



Assurance and Evaluation
Office of the Director-General

PRIMARY GROWTH PARTNERSHIP FINANCIAL MANAGEMENT: ASSURANCE ON FONTERRA'S USE OF FUNDING

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Growing and Protecting New Zealand



Audit of Primary Growth Partnership Financial Management: Assurance on Fonterra's Use of Funding Draft report

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SECTION 1: EXECUTIVE SUMMARY

OBJECTIVE OF WORK

1. The key objectives of our work were to provide assurance that Fonterra's financial management systems for PGP funding and co-funding of the Dairy Value Chain Transformation post farm gate sub programme are suitably robust and effective and to ensure that Fonterra could demonstrate that they have sufficient, relevant and reliable records to support the use of the funding and co-funding claims made to the Ministry.

OBSERVATIONS

Overall conclusions and observations

2. Our conclusions are that Fonterra's financial management systems (including systems for budgeting and forecasting, financial management reporting and monitoring, cost allocation and payment processes) for PGP funding and co-funding are suitably robust and effective.
3. We also conclude that the funding being provided by the Ministry for Primary Industries (MPI) and co-investors is being used to meet the costs of the post farm gate PGP programme. We conclude that:
 - Amounts being claimed from the Ministry are supported by documentary evidence.
 - Amounts being claimed are relevant and appropriate costs to be borne by the partnership programme.
 - An adequate process exists to value Fonterra contributions to the programme.
4. Fonterra recently commissioned PWC to do some work to audit 2011-12 PGP costs (see paragraph 24-28 for further details). We consider that this work provides some additional assurance that funding has been spent on meeting the costs of PGP.

RECOMMENDATION (1) for MPI: The Ministry might want to consider whether given the size of this PGP programme it might require some similar assurance work done on the financial management of the programme before the programme is completed in 2018.

MPI Management comment: agreed

5. As part of our work we were also asked to assess the continued need for Fonterra to retain a separate bank account for PGP funding (paragraph 29-31). It is our view that it is no longer necessary to require a separate bank account for PGP funds given the level of transparency that is provided by other elements of PGP financial management practices.

RECOMMENDATION (2) for MPI: The requirement for a separate bank account for holding PGP funding contributions should be removed.

MPI management comment: agreed and will consider

Specific observations and recommendations

6. Further details of the basis of our assessment of the elements of financial management can be found at Appendix One. Our two specific suggested recommendations/actions for Fonterra concern the:
 - **Budgeting processes (paragraph 32): RECOMMENDATION (3) for Fonterra -** the cash flow forecasts for the remaining four years of the programme 2014-15 to 2017-18 need to be revised as part of the next round of business planning. We would endorse the need for this exercise.

Fonterra management comment: We will address the out year investment projections as part of preparing the 2014-15 business plan

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- **Financial Management reporting processes (paragraph 33):**
RECOMMENDATION (4) for Fonterra: - there might be some benefit from Fonterra and Dairy NZ developing a process that allows them to have a more effective combined view of total programme spend/budgets etc to reflect the overall programme financial picture. The Ministry is already doing a similar analysis for its own purposes.

Fonterra management comment: we will create an additional overall programme financial position statement for the Programme Steering Group meetings based on both the Fonterra and Dairy NZ reports. We will do this as part of collating the meeting papers and we will put into effect for the next Programme Steering Group (PSG) in February.

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SECTION 2: INTRODUCTION

OBJECTIVES OF WORK

7. This report sets out the main findings and observations from the MPI Assurance and Evaluation team's recent work to assess Fonterra's financial management of the post farm gate element of the Dairy Value Chain Transformation post farm gate sub programme of the Primary Growth Partnership programme.
8. The key objectives of this work were to provide assurance that key elements of Fonterra's financial management systems for PGP funding and co-funding are suitably robust and working effectively and to ensure that Fonterra could demonstrate that they have sufficient, relevant and reliable records to support the use of the funding and co-funding claims made to the Ministry.

