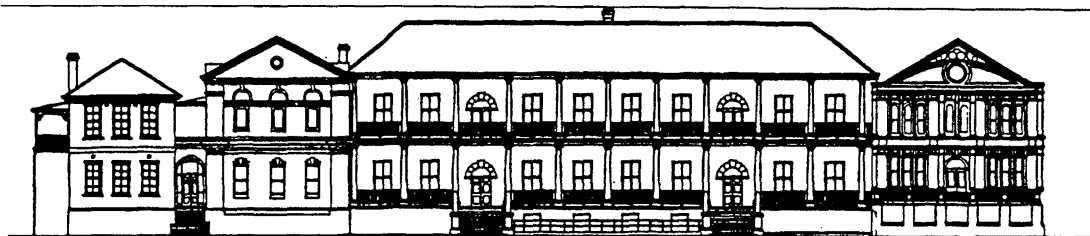




**PUBLIC ACCOUNTS COMMITTEE**

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**MATTERS ARISING FROM  
THE NSW AUDITOR-GENERAL'S  
REPORT 1995**



**Report No. 11/51  
[No. 101]**

**June 1996**

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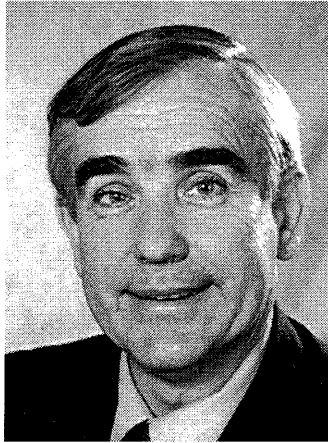
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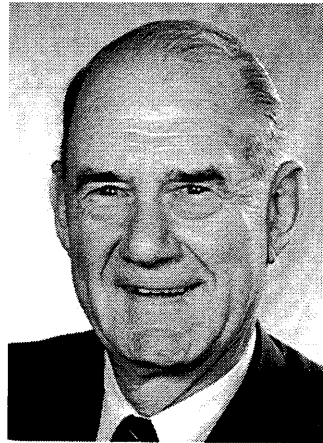
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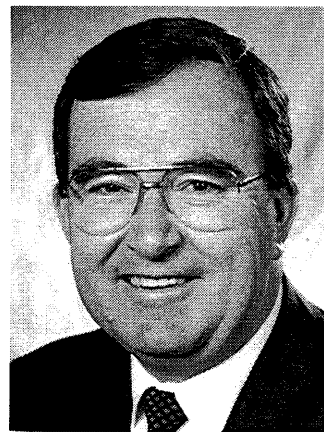
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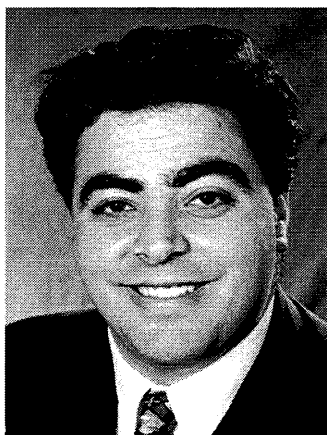
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# MEMBERS OF THE PUBLIC ACCOUNTS COMMITTEE

## **Mr Terry Rumble, FCPA, MP, Chairman**

Terry Rumble was elected Labor Member for Illawarra in March 1988. Before entering Parliament he qualified as an accountant and was employed in public practice and in the coal mining industry. He has served as a member of the Regulation Review Committee and is the Chairman of the Premier's Backbench Committee which involves Treasury, arts and ethnic affairs. Mr Rumble was elected Chairman of the Committee on 24 May 1995.

## **Mr Pat Rogan, MP, Vice-Chairman**

Pat Rogan has been member for East Hills since 1973. He has been active on numerous parliamentary committees in that time including the Joint Committee upon Public Accounts and Financial Accounts of Statutory Authorities. This was the Committee that reactivated a dormant Public Accounts Committee in 1983. Pat Rogan has also served as Shadow Minister for Minerals and Energy with a background as a senior sales engineer in automation.

## **Mr Joe Tripodi B.Ec (Hons), MP**

Joe Tripodi was elected to Parliament in March, 1995 as the Labor Member for Fairfield. Before entering Parliament he worked as an economist with the Reserve Bank of Australia and as a union official with the Labor Council of NSW.

## **Mr Ian Glachan, MP**

The Liberal Member for Albury since 1988, Ian Glachan has had a varied background. He served five years at sea as a marine engineer, was a farmer for ten years, and operated a newsagency in Albury for 18 years. Mr Glachan is also a past president of the Albury-Hume Rotary Club and a Paul Harris Fellow, an active member of the Anglican Church, and was the Legislative Assembly member on the Board of Governors of Charles Sturt University. He was Chairman of the Public Accounts Committee in late 1994 and early 1995.

## **Mr Ray Chappell, MP**

Ray Chappell was elected National Party Member for Northern Tablelands in May 1987. He has worked in university administration and in the building and retail industries, and he served four terms as an alderman on Armidale City Council. During his Parliamentary career Mr Chappell has served as Minister for Small Business and Minister for Regional Development, Shadow Minister, Chairman of several Select Committees and member of the Board of Governors of the University of New England.

# TABLE OF CONTENTS

<b>CHAIRMAN'S FOREWORD</b> .....	<b>i</b>
<b>FINDINGS AND RECOMMENDATIONS</b> .....	<b>ii</b>
<b>A: CROSS-PORTFOLIO ISSUES</b> .....	<b>1</b>
<b>1. The Auditor-General's Statutory Report</b> .....	<b>1</b>
1.1 Qualifications of the 1995 Public Accounts: Overview .....	1
1.1.2 Audit qualifications - are they important? .....	2
1.2 1995 Audit qualifications .....	5
1.2.1 <i>Qualification Point 1:</i> Land under roads and within road reserves .....	5
1.2.2 <i>Qualification Point 2:</i> Accounting for the State's interests in the Sydney Harbour Tunnel .....	7
1.2.3 <i>Qualification Point 3:</i> Government Schools' Bank Accounts .....	10
1.2.4 <i>Qualification Point 4:</i> Adjustment to asset value of \$331 million .....	12
1.2.5 <i>Qualification Point 5:</i> Non-compliance with Australian Accounting Standards ....	16
1.2.6 <i>Qualification Point 6:</i> School buildings - depreciation .....	17
1.2.7 <i>Qualification Point 7:</i> Crown Land nominal valuation of \$1 .....	19
1.2.8 <i>Qualification Point 8:</i> Unpaid salaries at 30 June .....	21
<b>2. Management of monies due to the state</b> .....	<b>23</b>
2.1 Debts written off .....	24
<b>3. Payments without Parliamentary Appropriation</b> .....	<b>27</b>
<b>4. Protected Disclosures</b> .....	<b>30</b>
<b>5. Setting of public sector accounting standards</b> .....	<b>32</b>

## **B. INDIVIDUAL AGENCIES**

<b>6.</b>	<b>Somersby Park Pty Ltd</b> .....	<b>34</b>
6.1	Background .....	34
6.1.1	What were the origins of Somersby Park Pty Ltd? .....	34
6.1.2	Why was it formed? .....	34
6.1.3	Who won the lease to run Old Sydney Town ? .....	34
6.2	Current situation .....	34
6.2.1	The losses .....	34
6.2.2	Changes to the leasing arrangement .....	35
6.2.3	Problems with the lessee on rental payments .....	35
6.2.4	Board's position on the late payments .....	36
6.2.5	NSW Treasury view on Somersby Park Pty Ltd .....	36
6.2.6	The problems with default .....	37
6.2.7	Due diligence by the Board .....	37
6.3	Conclusions .....	38
<b>7.</b>	<b>University of Newcastle Flying School</b> .....	<b>39</b>
7.1	Matter raised in 1995 Auditor-General's Report .....	39
7.2	Background of flying school .....	39
7.2.1	Formation of the Flying School .....	39
7.2.2	The integration of the Flying School into Newcastle University's curriculum .....	39
7.2.3	The University as Board Members .....	40
7.2.4	Closer identification and control by the University of Flying School .....	40
7.3	Financial operations of the Flying school .....	41
7.3.1	Issues contributing to the financial problems of the Flying School .....	41
7.3.1.1	Fees on fixed basis .....	41
7.3.1.2	Malaysian pilots relocate .....	41
7.3.2	Action taken by the University .....	42
7.3.3	University action on management controls .....	43
7.4	Current outcome .....	44
7.4.1	Receivership of the Flying School .....	44

7.4.2	Realised losses .....	44
7.4.3	Overall financial loss to University .....	45
7.4.4	Present situation of Newcastle University .....	45
7.5	Conclusion .....	46
<b>8.</b>	<b>State Rail Authority .....</b>	<b>48</b>
8.1	Background .....	48
8.1.1	Issues raised in the Auditor-General's report .....	48
8.1.2	Identification and Value of Inventories .....	48
8.1.3	The valuation of the SRA's fixed assets .....	48
8.1.4	Further matters raised by the Auditor-General .....	48
8.2	Public Accounts Committee inquiry .....	49
8.2.1	Accounting for inventories .....	49
8.2.1.1	Identification and value of inventories .....	49
8.2.1.2	Qualification of the Auburn Service Centre ...	51
8.2.2	Fixed Assets - Comparative Amounts .....	52
8.2.3	Stock Control .....	52
8.2.3.1	Theft .....	52
8.2.3.2	Hoarding of stock .....	52
8.2.3.3	Obsolescence of stores .....	53
8.2.3.4	Implementation of accrual accounting .....	53
8.2.4	Cost-benefit analysis .....	53
8.2.5	Overtime payments .....	54
8.3	Conclusion .....	56

**APPENDIX: Transcript of evidence, 29 May 1996**



## CHAIRMAN'S FOREWORD

One of the tasks of the Public Accounts Committee is to identify matters in the Auditor-General's report which it believes need to be followed up. In 1995, the Auditor-General published three volumes of his normal report, of which the third appeared in two large parts. It is these volumes which the Committee is following up in the present report.

The Committee has divided its follow-up report for this year into two segments. The first deals with cross-portfolio issues of a more general nature, such as the management of debtors across the public sector. The second deals with particular agencies where a problem has arisen.


Some of the issues raised in this report have been dealt with by the Committee in other reports. The most important one is the lack of suitable accounting standards to cover public-private infrastructure. For some time now, the Committee has been urging that such standards be adopted, and it is disheartening to see the slow progress that has been made by bodies such as the Australian Accounting Research Foundation on this matter.

The Committee would like to take this opportunity to urge those responsible to act with despatch and work toward the preparation of these standards.

The preparation of this report has been a team effort by the staff of the Public Accounts Committee. Part 1 was largely the work of John Lynas, our accounting and auditing adviser, on secondment to the Committee staff from the Audit Office, and Part 2 was largely the work of Kendy McLean. Kendy's work went far beyond that normally associated with the duties of an Assistant Committee Officer, and the Committee is particularly appreciative of her efforts.

The project was carried out under the direction of the Committee's Director, Ms Patricia Azarias, and the Committee appreciates her valuable co-ordination and editing efforts.

Last but not least, I would like to thank my fellow Committee Members, Pat Rogan (Vice-Chairman), Ray Chappell, Ian Glachan and Joe Tripodi, for their hard work and bipartisan spirit.

  
Terry Rumble,  
Chairman

# FINDINGS AND RECOMMENDATIONS

## A. CROSS-PORTFOLIO ISSUES

### *Qualification Point 1: Land under roads and within road reserves*

#### CONCLUSION

The Committee notes the difficulties faced by valuers and accountants in developing a valuation methodology and acknowledges the work completed to date in finalising this matter.

#### RECOMMENDATION

That the accounting for the value of land under roads be resolved as a matter of urgency. If the Public Sector Accounting Standards Board is unable to issue an Australian Accounting Standard to apply for the 30 June 1997 reporting year, then the Committee recommends that the Treasurer issue a Treasurer's Direction to remove any uncertainty.

### *Qualification Point 2: Accounting for the State's interests in the Sydney Harbour Tunnel*

#### FINDING

The absence of a definitive accounting standard to provide authoritative guidance to accountants and auditors is a major deficiency in the standard setting process and has a negative impact on public sector accountability.

This is especially regrettable in that it is now two and a half years since the PAC strongly recommended that work towards such a standard begin, and one and half years since AARF announced that such a project had started.

#### RECOMMENDATION

That the Public Sector Accounting Standards Board act to implement an accounting standard as a matter of urgency. The work should be finished by 30 June 1997. It should cover ONLY an accounting standard for infrastructure.

*Qualification Point 3: Government Schools' Bank Accounts*

**FINDING**

**That the current method of reporting on schools' bank balances and other matters is not satisfactory because it does not ensure full disclosure and therefore accountability.**

**RECOMMENDATION**

**That the status of individual school bank accounts be fully disclosed in the Department's 1996 financial statements.**

*Qualification Point 4: Adjustment to asset value of \$331 million*

**FINDINGS**

**That the Treasury was in error in issuing to the Department a Direction under the Public Finance and Audit Act 1983 to ignore the downward revaluation.**

**The Committee is concerned at the retrospective use of Treasurer's Directions and will be examining the broader question of Treasury's use of its delegated powers for reasons of administrative expediency and other questionable practices.**

**That even if it had been justified in issuing the Direction, the Treasury should not have done so three months too late.**

**RECOMMENDATION**

**That Treasury and the Audit Office schedule early meetings so that problems like this can be resolved before any qualifications have to be issued.**

*Qualification Point 5: Non-compliance with Australian Accounting Standards*

**CONCLUSION**

That, based on the opinion of the Auditor-General, adequate disclosure has been made in the notes to the financial statements. Accordingly, no further action was considered necessary at this time.

*Qualification Point 6: School buildings - depreciation*

**RECOMMENDATION**

That the Department closely monitor the implementation of the new system to ensure deadlines are met and that the new system allows for proper management information systems to be developed.

*Qualification Point 7: Crown Land nominal valuation of \$1*

**CONCLUSION**

The Committee concluded that the State's holding of undeveloped Crown land should be brought to account at a valuation reflecting the value to the community and not at a notional \$1.

**RECOMMENDATION**

That the development of an Australian Valuation Standard for Public Sector Assets be completed as a matter of urgency.

*Management of monies due to the State*

**FINDING**

The Committee notes the high absolute level of debtors and debts written off in the NSW public sector.

### **RECOMMENDATION**

**That the PAC undertake an inquiry into the effectiveness of the management of debtors in the NSW public sector.**

#### *Protected Disclosures*

### **RECOMMENDATION**

**That the costs and funding for protected disclosures be separately disclosed in the State budget papers.**

**Further, the Audit Office should be paid on a fee-for-service basis for work done on protected disclosures in line with the earlier recommendation of the Committee.**

#### *Setting of public sector accounting standards*

### **FINDING**

**The Committee holds the view that departure from an Australian Accounting Standard is not to be treated lightly and should only occur in unusual and infrequent circumstances. If a standard is considered to contain elements not applicable to the public sector, the Accounting Standards Board should be asked to redraft the standard as a matter of urgency.**

## **B. INDIVIDUAL AGENCIES**

### *Somersby Park Pty Ltd*

#### **RECOMMENDATION**

**That Crown law advice be sought on options, if any, available under the lease arrangements. This would then determine the extent to which the State may be exposed to any future liabilities and provide the financial information necessary to gauge the possible costs of altering lease arrangements.**

### *University of Newcastle Flying School*

#### **FINDING**

**It is obvious to the Committee however that the University has since demonstrated that it has learnt from this particular situation. With its tight control over the University of Newcastle Research Associates Ltd, the University has shown that it has both learnt from its experience and is capable of sound management practices.**

### *State Rail Authority*

#### **RECOMMENDATION**

**The Committee regards the accountability of the SRA on these matters as of considerable importance. The Committee recommends that the PAC conduct a review of the SRA in twelve months time in order to follow up action undertaken by the SRA in its financial management practices.**

## **A. CROSS-PORTFOLIO ISSUES**

### **1. The Auditor General's Statutory Report**

Under Division 6 sections 49 to 52 of the *Public Finance and Audit Act 1983*, the Auditor-General has a responsibility to report to Parliament annually on the results of his audit of the consolidated accounts of the Budget Sector. These accounts are termed "The Public Accounts", and they have had to be prepared since the beginning of self-government in this state. The Public Accounts do not include the accounts of public agencies which are not dependent on the state budget, such as Pacific Power or Sydney Water<sup>1</sup>.

It should be stressed that the following discussion covers only the qualifications on the **Public Accounts of the State**. These **Public Accounts** are essentially the result of a consolidation of the accounts of the whole Budget Sector. They are not the individual accounts of each budget sector agency.

This statutory requirement to report on the Public Accounts has two components:

- a requirement to report on the Budget Sector financial statements themselves; and
- a general reporting requirement on significant matters arising from the audit of those financial statements.

#### **1.1 Qualifications of the 1995 Public Accounts: Overview**

The 1995 Audit Opinion on the Financial Statements contains some eight individual points of qualification. These are :

- Land under roads;
- Sydney Harbour Tunnel;
- Government Schools' bank accounts;
- Asset valuation adjustment - \$331 million;
- Assets not previously-recognised;
- Depreciation of school buildings;
- Crown Land nominal valuation; and
- Salary expense-budget adjustment;

These points can be classified into two overlapping categories:

---

<sup>1</sup> The NSW Treasury also prepares Consolidated Accounts for the whole of Government, *including* the non-Budget Sector, but the Auditor-General is not legally obliged to audit these, and, remarkably, they are not tabled in Parliament.

- qualifications based on a difference of views on the application of accounting standards and best practice; and
- particular items in the accounts where, in the opinion of the auditor, the assertions by management are not supported by sufficient evidence to satisfy the auditors' examination.

The eight points are dealt with in turn in Section 1.2 below.

### *1.1.2 Audit Qualifications - Are they important?*

The Committee has heard conflicting views on the significance of these eight audit qualifications. In evidence to the Committee, the Secretary of the Treasury, Mr Michael Lambert, said:

*There are a number of qualifications. There are not many. There are a few qualifications in the Accounts.....*

*I must say, the areas of qualification where we have a difference with the Auditor-General are very limited, and they tend to, and have mainly, reflected different views about interpretation of the accounting standards<sup>2</sup>.*

The Treasury view is that, in other words, there are not many qualifications and they are more technical in nature. They are therefore not particularly important.

For the Auditor-General, however, eight audit qualifications are too many, even if the issues are questions of interpretation of the accounting standards. Such a large number of qualifications makes it difficult for the user of the accounts to obtain useful information from them. At the seminar organised by the Committee to discuss asset valuation, Mr Harris made the following statement:

*In some sense I regard as a failure any qualified opinion which has resulted from a difference of view with management, not data limitations but difference of view in management. It is a failure because we have not been able to convince preparers that they should follow the Accounting Standards as we see them. A difference of view with management is an issue that is really disappointing<sup>3</sup>.*

In further discussing the number of qualifications, Mr Harris advised the Committee that his office was holding discussions with Treasury with a view to reconsidering some of the accounting decisions made in previous years. The aim of these discussions is to reduce the number of audit qualifications on the accounts.

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<sup>2</sup> Evidence to Committee, 29 May 1996 p. 44-45.

<sup>3</sup> Mr A C Harris, NSW Auditor-General, *The Audit view - A True and Fair View*, PAC Asset Valuation Seminar, PAC report No 96, April 1996 p. 20.



*.....the number of qualifications attaching to the Whole of Government report is so large that any further serious qualification would bring into disrepute the Whole of Government accounts. So there is an earnestness, there is an awareness on the part of ourselves and Treasury that we need to get these qualifications down<sup>4</sup>.*

The Speaker of the Legislative Assembly, The Hon. John Murray MP, a former Chairman of the PAC, gave a parliamentarian's perspective on audit qualifications when he addressed the PAC Asset Valuation Seminar held in March 1996. Mr Murray said:

*I believe that the whole basis of public sector financial reporting is open to question if such basic issues.....cannot be adequately resolved. ....As Speaker I believe the Parliament deserves to have this matter resolved in an expeditious manner<sup>5</sup>.*

A private sector perspective on these public sector audit qualifications was given to the Committee by Mr John Shanahan, an audit partner with Deloitte Touche Tohmatsu and an acknowledged expert on technical accounting issues. Mr Shanahan is a member of the Treasurer's accounting advisory panel and has had experience as a consultant on accounting matters at state and federal levels of government. Mr Shanahan advised the Committee:

*Some of the qualifications which appear in New South Wales public sector accounts and various departmental accounts are unfortunate. I have said this to the Auditor-General. At times I find his qualifications are overly technical. At times we have said, "Oh, Mr Harris, that is not really worth the qualification." But he feels one is necessary.<sup>6</sup>*

Mr Shanahan's view comes from a private sector standpoint. In the private sector, accrual accounting has been used for decades, and contentious issues have been resolved long ago. In the public sector, however, contentious issues are still alive because the adoption of accrual accounting is so recent.

There are many issues which are still being addressed by the standard setters, the Australian Accounting Research Foundation. NSW in a sense has "jumped the gun" and has adopted accrual accounting before such issues have been resolved. Indeed, some of these issues have only emerged precisely because NSW has pioneered accrual accounting and reporting.

In view of the apparent conflict as to the significance of the audit qualifications, the Committee received advice from Professor Allen Craswell, Professor of Accounting at the University of Sydney:

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<sup>4</sup> Evidence to Committee, 29 May 1996 p. 48.

<sup>5</sup> The Hon. John Murray MP, *Official opening speech* PAC Asset Valuation Seminar, 16 February 1996, p. 7.

<sup>6</sup> Evidence to Committee, 6 March 1996, p. 62.

*In many cases, audit qualifications arise from uncertainty about the future or the application of accounting standards. Viewed in this light, an audit qualification is not necessarily a bad thing. They provide users of the financial statements with additional information that, in the auditor's professional opinion, is necessary for informed decisions. For this reason, auditors should be encouraged to supplement the information provided by managers by qualifying their reports<sup>7</sup>.*

In a sense, Prof. Craswell's viewpoint diminishes the negative aspect of a qualification, merely asserting that with additional information, the need for a qualification disappears.

The Committee believes that in this transitional phase the public interest is best served by a full and frank disclosure of all the major issues.

Another reassurance provided to the Committee was the fact that a new Australian Auditing Standard on Auditors Reports will be introduced in the 1996 reporting year. This will reduce many of the audit qualifications issued on the basis of uncertainty if there is full disclosure in the financial statements<sup>8</sup>.

Furthermore, the Committee notes that in 1996 the Treasury and the Audit Office will be working together more than they have in the past to reach agreement before the end of the year.

It is therefore to be expected that, in the future, the number of qualifications will decline. The Committee will be monitoring the number of qualifications received by the Public Accounts.

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<sup>7</sup> Professor Allen Craswell, University of Sydney, private briefing to Committee.

<sup>8</sup> Australian Auditing Standard AUS 702 *The Audit Report on a General Purpose Financial Report* issued in October 1995 with mandatory application from 1 July 1996 allows the auditor to refer to an "emphasis on matter" where adequate disclosure has been made in the financial statements. This change in the audit standard allows the auditor to reduce the number of technical qualifications where uncertainty exists.

## 1.2 1995 Audit Qualifications

### *1.2.1 Qualification Point 1: Land under Roads and within Road Reserves*

The Auditor-General and Treasury are not in agreement on the basis for inclusion of RTA-controlled land under roads and within land reserves. The Roads and Traffic Authority *include* such land on their financial statements for an amount of \$14.8 billion however, the Treasury *exclude* this amount when consolidating the RTA's accounts into the Public Accounts of the State and Whole of Government Consolidated Accounts for the New South Wales Public Sector.

The differences of opinion may be summarised as follows:

Organisation	Opinion	Result
RTA	Believes land under roads should be valued according to the average value of a measure of land for each local government area.	Values land under its roads at \$14.8 billion in its own accounts.
Treasury	Believes land under roads is worth a nominal \$1 because it has no alternative use.	Excludes \$14.8 billion (being the value RTA puts on its land) from the Public Accounts.
Valuer-General	Believes land under roads has a greater than nominal value, but is uncertain as to what that value really is.	Not applicable.
Auditor-General	Believes land under roads should be valued as RTA does.	Does not qualify RTA's accounts but does qualify the Public Accounts.

The basis for the RTA's position is that, fundamentally, it controls the land. According to Statement of Accounting Concepts 4 (SAC 4), if any entity controls an asset (in this case, land), as a result of past transactions or other past events, this asset should be recognised in that entity's accounts. SAC 4 says:

*Assets are future economic benefits controlled by the entity as a result of past transactions or other past events..*

The basis for the Treasury's position is that there can be no alternative use for the land under the road, and that therefore its value cannot be measured reliably at this time.

At the Asset Valuation Seminar held by the Committee as part of this inquiry, the Deputy Valuer-General, Mr Garry Kemp, advised the Committee on the current position of the Australian Valuation Standards Board:

*The Australian Valuation Standards Board is currently of the view that they do have a value but at the present time, it cannot be valued reliably. The argument that they should not be valued is based on the fact that roads are one of the major determinants of value to the adjoining land, the value of which is captured in the adjoining land. To value the road is therefore to "double dip"*<sup>9</sup>

The Public Accounts Committee noted the above view of the valuation profession. The Committee came to the conclusion that roads do have value which should be recorded and disclosed by the public sector body that has ownership and control over the road network. Mr Kemp further advised the Committee:

*Roads are obviously an asset. We spend millions a year on building them, maintaining them and making them safe. They make it possible for the community to function. They are an asset and therefore they should be valued*<sup>10</sup>.

The Australian Accounting Research Foundation has addressed the issue of accounting for land under roads in the context of local governments, government departments and financial reporting for the whole of government. The Public Sector Accounting Standards Board has concluded that land under roads *is* an asset and *should* be included in both the financial statements of governments and the road authorities they control. The Board proposes that transitional provisions be implemented in the process of land valuation. This will allow the resolution of practical issues in developing a methodology to measure the value of the land in a manner acceptable to all interested parties<sup>11</sup>.

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<sup>9</sup> Mr Garry Kemp *Current Issues in the Valuation of Assets* Public Accounts Committee Asset Valuation Seminar 16 February 1996, p. 76.

<sup>10</sup> op. cit. p. 76.

<sup>11</sup> Australian Accounting Research Foundation briefing paper dated 4 April 1996, made available to the Committee and acknowledged with thanks.

**CONCLUSION**

**The Committee notes the difficulties faced by valuers and accountants in developing a valuation methodology and acknowledges the work completed to date in finalising this matter.**

**RECOMMENDATION**

**That the accounting for the value of land under roads be resolved as a matter of urgency. If the Public Sector Accounting Standards Board is unable to issue an Australian Accounting Standard to apply for the 30 June 1997 reporting year, then the Committee recommends that the Treasurer issue a Treasurer's Direction to remove any uncertainty.**

***1.2.2 Qualification Point 2: Accounting for the State's interests in the Sydney Harbour Tunnel***

Accounting for the State's interest in the Sydney Harbour Tunnel has been a major issue in public sector accounting in New South Wales. For some three years, the Public Accounts of the State have received a qualified audit opinion because the Auditor-General has a different view from those of Treasury and the RTA as to the appropriate accounting treatment for the transaction.

Organisation	Opinion	Result
RTA	RTA does not own Tunnel, because it does not carry most of the risks. It merely has a right to receive the asset in 2022, the year the agreement ends. This right to receive the asset has a Present Value of \$434m at 30 June 1995.	RTA includes in its Financial Statements only the Present Value of the right to receive the asset, that is \$434m. It does not include the cost of construction, land resumption, financing and so on.
Auditor-General	RTA does own the Tunnel, because it does carry the risks. It should therefore include <i>all</i> the value of the Tunnel, that is, \$667m.	RTA should include the total cost of the Tunnel in its Financial Statements, that is \$667m.
Treasury	Agrees with the RTA.	Treasury includes the Tunnel on a rights to receive basis at \$434m.

