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Treasury Circular 2011/10

Unrestricted Distribution

Chief Executive Officers
Chief Financial Officers

Contact for Enquiries: Vote Analysts

GUIDANCE FOR THE OPERATION OF DEPARTMENTAL MEMORANDUM ACCOUNTS

1. This circular sets out further guidance to support the recent changes in the operation of memorandum accounts as outlined in section 6.3.7 and section 4.4.3 of the 2011 Treasury Instructions.

2. The contents in this circular should be read in conjunction with the requirements of Treasury Instructions and *Guidelines for Setting Charges in the Public Sector* (December 2002).
http://www.treasury.govt.nz/publications/guidance/planning/charges/charges-dec02.pdf.

3. In addition The Office of the Auditor-General published good practice guidelines "*Charging Fees for Public Sector Goods and Services*" (June 2008) http://www.oag.govt.nz/2008/charging-fees.

4. A number of government departments provide services that are funded not by the government, but by the third party users of those services. Treasury Instructions require that where departments provide services on a full cost recovery basis and the revenue and expenses will not necessarily equate in each financial year, the department is required to operate a memorandum account recording the accumulated surplus or deficit arising from the provision of the service.

5. The balance of each memorandum account is expected to trend to zero over a reasonable period of time, with interim deficits being met either from the department's balance sheet or by a capital injection sought from the Crown.

6. Memorandum accounts were established in 1995 as a way to improve transparency around outputs that are fully cost recovered from third parties through fees, levies or charges, and to provide a genuine commitment from departments to not benefit from over recovery.

7. As memorandum account surpluses are provided by third-party service recipients, they are ostensibly attributable to those third parties, rather than to the Crown. It therefore follows that they be excluded from the amount required to be paid to the Crown as part of a department's overall surplus.

8. With effect from 1 July 2011 departmental memorandum accounts will change from being “notional” accounts requiring note disclosure to being “real” accounts requiring separate recognition within the financial statements themselves. The effect of this is that the portion of surpluses in any financial year from those departmental services subject to memorandum accounts are no longer required to be paid to the Treasury as part of a department’s overall surplus, while the amount equivalent to deficits recorded on services subject to memorandum accounts would need to be added back to the overall net surplus a department would otherwise be required to pay to the Treasury for that financial year.

9. Some agencies operate other ‘hybrid’ memorandum accounts as a means to provide transparency to fee payers on how revenues contributed by them have been applied to expenditure incurred by the Crown. Examples include activities that include a combination of both departmental and non-departmental elements where the matching revenue and expense elements are not under the control of the same entity. While it may be desirable for agencies to continue reporting on such activities, they are considered outside the scope of the requirements of this circular.

10. As a consequence of these changes, this circular covers:

- *The calculation of the amount of surplus repayment*
- *The appropriate accounting treatment and disclosure of memorandum accounts activities and balances*
- *The effect of both surpluses and deficits on the net asset calculation and the capital charge levied*
- *The use of memorandum accounts and their relationship to capital investments*
- *Establishing the opening balances from memorandum account activities in a department’s Statement of Financial Position as at 1 July 2011*.
- *Funding and recovery of past memorandum account deficits*

The calculation of repayment of surplus

11. Section 4.4.3 of the Treasury Instructions outlines the basis for the calculation of departments’ provision for return of operating surplus.

12. From 1 July 2011, the provision for return of operating surplus shall be calculated by adjusting the overall operating surplus by:

- Deducting surpluses from third-party funded services that are subject to memorandum accounts (to avoid third party activities subsidising those of the Crown, as well as allowing retention of third party surpluses for funding deficits in future years), and

- Adding back the amount of deficits derived from third-party funded services that are subject to memorandum accounts.

13. These adjustments are necessary to avoid third parties subsidising Crown activities (memorandum account surpluses) or the Crown subsidising third party activities (memorandum account deficits).

14. This approach also allows retention of a surplus from third party activities for funding a future deficit, while also assuming that a deficit derived from third party activities will only require approval of a capital injection from the Crown, where such deficit is not able to be funded from the agency's working capital.

The appropriate presentation and disclosure of memorandum accounts activities and balances

15. Cabinet has agreed (per EGI Min (11) *6/7*) that surpluses associated with departmental memorandum accounts can be retained by the department (and therefore increase their net assets associated with the surpluses in any one year), and that for purposes of section 22(1) of the Public Finance Act 1989 this decision constitutes an agreement between the Minister of Finance and the Responsible Minister(s).