CONTEXT FOR WORK

9. The Primary Growth Partnership is a government-industry partnership that invests in significant programmes of research and innovation to boost the economic growth and sustainability of New Zealand's primary and food sectors.
10. The Ministry provides funding to the partners for the programmes. The partners are required to provide co-funding at least equivalent to the Ministry's funding. Co-funding can be either in the form of cash contributions or in kind contributions.
11. Each contract between the Ministry and the partners provides rights of access to records to carry out an audit of the partner's use of the funds.
12. The Ministry's Assurance and Evaluation team help provide additional comfort to the Ministry and the Minister around PGP partner's

management of funding and claims for funding through a programme of work to provide assurance on the partner's financial management of the programme. This work looks at the following elements of financial management:

- Financial management reporting processes
- Budgeting, cash flow and forecasting processes
- Cost allocation processes
- Payments processes

[This work also includes a review of documentation to substantiate some of the costs incurred by the Ministry and the partner.]

13. The total funding for the pre and post farm gate seven year programme is \$171m (\$85m from government and \$86m from partners) and the five themed programmes started in April 2011.
14. The Dairy Value Chain Transformation post-farm gate programme is a partnership between the Ministry, Fonterra and Zespri. The Fonterra Post Farm Gate element of the programme has approved funding of \$72.5m (\$31.5m from government and \$41m from Fonterra/Zespri (\$40.3m/\$0.7m split)) to cover delivery of a programme of projects across three of the five themes. These themes are:
 - Theme 3 Creating and Managing Food Structures
 - Theme 4 Transforming manufacturing and supply chain
 - Theme 5 Health and nutrition benefits
15. To the end of September 2013, \$14.6m has been spent on the post-farm gate element of the programme. Table 1 sets out the split of the funding of this spending to date. Most of this spending comprises the costs of research and development much of which is being undertaken by

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Massey University, Auckland University of Technology UniService, University of Otago and Fonterra's Research and Development Centre.

Table 1: Split of funding of spending to date

Period	MPI funding	Fonterra/Zespri	Total
2011-12	2,240,000	5,131,000	7,371,000
2012-13	2,863,000	3,185,000	6,048,000
Q1/13-14	820,000	975,000	1,795,000
Total to date	5,923,000	9,291,000	14,584,000

WHAT WE DID AND HOW WE DID IT

16. In order to assess the financial management systems being operated by Fonterra we spoke to the persons in the Ministry and partner organisations who managed the programme of work to understand the systems and processes being used to manage the funding/co-funding and make claims for funding.
17. This included the Fonterra General Manager Technology Strategy, Programme Administration Manager Research Partnerships, theme programme leads at Fonterra, and the Ministry PGP Investment Manager.
18. We also checked documentation and other underlying evidence which supports the Fonterra claims for funding including invoices, statements of works, contracts and other documents. The records that were reviewed covered the period January – September 2013 and covered some \$2.5m of the \$3.8m of the expenditure on the programme during this period.

19. We also reviewed documentation related to budgeting, forecasting and monitoring for a range of the projects being conducted as part of the overarching post farm gate programme.
20. We also obtained some assurances from the work of third parties about the effectiveness of financial management systems. Fonterra commissioned Price Waterhouse Coopers (PWC) to undertake some work to review the 2011-12 programme costs of \$7.3m and we reviewed the findings of this work. We comment on this work at paragraphs 24-28.

SECTION 3: FINDINGS & RECOMMENDATIONS OUR CONCLUSIONS

21. Our conclusions are that Fonterra's financial management systems (including systems for budgeting and forecasting, financial management reporting and monitoring, cost allocation and payment processes) for PGP funding and co-funding are suitably robust and effective.
22. We also conclude that the funding being provided by MPI and co-investors is being used to meet the costs of the post farm gate PGP programme (we base this conclusion on our review of the documentation and information supplied by Fonterra to support the transactions we sampled as part of our audit testing). We conclude that:
 - Amounts being claimed from the Ministry are supported by documentary evidence.
 - Amounts being claimed are relevant and appropriate costs to be borne by the partnership programme.
 - An adequate process exists to value Fonterra contributions to the programme including costs associated with the work of the Fonterra Research and Development Centre and Fonterra's Directorate of Science and Technology.

