Queensland Audit Office
*better public services*

# Water: 2015–16 results of financial audits

## Report 7: 2016–17

Queensland Audit Office

| | |
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QUEENSLAND
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14 December 2016

The Honourable P Wellington MP
Speaker of the Legislative Assembly
Parliament House
BRISBANE QLD 4000

Dear Mr Speaker

**Report to Parliament**

This report is prepared under Part 3 Division 3 of the *Auditor-General Act 2009*, and is titled *Water: 2015–16 results of financial audits* (Report 7: 2016–17).

In accordance with s.67 of the Act, would you please arrange for the report to be tabled in the Legislative Assembly.

Yours sincerely

Anthony Close
Auditor-General (acting)

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## The Queensland Audit Office

The Queensland Auditor-General, supported by the Queensland Audit Office, is the external auditor of the Queensland public sector. We provide independent audit opinions about the reliability of financial statements produced by state and local government entities.

We provide independent assurance directly to parliament about the state of public sector finances and performance. We also help the public sector meet its accountability obligations and improve its performance. This 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 of a public sector entity.

This report satisfies these requirements.

The Queensland Audit Office has a unique view across the entire Queensland public sector of matters affecting financial and operational performance. We use this perspective to achieve our vision of better public services for all Queenslanders by sharing knowledge, providing comprehensive analysis, and making well-founded recommendations for improvement.

# Contents

# Summary

## Introduction

Most public sector entities prepare annual financial statements. The Queensland Auditor-General is responsible for providing parliament with independent assurance of the financial management of public sector entities by auditing these financial statements.

This report summarises our financial audit results of the six main state and local government owned water entities, and two controlled entities.

These entities form part of the water supply chain in Queensland. The supply chain comprises bulk water suppliers, retailers, distributors, local governments, and smaller water boards.

Within South East Queensland, the Queensland Bulk Water Supply Authority (trading as Seqwater) is a key water entity that provides water treatment services. It also sells bulk water to the Northern SEQ Distributor-Retailer Authority (trading as Unitywater) and the Central SEQ Distributor-Retailer Authority (trading as Queensland Urban Utilities). These entities are responsible for distributing the water purchased from Seqwater to water users in their respective local government areas.

Queensland Urban Utilities (QUU) and Unitywater were established in 2010 with transfers of water and sewage infrastructure assets from eight local councils. QUU and Unitywater now own and manage the water distribution and sewerage treatment responsibilities of these councils, and provide each council with an annual participation return (which is similar to a dividend). Outside South East Queensland, SunWater Limited, Gladstone Area Water Board (GAWB), and Mount Isa Water Board (MIWB) own and operate infrastructure that stores and supplies bulk water to irrigators, industrial customers, and local governments.

Smaller water boards source and sell water primarily to irrigation customers in designated areas throughout the state. Local governments source and sell water to their ratepayers from a number of surface and groundwater sources. The results from our financial audits of these smaller water boards and councils are outside the scope of this report.

## Results of our audits

We provided unmodified audit opinions on the financial statements of all entities this year. This means that their financial statements were prepared according to requirements of legislation and Australian accounting standards, and can be relied upon.

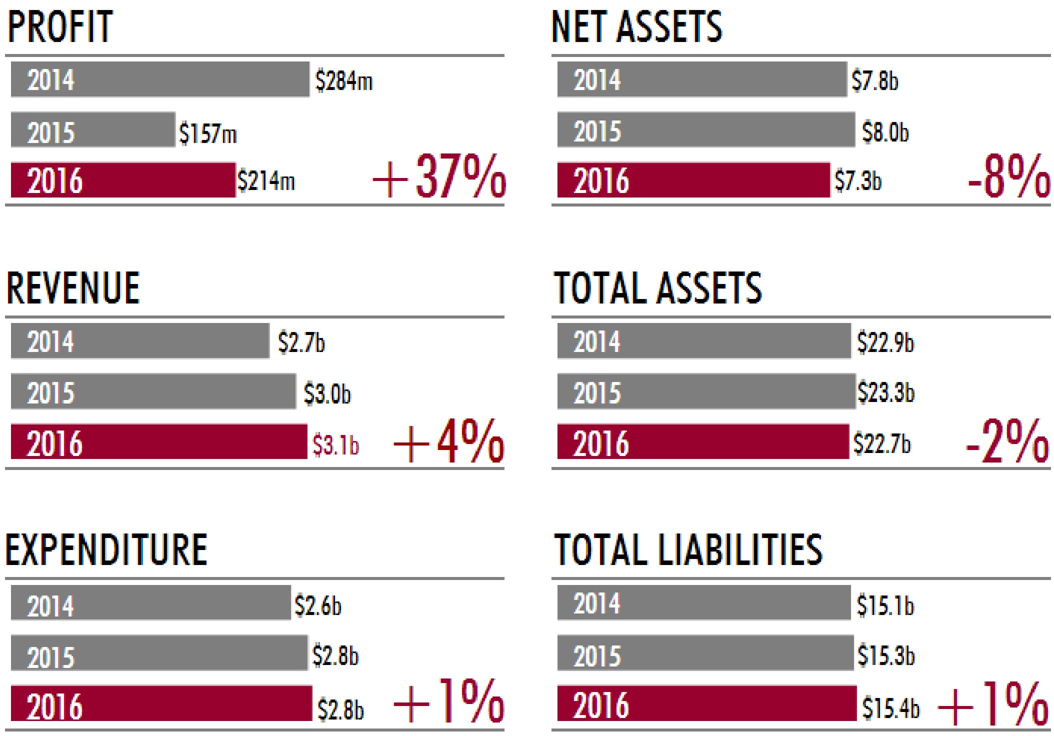
Five of the six water entities produced high quality financial statements for 2015–16. We certified the financial statements of these five entities within the statutory deadline of 31 August 2016.

While we issued an unmodified opinion on Seqwater's financial statements, it did not meet the statutory reporting deadline for the second consecutive year. This is because Seqwater lacked a robust methodology and quality assurance processes over the valuation of its assets.

Three material prior period errors were corrected and reported by Unitywater. The errors resulted from Unitywater not recording, in a timely manner, all donated assets received from developers in its asset register, and continuing to include a value in the financial statements for assets that were decommissioned and no longer used.

## Financial performance, position, and sustainability

**Figure A**
**Water sector 2015–16 financial snapshot**




*Source: Queensland Audit Office*

The sector typically has low profit margins. Bulk water and irrigation water prices are set by the state government, following oversight by the Queensland Competition Authority (QCA). In these areas of QCA scrutiny, the QCA calculates how much revenue entities can earn based on prudent and efficient operating costs and may also provide a return of, and on, assets, where appropriate. Prior to 2015–16, the QCA monitored the prices set by the distributor-retailers. The QCA will not step into the process unless directed by the state government.

Overall, profits for the water sector improved by 37 per cent compared to last year—revenue increased by four per cent while expenditure remained reasonably constant.

Sixty per cent of the increase in revenue was driven by increased cash and asset contributions from property developers for new development activity received by QUU and Unitywater. The remaining increase in revenue resulted from a greater consumption of water from the improved development activity and bulk water price increases.

Profits and retained earnings for 2015–16 supported the dividends and participation returns of $339 million made by the sector—$169 million to the state by SunWater, GAWB, and MIWB, and $170 million to local councils by the distributor-retailers. These were paid from cash, and no additional borrowings were made to fund the payments. The debt and equity ratios remain unchanged despite the dividend payments, differing from the energy entities owned by the state.

Dividends in 2015–16 increased from the previous year, as the shareholding ministers of SunWater required a special dividend of $130 million, and requested a share capital return of $130 million. This $260 million payment was required to support the state's debt action plan.

Seqwater did not report a profit, and consequently did not pay a dividend to the state.

Assets for the sector decreased by $530 million in 2015–16 (compared to an increase of $375 million in the previous year), mainly due to the reduction in value of Seqwater's infrastructure assets. Seqwater values its infrastructure assets using a discounted cash flow model—it takes the net revenue expected to be earned over the life of the assets and discounts this amount to today's value. Seqwater's assets decreased in value because it is expecting to earn less revenue from the use of its assets (a decline of nine per cent), while needing to increase capital expenditure in the future (57 per cent over a 40-year period) from the expectations it set last year. In 2015–16, Seqwater's valuation model included a $1.2 billion water supply augmentation from 2028 to maintain bulk water security.

As at 30 June 2016, water entities held $13.5 billion in debt, which remains steady. Of this total amount, $9.4 billion is held by Seqwater. This represents nine per cent of total state debt and continues to be guaranteed annually by the state government. Under the current pricing model, the price includes a return that equates to the cost of debt, allowing Seqwater to service its debt and meet its borrowing costs. In addition, the price also includes an allowance to earn sufficient revenue to cover the repayment of the water grid manager debt over the next 12 years.

All water entities are financially sustainable, although Seqwater's sustainability is dependent on the pricing methodology set by the state government, which requires QCA to provide revenue allowances that are sufficient to repay water grid manager debt by 2028.

## Seqwater's sustainability

Seqwater has not returned a profit in the past five years, and its net assets have not improved. It has assets valued at $11.1 billion, and borrowings of $9.4 billion.

The entity's profit is limited by the bulk water price, set by the minister, and the future demand and use of water; however, most of its expenditure—interest expense and depreciation—is fixed.

The *bulk water price* is set per kilolitre of water. This price is calculated by determining the total revenue to be earned by Seqwater and dividing the revenue by forecast use of water—giving a price per kilolitre.

The minister, on the advice of QCA, sets bulk water prices. This is known as a *price reset*. The next price reset is due on 1 July 2018.

The price path assumes that revenue increases for Seqwater will be driven by both increases in price and the demand for water. Demand for water is not reaching the levels originally expected, with resulting impacts on the revenue generated. If the demand for water remains at the current level of 165 litres per day per person (LPD) it is unlikely that Seqwater will earn sufficient revenue to service its debt until the next price reset.

Seqwater was created by amalgamating three previous bulk water entities in 2013. On creation, Seqwater acquired 15 per cent of its debt, $2.1 billion, from the former SEQ Water Grid Manager.

*Water grid manager debt* includes price path debt, which was incurred when bulk water prices charged were less than the cost of treatment and supply—water cost more than was charged to customers.

Since 2008, prices charged for bulk water have been increasing with an aim to charge consumers the full cost of water by 2018. This process was put in place to mitigate price shocks. The difference between revenue earned from consumers and the cost of water has been funded from debt. This debt is part of Seqwater's water grid manager debt account.

The significant investment in prior years in the South East Queensland bulk water sector, in particular the construction of the Gold Coast Desalination Plant and Western Corridor Recycled Water Scheme, has left Seqwater with a highly geared capital structure.

Seqwater is not required to make any principal repayments on the remaining $7.3 billion of borrowings while it is repaying the water grid manager debt. Seqwater commenced paying interest this year on all debt, rather than capitalising these costs—which in the past increased its debt. Any upward changes in interest rates has the potential to negatively affect the future operating position of Seqwater over time.

After the $2.1 billion water grid manager debt is repaid by 2028, Seqwater will have a debt to equity ratio of 70 per cent, which is within a reasonable range for regulated infrastructure entities.

Seqwater will rely on borrowings to fund capital projects in the future, including the $1.2 billion capital augmentation planned to commence in 2028.

## Internal controls

Good internal controls provide reasonable assurance that an entity is achieving its objectives relating to operations, reporting, and compliance.

We assess the financial controls used by public sector entities against the Committee of Sponsoring Organizations of the Treadway Commission (COSO) internal controls framework. This framework is widely recognised as the benchmark for designing and evaluating internal controls using five key elements including:

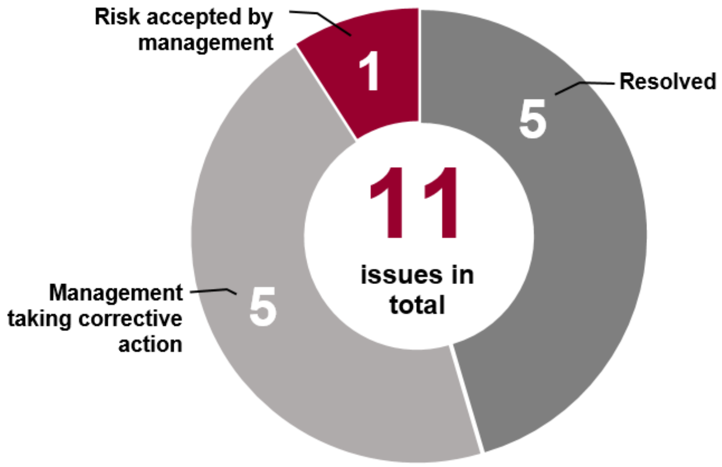
- control environment—actions, attitudes, and values that influence daily operations
- risk assessment—processes for identifying, assessing, and managing risk
- monitoring activities—oversight of internal controls for existence and effectiveness
- control activities—policies, procedures, and actions taken to prevent or detect errors
- information and communication—systems to inform staff about control responsibilities.

