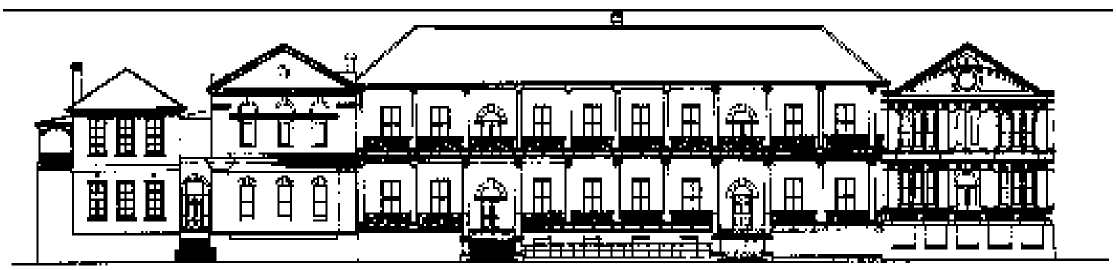
PUBLIC ACCOUNTS COMMITTEE

Follow-Ups of Auditor-General's Reports to Parliament 2001: Omnibus Volume



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Charter of the Committee

The Public Accounts Committee has responsibilities under the *Public Finance and Audit Act 1983* to inquire into and report on activities of government that are reported in the State's Public Accounts and the accounts of the State's authorities.[1] The Committee, which was established in 1902, scrutinises the actions of the Executive Branch of Government on behalf of the Legislative Assembly.

The Committee recommends improvements to the efficiency and effectiveness of government activities. The sources of inquiries are the Auditor-General's reports to Parliament, referrals from Ministers and references initiated by the Committee. Evidence is primarily gathered through public hearings and submissions. As the Committee is an extension of the Legislative Assembly its proceedings and reports are subject to Parliamentary privilege.

Members of the Committee

The Committee comprises members of the Legislative Assembly and assumes a bi-partisan approach in carrying out its duties.

Chairman:	Joseph Tripodi MP, Member for Fairfield
Vice-Chairman:	Pam Allan MP, Member for Wentworthville
Members:	Ian Glachan MP, Member for Albury
	Katrina Hodgkinson MP, Member for Burrinjuck
	Richard Torbay MP, Member for Northern Tablelands
	Barry Collier MP, Member for Miranda

[1] See Part 4 of the Act – The Public Accounts Committee.

Committee Secretariat

Secretariat members involved in the Inquiry were:

Committee Manager:	David Monk
Project Officer:	Vicki Buchbach
Committee Officer:	Jacqui Isles
Assistant Committee Officer:	Mohini Mehta
Advisor to the Committee:	John Viljoen

To contact the Committee:

Public Accounts Committee	Telephone (02) 9230 2631
Parliament House	Facsimile (02) 9230 2831
Macquarie Street	E-mail pac@parliament.nsw.gov.au
Sydney NSW 2000	

Chairman's Foreword

I am pleased to present this omnibus volume of follow-up inquiries by the Committee into Auditor-General's reports to Parliament. The three issues covered in this report are:

- the qualification of the accounts of the Building and Construction Industry Long Service Payments Corporation, due to it recognising changes in the value of investments as profit or loss. The Australian Accounting Standards limit this treatment to superannuation funds;
- the Department of Public Works and Services spending much of the year in overdraft; and
- the need for the Sydney Catchment Authority to improve its accounting procedures and cash position.

The Committee followed up a number of financial audit items from the Auditor-General's reports tabled in Parliament in late 2001 and early 2002. This collection represents issues the Committee did not progress beyond the submissions stage.

In the case of the Building and Construction Industry Long Service Payments Corporation, this was because the recently announced shift to International Accounting Standards will now permit the organisation to recognise the change in the value of its investments as profit or loss.

In 1993, the Audit Office regarded this issue as a technical qualification and recommended changes to the Australian Accounting Standards. It now appears that the adoption of International Accounting Standards will rectify the matter.

In the case of the other two inquiries, the Committee did not take further action because the submissions were comprehensive and demonstrated to the Committee that the necessary action was being taken. The Committee would like to congratulate these agencies on actively addressing the Auditor-General's concerns. The Committee would also like to thank them for writing good submissions that have allowed the Committee to complete its inquiries without expending further resources.

