Water Entities: Interim Results of the 2009–10 Audits

Victorian Auditor-General's Report

August 2010

2010-11:4

VICTORIA

Victorian
Auditor-General

Water Entities: Interim Results of the 2009–10 Audits

Ordered to be printed

VICTORIAN
GOVERNMENT PRINTER
August 2010

PP No 345, Session 2006–10

This report has been produced to ISO14001 environmental standards. It is printed on FSC credited Novatech Satin & Media Print Silk paper. The print supplier, Blue Star PRINT has initiated an EMS promoting minimisation of environmental impact thr the deployment of efficient technology, rigorous quality management procedures and a philosophy of reduce, re-use and recycle.

ISBN 978 1 921650 46 8

VAGO

Victorian Auditor-General's Office

Auditing in the Public Interest

The Hon. Robert Smith MLC
President
Legislative Council
Parliament House
Melbourne

The Hon. Jenny Lindell MP
Speaker
Legislative Assembly
Parliament House
Melbourne

Dear Presiding Officers

Under the provisions of section 16AB of the *Audit Act 1994*, I transmit my report on *Water Entities: Interim Results of the 2009–10 Audits.*

Yours faithfully

D D R PEARSON
Auditor-General

11 August 2010

Contents

Audit summary

Background

This report informs Parliament about developments within the water industry and internal control issues arising from our interim financial audit of 20 entities, comprising 19 water entities and one controlled entity.

All entities operate internal controls to maintain the reliability of their financial reporting, the efficiency and effectiveness of their operations and their compliance with all relevant laws and regulations. In our annual financial audit, we focus on the internal controls that relate to financial reporting. While it is not our responsibility to form an opinion on internal controls, we nevertheless raise with management any control weaknesses or breakdowns we identify.

This report comments on the effectiveness of internal controls supporting the preparation of the financial report and aspects of controls over creditors and capital projects.

Overall conclusion

Overall, we found that entity internal controls are adequate for financial reporting purposes. Nevertheless, opportunities to strengthen internal controls were identified in relation to information system controls, the maintenance of fixed asset registers, compliance with procurement policies and procedures, and the timely preparation and review of key account reconciliations.

Controls over the management of creditors and capital projects were generally adequate; nevertheless, controls should be further strengthened.

Performance reporting continues to be of limited utility, as the four metropolitan entities are not required to prepare a performance report for audit, while the 13 regional urban and two rural entities, who prepare performance reports, have no obligation to set a target for each performance indicator.

Findings

Financial reporting

The financial reports are prepared in accordance with Australian Accounting Standards, including the Australian Accounting Interpretations.

The main legislation governing financial reporting by the water industry is the *Financial Management Act 1994* (FMA) with 16 of the 20 entities required to comply with the FMA. The remaining four entities are companies and comply with the requirements of the *Corporations Act 2001*.

For 2009–10, the four metropolitan water entities revised their accounting policies to measure infrastructure assets at fair value, which is consistent with the accounting policy adopted for the preparation of the state's annual financial report. Regional urban and rural water entities will transition to fair value in 2010–11. This is notwithstanding that the fair value requirement in AASB 1049 *Whole of Government and General Government Sector Financial Reporting*, at the whole of government level, was first foreshadowed in May 2007.

Performance reporting

Financial Reporting Direction 27A *Presentation and Reporting of Performance Information* issued pursuant to the FMA requires the 13 regional urban and the two rural entities to prepare a performance report and submit it for audit. Directions issued by the Minister for Water under section 51 of the FMA specify the form and content of the performance report.

There continues to be no requirement for the 13 regional urban and two rural entities to set a target for each performance indicator included in the performance report. In 2008–09, 14 of the 15 performance reports contained non-financial indicators where no target had been set. In the absence of a target being set, information within a performance report is less meaningful and useful when assessing performance against entity plans.

Further, there remains no requirement for the four metropolitan entities to prepare a performance report and submit it for audit for 2009–10.

In December 2009, the *Public Finance and Accountability Bill* (the Bill) was introduced to Parliament. The Bill reflects the Government's 2006 election commitment to modernise fundamental legislation in Victoria, including the State's public finance legislation. The Bill includes a requirement for government planning, budgeting and accountability processes to focus on the achievement of outcomes. This reinforces the importance of establishing a comprehensive performance reporting framework in the water industry. At the time of finalising this report the Bill had not been passed.

Effectiveness of internal controls

Internal control encompasses the policies, systems and behaviours established by entities to reliably and cost effectively meet their objectives. Reliable internal controls are a prerequisite for effective and efficient delivery of reliable, accurate and timely internal and external reporting.

To the extent we examined those controls our assessment is that they were adequate for financial reporting purposes. Nevertheless, opportunities to further strengthen internal controls were identified, namely:

- improving information system controls at nine of the 20 entities (45 per cent)
- improving the maintenance of fixed asset registers at seven of the 20 entities (35 per cent)
- improving compliance with procurement policies and procedures at six of the 20 entities (30 per cent)
- more timely preparation and review of key account reconciliations at five of the 20 entities (25 per cent).

These improvements will enhance the reliability and effectiveness of internal controls.

Controls over creditors

At 30 June 2009, the water industry had creditors totalling approximately $800 million, representing an increase of $230 million or 39 per cent on the prior year.

The effective management of creditors becomes more critical as the volume and value of invoices being processed increases. It is also important from a cash flow perspective.

A review of controls over creditors at the 19 water entities was undertaken as part of our cyclical assessment of internal controls relating to significant annual financial report balances and disclosures consistent with the requirements of the Australian Auditing Standards.

Overall, the controls were found to be generally adequate. Nevertheless, deficiencies were noted as follows:

- five of the 13 regional urban entities did not have documented policies and procedures relating to creditor management
- of the 14 entities with policies and procedures, they were not approved by the governing board at eight entities (57 per cent)
- 15 entities (79 per cent) do not maintain and report to their governing board performance statistics relating to the management of creditors
- 11 entities (58 per cent) do not undertake a routine cleansing of the vendor masterfile to remove duplicated and superfluous data
- five entities (26 per cent) do not monitor aged creditor listings meaning that any delays in payment are less likely to be identified and addressed.

Our review indicates that the water entities generally pay supplier invoices within 30 days of receiving a valid invoice. As at 31 March 2010, the level of overdue invoices was not significant with 93 per cent of invoices within the range of one to 30 days and 99 per cent within 60 days.

Electronic funds transfer is the preferred mode of payment by 95 per cent of the entities.

Controls over capital projects

At 30 June 2009, the water industry had total assets of $21.1 billion, with infrastructure assets, property, plant and equipment accounting for $20.2 billion or 96 per cent of the total asset base.

In 2008–09 the total value of infrastructure assets, property, plant and equipment increased by $2 billion or 11 per cent from the prior year. The planned capital expenditure for the water industry for 2009–10 was $2.4 billion.

The effective management of capital projects is critical to the water industry given the materiality of the infrastructure asset balance and the significant ongoing capital expenditure program.

A review of the controls relating to the management of capital projects at the 19 water entities was also undertaken in 2009–10 as part of our cyclical assessment of internal controls relating to significant account balances.

Overall, the controls were found to be generally adequate. Nevertheless, areas for attention were noted as follows:

- three entities (16 per cent) did not have documented policies and procedures relating to capital projects management
- whilst 16 entities had policies and procedures:
  - they were not approved by the governing board at seven entities (44 per cent)
  - the regional urban entities commonly did not address government policy requirements, the development of a risk management plan, budgeting and budget approval, and assigning a sponsor to the project
- reporting to the governing board on the status of the capital expenditure program generally does not address the management of project risks or the achievement of outcomes
- four entities (21 per cent) had not included risks associated with the delivery of their capital expenditure program within their risk registers
- internal audit had not undertaken a review of compliance with capital projects management policies and procedures within the last three years at seven entities (37 per cent).

Our review of the capital expenditure programs across the water entities for 2009–10 indicates that projects are experiencing delays and/or budget overruns. Approximately 15 per cent of capital projects had experienced budget overruns while 10 per cent of capital projects had experienced delays based on the original planned completion date.

Factors contributing to the delays and budget overruns include:

- scope changes
- under estimation of the size and complexity of the project
- poor collaboration across project teams
- poor labour productivity and price escalation over the term of construction
- lack of change management practices
- project defects.

In response to the expanded capital work programs, we noted that 12 entities (63 per cent) had established a separate sub-committee, directly responsible to the governing board, to overview the management of capital projects from the initiation of contract proposals to post completion evaluations.

