Queensland Audit Office
better public services

Rail and ports: 2016–17 results of financial audits

Report 3: 2017–18

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Reference to comments

In accordance with section 64 of the *Auditor-General Act 2009,* we provided a copy of this report to the Deputy Premier, Minister for Transport and Minister for Infrastructure and Planning; the Director-General, Department of Transport and Main Roads; the Minister for Main Roads, Road Safety and Ports and Minister for Energy, Biofuels and Water Supply; the Treasurer, Queensland Treasury; Queensland Rail Group; Far North Queensland Ports Corporation Limited; Gladstone Ports Corporation Limited; North Queensland Bulk Ports Corporation Limited; Port of Townsville Limited. In reaching our audit conclusions, we have considered their/his/her view and represented them to the extent we deemed relevant and warranted in preparing this report.

Responses were received from the Treasurer and Minister for Trade and Investment, and from the Department of Transport and Main Roads. The responses are in Appendix A.

Report cost

This audit report cost $70 000 to produce.

Your ref:
Our ref: 11633

7 December 2017

Mr Neil Laurie
The Clerk of the Parliament
Parliament House
BRISBANE QLD 4000

Dear Mr Laurie

Report to Parliament

This report is prepared under Part 3 Division 3 of the *Auditor-General Act 2009*, and is titled *Rail and ports: 2016–17 results of financial audits* (Report 3: 2017–18).

In accordance with s.67 of the Act, would you please arrange for the report to be tabled. In accordance with s59A of the Parliament of Queensland Act and Standing Order 31, I request that this document be tabled during the period that the Legislative Assembly is dissolved.

Yours sincerely

Brendan Worrall
Auditor-General

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Report structure

CHAPTER 1

Provides a sector overview to assist with understanding the audit findings and conclusions.

CHAPTER 2

Delivers the audit opinion results and evaluates the timeliness and quality of reporting.

CHAPTER 3

Analyses the financial performance, position and future challenges of the entities.

CHAPTER 4

Assesses the strength of the internal controls designed, implemented and maintained by entities in the rail and ports sector.

Contents

Summary

Introduction

This report summarises the results of our financial audits of the Queensland Government's six rail and port entities being:

- the Queensland Rail Group (QR), including Queensland Rail Transit Authority (now Queensland Rail) and Queensland Rail Limited (QRL). QRL is a wholly owned subsidiary of Queensland Rail
- Far North Queensland Ports Corporation Limited (trading as Ports North)
- Port of Townsville Limited (PoTL)
- North Queensland Bulk Ports Corporation Limited (NQBP)
- Gladstone Ports Corporation Limited (GPC).

These entities provide passenger and freight transport facilities to generate profit and benefit the public.

QR's role as a Queensland railway manager and operator is to service the passenger, tourism, resources, and freight customer markets across more than 6 500 kilometres of track and third-party access.

Figure A shows Queensland has a network of 20 ports ranging from small community ports to large coal export terminals and a capital city multi-cargo port. The four government-owned port corporations manage 19 of these ports and a private company manages the Port of Brisbane.

Figure A
Queensland Port Network

Source: Trade Statistics for Queensland Ports 2014–15, Department of Transport and Main Roads.

Results of our audits

We issued unmodified audit opinions on all rail and port entities' financial statements this year within the statutory deadline of 31 August 2017. We do this when the financial statements are prepared in accordance with the relevant legislative and Australian accounting standards. In doing so, we confirm that readers can rely upon the audited financial statements.

Rail and port entities used good financial reporting practices to produce good quality financial statements for 2016–17 in a timely manner.

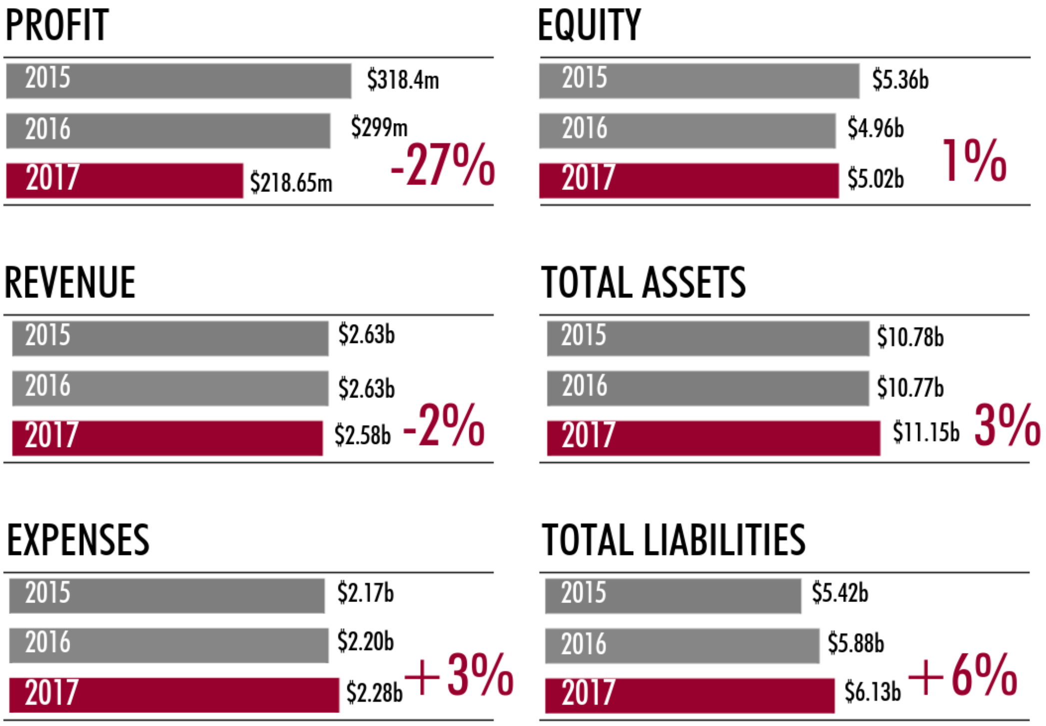
None of the six subsidiary companies across the rail and ports sector prepared financial statements for 2016–17. These entities were either dormant or small, and therefore did not need to prepare financial statements under the *Corporations Act 2001.*

QR is also subject to regulatory oversight by the Queensland Competition Authority for its below-rail services. These services relate to the management of the track, while above-rail services relate to the operation of trains. We issued an unmodified opinion on the 2015–16 regulatory financial statements for below-rail services provided by QR.

Financial performance, position, and internal controls

All rail and port entities achieved profits in 2016–17, although net profit after tax declined by 26.9 per cent compared to last year. Profits fell due to a combination of less revenue ($47 million), and increased expenses ($33 million).

Figure B
Aggregate rail and port entities financial snapshot 2016–17



Source: Queensland Audit Office.

Understanding financial performance

The entities receive revenue from sources internal and external to the Queensland Government, with QR sourcing 84.1 per cent of its revenue from a rail transport service contract with the state for the provision of Citytrain, Traveltrain, and rail infrastructure services. This remains consistent with the previous year.

Most revenue received from customers outside of government relates to rail network access, port access, commercial facility management, investment property and cargo handling of coal.

Profit after tax was nearly $218.6 million but this was down $80.3 million, or 26.9 per cent, from the previous year. The following factors contributed to this movement:

- higher employee expenses at QR of $46.9 million due to an increase in full-time equivalent employees and $12 million spending on rolling stock and track maintenance to support the expansion of the rail network
- a decrease in rail network access revenue of $50.5 million, which is 23.6 per cent lower than in 2015–16, due to Queensland Competition Authority requiring QR to credit back $29 million in over-recovered access charges and 7.3 per cent decrease in QR's gross tonne kilometres (GTKs) of goods transported over QR's network.

Understanding financial position

Net assets for the rail and port entities exceed five billion dollars, up one per cent from the previous year.

The rail and port entities are asset intensive, and collectively own and manage $11.1 billion of assets, including large and complex infrastructure assets. Property, plant and equipment represents 90 per cent of rail and port assets.

This year QR property, plant and equipment increased by $255 million. The assets are largely intended to improve and expand the rail network.

The Queensland Government, as owners of these entities, continued the policy of 100 per cent dividend payments of net profits after tax. Over the last three years, the rail and port entities have returned $275 million, $643 million and $284 million to the state government.