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23. Appendix One provides details of the basis on which our assessment of the main elements of the financial management process has been made. Paragraphs 24 to 33 provide some additional commentary on four specific areas;

- the need for Fonterra to continue to operate a separate bank account,
- our assessment of the recent work of PWC to review the 2011-12 financial statements and records for the programme,
- the need for Fonterra to revise long term budgets and monitor the overall spend of the combined pre/post farm financial position in collaboration with Dairy NZ.

SPECIFIC OBSERVATIONS FOR MPI PGP MANAGEMENT TO CONSIDER

Other sources of assurance on financial management– recent work by PWC

24. Fonterra commissioned PWC to do an audit related to the Statement of Financial performance from 18 April 2011 to 30 June 2012. The purpose of the engagement was to look at and reconcile financial statements against evidence of payments and to the general ledger. This limited engagement assessed elements of financial management by reviewing a sample of transactions and reconciling total costs to the ledger.

25. The Ministry might want to consider whether given the size of this programme it might require some similar work done to be done in the future before the completion of the programme in 2018.

26. Following this work the Programme Administration Manager Fonterra undertook a further review and reconciliation of these accounts and statements for 2011-12.

27. The PWC review and the Programme Administration Manager's follow up work identified a number of discrepancies which are part of normal financial accounting business: transactions coded to the wrong cost centre, lack of supporting evidence for some of the internal elements of the theme 3 and 4 costs and some variances between the amounts included in the financial statement for themes 3 and 5 and the amounts included in the associated general ledgers.

28. The conclusion of this work was that the total reported costs for 2011-12 were overstated by approx \$72k net – this has no impact on the funding amounts paid by the Ministry as all these overstated costs were being borne by Fonterra. We have reviewed the work done both by PWC (and the follow up work done by the Programme Administration Manager) and consider that this provides a sufficient level of comfort and assurance over the use of \$7.3m spent during 2011-12 on the programme.

Recommendation

Ref	Recommendation	Agreed/not agreed? (comments)
1	Consider whether given the size of this PGP programme it might require some similar assurance work done on the financial management of the programme before the programme is completed	Agreed

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The continued need for Fonterra to maintain a separate bank account for PGP funding

29. One of the requirements of the PGP contract between the Ministry and Fonterra was that Fonterra "hold all funding received from MAF¹ within specific bank accounts to be used only for the funding and Co-funding".
30. The intention of this arrangement was to ensure that funds remain separate and identifiable from other funding. There is a separate bank account in place which Fonterra has set up and uses to deposit its share of the contributions from MPI.
31. Fonterra have asked the Ministry to consider whether this bank account is still necessary. Given that the findings of this audit provide assurance that funds are separately identifiable and effectively managed, without the need for this account, we would recommend that Ministry PGP management consider whether this bank account is still needed.

Recommendation

Ref	Recommendation	Agreed/not agreed? (comments)
2	The requirement for a separate bank account for holding PGP funding contributions should be removed.	Agreed

¹ Now MPI

OBSERVATIONS FOR FONTERRA PGP MANAGEMENT TO CONSIDER

The need for Fonterra to revise longer term budgets as part of 2014-15 business planning process

32. Because of the interlinked nature of projects and the need for decisions on stop/go before committing further planned funds to a project the longer term thinking about exactly where to commit funds in 2014/15 to 2017/18 still needs to be considered (similar analyses have been done in earlier years). This will need to be done as part of the 2014-15 business plan (part of this process includes updating technology roadmaps) to better determine the spending for years 4 to 7 across each of the themes – this work is due to be done for March 2014.

