allocated after Cabinet approval of business cases for the specific projects.

In July and August 2018 the Ministry received further funding of \$2.255 billion for three new projects: Future Air Surveillance Capability; NH90 Simulator; and Dive and Hydrographic Vessel. See Note 5 in the Non-Departmental Financial Statements for more information.

⁸ In 2016/17 the also Ministry received one-off funding to meet the costs associated with the November 2016 Kaikoura earthquake in an Earthquake/Storm Damage appropriation.

THE MINISTRY'S OPERATIONS

MULTI-CATEGORY APPROPRIATION: POLICY ADVICE AND RELATED OUTPUTS

This appropriation is intended to achieve the provision of civilian advice on defence policy matters and development of international defence relations.

Under this Multi-Category Appropriation (MCA), the Minister of Defence purchases:

- advice on defence policy matters. This includes advice on:
 - strategies for achieving goals and outcomes
 - changes in the strategic environment with implications for defence policy
 - the defence and security policies of other countries
 - deployment of New Zealand Defence Force assets and personnel
 - the military capabilities required to meet defence policy goals, broad resource implications and the relative merits and risks associated with proposed capability options
- management and enhancement of bilateral and multilateral defence relations
- responses to Ministerial requests and Parliamentary Questions, Official Information Act enquiries and Ombudsmen correspondence.

| | 2016/17 | 2017/18 | |
|--|---------|-----------|-------------------------------------|
| Performance Measures | Actual | Budget | Actual |
| <i>Overarching Measure for Multi-category Appropriation</i> | | | |
| The performance of the MCA as a whole will be assessed by the average performance success of the below measures (Note 1) | +6.8% | >0% | +6.6% |
| Ministerial Services | | | |
| <i>This category is intended to achieve the provision of quality and timely Ministerial support to the Minister</i> | | | |
| Quality, as assessed by the percentage of first draft of all correspondence accepted by the Minister | 100% | ≥90% | 98% (102 of 104 items unchanged) |
| Timeliness, as assessed by the percentage of papers that were submitted by the timeframe set in legislation, or otherwise agreed with the Minister | 97% | ≥95% | 95% (99 of 104 items to time) |
| Policy Advice | | | |
| <i>This category is intended to achieve the provision of accurate, timely and responsive policy advice</i> | | | |
| Total cost per output hour of Policy Advice | \$71 | \$100 | \$91 |
| Technical quality of policy advice, as assessed by an independent review of a sample of policy papers | 76% | Mean ≥70% | 73% |

| | 2016/17 | 2017/18 | |
|--|---------------|---------------|---------------|
| Performance Measures | Actual | Budget | Actual |
| Minister's satisfaction with the quality of policy advice, as assessed by survey (Note 2) | 75% | ≥70% | 82% |
| Policy Support | | | |
| <i>This category is intended to achieve the provision of quality and timely policy support to the Minister</i> | | | |
| Minister's satisfaction with the quality of policy support, as assessed by survey | 70% | ≥70% | 80% |

Note 1: Measured by the difference between actual results and the budget standard of all percentage based measures within the MCA categories.

Note 2: These scores reflect a shared rating across both the Ministry of Defence and New Zealand Defence Force.

Further information

This output particularly relates to the Ministry's following core business activities:

- assessing and giving advice on the strategic defence environment
- contributing to regional and international defence engagements
- supporting New Zealand Defence Force deployments
- defining and selecting military capability
- assessing the benefits and capability and readiness of the Defence system
- administering the joint Ministry/Defence Force Capability Management System.

Further detail about 2017/18 policy advice activities are addressed in the preceding section Delivering on the Ministry's Strategic Intentions, particularly in relation to the following strategic priorities:

- strategic priority 1: Defence anticipates the dynamic security environment and contributes to a stronger national security sector
- strategic priority 2: Our defence diplomacy and support for deployments enhances New Zealand's security and other interests
- strategic priority 3: Defence advice balances policy capability and funding.

Cost for the year ended 30 June 2018

| | 2016/17 | 2017/18 | | |
|--|---------------|-----------------------|-----------------------|---------------|
| | Actual | Main estimates | Supp estimates | Actual |
| | \$000 | \$000 | \$000 | \$000 |
| Policy advice and related outputs multi-category appropriation | 6,837 | 7,170 | 8,118 | 7,949 |

DEPARTMENTAL OUTPUT EXPENSE: EVALUATION, AUDIT AND ASSESSMENT OF PERFORMANCE

This appropriation is intended to achieve the completion of an approved schedule of evaluations, audits and assessments as required by the Minister of Defence.

| | 2016/17 | 2017/18 | |
|--|---------------|---------------|---------------|
| Performance Measures | Actual | Budget | Actual |
| Ministerial Direction | | | |
| Evaluations, audits and assessments are in accordance with work priorities identified and advised by the Minister of Defence | Standard met | Standard met | Standard met |
| Process Quality | | | |
| All evaluations, audits and assessments meet the Ministry's pre-determined quality criteria | 100% | 100% | 100% |
| All major audits and assessments are externally quality assured. (Note 1) | New measure | 100% | 100% |

Note 1: Small, simple reviews may be peer reviewed by qualified Ministry staff from outside the Independent Review Division. All medium, large and/or complex reviews are reviewed by qualified persons external to the Ministry.

Further information

This output particularly relates to the Ministry's core business activity of undertaking evaluations and assessments directed by the Minister of Defence. Further detail about 2017/18 Independent Review Division activities is addressed in the preceding section Delivering on the Ministry's Strategic Intentions, particularly in relation to strategic priority 4: Defence successfully delivers and sustains systemic improvement.

Cost for the year ended 30 June 2018

| | 2016/17 | 2017/18 | | |
|---|---------------|-----------------------|-----------------------|---------------|
| | Actual | Main estimates | Supp estimates | Actual |
| | \$000 | \$000 | \$000 | \$000 |
| Evaluation, audit and assessment of performance | 2,185 | 2,384 | 1,947 | 1,870 |

DEPARTMENTAL OUTPUT EXPENSE: MANAGEMENT OF EQUIPMENT PROCUREMENT (DEPARTMENTAL) AND PROCUREMENT OF DEFENCE EQUIPMENT (CROWN)

This appropriation is intended to achieve the management of procurement of major military equipment in a transparent and fair way, and in accordance with government procurement policies. 'Major' means equipment that will have more than a \$15 million whole-of-life cost.

This output class involves:

- management of military equipment procurement functions on behalf of the Crown once equipment needs are determined and accepted by the Government. The acquisition process involves acquisition investigation, risk assessment, quality assurance, equipment selection, negotiation and execution of the contract arrangements, to the point when the equipment, initial training and spares are delivered to the New Zealand Defence Force
- management of any warranty provisions beyond delivery date
- management of financing commitments
- arrangement of on-sale to the New Zealand Defence Force and
- the provision of advice to industry on defence requirements.

| Performance Measures | 2016/17 | 2017/18 | |
|--|-------------------------|---------|------------------------------------|
| | Actual | Budget | Actual |
| <p>Cost: Each procurement or refurbishment project will be managed within its approved budget, inclusive of approved variations to the contract price and project budget.</p> <p><i>Note: Measured by the percentage of all projects that have total project-related expenditure incurred in the year within the approved project expenditure budget.</i></p> | 100% | 100% | 100% |
| <p>Quality of Deliverable: Each procurement or refurbishment project will achieve on delivery the agreed/contracted specifications that are critical to acceptance.</p> <p><i>Note: Measured by the percentage of accepted projects that meet all specifications that are critical to acceptance.</i></p> | 100% | 100% | 100% |
| <p>Schedule: Each procurement or refurbishment project will be managed to schedule, without avoidable schedule over-run.</p> <p><i>Note: Measured by the percentage of all projects where, during the year, the project delivery schedule is not extended by more than 10%.</i></p> | 85% (11 of 13 projects) | 85% | 82% (9 of 11 projects to schedule) |

Note: Only major projects covered by this appropriation are included in these measures.

Further information

This output particularly relates to the Ministry’s following core business activities:

