VICTORIA

Report of the
AUDITOR-GENERAL
on the
TREASURER'S STATEMENT

for the year ended 30 June 1990

MELBOURNE
JEAN GORDON, GOVERNMENT PRINTER
1990

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PREFACE

FORMAT AND CONTENT OF THIS REPORT

Section 47 of the *Audit Act* 1958 requires that I make and sign a report explaining the Treasurer's Statement in full. This requirement is met by presentation in this report of:

- a review and analysis of the State's financial operations for the year ended 30 June 1990, and the financial position at 30 June 1990;
- comment on significant trends emerging over time in regard to the financial operations and position of the State; and
- reference to other financial issues which, in my opinion, warrant Parliament's attention.

The report also contains information on certain matters which are required to be reported to Parliament under other provisions of the *Audit Act* 1958.

This report contains 2 parts:

- Review of the Treasurer's Statement; and
- Matters of special interest.

Part 1: Review of the Treasurer's Statement fulfils the statutory obligation, under section 47 of the *Audit Act* 1958, for the Auditor-General to provide Parliament with explanation and comments on the Treasurer's Statement.

Part 2: Matters of special interest sets out a number of issues which are regarded by audit as important for improving the financial operations and accountability of State Government organisations.

FUTURE REPORTS OF THE AUDITOR-GENERAL

In respect of 1989-90 activities, I plan to complete, as a minimum, the following reports:

- **Special Report No. 14 - Accommodation Management,** which will focus on accommodation management practices within a number of Victorian public sector organisations (*expected tabling date - October 1990*).
- **Annual Report of the Office of the Auditor-General**, prepared in accordance with the *Annual Reporting Act* 1983 and describing the Office's activities, including the presentation of audited financial statements *(expected tabling date - October 1990).*
- **Report on Ministerial Portfolios,** providing comment on significant findings arising from the audit of departments and public bodies as well as comments on matters of broad scope interest *(expected tabling date - Autumn session, 1991).*

ACKNOWLEDGEMENTS

I acknowledge the co-operation and assistance my officers have received from most organisations in the conduct of audits. The growing complexity and scope of government increasingly requires closer and continuous liaison between my staff and officers of auditee organisations. Appreciation is expressed for the co-operative and positive approach to audit recommendations by officers of government agencies and the assistance provided by the Government Printer in the preparation of this report.

PART 1

REVIEW OF THE TREASURER'S STATEMENT

1.1 SUMMARY OF MAJOR AUDIT OBSERVATIONS

The major audit observations arising from the review of the Treasurer's Statement are:

CURRENT YEAR'S FINANCIAL RESULTS

Page 11

- The overall deficit of the Consolidated Fund for the year was $1.4 billion.

  para. 1.3.3

- Recurrent expenditure of $432 million, including interest charges, was financed from borrowings.

  para. 1.3.3

- Expenditure of $100 million on finance charges was incurred without parliamentary authority.

  para. 1.3.4

- Significant State financial obligations, the settlement of which should have been recorded in the Consolidated Fund, were instead transacted outside the Consolidated Fund by public bodies.

  para. 1.3.2

- The Government reacted to severe cash liquidity difficulties in 1989-90 with a range of measures.

  para. 1.3.9

- Short-term financing cost the State $70 million, compared with $6 million in the previous year.

  para. 1.3.15

- The impact of interest costs of $122 million on long-term borrowings was deferred to future years.

  para. 1.3.17

IMPACT OF ESCALATING DEFICITS

Page 19

- Accumulated deficits of $8.5 billion arising from Consolidated Fund operations over the last decade have been funded from borrowings.

  para. 1.4.1

BUDGET SECTOR FINANCIAL COMMITMENTS *Page 25*

- Budget sector indebtedness exceeds $32.6 billion which is equivalent to $7 430 per capita. In addition, the annual cost to service budget sector borrowings is $330 per capita.

  para. 1.5.2

- During the year, 17 per cent of available revenue was used to meet finance charges.

  para. 1.5.64

- Artificial arrangement, involving the Melbourne and Metropolitan Board of Works, used by the Victorian Development Fund (VDF) to obtain funds from private sector fund managers of $870 million.

  para. 1.5.40

- Illegal issue by the VDF of Treasury Bills totalling $316 million.

  para. 1.5.46

- The absence of independent supervision of the VDF's operations could expose the State to substantial financial risk.

  para. 1.5.49

- The Government is to acquire up to $2.7 billion of debt and related finance costs of the State Bank Group, of which $2 billion is expected to be offset by the proceeds generated from the sale of the Bank.

  para. 1.5.69

- Any further deterioration in Tricontinental's financial position will be required to be met by the Government.

  para. 1.5.72

- On current estimates, the Government may be liable to pay up to $250 million under its commitment to depositors of the Farrow Group of Building Societies.

  para. 1.5.73

- The Government has established a credit facility to provide liquidity support to the building society industry.

  para. 1.5.86

ANALYSIS OF CONSOLIDATED FUND RECEIPTS — *Page 53*

- The Treasurer's Statement still does not disclose how proceeds from asset sales were utilised.

  para. 1.6.10

- An urgent need exists for the Government to undertake a review of its revenue management practices, given the substantial cash flow difficulties encountered during the year.

  para. 1.6.21

ANALYSIS OF CONSOLIDATED FUND PAYMENTS — *Page 63*

- Operating expenses of $[illegible]00 million were classified as "works and services expenditure" and funded from capital receipts, including borrowings.

  para. 1.7.5

- The acquisition by the Government of additional equity in the Flexible Tariff Management Unit Trust was not funded from the Consolidated Fund and thus was not subject to parliamentary scrutiny.

  para. 1.7.9

OTHER MATTERS — *Page 69*

- Finance charges of $35 million, paid from the Consolidated Fund without parliamentary authority, have not been acquitted.

  para. 1.8.1

1.2 OVERVIEW

1.2.1 In this report, reference has been made to expenditure of $35 million made without parliamentary appropriation and financial obligations of $65 million which have been transacted outside the Consolidated Fund. I am concerned that both forms of transactions circumvent parliamentary scrutiny and control of public funds.

1.2.2 The techniques currently employed in the Government's budget sector, such as accounting for transactions on a "nett" basis and the use of "off balance sheet" financing have the serious consequence of enabling significant financial transactions involving the Consolidated Fund to be entered into without parliamentary authority and scrutiny. If Parliament is to maintain its fundamental role of controller of the public purse, I believe that information on the "gross" flow of funds should be provided to the Parliament.

1.2.3 In the past year there has been considerable parliamentary and community debate regarding the financial management of the State, the increasing level of State debt and the State's capacity to address the current and future financial and economic issues.

1.2.4 The estimated indebtedness of the budget sector at 30 June 1990 amounted to $32.6 billion, with associated finance costs for the year of [illegible] billion. This compares with a $29.3 billion debt level at 30 June 1989 and finance costs of $1.2 billion for that year.

[illegible].5 The significant increase that has [illegible]curred in both the level of debt and [illegible]ciated finance costs has been [illegible]y due to:

- the State's economic program;
- an established practice of refinancing rather than retiring maturing debt;
- extended use of short-term financing;
- the practice of deferring the impact of finance costs to future periods;
- the effect of significant losses incurred by various enterprises including State-owned bodies; and
- lower than expected receipts resulting from a downturn in economic activity within the State.

1.2.6 During 1989-90, the Government continued with an asset sales program which over the last 3 years has raised $604 million. To date, the proceeds of these sales have not been used to retire debt.

1.2.7 The report indicates that, over the last decade, continuing and increasing deficits have been incurred by the State's budget sector which have been funded by borrowings. Although the majority of borrowings have resulted in the State acquiring assets, these have generally not been income-producing but rather infrastructure assets such as roads, hospitals and schools. As deficits have accumulated, the State's capacity to fund its expenditure programs has deteriorated, with a greater proportion of revenue being absorbed by finance charges. This places an ever increasing burden on both present and future taxpayers.

1.2.8 The Treasurer has announced that the primary focus of the 1990-91 Budget is to be debt management. A strategy to address the budget sector's debt burden was foreshadowed and is to include the following features:

- the establishment of a debt retirement fund which will be funded from asset sale proceeds and be applied to the reduction of debt;
- a reduction in borrowing requirements compared with previous years; and
- a nominal reduction in the level of debt.

1.2.9 The above strategy goes some way to address the State's debt burden. However, to obtain a long-term reduction in debt, the focus embodied in this year's Budget must be sustained. Should sufficient control not be exercised, the current difficulties experienced in the funding of government expenditures will be compounded, particularly in a climate of reducing Commonwealth financial assistance.

1.2.10 In addition to the measures announced by the Treasurer, the following matters identified by my Office in previous reports to Parliament would also assist in the management of the budget sector's debt:

- better revenue collection procedures at the State Taxation and Stamp Duties Offices;
- improved expenditure management practices aimed at minimising the costs incurred in providing services;
- maximised use of opportunities to contract out services to the private sector where there is scope for cost savings; and
- enhanced financial management reporting systems to disclose details of all actual debt outstanding and associated finance charges that have been incurred in the period.

1.2.11 Finally, the adoption of accrual accounting for the reporting of the budget sector's operations and financial position, to supplement the current cash-based system, will provide more meaningful information to Parliament. This will also facilitate introduction of consolidated reporting of public sector assets and liabilities, and greatly enhance the standard of accountability in Victoria.

1.3

CURRENT YEAR'S FINANCIAL RESULTS

KEY FINDINGS

- Expenditure of $100 million on finance charges was incurred without parliamentary authority.

  paras 1.3.4 to 1.3.7

- Significant State financial obligations, the settlement of which should have been recorded in the Consolidated Fund, were instead transacted outside the Consolidated Fund by public bodies.

  paras 1.3.2 to 1.3.4

- The overall deficit of the Consolidated Fund for the year was $1.4 billion.

  paras 1.3.1 to 1.3.3 and 1.3.8

- Recurrent expenditure of $432 million, including interest charges, was financed from borrowings.

  para. 1.3.3

- The Government reacted to severe cash liquidity difficulties in 1989-90 with a range of measures.

  paras 1.3.9 to 1.3.23

- Short-term financing cost the State $70 million, compared with $6 million in the previous year.

  paras 1.3.13 to 1.3.16

- The impact of interest costs of $122 million on long-term borrowings was deferred to future years.

  para. 1.3.17

Current year's financial results

Disagreement with the Treasurer's Statement

1.3.1 The Treasurer's Statement indicates an overall deficit before borrowings on the operation of the Consolidated Fund of $1 billion, (1988-89, $1.2 billion) with the recurrent deficit trebling to $332 million (1988-89, $116 million). To comply with the *Public Account Act* 1958 the Treasurer has balanced the Consolidated Fund and has done so through the use of borrowings.

1.3.2 However, a review of the Treasurer's Statement disclosed that:

- Borrowings from sale and lease-back arrangements totalling $347 million have not been classified as part of budget sector debt (refer paragraph 1.5.15 to 1.5.19);
- An amount of $35 million, which in audit opinion constitutes borrowings, was used to meet interest payments and was netted off within the Consolidated Fund against such payments; and
- Amounts totalling $65 million obtained by the Victorian Public Authorities Finance Agency (VicFin) on behalf of the Consolidated Fund were netted off outside the Fund against interest payments due from the Fund. Audit also regards these amounts as borrowings.

1.3.3 In order to arrive at the actual cash deficit for the year, before borrowings, the proceeds from sale and lease-back arrangements of $347 million need to be deducted from receipts and the 2 offsets against interest totalling $100 million added to payments. **After allowing for these adjustments, the overall deficit of the Consolidated Fund operations funded from borrowings is $1.4 billion, with the recurrent deficit $432 million.**

Payments made without parliamentary authority

1.3.4 The practice adopted of offsetting interest costs by borrowings had 3 serious implications in 1989-90:

- **expenditure on finance charges of $100 million was incurred without parliamentary authority;**
- **significant State financial obligations, which should have been recorded in the Consolidated Fund, were instead transacted outside the Fund by public bodies; and**
- **interest payments and borrowings of the Consolidated Fund have been understated by $100 million.**

1.3.5 The final expenditure, as determined by audit, on the item "Finance Charges - Capital Works Authority" was $642 million which exceeded the parliamentary appropriation of $542 million.

1.3.6 Table 1.3A compares the final expenditure with the relevant parliamentary appropriation.

TABLE 1.3A
EXPENDITURE WITHOUT PARLIAMENTARY AUTHORITY
(Program 726 - Item 3611)

Item		*($million)*
Appropriation -		
Appropriation as per *Appropriation (1989-90, No.1) Act* 1989		567
Transferred to Program 726 - Item 3481*(a)*		(25)
Final Appropriation (which equates with payments recorded in the Treasurer's Statement)		542
Payments not covered by Appropriation -		
Borrowings offset against payments	35	
Payment of finance charges by VicFin	65	100
Final expenditure for year		642
Excess of payments over Appropriation		100

(a) Transfer authorised by Governor-in-Council under section 25 of the *Audit Act* 1958.

1.3.7 While I see the fundamental issue as ensuring that all financial transactions of the Consolidated Fund are made with parliamentary authority, the Department of the Treasury has maintained that the transactions involving the $100 million are interest swap transactions which have been used as a part of the Government's debt management strategy over a number of years. However, I cannot agree with this view as the transactions in question involve the deferral of obligations and are in substance borrowings. Even if the Department's assertion on classification of interest swaps could be sustained, which as indicated I do not support, the fundamental issue of expenditure incurred without parliamentary authority remains.

Re-statement of financial results by audit

1.3.8 Table 1.3B shows the operating results of the Consolidated Fund as determined by audit, after eliminating borrowings, to identify the overall deficit funded from borrowings.

TABLE 1.3B
OPERATING RESULTS OF THE CONSOLIDATED FUND
($million)

Item	*(a)Actual 1988-89*	**Actual 1989-90**	*Budget 1989-90*	**Variation from Budget**
Recurrent -				
Receipts	10 149	**10 663**	10 828	**(165)**
Payments	10 265	**11 095**	10 883	**(212)**
Recurrent deficit for year	(116)	**(432)**	(55)	**(377)**
Works and services -				
Receipts excluding borrowings	882	**922**	1 102	**(180)**
Payments	1 977	**1 936**	2 007	**71**
Works and services deficit for year before borrowings	(1 095)	**(1 014)**	(905)	**(109)**
Overall deficit for year funded from borrowings	(1 211)	**(1 446)**	(960)	**(486)**

(a) For comparative purposes, figures as disclosed in my 1988-89 report have been adjusted to exclude all borrowings.

Consolidated Fund cash liquidity problems

1.3.9 Generally, patterns of revenue collection have not always matched with those of payments, resulting in temporary cash shortfalls in the Consolidated Fund. The Government has traditionally managed these shortfalls by the use of short-term financing.

1.3.10 During 1989-90 cash shortfalls experienced by the Government were substantially higher than in previous years. This position was due to a combination of factors, including a higher than expected level of finance charges, lower than anticipated taxation and asset sales receipts, and the fact that recurrent expenditure was not reduced during the year but was $212 million in excess of budget.

1.3.11 The Government reacted to these factors by pursuing a range of measures in 1989-90 to address the cash liquidity difficulties. These measures included:

- Extensive use of short-term financing at a cost of $70 million, compared with only $6 million in 1988-89;
- Deferring the impact of interest costs of $122 million on long-term borrowings to future periods;
- Higher than budgeted borrowings through sale and lease-back transactions of $167 million;

- Special borrowings of $90 million from the Victorian Development Fund to offset the failure to achieve budgeted receipts from asset sales;
- An early recall from the Government Employee Housing Authority of $29.6 million of loans with interest rates of 3 per cent. The Authority financed this transaction by raising borrowings with interest rates ranging from 15.3 to 15.5 per cent;
- Advanced call-up of $65 million of public authority dividends in February 1990 which normally would have been paid in the period March to June 1990; and
- A requirement for racing clubs to pay fractions and commissions of $8.2 million in June rather than July 1990.

1.3.12 Discussion on the above measures follows.

Increased use of short-term financing

1.3.13 The substantial cash shortfalls experienced during the year were mainly overcome by borrowings on a short-term basis from the Victorian Development Fund and VicFin.

1.3.14 Temporary borrowings during 1989-90 cost the Consolidated Fund $70 million. Borrowings obtained from the Victorian Development Fund and VicFin totalled $4.8 billion and $1.5 billion, respectively. As at 30 June 1990, an amount of $367 million in respect of borrowings from the Victorian Development Fund had not been repaid.

1.3.15 Table 1.3C shows the cost impact of the increased use of short-term financing in 1989-90 compared with prior years.

TABLE 1.3C
COST OF SHORT-TERM FINANCING
($million)

Year	*Amount*
1985-86	1
1986-87	14
1987-88	7
1988-89	6
1989-90	**70**

1.3.16 While audit recognises that many factors may influence financing costs, an analysis of the 2 temporary borrowing facilities utilised during the year revealed that costs were substantially lower for borrowings from VicFin. **If this agency alone had been used to obtain temporary finance, savings of around $6 million could have been achieved.**

Re-financing of interest costs on long-term borrowings

1.3.17 During 1989-90 the Government followed a policy of managing increases in finance charges on long-term borrowings through the restructuring of its debt portfolio with a view to spreading such costs over future years. **The impact of finance charges amounting to $100 million has been deferred to future periods by refinancing the amounts owed. In addition, the State has obtained financial instruments which defer the payment of interest for a number of years. Interest accrued on these debt instruments amounted to $22 million in 1989-90.** Further discussions on finance charges is provided in paragraphs 1.5.57 to 1.5.67 of this report.

Increased use of sale and lease-back arrangements

1.3.18 As part of its asset sales target of $560 million, the Government budgeted to receive $180 million through sale and lease-back arrangements. **However, to compensate for the shortfall in other projected asset sales, the use of these arrangements, which audit considers constitute borrowings, was extended with proceeds for the year totalling $347 million, which was $167 million above budget.**

Special borrowings

1.3.19 In June 1990, a decision was made to procure bridging finance to help offset the shortfall in proceeds from asset sales. A special arrangement was entered into between the Victorian Development Fund and the Department of the Treasury under which a $90 million advance was provided to the Consolidated Fund. The Government has indicated the advance is to be repaid from the proceeds it expects to receive from the sale of certain assets including the Queen Victoria and Royal Mint sites. This advance has been correctly disclosed in the Treasurer's Statement as *"borrowings in lieu of asset sales"* and is included as part of the State's budget sector borrowings.

Early recall of loans from Government Employee Housing Authority

1.3.20 Since 1971 the Government Employee Housing Authority has obtained from the Consolidated Fund a number of loans at concessional interest rates of 3 per cent to be repaid over a period of 53 years. **In 1989-90 the Authority was required to repay the outstanding balance of the loans amounting to $29.6 million together with interest charges of $890 000. To finance this payment, the Authority found it necessary to borrow $27 million at interest rates ranging from 15.3 to 15.5 per cent.**

Early collection of public authority dividends

1.3.21 Dividends and statutory contributions are received by the Consolidated Fund from various public authorities under the *Public Authorities (Dividends) Act* 1983 and other specific legislative provisions. Dividends are also received from the Portland Smelter Unit Trust by virtue of the State's equity in that Trust.

1.3.22 In past years, public authorities have been required by the Government to pay dividends on a monthly basis. **Due to the cashflow problems experienced by the Consolidated Fund in 1989-90, the Treasurer required the Melbourne and Metropolitan Board of Works and the State Electricity Commission of Victoria to pay in advance, in February 1990, dividends totalling $65 million normally due in the months March to June 1990.**

Advanced collections from racing industry

1.3.23 The *Racing Act* 1958 requires racing clubs to pay fractions arising from the rounding of dividends to the Consolidated Fund in July and January of each year. Following negotiations between the racing clubs and the Government, an agreement was reached for the July 1990 payments to be made in advance to the Consolidated Fund in June. **This arrangement resulted in 3 payments by racing clubs during the year with an extra $4.2 million being paid into the Consolidated Fund. In addition, commission on totalizator investments totalling $4 million, which was due in July 1990, was required to be paid in June.**

1.4 IMPACT OF ESCALATING DEFICITS

KEY FINDINGS

- Accumulated deficits of $8.5 billion arising from Consolidated Fund operations over the last decade have been funded from borrowings.
  paras 1.4.1 to 1.4.4
- Increased reliance on borrowings for the funding of programs has been consistent with the Government's economic strategy.
  paras 1.4.5 to 1.4.8
- Debt is becoming more difficult to manage as the Government's commitments have continued to increase at a greater rate than its income.
  paras 1.4.9 to 1.4.11

Impact of Consolidated Fund results on budget sector borrowings

1.4.1 Over the past 10 years the Consolidated Fund operations have resulted in accumulated deficits of $8.5 billion which have been funded from borrowings.

1.4.2 Table 1.4A summarises the financial operations of the Consolidated Fund for the years 1980-81 to 1989-90 and the impact of these operations on budget sector borrowings.

TABLE 1.4A ANALYSIS OF BUDGET SECTOR FINANCIAL PERFORMANCE
($million)

Item	*1980-81*	*1981-82*	*1982-83*	*1983-84*	*1984-85*	*1985-86*	*1986-87*	*1987-88*	*1988-89*	*1989-90*
Recurrent surplus/ (deficit)*(a)*	(19)	12	(148)	28	41	(60)	5	141	(116)	(432)
Works and services deficit	(238)	(339)	(441)	(785)	(869)	(1 019)	(1 129)	(1 049)	(1 095)	(1 014)
Annual deficit	(257)	(327)	(589)	(757)	(828)	(1 079)	(1 124)	(908)	(1 211)	(1 446)
Accumulated deficits funded from borrowings	**(257)**	**(584)**	**(1 173)**	**(1 930)**	**(2 758)**	**(3 837)**	**(4 961)**	**(5 869)**	**(7 080)**	**(8 526)**

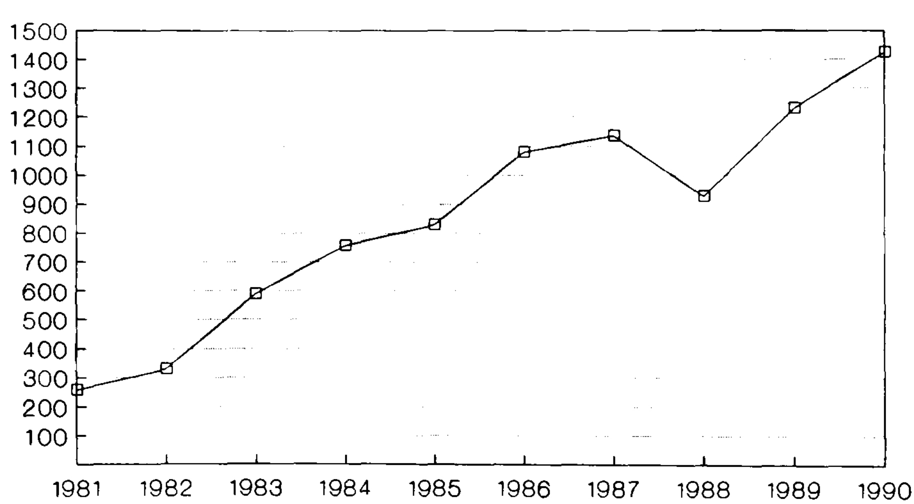
(a) In determining recurrent surplus/deficit for each period cash balances from prior years have been excluded.