These sub-committees provide a sharper focus on the delivery of the capital expenditure program and in conjunction with management play an important role by looking to clear any disruptions to the achievement of key milestones.

Recommendations

Recommendation	Page
Performance reporting arrangements should be further developed to include the four metropolitan water entities.	11
A target should be set for each performance indicator included in performance reports.	11
Water entities should assess the adequacy of their policies and processes against the commonly identified weaknesses within their respective internal control environments to assure they are operating in a reliable and cost-effective manner.	17
Comprehensive creditor and capital project policies and procedures should be developed by management and approved by governing boards.	22 & 31
Monitoring of creditor management performance should be established with periodic reporting to the governing board.	25
Governing boards should monitor and assess the adequacy of the risk management regimes and associated plans developed for capital projects.	33
Management should assess whether the desired project benefits and outcomes were achieved and report findings to the governing board.	33
Internal audit should conduct periodic reviews of the management of critical capital projects, including associated risks.	34

Submissions and comments received

In addition to progressive engagement during the course of the audit, in accordance with Section 16(3) of the *Audit Act 1994* a copy of this report, or relevant extracts from the report, was provided to the Department of Sustainability and Environment, the Department of Treasury and Finance and the 20 entities with a request for comments or submissions.

Agency views have been considered in reaching our audit conclusions and are represented to the extent relevant and warranted in preparing this report. Their full Section 16(3) comments and submissions; however, are included in Appendix B.

Audit conduct

The interim audit of the 20 entities was undertaken in accordance with Australian Auditing Standards.

The total cost of preparing and printing this report was $140 000.

1 Background

At a glance

Background

This report provides the interim results of the annual audit of the 2009–10 financial reports and performance reports, where applicable, of 20 entities comprising 19 water entities and one controlled entity.

An *Acquittal Report: Results of the 2009–10 Audits* report will include comment on the audit opinions issued for 2009–10, the timeliness and accuracy of the financial and performance reports, and financial sustainability of water entities.

Findings

- There continues to be no requirement for the regional urban and rural entities to set a target for each performance indicator included in the performance report. In 2008–09, 14 of the 15 performance reports contained non-financial indicators where no target had been set.
- There continues to be no requirement for the metropolitan entities to prepare a performance report and submit it for audit.
- Differences exist in relation to the measurement of infrastructure assets. For 2009–10, the four metropolitan water entities will report infrastructure assets at fair value. The regional urban and rural entities have been granted an extra 12 months to transition to fair value. Notwithstanding that the fair value requirement in AASB 1049, at the whole of government level, was first foreshadowed in May 2007.

Recommendations

- Performance reporting arrangements should be further developed to include the four metropolitan water entities.
- A target should be set for each performance indicator included in performance reports.

1.1 Introduction

The state election is scheduled for November 2010 with Parliament rising on 7 October 2010. This shortens our time line for reporting on financial audits. Accordingly, we have produced this interim report on the annual financial audit of financial and performance reports of the water entities and will provide a final acquittal report to the Parliament in February 2011.

This report is the third of seven reports to be presented to Parliament covering the results of the audits of public sector financial and performance reports. Figure 1A shows the intended reports and time frames.

This report comments on the effectiveness of internal controls supporting the preparation of the financial report and controls relating to creditors and capital projects.

Figure 1A
VAGO reports on the results of audits

Reports	Description
Portfolio Departments: Interim Results of the 2009–10 Audits	Tabled in Parliament on 28 July 2010, the report contains the interim results of the audits of 11 portfolio departments. It examined the effectiveness of internal controls for IT systems; for identifying, declaring and managing conflicts on interest; and for procurement. It also included comment on financial reporting developments.
Local Government: Interim Results of the 2009–10 Audits	Tabled in Parliament on 11 August 2010, the report contains the interim results of the audits of 79 local governments, 13 agencies they control and 12 regional library corporations. It examined the effectiveness of internal controls supporting the preparation of the financial reports and aspects of council governance and IT change management.
Water Entities: Interim Results of the 2009–10 Audits (this report)	This report provides the interim results of the audits of 20 entities comprising 19 water entities and one controlled entity. It examines the effectiveness of internal control supporting the preparation of the financial reports and aspects of how they manage capital projects and creditors.
Public Hospitals: Interim Results of the 2009–10 Audits	This report will provide the interim results of audits of approximately 110 agencies in the sector. It will examine the effectiveness of internal control supporting the preparation of the financial reports and aspects of how they manage leave and creditors *Proposed to be tabled in Parliament in September 2010*.
Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2009–10	This report will provide the result of the audit of the state's annual financial report. It will examine the quality and timeliness of financial reporting, explain significant financial results for the state and make observations on the status and financial implications of significant issues *Proposed to be tabled in Parliament in October 2010*.

Figure 1A
VAGO reports on the results of audits – *continued*

Reports	Description
Acquittal Report: Results of the 2009–10 Audits	This report will provide the results of the annual financial audit of financial and performance reports of approximately 420 agencies across all sectors including local government, water, and public hospitals. The report will include comment on the timeliness of their financial reporting and financial sustainability *Proposed to be tabled in Parliament in February 2011*.
Tertiary Education and Other Entities: Results of the 2010 Audits	This report will provide the results of the annual financial audits of 110 agencies that end their financial year other than 30 June 2010. It will examine timeliness of their financial and performance reporting, the effectiveness of their internal control, their financial sustainability and aspects of how they manage creditors, employee costs and student fee revenue *Proposed to be tabled in Parliament in May 2011*.

Source: Victorian Auditor-General's Office.

1.2 Scope

This report includes the results of our examination of internal controls related to the financial reporting responsibilities of 20 entities, comprising 19 water entities and one controlled entity. Our audits are undertaken on a progressive basis with the examination of internal controls undertaken prior to financial year end to assess the reliance that can be placed on internal controls in the production of the financial report.

1.2.1 Overview of Victoria's water industry

The Victorian water industry consists of 20 entities, comprising 19 water entities and one controlled entity (19 entities in 2008–09). All entities are wholly owned by the state government.

The water entities act as stand-alone businesses and are responsible for their own management and performance. Each governing board appoints a managing director who is responsible for the day-to-day operating activities of the entity.

The water entities are required to maintain sustainable management principles which give due consideration to environmental impacts and allow water resources to be conserved and properly managed for sustainable use and for the benefit of present and future generations.

The water industry can be divided into three sectors, namely: metropolitan, regional urban and rural. Figure 1B lists the 19 water entities and the controlled entity, classified by sector, with both the legal name and trading name specified.

Figure 1B
Water entities and the controlled entity

Entity	Trading name
Metropolitan sector	
Wholesaler	
Melbourne Water Corporation	Melbourne Water
Retailers	
City West Water Limited	City West Water
South East Water Limited	South East Water
Yarra Valley Water Limited	Yarra Valley Water
Regional urban sector	
Barwon Region Water Corporation	Barwon Water
Central Gippsland Region Water Corporation	Gippsland Water
Central Highlands Region Water Corporation	Central Highlands Water
Coliban Region Water Corporation	Coliban Water
East Gippsland Region Water Corporation	East Gippsland Water
Goulburn Valley Region Water Corporation	Goulburn Valley Water
Grampians Wimmera Mallee Water Corporation	GWMWater
Lower Murray Urban and Rural Water Corporation	Lower Murray Water
North East Region Water Corporation	North East Water
South Gippsland Region Water Corporation	South Gippsland Water
Wannon Region Water Corporation	Wannon Water
Western Region Water Corporation	Western Water
Westernport Region Water Corporation	Westernport Water
Rural sector	
Gippsland and Southern Rural Water Corporation	Southern Rural Water
Goulburn-Murray Rural Water Corporation	Goulburn-Murray Water
• Watermove Pty Ltd	• Watermove

