

# ***Water Entities: 2014–15 Audit Snapshot***

Tabled 10 December 2015

The Auditor-General provides assurance to Parliament on the accountability and performance of the Victorian Public Sector. The Auditor-General conducts financial audits and performance audits, and reports on the results of these audits to Parliament.

On 10 December 2015, the Auditor-General tabled his financial audit report, *Water Entities: 2014–15 Audit Snapshot*.

## Key messages

2

**Qualified audit reports were issued for 2014–15.**

**Internal control weaknesses not resolved in a timely manner.**

**Short-term and longer-term financial sustainability risks exist.**

**The water sector has significant and growing debt.**

The key messages for noting are:

- qualified audit reports were issued on the financial and performance reports of the four metropolitan water entities
- internal control weaknesses not resolved in a timely manner
- the financial performance of the water sector has shown improvement but short-term and longer-term financial sustainability risks exist
- the water sector has significant and growing debt as the water entities rely on debt to finance capital projects and other payments, such as dividends.

## Financial reporting

pages  
5–8

- Fifteen water entities received clear audit opinions on their 2014–15 financial reports.
- The four metropolitan water entities received qualified audit opinions due to:
  - errors in the fair valuation of infrastructure assets
  - assets and equity balances overstated by a combined \$1.3 billion at 30 June 2015.

The 19 water entities are required to prepare their financial reports in accordance with the *Financial Management Act 1994* and the Australian accounting standards.

Unqualified audit opinions were issued on the financial reports of 15 entities for 2014–15.

Qualified audit opinions were issued in relation to the four metropolitan water entities, due to errors with the fair valuation of their infrastructure assets. The errors overstated the value of infrastructure assets and the asset revaluation reserves by a combined \$1.3 billion.

The errors are a departure from Australian Accounting Standard AASB 13 *Fair value measurement*, which became effective from 1 July 2013.

## Financial reporting

pages  
8–12

- Internal control weaknesses and financial reporting issues include:
  - 17 extreme and high-risk issues
  - 54 medium-risk issues
  - predominantly relate to information technology, assets and the revenue billing systems.
- Prior year internal control weaknesses not resolved in a timely manner.

Effective internal controls are critical for the delivery of reliable, accurate and timely internal and external financial reports.

Whilst the internal controls, to the extent we tested those controls, were considered adequate for financial reporting purposes, we identified a number of instances where important internal controls can be strengthened.

Seventeen extreme and high-risk issues were reported to the governing body and management for action in addition to a further 54 medium-risk issues. The issues predominantly related to three areas:

- Information technology (i.e. IT security and user access, logging and patch management),
- infrastructure assets, property, plant and equipment
- Revenue billing systems

We also noted that 18 issues or 33% of prior period high and medium-risk issues remain unresolved—indicating internal control frameworks are not as effective as they should be.

## Financial results for 2014–15

pages  
16–22

- Net profit before tax \$430.6 million—an increase of \$109.7 million or 34%:
  - The four metropolitan entities generated \$399 million of the net profit before tax.
  - Fifteen entities reported a growth in their net profit before tax.
  - Four entities reported a net loss compared to six in the prior year.
- Dividend payments increased by \$82.4 million or 215% on the prior year.

The financial performance of the water sector has shown improvement.

For the year ended 30 June 2015, the 19 water entities generated a combined Net profit before tax of \$430.6 million—an increase of \$109.7 million, or 34 per cent.

The four metropolitan water entities generated \$399 million or 93% of the sector's net profit before tax.

We also noted that 15 entities reported a growth in their net profit before tax, and that only four entities reported a net loss compared to six in the prior year.

Dividends paid by the four metropolitan water entities totalled \$126.1 million in 2014–15, an increase of 215% on the prior year.

## Financial sustainability

pages  
23–31

- Liquidity risks exist for the metropolitan and regional urban water entities.
- Longer-term risks exist around the sector's ability to:
  - replace/renew assets
  - repay debt.

To be financially sustainable entities need the capacity to meet current and future expenditure as it falls due. Financial sustainability should be viewed from both a short-term and long-term perspective. We considered seven indicators over a five-year period:

1. Net result
2. Interest cover
3. Liquidity
4. Internal financing
5. Capital replacement
6. Debt-to-assets
7. Debt service cover

The short-term indicators highlight liquidity risk as an issue for the metropolitan and regional urban water entities due to the quantum of their short-term debt.

The longer-term financial sustainability risks relate to the water entities ability to generate sufficient cash flows to finance the replacement or renewal of assets and repay debt. I'll provide further comment on this matter under 'Trends in debt management'.