This year, we identified 11 internal control weaknesses across all six water entities in relation to manual controls. These deficiencies only affected the control activity component.

We identified a significant deficiency in relation to inadequate quality control processes in place at Seqwater for validating the inputs and calculations in their asset valuation model.

Figure B shows the status of the water sector in relation to these issues at 31 August 2016.

**Figure B**
**Status and number of 2015–16 internal control weaknesses at 31 August 2016**




*Source: Queensland Audit Office*

In addition, where entities outsourced their information technology services to third parties, we noted deficiencies at the service providers. This highlights the need for entities to implement effective monitoring over the service providers to ensure that there are appropriate controls in place.

Water entities are on track to resolve all outstanding issues by dates agreed with their respective boards. The proactive resolution of control deficiencies generally indicates a strong control environment.

## Reference to comments

In accordance with section 64 of the *Auditor-General Act 2009,* we provided a copy of this report to relevant entities with a request for comment.

We also gave a copy of this report to the Minister for Main Roads, Road Safety and Ports and Minister for Energy, Biofuels and Water Supply; the Director-General, Department of Energy and Water Supply; the Chief Executive Officer, Queensland Competition Authority and the Under Treasurer, Queensland Treasury for comment.

Responses were received from the Treasurer and the Chair, Gladstone Area Water Board. The responses are in Appendix A.

## Report structure

| Chapter | Description |
|---|---|
| Chapter 1 | provides the background to the report and the context needed to understand the audit findings and conclusions. |
| Chapter 2 | evaluates the audit opinion results, and the timeliness and quality of reporting. |
| Chapter 3 | analyses the financial performance, position, and sustainability to enhance accountability and transparency for transactions and events during the year. |
| Chapter 4 | assesses the strength of the internal controls designed, implemented, and maintained by entities in the water sector. |

## Report cost

This audit report cost $110 000 to produce.

# 1. Context

## Legislative framework

Water entities prepare their financial statements in accordance with the following legislative frameworks and reporting deadlines.

| Entity type | Entity | Legislative framework | Financial audit deadline |
|---|---|---|---|
| Statutory bodies | ▪ Queensland Bulk Water Supply Authority (trading as Seqwater)<br>▪ Northern SEQ Distributor-Retailer Authority (trading as Unitywater)<br>▪ Central SEQ Distributor-Retailer Authority (trading as Queensland Urban Utilities)<br>▪ Gladstone Area Water Board<br>▪ Mount Isa Water Board | ▪ *Financial Accountability Act 2009*<br>▪ Financial and Performance Management Standard 2009 | 31 August 2016 |
| Government owned corporation | ▪ SunWater Limited | ▪ *Government Owned Corporations Act 1993*<br>▪ *Corporations Act 2001*<br>▪ Corporations Regulations 2001 | 31 August 2016 |
| Controlled entities | ▪ Eungella Water Pipeline Pty Ltd<br>▪ Australian Water Recycling Centre of Excellence Ltd | ▪ *Corporations Act 2001*<br>▪ Corporations Regulations 2001 | 31 October 2016 |

*Source: Queensland Audit Office*

## Accountability requirements

The *Financial Accountability Act 2009* requires statutory bodies to:

- achieve reasonable value for money by ensuring their operations are carried out efficiently, effectively, and economically
- establish and maintain appropriate systems of internal control and risk management
- establish and keep funds and accounts that comply with the relevant legislation, including Australian accounting standards.

The *Government Owned Corporations Act 1993* establishes four key principles for government owned corporations:

- clarity of objectives
- management autonomy and authority
- strict accountability for performance
- competitive neutrality.

## Queensland state government financial statements

Each year, Queensland state public sector entities must table their audited financial statements in parliament.

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.

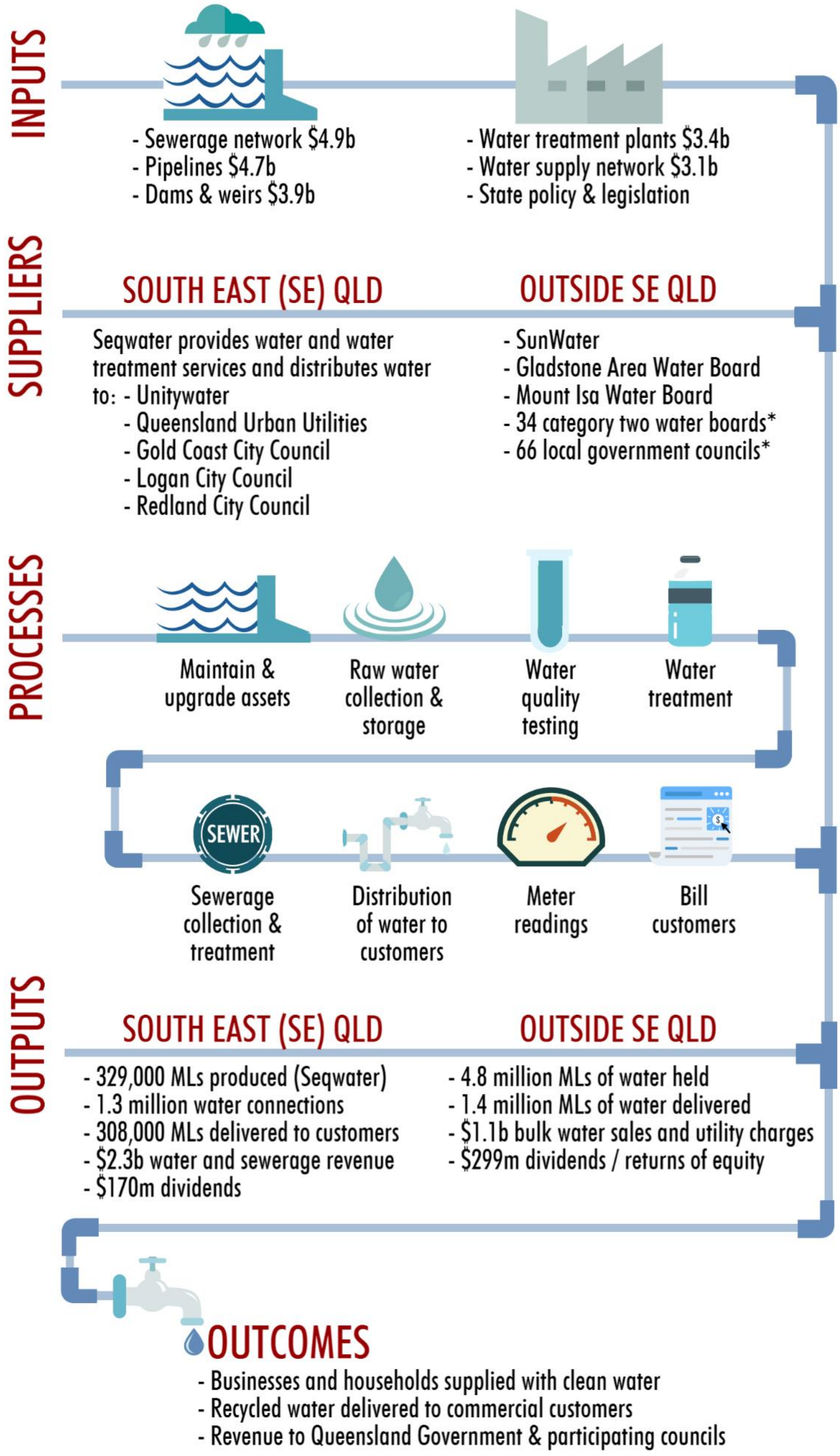
The auditor-general's audit opinion on these entities' financial statements assures users that the statements are accurate.

## Water entities

In Queensland, water is used primarily by households, agriculture, mining, electricity generation, tourism, and manufacturing industries. Direction and oversight of the water sector in Queensland is provided by the Department of Energy and Water Supply.

Figure 1A details the major state and local government owned entities that make up the water supply chain, as well as the inputs, suppliers, processes, outputs, and outcomes for the sector.

**Figure 1A**
**Function level inputs, suppliers, processes, outputs, and outcomes**




Note: * Output figures exclude these entities.

*Source: Queensland Audit Office*

## Water regulation

The Queensland Competition Authority (QCA) is the independent economic regulator of water and wastewater services in Queensland, seeking to ensure that consumers pay a fair price for efficient and sustainable services. The QCA has previously investigated and recommended bulk water prices to be charged by Seqwater based on the parameters set by the minister. It has also reviewed the pricing practices of SunWater and Gladstone Area Water Board. The QCA has previously monitored retail water prices in South East Queensland (SEQ) to assess whether households and businesses were paying a price that was comparable with the costs of providing the relevant services, with the most recent review ending in 2014–15. The QCA does not set the prices. In SEQ, the five water entities set the water retail prices. The QCA is also responsible for recommending irrigation prices charged by SunWater and Seqwater for approval by the Treasurer.

### Seqwater regulatory framework—bulk water prices

The Queensland Government sets the prices that Seqwater charges for bulk water supply and the QCA undertakes the price reviews as directed by the Treasurer.

In July 2008 the Queensland Government established a South East Queensland bulk water price path (*price path*) to phase in price increases associated with these costs and to repay the debt resulting from the under-recoveries during the price path. The price path was developed with a view to limiting price increases for bulk water over a 10-year period (2008–2018) in achieving a common bulk water price across all SEQ councils.

On 26 July 2016 the Treasurer issued a further direction to the QCA to investigate and report on the SEQ bulk water price path in order to inform the Queensland Government in preparation for the next regulatory pricing period, which is due to commence on 1 July 2018. The QCA provided its report on the SEQ bulk water price path on 26 October 2016. The objective of the report was to assist the Queensland Government in assessing the most appropriate way forward to determine SEQ bulk water prices, taking account of the impacts on SEQ water consumers, Seqwater, and the State of Queensland.

# 2. Results of our audits

## Chapter in brief

We audit the financial statements of state and local government owned water entities annually, and provide assurance that the reports are reliable and comply with accounting standards.

### Main findings

- Water entities that produced financial statements for 2015–16 received unmodified opinions as they complied with Australian accounting standards and relevant legislative requirements.
- We certified the financial reports for five of the six water entities by the legislative deadlines. In 2015–16, the absence of quality control processes over asset valuations at Queensland Bulk Water Supply Authority (Seqwater) resulted in material adjustments to its financial statements.
- Both Queensland Audit Office and Northern SEQ Distributor-Retailer Authority (Unitywater) management identified errors in asset and revenue figures that required the adjustment of prior year balances.

### Audit conclusions

The overall quality and timeliness of financial reporting continues to be appropriate for the majority of the entities, with Seqwater requiring further focus on asset valuations to meet its financial reporting statutory deadline.

## Introduction

This chapter details the reliability of the reported information by water entities that was subjected to audit.

Our audits provide confidence in the financial statements of public sector entities by intended users. We express an *unmodified* opinion when the financial statements are prepared in accordance with the relevant legislative requirements and the Australian accounting standards. We *modify* our audit opinion where financial statements do not comply, and are not accurate and reliable.

Sometimes we include an *emphasis of matter* in our audit reports to highlight an issue that will help users better understand the financial statements. They do not change our audit opinion.

The purpose of our analysis is to increase accountability and transparency in financial reporting by scrutinising the quality and timeliness of reporting.

## Conclusion

Readers can rely on the results in the audited financial statements of the water entities in 2015–16 because we issued unmodified audit opinions for each entity.

With the exception of Queensland Bulk Water Supply Authority (Seqwater), entities in the water sector maintained their strong record of timely and quality financial reporting. However, deficient financial governance practices mean that Seqwater has not met its financial reporting deadlines for the past two financial years. Large adjustments to asset figures were required to the draft financial statements that Seqwater provided to us for auditing.

Deficient asset accounting practices at Northern SEQ Distributor-Retailer Authority (Unitywater) resulted in the correction of three prior period errors. We were satisfied that the process adopted by management to capture and value the required adjustments were appropriate for 2015–16.

## Audit opinion results

Figure 2A details the audit opinions we issued for the 2015–16 financial year.

**Figure 2A**
**Audit opinions issued for the 2015–16 financial year**

| Element of water supply chain | Entity | Date audit opinion issued | Type of audit opinion issued |
|---|---|---|---|
| Bulk water suppliers | Seqwater | 15.09.16 | Unmodified |
| | SunWater Limited | 29.08.16 | Unmodified |
| | Gladstone Area Water Board (GAWB) | 31.08.16 | Unmodified |
| | Mount Isa Water Board (MIWB) | 26.08.16 | Unmodified |
| Distributor-retailers | Queensland Urban Utilities (QUU) | 19.08.16 | Unmodified |
| | Unitywater | 31.08.16 | Unmodified |
| Controlled entities | Australian Water Recycling Centre of Excellence (AWRCE) Ltd | 23.09.16 | Unmodified |
| | Eungella Water Pipeline Pty Ltd | 29.08.16 | Unmodified |

*Source: Queensland Audit Office*

Seven of the eight water entities (87.5 per cent) met their legislative deadlines (2014–15: 87.5 per cent).

