Rail and ports: 2015–16 results of financial audits

Report 6: 2016–17

www.qao.qld.gov.au LinkedIn: Queensland Audit Office November 2016

Queensland Audit Office

Location	Level 14, 53 Albert Street, Brisbane Qld 4000
PO Box	15396, City East Qld 4002
Telephone	(07) 3149 6000
Email	qao@qao.qld.gov.au
Online	www.qao.qld.gov.au

QUEENSLAND

Prepared under Part 3 Division 3 of the *Auditor-General Act 2009*

Front cover image is an edited photograph of Queensland Parliament, taken by QAO.

ISSN 1834-1128

Your ref:
Our ref: 2016-RTP-TRAN

Queensland Audit Office
better public services

30 November 2016

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

Dear Mr Speaker

Report to Parliament

This report is prepared under Part 3 Division 3 of the *Auditor-General Act 2009*, and is titled *Rail and ports: 2015–16 results of financial audits* (Report 6: 2016–17).

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

Yours sincerely

Anthony Close
Auditor-General (acting)

Queensland Audit Office
Level 14, 53 Albert Street, Brisbane Qld 4000
PO Box 15396, City East Qld 4002

Phone 07 3149 6000
Email qao@qao.qld.gov.au
Web *www.qao.qld.gov.au*

The Queensland Audit Office

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

We provide independent assurance directly to parliament about the state of public sector finances and performance. We also help the public sector meet its accountability obligations and improve its performance. This is critical to the integrity of our system of government.

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

This report satisfies these requirements.

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

Contents

Summary

Introduction

Most public sector entities prepare annual financial statements. The Queensland Auditor-General is responsible for providing parliament with independent assurance of the financial management of public sector entities through auditing these financial statements. The auditor-general also audits special purpose financial statements required by the Queensland Competition Authority (QCA), the regulator of rail infrastructure assets.

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

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

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

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

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

Results of our audits

Most rail and port entities prepared good quality, draft financial statements in a timely manner. Two entities completed asset valuations late in the year, which impeded their processes for preparing financial statements.

We provided unmodified audit opinions on all 2015–16 financial statements in the rail and port sector within the statutory deadline of 31 August 2016.

Our audits identified two prior period errors that were material to the financial statements and were corrected. These errors were the result of incorrect calculations and unsupported cash flow estimates in models used to estimate the fair value of assets (increased net assets by $191 million) and incorrectly carried-forward capital tax losses (decreased net assets by $5 million). Neither of these errors had a significant impact on the entities' profits this year.

Six out of seven subsidiary companies across the rail and port entities did not prepare financial statements for 2015–16. Of these, two obtained exemption through the Australian Securities and Investments Commission (ASIC) as they were part of a larger group, secured by a deed of cross guarantee with their parent entity to cover debts. The remainder were small in size and therefore do not need to prepare financial statements under the *Corporations Act 2001.*

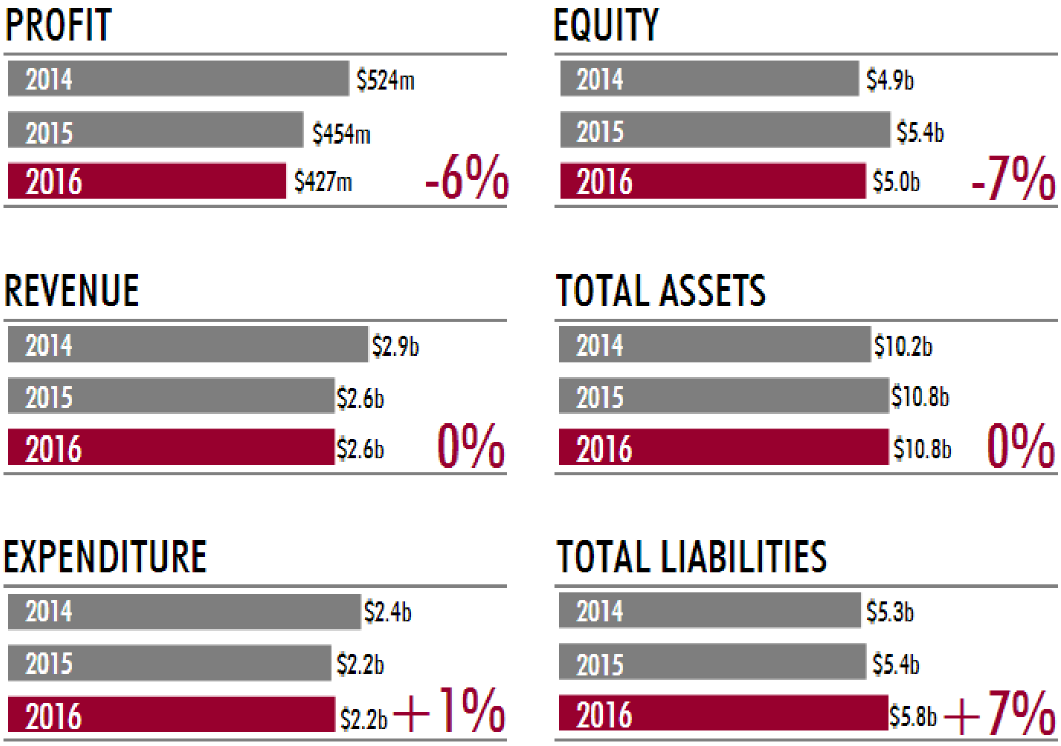
Queensland Rail Limited was the only subsidiary to prepare separate financial statements. This is because it is a large company required to prepare financial statements under the *Corporations Act 2001.*

QR is also subject to regulatory oversight by the Queensland Competition Authority for its *below-rail services*. These services relate to the management of the track, while above-rail services relate to the operation of trains. We issued an unmodified opinion on the 2014–15 regulatory financial statements for below-rail services provided by QR.

Financial performance, position, and sustainability

Overall, profits for the rail and port entities declined by six per cent compared to last year, although revenue has remained constant.

Figure A
Financial snapshot



Source: Queensland Audit Office.

The entities receive revenue from sources internal and external to the Queensland Government, with QR sourcing 82 per cent of its revenue from a rail transport service contract with the state for the provision of Citytrain, Traveltrain, and rail infrastructure services. This remained constant in 2015–16.

The majority of revenue received from customers outside of the government relates to rail network access, port access, and cargo handling of coal.

Rail network access revenue decreased by 8.9 per cent in 2015–16 due to a decrease in the gross tonne kilometres transported across QR's rail network.

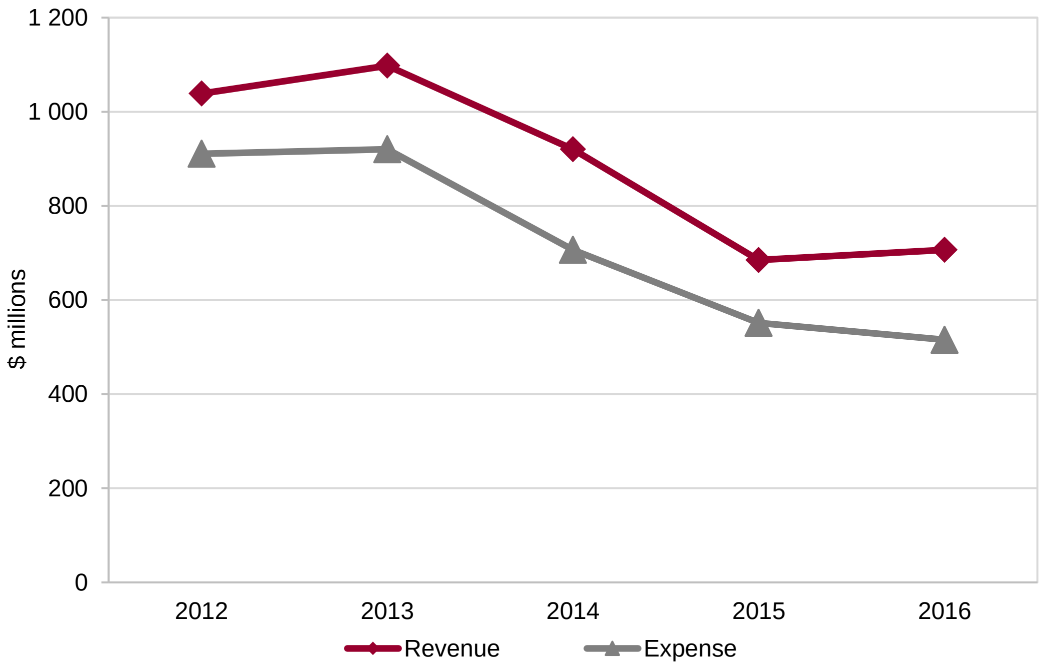
For the port entities, revenue increased by three per cent and is primarily driven by the quantity of commodities imported and exported (*throughput*).