To allow the Parliament and the general public to verify the Committee's conclusions for these two inquiries, both submissions are included in the appendix to this report.

I would also like to thank John Viljoen, Advisor to the Committee, whose technical expertise greatly assisted the Committee in researching and drafting the report.

Joe Tripodi

Joseph Tripodi MP
Chairman

Chapter One

Revenues of the Building and Construction Industry Long Service Payments Corporation

Introduction

Under its powers to follow-up reports of the Auditor-General in section 57(1) of the *Public Finance and Audit Act 1983,* the Committee resolved to inquire into the matter of the Corporation recognising net increases in the value of its non-current investments as revenue. This practice arose from the Corporation applying the Australian Accounting Standard for superannuation entities. Technically, the Corporation was not managing a superannuation plan and should have applied a different standard and recognised increases in value in a revaluation reserve (similar to a holding account).

This practice has resulted in a qualified Independent Audit Report for several years. The matter was raised in the *Auditor-General's Report to Parliament for 2001 – Volume 7*.[2]

Background

The Australian Accounting Standards currently relevant to this matter are AAS 25 "Financial Reporting by Superannuation Plans" and AASB 1041 "Revaluation of Non-Current Assets."

- AAS 25, which applies to superannuation plans only, requires that the net increase in value arising on the revaluation of non-current assets (including investments) be included in revenues in the Statement of Financial Performance.
- AASB 1041, which applies to most entities other than superannuation plans, requires that the increase in value arising on revaluation of non-current assets (including investments) be credited to an asset revaluation reserve in the Statement of Financial Position. That is, increases in values are not to be included in revenues in the Statement of Financial Performance.

The Corporation provides a portable long service scheme to workers in the building and construction industry. The scheme is a defined benefit plan, which means it provides benefits at a future time, based on the length of employees'

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[2] Auditor-General, *Auditor-General's Report to Parliament 2001*, Volume 7, Sydney, 2001, pp 433 – 434

service to the industry and the income they are receiving when the benefit is taken.[3]

In order to manage the scheme properly, the Corporation recognises the estimated future earnings from investments. To ensure the scheme is sufficiently funded, the Corporation's actuaries use investment income, including changes in the value of the Corporation's non-current investments, to meet increases in liabilities for benefits already existing for members of the scheme. Also, when determining the levy rate that must be applied to meet new liabilities, the actuaries recognise that the funds from the levy will themselves earn investment income.

The Corporation holds the view that it operates like a superannuation fund and to a large extent it does. It provides future benefits funded, in part, from income derived from non-current assets. The Corporation therefore argues it should use the same accounting principles as those applied in AAS 25,[4] which in part states:

> The primary function of superannuation plans is to act as a vehicle for the accumulation of assets to pay benefits to members and beneficiaries. Measuring assets at net market value as at the reporting date provides more relevant information to the users about the resources available to pay benefits than does the cost basis of measurement. The net market value basis of measurement is therefore required by this Standard. Information about the assets available to pay benefits will be relevant to an assessment of, in the case of defined benefit plans, the plan's ability to meet its obligations to members and beneficiaries and, in the case of defined contribution plans, the plan's ability to provide an adequate level of benefits for members and beneficiaries.[5]

The Committee understands both NSW Treasury and the Audit Office support the Corporation's view, but the long service scheme is not a superannuation plan and is not exempt by any provisions in AASB 1041 from complying with that standard. Therefore, the accounting standards dictate that the Corporation must comply with the requirements of AASB 1041. Non-compliance with AASB 1041 means the Auditor-General has no option but to qualify the Corporation's financial statements on technical grounds each year.