The returns continue to be funded through cash, borrowings, and contributed equity. In 2016–17 borrowings increased by $744 million to fund asset acquisitions and the payment of returns to the government declared in 2015–16. The impact on QR, GPC, and NQBP from these new borrowings is higher gearing levels, reduced profit margins and lower returns to government through lower dividends.

The increased gearing levels remain within capital structure benchmarks determined by Australian economic regulators for infrastructure and utility businesses.

Internal controls

This year we identified one significant deficiency in control activities at Gladstone Ports Corporation. The company is on track to resolve the issue by the board-approved target date.

We assessed the internal control systems of the other rail and port entities as effective, as we could rely on the internal controls to prevent, or detect and correct, misstatements in the financial statements, and achieve compliance with legislative requirements.

1. Sector overview

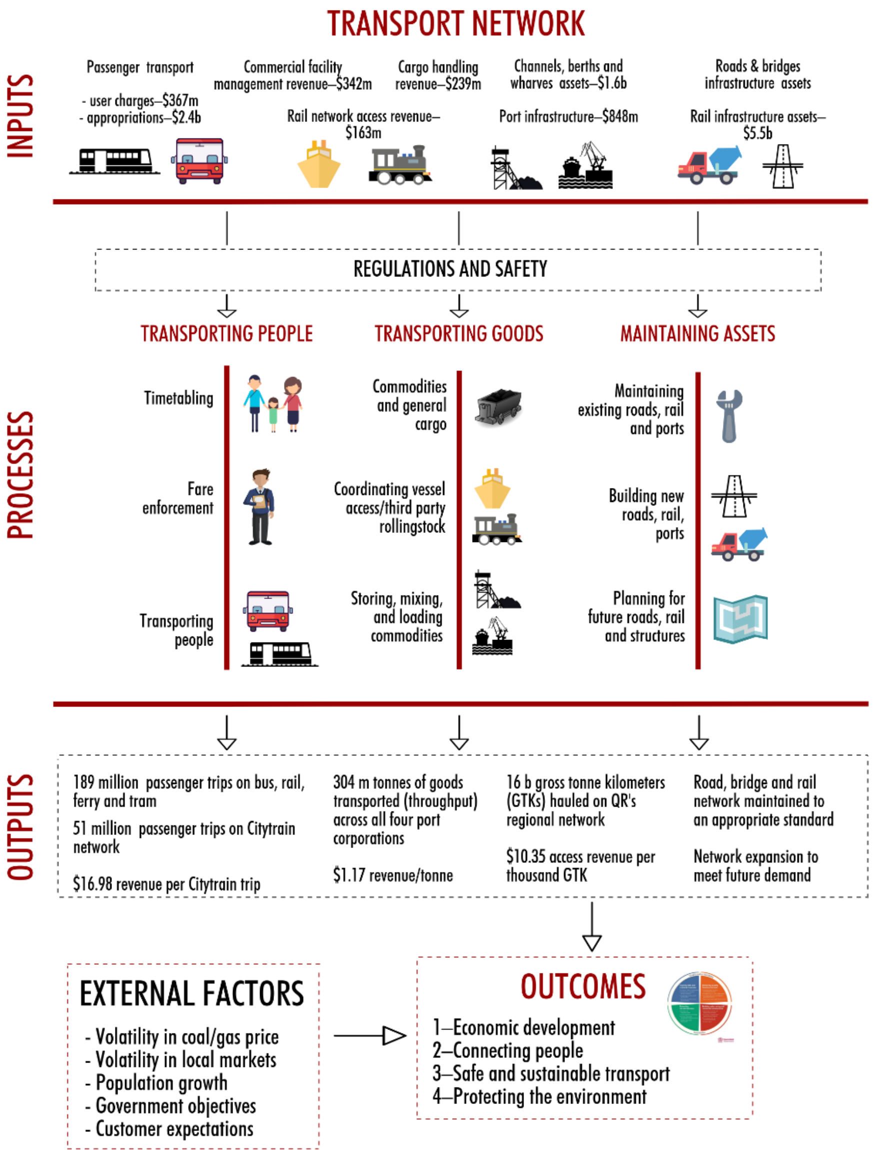
This report covers the entities within the responsibility of the Deputy Premier, Minister for Transport and Minister for Infrastructure and Planning, and the Minister for Main Roads, Road Safety and Ports.

This report focuses on the results of audits for 2016–17 for rail and port entities. These entities make a major contribution to the transport network by providing a wide range of services to Queenslanders.

The role of the Department of Transport and Main Roads (DTMR) is creating a single integrated transport network accessible to everyone. DTMR facilitates the shareholding and/or responsible ministers' responsibilities with respect to the rail and port entities and procures rail and bus services for Queenslanders.

Figure 1A details the major inputs, processes, outputs and outcomes for the transport network.

Figure 1A
Function level inputs, processes and activities, outputs and outcomes



Source: Queensland Audit Office.

2. Results of our audits

Introduction

This chapter examines the reliability of information reported by the entities that were subject to audit. We also analyse the quality and timeliness of financial reporting.

Conclusion

All rail and port entities have strong year end close processes, allowing them to produce high quality financial statements in a timely manner. We have issued unmodified audit opinions for all rail and port entities.

Audit opinion results

Figure 2A details the date of audit opinions we issued. Unmodified audit opinions were issued for all rail and port entities in 2016–17 (2015–16: 100 per cent).

Figure 2A
Date of unmodified audit opinions issued for 2016–17

Entity type	Entity	Date unmodified audit opinion issued
Government owned corporation	Far North Queensland Ports Corporation Limited	30.08.17
	Gladstone Ports Corporation Limited	31.08.17
	North Queensland Bulk Ports Limited	30.08.17
	Port of Townsville Limited	29.08.17
Statutory body	Queensland Rail	31.08.17
Wholly owned subsidiary of a statutory body	Queensland Rail Limited	31.08.17

Source: Queensland Audit Office.

Financial statement preparation

Rail and port entities have improved the effectiveness of financial statement preparation processes in comparison with the prior year. Figure 2B highlights our assessment of these processes for rail and port entities.

Figure 2B
Effectiveness of financial statement preparation processes

Source: Queensland Audit Office.

Our assessment criteria and detailed assessment by entity are outlined in Appendix D.

All outcomes were completed by the target dates for each rail and port entity.

Due to the nature, size and complexity of infrastructure assets held by rail and port entities, we encourage entities to continue to strive to complete their valuations earlier than 31 May each year to allow for sufficient internal and external review of the calculations, judgements, and assumptions.

Key audit matters

The Australian Auditing and Assurance Standards Board has adopted the international standard ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* for audits of listed entities.

Key audit matters are those areas that, in our professional judgement, pose a higher risk of material misstatement to the financial statements. A misstatement is material if it has potential to influence the decisions made by users of the financial statements. These matters mostly relate to major events and transactions that occur during the period, and those areas requiring significant judgement and estimation.

We included key audit matters in our independent auditor's report for Queensland Rail (QR) on depreciation expense, property, plant and equipment and indicators of impairment of property, plant and equipment. This year in our independent auditor's reports, we have reported on why the key audit matters were significant and the procedures we performed to address the matters.

We will formally adopt this standard for port entities' financial statements in 2017–18.

Regulated infrastructure

The Queensland Competition Authority (QCA) regulates access to essential infrastructure in Queensland, including rail transport infrastructure. QR has given to the QCA an access undertaking, which sets out the general terms and conditions under which QR will provide access to its below-rail infrastructure, including the tariff QR can charge customers.

Under the access undertaking, QR is required to prepare specific financial statements for QCA on the below-rail services QR delivered during the year.

Results of our audit of regulated below-rail services

We issued an unmodified audit opinion on the financial statements for below-rail services provided by QR for 2015–16 on 14 December 2016. We also included an emphasis of matter in our audit report to highlight that the report is specifically for the regulator and that the information is not intended for other uses.

> *Emphasis of matter:* a paragraph included with the audit opinion to highlight an issue of which the auditor believes the users of the financial statements need to be aware. The inclusion of an emphasis of matter paragraph does not modify the audit opinion.

Entities not preparing financial statements

Not all Queensland public sector rail and port entities produce financial statements. The full list of entities not preparing financial reports and the reasons for this are detailed in Appendix E.

3. Financial position, performance, and future challenges

Introduction

In this chapter, we assess the position, performance, future challenges and risks of the rail and port entities.

The information in an entity's financial statements describes its main transactions and events for the year. Over time, financial statements also help users to understand the sustainability of the entity and the industry.