Port throughput continues to be dominated by coal, alumina, and bauxite, although liquefied natural gas (LNG) contributed four per cent of total throughput in the first full financial year of operations at GPC's Curtis Island facility. Overall, throughput has continued to grow in 2015–16, albeit at a slower rate than previous years.

Total expenses for the sector remained constant this year. Reduced expenditure on supplies and services offset the increase in depreciation expense. The expected increase in depreciation was due to the flow on effect of asset revaluation increments in 2014–15 for port assets and purchases of rail assets in 2015–16.

Our analysis of revenue and expenditure over the last five years shows that the port entities respond to decreasing revenues by controlling expenditure. This limits the negative impact to profitability as demonstrated in Figure B below.

Figure B
Five-year comparison of financial performance for ports



Source: Queensland Audit Office.

The rail and port entities are asset intensive, and collectively own and manage $10.8 billion of assets, including large and complex infrastructure assets. Property, plant, and equipment represents 90 per cent of rail and port assets.

In total, rail and port entities underspent their capital budget on assets by 30 per cent ($312 million). Contributing factors include:

- changes in the timing of projects
- changes in the scope of projects and the construction methodology
- a lack of rigour in forecasting the timing of capital expenditure.

This year QR recorded $625 million of asset purchases and assets under construction. The purchased assets are largely intended to support two major Department of Transport and Main Roads projects: New Generation Rollingstock (NGR) and Moreton Bay Rail Link. The government's NGR project will see an increase to the south-east Queensland passenger train fleet.

The value of port property, plant, and equipment assets decreased by two per cent or $63 million this year, due to the impact that lower future revenue forecasts had on the valuation of infrastructure assets.

This year the Queensland Government, as owners of these entities, increased the dividend payout ratio from 80 to 100 per cent of net profits after tax. Over the last two years, the rail and port entities have returned $275 million and $643 million to the government respectively.

Additionally, NQBP returned capital of $20 million to owners this year and GPC declared a special dividend of $315 million in response to the state government's Debt Action Plan.

The returns are being funded through cash, borrowings, and realised and unrealised reserves. In 2016–17 we expect new borrowings of $648 million to fund the payment of returns to the government declared in 2015–16. The impact on QR, GPC, and NQBP from these new borrowings will be:

- higher gearing levels
- higher interest costs
- reduced profit margins
- lower returns to government.

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

Internal controls

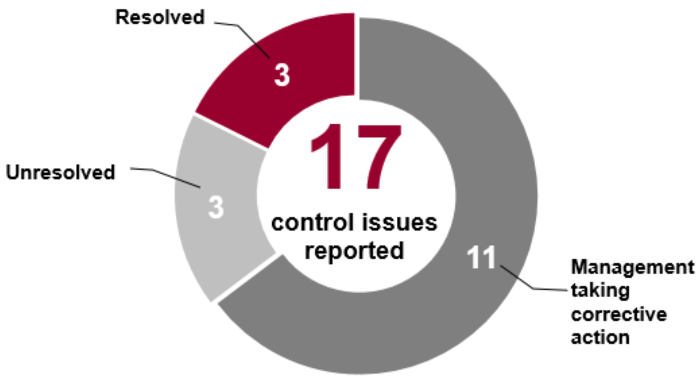
Good internal controls provide reasonable assurance that an entity is achieving its objectives relating to operations, reporting, and compliance.

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

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

We identified 17 issues across the six rail and port entities. Of the five COSO elements, these deficiencies only affected the control activities and control environment elements. Figure C below details the audit findings for these entities for the 2015–16 financial year.

Figure C
Status and number of 2015–16 internal control issues at 31 August 2016



Source: Queensland Audit Office.

We found fewer significant breakdowns in control activities through our audits this year. One significant deficiency, however, does require immediate attention by GPC management. We recommended GPC implement a quality assurance framework to ensure the validity and reliability of the inputs and calculations in the model used to measure the value of their infrastructure assets.

The strength of the GPC's control environment is challenged by the lack of appropriate segregation of roles between human resources and payroll business areas, and the failure to update policies in a timely manner.

Management at each entity have developed adequate action plans to address the control deficiencies we reported.

Reference to comments

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

We also provided a copy of this report to the Minister for Main Roads, Road Safety and Ports and Minister for Energy, Biofuels and Water Supply, the Minister for Transport and the Commonwealth Games, the Director-General, Department of Transport and Main Roads and the Under Treasurer, Queensland Treasury for comment.

Responses were received from Gladstone Ports Corporation, Queensland Rail, and the Treasurer. The responses are in Appendix A.

Report structure

Chapter	Summary
Chapter 1	provides the background to the audit, and the context needed to understand the audit findings and conclusions.
Chapter 2	evaluates the audit opinion results, timeliness, and quality of reporting.
Chapter 3	analyses the financial performance, position, and sustainability of transactions and events during the year.
Chapter 4	assesses the strength of the internal controls designed, implemented, and maintained by the rail and port entities.

Report cost

This audit report cost $95 000 to produce.

1. Context

Legislative framework

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

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

Source: Queensland Audit Office.

Accountability requirements

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

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

The *Government Owned Corporations Act 1993,* applicable to the four port entities, establishes four key principles for government owned corporations including:

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

Queensland state government financial statements

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

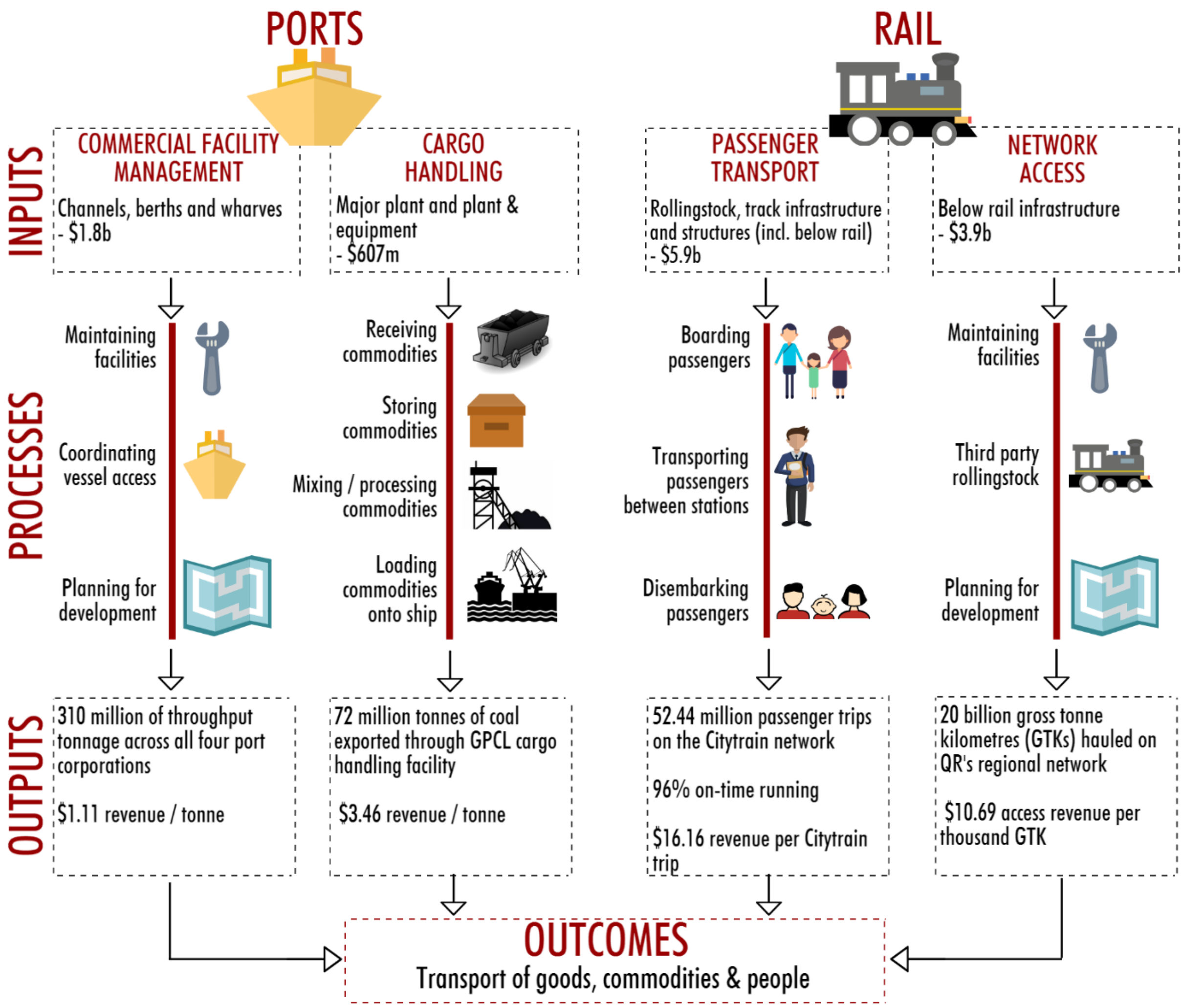
These financial statements may be used by a broad range of parties including parliamentarians, taxpayers, employees, and users of government services. For these statements to be useful, the information reported must be relevant and accurate.