16. Memorandum accounts information must be presented in the Information Supporting the Estimates. For each memorandum account this disclosure will include a summary of opening accumulated balances, movements for the year, closing accumulated balances, and comparative information.

17. Memorandum accounts should be separately disclosed within the Equity (previously known as Taxpayers' Funds) of a department's Statement of Financial Position in a department's annual report.

18. Because of this disclosure in the Statement of Financial Position, the Statement of Changes in Equity (previously the Statement of Changes in Taxpayers Funds) is required.

19. Notes to the accounts should provide information for each memorandum account on how its opening balance is adjusted by the end-of-year surplus or deficit in relation to the fee revenue and expenditure relating to that memorandum account.

20. These changes, which will ensure that fee payers are appropriately informed and provided assurance on their position, while remaining in compliance with accounting standards, are illustrated in Annex One. They have been discussed with the Audit Office, and are likely to be reflected in updates to the Model Financial Statements that Audit New Zealand produce.

The treatment of both surpluses and deficits derived from memorandum accounts on the net asset calculation and capital charging

21. To ensure that third parties who contribute to a surplus are not charged twice, the basis for the calculation of a department's capital charge will be amended to being based on only those net assets (equity) funded by the Crown and therefore excluding accumulated surpluses from memorandum accounts. To facilitate the calculation of capital charge, details of memorandum account surpluses and deficits will be requested by Treasury as at 31 December and 30 June each year (in addition to baseline and forecast exercises).

22. Conversely, where the Crown is funding losses from third party activities via a capital injection to supplement working capital, third party fee payers should continue to be charged on the capital contribution.

23. The following principles should be maintained:

- If the memorandum account runs accumulated deficits that have been funded either by a Crown capital contribution or from within a department's working capital then fee payers should be meeting the capital charge associated with this.

- If the memorandum account is running a cumulative surplus retained by the department then this part of equity <u>will not</u> be subject to capital charge.

24. In order to justify retention of these surpluses, departments should have adequate business plans, including capital management plans in place. This is not to allow opportunities for Treasury or any other entity to approve (or otherwise) the department's proposed capital management plan, but to ensure transparency of departments' retained surpluses.

The use of memorandum accounts and their relationship to capital investments

25. While departments can utilise their working capital how they feel works best for the provision of services, departments cannot borrow. To utilise surpluses as a funding source in this manner is contrary to the Public Finance Act.

26. While allowing an entity to retain surpluses attributable to third party activities, provides a greater opportunity for best utilisation of working capital for the provision of services, the entity will still need to consider the long run impact on cash flows and future fee rate setting. The entity will need to ensure that, in the event of the memorandum account moving into deficit in future, they have not increased the Crown's risk of having to unnecessarily underwrite the third party activities.

Establishing opening balances in a department's Statement of Financial Position as at 1 July 2011.

27. For PREFU 2011 departments operating departmental memorandum accounts will be required to complete an "off-line disclosure" spreadsheet which will be used as a pro-forma for the memorandum account changes. Departments will be required to submit this information to the Treasury at the same time they do their PREFU submission using the sharing tool to upload to CFISnet. Any changes to forecast capital contributions or withdrawals as a result of work done on the opening balances of memorandum accounts can be reflected in this off-line disclosure.

28. Changes in the Statement of Financial Position will be made in MBU once audited accounts are completed.

Establishing the Opening Balance where the memorandum account is in Surplus

29. A calculation is required to establish the opening position. In some cases this will require the repatriation of previous surpluses related to memorandum accounts paid to the Crown.

30. The accumulated memorandum account surplus to be returned to the department will need to be by way of capital injection - as the Crown had received that cash in prior years when surpluses were repaid.

31. Any changes will be amended as part of the 2011 PREFU baseline update and agreed by joint Ministers.

32. The opening balance will initially be recognised as a receivable (i.e. Debtor Crown). A phasing of the draw down against this part of the Debtor Crown will depend on the working capital needs of the entity associated with the memorandum account related activities, and on the agreed longer term fee strategy (offsetting surpluses and deficits over time). This will ensure that funds generated by past surpluses meet the objective of taking a longer term perspective for fee setting.

33. The appropriate journal entries to recognise the opening balance in relation to accumulated memorandum account surpluses previously repaid to the Crown will be as follows:

Dr Debtor Crown
Cr Taxpayers' funds (Retained earnings - Memorandum Accounts)

Establishing Opening balance where the Account is in Deficit

34. Where a department has been compensated for previous deficits (via capital contributions or through offsetting a memorandum account deficit against prior annual surplus repayments to the Crown), the "transfer" will be relatively straight forward for most departments as these deficits have already been offset by similar capital injections, with no impact on the net asset position of the department.