Our analysis helps users understand and use the financial statements by clarifying the financial effects of significant transactions and events in 2016–17. We also use metrics such as ratio analysis to highlight organisational performance issues.

Additionally, our analysis alerts users to future challenges, including existing and emerging risks the entities face.

Conclusion

The rail and port entities are financially sustainable. All six entities achieved profits in 2016–17 although financial performance declined from 2015–16. Net assets improved, which strengthened their financial position at 30 June 2017.

Their financial sustainability continues to depend on their ability to adapt to slowing growth in demand for commodities, future directions given by shareholding ministers, and any changes in government policy.

The rail and port entities' financial statements accurately reflect the main transactions and events of 2016–17.

Understanding financial performance

Overall, the financial performance of the rail and port entities declined in 2016–17, with net profit after tax reducing by $80.3 million or 26.9 per cent. Queensland Rail Group's (QR) profit fell by 39.2 per cent and port entities' profit reduced by 11.6 per cent.

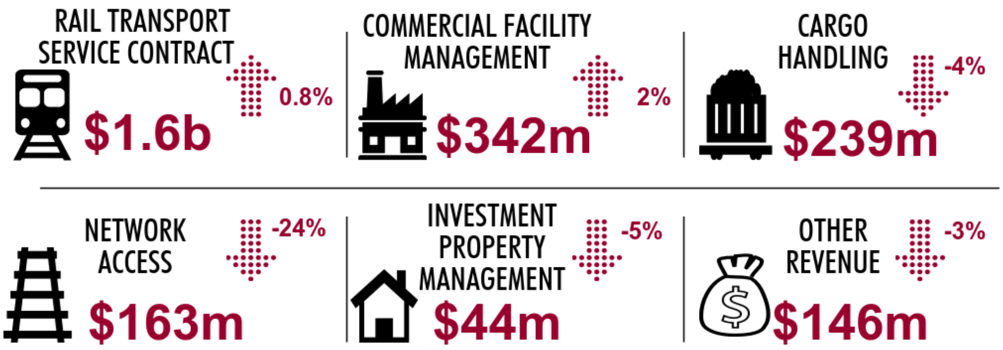
The reduced profitability of QR was affected by increased total expenses, including employee benefits and supplies and services, and decreased network access revenues from sources outside government.

Profitability of the rail and commodity-based port entities mostly depends on their ability to efficiently manage costs when demand for commodities (such as coal) is weakening.

Revenue

Total rail and ports revenue of $2.6 billion for the 2016–17 year was in line with revenue budgets, but less than the previous year's revenue by $47.2 million or 1.8 per cent.

Figure 3A
Major revenue for all entities in 2016–17



Source: Queensland Audit Office.

Events and transactions affecting revenue this year

Passenger transport revenue under the Rail Transport Service Contract

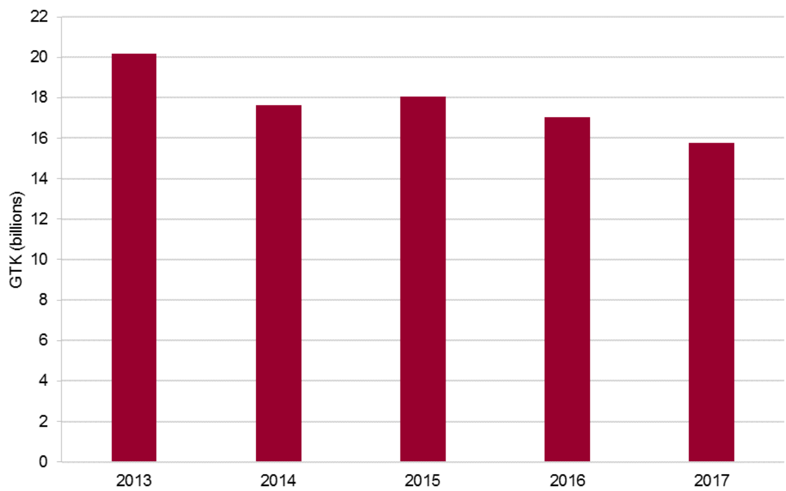
Under the Rail Transport Service Contract (TSC) with the Department of Transport and Main Roads, QR receives fixed payments for agreed services relating to the delivery of train services and maintenance of infrastructure. TSC revenue remained relatively constant this year, increasing by only $12.6 million (or 0.8 per cent).

QR network access revenue

QR's externally sourced revenue relates primarily to network access tariffs. In 2016–17 QR collected network access revenue from two rail operators. Network access revenue decreased by $50.4 million, primarily due to:

- Queensland Competition Authority ruling, requiring QR to credit back $29 million in over-recovered access charges since 1 July 2013
- a 7.3 per cent decrease in gross tonne kilometres (GTKs) of goods transported over QR's network. Figure 3B shows the decline in quantities transported over QR's network in the last five years.

Figure 3B
Gross tonne kilometres on QR's network



Source: Queensland Audit Office.

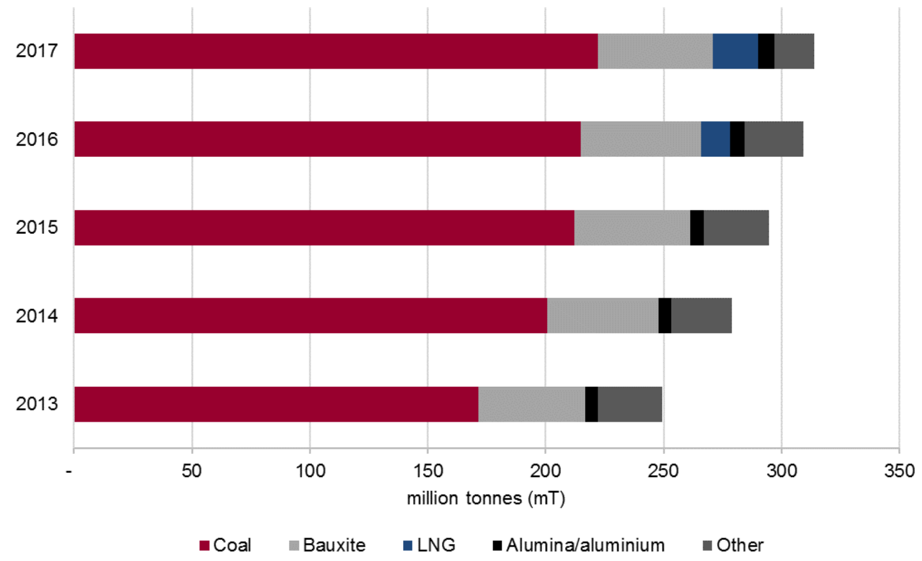
Cargo handling and commercial facility management revenue

The quantity of commodities and cargo transported, exported, and imported affects the revenue generated by port entities. The ports collect revenues based on number of vessel movements, size of the vessel, time spent at the port, services provided, and weight of the goods loaded or unloaded from the vessel.

Coal still represents the commodity with most tonnes exported through Queensland Government-owned ports. While bauxite exports remained consistent, liquefied natural gas (LNG) exports have increased by 56 per cent in 2016–17.

Figure 3C identifies the most significant commodities for the ports and the rate of growth in the last five years.

Figure 3C
Port throughput by commodity in the last five years



Source: Queensland Audit Office.

Cargo handling revenue predominantly relates to the exporting of coking coal and thermal coal at Gladstone Ports Corporation. Risks in earning revenue from cargo handling include handling less coal due to a decrease in coal exports and pricing. However, this risk to revenue can be mitigated by 'take-or-pay' contracts—where the customer either takes the product contracted for supply or pays a penalty.

Future challenges and emerging risks

New accounting standard—AASB 15 Revenue from contracts with customers

The revenue of rail and port entities will be affected by the new Australian Accounting Standards Board (AASB) standard AASB 15 *Revenue from contracts with customers.* This standard will apply to annual reporting periods beginning on or after 1 January 2018. The new standard is complex and includes more judgements than the current equivalent standard.

Rail and port entities have assessed that the standard may affect their accounting for revenue in the future and result in revenue being deferred in the year the standard is applied. However, the impact on their financial statements is not expected to be significant.