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

Rail and port entities

Figure 1A details the government entities in the rail and port sector, and their inputs, customers, and outcomes.

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



Source: Queensland Audit Office.

2. Results of our audits

Chapter in brief

We audit the financial statements of state government owned rail and port entities, and provide assurance that the financial statements are reliable and comply with accounting standards.

Main findings

- We certified all financial statements by legislative deadlines and issued unmodified opinions for all rail and port entities.
- We identified two prior period errors, both of which were corrected by the entities this year. The errors related to the valuation of property, plant and equipment and recognition of deferred tax assets.
- Four of the six entities did not need to make adjustments to the first completed draft before we certified their financial statements.
- The 2014–15 regulatory financial statements prepared for the below-rail services provided by the Queensland Rail Group complied with the requirements of the Queensland Competition Authority.

Audit conclusions

Most rail and port entities prepared good quality, draft financial statements in a timely manner. However, the late completion of asset valuations by two port entities impeded the process of preparing financial statements.

Introduction

This chapter details the reliability of the reported information of rail and port entities that was subjected to audit.

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

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

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

Conclusion

Readers can rely on the results in the audited financial statements of the rail and port entities because we issued unmodified audit opinions for each entity.

Most rail and port entities have mature year end processes that allow them to produce high quality financial statements in a timely manner. However, the late completion of asset valuations by two port entities impeded their financial statement preparation process.

Asset valuations continue to be an area of improvement for port entities. A lack of supporting documents and calculation errors resulted in significant adjustments to the draft financial statements and the correction of two prior period errors.

Audit opinion results

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

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

Entity	Date audit opinion issued	Type of audit opinion issued
Queensland Rail	31.08.16	Unmodified
Queensland Rail Limited	31.08.16	Unmodified
Far North Queensland Ports Corporation Limited (Ports North)	30.08.16	Unmodified
Gladstone Ports Corporation Limited (GPC)	31.08.16	Unmodified
North Queensland Bulk Ports Limited (NQBP)	31.08.16	Unmodified
Port of Townsville Limited (PoTL)	24.08.16	Unmodified

Source: Queensland Audit Office.

All rail and port entities met their legislative deadline of 31 August again this year (2014–15: 100 per cent).

Financial statement preparation

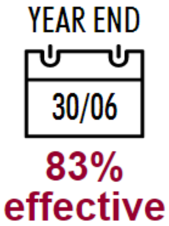
Entities that adopt effective financial reporting practices throughout the year should be able to produce a set of high quality financial statements in a timely manner.

To assess the financial statement preparation process we considered:

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

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

Year end close process



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

All delays experienced related to the valuation of non-current assets. Due to the large and complex infrastructure assets held by the entities, it is imperative that valuations are completed well before 30 June each year to allow for sufficient internal and external review of the calculations, judgements, and assumptions.

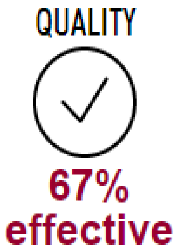
Timeliness of draft financial statements

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

Five of the six rail and port entities provided draft financial statements by the agreed date. Ports North, however, was not able to prepare its financial statements by the agreed date due to the loss of key financial reporting staff.

The average time taken to prepare the draft financial statements was 30.8 days from year end. This is in line with our expectations, and indicates the rail and port entities have given appropriate priority to the preparation of their financial statements.

Quality of draft financial statements



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

This year, quality was impacted by two adjustments related to discounted cash flow models used by port entities to calculate the fair value of their property, plant, and equipment. These models involve complex calculations, and require management to make significant judgements and assumptions about the future transactions of their entity.

We identified errors in calculations in models, and instances where management included cash flow forecasts without sufficient supporting documents. All identified errors were corrected by management before they issued their financial statements.

Prior period errors

When an entity is preparing financial statements, it may identify errors in the prior year accounts. These may also be detected by audit during the current year testing. If these errors are material, the accounting standards require corrections to be made to these comparative figures.

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

Prior period errors corrected in 2015–16 are detailed in Figure 2B.

Figure 2B
Prior period errors by entity

Entity	Details
GPC	There were three material adjustments due to calculation errors and unsupported capital expenditure cash flow forecasts used in the valuation model: ▪ property, plant, and equipment increased by $273m ▪ asset revaluation surplus increased by $191m ▪ deferred tax liability increased by $82m.
NQBP	Deferred tax asset and retained earnings decreased by $5m due to incorrectly recognised carried forward capital losses.

Source: Queensland Audit Office.

Regulated infrastructure

The Queensland Competition Authority (QCA) regulates third party access to essential infrastructure in Queensland, including below-rail infrastructure (that is, track infrastructure). This is achieved using an *access undertaking*, which sets out the general terms and conditions under which Queensland Rail Group (QR) will provide access to its regulated infrastructure, including the tariff QR can charge customers.

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

Results of our audits

We issued an unmodified audit opinion on the financial statements for below-rail services provided by QR for 2014–15 on 18 December 2015. We also included an emphasis of matter in our audit report to highlight that the report is specifically for the regulator and that the information is not intended for other uses.

We are due to certify the 2015–16 financial statements for QR's below-rail services prior to 31 December 2016, which is in line with QCA's requirements.

Entities not preparing financial statements

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

The full list of entities not preparing financial reports and the reasons for this are detailed in Appendix B.

3. Financial performance, position, and sustainability

Chapter in brief

This chapter details the major transactions and events that affected rail and port entities' 2015–16 financial statements. We alert users to future challenges, including existing and emerging risks for the sector. We also analysed the sustainability of entities.

Main findings

- Collectively, rail and port entities achieved their budgeted financial performance this year. The entities achieved profits this year ($299 million), but the total result was down by $19 million or six per cent from the prior year.
- Three ports improved their profit this year. Queensland Rail Group's (QR) profit decreased by 26 per cent.
- Less than 40 per cent of revenue earned by rail and port entities is from non-government sources.
- Non-government revenue is driven by the quantity of commodities transported using the rail and port facilities. 2015–16 is the first full financial year of operations at Gladstone Ports Corporation's (GPC) Curtis Island liquefied natural gas (LNG) facility, which contributed four per cent of total throughput.
- The increase in external revenue generated by the port entities this year has been offset by a decrease in QR's external rail network access revenue.
- QR's wage bill increased this year by $44.4 million (7.2 per cent) as a result of an increase in both the number of employees and pay rates. The growing costs to QR of meeting their obligation to pay employees' leave benefits also contributed.
- The combined value of port infrastructure assets fell by two per cent this year due to the impact of declining forecasts in revenue (6.2 per cent over the next five years) on asset values for the commodity-reliant port entities.
- New assets and assets under construction lifted the reported value of rail assets by three per cent. The rail and port entities struggled to deliver their intended capital programs this year, spending 30 per cent less than the $1 billon they budgeted.
- Both GPC and North Queensland Bulk Ports Corporation Limited will increase their borrowings in the 2016–17 financial year by an estimated 12 per cent and 16 per cent respectively. This is in line with the state’s Debt Action Plan, and debt to equity ratios will remain consistent with industry benchmarks.
- Higher levels of borrowings will put added pressure on entities to achieve the current levels of profit, and maintain or improve their existing credit rating.

Audit conclusions

Our analysis indicates the rail and port entities are financially sustainable. However, higher levels of financing expected in 2016–17 will challenge these entities to better manage their operational expense and asset management practices.

Understanding where and when development and maintenance of infrastructure assets needs to occur continues to be a key challenge for the entities.

Introduction

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

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

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

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

Conclusion

The rail and port entities are financially sustainable. Their financial sustainability depends on their ability to adapt to the new dividend payout ratio, slowing growth in demand for key commodities, future directions given by shareholding ministers, and any changes in government policy.

The rail and port entities' financial statements accurately reflect the main transactions and events of 2015–16.

Understanding financial performance

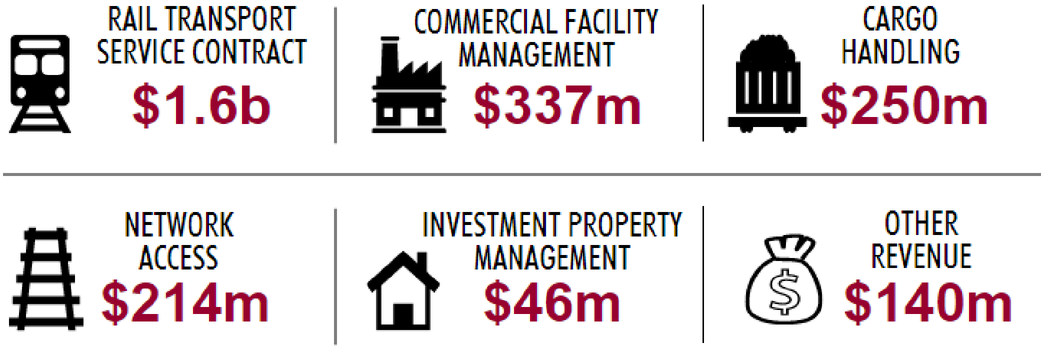
Overall, the financial performance of the rail and port entities declined in 2015–16, with profits falling by $19 million, or six per cent. Ports have achieved a 41 per cent increase, while Queensland Rail Group's (QR) profit fell by 26 per cent.