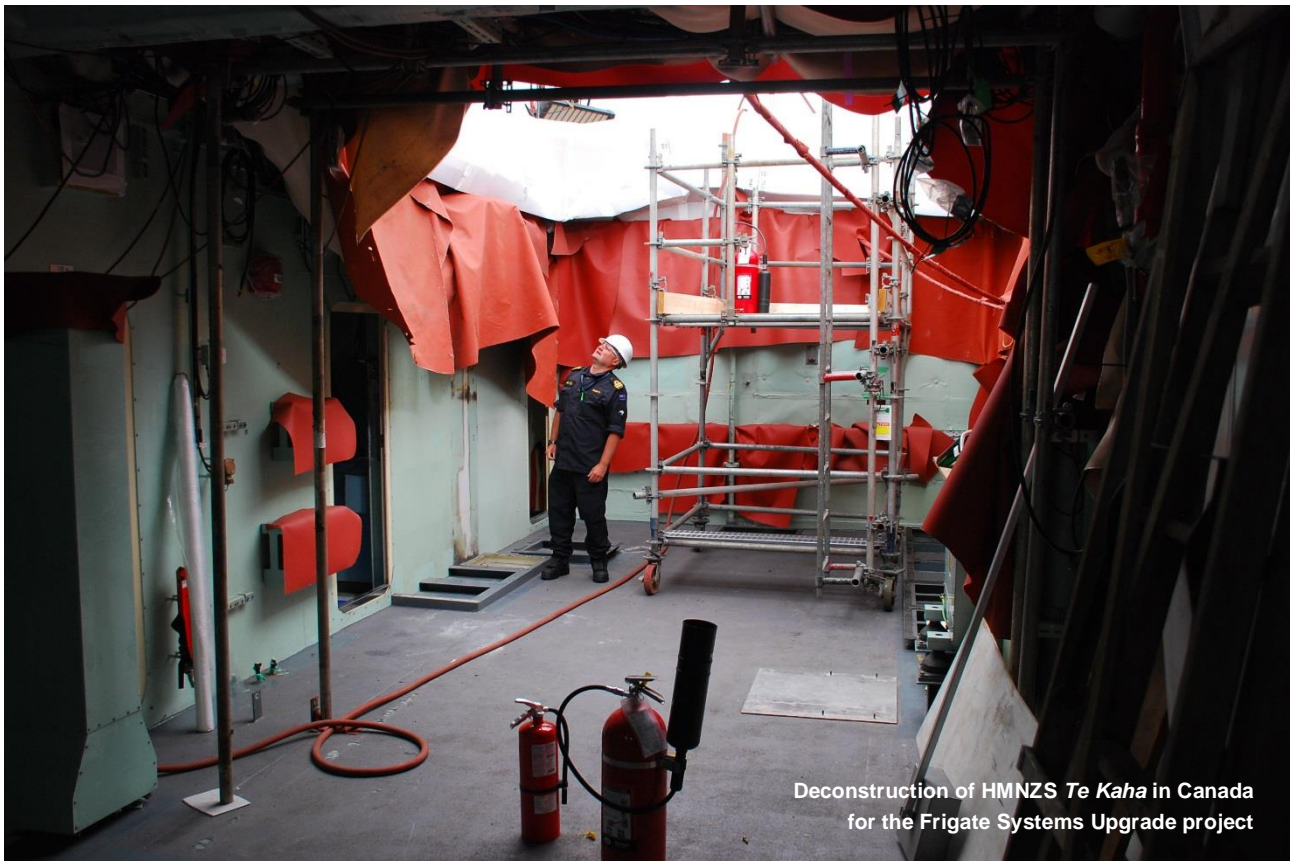
- acquiring and upgrading military capability
- administering the joint Ministry/Defence Force Capability Management System.

Further detail about 2017/18 equipment procurement operations are addressed in the preceding section Delivering on the Ministry’s Strategic Intentions, particularly in relation to the following strategic priorities:

- strategic priority 3: Defence advice balances policy, capability and funding.
- strategic priority 5: Defence is open, transparent, accessible and trusted.

Cost for the year ended 30 June 2018

| | 2016/17 | 2017/18 | | |
|-------------------------------------|---------|----------------|----------------|--------|
| | Actual | Main estimates | Supp estimates | Actual |
| | \$000 | \$000 | \$000 | \$000 |
| Management of equipment procurement | 8,490 | 11,008 | 11,018 | 10,769 |



MINISTRY OF DEFENCE – CAPITAL EXPENDITURE PERMANENT LEGISLATIVE AUTHORITY

This appropriation is intended to achieve the purchase and development of assets by and for the use of the Ministry in its day-to-day operations.

| | 2016/17 | 2017/18 | |
|--|---------------------|---------------------|---------------------|
| Performance Measures | Actual | Budget | Actual |
| Capital expenditure is within Capital Plan | Within Capital Plan | Within Capital Plan | Within Capital Plan |

Cost for the year ended 30 June 2018

| | 2016/17 | 2017/18 | | |
|---|---------------|-----------------------|-----------------------|---------------|
| | Actual | Main estimates | Supp estimates | Actual |
| | \$000 | \$000 | \$000 | \$000 |
| Capital expenditure permanent legislative authority | 373 | 350 | 350 | 123 |

DEPARTMENTAL OTHER EXPENSES – EARTHQUAKE/STORM DAMAGES

This appropriation was a temporary appropriation in 2016/17 intended to achieve the recognition of costs incurred by the Ministry of Defence resulting from the November 2016 Kaikoura earthquake. (Refer to Note 15 of the Departmental Financial Statements for further information.)

| | 2016/17 | 2017/18 | |
|--|----------------------|---------------|---------------|
| Performance Measures | Actual | Budget | Actual |
| Recognised expenses are within appropriation | Within appropriation | N/A | N/A |

Cost for the year ended 30 June 2018

| | 2016/17 | 2017/18 | | |
|-----------------------------|---------------|-----------------------|-----------------------|---------------|
| | Actual | Main estimates | Supp estimates | Actual |
| | \$000 | \$000 | \$000 | \$000 |
| Departmental other expenses | 1,063 | - | - | - |

NON-DEPARTMENTAL CAPITAL EXPENDITURE: PURCHASE OF DEFENCE EQUIPMENT

This appropriation is managed by the Ministry on behalf of the Minister of Defence.

This appropriation is intended to achieve the procurement of major military equipment in a transparent and fair way, and in accordance with government procurement policies.

| | 2016/17 | 2017/18 | |
|--|---------|---------|--------|
| Performance Measures | Actual | Budget | Actual |
| Performance measures are the same as used for the departmental appropriation Management of Equipment Procurement and are reported under the appropriation page 44. | | | |

Further information

This output particularly relates to the Ministry's following core business activities:

- acquiring and upgrading military capability
- administering the joint Defence Capability Management System.

Further detail about 2017/18 equipment procurement operations are addressed in the preceding section Delivering on the Ministry's Strategic Intentions, particularly in relation to the following strategic priorities:

- strategic priority 3: Defence advice balances policy, capability and funding
- strategic priority 5: Defence is open, transparent, accessible and trusted.

Cost for the year ended 30 June 2018

| | 2016/17 | 2017/18 | | |
|-------------------------------|---------|----------------|----------------|---------|
| | Actual | Main estimates | Supp estimates | Actual |
| | \$000 | \$000 | \$000 | \$000 |
| Purchase of defence equipment | 280,658 | 265,585 | 240,000 | 232,898 |

PART 3: STATEMENT OF RESPONSIBILITY AND AUDIT REPORT

STATEMENT OF RESPONSIBILITY

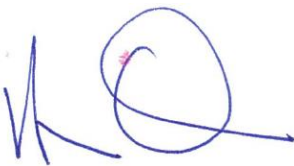
I am responsible, as Chief Executive of the Ministry of Defence (the Ministry), for:

- the preparation of the Ministry's financial statements, and statements of expenses and capital expenditure, and for the judgements expressed in them
- having in place a system of internal control designed to provide reasonable assurance as to the integrity and reliability of financial reporting
- ensuring that end-of-year performance information on each appropriation administered by the Ministry is provided in accordance with sections 19A to 19C of the Public Finance Act 1989, whether or not that information is included in this Annual Report and
- the accuracy of any end-of-year performance information prepared by the Ministry, whether or not that information is included in the Annual Report.

In my opinion:

- the financial statements fairly reflect the financial position of the Ministry as at 30 June 2018 and its operations for the year ended on that date and
- the forecast financial statements fairly reflect the forecast financial position of the Ministry as at 30 June 2018 and its operations for the year ending on that date.

Signed by:



Helene Quilter
Secretary of Defence

24 September 2018

Countersigned by:



Pasanka Wickremasinghe
Chief Financial Officer

24 September 2018

INDEPENDENT AUDITOR'S REPORT

AUDIT NEW ZEALAND
Mana Arotake Aotearoa

To the readers of Ministry of Defence's annual report for the year ended 30 June 2018

The Auditor-General is the auditor of the Ministry of Defence (the Ministry). The Auditor-General has appointed me, Karen Young, using the staff and resources of Audit New Zealand, to carry out, on his behalf, the audit of:

- the financial statements of the Ministry on pages 56 to 75 that comprise the statement of financial position, statement of commitments, statement of contingent liabilities and contingent assets as at 30 June 2018, the statement of comprehensive revenue and expense, statement of changes in equity, and statement of cash flows for the year ended on that date and the notes to the financial statements that include accounting policies and other explanatory information;
- the performance information prepared by the Ministry for the year ended 30 June 2018 on pages 12 to 37 and 41 to 47;
- the statements of expenses and capital expenditure of the Ministry for the year ended 30 June 2018 on pages 54 and 55; and
- the schedules of non-departmental activities which are managed by the Ministry on behalf of the Crown on pages 76 to 87 that comprise:
 - the schedules of assets; liabilities; capital commitments; and contingent liabilities and contingent assets as at 30 June 2018;
 - the schedules of expenses; revenue, capital receipts and capital expenditure for the year ended 30 June 2018; and
 - the notes to the schedules that include accounting policies and other explanatory information.

Opinion

In our opinion:

- the financial statements of the Ministry on pages 56 to 75:
 - present fairly, in all material respects:
 - its financial position as at 30 June 2018; and
 - its financial performance and cash flows for the year ended on that date; and

- comply with generally accepted accounting practice in New Zealand in accordance with Public Benefit Entity Standards Reduced Disclosure Regime; and
- the performance information of the Ministry on pages 12 to 37 and 41 to 47:
 - presents fairly, in all material respects, for the year ended 30 June 2018:
 - what has been achieved with the appropriation; and
 - the actual expenses or capital expenditure incurred compared with the appropriated or forecast expenses or capital expenditure; and
 - complies with generally accepted accounting practice in New Zealand; and
- the statements of expenses and capital expenditure of the Ministry on pages 54 and 55 are presented fairly, in all material respects, in accordance with the requirements of section 45A of the Public Finance Act 1989; and
- the schedules of non-departmental activities which are managed by the Ministry on behalf of the Crown on pages 76 to 87 present fairly, in all material respects, in accordance with the Treasury Instructions:
 - the assets; liabilities; capital commitments; and contingent liabilities and contingent assets as at 30 June 2018; and
 - expenses; revenue, capital receipts and capital expenditure for the year ended 30 June 2018.

Our audit was completed on 24 September 2018. This is the date at which our opinion is expressed.