35. In these cases the previous capital injections will not be repaid on 1 July, but as noted above, will be recovered as surpluses are made to rebalance the memorandum accounts (refer below).

36. To the extent that a department has not been compensated for past deficits, and there has been a reduction in the net asset position of the department, then the department should first ensure that they are providing the services in the most cost-effective way, that their underlying business model is robust, and seek to lower the cost of doing business, before seeking to shift further cost on to businesses through a fee increase (refer below).

Dr Taxpayers' Funds (retained earnings)
Cr Taxpayers' funds (Retained earnings - Memorandum Accounts)

Funding and recovery of past Memorandum Account deficits

37. The balance of each memorandum account is expected to trend toward zero over a reasonable period of time, with interim deficits being met either from cash on the department's balance sheet or by seeking approval for a capital injection from the Crown.

38. Cabinet has previously agreed to steps that need to be taken by a department whose memorandum account balance is deteriorating more rapidly than expected as a result of the economic downturn.

39. Current requirements on departments operating memorandum accounts are that requests for capital contributions in these situations should be accompanied by the following information:

- the amount sought;
- the current balance of the memorandum account;
- an explanation of the cause of the deficit; and
- an assessment of the need to, and /or restrictions on the ability to, adjust fee levels.

40. Irrespective of the reason for a deficit (including an economic downturn) departments should first ensure that they are providing the services in the most cost-effective way, that their underlying business model is robust, and consider lowering the cost of doing business, before considering shifting further cost on to businesses through increasing charges to third parties, or before seeking the safe option of a further capital injection from the Crown.

41. The attached decision tree diagram (refer Annex Two), sets out the steps that should be taken by a department whose memorandum account balance is moving into a deficit position.

42. These steps to be worked through by a department addressing a downturn in third party revenue do not alter the intention of memorandum accounts, but recognise that before increasing fees departments should be going through a robust process, considering various options and impacts on fee strategies.

43. Legislative authority rarely allows for over-recovery when charging a fee (and often legislative and/or administrative mechanisms do not allow for repayment of any over-recovery), and so memorandum accounts help avoid breaching any relevant legislative controls. The idea is to review fees to reflect the expected cost of service over a reasonable period of time (ignoring a temporary downturn), and to cover shortfalls in third party revenue due to a temporary downturn.

44. However, in operating memorandum accounts departments need to have the capacity through the fee charging mechanism to deal with shocks that may occur during that period and not warrant one off fee changes to deal with this. Assuming that the premise holds that the fee charging model should be based on a whole of life methodology then it is appropriate that whenever fees are reviewed a department should take a long term view on the recovery of cost for services provided to third party fee paying customers.

45. This will, at certain times, mean a pricing model to ensure recovery of the full costs of providing services will need to be factored into the fees to ensure that the full costs of providing services will be recovered over the long term. This will help determine the future pricing models that should be adopted.

The recovery of past deficits from future surplus revenue streams

46. With memorandum accounts surpluses being retained, and recognised separately in a department's statement of financial position, funding of any future deficits associated with that activity will be offset from the retained surpluses, until those surpluses have been fully utilised.

47. In certain circumstances however, a department whose memorandum account revenue is consistently less than the corresponding expenses, or surpluses have been fully utilised, this may result in the memorandum account falling into a deficit balance. The department may seek a capital contribution from the Crown to offset the losses (refer Treasury Circular 6.3.7) and therefore maintain its working capital in the short term. Where this arises, consideration of providing a capital injection will be on the basis of the assumption that:

- The memorandum account deficit will need to be managed over a period of time through a combination of revised fee setting and increased business efficiencies.

- Recovery of past deficit funding associated with those services needs to be made over a period of time and will include the accumulated losses brought forward. (The period of time taken to recover these deficits will be set by the individual memorandum account market conditions the service is trying to address).

- A pricing model to ensure recovery of the full costs of providing services over the long term will need to be factored into the fees rates set to ensure that the full costs of providing services will be recovered over the long term. This will help determine the future pricing models that should be adopted.

- Where a capital withdrawal is not directly attributed to surpluses generated from the activities covered by the memorandum account, then any reduction in capital charge could still be applied to the memorandum account activities in accordance with the agency's cost allocation methodology.

- Where a memorandum account is in a net deficit position and the Crown has consequently made a capital injection as a result of the department not being able to absorb the deficit from Balance Sheet working capital, then any future surpluses should generate a positive cash position, and that positive cash should then be used to action a corresponding capital withdrawal.