The reduced profitability of QR was the result of increased total expenditure (depreciation and employee benefits) and decreased revenues from sources outside government. For ports, the increase in profitability was the result of increased revenues, primarily relating to access to commercial facilities in Gladstone, and the fact that expenditure remained constant.

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

Revenue

Figure 3A
Total revenue for all rail and port entities by type in 2015–16



Source: Queensland Audit Office.

Total rail and port revenue in 2015–16 was:

- $2.6 billion, in line with their revenue budgets
- an increase on previous year revenue by $8.5 million, reflecting minor growth in most major revenue streams, offset by a reduction in cargo handling and network access revenue
- mostly constant for QR due to its rail transport service contract (TSC) with the State of Queensland for the provision of Citytrain, Traveltrain, and rail infrastructure services

All other significant revenue for the entities is derived from services provided to customers outside the Queensland Government.

Events and transactions affecting revenue this year

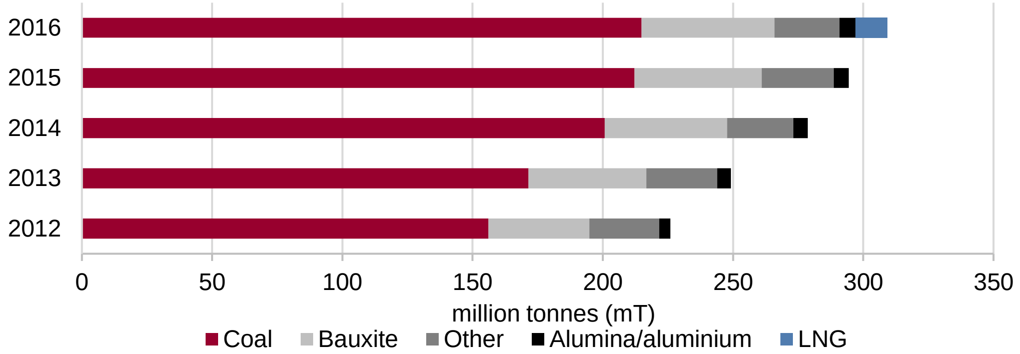
The quantity of key commodities transported, exported, and imported affects the own-source revenue generated by these entities.

The ports collect revenues based on:

- number of vessel movements
- size of the vessel
- time spent at the port
- services provided
- weight of the goods loaded or unloaded from the vessel.

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

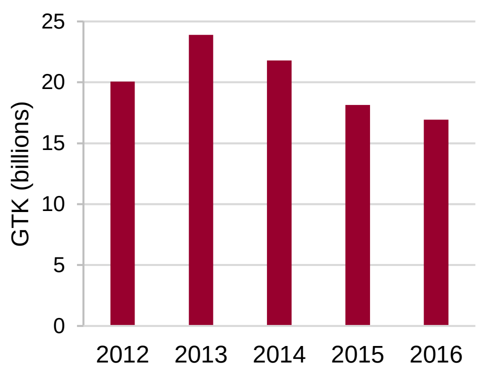
Figure 3B
Port throughput by commodity in the last five years



Source: Queensland Audit Office.

Coal represents 69 per cent of total tonnes imported and exported through the four Queensland government owned ports corporations. All cargo handling revenue relates predominantly to coal, as Gladstone Ports Corporation (GPC) is the only government-owned port in Queensland performing this function (at its RG Tanna coal terminal). Risks in earning revenue from cargo handling include handling less coal due to internal inefficiencies or a decrease in coal exports due to market conditions. However, this risk to revenue can be mitigated by ‘take or pay’ contracts—where the purchaser either takes the product contracted for supply or pays a penalty.

Figure 3C
Gross tonne kilometres on QR's network



Source: Queensland Audit Office.

QR's externally sourced revenue relates primarily to network access tariffs. In 2015–16 QR collected network access revenue from two rail operators under 37 agreements. Network access revenue decreased by $20.8m, primarily due to a 6.6 per cent decrease in gross tonne kilometres (GTKs) of goods transported over QR's network. Figure 3C shows the decline in quantities transported over QR's network in the last four years.

In addition to the drivers outlined, three key transactions and events are noteworthy this year.

New rail Transport Service Contract (TSC)

QR and the State of Queensland entered into a new rail TSC on 20 July 2015. Under the contract, QR receives fixed payments for agreed services relating to the delivery of train services and maintenance of infrastructure. TSC revenue remained relatively constant this year, increasing by only $38.5 million (or 2.5 per cent).

Refined nickel exports cease from Port of Townsville (PoTL)

Before February 2016, Queensland Nickel (QNI) imported nickel ore and exported refined nickel from PoTL through a subcontracting arrangement. In 2015–16 PoTL’s revenue from nickel ore imports and corresponding refined nickel exports decreased after QNI entered into voluntary administration. Figure 3D analyses the impact of this event on revenue.

Figure 3D
Impact of QNI voluntary administration

	2015–16	2014–15	Decrease
Nickel ore imported (tonnes)	1.6 million	2.9 million	1.3 million
Revenue related to nickel imports/ exports ($)	3.1 million	5.4 million	2.3 million
% of total PoTL revenue	4.1	7.1	3.0

Source: Queensland Audit Office.

Liquefied Natural Gas and Wiggins Island Coal Export Terminal (WICET) facilities

LNG exports from Curtis Island and coal exports from the WICET increased significantly in 2015–16. The ramp-up of exports from these facilities increased GPC's harbour dues revenue. Figure 3E analyses the impact of this event.

Figure 3E
Impact of LNG & WICET facilities at GPC

	2015–16 budget mil	2015–16 actual mil	2014–15 actual mil	Increase from 2014–15 mil
Curtis Island (LNG) tonnes exported	12	8	0.6	7.4
WICET (Coal) tonnes exported	5	4.8	nil	4.8
Harbour dues ($)	121.9	74.3	53.8	20.5

Source: Queensland Audit Office.

Future challenges and emerging risks

In 2016–17 we expect the following transactions and events to affect the revenue received by the rail and port entities.

QR's draft access undertaking

The Queensland Competition Authority (QCA) regulates third party access to Queensland's track infrastructure using an access undertaking. This sets out the general terms and conditions under which QR will provide access to its regulated infrastructure, including the tariff QR can charge for coal-carrying services on the West Moreton system.

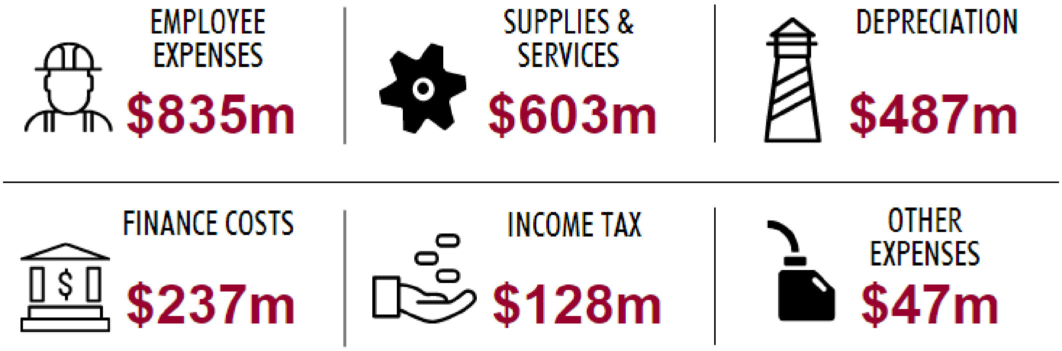
On 11 October 2016, the QCA approved QR's amended draft access undertaking for network access tariffs. QCA has ruled that QR is required to pay an 'adjustment amount' to certain customers for over-recovered access charges since 1 July 2013. The access undertaking sets out the methodology for calculating the adjustment. Due to the timing of the QCA's decision, revenues collected from coal-carrying services on the West Moreton system in 2015–16 were based on the tariffs from the last approved access undertaking (2010). In 2016–17 QR processed a credit note to return the access charges over-recovered from their main customer.

Demand for coal exports

Revenue earned from coal exports is significant for the rail and port sector. Lower export volumes will create challenges for these entities in 2016–17 to achieve revenue and profitability targets. We are satisfied that the affected entities are monitoring this risk through their internal risk management processes.

Expenditure

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



Source: Queensland Audit Office.

Total rail and port expenses in 2015–16 were:

- $2.3 billion, which was in line with budget
- constant, increasing by less than one per cent from the previous year.