The basis for our opinion is explained below. In addition, we outline the responsibilities of the Secretary of Defence and our responsibilities relating to the information to be audited, we comment on other information, and we explain our independence.

Basis for our opinion

We carried out our 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. Our responsibilities under those standards are further described in the Responsibilities of the auditor section of our report.

We have fulfilled our responsibilities in accordance with the Auditor-General’s Auditing Standards.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of the Secretary of Defence for the information to be audited

The Secretary of Defence is responsible on behalf of the Ministry for preparing:

- financial statements that present fairly the Ministry's financial position, financial performance, and its cash flows, and that comply with generally accepted accounting practice in New Zealand;
- performance information that presents fairly what has been achieved with each appropriation, the expenditure incurred as compared with expenditure expected to be incurred, and that complies with generally accepted accounting practice in New Zealand;
- statements of expenses and capital expenditure of the Ministry, that are presented fairly, in accordance with the requirements of the Public Finance Act 1989; and
- schedules of non-departmental activities, in accordance with the Treasury Instructions, that present fairly those activities managed by the Ministry on behalf of the Crown.

The Secretary of Defence is responsible for such internal control as is determined is necessary to enable the preparation of the information to be audited that is free from material misstatement, whether due to fraud or error.

In preparing the information to be audited, the Secretary of Defence is responsible on behalf of the Ministry for assessing the Ministry's ability to continue as a going concern. The Secretary of Defence is also responsible for disclosing, as applicable, matters related to going concern and using the going concern basis of accounting, unless there is an intention to merge or to terminate the activities of the Ministry, or there is no realistic alternative but to do so.

The Secretary of Defence's responsibilities arise from the Public Finance Act 1989.

Responsibilities of the auditor for the information to be audited

Our objectives are to obtain reasonable assurance about whether the information we audited, as a whole, is free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit carried out 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 of readers, taken on the basis of the information we audited.

For the budget information reported in the information we audited, our procedures were limited to checking that the information agreed to the Ministry's 2017–2021 Statement of Intent, Estimates and Supplementary Estimates of Appropriations 2017/18 for Vote Defence, and the 2017/18 forecast financial figures included in the Ministry's 2016/17 annual report.

We did not evaluate the security and controls over the electronic publication of the information we audited.

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

- We identify and assess the risks of material misstatement of the information we audited, 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 our 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.
- We 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 Ministry's internal control.
- We evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Secretary of Defence.
- We evaluate the appropriateness of the reported performance information within the Ministry's framework for reporting its performance.
- We conclude on the appropriateness of the use of the going concern basis of accounting by the Secretary of Defence and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Ministry's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the information we audited or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Ministry to cease to continue as a going concern.
- We evaluate the overall presentation, structure and content of the information we audited, including the disclosures, and whether the information we audited represents the underlying transactions and events in a manner that achieves fair presentation.

We communicate with the Secretary of Defence, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Our responsibilities arise from the Public Audit Act 2001.

Other information

The Secretary of Defence is responsible for the other information. The other information comprises the information included on pages 5 to 87, but does not include the information we audited, and our auditor's report thereon.

Our opinion on the information we audited does not cover the other information and we do not express any form of audit opinion or assurance conclusion thereon.

Our responsibility is to read the other information. In doing so, we consider whether the other information is materially inconsistent with the information we audited or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If, based on our work, we conclude

that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Independence

We are independent of the Ministry in accordance with the independence requirements of the Auditor-General's Auditing Standards, 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.

In addition to this audit, the Auditor-General has carried out an assurance review of the Major Projects Report 2017 prepared by the Ministry of Defence and the New Zealand Defence Force. Other than the audit and the Auditor-General's assurance review, we have no relationship with, or interests, in the Ministry.



Karen Young

Audit New Zealand

On behalf of the Auditor-General
Wellington, New Zealand

PART 4: APPROPRIATION STATEMENTS

STATEMENT OF EXPENSES AND CAPITAL EXPENDITURE AGAINST APPROPRIATIONS

For the year ended 30 June 2018

| Actual 2017 \$000 | | Forecast not audited 2018 \$000 | Main estimates 2018 \$000 | Supp estimates 2018 \$000 | Actual 2018 \$000 | Forecast not audited 2019 \$000 |
|-------------------------|---|--|------------------------------------|------------------------------------|-------------------------|--|
| | Vote: Defence | | | | | |
| | Departmental Appropriations | | | | | |
| | Appropriations for output expenses | | | | | |
| 2,185 | Evaluation, audit and assessment of performance | 2,384 | 2,384 | 1,947 | 1,870 | 2,294 |
| 8,490 | Management of equipment procurement | 11,008 | 11,008 | 11,018 | 10,769 | 9,628 |
| 10,675 | Total appropriations for output expenses | 13,392 | 13,392 | 12,965 | 12,639 | 11,922 |
| | Multi-category appropriations (MCA) | | | | | |
| | Policy advice and related outputs MCA | | | | | |
| 4,116 | Policy advice | 4,316 | 4,316 | 4,887 | 4,786 | 4,919 |
| 820 | Ministerial services | 861 | 861 | 975 | 954 | 981 |
| 1,901 | Policy support | 1,993 | 1,993 | 2,256 | 2,209 | 2,271 |
| 6,837 | Total multi-category appropriations | 7,170 | 7,170 | 8,118 | 7,949 | 8,171 |
| | Departmental Other Expenses | | | | | |
| 1,063 | Earthquake/storm damages | - | - | - | - | - |
| | Departmental capital expenditure | | | | | |
| 373 | Ministry of Defence – capital expenditure* | 350 | 350 | 350 | 123 | 350 |
| 18,948 | Total Departmental appropriations | 20,912 | 20,912 | 21,433 | 20,711 | 20,443 |
| | Non-Departmental Appropriations | | | | | |
| | Capital expenditure | | | | | |
| 280,658 | Defence equipment | 265,585 | 265,585 | 240,000 | 232,898 | 294,121 |
| 280,658 | Total Non-Departmental appropriations | 265,585 | 265,585 | 240,000 | 232,898 | 294,121 |
| 299,606 | Total appropriations administered by the Ministry of Defence | 286,497 | 286,497 | 261,433 | 253,609 | 314,564 |

Note: * The departmental capital expenditure appropriation is given by permanent legislative authority (PLA) under section 24(1) of the Public Finance Act 1989.

DEPARTMENTAL CAPITAL INJECTIONS

For the year ended 30 June 2018

The Ministry has not received any capital injections during the year (2017 – Nil).

STATEMENT OF EXPENSES AND CAPITAL EXPENDITURE INCURRED WITHOUT, OR IN EXCESS OF, APPROPRIATION OR OTHER AUTHORITY

For the year ended 30 June 2018

The Ministry has no instances of departmental or non-departmental unappropriated expenditure or capital expenditure (2017 – Nil).

STATEMENT OF DEPARTMENTAL CAPITAL INJECTIONS WITHOUT, OR IN EXCESS OF, AUTHORITY

For the year ended 30 June 2018

The Ministry has not received any capital injections during the year without, or in excess of, authority (2017 – Nil).

TRANSFERS UNDER SECTION 26A OF THE PUBLIC FINANCE ACT 1989

For the year ended 30 June 2018

The Ministry has not made any transfers under Section 26A of the Public Finance Act 1989 (2017 – Nil).

PERFORMANCE INFORMATION

Performance information for departmental appropriations and non-departmental capital expenditure is reported in part 2 of this Annual Report.

PART 5: DEPARTMENTAL FINANCIAL STATEMENTS

STATEMENT OF COMPREHENSIVE REVENUE AND EXPENSE

For the year ended 30 June 2018

| Actual 2017 \$000 | | Note | Forecast not audited 2018 \$000 | Actual 2018 \$000 | Forecast not audited 2019 \$000 |
|-------------------------|--|------|--|-------------------------|--|
| | Revenue | | | | |
| 17,130 | Revenue Crown | 2 | 20,462 | 20,062 | 20,093 |
| 921 | Other revenue | 2 | 100 | 664 | - |
| 18,051 | Total revenue | | 20,562 | 20,726 | 20,093 |
| | Expenses | | | | |
| 11,553 | Personnel expenses | 3 | 12,841 | 15,053 | 16,022 |
| 5,585 | Operating expenses | 5 | 7,266 | 5,213 | 3,644 |
| 212 | Depreciation and amortisation expense | 7,8 | 250 | 222 | 286 |
| 1,063 | Earthquake costs | 15 | - | - | - |
| 162 | Capital charge | 4 | 205 | 100 | 141 |
| 18,575 | Total expenses | | 20,562 | 20,588 | 20,093 |
| (524) | Surplus/(deficit) | | - | 138 | - |
| - | Other comprehensive revenue and expense | | - | - | - |
| (524) | Total comprehensive revenue and expense | | - | 138 | - |

The accompanying notes form part of these financial statements. Explanations of major variances against the 2018 forecast financial statements are shown in note 16.