We included an emphasis of matter in our audit reports on both controlled entities to highlight that only certain accounting standards were used in the preparation of their reports and their reports were not intended for other users. We also included a second emphasis of matter in our report on AWRCE to highlight that the company intends to de-register by 31 March 2017, with any residual amount remaining to be used as a contingency for deregistration costs.

## Financial statement preparation

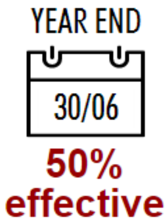
Entities that adopt effective financial reporting practices throughout the year should be able to produce a set of high quality financial statements in a timely manner.

To assess the financial statement preparation process we considered:

- the year end close process—whether key outcomes were delivered by agreed dates
- timeliness—whether we received a complete draft financial report by an agreed date
- quality—the extent of adjustments made to total revenue, expenditure, and net assets during our audit.

The following sections of this report detail the improvements required in financial statement preparation. Our assessment criteria and our detailed assessment by entity is outlined in Appendix B.

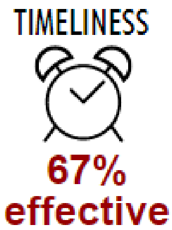
## Year end close process




Based on better practice guidance issued by the Queensland Under Treasurer in January 2014, we identified five key outcomes for entities to achieve before 30 June 2016. Early completion of these items means an entity has less risk that a financial report is not cleared in time for board signature, and certification by audit is achieved within statutory deadlines.

Only three of the six water entities completed all five key outcomes by the agreed dates. The timely resolution of key areas, such as the valuation of assets, did not meet our expectations for Seqwater and GAWB. With respect to SunWater, draft financial statements were not provided to audit for review in advance of the final audit visit.

## Timeliness of draft financial statements

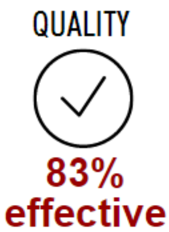



An entity's ability to prepare timely draft financial statements is an indicator of the strength of the entity's financial management processes. Financial statements are timely when they provide information for decision-makers in time to influence their decisions. As the timeliness diminishes, the statements are less relevant and useful to users of the financial statements.

Four of the six water entities provided draft financial statements by agreed dates, the exceptions being Seqwater and MIWB.

Seqwater did not meet its financial reporting deadline due to the absence of a robust methodology and quality assurance processes for the valuation of its assets.

## Quality of draft financial statements




The extent of adjustments made to a draft financial report indicates the effectiveness of an entity's internal review process to identify and correct errors before providing financial reports to audit.

The quality of the draft financial statements and supporting working papers provided were satisfactory for five of the six entities. These five entities did not require any large management or audit-initiated adjustments to their draft financial statements.

Significant adjustments, however, were made to the draft financial statements provided to audit by Seqwater. These adjustments were limited to its valuation of assets.

### Prior period errors

When an entity is preparing financial statements, it may identify errors in the prior year accounts. We may also detect prior period errors during our testing. If these errors are material, the accounting standards require corrections to be made to these comparative figures.

Had the material errors been identified in the year they occurred, they would either have been corrected in that year or a qualified audit opinion would have been issued.

Unitywater's prior period errors corrected in 2015–16 are detailed in Figure 2B.

**Figure 2B**
**Prior period errors for Unitywater identified in 2015–16**

| Description | Details |
|---|---|
| Delayed recognition of developer-contributed assets | ▪ We identified instances, dating back to 2011, of delayed recognition of assets donated by developers as part of the terms of a development agreement.<br>▪ Management's subsequent investigation confirmed an additional amount of $17.4 million was required to be recognised as both revenue and assets. |
| Decommissioned assets still assigned a financial value | ▪ Management identified an error dating back to 2011 where decommissioned physical assets incorrectly retained a financial value.<br>▪ Management's subsequent investigation resulted in $6.7 million being determined as an appropriate adjustment to assets for prior years. |
| Incorrect recognition of developer-contributed assets | ▪ Management identified an error where assets donated by developers had not been correctly accounted for as assets and revenue.<br>▪ Management's investigations determined that $21.3 million should be recognised for prior years dating back to 2011. |

*Source: Queensland Audit Office*

We were satisfied that the processes adopted by Unitywater management to identify, capture, and value the required adjustments were appropriate for 2015–16.

Unitywater management is currently undertaking a comprehensive review of its asset accounting practices to ensure these errors do not re-occur.

## Audit reporting changes

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

QAO will formally adopt this standard for financial statements prepared at 30 June 2017.

The new form of audit reporting will aid transparency by disclosing our audit response to the areas in the financial report that we consider require significant audit attention.

The new look audit report will continue to include our audit opinion on the financial report, and will now also include a section on key audit matters—those areas that, in our professional judgement, pose a higher risk of material misstatement of the financial report. These matters will mostly relate to major events and transactions that occur during the period, and those areas requiring significant judgement and estimation.

We will report on why we considered each key audit matter to be significant and give an overview of the key procedures we performed to address the matters.

## Entities not preparing financial statements

Not all public sector companies are required to produce financial statements. For state public sector companies other than government owned corporations, the board of directors consider the requirements of the *Corporations Act 2001* to determine whether financial statements need to be prepared. The board needs to revisit this assessment every three years or whenever a significant change occurs. There are two water entities that are not required to prepare financial statements.

Figure 2C lists the entities not preparing financial reports and their reasons.

**Figure 2C**
**Entities not preparing financial reports**

| Entity | Parent entity | Reason |
|---|---|---|
| North West Queensland Water Pipeline Pty Ltd | SunWater Limited | Board of directors determination |
| Burnett Water Pty Ltd | SunWater Limited | Board of directors determination |

*Source: Queensland Audit Office*

# 3. Position, performance, and sustainability

## Chapter in brief

This chapter details the major transactions and events that affected the water entities' 2015–16 financial statements in relation to revenue, expenditure, assets, debt, and equity. We alert users to future challenges, including existing and emerging risks for the sector. We also analyse the sustainability of entities where issues are apparent.

### Main findings

- Five of the six water entities achieved operating profits in 2015–16. Queensland Bulk Water Supply Authority (Seqwater) continues to incur operating losses consistent with the past five years. The financial performance and position of Northern SEQ Distributor-Retailer Authority (Unitywater) and Queensland Urban Utilities (QUU) continues to be stronger than other water entities in the sector.
- Revenue for the sector increased by $119 million (four per cent) from 2014–15 due to an increase in both prices and the number of connections. Queensland Competition Authority regulates Seqwater's prices, and previously monitored Unitywater and QUU's prices, with the most recent review ending in 2014–15.
- Seqwater’s financial performance and position is affected by the debt that it holds ($9.4 billion at 30 June 2016). Its operating result continues to be impacted by interest on this debt and annual depreciation charges on its water supply assets.
- Across the sector, net assets decreased by $675 million (eight per cent). The reported values of property, plant and equipment decreased by over $700 million, mainly due to a downward movement in asset valuation by Seqwater. This movement was a result of a changed expectation from last year that it would earn less revenue from the use of the assets, while needing to increase future capital expenditure.
- Dividends of $169 million were declared by three entities in 2015–16. This included a special dividend of $130 million declared by SunWater to be paid by 30 November 2016. SunWater also declared a return of equity of a further $130 million in response to a request from the shareholding ministers. Seqwater continued to make no dividend payments in 2015–16.
- Participation returns paid or payable by Unitywater and QUU for 2015–16 to their respective local councils amounted to $170 million, an increase of $50 million from the prior year.
- Seqwater and Gladstone Area Water Board (GAWB) need to redesign their current discounted cash flow asset valuation models, and implement formal processes to validate their model calculations and inputs.
- Our review of water entities' approaches to valuing their assets based on the income they generate to estimate fair values for their financial statements identified a range of departures from industry standard practices, in particular around the appropriateness of inputs and assumptions applied.
- Bulk water price resets for Seqwater rely on the accurate prediction of future water demand and population growth. The repayment of the water grid manager debt ($2.1 billion at 30 June 2016) by 2028 is incorporated into the bulk water prices.

### Audit conclusions

The water entities included in this report are financially sustainable. Seqwater's sustainability is dependent on future pricing policies to address its current performance and position. The Queensland Government continues to secure Seqwater's debt.

The bulk water price methodology may result in actual revenue earned differing from estimated revenue due to inaccurate demand forecasts resulting from changes in climatic conditions. While adjusted in future pricing resets, the deferred receipt of revenue can result in insufficient revenue being earned to fund operating expenses and repay water grid manager debt in the current period.

## Introduction

The information in the financial statements describes the main transactions and events for the year. Over time, financial statements also help users to understand the sustainability of the entity and the industry. Metrics, such as ratio analysis, allow users to understand organisational performance.

The purpose of our analysis is to help users understand and use the financial statements by clarifying the financial effects of key transactions and events in 2015–16.

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

In this chapter, we assess the position, performance, and sustainability of water entities.

## Conclusion

The water entities' financial statements accurately reflect the key transactions and events that occurred during 2015–16.

We considered the ability of the water entities to operate as going concerns in the context of their financial performance, position, and sustainability. We found all water entities to be financially sustainable, and assessed them as being able to pay their debts as and when they fall due.

However, Queensland Bulk Water Supply Authority (Seqwater) continues to be impacted by significant interest charges on its borrowings and by depreciation expenses on its bulk water supply assets. Seqwater’s financial position continues to be adversely affected by the debt it acquired from the construction of the state’s water grid, including the manufactured water assets, as well as the price path debt.

## Understanding financial performance

Profits for the water sector increased by $57 million in 2015–16, mainly due to increases in utility charges and developer contributions received by the water entities. At the same time, dividends on net profits after tax, to be paid to the state, have increased by $13 million.

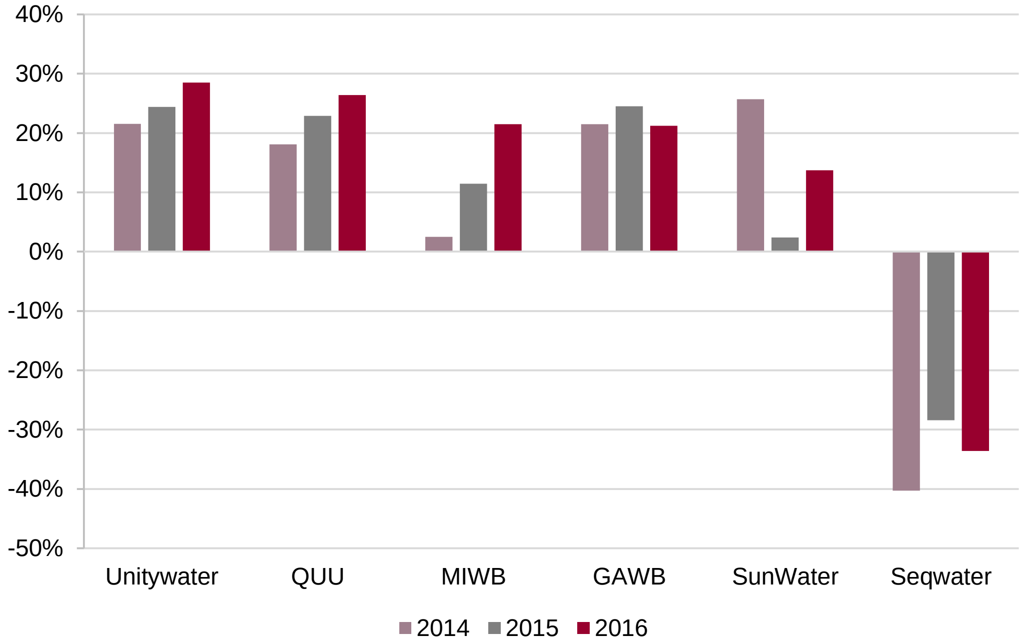
Based on a direction from the state government, SunWater is paying a special dividend of $130 million to the state, with payment due by 30 November 2016. The returns made by the distributor-retailers of water to their participating local governments amounted to $170 million for 2015–16. Seqwater continued to make no dividend payments to the state in 2015–16.

Five of the six water entities achieved operating profits in 2015–16, with Seqwater the exception. Seqwater’s results largely reflect the acquisition of highly geared businesses in the past, including climate resilient manufactured water assets. The financial performance and position of Northern SEQ Distributor-Retailer Authority (Unitywater) and Queensland Urban Utilities (QUU) both continue to be stronger than that of the other four entities. This has been the case since their inception in 2010.

### Operating ratio

The *operating ratio* is the operating result before tax expressed as a percentage of total revenue. It should be positive over the medium- to long-term if an entity is to remain financially sustainable. Figure 3A shows the operating ratio of each water entity over the past three financial years.

**Figure 3A**
**Operating ratio for water entities**




*Source: Queensland Audit Office*

Seqwater's negative operating ratio reflects its operating loss reported in 2015–16, which is also consistent with prior years and with its current price path and pricing methodology. This means sufficient revenue is not being generated to fund operating and capital expenditure commitments. While Seqwater is currently incurring losses, the price path process is such that Seqwater will over-recover costs for the ten-year period up to financial year 2028 in order to recoup the previous under-recoveries.