The rail and port entities combined employ 6 990 full-time equivalent employees. Employee expenses increased at QR by $44 million or 7.2 per cent.

Depreciation expense increased as expected by nearly seven per cent, reflecting the impact on depreciation from changes in asset values.

Events and transactions affecting expenditure this year

The rail and port entities manage significant infrastructure assets, and invest heavily in the maintenance and renewal of these assets. In 2015–16, capital investment in infrastructure assets was $718 million. The cost of repairs and maintenance is included in supplies and services expense.

The classification of expenditure relating to existing assets as capital or repairs and maintenance expenditure can involve elements of judgement and an understanding of the nature of the underlying asset. Applying judgement increases the risk of misclassifying this expenditure, resulting in accounting errors. The processes implemented to manage this risk vary between entities, and we have raised this control deficiency with management at one entity.

Each year we review the entities’ accounting policies and confirm they are consistent with the accounting standards. We also review sample asset-related expense transactions to ensure they have been correctly accounted for. This year we identified transactions totalling $9.5 million, which met the criteria for recognition as assets and were incorrectly recorded as expenses.

Increasing employee expenses contributed to the decline in QR's profits in 2015–16. Factors which led to this increase were:

- an increase of 3.1 per cent or 180 full-time equivalent employees ($6 million)
- increases in pay rates as a result of enterprise agreement outcomes ($18 million)
- growing costs to QR of meeting its obligation to pay employees' leave benefits ($23 million).

The downturn in the resource sector puts pressure on the rail and commodity-reliant port entities to make expenditure more efficient. We analysed expenditure and revenue across the last five years and noted that, as revenues decline, the entities have demonstrated their ability to reduce expenditure and maintain profitability.

Understanding financial position

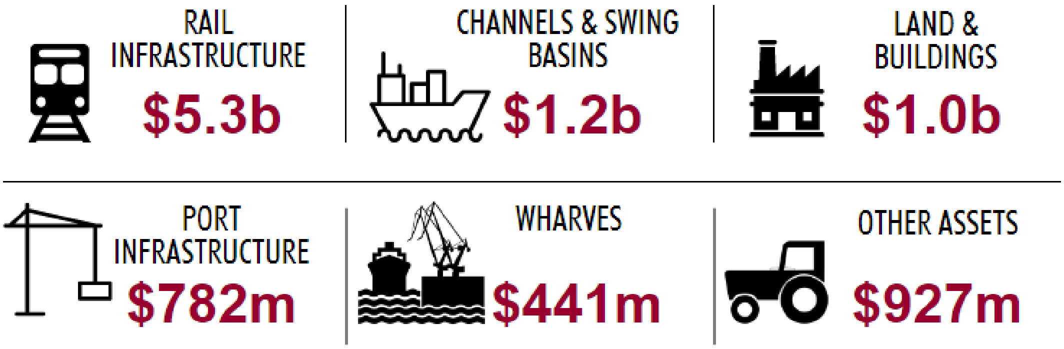
Assets and borrowings remained stable this financial year. The combined net asset position decreased primarily as a result of the change in the dividend payout ratio from 80 to 100 per cent and the special dividends declared this year.

The decrease in net assets was also driven by the decrease in the value of port assets. Port assets are valued predominately on the revenues that they are planned to realise against the expenditure required to maintain them. This is known as the *income based method*. Consequently, the forecast decrease in expected port entity revenues in the coming five years has served to reduce port asset values.

This decrease was offset by new assets purchased (or under construction) by QR, relating primarily to projects associated with the Moreton Bay Rail Link and preparing for the state's new passenger trains under the New Generation Rollingstock project.

Assets

Figure 3G
Assets for all entities by class in 2015–16



Source: Queensland Audit Office.

Total rail and port assets at the close of 2015–16 were:

- $10.8 billion for property, plant, and equipment, representing 90 per cent of total combined assets
- valued at two per cent less than previous year, reflecting the impact on asset valuations from lower forecasts of revenue in the future
- the total value of rail fixed assets has increased by three per cent from the prior year, primarily due to assets under construction on the QR network including the Lawnton to Petrie third track, and new assets built to stable and connect the incoming New Generation Rollingstock train fleet.

Events and transactions affecting assets this year

An asset's *cost* is the cash price of acquisition at the time the asset was acquired, less any accumulated depreciation.

An asset's *fair value* is the price that would be received to sell the asset to a market participant at the measurement date less any restrictions.

The key drivers of the movement in reported balances for property, plant, and equipment assets from year to year are asset additions, disposals, depreciation and, for entities that measure their assets on a fair value basis, revaluation increments and decrements.

The entities disposed of $23 million in assets during 2015–16, which did not have a significant impact on asset balances.

Measuring the value of assets

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

Accounting standards allow the entities to use either fair value or historical cost as the basis for measuring the value of their property, plant, and equipment assets. In Queensland, the majority of port assets are measured using fair value, while rail assets are measured at cost.

Port entities measure their assets at fair value, and consider whether there is a significant movement in the value of their assets each year. This year two ports revalued their assets upwards ($13 million) and the combined value of assets fell for two ports by $84 million. The port entities use the income-based method to calculate a fair value for the majority of their assets.

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

Four key inputs contributed to a decrease in the value of port assets this year.

Revenue forecasts

Entities using this method estimate revenue for the first five years based on their understanding of industry, market, and economic conditions, and apply a growth rate for the remaining years.

This year, the port entities decreased their total revenue forecasted for the next five years by 6.2 per cent, reflecting industry conditions for commodities in Queensland.

A decrease in the forecast revenue means that, overall, the entities expect to receive less cash. This pushes down the value of the assets.

Operating expenditure forecasts

The entities forecast a mostly constant level of operating expenditure for the next five years.

Future capital expenditure

The entities have considered their assets and prepared forecasts for the capital expenditure required to renew or upgrade the assets so they can generate the revenue as forecasted.

Capital expenditure forecasts for the next five years have increased by 17 per cent.

An increase in the future capital expenditure further pushes down the value of the assets.

Discount rate

Each of the entities engaged experts to calculate a *discount rate*, also referred to as the weighted average cost of capital (WACC). The discount rate is used in the valuation model to reflect the present value of the future cash inflows and outflows estimated by the port entities.

This year the average discount rates used by the entities decreased by 0.5 per cent. These changes reflect the experts' views about decreases in long-term risk-free rates.

A decrease in the discount rate also pushes up the value of the assets and, in this case, partly offsets the effect of decreased revenue forecasts.

In addition to the drivers outlined above, two key transactions and events are noteworthy this year:

New infrastructure assets at QR

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

Asset acquisitions had the most significant impact on the overall movement in QR's asset values in 2015–16.

This year QR spent $625 million purchasing or constructing new assets. Major projects included the Lawnton to Petrie third track and the stabling facilities for the new NGR trains.

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

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

All entities spent less than budgeted on assets

In 2015–16, the combined entities under-delivered on their capital programs, falling short of the $1 billion budget by 30 per cent.

We identified four main factors contributing to the shortfall:

- delays in starting and progressing major projects (majority of the shortfall)
- changes in the scope of projects
- changes in the methodology used to construct new assets
- lack of accuracy and rigour in forecasting capital budget expenditure.

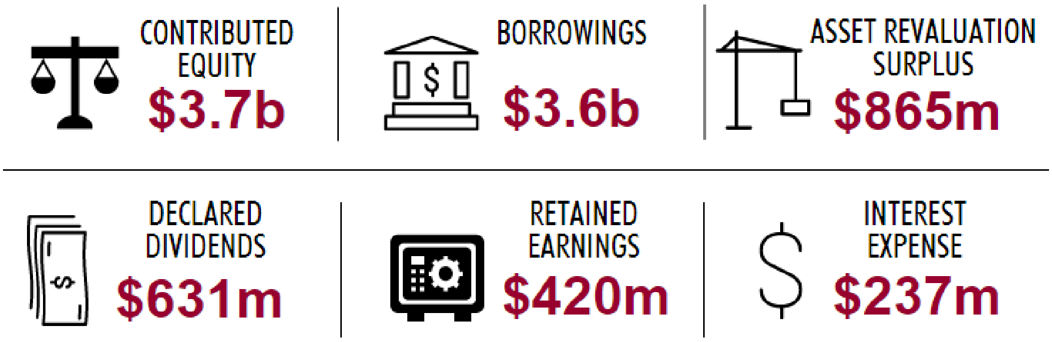
Future challenges and emerging risks

A challenge for the entities is understanding where development and maintenance of infrastructure assets needs to occur. Modelling demand for commodities; assessing the condition of existing assets; and aligning asset management practices to the state infrastructure plan are some of the areas these entities need to focus on.

Port entities also face the challenges of master planning for future development, better using existing asset portfolios, and managing environmental risks. The *Sustainable Ports Act 2015* was enacted in November 2015 and provides for the protection of the Great Barrier Reef World Heritage Area by managing port-related development in, and adjacent to, the area. The port entities will need to adapt to these new environmental standards, and undertake economically feasible developments in some areas. In response to some of these challenges, we have noted the entities considering strategies for maximising the use of existing channel assets.