STATEMENT OF FINANCIAL POSITION

As at 30 June 2018

| Actual 2017 \$000 | | Note | Forecast not audited 2018 \$000 | Actual 2018 \$000 | Forecast not audited 2019 \$000 |
|-------------------------|--------------------------------|------|--|-------------------------|--|
| | Assets | | | | |
| | Current assets | | | | |
| 4,970 | Cash and cash equivalents | | 3,019 | 4,061 | 4,967 |
| 164 | Receivables | 6 | 472 | 399 | 165 |
| 3 | Prepayments | | 8 | 99 | - |
| 5,137 | Total current assets | | 3,499 | 4,559 | 5,132 |
| | Non-current assets | | | | |
| 629 | Property, plant and equipment | 7 | 741 | 228 | 646 |
| 30 | Intangible assets | 8 | 154 | 24 | 18 |
| 659 | Total non-current assets | | 895 | 252 | 664 |
| 5,796 | Total assets | | 4,394 | 4,811 | 5,796 |
| | Liabilities | | | | |
| | Current liabilities | | | | |
| 1,984 | Creditors and other payables | 9 | 1,215 | 1,255 | 2,523 |
| 539 | Return of surplus to the Crown | 10 | - | 138 | - |
| 784 | Employee entitlements | 11 | 653 | 993 | 732 |
| 3,307 | Total current liabilities | | 1,868 | 2,386 | 3,255 |
| | Non-current liabilities | | | | |
| 136 | Employee entitlements | 11 | 242 | 72 | 188 |
| 136 | Total non-current liabilities | | 242 | 72 | 188 |
| 3,443 | Total liabilities | | 2,110 | 2,458 | 3,443 |
| 2,353 | Net assets | | 2,284 | 2,353 | 2,353 |
| | Equity | | | | |
| 2,353 | Taxpayers' funds | 12 | 2,284 | 2,353 | 2,353 |
| 2,353 | Total equity | | 2,284 | 2,353 | 2,353 |

The accompanying notes form part of these financial statements. Explanations of major variances against the 2018 forecast financial statements are shown in note 16.

STATEMENT OF CHANGES IN EQUITY

For the year ended 30 June 2018

| Actual 2017 \$000 | | Note | Forecast not audited 2018 \$000 | Actual 2018 \$000 | Forecast not audited 2019 \$000 |
|-------------------------|--|-----------|--|-------------------------|--|
| 3,416 | Balance at 1 July | | 2,284 | 2,353 | 2,353 |
| (524) | Total comprehensive revenue and expense | | - | 138 | - |
| (539) | Return of operating surplus to the Crown | 10 | - | (138) | - |
| 2,353 | Balance at 30 June | 12 | 2,284 | 2,353 | 2,353 |

The accompanying notes form part of these financial statements. Explanations of major variances against the 2018 forecast financial statements are shown in note 16.

STATEMENT OF CASH FLOWS

For the year ended 30 June 2018

| Actual 2017 \$000 | | Forecast not audited 2018 \$000 | Actual 2018 \$000 | Forecast not audited 2019 \$000 |
|-------------------------|---|--|-------------------------|--|
| | Cash flows from operating activities | | | |
| 17,130 | Receipts from Revenue Crown | 20,562 | 20,062 | 20,093 |
| 778 | Receipts from other revenue | - | 459 | - |
| (11,500) | Payments to employees | (12,566) | (14,902) | (16,090) |
| (4,948) | Payments to suppliers | (7,541) | (5,757) | (3,576) |
| (162) | Payments for capital charge | (205) | (100) | (141) |
| (482) | Goods and services tax (net) | - | (9) | - |
| 816 | Net cash flow from operating activities | 250 | (247) | 286 |
| | Cash flows from investing activities | | | |
| - | Receipts from sale of property, plant and equipment | - | - | - |
| (418) | Purchase of property, plant and equipment | (300) | (123) | (325) |
| (33) | Purchase of intangible assets | (50) | - | (25) |
| (451) | Net cash flow from investing activities | (350) | (123) | (350) |
| | Cash flows from financing activities | | | |
| (38) | Return of operating surplus | - | (539) | - |
| (38) | Net cash flow from financing activities | - | (539) | - |
| 327 | Net increase/(decrease) in cash | (100) | (909) | (64) |
| 4,643 | Cash at the beginning of the year | 3,119 | 4,970 | 5,031 |
| 4,970 | Cash at the end of the year | 3,019 | 4,061 | 4,967 |

The accompanying notes form part of these financial statements. Explanations of major variances against the 2018 forecast financial statements are shown in note 16.

STATEMENT OF COMMITMENTS

As at 30 June 2018

CAPITAL COMMITMENTS

Capital commitments are the aggregate amount of capital expenditure contracted for the acquisition of property, plant and equipment and intangible assets that have not been paid for or not recognised as a liability at the balance date.

The Ministry has no capital commitments (2017 – Nil).

NON-CANCELLABLE OPERATING LEASE COMMITMENTS

The Ministry leases property, plant and equipment in the normal course of its business. The lease of premises in Freyberg House was terminated as a result of the November 2016 Kaikoura Earthquake (refer note 15). The Ministry no longer has any non-cancellable operating lease commitments (2017 – Nil).

STATEMENT OF CONTINGENT LIABILITIES AND CONTINGENT ASSETS

As at 30 June 2018

CONTINGENT LIABILITIES

The Ministry has no quantifiable or unquantifiable contingent liabilities (2017 – Nil).

LEGAL PROCEEDINGS AND DISPUTES

The Ministry has no pending legal proceedings and disputes (2017 – Nil).

CONTINGENT ASSETS

Unquantifiable contingent assets

The Ministry has a contingent asset for an insurance claim for the damage and other costs incurred due to the November 2016 Kaikoura Earthquake (refer note 15). Specialist advice is being provided in preparing this claim which is currently not quantifiable. The Ministry expects to proceed with this claim during the 2018/19 financial year but has no known resolution date. This contingent asset is unchanged from 2016 due to the time required to quantify losses and prepare the claim.

Quantifiable contingent assets

The Ministry has no quantifiable contingent assets (2017 – Nil).

The accompanying notes form part of these financial statements. Explanations of major variances against the 2018 forecast financial statements are shown in note 16.

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2018

NOTE 1: STATEMENT OF ACCOUNTING POLICIES

REPORTING ENTITY

The Ministry of Defence (the Ministry) is a government department as defined by section 2 of the Public Finance Act 1989 and is domiciled and operates in New Zealand. The relevant legislation governing the Ministry's operations includes the Public Finance Act 1989 and the Defence Act 1990. The Ministry's ultimate parent is the New Zealand Crown.

In addition, the Ministry has reported on Crown activities that it administers in the non-departmental statements and schedules in part 6 of this Annual Report.

The Ministry's primary objective is to provide services to the New Zealand public. The Ministry does not operate to make a financial return. The Ministry has designated itself as a public benefit entity (PBE) for the purposes of complying with generally accepted accounting practice.

The financial statements of the Ministry are for the year ended 30 June 2018 and were approved for issue by the Secretary of Defence of the Ministry on 24 September 2018.

BASIS OF PREPARATION

The financial statements have been prepared on a going-concern basis, and the accounting policies have been applied consistently throughout the year.

Statement of compliance

The financial statements of the Ministry have been prepared in accordance with the requirements of the Public Finance Act 1989, which includes the requirement to comply with New Zealand generally accepted accounting practice (NZ GAAP), and Treasury Instructions.

The financial statements have been prepared in accordance and comply with Tier 2 PBE accounting standards. The Ministry meets the requirements of Tier 2 and is eligible for reduced disclosure reporting as its expenses are less than \$30 million and does not have publicly traded debt.

Presentation currency and rounding

The financial statements are presented in New Zealand dollars and all values are rounded to the nearest thousand dollars (\$000). The functional currency of the Ministry is New Zealand dollars.

Changes in accounting policies

There have been no changes in the Ministry's accounting policies since the date of the last audited financial statements.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Significant accounting policies are included in the notes to which they relate.

Significant accounting policies that do not relate to a specific note are outlined below.

Foreign currency transactions

Foreign currency transactions (including those for which forward foreign exchange contracts are held) are translated into New Zealand dollars using the exchange rates prevailing at the dates of the transactions.

Goods and Services Tax (GST)

All items in the financial statements, including appropriation statements, are stated exclusive of goods and services tax (GST), except for receivables and payables, which are stated on a GST inclusive basis. Where GST is not recoverable as input tax, then it is recognised as part of the related asset or expense.

The net amount of GST recoverable from, or payable to, the Inland Revenue Department (IRD) is included as part of receivables or payables in the statement of financial position.

The net GST paid or received from the IRD, including the GST relating to investing and financing activities, is classified as an operating cash flow in the statement of cash flows.

Income tax

The Ministry is a public authority and consequently is exempt from income tax. Accordingly, no provision has been made for income tax.

Forecast figures

The 2018 forecast figures are for the year ended 30 June 2018 and were published in the 2016/17 Annual Report. They are consistent with the Ministry's best estimate financial forecast information submitted to the Treasury for the Budget Economic and Fiscal Update (BEFU) for the year ending 2017/18.

The 2019 forecast figures are for the year ending 30 June 2019, which are consistent with the best estimate financial forecast information submitted to the Treasury for the BEFU for the 2018/19 financial year.

The forecast financial statements have been prepared as required by the Public Finance Act 1989 to communicate forecast financial information for accountability purposes. Forecast figures are unaudited and have been prepared using the accounting policies adopted in preparing these financial statements, except for the adoption of PBE IFRS 9 *Financial Instruments*, which New Zealand Crown has elected to adopt for the 2018/19 financial year. The adoption of this standard is considered to have no effect on the forecast financial statements.

The 2019 forecast financial statements ("Forecast") are prepared in accordance with and comply with PBE FRS 42 Prospective Financial Statements.

The forecast financial statements were authorised for issue by the Secretary of Defence of the Ministry on 4 April 2018.

While the Ministry regularly updates its forecasts, updated forecast financial statements for the year ended 30 June 2019 will not be published.

The significant assumptions underlying the forecast financial statements are:

- the functions performed and the appropriations administered by the Ministry will not change over the forecast period
- the Ministry will not receive any additional funding beyond that voted in the Estimates of Appropriations during the forecast period.

The actual financial results achieved for 30 June 2019 are likely to vary from the forecast information, and the variations may be material.

COST ALLOCATION POLICIES

The Ministry has determined the cost of outputs using the cost allocation system outlined below.

Direct costs are those costs directly attributable to an output. Indirect costs are those costs that cannot be attributed to a specific output in an economically feasible manner.