1.4.3 The above table indicates that:

- **Borrowings have been principally used to fund deficits on works and services operations. Works and services expenditure funded from borrowings has increased from $238 million in 1980-81 to $1 billion in 1989-90; and**
- **In the period the aggregate deficit on recurrent operations of $548 million has also been funded from borrowings.**

1.4.4 Furthermore, Chart 1.4B shows the rate of increase of annual deficits over the 10 year period.

CHART 1.4B ANNUAL DEFICITS
($million)



Why have deficits occurred?

1.4.5 Deficits have occurred in Victoria due mainly to the following factors:

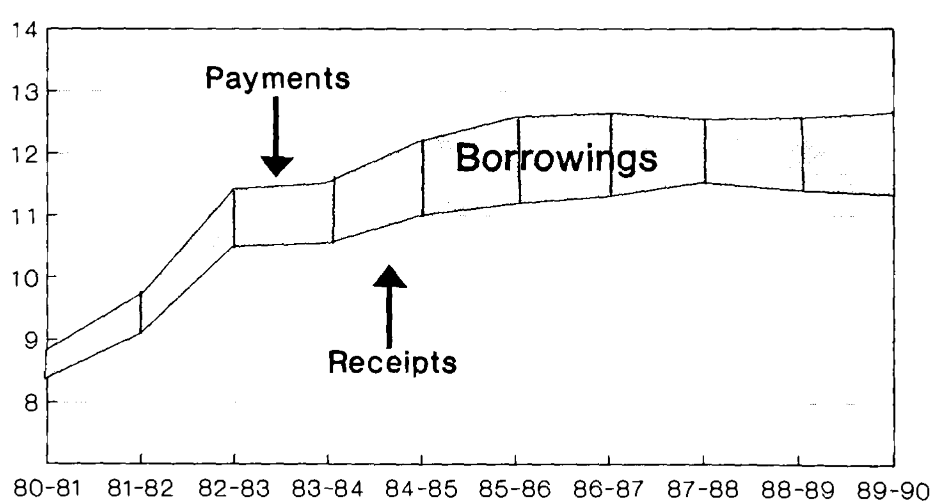
- the central focus of the Government's economic strategy which to date has been to promote long-term growth and increased employment in Victoria; and
- the established practice of the State to fund expenditure relating to the purchase or construction of assets, with long economic lives, from borrowings.

1.4.6 Under the economic strategy, the Government has implemented various expenditure programs targeted towards upgrading the State's economic and social infrastructure, with emphasis on transport, energy, education and health. At the same time, a range of taxes and charges have been held by the Government at or below the annual rate of inflation.

1.4.7 The rationale for the practice of funding expenditure on assets from borrowings is that major assets provide a stream of services to users over their productive lives and it is appropriate for beneficiaries of such services to contribute to the cost of the assets. Under this approach, present taxpayers do not totally fund assets which provide services to future generations.

1.4.8 **These factors have resulted in an increasing reliance by the State on borrowings for the funding of programs.** Chart 1.4C illustrates this position.

CHART 1.4C
FUNDING OF GAP BETWEEN RECEIPTS AND PAYMENTS
(in constant 1989-90 prices)
($million)



Implications of accumulating deficits and associated borrowings

1.4.9 Some generally accepted arguments for and against the practice of incurring deficits are stated below:

- deficits stimulate economic growth;
- funding of deficits by borrowings facilitates application of the user pay concept;
- deficits and debt expose the State to financial risk in times of economic downturn; and
- costs associated with current borrowings are passed to future generations.

1.4.10 Irrespective of the divergence in views on the desirability of deficits and their funding through borrowings, it is important that debt levels are carefully monitored and controlled. Without close scrutiny there is a risk that the growth in accumulated deficits and related borrowings could outpace the capacity of the State to meet associated borrowing costs, thereby placing pressure on the Government's ability to maintain existing levels of service or to introduce new programs.

1.4.11 Put simply, debt becomes increasingly difficult to manage if income does not keep pace with commitments. In this context, it is relevant to point out that, over the past decade, budget sector borrowings in Victoria, to fund deficits, have accumulated to $8.5 billion at 30 June 1990 which includes a deficit on recurrent operations of $548 million. The position becomes even more critical when other budget sector borrowings, such as the assumption of State Bank of Victoria and VEDC debt, are taken into account.

1.5

BUDGET SECTOR FINANCIAL COMMITMENTS

KEY FINDINGS

- Budget sector indebtedness exceeds $32.6 billion which is equivalent to $7 430 per capita.

  paras. 1.5.2 to 1.5.4

- The annual cost to the community to service budget sector borrowings is $330 per capita.

  para. 1.5.64

- During the year, 17 per cent of available revenue was used to meet finance charges.

  para. 1.5.64

- Finance charges incurred by the budget sector will rise by approximately $5 million per annum due to the downgrading of the State's credit rating.

  paras 1.5.66 to 1.5.67

- The absence of independent supervision of the Victorian Development Fund's (VDF) operations could expose the State to substantial financial risk.

  paras 1.5.49 to 1.5.53

- Illegal issue by the VDF of Treasury Bills totalling $316 million.

  paras 1.5.46 to 1.5.48

- Artificial arrangement, involving the Melbourne and Metropolitan Board of Works, used by the VDF to obtain funds from private sector fund managers of $870 million.

  paras 1.5.40 to 1.5.45

- Doubt exists as to the authority of the VDF to raise funds from Commonwealth and interstate statutory authorities.

  paras 1.5.54 to 1.5.56

- The Government is to acquire up to $2.7 billion of debt and related finance costs of the State Bank Group, of which $2 billion is expected to be offset by the proceeds generated from the sale of the Bank.

  paras 1.5.69 to 1.5.72

KEY FINDINGS - *continued*

- Any further deterioration in Tricontinental's financial position will be required to be met by the Government.

  para. 1.5.72

- On current estimates, the Government may be liable to pay up to $250 million under its commitment to depositors of the Farrow Group of Building Societies.

  paras 1.5.73 to 1.5.79

- The Government has established a credit facility to provide liquidity support to the building society industry.

  paras 1.5.86 to 1.5.89

SUMMARY OF BUDGET SECTOR FINANCIAL COMMITMENTS

1.5.1 The topic of State indebtedness has in recent times generated considerable community and parliamentary debate. It is therefore in the public interest to provide comment on the total indebtedness of the State's budget sector, including borrowings and other financial commitments.

Indebtedness

1.5.2 **The total budget sector indebtedness at 30 June 1990 is $32.6 billion, which is equivalent to approximately $7 430 per capita.** Table 1.5A summarises this indebtedness.

TABLE 1.5A
TOTAL BUDGET SECTOR INDEBTEDNESS
($billion)

Item	*Amount*
Borrowings	15.0
Employee entitlements -	
Unfunded superannuation liabilities*(a)*	16.0
Accrued leave	0.9
Creditors and accrued interest	0.7
Total indebtedness	**32.6**

(a) Based on latest available actuarial estimates of unfunded superannuation liabilities adjusted for inflation by audit.

1.5.3 Budget sector indebtedness comprises the debt of the Consolidated Fund and those statutory authorities whose operations are substantially funded from the Consolidated Fund. It does not include the debt of non-budget sector public bodies, such as the State Electricity Commission of Victoria, the Melbourne and Metropolitan Board of Works, and the Gas and Fuel Corporation.

1.5.4 The Treasurer's Statement provides certain information regarding the financial commitments of the budget sector, including the value of borrowings, trade creditors and contingent liabilities relating to government guarantees, but the information is not presented in a consolidated form. **In audit opinion, there is an urgent need for inclusion within the Treasurer's Statement of a consolidated statement of all budget sector financial commitments. This information would assist the Parliament in its consideration of the budget sector's financial position.**

1.5.5 A detailed analysis of budget sector borrowings and finance charges is provided in paragraphs 1.5.13 to 1.5.67 of this report.

Other financial commitments

1.5.6 In addition to the budget sector indebtedness referred to previously, the State has entered into a number of arrangements which will have a significant impact on its financial operations in future years. These arrangements were as follows:

- *State Bank Group*

  An agreement to acquire up to $2.7 billion of debt and related finance costs of the State Bank Group (which includes debt of $576 million assumed by the State under an earlier agreement) due to the poor financial performance of Tricontinental Corporation Limited, a subsidiary of the State Bank of Victoria. In view of the prohibitive level of the costs to service the acquired debt, **the Government has determined to sell the State Bank of Victoria to the Commonwealth Bank of Australia**. Under the agreement the State will be required to assume financial responsibility for any further increase in Tricontinental's bad debts;

- *Farrow Group of Building Societies*

  A government undertaking that the depositors' funds of the Farrow Group of Building Societies are to be guaranteed. The administrator of the Group has estimated that **the Government may be liable for up to $250 million** by way of shortfall on asset disposal. In addition, the State is liable to compensate the State Bank of Victoria for financing costs incurred by the Bank in funding returns to Farrow Group depositors; and

- *Operating leases*

  Operating lease arrangements entered into by the budget sector which have **commitments exceeding $630 million.**

1.5.7 More detailed information on these financial commitments is included in paragraphs 1.5.68 to 1.5.81 of this report.

Contingent liabilities

Guarantees

1.5.8 Government guarantees provided to private and public organisations up **to 30 June 1990 totalled $48.1 billion** and relate mainly to the repayment of borrowings. Details of guarantees are provided in the Treasurer's Statement.

Building society industry liquidity support scheme

1.5.9 Subsequent to 30 June 1990, **the Government established a credit facility** to provide liquidity support to the building society industry.

Victorian Equity Trust

1.5.10 The Government has executed a deed of covenant with the Victorian Equity Trust (VET) to meet, in the event of any default by the Victorian Economic Development Corporation, its commitments to unit holders of the VET.

1.5.11 An option is exerciseable by VET unit holders in 1992 to sell back trust units to the State. **If this option is taken up by all unit holders, audit estimates the financial obligation of the State would be around $700 million.**

1.5.12 Further comment on the State's contingent liabilities is contained in paragraphs 1.5.82 to 1.5.97 of this report.

BUDGET SECTOR BORROWINGS

What is the current level of budget sector borrowings?

1.5.13 The budget sector's accumulated borrowings at 30 June 1990 amounted to $15 billion, an increase of $9.4 billion over the last decade. This increase was largely accounted for by the need to fund deficits of the Consolidated Fund ($8.5 billion) as previously detailed in paragraph 1.4.2.

1.5.14 Table 1.5B details movements in budget sector borrowings during the year.

TABLE 1.5B

MOVEMENTS IN BUDGET SECTOR BORROWINGS
($million)

Item		*State*	*Common-wealth*	**Total**
Public Account -				
At 1 July 1989		6 104	6 201	**12 305**
Net borrowings Consolidated Fund	944			**944**
Borrowings from sale and lease-back arrangements	*347			**347**
Borrowings to defer interest payments	*78	*(a)*1 369		**78**
Assumption of State Bank debt		576		**576**
Indexation on loans		99		**99**
Discount on loans		98		**98**
Centralisation of Transport debt		67		**67**
Net borrowings held in Trust Fund		45		**45**
Assumption of VEDC debt		14		**14**
Redemption of debt		(10)	(48)	**(58)**
Total Public Account borrowings*(b)*		8 362	6 153	**14 515**
Budget sector statutory authorities -				
At 1 July 1990		560		**560**
Net borrowings		(47)		**(47)**
Total budget sector statutory authority borrowings		513		**513**
Total budget sector borrowings*(c)*		8 875	6 153	**15 028**

(a) The 1989-90 operating deficit of $1 446 million, as stated in paragraphs 1.3.8 and 1.4.2, is funded from borrowings of $1 369 million, a balance brought forward of $55 million and $22 million of interest expense that was refinanced and is included in the face value of budget sector borrowings disclosed in the Treasurer's Statement.

(b) Audit estimates that the cost of servicing the debt (finance charges) over the next 3 years, based on the current level of debt, assuming no early retirement of the debt and constant interest rates is: $1 380 million, 1990-91; $1 440 million, 1991-92; and $1 300 million, 1992-93.

(c) The Treasurer's Statement discloses budget sector borrowings of $14 603 million. However, this amount is understated by $425 million as those items asterisked (*) above have not been included in the Treasurer's Statement as borrowings.

Borrowings from sale and lease-back arrangements

1.5.15 Since 1982 the State, through the Public Transport Corporation, has made considerable use of sale and lease-back arrangements for the raising of finance. **At 30 June 1990, approximately 65 per cent ($767 million) of the value of all the Corporation's rolling stock assets was subject to such arrangements.**

1.5.16 During 1989-90 the Corporation entered into 4 sale and lease-back arrangements relating to rolling stock assets which included 36 suburban trains, 42 locomotives, 50 articulated light rail vehicles and 60 buses. The assets were sold offshore for $347 million and leased back by the Corporation for terms ranging from 4 to 7 years, with renewable options.

1.5.17 Based on the Department of the Treasury's assessment of these arrangements and after taking into account external accounting advice, the Department has classified the leases as operating leases. For this reason the leases have not been included in the Treasurer's Statement as budget sector borrowings or included as new borrowings for Loan Council purposes.

1.5.18 The lease arrangements, in substance, have not substantially transferred the risks and benefits incidental to ownership of the assets to an external party but have committed the State to future financial obligations. In audit opinion, having regard to the economic substance of the transactions, the leases are simply another form of borrowing and should have been taken into account for Loan Council purposes and reported as borrowings in the Treasurer's Statement.

1.5.19 The audit examination also disclosed that under these arrangements finance costs are higher than conventional forms of borrowings as a premium is payable in addition to the market rate.

Assumption of State Bank debt

1.5.20 Due to substantial financial difficulties experienced by Tricontinental Corporation Limited, a subsidiary of the State Bank of Victoria, the Treasurer of Victoria in February 1990 entered into an agreement with Tricontinental under which the State agreed to pay a maximum amount of $795 million over a 5 year period to compensate for bad debts written-off. A subsequent agreement between the Treasurer and the Bank provided that the Bank would make payments directly to Tricontinental in return for the State assuming debt of the Bank equal to the payments made. **Under the above arrangements, the State in 1989-90 assumed State Bank debt totalling $576 million.**

1.5.21 The annual cost to the State of servicing this debt is estimated by audit to be $81 million.

1.5.22 Before entering into these agreements the Department of the Treasury sought advice from the Solicitor-General as to the authority of the Treasurer to enter into such arrangements. In response the Solicitor-General advised that:

> *"In my opinion the Treasurer has power on behalf of the State of Victoria to enter into those 2 agreements. He will need an appropriation for that purpose to allow him to make payments of interest and principal in respect of the State Bank securities."*

1.5.23 The impact on the State of recent developments relating to additional financial support, including the sale of the Bank, is further discussed in paragraphs 1.5.69 to 1.5.72 of this report.

Impact of collapse of Victorian Economic Development Corporation

1.5.24 Due to the serious financial position of the Victorian Economic Development Corporation (VEDC), the Treasurer had directed, in November 1988, that the Rural Finance Corporation of Victoria (RFC) acquire certain of the assets, discharge all liabilities and take over management of the business and affairs of the VEDC.

1.5.25 During 1989-90 the Consolidated Fund assumed further VEDC debt of $14.2 million and the repayment of $10.8 million previously lent to the VEDC from the Victorian Investment Corporation Limited was forgiven. These actions were additional to those taken in the previous year, whereby:

- A $40 million loan to RFC from the Consolidated Fund was converted to an equity investment in that body. The Treasurer estimated that the cost of the arrangement to the Consolidated Fund would be $2.6 million a year;
- Responsibility for repayment of $20 million of VEDC debt was taken over by the State. The additional interest charges to the State were estimated by the Treasurer at $3.1 million a year; and
- The State purchased the VEDC's $2 million equity in the company, Victorian Investment Corporation Limited.

1.5.26 The State also holds equity capital of $32.6 million in the VEDC which is considered to have no value.

1.5.27 My previous report on the Treasurer's Statement indicated that the Consolidated Fund lost $52.6 million as a result of the collapse of the VEDC. The following table updates that position.

TABLE 1.5C
ACCUMULATED FINANCIAL IMPACT OF VEDC COLLAPSE ON CONSOLIDATED FUND

Item		*$million*
1988-89 -		
Debt assumed	20.0	
VEDC equity considered to have no commercial value	32.6	52.6
1989-90 -		
Debt assumed	14.2	
Debt forgiven	10.8	25.0
		77.6
Interest cost on debt assumed	4.6	
Income forgone on conversion of debt to equity	3.9	8.5
Total cost to Consolidated Fund at 30 June 1990		**86.1**

1.5.28 Audit estimates that the cost to the Consolidated Fund of debt assumed, forgiven and converted to equity will be $9 million in the 1990-91 year.

1.5.29 The current position of VEDC loans considered doubtful, when acquired by RFC in 1988-89, is disclosed in Table 1.5D.

TABLE 1.5D
VEDC DOUBTFUL DEBTS

Item	*$million*
Doubtful debts at date of transfer	111.7
Additional doubtful debts, 1988-89	18.3
Decrease in doubtful debts, 1989-90	(3.0)
	127.0
Less debts written-off by RFC	**57.2**
Total doubtful debts at 30 June 1990	69.8

Victorian Investment Corporation Limited

1.5.30 In my 1988-89 report on the Treasurer's Statement, comment was made on the sale of the Government's equity in the Victorian Investment Corporation Limited (VIC), which cost the State $25.5 million, to a subsidiary of the State Bank of Victoria for a nominal amount of $10. At the date of sale, assets and liabilities held by VIC were both valued at $14 million.

1.5.31 Prior to the sale, the State purchased VIC's investment shareholdings and certain other assets valued at $51.7 million. As consideration for these assets, the State assumed $51.7 million of VIC's liabilities and contingent liabilities estimated at $2.5 million.

1.5.32 Table 1.5E indicates the cost to the Consolidated Fund at June 1990 arising from the State's involvement with VIC.

TABLE 1.5E
ACCUMULATED FINANCIAL IMPACT OF VICTORIA INVESTMENT CORPORATION ON THE CONSOLIDATED FUND

Item		*$million*
1988-89 -		
Liabilities assumed	51.7	
Equity transferred at no value	25.5	77.2
Less assets assumed*(a)*		*(b)*51.7
		25.5
Interest expense		8.3
Payments made under indemnity provided		1.2
Revenue earned		(0.4)
Total cost to Consolidated Fund at 30 June 1990		**34.6**

(a) Based on valuation when transferred in 1988-89. At the date of preparation of this report, the Department of Industry had not reassessed the value of these assets.

(b) Loan forgiven of $10.8 million has not been included in the table as its ultimate impact is on VEDC (refer paragraph 1.5.25).

BORROWINGS BY THE VICTORIAN DEVELOPMENT FUND ON BEHALF OF THE CONSOLIDATED FUND

Introduction

1.5.33 The Victorian Development Fund (VDF) was established in 1982 under the *Public Account Act* 1958, and comprises the Cash Management Account (CMA) and the State Development Account (SDA) which are 2 accounts within the Trust Fund. The purpose of the VDF as outlined in the Treasurer's Second Reading speech to the Parliament was to provide efficient management of the Victorian public sector's liquid resources.

1.5.34 The Cash Management Account accepts deposits for periods of less than 12 months from public sector agencies declared as relevant authorities by the Governor-in-Council. Moneys standing to the credit of the Account can be lent to the Consolidated Fund or invested in any manner declared by the Governor-in-Council for periods of less than 12 months. The State Development Account has similar functions to the Cash Management Account but it can only accept deposits for periods exceeding 12 months.

1.5.35 Temporary cash shortfalls in the Consolidated Fund during 1989-90 were partly overcome by borrowing $4.8 billion from the Cash Management Account. Of this amount $4.4 billion had been repaid, leaving a balance of $367 million outstanding at 30 June 1990. **Interest paid by the Consolidated Fund on these advances amounted to $38 million.**

1.5.36 In addition, the Consolidated Fund borrowed $114 million during 1989-90 from the State Development Account to fund capital works.

Treasury Bills

1.5.37 In 1989 the Victorian Development Fund (Treasury Bills) Regulations were proclaimed under the Public Account Act. The Regulations provide that, inter alia:

- the Treasurer may issue Treasury Bills to relevant authorities **for deposits lodged** with the Cash Management Account or State Development Account;
- Treasury Bills are transferable by delivery; and
- the principal and interest moneys secured by Treasury Bills are payable to the holder.

1.5.38 During 1989-90 the VDF, on behalf of the Treasurer, issued Treasury Bills totalling $3.4 billion, part of which was on-lent to the Consolidated Fund.

1.5.39 An audit review of arrangements relating to the issue of Treasury Bills raised a number of significant concerns which are discussed below.

Artificial arrangement to obtain funds from private sector fund managers

1.5.40 The issue of Treasury Bills and their subsequent transfer by relevant authorities results in the State being indebted not only to public bodies but also to private sector fund managers approved by the Treasurer to deal in such instruments. The private sector fund managers approved to date are those which hold funds invested by public sector bodies.

1.5.41 As indicated previously, the issue of Treasury Bills is restricted to deposits received from relevant authorities. **A review of the issue of Treasury Bills disclosed that the VDF had entered into an artificial arrangement with a relevant authority, namely the Melbourne and Metropolitan Board of Works (MMBW).**

1.5.42 The process used was as follows:

- the VDF issued Treasury Bills **without receiving a deposit of funds** from the MMBW;
- the MMBW immediately transferred the Treasury Bills back to the VDF;
- the MMBW received a token amount by way of commission from the VDF for participating in this arrangement; and
- the Treasury Bills were then transferred by the VDF to private sector fund managers.