The Sydney Harbour Tunnel was the first of a wave of infrastructure assets where the financing and construction were undertaken by a mix of public and private sector interests. Due to the complexity of the financial arrangements which involved consideration of taxation and Loan Council requirements, in addition to finance arrangements, considerable debate has ensued as to the appropriate accounting treatment to ensure transparency. Resolution of the issue has been complicated by the lack of a definitive accounting standard to give authoritative guidance on the matter.

Indeed, it would be true to say that the disagreements are likely to continue until a proper standard is established.

In an earlier PAC report,<sup>12</sup> the lack of an applicable accounting standard was identified as a major problem in accounting and reporting on the financial operations of these complex large - scale business operations. The Committee reviewed existing accounting standards to assess whether the financial disclosure requirements were adequate for these operations. The Committee found<sup>13</sup> that not only were the existing standards inadequate

<sup>12</sup> PAC report 80: *Infrastructure Management and Financing in New South Wales, Vol. 2 Private-Public Partnerships- Risk & Return in Infrastructure Financing*, February 1994.

<sup>13</sup> Ibid. p. 166, *Lack of Accounting Standards*

but that a completely new accounting standard was required. This was considered preferable to amending existing standards.

In November 1994, the Australian Accounting Research Foundation announced that a project had commenced to study the implications to both public and private sector entities that are parties to joint private/public sector arrangements. The scope of the project would include the recognition, measurement and disclosure issues in respect of these arrangements.<sup>14</sup>

The Committee was most concerned to note that at June 1996 the proposed standard was still in the very early stages of development. This is a matter of considerable importance to the Australian economy as a whole, to the interest of the States, and to the accounting profession generally. It is urgent that the matter be resolved as quickly as possible.

#### **FINDING**

**The absence of a definitive accounting standard to provide authoritative guidance to accountants and auditors is a major deficiency in the standard setting process and has a negative impact on public sector accountability.**

**This is especially regrettable in that it is now two and a half years since the PAC strongly recommended that work towards such a standard begin, and one and half years since AARF announced that such a project had started.**

#### **RECOMMENDATION**

**That the Public Sector Accounting Standards Board act to implement an accounting standard as a matter of urgency. The work should be finished by 30 June 1997. It should cover ONLY an accounting standard for infrastructure.**

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<sup>14</sup> *Private sector involvement in the public sector AARF & AASB Report*, Australian Accounting Research Foundation, Melbourne, November 1994, p. 3.

During 1996-97 the Committee will be further considering these matters with the aim of making a major recommendation on the shape and content of the new Standard.

### ***1.2.3 Qualification Point 3: Government Schools' Bank Accounts***

The third qualification relates to the non-inclusion by Treasury in the Public Accounts of the State of some \$194 million held in government schools' bank accounts at 30 June 1995.

The Department of Education does not include in its financial statements cash held in local school bank accounts. The Committee noted that at 30 June 1995 the cash held in various bank accounts (principally in the Commonwealth Bank) for local schools amounted to some \$194 million (\$210 million at 30 June 1994).

In contrast, the Department of Health in its financial statements did include trust and other moneys held by individual hospitals (\$50.9m as at 30 June 1995) These were in turn consolidated into the Public Accounts of the State.

The Committee heard evidence from Treasury officials on this apparent inconsistency in accounting policy:

*Treasury: In schools we do not consolidate in financial statements accounts of the individual schools....In the hospital system area health services are treated as part of the system, and we consolidate those and they incorporate in their constituent hospitals. It is a question of defining what is the reporting indicator for the purposes of State financial reporting consolidation....<sup>15</sup>*

*We are not consolidating down to school level because we basically find the reporting entity exists to the Department of School Education and not down to individual schools, so we do not consolidate the actual cash balances.<sup>16</sup>*

It is estimated by the Department of School Education that to upgrade the standard of bookkeeping and accounting within individual schools would cost millions of dollars. This appears to be a main reason why it is not done.

This does not appear logical to the Committee. In fact, the Committee doubts that the figure would be so high. Figures are already prepared and audited at local school level. The only extra work involved would therefore appear to be a consolidation, a task which computer-based accounting systems should render quickly and easily.

It may be administratively inconvenient and costly for the reporting entity to extend down to the individual school, but the Committee considers it is the only way for proper

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<sup>15</sup> Evidence to Committee, 6 March 1996 p. 70.

<sup>16</sup> Ibid. p. 72.



accountability to be achieved. In addition, only this level of reporting is satisfactory under accrual accounting.

The Committee questioned officers from the Department of School Education on the source and ownership of money held in school bank accounts:

*Department: Schools are treated separately from the department's accounting records, and report on a cash basis. They are not part of the accrual accounting exercise implemented by the Department. The only things that are not included (in the Departments financial statements) are school -raised incomes and school bank balances...*

*Committee: Who owns the money?*

*Department: It is public money; definitely public money.*

*Committee: But who owns it, you or the school?*

*Department: We contend that the school owns it. A lot of the money has been generated through community sources, but we still deem all money that resides in a school bank account to be public money.*

### **FINDING**

**That the current method of reporting on schools' bank balances and other matters is not satisfactory because it does not ensure full disclosure and therefore accountability.**

### **RECOMMENDATION**

**That the status of individual school bank accounts be fully disclosed in the Department's 1996 financial statements.**

The Committee commends the excellent work done by local school communities in raising and allocating funds for the local schools. The Committee is aware of community concerns that consolidation may be a prelude to a central "take-over" of locally-raised funds. However, the Committee wishes to stress that its recommendation is not intended in any way to limit any local school's access to the funds it has raised. The Committee's recommendation is made for accounting purposes only, to improve accountability to the broader community. The Committee believes that full and frank disclosure in the

accounts is the best protection any local community can have against any potential central "take-over".

*1.2.4 Qualification Point 4: Adjustment to asset value of \$331 million*

This qualification arises from a disagreement on the accounting treatment for the very large downward adjustment of the book value of land at the Royal North Shore Hospital in Sydney.

By way of background, it should be pointed out that when accrual accounting was introduced to the Health Department and the Area Health Services in 1989, the accounting policy in place provided that all long-term assets had to be revalued on a commercial basis. That is, they had to be valued using commercial criteria.

In 1995 there was a change in accounting policy. Now long-term assets have to be revalued according to their value in use. That is, a hospital on a site has no alternative or commercial use. It cannot be anything else but a hospital and should be valued as such.

This change in accounting policy led to a large downward revaluation of Royal North Shore Hospital. In 1995, the Valuer-General, implementing the new policy during his regular revaluation, valued the hospital at \$331m less than its previous valuation.

Part of the drop could be attributed to the fall in real estate values in the area at the time. Two parcels of State Rail land at St Leonards, adjoining the hospital, were sold in 1990 for residential and commercial redevelopment at significantly higher prices in 1990 than would have been the case in 1995:

*Valuer-General: The site that was sold by State Rail for something like \$65 million has since been sold recently for \$15 million. That is a fairly dramatic example of how . . . . values (change)<sup>17</sup>.*

Pointing out the change in policy, the Valuer-General also told the Committee:

*Valuer-General: ....we made a valuation on the assumption that it would be a commercial site ...which was the way it was required to be done at the time, and currently it is valued on its existing use. I think it is now being brought to its proper valuation and accounting methodology.<sup>18</sup>*

The Treasury was reluctant to disclose such a large downward revaluation because under AAS10 "Accounting for the Revaluation of Non-Current Assets", the \$331m would have

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<sup>17</sup> Evidence to Committee, 6 March 1996 p. 18.

<sup>18</sup> Evidence to Committee, 6 March 1996 p. 17.

had to be recorded as an expense in both the Department's and the Public Accounts. The Treasury felt that such an expense was undesirable because it would have increased the State's deficit by \$331m. The Treasury reasoned that nothing had changed – the hospital was the same, the land was the same, and hospital operations were unaffected. The expense of \$331m, in other words, did not result from any additional hospital operations, but only from a book entry. The Treasury felt that recording it as an expense would constitute a distortion:

*Treasury: In our view, that would have distorted the financial accounts so we looked at that closely because of its materiality and formed a view on it that was based on our view about what is true and fair<sup>19</sup>.*

The Audit Office, however, held the stricter view that AAS10 should be complied with, and that the decrease in value of \$331m *should* be shown as an expense. The Auditor-General advised the Committee:

*Auditor-General: The standard says when you revalue and you get a decrement.....you take it to the expense account, and that is the way KPMG read it.*

Mr Lambert went on:

*Mr Lambert: The auditor certainly had a particular view. We had a contrary view to that but in the end Treasury is responsible for accounting policy in New South Wales and we advise the Treasurer.....<sup>20</sup>*

The Director of Accounting Policy at Treasury advised the Committee on the aspects of accounting policy relevant to this case as follows:

*Treasury: ...we did not believe that it should go through the profit and loss statement because it had no impact and that it did not relate to the operations of the organisation in that year.....Our view is that it was an error in the valuation method of the agency rather than contravention of any accounting standard.....<sup>21</sup>.*

The General Manager, Financial and Commercial Services, Department of Health, Mr Ken Barker, said that this and similar adjustments should be made against the operating statement in line with commercial practice, and in compliance with generally accepted accounting principles:

*Mr Barker: I have a view that we should account for them in line with the accounting standards and process that through the operating statement as we were going to do with the Northern*

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<sup>19</sup> Evidence to Committee, 29 May 1996 p. 45.

<sup>20</sup> *ibid.*, p. 45.

<sup>21</sup> *ibid.*, p. 69.

*Sydney one.....Treasury issued us a direction. (The adjustment) was to be shown against equity.*<sup>22</sup>

Each side has valid arguments. However, the Committee is forced to conclude that an Australian Accounting Standard must be complied with, however inconvenient the results.

Although the Treasury may have had a valid argument, it erred in issuing to the Department in *October 1995* (that is, a full three months after the 1994-5 accounts had closed) a Direction under Sections 9(2)(n) and 45E of the *Public Finance and Audit Act 1983*. This Direction reversed the Department's original accounting entries which recognised the asset write-down as an abnormal item. In other words, the Treasury was seeking, three months late, to impose its own standard of reporting on the Department of Health, in opposition to AAS10.

#### **FINDINGS**

**That the Treasury were in error in issuing to the Department a Direction under the *Public Finance and Audit Act 1983* to ignore the downward revaluation.**

**The Committee is concerned at the retrospective use of Treasurer's Directions and will be examining the broader question of Treasury's use of its delegated powers for reasons of administrative expediency and other questionable practices.**

**That even if it had been justified in issuing the Direction, the Treasury should not have done so three months too late.**

The question of timing was raised. The Health Department had commenced implementation of accrual accounting in 1989-90 and the revaluation in question was part of its three year cyclical revaluation of land and buildings. The Department held the view that, due to the ongoing nature of the revaluation process for the whole of the Department's property portfolio, in the normal course of events property values would fluctuate on a regular basis:

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<sup>22</sup> *ibid.*, p. 40.

*Mr Barker: There is the potential for that sort of thing this year and next year because in valuing its assets Health took three years to implement accrual accounting. Therefore we have different entities each three years re-doing their asset valuations<sup>23</sup>.*

Another important issue raised by the Health Department is that hospitals do close and transfer operations to new sites and consequently old redundant sites are sold:

*Mr Barker: ...if you went back 10 years , people at the “Kids” hospital at Camperdown may have said they were always going to stay at Camperdown. We now know they are out at Westmead and the Camperdown property is now being disposed of.<sup>24</sup>*

The Auditor-General advised the Committee that the audit in question was contracted out to KPMG Peat Marwick, a Big 6 international firm of accountants. The contract auditors had themselves accepted the treatment proposed by the Health Department and advised the Auditor-General to sign the independent audit opinion.

In further discussing the underlying transaction, the Committee concluded that the revaluation came about as a result of a change in policy and not as a result of correcting an initial error:

*Committee: I think Treasury might have been a little lenient in just saying” We will pass it off as a mistake in valuation and not worry about it too much.” It is a pretty big mistake, \$331 million.*

*Auditor-General: Yes, but it was not. The answer was the change in valuation to an in-use valuation from a different form of valuation. It was not a mistake like someone putting the wrong figure on a piece of paper.*

*Committee: I see your point. It was a deliberate change?<sup>25</sup>*

In discussing the matter with the Auditor-General, the Committee found itself facing an impasse in that the auditors and accountants could not agree on a treatment that was acceptable to both sides. The Committee recalled the earlier advice from Professor Allen Craswell to the effect that qualification ensures that additional information is brought to the attention of the users of the report. It is unfortunate that in this particular case the heat generated in the argument seems to relate to the question of compliance with accounting and auditing standards.

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<sup>23</sup> Evidence to Committee, 6 March 1996 p. 40.

<sup>24</sup> *ibid.*, p. 40.

<sup>25</sup> *ibid.*, p. 80.

## RECOMMENDATION

**That Treasury and the Audit Office schedule early meetings so that problems like this can be resolved before any qualifications have to be issued.**

### *1.2.5 Qualification Point 5: Non-Compliance with Australian Accounting Standards*

This qualification point arises due to the requirement in Australian Auditing Standards<sup>26</sup> that non-compliance with a standard requires an automatic audit qualification. This may be even though the auditor is satisfied that there is full disclosure and the users of the financial report have sufficient details to adequately assess the impact of the particular transactions.

AUS 702.45 says:

*Where there has been a departure from an Accounting Standard . . .the Auditor shall express a qualified opinion.*

To comply with AAS 1 *Profit and Loss or Other Operating Statements* it would be necessary for Treasury to bring to account as revenue the value of items brought to account for the first time. However, in the Public Accounts, the Treasury bring to account as an adjustment, in other words as an abnormal item, the value of an asset when they bring it to account for the first time.

The Auditor-General is therefore obliged by AUS 702 to qualify the Public Accounts. This is why the qualification appears in Volume 3 of his report (p.49). However, he does so reluctantly because he agrees with the Treasury's practice of first bringing assets to account as an adjustment. Together with the Treasury, he believes that to do otherwise (that is, to bring the assets to account as income) would be misleading. This is because the assets are simply not income, as can be seen from the table below.

Accrual accounting requires that all assets be brought to account. This has been done progressively in NSW over a number of years. When AAS 1 was developed, it was never envisaged that organisations using AAS 1 would progressively implement accrual accounting over a number of years.

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<sup>26</sup>

AUS 702

## *Cross-portfolio issues*

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The following table shows the items brought to account for the first time in each of the last two financial years:

Item	1995	1994
RTA land acquired for future road works	\$292m	\$964m
Water Resources - Land under Infrastructure assets	Nil	\$113m
TAFE Land Buildings and equipment	Nil	\$53m

### **CONCLUSION**

**The Committee concluded that, based on the opinion of the Auditor-General, adequate disclosure has been made in the notes to the financial statements. Accordingly, no further action was considered necessary at this time.**

The Committee has not made a recommendation on this point.

#### *1.2.6 Qualification Point 6: School Buildings - depreciation*

This qualification relates to the audit view that the lack of appropriate systems meant that the carrying value and depreciation charges in the accounts have not taken into consideration the following factors: condition of individual assets; maintenance and re-furbishment regimes; or estimated economic lives.

The Department of School Education advised the Committee on the value of school buildings:

*Department: We regard the buildings as having a \$10 billion replacement value and a written down value of about \$7 billion, and the sites are worth about another \$3 billion. On top of that we have 6,000 units of demountable accommodation which regularly moves..... The demountable stock is worth \$500 million to replace.<sup>27</sup>*

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<sup>27</sup> Evidence to Committee, 6 March 1996 p. 49.

The Committee was concerned to note that it took the externally imposed introduction of accrual accounting to force the Department of Education to improve the quality of its data on the condition and value of its asset base. The Department advised the Committee:

*Department: The problem the Department of School Education faced in endeavouring to value its assets and appropriate depreciation component was that it really did not have a very comprehensive and descriptive inventory of all its assets. It had assets by schools and by floor area but not by condition and method of construction.<sup>28</sup>*

The Committee was also concerned to note the following frank admission from the Department:

*Department: There is an asset register today...it is not sufficiently comprehensive for good management decisions but we do know with some high degree of accuracy now the condition of our assets<sup>29</sup>.*

The Committee was pleased to note however that a new asset management system was due to be placed on-line by the Department in April 1996. The Department advised the Committee on the following highlights of this system:

*Department: The first phase of it comes on-line next month: an asset management system which will give us very accurate data on our sites; anything that affects those sites.... Within another 12 months we will be in a position where every school in New South Wales will have a very comprehensive graphical and written set of data .....It will be the system on which asset management is carried out. We think that it is a fairly major achievement because it is a very large portfolio of property.<sup>30</sup>*

The Committee indicated to the Department that it has an ongoing interest in this matter and will read with interest future reports by the Department and the Auditor-General on this and other related matters.

### **RECOMMENDATION**

**That the Department closely monitor the implementation of the new system to ensure deadlines are met and that the new system allows for proper management information systems to be developed.**

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<sup>28</sup>     *ibid.*, p. 46.

<sup>29</sup>     *ibid.*, p. 48.

<sup>30</sup>     Evidence to Committee, 6 March 1996 p. 48.



*1.2.7 Qualification Point 7: Crown Land nominal valuation of \$1*

The Auditor-General has issued a qualification on the Public Accounts based on the inclusion of undeveloped Crown Land at a valuation of a nominal one dollar. The State controls a substantial amount of undeveloped Crown Land. The orderly release of this land generates a sizeable amount of revenue to the State through the sale of Crown Land home sites program (mainly urban land) and the Crown Land development program (mainly non-urban land). The Public Accounts of the State show<sup>31</sup> that for the past two financial years, gross sales of Crown Land have enabled the following distributions to be paid to the Consolidated Fund:

Sales of Crown Lands	1994/1995 \$m	1993/94 \$m
Crown Land Home sites	22.9	37.3
Land Development	10.1	9.4
Total	33.0	46.7

Source: Public Accounts of the State, table 4 - 1994/1995 and 1993/1994

The Committee further considered the issues involved in the inclusion of Crown Land and the value to be placed on the land. It was obvious to the Committee that the valuation to be placed on the land should not involve short term commercial values subject to the fluctuations of the economic cycle.

At the Asset Valuation Seminar held by the Committee as part of the inquiry into Accrual Accounting, the Deputy Valuer-General gave this interesting example of the effects of the economic cycle and current short-term trends in property investments.

*Mr Kemp: In 1988, the total land value for the City of Sydney was \$ 15 billion and in 1992, it was \$5 billion. So that is the effect of the recession.....<sup>32</sup>.*

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<sup>31</sup> The introduction of accrual accounting in the NSW budget sector has allowed for the financial operations to be disclosed in the accounts on an accruals basis. In 1994/95 and 1993/94 the accounts were prepared on a part accruals basis and paid a dividend to the Consolidated Fund entity. In previous years, that is up to 1992/93 the land sales operations were brought to account on a cash basis with the gross sales recorded on a cash basis.

<sup>32</sup> Proceedings of *Seminar on Asset Valuation in the Public Sector*, NSW Parliament House, 16 February 1996, p. 102.

The Committee, being aware of the substantial swings in market values, considered other bases for valuation that would withstand short-term market fluctuations. The Valuer-General advised the Committee:

*Valuer-General: I think what is really essential is to assess the development potential of the Crown Land and to bring that to account. One of the major problems with the Crown Estate is that an enormous amount of it is subject to native title claims and until such time as those native title claims are resolved it is very difficult to assess what potential the land would have.<sup>33</sup>*

The question of the appropriate valuation to be placed on Crown Land or on other government controlled land was considered by the Committee. The Committee realised that including the value of long term land holdings at current market rates would be misleading and would be unlikely to provide any reliable information. The Committee considered expert evidence from the Valuer-General.

The Committee has considered the need for suitable criteria against which the valuation process can be measured. To be effective and reliable, the valuation process should be able to be benchmarked against a readily understood and accepted criteria. There is a need for such criteria to be incorporated into a set of standards against which individual valuations can be compared.

The Valuer-General advised the Committee on the work that has been done in the past ten years by the Australian Institute of Valuers and Land Economists. This deals with the development of a written code of ethics for valuers and the development of a series of valuation standards that would be applicable to both the public and private sectors:

*Valuer-General: A number of these standards have been issued, primarily those on mortgage valuations, valuations of commercial property and valuation of residential property. We are currently working on the standards for valuation of public sector property<sup>34</sup>.*

The Committee is pleased to note that a valuation standard for public sector assets is now being developed, and recommends that the standard be finalised as a matter of urgency. However the Committee acknowledges that there are practical difficulties with evaluating some public land.

The Committee noted the absence of a definitive standard for valuing public sector assets including undeveloped Crown Land. The Committee pursued with the Valuer-General an acceptable methodology by which Crown Land could be valued:

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<sup>33</sup> Evidence to Committee, 6 March 1996 p. 19.

<sup>34</sup> *ibid.*, p.19.

*Valuer-General: I would think that taking a very broad brush approach, I would approach it on the same basis as National Parks lands. It is land that is locked up. It is controlled but it has a value to the community and that should be recognised. I do not think that \$1 makes any contribution to the situation at all.<sup>35</sup>*

### **CONCLUSION**

**The Committee concluded that the State's holding of undeveloped Crown land should be brought to account at a valuation reflecting the value to the community and not at a notional \$1.**

### **RECOMMENDATION**

**That the development of an Australian Valuation Standard for Public Sector Assets be completed as a matter of urgency.**

#### *1.2.8 Qualification Point 8: Unpaid Salaries at 30 June*

Included in the report containing the Public Accounts is a statement showing the budget result for the year on a Government Finance Statistics (GFS) Basis. The GFS method of presenting reports on government financial statistics is based on an international standard developed by the International Monetary Fund (IMF). The IMF standard has a mandatory application to Australia due to Australia's membership of the IMF. The IMF Manual specifies a cash basis for preparing the GFS accounts.

The GFS (that is, cash) basis of reporting has a role in providing information to readers on the total flow of funds used by the government's budget sector:

*The GFS basis should not include internal transfers between government accounts. It should only include payments to and from bodies outside the state's public sector. In other words, it should include only cash data representing actual cash payments or receipts, not ordinary internal transfers.<sup>36</sup>*

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<sup>35</sup> Evidence to Committee, 6 March 1996, p. 19.

<sup>36</sup> See Australian Bureau of Statistics *Introduction of an Accruals Basis in Government Finance Statistics*, 1195 Government Finance Statistics Conference, Conference Item 4.

The GFS result shows a surplus of \$208 million on a cash basis whilst the accruals based Public Accounts show a deficit of \$59 million.

The Auditor-General has issued a qualified audit opinion on the GFS cash-based statement. The basis for the audit qualification is a transfer of \$44 million at 30 June 1995.

This transfer was made by Treasury into a Special Deposits Account "Balance of Salaries Suspense Account" in order to bring to account the state's unpaid salaries from last payday in June to 30 June 1995. The Auditor-General correctly points out that this account was an internal account, and that this transfer was therefore an internal transfer, which does not comply with the IMF's GFS requirements.

However, this problem may not be permanent.

The adoption of accrual accounting for governments around the world has commenced. In 1993 the United Nations revised its System of National Accounts to provide for national accounts to be compiled on an accruals basis.

The Australian Bureau of Statistics has commenced a project to review the methodology used in Government Finance Statistics to allow for incorporation of accruals data into the statistics.

The Committee notes the qualification but does not make a recommendation in this case.

## **2. Management of monies due to the state**

The Public Accounts of the State disclose that as at 30 June 1995 total debts due to the State budget sector amounted to \$1.6 billion. This amount includes dividends due but not paid from non-budget sector agencies (\$723 million) and state taxation debtors (\$259 million).

The implementation of accrual accounting across the budget and non-budget sectors has allowed for the preparation of consolidated financial statements for the whole of the NSW budget sector. These consolidated financial statements follow generally accepted accounting principals (GAAP) and in particular are prepared in line with the principles of consolidation in Australian Accounting Standard AAS 24 "*Consolidated Financial Reports*".

At the time of drafting this report, the Public Sector Accounting Standards Board has prepared an exposure draft for inviting comment on a proposed Australian Accounting Standard for "*Financial reporting by governments*". This exposure draft proposes that the principles of consolidation in AAS 24 be applied to the process of preparation of consolidated whole of government financial reports.

For a number of years, the Treasury have prepared whole of government financial reports for the NSW public sector. In the more recent times these reports have been prepared on an accruals basis and can be compared with group consolidated reports provided by any large company in the private sector.

The effects of consolidation are to eliminate all transactions between controlled entities that make up the group to be consolidated. For the public sector this means that debts due to the Treasury from a government agency resulting from a dividend due but not paid as at 30 June are eliminated as part of the consolidation process. This then brings to account the assets and liabilities on a net basis.<sup>37</sup>

The elimination of dividend debts due to Treasury upon the consolidation of the net assets and liabilities show the actual level of debts due to the State by external parties. The Whole of Government Financial Report as at 30 June 1995 discloses the following:

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<sup>37</sup>

See Australian Accounting Standard AAS 24 para. 63 for more detailed commentary.

## **Total Public Sector Debtors**

### *Sundry Debtors Money Due to the State*

<b>Description</b>	<b>1994/95 \$Million</b>	<b>1993/94 \$Million</b>	<b>1992/93 \$Million</b>
Budget	557	555	438
Non-budget sector	946	1144	1104
<b>Sub-total</b>	<b>1503</b>	<b>1699</b>	<b>11545</b>
less provision doubtful debts	129	125	54
<b>TOTAL</b>	<b>1374</b>	<b>1574</b>	<b>1491</b>

Source: Consolidated Financial Statements NSW Treasury 1995, 1994, 1993

Upon reviewing these figures the Committee was concerned that, at this point in time, there is no benchmark to compare the performance of the NSW Public Sector as no other jurisdiction in Australia prepares whole of government financial reports.

The Committee noted that over the past three years the balance at 30 June each year had fluctuated between 1.3 and 1.5 billion dollars. To speed up the process of collection of debtors into cash would add substantially to the state's cash balances.

### **2.1 Debts written off**

The Committee then considered the reported debt write off as part of this review of debt management. The Committee noted that the Auditor-General's Report to Parliament includes an appendix detailing debts written off by budget sector agencies and non-budget sector authorities.

*Cross-portfolio issues*

*New South Wales Public Sector  
Debts written off by agencies classified by type*

Description	1994/95 \$ million	1993/94 \$ million	1992/93 \$ million
Budget sector agencies	22.9	34.3	11.8
Statutory bodies - general	12.1	21.0	22.6
Electricity supply authorities	9.6	3.8	4.1
Area and District Health Services	8.4	6.5	3.1
<b>TOTAL - NSW Public Sector</b>	<b>53.0</b>	<b>65.6</b>	<b>41.6</b>

Source: Auditor-General's Reports to Parliament 1993, 1994 and 1995.

	\$ million
Less than 90 days	223
Over 90 days	175
Not aged	188
<b>Total</b>	<b>586</b>

Source: Auditor-General's Report to Parliament 1995, Vol 3, p. 826.

The Committee was concerned at:

- the \$175 million in debtors over 90 days. This could be considered to be in excess of normal commercial trading terms; and

- the \$188 million reported as not being aged. This raises a number of questions as to the adequacy of financial management systems and the effectiveness of debt recovery processes.

The Committee acknowledges that in the context of \$10.3 billion in state revenues, \$1.6 billion (total roll of debtors) and \$53 million in debts written off may not be considered as representing a high percentage, especially when compared with commercial practice. It may in fact be a tolerable level.