Debt and equity

Figure 3H
Total debt and equity for all entities 2015–16



Source: Queensland Audit Office.

Total rail and port liabilities at the close of 2015–16 were:

- $5.3 billion, two-thirds of which are borrowings
- Ninety-six per cent of these Queensland Treasury Corporation (QTC) borrowings are held by QR ($3 billion) and GPC ($0.46 billion). Far North Queensland Ports Corporation (Ports North) has no borrowings.
- The entities reported a yearly decrease in equity of eight per cent to $5 billion, primarily due to the $315 million special dividend declared by GPC.

Equity represents the value of the state's ownership interest in these businesses.

Events and transactions affecting debt and equity this year

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

Borrowing levels remained steady over the past 12 months and none of the entities breached their debt covenants with QTC.

Each year, rail and port entities evaluate their compliance with the restrictions in their debt agreements with QTC. The key measure used is the ratio of earnings before interest and tax to interest expense. This is often referred to as earnings before interest and tax (EBIT) interest coverage. The average EBIT interest coverage improved by 13 per cent from last year, increasing from 2.40 to 2.72, above the coverage expected by QTC of 1.25. This indicates that the entities had more funds available to pay their interest expense.

The dividend payout ratios are set for each entity by the state government. In 2015–16, the government changed the dividend payout ratio from 80 per cent to 100 per cent of net profit after tax for all rail and port entities.

In total for 2015–16, the entities made profits after tax of $299 million. Dividends provided for, and other distributions to owners for 2015–16, totalled $643.5 million, including the special dividend of $315 million declared by GPC and a return of capital of $20 million by North Queensland Bulk Ports Corporation Limited (NQBP) to the state government.

The special dividend declared by GPC decreased the combined value of the state's ownership interest in these entities by six per cent.

Retained earnings are prior year profits that have not been paid out as dividends.

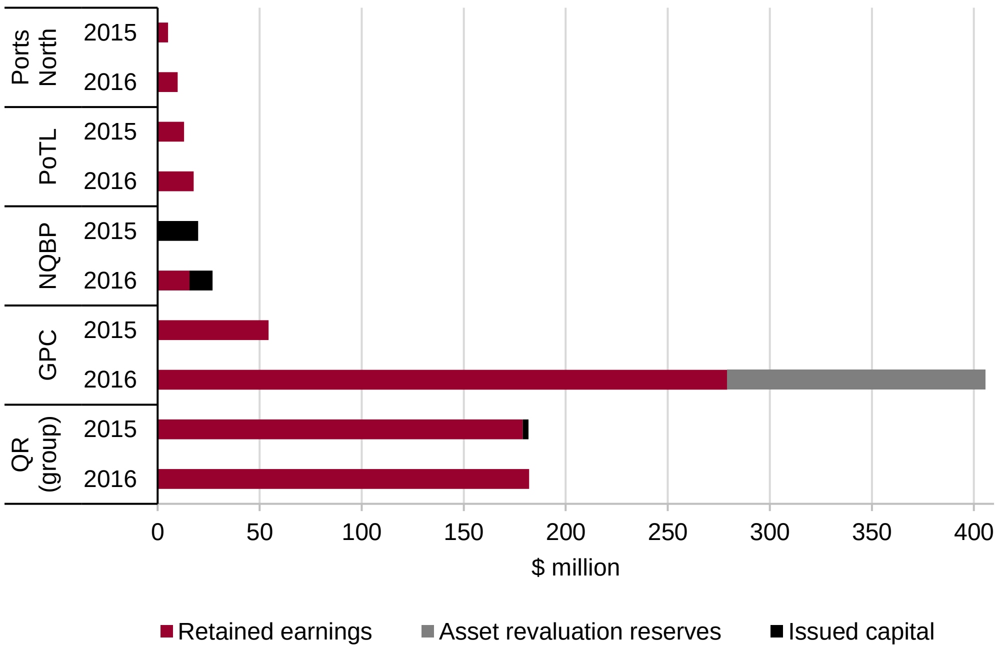
The *asset revaluation surplus* represents the valuation increases above the historical cost of the entity's assets.

Issued capital is the total of shares held by shareholders.

Historically, dividends were funded using retained earnings. This year the entities funded dividends using retained earnings and the unrealised asset revaluation surplus. When entities revalue their assets, downward movements are recognised on the balance sheet to the extent that the entity has an asset revaluation surplus. Any downward movements in excess of this surplus are recognised as an expense and reduce the entity's profit. Funding dividends from the asset revaluation surplus reduced this reserve at GPC from $463 million to $302 million.

For the financial years 2014–15 and 2015–16 the rail and port entities returned $275 million and $643 million to the state government respectively. Unrealised asset revaluation surplus was reduced by $127 million, with a further $756.5 million being funded from earnings realised through yearly operations. Figure 3I shows how entities funded these distributions to the state government.

Figure 3I
Returns to the Queensland Government



Source: Queensland Audit Office.

Future challenges and emerging risks

The state government's revision of the capital structure and dividend payout ratios will continue to challenge rail and port entities to maintain and improve their credit ratings.

The regearing of GPC and NQBP in 2016–17 will also present challenges to these entities to fund new port infrastructure solutions and achieve asset replacement strategies, especially if current levels of profit and dividends are to be maintained.

In 2016–17 we expect QR, GPC, and NQBP to take up $675 million in new borrowings to:

- pay dividends declared to government in 2015–16
- fund the return of capital to the state government in 2016–17
- fund the replacement and creation of new rail and port assets.

The special dividend declared by GPC in 2015–16 of $315 million, funded by these new borrowings, will result in a 6.4 per cent increase in the level that it is financed through borrowings. We estimate the new borrowings will increase the portion these entities are financed through borrowings, by 4.4 per cent, to nearly 50 per cent for these three entities and separately by two per cent (QR), by 12 per cent (GPC) and by 16 per cent (NQBP). Despite this increase, the gearing of the rail and port entities continues to be within capital structure benchmarks determined by Australian economic regulators for infrastructure and utility businesses.

4. Internal controls

Chapter in brief

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

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

Main findings

- Over half of the control deficiencies we identified during 2015–16 relate to manual control activities.
- We identified one significant deficiency in 2015–16, which we believe may lead to material misstatement and requires urgent attention. We noted that a formal review of the inputs and calculations in the model used to calculate the fair value of GPC's assets had not been implemented.
- Within one entity we identified a number of information technology system control deficiencies. A number of automated system controls were either not designed appropriately or were not functioning correctly.
- We did not identify any deficiencies relating to risk assessment, information and communication, and monitoring of controls during the year.

Audit conclusions

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

Although our testing of the effectiveness of these controls identified one significant deficiency at one entity, we concluded that overall internal controls are mitigating the risks that prevent this entity from achieving reliable financial reporting.

Overall, the risk of undetected fraud or errors within financial systems and entities' financial reporting remained stable from previous audit periods, and we can continue to rely on the control environments for audit purposes.

Introduction

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

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

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

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

We have provided a summary of our control assessments in Appendix C.

Conclusion

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

Gladstone Port Corporation (GPC) needs to bring its internal control systems into line with our expectations for an entity of its size and risk profile. In 2015–16 we identified a control deficiency at GPC which we believe may lead to the value of assets being materially misstated in the financial statements. While we have noted some improvement in 2015–16, 39 per cent of control deficiencies raised in the past two years are unresolved.

Internal control framework

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

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

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

Selecting internal controls to test

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

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

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

Our initial assessments indicated that we could rely on financial controls in place at each entity. Our assessment of the effectiveness of each entity's controls relating to each COSO component is detailed in Appendix C.

Our rating of internal control deficiencies

> *Significant deficiency* (high risk matters): a deficiency that either alone or in combination with multiple deficiencies may lead to a material misstatement in the financial statements. They require immediate management action and are reported to those charged with governance.
>
> D*eficiency:* occurs when internal controls are missing or are ineffective. Deficiencies may lead to an environment which is not supportive of high quality financial statements.

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

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

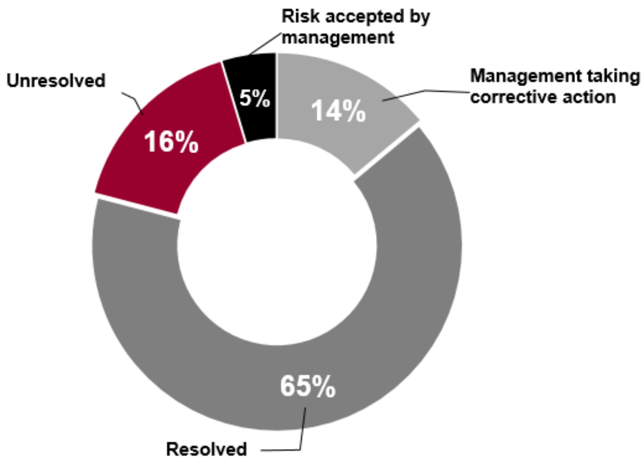
We increase the rating to a significant deficiency from deficiency based on the risk of material misstatement in financial statements, the potential to cause financial losses, or an event causing major business interruptions.