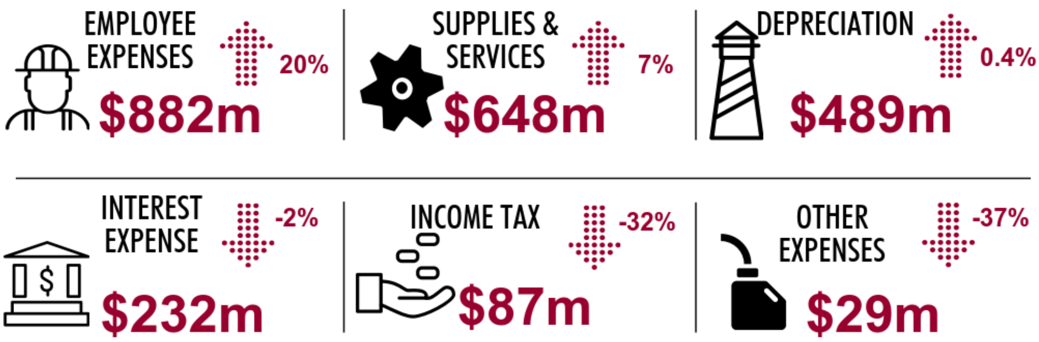
Credit risk exposure

Take-or-pay contracts are industry standard agreements between ports and customers to guarantee an amount of throughput, usually at a fixed price. While these agreements reduce revenue risk for ports by shifting the risk to customers, we have observed an increase in the instances where ports are varying these agreements to reduce the risk of their customers defaulting on contracts. If this trend continues, there is an increased risk to achieving revenue targets.

Expenses

Total rail and ports' expenses of $2.3 billion for the 2016–17 year were in line with respective entities' expense budgets and overall costs increased three per cent more than the previous year. The rail and port entities employ 7 550 full-time equivalent employees, which is an increase of 567 or 8.1 per cent from 2015–16.

Figure 3D
Major expenses for all entities in 2016–17



Source: Queensland Audit Office.

Events and transactions affecting expenses this year

Employee benefit expenses

Increasing employee benefit expenses at QR of $46.9 million contributed to the decline in profits for 2016–17. Factors leading to this increase in payroll costs included a planned increase of 9.4 per cent or 561.6 full-time equivalent employees to accommodate the expansion of the rail network, and an increase in salaries and wages costs from enterprise bargaining outcomes.

Employee benefits expense increases were partially offset by a reduction in the estimated future long service leave and other employee expenses of $13 million due in part to a change in the discount rate (being Australian high-quality corporate bonds) used to calculate these liabilities.

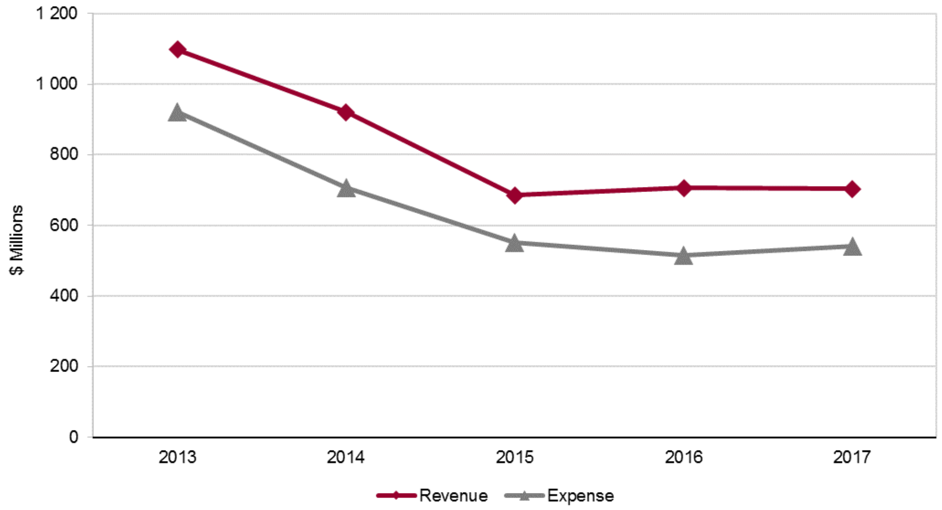
Supplies and services

In 2016–17, an increase in supplies and services expenses further contributed to the decline in profits. Factors which led to this include:

- an increase in spending on rolling stock and track maintenance of $12.3 million. The rail and port entities manage significant infrastructure assets, and invest heavily in the maintenance and renewal of these assets
- professional services cost increases of $12.4 million mainly due to costs associated with addressing the recommendations from the QR train crewing practices commission of inquiry.

The downturn in the resource sector puts pressure on the rail and commodity-reliant port entities to identify efficiencies in their business operations. We analysed expenses and revenue across the last five years and noted that, as revenues decline, the entities have demonstrated their ability to reduce expenses and maintain profitability as demonstrated in Figure 3E below.

Figure 3E
Five-year comparison of financial performance for ports



Source: Queensland Audit Office.

Understanding financial position

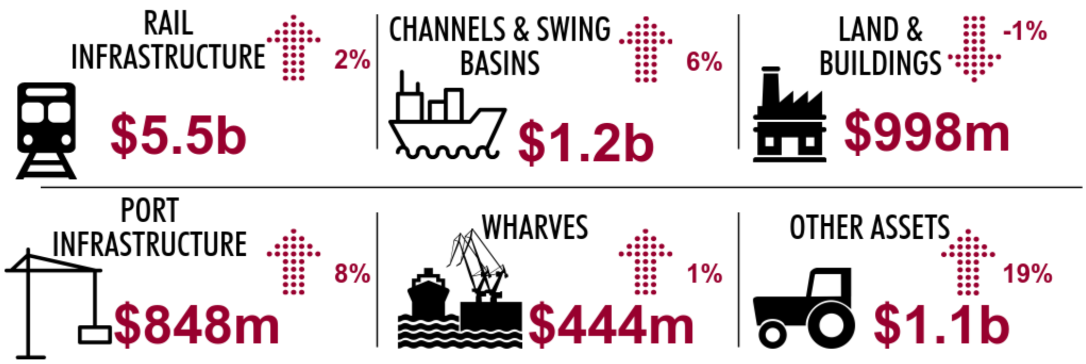
Assets and liabilities increased by 3.5 per cent and 5.5 per cent respectively. The combined net asset position increased by $53.2 million or one per cent primarily due to:

- an increase in the fair value of property, plant and equipment. Port assets are valued predominately on future profits. This is known as the income-based valuation method. The forecast increase in expected ports profits in the coming years has increased the fair value of port assets
- offset by a return of capital to the State of Queensland mostly funded by additional borrowings.

Assets

Total rail and port assets of $11.2 billion as at 30 June 2017 increased by $375 million or 3.5 per cent. This was represented by $10.1 billion in property, plant and equipment.

Figure 3F
Total property, plant and equipment for all entities at 30 June 2017



Source: Queensland Audit Office.

Events and transactions affecting assets this year

New infrastructure assets at QR

Asset acquisitions had the most significant impact on reported asset balances, with QR adding $255 million of new rail infrastructure and other assets.

Major projects included the Coomera to Helensvale duplication, stabling facilities for the new New Generation Rollingstock (NGR) trains, Roma Street to Corinda signalling, and Graceville and Dinmore Station upgrades.

Several significant rail assets currently under construction, or recently completed, are owned by the Department of Transport and Main Roads. These include the significant assets related to the Moreton Bay Rail Link, the NGR, and the related maintenance facilities.

The NGR project involves the purchase of 75 new passenger trains and three training simulators. As these assets are completed, it is expected that they will be leased to QR under a peppercorn lease.

> A *peppercorn lease*, also referred to as *a below-market lease,* is a lease arrangement where the value of the leased asset is significantly higher than the future minimum lease payments.

Measuring the value of port assets

In Queensland, most port entities' assets are measured using fair value estimated by an income-based valuation approach.

This year, two ports revalued their property, plant and equipment assets upwards by $219 million. The reasons for this were due to revised estimates of future net cash inflows and a reduction in the weighted average cost of capital rates used. The two ports are estimating that they will generate more profit in future years from the same asset base as compared with this time last year.

> Under the *income-based approach*, entities estimate the future cash inflows and outflows that they expect their assets to generate. They then use a discount rate to the convert future cash flows into a present day value of their assets.