However, because the numbers are high in absolute terms, the Committee foreshadows its intention to monitor the management of debtors by public sector agencies and conduct a full inquiry in the next financial year.

#### **FINDING**

**The Committee notes the high absolute level of debtors and debts written off in the NSW public sector.**

#### **RECOMMENDATION**

**That the PAC undertake an inquiry into the effectiveness of the management of debtors in the NSW public sector.**



### **3. Payments without Parliamentary Appropriation**

Under the Westminster system of government, the Parliament has ultimate control over the taxes and charges paid by the taxpayer. All taxes and charges must be levied only with the consent of Parliament and all money raised must be paid into the Consolidated Fund. Money can only be paid from the Fund with the authority of Parliament through an Appropriation Act.

There is, however, one exception. Section 22 of the Act allows the Treasury to make payments on its own initiative, that is without Parliament's approval. Under the Act, this is called "the exigencies of government". It is up to the Treasury to provide a strong reason for doing so. The approval of the Treasurer must be obtained by Treasury officials before any Section 22 payment is made.

It is clear that the intention of the Act was to limit Section 22 payments to emergencies like disaster relief. Regrettably, however, the Act does not define "exigencies". This uncertainty has led to what the Committee has often criticised as over-use of the Section by the Treasury.

For example, Section 22 has been used to pay for items like bicentennial programs, computer acquisition, arrears of maintenance and employment compensation. None of this could be considered of an emergency nature.

In 1989, the Committee reviewed<sup>38</sup> the operations of section 22 of the Act and noted that a majority of the payments were, in fact, simply transfers between Treasury accounts and did not represent actual payments for goods or services supplied.<sup>39</sup> In the case of the Bicentennial programs, the State had many years' notice.

In 1995, Treasury made about \$471m in non-emergency payments using Section 22 as a justification. These went, for example, to pay for costs of the Office of the Board of Studies (\$637,000) and \$3.6m of capital works and services for TAFE.

Even the Treasury agrees that the imprecision of the wording of the Act leaves the way open for abuse:

*Mr Lambert: We have decided that it is appropriate to tighten it [the wording of the Act] up.*

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<sup>38</sup> PAC Report 43: Report on Payments without Parliamentary Appropriation, Feb 1989, p. 10.

<sup>39</sup> Evidence to Committee, 29 May 1996 p. 38.

However, there was one particular instance in 1995 where Treasury not only made a non-emergency payment under Section 22, but failed even to obtain proper approval by the Treasurer for that payment.

On 29 and 30 June, it paid \$30m, beyond the budget sanctioned by the Parliament, into the State Superannuation Investment and Management Corporation. Approval from the Treasurer was only obtained for \$15m under Section 22.

This means that not only was a non-emergency payment made using Section 22 as a “justification”, but also, and even worse, that the Treasurer’s approval was not even obtained for part of that payment.

To further compound this breach of the legislation, the Treasury made these payments on the last two days of the financial year. This appears to reinforce the Committee’s earlier findings that many Section 22 payments were merely a device to balance the state’s books at balance date:

*Committee: In addition to the payments authorised under section 22, the Committee would like you to confirm that an additional payment of \$15m was made to the super fund and was not authorised . . . was this an unauthorized payment, was it urgent and, I guess, why was it done? Can you justify Treasury not complying with the law in making payments of taxpayers’ funds to bodies associated with the super fund?*

*Mr Lambert: I will take that on notice ...*

Later the Treasury provided the following written response:

*Budget estimates for cash contributions by the Government to employee superannuation for 1994-95 were \$820 million.*

*Actual cash payments were \$850 million resulting in payments exceeding budget estimates by \$30 million. Supplementation of \$15 million was specifically approved by the Treasurer or superannuation contributions. The other \$15 million was paid for out of the unused supplementation obtained for the “Other Service-wide Activities” Program (No. 68.1.3) under Crown Transactions.*

*Various supplementations totalling \$167 were obtained for Program No. 68.1.3 during the year. In the event, it transpired that the total Program budget overrun was only \$141 million. Therefore, the second payment of \$15 million, which was part of the \$141 million overrun, had also been approved by the Treasurer under global budgeting.*

There thus appears to be two issues:

- The fact that monies were paid under Section 22 to the superfund when no real emergency existed; and

- The unexpected discovery by Treasury of the previous authorisation which allowed the inclusion of the last \$15 million under section 22. The Auditor-General was not able to see the relevant papers; however these were made available to the Committee later after it had raised the matter at the hearings.

The Committee concluded that Section 22 had been used to achieve a balanced cash budget result.

The Committee is, however, pleased to note that a consultative document prepared by Treasury on the proposed rewrite of the Public Finance and Audit Act includes discussion on a proposal to prepare a second appropriation bill later in the financial year. This is to obtain Parliamentary approval for payments that otherwise might be made under the Section 22 facility.

The Committee supported the proposal for a second appropriation bill. This proposal is in line with an earlier recommendation by the Committee.

## **4. Protected Disclosures**

Comment on the *Protected Disclosures Act 1995* was included in Volume 3 of the 1995 Auditor-General's annual report to Parliament. The Act came into force on 1 March 1995.

In this report, the Auditor-General noted that, in his opinion, the reporting obligations imposed upon him by this Act are unsuitable. The principal reason for this view is the requirement for the Auditor-General to undertake a special audit on a matter raised by a protected disclosure. The provisions of the special audit legislation require the Auditor-General to report "as soon as practicable" to the Parliament on the outcome of the special audit. This applies even if the special audit discloses that a protected disclosure is without substance.

The Auditor-General has brought to the attention of Parliament an alternative reporting regime. This would require less urgent reports to be included in one of the Auditor-General's Reports to Parliament. In 1995 the three volumes of the Auditor-General's reports were presented to Parliament in May, November and December.

The Committee supports the proposal by the Auditor-General. If, however, a delay exceeding three months would result, the report on the protected disclosure audit should be reported separately.

The Auditor-General has also reported on the funding implications for the Audit Office of the necessity to undertake special audits on protected disclosures.

In a 1990 report, the Public Accounts Committee reviewed the operations of the Audit Office and made recommendations on new funding arrangements for special or performance audits. The Government accepted the Committee's recommendations and since that time the state's budget has included an appropriation to the Audit Office to fund special audits. In 1996/97 the budget appropriation to the Treasury for payments to the Auditor-General for special audits was \$500,000.<sup>40</sup>

The cost of the Auditor-General's current performance audit programme is substantially more than the \$500,000 provided by Treasury. The Audit Office makes up the shortfall from fees charged to departments and authorities for the audit of their financial statements.

The PAC supports in principle the Auditor-General's position on the funding for protected disclosure investigations. This view holds that they should be separately disclosed to enable the costs to be transparent. The present arrangements result in the following: the costs of financial statement audits being overstated; the costs of

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<sup>40</sup> Budget paper No. 3 1996-97, p. 663.

performance audits exceeding by a significant amount the Treasury appropriation; and the costs of protected disclosure investigations being mixed with special audits.

The Public Accounts Committee has for some time advocated that the costs of all public sector programs and activities should be transparent and clearly disclosed.

**RECOMMENDATION**

**That the costs and funding for protected disclosures be separately disclosed in the State budget papers.**

**Further, the Audit Office should be paid on a fee-for-service basis for work done on protected disclosures in line with the earlier recommendation of the Committee.**

The Auditor-General reports that up to December 1995, ten disclosures had been made to his Office. The action taken on the disclosures is as follows:

**Protected disclosures to the Auditor-General 1995**  
**Disposal of Cases**

- **1 disclosure was considered not protected in terms of the Act.**
- **1 disclosure not investigated further after preliminary assessment.**
- **1 investigation finalised.**
- **7 currently being assessed.**

The Committee made two observations in connection with this matter:

- **only one investigation has been finalised out of the ten disclosures made to the Audit Office; and**
- **the fact that protected disclosures can be anonymous and made over the telephone would tend to increase their number and therefore the costs of dealing with this kind of issue.**

## **5. Setting of public sector accounting standards**

The Auditor-General has reported to Parliament on what he considers to be a conflict of interest for the NSW Treasury. He says that Treasury sets both financial policies and prepares financial statements for the public sector. In other words, Treasury sets its own rules.

Specifically, the Auditor-General has raised the following points:

- Treasury officers issue Directions which are contrary to accounting standards thereby triggering an automatic audit qualification;
- Treasury officers can issue Directions which, in the opinion of an agency, will not result in a true and fair view of the agency's accounts. However, under the law, the agency is obliged to comply with such Directions. Later, the agency officers who are required to sign the financial statements face a conflict between their own opinion and the Treasurer's Direction;
- There appears to be inconsistencies in some Treasurer's Directions. One example cited by the Auditor-General is the NSW Financial Institutions Commission. The Commission failed to follow a Treasurer's Direction and received a qualification for not complying with that Direction, and the Direction was subsequently withdrawn. The Auditor-General cites numerous examples of such inconsistencies;
- Treasury officers occasionally issue written advice to agencies without making it clear whether that advice is mandatory or simply constitutes guidance; and
- Treasury officers issue instructions for the preparation of agencies' accounts after the financial accounts should have been closed.

The Committee views these criticisms seriously. It will be inquiring in due course as to the factors that brought them about. The Committee also believes that the Parliament ought to have a role in reviewing high level accounting directions, just as it reviews ordinary regulations. This matter should be dealt with in the new financial legislation.

The Committee noted that most of the matters raised as specific issues by the Auditor-General would not have emerged as issues if the State still reported on a cash accounting basis. The implementation of accrual accounting on a progressive basis has resulted in the more complex and controversial items being amongst the last to be incorporated into the State's accounts.

The NSW Treasury is a major player in the development of those Australian Accounting Standards which address specific public sector accounting issues. The Committee is pleased to note that the Treasury in its Annual report for 1994 and 1995 reported that a senior officer is a member of the Public Sector Accounting Standards Board. This therefore allows Treasury to have its views raised at a senior level.

#### **FINDING**

**The Committee holds the view that departure from an Australian Accounting Standard is not to be treated lightly and should only occur in unusual and infrequent circumstances. If a standard is considered to contain elements not applicable to the public sector, the Accounting Standards Board should be asked to redraft the standard as a matter of urgency.**

## **B. INDIVIDUAL AGENCIES**

### **6. Somersby Park Pty Ltd**

#### **6.1 Background**

##### *6.1.1 What were the origins of Somersby Park Pty Ltd?*

Somersby Park Ltd is the company formed by the NSW Government and Westpac as the vehicle to lease out the former Old Sydney Town. The NSW Government (Department of Tourism) owns 75% and Westpac 25%.

Prior to 1989, the accounts of Somersby Park were reflected in the Tourism Commission's financial statements. Following the introduction of accrual accounting, it was decided that the accounts should be incorporated directly into the Consolidated Financial Statements for NSW given that the state controls 75% of its shares.

##### *6.1.2 Why was it formed?*

Somersby Park was formed by the NSW Government in order to transfer management of the old Sydney Town site to a private company. Therefore ownership of the site was retained by the State with its operational management run privately with oversight provided by the Somersby Park Board.

##### *6.1.3 Who won the lease to run Old Sydney Town ?*

On 1 August 1987 the Far East Hotels and Entertainment Pty Ltd won the contract to operate the former Old Sydney Town for 80 years.

The complex is managed by Warwick Amusements Pty Ltd, a member of the Far East Hotels & Entertainment company.

#### **6.2 Current situation**

##### *6.2.1 The losses*

Old Sydney Town has accumulated substantial losses over many years, standing at \$8.8 million in 1995. The Board stressed however that these were not operating losses and were incurred prior to the management of Somersby Park Pty Ltd.



The Board outlined that these losses comprise of two main components - losses incurred under the former Government's management in the setting up of Old Sydney Town (\$4.9 million) and a revaluation of assets in 1993 (\$4 million).

*Mr Oliver: ...I think it is wrong to say that they are growing losses. Essentially the loss simply arises from a writedown in the property itself. It is not a question of continuing losses but the loss has been incurred..*

*Ms Calkin: The losses represent both the Government's and Westpac's funding of Old Sydney Town when it was actually operating itself before it set up Somersby Park.<sup>41</sup>*

The Committee acknowledges this as being correct, however points to the significant loss in the asset revaluation as reflective of the decline in the commercial viability of Old Sydney Town.

### *6.2.2 Changes to the leasing arrangement*

Two variations of the lease have been executed. The first variation was signed in January 1993 with the Board agreeing to a concessional repayment program dating from 1992 to run till 1995. This variation also stipulated that there be no defaults in the payment of lease rentals and that \$12 million be paid on the construction of a hotel complex by July 1998.

The second variation signed in August 1995 made the provision for the Somersby Park Board to have the power to decide when the lessee was in default.

The payment program contained in the first variation expired in April 1995. The lessee has requested an extension on that program and also on some additional capital expenditure. This situation is now before the shareholders who will decide whether to further extend financial arrangements to enable Warwick Amusements to continue or to declare default.

### *6.2.3 Problems with the lessee on rental payments*

In 1993 the Auditor-General sent a management letter to Warwick Amusements regarding consistently late lease payments and expressed doubts on the "going concern" status of Somersby Park due to both overdue payments and a large accumulated deficiency.

The Auditor-General's 1994 report noted that the new lease arrangement was negotiated as a result of the lessee's financial difficulties which had led to non-payment of the previous lease. The Auditor-General again sent a management letter

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<sup>41</sup> Evidence to Committee, p. 32..

which stated the need for prompt payments on lease income in the future, to which Somersby Park agreed.

In May 1996, the Board stated in evidence to the Committee that the lessee, Warwick Amusements, is currently not paying rent either regularly or in full:

*Ms Calkin: "It is not as if we are getting no income; it is just not every quarter that we are getting it. We are not getting the full amount, but we are certainly getting it".*<sup>42</sup>

#### *6.2.4 Board's position on the late payments*

The Board has currently placed the decision of how to deal with the late payment of the lessee before the shareholders. The Board now awaits their decision to see whether it will have to use its power, as outlined in the second variation of the lease, to call Warwick Amusements in default.

The Board appeared reluctant to push for default and indicated that it had faith in Warwick Amusements ultimately coming through with the payments.

*Mr Glachan: ..So you are hoping that they will eventually pay up?*

*Ms Calkin: Yes.*<sup>43</sup>

#### *6.2.5 NSW Treasury view on Somersby Park Pty Ltd*

In evidence before the Committee, the Secretary to the NSW Treasury, Mr Michael Lambert, indicated that, whilst the Government was presently involved with Somersby Park as a 75% stakeholder, it was a result of past government actions and not necessarily the intent of the present Government:

*Mr Lambert: The State inherited this going back in the 1970s. It was not a conscious decision of government to be involved in this.*<sup>44</sup>

Further, whilst Mr Lambert acknowledged that at present it was concerned with how Somersby Park Pty Ltd was operating, it foresaw that in the future it may not have this role:

*Mr Lambert: Our general view and advice to government will be at the appropriate time to divest itself of that (Somersby Park) interest.*<sup>45</sup>

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<sup>42</sup> Ibid., p. 33.

<sup>43</sup> ibid., p. 34.

<sup>44</sup> ibid., p. 41.

<sup>45</sup> ibid., p. 42.

*6.2.6 The problems with default*

The main concern with pursuing the default option is the cost. There is a strong possibility that Warwick Amusements could sue Somersby Park Pty Ltd for not fulfilling contractual obligations. There are also other concerns such as who should, and would, buy the site; the possible loss of jobs and its effect on the local area; and the perception that the Government is willing to break long-term leases.

*6.2.7 Due diligence by the Board*

As stated above, the Far East Hotels and Entertainment Pty Ltd won the overall contract to operate the Old Sydney Town site with management of the site delegated to Warwick Amusements Pty Ltd. Mr Deacon Chiu owns the Far East Hotels and Entertainment Pty Ltd and Mr Dick Chiu, his son, is the chairman of Warwick Amusements Pty Ltd. Therefore the management of the old Sydney Town site is solely in the hands of Mr Deacon Chiu and Mr David Chiu, noting of course the oversight role of the Somersby Park Board.

In 1988 Mr Deacon Chiu and Mr David Chiu were charged in Hong Kong with several serious fraud offences. This was reported in several Australian newspapers.

On December 1993 raids were made on several Hong Kong companies including the offices of the Far East Consortium International, which is controlled by Mr Deacon Chiu. All these companies were subsequently suspended from trading on the Hong Kong Stock Exchange.

The Committee heard the following evidence from several of the Board's directors at the Public Hearing:

*Chairman:..With regard to this particular inquiry relating to Somersby Park Pty Limited, the first question is: Did the charges against Mr Chiu ever influence the Somersby Park Pty Limited board? Were they ever considered to be grounds for the renegotiation of the lease? Did the minister of the day express disquiet that the Somersby Park lessee was being indicted for fraud?*

*Mr Oliver: I have no knowledge of that.*

*Ms Calkin: Nor do I.*

*Mr Surgeon: No, we do not know anything about that.*

*Chairman: Were any of these things discussed at board level?*

*Ms Calkin: None of us were directors during that period.<sup>46</sup>*

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<sup>46</sup> Evidence to Committee, p. 31.

Ms Calkin was appointed to the Board in 1989/90, Mr Surgeon in 1990 and Mr Oliver in 1990/91. Considering that several variations of the lease have transpired in this time, the Committee is concerned that no due diligence investigations were made in the process of renegotiating conditions to ensure that the lessee was of sound reputation.

It should be noted that Mr Deacon Chiu has subsequently been acquitted of the fraud charges on medical grounds.

### **6.3 Conclusions**

The Committee notes the evidence of Mr Lambert, who pointed out that it may not necessarily be a "natural role" for the Government to be such a large stakeholder in a commercial operation, such as Somersby Park Pty Ltd<sup>47</sup>. This view acknowledges the change in commercial outlook of governments that has occurred over the last few decades. The original investment into the Old Sydney Town site was a decision of the Federal Government in the 1970s and later handed to State Government to manage.

The Committee also acknowledges that entering into the 80 year lease by the State Government in the late 1980's may not have been the best commercial decision and appreciates the concerns of the present Government on its viability.

It is not the role of the Committee to recommend action on a commercial decision which is the prerogative of the Board. However, the Committee would like to see that all the relevant information is placed before the Board and the Minister to enable them to make a decision on the appropriate course of action.

#### **RECOMMENDATION**

**That Crown law advice be sought on options, if any, available under the lease arrangements. This would then determine the extent to which the State may be exposed to any future liabilities and provide the financial information necessary to gauge the possible costs of altering lease arrangements.**

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<sup>47</sup> *ibid.*, pp. 41, 42.

## **7. University of Newcastle Flying School**

### **7.1 Matter raised in 1995 Auditor-General's Report**

In the 1995 Auditor-General's report it was stated that the University of Newcastle Flying School was in receivership. The Committee was also aware of comments made by the Auditor-General on the Flying School's losses in previous years. The Committee was therefore concerned about the nature of the University's involvement and the quality of its management decisions in this venture and thus proceeded to investigate.

### **7.2 Background of flying school**

#### *7.2.1 Formation of the Flying School*

In the early 1960s the Nationwide Aviation Space Academy was formed to offer flight training at Cessnock. On 27 October 1983 this Flying School became a company known as Civil Air Training Academy (CATA). CATA bought the assets of Nationwide Aviation Space Academy in December 1983 and thereby assumed total ownership and control of the Flying School operations. Cessnock City Council leased the Cessnock Airport terminal building and some land to the company for its operations.

#### *7.2.2 The integration of the Flying School into Newcastle University's curriculum*

CATA approached the University of Newcastle in 1984 with the idea that civil air pilots required a more professional background than they presently held and that a logical course of action would see a coordination between flying tuition and a university course on aviation. The University liaised with national and international pilot associations, including senior management in Qantas who assisted in planning the course, and following positive feedback, developed a degree in aviation.

The majority of the 30 students accepted into the Bachelor of Science degree in Aviation used the Flying School each year and usually gained their commercial pilot licence here (although this is not a requirement of the degree). Students thus usually graduate from the Academy with a Commercial Pilot Licence and Multi-Engine Command Instrument Rating. The flying course is completed in the first two years of the University course with advanced courses offered in third year including advanced instrument flight, flight instructor and airline preparation courses.<sup>48</sup>

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<sup>48</sup> *University of Newcastle 1993 Annual Report*, p. 53.

The University admitted that the commercial success of the Flying School was secondary to its educational value, stating that, under university control, it was “*at all times...a non-profit training organisation in the area of pilot training*”<sup>49</sup>.

However, they also stated that, in concurrence with the move to establish business enterprises given increasingly limited Federal funding, there was no intention by the University to subsidise the venture. The University further commented that they had hoped that the industry would pick up and supply more potential students than has otherwise been the case.<sup>50</sup>

### *7.2.3 The University as Board Members*

Whilst CATA was an independent organisation, its Board of 8-10 members included several university representatives. A memorandum of understanding was agreed to between CATA and the University which assumed that the University would eventually control the Flying School.

This changeover in control occurred in 1990 when the flying school became a subsidiary company of the University, which thus attained authority over the conduct of business but not the assets.<sup>51</sup> The University has had, therefore, total control of CATA and then UNFS since 1990. It also has had access to information of the flying school's operations as Board members prior to this.

### *7.2.4 Closer identification and control by the University of Flying School*

The CATA changed its name to the University of Newcastle Flying School on 18 February 1994. The reason given by the University for the name change from CATA to UNFS was the University's increasing identification of the school as part of its university curriculum. There was also the fact that the University controlled the Board as owners of the company. The University felt it was therefore appropriate to “*reflect that involvement in the name of the company*”<sup>52</sup>.

The structure of the UNFS was that of a non-profit company limited by guarantee and a subsidiary of the University with a Board comprising of 11 members.

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<sup>49</sup> Evidence to Committee, 29 May 1996, p. 19.

<sup>50</sup> *ibid.*, p. 30.

<sup>51</sup> *ibid.*, p. 19.

<sup>52</sup> *ibid.*, p. 20.

## **7.3 Financial operations of the flying school**

### *7.3.1 Issues contributing to the financial problems of the Flying School*

#### *7.3.1.1 Fees on fixed basis*

Students paid a fixed fee of \$30,000 to cover the cost of gaining their commercial pilot's licence over a two year period. This payment was made to the flying school as a separate company and not part of the University. This was because the Higher Education Funding Act does not allow for charges such as flying training to be made by the University. Therefore the flying school was kept as a parallel operation and the fees separate from the costs of the University's aviation degree.

The fixed fee contract became a significant concern when students took more hours to complete training than their schedules set out. In 1994 a review was conducted by an external consultant, organised by the University when problems began to be more apparent. This review discovered that the main reason for the financial problems of the UNFS was that students were overflying the hours in their contract. In evidence before the Committee, Mr Brian Penfold, Executive Director of Finance and Property at the University of Newcastle said:

*One of the major problems that we then detected was that a lot of the students were overflying the hours that were allowed by their contract... We were unable to charge for those extra hours because it was a fixed fee contract... That was a major reason why the company got into financial difficulty.<sup>53</sup>*

When students failed to fulfil the requirements for their licence within the allotted time, the costs of their training significantly increased at the expense of the Flying School and not the individual students.

#### *7.3.1.2 Malaysian pilots relocate*

The sources of income for CATA thus consisted partly of (restricted) flying fees paid by students and partly of the proceeds from its Integrated Commercial School, which involved an accelerated in-house course training pilots for up to a year.

A contract with Malaysian Airlines in training their pilots was a major revenue earner and had been since the late 1980s. It annually trained between 60-80 students at a cost of \$45,000 per student. This generated an annual income of approximately \$2-3 million. Its loss in 1994 produced a considerable gap in the Flying School's revenue.

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<sup>53</sup> Evidence to Committee, 29 May 1996, p. 23.

The reason for the loss of this contract was twofold. There was the downturn in pilot positions which led to less demand for pilot training. There was also the decision by Malaysian Airlines to train pilots domestically rather than overseas in order to reduce costs.

Professor MacDonald, University of Newcastle's Pro Vice-Chancellor, commented that this contract with Malaysia was incorporated in a forward business plan and thus added to the view of the Flying School's viability. Subsequently, its absence further attributed to financial difficulties.

*Our business plan had a forward projection including the MAS [Malaysian Airlines] course. That of course went out the window when they decided to transfer that back to Malaya.<sup>54</sup>*

The 1994 financial statements indicated the increasingly parlous state of the company's finances. The operating loss for 1994 was \$2.8 million, compared with \$178,395 in 1993. Whereas income was \$3.7 million in 1993, this declined to \$1.9 million in 1994. Expenditure was \$3.1 million in 1994 and \$3.9 million in 1993. An aircraft crash in 1994 further added to the financial woes of the company given a claim for damages and injury of \$250,000.

Given the combination of these factors, as well as the downturn in the aviation industry in the early 1990s resulting in fewer pilot jobs, the financial fortunes of the Flying School considerably declined.

### *7.3.2 Action taken by the University*

As the financial problems identified above became apparent, the University became concerned about CATA's financial viability. In order to stabilise this, the company sold 22 aircraft to the University in September 1993 for \$500,000 which were then leased back to CATA. This was intended to prevent imminent closure of the Flying School, which would have occurred without such financing. This then allowed students to complete their training. Student fees had been paid in advance and the University felt it was its responsibility to ensure that they qualified.<sup>55</sup> The University contended also that, as the aircraft were valued at more than \$500,000, it was "a reasonable purchase".<sup>56</sup>

The University entered into an agreement to lease the aircraft back for \$100,000 in the first year of the agreement, with the subsequent rental payments to be variable. (This

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<sup>54</sup> Evidence to Committee, 29 May 1996, p. 21.

<sup>55</sup> *ibid.*, p. 19.

<sup>56</sup> *ibid.*, p.19.



overall deal was later examined by Arthur Andersen in 1995 within the context of the receivership. Under section 588FB of the Companies Law, the Liquidator can recover monies from a party who gains benefit from an uncommercial transaction which may not have been entered into given the company's circumstances of liquidation. The liquidator approved this transaction as it provided commercial benefits to the company.)

The University further increased its risk exposure in guaranteeing a second ranking mortgage over the land and buildings worth \$1,212,126, with the National Australia Bank holding the first ranking mortgage worth \$399,004 in 1994. This loan by the University was eventually written off.

The Audit Office commented in correspondence dated 6 June 1996 that, given the write-off of this \$1.2 million loan by the University, it should be added to the total loss sustained by the University following the receivership of the Flying School.

This then makes the total loss \$2 million to the University of Newcastle.

### *7.3.3 University action on management controls*

The University employed a consultant, Mr Ross Evans, an experienced aviation trainer, to conduct a review of the management of the Flying School in mid-1994. They also directed the University's accountant to assist in reviewing the situation. However the University admits that this was "*some years later, when we detected that some things were not going right*".<sup>57</sup>

Following the completion of the review in July 1994, the University restructured the company, retrenched staff and restricted training to university students only. In October 1994 half of the 25 staff were retrenched to reduce costs with the remainder retrenched the following January upon receivership. The costs of the redundancy packages are included in the total of the University's losses.

The University representatives explained that poor internal monitoring of financial performance had resulted for two main reasons:

- the Flying School began as a separate entity and therefore appropriate internal auditing controls were not instituted by the University in the former years as the company was not under the University's control; and
- the management had been left in the hands of aviation professionals who were not business managers.

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<sup>57</sup> Evidence to Committee, 29 May 1996, p. 23.

*Mr Penfold: the members of the senior operational management of the company were experts in aviation; obviously they were not expert in business affairs.<sup>58</sup>*

They stated that these professionals didn't have the appropriate management skills and had not developed an adequate system on which to gauge how many flying hours students would need to attain the required levels. These contracts were later changed by the University to ensure that students who were spending further hours flying than as identified in the initial course contract were being charged accordingly.