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

Status of internal control deficiencies

During the last two years we identified and communicated to management a total of 43 internal control deficiencies across all COSO components. Figure 4A outlines the current status of the control issues identified.

Figure 4A
Status of control issues reported to management in the last two years



Source: Queensland Audit Office.

Four of the six entities either addressed their identified control deficiencies or are on track to do so by the agreed date. This proactive resolution of control deficiencies indicates a strong control environment. For Far North Queensland Ports Corporation Limited (Ports North), we have not identified any internal control deficiencies in the last two years, indicating a strong control environment.

The unresolved and overdue issues we identified relate to GPC and are deficiencies in system access controls and the integration of asset management practices with accounting for property, plant, and equipment.

Control environment

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

The control environment is defined as management's actions, attitudes, and values that influence day-to-day operations.

We identified two deficiencies in GPC's control environment, relating to the lack of appropriate segregation of duties between business areas and the failure to update policies in a timely manner.

Control activities

- Manual controls
- Automated controls

Control activities are policies and procedures that help ensure management directives are carried out and that necessary actions are taken to address identified risks. These activities operate at all levels and in all functions, and can be designed to prevent or detect errors entering financial systems.

The mix of control activities can also be categorised into manual control activities and information technology (IT) system controls.

Manual control activities

Manual controls contain a human element, which can provide an opportunity to assess the reasonableness and appropriateness of transactions. These controls may also be less reliable than automated elements because they can be more easily bypassed or overridden.

They include activities such as approvals, authorisations, verifications, reconciliations, reviews of operating performance, and segregation of incompatible duties. Manual controls may be performed with the aid of IT systems.

Over half of the control deficiencies we identified during 2015–16 (65 per cent) relate to manual control activities.

We identified one significant deficiency across all six entities. This was at GPC, where we noted a lack of formal processes to validate and quality-check the inputs and calculations in the model used to determine the fair value of assets. Our review identified an extensive range of inaccuracies in spreadsheet calculations and inputs. As small changes in inputs and calculations can have a significant impact on the calculated asset value, we believe this may lead to material misstatement and requires urgent attention.

Additionally, across the sector we identified deficiencies in manual controls relating to revenue, payroll processing, purchase order approval and accounting for property, plant, and equipment

In all cases, management's proposed actions were reasonable and we expect that the deficiencies will be resolved in a timely manner.

Information technology (IT) system controls

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

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

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

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

We identified a number of IT system deficiencies at GPC. These deficiencies primarily result from the implementation of a new IT system, which went live on 1 July 2014. A number of automated system controls had an ineffective design or were not functioning correctly. The entity has continued working towards resolving these issues and we expect full resolution within the coming year.

These deficiencies provide a timely reminder for all entities to ensure that new IT systems have appropriately designed automated controls and that management ensure sufficient control testing has been undertaken before the system goes live.

Risk assessment

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

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

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

After extensive research into current developments in the public and private sectors in Australia and overseas, Queensland Audit Office developed a risk management maturity model.

The model is now publicly available on our website. We encourage all public sector entities to conduct a self-assessment.

We did not identify any deficiencies relating to risk management during the year.

Information and communication

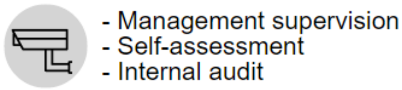
- Non-financial systems
- Financial systems
- Reporting systems

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

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

We did not identify any deficiencies relating to information and communication controls during the year. We noted the entities' addressed prior year information and communication control issues, and improved their capabilities to provide timely and relevant information to support their operation of internal controls and preparation of financial reports.

Monitoring activities

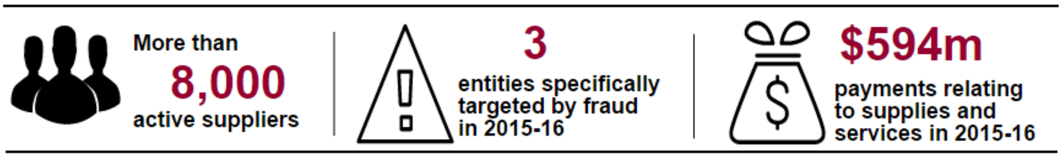


Monitoring activities are the methods management uses to oversee and assess whether internal controls are present and operating effectively. This may be achieved through ongoing supervision, periodic self-assessments, and separate evaluations. They also concern the evaluation and communication of control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

Typically the internal audit function and an independent audit and risk committee are charged with the responsibility to oversee the implementation of controls and the resolution of control deficiencies. These two functions work together to ensure that internal control deficiencies are identified and then resolved in a timely manner.

We did not identify any deficiencies in monitoring activities within any of the entities this year.

Fraud awareness



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

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

The scam

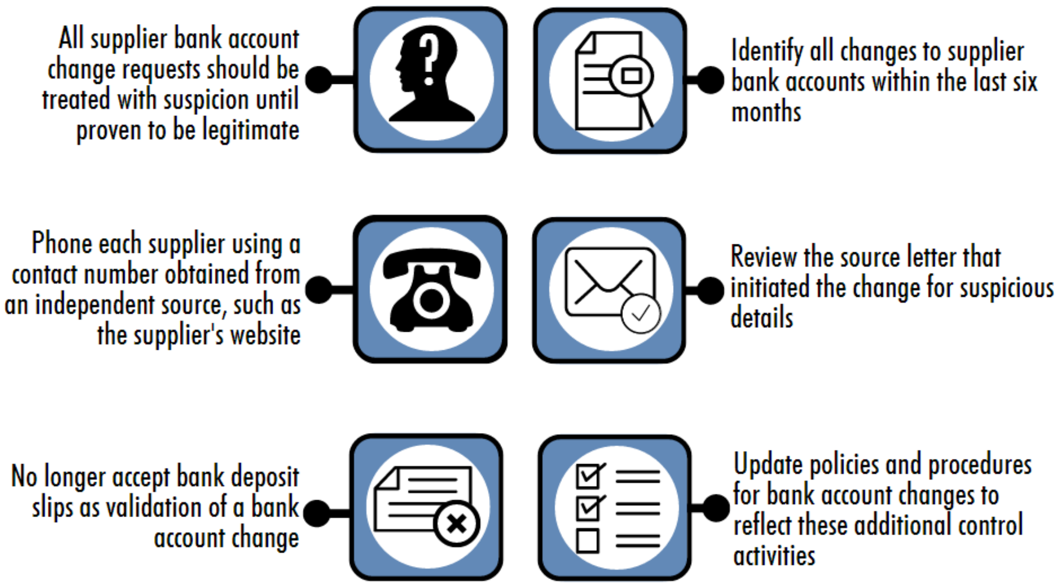
During the financial year, a malicious fraud scheme targeted public and private sector entities. The scammers used fraudulent documents to change an existing supplier's bank account details and divert payments to illegitimate bank accounts.

Our responsibilities

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

Our response

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



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

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

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

Appendices

Appendix A—Full responses from entities

In accordance with section 64 of the *Auditor-General Act 2009*, we gave a copy of this report with a request for comment to the Minister for Transport and the Commonwealth Games; the Director-General, Department of Transport and Main Roads; and the Under Treasurer, Queensland Treasury for comment.

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

- the Queensland Rail Group (QR), including the Queensland Rail Transit Authority (now Queensland Rail) and Queensland Rail Limited
- Far North Queensland Ports Corporation Limited (Ports North)
- Gladstone Ports Corporation Limited (GPC)
- North Queensland Bulk Ports Corporation Limited (NQBP)
- Port of Townsville Limited (PoTL).

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

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

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

This appendix contains their detailed responses.

Comments received from Chief Executive Officer, Gladstone Ports Corporation

Gladstone Ports Corporation
Growth, Prosperity, Community.

Our Ref: #1298776
Your ref: 11581 Mr P Flemming
MG:vo

23 November 2016

Mr Anthony Close
Auditor General (acting)
Queensland Audit Office
PO Box 15396
CITY EAST QLD 4002

Dear Mr Close

REPORT TO PARLIAMENT NOVEMBER 2016

Thank you for your letter of 4 November 2016 providing the November 2016 QAO report to parliament (Rail and Transport). The control deficiencies mentioned therein are noted. We have provided under separate cover to you a detailed response to the items identified in your report.

The one major (valuation model) deficiency which created a prior period material balance sheet adjustment was rectified during the audit process.

A brief summary of the audit items is reiterated below.

Valuation Model

1. The valuation model was written by QTC in 2014 as a result of GPC converting to the use of an income based valuation methodology to determine the value of its asset base.