In the *Auditor-General's Report to Parliament for 1993 - Volume 3,* the Auditor-General discussed the benefits of market value accounting. The report recommended the Accounting Standard dealing with the revaluation of non-current assets (at that time AAS 10) be amended promptly so that its potential to cause confusion in certain circumstances could be avoided.[6]

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[3] Correspondence from the Hon John Della Bosca MLC, Special Minister of State, Minister for Industrial Relations, Assistant Treasurer, Minister Assisting the Premier on Public Sector Management, Minister Assisting the Premier for the Central Coast, to the Public Accounts Committee, 14 August 2002

[4] *ibid.*

[5] Australian Accounting Standard AAS 25 " Financial Reporting by Superannuation Plans"

[6] Auditor-General, *Auditor-General's Report to Parliament 1993*, Volume 3, Sydney, 1993, pp 69 - 71

This recommendation, however, was not accepted by those involved in setting the Accounting Standards and, in the *Auditor-General's Report to Parliament for 1994 - Volume 1,* the Auditor-General advised of the necessity to express a "technical" qualification where market value accounting is applied to non-current financial assets outside the procedures set down by AAS 10.[7]

The Committee notes audit qualifications apply to the WorkCover Authority of NSW and Workers' Compensation (Dust Diseases) Board for similar reasons.

To date, attempts to have the accounting standards modified to validate the accounting treatment used by these organisations have been unsuccessful.

A development has occurred since this inquiry was initiated that may resolve the issue within the next two years. A recent announcement by the Financial Reporting Council (FRC) has confirmed that Australia will be adopting the International Accounting Standards (IAS) on 1 January 2005.

Adoption of International Accounting Standards By 2005

The Chairman of the FRC, Mr Jeffrey Lucy, AM, announced on 3 July 2002 that the FRC had formalised its support for Australia's adoption of the IASs by 1 January 2005.[8]

This will mean that, from 1 January 2005, the accounting standards applicable to reporting entities in Australia will be the standards issued by the International Accounting Standards Board (IASB). After that date, audit reports will refer to entities' compliance with IASB standards.

The FRC considered the issue at its meeting on 28 June 2002 and formally endorsed the 2005 objective.[9]

Implementation issues still need to be considered by the FRC and the Australian Accounting Standards Board (AASB) between now and 2005. These could relate, for example, to the timing of the introduction of particular IASB standards in Australia before 1 January 2005 as well as to issues of interpretation.

In June 2002, the AASB issued an *Invitation to Comment on the Proposed Improvements to International Accounting Standards IAS 32 Financial Instruments: Disclosure and Presentation* and *IAS 39 Financial Instruments: Recognition and Measurement,* which are the subject of an IASB Exposure Draft.

The purpose of this invitation to comment is consistent with the AASB's accounting standards international convergence and harmonisation policy. According to the invitation to comment, the AASB intends to:

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[7] Auditor-General, *Auditor-General's Report to Parliament 1994*, Volume 1, Sydney, 1994, p 41

[8] Bulletin of the Financial Reporting Council 2002/4 "Adoption of International Accounting Standards By 2005", 3 July 2002

[9] *ibid.*

- issue the revised IAS 39 "Financial Instruments: Recognition and Measurement," resulting from the IASB Improvements project, as a AASB Standard; and
- converge AASB 1033 and AAS 33 "Presentation and Disclosure of Financial Instruments" with the revised IAS 32 "Financial Instruments: Disclosure and Presentation."

There is currently no Australian Accounting Standard that deals with the recognition and measurement of financial instruments such as IAS 39. AASB 1033 and AAS 33, which are based on IAS 32 issued in 1995, deal only with the presentation and disclosure of financial instruments. Therefore IAS 39 is of particular relevance because it deals specifically with the recognition and measurement of financial assets and liabilities, which includes non-current investments.

The AASB is seeking comments on the proposed improvements to IAS 32 and 39 because the resulting revised IASB Standards will become the future Australian Standards.

Operation of the New Standard

The main provisions of the proposed IAS 39 that will affect the Corporation and other entities when the IASs are adopted in Australia are summarised below.

Measurement

The proposed IAS 39 requires financial assets and financial liabilities to be measured at cost on initial recognition. However, an entity will be permitted to measure any financial asset or liability at fair value, with changes in fair value to be recognised in profit or loss, if designated at initial recognition as "held for trading".