Direct costs are charged directly to outputs. Indirect costs are charged to outputs based on a predetermined ratio. This ratio is assessed annually based on the services expected to be provided for each output over the ensuing year.

There have been no changes in cost accounting policies, since the date of the last audited financial statements.

CRITICAL ACCOUNTING ESTIMATES AND ASSUMPTIONS

In preparing these financial statements, estimates and assumptions have been made concerning the future. These estimates and assumptions may differ from the subsequent actual results. Estimates and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. There are no estimates or assumptions that are considered to have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

CRITICAL JUDGEMENTS IN APPLYING THE MINISTRY'S ACCOUNTING POLICIES

The Ministry had to exercise its judgement in determining the condition and value of property, plant and equipment recovered following the November 2016 Kaikoura earthquake (refer notes 7 and 15).

NOTE 2: REVENUE

Accounting policy

Revenue Crown

Revenue from the Crown is measured based on the Ministry's funding entitlement for the reporting period. The funding entitlement is established by Parliament when it passes the Appropriation Acts for the financial year. The amount of revenue recognised takes into account any amendments to appropriations approved in the Appropriation (Supplementary Estimates) Act for the year and certain other unconditional funding adjustments formally approved prior to balance date.

There are no conditions attached to the funding from the Crown. However, the Ministry may only incur expenses within the scope and limits of its appropriations.

The fair value of Revenue Crown has been determined to be equivalent to the funding entitlement.

Other Revenue

Costs incurred by the Ministry in the pre-acquisition stages of acquisition projects are recovered from the New Zealand Defence Force. This is classified as an exchange transaction.

Other cost recoveries relate to contributions from the New Zealand Defence Force for development of New Zealand Defence Force-specific items, incurred by the Ministry as part of the Defence Capability Change Action Programme.

Breakdown of other revenue

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|--|-------------------------|
| 921 | Pre-acquisition project costs from New Zealand Defence Force | 514 |
| - | Other cost recoveries | 150 |
| 921 | Total other revenue | 664 |

NOTE 3: PERSONNEL EXPENSES

Accounting policy

Salaries and wages

Salaries and wages are recognised as an expense as employees provide services.

Superannuation schemes

Employee contributions to the State Sector Retirement Savings Scheme, KiwiSaver, and the Government Superannuation Fund are accounted for as defined contribution superannuation schemes and are expensed in the surplus or deficit as incurred.

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|---|-------------------------|
| 11,087 | Salaries and wages | 14,292 |
| 385 | Employer contributions to defined contribution plans | 450 |
| 81 | Increase/(decrease) in employee entitlements and Holidays Act expense | 311 |
| 11,553 | Total personnel expenses | 15,053 |

NOTE 4: CAPITAL CHARGE

Accounting policy

The capital charge is recognised as an expense in the period to which the charge relates.

Further information

The Ministry pays a capital charge to the Crown on its equity as at 30 June and 31 December each year. The capital charge rate for the year ended 30 June 2018 was 6.0% (2017 7.0% from 1 July 2016 to 31 December 2016 and 6.0% from 1 January 2017 to 30 June 2017).

NOTE 5: OPERATING EXPENSES

Accounting policy

Operating expenses are recognised when goods and services are received.

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|--|-------------------------|
| 105 | Audit fees for financial statements | 108 |
| 1,785 | Consultancy | 2,133 |
| 881 | Professional services | 187 |
| 871 | Travel and related costs | 858 |
| 262 | Courses, conferences and exhibitions | 203 |
| 449 | Rental of premises | 352 |
| 230 | Legal | 130 |
| 88 | Grants and contributions | 142 |
| - | Write-off of property, plant and equipment | 309 |
| 914 | Other operating costs | 791 |
| 5,585 | Total operating expenses | 5,213 |

NOTE 6: RECEIVABLES

Accounting policy

Short-term receivables are recorded at the amount due, less any provision for uncollectability.

A receivable is considered to be uncollectable when there is evidence that the amount will not be fully collectable. The amount that is uncollectable is the difference between the carrying amount due and the present value of the amount expected to be collected.

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|---|-------------------------|
| | Receivables from exchange transactions | |
| 164 | Debtors | 399 |
| - | Less provision for impairment | - |
| 164 | Net debtors | 399 |
| 164 | Total receivables from exchange transactions | 399 |
| - | Receivables from non-exchange transactions | - |
| 164 | Total receivables | 399 |

The carrying value of debtors and other receivables approximates their fair value.

NOTE 7: PROPERTY, PLANT AND EQUIPMENT

Accounting policy

Property, plant and equipment consists of leasehold improvements, furniture and office equipment.

Property, plant and equipment is measured at cost, less accumulated depreciation and impairment losses.

Additions

The cost of an item of property, plant and equipment is recognised as an asset if, and only if, it is probable that future economic benefits or service potential associated with the item will flow to the Ministry and the cost of the item can be measured reliably.

Individual assets, or groups of assets, are capitalised if their cost is greater than \$5,000. The value of an individual asset that is less than \$5,000 and is part of a group of similar assets is capitalised.

In most instances, an item of property, plant and equipment is recognised at its cost.

Disposals

Gains and losses on disposals are determined by comparing the net disposal proceeds with the carrying amount of the asset. Gains and losses on disposals are included in the surplus/deficit.

Subsequent costs

Costs incurred subsequent to initial acquisition are capitalised only when it is probable that future economic benefits or service potential associated with the item will flow to the Ministry and the cost of the item can be measured reliably.

Depreciation

Depreciation is provided on a straight-line basis on all property, plant and equipment at rates that will write off the cost of the assets to their estimated residual values over their useful lives. The useful lives and associated depreciation rates of major classes of assets have been estimated as follows:

| | |
|--------------------|-------------|
| Furniture | 2½-10 years |
| Office equipment | 5-10 years |
| Computer equipment | 3-5 years |

Leasehold improvements are depreciated over the unexpired period of the lease or the estimated remaining useful lives of the improvements, whichever is the shorter.

The residual value and useful life of an asset is reviewed, and adjusted if applicable, at each financial year-end.

Impairment

Property, plant and equipment and intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

If an asset's carrying amount exceeds its recoverable amount, the asset is impaired and the carrying amount is written down to the recoverable amount.

Any impairment loss or reversal of an impairment loss is recognised in the surplus or deficit.

| | Actual 2018 | | | |
|---|---------------------------|---------------------|-------------------------------------|--------------|
| | Leasehold improvements | Office furniture | Office and computer equipment | Total |
| | \$000 | \$000 | \$000 | \$000 |
| Cost or valuation | | | | |
| Balance at 1 July 2016 | 2,941 | 476 | 835 | 4,252 |
| Additions | 152 | 59 | 129 | 340 |
| Disposals | (2,625) | - | (21) | (2,646) |
| Balance at 30 June 2017 | 468 | 535 | 943 | 1,946 |
| Balance at 1 July 2017 | 468 | 535 | 943 | 1,946 |
| Additions | 36 | 14 | 73 | 123 |
| Disposals | - | (446) | (59) | (505) |
| Balance at 30 June 2018 | 504 | 103 | 957 | 1,564 |
| Accumulated depreciation and impairment losses | | | | |
| Balance at 1 July 2016 | 1,883 | 119 | 771 | 2,773 |
| Depreciation expense | 121 | 56 | 28 | 205 |
| Eliminate on disposal | (1,656) | - | (5) | (1,661) |
| Balance at 30 June 2017 | 348 | 175 | 794 | 1,317 |
| Balance at 1 July 2017 | 348 | 175 | 794 | 1,317 |
| Depreciation expense | 74 | 67 | 75 | 216 |
| Eliminate on disposal | - | (170) | (27) | (197) |
| Balance at 30 June 2018 | 422 | 72 | 842 | 1,336 |
| Carrying amounts | | | | |
| At 30 June and 1 July 2017 | 120 | 360 | 149 | 629 |
| At 30 June 2018 | 82 | 31 | 115 | 228 |

There are no restrictions over the title of the Ministry's property, plant and equipment, nor is any property, plant and equipment pledged as security for liabilities.

NOTE 8: INTANGIBLE ASSETS

Accounting policy

Additions

Software developing costs, including licenses are capitalised on the basis of the costs incurred to acquire and bring to use the specific software.

Costs associated with maintaining computer software are recognised as an expense when incurred.

Amortisation

The carrying value of an intangible asset with a finite life is amortised on a straight-line basis over its useful life. Amortisation begins when the asset is available for use and ceases at the date that the asset is derecognised. The amortisation charge for each period is recognised in the surplus or deficit.

The useful lives and associated amortisation rates of major classes of intangible assets have been estimated as follows:

| | |
|-------------------|-----------|
| Computer software | 3-5 years |
|-------------------|-----------|

Impairment

Refer to the policy for impairment of property, plant, and equipment in Note 7. The same policy applies to the impairment of intangible assets.

Critical accounting estimates and assumptions

Useful lives of software

The useful life of software is determined at the time the software is acquired and brought into use and is reviewed at each reporting date for appropriateness. For computer software licences, the useful life represents management's view of the expected period over which the Ministry will receive benefits from the software, but not exceeding the licence term.

| | Actual 2018 | |
|---|-------------------|----------------|
| | Software \$000 | Total \$000 |
| Cost | | |
| Balance at 1 July 2016 | 958 | 958 |
| Additions | 33 | 33 |
| Disposals | - | - |
| Balance at 30 June 2017 | 991 | 991 |
| Balance at 1 July 2017 | 991 | 991 |
| Additions | - | - |
| Disposals | - | - |
| Balance at 30 June 2018 | 991 | 991 |
| Accumulated amortisation and impairment losses | | |
| Balance at 1 July 2016 | 954 | 954 |
| Amortisation expense | 7 | 7 |
| Disposals | - | - |
| Balance at 30 June 2017 | 961 | 961 |
| Balance at 1 July 2017 | 961 | 961 |
| Amortisation expense | 6 | 6 |
| Disposals | - | - |
| Balance at 30 June 2018 | 967 | 967 |
| Carrying amounts | | |
| At 30 June and 1 July 2017 | 30 | 30 |
| At 30 June 2018 | 24 | 24 |

There are no restrictions over the title of the Ministry's intangible assets, nor are any intangible assets pledged as security for liabilities.