2. The model was used to prepare the valuation calculation for the 2014, 2015 and 2016 financial statements.

3. The valuation was reviewed during the 2014 and 2015 end of year processes, and significant learnings and methodology have been debated and resolved. The valuation process is an estimate at a point in time, and significant movements can occur from a number of the parameters. GPC will continue to refine its methodology. These models involve complex calculations and require management to make significant judgements and assumptions about the future transactions of their entity.

.../2

- 2 -

▪ Ph: +61 7 4976 1333 ▪ Fax: +61 7 4972 3045 ▪ 40 Goondoon St/PO Box 259, Gladstone QLD, 4680, AUSTRALIA ▪ www.gpcl.com.au
▪ Gladstone Ports Corporation Limited ▪ ACN 131 965 896 ▪ ABN 96 263 788 242

Comments received from Chief Executive Officer, Gladstone Ports Corporation

4. During the 2016 audit several calculation errors flowing through the model were identified. These errors were fixed in the model and agreed with QAO prior to finalisation of the financial statements. The impact was that the 2015 financial statements were restated.

5. GPC's reporting models will be refreshed in 2016-17 and improved governance arrangements over changes to the models are being implemented.

Payroll

1. The payroll related control deficiencies reported by QAO are being considered further by management and where appropriate corrective action is being taken having regard to the costs and benefits.

Status of outstanding issues

Of the control issues outstanding as at the report date, 7 items currently remain to be done

- 3 relate to the modelling discussed above and are currently being resolved
- 1 item relates to a technical issue in the IT system however GPC uses a manual work around
- 1 is a procurement project(P2P) which is nearing completion with implementation early 2017
- 1 relates to a particular security report on system access requiring the purchase of a 3rd party tool
- 1 item (purchase order amendments), which would be more appropriately classed as an efficiency item.

GPC appreciates the suggestions made by QAO and will ensure sufficient resources are in place to resolve the remaining matters.

Yours sincerely

PETER O'SULLIVAN
CHIEF EXECUTIVE OFFICER

• Ph: +61 7 4976 1333 • Fax: +61 7 4972 3045 • 40 Goondoon St/PO Box 259, Gladstone QLD, 4680, AUSTRALIA • www.gpcl.com.au
• Gladstone Ports Corporation Limited • ACN 131 965 896 • ABN 96 263 788 242

Comments received from Chief Financial Officer and Executive General Manager – Commercial & Strategy, Queensland Rail

QueenslandRail

Level 9 Rail Centre 1
305 Edward Street
Brisbane QLD 4001

T 07 3072 5868
jim.benstead@qr.com.au
queenslandrail.com.au

Our Ref: MCR-16-1267

25 November 2016

Mr Anthony Close
Auditor-General (acting)
Queensland Audit Office
PO Box 15396
CITY EAST QLD 4002

Dear Mr Close

Thank you for your letter addressed to our Chair, Ms Nicole Hollows, dated 4 November 2016 providing your proposed report to Parliament titled *Rail and transport: 2015-16 results of financial audits.*

We have appreciated the opportunity to provide feedback, and following further consultation with Mr David Adams from your office, we are now comfortable that the report reflects correct and relevant information.

Yours sincerely

JBenstead

Jim Benstead
A/Chief Financial Officer and
Executive General Manager - Commercial & Strategy

cc: David Adams
Director, Queensland Audit Office

The Queensland Rail Group including Queensland Rail (ABN 68 598 268 528) and Queensland Rail Limited (ABN 71 132 181 090)

Comments received from Treasurer, Queensland Treasury

Queensland Government

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

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

ABN 90 856 020 239

Our Ref: 04215-2016

28 NOV 2016

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

Dear ~~Mr Close~~ ANTHONY

Result of 2015-16 Financial Audit of Rail and Transport Entities

Thank you for the opportunity to provide feedback on the Queensland Audit Office (QAO) report on the 2015-16 audit results for the Queensland Government's port Government owned corporations (GOCs) and Queensland Rail.

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

I also note the QAO's conclusions in relation to financial performance, including that all of the rail and port entities are financially sustainable.

In this context, the report acknowledges the Debt Action Plan announced as part of the 2015-16 Budget, which included changes to the capital structure and dividend payout ratios of GOCs.

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

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

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

Comments received from Treasurer, Queensland Treasury

A key objective for Government is ensuring that the State's GOCs operate as efficiently as possible in order to improve returns and optimise the value of shareholders' significant investment in the entities.

In this context, the Government also revised dividend payout ratios with a view to supporting more efficient capital management in the businesses.

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

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

I trust this information is of assistance to you.

Yours sincerely

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

Appendix B—Entities not preparing financial reports

The auditor-general will not be issuing audit opinions for the following controlled public sector entities for the 2015–16 financial year as they have not prepared financial statements.

Public sector entity	Reason for not preparing financial statements
Gladstone Ports Corporation Limited	
Controlled entities	
Gladstone Marine Pilot Services Pty Ltd	Board of directors determination
Gladstone WICET Operations Pty Ltd	Board of directors determination
Queensland Rail Limited	
Controlled entities	
On Track Insurance Pty Ltd	Board of directors determination
North Queensland Bulk Ports Limited	
Controlled entities	
Mackay Ports Limited	Deed of cross guarantee ASIC order
Ports Corporation of Queensland Limited	Deed of cross guarantee ASIC order

Appendix C—Our assessment of financial governance

Auditing internal controls

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

Internal controls

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

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

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

A deficiency occurs when internal controls are unable to prevent, detect, or correct errors in the financial statements or where internal controls are missing. Deficiencies may lead to an environment which is not supportive of high quality financial reporting.

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

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

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

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

Financial statement preparation

Year end close process

State public sector entities should have a robust year end close process to enhance the quality and timeliness of the financial reporting processes. In January 2014, the Queensland Under Treasurer recommended the completion of five key areas before 30 June each year, to enable a timely audit clearance of the financial statements at year end:

- finalising non-current asset valuations by 31 March
- preparing complete pro forma financial statements by 30 April
- resolving accounting issues by 30 April
- completing hard or soft close processes
- concluding all asset stocktakes by 30 June.

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

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

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

Timeliness of draft financial statements

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

Rating	Timeliness of draft financial statements assessment
● Effective	Acceptable draft financial statements were received on or prior to the planned date
● Generally effective	Acceptable draft financial statements were received within two days after the planned date
● Ineffective	Acceptable draft financial statements were received more than two days after the planned date

Quality of draft financial statements

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

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

Result summary

This table summarises our assessment of the six rail and port entities' internal controls and their financial statement preparation processes.

Entity	Internal controls					Financial statement preparation		
	CE	RA	CA	IC	MA	YE	T	Q
Rail								
Queensland Rail Limited	🟢	🟢	🟡	🟢	🟢	🟢	🟢	🟢
Queensland Rail	🟢	🟢	🟡	🟢	🟢	🟢	🟢	🟢
Ports								
Far North Queensland Ports Corporation Limited	🟢	🟢	🟢	🟢	🟢	🟢	🔴	🟢
Gladstone Ports Corporation Limited	🟡	🟢	🔴	🟢	🟢	🟢	🟢	🔴
North Queensland Bulk Ports Corporation Limited	🟢	🟢	🟡	🟢	🟢	🟡	🟢	🟢
Port of Townsville Limited	🟢	🟢	🟡	🟢	🟢	🟢	🟢	🟡

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

Appendix D—Glossary

Term	Definition
Accountability	Responsibility of public sector entities to achieve their objectives in reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties.
Acquisition	Establishing control of an asset, undertaking the risks, and receiving the rights to future benefits as would be conferred with ownership, in exchange for the cost of acquisition.
Auditor-General Act 2009	An Act of the State of Queensland that establishes the responsibilities of the Auditor-General, the operation of the Queensland Audit Office, the nature and scope of audits to be conducted, and the relationship of the Auditor-General with parliament.
Australian accounting standards	The rules by which financial statements are prepared in Australia. These standards ensure consistency in measuring and reporting on similar transactions.
Capital expenditure	Amount capitalised to the balance sheet for contributions by an entity to major assets owned by the entity, including expenditure on: ▪ capital renewal of existing assets that returns the service potential or the life of the asset to that which it had originally ▪ capital expansion which extends an existing asset at the same standard to a new group of users.
Deficiency	Occurs where we have assessed the control is designed or implemented in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or where that control is missing.
Discount rate	Interest rate used to calculate the present day value.
Gross tonne kilometre (GTK)	Unit of measurement for freight turnover in rail transport calculated by multiplying the weight of goods transported by the distance covered.
Prior period error	Omissions from, and misstatements in, an entity’s financial statements caused by not using or misusing information that was available or could have been obtained and taken into account in preparing the financial statements.
Significant deficiency	A deficiency in internal control, or combination of deficiencies in internal control, that, in our professional judgement, may lead to a material misstatement in the financial statements. Significant deficiencies require immediate management action and are always of sufficient importance to merit the attention of those charged with governance.
Financial sustainability	Entities’ ability to repay their liabilities as and when they fall due during the next financial year.

Auditor-General reports to parliament

Reports tabled in 2016–17

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

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