1.5.43 The total value of Treasury Bills which were involved amounted to $870 million with the MMBW only receiving $13 757 for its participation.

1.5.44 In audit opinion, the above arrangements were entered into so that Treasury Bills could be issued to and deposits received from the private sector fund managers while giving the appearance that the VDF had complied with the requirements of the Regulations.

1.5.45 Subsequent to audit raising this issue, the Department of the Treasury has advised that the transactions in question have been stopped and that it will ensure the establishment of alternative distribution arrangements for Treasury Bills.

Illegal issue of Treasury Bills direct to private sector fund managers

1.5.46 An additional matter concerned the issue of 76 Treasury Bills amounting to $316 million direct to private sector fund managers over a 6 month period.

1.5.47 Such action is contrary to the Victorian Development Fund (Treasury Bills) Regulations in that the initial issue of a Treasury Bill did not involve a relevant authority. Audit was advised by the management of the VDF that the issue of the Treasury Bills without complying with the legal requirements was due to the staff involved confusing "*approved holders*" with "*relevant authorities*".

1.5.48 It is highly disturbing that these illegal transactions were allowed to continue over a 6 month period given that the VDF operates with substantial sums of money in a high-risk financial environment.

Lack of independent oversight of VDF operations

1.5.49 The matters identified by audit indicate a clear need for more effective monitoring of VDF operations.

1.5.50 The VDF has over the years considerably increased its level of activity as approved by the Government with annual turnover in a highly volatile environment now in excess of $46 billion.

1.5.51 Unlike other government financial institutions, the VDF does not have an independent board to oversee its operations, nor does it have an effective internal audit function. (Refer to additional comments on internal audit in Section 2.5 of this report.) The current Committee of Management does not have the required independence as it consists of 2 senior officials of the Department of the Treasury, one of whom is the General Manager of the VDF.

1.5.52 Audit is of the view that the absence of independent supervision of the VDF's operations could expose the State to substantial financial risk.

1.5.53 In respect of this issue, the Department of the Treasury has advised that it acknowledges the desirability of establishing more independent oversight of VDF operations, it will provide for an independent advisor and it has strengthened the Committee of Management by an additional 3 senior officers of the Department.

Probable extension of powers beyond those envisaged by Parliament

1.5.54 The purpose of the VDF as outlined in Parliament on its establishment was to manage Victorian public sector liquid assets. However, for a number of years, as approved by the Government, deposits have also been accepted from Commonwealth and interstate statutory bodies. At 30 June 1990 deposits held from such bodies totalled $470 million.

1.5.55 When the question of the legality of deposits accepted from outside Victoria was raised by audit, the VDF obtained an opinion from its solicitors which states, inter alia:

> *"It is acknowledged that the objective of the Government in establishing the CMA and the SDA could be interpreted, on the basis of the Hansard debates, to be to maximise the returns on the financial assets of State public authorities and the Public Account on the basis that the Government would not have been concerned with the returns of non-State public authorities. However the Hansard debates are not conclusive on this point since the issue of whether non-Victorian public authorities should be able to make deposits in the CMA and the SDA was never specifically raised. As previously advised the courts require a limitation on the ordinary meaning of words in legislation to be demonstrated before it will be inferred.*

"A further consideration is that if the Government had wished to exclude the possibility of non-Victorian public authorities being declared as a 'relevant authority' then it would have been a simple matter to include an appropriate provision in the Act.

"In summary it is our view that the provisions of the Act relating to the prescription of a relevant authority should not be interpreted in the restrictive manner suggested by the Auditor-General."

1.5.56 Despite the views expressed above, I am not convinced that it was the intention of Parliament to empower the VDF to accept deposits from non-Victorian public authorities. This matter requires clarification.

FINANCE CHARGES

1.5.57 In 1989-90 interest charges paid on borrowings by the State and included in the Treasurer's Statement amounted to $1.4 billion (1988-89, $1.2 billion). However, as the Treasurer's Statement is prepared on a cash basis of accounting, this figure does not reflect interest incurred but not paid in the period.

1.5.58 An analysis of finance charges revealed that the total interest incurred in 1989-90 by the State (calculated on an accrual basis) was $1.8 billion. The difference of $381 million between interest paid (as disclosed in the Treasurer's Statement) and interest incurred is due to:

- **the Government's policy of structuring its debt portfolio, in 1989-90 and prior years, in a manner which defers the impact of interest payments to future periods ($200 million);**
- **the deferral of interest payments to VicFin by up to one month as a consequence of a change, in June 1989, in payment arrangements ($59 million); and**
- **the normal accruing of interest where interest incurred is paid in the next financial year ($122 million).**

1.5.59 The need to reconcile interest paid on a cash basis with real interest costs for the year (interest incurred on an accrual basis) would not be necessary if the Treasurer's Statement also included information prepared under accrual accounting principles.

1.5.60 Details of interest paid and interest incurred in the period and accrued at year-end are given in Table 1.5F.

TABLE 1.5F
PUBLIC ACCOUNT INTEREST CHARGES
(Excludes statutory authority interest payments)
($million)

Item	*Interest incurred but not paid at 1 July 1989*		*1989-90 Interest incurred*		*1989-90 Interest paid*		*Interest incurred but not paid at 30 June 1990*
		+		-		=	
Charges on Commonwealth borrowings	79		707		625		161
Charges on State borrowings -							
Capital Works Authority*(d)*	320		875		692		503
Victorian Development Fund -							
Cash Management Account	-		44		38		6
State Development Account*(a)*	31		105		95		41
VicFin	-		32		32		-
Total interest charges	430		**1 763**		*(b)***1 482**		711
Less portion relating to capital growth of debt							153
Accrued interest at 30 June 1990							*(c)*558

(a) Payments on account of State borrowings do not include internal transactions relating to amounts charged to departmental programs in respect of advances under the State Development Program.

(b) Includes $1 382 million interest payments disclosed in the Treasurer's Statement, and $100 million of interest payments that were netted-off against the proceeds received from refinancing transactions. In addition to the total interest charges, the State also made contributions to the South Eastern Medical Centre totalling $21.6 million for the purpose of meeting the Centre's interest charges.

(c) The Treasurer's Statement discloses accrued interest of $608 million, however, this amount is overstated by $50 million as interest accrued has been incorrectly determined.

(d) The Treasurer's Statement refers, by way of footnote on page 129, to interest swap receivables of $364.7 million and payables of $397.6 million. Audit review disclosed that the majority of these arrangements were currency swaps undertaken by VicFin in its own right and did not result in obligations to the Consolidated Fund.

Use of capital funding to meet interest charges

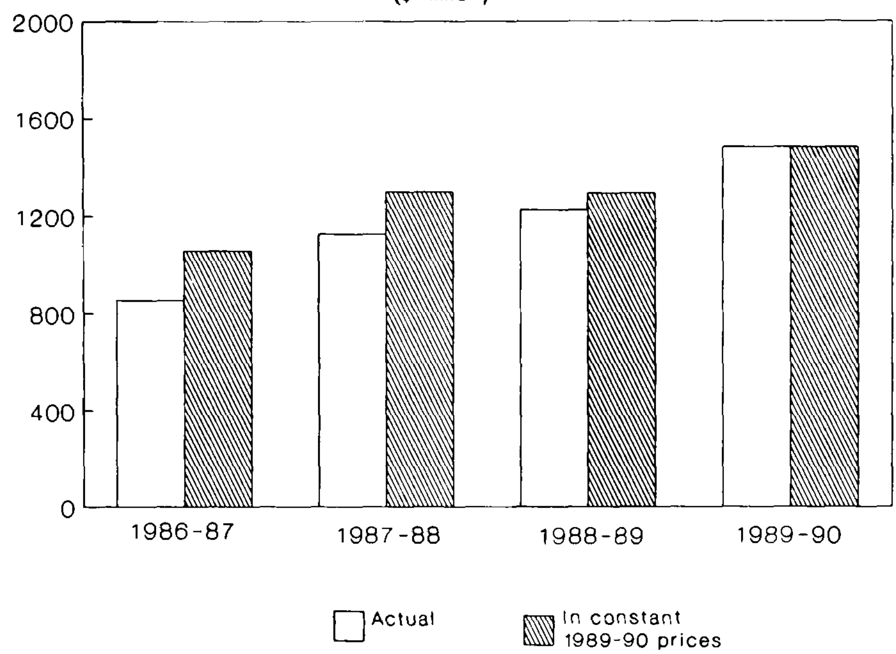
1.5.61 An audit analysis of actual funding sources used to meet interest payments disclosed that approximately $197 million of interest charges was directly funded from borrowings, sale of assets and works grants.

1.5.62 As stated in previous reports to Parliament, the practice of funding recurrent charges such as interest from borrowings is contrary to the principles of sound financial management in that capital funding should be used for capital works, purchase of assets and provision of government infrastructure, all of which create long-term economic and social benefits to the State.

Impact of servicing the State's Public Account borrowings

1.5.63 Chart 1.5G indicates the costs paid by the State in servicing its borrowings for the years 1986-87 to 1989-90. It was not possible to include in the chart finance charges actually incurred as this information is not available for the period covered.

CHART 1.5G
FINANCE PAYMENTS TO SERVICE BORROWINGS
($million)



1.5.64 The analysis of Public Account finance charges paid disclosed that:

- **Actual finance charges paid have increased from $855 million in 1986-87 to $1 482 million in 1989-90.** This variation represents a 73 per cent increase in actual terms, or a 40 per cent increase in constant 1989-90 prices;
- Finance charges are continuing to absorb an increasing proportion of the State's revenue available for general application. **In 1989-90, 17 per cent of the revenue available for general application was used to meet finance charges, compared with 12.7 per cent in 1986-87**; and
- **The annual cost to the community to service Public Account borrowings has also increased over this period from approximately $200 per capita in 1986-87 to approximately $330 per capita in 1989-90,** an increase of 65 per cent (35 per cent in constant 1989-90 prices).

1.5.65 In this context, I note that the Treasurer in his Budget Speech has acknowledged that the cost of servicing debt has now reached a point where the policies of the past require a fundamental change.

Impact of downgrading of State credit rating

1.5.66 In June 1990, an international credit rating agency downgraded the State's Australian dollar denominated debt from a rating of AAA to AA1. The rationale for this downgrading was that the agency considered the State had a slightly diminished capacity to address its economic and financial problems. The reasons given included the relatively high levels of public sector debt and debt charges as a percentage of revenue and the losses of State-owned enterprises.

1.5.67 The major consequence of this downgrading is that the State now has to offer a higher rate of interest to attract funds. Based on the State's 1990-91 borrowings program, audit estimates that finance charges incurred by the budget sector could rise by approximately $5 million per annum. In addition, finance charges incurred by non-budget sector agencies will be affected by this downgrading.

OTHER FINANCIAL COMMITMENTS OF THE STATE

1.5.68 In addition to the budget sector indebtedness summarised in paragraph 1.5.2, the State has entered into a number of arrangements, involving significant financial commitments, which will impact on its future financial operations. Details of these financial commitments follow.

State Bank Group

1.5.69 As reported in the 1990-91 *Budget Papers* the financial position of the State Bank Group has deteriorated substantially, requiring further financial support from the State. The total amount of financial support was increased to approximately $2.7 billion and is disclosed in Table 1.5H.

TABLE 1.5H
FINANCIAL ASSISTANCE PROVIDED TO STATE BANK GROUP
($million)

	State Bank	*Tricontinental*	**Total**
Debt assumed by the State to 30 June 1990	-	576	**576**
Future assumption of debt*(a)*	510	1 046	**1 556**
	510	1 622	**2 132**
Funding costs on non-performing loans to 30 June 1990	52	250	**302**
	562	1 872	**2 434**
Estimated funding costs on non-performing loans incurred after 30 June 1990			**266**
Total financial support from State			**2 700**

(a) Debt to be assumed when the Bank considers it appropriate to write-off non-performing loans, but not later than February 1995.

1.5.70 Due to the massive burden that the $2.7 billion support measure would have placed on the Victorian taxpayers, the Government decided to sell the Bank to the Commonwealth Bank of Australia for a package valued at approximately $2 billion. The *Budget Papers* indicated that the sale of the Bank will involve:

- a sale price of $1.6 billion;
- a tax compensatory package of $413 million from the Commonwealth; and
- the elimination of the support agreement (referred to in paragraph 1.5.20) except for borrowings of $576 million assumed by the State up to June 1990 together with a further amount which has not yet been determined.

1.5.71 Audit was advised that the Government will acquire Tricontinental Corporation Limited, at a cost of $194 million. Tricontinental at the present time has a net deficiency of $1.6 billion.

1.5.72 It is understood that the settlement of financial arrangements under the sale has not yet been finalised by the parties. **The remaining $700 million arising from the debt of the State Bank Group will be met by the Government. In addition, as the Government will obtain ownership of Tricontinental, it will be responsible for meeting any further increase in bad debts and additional costs incurred by the company.**

Farrow Group of Building Societies

1.5.73 Following the forced closure of the Farrow Group of Building Societies (consisting of the Pyramid, Geelong and Country Wide Building Societies) in June 1990, the Government announced that depositors with the Farrow Group of Building Societies would receive, over time, the full amount of the principal component outstanding at 24 June 1990. This announcement was made without legislative backing.

1.5.74 Based on the above government commitment, the State entered into an arrangement with the State Bank of Victoria under which the Bank, in August 1990, was to fund an initial payment of 25 per cent of deposits held which totalled $367 million. The arrangement also provides for the State to indemnify the Bank against any shortfall between the amount received by the Bank from the administrator of the Farrow Group and the amount paid by the Bank to depositors.

1.5.75 Prior to entering into the above arrangement, the Treasurer was advised by the Solicitor-General that, inter alia:

> *"I have no doubt that the Treasurer has power to enter into such an agreement so as to bind the Crown".*

1.5.76 Audit was advised that the amount paid by the State Bank to depositors under this arrangement was $264 million as at 26 September 1990 and that the offer to depositors will close at the end of October 1990. An amount equal to the interest cost incurred by the Bank in funding this facility is required under the arrangement to be met by the State. The 1990-91 Budget Papers indicate the cost for that year is estimated at $55 million.

1.5.77 As stated in the *Budget Papers,* the administrator appointed by the Registrar of Building Societies has estimated in an interim report that the **shortfall to depositors and investors from the immediate realisation of assets would be in the order of $250 million.** However, the administrator further states this amount would be minimised by an orderly realisation of assets.

1.5.78 The Office of the Victorian Government Solicitor has advised audit that there is currently a Supreme Court action pending against the State and 2 members of Government relating to public representation made in respect of the financial position of the Pyramid Building Society. The plaintiff, an investor in the Society, is claiming damages.

1.5.79 At the time of preparation of this report audit was unable to determine the full impact of the above government commitment on the State.

Operating lease commitments

1.5.80 The use of operating leases within the budget sector has significantly increased in recent years, particularly in relation to the provision of office accommodation and equipment. In 1989-90 lease payments made by budget sector agencies under operating lease arrangements exceeded $108 million.

1.5.81 The budget sector's financial commitments include future obligations under these arrangements. **An audit review of major budget sector operating leases revealed commitments at 30 June 1990 in excess of $636 million.** Table 1.5I provides details of the timing of these commitments.

TABLE 1.5I
OPERATING LEASE COMMITMENTS
($million)

Year	*Value*
1990-91	97
1991-92	86
1992-93	84
1993 onwards	369
Total commitments	**636**

CONTINGENT LIABILITIES

1.5.82 Contingent liabilities can be described as potential commitments, the occurrence of which is dependent upon future events or outcomes. This section of the report provides information on the State's contingent liabilities at 30 June 1990.

Government guarantees

1.5.83 The State has provided guarantees on the borrowings of various private and public sector organisations and financial institutions. In the event that the various organisations cannot meet their commitments, the State will be required to assume any liability under these guarantees.

1.5.84 The Treasurer's Statement discloses that the estimated contingent liability for government guarantees at 30 June 1990 was $48.1 billion.

1.5.85 Comment on a number of guarantees follows.

Building society industry liquidity support scheme

1.5.86 The liquidity difficulties and the subsequent forced closure of the Farrow Group of Building Societies in June 1990 resulted in a general lack of community confidence in the stability of the building society industry.

1.5.87 In order to stabilise the industry, the Government in July 1990 established a line of credit for all Victorian building societies, with the exception of building societies within the Farrow Group.

1.5.88 Under the arrangements, a credit facility was established through VicFin which is to advance funds as necessary to the Victorian Building Societies Council. The Council would in turn lend funds, at its discretion, to individual building societies to meet liquidity needs. Moneys advanced are subject to a charge over the assets of the relevant building societies at an interest cost comparable with the commercial cost of funds.

1.5.89 Funds advanced by VicFin under this arrangement are subject to a government indemnity under the Housing Act.

St Andrews Hospital guarantee

1.5.90 St Andrews Hospital is a non-profit charitable hospital which has been located in East Melbourne for 55 years. In 1977 the Hospital was provided with a government guarantee to cover a number of loans provided by financial institutions to the value of $28 million for the Hospital's building expansion program. In 1983 the government guarantee was increased to $37 million and the Government obtained a first mortgage over the Hospital site as security over the guarantee.

1.5.91 In July 1985 the Hospital defaulted on several loan repayments because of financial difficulties arising from building delays and a legal disputation with the building contractor. As a result, the financial institutions called on the government guarantee.

1.5.92 In September 1989 the Treasurer served a Notice of Default under the registered mortgage and elected to exercise his powers under the mortgage including the power of sale.

1.5.93 A sale had not been achieved by December 1989 at which time the receiver/managers provided a number of costed options for the future of the hospital with the "*best option*" involving the Hospital trading on with additional consulting suites at the site. However, after consideration of these options, the Treasurer and the Minister for Health announced in April 1990 that the Peter MacCallum Cancer Institute would purchase the Hospital site for $32 million.

1.5.94 At 30 June 1990 the cost incurred by the State under the guarantees was $23 million. Audit estimates the State will incur further costs of $42 million to cover winding-up expenses and an amount owed to the State Superannuation Board.

Victorian Equity Trust

1.5.95 The Victorian Equity Trust (VET) is a publicly listed trust that was established by the State in 1988 to raise $500 million in equity funding for the Portland Smelter Unit Trust and the State's 3 major statutory authorities, the State Electricity Commission of Victoria, the Gas and Fuel Corporation of Victoria, and the Melbourne and Metropolitan Board of Works.

1.5.96 VET unit holders have the option of selling their units to the Victorian Economic Development Corporation (VEDC) on 1 June 1992 at a set price based on the All Ordinaries Index at the time, after deducting the value of distributions made up to that date (at 1992 prices).

1.5.97 A significant call on State resources will occur in June 1992 if VET unit holders take up the option to sell their unit holdings to the VEDC and replacement buyers are not found to purchase the units. Audit estimates that if the All Ordinaries Index is at the current (September 1990) level in June 1992, the funding required if all options were exercised would be in the vicinity of $700 million.

1.6 ANALYSIS OF CONSOLIDATED FUND RECEIPTS

KEY FINDINGS

- Receipts, excluding borrowings, for the year were $345 million below budget.

  paras 1.6.1 to 1.6.2

- An urgent need exists for the Government to undertake a review of its revenue management practices, given the substantial cash flow difficulties encountered during the year.

  para. 1.6.21

- Willsmere Hospital was sold for $21 million below the reserve price of $36 million.

  paras 1.6.15 to 1.6.17

- The Treasurer's Statement still does not disclose how proceeds from asset sales were utilised.

  para. 1.6.10

- Non-budget sector agency employer contributions to the State Superannuation Fund continue to be utilised to finance Consolidated Fund operations.

  paras 1.6.32 to 1.6.34

- The Treasurer forgave a further $51 million of MMBW debt bringing the total debt forgiven to $162 million.

  paras 1.6.35 to 1.6.36

Summary of financial transactions

1.6.1 In the 1989-90 Budget, it was estimated that the total receipts, excluding borrowings, of the Consolidated Fund would be $11.9 billion. Actual receipts for the year were $11.6 billion ($345 million below budget). The major shortfalls in receipts were in the areas of taxation ($173 million) and asset sales ($181 million).

1.6.2 Table 1.6A provides a summary of the year's receipts.

TABLE 1.6A BUDGETED AND ACTUAL RECEIPTS*(a)*
($million)

Item	*1988-89 Actual*	**1989-90 Actual**	*1989-90 Budget*	**1989-90 Variance**
Recurrent -				
Taxation	4 532	**4 796**	4 969	**(173)**
Commonwealth	3 757	**3 896**	3 840	**56**
Other	1 860	**1 971**	2 019	**(48)**
Total recurrent	10 149	**10 663**	10 828	**(165)**
Works and services -				
Commonwealth	621	**701**	692	**9**
Sale of assets *(a)*	205	**199**	380	**(181)**
Other	56	**22**	30	**(8)**
Total works and services	882	**922**	1 102	**(180)**
Total receipts *(a)*	11 031	**11 585**	11 930	**(345)**

(a) Excludes all borrowings.

Taxation

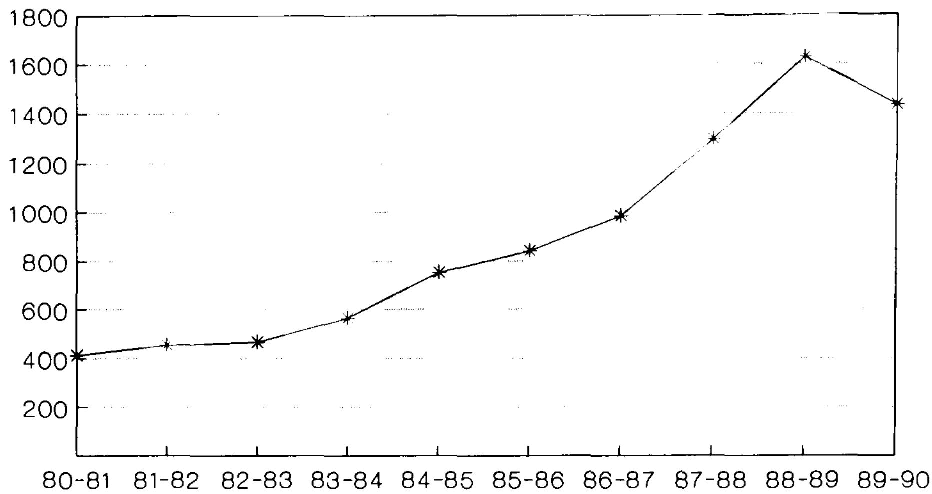
1.6.3 Taxation receipts principally comprise amounts collected from the levying of stamp duty, payroll tax, licence fees, Tattersalls duty and land tax. As indicated in the above table, receipts in 1989-90 from this source amounted to $4.8 billion which was $173 million below the budget estimate of $4.9 billion.