- An entity should repay capital injections (that it received to fund memorandum account deficits) by way of a cash payment to the Crown over the same period of time as the memorandum account cycle.

For example

Department Results	**Year Zero**	**Year One**	**Year Two**	**Year Three**	**Year Four**
(all $'000)					
Annual operating Result for Memo A activities - Surplus /(Deficit)	2,000	(10,000)	-	6,000	5,000
Memo A account operating impact					
Opening balance Memo Account A	0	2,000	8,000	(8,000)	(2,000)
Deficit for Memorandum Account A	0	(10,000)	0	-	-
Surplus for Memorandum Account A	2,000	-	0	6,000	5,000
Net closing operating balance for Memo A accumulated Surplus/(Deficit)	2,000	(8,000)	(8,000)	(2,000)	3,000
***Memorandum Account deficit funding**:*					
Opening capital funding position	0	0	8,000	8,000	2,000
Capital Injection to fund shortfall[1]	0	8,000	0	0	0
Capital Withdrawal to recover funding shortfall	0	0	0	(6,000)	(2,000)
Net Capital impacts of Memo A	**0**	**8,000**	**8,000**	**2,000**	**0**

[1] Assume the entity cannot meet the deficit/cash shortfall form current cash reserves

ANNEX ONE: Disclosure in Financial Statements

Statement of Changes in Equity for the year ended 30 June 201X

Actual			*Notes*	*Actual*	*Main*	*Supp*
					estimates	*Estimates*
$'000				*$'000*	*$'000*	*$'000*
	Total Equity at start of year					
	Crown Capital and retained earnings		a			
	Memorandum Accounts (net position)		a,b			
	Property Revaluation Reserve		a			
	Total equity as at 1 July					
	Changes in equity during the year					
	Capital withdrawals Capital injections					
	Total comprehensive income					
	Provision for return of Surplus					
	Total changes in equity during year					
	Total Equity at end of year					
	Crown Capital and retained earnings		A			
	Memorandum Accounts (net position)		a,b			
	Property Revaluation Reserve		A			
	Total equity as at 30 June					

Memorandum Accounts

(Note Disclosure, b)

For year ended 30 June 20X1

	Opening Balance	Revenue	Expenses	Surplus/ Deficit	Closing Balance
	$'000	$'000	$'000	$'000	$'000
Memorandum Account 1					
Memorandum Account 2					
Memorandum Account 3					
Memorandum Account 4					
Total Memorandum Accounts					

For year ended 30 June 20X2

	Opening Balance	Revenue	Expenses	Surplus/ Deficit	Transfers[2]	Closing Balance
	$'000	$'000	$'000	$'000	$'000	$'000
Memorandum Account 1						
Memorandum Account 2						
Memorandum Account 3						
Memorandum Account 4						
Total Memorandum Accounts						

Action taken to address surpluses

Memorandum Account A – Output Expense 1 Delivery of 3rd party services to A

A revised fee strategy is currently being developed to ensure that fee structure and associated revenues are in line with the forecast activities, in line with recent internal changes to the provision of these services.

Action taken to address deficits

Memorandum Account B – Output Expense 2 Delivery of 3rd party services to B

The Delivery of 3rd Party Services Office has a strategy of maintaining the memorandum account in a balanced state over the long term. It allows for changes in volumes resulting from fluctuations in economic activity and other matters. The strategy model takes account of new initiatives, volume considerations and a revised pricing schedule. These are considered annually as part of the strategy.

[2] Capital transferred to/from memorandum accounts

Equity

Note Disclosure, a

Equity

Crown Capital and retained earnings

Memorandum Accounts (net position)

Property Revaluation Reserve

Crown Capital and retained earnings

Balance as at 1 July

Capital Contributions

Capital withdrawals

Operating Balance for year
(excluding memorandum accounts)

Transfers to / from memorandum accounts

Transfers to / from property revaluation reserves

Provision for return of surplus

Balance as at 30 June

Memorandum Accounts

Balance as at 1 July

Net memorandum account surpluses/deficits

Capital transferred to/from memorandum accounts

Balance as at 30 June

Property Revaluation Reserve

Balance as at 1 July

Revaluation gains Balance as at 1 July

Transfer to retained earnings on disposal

Balance as at 30 June

Followed by Narrative with explanations of transfers.

A split of Crown Capital contributed and retained earnings, if possible would be encouraged.

ANNEX TWO: Steps that need to be taken by a department whose memorandum account balance is moving into a deficit position