The strong financial performance of the distributor-retailers is not as prominent when comparing operating results to total revenue. They have relatively smaller margins than the other entities because they base their revenue on previous maximum allowable revenue benchmarks that were set by the Queensland Competition Authority (QCA).

The distributor-retailers are looking to diversify their sources of revenue to improve profits while minimising price increases to customers.

## Revenue

**Figure 3B**
**Total revenue for all entities by type in 2015–16**


*Source: Queensland Audit Office*

Revenue received by the water sector predominantly comprises user charges and developer contributions—96 per cent in total for 2015–16.

The water entities reported $3.1 billion of revenue in the 2015–16 financial year, an increase of $119 million (four per cent) from the prior year. This increase relates to growth in both major revenue streams.

## Events and transactions affecting revenue this year

### Increased prices, consumption, and connections

User charges represent 84 per cent of sector revenue. Seqwater is a bulk water supplier and collects user charges from South East Queensland local water retailers, local governments (Gold Coast, Logan, and Redland City Councils), power stations, and other industrial and rural customers. These charges are regulated by the Queensland Competition Authority (QCA) and set by the minister. With respect to rural water supply, the price charged to irrigators is set by the minister and the Treasurer.

QUU, Unitywater, and the three local councils noted above are the local water retailers for South East Queensland (SEQ). Their revenue from user charges comes directly from businesses and households in their respective local government areas through water usage, sewerage transport and treatment, and wastewater services.

The growth in revenue from user charges in 2015–16 was driven by increases in:

- bulk water prices set by the state government ($23.4 million or two per cent)
- bulk water consumption charges ($54.8 million or four per cent)
- the number of connections during the year (14 700 connections or two per cent).

### Increased property development in the regions

Revenue from developer contributions comes in the form of donated assets and cash contributions. QUU and Unitywater use non-refundable contributions from developers to fund their asset replacement and expansion programs. There was an increase of $62 million (20 per cent) in developer contributions from the prior year, primarily as a result of increased residential property development in the regions.

### Continued support for rural water supply

SunWater receives significant community service obligation (CSO) payments from the state. In 2015–16 it received $10.1 million (2014–15: $11.3 million) in CSO payments in recognition of the current rural water pricing policies. These policies determine how much irrigators are charged, the extent of urban water deliveries to a local council, and other activities for which there are no other revenue sources.

Seqwater also receives CSO payments from the state. In 2015–16 it received $2.1 million (2014–15: $2.2 million) to facilitate the provision of irrigation water to rural irrigators.

## Future challenges and emerging risks

The water sector in Queensland faces a number of financial challenges. With constraint around their ability to generate revenue, all water entities need to continually focus on ways they can achieve cost-efficiencies to generate an underlying profit.

### Growth in demand slower than expected

Seqwater's ability to generate profits is restricted by their need to service debt of $9.4 billion at 30 June 2016—representing nine per cent of total state debt. To repay the price path debt component ($2.1 billion at 30 June 2016) in the next 12 years, Seqwater is reliant on growth in prices and volume.

The price path set by the QCA assumes that revenue increases for Seqwater will be driven by both increases in price and an increase in demand for water. The prices that Seqwater is permitted to charge are based on an assumption of increasing residential demand for water of 20 litres per person per day by 2021 and remaining at that level over the forecast period. Demand for water is not reaching the levels originally expected, with resulting impacts on the revenue generated.

If demand for water does not increase as predicted, a price reset will be required to ensure that Seqwater will earn sufficient revenue to service its debt and meet its operating expenses.

Figure 3C shows a comparison between forecast and actual demand for water for the past three financial years.

**Figure 3C**
**Demand forecasts vs. actuals**

| | 2014 | 2015 | 2016 |
|---|---|---|---|
| Forecast (ML) | 277 058 | 297 540 | 301 225 |
| Actual (ML) | 291 327 | 291 760 | 294 763 |

*Source: Queensland Bulk Water Supply Authority*

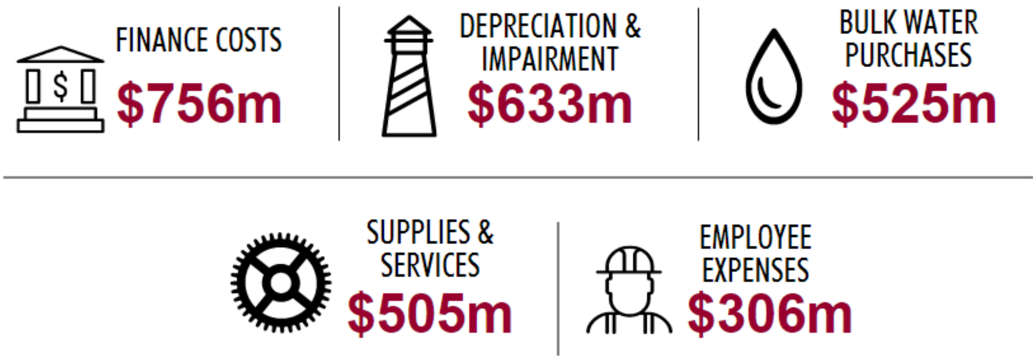
### New revenue streams

An emerging trend this year is water entities investing in services outside of their core operations to seek new and more diversified revenue streams. This strategy aims to maintain profits and spread their risk while minimising price increases to customers.

Entities are looking to transition from their current role as water providers, traditionally focused on building and maintaining physical assets, to that of customer-oriented water solutions providers, offering products and services that help customers get value from their water use.

## Expenditure

**Figure 3D**
**Total expenditure for all entities by type in 2015–16**




*Source: Queensland Audit Office*

The water entities reported $2.8 billion of expenditure in the 2015–16 financial year, an increase of $36.5 million (1.3 per cent) from the prior year. The main points are:

- Finance costs are the most significant expense for the water sector and move in line with the level of borrowings held by entities. Seqwater incurred 73 per cent of total finance costs for the sector.
- Depreciation, although fairly constant, moves in line with the capitalisation of new projects, disposals, and revaluation of assets.
- Unitywater and QUU accounted for 50 per cent of total expenditure by the sector. Bulk water purchases by these two entities increased by $27.4 million (5.5 per cent) from the prior year.

## Events and transactions affecting expenditure this year

### Maintaining water security in South East Queensland

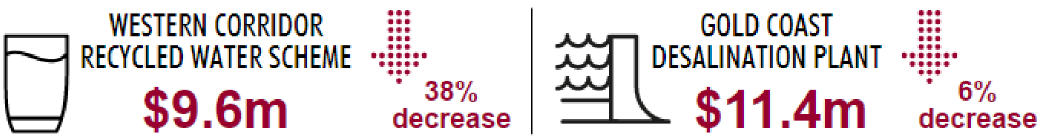
Seqwater manages and maintains around $9 billion of water supply assets, including dams, weirs, water treatment plants, reservoirs, pumps, and pipelines. In addition, Seqwater manages and maintains $2.2 billion of climate resilient manufactured water assets, such as the Gold Coast Desalination Plant and the Western Corridor Recycled Water Scheme.

In 2015–16, the desalination plant produced 1 258 megalitres of water, representing 0.4 per cent of total water supplied by Seqwater. The Gold Coast Desalination Plant (GCDP) continues to provide a climate resilient and contingent supply option for the South East Queensland Water Grid. The plant currently operates in a 'hot standby' mode, which means it is operated at a level of water production required to maintain the plant in a state of readiness to deliver 33 per cent of capacity within 24 hours, and 100 per cent within 72 hours if required.

The manufactured water assets form an integral part of maintaining water security for the South East Queensland region. However, Seqwater carries the debt associated with these assets along with the responsibility to maintain the assets.

Figure 3E details the costs to maintain and operate the manufactured water assets in 2015–16 and in comparison with the prior year.

**Figure 3E**
**Manufactured water assets—annual maintenance and operating costs**




*Source: Queensland Bulk Water Supply Authority*

The GCDP is used for general operational purposes, which include supplementing supply in the local network or assisting with maintenance needs on other assets where it is considered cost-effective to do so.

A cost-efficiency program was implemented in 2014–15. The total costs to maintain and operate the GCDP in 2015–16 were $11.4 million, a reduction of $731 000 (six per cent) from the prior year.

On 31 March 2015, the decommissioning program of the Western Corridor Recycled Water Scheme (WCRWS) was completed and the scheme was placed in 'care and maintenance' mode due to the low risk to water supply. The total costs to maintain and operate the WCRWS in 2015–16 were $9.6 million, a reduction of $5.8 million (38 per cent) from the prior year.

### Seqwater's sustainability assured

Seqwater's operating result continues to be impacted by the high level of interest on its borrowings (2015–16: $552 million) and annual depreciation charges (2015–16: $272 million) on its water supply assets.

The Queensland Treasurer, in June 2016, confirmed the state government's commitment to assuring Seqwater's solvency and ongoing viability, including the provision of funding facilities.

As a result of this commitment, the availability of a working capital facility of $200 million, and a cash balance of $133 million, Seqwater was deemed sustainable at 30 June 2016.

### Future challenges and emerging risks

A future challenge for water entities is to search for cost-efficiencies to ensure financial sustainability over the long-term. As an example, QUU reported commitments amounting to $284 million at 30 June 2016 which includes the provision of infrastructure maintenance services. QUU entered into a contract with Utilita Water Solutions to outsource the delivery of its planned infrastructure maintenance work from 1 July 2016. It is intended that this new arrangement will enable the delivery of maintenance efficiencies and a lower cost to customers.

## Understanding financial position

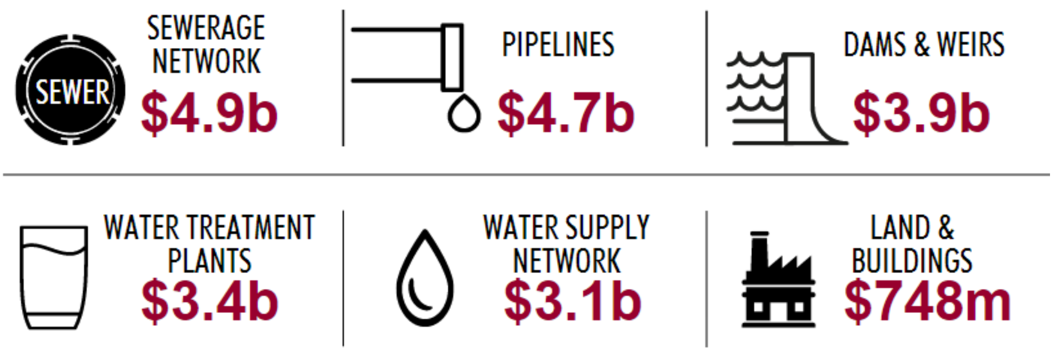
The water sector has $21.3 billion in property, plant, and equipment, and is $13.5 billion in debt to the Queensland Treasury Corporation (QTC) and participating local councils.

The value of total assets decreased by $530 million (2.3 per cent) in 2015–16, due mainly to the recognition of a $707 million downward movement in asset valuations. This was partially offset by increases in cash balances of $165 million across the sector.

The financial position of Seqwater continues to be affected by the debt it holds. QUU and Unitywater continue to have the strongest financial position across the sector with combined net assets of $4.8 billion at 30 June 2016.

## Assets

**Figure 3F**
**Total assets for all entities by type at 30 June 2016**




*Source: Queensland Audit Office*

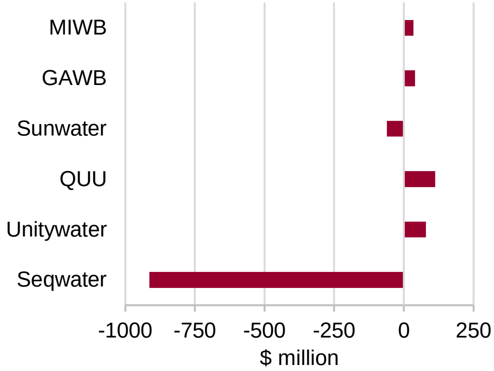
The water entities reported $22.7 billion of assets at 30 June 2016, consisting primarily of property, plant, and equipment (93.7 per cent of total assets).

### Events and transactions affecting assets this year

The key drivers of property, plant, and equipment (PPE) values are asset additions, disposals, depreciation, impairment for assets measured at cost and, for entities which measure their assets on a fair value basis, revaluation movements. In this section we focus on the re-measurement of assets as it is the movement most subject to assumptions and judgements.

### Decreased asset values for Seqwater

**Figure 3G**
**PPE movements 2015–16 by entity**




*Source: Queensland Audit Office*

Total PPE decreased by over $700 million (3.2 per cent) from the prior year. Figure 3G shows a breakdown of this movement by water entity.