1.6.4 Since 1980-81 there has been an increasing reliance on taxation revenue for the funding of operations. Taxation accounted for 45 per cent of all recurrent receipts in 1989-90 as against 39 per cent in 1980-81. In particular, taxation revenue from stamp duty, between 1980-81 and 1988-89, accounted for a greater proportion of receipts due to an economic climate which had been conducive to increased activity in the property and financial markets.

1.6.5 However, due to the slow down in the economy in 1989-90, the level of receipts from stamp duty fell substantially.

1.6.6 Chart 1.6B shows stamp duty receipts over the past decade.

CHART 1.6B STAMP DUTY RECEIPTS
($million)



Asset sales

1.6.7 In recent years the Government has placed greater reliance on generating revenue from asset sales with revenue increasing from $42 million in 1985-86 to $199 million in 1989-90.

1.6.8 Asset sales for the current year (not including sale and lease-back transactions) were $181 million below budget. Major reasons for the budget shortfall were:

- a slowdown in the property market resulting in lower property prices;
- failure of the Government during the year to successfully complete the proposed sale of various properties; and
- the proposed purchase by the Government Employee Housing Authority (GEHA) of budget sector housing stock, which was anticipated to contribute $100 million in revenue, not proceeding because the necessary legislative amendments were not passed by Parliament.

1.6.9 Table 1.6C provides a summary of asset sales by agency in 1989-90.

TABLE 1.6C ASSET SALES BY AGENCY, 1989-90
($million)

Agency	*Sales*
Department of Property and Services	93
Transport authorities	54
Ministry of Education	32
Major Projects Unit	16
Other	4
Total	199

1.6.10 While it is the Treasurer's stated policy to apply proceeds from asset sales to the acquisition of new capital assets, the Treasurer's Statement still does not disclose how such proceeds were utilised. I reiterate the recommendation contained in previous reports that details of expenditure funded from proceeds of asset sales be clearly disclosed in the Treasurer's Statement.

Major asset sales for the year

1.6.11 Major asset sales for the year are set out in the following table.

TABLE 1.6D MAJOR ASSET SALES

Property sold	*($million)*
Port Melbourne land	40
Windsor Hotel	18
Willsmere Hospital	15

Sale of land at Port Melbourne

1.6.12 The Government decided to sell 21 hectares of Crown land in Port Melbourne, which was leased to a private sector company that had spent in excess of $18 million in the development of the site.

1.6.13 The Government provided the lessee with the first option to purchase the site which had been valued at between $60.4 million and $70 million in September 1989.

1.6.14 The sale of the site was not completed until June 1990 at a price of $4.8 million below the reserve price set in September 1989 of $44.8 million (after allowing for improvements by the lessee). The Valuer-General considered this price was reasonable in view of the downturn in the commercial property market since the reserve price had been set.

Willsmere Hospital

1.6.15 Willsmere Hospital and associated lands have been a well-known landmark in Kew for more than a century. In 1987 the management of the Hospital site was placed with the Victorian Government Major Projects Unit to facilitate its sale. The site was valued by the Valuer-General and 2 independent valuers in December 1989 at between $25 million and $36 million. The reserve price for the sale was set at $36 million.

1.6.16 Public tenders closed in February 1990 with tenders ranging between $10 million and $17.8 million. Following assessment and negotiations with tenderers, the matter was referred to a **Cabinet committee which after due consideration of the tenders' development proposals, directed the Victorian Government Major Projects Unit to negotiate a sale with a tenderer nominated by the Committee.**

1.6.17 In April 1990 the Minister for Major Projects, the Minister for Planning and Urban Growth and the Treasurer formally approved the sale for $15 million. This price was $21 million below the reserve price and $2.8 million below the highest tender.

Willsmere Hospital, located on 22 hectares of land, sold in April 1990.

Windsor Hotel

1.6.18 The Windsor Hotel was acquired by the Government in December 1976 for $5 million. In August 1980, the premises were leased for 22 years at an annual rental of $700 000.

1.6.19 In December 1989 the Government decided to offer the Hotel for sale by public tender with the reserve price being set at the Valuer-General's valuation of $16.85 million.

1.6.20 After evaluation of the 3 tenders received the Hotel was sold for $17.7 million. The highest tender of $22 million was rejected on the ground that the identity of the parties involved was not disclosed to the Government.

Windsor Hotel, sold in June 1990.

Delays in the collection of revenue

1.6.21 As previously indicated in paragraph 1.3.9, the State generally spends money from the Consolidated Fund at an earlier stage than it collects revenue. **Because periodic cash shortfalls are met by temporary financing arrangements, any delays in the collection of revenue add to the costs that are incurred by the State to fund its operations. Given the substantial increases in short-term borrowing costs, it would be opportune for the Government to undertake a review of its cash management practices.**

1.6.22 In previous reports to Parliament, audit has commented on significant deficiencies in practices relating to the collection of taxation revenue by the State Taxation Office and Stamp Duties Office and the collection of outstanding fines by the Office of the Chief Commissioner of Police. These deficiencies contributed to the untimely collection of State revenues.

1.6.23 An audit review of these matters in 1989-90 revealed the following.

Collection of taxation revenue

Outstanding collections

1.6.24 **Outstanding amounts due to both the State Taxation and Stamp Duties Offices increased significantly during the year.** Specifically:

- Debtors of the State Taxation Office were $118 million at 30 June 1990, a 51 per cent increase from the previous year, with most **payroll tax debtors** outstanding in excess of 90 days. In addition, 20 per cent of **land tax debtors** were outstanding in excess of 90 days, of which $10 million related to assessments issued prior to July 1989; and
- Stamp Duties Office debtors at 30 June 1990 amounted to $23 million as against $12 million in 1989.

Delays in issuing assessments

1.6.25 As indicated in my previous report on the Treasurer's Statement, substantial scope exists for the more timely issue of land tax assessment notices by the State Taxation Office. **The benefits of early collection have not been achieved as the Office has continued to maintain its long standing practice of issuing notices progressively throughout the year rather than in the first quarter as suggested by audit.**

Outstanding warrants

1.6.26 In previous reports to Parliament audit commented that the Office of the Chief Commissioner of Police did not actively pursue the enforcement of outstanding court fines for which it was responsible, and that immediate action was needed in order to minimise the revenue loss to the State.

1.6.27 The Economic and Budget Review Committee's May 1990 report on matters arising from the Auditor-General's 1987-88 report stated that:

> *"The Committee is dissatisfied with the obvious lack of urgency demonstrated by the Police Force and the Ministry in resolving the problem of outstanding warrants. It does not believe that either body responded to the Auditor-General's concern in an appropriately prompt or serious manner. The Committee stresses that the Ministry must pursue the task of collecting outstanding warrants as a matter of urgency. Progress will be monitored by the Committee and it is expected that the Secretary of the Ministry will be called by the Committee to a hearing at an appropriate time in the future."*

1.6.28 At 30 June 1990 the value of outstanding warrants issued for the payment of fines, according to Police records, was $47 million ($46 million, 1988-89). However, as in previous years, concern regarding the reliability of this value resulted in the Attorney-General's Department providing its own estimate of outstanding warrants of $29 million ($27 million, 1988-89).

1.6.29 During 1989-90 the following actions were taken to address the deficiencies relating to the execution of outstanding warrants:

- the establishment of a group within the Chief Commissioner's Office with responsibility for reducing the number of outstanding warrants; and
- the engagement of private investigation agencies to provide details on the whereabouts of offenders.

1.6.30 The Office of the Chief Commissioner of Police considers that the above actions should ensure a significant reduction in the present backlog of warrants within 2 years.

1.6.31 The *Magistrates' Courts Act* 1989, proclaimed in July 1990, provided that from 1 September 1990 warrants will be declared null and void if not executed within 5 years. As a result of this provision, a considerable number of long outstanding warrants are likely to be written-off in 1990-91.

Employer superannuation contributions

1.6.32 During the year the Consolidated Fund received $8.6 million from non-budget sector agencies for employer contributions to the State Superannuation Fund for employees who are members of the Fund. This practice has been followed for a number of years.

1.6.33 These contributions are not passed on by the Consolidated Fund to the State Superannuation Fund until such time as superannuation benefits are paid to relevant employees.

1.6.34 In effect, the Consolidated Fund gains from the use of these funds to finance current operations while assuming employer liability for superannuation which will not be paid until future periods.

Forgiveness of Melbourne and Metropolitan Board of Works debt

1.6.35 As part of a package designed to improve the financial performance of the Board of Works, the Treasurer in the past 2 years approved the forgiveness of debt totalling $111 million owed by the Board to the State. **During 1989-90 the Treasurer approved the forgiveness of a further $51 million of the Board's debt, bringing the total debt forgiven to $162 million.**

1.6.36 The Treasurer has indicated that the interest forgone relating to the above debt will be eventually replaced by higher dividend payments from the Board to the Consolidated Fund. **However, in real terms the dividend recovered from the Board has decreased by 3 per cent over the last 3 years.**

Delays in obtaining Commonwealth funding

1.6.37 Under the *States Grants (Tertiary Education Assistance) Act* 1984, audited expenditure statements for TAFE grants are to be submitted to the Commonwealth no later than 30 September following the year when grants are provided. The State Training Board arranges for these statements to be audited by a firm of private practitioners. **The Commonwealth Government has consistently withheld substantial levels of grant moneys due to the Consolidated Fund because expenditure statements had not been furnished by the prescribed deadline.**

1.6.38 The previous reports of the Auditor-General have included comment on the delays of the State Training Board in forwarding audited financial statements to the Commonwealth Government. **The failure to provide audited statements over the past 3 years, and the consequential delay in receiving Commonwealth grants, have resulted in investment interest forgone by the State of around $2.5 million.**

1.7

ANALYSIS OF CONSOLIDATED FUND PAYMENTS

KEY FINDINGS

- The acquisition by the Government of additional equity in the Flexible Tariff Management Unit Trust was not funded from the Consolidated Fund and thus was not subject to parliamentary scrutiny.
  paras 1.7.9 to 1.7.13

- Payments for the year were $141 million above budget.
  para. 1.7.1

- Operating expenses of $300 million were classified as "works and services expenditure" and funded from capital receipts, including borrowings.
  para. 1.7.5

- The absence of proper segregation between operating and capital transactions precludes meaningful analysis by users of the Treasurer's Statement.
  paras 1.7.4 to 1.7.8

- A Public Account advance of $60 million to purchase rolling stock was not recouped from the Public Transport Corporation at year-end.
  paras 1.7.14 to 1.7.16

Summary of financial transactions

1.7.1 In the 1989-90 *Budget Papers*, it was estimated that the total payments of the Consolidated Fund would be $12.9 billion, comprising $11 billion for Annual Appropriations and $1.9 billion for Special Appropriations. **However, the actual payments for the year were in total $141 million above budget.** Table 1.7A summarises the year's payments.

TABLE 1.7A BUDGETED AND ACTUAL PAYMENTS
($million)

Item	*1988-89 Actual*	**1989-90 Actual**	*1989-90 Budget*	**1989-90 Variance**
Recurrent -				
Annual appropriations	8 545	**9 199**	9 038	**(161)**
Special appropriations	1 720	**1 896**	1 845	**(51)**
Total recurrent	10 265	**11 095**	10 883	**(212)**
Works and services -				
Annual appropriations	1 960	**1 920**	1 997	**77**
Special appropriations	17	**16**	10	**(6)**
Total works and services	1 977	**1 936**	2 007	**71**
Total payments	12 242	**13 031**	12 890	**(141)**

Major budget variances

1.7.2 Actual expenditure exceeded budget due to:

- greater than anticipated number of employees retiring from the new superannuation scheme;
- salary and wages increases in the education and health sectors; and
- increased contributions to transport authorities mainly to offset revenue losses occasioned by the introduction of a new ticketing system and an associated industrial dispute.

1.7.3 The increased expenditure was offset to some extent by capital expenditure savings from the Treasurer's Major Initiatives Program.

Lack of clear distinction between operating and capital expenditure

1.7.4 As pointed out in paragraph 1.3.3, the State's 1989-90 budget sector deficit of $1.4 billion includes $432 million arising from recurrent operations which was funded from borrowings.

1.7.5 As identified in previous Auditor-General's reports to the Parliament, recurrent expenditure includes a number of capital items and conversely works and services expenditure includes significant operating costs. **An audit review of 1989-90 expenditure identified that approximately $300 million of operating expenditure has been classified as "works and services expenditure".** Table 1.7B sets out the categories and levels of such expenditure.

TABLE 1.7B
OPERATING COSTS RECORDED
UNDER WORKS AND SERVICES EXPENDITURE
($million)

Category	*Amount*
Repairs and maintenance	133
Finance charges	97
Housing rental assistance	52
Timber industry strategy and fire suppression	18
Total	**300**

1.7.6 The absence of a proper segregation between operating and capital transactions limits meaningful financial analysis being undertaken by users of the Treasurer's Statement.

1.7.7 Audit has consistently maintained that a proper classification of budget sector expenditures into operating and capital items would significantly improve the value of the Treasurer's Statement for economic decision-making and provide useful information on the State's finances.

1.7.8 The Government has indicated that it will give attention to the issue of reclassifying transactions between the recurrent and works and services sectors of the Consolidated Fund in its current review of the Public Account Act.

Acquisition of equity in lieu of dividends

1.7.9 The State Trust Corporation is the trustee of the Flexible Tariff Management Unit Trust (FTMUT) of which the Treasurer is the sole unit-holder. The FTMUT is responsible for meeting the Government's obligations to the State Electricity Commission of Victoria (SECV) under a number of deeds entered into between the SECV, the Portland Smelter Services Pty Ltd and Alcoa, to facilitate a flexible electricity tariff. This tariff fluctuates in line with world aluminium prices for the Point Henry and Portland Smelters. The deeds essentially provide for payments to be made by the FTMUT to the SECV when aluminium prices fall below a stipulated level and conversely require Alcoa to pay certain amounts to the FTMUT when prices rise above that level.

1.7.10 Due to low aluminium prices, the FTMUT made payments to the SECV totalling $50 million during 1989-90. These payments were financed from:

- A standby loan facility arranged by the Corporation with the Victorian Development Fund ($20 million). A government guarantee of $20 million was executed during 1989-90 in relation to the standby loan facility to limit any future liability of the Corporation; and
- The Portland Smelter Unit Trust, which is owned by the State, purchasing units in the FTMUT ($30 million).

1.7.11 The trust deed of the Portland Smelter Unit Trust was changed during 1989-90 to enable it to acquire units in the FTMUT. The units acquired were immediately transferred to the Treasurer of Victoria as part of the dividend due to the Government from the Trust.

1.7.12 The method used by the Government to acquire equity units in the FTMUT differed substantially from the practice of previous years, whereby parliamentary appropriations were used for this purpose. I consider that transactions of this nature should be funded from within the Consolidated Fund and thus be subject to direct scrutiny by the Parliament.

1.7.13 Subsequent to 30 June 1990, additional payments totalling $30 million were made by the FTMUT to the SECV. To finance these additional payments, the value of the Victorian Development Fund loan facility was increased to $80 million.

Outstanding advance to Public Transport Corporation

1.7.14 During 1989-90 the Public Transport Corporation purchased certain light rail vehicles and buses which were to be sold and immediately leased back in the year. The acquisition of these vehicles was partly funded from a temporary advance of $60 million, under the provisions of the *Public Account Act* 1958. The Act authorises the Treasurer to make such temporary advances pending recoupment.

1.7.15 As indicated in the 1990-91 *Budget Papers* it was originally planned that part of the proceeds from the sale and lease-back arrangements would be retained by the Corporation to repay the amounts advanced. However, it was subsequently decided that all the proceeds from the sale would be paid to the Consolidated Fund during 1989-90 and the repayment of the advance be provided for by way of parliamentary appropriation in 1990-91.

1.7.16 **As a result, the temporary advance of $60 million had not been recouped from the Corporation at 30 June 1990.**

Ministry of Education works and services payments

1.7.17 The Auditor-General's *Report on Ministerial Portfolios, May 1990* commented on irregular works and services payments made by the Ministry of Education in May and June 1989 and identified a number of matters which the Ministry needed to address to ensure sound financial management.

1.7.18 A review of subsequent action taken by the Ministry revealed that:

- All relevant personnel have been made aware of their responsibilities under the *Annual Reporting Act* 1983 and the Treasury Regulations 1981 and the penalties for non-compliance;
- Management information systems at the Ministry's Office of Schools Administration and at the regional level are being upgraded and improved;
- Several options relating to the functions of internal audit are currently being considered by the Ministry following a recent review of its operations by the Public Service Board at the Ministry's request;
- Twenty-one officers received administrative cautions in relation to their conduct as a result of disciplinary action taken by the Ministry;
- The Ministry was not in a position to determine the full extent of the irregular payments as its detailed examination of May/June 1989 expenditures did not include transactions valued at less than $10 000. The Ministry advised audit that available resources did not permit the review to be extended to such payments; and
- Goods and services to the value of $66 700 paid for in May/June 1989 still had not been received at 30 June 1990.

1.7.19 A review by this Office of 1989-90 year-end works and services expenditure and further testing by internal audit during April, May and June 1990 revealed no further instances of irregular payments and indicated that the corrective action taken by the Ministry had been successful.

1.8 OTHER MATTERS

KEY FINDING

- Finance charges of $35 million, paid from the Consolidated Fund without parliamentary authority, have not been acquitted.

  paras 1.8.1 to 1.8.3

Treasurer's acquittance

1.8.1 Section 34 of the *Audit Act* 1958 requires me to acquit the Treasurer for the amount of the public moneys spent which has been ascertained by me to have been duly and properly expended. This section excludes from the acquittance expenditure which is *"... the subject of query or observation or of show cause action or of disallowance or surcharge".*

1.8.2 All moneys disbursed from the Public Account in 1989-90 were acquitted by me to the Treasurer except for:

- **an amount of $35 million which, as explained in paragraph 1.3.2 of this report, represents interest charges which were paid from the Consolidated Fund without parliamentary authority**; and
- the value of advances totalling $69.5 million to departments on hand at 30 June 1990.

1.8.3 In addition, attention is drawn to an amount of $65 million of interest charges, commented on also in paragraph 1.3.2, which should have been paid from the Consolidated Fund.

Trust Fund

1.8.4 The *Public Account Act* 1958 allows the Treasurer to establish trust accounts and indicate the purpose for which they were established. Any expenditure from the trust accounts must be in accordance with the purpose of the account. The Trust Fund is separate from the Consolidated Fund.

1.8.5 The Trust Fund records transactions relating to:

- various suspense and clearing accounts which have been established to facilitate accounting procedures and to improve cash management;
- the Works and Services Account;
- the Victorian Development Fund, encompassing the Cash Management Account and the State Development Account;
- several Commonwealth and joint Commonwealth/State trust accounts used for passing specific Commonwealth Grants etc. to educational institutions, housing and transport authorities;
- specific State trust accounts established by legislation for specific purposes, e.g. Hospitals and Charities Fund; and
- accounts established to manage bequests, scholarships etc.

1.8.6 Summaries of the transactions and balances of the various trust accounts comprising the Trust Fund are given in the Treasurer's Statement.

1.8.7 Details of new accounts opened within the Trust Fund during the year and the purpose for which they were established, as indicated in the Treasurer's approvals or enabling legislation, are set out in Table 1.8A.

TABLE 1.8A NEW TRUST ACCOUNTS

Account or Fund	*Purpose for which established*
Brothel Licensing Board Trust Fund	To record moneys received under to the Prostitution Regulation Act and the payment of expenses permitted to be paid under the Act.
Cash Suspense Accounts • Ministry of Consumer Affairs • Police	To facilitate the drawing, by the agencies, of their own cheques and the drawdown of funds from the Public Account to meet such cheques.
Corporate Card Suspense Account	To record the receipt of funds from the relevant Appropriation programs of participating agencies and the disbursement of such funds to the corporate card contractor.
Courtlink Trust Account	To record moneys received by the Attorney-General's Department in accordance with orders made in Magistrates' Courts prior to the payment of those moneys to individuals and organisations pursuant to the court orders.
Conservation, Forests and Lands Research Projects Trust Account	To record the receipt and disbursement of funds received for specific research projects.
Occupational, Health and Safety Initiatives Trust Account	To record the receipt of $8 million from the Accident Compensation Commission and subsequent expenditure incurred by the Department of Labour on occupational health and safety initiatives.
Property and Services Agency Trust Account	To record the receipt of funds from client departments and agencies for fit-out works and the disbursement thereof on such associated works.
Revenue Suspense Account • Ministry for the Arts	To facilitate the drawing, by the agency, of its cheques and the drawdown of funds from the Public Account to meet such cheques.
State Electoral Office Agency Trust Account	To record the receipt of funds from departments/agencies for the conduct of non-parliamentary elections and the disbursement of those funds on expenditures incidental to the conduct of such elections.
VICSES Volunteer Units Trust Account	To record the receipt of funds from donations and corporate sponsorships to the Victorian State Emergency Services and the disbursement of such funds on equipment.
Working Accounts • Information Victoria Bookshop • State Supply Services • Advic	To record the transactions of agencies including the direct charging of all purchases and operating expenses, with the exception of salaries.

1.8.8 The following account was closed during 1989-90:

- Victorian Fishing Industry Trust Account.

Balances of the Public Account

1.8.9 The transactions of the Public Account for the past 2 years and the investment of the resulting balances are summarised in Table 1.8B.