NOTE 9: CREDITORS AND OTHER PAYABLES

Accounting policy

Short-term creditors are recorded at the amount payable.

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|---|-------------------------|
| 500 | Creditors | 489 |
| 1,224 | Accrued expenses | 483 |
| 260 | GST payable | 283 |
| 1,984 | Total creditors and other payables | 1,255 |

Creditors and other payables are non-interest bearing and are normally settled on 30-day terms, therefore the carrying value of creditors and other payables approximates their fair value.

NOTE 10: RETURN OF OPERATING SURPLUS

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|--|-------------------------|
| (524) | Net surplus/(deficit) | 138 |
| | Add back Other Expense appropriations: | |
| 1,063 | Earthquake/storm damages | - |
| 539 | Total return of operating surplus | 138 |

The return of operating surplus to the Crown is required to be paid by 31 October of each year.

NOTE 11: EMPLOYEE ENTITLEMENTS

Accounting policy

Short-term employee entitlements

Entitlements expected to be settled within twelve months of balance date are measured at nominal values based on accrued entitlements at current rates of pay.

These include salaries and wages accrued up to balance date, annual leave earned but not yet taken at balance date, retiring and long service leave entitlements expected to be settled within 12 months, and sick leave.

Long-term employee entitlements

Employee entitlements that are due to be settled beyond twelve months after the end of the reporting period in which the employee renders the related service, such as long service leave and retiring leave, are calculated on an actuarial basis. The calculations are based on:

- likely future entitlements accruing to staff, based on years of service, years to entitlement, contractual entitlement information and the likelihood that staff will reach the point of entitlement
- the present value of the estimated future cash flows.

Critical accounting estimates and assumptions

Long service leave and retirement gratuities

The measurement of the long service leave and retirement gratuities obligations depend on a number of factors that are determined on an actuarial basis using a number of assumptions. Two key assumptions used in calculating this liability include the discount rate and the salary inflation factor. Any changes in these assumptions will affect the carrying amount of the liability.

Expected future payments are discounted using a weighted average discount rate of 3.00% (2017 2.84%) and an inflation factor of 2.0% (2017 3.0%) based on Treasury discount rates.

If either the discount rate or the salary inflation factor were to change by 1% from the Treasury's discount rates, with all other factors held constant, the carrying amount of the liability and the surplus/deficit would change by less than \$9,000.

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|--|-------------------------|
| | Current provisions are represented by: | |
| 710 | Annual leave | 891 |
| 22 | Sick leave | 28 |
| 52 | Retirement and long service leave | 74 |
| 784 | Total current provision | 993 |
| | Non-current employee entitlements are represented by: | |
| 136 | Retirement and long service leave | 72 |
| 920 | Total employee entitlements | 1,065 |

NOTE 12: EQUITY

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|---|-------------------------|
| | Taxpayers' funds | |
| 3,416 | Balance at 1 July | 2,353 |
| (524) | Net surplus/(deficit) | 138 |
| - | Capital contribution from the Crown | - |
| (539) | Provision for repayment of surplus to the Crown | (138) |
| 2,353 | Taxpayers' funds at 30 June | 2,353 |

NOTE 13: RELATED PARTY TRANSACTIONS AND KEY MANAGEMENT PERSONNEL

Accounting policy

The Ministry is a wholly-owned entity of the Crown.

All transactions with related parties have been undertaken either:

- within a supplier/client relationship on terms and conditions no more or less favourable than those it is reasonable to expect of the Ministry would have adopted in dealing with the party on an arm's length basis, and/or

- with other government agencies consistent with the usual operating arrangements between the Ministry and those agencies.

Key management personnel compensation

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|--|-------------------------|
| | Leadership team, including the Secretary of Defence | |
| 1,790 | Remuneration | 1,853 |
| 6 | Full-time equivalent staff | 6 |

Key management personnel include the Secretary of Defence and the five members (2017 – five) of the Leadership Team.

The above key management personnel compensation excludes the remuneration and other benefits received by the Minister of Defence. The Minister's remuneration and other benefits are not received only for his role as a member of key management personnel of the Ministry. The Minister's remuneration and other benefits are set by the Remuneration Authority under the Members of Parliament (Remuneration and Services) Act 2013 and are paid under Permanent Legislative Authority, and not paid by the Ministry of Defence.

NOTE 14: FINANCIAL INSTRUMENTS

The carrying amounts of financial assets and financial liabilities in each of the financial instrument categories are as follows:

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|---|-------------------------|
| | Loans and receivables | |
| 4,970 | Cash and cash equivalents | 4,061 |
| 164 | Debtors and other receivables | 399 |
| 3 | Prepayments | 99 |
| 5,137 | Total loans and receivables | 4,559 |
| | Financial liabilities measured at amortised cost | |
| 1,984 | Creditors and other payables | 1,255 |

NOTE 15: KAIKOURA EARTHQUAKE

The November 2016 Kaikoura earthquake caused significant damage to the Ministry's leased premises in Defence House. The Ministry was operational six working days after the earthquake with Ministry staff located at several alternate sites across the greater Wellington area.

In early-2017 the landlord advised that the damage to Defence House was too severe to repair and it would be demolished. The Ministry has established temporary premises in Freyberg Building in central Wellington, co-located with the New Zealand Defence Force. The Ministry expects to move into leased long-term premises in early 2019/20.

Earthquake costs

The major costs to the Ministry from the earthquake were the cost of assets destroyed and the capital cost associated with establishing the new office in Freyberg Building.

In 2016/17 the Ministry recognised expenses of \$1,063,000 and capital expenditure of \$319,000 due to the earthquake. No additional costs were recorded in 2017/18.

Insurance claim

The Ministry is preparing insurance claims for damage and other costs incurred due to the earthquake. Specialist advice is being obtained in the preparation of the claims which are currently not quantifiable. The Ministry expects to proceed with the claims during the 2018/19 financial year but has no known resolution date.

The amount claimed under insurance policies is likely to differ from the amounts reported as earthquake costs in these financial statements. These differences are largely due to valuation methods for damaged assets and categorisation of costs differing between those used under insurance policies and used in the financial statements.

NOTE 16: EXPLANATION OF MAJOR VARIANCES AGAINST FORECAST

Explanations for major variances from the forecast financial statements for 2017/18 are as follows:

Statement of comprehensive revenue and expense

Revenue Crown

Revenue Crown decreased during the year as some of the costs relating to the implementation of the Enhancements to Defence Capability Development and Acquisition initiative were deferred to 2018/19 along with the related funding.

Other revenue

The increase in Other Revenue primarily results from the New Zealand Defence Force reimbursing the Ministry for costs incurred in the pre-acquisition stage of two additional acquisition projects, which were approved by Cabinet during the year.

Personnel and Operating expenses

The increase in Personnel expenses and reduction in Operating expenses against forecast reflects changes in the Ministry's cost structure as the implementation of the Enhancements to Defence Capability Development and Acquisition initiative nears completion. Costs incurred during implementation, such as consultants and costs of developing new frameworks and processes, are declining and being replaced by personnel costs as staff are employed to operate within the new structure.

Statement of financial position

Property, plant and equipment

The decline in the value of property, plant and equipment from the forecast results from the write-off of some assets that were recovered from the Ministry's former premises following the November 2016 Kaikoura earthquake. These assets had been in storage in the expectation they would be used when the Ministry transferred to its eventual long-term premises. These became surplus to requirement during the year as the requirements for the Ministry's new premises were clarified. The assets were written-off as they were considered to have no saleable value.

Additionally, capital expenditure on new assets was lower than forecast during the year as expected asset purchases to fit out the Ministry's temporary premises were not required.

Statement of cash flows

Variances in cashflows largely reflect the above explanations. Further variances arise from the timing of payment following invoicing as reflected by variances in the debtors and creditors balances.

NOTE 17: EVENTS AFTER BALANCE DATE

There have been no significant events after balance date.

PART 6: NON-DEPARTMENTAL STATEMENTS AND SCHEDULES

The following non-departmental statements and schedules record the revenue, expenses, assets, liabilities, commitments, contingent liabilities and contingent assets that the Ministry manages on behalf of the Crown.

SCHEDULE OF NON-DEPARTMENTAL REVENUE

For the year ended 30 June 2018

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|---------------------------------------|-------------------------|
| 2,821 | Realised foreign exchange gains | 18,174 |
| 1,142 | Realised gains on derivatives | 11,127 |
| 290 | Unrealised gains on derivatives | 7,450 |
| 65 | Unrealised foreign exchange gains | - |
| 843 | Interest | 1,782 |
| 5,161 | Total non-departmental revenue | 38,533 |

SCHEDULE OF NON-DEPARTMENTAL EXPENSES

For the year ended 30 June 2018

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|--|-------------------------|
| 7,656 | Realised foreign exchange losses | 3,081 |
| 362 | Realised losses on derivatives | 677 |
| 14,697 | Unrealised losses on derivatives | 1,383 |
| - | Unrealised foreign exchange losses | - |
| 7,688 | GST input expense | 8,766 |
| 30,403 | Total non-departmental expenses | 13,907 |

The accompanying notes form part of these financial statements. For a full understanding of the Crown's financial position and the results of its operations for the period, reference should be made to the consolidated Financial Statements of the Government for the year ended 30 June 2018.