This decrease was mainly due to the recognition of a downward movement in asset valuations ($718 million) and depreciation charges ($268 million), offset by acquisitions ($82 million) for Seqwater. Its assets decreased in value because it is expecting to earn less revenue from the use of the assets, while needing to increase capital expenditure, in the future from the expectations set last year.

This year, Unitywater changed its accounting policy for the measurement of its infrastructure assets from fair value basis to historical cost. Unitywater's key stakeholders supported the change in policy and confirmed that assets reported at historical cost would be more relevant to their information and economic decision-making needs. Balances did not need to be restated as historical cost was materially the same as the current fair value.

### Local management arrangements

SunWater's eight channel irrigation schemes (infrastructure to distribute water from its source to irrigators) will move to local management arrangements, involving the transfer of water distribution assets (with a historical cost of $930 million) and the operational responsibilities for those assets to locally owned companies and/or cooperatives.

Four of the channel irrigation schemes (St George, Eton, Emerald, and Theodore) have commenced the process of transitioning to local management arrangements at no cost to the recipients of the assets, subject to reaching final agreement on the terms and conditions of the transfer with the state government. This will involve the establishment of five special purpose entities to facilitate the transfer, which will be controlled entities of the Department of Energy and Water Supply.

The remaining four irrigation schemes (Burdekin-Haughton, Bundaberg, Lower Mary, and Mareeba-Dimbulah) have been invited to conduct additional work and resubmit revised business proposals for consideration by the state government.

## Measuring the value of assets

The Australian accounting standards allow entities to use either fair value or cost as a basis for measuring the value of their assets.

Water entities use different techniques to report assets in their financial statements, which impacts on comparability across the water sector.

Seqwater, QUU, Gladstone Area Water Board (GAWB) and Mount Isa Water Board (MIWB) record assets at fair value in their financial statements—using either income or current replacement cost approaches. Unitywater and SunWater report their assets at historical cost.

When entities report their assets at fair value, they revisit the amounts recorded each year to reassess the valuation.

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 convert future cash flows into a present day value of their assets.

Three water entities—Seqwater, GAWB, and QUU—have used an income-based approach to calculate fair value for their assets. This method is used to estimate fair value where revenue is earned from a customer using infrastructure assets. This can be a complex valuation methodology with significant judgements and estimates.

Our audit of income-based valuations at Seqwater and GAWB identified issues relating to the quality of the model for asset values and the appropriateness of valuation inputs and assumptions used within it. The key issues that need to be considered by these water entities include:

- a review of inputs, assumptions, and calculations used by the entities for reasonableness and accuracy
- the need for a significant re-design and improvement to asset valuation models currently in place at the entities
- the need to design and implement formal processes to validate calculations and inputs in the models.

Seqwater and GAWB are proactively implementing an asset valuation plan for 2016–17.

**Fair value measurement using the income-based method—breaking it down**

Two key inputs have contributed to a decrease in the value of Seqwater's assets this year.

### Revenue forecasts

Seqwater estimated the most likely demand forecast for physical sales projections and ongoing levels of service requirements.

This year Seqwater decreased its total revenue forecasts by nine per cent, which means that it will receive less cash. This lowers the value of the assets.

> In 2008, the Queensland Government established a 20-year *price path* of annual price increases to gradually repay debt and achieve a common bulk water price across all South East Queensland councils.

In addition, three pricing scenarios were applied by Seqwater in 2015–16 to compute the valuation of its infrastructure assets. This represented a change from the prior year, where a single pricing scenario was adopted. In the context of the pricing scenarios, the intention was to continue the bulk water price path, which incorporates the repayment of the water grid manager debt by financial year 2028.

Revenue cash flows for the financial years 2019 to 2028 were based on the current QCA bulk water price path to 2018, and the estimated bulk water price path from 2019 to 2028.

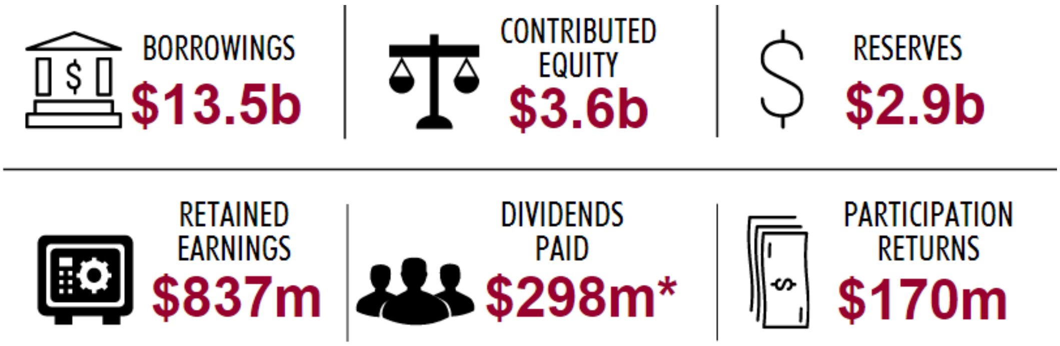
### Future capital expenditure

Seqwater prepared forecasts for the capital expenditure required to maintain its assets so it could generate the revenue as forecasted. This year there was an increase of 57 per cent in its total capital expenditure forecasts. This included $1.2 billion on water supply augmentation from the financial year 2028 in order to maintain bulk water security, as set out in the *South-East Queensland's Water Security Program 2015–2045.* The augmentation was not included in the prior year's valuation as it was only approved in October 2015.

An increase in future capital expenditure means that more expenditure is required by Seqwater, which decreases the value of the assets.

## Debt and equity

**Figure 3H**
**Total debt and equity for all entities by type at 30 June 2016**




Note: * Includes a return of equity by SunWater at the request of the shareholding ministers, payable by 30 November 2016.

*Source: Queensland Audit Office*

### Debt and equity at a glance

Debt in the water sector is made up of borrowings from the QTC. In addition, participating local governments provided separate fixed rate loans to QUU and Unitywater on their inception in 2010.

Equity includes share capital held by the Queensland Government and the participating councils, transactions with owners (such as dividend payments and return of equity), asset valuation reserves, and retained earnings.

At 30 June 2016, water entities held $13.5 billion in debt, with $9.4 billion attributed to Seqwater (70 per cent). The significant investment in prior years in the SEQ bulk water sector has left Seqwater with a highly geared capital structure (86 per cent at 30 June 2016).

Figure 3I shows a breakdown of the debt held by Seqwater at 30 June 2016.

**Figure 3I**
**Seqwater borrowings at 30 June 2016**

| Facility | Balance 30 June 2016 $000 | % of total debt |
|---|---|---|
| Water grid manager debt | 2 148 880 | 22.8 |
| Drought assets debt | 5 410 472 | 57.4 |
| Non-drought assets debt | 1 861 050 | 19.8 |
| **Total** | **9 420 402** | **100.0** |

*Source: Queensland Audit Office*

The price path set by the minister on advice of QCA in 2015 allowed sufficient revenue to support the commencement of repayment of the water grid manager debt. The next price reset is due on 1 July 2018, and the accuracy of forecasts within the pricing model relating to population growth, demand for water, fixed costs, and other inputs will affect the revenue earned by Seqwater.

The repayment profile for the remaining two facilities are interest-only repayments with no fixed repayment date for the principal component of the debt.

## Events and transactions impacting on debt and equity this year

### Movement in debt

The entities' borrowings across the water sector increased by $91 million in 2015–16.

In 2015–16, Seqwater capitalised interest charges which resulted in an increase of $115.8 million in the level of its debt. The increase in borrowings across the sector was partly offset by SunWater repaying borrowings of $21.75 million in 2015–16. Over the past four financial years, four out of the six entities have repaid debt. The debt held by QUU has remained stable for the last three years.

QUU repaid participating loans totalling $471.3 million to the Brisbane City Council during 2015–16 through refinancing arrangements with QTC.

### Declared dividends

In 2015–16, three water entities made dividend returns of $39 million to the state government using their own cash funds.

SunWater made a provision for a 2015–16 dividend, comprising an additional special dividend of $130 million as directed by the shareholding ministers and a dividend of $29 million (being 100 per cent of the operating profit after tax). This was in addition to a return of equity of a further $130 million in response to a request from the shareholding ministers.

SunWater's financial position has been impacted by the recognition of these payments with less reserves available to meet future unexpected costs. However, cash flow forecasts, which include approved borrowings up to $100 million for 2016–17, indicate that all expenses could be met as and when they fall due. In addition, a letter from the shareholding ministers confirmed that resources would be made available to SunWater to undertake essential capital works and would continue to support the Board of SunWater in achieving its objectives and maintaining a viable and sustainable business.

Consistent with prior years, Seqwater reported an operating loss after tax ($196 million in 2015–16) and, therefore, continues to make no annual dividend returns to the state government.

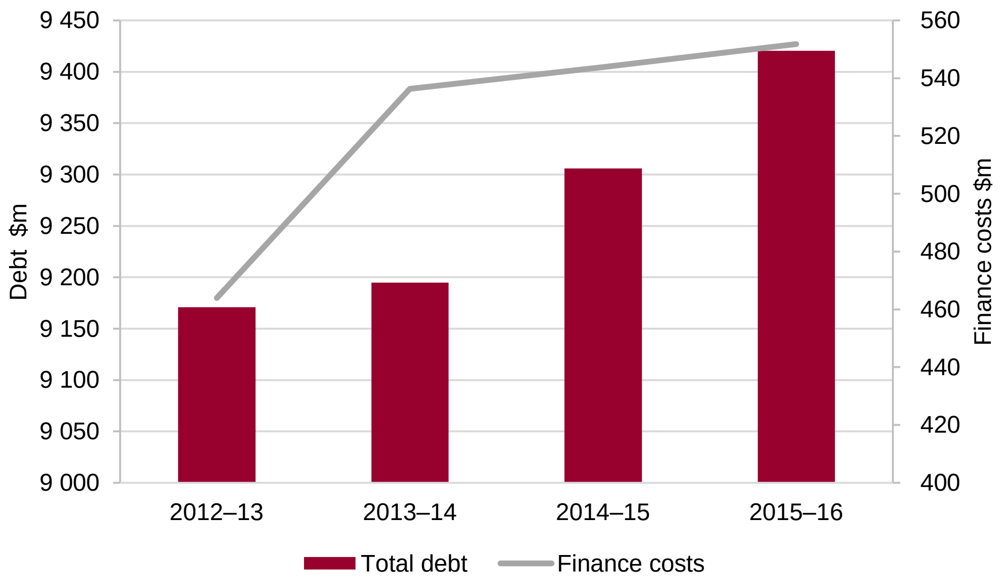
Participation returns are paid by QUU and Unitywater to local governments in accordance with participation agreements based on post-tax operating profits. Total participation returns paid or payable for the 2015–16 financial year amounted to $170.2 million, an increase of $50.3 million from the prior year.

### Debt and liability outlook

The *South East Queensland Water (Restructuring) Act 2007* required Seqwater to operate as a commercial enterprise.

Seqwater's financial performance will continue to be affected by $9.4 billion in borrowings that were used to fund the cost of constructing non-drought assets, drought assets including its manufactured water assets, and the water grid manager debt required to finance operating losses. Figure 3J below shows the level of debt and borrowing costs incurred over the past four financial years.

**Figure 3J**
**Seqwater—debt vs. finance costs**




*Source: Queensland Audit Office*

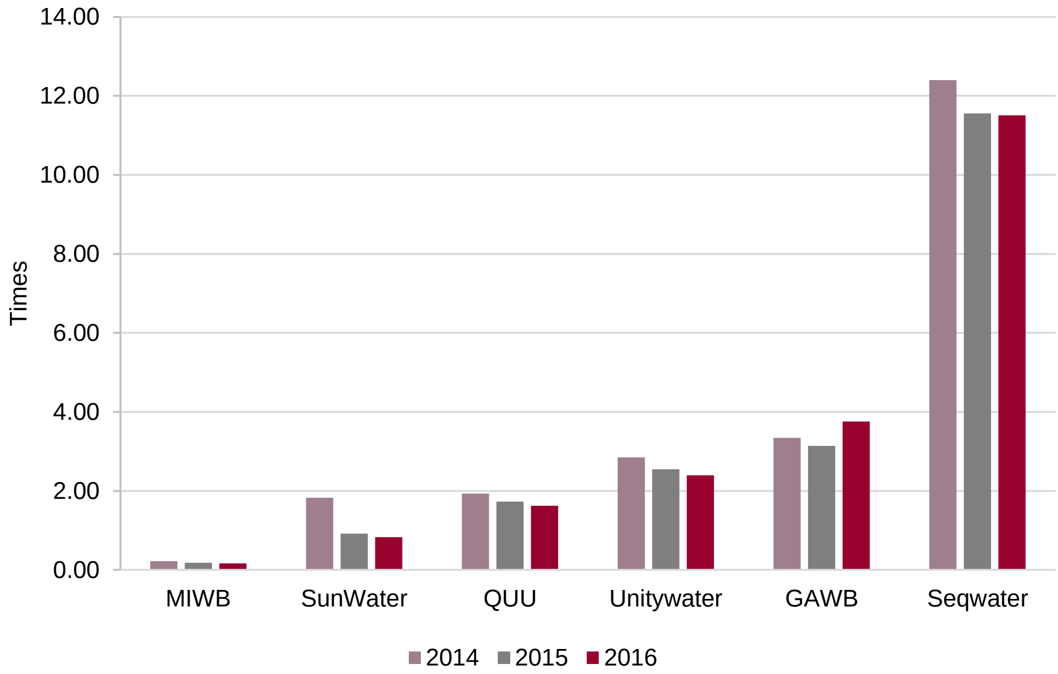
Borrowing costs increased by $88 million (19 per cent) and the level of debt by $250 million (three per cent) since the restructure of the bulk water supply industry in 2013. Furthermore, interest rate movements can affect interest payments and future borrowings if Seqwater is required to borrow to fund ongoing expenditure.