TABLE 1.8B
RECEIPTS AND PAYMENTS OF THE PUBLIC ACCOUNT
($million)

Item	*1988-89*	*1989-90*
Balance 1 July	517	436
Receipts -		
Consolidated Fund	12 126	12 910
Trust Fund -		
Works and Services Account	891	519
Other	41 826	66 391
	55 360	80 256
Payments -		
Consolidated Fund	12 242	12 965
Trust Fund -		
Works and Services Account	921	474
Other	41 761	66 410
	54 924	79 849
Balance 30 June	**436**	**407**
Represented by the following investments -		
Trust Fund -		
Cash at bank	7	(5)
Fixed deposit accounts	6	10
Short-term deposits	47	-
State Bank equity contribution	45	45
Stocks and securities	52	3
Investment with the Victorian Development Fund *(a)*	188	262
Advances -		
Consolidated Fund *(b)*	22	22
Departments and other purposes	14	70
Total Trust Fund	381	407
Consolidated Fund -		
Investments with the Victorian Development Fund *(a)*	55	-
Total investments at 30 June	**436**	**407**

(a) The Victorian Development Fund acts as Funds Manager to the Public Account.

(b) Previous reports of the Auditor-General have referred to the fact that the balance of Consolidated Fund deficits of $22 million to 30 June 1970, which was financed by way of advances from moneys standing to the credit of the Trust Fund, was still unfunded. These deficits were incurred prior to amendments to the Public Account Act in 1970 which preclude the Consolidated Fund from going into deficit.

1.8.10 As previously stated, the receipts of both the Consolidated Fund and the Trust Fund include various borrowings and the balances are therefore arrived at after such borrowings. Further, part of the balances is not available for general government purposes, e.g. payroll deductions awaiting remittance to the Australian Taxation Office, unspent Commonwealth specific purpose grants and moneys held in trust for specific purposes.

1.8.11 The net effect of the year's transactions was a decrease of $29 million in the total balances of the Public Account, brought about by a decrease of $55 million in the balance of the Consolidated Fund and an increase of $26 million in the balance of the Trust Fund.

Transfer of Appropriations

1.8.12 The *Audit Act* 1958 provides that I summarise in my report approvals given by the Governor-in-Council for the transfer of appropriations between items within programs. It should be noted that the transfers do not vary the upper limit of the parliamentary authority for expenditure of funds under each program.

1.8.13 Total transfers under section 25 of the *Audit Act* 1958 for 1989-90 are summarised in Table 1.8C.

TABLE 1.8C
TRANSFERS UNDER SECTION 25 OF THE AUDIT ACT 1958
($)

Entity (a)	*Total transfers approved*
Agriculture and Rural Affairs	1 075 000
Arts	41 455
Attorney-General	522 995
Corrections	472 000
Community Services	3 750 300
Conservation, Forests and Lands	2 433 023
Education	6 970 000
Ethnic Affairs	5 100
Health	1 292 800
Housing and Construction	202 000
Industry, Technology and Resources	83 742
Labour	499 000
Parliament	158 000
Planning and Environment	344 780
Police and Emergency Services	168 000
Premier and Cabinet	326 000
Property and Services	220 643
Sport and Recreation	3 000
Treasurer	35 791 352
Water Resources	12 000

(a) In accordance with program titles within the *Appropriation (1989-90, No. 1) Act* 1989.

1.9

COMMENTS BY THE DEPARTMENT OF THE TREASURY

The following comments on issues raised by audit in relation to the Treasurer's Statement have been provided by the Department of the Treasury.

Paragraph 1.3.2

The transactions in question were entered into after Treasury obtained independent accounting and legal advice that they did not constitute borrowings but operating leases ($347 million) and interest swaps ($100 million), and that the interest swaps could be treated on a net basis. Treasury has just received supplementary legal advice in respect of the $100 million transactions which confirms that they are not borrowings. This advice supports the accounting and appropriation approach in respect of the $65 million referred to above, but indicates that the $35 million should not have been treated on a net basis. Rather, there should have been a gross receipt of $35 million and a gross appropriation of $35 million. The Solicitor-General supports this advice.

The accruals and flows have been included in the Treasurer's Statement together with other swap flows so that the activity and treatment are disclosed to Parliament.

Paragraph 1.3.4

As indicated in the comment on paragraph 1.3.2, Treasury has received independent legal advice that the $100 million transactions were not borrowings. The legal advice which has just been received, and which is supported by the Solicitor-General, agrees with the treatment of the transactions except for the $35 million interest swap receipt which should not have been treated on a net basis. The advice confirms the treatment of the $65 million transactions on a net basis.

Paragraph 1.3.7

Treasury also sees the fundamental issue as one relating to parliamentary authority. As indicated previously, the Department obtained independent accounting advice concerning the transactions in question and, on the basis of that advice, believed that it treated the transactions correctly, in terms of classification, accounting and appropriation. In view of the legal advice that the Department has now received, the Department appreciates that there is a technical difficulty. The Department intends to address the issue with the Treasurer as a matter of urgency.

Paragraph 1.3.8

The reorganisation of Consolidated Fund transactions shown in Table 1.3B is inconsistent with the accounting conventions for the recording of transactions as set out in the Public Account Act, Audit Act and Appropriation Act. The presentation of borrowing as a receipt in the works and services sector of the Consolidated Fund, and the presentation of either a drawdown of a deposit or a short-term borrowing from the Cash Management Account as a recurrent receipt is the appropriate form of presentation of Consolidated Fund transactions. There is no such thing as a "below the line" format for presentation prescribed in the governing legislation. This is not to say, of course, that there is not a need for a different presentation of information for analysis of budgetary policy. This need is recognised and is met by the presentation in the Budget Papers of comprehensive consolidated data in the national accounting format, covering all budget sector transactions, including those recorded outside the Consolidated Fund.

Paragraph 1.3.16

The Victorian Development Fund (VDF) is used as a source of temporary borrowing, generally for periods up to 30 days, whereas borrowings from VicFin for temporary purposes are for periods between 30 and 180 days. This reflects the relative efficiency of the source of funds to these 2 agencies.

VDF relies largely on short-term deposits, whereas VicFin operates in the longer end of the market using promissory notes with terms of between 30 and 180 days. Because of the inverse yield curve, i.e. shorter-term interest rates are at higher levels than longer-term interest rates, the cost of borrowing for periods of up to 30 days was higher than in the 30 to 180 day period. For instance, the average interest rate at the shorter end was about 3 per cent higher than the longer end.

The difference in borrowing costs between the 2 agencies is primarily the result of the difference in interest rates between the 2 periods in which the agencies borrowed. Therefore, had all borrowings been undertaken from VicFin, a similar cost differential would have resulted.

Paragraph 1.3.18

Treasury disagrees with the view of audit that the sale of light rail vehicles and buses represents borrowings. Following independent accounting advice, Treasury believes that it has quite properly treated the sale and lease-back arrangements as an asset sale and lease-back on an operating lease basis. Ownership has passed to a third party and the operating lease payments will be made by the Public Transport Corporation from appropriated funds.

Paragraph 1.3.20

The loans to the Government Employee Housing Authority (GEHA) had a repayment schedule spread over a long period and the interest rate was 3 per cent. Because GEHA borrowed at market rates from the Victorian Development Fund, this meant the loss of a subsidy. However, at the same time, to maintain the financial viability of GEHA, the Treasurer agreed to the provision of additional funds in the budget to move rents to a market basis. In other words, the appropriations contained an amount to enable the relevant departments to supplement the subsidised rent paid by the tenants to GEHA. This means that GEHA has been moved on to a commercial basis.

Paragraph 1.4.3

Table 1.4A shows a calculation of a "deficit" on Consolidated Fund transactions which it describes as being funded from borrowings. This is incorrect as changes in cash balances have been included "below the line". For example, the current account "surplus" in 1987-88 of $141 million reflects a deposit in the Cash Management Account and the "deficit" in 1988-89 of $116 million reflects a drawdown of a deposit in the Cash Management Account.

Paragraph 1.4.11

The Government's debt management strategy is described in Budget Paper No.2, Budget Strategy and Review 1990-91, Chapter 5, and in the Notes to the Treasurer's Statement for 1989-90 at pp. xxiv to xxvi. The essential elements of this strategy are the retirement of debt and the management of the time profile of interest payments over the medium-term to ensure that they remain at manageable levels. As a consequence of this strategy budget sector debt is projected to decline between June 1990 and June 1991.

Paragraph 1.5.18

Treasury obtained accounting opinion from senior partners in the leading accounting firms confirming that the leases were operating leases not finance leases. Therefore, Treasury does not accept that the leases should be reported as borrowings in the Treasurer's Statement or for Loan Council purposes.

Paragraph 1.5.19

The conclusion drawn by audit is incorrect. The rental cost of leases undertaken by the Government during 1989-90 are up to 1 per cent below the cost of borrowing.

Paragraph 1.5.44

Treasury notes that the VDF received legal advice that the transactions in question were legal.

Paragraph 1.5.48

Without wishing to diminish the significance of this matter, Treasury notes that 13 transactions were involved on 11 different days over a 3 month period. The transactions were stopped immediately management became aware of them and operational procedures strengthened.

Paragraph 1.5.53

While Treasury accepts the need to strengthen the Board, it should be noted that the existing Board structure operates on formal lines:

- *(i) a corporate plan is presented to the Treasurer each year;*
- *(ii) the management of VDF works within delegated authorities from the board of management contained in a formal policy and procedures manual;*
- *(iii) the powers of the VDF are established by the Governor in Council;*
- *(iv) asset growth (both on and off balance sheet) is constrained by a notional capital base analogous to Reserve Bank of Australia arrangements.*

Treasury proposes also that the Auditor-General or a senior representative of the Auditor-General be invited to attend meetings of the audit committee of the VDF on external audit matters.

Paragraph 1.5.62

The amount of $197 million presumably comprises $97 million of interest appropriations from the works and services sector of the Consolidated Fund together with the interest swap transactions totalling $100 million mentioned in paragraph 1.3.2. According to legal and accounting advice received by Treasury these transactions do not involve a borrowing used to make an interest payment. Accordingly, the $100 million should not be counted as similar to the $97 million.

A distinction is made between recurrent transactions and works and services transactions in appropriation legislation, and hence in the recording and reporting of transactions in the Consolidated Fund. This categorisation of Consolidated Fund receipts and payments has been adopted by Victorian Governments over many years. As noted in the First Report of the Auditor-General for the year ended 30 June 1986 (page 75), "recurrent expenditure" includes a number of capital transactions and conversely "works and services expenditure" includes significant operational expenditure.

One such transaction which has been fully explained in the Budget Papers over a number of years relates to the Government's decision to phase out progressively the capitalisation of finance charges for transport in excess of the long-term real interest rate component. This decision as taken in the 1986-87 Budget (see Budget Paper No.2, Budget Strategy and Review 1986-87, page 92) and has been implemented in subsequent years with a progressive decline in the size of the charge involved. The 1990-91 budget is the last Budget in which an amount of interest in respect of debt previously raised by the public transport authorities is appropriated from the works and services sector.

Paragraph 1.5.64

The figure for budget sector interest paid (cash basis) for 1989-90 is $1 441.8 million and for 1986-87 is $1 067.8 million, as shown in Budget Paper No.2, Budget Strategy and Review 1990-91, Table A.3. The increase between these 2 years is 35 per cent.

Paragraph 1.5.67

Audit calculation of the cost of the down grading is grossly overstated. The effect of the down grading is confined to fixed interest borrowings. The full year annual additional cost is estimated to be about $1.8 million.

Paragraph 1.6.2

This table incorrectly represents Consolidated Fund receipts because it excludes receipts from sale of transport assets by sale and lease-back operating leases from the figure for sale of assets, and excludes changes in cash balances held in the Cash Management Account and the Works and Services Account.

Paragraph 1.6.10

As noted in Budget Paper No.6, Supplementary Budget Information 1990-91, page 46, a central feature of the program to dispose of surplus property has been the treatment of receipts as a general source of funding for the budget sector capital works program, with a requirement that all budget sector agencies (except Housing and Construction) pay sale proceeds into the works and services sector of the Consolidated Fund. This approach ensures that funds are allocated to capital projects according to the Government's priorities and that "asset rich" agencies do not benefit at the expense of "asset poor" agencies.

In 1990-91, to monitor the application of receipts from asset sales to particular items in the budget sector capital works program, information detailing all sales and their projected receipts stream for the financial year will be provided by agencies to Treasury and plotted against the approved list of capital works projects included in the Budget to show the direct relationship between asset disposals and the asset renewals program.

Paragraph 1.6.24

Increases in payroll tax debtors were due to increased numbers of default assessments, a reduction of backlogs from unassessed field auditors, liquidity problems of taxpayers and use by taxpayers of legal processes which delay collections.

The increase in land tax debtors is in line with the increase in the base notwithstanding the late passage of legislation for 1990 tax which delayed the initial assessment and further recovery action.

As earlier advised to the Audit Office, the $23 million identified as outstanding debts at the Stamp Duties Office is composed entirely of amounts subject to litigation and other legal process. The timing of ultimate collection is largely outside the discretion of the Office.

Paragraph 1.6.25

As indicated in its management response in the Treasurer's Statement 1988-89 (see pp. 40-1), the State Tax Office believes that it is not practical to issue all assessments in the first quarter of the calendar year.

Paragraph 1.7.7

See management response to paragraph 1.5.62 on the categorisation of transactions In the Consolidated Fund.

PART 2

MATTERS OF SPECIAL INTEREST

2.1 SUMMARY OF MAJOR AUDIT OBSERVATIONS

The major audit observations dealing with matters of special interest are:

IMPLEMENTATION OF DISPATCH AND MANAGEMENT INFORMATION SYSTEM AT METROPOLITAN AMBULANCE SERVICE *Page 85*

- Serious shortcomings in the implementation of a major dispatch and information system at the Metropolitan Ambulance Service.

  para 2.2.3

FUNDING OF VICTORIAN PUBLIC HOSPITALS *Page 95*

- Victoria incurred a reduction in Commonwealth funding available to public hospitals of approximately $32 million in the period 1988 to 1990 due to the failure of hospitals to treat the specified levels of Medicare patients.

  para. 2.3.5

- There are incentives for Victorian public hospitals to treat high levels of private patients, an action which impacts upon waiting lists and the level of access for Medicare patients.

  para. 2.3.7

NEED FOR ACCRUAL ACCOUNTING AND CONSOLIDATED ACCOUNTS OF THE STATE *Page 101*

- Substantial improvement in the quality of financial reporting by Victorian public bodies has occurred since the introduction of the Annual Reporting Act.

  para. 2.4.10

- Adoption of accrual accounting within the budget sector will provide similar opportunities for improvement in management decision-making and financial reporting, and enhance the standard of accountability.

  para 2.4.4

NEED FOR MORE EFFECTIVE INTERNAL AUDIT IN THE PUBLIC SECTOR *Page 107*

- Substantial scope exists for internal audit services, including EDP, to be provided under contractual arrangements.

para 2.5.13

NEED FOR CODE OF CONDUCT FOR BOARD MEMBERS AND DIRECTORS OF PUBLIC BODIES *Page 123*

- Recent developments within both the private and public sectors have reinforced the need for a code of corporate practice for public sector board members and directors.

para 2.6.3

2.2

IMPLEMENTATION OF DISPATCH AND MANAGEMENT INFORMATION SYSTEM AT METROPOLITAN AMBULANCE SERVICE

KEY FINDINGS

- The Health Department Victoria reimbursed the Metropolitan Ambulance Service $1.8 million for Stage 1 of the CADAMS project, the funding of which was not approved by the Minister.

  paras 2.2.13 to 2.2.15

- Duplicate payments to the Ambulance Service in excess of $700 000 were made by the Health Department Victoria.

  para. 2.2.16

- Completion of the CADAMS project is more than 2 years behind schedule.

  para. 2.2.3

- Under the contract agreement, the Ambulance Service was required to make substantial payments to the contractor even though software had not been delivered.

  paras 2.2.5 to 2.2.9

- Benefits from systems implementation will not be achieved within the forecast timeframe.

  paras 2.2.11 to 2.2.12

BACKGROUND

2.2.1 Following a review of ambulance services in Victoria in 1984 the Public Bodies Review Committee recommended that the Metropolitan Ambulance Service and the Health Department Victoria co-ordinate work on a computer-aided dispatch and management information system (CADAMS) as a matter of high priority. The project was approved by the Department in 1986 and was to proceed in 3 stages as outlined in Table 2.2A.

TABLE 2.2A CADAMS PROJECT DEVELOPMENT
($million)

Project stage	*Budget*
STAGE 1 Development of computer-aided dispatch system incorporating a modern communications system, voice switching system and implementation of management information systems relating to patient accounts, subscribers and a general ledger accounting package. This stage was to be fully-funded by the Ambulance Service.	2.6
STAGE 2 Further development of computer-aided dispatch system incorporating the major incident system, estimated vehicle location system, remote network control, mobile data terminals and integration of various enhanced management information systems. This stage was to be fully-funded by the Department. Expenditure under the Public Sector Capital Works Program was provided for in the 1987-88 Budget.	3.9
STAGE 3 Construction of an enlarged modern communications centre at Frankston providing total back-up computer facilities for Stages 1 and 2 and an integrated communication system connected with major public hospitals. Although the Ambulance Service was advised in June 1989 that the Department had approved of this Stage proceeding, the Government has not provided funding. The Ambulance Service has undertaken to fund this stage in the interim on the condition that it will be partially reimbursed at a later date, with the total cost of the project being split 50/50 between the Ambulance Service and the Department.	3.0
Cost of project	9.5
Consultancy fees payable to project manager (a private accounting firm)	0.3
Total cost of project	**9.8**

2.2.2 A cost-benefit analysis of the project was undertaken by the Ambulance Service in 1985 and provided to the Department. The Ambulance Service calculated that the $10 million cost of the project would be recouped by way of productivity gains and cash savings over a 5 year period. Apart from these savings, the main benefits of the system were seen as:

- reducing the emergency response time by 3 minutes;
- better utilisation of Ambulance Service resources and skill levels;
- rationalisation of the emergency car system;

- improving cash flows; and
- providing a computer base from which the business operations of the Ambulance Service could be expanded.

Management response by Health Department Victoria

Health Department Victoria funding approval of Stage 3 has not been given to the Ambulance Service.

The implementation of the CADAMS project was also subject to the agreement that the Department would fund 50 per cent of the total cost of CADAMS Stage 1, 2 and 3, plus the relocation of headquarters of the Ambulance Service to Doncaster and the establishment of the vehicle service centre and branch station in South Melbourne. The total payments by the Health Department Victoria to 30 May 1990 of $6.4 million towards the total expenditure on these projects ($12.8 million) is in line with the 50/50 funding commitment given by the Department subject to final detail adjustment in Stage 3 CADAMS.

DEFICIENCIES ARISING FROM THE PROJECT

2.2.3 The principal contractor anticipated that obligations under the contract would be completed by February 1989. However, at the date of preparation of this report, only Stage 1 of the project has been completed. Stage 2 of the project has encountered serious problems and the major components of this Stage are unlikely to be completed before mid-1991, more than 2 years behind schedule.

2.2.4 The numerous problems and deficiencies that have occurred with the CADAMS project as detailed below indicate a need for substantial improvement in contract evaluation procedures, project supervision, legal safeguards, financial controls and monitoring procedures within both the Ambulance Service and the Department.

Contract deficiencies

2.2.5 The request for tender for the project's principal contract for Stages 1 and 2 was issued in 1986 to 4 specific suppliers. The successful firm, a large international computer company, was chosen mainly on the basis of the firm having developed a software package in the USA which was closely aligned with the Ambulance Service's requirements. The package was inspected by the project manager and Ambulance Service officers who were satisfied it could be modified for Victorian use. In May 1987 the project manager assured the Ambulance Service of the viability of the project despite the use of state-of-the-art technology.

2.2.6 After the contract was signed the successful firm sub-contracted to another firm the task of modifying the software package obtained from the USA to meet the requirements of the Ambulance Service.

2.2.7 The original contract negotiated with the principal contractor was signed in November 1987 and provided for a fixed price of $5.9 million, payable in instalments over a period to June 1989. The contract price was subsequently amended to $4.9 million due to the inability of the contractor to design an automatic vehicle location system to the Ambulance Service's specifications. **Although the contract was extremely detailed as to the specifications and standards required by the Ambulance Service, it contained a serious deficiency in that the Ambulance Service was obliged to make payments at regular intervals regardless of whether the software was delivered or performance standards were met.** Audit was advised that established procedures within the Ambulance Service required contract agreements to be scrutinised by its legal officers prior to approval by the Department.

2.2.8 The Ambulance Service paid the contractor by 30 June 1989 the total contract sum of $4.9 million, less 10 per cent retention. However, the major elements of the software had not been delivered due to significant development problems associated with the advanced technology. The Ambulance Service considers it is holding as security a processor valued at $1.4 million delivered in advance for Stage 3 of the project and for which payment has not been made to the contractor.

2.2.9 The contractor's liability for non-performance under the agreement is limited to only 5 per cent of the value of the particular Stage from which a claim may arise.

- *Management response by Ambulance Service*

  The Service considered that it did not have sufficient expertise to manage the project and in consultation and agreement with the Health Department Victoria, decided that a project manager be appointed. A consultancy/project management brief was established and let for tender. One aspect clearly identified in the scope of the consultancy was for the tenderer to advise on contract design and requirements. This requirement was formally accepted by the successful tenderer. The project managers were appointed with the approval of the Health Department Victoria and were required in particular to advise on all technical aspects of the project and in the design of contract documentation.

  The Service relied upon the advice of its project managers and solicitors in the development of contract documentation.

  The fixed price contract negotiated by the Service has proved beneficial, due to the contractor's obligation to provide additional hardware to the value of $1 million at no cost to the Service, resulting in adherence to the original funding commitments.

- *Management response by Health Department Victoria*

  The Ambulance Service contract with the successful tenderer was subject to advice by its solicitors and the project manager who regarded it as appropriate for the developmental nature of this project. The Ambulance Service consider it is in line with industry practice for such contracts.

Unsatisfactory performance of principal contractor

2.2.10 The contractor seriously under-estimated the complexity and cost of the project resulting in the contract delivery time being extended by the contractor from the original estimate of 13 months to at least 4 years. Major factors were:

- A realisation by the contractor after signing the contract that the size of the processors required was grossly under-estimated and 2 additional high performance processors worth $1 million had to be provided at the contractor's expense;
- Despite the contractor and the Ambulance Service originally considering that the software package developed in the USA could be modified, subsequent events disclosed that this process was not feasible. Eventually, in late 1988, the conversion was scrapped, with new software to be developed by the sub-contractor. In audit's view the project manager should have known at an early stage that the package was not capable of modification and then further delays in developing new software could have been minimised; and
- A dispute arose between the contractor and sub-contractor as to which firm would bear the legal responsibility for the new software performing to contract specifications. This dispute, which is still to be resolved, has led to further unsatisfactory delays in software development and delivery.