Recommendation

Ref	Recommendation	Agreed/not agreed? (comments)
3	Revise longer term budgets as part of 2014-15 business planning process.	Agreed

The need for Fonterra and Dairy NZ to consider monitoring of overall spend against overall budget

33. To date there has been limited monitoring by Fonterra/Dairy NZ of how the Dairy NZ/Fonterra elements of the overall Dairy Value Chain spend are tracking against the overall budget. The \$72.5m funding profile for the Fonterra element includes Fonterra contribution of \$41m which Dairy NZ leverages off to ensure that the overall split of MPI to industry costs remain 50:50 so it is important that the programme partners have an

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overview of this. The Ministry is already doing a similar analysis for its own purposes.

Recommendation

Ref	Recommendation	Agreed/not agreed? (comments)
4	Monitor and report at high level on total programme spend and budget and then by each theme 1 to 5 to give an overall picture of spend against actual and budge	Agreed

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Appendix One Overall Assessment of Fonterra PGP financial management processes

Process	Conclusions and observations
Budgeting, cash flow and forecasting processes	<p>Overall conclusion: Budgeting and forecasting processes are sufficiently robust and are commensurate with the size and complexity of the Fonterra sub programme.</p> <ul style="list-style-type: none"> ○ As part of our work we looked at how some of the budgets had been set for a range of projects and elements of programmes against supporting evidence. There is sufficient rigour around budget setting and sufficient evidence to support budget assumptions. ○ Budgets are set for each of the three themes at a sufficient level of detail (milestone and individual project) with the input of the three theme leaders, the Chief Scientist and the Programme Admin Manager. ○ Budgets are recorded in a series of spreadsheets which clearly and concisely set out the proposed spending – these are also reported for quarterly reporting of financial performance. ○ Forecasting is done formally as a minimum three times a year at the end of the second, third and fourth quarters - as part of our work we looked at the processes used to forecast and reforecast costs for the same projects and elements assessed as part of the checks on budgeting. <p>Observations Because of the interlinked nature of projects and the need for decisions on stop/go before committing further planned funds to a project, the longer term thinking about where exactly to commit funds in 2014/15 to 2017/18 still needs to be considered (similar analyses have been done in earlier years). This will need to be done as part of the 2014-15 business plan (part of this process includes developing technology roadmaps) to better determine the spending for years 4 to 7 across each of the themes – this work is due to be done for March 2014. It is likely that programme will shorten and outyear costs reduce as more funds spent earlier.</p> <p>RECOMMENDATION FOR FONTERRA (recommendation 3 in main body of report): There will be a need to revise longer term budget as part of 2014-15 business planning.</p>
Financial management reporting processes	<p>Overall conclusion: Financial management reporting and monitoring processes are sufficiently robust and commensurate with the size and complexity of the Fonterra sub programme.</p> <ul style="list-style-type: none"> ○ Reporting is done formally each quarter - as part of our work we looked at monitoring and reporting for a range of projects and elements of programmes against supporting evidence. There is sufficient rigour around this monitoring and reporting. ○ Reports are developed with the input of the theme leaders who provide commentary on any variances. The quality and level of detail is commensurate with the scale and complexity of the spending. The financial reports for the Programme Steering Group

