SUBMISSION TO PUBLIC ACCOUNTS COMMITTEE

ISSUE

The Committee has requested to be informed about:

- The reasons for the Department's cash position generally remaining in overdraft except when customers pay their bills just before year end; and

- Why this situation has only started to occur since the Department commenced operating on a commercial basis.

The inquiry by the Committee is to focus on the findings presented in the audit report (reference Auditor-General's Report to Parliament for the year ending 30 June 2001 - Volume One, Pages 167-173 and Volume Seven, Pages 547-550).

RESPONSE

1. Changes in Cash Position 1998/99 to 2000/01

The Department's combined cash and investment balance first went into overdraft in late September 2000 and remained in overdraft until late May 2001. During this period the average daily overdraft balance was $20M overdrawn with a maximum overdrawn position of $42M incurred in late November 2000. As a result, in February 2001 the Department sought approval from NSW Treasury to operate a permanent overdraft facility of $45M. As a comparison the average cash and investment balance for the same period (October to May) for 1999/00 was $51M per month, while for the same period for 1998/99 was $93M. The reduction in the average annual cash and investment balance since 1998/99 is attributed to the following reasons:

(a) Reduction from 1998/99 to 1999/00 is approximately $50M and is mainly due to:

- Payment of special dividends to NSW Treasury $22M, including $3.5M for City Improvement Project and $4.6M from sale of former Government Motor Services property in 1997/98;

- Payment of Income Tax equivalent payments to NSW Treasury - $12M;

- Payments for capital expenditure on restacking of McKell Building (main office), Y2K rectifications and implementation of the Department's ERP system - $15M.

The effect of these payments has been to reduce the available floating cash balance to cover unpredicted cash flow spikes. The payment for Tax and Dividends for this year was substantially greater than normal due to a change in Accounting Standards which required the Department to write back provisions set aside for job rectification. This significantly increased the payments to Treasury without realising any actual cash benefit for the organisation.

(b) Reduction from 1999/00 to 2000/01 is equivalent to $60M and is mainly due to:

- An increase in debtors balances from client agencies mainly due to delayed payments from clients arising after the Goods and Services Tax (GST) was implemented and disruption to work undertaken and payments from clients caused by changed business practices during the Sydney Olympics in September 2000 - $40M.

- There is a double impact in respect of GST as the amount of the GST on client invoices is required to be paid to the Australian Tax Office by the 21^{st} of the following month, in some cases before the Department is paid for its services - $2M.

- An increase in unbilled work in progress net of advanced claims. The extent of claiming in advance for work done to the end of the current month affects the cash position as DPWS is not a financier but relies on client funds to pay for work undertaken by contractors. At year end net unbilled work in progress was a net credit of $54.7M at 30 June 2000 but had fallen to a net credit of $24.5M at 30 June 2001, a reduction of $30M at year end. Major contributors to this position were the Sydney 2000 Olympics where billings were delayed due to staff shortages as well as the re-engineering of project management responsibilities following the implementation of the new ERP system, resulting in short-term delayed billings.

- In order to improve the Government's relationship with contractors, the Department initiated new contracts which revised contractor payment arrangements. These contracts, called C21, have shorter settlement terms and therefore have contributed to the reduced cash balance. For the 12 months ending June 2001, it is estimated that $300M C21 contracts were entered into which equates to a $6M deterioration in cash position based on one week earlier payment terms. This is not an issue of clients delaying payments, rather, the initial reduction in DPWS' accounts payable balance.

- During this period the Department incurred capital expenditure of $21.5M which, although at the same level as 1999/00, has had a significant impact on cash flow. In comparison, depreciation provided to enable asset replacement has averaged $10.8M. The main reason for the increase is the upgrading of the Department's IT infrastructure including finalisation of the implementation of the new ERP system and purchase of special purpose vehicles for leasing to agencies through StateFleet Services.

In respect of debtors and the GST impact, it should be noted that in a number of cases the delayed client payments were still within DPWS debtor terms but were not as prompt as previously paid (ie move from 15 days to 30 days terms).