Financial Assets and Financial Liabilities Held for Trading

A financial asset or financial liability held for trading is one that, upon initial recognition, is either designated by the entity as held for trading or, if not designated as such, is a financial instrument that:

- is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
- is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
- is a derivative (except for a derivative that is a designated and effective hedging instrument).[10]

[10] Exposure Draft of Revised International Accounting Standard IAS 39 "Financial Instruments: Recognition and Measurement"

> Any financial instrument may be designated as held for trading when it is initially recognised.

Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin. However, designation of a financial instrument as held for trading is not precluded simply because the entity does not intend to sell or repurchase it in the near term.

Under this Standard, an entity may designate any financial instrument irrevocably on initial recognition as held for trading.

Fair Value Election

The IASB Exposure Draft proposes that an entity can elect to measure all financial assets and financial liabilities at fair value.

Recognition of Changes in Fair Value

The proposed IAS 39 requires all gains or losses arising from changes in fair value of financial assets or financial liabilities held for trading to be recognised in net profit or loss. This would include non-current investments.

Gains and Losses

A recognised gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship shall be reported as follows:

> …a gain or loss on a financial asset or financial liability held for trading shall be recognised in profit or loss for the period in which it arises…[11]

Transitional Arrangements

The IASB Exposure Draft proposes that the changes to IAS 39 be applied retrospectively except for any gains or losses relating to cash flow hedges that have been included in the carrying amount of non-financial items.[12]

Conclusion

Provided the relevant provisions of IAS 39 are accepted without significant amendment, it would appear that if the Corporation and other affected entities designate their financial instruments as held for trading, they will be required to recognise any changes in their values in profit or loss in the statement of financial performance.

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[11] *ibid.*

[12] *ibid.*

This accounting treatment will be consistent with that already adopted by the Corporation. It will no longer be required to recognise increases in values through an asset revaluation reserve and will avoid further qualifications for non-compliance with the Revaluation of Non-current Assets Standard (currently AASB 1041).

It should be noted that this may not be possible until after 1 January 2005 when Australia adopts the IASs, unless the AASB issues a standard based on IAS 39 prior to that date.

On this basis, the Committee concluded that no further action on this issue is warranted at this stage.

Chapter Two

Cash Position of the Department of Public Works and Services

Introduction

Under its powers to follow-up reports of the Auditor-General in section 57(1) of the *Public Finance and Audit Act 1983,* the Committee resolved to inquire into the matter of the Department of Public Works and Services' cash position remaining in overdraft for most of the financial year. The matter was raised in the *Auditor-General's Report to Parliament for 2001 – Volume 7.*[13]

The Committee wished to be informed about:

- the reasons for the Department's cash position generally remaining in overdraft except when customers pay their bills just before year-end; and
- why this situation has only started to occur since the Department commenced operating on a commercial basis.

The Committee asked the Department to prepare a written submission detailing why this situation had developed. The Committee received a submission on 20 August 2002, which it found to be very thorough, informative and addressed the issues. Accordingly, the Committee decided not to take further action, apart from publishing the submission (see the appendix). A summary is presented below.

Background

The Department's combined cash and investment balance first went into overdraft in late September 2000 and remained in overdraft until late May 2001. During this period the average daily balance was $20 million overdrawn, with a maximum overdrawn position of $42 million in late November 2000. By comparison the average cash and investment balances for the same period in the previous two years were positive $51 million in 2000 and positive $93 million in 1999. This means that over a two-year period the average cash and investment position deteriorated by $113 million.[14]

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[13] Auditor-General, *Auditor-General's Report to Parliament 2001*, Volume 7, Sydney, 2001, p 547 and p 549

[14] Department of Public Works and Services, Submission to the Public Accounts Committee, 19 August 2002, p 1

Reasons for Deteriorating Liquidity

1998/99 to 99/00

The Department attributed its deteriorating liquidity to the following:

Reason	Amount ($ million)
Special dividend paid to NSW Treasury	22.0
Income tax equivalent payments to NSW Treasury	12.0
Capital expenditure: restacking main office, Y2K rectifications, and implementation of new ERP system	15.0
Total net decrease in cash balances	49.0

Source: DPWS submission p 1

The payment of dividends and tax was much greater than normal due to a change in accounting standards, which the required the write back of provisions set aside for job rectification.