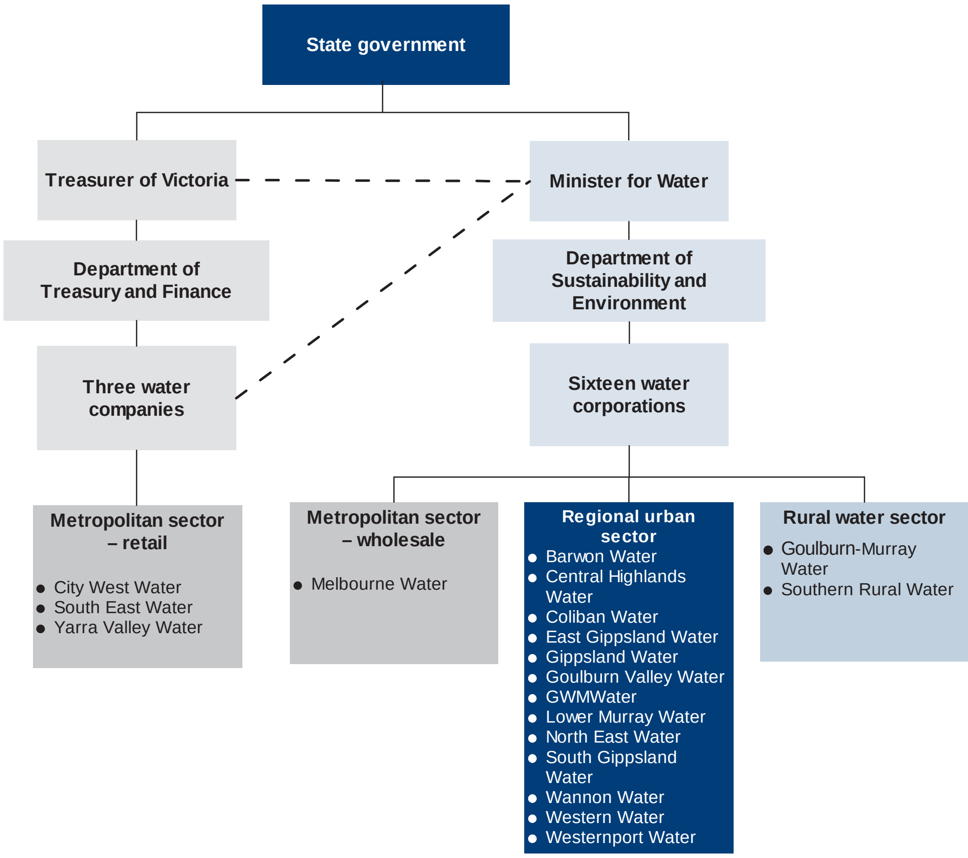
Source: Victorian Auditor-General's Office.

Governance

The responsible Minister is the Minister for Water, however, the three retail distribution companies also report to the Treasurer of Victoria. The relationship between the Minister for Water and the water entities is established by the *Water Act 1989* and the *Water Industry Act 1994*. The Office of Water, a business unit within the Department of Sustainability and Environment (DSE), supports and advises the Minister for Water.

Figure 1C provides an overview of the accountability arrangements and lines of reporting by the 19 water entities that provide essential water and sewerage services to people living in Victoria. It excludes Watermove Pty Ltd, a controlled subsidiary of Goulburn-Murray Water.

Figure 1C
Water industry overview



Source: Victorian Auditor-General's Office.

1.2.2 Sector developments

Water industry reforms

The government announced on 3 July 2008 that the status of the three retail distribution companies would be changed from state-owned companies, reporting under the *Corporations Act 2001*, to publicly owned statutory authorities, reporting under the *Financial Management Act 1994*.

The retailers are working with the Department of Treasury and Finance (DTF) and DSE to achieve a smooth transition to a new accountability regime. Subject to the introduction of enabling legislation, the anticipated effective date is now 1 July 2011.

Watermove Pty Ltd

Watermove Pty Ltd is an Australian proprietary company limited by shares. The company is a controlled subsidiary of Goulburn-Murray Water (G-MW).

The company commenced operations on 1 November 2009 and is an on-line broker that manages a 'water exchange' that facilitates the trade of temporary water throughout Victoria and Southern New South Wales.

The water exchanges were previously managed by a business unit within G-MW.

Securing Our Natural Future – white paper for land and biodiversity

In December 2009, the government released its *Securing Our Natural Future* – a white paper for land and biodiversity at a time of climate change. The paper outlined reforms to government processes and institutions which lead and facilitate the sustainable management of Victoria's land, water and biodiversity.

From 1 July 2011 the activities of Melbourne Water, the Port Phillip and Westernport Catchment Management Authority and the Central Coastal Board will be brought together to create a new entity.

1.3 Financial audit framework

Audit of financial reports

An annual financial audit has two aims:

- to give an opinion consistent with Section 9 of the *Audit Act 1994*, on whether financial reports are fairly stated; and
- to consider whether there has been any wastage of public resources or any lack of probity or financial prudence in the management or application of public resources, consistent with Section 3A(2) of the *Audit Act 1994*.

The assessment of an entity's internal controls is an integral part of a financial audit. 'Internal control' is how an organisation or entity can reasonably assure that its financial reporting is reliable, its operations are effective and efficient and that it is complying with laws and regulations.

Australian Auditing Standard 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* requires the auditor to understand and assess each entity's internal controls.

The financial audit framework applied in the conduct of the 2009–10 audits of the entities is set out in Figure 1D.

Figure 1D
Financial audit framework

Planning

Planning is not a discrete phase of a financial audit, rather it continues throughout the engagement. However, initial audit planning is conducted at two levels:

- At a high or entity level, planning involves obtaining an understanding of the entity and its environment, including its internal controls. The auditor identifies and assesses: the key risks facing the entity; the entity's risk mitigation strategies; any significant recent developments; and the entity's governance and management control framework.
- At a low or financial statements line item level, planning involves the identification, documentation and initial assessment of processes and controls over management, accounting and information technology systems.

The output from the initial audit planning process is a detailed audit plan and a client strategy document, which outlines the proposed approach to the audit. This strategy document is issued to the client after initial audit planning and includes an estimate of the audit fee.

Conduct

The conduct phase involves the performance of audit procedures aimed at testing whether or not financial statement balances and transactions are free of material error. There are two types of tests undertaken during this phase:

- Tests of controls, which determine whether controls identified during planning were effective throughout the period of the audit and can be relied upon to reduce the risk of material error.
- Substantive tests, which involve: detailed examination of balances and underlying transactions; assessment of the reasonableness of balances using analytical procedures; and a review of the presentation and disclosure in the financial statements, for compliance with the applicable reporting framework.

The output from this phase is a final (and possibly an interim) management letter which details significant findings along with value-adding recommendations on improving controls and processes. These documents are issued to the client after any interim audit work and during the reporting phase.

Reporting

The reporting phase involves the formal presentation and discussion of audit findings with the client management, and / or the audit committee. The key outputs from this process are:

- A signed audit opinion, which is presented in the client's annual report alongside the certified financial statements.
- A report to Parliament on significant issues arising from audits either for the individual entity or for the sector as a whole.

Source: Victorian Auditor-General's Office.

Audit of performance reports

Section 8(3) of the *Audit Act 1994* provides the Auditor-General with the authority to audit performance indicators included in the annual reports of public sector entities. The *Audit Act 1994* provides that performance indicators can be assessed in terms of whether performance is fairly represented.

1.4 Reporting framework

The 20 entities are required to prepare an annual financial report, with the 13 regional urban and two rural entities also required to prepare a performance report. The financial and performance reports must be audited.

1.4.1 Financial reporting

The financial reports are prepared in accordance with Australian Accounting Standards, including the Australian Accounting Interpretations.

The main legislation governing financial reporting by the water industry is the *Financial Management Act 1994* (FMA) with 16 of the 20 entities required to comply with the FMA. The three metropolitan retail distribution companies and Watermove Pty Ltd, comply with the requirements of the *Corporations Act 2001*.

Financial Management Act 1994

Under the FMA, the Minister for Finance has the authority to issue directions in relation to financial administration and reporting issues. These directions set the minimum standards for public sector agencies to achieve sound systems of internal control to support financial management.

The FMA requires an entity to submit their annual report for tabling in the Parliament, within four months of the end of the financial year, including the financial report, which should be prepared and audited within 12 weeks.