## Performance reporting

pages  
34–39

- Consists of financial and non-financial indicators.
- Fifteen clear audit opinions were issued.
- Qualified audit opinions were issued on the four metropolitan water entities performance reports due to the errors with the valuation of infrastructure assets.
- Processes surrounding preparation of performance reports not as mature as those applied to financial reporting.

The 19 water entities were required to include an audited performance report in their annual report for 2014–15. The performance report contains predetermined financial and non-financial indicators and targets, actual results achieved, and explanations of significant variances in performance between the targets and prior year performance.

Fifteen clear audit opinions were issued for the year ended 30 June 2015.

Qualified audit opinions were issued on the four metropolitan water entities performance reports, as errors with the valuation of infrastructure assets (as mentioned earlier) impacted the calculation of three financial performance indicators.

Consistent with our observation in the prior year, the processes surrounding the preparation of performance reports, are not as mature as those applied to financial reporting.

## Trends in debt management

pages  
42–52

- Borrowings have increased by 29% over the past five years
  - \$10.4 billion in 2014–15 vs \$8 billion in 2010–11
  - The four metropolitan water entities account for 80% of the total debt.
- At 30 June 2015 the water sector held 25% of the state's overall borrowings.
- Water entities are expected to increase their borrowings by a further 19% in the period to 2018–19.

We have analysed trends in debt management over the past five years and note:

- the water sector has increased their level of borrowings by 29%. (\$10.4 billion in 2014–15 compared to \$8 billion in 2010–11)
- the four metropolitan water entities account for 80% of the water sector's total debt
- the water sector's borrowings in turn account for 25% of the state's overall debt; and
- the water sector's borrowings are forecast to increase by a further 19% by 2018–19 (total debt to reach \$12.4 billion by 30 June 2019).



## Trends in debt management – *continued*

pages  
42–52

- There has been, and continues to be, a reliance on debt to finance capital projects and other obligations.
- The water entities traditionally rollover rather than repaid maturing debt
  - Of the \$3.7 billion of maturing debt over the past five years, \$2.7 billion was not repaid.
  - Eight entities did not repay any debt over the past five years.
- Only three water entities had a formal debt management plan or strategy.

There has been, and continues to be, a reliance on debt by the water sector to finance capital projects and other obligations, such as dividends.

Of the \$3.7 billion of maturing debt during the five-year period, \$2.7 billion was not repaid, it was rolled over. Eight entities across the sector did not repay any debt over the period.

Accordingly, it is recommended that water entities develop a dedicated debt management plan or strategy to map out their approach to debt and its use over the medium and longer term. At present only three entities have a formal debt management plan or strategy.

Whilst the water entities have maintained an adequate level of interest cover to service their debt, longer-term financial risk exists for the state—if the primary source of funding capital projects is derived from debt, which is rolled over and not repaid.

## Recommendations

10

1. That water entities address issues raised in audit management letters on a timely basis so that any weaknesses in their control environment are rectified promptly.
2. That metropolitan water entities change their current valuation model used to estimate the fair value of infrastructure assets to correct the errors identified by audit in the qualification.

That water entities:

3.
  - enhance their performance reporting processes in regards to roles and responsibilities, data collection, quality assurance and report preparation
  - critically assess the requirements of Ministerial Reporting Direction (MRD) 01 *Performance Reporting* to ensure its appropriate application in preparing their performance reports.

The report contains five recommendations

- three directed towards all water entities
- one specific to the metropolitan water entities
- one for the Department of Environment, Land, Water & Planning to action.

The department accepted all recommendations.

The recommendations are:

1. That water entities address issues raised in audit management letters on a timely basis so that any weaknesses in their control environment are rectified promptly.
2. That metropolitan water entities change their current valuation model used to estimate the fair value of infrastructure assets to correct the errors identified by audit in the qualification.
3. That water entities:
  - enhance their performance reporting processes in regards to roles and responsibilities, data collection, quality assurance and report preparation; and
  - critically assess the requirements of Ministerial Reporting Direction (MRD) 01 Performance Reporting, to ensure its appropriate application in preparing their performance reports.

## Recommendations – *continued*

11

4. That the Department of Environment, Land, Water & Planning conducts a more robust review of water entities' draft corporate plans to detect any disparities with MRD 01 and undertake a comprehensive review of MRD 01 non-financial KPIs for consistency.
5. That water entities establish a dedicated debt management strategy or plan that maps out their approach to debt management and usage over the medium and longer term.

4. That the Department of Environment, Land, Water & Planning conducts a more robust review of draft corporate plans submitted to detect any disparities with MRD 01, and undertake a comprehensive review of MRD 01 non-financial key performance indicators for consistency.
5. That water entities establish a dedicated debt management strategy or plan, that maps out their approach to debt management and usage over the medium and longer term.

## Contact details

12

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