1999/00 to 00/01

Reason	Amount ($ million)
Increased debtors' balances due to delayed payments from customers caused by introduction of GST and changed businesses practices during the Olympics in September 2000	40.0
Requirement to sometimes pay GST on client invoices to ATO before the Department received payment for its services	2.0
Delayed billings due to staff shortages caused by the Olympics; changed management responsibilities following implementation of ERP system	30.0
New C21 contracts with suppliers which reduced settlement terms by one week	6.0
Total net decrease in cash balances	78.0

Source: DPWS submission pp 1-2

It is important to note that the Department has an annual cash flow of approximately $1.8 billion, which equates to an average of $150 million per month. Therefore a one-week delay in billing clients, receipt of client payments, or a reduction of one week in payment of suppliers can worsen cash flows by approximately $40 million.

It is also important to note the cyclical nature of the Department's business, which is directly related to the building industry's traditional slow down over the Christmas and New Year period.[15]

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[15] *ibid.* p 4

Current Cash Position

The Department went into overdraft again in September 2001 until January 2002, peaking at $32 million during this period. However, from January 2002 to August 2002 (the date of the Department's submission) the balance has been positive, with an average daily balance of $65 million.

Action taken by the Department to Improve Its Cash Position

As a result of the Department's deteriorating cash position it put in place a number of strategies to improve its cash flow. These strategies have improved cash balances during 2001-02, particularly during the second half of the year.

These strategies and actions included:

- Issuing a new policy covering debtor terms of trade, collection and follow up procedures.
- Setting targets for debtor balances exceeding 60 and 90 days on a Division/Group/Business Unit basis. The Executive Finance Committee and the monthly Executive Meeting monitor performance against target.
- Amending senior managers' performance agreements to incorporate debtors targets, focusing on detailed follow up and collection. This was implemented across the organisation.
- Setting up a full time turnaround project team under the control of the Chief Financial Officer. The team's major focus is to improve the Department's operating performance and cash flow, including the above debtor strategies as well as improved management of work in progress (WIP).
- Completely reviewing WIP and setting targets for unbilled WIP at a Group/Business Unit level, ensuring client billings are promptly issued and delays eliminated. This included reviewing billing procedures and resulted in more clients being billed in the middle of the month for work to be carried out by the end of the month. For example, the Department of Education and Training's condition based maintenance component of the Faculties Maintenance Contract, which averages $8 – $10 million per month, was brought onto this billing procedure. Previously it operated one to two months in arrears.
- Reviewing all suppliers' payment terms to ensure payments are not made earlier than normal commercial terms. Previously, some suppliers were requesting early payment. This practice has stopped.[16]

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[16] *ibid.* pp 2-3

Commercialisation of the Department

The Department does not believe its liquidity difficulties were attributable to its operating on a commercial basis. The Department believes it has been operating on a commercial basis since 1992-93, when, for the first time, it became an off-budget agency and received no recurrent support from Government. The Department also underwent a major business restructure in 1995, and this structure has remained largely unchanged since then.[17]

Conclusions

The Department has experienced deteriorating liquidity over the last three years, which has been caused by external and internal circumstances and events.

The Department appears to have taken appropriate corrective action to improve its cash flow position to prevent it having to operate permanently in overdraft.

However, because of the cyclical nature of its business, it may be necessary for the Department to go into overdraft at certain times of the year. To cater for this possibility, the Department has sought and obtained approval from the Governor to operate a permanent overdraft facility of $45 million for the purpose of meeting periodic negative cash flows in its general operations.

On this basis, the Committee concluded that no further action on this issue is warranted at this stage.

[17] *ibid.* p 4

Chapter Three

Sydney Catchment Authority's Cash Position and Fundamental Accounting Procedures

Introduction

Under its powers to follow-up reports of the Auditor-General in section 57(1) of the *Public Finance and Audit Act 1983,* the Committee resolved to inquire into the matter of the Sydney Catchment Authority's short term liquidity position and the critical need for it to improve its fundamental accounting procedures. The matter was raised in the *Auditor-General's Report to Parliament for 2001 – Volume 7.*[18]

The Committee wished to inform itself about the Authority's:

- liquidity position and ability to effectively manage its cash requirements; and
- significant deficiencies in its accounting processes and internal controls.