Corporations Act 2001

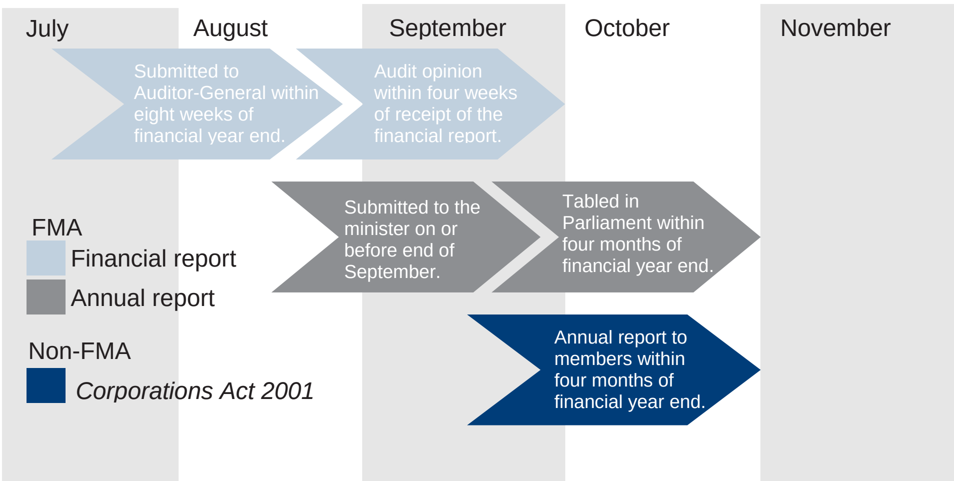
The *Corporations Act 2001* requires a company to report to their members within four months after the end of their financial year. However, as controlled entities of the state and to facilitate the preparation of the annual report of the State of Victoria, the provisions of the FMA require the financial report to be finalised within 12 weeks.

The four companies are also encouraged to comply with the requirements of the Financial Reporting Directions (FRD) to achieve consistency in the application of accounting policies from a whole of government financial reporting perspective.

Legislated reporting time frames

Figure 1E summarises the legislated reporting time frames.

Figure 1E
Legislative financial reporting time frames



Source: Victorian Auditor-General's Office.

Reporting time frames of material entities

To facilitate the preparation of the annual financial report of the State of Victoria, DTF specifies an earlier time line for the 47 material entities across the public sector. The revised time frames were:

- draft financial report submitted to VAGO by 26 July 2010
- the governing board adopt and sign the financial report by 11 August 2010.

Six water entities were required to meet the earlier time lines. They were:

- Barwon Water
- City West Water
- Goulburn-Murray Water
- Melbourne Water
- South East Water
- Yarra Valley Water.

Financial reporting developments

FRD 121 *Infrastructure Assets (Water/Rail)* allowed the 19 water entities to record infrastructure assets at cost within their financial report in 2008–09. However, the entities were required to determine the fair value of their infrastructure assets as at 30 June 2009 with the revised values submitted to DTF to facilitate the preparation of the annual report of the State of Victoria.

For 2009–10, the four metropolitan water entities revised their accounting policies to measure infrastructure assets at fair value, which is consistent with the accounting policy adopted for the preparation of the state's annual financial report. Regional urban and rural water entities will transition to fair value in 2010–11. The additional 12 months allow the entities to validate and update information within their asset systems and for qualified valuers to be engaged.

Compared with the valuation policies and practices of other states and territories, Victoria is one of four Australian jurisdictions yet to require water infrastructure assets to be measured at fair value in entity financial reports. This is notwithstanding that the fair value requirement in AASB 1049 *Whole of Government and General Government Sector Financial Reporting,* at the whole of government level, was first foreshadowed when the accounting standard was exposed as a draft in May 2007.

In our reports, *Water Entities: Results of the 2008–09 Audits* and *Portfolio Departments and Associated Entities: Results of the 2008–09 Audits* tabled in Parliament last year, we recommended that like transactions and events should be consistently treated across the public sector so that financial reports are comparable. We note that the differences were not fully eliminated this financial year but should be eliminated for the 2010–11 year.

The progress towards fair value should have commenced earlier given that AASB 1049 *Whole of Government and General Government Sector Financial Reporting* was released in October 2007 to require infrastructure assets be measured at fair value in the whole of government financial statements.

1.4.2 Performance reporting

FRD 27A *Presentation and Reporting of Performance Information* issued pursuant to the FMA requires the 13 regional urban and the two rural entities to prepare a performance report and submit it for audit.

The directions issued under section 51 of the FMA specify the form and content of the performance report. The report is to include commentary explaining the reason for significant variations between:

- a target and actual performance
- performance between years.

However the directions do not require the water entities to set a target for each performance indicator included in the performance report.

In 2008–09, 14 of the 15 performance reports contained non-financial indicators where no target had been set. In the absence of a target being set, information within a performance report is less meaningful and useful when assessing performance against entity plans.

Further, there remains no requirement for the four metropolitan entities to prepare a performance report and submit it for audit for 2009–10.

In its June 2009 report, *New Directions in Accountability: Inquiry into Victoria's Public Finance Practices and Legislation* (Report No 85), the Public Accounts and Estimates Committee (PAEC) found that the more progressive jurisdictions require all public sector entities to produce audited performance reports for inclusion in their annual report to Parliament.

In December 2009, the Government provided their response to PAEC's 85th report, accepting in principle that the departments and the majority of public bodies will be required to prepare performance measures for inclusion in their annual report. The specific content and extent of performance reporting is however still under consideration.

Also in December 2009, the *Public Finance and Accountability Bill* (the Bill) was introduced to Parliament. The Bill reflects the Government's 2006 election commitment to modernise fundamental legislation in Victoria, including the State's public finance legislation. The Bill includes a requirement for government planning, budgeting and accountability processes to focus on the achievement of outcomes. This reinforces the importance of establishing a comprehensive performance reporting framework in the water industry. At the time of finalising this report the Bill had not been passed.

Recommendations

1. Performance reporting arrangements should be further developed to include the four metropolitan water entities.

2. A target should be set for each performance indicator included in performance reports.

1.4.3 Audit opinion

Independent audit opinions add credibility to the financial report and the performance report by providing assurance that the information is reliable and a clear audit opinion confirms that the financial report and performance report has been prepared in accordance with the requirements of the relevant accounting standards and legislation.

If the report has not been prepared in accordance with the relevant reporting framework it is issued with a qualified audit opinion. A qualified audit opinion means that the report is materiality deficient and is therefore less reliable and useful as an accountability document.

As of 6 August 2010 no financial reports or performance reports had been finalised for the year ended 30 June 2010.

An *Acquittal Report: Results of the 2009–10 Audits* report will include comment on the audit opinions issued for 2009–10, the timeliness and accuracy of the financial and performance reports, and financial sustainability of water entities.

2 Effectiveness of internal controls

At a glance

Background

Internal control encompasses the policies, systems and behaviours established by entities to reliably and cost effectively meet their business objectives.

When undertaking our financial audit we conduct an assessment of the effectiveness of internal controls established by management for financial reporting purposes. While it is not our responsibility to form an opinion on internal controls we nevertheless raise with management any control weaknesses or breakdowns we identify.

Findings

- Overall, our assessment of the internal control structure is that they were adequate for financial reporting purposes.
- Nevertheless, opportunities to further strengthen internal controls were identified, namely:
    - improving information system controls at nine of the 20 entities (45 per cent)
    - improving the maintenance of fixed asset registers at seven of the 20 entities (35 per cent)
    - improving compliance with procurement policies and procedures at six of the 20 entities (30 per cent)
    - more timely preparation and review of key account reconciliations at five of the 20 entities (25 per cent).

Recommendation

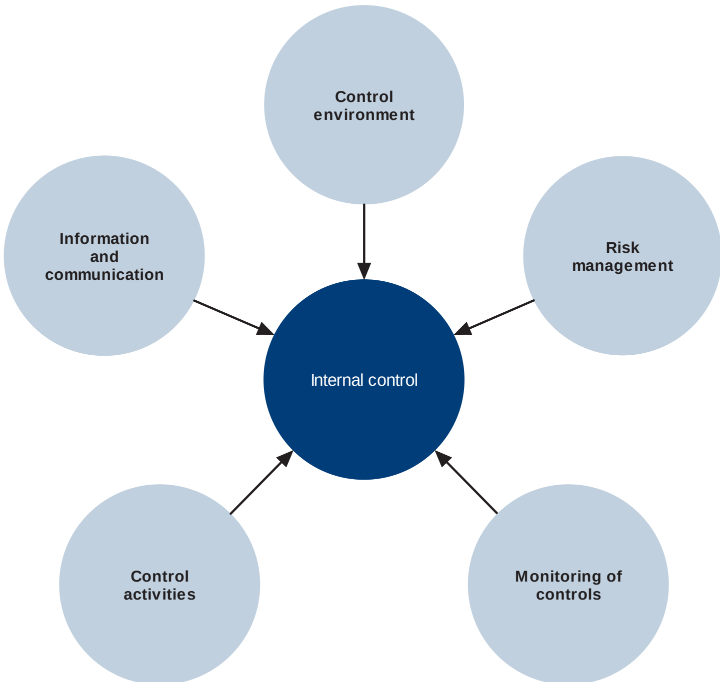
Water entities should assess the adequacy of their policies and processes against the commonly identified weaknesses within their respective internal control environments to assure they are operating in a reliable and cost-effective manner.