2. Current Cash Position - 2001/02

The Department again went into overdraft in September 2001 and remained until the end of January 2002 but the balance has remained positive up to the current date.

As a result of the Department's reducing cash position during 2000/01, a number of strategies were put in place to improve cash flow which has had a beneficial impact on cash balances during 2001/02, particularly during the second half of 2001/02. These strategies and actions comprised:

- A new policy was issued covering debtor terms, collection and follow up procedures to improve debtor control and cash management.

- Individual debtors targets were set for debts exceeding commercial terms ie targets have been set for debts exceeding 60 and 90 days. These targets are reported against on a Division/Group/Business Unit basis. Monitoring of achievement of debtor targets is undertaken by the Executive Finance Committee and the monthly Executive Meeting.

- Additional improved policies for debtors follow up and collection were implemented, including amendment of senior managers' performance agreements, to incorporate debtors targets and a greater focus on detailed follow up and collection was implemented across the organisation. This involved a clear recognition that overdue debtors was not simply a finance issue but rather a general management issue. Therefore all Executives who had a client involvement including up to the level of Director-General when visiting the clients would include on the agenda, if applicable, the issue of overdue debts. Additional effort from all senior managers was required. As an example, a long standing problem was a delay in processing claims by the Treasury Managed Fund (TMF) for the Department of Education and Training (DET) insurance claims whereby DET would not pay the Department until the TMF paid the claim. DPWS directly approached the TMF and helped expedite these claims to improve overdue debtor performance.

- A full-time financial turnaround project team was set up under the control of the Department's Chief Financial Officer with a major focus to improve DPWS' operating performance and cash flow. The results in respect of the latter covered the above debtor strategies and also included improved management of the Department's work in progress.

- A complete review of work in progress was undertaken, including the setting of targets for unbilled work in progress at a Group/Business Unit level. Steps were taken to ensure client billings were promptly issued and delays were eliminated. In addition, a review was undertaken of the Department's cash flow billing procedures for project work where clients are billed in the middle of the month for work to be carried out by month end. This resulted in more clients being included in this strategy, eg the Department of Education and Training condition based maintenance component of the Faculties Maintenance Contract which averages $8M to $10M per month was brought onto the cash flow billing procedure, whereas it previously operated one to two months in arrears.

- All creditors masterfiles were reviewed to ensure that payments were made in accordance with normal commercial terms. In some cases, creditors were requesting payment earlier than normal commercial terms and this was remedied.

The impact of the above strategies has been that the cash balance for the Department's critical cash flow period of October to May has improved from a daily average of $20M overdraft in 2000/01 to $6M daily cash balance in 2001/02.

3. Comparison of All Years - Cash Flow and Debtors

Attached are two graphs depicting:

Tab (1) Daily cash and investment balances 1 July 1998 to 22 July 2002; and
Tab (2) Trade debtors balances 1998/99 to 2001/02.

Re Tab (1) - The graph line for 2000/01 (purple) shows the reduction of the Department's cash position which first went into overdraft in late September 2000 and returned to a positive balance in May 2001. The graph line for 2001/02 (green) depicts an improved cash position, particularly from January 2002 until current where the balance is well in excess of 2000/01 and has remained positive with an average daily balance of $65M.

It is important to note that the Department has an annual cash flow of approximately $1.8 billion which equates to an average of $150M per month. Therefore a delay of one week of billing, one week in advance for contract payments or a delay in client payments can approximate $40M which, due to the cyclical nature of the Department's business, can have a significant impact on the daily cash balance. For the year depicted in Tab 1, the variation between the maximum cash balance and the minimum is between $130M - $150M. This is due to the cyclical nature of our business, particularly the building industry where there is a traditional slowdown over the Christmas/New Year period.