SCHEDULE OF NON-DEPARTMENTAL ASSETS

As at 30 June 2018

| Actual 2017 \$000 | | Note | Actual 2018 \$000 |
|-------------------------|--|------|-------------------------|
| | Current assets | | |
| 207,942 | Cash and cash equivalents | | 251,243 |
| 191,364 | Receivables from exchange transactions | 2 | 189,201 |
| 290 | Derivative financial instruments | 4 | 1,100 |
| 399,596 | Total current assets | | 441,544 |
| | Non-current assets | | |
| - | Derivative financial instruments | 4 | 211 |
| - | Total non-current assets | | 211 |
| 399,596 | Total non-departmental assets | | 441,755 |

SCHEDULE OF NON-DEPARTMENTAL LIABILITIES

As at 30 June 2018

| Actual 2017 \$000 | | Note | Actual 2018 \$000 |
|-------------------------|---|------|-------------------------|
| | Current liabilities | | |
| 131,958 | Creditors and other payables | 3 | 52,709 |
| 8,760 | Derivative financial instruments | 4 | 870 |
| 140,718 | Total current liabilities | | 53,579 |
| | Non-current liabilities | | |
| 6,139 | Derivative financial instruments | 4 | 513 |
| 6,139 | Total non-current liabilities | | 513 |
| 146,857 | Total non-departmental liabilities | | 54,092 |

The accompanying notes form part of these financial statements. For a full understanding of the Crown's financial position and the results of its operations for the period, reference should be made to the consolidated Financial Statements of the Government for the year ended 30 June 2018.

SCHEDULE OF NON-DEPARTMENTAL CAPITAL RECEIPTS

For the year ended 30 June 2018

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|--|-------------------------|
| 3,629 | ANZAC Frigate Platform Systems Upgrade | - |
| 66,285 | ANZAC Frigate Systems Upgrade | 70,996 |
| 643 | C-130 Hercules Life Extension | 50 |
| 1,697 | Defence Command and Control System | (292) |
| 25,771 | Individual Weapons Replacement | 7,573 |
| - | Dive and Hydrographic Vessel | 249 |
| 10,125 | Maritime Helicopter | 32 |
| 101,248 | Maritime Sustainment Capability | 110,089 |
| 1,517 | Medium-Heavy Operational Vehicles | 8 |
| 1,838 | Medium Utility Helicopter | - |
| 16,634 | Network Enabled Army | 15,656 |
| - | NH90 Simulator | 315 |
| 135 | P-3K Orion Missions Systems Upgrade | - |
| 88 | Pilot Training Capability | - |
| 1,135 | Protector Remediation | - |
| 16,024 | Special Operations Vehicles | 9,845 |
| 15,930 | Strategic Bearer Network | 4,560 |
| 668 | Training/Light Utility Helicopter | - |
| 17,256 | Underwater Intelligence, Surveillance and Reconnaissance | 13,283 |
| 35 | 81mm Mortar Replacement | 534 |
| 280,658 | Total non-departmental capital receipts | 232,898 |

The accompanying notes form part of these financial statements. For a full understanding of the Crown's financial position and the results of its operations for the period, reference should be made to the consolidated Financial Statements of the Government for the year ended 30 June 2018.

SCHEDULE OF NON-DEPARTMENTAL CAPITAL EXPENDITURE

For the year ended 30 June 2018

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|--|-------------------------|
| 3,629 | ANZAC Frigate Platform Systems Upgrade | - |
| 66,285 | ANZAC Frigate Systems Upgrade | 70,996 |
| 643 | C-130 Hercules Life Extension | 50 |
| 1,697 | Defence Command and Control System | (292) |
| 25,771 | Individual Weapons Replacement | 7,573 |
| - | Dive and Hydrographic Vessel | 249 |
| 10,125 | Maritime Helicopter | 32 |
| 101,248 | Maritime Sustainment Capability | 110,089 |
| 1,517 | Medium-Heavy Operational Vehicles | 8 |
| 1,838 | Medium Utility Helicopter | - |
| 16,634 | Network Enabled Army | 15,656 |
| - | NH90 Simulator | 315 |
| 135 | P-3K Orion Missions Systems Upgrade | - |
| 88 | Pilot Training Capability | - |
| 1,135 | Protector Remediation | - |
| 16,024 | Special Operations Vehicles | 9,845 |
| 15,930 | Strategic Bearer Network | 4,560 |
| 668 | Training/Light Utility Helicopter | - |
| 17,256 | Underwater Intelligence, Surveillance and Reconnaissance | 13,283 |
| 35 | 81mm Mortar Replacement | 534 |
| 280,658 | Total non-departmental capital expenditure | 232,898 |

The accompanying notes form part of these financial statements. For a full understanding of the Crown's financial position and the results of its operations for the period, reference should be made to the consolidated Financial Statements of the Government for the year ended 30 June 2018.

SCHEDULE OF NON-DEPARTMENTAL CAPITAL COMMITMENTS

As at 30 June 2018

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|--|-------------------------|
| | Non-cancellable capital commitments | |
| 138,237 | Not later than one year | 194,629 |
| 133,648 | Later than one year and not later than two years | 136,991 |
| 57,386 | Later than two years and not later than five years | 8,310 |
| - | Later than five years | - |
| 329,271 | Total non-cancellable capital commitments | 339,930 |

SCHEDULE OF NON-DEPARTMENTAL CONTINGENT LIABILITIES AND CONTINGENT ASSETS

As at 30 June 2018

CONTINGENT LIABILITIES

The Ministry on behalf of the Crown has no contingent liabilities (2017 – Nil).

CONTINGENT ASSETS

The Ministry on behalf of the Crown has no contingent assets (2017 – Nil).

The accompanying notes form part of these financial statements. For a full understanding of the Crown's financial position and the results of its operations for the period, reference should be made to the consolidated Financial Statements of the Government for the year ended 30 June 2018.

NOTES TO THE NON-DEPARTMENTAL SCHEDULES

NOTE 1: STATEMENT OF ACCOUNTING POLICIES

Reporting entity

These non-departmental statements and schedules present financial information on public funds managed by the Ministry on behalf of the Crown.

These non-departmental balances are consolidated into the Financial Statements of the Government for the year ended 30 June 2018. For a full understanding of the Crown's financial position, results of operations and cash flows for the year, reference should also be made to the Financial Statements of the Government for the year ended 30 June 2018.

Basis of preparation

The non-departmental statements and schedules have been prepared in accordance with the accounting policies of the Financial Statements of the Government, Treasury Instructions, and Treasury Circulars.

Measurement and recognition rules applied in the preparation of these non-departmental statements and schedules are consistent with New Zealand generally accepted accounting practice (Tier 1 Public Sector Public Benefit Entity Accounting Standards) as appropriate for public benefit entities.

Changes in accounting policies

There have been no changes in the Ministry's accounting policies since the date of the last audited financial statements.

Summary of significant accounting policies

Significant accounting policies are included in the notes to which they relate.

Significant accounting policies that do not relate to a specific note are outlined below.

Revenue

Interest income is recognised using the effective interest method.

Foreign currency transactions

Foreign currency transactions (including those for which forward foreign exchange contracts are held) are translated into New Zealand dollars using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the schedule of non-departmental income or expenses.

Goods and Services Tax

All items in the financial statements, including appropriation statements, are stated exclusive of goods and services tax (GST), except for receivables and payables, which are stated on a GST inclusive basis. In accordance with Treasury instructions, GST is returned on revenue received on behalf of the Crown, where applicable. However, an input tax deduction is not claimed on non-departmental expenditure. Instead, the amount of GST applicable to non-departmental expenditure is recognised as a separate expense and eliminated against GST revenue on consolidation of the Financial Statements of the Government.

Commitments

Expenses yet to be incurred on non-cancellable contracts that have been entered into on or before balance date are disclosed as commitments to the extent that there are equally unperformed obligations.

Cancellable commitments that have penalty or exit costs explicit in the agreement on exercising that option to cancel are included in the statement of commitments at the value of that penalty or exit cost.

NOTE 2: RECEIVABLES

Accounting policy

Receivables are initially measured at the amount due and subsequently measured at amortised cost using the effective interest method, less any provision for uncollectability.

Impairment of a receivable is established when there is objective evidence that the Ministry will not be able to collect amounts due according to the original terms of the receivable. As the Ministry's principal debtor is the New Zealand Defence Force the risk of impairment is highly improbable.

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|---|-------------------------|
| | Receivables from exchange transactions | |
| 191,364 | Debtors | 189,201 |
| - | Less provision for impairment | - |
| 191,364 | Net debtors | 189,201 |
| 191,364 | Total receivables from exchange transactions | 189,201 |
| - | Receivables from non-exchange transactions | - |
| 191,364 | Total receivables | 189,201 |

There are no debtors past due (2017 - NIL).

NOTE 3: CREDITORS AND OTHER PAYABLES

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|---|-------------------------|
| 34,372 | Creditors | 408 |
| 97,586 | Accrued expenses | 52,301 |
| 131,958 | Total creditors and other payables | 52,709 |

NOTE 4: FINANCIAL INSTRUMENTS

Accounting Policy

The Ministry uses derivative financial instruments to hedge its exposure to foreign exchange movements. In accordance with its Foreign Exchange Management policy, the Ministry does not hold or issue derivative financial instruments for trading purposes. The Ministry has not adopted hedge accounting.

Derivatives are initially recognised at fair value on the date a derivative contract is entered into and are subsequently re-measured at their fair value at each balance date. Movements in the fair value of derivative financial instruments are recognised in the schedule of non-departmental income or schedule of non-departmental expenses.