2.1 Introduction

Each entity's governing body is responsible for the development and maintenance of its internal control structure. Internal control refers to systems, processes and procedures that are established by the entity.

Figure 2A identifies the main components of an effective internal control framework. Sound internal controls provide an effective and efficient vehicle for the delivery of reliable, accurate and timely internal and external reporting.

Figure 2A
Internal control framework



Source: Victorian Auditor-General's Office.

In the diagram:

- the **control environment** provides the fundamental discipline and structure for controls and includes governance and management functions and the attitudes, awareness, and actions of those charged with governance and management
- **risk management** involves identifying, analysing and mitigating risks
- **monitoring of controls** assess the effectiveness of internal controls in practise
- **control activities** are the policies, procedures and practices that management prescribes to help meet entity objectives
- **information and communication** involves communicating control responsibilities throughout the portfolio department and providing information in a form and time frame that allows officers to discharge their responsibilities.

The annual financial audit enables the Auditor-General to form an opinion on an agency's financial report. An integral part of this process, and a requirement of Australian Auditing Standard 315 *Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement*, is to assess the adequacy of the entity's internal control framework and governance processes as they relate to the accuracy, completeness and reliability of financial reporting.

Internal control weaknesses we identify during an audit will usually not result in a qualified audit opinion. A qualification is usually only warranted if weaknesses cause significant uncertainty about the financial information being reported. Often, an entity will have other compensating controls to mitigate the risk of material error. Weaknesses we identify during an audit of an entity are brought to the attention of the chairman, managing director and audit committee.

Section 16 of the *Audit Act 1994* empowers the Auditor-General to report to Parliament on the results of audits. This section of the report summarises the internal control weaknesses commonly identified during the financial audit for the year ended 30 June 2010.

2.2 Common internal control weaknesses

Overall, our assessment of the internal control structures at the 20 entities is that they were adequate for financial reporting purposes. Nevertheless, we identified a number of instances where important internal controls should be further strengthened. These matters were reported to the relevant entity's governing body and management team.

The most commonly identified control weaknesses related to:

- information system controls
- maintenance of fixed asset registers
- procurement
- preparation and review of account reconciliations.

Information system controls

The key information systems of an entity contain personal details of employees, customers and suppliers. It is important that access to information systems is appropriately restricted to protect the confidentiality of the data.

The effective management of information systems is also critical to the reliability and integrity of financial data.

Weaknesses in information system controls increase the risks of unauthorised access and fraudulent activity.

In 2009–10, control weaknesses were identified at nine entities (45 per cent) including:

- lack of a current information technology strategic plan
- absence of an information technology business continuity and disaster recovery plans and/or testing of the plans
- weak password settings, including use of non complex passwords and no regular changes to passwords
- inadequate controls over network security
- poor security over electronic fund transfer files
- inadequate change management procedures
- lack of monitoring of the activities of privileged users, such as system administrators
- existence of out dated policies.

Maintenance of fixed asset registers

The fixed asset register is a critical system that provides management with information relating to the assets it controls. Each asset is assigned an asset number with the purchase date, the gross cost or revalued amount, and the asset's useful life recorded. At the end of each month the system is able to calculate the depreciation charge.

In order for management to be provided with complete and accurate data it is therefore critical that information relating to asset additions, disposals, retirements, revaluations and the reassessment of an asset's useful life is processed in a timely manner.

Our review identified delays in updating the fixed asset register with data relating to asset additions and disposals at seven entities (35 per cent), comprising six regional urban and one rural entity.

Procurement

Entities should have in a place a set of policies and procedures that address the procurement of goods and services. Whilst policies and procedures exist, we noted weaknesses in the application of the policy and procedures at six entities (30 per cent), comprising two metropolitan and four regional urban entities, including:

- inadequate segregation of duties in relation to the raising and approving of purchase orders
- purchase orders being raised upon receipt of an invoice although the policy requires a purchase order to be raised at time of initiating purchase
- documentation to support transactions was missing
- the transaction was not approved by an appropriate delegate.

Preparation and review of account reconciliations

A financial report is generally prepared based on information captured by the entity's general ledger, with key balances within the general ledger often supported by information recorded in subsidiary ledgers such as accounts payable, billing, fixed assets and payroll systems. As a result, a periodic reconciliation of the general ledger with the subsidiary ledger balances is vital to confirm the completeness and accuracy of data.

Timely preparation and independent review of key account reconciliations decreases the risk that errors may go undetected or may not be resolved in a timely manner; both of which can adversely affect the accuracy of periodic financial reporting.

This year, issues relating to key account reconciliations were identified at five entities (25 per cent), comprising one metropolitan and four regional urban entities. The key issues were:

- account reconciliations were not prepared
- account reconciliations were not independently reviewed
- documentation to support reconciling items not being attached to the reconciliations
- unreconciled items not being investigated and resolved promptly.

Recommendation

3. Water entities should assess the adequacy of their policies and processes against the commonly identified weaknesses within their respective internal control environments to assure they are operating in a reliable and cost-effective manner.

3 Controls over creditors

At a glance

Background

At 30 June 2009, the water industry had creditors totalling approximately $800 million, representing an increase of $230 million or 39 per cent on the prior year.

A review of controls over creditors at the 19 water entities was undertaken as part of our cyclical assessment of internal controls relating to significant annual financial report balances and disclosures.

Findings

- Five of the 13 regional urban entities did not have documented policies and procedures relating to creditor management.
- Of the 14 entities with policies and procedures, they were not approved by the governing board at eight entities (57 per cent).
- Fifteen entities (79 per cent) do not maintain and report to their governing board performance statistics relating to the management of creditors.
- Eleven entities (58 per cent) do not undertake a routine cleansing of the vendor masterfile to remove duplicated and superfluous.
- Five entities (26 per cent) do not monitor aged creditor listings meaning that any delays in payment are less likely to be identified and addressed.
- Coliban Water continued to draw upon short term borrowings during the financial year to pay creditors in accordance with the agreed payment terms. Steps have been taken to improve the financial sustainability of the business.

Recommendations

- Comprehensive creditor management policies and procedures should be developed by management and approved by governing boards.
- Monitoring of creditor management performance should be established with periodic reporting to the governing board.

3.1 Introduction

At 30 June 2009, the water industry had creditors totalling approximately $800 million, representing an increase of $230 million or 39 per cent on the prior year.

The increase was driven by the capital expenditure programs of the entities as numerous capital projects were being delivered across the state in response to a period of unprecedented drought conditions.

The effective management of creditors becomes more critical as the volume and value of invoices being processed increases. It is also important from a cash flow perspective.

Entities delaying the payment of suppliers and/or the drawing upon short term finance to pay operating costs may have issues relating to financial sustainability which require close monitoring by the governing board.

This chapter relates to the 19 water entities, it excludes Watermove Pty Ltd.

3.2 Controls over creditors

The Standing Directions issued by the Minister for Finance outline the expectations of the government with respect to internal control. The directions address the authorisation and approval of transactions, the payment of invoices, and the timely and accurate reporting of financial information.

3.2.1 Creditor management framework

The governing board is responsible for establishing controls relating to the accounts payable function. Controls should address the initiation, approval, processing, payment, and recording and reporting of transactions. The controls should facilitate effective monitoring and provide for board oversight of performance.

Effective creditor controls and processes include:

- comprehensive policies and procedures
- appropriate management practices, and
- sound governance and oversight arrangements.

The key elements of an effective creditor management framework are further detailed in Figure 3A.

Figure 3A
Elements of an effective creditor management framework

Component	Elements

Policies and procedures	• Comprehensive guidelines for each phase of the accounts payable process exist
	• Policies and procedures should:
	  • contain an objective
	  • make reference to state government and/or departmental requirements
	  • specify the entity's terms of trade
	  • address financial delegations and the segregation of incompatible duties
	  • outline the roles and responsibilities of staff
	  • specify the nature and regularity of reporting.