Future challenges and emerging risks

Assets

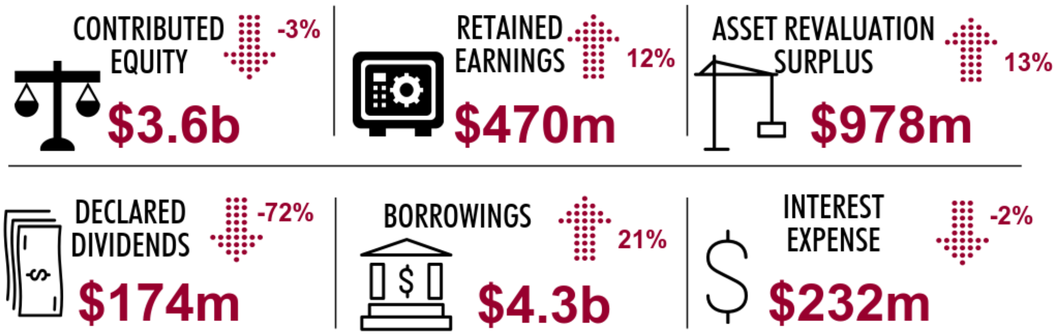
A challenge for infrastructure asset entities is to build resilient asset portfolios. This requires better understanding of the lifetime cost of significant infrastructure assets and balancing the future expansion or renewal of assets against ongoing maintenance requirements. QR is currently embarking on modernising assets throughout South East Queensland. Whole-of-life asset costing information is critical to future budgeting considerations to ensure the rail network remains financially sustainable.

Port entities also face the challenges of master planning for future development, better use of existing asset portfolios, and managing environmental risks. The *Sustainable Ports Development Act 2015* was enacted in November 2015 and provides for the protection of the Great Barrier Reef World Heritage Area by managing port-related development in, and adjacent to, the area.

Debt and equity

Total rail and port liabilities at 30 June 2017 were $6.1 billion of which 71 per cent are borrowings. Ninety-four per cent of borrowings are with the Queensland Treasury Corporation and held by QR ($3.3 billion) and Gladstone Ports Corporation ($0.78 billion). Ports North has no borrowings.

Figure 3G
Major components of debt and equity for all entities for 2016–17



Source: Queensland Audit Office.

Events and transactions affecting debt and equity this year

Consistent with the principles of the Queensland Government's Debt Action Plan, rail and port entities took up $744 million in new borrowings in 2016–17 to fund asset acquisitions, pay dividends declared to government and fund the return of capital to the state government.

The gearing of the rail and port entities continues to be within capital structure benchmarks determined by Australian economic regulators for infrastructure and utility businesses.

> *Debt covenants* are the rules and restrictions associated with a debt agreement or loan that protect the lender by restricting the activities of the borrower.

Each year, rail and port entities evaluate their compliance with their debt covenants. The key measure used is the ratio of earnings before interest and tax to interest expense. This is often referred to as earnings before interest and tax (EBIT) interest coverage. The average EBIT interest coverage declined by 17 per cent from last year, decreasing from 2.72 to 2.26. However, it is still above the coverage required of 1.25.

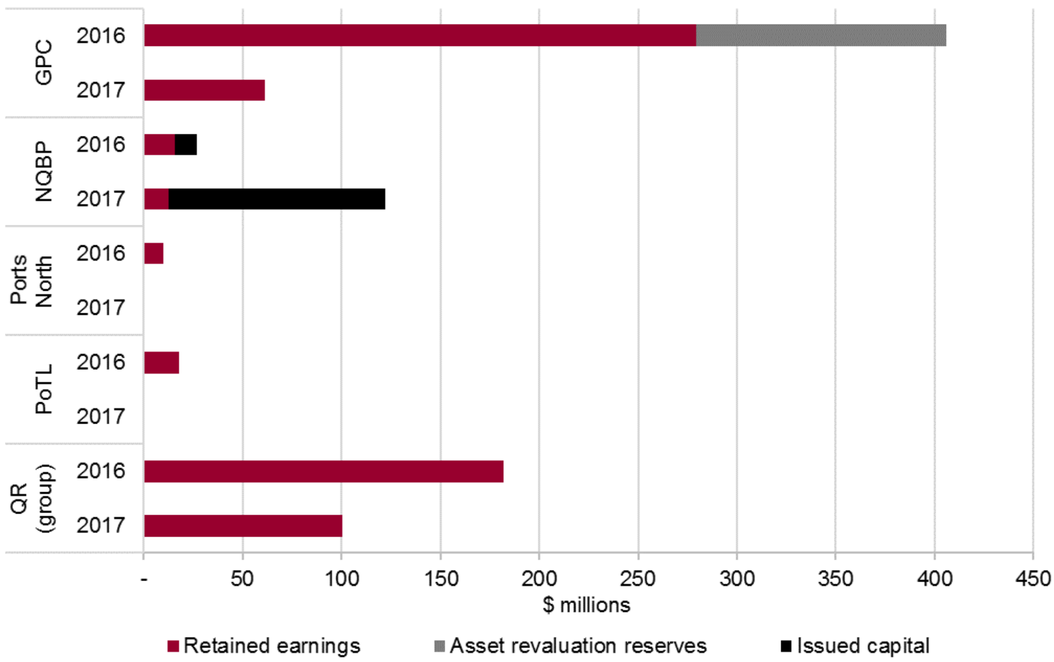
> *Retained earnings* are prior year profits that have not been paid out as dividends.
>
> The *asset revaluation surplus* represents the valuation increases above the historical cost of the entity's assets.
>
> *Contributed equity* is the investment in the entity by shareholders.

The dividend payout ratios are set for each entity by the state government. In 2016–17, the rail and port entities recommended a final dividend of 100 per cent of net profit after tax. Two ports entities received approval to retain their dividend to contribute towards projects such as channel capacity upgrade and a shipping development project.

In total for 2016–17, the rail and port entities made profits after tax of $219 million. Dividends provided for, and to, owners for 2016–17, totalled $174 million. This year entities provided for dividends using retained earnings and North Queensland Bulk Ports Corporation Limited (NQBP) returned $110 million of contributed equity to the state government.

Figure 3H shows how the entities funded distributions to the state government.

Figure 3H
Distributions made to the Queensland Government



Note: GPC—Gladstone Ports Corporation; NQBP—North Queensland Bulk Ports Corporation Limited; Ports North—Far North Queensland Ports Corporation Limited; PoTL—Port of Townsville Limited; QR—Queensland Rail Group.

Source: Queensland Audit Office.

Future challenges and emerging risks

Debt and equity

The state government's revision of the capital structure and dividend payout ratios in 2015–16 continues to challenge rail and port entities to maintain their credit ratings and plan for future growth. Rail and port entities will need to focus their planning efforts to ensure adequate funding is available when needed.

New accounting standard—AASB 16 Leases

The new accounting standard Australian Accounting Standards Board (AASB) 16 *Leases*, for reporting periods beginning on or after 1 January 2019, will introduce a single lease accounting model. There will no longer be a distinction between a finance lease (on-balance sheet) and an operating lease (off-balance sheet). The effect on the statement of financial position will be to include a lease liability for future operating lease payments and a corresponding lease asset. Therefore, interest bearing liabilities will appear to be higher. Net profit may at times be higher, and other times lower, than current accounting. This will affect the calculation of dividends where the amount to be paid as dividends is based on reported profit.

All leases, except those with a term of less than twelve months, or of a low value (less than approximately $7 500–$10 000), will be affected. The accounting is like that of existing finance leases and will require the recognition in the statement of financial position of:

- a right-of-use asset (representing the right to use the underlying leased asset)
- a liability (representing the obligation to make lease payments).

Similarly, amortisation on the right-to-use asset and finance charge on the lease liability will be recognised as expenses in net income. The total of these two amounts will differ from the previous operating lease expense.

While the accounting appears like a finance lease, there are complex calculations involved for rental adjustments, such as consumer price index adjustments and market reviews.

Operating results may be affected by this new standard through the passage of time, rather than changes in underlying operations. This is referred to as the financing effect. When compared to current operating lease accounting, the new standard will result in reduced net profit in the initial years of a lease (because of the higher finance charge on the higher lease liability), and increased net profit in the later years (when there is a lower finance charge on the lower lease liability).

In 2016–17, the rail and port entities collectively reported operating lease expenditure of approximately $43 million in their financial statements. These included leases over office space, buildings, and plant and equipment. Each rail and port entity may need to include higher commitments in the lease liability, depending on whether the entity is 'reasonably certain' to exercise any options including to renew the lease.

Rail and port entities do not expect that the leasing standard change will have a material impact on their financial statements. However, some entities will have to perform detailed analysis before they can be certain about their initial assessments.

As this accounting standard change has the potential to impact profitability, rail and port entities will have to perform further analysis to ensure medium-term strategic plans are not materially impacted by this accounting change.