The Committee asked the Authority to prepare a written submission detailing what it had done to address the issues raised by the Auditor-General. The Committee received a submission on 12 August 2002, which it found to be thorough, informative and addressed the issues. Accordingly, the Committee decided not to take further action, apart from publishing the submission (see the appendix). A summary is presented below.

Background

During the year ended 30 June 2001, the Authority's cash position deteriorated by $16.6 million. This resulted in its current liabilities exceeding its current assets by $17 million, indicating that it may encounter short-term liquidity difficulties. The Authority obtained a loan of $10 million in August 2001 and had approval for additional loans of $20 million to fund its operations and capital expenditure. Despite this, the Audit Office believed the Authority needed to improve its cash flow analysis to more effectively manage its future cash requirements.

The Audit Office also believed there was a critical need for the Authority to improve its fundamental accounting procedures and noted there were significant deficiencies in its accounting processes and internal controls.[19]

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[18] Auditor-General, *Auditor-General's Report to Parliament for 2001,* Volume 7, Sydney, 2001, pp 253-254
[19] *ibid.*

Action taken by the Authority

Corporate Governance

The Audit Office raised concerns that the Audit Committee required greater accounting and financial experience. In response, the Minister appointed new members, with appropriate financial qualifications and experience, to the Authority's Board and the Audit Committee. Representatives of the Audit Office, the Authority's Internal Audit and the Chief Financial Officer attend each Audit Committee meeting as invitees.

The Board now has two standing committees that focus on corporate governance and audit respectively.

The Audit Committee focuses on internal control issues, accounting policies, principles and authorisations and monitors all issues identified by the Audit Office, as well as by the internal audit program throughout the year.[20]

Liquidity

To address this issue the Authority has developed a cash flow monitoring system to actively monitor its cash requirements. During the 2001-02 financial year, with careful monitoring of cash requirements, the Authority only had to borrow on two occasions. These were short-term borrowings and were repaid within the year. As capital expenditure did not meet budget projections, long term loans were not required.[21]

Internal Audit

Of eighteen areas identified to have internal control issues by the Audit Office, the Authority's Internal Audit has expressly addressed twelve.

The following specific actions were taken as a matter of priority:

- Finance staff were trained to perform accurate, monthly reconciliations. Appropriately qualified senior financial staff review these documents.
- Higher professional standards are now required of finance processing staff, who have been supported by increased professional training.
- The financial system was completely reviewed. New security levels were installed ensuring appropriate segregation of duties throughout the system.
- A business continuity plan was developed for the SUN financial system.
- An anti-virus system now protects all computers within the Authority.

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[20] Sydney Catchment Authority, Submission to the Public Accounts Committee, 12 August 2002, p 2

[21] *ibid.* p 1

- The Warragamba Spillway project was fully reconciled and procedures are in place to undertake this reconciliation monthly.
- Control procedures were developed and implemented to ensure only approved transactions are recorded in the investment and operating accounts.
- Financial authorisations were reviewed and approved by the Minister and Chief Executive. Senior managers and relevant staff were trained in their use and application.
- The outsourced payroll function was reviewed and procedures are in place to record these payroll costs and employee entitlements directly in the general ledger.

Further, a major project-integrating manual and computerised finance and finance related business systems has commenced. All processes have been mapped and a draft finance manual has been developed for use when the integrated systems are implemented. The Audit Committee and the Board have approved the project and believe it will address the major internal control deficiencies identified by the Audit Office.[22]

Conclusions

The Authority appears to have taken appropriate corrective action to improve its liquidity and cash flow management. It has implemented appropriate procedures and internal controls to address the Audit Office's concerns.

The development of a comprehensive business plan, implementation of appropriate processes, procedures and staff training have been significant achievements during the year. The Authority's Board and management are to be congratulated on addressing the issues so promptly and effectively.

The Audit Office has informally advised that there has been a considerable improvement in practices and procedures within the finance function since the early part of the financial year ended 30 June 2002 and that the finance team has done a great job in helping to achieve this outcome.

On this basis, the Committee concluded that no further action on this issue is warranted at this stage.

[22] *ibid.* pp 3 & 4

Appendix

Submissions