## **7.4 Current outcome**

### *7.4.1 Receivership of the Flying School*

In January 1995 the Board directors decided that the company was economically unviable. The liquidators, Arthur Andersen, were appointed on 24 January 1995. Trading continued to fulfil commitments and ceased on 17 February 1995. This period, between 24 January and 17 February, was paid for by the University.

The liquidator advertised the full property and assets in the Sydney Morning Herald, Financial Review and Newcastle Herald. Whilst 80 enquiries were made and 39 information memorandums were sent out to interested parties, offers were too low for the original sale arrangement to go ahead. It was therefore decided to sell the land and buildings separately from the other assets.

### *7.4.2 Realised losses*

The auction on the land and buildings took place on 19 May 1995 and sold for \$341,000. (Valued on a going concern basis at \$680,000 and on forced sale between \$300,000-\$400,000 by Knight Frank Hooker (Newcastle)). KFH commission, advertising and other related costs cost \$17,976 leaving a net return of \$323,024. This went to the National Bank as the first mortgager but was not enough to pay the full debt. Before the Bank gave the overdraft, the land valuation was \$1 million. The auction, however, realised it at around \$300,000. No money from this auction went to the University as it all was required to pay the National Bank as first mortgager although it was not even enough for them to break even. Therefore, the University's Executive Director of Finance and Property explained, "(the National Bank) *actually lost money... It lent us something like \$400,000 and it got back \$300,000*".<sup>59</sup>

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<sup>58</sup> *ibid.*, p. 23.

<sup>59</sup> Evidence to Committee, 29 May 1996, p. 22.

The auction for stock, plant and equipment took place on 4 May 1995. The total proceeds, which included 16 of the University's 22 aircraft, amounted to \$294,644. Following the deduction of costs (commission, advertising etc.), the net result was \$264,731. An initial dividend to the University was paid from this and a final dividend will be received following the finalisation of debtor collections. The remaining aircraft are to be sold at the end of 1996.

Student debts were estimated by Arthur Andersen to be \$39,430 following an adjustment from the initial figure of \$74,156. Letters of demand were sent to students and, as a result, the liquidator received \$19,632. However, no further repayments were expected to be received.

#### *7.4.3 Overall financial loss to University*

Following the sale of the remaining aircraft, the University estimates that "*overall, \$800,000 will be lost to the university*".<sup>60</sup>

To cover this loss, the University is to use the interest from its discretionary income (income received from investments) as budgeted for over the last few years. This money would have been reinvested in a futures reserve for when likely budget cuts arise from the August 1996 budget. However, the University stated in evidence that this money was insignificant in the event of the overall budget which totalled \$130 million.

As stated previously, evidence received by the Committee from the Audit Office following the Public Hearing stated that the true loss to the University should include the \$1.2 million loan the University was forced to write off at 31 December 1994.

This then brings the total loss to \$2 million.

#### *7.4.4 Present situation of Newcastle University*

Students commented that the closure of the Flying School marked the loss of an Australian flight training institution and feared that the perception of their qualifications may suffer as a result<sup>61</sup>.

In order to prevent this happening, the University has stated that it will continue to offer the Bachelor of Science (Aviation) degree and students will be able to choose where they undertake their practical flight training. The University has agreed to lease seven of its aeroplanes to Avondale college which operates a Flying School in

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<sup>60</sup>        *ibid*, p.22.

<sup>61</sup>        Newcastle Herald, 17 February 1995.

Cooranbong. Provisions have also been made for students to study at Avondale College whilst undergoing their practical training in order to keep both the theoretical and practical components of their course together.<sup>62</sup>

In an article in the Newcastle Herald on 22 March 1995, it was reported that the Aviation Department of Newcastle University has indicated its satisfaction with this new arrangement and Avondale College has given a similar endorsement.

The University is also successfully managing its currently only controlled entity, the University of Newcastle Research Associated Ltd, which supplies a research and consultancy service. In managing this entity, the University has ensured from initiation that tight controls have been applied in respect to internal audit and management practices. Every two months the company reports to the University Council on activities and cash flow. Its annual report is forwarded to the Council allowing substantial oversight by the University. It is reported by the University to be doing well and recorded an operating surplus in 1996 of \$230,000.<sup>63</sup>

## 7.5 Conclusion

The University of Newcastle and its association with the Flying School began as an innovative idea with the main aim being the educational prerogative that befits a university institution. The Committee recognises that firstly, universities do not have the same focus as commercial companies and secondly, they have had little experience in this arena. Therefore it is understandable that some commercial operations associated with universities are bound to encounter difficulties.

The University expressed no regret in their involvement with the flying school. However, given the opportunity, the University stated:

*Mr Penfold: we would have been more diligent in respect of the funding of the school without a doubt and we would have imposed university practices on the school much earlier<sup>64</sup>.*

However, the Committee does not totally excuse the University from its inability to run the flying school efficiently. The main criticism of the University of Newcastle is its failure to implement adequate internal controls at an earlier stage.

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<sup>62</sup> Newcastle Herald, 22 March 1995.

<sup>63</sup> *NSW Auditor-General's report for 1996*, p. 215.

<sup>64</sup> Evidence to Committee, 29 May 1996, p. 29.

### *Individual agencies*

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The University's involvement on the Board and eventual control of the Board allowed it clear access to oversight the flying school's operations. This raises the questions as to why more action or even reviews were not taken sooner to rectify both management and financial operations. It also raises the question as to why the University allowed the flying school to be run by aviation trainers and not include management personnel.

#### **FINDING**

**It is obvious to the Committee, however, that the University has since demonstrated that it has learnt from this particular situation. With its tight control over the University of Newcastle Research Associates Ltd, the University has shown that it has both learnt from its experience and is capable of sound management practices.**

## **8. State Rail Authority**

### **8.1 Background**

#### *8.1.1 Issues raised in the Auditor-General's report*

In the Auditor-General's 1995 Annual Report, several comments were made relating to the operations of State Rail which required further investigation by the Public Accounts Committee. These centred on bringing inventories to account and the evaluation of the SRA's fixed assets.

#### *8.1.2 Identification and Value of Inventories*

The Auditor-General issued a qualified opinion on the value of inventories disclosed in user stores in the period 30 June 1994 to 30 June 1995.

The Auditor-General followed this with comment in his 1995 report on the valuation of stores and material at the Auburn Service Centre. The Auburn Service Centre is where Maintrain Ltd, a unit of Goninans Ltd, provides train maintenance services as required by the SRA. The contract is for the maintenance operations to be purchased, managed and recorded by Goninans but with SRA ownership of the inventory.

An adverse comment on this operation was made by the Auditor-General. This was due to the valuation being based on a composition of last purchase price, weighted average cost and nominal values (one cent). The Auditor-General commented that use of last purchase price in valuing was outside Australian Accounting Standard AAS2 "Measurement and Presentation of Inventories in the Context of the Historical Cost System".

#### *8.1.3 The valuation of the SRA's fixed assets*

The Auditor-General also commented on the valuation of the SRA's fixed assets. This comment noted the lack of data for individual fixed assets that make up each asset category, thereby preventing accurate valuation.

#### *8.1.4 Further matters raised by the Auditor-General*

In addition to the above comments, several other significant matters were brought to light in the Auditor-General's report. These included control weaknesses within the user stores stock-take and inventory procedures; control weaknesses within payroll records procedures with time sheets not properly certified and overtime worked when not yet approved; and significant payments in overtime and allowances to employees in excess of standard base pay.

It was therefore of concern to the Committee that State Rail was experiencing such problems. It resolved to hold an inquiry in order to ensure that the appropriate procedures were being pursued by the Authority to rectify these problems.

## 8.2 Public Accounts Committee inquiry

The Public Accounts Committee wrote to the State Rail Authority on 19 February 1996 requesting a response on the above matters raised in the 1995 Auditor-General's report.

Following this, the Committee held a Public Hearing on 29 May 1996 in order to allow further discussion of these issues. Evidence was provided by Mr Len Harper, Chief Executive Officer of State Rail, and by Messrs Tony Harris (Auditor-General), Jim Mitchell (Deputy Auditor-General) and Tony Whitfield (Assistant Auditor-General).

The main issues were as follows:

### 8.2.1 *Accounting for Inventories*

#### 8.2.1.1 *Identification and value of inventories*

In response to the Committee's correspondence in February 1996, the SRA explained that it had been a significant task over the last few years in bringing these stores to account.

Its written response stated:

*Work has been progressing for a number of years to have these stores, which are not part of official inventory, brought to account in the balance sheet. This has been a major exercise...<sup>65</sup>*

In evidence to the Committee, Chief Executive Officer, Mr Harper, explained that this process has involved identification, cataloguing and valuation of stock holdings at nearly 600 official user locations and 20,000 non-official stores.<sup>66</sup> This gives an indication of the magnitude of the task that faces the SRA in accounting for its stores.

The SRA had expected to complete this exercise by 30 June 1995. However, this could not be achieved in time for the Auditor-General's report. The SRA now expects the process to end by 30 June 1996, with most identification and cataloguing work

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<sup>65</sup> SRA Letter to Committee, 29 March 1996, p. 2.

<sup>66</sup> Evidence to Committee, 29 May 1996, p. 2.

completed in February 1996. (This has been followed with a stock take before the agency changes to the new software package which will recognise the items in the accounts as at 30 June 1996.)<sup>67</sup>

Mr Harper commented in evidence that the process of inventory management only began in 1991. Prior to this it was “*a mess*”.<sup>68</sup> He said it had taken the Authority several years just to gain even basic control in this area. He gave two reasons for the “*mess*”:

- previously inventory purchases had been treated as an expense in the accounts at the time of purchase and unused stores were not recorded as stock on hand; and
- unused stores were not brought to account as assets in the financial statements.

The implementation of accrual accounting necessitated a change in accounting practice and therefore a process of identifying and valuing stores was initiated.

In evidence before the Committee, Mr Harper stated that the estimated value of inventories was \$70 million. However, Mr Whitfield, Assistant Deputy-General, stated that Mr Harper did not highlight the value of total inventories and only noted official stores already accounted for. This then did not provide an accurate estimate of the true value of inventories which should include both official and unofficial (user) stores.

The Audit Office explained that official stores accounted for were valued at \$70 million and unofficial, or user, stores at \$81 million. The SRA has spent the last several years identifying, cataloguing and valuing these user stores but was unable to complete the process by 30 June 1995. This then brings the “*total inventory to \$150 million, if that was properly accounted for, plus that 40% of items that are valued at 1 cent that may well need to be revalued upwards*”.<sup>69</sup>

Mr Whitfield said that, on this last matter, some of the line items may be worth between \$10,000 and \$20,000. This then further escalates the value of inventory not properly accounted for even beyond the figure of \$81 million and the total inventory value beyond \$150 million.

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<sup>67</sup> SRA Letter to Committee, 29 March 1996, p. 2.

<sup>68</sup> *ibid.*, p.2.

<sup>69</sup> Evidence to Committee, 29 May 1996, p. 66.



Mr Pat Rogan, Vice-Chairman of PAC, said of Mr Harper's statement on the value of inventories, that "*obviously there would appear to be some qualification required in his response*".<sup>70</sup>

After some discussion, the Committee resolved to consider the matter further once the SRA had fully completed its inventory study in 1997.

8.2.1.2      *Qualification of the Auburn Service Centre*

The Auditor-General made a qualification relating to the accounts of Maintrain Ltd, the company owned by Goninans Ltd that provides train maintenance services to the SRA.

It was noted in the 1993/94 accounts that a weighted average cost process was not used by Goninans Ltd, which accounts for the inventory. Such a process readily shows the true cost of the goods remaining in store by recognising both present and historic values as opposed to assessment on either past or present values, which would present a distorted value. The implementation of amended software in 1994/95 now values on a weighted average cost basis.

However the SRA stated that the process of revaluing was not possible prior to implementing the new software and therefore Maintrain's value of \$26 million was composed of 40% of items being valued at one cent and 60% valued at last purchase price. This approach yields a significant distortion. Its direct contradiction with Accounting Standard AAS2 resulted in the Auditor-General's qualification.

The SRA stated in its letter dated 29 March 1996 that, while it realised this did not adhere to the required accounting standards, "*in the circumstances, no other valuation was available*". The SRA promised that the new system would deliver valuation on the correct weighted average cost.

In relation to according a nominal value of one cent to some items, the SRA claimed this was due to potential obsolescence and therefore worth little real value other than they were still part of stock to be recorded:

*SRA: In order to have a record of these items, they are carried in the inventory system, and because a valuation is mandatory, a nominal value is utilised<sup>71</sup> (commonly one cent).*

The SRA state that a review is currently being conducted on this matter and that one cent items will either be disposed of or re-valued by 31 May 1996.

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<sup>70</sup> Evidence to Committee, 29 May 1996, p. 67.

<sup>71</sup> Letter to Committee, 29 March 1996, p. 3.

### *8.2.2 Fixed Assets - Comparative Amounts*

The SRA stated that the Auditor-General's comment on fixed assets related to the comparative figures for 1993/94 and that the completion of the computerised fixed asset register and revaluation of all fixed assets has led to a clear audit in 1995.

The Authority did comment that, although the Auditor-General accepted the fixed assets records as satisfactory for auditing purposes prior to 1994, he did not accept them in the 1994 audit. The SRA attempted to bring forward the work for the 1993/94 accounts however this was not possible and hence the qualification.

### *8.2.3 Stock Control*

#### *8.2.3.1 Theft*

Mr Harper acknowledged that there had been previous acceptance of pilfering with little control by management to prevent it.

Outlining this previous lack of management in the maintenance and administration of stores, Mr Harper commented:

*It is like owning the cash register at Coles and saying "Go for your life". There was no control.<sup>72</sup>*

It is presumed by the Committee that the tighter management controls and inventory procedures currently being implemented will rectify this situation.

#### *8.2.3.2 Hoarding of stock*

Also noted in evidence before the Committee was the problem of unofficial caches. Staff have previously not trusted the system to provide the materials they need and therefore keep the stock they envisage they will require on hand. Mr Harper said that current turnover of stores is 2.9, below the acceptable industry standard of 4-5<sup>73</sup>. (turnover of stores relates to the usage and holding of stock - a reading of 2.9 indicates that 2.9 times of average stock has been issued in one year.)

Again it is presumed by the Committee that tighter management controls and inventory procedures will rectify this situation.

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<sup>72</sup> Evidence to Committee, 29 May 1996, p. 5.

<sup>73</sup> *ibid.*, p. 5.

8.2.3.3 *Obsolescence of stores*

Mr Harper said “*surprisingly...there wasn't a great deal of total obsolescence*”.<sup>74</sup>

However Mr Harper also commented that “*you would be right in saying that there was a fair proportion of goods in store that were obsolete to requirements or if they weren't totally obsolete they were a very costly item to have on the shelf.*”<sup>75</sup>

Clearly the true levels of obsolescence are not yet known. Given that the identification and valuation of inventory has yet to be properly finalised and accounted for, it is too soon to know the true levels of obsolescence.

The Committee notes the current processes underway in improving the management and administration of stores and presumes that the above practices will both be identified and rectified as a result.

The Committee would like to also note that it will closely monitor these procedures and will request further responses in 1997 on these matters.

8.2.3.4 *Implementation of accrual accounting*

Mr Harper reported that the Authority still operates on a cash accounting basis and aims to implement accrual accounting in 1996/97.

However the Audit Office corrected Mr Harper's statement that 1995/96 was the first year of accrual accounting for the SRA and stated that the SRA had been on accruals basis for a number of years.

8.2.4 *Cost-benefit analysis*

In evidence before the Committee, Mr Harper commented that prior to his appointment, there was no cost-benefit analysis for fit for purpose or safety issues. Such analyses were only completed on matters of growth, investment or re-investment. This situation has now changed and since June 1995 cost-benefit analyses have been carried out for all capital expenditures over \$500,000 as required by Treasury.<sup>76</sup>

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<sup>74</sup> Evidence to Committee, 29 May 1996, p 6.

<sup>75</sup> *ibid.*, p. 5.

<sup>76</sup> *ibid.*, p. 7.

Mr Harper said that 20% of cost-benefit analyses are less than \$500,000 and are conducted in-house. The remaining 80% are over \$500,000 and are evaluated by external consultants, each such evaluation costing between \$10-20,000.

The Authority has also issued a guide to evaluation in June 1995 to ensure that staff are aware of such procedures.

The Committee notes that it will actively monitor State Rail's use of cost benefit analyses.

### *8.2.5 Overtime payments*

Statistics in the 1995 Auditor-General's report revealed that 6,500 SRA staff members earn over 50% of their base salary in overtime.

The following table on the payroll of non-SES employees was included in the Auditor-General's report:

	Hours (000)	\$'000
Base Paid	35,992	527,787
Overtime	8,757	123,959
Higher Duties		26,106
Shift Penalties		15,523
Tonnage/Dirt Money		9,760
Other Allowances		7,118
Contractors		105
Travel and Reimbursement of Expenses		20,942
Sick Pay		24,071
Payments from Leave Provision		138,051
<b>Total</b>		<b>893,422</b>

The Auditor-General further commented that:

*The highest percentage paid in excess of base pay to an employee was 268%. The earnings of a selection of 128 employees who had been paid in excess of 100% over their base pay in 1993-94 were compared to their earnings for the year ended 30 June 1995. This comparison revealed that all but two of them received greater than 95% above their base pay in both years.<sup>77</sup>*

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*NSW Auditor-General's Report for 1995, p. 392.*

The SRA contended in evidence that the figures on overtime in the Auditor-General's report included allowances as well as overtime which then incorporates higher grading, Saturday and Sunday loadings, special allowances, etc.

Therefore the SRA says that the real figure of overtime is closer to 24% (that is, 24% of an employees total pay is comprised of overtime payments). However, this is still well over the normal amount of 15-20% and reveals considerable inefficiencies within the system, which the SRA admits.

*So when you look at overtime, standing alone within State Rail it is of the order of 24 per cent at present. That is still over and above the norm<sup>78</sup>*

The problems with this system as identified by Mr Harper include:

- the use of a 5 day roster instead of a 7 day roster, thereby having to allow Saturday and Sunday loading allowances;
- inefficient maintenance of fleet; and
- critical shortages of staff following downsizing.

The Committee notes actions taken by the SRA which include negotiating with unions and enterprise bargaining (since September 1995); streamlining management and administrative positions and correcting the lack of reconciliation between overtime and actual times worked. Extra staff are being employed to make up shortages, particularly on stations. There is, however, also a high turnover rate and therefore the number of staff is not yet at the optimal level.

The Committee also noted a recent strike by railway staff on 14 June 1996. It was reported that a work ban was placed on metropolitan railways by CityRail employees as a result of failing to win interim wage increases or pay for extra duties performed. Staff-related issues are obviously a significant problem that will require further negotiations between management and staff within the SRA.<sup>79</sup>

The Audit Office provided a clarification of their figures on overtime in reply to the SRA's evidence.

Mr Whitfield, Assistant Auditor-General, disputed Mr Harper's justification for the extremely high statistic on overtime, saying that allowances were not included in their report:

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<sup>78</sup> Evidence to Committee, 29 May 1995, p. 9.

<sup>79</sup> Telegraph Mirror, 14 June 1996.

*Mr Whitfield: In the table we put in, using the State Rail's figures, the allowances were pulled out separately*<sup>80</sup>

Clearly this matter requires further discussion between the Audit Office and the SRA.

Mr Whitfield pointed to past confusion within the SRA on accounting methods used to identify payments additional to salary. In 1994, a consultant was employed to inquire into such systems and found their reporting systems inadequate. However, while previously internal management controls on overtime were not complied with, the Audit Office acknowledged that are now rectifying this:

*Mr Whitfield: Our understanding is they have been putting in effort to control it.*<sup>81</sup>

### **8.3 Conclusion**

The Committee was considerably concerned about the variety and magnitude of problems that have evolved within the SRA. It is noted that many of these resulted from a cash accounting basis which hid such problems as inadequate inventory control, pilfering, hoarding of stock and an obscuring of the true values of stock on hand. The continuing problem with overtime payments is also an issue that requires the immediate attention of the SRA, a problem that has implications for the efficient management of its resources.

The Committee realises that management practices prior to the 1990s were also to blame and that in many ways it was the culture of the SRA that prevented it from being brought to true account. The acceptance of overtime payments being paid without the proper checks and accountability and the theft and hoarding of equipment were part of a cultural outlook that viewed this as a common and acceptable practice.

The Committee notes that in recent years considerable changes have been introduced to the management practices of the SRA and that these should substantially alter the outmoded accounting practices previously used. This should also shift the outlook of the SRA to that of a more commercial, competitive and accountable organisation.

These processes are still underway within the SRA. However, while substantial progress has been made on a wide range of issues, the SRA has not yet rectified a number of problems. The matters of inventory control and overtime payments are still of concern to the Committee and will be closely scrutinised.

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<sup>80</sup> Evidence to Committee, 29 May 1996, p. 67.

<sup>81</sup> Ibid., p. 67.

**RECOMMENDATION**

**The Committee regards the accountability of the SRA on these matters as of considerable importance. The Committee recommends that the PAC conduct a review of the SRA in twelve months time in order to follow up action undertaken by the SRA in its financial management practices.**

**REPORT OF PROCEEDINGS BEFORE**

**PUBLIC ACCOUNTS COMMITTEE**

**SPECIAL COMMITTEE OF INQUIRY INTO  
THE AUDITOR-GENERAL'S FOLLOW-UP  
VOLS 1, 2 & 3**

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At Sydney on Wednesday, 29 May 1996

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**The Committee met at 9.45 a.m.**

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**PRESENT**

Mr Terry Rumble (Chairman)  
Mr I Glachan  
Mr R Chappell  
Mr J Tripodi  
Mr P Rogan

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LEONARD JOHN HARPER, Chief Executive Officer of the State Rail Authority, [REDACTED], sworn and examined:

CHAIRMAN: Did you receive a summons issued under my hand to attend before this Committee?

Mr HARPER: I did.

CHAIRMAN: The Auditor-General's audit opinion on the financial statements of the State Rail Authority drew attention in the notes to inventories, stores and materials on hand which were valued at a nominal \$1. Will you tell the Committee about this; and do you have an estimate of the value of the inventories shown in the accounts at a notional value of \$1?

Mr HARPER: The Auditor's comment referred to the user stores or the inventory of State Rail in the 1994/95 accounts where at that time evaluations had not been completed and a number of the stores were either valued at zero, 1 cent or \$1 in those cases. Whilst they had been brought to account and debited against the work and expenditures, their evaluations had not been completed.

What needed to be done, and what has been done and is near completion, is for those stores to be identified for them to be evaluated in terms of the real value of the business, in most cases the replacement cost; and where they were identified as having no value, in most cases therefore obsolete, sold or disposed of in some form or another. Importantly, for those goods to be catalogued, recorded, and their use recognised in the transfer of goods from one point to another, which would lead to the economic ordering of those inventories.

What we are talking about here is the management of inventory, which wasn't in place as at 1994/95. We have been processing that right throughout the 1995 year by undertaking full cataloguing, and as of today we have most of the inventory on a new automated inventory account system, which is the MINCOM system, and by 14 June this year we will have all user stores catalogued, valued and recorded. The only exception will be with Rail Services, which is a group that will be operating as a construction group after 1 July. All their accounts, whilst they will be catalogued, valued and recorded will not be on the automated system until some time later in the 1996/97 year when we will transfer them across to that MINCOM system.

Our whole intent, given the qualification in the Auditor's report in the 1994/95 accounts, is to have those inventories in a managed state so that we don't have a qualified account in 1995/96. We will not have a qualified account in 1995/96.

CHAIRMAN: Just going back, can you inform us when the State Rail Authority changed over to the system of accrual accounts? Wouldn't that at that point in time have necessitated a valuation being put on inventories?

Mr HARPER: To answer your last part, yes, it would have, but State Rail has been operating on a cash accounting basis and continues to operate on a cash accounts basis in the

1995/96 year. 1996/97 will be the first formal year of accrual accounting following an arrangement between Treasury and the organisation. We are still drawing down on cash accounts.

Mr CHAPPELL: The first part of that question—do you have any estimate of the value of the stores you are likely to bring forward?

Mr HARPER: Not in dollars, but the total inventory is roughly \$70m.

CHAIRMAN: More of an accounting type question—the Australian Accounting Standard AAS2 Accounting for Measurement of Presentation of Inventories has been in operation since 1976; did State Rail accounting and stores people have difficulty in implementing this standard?

Mr HARPER: I am an accountant, but if you can describe what the standard is I might be able to answer that.

CHAIRMAN: It is an accounting standard called Accounting for Measurement of Presentation of Inventories, which was brought into operation in 1976.

Mr HARPER: I can't answer that question.

Mr TRIPODI: In a written response to the Committee, the Authority stated that the identification of cataloguing and valuation of stock holdings at nearly 600 user locations was a major exercise. Why had this action not been taken previously?

Mr HARPER: Up until 1991, in fact stepping back a little bit to answer that question, as you say there were some 600 official stores across the organisation. There are also something in the order of 20,000 non-official stores across the whole organisation and, to put it bluntly, the inventory management of State Rail was in a mess. There was no means by which we could understand, control or manage the issues of inventory usage.

State Rail recognised this a few years earlier, but it was in 1991 before it started to go around in a three-stage fashion to begin to identify basically what it had; to put it into stacks, to put it loosely, to count it; to understand where it sat; and to put it into some record form. That took the next three years before it got those rudimentary efforts of inventory management into place. There was no attempt at that time to really evaluate it and to place it in any sort of recorded method that would allow drawdowns to take place and accounting of those drawdowns to be accounted for. It has been since then that that work has been undertaken. I described the tail end of that to the Chairman just a moment ago.

But to answer the question, in an organisation that for years had been operating in a total consolidated way where its financial support was straight out of Treasury without much verification, it was the difference between what it earned and what it cost, in cash form, not accrued form, and that money had been coming across in that form for many, many years. Then the management of the inventory or the cost in the inventory process was one that was always

absorbed in the system as a whole and there wasn't a focal eye, a microscopic eye, on the detail of things that are needed in business if you are there to make a profit or to return a commercial return.

The emphasis was never there, and it was only when State Rail understood the dramatic state to which it had reached when it could not begin to identify what it had on hand, that it understood clearly that something had to be done.

Mr TRIPODI: You mentioned earlier a value. What is the value of the inventory now?

Mr HARPER: Around \$70m. The main part is broken up within the groups of CityRail or Main Train, where we hold our inventory over there with fleet maintenance, which is of the order of about \$40m; and \$30m is split mainly between the Rail Services Group and the Freight Rail Group. Freight Rail has something of the order of about \$5m to \$6m, and the rest is made up of \$25m at Rail Services.

Mr TRIPODI: At this stage you have come to recording the level of inventory you have. There are no inventory control techniques in existence at the moment?

Mr HARPER: Now there are.

Mr TRIPODI: That is pretty recent?

Mr HARPER: That was within the last nine months.

Mr TRIPODI: In determining where to allocate the maintenance program, how was that done in the past? Now that you have a proper record of assets, you can now allocate your maintenance program with a consequence—maintenance of stores?

Mr HARPER: One might say that we have actually cleaned the field of the rubbish and put it into more of a "green field" state of affairs. But the important issue is the ongoing maintenance or the management of those inventory stores and, as I mentioned before, it is very simple, to get the commercial attitudes into an organisation so that there is economic ordering, so that there is timely ordering—I will not go into the essence of just in time issues—and very importantly that people have on hand only what they need to have on hand and that the rest of the money is invested in things which give better returns.