Management practices	• Regular cleansing of the vendor masterfile to confirm the integrity of standing data • Generation and review of aged creditor listings • Timely and accurate payment of creditors • Systems enable efficient payment processing • Key performance indicators set and reported against
Governance	• Review, update and approve policies and procedures • Monitor compliance with approved policies and procedures • Assessing the nature and level of risk attached to creditors from an entity perspective • Regular reporting to the governing board and/or sub committee of the board • Monitoring performance given key performance indicators set

Source: Victorian Auditor-General's Office.

3.2.2 Policy and procedures

The existence of policies and procedures is an important reference point so that tasks are completed in a consistent manner and result in valid transactions being recorded and reported.

Existence of policies and procedures

Our review indicates that five of the 13 regional urban entities did not have documented policies and procedures relating to creditor management, although two of these entities were in the process of drafting policies and procedures.

Adequacy of policies and procedures

Fourteen entities (74 per cent) have creditor management policies and procedures in place. The following important aspects of creditor management were generally addressed by the policies and procedures:

- policy objectives
- the period within which suppliers are to be paid
- reference to state government and/or departmental requirements
- authorisation and approval arrangements for purchase orders and payment of invoices
- roles and responsibilities of staff.

However, we noted that the policies and procedures of six regional urban entities (43 per cent) do not address the reporting and monitoring of performance or the setting of key performance indicators with respect to creditors.

Board approval of policies and procedures

The primary responsibility for setting policies and procedures rests with executive management. These should however be approved by the governing board before their release to staff.

Of the 14 entities with policies and procedures, they were not approved by the governing board at eight entities (57 per cent). We also noted that it had been more than two years since policies and procedures were last reviewed at two of these entities (14 per cent), comprising one regional urban and one rural entity.

In the absence of governing board approval and a periodic review there is a higher risk that:

- the policies and procedures are inadequate
- gaps in policies and procedures may not be identified
- the policies and procedures may no longer reflect government policy.

Recommendations

4. Comprehensive creditor management policies and procedures should be developed by management and approved by governing boards.

5. Creditor management policies and procedures should be periodically reviewed and updated.

3.2.3 Management practices

Maintenance of the vendor masterfile

Financial systems, such as accounts payable, rely on the maintenance of standing data within masterfiles to enable the processing of individual payments. The standing data would include a suppliers name, address, terms of trade, preferred payment option, bank account details and payment history.

It is important that all changes made to standing data are complete, accurate and legitimate, otherwise subsequent processing errors can be repeated many times over. Further, an independent review of masterfile changes is important for the detection and timely correction of unintentional or fraudulent changes, and to reduce the risk of payments being made to unauthorised suppliers or payments being made to fictitious suppliers.

A regular cleansing of data within the masterfile also allows for the detection and removal of duplicated and superfluous data. Cleansing of the data can also improve the operational efficiency of the system.

Our review indicated that 11 entities (58 per cent), comprising nine regional urban and the two rural entities, do not undertake a routine cleansing of the vendor masterfile to remove duplicated and superfluous data.

Recommendation

6. Cleansing of the vendor masterfile should be scheduled at least annually.

Ageing of creditors

Creditors generally have payment terms from immediate to 30 days.

Delays in paying suppliers have the potential for reputational damage and for discounts for early payment not to be realised. They can also impact upon an entity’s cash flow projections and the need to access short term borrowings for working capital purposes.

As at 31 March 2010 the level of overdue invoices was not significant with 93 per cent of invoices being within the range of one to 30 days and 99 per cent within 60 days.

Whilst our review indicates that the water entities generally pay supplier invoices within 30 days of receiving a valid invoice, management at five entities (26 per cent), comprising four regional urban and one rural entity, do not monitor the ageing of creditors meaning that any delays in payment are less likely to be identified and addressed.

We noted that Coliban Water continued to draw upon short term borrowings during the financial year to pay creditors in accordance with the agreed payment terms. Coliban Water forecast in their approved corporate plan negative cash flows from operating activities of $5 million for the 2009–10 year. Steps have been taken to improve the financial sustainability of the business and increase the cash flows from operating activities in future years. This has included a review of costs by management to identify savings. The Essential Services Commission considered a pricing submission by Coliban Water and approved an increase to prices, effective 1 July 2010. The approved price adjustments are expected to increase Coliban Water's revenue by $4.9 million in 2010–11.

Payment of creditors

Technology is increasingly integral to managing an efficient creditor management system. Key accounting systems now incorporate functions including on-line purchasing, electronic approvals, the scheduling of payments, electronic funds transfers, the use of emails to send remittances, and the automated generation of aged creditors' analysis. These innovations present both opportunities for efficiency gains in terms of timely and quick processing but can equally represent a risk to the control environment and therefore warrant ongoing attention, both by management and the governing board.

In examining the efficiency of payment processing for the water entities, we looked for the following:

- electronic funds transfer as the preferred method for payment
- the system's ability to schedule payments in accordance with the agreed payment terms.

Our review indicates that electronic funds transfer (EFT) is being employed as a preferred mode of payment by 18 entities (95 per cent). On average, 75 per cent of total payments are made using EFT.

Southern Rural Water utilises an EFT facility for approximately five per cent of supplier payments, with payment by cheque still the preferred payment mode. A move to increasing the level of EFT payments would increase the efficiency of payment processing.

Our review reveals that appropriate attention had been given to implementing controls that restrict access to the EFT facility at 17 entities (89 per cent).

We also noted that the accounts payable systems facilitate the scheduling of payments. Supplier invoices are flagged for payment by the accounts payable system given the agreed payment terms, as part of the weekly, fortnightly or monthly payment process.

Detection of overpayments and duplicated payments

While it is recognised that errors in processing of creditor payments will occur, this can be mitigated by having controls in place which either isolate those errors at the input stage or allow detection prior to payment. For example, the capacity to identify possible overpayments or duplicated payments should be programmed into the system so possible errors are reported for investigation.

The review confirmed that system controls exist within the accounts payable systems to assist with the prevention of duplicate payments. We also noted that a number of entities generate exception reports and engage their internal auditors to assist with the detection of overpayments and duplicated payments.

3.2.4 Governance

Internal audit

All water entities have an internal audit function and the internal auditors are generally engaged to undertake a review of key accounting systems on a rotational basis.

The work of internal audit can provide management with assurance that the entity's policies and procedures are being complied with. Our review of internal audit plans indicates that internal audit had undertaken a review of creditor management at 17 entities (89 per cent) within the past three years.

Monitoring of creditor management performance

Key performance indicators over creditor management can relate to the achievement of payment terms, the number of late payments, duplicate payments, supplier complaints, active suppliers, the ageing of creditors and percentage of payments made via EFT.

Our review indicated that 15 entities (79 per cent) do not maintain and report performance statistics to their governing board relating to the management of creditors.

Recommendation

7. Monitoring of creditor management performance should be established with periodic reporting to the governing board.

4 Controls over capital projects

At a glance

Background

Planned capital expenditure for the water industry was $2.4 billion for 2009–10.

Findings

- Three entities (16 per cent) did not have documented policies and procedures relating to capital projects management.
- Whilst 16 entities had policies and procedures:
  - they were not approved by the governing board at seven entities (44 per cent)
  - the regional urban entities commonly did not address government policy requirements, the development of a risk management plan, budgeting and budget approval, and assigning a sponsor to the project.
- Reporting to the governing board on the status of the capital expenditure program generally does not address the management of project risks or the achievement of outcomes.
- Twelve entities (63 per cent) have established a separate board sub-committee to oversight the delivery of the capital expenditure program.
- Fifteen per cent of capital projects had experienced budget overruns in their delivery.
- Ten per cent of capital projects had experienced delays in completion based on the original planned completion date.

Recommendations

- Comprehensive capital project policies and procedures should be developed by management and approved by governing boards.
- Governing boards should monitor and assess the adequacy of the risk management regimes and associated plans developed for capital projects.
- Management should assess whether the desired project benefits and outcomes were achieved and report findings to the governing board.
- Internal audit should conduct periodic reviews of the management of critical capital projects, including associated risks.

4.1 Introduction

At 30 June 2009, the water industry had total assets of $21.1 billion, with infrastructure assets, property, plant and equipment accounting for $20.2 billion or 96 per cent of the total asset base.

In 2008–09 the total value of infrastructure assets, property, plant and equipment increased by $2 billion or 11 per cent from the prior year. The planned capital expenditure for 2009–10 was $2.4 billion.

The effective management of capital projects is therefore critical given the materiality of the infrastructure asset balance and the significant capital expenditure program.

This chapter relates to the 19 water entities, it excludes Watermove Pty Ltd.

