VICTORIA

Victorian
Auditor-General

Audit summary of Water Entities: Interim Results of the 2009–10 Audits

Tabled in Parliament
11 August 2010

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

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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