4. Internal controls

Introduction

This chapter evaluates the effectiveness of internal controls as they relate to our audit.

Through our analysis, we aim to promote stronger internal control frameworks, and to mitigate financial losses and damage to public sector reputation by initiating effective responses to identified control weaknesses.

Conclusion

Rail and port entities' internal control systems generally support our reliance on those systems for our audits.

In 2016–17 we identified a significant deficiency at Gladstone Ports Corporation (GPC) that increased the risk of unauthorised changes going undetected in GPC's accounting system database environment. The corporation is taking corrective action to address this significant control deficiency and their initial review concluded that no unauthorised changes were made to the accounting system.

Our audit of internal controls

We assess the design and implementation of internal controls to ensure they are suitably designed to prevent, or detect and correct, material misstatements in the financial report. We also assess whether they achieve compliance with legislative requirements and make appropriate use of public resources. Where we identify controls that we plan to rely on, we test how effectively these controls are operating to ensure they are functioning as intended.

We are required to communicate deficiencies in internal controls to management.

Our rating of internal control deficiencies

Deficiency: arises when internal controls are ineffective or missing, and are unable to prevent, or detect and correct, misstatements in the financial statements. A deficiency may also result in non-compliance with policies and applicable laws and regulations and/or inappropriate use of public resources.

Our rating of internal control deficiencies allows management to gauge relative importance and prioritise remedial actions.

We increase the rating from a deficiency to a significant deficiency when:

- we consider immediate remedial action is required
- there is a risk of material misstatement in the financial statements
- there is a risk to reputation
- the non-compliance with policies and applicable laws and regulations is significant
- there is potential to cause financial loss including fraud
- management has not taken appropriate timely action to resolve the deficiency.

Control deficiencies categorised by COSO component

We categorise internal controls using the Committee of the Sponsoring Organizations of the Treadway Commission (COSO) internal controls framework, which is widely recognised as a benchmark for designing and evaluating internal controls.

The framework identifies five components that need to be present and operating together for a successful internal control system. These components are explained in Appendix F.

Figure 4A below shows the number of control deficiencies categorised by COSO component reported to management in 2016–17.

Figure 4A
Number and category of internal control deficiencies for rail and port entities

Control environment *Structures, policies, attitudes and values that influence daily operations*	**Risk assessment** *Processes for identifying, assessing and managing risk*	**Control activities** *Implementation of policies and procedures to prevent or detect errors and safeguard assets*	**Information & communication** *Systems to capture and communicate information to achieve reliable financial reporting*	**Monitoring activities** *Oversight of internal controls for existence and effectiveness*
One deficiency	Nil	One significant deficiency Three deficiencies	Nil	Nil

Source: Queensland Audit Office adapted from Committee of the Sponsoring Organizations of the Treadway Commission (COSO) internal controls framework.

Control activities

Information technology general controls

This year we identified a significant deficiency over database change monitoring controls at GPC. The accounting system database did not have adequate logging and monitoring of changes made by users. This increased the risk of unauthorised database changes not being detected and corrected in a timely manner.

The corporation is acting to address the issue and is updating processes to incorporate an automated system to record database changes.

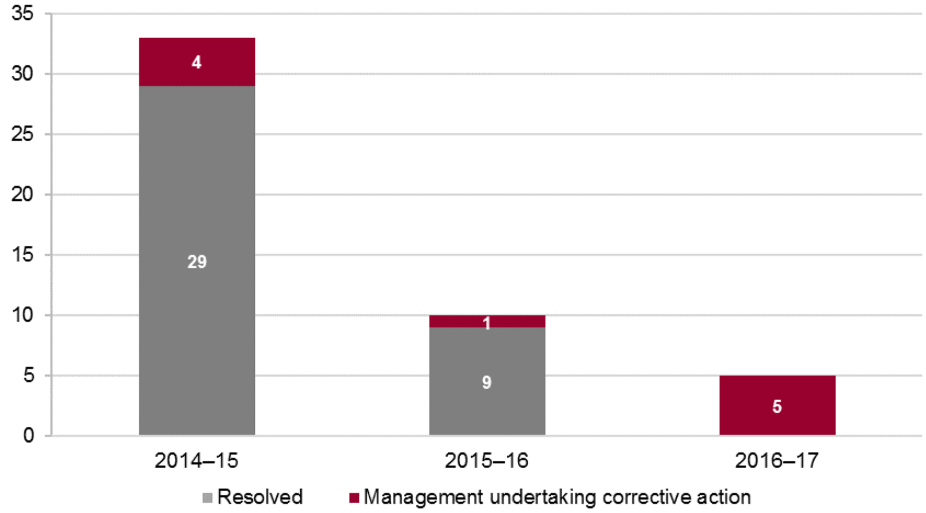
Status of internal control deficiencies

Management, and those charged with governance, are responsible for the efficient and effective operation of internal controls. An audit committee may be established to assist those charged with governance to obtain assurance over internal control systems. An audit committee is responsible for considering audit findings, management responses to those findings, and the status of audit recommendations. Where internal control deficiencies are not appropriately actioned in a timely manner, this may indicate deficiencies in an entity's control environment.

We have analysed the appropriateness and timeliness of remedial action undertaken to resolve control deficiencies reported to management. During the last three years we reported a total of 48 control issues.

All six entities either addressed their identified control deficiencies or are on track to do so by the agreed date. Figure 4B outlines the status of the control issues reported.

Figure 4B
Status of control issues reported to management over the last three years



Appendices

Appendix A—Full responses from agencies

As mandated in section 64 of the *Auditor-General Act 2009*, the Queensland Audit Office gave a copy of this report with a request for comments to

- the Deputy Premier, Minister for Transport and Minister for Infrastructure and Planning; the Director-General, Department of Transport and Main Roads
- the Minister for Main Roads, Road Safety and Ports and Minister for Energy, Biofuels and Water Supply
- the Under Treasurer, Queensland Treasury.

We also provided a copy of this report to the heads of the following agencies with an option of providing a response:

- the Queensland Rail Group (QR), including Queensland Rail Transit Authority (now Queensland Rail) and Queensland Rail Limited (QRL). QRL is a wholly owned subsidiary of Queensland Rail
- Far North Queensland Ports Corporation Limited (trading as Ports North)
- Gladstone Ports Corporation Limited (GPC)
- North Queensland Bulk Ports Corporation Limited (NQBP)
- Port of Townsville Limited (PoTL).

We provided a copy of this report to the Premier and Minister for the Arts; the Treasurer and Minister for Trade and Investment; and the Director-General, Department of the Premier and Cabinet for their information.

The heads of these agencies are responsible for the accuracy, fairness and balance of their comments.

This appendix contains their detailed responses to our audit recommendations.

Comments received from the Treasurer, and Minister for Trade and Investment

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QUEENSLAND AUDIT OFFICE

Queensland Government

Treasurer
Minister for Trade and Investment

1 William St Brisbane
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ABN 90 856 020 239

Our Ref: 03830-2017
Your Ref: 11633

27 OCT 2017

Mr Brendan Worrall
Auditor-General of Queensland
Queensland Audit Office
PO Box 15396
CITY EAST QLD 4002

Dear Mr Worrall

Rail and Ports: 2017 Results Of Financial Audits Report

Thank you for providing a copy the proposed Queensland Audit Office (QAO) *Rail and Ports: 2017 results of financial audits* report and the opportunity to provide comments.

I note that unmodified audit opinions were provided on all 2016-17 financial statements for the rail and port entities, and that the QAO concludes that the rail and port entities are financially sustainable.

I also appreciate the guidance provided regarding the potential impacts on future operating results due to the introduction of new accounting standards AASB 15 and AASB 16.

The report covers the regearing of the entities to more commercial levels reflecting the principles of the Debt Action Plan. The gearing ratios of the entities remain within capital structure benchmarks for infrastructure and utility businesses determined by Australian economic regulators, and all maintain a standalone investment grade credit rating.

A key objective for the Queensland Government is ensuring that government-owned enterprises operate as efficiently as possible and are able to adapt to changing market conditions. In this regard, the report notes that port entities have demonstrated their ability to reduce expenses and maintain profitability in response to declining revenues.

The report also highlights the increased expenditure and investment by Queensland Rail (QR). QR is focused on the implementation of the Response and Recovery program from the 2017 *Queensland Rail Train Crewing Practises Commission of Inquiry* and the subsequent *Fixing the Trains Implementation Plan*. This has prompted additional recruitment to ensure existing and additional services are safely and sustainably staffed.