That attitude is coming about as a result of the commercial needs that are there with the rail restructure that is going on. One cannot say that it is all in place and it is now operating perfectly, because it is not. We still have people who, because of the lack of trust of being able to drawdown stores when they want stores, have got an unofficial cache of the equipment they need. We know it is there—we didn't know that before—sitting there in readiness for use next week because they don't trust the system. What we have got to be able to put into place, and we are putting into place through a better automated system that basically says very simply to anybody using a modem, or is in a position to use a modem, is that these are the stores that are available in the system, if I want a widget, "Oh, they have some at Enfield, I will get the widgets

sent over here", rather than keeping 25 widgets on hand all the time whether they need them or not. That is what happened in the past.

Mr TRIPODI: Is there an intention to implement just-in-time inventory control?

Mr HARPER: There is, very much so. But, once again, it is on the basis of having the processes right, the management understanding right and having the back-up or the automation or the equipment that will help you do that. We are doing that in all three stages at the same time, because it needs to be done at the same time. It is not a one-on-one basis.

Mr CHAPPELL: Given that there has been no effective management of stores inventory over all these years, is anything done to prevent pilfering?

Mr HARPER: The normal things that they would have undertaken—here we are talking about history so I can't stand back and say this with any real verification, but I am aware that normal things they would have done are to make sure that there were such things as securities in place, there are always checks at workshops every night. If one was go out there, one of the major jobs of the gatekeeper was to check out bags, those sort of things. It is the old story of, "What are you pinching; wheelbarrows, I suppose".

Those sort of policing techniques are always in place, I can recall that.

But in terms of management techniques, there were few management techniques that would have provided for an overall effectiveness of maintaining management and administration of stores. You can't say that there was when the records show that people didn't even have a trading account for particular items, catering, for instance. One would expect when a train went out, they would know what was on it, they would know what purchases were supplied, they would know what came off and they could do a reconciliation of accounts. Very simple things like that. Manual systems weren't in place. It was a matter of loading what they thought was needed for the trip, taking off what was left, and counting up the cash at the end of the day. Under those conditions it is like owning the cash register at Coles and saying, "Go for your life". There was no control.

Mr CHAPPELL: Given that there was no control over that aspect, except a bit of policing at larger workshops and not the smaller ones because "everyone trusts everyone to pilfer", getting on to the management of obsolescent stores, if you say that people didn't trust the system to supply on time and therefore they hold some in store just in case, presumably a great proportion of what was being held in store was going to become obsolescent before you use it anyway. Do you have any idea of what the management of that was and what sort of wastage rate was involved in all of that?

Mr HARPER: I can't assess the wastage rate but you would be right in saying that there was a fair proportion of goods in store that were obsolete to requirements, or if they weren't totally obsolete they were a very costly item to have on the shelf for their turnover rate of less than once in a year or more than a year usage. There is no doubt that there was some fairly costly equipment, \$2000 in this case and \$2000 in that case, which would all add up, that probably had

a turnover rate of less than one a year being held on the shelves.

At the moment the turnover rate is about 2.9, that is, distillate. That is still not commercially good. We need something to be around about 4 or 5 before we can say we are happy with that, which also says to us that our existing inventory holdings are higher than they need to be. This comes to the second part of the question, that we are now going through processing the sort of goods and their life and the life in store and the life in turnovers so we can equate that to how many of those type of goods we should have so that we overcome the obsolescence of goods.

Mr CHAPPELL: Given that you have been going through this process of bringing all of your stores into account and you have been identifying and cataloguing and so forth, do you have any idea of just how much material you have found which is now totally obsolescent, you know, years past its use-by date?

Mr HARPER: Surprisingly it wasn't all that much because the tendency has been, even in "rat nesting", to only hold on to those sort of things they knew they would need sometime. So there wasn't a great deal of total obsolescence. What we found is that some of the equipment was being held, generally on the part of the people holding it, but not at a good use rate. In other words, we had brake drums held because they might need them, but they weren't honed out well enough to use. They didn't know that so we had to dispose of a lot of goods at zero cost, particularly when we went across to Main Train and we realised that we needed to manage our inventories in order to maintain a worthwhile partnering arrangement with Main Train, otherwise they would not be in the position to gain in the contract, in productivity sharing, if we didn't manage the system.

There was therefore a discipline upon us and we started to do that. But when we went through that process we found that the main part of the brake drums—I am sticking with that piece of equipment—were useless and had been held in store for sometime, that they were useless because they were honed out wrong and were not to specification and we threw them away, a complete write off of brake drums that had been held that were not really obsolescent but useless for requirements.

Mr CHAPPELL: So I guess the overall summary is that there was no control over cost of stores?

Mr HARPER: There was no formal—I will not say formal—there was no total control over the stores that allowed it to be an efficient or economic store arrangement. There was control over stores in each of the separate areas, and every subforeman knew exactly what he had on hand. They were not particularly concerned about the evaluation of that because there were no job cards, they were not setting up the material and the manufacturing accounts, but in terms of what they had you can bet your life they knew exactly what they had and they knew how many they needed to have to be satisfied in their own place. But there was no total overall understanding or management of it as such.

Mr TRIPODI: The only control technique was supervisors?

Mr HARPER: It was further than that. There was certainly an estimate of—there was stocktaking, so at one point or another there were estimates of how many stores were around. What they didn't always know was how many of these unofficial stores were there and in that case, yes, the supervisor concerned was maintaining the stock. But in the overall sense of the business as a whole, of State Rail as a whole, there was an estimate of inventory, there was an opening and a closing and there was a drawdown on them as they were recorded through the works order program which was in place then. Whilst that was all very formal and all very right, it didn't cover the total inventory and therefore you couldn't say it was totally managed, that is the point I am making.

Mr GLACHAN: Can you describe your cost benefits system, the system of cost benefit analysis, the methods you employ and what projects they apply to?

Mr HARPER: The question, I take it, emanates from the Auditor's comment that CityRail had not always undertaken cost benefit analysis?

Mr GLACHAN: That is right.

Mr HARPER: I had the pleasure of being asked to come across to head up CityRail in June last year. Before that I was Chief Executive of State Transit and I came across there on the premise that it needed a great deal of a shake up, and it did, and one of the issues that wasn't taking place very dear to my heart was the undertaking of cost benefit analysis in capital programs. I found across the organisation in general that it was occurring, that there was a requirement for it to occur but that CityRail had taken an attitude or a view that, if there was a project which involved matters of fit for purpose or safety issues, an economic valuation was not required. They only undertook the evaluation when there was a growth or investment or reinvestment issue in place.

From round about June last year coincidentally we have been undertaking a cost benefit analysis of all capital expenditures over half a million dollars as required by Treasury. In fact, State Rail has a guide to evaluation. That came out round about the middle of last year, so we let everyone understand what they were meant to do. That was occurring in other parts within the rail services, within Freight Rail, and what we now do is go out to tender in every case.

We do have some in-house evaluations for some of the smaller ones of less than the \$500,000. Those over \$500,000, we generally engage somebody to come in and do it. I have brought some examples along, if you want to look at them. They cover all aspects. I am a very disciplined economist myself and I can assure you that they follow every aspect.

That whole group that I will leave looks at the particular issue; test the point of the purpose of the investment; the objectives of the investment; the options that are available to them; look at the base case option and test that base case option before they assess the other options; go through the assessment of financial cost; go through the assessment of economic cost, social type costs and intangibles; then go through and do the matching of present value, net balance, IRR and payback schemes. They then come up with a recommendation as to whether it should go ahead, whether the base case has any value and whether or not there are any options

within that assessment that show the way.

We are talking about it being worthwhile in terms of everything must be measured and so that it is not enough to say, "Oh, it is a safety issue, it needs to be done". In the early days of CityRail I used to throw it back and say, "It can be measured, tell me what safety will cost us or benefit from the whole issue?". It is a very well structured approach now that previously in CityRail wasn't as well structured. Within other parts of State Rail they were certainly more advanced.

Mr GLACHAN: How many projects would fall under the \$500,000?

Mr HARPER: Very few. I would say you are looking at the 80/20 rule. I would say 20 per cent of the projects would fall under the \$500,000. The major part would be over \$500,000. In the last 12 months we have probably evaluated over 100 capital programs. I am not saying we have completed 100 capital programs, but there were 100 evaluated.

Mr GLACHAN: How much do you have to pay for all these evaluations?

Mr HARPER: Between \$10,000 and \$20,000 each evaluation.

Mr GLACHAN: Where the expenditure is over \$500,000?

Mr HARPER: Yes, over \$500,000.

Mr GLACHAN: The Auditor-General says that 6500 staff earned in excess of 50 per cent of their base salary in overtime. This isn't a very efficient work practice. What is your view about that? How does this occur?

Mr HARPER: It is not a very efficient work practice, that is correct. If you look at the norm in industry—I am talking about a manufacturing and operating type industry—the norm in overtime sits anywhere between 15 and 20 per cent. If you have got more overtime than that in the system it is usually because you have got a shortage of staff, you have an inefficient rostering system, in other words, you are doing things you should not be doing, usually as a result of work practices or it is one or the other or a mixture of both.

The figures mentioned in the Auditor-General's report refer to overtime and allowances and that is a bit misleading because allowances could be anything from higher grade, Saturday or Sunday work, loadings, special allowances for dirt money, meal money, the whole lot. It equates to anything, depending on which particular area you are working in. It equates to anything between 10 and 20 per cent of the moneys over and above the base rate, those allowances alone. So when you look at overtime, standing alone within State Rail it is of the order of 24 per cent at present. That is still over and above the norm.

But there are a couple of issues that are very important to understand. One is certainly the efficiency, or more likely the inefficiencies, and we won't pretend they are not there in the organisation and have to be fixed. The second one is the work methods or work practices, which

I just want to make mention of. But within the inefficiencies, getting back to those three points, not enough staff or inefficient rostering is clearly one of the areas for improvement within State Rail in work practices, the way we handle things.

I will give you a couple of quick examples. We have work practices which result in staff working on the track between 6am and 6pm. What we think is that it would be better to have the work done at night. In Europe and the States that is the way it operates—24 hours a day, seven nights a week. We work our staff on a five-day roster, not seven days, so we don't get the best use out of staff; and we are going through a process with our staff and the unions at the moment on enterprise bargaining to bring that about.

That also brings about something which I will quickly mention: It is not only just in overtime, it also reduces your staff requirements fairly significantly when you have better use, where you can spread them over time. The same applies with maintenance of the fleet. We bring on our main fleet rosters at 7 o'clock in the morning to go home about 4 o'clock in the afternoon, just at the time when passengers want to travel. When the cars are available, say on Saturday and Sundays, it is OT rate, or late at night when the trains are down on the ground, as it were, we haven't got people working. So it is those inefficiencies within the use of existing resources which are important. I am just not talking about people, but machines and the whole issue.

The other issue of inefficiencies relates very much to shortages within the critical areas. State Rail, like many government owned enterprises, for the past several years has done a pretty good job toward bringing down the number of people working in the organisation to a level where it ought to be. But, having said that, there are a number of areas where critical shortages or shortages in critical areas have occurred. Station staffing is one of those. It has been somewhat of an artificial effort to maintain a reduced number of staff and work higher levels of overtime rather than to increase the number of staff necessary to do the right job.

We are going through the process now of increasing staff. In fact, since November last year we have increased station staff by around 140 people. Of course, there was a need to do it in terms of customer service. But it is also bringing down the overtime rate, which was at that point sitting around about 35 per cent for station staff. It is closer to 30 per cent now and it needs to be brought down to around 25 per cent. They are the sort of inefficiencies I am talking about that are inherent in a lot of systems and in a lot of organisations, as they are within State Rail.

The area of working format is pretty important to mention. Railways always has been said to me to be unique. I don't believe they are unique but they have got some uniqueness about them. For instance, railways have been two businesses for a long time, either carrying goods and people, or maintaining the way. There is a conflict between those two businesses. So what it has tended to do is maintain the way when the carriage of goods and people is not disturbed all that much, which means that they bring people on at weekends as a rule. The same people they bring on at weekends as a rule are the same people who work Monday to Friday.

Within the track work area—and the main part of that 6000 people are within the track work area, in fact, the exception is very much in the track work area, where in the main these



people are working regularly on weekends as a part of their roster and 12-day fortnights as a regular part of their roster.

CHAIRMAN: You said before it was around 24 per cent of the total would work overtime. The 6500 that was mentioned, what would that be reduced to in terms of numbers?

Mr HARPER: The 24 per cent which we are looking at at the moment is in fact the average overtime worked over and above the base salary. However, the range is the issue, because the range goes from zero to 250 per cent. What I am saying, if you look at the distribution curve, is round about 25 per cent of your staff are working an excess amount of overtime, with between 50 and 100 per cent increased on their base rate.

Mr GLACHAN: Some people are working?

CHAIRMAN: What numbers would that be?

Mr HARPER: You are talking of the order of about 3500 to 4000 people.

CHAIRMAN: That is gradually being reduced as you are putting more people working on stations; and you are going to employ more people in track work or just rearrange their rosters?

Mr HARPER: The important things we did since that audit report came out was putting things into a sensible management format and that is, firstly, understanding the need for the overtime in the first place, in other words, it has to be programmed, it has to be preplanned and signed off before it is worked, it has to be verified as it is worked, as against the plan, as against actual and, importantly, what we have now in place at State Rail is a regular monthly reporting mechanism to management and to the board of the amount of overtime worked across the organisation by business group and by classification in each business group.

The areas where the overtime is still high, around about 30 per cent on base rate, is within the stations, and about 35 per cent within the infrastructure area. Ordinarily in the administrative areas it sits less than 5 per cent, and within the other areas of freight, except for the infrastructural work, it sits at round about 15 to 20 per cent.

Mr GLACHAN: If you were to come back here next year about this time and we asked you similar questions, what do you think your answers would be then?

Mr HARPER: I would say the range would have reduced but the average would be very much the same.

Mr TRIPODI: The decision in the past to lay off an enormous number of employees, what you are saying now is that was actually an inefficient decision?

Mr HARPER: I didn't say that. I said there was a need for numbers to be reduced significantly. There is no question about that. But the point is, in a number of areas it went

below the area.

Mr TRIPODI: The optimal level?

Mr HARPER: Yes.

Mr TRIPODI: So it was inefficient?

Mr HARPER: I wouldn't call that inefficient, I would say there was, let me say, an effort to reduce staff that was necessary to be reduced, and the example I mentioned of stations is a very good example which refers to the comments I have been making. There was also the introduction to a pretty good system we have now in place called automatic ticketing. It created the opportunity for magnetic-based tickets, ticket vending machines, ticket office, cash registry machines and fairly sophisticated machines to come into place to help us measure sales, understand more management information and reduce fare evasion and to make things more customer based in the way in which we sold tickets. It achieved all those things, not to the same merit we would have expected, but it achieved that in some form or another.

One of the calculations in the implementation of that system was that it would save something like 300 station staff, in other words, the machines would replace the staff. It does not happen that way. Machines do not replace staff. Passengers and staff throughout our industry, the transport industry, do require the customer service that can only be delivered through people and in all cases ticket vending machines and automatic ticketing processes are supplementary to that service. Everywhere you go except within a closed system like Hong Kong or Singapore—we don't have a closed system, we have barriers at every station—you require personal sales officers.

So the first intention to reduce some 300 staff because of the automatic ticketing had already commenced, and they got down to the point where they reduced the staff to the order of about 150 beyond the means where they could operate and they were holding them there, artificially holding them there, by working overtime.

Mr TRIPODI: That is what blew it out?

Mr HARPER: Yes. It was wonderful to be able to come in and report and say, "All my staff levels have come down, what a marvelous performance indicator, I lost so many staff".

Mr TRIPODI: Were a lot of these decisions driven by trying to get the performance indicators looking good?

Mr HARPER: I suppose. I can't answer that for myself, but I do know this much, that when one of the performance indicators was how many staff you lost this week, I felt that we were in the wrong business, that we weren't delivering service, we weren't looking at customer issues, we were looking at how many more people we could get out of the place. That may not have been the answer.

Mr CHAPPELL: With the broad assumption that that is going to lead to greater efficiency?

Mr HARPER: Yes, from a cost side accountancy/economist's point of view that 65 per cent of costs in a business are labour, so get rid of more labour and reduce the costs, without an understanding of the impact on the business.

Mr TRIPODI: The answer to my original question is yes?

Mr HARPER: It is not.

Mr TRIPODI: If you drive the staff levels below optimal levels, it is --

Mr HARPER: You asked is it inefficient. I said, no, it is not inefficient.

Mr TRIPODI: We have just seen blow outs in overtime.

Mr HARPER: I wouldn't call that inefficient. What I would say is that they went to a level where they believed they ought to be and when they realised they should not have been in that position, they started to bring on staff. The attrition rate within State Rail is 16 per cent. That means one in six people leaving. In the station area, it is about 25 per cent, which means albeit in the 6 months I was with CityRail we were increasing staff and at the end of the day I was still 84 short from where I started. I was losing them quicker than I could employ them. It was not a matter of inefficiency, it was recognising the point of no return and trying to do something about it. But we had gone past the optimal levels.

Mr GLACHAN: In relation to your overtime, you said you were negotiating with the unions and looking at enterprise bargaining?

Mr HARPER: Yes.

Mr GLACHAN: When did you start the negotiations?

Mr HARPER: We started the initial work, and I will not call that negotiations, but participation with unions back in August/September last year.

Mr GLACHAN: In an effort to try to reduce the overtime?

Mr HARPER: In an effort to get better use out of people and reduce costs totally, yes.

Mr GLACHAN: How are those negotiations progressing?

Mr HARPER: Extremely well. We had a report only yesterday from people looking at the track maintenance area who have been working with the staff and the unions in a work and job redesign project. That was basically said, "What is a better way in which we can do the work; what is a better means of being able to get a better product out at the end of the day and

deliver the service to the customer". They are beginning to understand they have got customers, which is an important turn about in the railways, and how can we share in those gains, because that is part of the enterprise agreement arrangement.

We are looking at opportunities of being able to work people on 7-day rosters. That means that Saturday time is not time and a half, it is part of your rostered work, that overtime is actually put into an aggregate wage arrangement, all allowances come in under an aggregate wage arrangement and that you have to work up to an agreed amount of overtime at no extra cost because it is already in your salary base.

In Sydney Ferries within State Transit—I can speak with authority there—we actually have introduced those enterprise agreements, so in the ferry business we have an aggregate wage for our ferry masters, engineers and captains where the wage rate has been struck based upon their overtime and on their allowances, and they work up to a period of 98 hours in a fortnight without any overtime whatsoever.

Mr ROGAN: Going back to the first question from the Chairman dealing with your inventories, stores and materials where a lot of those were on the books at \$1, 1 cent or no value, how does that relate to the \$70m that you talked of at a later stage of inventories? Were they brought back onto the books to give them that value of \$70m?

Mr HARPER: Those that were valued at other than the 1 cent and \$1 value, yes, they were brought back on the books. We still have a number of items on the accounts which are valued at 1 cent but they form part of the obsolete group that I referred to before and that group of stores is going through the process of disposal. So there are some items on the inventory records which still remain at a nominal rate because they are considered to be obsolete to requirements and therefore of no resaleable value.

Mr ROGAN: So the accounts that were presented each year during this period, you would say they were accurate but that they did not really truly reflect the situation so far as the accounts within the State Rail Authority?

Mr HARPER: They were accurate in terms of the accounting standards and they represented from the Auditor's point of view true records of the Authority at the time. However, the point is that the Authority at that time wasn't in a position to have a genuine evaluation of all their stock. They didn't have a genuine evaluation and that is what the Auditor-General picked up. It recognised there was fairness, trueness and fairness in the accounting presentation but that in the elements of the inventory stores themselves clearly the evaluation was an estimate or a provision rather than the real cost.

Mr ROGAN: Whilst the public were looking at the State Rail Authority and seeing an XPT Tangara image, the reality was as far as the accounts were concerned it was a steam train era they were operating in stores?

Mr HARPER: I think that is a marvelous synonym that I would like to repeat sometime. But really in certain areas of the management of stores, yes, that is true. You couldn't have come

up with, for instance, a total costing process within State Rail at the time other than making an estimate of the material component of that cost. That was done and it was an estimate. But basically you can't operate that way in commercial terms. From a customer's point of view I think it is fair to say that they saw good trains, they probably considered it a reasonably good service and were seeing some modern entity being put into the system, but the process of managing those systems was still lacking.

Mr ROGAN: Does the Authority have criteria to determine the relative efficiency of using salary and wages staff with or without overtime as against the use of contract staff? What impact would such a staff mix have on the effectiveness of State Rail operations?

Mr HARPER: The answer to that is yes. We follow some benchmarks across various industries to get a recognition of what that mix and match should be. At the moment we have a ratio of about one administrative staff to five operative officers—one white collar to five blue collar, whatever you like to call them. In business it should be somewhere between one to about seven or nine. In some really skinny businesses—I am talking about high technology, high machine equipped businesses—it is about one to 12 or 15. So we are at the lower end of the scale in railways, not just in State Rail but in railways generally, because railways haven't equipped as quickly as other industries have in the technology of things.

I will not go into all the background of that because you will keep me going for an hour, but the point is that that is a ratio which says to us, you have got more people in the main administrative staff than you need, the blue collar workers and unions will say, no, you have not got enough blue collar workers, but that is not the case, it is the other way round.

What we are going through at the moment is streamlining the number of administrative positions and management positions across the organisation. We clearly have more managers than we need within State Rail and the process is in downsizing that by bringing in fewer levels of management, stronger lines of direct accountability and taking away the unnecessary hurdles and the restraints of middle management when there are too many of them. And that is what is happening in this organisation and many other organisations, I suggest, private and public, not just State Rail.

Mr ROGAN: Lastly, there is a further comment by the Auditor-General relating to the lack of reconciliation between approvals for overtime and the actual times worked. How does the Authority control this expenditure if approvals are not being monitored?

Mr HARPER: They couldn't have done it effectively in that way. In some areas it wasn't being checked in the way it ought to have been. It was being signed off by the person who was responsible for that group of people without necessarily checking it against actual times. Since then, in an effort to reduce overtime, we have been planning the overtime or planning the work and the component of overtime in that work and making sure that in the verification of time sheets that that work that is actually worked is reconciled with the planned work and with the work shown on the time sheet. That has been operating now since about the beginning of the 1995/96 year.

Mr GLACHAN: On the overtime question, which is a major issue for you, what you have been saying to us I take it is that you are putting on staff where the staff levels have been too low to maintain the level of service you need?

Mr HARPER: Yes.

Mr GLACHAN: That has resulted in unnecessary overtime. You are also negotiating with the unions and the staff to get a better use of your labour force?

Mr HARPER: Yes.

Mr GLACHAN: And are there any other things that you are doing? Those are two major initiatives, but anything else?

Mr HARPER: There are the management processes being put in place.

Mr GLACHAN: To make sure it is necessary overtime?

Mr HARPER: Yes, and, more importantly than that, does the work need to be done, particularly with track work.

Mr GLACHAN: And on overtime there are four major points you are working on?

Mr HARPER: Yes.

(The witness withdrew)

RONALD JAMES MACDONALD, Pro Vice-Chancellor for Research, University of Newcastle,  
[REDACTED], and

BRIAN LEWIS PENFOLD: Executive Director of Finance and Property, University of Newcastle,  
[REDACTED] sworn and examined:

CHAIRMAN: Did you receive a summons issued under my hand to attend before this Committee?

Prof MacDONALD: I did.

Mr PENFOLD: Yes.

CHAIRMAN: The inquiry today is to do with the flying school. Could I ask you first off why did the university feel it was necessary to get involved commercially with this business?

Prof MacDONALD: I can answer at least part of that. I was involved in the very early days of setting up the flying school. The flying school, at that stage, was known as CATA the Civil Air Training Academy. It was a separate organisation which approached the university with a proposal that civil air pilots required a much more professional background than they currently had and that part of that background could be achieved by coordinating flying instruction with a university course which covered all aspects of flying and particularly aviation, legislation and science.

I am quoting from memory because a lot of our documents are with the liquidators, but it was about 1984 when the first approaches were made, over a period of a couple of years. At that stage, I was the Dean of Science in the Faculty of Science at the university. We continued those negotiations with CATA, set up a proposal. We talked a lot to both the national and the international pilots associations, who were very much behind the proposal and, eventually, we established a degree in aviation.

Unfortunately, although we negotiated very strongly with DEET at the time, with the Federal Government, we were never able to actually have the flying fees incorporated as part of the structure of the course because under the Higher Education Funding Act, the university was not able to charge a fee for the flying training were it to be a subject within the degree of aviation, so it always had to be maintained as a parallel operation.

For the first several years CATA was that parallel operation. CATA was an independent organisation where but there were representatives of the university on the board of CATA. However, a memorandum of understanding was struck that, at some stage, the university would assume responsibility for CATA as an independent organisation and this it did in approximately 1990. Around about 1990, the university eventually assumed full responsibility for CATA. It did not assume responsibility for its assets but it certainly assumed responsibility for the conduct of the business of CATA, which at all times was a non-profit training organisation in the area of pilot training.

CHAIRMAN: Why did the university buy 22 aircraft in September 1993 when the company had already been experiencing cash flow difficulties?

Mr PENFOLD: It was for the very reason that it was experiencing cash flow difficulties. The vice-chancellor of the university, on the advice of the board of the company, had taken a decision that it was paramount that the students' interests be met and that we were in no way going to allow the company to fold with students having paid fees in advance and only partially having completed their courses. So we were trying to restructure the company at that stage and one way of doing that was to purchase the aircraft. They were purchased at the cost of \$500,000, as you mentioned. They were actually valued at much more than that and we thought from the university's point of view that that was a reasonable purchase. On the other side of that, we leased them back at quite a concessional rate.

Mr GLACHAN: To CATA?

Mr PENFOLD: To the flying school, yes.

Mr GLACHAN: How much did you buy?

Mr PENFOLD: Twenty-two.

CHAIRMAN: What is the value of the fixed and floating charge granted in June 1994?

Mr PENFOLD: Well, it was a floating charge, so I guess to answer that, the amount of money that the university had advanced to the flying school as at that stage—what was the date again?

CHAIRMAN: This is June 1994.

Mr PENFOLD: June 1994, the university at that stage had lent the company \$200,000 and that would have been the value of the charge. It was a floating charge.

CHAIRMAN: What was the background to the change of name in February 1994 from the Civil Air Training Academy to the University of Newcastle Flying School?

Prof MacDONALD: The Civil Air Training Academy had been originally registered at NASA, the Nationwide Aviation Space Academy. It changed to CATA somewhere around the early 1980s. One of the problems that was occurring was that we were getting rumblings from the industry, almost entirely through this operation, that CATA as an establishment did not necessarily have a good name in the industry. Since the university was now becoming more and more closely identified with the operations, given that it now controlled the board, we were very concerned about the reputation of the university perhaps being in any way affected by the possible reputation of CATA. We never ever found any evidence that suggested that the adverse comments that were being made were based on fact, by the way.

Mr GLACHAN: What sorts of comment were they?



Prof MacDONALD: Mainly that the standard of training being given to the pilots was not good and that there was a continuing disagreement between the Civil Aviation Bureau that was responsible for the licensing of CATA as an integrated flying school and the management of CATA itself. By this time, we were largely responsible for the management. We had good dealings with the federal civil air training department—or whatever it was called at the time—which was responsible for licensing, and we had no problems with it.

However we were also concerned that there was a much greater involvement and an obvious involvement at the university, so we felt we should really reflect that involvement in the name of the company; consequently we changed it to the University of Newcastle.

Mr GLACHAN: So you were running the company?