### Debt to revenue ratio

When forming an audit opinion on an entity's financial statements, we assess its ability to continue as a going concern.

As a sector, debt as at 30 June 2016 was over four times revenue in 2015–16, which is consistent with the prior year. Figure 3K shows the debt to revenue ratio for the past three financial years by entity.

**Figure 3K**
**Debt to revenue ratio for water entities**




*Source: Queensland Audit Office*

The debt to revenue ratio assesses an entity's ability to pay the principal and interest on borrowings, as and when they fall due, from the funds that the entity generates. Seqwater continues to have a significantly higher debt to revenue ratio than all other water entities, attributed to the loans it acquired from the merger with other bulk water entities. The loans held continue to be secured by repeated guarantees from the shareholder, meaning that the risk of Seqwater not paying the principal and interest on its loans with QTC is held by the state.

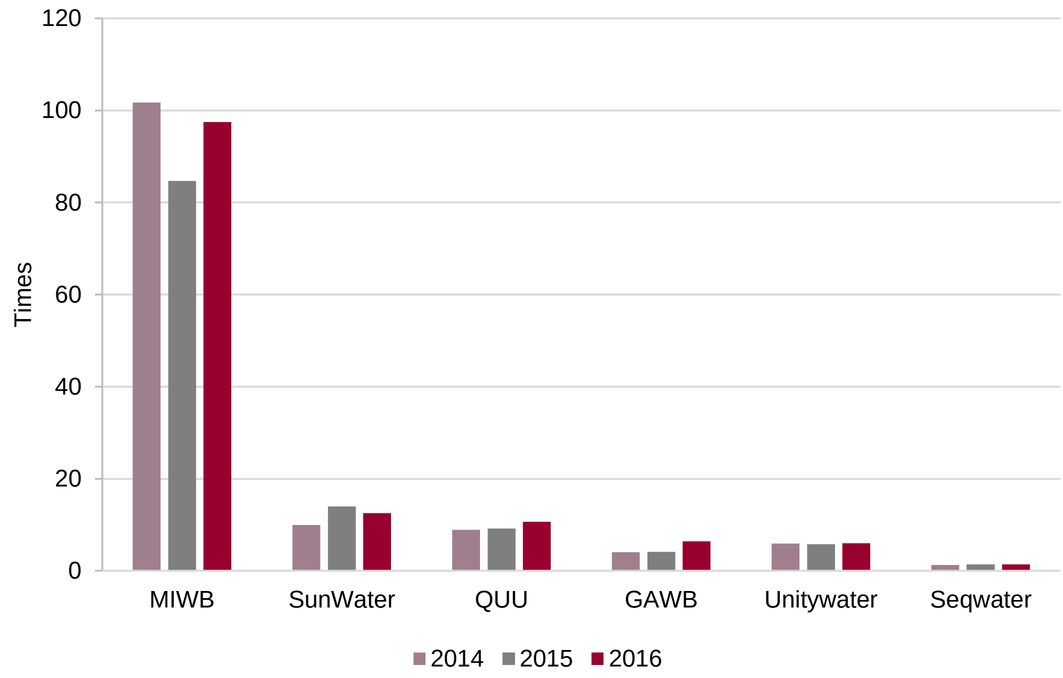
GAWB continues to have the second highest debt to revenue ratio in the water sector. Its loans ($231 million at 30 June 2016) have remained stable for the past three financial years, with a decrease in the amount owing of one per cent since 2013–14.

The majority of loans held with QTC have variable interest rates. Notwithstanding a shareholder guarantee over the payment of loans, the risk of interest rate movements can have a significant impact on interest payments and, therefore, the ability of Seqwater to pay other ongoing operating expenses going forward. In terms of sensitivity, a movement of just 0.1 per cent in interest rates would result in a corresponding increase in borrowing costs of approximately $9.4 million per annum.

## Interest coverage

The interest coverage ratio is a measure of debt sustainability used to determine an entity's ability to pay interest on its outstanding debt obligations from the revenue that it generates. Figure 3L shows the interest coverage ratio for the past three financial years for each entity. Five out of the six entities have maintained an adequate level of interest cover and they continue to generate sufficient cash flows and operating profit to service their debt obligations.

**Figure 3L**
**Interest coverage**




*Source: Queensland Audit Office*

# 4. Internal controls

## Chapter in brief

This chapter details our assessment of the strength of the internal controls designed, implemented, and maintained by water entities to ensure reliable financial reporting.

We assess financial 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.

### Main findings

- We identified deficiencies in the timely recognition of developer contributions at Northern SEQ Distributor-Retailer Authority (Unitywater) and the need for improved quality control processes over the asset valuations at Queensland Bulk Water Supply Authority (Seqwater) and Gladstone Area Water Board (GAWB).
- Unitywater and Central SEQ Distributor-Retailer Authority (Queensland Urban Utilities) rely on third party vendors to provide information technology (IT) services, including network, operating system, database, infrastructure, and IT and application support services. Deficiencies identified at these vendors highlighted the need for these entities to implement effective monitoring over the providers to ensure that they have appropriate controls in place.
- Overall, the number of unresolved control deficiencies has decreased significantly from prior years.
- We did not identify issues with the control environment, risk assessment, monitoring activities, or information and communication elements of the COSO framework.

### Audit conclusions

Our preliminary assessment of the control environment for the entities supported reliance on their internal control systems.

Ineffective controls over asset accounting and asset valuations at three of the six water entities increased the risk of errors in their 2015–16 financial statements. Entities are taking corrective action to resolve these matters.

## Introduction

This chapter evaluates the effectiveness of the internal controls maintained by water entities. The purpose of these controls is to mitigate risks that may prevent an entity from achieving reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations.

As part of our audit, we assess the design and implementation of these controls and, where we identify controls that we intend to rely on, we test how effectively these controls are operating.

If we assess an entity's internal controls as not being well designed, not operating as intended, or missing controls that should be in place, we are required to communicate these deficiencies to management.

By reporting on our analysis we aim to promote a stronger control environment, and to mitigate financial losses and damage to public sector reputation by initiating effective responses to identified control weaknesses.

A summary of our control assessments is provided in Appendix B.

## Conclusion

Our assessment of the control environment for water entities supports our reliance on their internal control systems.

The risk of undetected errors within financial systems and the entities' financial reporting has remained stable from previous years.

The water entities have made some improvements to their internal control systems and in resolving issues raised with management in prior years. However, the significant control deficiency identified at Queensland Bulk Water Supply Authority (Seqwater) had the potential to lead to the value of assets being materially misstated in the financial statements.

Control deficiencies identified at information technology (IT) service providers for Central SEQ Distributor-Retailer Authority (Queensland Urban Utilities or QUU) and Northern SEQ Distributor-Retailer Authority (Unitywater) supports the need for water entities to maintain vigilance over their own control environments. Supplementary controls, which assist them to monitor their transactions, are critical to maintaining the strength of their internal control framework.

## Internal control framework

We assess 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 defines five key components to a successful internal control system. These include the control environment, risk assessment, monitoring activities, control activities, and information and communication.

All of the components need to be present and operating together as an integrated system of internal control. When this is the case, entities reduce the risk of not achieving their objectives.

### Selecting internal controls to test

We assess the design and implementation of each entity's controls to assist us in determining the nature, timing, and extent of testing to be performed.

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 facilitates an efficient audit.

Our initial assessments indicated that we may be able to rely on the financial controls in place at each entity. Our assessment of the effectiveness of each entity's controls relating to each COSO element is detailed in Appendix B.

## Our rating of internal control deficiencies

*Significant deficiency (high risk matters):* a deficiency that either alone or in combination with multiple deficiencies may lead to a material misstatement in the financial statements. They require immediate management action and are reported to those charged with governance.

*Deficiency:* occurs when internal controls are missing or ineffective. Deficiencies may lead to an environment that is not supportive of high quality financial reporting.

We assess all internal control deficiencies based on their potential to cause a material misstatement in the financial statements—either alone or forming part of an environment supportive of effective record keeping.

Our ratings allow management to gauge relative importance and prioritise remedial actions.

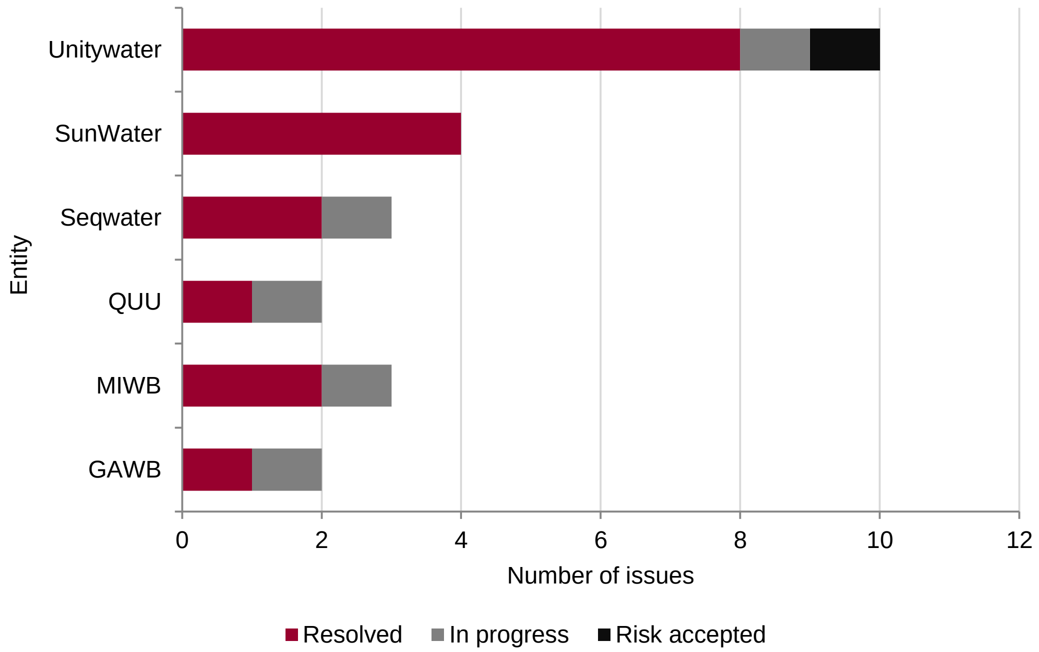
We increase the rating to a significant deficiency from deficiency based on the risk of material misstatement in financial statements, the potential to cause financial losses, or an event causing major business interruptions.

The following sections of this report detail the control deficiencies identified by COSO element. We also consider the appropriateness and timeliness of the remedial action undertaken to resolve audit matters identified.

## Resolution of identified deficiencies

During the last two financial years we identified and communicated to management 24 internal control deficiencies across all COSO elements. Figure 4A shows the status of these issues at 31 August 2016.

**Figure 4A**
**Status of control issues as at 31 August 2016**




Note: Mount Isa Water Board (MIWB), Gladstone Area Water Board (GAWB)

*Source: Queensland Audit Office*

All six water entities either addressed their identified control deficiencies or are on track to do so by the agreed date. This proactive resolution of control deficiencies indicates a strong control environment across the entities.

Those issues where management are taking corrective action include the need to implement improved asset accounting practices, in particular, the need to implement formal processes across entities to validate asset valuation model calculations and inputs.

## Control activities

- Manual controls
- Automated controls

Control activities are policies and procedures that help ensure management directives are carried out and that necessary actions are taken to address identified risks. 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 also be categorised into manual control activities and IT system controls.

### Manual control activities

Manual controls contain a human element, which can provide an opportunity to assess the reasonableness and appropriateness of transactions. These controls may also be less reliable than automated elements because 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 IT systems.

We identified a significant deficiency at Seqwater relating to the lack of quality assurance processes to validate inputs and calculations in their asset valuation models.

We noted deficiencies relating to:

- the need for improved quality assurance processes over asset valuations at Gladstone Area Water Board (GAWB)
- the untimely recognition of developer contributions and the absence of review over monthly reconciliations between the fixed asset register and the general ledger at Unitywater
- weaknesses in customer billing processes at Queensland Urban Utilities (QUU)
- controls over banking processes and the lack of an independent review over journals at SunWater
- employee entitlements, water charges, and inconsistency between internal policies at Mount Isa Water Board (MIWB).