- *Management response by Ambulance Service*

Over the period of the contract to date, the Service has on numerous occasions officially expressed its concerns in the delay of the project. Both the principal contractor and the software sub-contractor, under-estimated the complexity and size of the project and it is evident that both firms are "hurting" considerably as a result of the difficulties associated with the completion of the project. Also significant is the principal contractor's commitment to complete the project which has been reinforced on a number of occasions. The contractor is now prepared to accept sole responsibility for the development and provision of all CADAMS software not yet provided to the Service.

Projects of this type, with their state-of-the-art technology, require a dual track method of research and development which inherently creates some delays.

The Service believes that, following a recent review by its officers including discussions with the prime contractor, the original objectives are still achievable.

In recent discussions with the Health Department Victoria, it has been decided to replace the existing project monitoring and control committees with a joint Departmental, Service and Prime Contractor Committee. This Committee will be responsible for the overall co-ordination, review and continued implementation of the CADAMS project, including a review of the performance of the contractor.

- *Management response by Health Department Victoria*

It is true that the development of Stage 2 has encountered problems that were not originally envisaged. The basis of these problems (and hence a delay in completion) is the fact that the adaptation of a computer package (Public Safety Systems) in operation in the USA, could not be achieved. To achieve the technical requirements of the Ambulance Service specification, it was then necessary for the contractor to develop new computer software. This had no impact on the total project cost (contract price) to the Ambulance Service.

The Ambulance Service has not compromised either the project objectives or its specification requirements to be met by the contractor who remains committed to successful implementation.

Stage 1 of CADAMS has been successfully implemented. Stage 2 of the project has been partly implemented and is expected to be completed by December 1991.

The overall performance under the contract is represented by the supply and successful operation of hardware and software systems. The supply of computer hardware exceeds original contract expectations while performance on the supply of software has been delayed due to the need to undertake more fundamental developmental work rather than adaptation of an existing system.

The role of the project manager will be subject to review by the Department and the Ambulance Service. The ongoing management of the project will be assumed by a joint Health Department Victoria/Ambulance Service Project Management Group. A key role of the project group will be to review the performance of the contractor and take any necessary corrective action.

Benefits reduced

2.2.11 A recent assessment by the Ambulance Service of CADAMS indicated that, while many of the benefits originally anticipated were still achievable in terms of improved operational and administrative efficiency, the projected level of productivity and monetary savings of $10 million over 5 years would not be achieved. This projection, which was provided to the Department in 1985, did not take into account the cost of training staff, additional equipment, maintenance costs, accommodation, up-grading the power supply, industrial relations problems etc.

2.2.12 These costs, are estimated at $2.7 million in the first year and from at least $1.3 million annually thereafter. As a result of these additional costs actual monetary savings from the full implementation of CADAMS are likely to be minimal.

- *Management response by Ambulance Service*

  It was apparent that some areas were not considered in the original submission and subsequent review, which would have an impact upon government and Service funding. The key items not considered or fully evaluated were the expenses involved in the training of operational staff and the recurrent resources required to maintain the computer network.

  It is evident that the original stated $10 million savings is comprised of improved efficiencies in the delivery of health services with virtually no actual cash savings. However, the Service believes that the original objectives are still achievable and will be met by the project on completion.

- *Management response by Health Department Victoria*

  Audit has based its finding on an early feasibility study by the former Ambulance Service Board. It has not established that this was the basis on which the project was supported by the new Board or approved for funding by the Department.

  Audit comment assumes that benefits at $10 million were based on expected actual cash outlay savings of this amount when it was a figure that largely represented the monetary value of expected improved efficiency, productivity and service improvements.

  It was expected that there would be some costs involved in the areas of staff training and operational support.

The recent estimates by the Ambulance Service of $2.7 million in the first year and $1.3 million a year thereafter are not accepted by the Health Department Victoria at this stage. This issue is being examined by the Health Department Victoria in detailed discussion with the Ambulance Service.

The Ambulance Service and Health Department Victoria consider that significant efficiencies, productivity and service improvements can be achieved through the implementation of CADAMS.

Ministerial approval not provided for Stage 1 payments

2.2.13 The Appropriation Acts for 1987-88 and 1988-89 did not provide specific details of individual projects under the Statewide Capital Works program. However, this supplementary information was contained in Budget Information Papers entitled "*Public Sector Capital Works Programs*" prepared by the Department of the Treasury. These documents for 1987-88 and 1988-89 clearly specified that funding of Stage 2 only of the CADAMS program to a value $3.9 million was to be undertaken in the overall context of the Health works and services expenditure approved in the Appropriation Act. In addition, departmental documentation disclosed that the Ambulance Service was advised by the Department in 1987 that, in accepting the contract for Stage 1 of the project, no government funds were to be provided for that Stage.

2.2.14 Despite approvals being restricted to Stage 2 of the project, the Department subsequently reimbursed the Ambulance Service for payments totalling $1.8 million relating to Stage 1 of the project, the cost of which was to be entirely borne by the Ambulance Service. Although the Department maintained that allocations for projects in the works and services appropriation can be varied by the Minister it was unable to provide documentary evidence that the then Minister approved of any variation relating to the funding of Stage 1.

2.2.15 It is of serious concern that the Department utilised substantial moneys for a purpose other than that approved by the then Minister.

- *Management response by Health Department Victoria*

Computer Aided Dispatch is one component of a major capital works program totalling $17.7 million negotiated between the Metropolitan Ambulance Service and the Health Department Victoria.

The program involved the following projects:

(i) relocation of the Ambulance Service from Latrobe Street to Doncaster;

(ii) establishment of a garage and workshop in South Melbourne;

(iii) development and installation of a computer-assisted dispatch system; and

(iv) refurbishment of Frankston station to provide for the extension of CADAMS.

Although funding of each project was identified separately, it was also agreed that the overall program would involve 50/50 contributions by Health Department Victoria and the Ambulance Service.

The Department does not accept that payments were made to the Ambulance Service without Ministerial approval. The CADAMS project was approved by the Minister as one component of a broader $17.7 million Ambulance Capital Works Program on the basis of 50/50 funding contributions by Health Department Victoria and the Ambulance Service. Variations to the initial funding proposed for Stages 1 and 2 of CADAMS have not breached Ministerial approval for the funding of the overall program. It is also wrong to infer that moneys were applied "for another purpose" other than for the purposes of the CADAMS project.

The Department agrees that grants made to the Metropolitan Ambulance Service in respect of Stage 1 did not accord with the approval given for the commencement of that project but in the context of the total project they are within the overall 50/50 funding arrangement for the Ambulance Services Capital Works Project.

Funds expended on CADAMS were available from the Department's works and services appropriation. Allocations for projects in the Works and Services Program can be determined by the Minister.

Duplication of payments

2.2.16 In addition to the unauthorised expenditure detailed above, **the Department also made duplicate payments totalling $716 000 representing reimbursement of expenditure incurred by the Ambulance Service on Stages 1 and 2 of the project.** These duplications, which were detected by audit, arose as a result of the following factors:

- The intention of the Department to fully utilise the Parliamentary Works and Services Appropriation of $3.9 million by 30 June 1989;
- The practice of the Department, as specified on the works claim forms, that original invoices from the Ambulance Service were not required when submitting claims for reimbursement. As a result, photocopies of invoices were submitted and reimbursed several times without query;
- Internal control mechanisms within both the Department and the Ambulance Service being seriously deficient; and
- The Ambulance Service maintaining that it was urgently requested by the Department to submit duplicate invoices in respect of both Stages of the project before 30 June 1989, regardless of whether original invoices had already been submitted and paid previously. It was the understanding of the Ambulance Service that the Department would eventually reconcile the claims in accordance with approved funding levels at a later stage.

- *Management response by Ambulance Service*

The Service applied for the funds in good faith and on advice from the Health Department Victoria. The issues raised by audit were subsequently the subject of several internal investigations and 2 independent external investigations.

As a result, the Service believes that the overall shared funding allocation has not been compromised.

- *Management response by Health Department Victoria*

  Audit opinion as to the intention of the Department to fully utilise the Appropriation by 30 June 1989 is incorrect. The Department could carry forward any unspent funding on this program as part of its base funding for 1989-90. It is therefore not clear what the Department would have had to gain by deliberately acting in the way that audit had presumed.

  While duplicate invoices totalling $715 724 were submitted to the Department, payments made on the basis of the duplicate invoices totalled $569 499. Later claims totalling $544 609 have largely offset this amount.

  The Department accepts that these payments were made without proper regard to the Treasury Regulations and the procedures for the payment of grants for capital projects.

  While payments have been made inappropriately, the payments resulted from an over emphasis by staff on clearing grants too readily up to the project commitment level (and within the 50/50 funding arrangement for the $17 million Capital Works Program) without due attention to the detailed supporting documentation and the staging of the CADAMS project.

  It is not at all clear if the discussion between the Health Department Victoria and Service officers is accurately represented by the assertion that the Service was required to submit duplicate invoices regardless of whether original invoices had already been submitted and paid. Duplicate invoices were requested by the Department's officers to assist in identifying original invoices that were held by the Department, and not reimbursed to the Service. It was expected that a reconciliation would be made by the Service officers to effect appropriate reimbursement. This reconciliation was not carried out at that time but it has subsequently been reconciled.

  The Department has established procedures for the payment of grants for Capital Works. This project is not representative of the Capital Works Program where formal project management arrangements are in place in respect of the building and construction activities. The nature of the CADAMS project required some modification of approach and, in doing so, there was an over-reliance on, and acceptance of, the Service management of the project.

  The Department has completed a review of all project management procedures and controls and is satisfied that, generally, controls are being complied with.

2.3 FUNDING OF VICTORIAN PUBLIC HOSPITALS

KEY FINDINGS

- Victoria incurred a reduction in Commonwealth funding available to public hospitals of approximately $32 million in the period 1988 to 1990 due to the failure of hospitals to treat the specified levels of Medicare patients.

  para. 2.3.5

- There are incentives for Victorian public hospitals to treat high levels of private patients, an action which impacts upon waiting lists and the level of access for Medicare patients.

  para. 2.3.7

- There is a need for the Health Department Victoria to continue strategy developments aimed at improving the access of Medicare patients to public hospitals and addressing the Medicare penalty imposed by the Commonwealth Government.

  paras 2.3.8 to 2.3.10

BACKGROUND

2.3.1 Under the Commonwealth Government's Medicare policy universal access to public hospital inpatient and outpatient services is provided free of charge to all Australian citizens. These services are provided through a network of public hospitals controlled by the States. Although the responsibility for funding the public hospitals is primarily that of the States, the Commonwealth Government provides assistance in the form of:

- Financial Assistance Grants, which are general revenue assistance grants, a proportion of which is applied by States towards public hospitals; and
- Specific Purpose Grants, which mainly comprise Hospital Funding Grants payable under the Medicare Agreement.

2.3.2 Over recent years, Commonwealth Government financial assistance to Victoria has been reduced in real terms, which in turn places an increasing burden on Victoria to adequately fund the public hospital system through grants paid from the Hospitals and Charities Fund and through hospital generated revenue, of which the collection of fees from private patients is a major component.

2.3.3 As stated in my *Special Report No. 12* on the Alfred Hospital in May 1990, there are considerable financial advantages to both the hospitals and to a lesser extent, privately insured patients, arising from the treatment of private patients in public hospitals under the current Medicare arrangements. **However, in treating large numbers of private patients, Victoria forgoes significant Commonwealth funding as a result of the penalty provisions contained in the Medicare Agreement. In addition, the capacity of hospitals to treat public patients is reduced.**

MEDICARE PENALTY PROVISION

2.3.4 Under the current Medicare Agreement which was prepared in accordance with the principles established at the June 1988 Premiers' Conference it is the stated intention of the Commonwealth that access to public hospitals by Medicare patients is not diminished. In accordance with this intention, incentives are provided to encourage the more effective use of recognised hospital facilities, including the aim of each State and Territory providing a level of public hospital access for Medicare patients which is equivalent to a minimum of 53 per cent of the total patient bed days available in all recognised public and private hospitals in each State or Territory. This percentage is regarded by the Commonwealth as the minimum level necessary to ensure Medicare patients have adequate access to hospital services. The Agreement further provides that where a State or Territory fails to meet this quota, which is calculated on the basis of public bed days expressed as a percentage of total bed days available in both the public and private hospital systems, its annual Hospital Funding Grant is reduced by $155 for every public patient bed day below this level.

2.3.5 **As a consequence of this penalty provision Victoria had its Hospital Funding Grant reduced by $16.6 million in 1988-89 and $15.3 million in 1989-90 for failing to achieve the 53 per cent Medicare patient occupancy rate. A provisional estimate by the Department of the expected reduction in 1990-91 is $16 million. With the exception of the Australian Capital Territory, which has incurred minor reductions during the same period, Victoria is the only State in Australia to incur this penalty.**

2.3.6 The average Australia-wide bed occupancy rate for public patients in 1988-89 was 58.8 per cent as compared with Victoria's rate of 52.8 per cent. The 1989-90 penalty of $15.3 million incurred by Victoria was originally estimated at $35 million. Following representations by Victoria to the Commonwealth Government, agreement was reached that compensable patients such as Veterans Affairs' patients and Transport Accident Commission admissions were to be excluded from the penalty calculation and the required Medicare patient occupancy level was raised from 53 to 55.85 per cent.

2.3.7 Although the revised formula achieved a reduction in Victoria's penalty in 1989-90 the penalty will most likely continue to be incurred in future years unless new strategies are developed. Influencing factors are:

- *Level of private health insurance*

  An Australian Bureau of Statistics survey in March 1990 disclosed that **while on average 44.6 per cent of Australia's population had some form of private health cover, Victorian coverage was 50.3 per cent.** The higher than average level of Victorian health insurance cover suggests that more Victorians prefer to be treated as private patients, thereby impacting upon the ratio of public patients to overall number of patients being treated.

- *Number of private hospitals*

  By comparison with the rest of Australia, **Victoria has a large number of private hospitals, resulting in a ratio of private beds to total beds of 30 per cent, the highest of any State.** Nationally there is an average ratio of 25 per cent. While it is argued that as a result of this factor public hospital demand is likely to be reduced, the reality is that the private hospital system is under-utilised, with many private patients preferring to be treated in public hospitals.

- *Treatment of private patients in public hospitals*

  Under the Medicare Agreement a person's health insurance or financial status will not be a determinant in the priority for receiving care and treatment in a public hospital. **As a result, a large number of privately insured patients seek treatment in public hospitals, a factor which can impact significantly on the ability of these hospitals to treat public patients and reduce waiting lists.**

Data produced on bed occupancy rates in 1988-89 by the Health Department Victoria in respect of 59 of the State's larger public hospitals disclosed that, on average, 35 per cent of patients in these hospitals were private patients, including a small percentage of patients treated as private whose charges are payable by Veterans Affairs, Transport Accident Commission etc. Certain large hospitals were recorded as having relatively high percentages, e.g. St George's Hospital (63 per cent), Mercy Maternity Hospital Inc. (53 per cent), Geelong Hospital (49 per cent) and Alfred Hospital (39 per cent).

Despite the encouragement by the Commonwealth under the Medicare Agreement for the State to treat a certain level of Medicare patients and the resultant financial penalty borne by the State if the agreed percentage is not met, the reality is there are incentives for public hospitals to treat private patients, namely:

- the hospital benefits from the income received from health funds and through Medicare benefits for diagnostic investigations;
- private practice arrangements in public hospitals provide substantial benefits to both doctors and hospitals; and
- due mainly to ancillary charges, the private patients often find it cheaper to be treated in public hospitals compared with private hospitals.

▸ *Outpatients*

Health Department Victoria statistics indicate that **Victoria treats significantly more outpatients than the national average.** Although this high level of outpatient treatment can, in some instances, be regarded as an alternative to hospitalisation, it is not recognised by the Commonwealth Government when calculating the Medicare penalty.

SUMMARY

2.3.8 It is acknowledged that the cost of the Medicare penalty to Victoria in the period 1988 to 1990 of around $32 million was largely offset by the additional revenue gained by public hospitals from treating private patients. However, the comments contained in my report to Parliament on the Alfred Hospital in May 1990 are re-iterated:

> *"There is no priority of access for persons of lower socio-economic groups to receive necessary but elective treatment at a public hospital. They must compete for scarce resources with more affluent members of the community who, by virtue of private health insurance, have the option to exercise free choice of either private or public care in the dual hospital system. Because of the higher level of private hospital charges, those without private insurance, in particular the disadvantaged, have no option but to seek treatment in a public hospital.*

"There appears to be an inherent conflict between the State/Federal Medicare arrangements which enable all persons to receive free treatment at public hospitals irrespective of socio-economic status and the general thrust of the Victorian State Government Social Justice Strategy which attempts to cater for the needs of the disadvantaged members of the community by:

- *reducing disadvantage caused by unequal access to economic resources and power; and*
- *increasing access to essential goods and services according to need.*

"The health profile of the lower socio-economic groups cited by various authorities suggests that such persons need added support of easy access to care and sickness prevention services.

"If persons with private hospital insurance at higher than basic cover are treated in public hospitals for illnesses which could equally be treated in a private hospital, the result must be a reduction in the availability of beds for the disadvantaged."

2.3.9 In audit opinion there is a need for the Health Department Victoria to continue to develop and promote new strategies to:

- create incentives for public hospitals to improve Medicare patient access, a measure which could also reduce public hospital waiting lists; and
- address the perceived inequities in the calculation of the Medicare penalty provisions to take account of certain specific features of the Victorian hospital system.

2.3.10 It is important that strategies be available in order that Victoria can provide input into the Medicare review currently being undertaken by the Commonwealth Government and when the Medicare Agreement is re-negotiated in 1993.

2.4

NEED FOR ACCRUAL ACCOUNTING AND CONSOLIDATED ACCOUNTS OF THE STATE

KEY FINDINGS

- Substantial improvement in the quality of financial reporting by Victorian public bodies has occurred since the introduction of the Annual Reporting Act.
  para. 2.4.10

- Adoption of accrual accounting within the budget sector will provide similar opportunities for improvement in management decision-making and financial reporting, and enhance the standard of accountability.
  paras 2.4.4 to 2.4.14

BACKGROUND

2.4.1 Use of an accrual basis of accounting involves recognition within financial statements of expenses at the time an obligation to pay arises rather than when payment is made and of revenue when due or earned rather than when received. The accrual accounting basis also requires recognition by an entity of all assets and liabilities and disclosure of its true financial position at balance date.

2.4.2 By comparison, financial information reported by entities which operate on a cash-based system of accounting is generally limited to amounts actually received and paid during a period.

2.4.3 Reports of the Auditor-General since 1985-86 have consistently advocated the adoption of accrual accounting principles for the recording and reporting of the State's financial transactions. The reports have also recommended preparation by the State of annual consolidated financial statements incorporating assets and obligations of all public sector entities and disclosing, for parliamentary scrutiny, the financial position or net equity of the State.

WHY HAS AUDIT CALLED FOR USE OF ACCRUAL ACCOUNTING AND CONSOLIDATED REPORTING?

2.4.4 Accrual accounting principles are concerned with the disclosure of all of an entity's assets, liabilities, revenues and expenses, i.e. the totality of its financial position and status. Also, where accrual accounting is applied uniformly across a group of related entities, e.g. subsidiaries of a parent company or groupings of public sector bodies, consolidated financial statements showing the group's operating results and financial position can be prepared.

2.4.5 The application of accrual accounting principles means that users of financial reports are in a much sounder position to form judgement on the overall financial health of an entity. For example, the availability of periodic information on the State's total liabilities would enable Parliament and the public to assess the level of financial obligations which will need to be met by taxpayers in future years.

2.4.6 With accrual accounting, organisational management has available more comprehensive information in such areas as costs of services and magnitude of asset holdings and obligations to assist in decision-making on financial management matters, e.g. level of fees that ought to be levied on users of a particular service and identification of under-utilised assets including the implications of their sale or retention.

2.4.7 In Victoria, most public bodies (other than departments) record and report financial transactions on an accrual basis. On the other hand, departments and the Government's central financial systems have traditionally operated on a cash basis in line with the State's annual budget process and legislation underlying the system of parliamentary authorisation for the collection and use by government of public moneys.

2.4.8 The principal message conveyed by audit over the years has been that the information needs of both users and preparers of public sector financial statements can only be fully satisfied if accrual accounting principles are uniformly applied across the whole of government.

CURRENT STATUS OF FINANCIAL REPORTING WITHIN VICTORIAN PUBLIC SECTOR

2.4.9 In the Victorian public sector, audited financial information is reported annually to the Parliament from 3 main sources, namely:

- public bodies (or statutory authorities);
- government departments (now officially titled *"administrative units"*); and
- Treasurer's Statement (a detailed statement on financial transactions within the Consolidated Fund and the Trust Fund).

2.4.10 As mentioned in an earlier paragraph, most public bodies prepare financial statements on an accrual accounting basis. The accounting and financial reporting standards of the majority of these bodies are governed by regulations under the Annual Reporting Act which include a requirement that designated bodies adhere to professional accounting standards. Audit opinions expressed by the Auditor-General on the financial statements of these bodies refer to compliance with relevant legislation and fair presentation of information in accordance with Australian Accounting Standards. **There is little doubt that, since the introduction of the Annual Reporting Act in 1983, there has been a substantial improvement in the quality of financial reporting by public bodies in Victoria.**

2.4.11 The information communicated annually to the Parliament in financial statements of departments and in the Treasurer's Statement is primarily cash-based. The format of departmental financial statements is determined under the Annual Reporting Act and provides for receipts and payments to be presented under programs in line with the State's program budgeting framework.

2.4.12 Under annual reporting regulations, departments are required to report certain accrual-based information such as debtors, creditors, annual and long service leave liabilities etc. as a supplement to statements of receipts and payments. Also, information presented in the Treasurer's Statement has, over the years, been extended to cover a range of supplementary data including details of departmental debtors and creditors, public sector debt and equity capital held by the State.

2.4.13 The supplementary reporting of accrual information by departments and in the Treasurer's Statement has helped towards overcoming the inherent deficiencies of the cash-based system of accounting. Audit considers, however, that this incremental approach has also had the effect of making the relevant financial reports more complex and detailed and, as a consequence, more difficult for users to comprehend. In addition, use of a mix of cash and accrual accounting in this area has prevented adoption of a common basis of reporting across the public sector and development of government-wide financial statements disclosing the State's total assets and liabilities and its net equity.