Prof MacDONALD: We were running the company

Mr GLACHAN: You lent them money, you bought the aircraft, you were leasing them back at a concessional rate. What was your source of income? What was the company's source of income?

Prof MacDONALD: This is also one of the problems that started to occur about this time. The source of income of the company itself was the flying fees.

Mr GLACHAN: And who paid those?

Prof MacDONALD: The students.

Mr GLACHAN: So the students undertook a course in aviation called a bachelor degree in aeronautical—

Prof MacDONALD: That is the problem I alluded to before. Under the Higher Education Funding Act for universities, we are not allowed to charge fees for any part of a university course which is a—

Mr GLACHAN: But the company could, CATA could?

Prof MacDONALD: CATA could, but we could not give credit in a university course. If we said it was to be an essential part of the course, of the degree, then we would have to provide it, so we would have had to pay the fee to CATA on behalf of the university. We could not do that, so—

Mr GLACHAN: Did you have to do that for any students?

Prof MacDONALD: No. All the students took the course.

Mr GLACHAN: Knowing they had to pay their own fees?

Prof MacDONALD: Knowing they had to pay their own fees. We also were running CATA itself and as well as being combined with the university and the degree of aviation, it was associated with what was called an Integrated Commercial School, which ran training for pilots.

Mr GLACHAN: For other people?

Prof MacDONALD: For other people who were not university oriented, but they did an accelerated in-house course for I think 11 months, which was sold. We actually had a contract with Malaysian Airlines, for example, to do the training for their pilots. About the stages that these financial difficulties started coming up, Malaysian Airlines had also decided to remove its flight training in-house to Malaysia because they were starting to pay too much for overseas training. Our business plan had a forward projection including the MAS course. That of course went out the window when they decided to transfer that back to Malaya.

Mr TRIPODI: What is the current value of land and buildings?

Mr PENFOLD: The current value, I am not sure about. Certainly when the company acquired the land and buildings, there had been two valuations at just under \$1 million. When the company was nearing the liquidation stages, we again received a valuation, but at that stage something like \$250,000 was being suggested. One of the two original valuations was done when the company took over the land from the person who virtually owned NASA, the National Aviation Space Academy. At that time, the valuation was done and it was thought reasonable that the company pay that sort of money.

We received an overdraft from the National Australia Bank some years later to pay off that particular vendor of the land and buildings. The vendor was being paid monthly, but we decided it would be more cost effective to get an overdraft and pay the vendor out. Before the bank gave us that overdraft, it had a valuation done independently and the land was valued at \$1m. The actual sale price at auction, I cannot give you specifically, but it was somewhere around \$300,000. That was following the liquidation, following the liquidator being appointed. So the National Australia Bank actually lost money. It lent us something like \$400,000 and it got back something like \$300,000 because that was all that the mortgage covered.

Mr TRIPODI: So how much will the university lose altogether?

Mr PENFOLD: It is still not finalised because we still own seven aircraft which we are leasing to the Avondale Seventh Day Adventist School. University students are actually being trained there. We have leased those aircraft to them. We intend to dispose of those aircraft at the end of this year. Based on what we got for the original 15 aircraft, if we get similar sorts of prices for these seven, I would say that, overall, about \$800,000 will be lost to the university after it has all been washed up.

Mr GLACHAN: Where will that \$800,000 come from? How will you make that up?

Mr PENFOLD: It has already been budgeted for over the last couple of years.

Mr GLACHAN: Out of what money?

Mr PENFOLD: Out of what the university calls discretionary income, which is basically investment income, income from our investment earnings. The university has \$50m to \$60m in investments. That is not free money; it is tied money, but we have the interest on that money. Most of that interest is free money for us to dispose of as we wish and we have applied some of that interest towards that loss.

Mr CHAPPELL: What internal controls did you have over the management? Was it the usual university administrative type of internal controls or what?

Mr PENFOLD: No, we did not have the usual administrative university controls because again this was a separate entity. Until 1990, the accounting was carried out by an external accounting firm. I guess we were relying on that firm, to some extent, for the internal controls and it was doing the audits. In 1990—

Mr CHAPPELL: Was that the same firm?

Mr PENFOLD: Yes, the same firm. Well, I guess there was an internal sort of audit. I cannot actually recall now back in 1989 whether it was actually doing an audit as well as preparing the accounts. It was a chartered accounting firm from Sydney that was actually preparing the accounts and I cannot recall if there was an external audit.

Mr CHAPPELL: So they were virtually doing the financial management and the auditing of the financial management?

Mr PENFOLD: I am not absolutely certain of that, to be honest. From 1990, that is when, under the Public Finance and Audit Act, the flying school became a subsidiary of the university and the Auditor-General then became the auditor of the flying school. I guess when we talk about internal controls, in hindsight we can see where the problem areas. The members of the senior operational management of the company were expert in aviation; obviously, they were not expert in business affairs. We appointed a consultant some years later when we detected that some things were not going right and that the cash flow was a problem and particularly when Malaysian Airlines pulled out, it became really evident. We also engaged our own accountant.

One of the major problems that we then detected was that a lot of the students were overflying the hours that were allowed by their contract. There is a curriculum set down whereby they are to achieve a certain qualification by virtue of flying a certain number of hours. If they were not being instructed in an appropriate manner or if the students happened to be slow learners, then they were taking more hours. We were unable to charge for those extra hours because it was a fixed-fee contract. That was costing a lot of money. That was a major reason why the company got into financial difficulty.

Mr TRIPODI: But you could have failed those students and then have them pay again for another term, could you not?

Mr PENFOLD: Apparently, with the way the contracts were written, there was an agreement that they would be brought up to a certain standard for a commercial pilot's licence and they would pay a certain fee to get to that stage.

Mr GLACHAN: To reach that standard?

Mr PENFOLD: That is right.

Mr GLACHAN: But some must have achieved that standard early?

Mr PENFOLD: No, not particularly because—

Prof MacDONALD: Nobody achieved less than the number of hours, but a substantial proportion of students actually had to take more than the number of hours.

Mr GLACHAN: Those who worked out the contract made a mistake, did they not?

Mr PENFOLD: As I understand it, the contract is based on federal law in some way. The aviation authority says that to get a commercial pilot licence, students have to do certain things and they have to spend certain hours doing certain things.

Mr GLACHAN: But whoever developed the contract should have developed it so that some would achieve that goal early and you would save money on them to make up for those who would be late. You know that everyone will not achieve at the same level, so you develop a contract so that the early achievers make up for those who are slower.

Mr PENFOLD: Those contracts were changed in the later years.

Mr GLACHAN: To allow for that?

Mr PENFOLD: To stop that. In fact, in the last year of operations we were charging students a lot of money for overflying their contract.

Prof MacDONALD: I think it is fair to say, as Brian indicated, that the expert aviators were not so hot on the management side and they did not keep enough track of the actual hours that were required to get certain students to certain levels.

Mr CHAPPELL: I wish to come back to my first question, which was whether you were using the usual sorts of internal university administrative reporting structures and the answer to that was no. What about the other university-related businesses? Would they also have been managed in this sort of way with their own contracted accounting firm doing financial management and the audit plan?

Mr PENFOLD: The university only has one other subsidiary company. It is the University of Newcastle Research Associates Limited. Professor MacDonald is now the chairman of that company. It has its own accountant outside the university environment and it

has its own external audit—Price Waterhouse or one of the big six firms. Again they do that as an agent of the Auditor-General's department, so the Auditor-General is responsible for the audit.

Mr CHAPPELL: That is the external audit. What about the internal audit?

Mr PENFOLD: I do not know if there is an internal auditor or accountant.

Mr CHAPPELL: This is only a subsidiary sort of question because we were looking only at the flying school, but are you happy that you have learnt some lessons from the flying school experience to apply to the management and the type of discipline for the other business?

Prof MacDONALD: I do not think the same comments relate to the university's company that relate to the flying school. The university set up the company in the first place and has maintained control through the membership of the board to make sure it has conformed to good management practice all the way through, and that company is doing reasonably well.

Mr PENFOLD: The thing that is different about the research company is that, every two months, it reports to the university council on its activities, on its cash flow, and its annual report goes forwarded to the university council. So there certainly is a much tighter oversight of that particular company than there was of the flying school. It was only in the last few years that those sorts of reports started to come through to the university council. Something we have certainly learnt, if you like, is that that should be the approach to be followed for any future subsidiaries.

Mr TRIPODI: In regard to the comment you made earlier, the Auditor-General's report 1995—under "Controlled Entities of the University of Newcastle", talking about Research Associates Limited—stated:

The company recorded an operating loss after abnormal items, of an item of 191,000, after bringing to account income of 5.2m and expenditure of 5m including donations to the University of Newcastle of 151,000.

There was an operating loss. You said it was—

Prof MacDONALD: In 1995?

Mr TRIPODI: Yes.

Mr PENFOLD: That would relate to 1994.

Mr TRIPODI: That was a report delivered in 1995.

Prof MacDONALD: For the last two years, it has reported an operating profit. We did a restructuring in the company.

Mr PENFOLD: There has been a significant turn around in the results of that company over the last two years.

Mr TRIPODI: So last year, you recorded a loss?

Prof MacDONALD: No. I am a little concerned about your dates on that because the last time that the company recorded a loss was the financial year 1994.

Mr PENFOLD: That is the one that is referred to.

Mr TRIPODI: That is the 1995 report.

Mr PENFOLD: In 1995 there was certainly a profit of a couple of hundred thousand, from memory.

Prof MacDONALD: It has been approximately \$300,000 profit for the last two years. In the previous year, the total sales were \$5.6m and last year, the sales was \$4.7m or \$4.8m. In both cases, as well as making donations to the university, it has also declared a profit. I think it was about \$200,000 last year and \$300,000 the year before.

Mr CHAPPELL: Back to the flying school. Could you just run past that point again where the business was obviously starting to go bad. What did you institute at that stage in terms of increased reporting requirements and so forth?

Mr PENFOLD: We engaged a consultant, Mr Russ Evans, who would appear to be one of the most experienced aviation trainers in Australia. We engaged him to give us an idea of what was going wrong because we people on the board were not aviators as such and we were relying on the management to provide us with information. We put in our own accountant as well to let us know what was happening on the financial side. We got a report back saying that so many students were overflying their hours and so many students were behind in the particular area they should have been in the syllabus and that it would cost us a lot of money.

That was when we restructured the company. We put off a lot of staff. The vice-chancellor had decided at that stage that we would take no more private students and we would only look at university students. But we also gave the commitment that we would look after any students at the school at that particular time, whether they be from the university or not; we would see them through to the end of their course even though it would cost the company and, in the end the university, quite a lot of money to do it.

Mr CHAPPELL: So it was a flying school manager expert that you brought in?

Prof MacDONALD: Yes.

Mr PENFOLD: Correct.

Mr CHAPPELL: Were you happy with his business management acumen?

Mr PENFOLD: We brought in an accountant as well, so they worked together.

Mr CHAPPELL: So you reckoned the two of them working together gave you the full scope of information that you needed?

Mr PENFOLD: They certainly did, yes.

Mr GLACHAN: You said that you were going to use the interest on university investments to make up the losses. What would you have used that interest on otherwise if you had not had these losses, what sorts of things?

Mr PENFOLD: The present vice-chancellor's attitude to investment earnings is that they should not be spent at all; they should be retained to try to build up the university's reserves to try to meet the crisis that is likely to happen in universities when the Federal Government brings down its budget on 20 August, when it seems that funds will be cut quite markedly.

Mr GLACHAN: So it could be said, then, that because you now do not have that interest to reinvest, the losses will in some way affect students?

Mr PENFOLD: The university students?

Mr GLACHAN: Yes.

Mr PENFOLD: No, because those particular funds are not there to --

Mr GLACHAN: But you just said you would have used the interest to reinvest. You would have reinvested the interest, so that in the future you would have had more interest to make up for any cuts to the university funding that the Federal Government or some body might make.

Prof MacDONALD: The likely effect of it is that we might have delayed the introduction of an expensive course that required development capital, for example, for one year. It may have meant that we would have to phase out building programs slightly differently because the money might have been used to supplement some of the building. In that sense you can say yes, the students might well have been affected.

Mr PENFOLD: To put it in context, if we had invested that \$800,000 and maybe received \$70,000 or \$80,000, we are talking about an operating fund in the university of \$130m, so it is not a significant amount.

Mr GLACHAN: I understand.

Prof MacDONALD: It is also a total budget for the university of \$175m.

Mr GLACHAN: So it will not have a significant effect on the students?

Prof MacDONALD: It is one that we did not want to have, but I do not believe that it has severely damaged any university students within the Callaghan campus.

Mr PENFOLD: The university could have walked away from it, but students would have suffered and we decided not to do that.

Mr GLACHAN: How were the retrenched staff assisted? Have they been given other jobs and what was the cost of retrenching staff?

Mr PENFOLD: I do not have with me the actual costs of retrenching. We retrenched them strictly under the conditions of the award under which they were engaged. They were given reasonable notice. I think they knew themselves, say, 12 months out from when the company was actually liquidated, that it was in trouble. We laid off probably half the staff six months before it was actually liquidated, and we gave no commitment whatsoever to the remaining staff that business would be ongoing. We said we were trying to restructure, but there was some doubt as to whether their jobs would remain.

Mr GLACHAN: Were those costs added to your losses or were they separate as part of the loss account?

Mr PENFOLD: They are part of it, yes, the retrenchment payments were included.

Mr ROGAN: I wish to put something on the record again you that on earlier. Why was the contract with Malaysian Airlines lost?

Prof MacDONALD: Principally because Malaysian Airlines decided that it was going to shift its training. There were two reasons: One was that in the 80s, certainly in the late 80s, most airlines around the world were planning for major expansion. Qantas, for example, from the mid-80s to about 1988, was talking about taking on 200 pilots a year. There was a downturn in the aviation industry in the early 90s and one of the results of that downturn was that Qantas not recruit pilots, so that was one effect, and Malaysia did not need as many pilots.

The other point was that Malaysian Airlines was shifting back its training to Malaysia rather than do it overseas as it was more cost effective for them to do it there.

Mr ROGAN: The university's 1994 report mentions only that a receiver/manager was appointed without giving any explanation. Could you tell the Committee why no explanation was offered in this annual report, especially given that the 1993 annual report had been so optimistic?

Mr PENFOLD: No, I cannot recall. The annual report does not come within my specific area. I look after the annual accounts. Is that a notation to the accounts or from the annual report?

Mr ROGAN: No, it is from the annual report. Maybe we can give you that question in writing and you can take it on notice.

Mr PENFOLD: Yes, that would be fine.

Mr ROGAN: You can provide us with some information later on.

Mr PENFOLD: Yes, we can.



Mr ROGAN: If the university had the time over again, would you have made the investment in the flying school on the same basis as previously? I guess hindsight is a marvellous thing.

Prof MacDONALD: I think we would certainly say that the probability is that yes, we would invest in the school but not on the same basis. We would have been much more diligent in respect of the running of the school, without a doubt, and we would have imposed university practices on the school much earlier.

Mr TRIPODI: You may have answered this earlier. Were your initial intentions to get involved with NASA commercial or educational or both?

Prof MacDONALD: From the university's point of view, it was, first of all, to provide a high quality degree in aviation which would be recognised in the industry. We had a lot of support from the industry at that stage. We had members of Qantas—for example, senior management people on the aviation side of Qantas—who were involved very much with the university in the planning of the course, et cetera, as were most airlines in Australia. So it was really an educational perspective that we were bringing in, but one which would be required to pay its way.

We had no intention, at that stage, of the university subsidising the school at all. We were also hopeful that the climate within the university area would change in the next decade or so and that we would have been allowed actually to start charging fees within the university perspective rather than as a separate body.

Mr PENFOLD: It was a company limited by guarantee, so there was no possibility of any dividends being paid to the university or any other body, so it was not entered into to get commercial profit for the university in any way; it was basically educational.

Mr TRIPODI: But the engagement of private students was --

Mr PENFOLD: The reason for that was so that the company could end up with a surplus to be reinvested in the school in the facilities. Many of the buildings were quite run down. The planes, of course, were getting old and they are very expensive to replace, so it was seen as necessary to engage in commercial activities to that extent to be able to reinvest the funds into the school.

Prof MacDONALD: Also our engagement with Malaysian Airlines and some negotiations that were going on with a number of other airlines around the world suggested to us that we could possibly charge fees within a full-fee-paying overseas student operation, which would have returned again some profit element, which would have been used to enhance the facilities.

(The witnesses withdrew)

WARWICK STUART OLIVER, Bank Officer, [REDACTED],

JENNIFER CALKIN, Tourism Consultant, [REDACTED], and

JOHN EDWARD SURGEON: Bank Officer, Westpac, [REDACTED], sworn and examined:

CHAIRMAN: Did you receive a summons issued under my hand to attend before this Committee?

Mr OLIVER: Yes.

Ms CALKIN: Yes.

Mr SURGEON: Yes

CHAIRMAN: We have a list of questions to ask you and I would like to make the offer from the outset that if you wish to go into camera, if you think there is anything confidential, we would be happy to oblige you.

With regard to this particular inquiry relating to Somersby Park Pty Limited, the first question is: Did the charges against Mr Chiu ever influence the Somersby Park Pty Limited board? Were they ever considered to be grounds for the renegotiation of the lease? Did the minister of the day express disquiet that the Somersby Park lessee was being indicted for fraud?

Mr OLIVER: I have no knowledge of that.

Ms CALKIN: Nor do I.

Mr SURGEON: No, we do not know anything about that.

CHAIRMAN: Were any of these things discussed at board level?

Ms CALKIN: None of us were directors during that period.

CHAIRMAN: So there is nothing reported in board minutes about any of those questions I asked?

Mr SURGEON: Not that I am aware of. I think the matters you are talking about go back probably to 1987, 1988, which is well before our time. Jenny Calkin came on the board in 89/90; I was secretary in 1990; and Warwick Oliver came on in 1990/91, so it was well before that.

Mr TRIPODI: Did any minister ever seek advice from the department on the growing losses and if not, why not; and what advice did the board give ministers on the best way to stem those losses that were occurring?

Mr OLIVER: The short answer is no. I think it is wrong to say that they are growing losses. Essentially, the loss simply arises from a writedown in the property itself. It is not a question of continuing losses but the loss has been incurred and is reflected in the books of account.

Ms CALKIN: The losses represent both the Government's and Westpac's funding of Old Sydney Town when it was actually operating itself before it set up Somersby Park. When it established Somersby Park, it capitalised those losses into the company.

Mr GLACHAN: So there were losses when it was being run by the Government and Westpac?

Ms CALKIN: Yes.

Mr GLACHAN: So they were making losses then?

Mr SURGEON: There were certain losses made and during the course of the time when the Government and the bank were running Old Sydney Town's business, from time to time certain amounts of loans were forgiven and capitalised, so there is about \$4m-odd in the reserves, which reflects that.

Mr GLACHAN: Who forgave the loans?

Mr SURGEON: The Minister for Tourism.

Mr GLACHAN: Government loans from the Government?

Ms CALKIN: From the Government, yes.

Mr SURGEON: Yes.

Mr GLACHAN: Did Westpac forgive them?

Ms CALKIN: Yes.

Mr SURGEON: Yes.

Mr GLACHAN: Now the situation is that the company now leases the centre to Warwick Amusements?

Mr SURGEON: Yes.

Mr GLACHAN: And they pay so much for the lease?

Ms CALKIN: Yes.

Mr GLACHAN: Are they paying that on a regular basis?

Mr SURGEON: No.

Mr GLACHAN: They are not?

Mr SURGEON: They are behind.

Mr GLACHAN: They are behind in their payments?

Mr SURGEON: Yes.

Mr GLACHAN: Therefore your losses are increasing. I think Mr Oliver said it is not a continuing loss, but if they are not paying the lease, your losses are increasing.

Mr OLIVER: No; it simply means that we are not getting any income.

Mr GLACHAN: Well, if you are not getting any income --

Mr OLIVER: The losses--

Mr GLACHAN: You have a business, you have a property and you are not getting anything back from it. That sounds look a loss to me, I do not know.

Mr OLIVER: Well, it is income we are not getting.

Mr GLACHAN: Income forgone?

Mr OLIVER: Right.

Mr GLACHAN: Are you going to write that off or are you going to get it?

Mr SURGEON: Well, that is --

Mr GLACHAN: Will you get that income or will you just let it go?

Ms CALKIN: To our knowledge, we are getting the income. The lessees are paying, while it is not to their payment schedule. They say that they are going through some tough times and they are reorganising things and they are paying. So it is not as if we are getting no income; it is just not every quarter that we are getting it. We are not getting the full amount, but we are certainly getting some from them.

Mr GLACHAN: So they have a lease arrangement with you under which they have to pay a certain amount at a certain time?

Ms CALKIN: Yes.

Mr GLACHAN: But you are not insisting on that? You are letting them tell you when they will pay you?

Ms CALKIN: The Old Sydney Town money is coming in basically on time.

Mr SURGEON: There are three separate leases—the lease for the amusement park or the lease rentals for that are coming in, but not necessarily on the due date.

Mr GLACHAN: They are coming in when it suits them --

Mr SURGEON: Yes.

Mr GLACHAN: -- not when it suits the terms of the lease.

Mr SURGEON: However, two variations of lease have been executed. The first variation of lease was worded in such a way that should a payment be missed, the lessees would be in default. Further to that, we had a second variation of lease, which put the option on whether they were in default upon us; so we, Somersby Park, say when they were in default.

Mr GLACHAN: And you are not saying that at this stage?

Mr SURGEON: We are not saying that at the moment.

Mr GLACHAN: So you are hoping that they will eventually pay up?

Ms CALKIN: Yes.

Mr GLACHAN: When will you come to the conclusion that they will not pay up? When will you start? If they do not pay up, when will you make the decision and say, "Well, we have to do something"?

Mr SURGEON: That has to be --

Mr GLACHAN: You have not faced that yet?

Mr SURGEON: Those matters are before the shareholders. We are waiting on a decision from the shareholders concerning that matter and other matters.

Mr GLACHAN: But you are the board; does not the board make the decisions? Does the board refer all these things to the shareholders?

Mr SURGEON: The board agreed to a concessional repayment program for three years. Those three years expired last April. --

Mr GLACHAN: When you say "last April", what do you mean?

Mr SURGEON: April 1995. The lessees have requested an extension on that program and also on some capital expenditure that required to be made under the lease. Those matters are before the shareholders and we are waiting for a decision.

CHAIRMAN: Apart from what you have already said, could you just give us a broad overview of your experiences since you have been board members, tell us how the losses have accumulated to date, the areas where they have accumulated and give us an idea, without infringing on what we were talking about before, on how you plan to extricate from Somersby as far as the losses are concerned? Could you just give us a broad thumbnail sketch of the background behind it and the future plans, please.

Ms CALKIN: I think we should discuss this --

Mr OLIVER: Do we want to talk about this in camera?

Ms CALKIN: Can we request that it be discussed in camera?

CHAIRMAN: Yes, of course

(Evidence continued in camera)

(Public hearing resumed)

MICHAEL GEORGE LAMBERT, Secretary, New South Wales Treasury, [REDACTED],

DANIEL GRAHAM, Manager of Infrastructure Assessment, New South Wales Treasury, [REDACTED], and

JOHN RONALD CHAN-SEW, Acting Director, Accounting and Financial Policy, [REDACTED], affirmed and examined:

VICE-CHAIRMAN: I will ask each of you in turn, did you each receive a summons under the hand of the Chairman to attend the Committee?

Mr LAMBERT: Yes.

Mr GRAHAM: Yes.

Mr CHAN-SEW: Yes.

VICE-CHAIRMAN: I guess you all understand the nature of our proceedings today. Payments under section 22 have been a matter of concern to the Committee for many years. In 1994/95 the payments authorised under section 22 for payments in excess of the budget allocation amounted to \$253m for recurrent services and \$218m for capital works and services. Can you describe the circumstances surrounding payments of \$471m in excess of the budget and how did they satisfy the definition of exigencies of government in the words of section 22?

Mr LAMBERT: I will have to take that on notice. I cannot give you a response.

VICE-CHAIRMAN: Again, I guess you will need to take on notice, in particular the payments made on 29 and 30 June of some \$100m into the Superannuation Board. Were these payments made to balance the cash budget?

Mr LAMBERT: For the super payments, of the \$100m there was \$70m applied to the unfunded liability of the closed pool scheme and \$30m was a payment for the open scheme, First State Super. The \$30m was largely required to meet the budgeted level of \$153m of payments, which it duly did, with a slight excess of about \$10m above the budget payment.

Mr GLACHAN: Why the excess of \$10m?

Mr LAMBERT: We are forecasting. We just made an assessment that that was required and we just made an error of \$10m. That carries forward to the next year, it is offset against next year's payments.

Mr GLACHAN: Why is it done on those dates of 29 and 30 June?

Mr LAMBERT: We try to get as close as we can to the final result. There are always going to be errors involved. Even when we work out the initial figures after 30 June, we

subsequently find other errors or revisions occur, but we always have a balancing payment towards the end and that was the \$30m. We forecasted we needed about that much but in the end it worked out slightly less than that, about \$10m less.

VICE-CHAIRMAN: In addition to the payments authorised under section 22, the Committee would like you to confirm that an additional payment of \$15m was made to the super fund and was not authorised by the budget process or by section 22. Was this an unauthorized payment, was it urgent and, I guess, why was it done? Can you justify Treasury not complying with the law in making payments of taxpayer's funds to bodies associated with the super fund?

Mr LAMBERT: I will take that on notice once again.

VICE-CHAIRMAN: Is there a definition that Treasury has of what constitutes exigencies of government under section 22?

Mr LAMBERT: There is not a definition that has been established at this stage but, as you are aware, with the financial legislation rewrite we have proposed a revised approach which largely reflects the recommendations of this Committee. That is in a discussion draft which has been circulated. It is subject to government and parliamentary approval but we will enact that definition and those procedures in the future.

Mr CHAPPELL: Can you put the basic elements of that before us today?

Mr LAMBERT: We want to move away from this area, from the current practice, to a system whereby only things that are urgent and unforeseen would be covered.

Mr CHAPPELL: By a special approval, as in a section 22 approval?

Mr LAMBERT: Yes. Other than that, we would require any other matters to be subject to a separate appropriation bill.

Mr CHAPPELL: Isn't that what section 22 is all about, only matters that are unforeseen?

Mr LAMBERT: That is what is basically said to be the case but in practice it can vary from that. We have decided that it is appropriate to tighten it up. Our recommendation or proposal reflects the recommendations of this Committee.

Mr CHAPPELL: That is the very reason we are here today, because different parties from different angles have a degree of differences as to how much latitude was involved in the interpretation of exigencies?

Mr LAMBERT: There are some operational statements in there. I cannot remember exactly the term, perhaps John can, but there are some operational statements in there about how you would operationalise those definitions.

Mr CHAN-SEW: The intention is to include in the legislation those specific instances



where the existing section 22 provision could be utilised. One is natural disasters, the other one is unforeseen court verdicts, and a third one is unforeseen contractual obligations. They are actually in the consultative document. Obviously we need to get views from other parties, but that is the proposal.

Mr GLACHAN: You are saying at present you can make transfers of money under this provision because it has happened in the past?

Mr LAMBERT: Basically it is true that a general statement is unforeseen and urgent, but then --

Mr GLACHAN: You spoke earlier of the superannuation payment. You said that you knew these things were going to happen, you knew there was --

Mr LAMBERT: In dealing with a \$20 billion budget and \$20 billion expenditure, and dealing with the fact that during the course of the year you are making projections, there is room for error. The numbers we are talking about might seem like large numbers but in the context of \$20 billion they are quite small numbers. We made an assessment about the level of payments that had to be made to get to the required target funding for superannuation and in the end we were out slightly on that.