During 2016-17, QR made a number of significant investments in improving rail services include the Coomera to Helensvale duplication, New Generation Rollingstock stabling facilities, Roma Street to Corinda signalling, and Graceville and Dinmore Station upgrades.

The Government supports these investments in improved rail operations, hiring practises and customer services, and will monitor progress toward increased safety, efficiency and commercial competitiveness in QR's services.

The performance and sustainability of the rail and port entities will continue to be monitored by the Government to ensure continued improvement, prudent investment and the delivery of services to support the Queensland economy.

Once again, thank you for the opportunity to comment on the report. I understand officers from Queensland Treasury have discussed these matters with the QAO, along with minor suggestions relating to presentation and drafting of the report.

Yours sincerely

Cu Pitt

HON. CURTIS PITT MP
Treasurer
Minister for Trade and Investment

Comments received from Director-General, Department of Transport and Main Roads

Queensland Government

Office of the
Director-General

Department of
Transport and Main Roads

Our ref: DG34320

Your ref: 11633

27 OCT 2017

Mr Brendan Worrall
Auditor-General
Queensland Audit Office
PO Box 15396
CITY EAST QLD 4002

Dear Mr Worrall

Thank you for your letter of 9 October 2017 about Queensland Audit Office (QAO) – Rail and ports: 2017 results of financial audits.

I note you also wrote to the Honourable Jackie Trad MP, Deputy Premier, Minister for Transport and Minister for Infrastructure and Planning and to the Honourable Mark Bailey MP, Minister for Main Roads, Road Safety and Ports and Minister for Energy, Biofuels and Water Supply about the same matter.

I have noted that unmodified audit opinions were provided on all 2016–17 financial statements for the rail and port entities and that QAO concludes the rail and port entities are financially sustainable.

QAO also highlights the increased expenditure and investment by Queensland Rail. Queensland Rail is focused on the implementation of the response and recovery program from the 2017 *Queensland Rail Train Crewing Practises Commission of Inquiry* and the subsequent *Fixing the Trains Implementation Plan*. This has prompted additional recruitment to ensure existing and additional services are safely and sustainably staffed.

During 2016–17, Queensland Rail made a number of significant investments in improving rail services, including the Coomera to Helensvale duplication, New Generation Rolling Stock stabling facilities, Roma Street to Corinda signalling and Graceville and Dinmore station upgrades.

These investments in improved rail operations, hiring practices and customer services should allow progress toward increased safety, efficiency and commercial competitiveness in Queensland Rail's services.

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In addition to the above general comments, the Department of Transport and Main Roads' (TMR) more specific comments on the proposed report are provided in the enclosed document. The comments mainly pertain to general points of clarification, including updating text on the role of TMR and the impact of the *Sustainable Ports Development Act 2015* on restricting port development in the Great Barrier Reef World Heritage Area, as well as identifying typographical edits.

I appreciate the opportunity to provide comments on the proposed report and look forward to the final report being tabled in parliament.

Yours sincerely

Neil Scales.

Neil Scales
Director-General
Department of Transport and Main Roads

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Appendix B—The Queensland Audit Office

The Queensland Auditor-General, supported by the Queensland Audit Office, is the external auditor of the state's public sector. Each year through our financial audit program, we form independent audit opinions about the reliability of financial statements produced by state and local government entities.

We provide independent assurance directly to parliament about public sector finances. We also help the public sector meet its accountability obligations. Our role and the work we do is critical to the integrity of our system of government.

The auditor-general must prepare reports to parliament on each audit conducted. These reports must state whether the financial statements of a public sector entity have been audited. They may also draw attention to significant breakdowns in the financial management functions. This report satisfies these requirements.

Appendix C—Legislative context

Framework

The financial reporting deadline for the rail and port entities is 31 August. The entities prepare their financial statements in accordance with the following legislative frameworks:

Entity type	Entity	Legislative framework
Statutory body	Queensland Rail	▪ *Financial Accountability Act 2009* ▪ *Financial and Performance Management Standard 2009*
Wholly owned subsidiary of a statutory body	Queensland Rail Limited	▪ *Corporations Act 2001* ▪ *Corporations Regulations 2001*
Government owned corporation	Far North Queensland Ports Corporation Limited Gladstone Ports Corporation Limited North Queensland Bulk Ports Limited Port of Townsville Limited	▪ *Government Owned Corporations Act 1993* ▪ *Corporations Act 2001* ▪ *Corporations Regulations 2001*

Source: Queensland Audit Office.

Accountability requirements

The *Financial Accountability Act 2009* applicable to Queensland Rail requires statutory bodies to:

- establish and keep funds and accounts that comply with the prescribed requirements
- establish and maintain appropriate systems of internal control and risk management
- achieve reasonable value for money by ensuring the operations of the statutory body are carried out efficiently, effectively, and economically

The *Government Owned Corporations Act 1993* applicable to the four port entities, establishes four key principles for government owned corporations including clarity of objectives, management autonomy and authority, strict accountability for performance, and competitive neutrality.

Queensland state government financial statements

Queensland state public sector entities must table their audited financial statements in parliament annually. These financial statements are used by a broad range of parties including parliamentarians, taxpayers, employees, and users of government services. For these statements to be useful, the information reported must be relevant and accurate.

The auditor-general's audit opinion on these entities' financial statements assures users that the statements are accurate and in accordance with relevant legislative requirements. We express an *unmodified opinion* when the financial statements are prepared in accordance with the relevant legislative requirements and Australian accounting standards. We *modify* our audit opinion where financial statements do not comply with the relevant legislative requirements and Australian accounting standards, and are not accurate and reliable.

Appendix D—Our assessment of financial statement preparation

Our assessment of the effectiveness of financial statement preparation processes involved considering three components—the year end close process, and the timeliness and quality of financial statements.

Result summary

This table summarises our assessment of financial statement preparation processes across the six rail and port entities producing a financial report.

Entity	Financial statement preparation		
	Year end close process	Timeliness of draft financial statements	Quality of draft financial statements
Queensland Rail	●	●	●
Queensland Rail Limited	●	●	●
Far North Queensland Ports Corporation Limited	●	●	●
Gladstone Ports Corporation Limited	●	●	●
North Queensland Bulk Ports Corporation Limited	●	●	●
Port of Townsville Limited	●	●	●

Source: Queensland Audit Office.

We assess financial statement preparation processes under the following criteria.

Year end close process

State public sector entities should have a robust year end close process to enhance the quality and timeliness of the financial reporting processes. This year we assessed processes for year end financial statement preparation against the following key targets where applicable:

- prepare pro-forma financial statements by 30 April
- resolve known accounting issues by 30 April
- complete non-current asset valuations by 31 May
- complete early close processes
- conclude all asset stocktakes by 30 June.

These targets were developed based on advice previously issued by the Under Treasurer in 2014, and better practice identified in other jurisdictions.

Rating scale	Assessment criteria—year end close process
● Fully implemented	All key processes completed by the target date
● Partially implemented	Three key process completed within two weeks of the target date
● Not implemented	Less than two key processes completed within two weeks of the target date

Timeliness of draft financial statements

We assessed the timeliness of draft financial statements by considering whether entities prepared financial statements according to the timetables set by management. This includes providing auditors with the first complete draft of financial statements by the agreed date. A complete draft is one that management is ready to sign and where no material errors or adjustments are expected.

Rating scale	Assessment criteria—timeliness of draft financial statements
● Timely	Acceptable draft financial statements received on or prior to the planned date
● Generally timely	Acceptable draft financial statements received within two days after the planned date
● Not timely	Acceptable draft financial statements received greater than two days after the planned date

Quality of draft financial statements

We calculated the difference between the first draft financial statements submitted to audit and the final audited financial statements for the key financial statement components of total revenue, total expenses, and net assets. Our quality assessment is based on the percentage of adjustments across each of these components.

Rating scale	Assessment criteria—quality of draft financial statements
● No adjustments	No adjustments were required
● No significant adjustments	Adjustments for any of the three key financial statement components of total revenue, total expenses and net assets were less than five per cent
● Significant adjustments	Adjustments for any of the three key financial statement components of total revenue, total expenses and net assets were greater than five per cent

Appendix E—Entities not preparing financial reports

The auditor-general will not issue audit opinions for the following public sector entities for the 2016–17 financial year, as they have not produced a financial report.