2.4.14 While recognising the improvements achieved to date in public sector financial reporting, in my opinion, the adoption of accrual accounting for recording and reporting all financial transactions offers great potential for assisting management decision-making and enhancing the process of accountability to the Parliament.

ACTIONS BY THE DEPARTMENT OF THE TREASURY

Asset recording and reporting

2.4.15 A key element in the development of accrual accounting is the identification and valuation of assets.

2.4.16 During 1987, the Government commenced a major project relating to asset recording and reporting by departments with the objective that departments would be reporting details of all assets and their values in financial statements by 30 June 1989.

2.4.17 As part of this exercise, the Department of the Treasury issued, during the period December 1987 to April 1989, 4 position papers on various aspects of asset recording and reporting and is currently finalising an accounting policy statement on this subject. The policy statement is expected to consolidate the results of the Department's consultation with relevant parties on the 4 position papers. It is likely to cover all aspects of asset recording and reporting including the specific technical issues associated with the ownership and valuation of community assets unique to the public sector, e.g. roads, cultural assets and undeveloped Crown land. Resolution of problems arising from these technical issues has contributed to the delay in finalisation by the Department of its policy statement.

2.4.18 Departments have found the overall tasks associated with the project to be substantial. As a result, the original Government target of having all departmental assets identified and valued at 30 June 1989 was not achieved. In fact, information relating to the valuation of all assets will not be finalised for some time as the Treasurer has recently approved a 3 year program involving valuation of all budget sector land and buildings by the Valuer-General.

2.4.19 As an interim reporting measure, departments have been required, since 1988-89, to incorporate in their annual reports to Parliament summary information on assets, distinguishing between community assets and assets directly associated with departmental operations.

2.4.20 The program of asset recording and reporting by departments has extended over several years. It is important that the Department of the Treasury ensures that the remaining segments of the program are completed in a timely manner. **I would hope that the Department takes action to integrate the asset project with a wider strategy aimed at implementation of accrual accounting by departments.**

Preliminary estimates of total public sector assets and liabilities

2.4.21 The Comptroller-General of the Department of the Treasury has been progressively developing preliminary estimates of assets and liabilities held by agencies within the Victorian public sector.

2.4.22 Audit has been advised that preliminary figures on assets and liabilities up to 30 June 1989 have recently been completed by the Department.

2.4.23 It is pleasing to report that the Department intends, in due course, to publish the results of its research to date in the form of a discussion paper.

Management response by Department of the Treasury

Treasury agrees that information of an accrual-based nature is a valuable complement to cash-based information for budget sector transactions and has been instrumental in requiring the provision of such information. There are, though, different views about the merits of adopting full accrual accounting for the budget sector. Some commentators argue that cash-based accounting is more appropriate for the largely non-commercial budget sector; others support modified accrual accounting.

In this context, Treasury notes that the Public Sector Accounting Standards Board has commenced work on projects for Reporting by Departments and Reporting by Whole of Government, supported financially by all State and Territory Treasurers and the Commonwealth Minister for Finance. That work will consider a range of issues associated with cash-based and accrual information and the information needs of users.

2.5

NEED FOR MORE EFFECTIVE INTERNAL AUDIT IN THE PUBLIC SECTOR

KEY FINDINGS

- Since the previous review of internal audit in 1986, there has been limited improvement in the key areas of executive commitment, planning and level of expertise.
  para. 2.5.13
- Substantial scope exists for internal audit services, including EDP, to be provided under contractual arrangements.
  paras 2.5.42 to 2.5.48
- The Bureau of Internal Audit has not effectively carried out its responsibilities.
  paras 2.5.53 to 2.5.55
- Few public hospitals have established an effective internal audit function.
  paras 2.5.56 to 2.5.59
- Unlike the position with statutory authorities, there has been limited use made of audit committees within government departments.
  paras 2.5.19 to 2.5.20
- Internal audit strategies dealing with fraud prevention are not effective.
  paras 2.5.51 to 2.5.52

BACKGROUND

2.5.1 The internal audit function is recognised as providing valuable assistance to management in ensuring effective and efficient management of resources at their disposal. As part of its overall financial management and accountability strategy, the Victorian Government in 1983 recognised the importance of upgrading the internal audit function in the Victorian public sector. Subsequently, a number of significant developments occurred which have impacted on the effectiveness of internal audit operations. These developments are discussed below.

2.5.2 The Parliamentary Economic and Budget Review Committee in its 1983 report, *Improving Government Management and Accountability* identified a number of inadequacies regarding internal audit operations within the Victorian public sector. Specific concerns identified were:

- failure by many organisations to establish an internal audit function;
- limitation of the scope of internal audit coverage to financial and compliance issues; and
- inadequate staff resources and training of internal auditors.

2.5.3 The Bureau of Internal Audit was established by the Department of the Treasury (formerly the Department of Management and Budget) in 1983, with responsibilities for the development of the internal audit function throughout the Victorian public sector.

2.5.4 Over the past decade or more, reports of the Auditor-General have commented on the deficiencies in internal audit in the Victorian public sector. A special report of the Auditor-General to Parliament in 1986 concluded that:

- there was a serious lack of executive support for internal audit;
- many organisations had either not established or adequately resourced an internal audit unit;
- the majority of organisations had not established audit committees;
- the greater proportion of internal audit staff did not possess the necessary skills to undertake effective reviews of computerised systems;
- inadequate attention had been given to the planning processes including prioritisation and coverage of all auditable areas; and
- the failure of the Department of the Treasury to adequately resource the Bureau had not enabled the Bureau to effectively achieve its objectives.

2.5.5 In September 1987, the Victorian Government adopted a policy requiring the establishment of an adequate internal audit function within all public sector organisations.

2.5.6 During September 1988, a further review was undertaken by my Office to determine the progress made by government departments in establishing internal audit units in accordance with government policy directives. The review indicated that progress in the implementation of viable internal audit units within government departments and branches had been very slow and that, in the larger departments, internal audit units were not in a position to provide sufficient coverage of major auditable areas.

2.5.7 A major finding of the Fergus Ryan report of December 1988, addressing mismanagement within the Victorian Economic Development Corporation (VEDC), was the failure by the internal auditors of the VEDC (a firm of chartered accountants) to provide a timely review and report on all major risk areas of the VEDC's activities. This failure was seen as contributing to the difficulties encountered by the VEDC.

2.5.8 As a result of the report, the Treasurer issued a Ministerial Statement on 21 December 1988. In this statement, the Treasurer indicated that:

> *"Internal audit is seen by the Government as a key management control which operates principally by keeping management informed regarding the adequacy of all other controls and systems".*

2.5.9 Further, the Treasurer directed that all major statutory authorities and government-controlled companies establish an audit committee to review audit reports and ensure that appropriate corrective action is taken.

OBJECTIVES AND SCOPE OF THE REVIEW

2.5.10 During 1990 audit reviewed the quality and effectiveness of the internal audit operations of a selected number of organisations within the Victorian public sector. The review set out to determine whether:

- clearly defined central government policies and guidelines on internal audit have been observed;
- appropriate policies and objectives have been developed by individual organisations which are consistent with overall government guidelines pertaining to internal audit;
- operations of internal audit are considered in the context of an effective risk management strategy by each organisation;
- internal audit units are staffed by persons possessing the range of skills and expertise, including EDP, required to provide high level independent advice on the efficiency and effectiveness of manual and computerised systems and the integrity of financial and management information;
- audits are effectively planned and managed in accordance with appropriate professional auditing standards and ensure the effective use of resources;
- the Bureau has effectively met its objectives of developing the internal audit function throughout the Victorian public sector; and
- the situation has improved since the previous audit reviews.

2.5.11 The scope of the review included an examination of the role and functions of the Bureau and the operations of internal audit units within 24 organisations considered to be representative of the whole Victorian public sector. In addition, a survey was undertaken of 38 Victorian public hospitals to ascertain the extent to which internal audit operations exist within the public hospital industry.

SUMMARY OF OVERALL CONCLUSIONS

2.5.12 The most pleasing aspect of the review was the initiative taken by all statutory authorities examined in establishing audit committees in accordance with government policy.

2.5.13 The review, however, also disclosed that internal audit within the public sector continues to be ineffective. Specific concerns are that:

- **although executive management generally understood the role of internal audit, deficiencies still existed in the commitment given by management to resourcing the units and monitoring their performance;**
- **there is inadequate audit coverage of computer systems due primarily to the lack of EDP skills possessed by internal audit staff;**
- **planning strategies both long-term and short-term are insufficient to ensure that effective audits are undertaken;**
- **the level of training being provided to internal audit staff by organisations is considered inadequate; and**
- **the Bureau does not effectively carry out its responsibilities in relation to the development of internal audit throughout the Victorian public sector.**

WHAT IS INTERNAL AUDIT?

2.5.14 Internal audit in the Victorian public sector is defined by the Department of the Treasury as:

> *A systematic independent review and appraisal of all agencies' operations for purposes of advising management as to the efficiency, economy and effectiveness of the internal management practices and controls.*

2.5.15 The internal audit function within the Victorian public sector is seen by the Treasury as a vital part of the management of the State. However, unless the internal audit unit is effective, it will not provide executive management with sufficient comfort as to the propriety of an organisation's activities.

IMPORTANCE OF MANAGEMENT'S COMMITMENT TO INTERNAL AUDIT

2.5.16 The commitment from executive management has a major bearing on the effectiveness of the internal audit unit. Such commitment is demonstrated by:

- involvement in the establishment of the internal audit charter;
- constructive input to both long-term and annual plans;
- requiring periodic performance evaluation of the internal audit unit; and
- ensuring that due consideration is given to audit recommendations.

2.5.17 Active commitment from management should ensure appropriate resources are provided to internal audit, that it has a high profile within the organisation, and is accepted by all levels of management.

2.5.18 The review indicated that in over half of the organisations examined, executive management possessed a good understanding of the role of internal audit and the ways in which it can assist management.

2.5.19 The review also disclosed that in 90 per cent of organisations, there was constructive input into the audit process by either the executive or the audit committee and audit recommendations received adequate consideration. However, in 40 per cent of organisations reviewed, executive management involvement did not extend to effective monitoring of the operations of the internal audit unit. In particular, executive management had failed to establish performance indicators to assess the cost-effectiveness of the unit or ensure that internal audit resources were being channelled into those areas that provide the greatest value to the organisation.

2.5.20 To ensure the most efficient and effective use of internal audit resources, appropriate performance indicators should be developed and regularly monitored by executive management.

AUDIT COMMITTEES

2.5.21 The role of an audit committee is generally to review the organisation's responses to audit reports prepared by both internal and external audit and provide an effective means of communication between internal and external auditors and executive management. Specifically, the role of an audit committee should be to:

- review the strategic audit plan and annual audit programs developed by internal audit;
- review the quality of work undertaken by the internal audit unit;
- receive and consider periodic activity reports from internal audit; and
- consider matters raised in reports of the Auditor-General.

2.5.22 Table 2.5A indicates statutory authorities have taken effective action in establishing audit committees.

TABLE 2.5A
ESTABLISHMENT OF AUDIT COMMITTEES

Type of organisation	*Number of organisations*	*Audit committees in existence*	
		1987	*1990*
Statutory authorities	10	2	10
Departments (a)	14	2	5

(a) Includes the Victorian Development Fund.

2.5.23 The review indicated that in 90 per cent of cases, either the audit committee or executive management reviewed audit plans and, generally, consideration was given to matters raised in audit reports. However, it was disturbing to note that in 54 per cent of organisations, the audit committee had not undertaken a quality review of the internal audit work performed.

2.5.24 In order for the internal audit unit to be subject to proper performance evaluation, it is essential that a quality review be undertaken, on an ongoing basis, by the audit committee.

2.5.25 As the Treasurer's directive to establish audit committees was specific to statutory authorities and government-controlled companies, and did not apply to government departments, the establishment of an audit committee has been given low priority within departments.

2.5.26 In view of the increasing complexity and scope of operations within departments, the effectiveness of internal audit would be greatly enhanced by the introduction of an audit committee in all major departments.

ATTRIBUTES OF AN EFFECTIVE INTERNAL AUDIT UNIT

2.5.27 In my view, an internal audit unit should possess the following attributes if its function is to be effective and of benefit to the organisation.

- *Independence*: Internal audit is a staff function as distinct from a line function. The internal auditor must have no authority or responsibility for the activities subject to audit. In this context, a formally approved internal audit charter is necessary to establish the objectives, responsibilities and authority of the internal auditor.
- *Overview by audit committee*: The audit committee should review audit plans (both annual and long-term) and the quality of the internal auditor's work ensuring that due consideration is given to recommendations contained in periodic internal audit reports.
- *Planning*: The internal auditor should develop appropriate long-term and annual audit plans as part of an effective risk management strategy. Monitoring of audit plans should be on a continuing basis having regard to changing circumstances.

- *Scope and coverage*: The scope of audit should ensure that all auditable areas are identified and subjected to examination within the planned audit cycle.
- *Management*: The internal audit manager should ensure that audits are conducted in a professional manner by staff possessing the necessary skills. Audit budgets need to be monitored against actual times, and a quality assurance program maintained.
- *Reporting*: Internal audit reports, incorporating observations and recommendations should be prepared on a timely basis and directed, in the first instance, to the chief executive or the audit committee for appropriate action.
- *Resources*: It is essential that the unit be provided with adequate staff resources who possess the necessary skills (particularly EDP) to carry out audit assignments of all major auditable areas in the most efficient and effective manner.

Independence

2.5.28 The effectiveness of the internal audit function depends substantially on its degree of independence. In 88 per cent of organisations reviewed, the internal audit unit acted independently of line management and was totally involved in audit-related activities. However, the remaining 12 per cent of units participated in non-audit related activities, e.g. design and/or implementation of new systems, which the unit will eventually be required to review and report back to executive management. This involvement in operational responsibilities impairs the independence of the internal audit unit and restricts its contribution to executive management.

2.5.29 The independent status of the internal audit function should be clearly specified in the internal audit charter and reaffirmed by executive management.

Audit planning

2.5.30 If internal audit is to be effective, there is a need to determine clear objectives and establish proper planning processes. In developing audit plans the following elements require consideration:

- definition of the total audit responsibilities including audit of computerised systems;
- ranking audits in order of priority;
- preparation of long-term strategic plans;
- development of an annual audit plan having regard to such aspects as audit risk, materiality, complexity of systems, previous audit coverage, requirements of the chief executive and recent changes within the organisation; and
- establishment of a detailed audit program.

2.5.31 **It is disturbing to note that planning strategies both long-term and short-term were insufficient to ensure that effective audits were undertaken.** The review indicated that:

- 44 per cent of internal audit units had not defined all auditable areas or assigned a priority to the areas identified;
- annual and long-term plans had not been developed by 32 per cent of units; and
- 36 per cent of units had not developed their audit plans based on a risk assessment.

2.5.32 **The lack of independent assurances on the operations of organisations exposes executive management to risk. Management or the audit committee need to carefully scrutinise, and where necessary amend, the annual audit plans ensuring they are comprehensive, have regard for risk and materiality, are complementary to the organisational objectives and attainable with the resources available.**

Scope and coverage by internal audit

2.5.33 Internal audit is a major part of the control mechanisms within any organisation, its principal objective being to provide executive management with an independent and systematic appraisal of all aspects of operations within the organisation. In broad terms, the scope of the audit should include reviews of:

- financial systems, including computerised systems to provide an assurance to executive management prior to their attestation of financial statements;
- procedures to ensure compliance with legislation, regulations, policies and internal directives as well as informing executive management of any departures from such requirements; and
- management processes in terms of economy, efficiency and effectiveness.

2.5.34 **The review identified that, in general, organisations failed to provide adequate audit coverage.** Detailed findings of the review indicated that:

- 36 per cent of units had satisfactorily undertaken financial audits (excluding reviews of computerised systems);
- 80 per cent of units failed to satisfactorily conduct reviews of computerised systems;
- only 16 per cent of units conducted compliance audits; and
- 80 per cent of units failed to undertake performance audits.

2.5.35 The lack of appropriate internal audit coverage of computer systems within the organisations reviewed is illustrated in Table 2.5B.

TABLE 2.5B
REVIEWS OF COMPUTER SYSTEMS UNDERTAKEN BY INTERNAL AUDIT DURING 1989-90

Type of reviews	*Limited reviews*	*No reviews*
Operating system, telecommunication, networks	3	13
Disaster recovery	3	11
Purchasing systems	8	10
Database, system/methodologies	5	14
System security reviews	4	10

2.5.36 Further, audit views with concern the failure of 75 per cent of the organisations' internal audit units to utilise computer-assisted audit techniques which enhance the overall efficiency, effectiveness and independence of the audit of computerised systems.

2.5.37 The failure of internal audit to provide sufficient coverage of the major auditable areas results in executive management not having received assurances in relation to the integrity of financial or non-financial information, economy and efficiency in the use of resources, and the effectiveness of program delivery.

Management of the internal audit function

2.5.38 The proper utilisation of internal audit resources is a contributing factor in the effective and efficient operations of the internal audit unit. In this regard, the internal audit manager should establish audit budgets and maintain a quality assurance program to evaluate the operations of the unit.

2.5.39 The quality assurance program should include the following elements:

- supervision of the work of internal audit staff to ensure compliance with organisational policies and procedures, standards set by the Australian accounting bodies and the audit programs;
- review of the quality of the work performed;
- compliance with audit budgets and detailed explanations for any variances; and
- regular monitoring of performance against audit plans.

2.5.40 The review disclosed that:

- Adequate audit documentation had been maintained for the audit tasks undertaken within 71 per cent of organisations. There was sufficient evidence to indicate that quality reviews had been undertaken by internal audit management; and
- Only 46 per cent of the organisations examined had proper management information systems in place to ensure actual times were regularly monitored against approved budgets.

2.5.41 The efficiency and effectiveness of the operations of the internal audit unit would benefit from the implementation of quality review of work undertaken, in conjunction with regular monitoring of individual staff performance.

Staff resources

2.5.42 The effectiveness of internal audit depends to a large degree on the availability of suitably qualified staff, possessing up to date professional knowledge and skills to ensure that all auditable areas receive adequate audit attention within the planned audit cycle.

Resourcing levels

2.5.43 The review disclosed that out of an establishment of 91 staff within the selected bodies, only 78 internal audit staff positions were filled. Of the 78 internal audit staff only 18 possessed EDP skills and were employed in only 44 per cent of the organisations. In light of the increasing reliance by executive management on computerised information systems, audit expresses concern that there has been minimal improvement in the level of EDP skills possessed by internal audit staff since the previous review.

2.5.44 Audit considers that organisations which have internal audit units with limited internal audit resources are not well situated to possess the skills to effectively plan, manage and undertake computer reviews.

2.5.45 While it is not possible to determine the number of internal auditors required for an adequate internal audit function, it is reasonable to assume that an effective internal audit unit would have sufficient staff with the necessary expertise to conduct investigations of all auditable areas of an organisation within a planned cycle.

2.5.46 The limited numbers of internal audit staff within certain organisations highlights the staffing inadequacies when compared with the magnitude of the operations of such organisations. A number of organisations control substantial financial resources, as detailed in Table 2.5C, and due to the size of their internal audit units, these resources are not subject to adequate internal audit coverage.

2.5.47 The review also found that organisations had not considered the option of utilising internal audit resources under contractual arrangements.

TABLE 2.5C
RESOURCING OF INTERNAL AUDIT

Organisation	*Total expenditure ($million)*	*Number of internal audit staff*	*Internal audit staff possessing EDP qualifications*
Totalizator Agency Board	1 644	10	2
Department of Community Services	709	5	-
Gas and Fuel Corporation	567	17	2
Office of the Chief Commissioner of Police	554	1	1
Victorian Development Fund	295	1	-
Rural Water Commission	131	2	1
Ministry for the Arts	103	2	-
Department of Labour	76	3	-

2.5.48 Organisations with substantial financial resources and associated computer systems, which have limited internal audit resources should give consideration to contracting either all or part of the internal audit function to private accounting firms.

Professional development

2.5.49 The results of the review suggest that, generally, provision of training and professional development is insufficient for staff to maintain and develop internal audit skills. Audit found that a structured or systematic approach towards identifying and determining professional training requirements did not exist in any of the organisations. Consequently, training has been undertaken on an ad hoc basis without due regard to long-term professional development needs of staff, in particular, the training provided did not adequately address EDP development needs.

2.5.50 Audit is of the view that members of an internal audit unit should possess the appropriate audit and EDP skills to ensure the achievement of an effective audit. In this regard, there is need for a more formalised approach towards the management of internal audit training and professional development activities.

LACK OF FRAUD MANAGEMENT STRATEGIES

2.5.51 The implementation and ongoing monitoring of controls and the assessment of risk is a responsibility of executive management. In this regard, executive management cannot rely solely on the external auditor to identify areas where controls are not in place, or are by-passed, thereby exposing them to the on-going risk of fraud.

2.5.52 It is disturbing to note that 56 per cent of organisations had no procedures in place to assess the risks and identification of steps required to detect and or minimise fraud. In addition, it was noted that:

- 72 per cent did not regularly examine controls over computer applications to determine whether they were adequate in the prevention or detection of fraud; and
- 68 per cent failed to have the environmental controls over their computer systems thoroughly reviewed.

HAS THE BUREAU OF INTERNAL AUDIT BEEN EFFECTIVE?

2.5.53 The functions of the Bureau are:

- development and promulgation of internal audit policies and procedures throughout the public sector;
- provision of internal audit services to departments and various government agencies which cannot support a viable internal audit unit; and
- conducting the internal audit of the Department of the Treasury.

2.5.54 The review indicated that the Bureau has not effectively carried out its responsibilities in the following areas:

- monitoring and evaluating compliance of internal audit units with government policy, auditing standards and guidelines;
- provision of internal audit services to public sector bodies unable to maintain an effective internal audit unit;
- coverage of the internal audit function within the Department of the Treasury, including the Victorian Development Fund;
- audit coverage of the Treasurer's Statement and the central accounts of government within the Department of the Treasury;
- development and conduct of professional development and training courses to meet the needs of internal auditors within the public sector; and
- maintenance, development and promulgation of policies, standards and manuals pertaining to internal audit.