The full fair value of a foreign exchange derivative is classified as current if the contract is due for settlement within 12 months of balance date. Otherwise, foreign exchange derivatives are classified as non-current.

Financial instrument categories

The carrying amounts of financial assets and financial liabilities in each of the financial instrument categories are as follows:

| Actual 2017 \$000 | | Actual 2018 \$000 |
|-------------------------|---|-------------------------|
| | Loans and receivables | |
| 207,942 | Cash and cash equivalents | 251,243 |
| 191,364 | Debtors and other receivables | 189,201 |
| 399,306 | Total loans and receivables | 440,444 |
| | Fair value through profit and loss – designated as such upon initial recognition | |
| 290 | Derivative financial instrument assets | 1,311 |
| 14,899 | Derivative financial instrument liabilities | 1,383 |
| | Financial liabilities measured at amortised cost | |
| 131,958 | Creditors and other payables | 52,709 |

The notional principal amount of outstanding forward exchange contract derivatives at 30 June 2018 is NZD 218.6 million (2017 – NZD 265.6 million). The contracts consist of the purchase of (amounts in foreign currency):

| Actual 2017 fx 000 | | Actual 2018 fx 000 |
|--------------------------|-----------------------|--------------------------|
| - | Australian dollars | 4,500 |
| 325 | British pounds | - |
| 2,800 | Canadian dollars | 85,450 |
| 3,790 | Euros | 509 |
| 187,600 | United States dollars | 78,830 |

Fair value hierarchy disclosures

For those instruments recognised at fair value in the statement of financial position, fair values are determined according to the following hierarchy:

- Quoted market price (level 1) – Financial instruments with quoted prices for identical instruments in active markets.
- Valuation technique using observable inputs (level 2) – Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.
- Valuation techniques with significant non-observable inputs (level 3) – Financial instruments valued using models where one or more significant inputs are not observable.

The following table analyses the basis of the valuation of classes of financial instruments measured at fair value in the statement of financial position.

| | Total | Valuation technique | | |
|----------------------------------|--------|---------------------|-------------------|-----------------------------------|
| | | Quoted market price | Observable inputs | Significant non-observable inputs |
| | | \$000 | \$000 | \$000 |
| 2018 | | | | |
| Financial assets | | | | |
| Derivative financial instruments | 1,311 | - | 1,311 | - |
| Financial liabilities | | | | |
| Derivative financial instruments | 1,383 | - | 1,383 | - |
| 2017 | | | | |
| Financial assets | | | | |
| Derivative financial instruments | 290 | - | 290 | - |
| Financial liabilities | | | | |
| Derivative financial instruments | 14,899 | - | 14,899 | - |

There were no transfers between the different levels of the fair value hierarchy.

Financial instrument risks

The Ministry's activities expose it to a variety of financial instrument risks, including market risk, credit risk and liquidity risk. The Ministry has a series of policies to manage the risks associated with financial instruments and seeks to minimise exposure from financial instruments. These policies do not allow any transactions that are speculative in nature to be entered into.

Market risk

Currency risk

Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

The Ministry purchases capital equipment internationally and is exposed to currency risk arising from various currency exposures, primarily with respect to the United States, Canadian and Australian dollars, British pounds and Euro. Currency risk arises from future capital purchases and recognised liabilities, which are denominated in a foreign currency.

The Ministry's Foreign Exchange Management Policy requires the Ministry to manage currency risk arising from future transactions and recognised liabilities by entering into foreign exchange forward contracts to hedge the entire foreign currency risk exposure. The Ministry's policy has been approved by the Treasury and is in accordance with the requirements of the Treasury Guidelines for the Management of Crown and Departmental Foreign Exchange Exposure.

Credit risk

Credit risk is the risk that a third party will default on its obligation to the Ministry, causing the Ministry to incur a loss. In the normal course of its business, credit risk arises from debtors, deposits with banks and derivative financial instrument assets.

The Ministry is only permitted to deposit funds and enter into foreign exchange forward contracts with approved counterparties. These entities have high credit ratings. For its other financial instruments, the Ministry does not have significant concentrations of credit risk.

The Ministry's maximum credit exposure for each class of financial instrument is represented by the total carrying amount of cash and cash equivalents, net debtors (note 2), and derivative financial instrument assets. There is no collateral held as security against these financial instruments, including those instruments that are overdue or impaired.

Liquidity risk

Liquidity risk is the risk that the Ministry will encounter difficulty raising liquid funds to meet commitments as they fall due.

In meeting its liquidity requirements, the Ministry closely monitors its forecast cash requirements with expected cash drawdowns from the New Zealand Debt Management Office. The Ministry maintains a target level of available cash to meet liquidity requirements.

Contractual maturity of financial liabilities, excluding derivatives

The table below analyses the Ministry's financial liabilities (excluding derivatives) into relevant maturity groupings based on the remaining period at balance date to the contractual maturity date. The amounts disclosed are the contractual undiscounted cash flows.

| At 30 June 2018 | Less than 6 months \$000 | 6-12 months \$000 | 1-5 years \$000 | Over 5 years \$000 | Total \$000 |
|------------------------------|-----------------------------|----------------------|--------------------|-----------------------|----------------|
| 2018 | | | | | |
| Creditors and other payables | 52,709 | - | - | - | 52,709 |
| 2017 | | | | | |
| Creditors and other payables | 131,958 | - | - | - | 131,958 |

Contractual maturity analysis of derivative financial instrument liabilities

The table below analyses the Ministry's forward foreign exchange contract derivatives into relevant maturity groupings based on the remaining period at balance date to the contractual maturity date. The amounts disclosed are the contractual undiscounted cash flows.

| | Liability carrying amount \$000 | Asset carrying amount \$000 | Contractual cash flows NZ \$000 | Less than 6 months NZ \$000 | 6-12 months NZ \$000 | 1-2 years NZ \$000 | 2-5 years NZ \$000 |
|---|------------------------------------|--------------------------------|------------------------------------|--------------------------------|-------------------------|-----------------------|-----------------------|
| Gross settled forward foreign exchange contracts: | | | | | | | |
| 2018 | 1,383 | 1,311 | | | | | |
| - outflow | | | 218,609 | 92,691 | 91,199 | 34,719 | - |
| - inflow | | | 218,310 | 92,948 | 91,103 | 34,259 | - |
| 2017 | 14,899 | 290 | | | | | |
| - outflow | | | 282,943 | 87,225 | 85,447 | 110,271 | - |
| - inflow | | | 265,642 | 82,910 | 80,308 | 102,424 | - |

Sensitivity analysis

The table below shows the net effect on the reported gains and losses from movements in exchange rates and derivative values if the New Zealand dollar had been either 5% stronger or weaker at balance date.

| | 2017 | | | 2018 | | |
|---|------------------------------------|----------------------|--------------------------|------------------------------------|----------------------|--------------------------|
| | Cash and cash equivalents \$000 | Derivatives \$000 | Net gain/(loss) \$000 | Cash and cash equivalents \$000 | Derivatives \$000 | Net gain/(loss) \$000 |
| Effect on surplus if NZ dollar strengthened by 5% | | | | | | |
| AUD | (41) | - | (41) | (660) | (230) | (890) |
| CAD | (1,984) | (139) | (2,123) | (2,561) | (4,469) | (7,030) |
| EUR | (529) | (283) | (812) | (219) | (42) | (261) |
| GBP | (1,609) | (28) | (1,637) | (966) | - | (966) |
| NOK | (6) | - | (6) | (7) | - | (7) |
| SEK | (4) | - | (4) | - | - | - |
| USD | (5,095) | (12,006) | (17,101) | (5,511) | (5,470) | (10,981) |
| Total | (9,268) | (12,456) | (21,724) | (9,924) | (10,211) | (20,135) |
| Effect on surplus if NZ dollar weakened by 5% | | | | | | |
| AUD | 46 | - | 46 | 730 | 254 | 984 |
| CAD | 2,193 | 154 | 2,347 | 2,829 | 4,939 | 7,768 |
| EUR | 585 | 312 | 897 | 242 | 46 | 288 |
| GBP | 1,778 | 30 | 1,808 | 1,068 | - | 1,068 |
| NOK | 7 | - | 7 | 7 | - | 7 |
| SEK | 5 | - | 5 | - | - | - |
| USD | 5,632 | 13,270 | 18,902 | 6,091 | 6,046 | 12,137 |
| Total | 10,246 | 13,766 | 24,012 | 10,967 | 11,285 | 22,252 |

NOTE 5: EVENTS AFTER BALANCE DATE

Future Air Surveillance Capability

On 2 July 2018 Cabinet authorised the Ministry to purchase four Boeing P-8A Poseidon maritime patrol aircraft, associated training systems and equipment, and the infrastructure and other components required to bring the P-8As into service. The project's overall budget is \$2.346 billion.

NH90 Simulator

On 25 July 2018 the Minister of Defence and Minister of Finance ('Joint Ministers') authorised the Ministry to purchase a flight training simulator for the Royal New Zealand Air Force's NH90 helicopters. The Ministry received an appropriation of \$42.7 million spread over two years to acquire the simulator and associated infrastructure and introduction into service costs.

Following the approval the Ministry hedged the foreign currency components of this acquisition, purchasing Australian and Canadian dollars, and euros through spot and forward foreign exchange trades.

Dive and Hydrographic Vessel

On 19 August 2018 Joint Ministers authorised the Ministry to purchase and modify a second hand commercial offshore support vessel to provide support to the New Zealand Defence Force's dive and hydrographic capabilities. The Ministry received an appropriation of \$98.4 million spread over three years for the acquisition, modification and associated costs.

Following the approval the Ministry hedged the foreign currency components of this acquisition, purchasing Norwegian krone and other currencies through spot and forward foreign exchange trades.