Mr GLACHAN: If these rules you are just talking about now are introduced, you will not be able to make those payments under section 22 in the future if they come into effect?

Mr LAMBERT: It is a question of whether they meet the criteria.

Mr GLACHAN: It will meet the criteria if it is a natural disaster or unforeseen court verdict, but these circumstances will not fit then, will they?

Mr CHAPPELL: What if you have got \$50m left over in cash and you decide to put it into superannuation?

Mr LAMBERT: It would not meet that. The definitions that are proposed wouldn't meet that. That would not be classified as such.

Mr GLACHAN: If these definitions are accepted, you will not be able to do what you did with the superannuation payment under that section 22?

Mr LAMBERT: That is right.

Mr GLACHAN: So under what section would you do it? It would just be your normal practice?

Mr LAMBERT: It would have to be appropriated if we wished to do it—seek appropriation.

Mr GLACHAN: You would have to bring it to the parliament, bring a bill asking to

transfer some money because your projections worked out not to be correct and you needed to top up the fund?

Mr LAMBERT: Part of the \$30m was a legitimate payment. We just got an error factor in that. Certainly the \$70m component, which is increasing the level of funding, would require an appropriation.

Mr GLACHAN: That would have to come in by legislation through parliament?

Mr LAMBERT: Yes.

VICE-CHAIRMAN: I guess I should indicate that certainly before my time on the Public Accounts Committee there has always been concern expressed at the Public Accounts Committee level and certainly by others in the parliamentary system that unless this section 22 is tightly controlled, that it would enable a government to balance the books, to give a surplus at the end of the year instead of a deficit, which would look good, by simply transferring funds around. Do you understand that concern?

Mr LAMBERT: It cannot actually make a thing look better. It can make a thing look worse. You cannot transfer a deficit into a surplus by that mechanism. But you can actually make a deficit, a position, look worse.

Mr CHAPPELL: You can make a surplus look like less of a surplus?

Mr LAMBERT: Yes. But you cannot fundamentally change the underlying position. We recognise the weaknesses there. From our point of view we have no difficulty at all with tightening up the section and we have advocated that in the exposure draft. We do produce budget paper information in the general government side which does present on an ABS basis the budget information and would extract from any of these distortions that occur, so there is available to the public in one of the budget papers information that is not effected by such transactions.

Mr TRIPODI: You might be concerned about it, but you are still using section 22 in an incorrect manner; are you not?

Mr LAMBERT: It could be argued that the Government of the day does but it is a question of interpretation of what is "urgent and unforeseen".

Mr TRIPODI: Two paragraphs from the report said: "Superannuation payments of \$70m were paid to reduce unfunded liabilities and resulted in budget estimates being exceeded by \$30m. A \$30m payment within budget estimates was paid to the First Super Scheme. This scheme is required to be fully funded and therefore should have no unfunded liabilities. Although requested, no documentation was produced evidencing that unfunded liabilities existed at 30 June 1995. The result of this payment was that the scheme was overfunded by \$30m at 30 June 1995. Although it is government policy to reduce unfunded superannuation liabilities, when large payments are made in the last 2 days of the year and there is a lack of adequate supporting

documentation to justify these payments doubts are raised as to whether the payments were to meet policy or to achieve a targeted budget result for the year". What is your answer to that?

Mr LAMBERT: I understand that statement is not correct. The \$30m was made to meet the actuarial assessment of the liability. In the end there was an error of about \$10m in payments, not \$30m.

Mr TRIPODI: What about the issue of no supporting documentation?

Mr LAMBERT: The budget amount of \$154m, which is the amount we are targeting in terms of contributions, is based on the actuarial assessment of the amount of payments required actuarially to fully fund the scheme, and we were targeting that. In the end, two-thirds of the payment we made was required, \$20m of the \$30m was required. We overfunded in error by \$10m, not by \$30m.

VICE-CHAIRMAN: You have more or less I think answered the next question but I will put it on the record anyway: Do you have a view on the appropriateness of executive government complying with the budget appropriation by the legislature in the spending of public money?

Mr LAMBERT: We support the appropriation process and we support any mechanisms to improve its effectiveness of operation. That is reflected in the proposals that are being prepared on the reform of the financial legislation.

Mr CHAPPELL: Basically that will still be a two-part process appropriate for all of the foreseeable and everything else, plus still a section 22 type?

Mr LAMBERT: A tightened section 22 and the potential for further end-year appropriation bills to cover things not covered by section 22.

Mr CHAPPELL: It will be the process of mini appropriations that the reform will concentrate on?

Mr LAMBERT: Yes.

VICE-CHAIRMAN: Would you see, if recommendations or proposals are adopted, that that would lift from Treasury any allegations that it has been heaved or influenced to make these payments at any particular time?

Mr LAMBERT: I am not aware of any such accusations.

VICE-CHAIRMAN: It certainly would put it above any such suggestion or implication?

Mr LAMBERT: It would certainly avoid any implication to that extent and make the process much more transparent than it is at the moment; and we are very supportive of improved transparency of processes.

Mr CHAPPELL: I think the inference has been drawn from that current lack of transparency and from the lack of clarity in terms of what constitutes an exigency of government under section 22, what is unforeseen—I think the word should be unforeseeable rather than unforeseen—and how urgent is urgent. Does it always mean the 30th of June or even the 29th of June?

Mr LAMBERT: Yes.

VICE-CHAIRMAN: The Committee has under notice the State's investment in Somersby Park—we have just talked to those people prior to you coming in—the landlord of the Old Sydney Town tourist facility near Gosford, which at the end of 1995 the accumulated losses were reported at \$8.8m. Has Treasury a view on the State's continuing involvement in such ventures?

Mr LAMBERT: The State inherited this going back into the 1970s. It was not a conscious decision of government to be involved in this. Clearly, given we are a 75 per cent shareholder of Somersby Park Pty Ltd, it is not a natural role for the Government to be a shareholder in a commercial venture and our general view and advice to government will be at the appropriate time to divest itself of that interest. But at the present moment we have that interest and there is an issue of how we manage that interest.

VICE-CHAIRMAN: How do you treat such losses in the accounts of Treasury, in the accounts of the Department of Tourism and the consolidated accounts of the State?

Mr LAMBERT: It is a company where shareholding is vested in the Minister. I don't believe they are treated in the Department's accounts but they are treated in the consolidated accounts of the State of New South Wales.

Mr GLACHAN: I want to ask a question about the Auditor general's mandate. He has reported to the parliament on the gap that is said to exist due to the Auditor-General's audit mandate not extending to local government. Can you tell us what the Treasury position is regarding the audit mandate?

Mr LAMBERT: Local government has to obviously appoint external auditors and they have to meet certain criteria. The Auditor-General can be the auditor, as I would understand it, but that is a decision for the councils themselves to undertake that function. In the end I suppose we are not quite certain why there needs to be a mandated role for the Auditor-General in this area. If there are appropriate standards and criteria for the selection of auditors, it is really the councils that should be responsible for their choice of auditor and they should not have to have a tied mandated role given that they are effectively, not strictly, but effectively another tier of government.

Mr GLACHAN: If they are another tier of government, wouldn't it follow that the Auditor-General would be the best person to be involved in the audit?

Mr LAMBERT: Generally what I am saying is that elected councils should have that role to determine themselves. We should not be in a position to mandate that position.

Mr GLACHAN: Is there a gap between the Auditor-General's role under the protected disclosures legislation and the responsibilities given to the Ombudsman and the ICAC?

Mr LAMBERT: I really would have to take that on board. I am not aware.

Mr CHAN-SEW: If I can just comment that my understanding is that the Protected Disclosures Act does not cover the local government sector, whereas the Ombudsman and ICAC's jurisdiction extends to the local government sector. That is why, when you look at the legislation, people within the local government sector can take a claim to the Ombudsman but not the Auditor-General. It is a question of the extent of the Auditor-General's jurisdiction. That is my understanding for that particular gap.

VICE-CHAIRMAN: I think it was raised in the House the other week actually.

Mr CHAN-SEW: I understand that particular legislation is being looked at by the Parliamentary Committee on the Office of the Ombudsman at the moment.

Mr CHAPPELL: You have the Pasture Protection Boards, the Rural Land Boards and the Aboriginal Land Councils as well as local government?

Mr CHAN-SEW: Yes.

Mr GLACHAN: Does Treasury have a position on the audit mandate being extended to other government bodies that have access to public moneys but are not audited by the Auditor-General and do not report directly to parliament which Mr Chappell has just mentioned? Have you got a view on that?

Mr LAMBERT: What sort of bodies are we talking about?

Mr GLACHAN: Rural Land Protection Boards and Aboriginal Land Councils.

Mr TRIPODI: Even private community associations that are recipients of government grants?

Mr LAMBERT: Off the top of my head I would be somewhat reluctant to mandate there. I would have thought what you wanted to do is establish there is appropriate external audit and that it must be certified and approved to meet certain criteria, but I don't think you would necessarily want to tie it to the Auditor-General. Government has contracts with private sector companies too. I don't see that we would want to mandate that they be audited by the Auditor-General. There has to be some mutual recognition here. The Auditor-General has to be able to recognise and rely upon the work of other auditors in certain areas.

Mr CHAN-SEW: In relation to the payment of grants to community organisations, that issue is covered in the consultative document and there is a proposal in there in fact that in respect of government grants given to community organisations that maybe the way to go is, where appropriate, to attach a condition for the recipient of the grant to provide the Government

with an auditor report as to how the money was spent and whether it was spent in accordance with the intended purpose and so on.

Mr TRIPODI: There are some unreputable auditors, so there is a very big problem. Quite seriously, in my electorate I have that problem at the moment over government grants where I want the association to be audited and the Government does not have any authority to do it. There is a local slightly incorporated auditor down the back who did it for them and that is it, that is the extent of the surveillance that occurs on that grant. With regard to public sector accounting standards, the audited opinion of both the public accounts and the whole of government consolidated statement contains similar qualifications relating to the lack of appropriate accounting standards for the big infrastructure projects involving State and government agencies. What steps has Treasury taken to overcome this situation?

Mr LAMBERT: To overcome what situation?

Mr TRIPODI: The qualifications with regard to that?

Mr LAMBERT: There are a number of qualifications. There are not many. There are a few qualifications in the accounts. It gets down to an issue of the fact that the Auditor-General feels bound by accounting standards and we believe that in addition to that consideration has to be given to true and fair, and in fact the Act does refer to the concept of true and fair. There can be a conflict between what is true and fair and the accounting standards. For example, I am chair of Treasury Corporation, where we adopt market value accounting. There is an international standard adopted but no Australian standard. That resulted in our accounts being qualified, but at the same time the Auditor-General recognised that we were producing true and fair accounts.

This has been discussed by the heads of Treasury and also discussed in the exposure draft on financial legislation. The situation in the private sector is that where an entity believes that there is a conflict, that can be handled by the Australian Companies Commission, which is an independent body. What we are looking at is whether there is some equivalent body we can vest with the responsibility to look at these issues when they arise and relieve the Auditor-General of having to make a qualification where it is considered that there are good and efficient reasons why an accounting standard should be varied to reflect true and fair positions.

I must say, the areas of qualification where we have a difference with the Auditor-General are very limited, very limited, and they tend to and have mainly reflected different views about interpretation of the accounting standards.

Mr CHAPPELL: Or the application thereof. For instance, from time to time you hear of complaints of Treasury heavying a department in terms of how they account for certain values of the business. One that came to mind was the North Shore Hospital land revaluation with some \$331m involved. Should Treasury be intervening with particular agencies as to how they should account for those matters or should you simply have a policy standard against which departments are required to operate?

Mr LAMBERT: We have accounting policies but that was a fairly material transaction

that had a significant impact. In our view, that would have distorted the financial accounts so we looked at that closely because of its materiality and formed a view on it and that was based on our view about what is true and fair. We thought that to account for the way it was being proposed would have been in conflict with true and fair presentation.

Mr CHAPPELL: They and the Auditor, I understand?

Mr LAMBERT: The auditor certainly had a particular view. We had a contrary view on that. But in the end Treasury is responsible for accounting policy in New South Wales and we advise the Treasurer, and we certainly regard it as our role to be involved in those sort of issues.

Mr CHAPPELL: In that issue and presumably the odd ones that come up?

Mr LAMBERT: Yes.

Mr CHAPPELL: Is it simply a matter of dispute about the interpretation of the accounting standard or is it that there is a straight out conflict about what is right and proper for reporting?

Mr CHAN-SEW: On that occasion we certainly took a different interpretation of a specific accounting standard and, of course, overriding that too we did apply the true and fair test, as Mr Lambert said. That particular treatment in fact now is covered by accounting standards and on that occasion there was a difference in interpretation.

VICE-CHAIRMAN: I have a list of 17 questions here dealing with infrastructure. I am just looking at the time and wondering, if we give them to you on notice, is it possible to have them answered, together with the other questions that you have taken on notice, by 7 June?

Mr LAMBERT: Yes. I am happy to do that, if we could get a transcript of the other questions on notice?

VICE-CHAIRMAN: Yes, that will be arranged.

(The witnesses withdrew)

ANTHONY THOMAS WHITFIELD, Assistant Auditor-General, [REDACTED],  
and

JAMES REGINALD MITCHELL, Deputy Auditor-General, [REDACTED] sworn  
and examined:

ANTHONY CLEMENT HARRIS, Auditor-General, [REDACTED], affirmed and  
examined:

VICE-CHAIRMAN: I apologise for our Chairman's absence. He had to go down to the  
chamber to rearrange things as he is scheduled to speak on the Budget.

You have received a summons under the hand of the Chairman to attend today?

Mr WHITFIELD: Yes.

Mr HARRIS: Yes.

Mr MITCHELL: Yes.

VICE-CHAIRMAN: In the audit opinion on the public accounts for 1995, you have  
again drawn to the attention of Parliament a number of audit qualifications. Some have been  
around for some time and relate to accounting treatment for infrastructure assets. What can you  
tell the Committee on the resolution of this matter?

MR HARRIS: I suppose it is in the nature of auditors and bankers that they go around  
looking for homes for liabilities which most agencies in the private sector seem not to wish to  
recognise. There is also an incentive in the government arena not to recognise liabilities. The  
incentive comes from a number of sources. It came from the early application of Loan Council  
rules, which were quite strict. It comes from the desire to maintain credit ratings done by the  
ratings' agencies and any associated policies related to debt management that the Government  
might have. It also comes from a desire to extract taxation benefits at the State level by shifting  
taxation payments onto the Commonwealth.

Those three incentives remain current for New South Wales now, although the stringency  
of the Loan Council rules has reduced that as an important incentive. So, it remains the job of  
auditors to try to make sure that all liabilities are booked.

The growth in recent years of private provision of public infrastructure has given rise to  
a number of concerns that we have had with the State's dealings, and these are again reported in  
today's report. I suppose, in some senses, what we are hoping for say good standard that enables  
us quite clearly and unambiguously to insure that they are treated correctly. Having said that,  
the standards, in a number of circumstances, are adequate. We still have disagreements with the  
State authorities about the treatment of liabilities. That again is evidenced in today's report.

We are trying to impress upon the States that if they take all the risks associated with this



infrastructure, they ought to recognise it properly in their accounts. There has been a gradual appreciation at the State level that our argument has some cogency and there now appears to be a greater willingness on the part of Treasury to sit down with us with a reasonably open mind and reconsider some of the decisions that it has taken in prior years.

It is important that Treasury do so because the number of qualifications attaching to the whole of government report is so large that any further serious qualifications would bring into disrepute the whole of government accounts. So there is an earnestness, there is an awareness on the part of ourselves and Treasury that we need to get these qualifications down.

With the RTA and the tunnel, we are working on a set of words, which, while it preserves each other's opinion, does allow me to withdraw the qualification because it does allow an interpretation by the reader in a way that is consistent with my view of the treatment of the tunnel. In other matters, it probably will not be as simple as that and there will need to be a change of mind by one or other of us.

Mr GLACHAN: Who should change their mind?

MR HARRIS: I was disappointed, for example, with respect to Fanmac, which has been the cause of a long-standing difference between us and Treasury. I was disappointed that the Treasury's advisory panel, when it considered the matter on three occasions, came down 50/50; but the preponderance of accounting firms' views was that it was a liability that ought to be recognised. That is a view that the Auditor-General had, and I was a bit disappointed that the Government did not adopt that view.

The Auditor-General does not have the same biases and prejudices or the same pressures and conflicts of interest that the Government has. I would have thought that they would have seen that that was enough to justify the treatment of Fanmac as a liability. As is turning out, the Government is buying all of the bonds issued by the Fanmac trust supporting HomeFund as they expire— it is buying them all.

So who should change? We do not do this lightly. We have a very serious and earnest consideration before we make a qualification and when we do so, we do it because we believe it.

Mr GLACHAN: Do they not, on the other hand, have an earnest consideration too and do they not do it because they believe it?

MR HARRIS: I do not actually think that's correct, no. For example we sat down with Treasury officers with regard to the issue of the Port Macquarie Base Hospital. We said that our examination of the details of the arrangement suggested there was a liability there. The Treasury office response was that those were not the details of the arrangements that it knew about. But in spite of the fact that they were new arrangements to those in Treasury, they were not going to change their minds. That did not appear to me to be an open consideration of facts, but a closed view based on a predisposition. The Department of Health agrees with us in our assessment on that matter, four accounting firms agree with us on that matter, and Treasury does not.

Mr GLACHAN: Could I add to that that Treasury say that it sets the standards for accounting in New South Wales.

MR HARRIS: If the Parliament believes that the auditee should set the standards by which it is audited, then we might as well go home. In fact, the Treasury says in its whole of government accounts what standards it applies. In the public accounts, they say they apply the consolidation standard applying to the private sector, namely, AAS24. They say that—well, we expect them to apply that.

It is true that the Treasurer can give a regulation to define a profit as a loss. I do not think that it is appropriate that the Treasury be put into that position of a conflict. We are working with Treasury to identify other means by which the standards can be set if governments disagree with standards that apply to everybody else in Australia.

Mr CHAPPELL: If I may, by way of clarification, refer to that last point. I think they were answering a question of mine in that regard. They were really saying that they established what standards would be applied for the other agencies of government in terms of their reporting of the whole of government accounts. That is what they were really saying, so it is in the quite the same thing at all.

Mr GLACHAN: Yes. I have misled you there a little.

MR HARRIS: I suppose it is the same, because when the Department of Health said, "Yes, we have a liability to the Port Macquarie Hospital and that is \$280m-odd", the Treasury said, "We do not want to recognise that liability on our books, so we are telling you it is not a liability". It is reflected in the Treasury's books ultimately and it is saying, "Well, we do not want that in our books, so here is a direction saying, 'Do not do it that way'". That means if everyone sets their own standards, then it is no use comparing Victoria's whole of government reports with anybody else's because they will all have these funny little outs. That is the issue we are trying to address.

VICE-CHAIRMAN: Can I ask for your comment on any progress that might be being made in the development of a standard for the accounting treatment of public and private infrastructure projects? You referred to AAS24, but clearly that is being interpreted one way by Treasury and interpreted another way by yourselves. It would obviously be very desirable to have a standard that it recognised throughout Australia and one which is binding on the Treasury here as equally it would be for Queensland, Victoria or any other State.

MR HARRIS: We are working with ARF, the Accounting Foundation. Some months ago the Australian Council of Auditors-General, ACAG, had a meeting with that foundation and had a discussion about a paper that ARF had drafted in order to allow the foundation to have our views on the matter. On behalf of ACAG, I have written to the Accounting Foundation supporting this discussion paper and welcoming the priority that it is giving to this project. So there is capacity for it to be developed.

On the other hand, there are now standards that are sufficiently robust to enable four

accounting firms—Coopers, KPMG and whoever the other two are—to agree us on the treatment of Port Macquarie Base Hospital. The standards are there. The methodology is there, sufficiently robust to enable us to get to a view on this matter, with the bulk of everyone agreeing.

The difficulty we have with the Accounting Foundation setting a standard in this area and one that was discussed with the Australasian Council of Auditors-General is that it may be that the standard applicable to the infrastructure will not be accepted by the private sector because it has serious implications for the private sector that it may not wish to see adopted. Since the private sector is the other side of the deal, any standards set in the public sector arena relating to this will have implications for the private sector.

VICE-CHAIRMAN: Would it be feasible to have one standard applying to the public sector and one to the private sector and for them to be mutually compatible in their treatment, recognising the different role of government and the private sector?

MR HARRIS: That would be very hard. If we have a deal where the private sector and the public sector are involved and the public sector treats it one way and the private sector treats it another way, that means we would have inconsistent accounts for the nation as a whole. So if we say, "This is a liability", somebody should go around saying, "There is an asset"; and if we have an asset somebody should go around saying, "They have a liability", as it were. So there has to be that balance.

So the private sector may veto the development of this standard. It is because of that possibility that I have been thinking of other options. One would involve treasuries and auditors-general sitting down in the absence of an acceptable standard being developed through the usual mechanisms and saying, "In the absence of the standard, we will develop this standard." It does not overcome the problem of inconsistencies that you alluded to.

VICE-CHAIRMAN: I think you have partly answered this question. If the standard-setters cannot finalise the matter, should the regulatory process be used to resolve the matter by the making of a regulation or by the issue of a Treasurer's direction.

MR HARRIS: I think I am prepared to work towards that end. It is a second-best outcome, but it may be a necessary outcome. I am happier to do it where the private sector is not involved. We do not have a good compliance standard for auditing. The private sector is not all that interested in compliance standards for auditing. So I am happy to develop that; there will not be any particular conflict with the private sector. In the area that we are talking about there is likely to be conflict and I would rather have the private sector and public sector on the same footing, if we can. If we cannot, we will just go our own way.

VICE-CHAIRMAN: The Chairman is back now so he might want to take up the next question.

Mr CHAPPELL: Surely the Treasurer's direction approach puts it right back over there in the way that you would find incompatible or, most likely, you would find incompatible.

MR HARRIS: It can be yes.

Mr CHAPPELL: That is probably not a good direction for you to be preparing to settle on anyhow.

MR HARRIS: What happens then is that it puts me in the conflict with my own professional standards. We overcome that by saying in the independent audit report that the department has done the right thing in meeting the directions issued by the Treasurer, but it has done the wrong thing in ignoring the accounting standards which purport to underlie the financial statements, so the opinion has both elements covered. Some auditors-general will not do that because they believe that the Parliament's or the Treasurer's direction would override the standards such that they do not need to talk about the standard.

I think there is a view in New South Wales amongst staff that they wish to be part of the Australia-wide accounting auditing profession. They can tolerate an independent audit report that says they have done the right thing by the Treasurer's direction but the wrong thing by the accounting standards, in order to stay part of the profession or to be recognised as part of the profession.

Mr GLACHAN: You have had something to say about the use of section 22.

MR HARRIS: Yes.

Mr GLACHAN: This is dealing with substantial payments outside the budget forecast. Can you let us know how you think issue process should be tightened up?

MR HARRIS: I actually think that is a very --

Mr ROGAN: May I interpose there. We heard from people from Treasury just before you. They to this document that has been released out and they indicated that they want to work towards --

Mr HARRIS: The draft document?

Mr ROGAN: -- The draft document that is being implemented. In your answer you might want to make some reference to that and let us have your views on that document.

MR HARRIS: I think this is actually something that is vital to the role of the Public Accounts Committee's role. This sounds a bit didactic, but it seems to me that the Parliament in New South Wales has lost control over expenditures.

Mr GLACHAN: Because they are moving these moneys about?

MR HARRIS: Because the Executive has so much flexibility that there is no effective control, and this can be suggested in a number of ways. There are very few appropriation items in the Appropriations Bill presented in New South Wales. For example, there is one

appropriation item for schools that covers secondary schools, primary schools, special schools, government schools and non-government schools—a vast amount of money that can be used for any of those purposes. So there is already in the Appropriations Bill, because the appropriation items are so broad, a degree of latitude that does not exist in many other Westminster systems. It does exist in Queensland, I admit, but not many others.

Secondly, those in the legislature have been authorised by parliament that when they exhaust funds in one appropriation, they can, without further approval processes, take moneys from another item. So they have come to parliament and said that they will spend money for certain purposes. If they do not want to, they do not have to; they can take money out of the item and put it somewhere else.

Thirdly, they have an advance to the Treasurer, which allows them to spend money whether or not the issue is urgent and whether or not the issue was known to the Government before they introduced the Bill. So if the Government thinks that the assembly might not be tolerating of a particular provision, it need not put it up. It can wait until the Bill is passed and spend it out of the advance.

Fourthly, when all else has failed, they can use section 22—just spend the money. This lack of oversighting means that when Treasury is involved in accounting for its moneys after the end of the year, it does not bother doing it during the year to any great degree because it does not have to. At the end of the year, they say, "We have overspent the provision. We will apply this against the advance, so that is okay. Well, we have spent the advance, so we will apply the balance against section 22". There is no particular restriction on them in determining what they will spend with respect to parliament authority.

That is not the only example where the Executive appears to dominate the Parliament, but it is one that goes to the heart of the PAC and the Parliament's role, it appears to me.

Mr ROGAN: May I just put a supplementary question. Without wishing to speak on behalf of Treasury, I would interpret what Treasury also said a little earlier today to be that these expenditures are only very small in comparison with their \$20 billion. Without understating what you have said, would you still believe though that strong statement you made is still appropriate given the amounts of money involved?

MR HARRIS: You have raised an issue there about fiscal prudence. I am not saying that the Government is spending money in such a manner as to endanger the fiscal status of the State. If we take a good example in another jurisdiction, say, we take the legal bill of the previous Health Minister Carmen Lawrence, that was a matter of some contest at the parliamentary level as to whether it was legitimate commitment. In New South Wales, that debate would not arise because the Government is under no hesitation that it has the power to meet the Bill.

In the Commonwealth, the government could not meet the Bill without talking to parliament even though it was a small amount of money, because parliament has said, "You do not spend money without our approval unless it is urgent and unforeseen or unless you have

asked us beforehand. " So as small as it was, it was an important issue.

Mr ROGAN: So it is not the amount, but it is the principle of what is happening?

MR HARRIS: Yes.

Mr CHAPPELL: So it virtually needed to be a line item in the Estimates; is that right?

MR HARRIS: I am not quite aware of the circumstances. I think it goes like this: It was not an expenditure that parliament had authorised, therefore it was a new program. Because it was a new program, it had to be introduced in Bill No. 2 as a specifically new program. They had not done that; therefore, they had to go for the advance to the Minister for Finance. They could not do that because it was not urgent or unforeseen. It has to be both urgent and unforeseen. It might have been unforeseen, but it was not urgent, so the lawyers could have waited until parliament had been asked; indeed, that is what did happen. So I think that was the route down which it went.

Mr TRIPODI: It is very easy for the auditor to be critical of Appropriations that are inconsistent with what is stated in the Budget, but the reality is that budget expenditure, actual expenditure, does swing with the business cycle. At the end of the day, they are only forecasts and if they use section 22 to balance unforeseen forecasts, which are not possible to forecast, even though what you are saying is that section 22 may be the wrong mechanism by which you do that balancing, there needs to be a means by which that balancing can occur. So do you think we should have the department recommending to them some other mechanism by which they can balance the reality against the forecast?

MR HARRIS: In the discussions with Treasury, although this Government reduced the advance to the Treasurer significantly, I suggested that the advance was not a very large amount of money in proportion to the total money spent by the Government and that if the advance were larger, one could not criticise the provision on that basis. At the same time, I suggested that maybe the advance should not be used other than for urgent and unforeseen purposes. So that is both an expansion of the power and a limitation of the appropriation head.