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Process	Conclusions and observations
	<p>include some commentary and a series of tables for each of the 3 themes with financial information.</p> <ul style="list-style-type: none"> Effective systems and processes for financial management are in place which include reconciliation controls to check amounts posted to general ledger codes against transactions and claimed from MPI: these operate as an effective control for checking completeness. Reporting and monitoring will be further enhanced by the development of effective tools such as Sharepoint. This is a web based product which allows the collection, collation and retention of information and data on each programme and project. While this requires data and information to be entered manually it does provide a good basis for driving reporting in the future. It has the functionality to allow input and manipulation of data in excel . It also allows the tracking of budgeted and actual financial information for projects, milestones, deliverables and free text commentary. <p>Observations</p> <p>To date there has been limited monitoring by Fonterra/Dairy NZ of how the Dairy NZ/Fonterra elements of the overall Dairy Value Chain spend are tracking against the overall budget. The \$72.5m funding profile for the Fonterra element includes the Fonterra contribution of \$41m which Dairy NZ leverages off to ensure that the overall split of MPI to industry costs remain 50:50 so it is important that the programme partners have an overview of this. The Ministry is already doing a similar analysis for its own purposes.</p> <p>RECOMMENDATION FOR FONTERRA AND DAIRY NZ(recommendation 4 in main body of report): There is a need for the combined partners Dairy NZ/Fonterra to monitor and report at high level on total programme spend and budget and then by each theme 1 to 5 to give an overall picture of spend against actual and budget – this is something the partners need to consider.</p>
Cost allocation processes	<p>Overall conclusion</p> <p>There are satisfactory processes for allocating, splitting and attributing costs between costs borne by Fonterra and those claimed from the Ministry.</p> <ul style="list-style-type: none"> Costs attributed between the Ministry and Fonterra on a 45:55 % split basis – claims and reports checked to ensure this calculation was correct Fonterra internal costs are attributed and charged on the basis of an annualised FTE unit cost – this calculation is based on an assessment of the total costs and headcount of the centre. We assessed the overarching methodology used to calculate this cost – at a high level the calculations look reasonable. Costs of other research providers are calculated on the basis of the providers agreed prices for the work. It was not part of the remit of this work to look at whether these contracts represent best value for money
Processing of payments	<p>Overall conclusion</p> <p>There are satisfactory processes for making and recording payments and these include:</p> <ul style="list-style-type: none"> Sufficient checking, oversight and approval of payments Effective separation and segregation of duties between procurers of services and accounts payable processing function and other accounting functions

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Process	Conclusions and observations
	<ul style="list-style-type: none"> ○ Controls over access to the accounts payable processing system (not tested) ○ Effective workflow processes embedded within the accounting software system SAP
Review of documentation and information	<p>Overall conclusion: The amounts being claimed from Ministry for actual cash costs are supported by sufficient, relevant and reliable records and the criteria for the funding are being met. This is based on:</p> <ul style="list-style-type: none"> ○ A review of 24 transactions selected for testing which accounted for \$2.5m of the approximately \$3.8m of PGP costs expenses incurred during the nine month period January to September 2013 i.e. approximately 65% of costs. ○ Sighting of signed contracts and statement of works, payment invoices and supporting documents such as progress reports on deliverables, for calculations of costs, other evidence to support deliverables of the programme for each of the transactions selected. ○ Review of files of invoices for all other transactions since June 2012 to identify any other potential transactions of interest i.e. other research organisations providing services not reviewed as part of main sample or other types of costs/method of payment not tested.

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SECTION 4: Action Plan

No	Recommendations	Action Description	Due Date	Responsibility
1	Consider whether given the size of this PGP programme it might require some similar assurance work done on the financial management of the programme before the programme is completed	MPI to agree timing for another assurance audit.	June 2014	Director PGP MPI
2	The requirement for a separate bank account for holding PGP funding contributions should be removed.	Confirm that Fonterra can close this account.	March 2014	Investment Manager - MPI
3	Revise longer term budgets as part of 2014-15 business planning process.	Develop out year investment projections as part of 2014-15 business planning process.	June 2014	General Manager technology Strategy Fonterra
4	Monitor and report at high level on total programme spend and budget and then by each theme 1 to 5 to give an overall picture of spend against actual and budge	Create an additional overall programme financial position statement for the PSG meetings based on both the Fonterra and Dairy NZ reports.	Next PSG meeting February	Programme Administration Manager Fonterra