Public sector entity	Reason for not preparing financial reports
Controlled entities of Gladstone Ports Corporation Limited	
Gladstone Marine Pilot Services Pty Ltd	Board of director's determination
Gladstone WICET Operations Pty Ltd	Dormant
Controlled entities of Queensland Rail Limited	
On Track Insurance Pty Ltd	Board of directors' determination
Controlled entities of North Queensland Bulk Ports Limited	
Mackay Ports Limited	Dormant
Ports Corporation of Queensland Limited	Dormant

Appendix F—Our audit of internal controls

Internal controls are designed, implemented and maintained by entities to mitigate risks that may prevent them from achieving reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations.

In undertaking our audit, we are required under the Australian auditing standards to obtain an understanding of an entity's internal controls relevant to the preparation of the financial report.

We assess internal controls to ensure they are designed to prevent, or detect and correct, material misstatements in the financial report, and achieve compliance with legislative requirements and appropriate use of public resources.

Our assessment determines the nature, timing, and extent of testing we perform to address the management assertions at risk of material misstatement in the financial statements.

Where we believe the design and implementation of controls is effective, we select the controls we intend to test further by considering a balance of factors including:

- significance of the related risks
- characteristics of balances, transactions, or disclosures (volume, value, and complexity)
- nature and complexity of the entity's information systems
- whether the design of the controls addresses the management assertions at risk and facilitates an efficient audit.

Where we identify deficiencies in internal controls, we determine the impact on our audit approach, considering whether additional audit procedures are necessary to address the risk of material misstatement in the financial statements.

Our audit procedures are designed to address the risk of material misstatement, so we can express an opinion on the financial report. We do not express an opinion on the effectiveness of internal controls.

Internal controls framework

We categorise internal controls using the Committee of the Sponsoring Organizations of the Treadway Commission (COSO) internal controls framework, which is widely recognised as a benchmark for designing and evaluating internal controls.

The framework identifies five components for a successful internal control system. These components are explained below.

Control environment

- Cultures & values
- Governance
- Organisational structure
- Policies
- Qualified & skilled people
- Management's integrity & operating style

The control environment is defined as the structures, policies, attitudes and values that influence day-to-day operations. As the control environment is closely linked to an entity's overarching governance and culture, it is important that the control environment provides a strong foundation for the other components of internal control.

In assessing the design and implementation of the control environment we consider whether:

- those charged with governance are independent, appropriately qualified, experienced, and active in challenging management, ensuring they receive the right information at the right time to enable informed decision-making
- policies and procedures are established and communicated so people with the right qualifications and experiences are recruited, they understand their role in the organisation, and they also understand management's expectations towards internal controls, financial reporting and misconduct including fraud.

Risk assessment

- Strategic risk assessment
- Financial risk assessment
- Operational risk assessment

Risk assessment relates to management's processes for considering risks that may prevent an entity from achieving its objectives, and how management agree risks should be identified, assessed, and managed.

To achieve appropriate management of business risks, management can either accept the risk if it is minor, or mitigate the risk to an acceptable level by implementing appropriately designed controls. Risks can also be eliminated entirely by choosing to exit from a risky business venture.

Control activities

- General information technology controls
- Automated controls
- Manual controls

Control activities are the actions taken to implement policies and procedures in accordance with management directives and ensure identified risks are addressed. These activities operate at all levels and in all functions, and can be designed to prevent or detect errors entering financial systems.

The mix of control activities can be categorised into general information technology controls, automated controls and manual controls.

General information technology controls

General information technology controls form the basis of the automated systems control environment. They include controls over information systems security, user access and system changes. These controls address the risk of unauthorised access and changes to systems and data.

Automated control activities

Automated controls are embedded within information technology systems. These controls can improve timeliness, availability, and accuracy of information by consistently applying predefined business rules. They enable entities to perform complex calculations in processing large volumes of transactions, and improve the effectiveness of financial delegations and segregation of duties.

Manual control activities

Manual controls contain a human element, which can provide the opportunity to assess the reasonableness and appropriateness of transactions. However, these controls may be less reliable than automated elements as they can be more easily bypassed or overridden. They include activities such as approvals, authorisations, verifications, reconciliations, reviews of operating performance, and segregation of incompatible duties. Manual controls may be performed with the aid of information technology systems.

Information and communication

- Non-financial systems
- Financial systems
- Reporting systems

Information and communication controls are the systems used to provide information to employees, and the ways that control how responsibilities are communicated.

This aspect of internal control also considers how management generates financial reports, and how these reports are communicated to internal and external parties to support the functioning of internal controls.

Monitoring activities

- Management supervision
- Self-assessment
- Internal audit

Monitoring activities are the methods management uses to oversee and assess whether internal controls are present and operating effectively. This may be achieved through ongoing supervision, periodic self-assessments, and separate evaluations. They also concern the evaluation and communication of control deficiencies in a timely manner to effect corrective action.

Typically, the internal audit function and an independent audit and risk committee are responsible for implementing controls and resolving control deficiencies. These two functions work together to ensure that internal control deficiencies are identified and then resolved in a timely manner.

Appendix G—Glossary

Term	Definition
Accountability	Responsibility of public sector entities to achieve their objectives of reliable financial reporting, effective and efficient operations, compliance with applicable laws, and reporting to interested parties.
Acquisition	Establishing control of an asset, undertaking the risks, and receiving the rights to future benefits as would be conferred with ownership, in exchange for the cost of acquisition.
Auditor-General Act 2009	An act of the State of Queensland that establishes the responsibilities of the Auditor-General, the operation of the Queensland Audit Office, the nature and scope of audits to be conducted, and the relationship of the Auditor-General with parliament.
Auditor's opinion	A written expression of the auditor's overall conclusion on the financial report based on audit evidence obtained.
Australian accounting standards	The rules by which financial statements are prepared in Australia. These standards ensure consistency in measuring and reporting on similar transactions.
Capital expenditure	Expenditure to acquire assets or improve the service potential of existing assets that is capitalised to the balance sheet.
Control environment	The structures, policies, attitudes and values that influence daily operations. A component of internal control that provides the foundation for other elements of internal control.
Deficiency	Arises when internal controls are ineffective or missing, and are unable to prevent, or detect and correct, misstatements in the financial statements. A deficiency may also result in non-compliance with policies and applicable laws and regulations and/or inappropriate use of public resources.
Discount rate	Interest rate used to calculate the present day value.
Emphasis of matter	A paragraph included with the audit opinion to highlight an issue of which the auditor believes the users of the financial statements need to be aware. The inclusion of an emphasis of matter paragraph does not modify the audit opinion
Financial Accountability Act 2009	An act of the State of Queensland that establishes accountability for the administration of the state's finances and financial administration of departments and statutory bodies, as well as annual reporting to parliament by departments and statutory bodies.
Financial and Performance Management Standard 2009	Subordinate legislation of the State of Queensland that provides a framework for an accountable officer of a department, or a statutory body, to develop and implement systems, practices, and controls for the efficient, effective, and economic financial and performance management of the department or statutory body.

Term	Definition
Financial sustainability	Entities' ability to repay their liabilities as and when they fall due during the next financial year.
Gross tonne kilometre (GTK)	Unit of measurement for freight turnover in rail transport calculated by multiplying the weight of goods transported by the distance covered.
Impairment	When an asset's carrying amount exceeds the amount that can be recovered through use or sale of the asset.
Misstatement	Australian Auditing Standard ASA 450 *Evaluation of Misstatements Identified during the Audit* defines a misstatement in the following way: A difference between the amount, classification, presentation, or disclosure of a reported financial report item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. Misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgement, are necessary for the financial report to be presented fairly, in all material respects, or to give a true and fair view.
Significant deficiency	A deficiency, or combination of deficiencies, in internal control that requires immediate remedial action.
Useful life	The number of years the entity expects to use an asset (not the maximum period possible for the asset to exist).
Weighted average cost of capital (WACC)	The WACC rate is used in the valuation model to reflect the present value of the estimated future cash inflows and outflows. These changes reflect the experts' views about changes in long-term risk-free rates.

Auditor-General reports to parliament

Reports tabled in 2017–18

Number	Title	Date tabled in Legislative Assembly
1.	Follow-up of Report 15: Environmental regulation of the resources and waste industries	September 2017
2.	Managing the mental health of Queensland Police employees	October 2017
3.	Rail and ports: 2016–17 results of financial audits	December 2017

Contact the Queensland Audit Office