4.2 Controls over capital projects

Victoria has experienced drought conditions since 1997. A period of sustained below average rainfall has driven a significant investment in new infrastructure as evidenced by the various capital projects that are currently being undertaken by the 19 water entities.

It is important that controls are effective and that an entity's information systems support the management of these assets and related projects, and provide complete and accurate information for inclusion in external and internal reports.

Figure 4A provides a summary of the actual payments relating to capital expenditure at the water entities for 2007–08 and 2008–09 financial years, and the planned capital expenditure for 2009–10. The figure indicates a significant investment in infrastructure assets by water entities, with the metropolitan water sector delivering a number of major projects over the past three years.

Figure 4A
Capital expenditure for a three-year period

Entity	2007–08 Actual $'000	2008–09 Actual $'000	2009–10 Planned $'000
Metropolitan sector			
Wholesaler			
Melbourne Water	367 799	939 213	1 057 400
Retailers			
City West Water	53 939	90 007	142 912
South East Water	100 017	123 290	148 500
Yarra Valley Water	153 865	175 798	323 830
Sub-total	**675 620**	**1 328 308**	**1 672 642**
Regional urban sector			
Barwon Water	55 960	76 494	102 616
Central Highlands Water	151 957	61 350	46 938
Coliban Water	92 735	73 777	30 411
East Gippsland Water	16 701	19 150	22 202
Gippsland Water	107 315	102 060	36 971
Goulburn Valley Water	25 415	28 840	39 433
GWMWater	213 514	248 595	105 735
Lower Murray Water	31 218	34 129	69 201
North East Water	17 249	19 408	20 460
South Gippsland Water	8 276	9 162	14 500
Wannon Water	25 537	30 124	52 518
Western Water	33 397	39 960	35 693
Westernport Water	7 044	4 268	3 994
Sub-total	**786 318**	**747 317**	**580 672**
Rural sector			
Goulburn-Murray Water	76 310	184 874	141 300
Southern Rural Water	14 319	13 878	18 000
Sub-total	**90 629**	**198 752**	**159 300**
Total	**1 552 567**	**2 274 377**	**2 412 614**

Source: Victorian Auditor-General's Office.

4.2.1 Capital projects management framework

Effective capital project controls and processes include:

- comprehensive policies and procedures
- appropriate management practices
- sound governance and oversight arrangements.

Figure 4B provides further details in relation to an effective capital projects management framework.

Figure 4B
Elements of an effective capital projects management framework

Component	Elements

Policies and procedures	• Comprehensive guidelines relating to capital project management exist
	• Policies and procedures should contain information relating to:
	  • objectives of the policy
	  • frequency at which the policies and procedures would be reviewed
	  • criteria for selecting a project and when a business case is to be prepared
	  • the regulatory framework
	  • compliance with the directions and policy of state government
	  • budget approval regime
	  • developing a risk management plan
	  • assigning a sponsor to the project
	  • appointment of project managers
	  • preparation of project specifications and a project plan
	  • circumstances in which probity auditors and advisors are involved prior to awarding a contract
	  • status reports and reporting to the governing board.

Management practices	• Regular monitoring of capital projects by the executive management team in terms of:
	  • the project being delivered on time and within budget
	  • achievement of project outcomes and benefits
	  • the management and mitigation of project risks
	• Timely and accurate processing of project costs within supporting ledgers
	• Consolidate learning's arising from the post project evaluation process.

Governance	• Review, update and approve policies and procedures • Assess the nature and level of risk attached to the delivery of capital projects from an entity perspective • Monitor compliance with management policies and procedures • Regular reporting to the governing board.

Source: Victorian Auditor-General's Office.

4.2.2 Policy and procedures

Existence of policies and procedures

Our review indicated that three entities (16 per cent), comprising two regional urban and one rural entity, did not have comprehensive policies and procedures relating to capital projects management.

Adequacy of policies and procedures

Where policies and procedures exist they generally contained information relating to:

- objectives of the policy
- the regulatory environment within which the water entity operates
- the criteria for selecting a project and when a business case is to be prepared
- appointment of project managers
- status reports and reporting to the governing board.

However, areas for further improvement include:

- assigning a sponsor to the project at five entities (31 per cent), comprising four regional urban and one rural entity
- budgeting and budget approval at three regional urban entities (19 per cent)
- development of a risk management plan at four entities (25 per cent), comprising one metropolitan and three regional urban entities
- government policy requirements for projects at two regional urban entities (13 per cent)
- the circumstances in which a probity auditor and advisor should be involved prior to awarding a contract at seven entities (44 per cent)
- the frequency at which capital projects management policies and procedures should be reviewed and updated at nine entities (56 per cent).

Board approval of the policies and procedures

Of the 16 entities with policies and procedures, they were not approved by the governing board at seven entities (44 per cent), comprising two metropolitan and five regional urban entities. Also, we noted that the policies and procedures had not been reviewed within three years at one regional urban entity.

In the absence of governing board approval and a periodic review:

- there is a higher risk that the policies and procedures are inadequate
- that gaps in the policies and procedures may not be identified
- the policies and procedures may no longer reflect government policy.

Recommendation

8. Comprehensive capital project policies and procedures should be developed by management and approved by governing boards.

4.2.3 Management practices

All water entities maintain systems which enable the production of monthly reports relating to work in progress and completed projects listings, from which postings to general ledgers are made. These reports allow project managers and executive management to review, and report upon, the progress of projects and complete analysis of financial and other outcomes for finalised projects.

Monitoring of capital projects

Regular monitoring of capital projects by executive management teams is central to assessing whether projects are running on time, on budget, project benefits are being achieved and the project risks are being adequately managed and mitigated.

Our review revealed that whilst the executive management teams are monitoring the status of projects, additional attention should be given to the:

- achievement of project outcomes at four regional urban water entities (21 per cent)
- management of project risks at five regional urban water entities (26 per cent).

Financial and timing outcomes

Our review of the capital expenditure programs across the water entities for 2009–10 indicates that projects are experiencing delays and/or budget overruns. Approximately 15 per cent of capital projects had experienced budget overruns while 10 per cent of capital projects had experienced delays in completion based on the original planned completion date.

Factors contributing to the delays and budget overruns include:

- scope changes
- under estimation of the size and complexity of the project
- poor collaboration across project teams
- poor labour productivity and price escalation over the term of construction
- lack of change management practices
- project defects.

Conduct of post project evaluations

An important aspect of the capital works process is the learning's that can be derived from the analysis of whether the projected outcomes of the project were achieved, and whether the project was completed on time and within budget. The application of learning's by management to similar projects in the future should improve the entity's ability to deliver projects on time and within budget.

Our review found that three regional urban entities (16 per cent) did not undertake a post project evaluation at the completion of capital projects.

Recommendations

9. Governing boards should monitor and assess the adequacy of the risk management regimes and associated plans developed for capital projects.
10. Management should assess whether the desired project benefits and outcomes were achieved and report findings to the governing board.
11. Management should undertake post project evaluations to learn from recent projects and report findings to the governing board.

4.2.4 Governance

Reporting to the board

To facilitate effective decision making by the governing board, internal reports should be prepared on a regular basis, contain complete and accurate information with sufficient commentary included to inform the board and assist with their decision making.

Our review of reporting to the board indicates that reports are generally provided on a monthly or quarterly basis. The reports relate to the overall capital expenditure program and/or specific projects. Whilst the reports generally focus on the achievement of key milestones and contain associated commentary, greater attention should be given to reporting on the:

- achievement of project outcomes
- management of project risks.

Emergence of board sub-committees

In response to the expanded capital work programs, we noted that 12 entities (63 per cent) have established a separate sub-committee, directly responsible to the governing board, to overview the management of capital projects from the initiation of contract proposals to post completion evaluations.

These sub-committees provide a sharper focus on the delivery of the capital expenditure program and in conjunction with management play an important role by looking to clear any disruptions to the achievement of key milestones.

To permit effective monitoring of performance against delivery dates and cost, regular reports are prepared by the entities and are provided to the sub-committees with commentary on variations against targets.

Risk management

With a significant capital works program underway, it is important that the risks associated with contract management and project delivery are monitored by the executive management team and governing board.

Our review of the risk registers of the water entities indicated that four entities (21 per cent), comprising three regional urban and one rural entity, do not include risks associated with the delivery of its capital expenditure program within their risk register.

The inclusion of risks in a central register:

- allows risks to be rated and ranked
- facilitates the on-going management of risks.