## Information Technology (IT) system controls

IT system controls are the control activities that relate to the maintenance and operational capability of the IT system.

IT system controls can improve timeliness, availability, and accuracy of information by consistently applying predefined business rules. They can enable the performance of complex calculations in processing large volumes of transactions, and improve the effectiveness of financial delegations and segregation of duties.

Effective controls over IT systems can reduce the risk that controls will be circumvented, and maintain the integrity of information and security of data.

Conversely, poorly managed IT system controls can increase the risk of unauthorised access, which may result in the destruction of data or recording of non-existent transactions.

We did not identify any new deficiencies in IT system controls within water entities this year.

Deficiencies were identified at one entity in the prior year in relation to:

- inappropriate access to accounts payable and payroll payment files
- change control procedures
- a lack of review over user access privileges
- management of the delegations of former employees.

We are satisfied that management has implemented all our recommendations during 2015–16 and that these deficiencies have been resolved.

## Information technology service providers

In the water sector, Seqwater, GAWB, MIWB, and SunWater maintain their own IT systems.

QUU and Unitywater, however, rely substantially on third party vendors to provide IT services, including network, operating system, database, infrastructure, and application support services. Our testing over these IT control environments found that controls were suitably designed and generally operated effectively throughout the 2015–16 year.

We noted deficiencies, however, in the strength of passwords, support for changes to user access, monitoring of user access, and physical access controls. The identification of these deficiencies highlights the need for these water entities to implement effective monitoring over service providers to ensure there are appropriate controls in place.

## Control environment

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

The control environment is defined as management's actions, 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.

No control environment deficiencies were identified this year.

## 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 for forming an agreement about how the risks should be identified, assessed, and managed.

Appropriate management of business risks can be achieved either by management accepting the risk, if it is minor, or mitigating the risk to an acceptable level through the implementation of appropriately designed controls. Risks can also be eliminated entirely by choosing to exit from a risky business venture.

We did not identify any deficiencies relating to risk assessment during the year. This indicates that senior management groups have identified the key business risks that their entities face, and they are appropriately managing and addressing them.

## 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 charged with the responsibility to oversee the implementation of controls and resolution of control deficiencies. These two functions work together to ensure that internal control deficiencies are identified and then resolved in a timely manner.

We did not identify any deficiencies in monitoring activities within water entities this year. This illustrates that each entity is appropriately and effectively monitoring its internal control environment.

## 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 they are communicated to internal and external parties to support the functioning of internal controls.

We did not identify any deficiencies relating to information and communication during the year.

## Fraud awareness


Management are responsible for the systems of internal control designed to prevent and detect fraud within their entities.

Suppliers often change bank account details. The payments made to these suppliers during the year can be significant. Annually, we report weaknesses with the controls operating over the integrity of supplier data.

### The scam

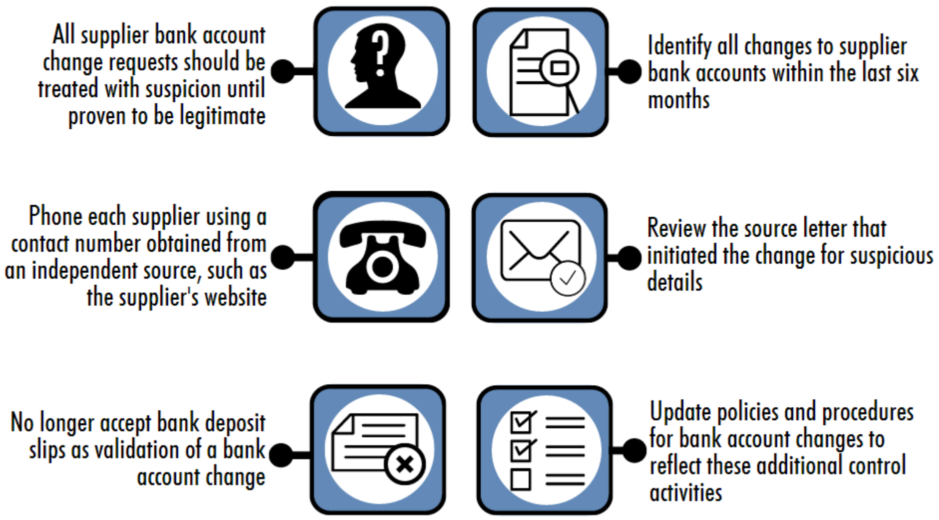
During the financial year, a malicious fraud scheme targeted public and private sector entities. The scammers used fraudulent documents to change an existing supplier's bank account details and divert payments to illegitimate bank accounts.

### Our responsibilities

During an audit, we assess the risk of material misstatement due to fraud and respond by developing specific audit procedures to address the risks identified.

### Our response

In response to the identified fraud scheme this year, we asked all entity chief financial officers to independently verify their supplier bank account details. We recommended entities exercise increased vigilance over new requests to change supplier bank account details.




We also performed targeted procedures over controls for suppliers' bank account changes at all water entities. We used computer-assisted audit techniques to target higher risk bank account changes.

Our testing of internal controls found that controls in this area were operating effectively and appropriate supporting documentation was maintained. Where we challenged the authenticity of a document, no frauds were detected.

Although no further fraudulent payments have been detected, entities need to remain on high alert of this, and other fraudulent schemes, and allocate sufficient resources to their support staff to ensure proper interrogation of documents requesting changes to bank account details.

# Appendices

# Appendix A—Full responses from agencies

In accordance with section 64 of the *Auditor-General Act 2009*, we gave a copy of this report with a request for comment to the Minister for Main Roads, Road Safety and Ports and Minister for Energy, Biofuels and Water Supply; the Director-General, Department of Energy and Water Supply; the Chief Executive Officer, Queensland Competition Authority; and the Under Treasurer, Queensland Treasury for comment.

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

- Queensland Bulk Water Supply Authority (trading as Seqwater)
- Northern SEQ Distributor-Retailer Authority (trading as Unitywater)
- Central SEQ Distributor-Retailer Authority (trading as Queensland Urban Utilities)
- SunWater Limited
- Gladstone Area Water Board
- Mount Isa Water Board.

We provided a copy of this report to the Premier and Minister for the Arts; Treasurer, Minister for Aboriginal and Torres Strait Islander Partnerships and Minister for Sport; and the Director-General, Department of the Premier and Cabinet for their information.

We have considered all views provided to us in reaching our conclusions, and these are represented to the extent relevant and warranted in preparing this report.

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

This appendix contains their detailed responses.

# Comments received from Treasurer, Queensland Treasury

Queensland Government

Treasurer
Minister for Aboriginal and Torres Strait Islander Partnerships
Minister for Sport

Level 38
1 William Street
GPO Box 611 Brisbane
Queensland 4001 Australia
**Telephone** 07 3719 7200
**Email** treasurer@ministerial.qld.gov.au
**Website** www.treasury.qld.gov.au

ABN 90 856 020 239

*Our Ref: 04256-2016*

08 DEC 2016

Mr Anthony Close
Acting Auditor-General of Queensland
Queensland Audit Office
PO Box 15396
CITY EAST QLD 4002

Dear Mr Close

**Water: 2015-16 results of financial audits**

Thank you for the opportunity to provide feedback on the Queensland Audit Office report *Water: 2015-16 results of financial audits*.

I note that unmodified audit opinions were provided on all financial statements for 2015-16 across the water sector.

However, while the Queensland Audit Office concluded that all of the water entities are financially sustainable, the report highlighted Seqwater's significant debt levels, most of which is a direct result of the construction of South East Queensland's (SEQ's) interconnected water grid and climate resilient infrastructure. Both the Government and Seqwater are aware of these financial challenges.

That is why successive Queensland Governments have undertaken periodic price reviews, the most recent of which involved directing the Queensland Competition Authority to recommend prices for the period 1 July 2015 to 30 June 2018. As a result of these price reviews, the Government has in place pricing arrangements for SEQ bulk water that seek to balance the needs of consumers and the avoidance of price shocks, and Seqwater's ability to manage its debt. The Government acknowledges that a credible plan to repay debt is important and, accordingly, policy settings have regard to the repayment of the price path debt by 2028.

SEQ bulk water prices are currently set for three years, with the current period set to expire on 30 June 2018. The next pricing review is expected to commence in 2017, for new prices to take effect on 1 July 2018. This review will address other concerns that were raised in the report regarding water demand being lower than forecast, which has led to a risk of insufficient revenue for Seqwater in the current period.

## Comments received from Treasurer, Queensland Treasury

I also note that the report makes unfavourable mention of Seqwater's financial management reporting and methodology and quality assurance processes regarding the valuation of its assets. Minister Bailey and I will be writing to Seqwater to seek assurances that these issues have been rectified and will not occur again.

Furthermore, the report acknowledges the Debt Action Plan announced as part of the 2015-16 Budget, which included changes to the capital structure and dividend payout ratios of Government Owned Corporations (GOCs), including SunWater Limited.

In developing the Debt Action Plan, the Government undertook a detailed Review of State Finances, and considered the overall efficiency and structure of the State's Balance Sheet.

The Review of State Finances, informed by Queensland Treasury Corporation's assessment and analysis by KPMG, suggested there was capacity to increase the gearing levels of the State's GOCs to more commercial levels. The levels of gearing were set at a level consistent with metrics applicable to a standalone investment grade credit rating, while ensuring the businesses could continue to finance their future capital expenditure needs.

However, the Government was also mindful of the business environment confronting GOCs and considered impacts of regearing on the longer term sustainability of these businesses. The Government decided not to regear a number of the GOCs and commercial statutory bodies, including Port of Townsville Limited and Far North Queensland Ports Corporation Limited.

A key objective for Government is ensuring that the State's GOCs operate as efficiently as possible in order to improve returns and optimise the value of shareholders' significant investment in the entities. In this context, the Government also revised dividend payout ratios with a view to supporting more efficient capital management in the businesses.

As a result of the regearing measures announced in the 2015-16 Budget and Mid Year Fiscal and Economic Review, over $5 billion will be made available to the General Government sector across the forward estimates for debt reduction. This will ensure that the Government is making the best use of its available capital by focusing on reducing General Government debt, as recommended in the Review of State Finances.

The Government will continue to monitor the financial performance and sustainability of the water entities, with a view to ensuring that returns are maximised while ensuring that the entities maintain metrics consistent with an investment grade credit rating.

I trust this information is of assistance to you.

Yours sincerely

**HON. CURTIS PITT MP**
Treasurer
Minister for Aboriginal and Torres Strait Islander Partnerships
Minister for Sport

# Comments received from Chair, Gladstone Area Water Board

Gladstone Area Water Board

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Service Provider: 200

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GLADSTONE QLD 4680

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147 Goondoon Street
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Tel: (07) 4976 3000
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5 December 2016

Mr Anthony Close
Auditor-General (acting)
Queensland Audit Office
14/53 Albert Street
BRISBANE CITY QLD 4000

Dear Mr Close

**Re: Comments on draft report 'Water: 2015-2016 Results of Financial Audits'**

Thank you for your letter dated 17 November 2016, providing a copy of the draft report with respect to the results of financial audits for the Government owned and controlled water entities (**Draft Report**).

Gladstone Area Water Board (GAWB) takes great pride in the production of high quality statutory accounts which are provided in a timely manner. GAWB's management and Board place substantial value on its excellent history around the production of its statutory accounts as being reflective of the sound administration of the business. GAWB is pleased to have received an unmodified opinion for the 2015/16 financial year, confirming that it has complied with the Australian Accounting Standards and relevant legislative requirements, and that GAWB's financial audit was certified within the statutory timelines[1]. GAWB is also pleased that the overall audit conclusion is that *'the water sector maintained their strong record of timely and quality financial reporting*[2].

GAWB strives for continued excellence in its reporting with a view to ensuring GAWB achieves ratings of fully 'Effective' in all areas in future audits (including the present 2016/17 year). GAWB and QAO are working together to resolve the issues raised by 31 March 2017.

The two areas referred to in the Draft Report at Appendix B as being 'Generally effective' relate to 'control activities' (which are part of internal controls) and 'year-end close processes'. Appendix B refers to those items in a general sense; however, as the body of the Draft Report explains, in each case the issues identified by the QAO have arisen out of differing views on the technicalities of GAWB's approach to revaluation of its assets. In particular, they relate to the control activities in place to manage the information included within the asset revaluation and also the timely finalisation of reports taking into account the asset revaluation. In all other aspects of reporting GAWB has been fully 'Effective'.