2.5.55 Urgent action is required by the Department of the Treasury to clarify the responsibilities and priorities of the Bureau. Without this direction, it is not possible for the Bureau to satisfactorily achieve its objectives and service the internal audit needs of both the Department and the public sector as a whole.

Management response by Department of the Treasury

The audit report fails to adequately acknowledge the significant amount of work carried out by the Department since 1986.

This has included the following publications:

- 1986 *Discussion document on the internal audit function in government departments and agencies;*
- 1987 *Internal audit - The Victorian Sector - An introduction to the Function for Management and Staff;*
- 1987 *Victorian Public Sector Internal Audit Manual;*
- 1988 *Final report - Performance Appraisal of Internal Audit units within the Victorian Public Sector;*
- 1989 *Internal Audit in a Computer Environment - supplement to the Internal Audit Manual; and*
- 1989 *Draft Standards for Internal Controls in the Victorian Public Sector.*

In addition to the issue of publications, the Bureau of Internal Audit has carried out a number of training and development initiatives over the years including various seminars and 4 internal audit development programs.

It is pleasing to note that audit agrees in broad terms with the role and function of internal audit as outlined in the 1987 publications mentioned above.

It is intended as part of training and development associated with financial controls generally to undertake training and development programs for internal audit in 1991 through the Resource Management Development Branch in the Comptroller-General's Division.

There has been monitoring by Bureau of Internal Audit of the Government's decision to require the establishment of an internal audit in departments within 12 months from September 1987. Nonetheless, given that it is now 2 years since the period when all departments were required to establish an internal audit function, a detailed review of the current status and quality of internal audit in the budget sector will be undertaken by the Financial Management and Operational Efficiency Branch of the Comptroller-General's Division. This review is intended to be completed by February 1991.

On the question of the provision of internal audit services to agencies which are unable to maintain an effective internal audit unit, there has never been a compulsion on agencies to use the services of the Bureau of Internal Audit. The Bureau, however, on a user pays basis, competes to provide services and has, over the past 18 months, won a number of new clients and maintained existing clients.

The scope of coverage of internal audit in the Department of the Treasury is such that the head office, Stamps and Taxes Office have arrangements for audit coverage and appropriate reporting arrangements to the Director-General. With respect to the Victorian Development Fund, action is being taken to ensure internal audit coverage and appropriate reporting to the Director-General.

The Bureau of Internal Audit has provided an audit of the processes for preparation of the Treasurer's Statement. It is not possible for the Bureau to carry out an audit of the departmental records which provide the basis of the records maintained centrally. The departmental records are subject to audit by internal audit within departments and through statutory auditing and reporting requirements by the Auditor-General.

As indicated earlier, it is intended to reinstitute training and development program for internal audit as part of a financial control development program.

ABSENCE OF INTERNAL AUDIT IN PUBLIC HOSPITALS

2.5.56 Within the Victorian public hospital industry there are 142 hospitals with a combined budget of over $2 200 million a year.

2.5.57 In a sample of 38 public hospitals throughout Victoria, audit noted:

- only 5 hospitals maintained a full-time internal audit function of which 2 had also established an audit committee; and
- there was an absence of formal Health Department Victoria policies in relation to the internal audit function in public hospitals.

2.5.58 Failure of the public hospital industry to establish viable internal audit units impacts on the ability to improve financial management. A co-ordinated, centralised approach to the establishment of internal audit within the hospital sector would afford the opportunity for significant benefits and cost savings to hospitals which could be re-directed to health care programs.

2.5.59 In view of the need to upgrade the standard of financial management and related reporting and financial systems throughout the hospital industry, (identified in my *Report on Ministerial Portfolios, May* 1990) **appropriate policies and guidelines (reflecting overall government policy) should be developed by the Department to ensure that maximum benefit is derived through the introduction of internal audit into the hospital industry. To complement the effectiveness of the overall audit process, hospitals should also establish audit committees.**

Management response by Health Department Victoria

Both the Health Department Victoria and hospitals acknowledge that internal audit can play a major role in assisting management in ensuring effective and efficient management of resources at their disposal. At a minimum, however, it is expected that hospitals maintain an appropriate level of internal control of financial transactions.

The Department will continue to support the establishment of internal audit functions in public hospitals and work to ensure that this is done in the most appropriate way given the funding constraints and the practical difficulties for small hospitals.

2.6 NEED FOR CODE OF CONDUCT FOR BOARD MEMBERS/DIRECTORS OF PUBLIC BODIES

KEY FINDING

- Recent developments within both the private and public sectors have reinforced the need for a code of corporate practice for public sector board members and directors.

  paras 2.6.3 to 2.6.6

BACKGROUND

2.6.1 In my September 1989 report to Parliament on the Treasurer's Statement, I compared the duties and responsibilities of public sector board members and directors with their counterparts in the private sector. While accepting that public bodies often operate under conditions not normally encountered in the private sector, I concluded that there should be no difference in the duty of care or accountability of parties entrusted with either shareholders' or taxpayers' funds.

2.6.2 After identifying several instances where public sector board members and directors had not effectively exercised their responsibilities, I recommended that a code of conduct and guidelines be developed in relation to the duties, responsibilities and accountability of persons appointed to public sector boards responsible for the management of public moneys.

DEVELOPMENTS SINCE THE SEPTEMBER 1989 REPORT

2.6.3 Since my September 1989 report, both the private and public sectors have experienced several instances of failure arising from financial problems and liquidity crises. At the same time, the image of the business community has been tarnished with a questioning by regulatory bodies and the broader community of the ethical behaviour of directors involved in these collapses. These developments have prompted action within the private sector to promote higher standards of corporate behaviour.

2.6.4 In June 1990, a group of business and professional organisations under the auspices of the National Companies and Securities Commission issued a public discussion paper *"Corporate Practices and Conduct"* aimed mainly at strengthening corporate accountability as it affects the role of directors. The discussion paper includes a draft code of conduct for directors to assist them *"... to carry out their duties and responsibilities with a commitment to honesty, fair dealing and the common good"*.

2.6.5 In terms of action taken within the public sector since my 1989 review, the Department of the Treasury has advised my Office that draft *"Guidelines for Members of Public Sector Boards"* are currently being developed. In addition, the Department has recently issued for comment an *"Accountability Checklist for Public Sector Board Members"* which provides guidance on matters such as strategic direction, management practices, internal controls, performance monitoring, legislative compliance and performance accountability.

2.6.6 Given the issues outlined in my September 1989 report and the need now recognised in the private sector to promote higher standards of corporate performance by directors, I consider that early finalisation of the tasks currently underway in the Department of the Treasury is vital.

Management response by Department of the Treasury

The Department of the Treasury intends to complete both the guidelines and the accountability checklist for publication before the end of 1990. It is likely, however, that the accountability checklist will be available first and should be published before the end of October 1990.

IMPETUS FOR LEGISLATIVE CHANGE

2.7.1 For some years, reports of the Auditor-General to Parliament have commented on the need for a comprehensive review of the State's audit legislation. Also, as far back as 1983, the Economic and Budget Review Committee strongly recommended a wide ranging revision of the *Audit Act* 1958 as part of its call for an urgent upgrading of resource management and accountability legislation in the State.

2.7.2 My September 1989 report to Parliament on the Treasurer's Statement outlined 2 important incidents which reinforced the urgency for legislative action. These incidents were:

- a decision by the Speaker of the Legislative Assembly in March 1989 to initially decline to table my *Special Report No. 11* dealing with *Financial Assistance to Industry* because of doubts about the power of the Auditor-General to conduct value-for-money audits; and
- denial to audit of access to certain records and documents at the Stamp Duties Office and the State Taxation Office on the basis of secrecy provisions in the enabling legislation of those agencies.

2.7.3 As a consequence of the above instances, the Government undertook a limited review of the State's audit legislation during 1989 to clarify the powers of the Auditor-General with regard to value-for-money auditing and to overcome the access problems experienced by audit. This process culminated in the submission of amending legislation to Parliament in November 1989. The amending legislation, the *Audit (Amendment) Act* 1990, was passed by the Parliament in May 1990 and became operative on 13 June 1990.

SUMMARY OF PRINCIPAL AMENDMENTS

2.7.4 The main changes to the Audit Act introduced under the *Audit (Amendment) Act* 1990 are summarised below:

- Removal of any restriction on official access by the Auditor-General to all information held by Government agencies;
  - This amendment resolves the serious problems which arose from the denial to audit of access to official records at the 2 government agencies referred to above.
- Confirmation of the authority of the Auditor-General to conduct performance (value-for-money) audits and to report the results, incorporating auditee responses, to the Parliament;
  - The relevant section empowers the Auditor-General, at such intervals as he or she thinks fit, to conduct audits *"... to determine whether a department or public authority is achieving its objectives effectively and doing so economically and efficiently and in compliance with all relevant Acts".*

- Inclusion within the Act of a definition of policy objectives of the Government together with a provision that the Auditor-General is not entitled to question the merits of such objectives. The Act defines "policy objectives" as:
  - *"any policy objective of the Government contained in a record of a policy decision of Cabinet, a policy direction of a Minister, a policy statement in any Budget Paper or any other document evidencing a policy decision of the Cabinet or a Minister".*
- Authority for conduct of a performance audit of the Auditor-General at least once every 3 years by an auditor appointed by Parliament on the recommendation of the Economic and Budget Review Committee; and
- A requirement that the Auditor-General apply the general auditing standards issued by the Australian Society of Certified Practising Accountants and the Institute of Chartered Accountants in Australia.
  - However, I should point out that it has been a long standing practice of my Office that all audits are carried out in accordance with the Statements of Auditing Standards issued by the professional accounting bodies.

IMPACT OF THE 1990 AMENDMENTS

2.7.5 I welcome the passing by the Parliament of the amendments to the audit legislation.

Access to information

2.7.6 The removal of all impediments to access by my Office to information held by government agencies was vital to effective discharge of my responsibility, on behalf of the Parliament, to undertake a continuing and complete scrutiny of public sector financial and resource management.

Interpretation of government policy

2.7.7 The scope of an Auditor-General's function under the Westminster system does not extend to questioning or forming judgement on policy decisions of government. The Auditor-General's independent review role has traditionally been confined to evaluation of the processes followed by public sector agencies in the implementation of policies and achievement of related operational goals. **This important principle has been strictly adhered to by my Office since the early 1980s, when value-for-money audit issues began to assume prominence in reports of the Auditor-General to Parliament.**

2.7.8 The inclusion within the amending legislation of a definition of government policy objectives is aimed, no doubt, at minimising difficulties and uncertainty in the highly sensitive area of policy interpretation.

2.7.9 I have some concerns, however, with the wide ranging nature of the statutory definition of policy objectives. The definition focuses on **where** a policy decision may be found rather than **what** constitutes the policy decision. As such, potential exists for a decision directly connected with implementation of higher level policy of government to be classified as a policy objective simply as a result of action to bring the decision within the ambit of the statutory definition. The protection offered by the definition would then insulate the decision from evaluative comment by the Auditor-General and from subsequent scrutiny by the Parliament.

2.7.10 I have conveyed my reservations on this matter to the Government. I consider that care will need to be exercised by all parties with responsibility connected with the legislation (Parliament, Government, management and my Office) to ensure that the spirit of the policy definition is followed.

Completion of review of audit legislation

2.7.11 In view of the action taken by the Government to amend the audit legislation in respect of the matters referred to above, it is now appropriate that the remaining outdated provisions of the Audit Act be quickly upgraded.

2.7.12 It is pleasing to note that the Department of the Treasury intends to submit recommendations to the Treasurer in 1990-91 on further changes to the Audit Act *(1990-91 Budget Paper Number 5).*

2.7.13 It is to be hoped that in considering further legislative changes, the following views which were expressed in the Foreword to my May 1990 *Report on Ministerial Portfolios* will be borne in mind:

> *"I firmly believe that independent examinations of economy, efficiency and effectiveness in policy implementation must be an integral part of the audit of all public bodies and that the results of those examinations should be promptly reported to the public through the Parliament . . . However, in respect of those public bodies, including public sector companies and trusts which are audited by private auditors, I recommend to the Parliament that it consider the necessary changes to existing auditing provisions to ensure that such bodies are subject to similar audit scrutiny and reporting."*

OUTLINE OF MATTERS RAISED IN MY SEPTEMBER 1989 REPORT

2.8.1 An overview of the current status of the implementation of program budgeting within Victoria was presented in my September 1989 report on the Treasurer's Statement. That report summarised the main progress achieved to date since the formal introduction of program budgeting in 1984-85. In addition, the review identified 3 specific areas which, in audit opinion, have hindered the effectiveness of program budgeting, namely:

- inadequate monitoring and evaluation of program performance;
- absence of full-cost data in programs; and
- inappropriate expenditure descriptions.

2.8.2 **The key audit conclusion was that the establishment of formalised mechanisms for reporting by departments to the Parliament and Government on levels of efficiency and effectiveness achieved in delivery of programs was essential if the benefits offered by program budgeting were to be fully realised.**

REPORT BY ECONOMIC AND BUDGET REVIEW COMMITTEE

2.8.3 Since my September 1989 report, the Economic and Budget Review Committee finalised its inquiry into the implementation of program budgeting in budget sector agencies within the Victorian public sector. The Committee's report was tabled in Parliament in April 1990.

2.8.4 The results of the Committee's detailed research on program budgeting and related recommendations are presented in the Committee's report under 3 key headings, namely:

- program classification of expenditure;
- nature and role of performance indicators; and
- program evaluation and budgeting.

2.8.5 The Committee's principal conclusion in relation to program classification of expenditure was that it is neither possible nor desirable to classify all expenditure meaningfully and reliably by final output. While specifically recognising the value of classification by output as a budget management tool, the Committee considered that the mix of expenditure classification principles employed (e.g. classification by organisational unit, line-item or output) should be that which best suits the budgetary environment.

2.8.6 On the question of performance indicators, the Committee recommended that public sector agencies be required, under legislation, to report particular selected indicators at specified regular intervals. It further recommended that the performance of selected agencies in the development of performance indicators be subject to specific scrutiny by its Public Accounts and Estimates Sub-committees.

2.8.7 The Committee emphasised the need for action by the Department of the Treasury to develop and extend the role of program evaluation and the use of performance indicators throughout the Victorian public sector.

2.8.8 While consensus of view exists between the Committee and audit on the pressing need for external reporting by agencies of program performance, the Committee rejected the audit view, expressed in the September 1989 report, that non-allocation of significant costs to individual programs may impair management decisions on programs, including their continuation or otherwise.

ACTION BY THE DEPARTMENT OF THE TREASURY

2.8.9 Since my September 1989 report, the Department of the Treasury has issued a series of circulars to budget sector agencies which provide advice and guidance on:

- development of 3-year strategy plans, within the 1990-91 Budget context, to clarify key issues facing an agency and its objectives arising from these issues; and
- identification of specific output targets associated with agency objectives and the indicators to be used to monitor agency performance against these targets.

2.8.10 In addition, the Department is developing more detailed guidance on program evaluation and review techniques for budget sector managers.

2.8.11 The Department considers that these latest initiatives, directed to the improved efficiency, effectiveness and accountability of the budget sector, complement a number of financial management reforms adopted during the 1980s including the introduction of program budgeting.

2.8.12 The Department has advised audit that it is currently preparing for the Treasurer's consideration a response to the April 1990 Report of the Economic and Budget Review Committee.

2.9

STATUS OF MATTERS RAISED IN PREVIOUS REPORTS ON THE TREASURER'S STATEMENT

2.9.1 Previous *Reports of the Auditor-General on the Treasurer's Statement* have contained comments and recommendations on a number of issues relating to public sector resource management, and compliance with legislation and other directions. The current status of action taken to address concerns expressed by the Auditor-General is presented in Table 2.9A.

TABLE 2.9A STATUS OF MATTERS RAISED IN PREVIOUS REPORTS ON THE TREASURER'S STATEMENT

Report	*Issue*	*Status at date of preparation of this report*
	ASSET SALES	
1987-88 1988-89	In view of the significance of the Government initiative to sell surplus assets to fund new assets, details of how the funds were expended should be clearly disclosed in the Treasurer's Statement.	The Treasurer's Statement still does not disclose how the funds generated from the sale of surplus assets were expended. Further comment is contained in paragraphs 1.6.7 to 1.6.10 of this report.
	COLLECTION OF STATE TAXATION	
1988-89	State budget strategies for major revenue raising agencies need to focus on enhancing revenue collection as well as reducing costs to ensure maximum benefits accrue to the State.	Position unchanged. Difficulties continued to be experienced in the collection of Taxation Revenue by the Stamp Duties and State Taxation Offices.
	Penalty taxes are not imposed on amounts received within the month, but after the due date.	Position unchanged. The State Taxation Office (STO) considers that it is not feasible to enforce the imposition of additional tax in these cases.
	Excessive delays occurred in issuing payroll tax assessments and the follow-up of outstanding debts from defaulting taxpayers.	The introduction of computerised payroll tax assessments and the re-allocation of resources has substantially increased the number of assessments issued and doubled the value of tax collected from defaulting employers.

TABLE 2.9A STATUS OF MATTERS RAISED IN PREVIOUS REPORTS ON THE TREASURER'S STATEMENT - *continued*

Report	*Issue*	*Status at date of preparation of this report*
	COLLECTION OF STATE TAXATION - *continued*	
	More stringent monitoring and follow-up may have resulted in revenue due under arrangements being collected in a more timely manner.	The management of arrangements has been improved through systems enhancements which facilitate better prioritisation and monitoring of the larger debts. These debts constitute a significant proportion of the total debt under arrangements.
	More timely issue of payroll tax assessments and prompt follow-up of outstanding debts may have reduced the incidence of debts from companies now in liquidation.	Computerisation of default assessments has resulted in more timely issue of assessments and prompt follow-up of outstanding debts. However, in the last 12 months the gross debt in the insolvency area has increased from $16.7 million to $21.3 million.
	Significant delays occurred in processing annual adjustments and issuing assessments and refunds to taxpayers.	There has been an improvement in the timeliness of processing annual adjustments.
	More timely issuing of land tax assessments would result in a substantial increase in revenue to the State.	Position unchanged. Further comment is contained in paragraph 1.6.25 of this report.
	Need for STO to take decisive action to improve the accuracy of ownership details in its land tax system.	An arrangement for the central lodgement of change of ownership notices within the Land Titles Office is expected to be implemented when funds become available. It is anticipated that the proposed system will aid the STO in maintaining accurate and up to date ownership details and consequently result in more timely collection of land tax.
	Substantial scope to further increase the revenue of the State if greater prominence was directed towards the detection of tax avoidance and evasion.	Additional funds have been allocated in the 1990-91 Budget for specific investigation projects. STO has indicated that these projects have already identified substantial amounts in payroll tax arrears.
	Weaknesses in information systems restricted the ability of the STO to identify all tax due to the State. The STO estimated that a gain of $11 million a year would result from increased revenue and reduced operating costs following the implementation of a new computerised system.	The STO has continued with the development of the Information System Strategy and during July 1990 made a submission to the Treasurer for the necessary funds to proceed.

TABLE 2.9A STATUS OF MATTERS RAISED IN PREVIOUS REPORTS ON THE TREASURER'S STATEMENT - *continued*

Report	*Issue*	*Status at date of preparation of this report*
	CONSOLIDATED FUND DEFICITS	
1978-79 1979-80	A Consolidated Fund deficit of $22 million at 30 June 1970 is still unfunded and temporarily financed from the Trust Fund.	Position unchanged.
	DEPARTMENTAL PHYSICAL ASSETS	
1985-86 1986-87	Improvements needed in the recording, control and reporting of departmental physical assets.	The Treasury (Asset Register) Regulations 1988 were amended to require that administrative units maintain asset registers to record and control fixed assets. Position on reporting of assets by departments is still not finalised. Further comment is contained in paragraphs 2.4.15 to 2.4.20 of this report.
	DUTIES AND RESPONSIBILITIES OF BOARD MEMBERS/DIRECTORS OF PUBLIC BODIES	
1987-88 1988-89	Criteria need to be established for the selection of board members/directors and a code of conduct developed covering duties, responsibilities and accountability of persons appointed to public sector boards.	Draft guidelines for members of public sector boards are being developed by the Department of the Treasury. Further comment is contained in Section 2.6 of this report.
	ENGAGEMENT OF CONSULTANTS	
1987-88	Effectiveness Review Committee guidelines on the submission of post-project evaluation reports need to be adhered to by public sector bodies.	Position unchanged. Delays continue to occur in the submission of post-project evaluation reports.
	INTERNAL AUDIT IN THE BUDGET SECTOR	
1987-88	Government policy required the implementation of an adequate internal audit function in departments by September 1988.	Adequate internal audit functions have still not been established in a number of departments. Further comment is contained in Section 2.5 of this report.

TABLE 2.9A STATUS OF MATTERS RAISED IN PREVIOUS REPORTS ON THE TREASURER'S STATEMENT - *continued*

Report	*Issue*	*Status at date of preparation of this report*
	LIABILITIES OF THE STATE	
1987-88	Need for development of a strategic plan to identify the State's aggregate liabilities and for reporting this information as part of consolidated financial statements.	The Comptroller-General of the Department of the Treasury has prepared preliminary estimates of the assets and liabilities of the State at 30 June 1989. The Department intends, in due course, to publish this information as a discussion paper.
	PROGRAM BUDGETING	
1988-89	Formalised mechanisms for reporting by departments on program performance are necessary if benefits offered by program budgeting are to be fully realised.	Report by the Economic Budget and Review Committee on Program Budgeting was tabled in Parliament in April 1990. The Committee has recommended introduction of program reporting by departments. The Department of the Treasury is currently addressing issues raised by the Committee. Further comment is contained in Section 2.8 of this report.
	RESOURCE MANAGEMENT AND ACCOUNTABILITY LEGISLATION	
1985-86 1986-87 1988-89	Modern resource management and accountability legislation is required to replace the outmoded provisions of the Audit Act and other associated Acts.	Position unchanged apart from the 1990 amendments to the Audit Act. Further comment is contained in Section 2.7 of this report.
	TREASURY/DEPARTMENTAL RECONCILIATION PROCEDURES	
1986-87	Need for the Department of the Treasury, in conjunction with departments, to review existing Treasury/departmental reconciliation procedures and the adequacy of existing financial information systems.	Some departments still had difficulty in effecting year-end reconciliations with Treasury within the required timeframe.