Internal audit

All water entities have an internal audit function and the internal auditors generally undertake a review of key accounting systems on a rotational basis. Given the importance and significance of the capital expenditure programs at most entities, internal audit could be engaged to review various aspects of an entity's policies and procedures.

Internal audit had not undertaken a review of the water entities compliance with its capital project management policies and procedures within the last three years at seven entities (37 per cent), comprising six regional urban and one rural water entity.

Recommendations

12. The risks associated with ineffective capital management practices should be incorporated in the entity's risk register.
13. Internal audit should conduct periodic reviews of the management of critical capital projects, including associated risks.

Appendix A. Acronyms and glossary

Acronyms

AASB	Australian Accounting Standards Board
DSE	Department of Sustainability and Environment
DTF	Department of Treasury and Finance
FMA	*Financial Management Act 1994*
FRD	Financial Reporting Direction
VAGO	Victorian Auditor-General's Office.

Glossary

Accountability

Responsibility on public sector entities to achieve their objectives, with regard to reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties.

Acquisition

Acquisition, in relation to assets, means establishing control over the asset, assuming the risks and receiving the right to future benefits, as would be conferred with ownership, in exchange for a cost of acquisition.

Asset

A resource controlled by an entity as a result of past events, and from which future economic benefits are expected to flow to the entity.

Auditor’s opinion

Positive written expression within a specified framework indicating the auditor’s overall conclusion on the financial report based on audit evidence obtained.

Capital expenditure

Amount capitalised to the balance sheet for contributions by a public sector entity to major assets owned by the entity, including expenditure on:

- capital renewal of existing assets that returns the service potential or the life of the asset to that which it had originally
- capital expansion, which extends an existing asset at the same standard to a new group of users.

Construction in progress

The classification of costs incurred to date, including materials, labour and overhead on a fixed asset, which are to be capitalised on completion of the fixed asset.

Corporations Act 2001

The *Corporations Act 2001* is the principal legislation regulating companies in Australia.

Fair value

The amount for which an asset (financial or non-financial) could be exchanged between knowledgeable and willing parties in an arm's length transaction.

Financial Management Act 1994

The *Financial Management Act 1994* was developed to improve financial administration and accountability and provide for annual reporting to the Parliament by all Victorian public sector agencies.

Financial report

Structured representation of the financial information, which usually includes accompanying notes, derived from accounting records and intended to communicate an entity’s economic resources or obligations at a point in time and changes therein for a period in accordance with a financial reporting framework.

Financial Reporting Direction

Financial reports are prepared in accordance with Australian Accounting Standards and Interpretations as issued by the Australian Accounting Standards Board (AASB). Where an AASB standard provides accounting treatment options the Department of Treasury and Finance issues a Financial Reporting Direction to make sure consistent application of accounting treatment across the Victorian public sector in compliance with that particular standard.

Financial sustainability

An entity's ability to manage financial resources so it can meet spending commitments, both at present and into the future. For water bodies this refers to charging sufficient water charges over the long term, to maintain infrastructure assets and associated services in the supply of water.

Financial year

The period of 12 months from which a financial report is prepared ending on 30 June each year.

Going concern

An entity which is expected to be able to pay its debts as and when they fall due, and continue in operation without any intention or necessity to liquidate or otherwise wind up its operations.

Hard close

An audit visit undertaken near the end of the financial year with the intention of substantiating figures to be provided in the financial statements that are available at that time.

Independent auditor's report

Issued after an audit and contains a clear expression of the auditor's opinion on the entity's financial report.

Infrastructure assets

Encompass substructures or underlying systems held by water entities to facilitate the harvesting, storage, treatment and transfer of water to meet customer needs/requirements; and that underlie sewerage and drainage systems.

Internal control

A process affected by an entity's structure, work and authority flows, people and management information systems, designed to assist the entity accomplish specific goals and objectives. Internal control is a means by which an entity's resources are directed, monitored and measured. It plays an important role in preventing and detecting fraud and protecting the entity's resources.

Liability

A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Materiality

In relation to information, information that if omitted, misstated or not disclosed has the potential to adversely affect decisions about the allocation of scarce resources made by users of the financial report or the discharge of accountability by management or the governing body of the entity.

Public sector entity

A department; local government; statutory body; an entity controlled by government body, or public sector entity.

Qualification

A qualification is issued when the auditor concludes that an unqualified opinion cannot be expressed due to one of the following reasons:

- disagreement with those charged with governance
- conflict between applicable financial reporting frameworks
- limitation of scope.

A qualified opinion shall be expressed as being except for the effects of the matter to which the qualification relates.

Valuation

The process of applying a value to an asset.

Appendix B. *Audit Act 1994* section 16—submissions and comments

Introduction

In accordance with section 16(3) of the *Audit Act 1994* a copy of this report was provided to the Department of Sustainability and Environment, the Department of Treasury and Finance and the 20 entities with a request for comments or submissions.

The comments and submissions provided are not subject to audit nor the evidentiary standards required to reach an audit conclusion. Responsibility for the accuracy, fairness and balance of those comments rests solely with the agency head.

Submissions and comments received

RESPONSE provided by the Secretary, Department of Sustainability and Environment.

Department of Sustainability and Environment

Ref: SEC006939
File: AU/02/3005

8 Nicholson Street
PO Box 500 East Melbourne
Victoria 8002 Australia
Telephone: (03) 9637 8000
Facsimile: (03) 9637 8100
ABN 90 719 052 204
DX 210098

Mr D D R Pearson
Auditor General
Auditor General Victoria
Level 24
35 Collins Street
MELBOURNE VIC 3000

Dear Mr Pearson

PROPOSED REPORT ON WATER ENTITIES - INTERIM RESULTS OF THE 2009 - 10 AUDITS

Thank you for your letter dated 27 July 2010, concerning the proposed audit report *Water Entities: Interim Results of the 2009-10 Audits.*

I note your findings that water corporation's controls concerning internal management, creditors and capital projects are generally adequate, and I accept your recommendations on these matters. DSE will continue to engage with water corporations to ensure your recommendations are actioned.

The audit report acknowledges that Financial Reporting Direction FRD121 Infrastructure *Assets (Water/Rail)* specified when the water entities should adopt fair value in their entity reports and that they have complied with it. FRD121 should also be considered in the context of Financial Reporting Direction FRD103D *Non-Current Physical Assets*, which sets a five year cycle for asset valuations with water assets due to be valued in 2010-11. The adoption of fair value in the water sector in 2010-11 should therefore be seen in the context of a planned cycle of valuations across the Victorian government.

With regard to performance reporting, DSE is continuing to work towards improving requirements and I welcome the emphasis on this topic.

I thank you for this opportunity to comment on the interim audit results.

Yours sincerely

Greg Wilson
Secretary

3/08/10

Privacy Statement
*Any personal information about you or a third party in your correspondence will be protected under the provisions of the **Information Privacy Act 2000**. It will only be used or disclosed to appropriate Ministerial, Statutory Authority, or departmental staff in regard to the purpose for which it was provided, unless required or authorised by law. Enquiries about access to information about you held by the Department should be directed to the Manager Privacy, Department of Sustainability & Environment, PO Box 500, East Melbourne, 3002.*

Victoria The Place To Be

Auditor-General’s reports

Reports tabled during 2010–11

Report title	Date tabled
Portfolio Departments: Interim Results of the 2009–10 Audits (2010–11:1)	July 2010
Taking Action on Problem Gambling (2010–11:2)	July 2010
Local Government: Interim Results of the 2009–10 Audits (2010–11:3)	August 2010

VAGO’s website at <www.audit.vic.gov.au> contains a comprehensive list of all reports issued by the Office. The full text of the reports issued is available at the website.

VAGO

Victorian Auditor-General's Office

Auditing in the Public Interest

Availability of reports

Copies of all reports issued by the Victorian Auditor-General's Office are available from:

- Information Victoria Bookshop
  505 Little Collins Street
  Melbourne Vic. 3000
  AUSTRALIA

  Phone: 1300 366 356 (local call cost)
  Fax: +61 3 9603 9920
  Email: <bookshop@diird.vic.gov.au>

- Victorian Auditor-General's Office
  Level 24, 35 Collins Street
  Melbourne Vic. 3000
  AUSTRALIA

  Phone: +61 3 8601 7000
  Fax: +61 3 8601 7010
  Email: <comments@audit.vic.gov.au>
  Website: <www.audit.vic.gov.au>