**GAWB's approach to asset revaluation**

To consider the issues raised in the Draft Report, it is necessary to understand GAWB's approach to asset revaluation. GAWB, like Seqwater, QUU and MIWB records assets at fair value in its financial statements and to do so revisits the amounts recorded each year to reassess the valuation. The Draft Report

[1] Draft Report, pages 1 and 11
[2] Draft Report, section 2, page 12

ISO 9001 Quality Management
AS/NZS 4801:2001 Occupational Health and Safety Management
ISO 14001 Environmental Management
ISO 55001 Asset Management

## Comments received from Chair, Gladstone Area Water Board

acknowledges that the asset valuation methodology can be complex as it involves significant judgments and estimates.[3]

The approach that GAWB has taken in its 2015/16 accounting is consistent with the approach that GAWB adopted to value its assets in the 2014/15 year. As such, the assumptions used by GAWB in its valuation approach are consistent year on year and also consistent with advice GAWB received from independent advisors on specific aspects. In addition, the assumptions used by GAWB in its valuation approach are based on principles endorsed by the Queensland Competition Authority.

The Draft Report indicates that GAWB needs *'to redesign their current discounted cash flow asset valuation models, and implement formal processes to validate their model calculations and inputs'*.[4] The Draft Report reiterates that GAWB needs to consider:

1. a review of inputs, assumptions and calculations used for reasonableness and accuracy; and
2. the need for a significant re-design and improvement to asset valuation models in place.[5]

Given the complexities of asset valuation, it is unsurprising that there are differing views as to the appropriate assumptions to be used when undertaking the asset revaluation for GAWB.

Throughout correspondence and discussion with QAO, we have confirmed that although GAWB considers the model to be accurate, we will review and restructure the valuation model with the assistance of a specialist advisor. GAWB will continue to make such specialist advice available to the QAO as we have in the past, believing that a sensible outcome is more possible when both parties have access to all advice available. QAO has only recently provided GAWB with a copy of the independent advice the QAO has received on asset valuation issues and GAWB is confident it will be able to provide further information to QAO and its advisers to reach alignment as to the appropriate approach to the asset revaluation before the commencement of the 2016/17 audit.

**Year-end close out**

The Draft Report indicates that the timely resolution of key areas such as valuation of assets did not meet QAO's expectations.[6]

As discussed above, GAWB has had ongoing dialogue with QAO extending to both the previous and current audit periods regarding the approach to asset revaluation. GAWB has raised with the QAO that if QAO and GAWB are able to achieve greater clarity as to the process to be followed to reach a resolution of issues regarding the asset revaluation, that will enable the QAO and GAWB to achieve finalisation of the audit in a timely manner.

[3] Draft Report, section 2, page 25
[4] Draft Report, section 2, page 16
[5] Draft Report, section 3, page 25
[6] Draft Report, section 2, page 13

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## Comments received from Chair, Gladstone Area Water Board

GAWB appreciates the steps that QAO has taken following these discussions to release to GAWB the independent advice that the QAO commissioned at GAWB's expense earlier in the year in respect of GAWB's asset valuation. Having now seen that advice, it reveals that QAO's advisors have made assumptions on GAWB's business with respect to, for example, the nature and duration of the contracts with customers. These assumptions are not in all instances an accurate reflection of GAWB's business and may have influenced the opinions formed. GAWB remains confident that if our management is able to meet with QAO and its advisors we will be able to provide information that will enable us to reach alignment as to the appropriate approach to the asset revaluation.

GAWB intends to continue to work with QAO to ensure that any shortcomings in the process regarding the year end are not replicated. GAWB looks forward to achieving the timelines for resolution of the 2016/17 financial year in due course.

**Internal controls – control activities**

So far as control activities are concerned, the Draft Report identifies that there was an absence of quality control processes over the asset valuations[7]. GAWB understands from correspondence with the QAO that the concern the QAO had during the 2015/16 year was that there were errors in the data included within the asset revaluation model calculations and inputs, which is highlighted in the Draft Report as the need for GAWB to *'design and implement formal processes to validate calculations and inputs in the models'*[8] and issues regarding the quality of the spreadsheet used to model asset values.[9]

GAWB acknowledges that there were errors in the input data for the asset revaluation model and is committed to putting in place internal controls to ensure the accurate preparation of the model going forward.[10]

GAWB would like to reiterate the commitment it has made in recent correspondence and discussions with the QAO to ensure that issues identified by the QAO during the 2015/16 audit, and referred to in the Draft Report, are addressed in a timely manner and are not replicated in the 2015/16 audit. To this end, GAWB is pleased to work with QAO to achieve the QAO's target of reaching agreement on all issues regarding the revaluation model by 31 March.

Yours faithfully,

Denis Cook
**Chair**
**Gladstone Area Water Board**

CC: Jim Grayson, Chief Executive Officer
CC: John Orange, Chair Audit Committee

[7] Draft Report, section 4, pages 31 and 34
[8] Draft Report, section 3, page 25
[9] Draft Report, section 3, page 25
[10] Draft Report, section 3, pages 33 and 34

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# Appendix B—Our assessment of financial governance

## Auditing internal controls

In conducting an audit, we assess the design and implementation of internal controls to ensure they are suitably designed to prevent, detect, and correct material misstatements. Where the audit strategy requires it, we also test the operating effectiveness to ensure the internal controls are functioning as designed.

### Internal controls

Our assessment of internal control effectiveness is based on the number of deficiencies and significant deficiencies identified during the audit.

We have categorised each deficiency against the five elements of internal control under the internationally recognised Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework. These elements are:

- control environment—management’s actions, attitudes, and values that influence day-to-day operations
- control activities—policies and procedures that help ensure management directives are carried out and that necessary actions are taken to address identified risks
- risk assessment—management's processes for considering risks that may prevent an entity from achieving its objectives and for forming a basis as to how the risks should be identified, assessed, and managed
- information and communication controls—the systems used to provide information to employees and the ways that control responsibilities are communicated
- monitoring activities—the methods management employs to oversee and assess whether internal controls are present and operating effectively.

A deficiency occurs when internal controls are unable to prevent, detect, or correct errors in the financial statements, or where internal controls are missing.

A significant deficiency is a deficiency that either alone or in combination with multiple deficiencies may lead to a material misstatement in the financial statements. They require immediate management action.

The following table outlines the ratings we use to assess internal controls:

| Rating | Internal controls assessment |
|---|---|
| ● Effective | No deficiencies identified in internal controls. |
| ● Generally effective | Deficiencies identified in internal controls. |
| ● Ineffective | Significant deficiencies identified in internal controls. |

The deficiencies detailed in this report were identified during the audit and may have been subsequently resolved by the entity. They are reported here because they impacted the overall system of control during 2015–16.

# Financial statement preparation

## 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. In January 2014, the Queensland Under Treasurer recommended the completion of five key areas before 30 June each year to enable a timely audit clearance of the financial statements at year end:

- finalising non-current asset valuations
- preparing complete pro forma financial statements
- resolving accounting issues
- completing hard or soft close processes
- concluding all asset stocktakes.

The extent of these key processes and the actual planned dates to perform these processes can vary on the needs of each entity. The target date for completion of these processes should be documented in a financial report preparation plan.

To be effective, year end processes need to be performed in accordance with the financial report preparation plan, and supporting documents made available for audit in a timely manner.

The following table outlines the ratings we use to assess year end close processes:

| Rating | Year end close process assessment |
|---|---|
| ● Effective | All five key processes were completed by the planned date. |
| ● Generally effective | Three of the five key processes were completed within two weeks of the planned date. |
| ● Ineffective | Less than three of the five key process were completed within two weeks of the planned date. |

## Timeliness of draft financial statements

To assess timely draft financial statement effectiveness, we have compared the financial report preparation plan's target date to prepare the first draft financial statements against the actual date acceptable draft financial statements were received by audit.

The following table outlines the ratings we use to assess timeliness of draft financial statements:

| Rating | Timeliness of draft financial statement assessment |
|---|---|
| ● Effective | Acceptable draft financial statements were received on or prior to the planned date. |
| ● Generally effective | Acceptable draft financial statements were received within two days after the planned date. |
| ● Ineffective | Acceptable draft financial statements were received more 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 expenditure, and net assets. Our quality assessment is based on the percentage of adjustments across each of these components.

The following table outlines the ratings we use to assess the quality of the draft financial statements:

| Rating | Quality of draft financial statements assessment |
|---|---|
| ● Effective | No adjustments were required. |
| ● Generally effective | Adjustments for any of the three financial statement components were less than five per cent. |
| ● Ineffective | Adjustments for any of the three financial statement components were greater than five per cent. |

## Result summary

This table summarises our assessment of water entities' internal controls and the financial statement preparation processes across the six entities producing a financial report.

| Entity | Internal controls | | | | | Financial statement preparation | | |
|---|---|---|---|---|---|---|---|---|
| | CE | RA | CA | IC | MA | YE | T | Q |
| **Distributor-retailers** | | | | | | | | |
| Queensland Urban Utilities | 🟢 | 🟢 | 🟡 | 🟢 | 🟢 | 🟢 | 🟢 | 🟢 |
| Unitywater | 🟢 | 🟢 | 🟡 | 🟢 | 🟢 | 🟢 | 🟢 | 🟢 |
| **Bulk water suppliers** | | | | | | | | |
| Seqwater | 🟢 | 🟢 | 🔴 | 🟢 | 🟢 | 🟡 | 🔴 | 🔴 |
| SunWater Limited | 🟢 | 🟢 | 🟡 | 🟢 | 🟢 | 🟡 | 🟢 | 🟢 |
| Gladstone Area Water Board | 🟢 | 🟢 | 🟡 | 🟢 | 🟢 | 🟡 | 🟢 | 🟢 |
| Mount Isa Water Board | 🟢 | 🟢 | 🟡 | 🟢 | 🟢 | 🟢 | 🟡 | 🟢 |

Note: CE = Control environment, RA = Risk assessment, CA = Control activities, IC = Information and communication, MA = Monitoring activities, YE = Year end close processes, T = Timeliness, Q = Quality.

*Source: Queensland Audit Office*

# Appendix C—Glossary

| Term | Definition |
|---|---|
| Accountability | Responsibility of public sector entities to achieve their objectives in reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties. |
| *Auditor-General Act 2009* | An Act of the State of Queensland that establishes the responsibilities of the Queensland Auditor-General, the operation of the Queensland Audit Office, the nature and scope of audits to be conducted, and the relationship of the Queensland Auditor-General with parliament. |
| Australian accounting standards | The rules by which financial statements are prepared in Australia. These standards ensure consistency in measuring and reporting on similar transactions. |
| Australian Accounting Standards Board (AASB) | An Australian Government agency that develops and maintains accounting standards applicable to entities in the private and public sectors of the Australian economy. |
| Capital expenditure | Amount capitalised to the balance sheet for contributions by an entity to major assets owned by the entity, including expenditure on:<br>▪ capital renewal of existing assets that returns the service potential or the life of the asset to that which it had originally<br>▪ capital expansion that extends an existing asset at the same standard to a new group of users. |
| Category 2 water board | Smaller water boards that source and sell water primarily to irrigation customers in designated areas throughout the state. |
| Community service obligations | Government payments to commercial entities to provide services that are not in the entity's commercial interests. |
| Depreciation | The systematic allocation of a fixed asset's capital value as an expense over its expected useful life to take account of normal usage, obsolescence, or the passage of time. |
| Discount rate | Interest rate used to calculate the present day value. |
| Drought assets | Assets that were constructed in response to the Millennium drought, such as the Gold Coast Desalination Plant and Western Corridor Recycled Water Scheme. These assets do not form part of the integral water source and/or core supply of water. |
| 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. |
| Gearing | The level of an entity's debt related to its equity capital. |

| Term | Definition |
|---|---|
| Going concern | Means an entity is expected to be able to pay its debts as and when they fall due, and to continue to operate without any intention or necessity to liquidate or wind up its operations. |
| Impairment | When an asset's carrying amount exceeds the amount that can be recovered through use or sale of the asset. |
| Interest coverage ratio | Revenue generated to Queensland Treasury Corporation interest expense |
| Net assets | Total assets less total liabilities. |
| Net debt | Total Queensland Treasury Corporation borrowings less cash. |
| Terminal value | Terminal value represents all future cash flows in an asset valuation model. In a discounted cash flow valuation, the cash flow is projected for each year into the future for a certain number of years, after which annual cash flows cannot be forecast with reasonable accuracy. At that point, rather than attempting to forecast the varying cash flow for each individual year, a single value representing the discounted value of all subsequent cash flows is used. This single value is referred to as the terminal value. |
| Useful life | The number of years the entity expects to use an asset (not the maximum period possible for the asset to exist). |

*Source: Queensland Audit Office*

# Auditor-General reports to parliament

## Reports tabled in 2016–17

| Number | Title | Date tabled in Legislative Assembly |
|---|---|---|
| 1. | Strategic procurement | September 2016 |
| 2. | Forecasting long-term sustainability of local government | October 2016 |
| 3. | Follow-up: Monitoring and reporting performance | November 2016 |
| 4. | Criminal justice system—prison sentences | November 2016 |
| 5. | Energy: 2015–16 results of financial audits | November 2016 |
| 6. | Rail and ports: 2015–16 results of financial audits | November 2016 |
| 7. | Water: 2015–16 results of financial audits | December 2016 |

www.qao.qld.gov.au/reports-resources/parliament