Re Tab (2) - One of the major reasons for the reduction in the Department's cash position was an increase in the level of debtors balances. This is quite evident from the graph with the 2000/01 balances (grey) where debtors significantly increased in September/October/November 2000 and remained high until November 2001 (refer 2001/02 - red). Debtors balances have also been unfavourably influenced by the inclusion of GST (+10%) and inflation over the depicted four year period. It is, however, pleasing to note that debtors balances have reduced since November 2001.

4. Commercialisation of DPWS

In respect of the request from the Public Accounts Committee as to why the Department's cash position went into overdraft when we commenced operating on a commercial basis, the graph at Tab (1) indicates DPWS first went into overdraft in September 2000. However, the Department has operated on a commercial basis since 1992/93 when for the first time it became an off-budget agency and therefore received no recurrent support from Government. At this time the Department restructured its operation and created responsible Business Units, changed to accrual accounting and prepared its accounts on a full commercial basis. The Department was also classified by NSW Treasury as a General Government Non Budget Dependent Agency.

The Department underwent a major business restructure in 1995 when sections of the organisation were transferred to other agencies and businesses from other agencies were also merged with the organisation to form the Department of Public Works and Services (DPWS). The Department's structure was then realigned with the change in business focus to form a cohesive group. This structure has been largely unchanged since 1995. During this time and up to the current date, the Department continued to operate on a commercial basis.

SUMMARY

It is acknowledged that the Department's cash position reduced during late 2000 and went into overdraft and remained until May 2001. Since that date DPWS has incurred periods where the balance has again gone into overdraft but this was at a lower level than the previous year and the balance has been positive since late January 2001. However, there were a number of reasons why the Department went into overdraft and corrective action was taken to remedy these matters.

In view of the size of the Department's cash flow ($150M per month) its average cash balance (1999/00 $66M; 2000/01 $8M; 2001/02 $20M) and the cyclical nature of its business, it is considered there will always be periods during the year (especially December/January) when the Department may go into overdraft. As a result, it was considered necessary to set up a permanent overdraft facility of $45M.

As previously indicated, the Department has incurred considerable capital expenditure in prior years (ERP system, vehicle fleet acquisitions etc) which has averaged $21M per year over the period 1998/99 to 2000/01 but has declined to $11M in 2001/02. During this period, all capital expenditure was funded from internally generated funds. As the main source of funds for capital expenditure is depreciation, which has averaged only $9M - $10M per year, this represents a sizeable shortfall which has negatively impacted on the cash balance. As a result, NSW Treasury has agreed that any special capital expenditure requirements for 2002/03 should be covered by a borrowing program. This particularly relates to funding for the new e-Marketplace for whole of Government procurement and IT infrastructure expenditure required by CCSU for provision of the shared services for client agencies.

In conclusion, the Department considers that sufficient corrective action has been taken to prevent going into overdraft on a permanent basis but believes, because of the cyclical nature of our business, that there will always be periods during the year when the overdraft facility will be required, a position supported by Treasury.

RML 2002/2029

Mr Joseph Tripodi MP
Member for Fairfield
Chairman
Public Accounts Committee
Legislative Assembly
Parliament House
Macquarie Street
SYDNEY NSW 2000

Dear Mr Tripodi

I refer to your letter of 9 July 2002 regarding notification that, pursuant to Section 57(1) of the Public Finance and Audit Act 1983, the Public Accounts Committee is currently inquiring into matters arising from the Auditor-General's reports to Parliament of 2001.

Your letter advised that, included in the matters to be examined, is the issue of the Department of Public Works and Services' cash position remaining in overdraft for most of the financial year and requested that the Committee desired to be informed about:

- The reasons for the Department's cash position generally remaining in overdraft except when customers pay their bills just before year end; and

- Why this situation has only started to occur since the Department commenced operating on a commercial basis.

The inquiry by the Committee is to focus on the findings presented in the audit report.

Attached is a submission covering the requested information from the Department of Public Works and Services.

The contact point for the Department for further information about the submission, if required, is Stephen Mudge, Chief Financial Officer, on telephone (02) 9372-7150.

Yours sincerely

The Hon Morris Iemma, MP
Minister for Public Works and Services