I do not have any particular like for section 22, but if section 22 were phrased in a way that allowed them not just to spend money when they thought the exigencies of the State required them to spend it but to spend it on really urgent and really unforeseen matters, and they could be specified more closely. They could be specified as the direct consequences of natural disasters; they could be specified as payments to meet legally required payments that were unforeseen, or court orders—legally required payments would include salary increases because they are a matter of law—and other awards by courts that are unforeseen.

You could satisfy the needs of the Government that it must continue to be able to meet the required expenditures of the day, but satisfy the needs of the parliament that moneys are not being spent without coming to parliament except where they very urgently must. It is that kind of fencing that may be quite useful. It is not unheard of in the Commonwealth arena for there to be several sets of Appropriation Bills. In other words, the government will come back to

parliament. When they see the first Appropriation Acts being exhausted, they will come back and say, "We have run out of money. Can we talk to you about giving us some more money for these purposes?" That can be done three times during the course of a financial year. They will come back and say, "We have spent the taxpayers' money that you gave us. Can we spent some more?"

Mr CHAPPELL: Is that the original and two returns or --

MR HARRIS: The original and two returns. It does not always happen. That is the extreme. Quite commonly, it was the original and one return. Here, there is no need to do that.

Mr CHAPPELL: Just invoke section 22.

CHAIRMAN: On the same subject, in 1995, some of the payments made were to the Superannuation Board. As it does not appear that they were urgent or in any way qualified as an exigency, could you give us your opinion on these payments, as Auditor-General, including comment on the \$15m payment said to be unauthorised.

MR HARRIS: This is a good example where I think Treasury looks at the bottom line and says, "we have some capacity to spend some money", so I think in that year, on 29 June, it sent a cheque to the Superannuation Board for \$55m, that reflecting the current view about the outcome of the fiscal year. On the last day of the year, Treasury said, "We have some more scope, so we will send another \$15 million to the Superannuation Board". This was not for any itemised urgent matter but in order to contribute to reducing the unfunded liability of the superannuation scheme. It was nothing that could not have awaited 1 July, but it seemed to be a good idea to balance the books in line with the budget expenditure and they had this capacity, so they spent it.

The law says—your law—that the officers are not to spend money that is not appropriated without the Treasurer's approval. That is indeed what happened with that \$15m. It was done inadvertently; it was not done callously. People did not sit down and say, "I am going to break the law today I am going to write a cheque for \$15"; it was a matter of a mistaken calculation that they wrote a cheque for \$15m which was not authorised. We are probably lucky we do not operate in the days of Charles I or Charles II or something because the king might have got reasonably upset.

Mr ROGAN: Was that appropriated money or would that be a transfer?

MR HARRIS: No, that was in excess of appropriations and it required the Treasurer's approval.

Mr GLACHAN: And they did not get the Treasurer's approval?

MR HARRIS: They did not get the Treasurer approval—well, they got it afterwards, but they did not get it at that time. I am assuming they got it afterwards, but they did not get it at that time. I do not think there is any debate about the matter between us and Treasury as to the facts of the circumstance. It is just that Treasury would say, "This is a technical breach". By that they

mean, "If we had asked for at approval, we would have got it". That is like saying, "If we had asked parliament, they would have agreed. We forgot to ask parliament, and we did not pass the law because we forgot to ask parliament, so it is a technical breach of the law".

Mr GLACHAN: So Mr Tripodi's point is a valid one then. Section 22 should be tightened up in the way you have mentioned, but there should be another mechanism for them to be able to do things like this legally if the need arises.

MR HARRIS: You are almost saying the same thing. Section 22 should be tightened up so that they only spend money when the need arises. You are trying to define "need" narrowly and they are trying to define "need" broadly. It is not self-evident. The exigencies of the State means that in somebody's mind this would be a useful thing to do.

Mr GLACHAN: A crisis?

MR HARRIS: No; an exigency is something useful to do for the State.

Mr TRIPODI: You cannot be too critical. You can be critical of not following the process, but not too critical of them saying, "We have this debt over here. We have \$30m. Why do not we add it to that debt?"

MR HARRIS: I am not critical of the words; I --

Mr GLACHAN: Just the way --

Mr TRIPODI: The approach?

MR HARRIS: I am critical that you established a law, presumably because you thought it was useful, not to have public servants deciding for themselves what was good and what was bad, but that when the Parliament's appropriation had been exhausted and it wanted to spend money, it had go to a responsible minister, but they did not. As I say, it was an accident. It wasn't a thumbing of the nose either at the Treasurer or at the Parliament, but it does demonstrate that there is a cavalier attitude about parliament's control of expenditure.

For example, parliament has, in its wisdom, required that any movement of moneys from one appropriation to appropriation item to another be identified to the Auditor-General. They do not do that. They do not do that. Why should they bother telling the Auditor-General that it shifted money from one head of spending to another head of spending? It is not an affront to me; it is just an expression that this is not really a matter of concern to me. They do not understand the role of parliament in limiting the Executive's use of taxpayers' moneys because that is what parliament is all about, controlling the exercise of the Executive's delegation.

CHAIRMAN: Could I move on now to the audit mandate. In reporting to parliament on the operations of the Protected Disclosures Act, you drew attention to the audit mandate and the exclusion of local government. In addition to local government, are there any other areas you consider you should extent your audit coverage to?



Mr HARRIS: I face a moral hazard in talking about this issue because it looks like I am trying to aggrandise the office, so I try to be very careful about it. But I do get letters all the time from Ministers and non Ministers saying, "Please look at this", and I write to them saying I cannot because the parliament's legislation does not allow the matter to come under my mandate. The areas that I get most letters about are local government and the local Aboriginal Land Councils.

It comes as a surprise to some former Ministers that I do not audit that, and it comes as a surprise to some Ministers as well as former Ministers that protected disclosures about substantial waste in local government is not a matter that I can look at. No-one can look at it in those terms. There is a vacuum in the law. I suppose my concern is a bit deeper because the legislation allows each of those entities to appoint its own auditor. It is not a situation where you agreed with the Auditor-General. You do not allow the Government to appoint the Auditor-General unilaterally, you say, no, the auditee should not appoint the auditor.

What the government can do is give a name to the parliament, and the parliament through the PAC will see whether it is a fitting person. The idea of doing that is to try to insulate the Auditor from pressures that could be put on by the auditee. You do that in a number of ways.

Mr TRIPODI: Doesn't that also happen at the local government area?

Mr HARRIS: No, each council appoints its own auditor.

Mr TRIPODI: That is a tier of government appointing an auditor to audit the executive or branch arm of the council?

Mr HARRIS: The council executive appoints the auditor who audits their accounts.

Mr TRIPODI: Repeat that again?

Mr HARRIS: The council members appoint the auditor who is to audit the council's accounts. It does not happen at the State. It does not happen in the private sector. In theory at least in the private sector, although in practice there is a different view, it is the shareholders who appoint the auditor for public companies, not the directors and not the executive, because the theory says it is the executive and directors' accounts that are being audited and so they should not appoint the auditor.

Mr TRIPODI: But the mayor is the executive of council?

Mr HARRIS: No, the chief executive is under the law, but the council signs the accounts. The council and the chief executive sign the accounts and they appoint the auditor. I am put under great pressure when I wish to qualify an account. That is when they can't fire me; and they have to pay the bill. If I am in the private sector and I go to you and say, "Look, I disagree with your treatment of this lease, I actually think you have borrowed the money", the response is, "You maybe right and, by the way, I wanted to talk to you about my dissatisfaction with the services you are providing and to advise you that we are going out to tender".

Mr CHAPPELL: "Do you still want to qualify that?"

Mr HARRIS: Yes.

Mr TRIPODI: That happens everywhere in the private sector. You can't operate under the assumption that is occurring. The law cannot assume that there is a level of corruption involved. You can put mechanisms in to control it but you cannot assume that in every situation where a council is engaging the auditor that the auditor is subjected to duress?

Mr HARRIS: I am saying that to avoid the possibility of that duress, there is a principle that says the auditee should not appoint the auditor, and that is just --

Mr TRIPODI: The ratepayers are represented by the council, so as close as you can get to the constituency or the shareholders are the councillors?

Mr HARRIS: Under that argument you would allow all statutory authorities to appoint the auditor because the local council is a creature of government.

Mr TRIPODI: But it is a separate tier of government.

Mr HARRIS: It is a separate tier of government but it is still subject to the principle that the auditee should not appoint the auditor. That is not a principle you want broached in the State but you are happy to see broached at the Aboriginal Local Land Council level, at the local government level and at the Pasture Protection Boards, and I think that is all. This is of course a much broader question than protected disclosure.

Mr GLACHAN: With the Rural Land Protection Boards, could not the ratepayers appoint the auditor at a general meeting of ratepayers?

Mr HARRIS: They could, and I suppose that is what happens in America, the auditor becomes an elected official. But typically in the Westminster system we do it through an appointment process. Now, I am not seeking to audit local government or Aboriginal Local Land Councils or Pasture Protection Boards, but we have raised with each of the relevant Ministers that they may see value in an arrangement where I appoint the auditor so that the auditor works for me rather than for the mayor or for the CEO of the council and that I pay the auditor. This does not reduce your economies and it does not reduce your regional involvement of auditors. In fact, it is identical to the arrangement that occurs when the then government gave district health services to the Auditor-General.

They were previously being audited by auditors appointed by the hospitals. The Government said that is not really sensible, what we will do is ask the Auditor-General to audit them in the knowledge that he will not actually personally audit more than a couple of them, what he will do is contract out the audits and supervise the audits.

That process allowed in our view, well, it is not our view, it did result in a reduction in the fee but it also resulted in an increase in the quality of the audit. You might say, where is the

precedent for this. Queensland audits local government. The Auditor-General contracts them out, as does Victoria and Tasmania. It is not an unusual application of that principle. What are the consequences if you don't do it? I don't know because I am not that close to local councils.

We are involved in one matter at the moment where we have seen the Auditor write to a council to say, "This lease is really a borrowing and if you persist"—no, he did not go on to say that but—"the standards say that if you persist to treat it as an operating lease we will have to qualify your accounts". That did not occur. The auditor decided, in our view inconsistently with the standard, not to qualify the accounts, as he more or less said he had to do. I don't know the full circumstances of that but it is an issue that is worrying.

CHAIRMAN: The proposition that you put up for argument sake that you appoint the external auditors for the shires and councils, what would be the resource implications of that?

Mr HARRIS: For us?

CHAIRMAN: Yes.

Mr CHAPPELL: And therefore for the Government?

Mr HARRIS: Well, it might not be for the Government because we would under these arrangements charge the councils for our costs. As we saw with the district health services, the costs of the auditor plus our costs were lower than their previous auditor costs because we put them out to tender, which they had not done previously. Local government has gone out to tender so I do not expect to get the same type of savings, if any. What it would involve for us is staff to liaise with the auditors so that they know the expectations that we have in audits, what our standards are, what kind of work we want them to do, and we would liaise with them on the engagement plan and we would liaise with them on the management letter and we are available during the course of the year to talk to about problems with them.

What kind of cost is that? It is not very large, a small staff of three or four plus some SES time, as it does take up some SES time. To do the electricity distribution councils and to do the district health services, all of that involves four full time staff and some SES time.

Mr ROGAN: You do that, actually do the auditing, or oversight the appointment?

Mr HARRIS: We oversight. We run the tenders, we talk to the councils about the tendering process, we talk to them and say, "Look, are there people that you don't want to be tenderers that you would rule out and why", because they might know about conflicts of interest or inadequate services. Sometimes they say they don't want somebody who they regard as good because they regard them as good, and we say, "No, we will leave them in the process".

Mr CHAPPELL: Because they gave a qualified report last time?

Mr HARRIS: Yes. They do that work and the quality control.

Mr ROGAN: But the report that appears in your report to the parliament is done by your personnel?

Mr HARRIS: No, it is a mixture of contract audits and personal audits.

CHAIRMAN: So overall what would you say are the advantages to parliament about this scheme you are just talking about?

Mr HARRIS: The Victorian Minister, when he spoke about it last year, said that it would increase consistency across the local government arena, it would increase the quality of the audits across the arena and it would allow statewide trends to be detected and reported on. It has the added advantage in New South Wales that it would allow protection disclosure of significant waste to be made to the Auditor-General, without suggesting there is any happening at the moment.

CHAIRMAN: By implementing this system it puts it above reproach?

Mr HARRIS: Yes, and it meets that principle that the auditee should not appoint the auditor. It improves confidence in the system. We are involved in an inquiry of a protected disclosure relating to a council but not in our own right. Members of the council and members of this parliament asked us to become involved and we said we could not. In fact the Minister has asked us occasionally to become involved and we said we cannot. When residents care to talk to us about this, we say that we cannot do this but that we can talk to the Ombudsman and provide our staff to the Ombudsman. The Ombudsman can second our staff and our staff can help the Ombudsman work on the matter and understand the matter and report to the Ombudsman and he can then make a report to parliament.

I suppose we do that all the time but recently I had a deputy mayor write to me about significant substantial waste and I said, "I cannot do it, I will send your letter on to the Ombudsman", and the deputy mayor wrote back and said I had taken a very narrow interpretation and I should do it. I had to write back and say, "It is not a narrow interpretation, I cannot help you any more other than give it to the Ombudsman". I think protected disclosure waste illustrates that there is a hole in the legislation.

Mr ROGAN: Even if the system that you would like to see put in place is, that is, you appoint the auditors, that still would not without other changes—which I would like you to answer whether you want them as well—still allow you to directly intervene and accede to the request, as you acceded to that request from that deputy mayor?

Mr HARRIS: Once the Auditor-General of New South Wales can audit local councils, the Auditor-General can then do protected disclosure and he can then do any special audits that might be required and he can respond to requests from the Assembly or the Parliament or from the Minister to look at particular matters that have arisen. But at the moment the Minister can say to me, "Look, I want you to look at this and I will pay you" and I say, "no, I can't do it", just as I cannot look at BHP's coke operations at Port Kembla.

Mr CHAPPELL: But you could ask the Ombudsman?

Mr HARRIS: Yes, and the Ombudsman is paid for that.

CHAIRMAN: Before we leave this subject, do you wish to extend your audit to schools? There was some rumour you wanted to audit every school?

Mr HARRIS: It is not a matter of want but what does the law require. The law says that if there is a reporting entity controlled by the State then I should audit the accounts. The question is, are schools a reporting entity? In some jurisdictions they are. In some jurisdictions they are not. It depends on an assessment of the responsibilities given to individual schools and their autonomy. They are some of the characteristics that would determine whether they are reporting entities. There is a view in the office that schools are a reporting entity.

I actually wrote to the Minister and said, "If this view is maintained and you don't want me to audit them, change the Act, easy, just change the Act and say 'except in schools'." I am quite relaxed about that because that is parliament taking a view on the matter. On the other hand, the Minister might want me to audit the accounts of schools. We actually do 80 a year under contract, and we do look at their financial statements. The rest of them are done by the Department of Education's internal audit. I am relaxed about that continuing. I don't have any sense of urgency about that matter. When I spoke to the Minister most recently I said, "Don't worry about this issue, it is with us, there is no need for you to get agitated about it, I will not do anything until I come back to you". I am not in a particular hurry about this because it is something we have to think through reasonably carefully.

CHAIRMAN: Once again, have you thought about the resources that would be needed?

Mr HARRIS: Yes. We have said, at least internally if not externally, that we would try to get pro bono auditors in whom we could rely on, who could do it for free. I don't do the auditing of the local scouts but there is a company auditor that does them for free. I have to put the financial statements up. I do that for free. You can get pro bono people doing this. You can group them together to reduce the charges. It may cost as much as the interest earned on the idle money held by schools.

Mr GLACHAN: They want that money, though.

Mr HARRIS: They want the idle money and the interest. There is \$250m or so.

Mr CHAPPELL: Has not that all been clawed back?

Mr HARRIS: No. I think there are good reasons for liking that interest. I am reasonably relaxed not to pursue that issue with any great energy at the moment. The Government may come to a view that it wishes to increase the autonomy of schools, in which case the Minister might say that he would like to see them report to the community and to see the audit's opinion attached to it.

Mr CHAPPELL: They were extended a fair degree of autonomy in using their fund. They were given a global allocation a few years ago and I think that still continues. They are certainly more accountable than they used to be.

Mr HARRIS: Yes, and that is what led to the question. The flip side of it is that if schools are not reporting entities, that is, subsidiaries if you like of the department, then they are branches. They have to be one or the other. Everyone understands that. If they are branches, the Department of Education has to consolidate all their financial statements. It is reasonably agreed that they are one or the other. Each of them has costs attached to it.

Mr CHAPPELL: Can I come to a bit of a wrap-up on accountability standards generally throughout the State. Based on the large number of matters that you deal with across the course of a year, what is your overall opinion on the standard of accountability in the New South Wales public sector?

Mr HARRIS: I have said in a speech before that if members of the public or members of parliament thought that I spent 92 per cent of my resources on signing independent audit reports about the financial statements of entities that you would be entitled to say, "Is that all, I would have expected that the financial statements of entities are accurate anyway, that is a given, and you spend 92 per cent of your resources telling me that they are accurate. Within \$300m or whatever our differences are does not seem to be much in terms of accountability, it does not seem to have--

Mr CHAPPELL: Not much added value?

Mr HARRIS: It does not seem that the Auditor-General is really helping parliament very much. I was surprised to learn that Queensland spends 20 per cent of its money on that and spends the bulk of its money on reviews and compliance issues. So that is a very big issue for me, trying to work out whether I am actually meeting your needs or not and how can I better meet your needs without increasing costs. We have asked you the former question and we are thinking about the latter question ourselves. So there is that issue for accountability.

That is only for the Auditor-General, I suppose. I can put it another way and say that the principal accountability mechanism appears to be the annual report. This Committee put out a report recently saying that was inadequate, the way that accountability requirement is executed is inadequate, and I suppose I would go on to say that as good as accrual statements are—and it is very important that we have them—they are not as useful in the public sector as they are in the private sector and they should not be relied upon as being the equivalent. What we have to have, and the Committee has commented on this, is some more authoritative statements about what agencies are doing with the money that you allow them to spend, and that is performance indicators and all that kind of stuff. So I think the issues are on the table, the issue of compliance, the issue of performance reports, the issue of performance indicators, they are all on the table. I think you have the capacity to see within this term of government a worthwhile change in the accountability relationships in this State, and you have got most of them under your fingertips now.

Mr ROGAN: Mr Harris, some of your officers were here earlier when some of the other authorities were giving evidence. Could I perhaps ask then whether, particularly when Mr Harper was giving evidence about the State Rail Authority when he answered questions on the audit report qualification on inventory, can your officers make any additional comment on this matter?

Mr WHITFIELD: I would be happy to answer that. When Mr Harper was talking this morning about inventory, there was some confusion in my mind as to what he was getting at because inventory in the State Rail Authority comes in three categories. There are official stores which have always been accounted for in the books of State Rail and been adequately controlled; and within those official stores there is a subset called Main Train, which is the inventory in relation to the contracted out service provision of maintaining the trains. That was part of our qualification, the \$26m within the \$70m of total inventory on the books was a problem in that 40 per cent of that inventory was valued at 1 cent and other components of that were valued at last purchase price. Both of those methods of valuation are contrary to AAS2, so that is in relation to that.

On top of that, there are the user stores that he referred to, and there is some estimate of \$81m worth of inventory that is not in the books of State Rail, has not been in the books of State Rail for sometime, and they have been trying over the past 2 years to identify, catalogue and value that inventory. They were not able to do it by 30 June 1995, therefore we qualified. They are in the process of doing it now and they estimate that by 30 June they will be able to have it identified, valued, catalogued and brought into the books.

Mr CHAPPELL: I asked for a guestimate of that and he said about \$70m.

THE WITNESS: That is the value of inventory already accounted for in the books. There is a further \$80m that had been previously expended but is still on hand and is not shown as an asset of the State Rail Authority at this point. That the total inventory is some \$150m, if it was properly accounted for, plus that 40 per cent of items that are valued at 1 cent that may well need to be revalued upwards once they have identified them and worked out what their true value is.

Mr GLACHAN: That is 1 cent for the whole 40 per cent?

Mr WHITFIELD: It is 40 per cent of the line items that are individually valued at 1 cent each. Some of those may be worth \$10,000 each or \$15,000 or \$20,000 or whatever, but they were transferred when the Main Train operation was set up from the old stores and valued at 1 cent.

Mr ROGAN: I put to Mr Harper—and I guess it is a little unfair that he is not here but I am sure he would be quite prepared to answer or make a response in writing to the questions we are talking about here—that whilst he indicated that the annual report which the public sees and the parliament sees is accurate, I put to him that it was very misleading; and it would be even more misleading given the figures that you have just referred to?

Mr WHITFIELD: If you read the audit qualification, that audit qualification specifically

says that there are inventory items that are not able to be estimated that have not been included in the value of inventory, and I understand that the State Rail Authority sent up to the Public Accounts Committee a report on the user stores in which it refers to the \$81m worth of inventory not being accounted for at this point.

Mr GLACHAN: How do they know it is \$81m if it is all valued at 1 cent?

Mr WHITFIELD: It is a rough estimate. In trying to get it valued for 1995, it commissioned Brambles to go out and identify, catalogue and value the inventory.

By 30 June 1995 it had only been able to go out and identify and value 30 per cent of the inventory. By extrapolating that 30 per cent they were able to value, they arrived at an estimate of \$81m, and they are still working on it. They are making progress. They are indicating that by 30 June they will have it completed.

Mr ROGAN: I must admit—I am quite happy for it to be on the record—that I personally was quite impressed with Mr Harper's grasp of the operations under him and his ability to be able to answer questions most times without any real notes, but just on this area obviously there would appear to be some qualification required in his response.

Mr WHITFIELD: I think that is a fair comment.

Mr ROGAN: The Committee was very interested in the control of overtime at State Rail. Can you comment on the evidence that you heard this morning given by Mr Harper?

Mr WHITFIELD: Since the matter was raised with the State Rail Authority, our understanding is they have been putting in effort to control it. Where the Audit Office was coming from was the fact that over a number of years there have been very high levels of overtime and, again in our report to parliament, we indicated where we had taken a sample of approximately 100 individuals and then looked back in the previous 12 months and 95 per cent of those same 100 individuals had a very similar level of overtime. They were individuals that were earning in excess of 100 per cent of their base salary in overtime.

Mr CHAPPELL: Overtime and allowances, because he was very specific that he was at disagreement with the Audit Office, that a lot was allowances?

Mr WHITFIELD: In the table we put in, using the State Rail's figures, the allowances were pulled out separately. The area there was some confusion was the way the State Rail Authority does their accounting. If someone is moved into a higher duty position and gets paid a higher duty allowance what they then do is, any overtime that individual works does not get recorded as overtime but as higher duty allowance, instead of splitting the wage. So they have got a problem with their reporting systems, and in fact they had an independent consultant in 1994 do a study of their overtime and he came out with similar results that we did. He also made the comment that their reporting system was insufficient to allow the line management to adequately manage the system.



Where we were coming from is that they have agreed procedures in terms of control of overtime and the amount of overtime that is considered excessive and what management's responsibilities were but those things were not being complied with. We now understand that they are moving in that direction and starting to comply with the requirements. Again, his comment is correct that with the overtime results, because of the work practices, if they were to move to a 7-day roster instead of a 5-day roster, that would alleviate some of the problem.

Mr TRIPODI: Just another point that was raised in our discussions with the State Rail CEO. He believed in some areas they cut back employees too much, which contributed to a blow out in their overtime. He particularly said on stations that was so. I asked him whether that related to the fact that often the CEO's would be motivated to look at performance indicators, that in order to make performance indicators look good you continue to cut employees and it would make you look more efficient. We have discussed this issue before with you, that rather than good management becoming the objective of the organisation the objective of the organisation becomes the targeting of performance indicators, which is a very big issue and debate, and is very important.

You raised earlier today that you still believed we should go down the road of performance indicators. Here we have a good example where the performance indicators have damaged the efficiency of the organisation. Do you have any comments on that?

MR HARRIS: It is a wrong performance indicator.

Mr TRIPODI: I agree.

MR HARRIS: This is an issue that we are particularly looking at in the special audit on redundancy. We are looking at whether redundancy has backfired on overtime and on contractors and rehiring redundant personnel. But when you are looking at the efficiency of an organisation, it is not good enough just to look at staff numbers coming down because they can be coming down while overtime and contractor costs can be going up. So you do need to look at the whole of an organisation's operations.

Anyone who says staffing is a particular issue—I had better be careful here, because I can get into trouble—has to be very careful about setting a performance indicator that says, "I am going to cut the staff by one-third", because that may result in a perverse outcome.

Mr TRIPODI: Performance indicators are usually a time-series of information; they are prepared over time. What happens if someone decides that a performance indicator is not relevant? For example, a CEO who was appointed one year ago inherited that performance indicator which was wrong. He will be judged on that and if he decides to dump that and switch to another one, then he will be criticised for doing so.

MR HARRIS: He might be. Of course, the other tendency is that if you do not like a valid performance indicator's results, you dump that and get an invalid one.

Mr TRIPODI: That is right.

MR HARRIS: There is nothing you have said that I disagree with.

CHAIRMAN: With respect to the University of Newcastle Flying School, can you advise the Committee on your involvement with the flying school as the external auditor. Prior to the involvement of the Audit Office as external auditor, did the same chartered accountancy firm undertake accounting and auditing services. Was this a conflict of interest?

MR HARRIS: That is a question the answer to which is not immediately available to me. I can say that we have now told all our contract auditors that they may do no engagement with the audit client that the Auditor-General cannot do. If parliament has said that I cannot do certain things because that may infringe upon my audit capacity, nor can the contractors that I appoint. This resulted in some consternation on their part, but it is a policy that is now in effect. I cannot answer the direct question you have asked as to whether the auditor at the time did provide accounting advice. Accounting advice, is that the question?

Mr ROGAN: Accounting services.

CHAIRMAN: Accounting services and auditing services.

MR HARRIS: Accounting services would be a conflict because you are setting up the financial statements which you yourself are auditing; accounting advice would be okay because you have to do that as an auditing function anyway.

CHAIRMAN: So perhaps you can come back to us on that one?

MR HARRIS: I will come back to you on that, Mr Chairman, yes.

CHAIRMAN: I have a question on the Somersby evidence that was given today, which is just a broad question. Can you comment on the Government's involvement in Somersby Park Pty Limited?

MR HARRIS: I go back a long way with Somersby, because I dealt with it when I was in the Commonwealth. I think we persuaded the State to take it over.

Mr CHAPPELL: It seemed like a good idea at the time.

Mr MITCHELL: And it was for the Commonwealth.

MR HARRIS: When you have made a deal that has not turned out well, I suppose you are always chasing losses. I know that the Government is seeking to reduce its involvement in Somersby in an equitable and efficient way. Our involvement with it at the moment is just as auditors of the company. We merely get the financial statements and attest to their accurateness. That gives us some insights into the business. There are some insights as to the dealings by the leaseholder with us, but those observations are not the subject of a special audit and they are only casual observations. I suppose all that means is that I am a bit shy about telling you what we think because of the record.

CHAIRMAN: This is a related type of question. You have reported to parliament on the "going concern" basis of concerns being dependent on the continuing support from its creditors. Have you any idea of the current financial position of Somersby Park?

MR HARRIS: With respect to this financial year?

CHAIRMAN: Yes.

MR HARRIS: We understand that the lessees are still behind in their lease payments; that the amount of default has grown; that there have been no loan repayments during the period; that there have been no amendments to the leases during the period; and that parties are considering their options, each of which has unpalatable issues tied to it.

(The witnesses withdrew)

(The Committee adjourned at 1.25 p.m.)

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