



Water: 2017–18 results of financial audits

Report 8: 2018–19



Your ref:
Our ref: 11980
Vaughan Stemmett—3149 6046

15 November 2018

The Honourable C Pitt MP
Speaker of the Legislative Assembly
Parliament House
BRISBANE QLD 4000

Dear Speaker

Report to parliament

This report is prepared under Part 3 Division 3 of the *Auditor-General Act 2009*, and is titled *Water: 2017–18 results of financial audits* (Report 8: 2018–19).

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

Yours sincerely

A handwritten signature in blue ink, appearing to read "B. Worrall".

Brendan Worrall
Auditor-General

Contents

Summary	1
1. Sector overview	6
2. Results of our audits	7
3. Financial position, performance, and sustainability	10
4. Internal controls	34
Appendices	37
A. Full responses from agencies	38
B. Water entities	41
C. Entities not preparing financial reports	43
D. Legislative context	44
E. Our assessment of financial statement preparation	46
F. Key audit matters	49
G. Key financial information	50
H. Our audit of internal controls	51
I. Glossary	54

Summary

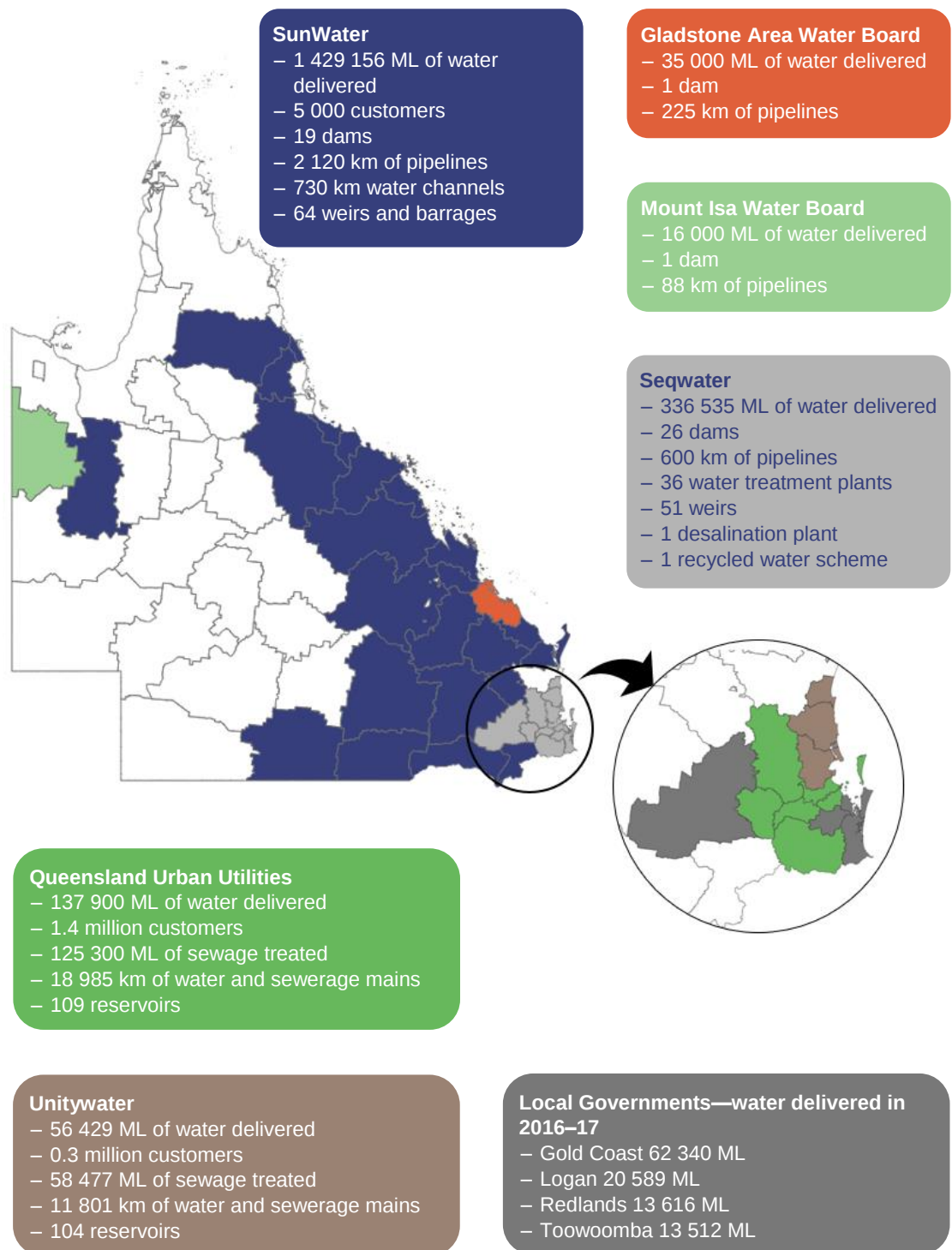
This report summarises our financial audit results of six water entities:

- Seqwater
- SunWater
- Gladstone Area Water Board (GAWB)
- Mount Isa Water Board (MIWB)
- Queensland Urban Utilities (QUU)
- Unitywater.

The results from our financial audits of smaller water boards and councils are outside the scope of this report. These include river improvement trusts, water authorities, water boards, and drainage boards that provide services to local councils and small communities. Local governments source and sell water to their ratepayers from a number of surface and groundwater sources.



Figure A
Queensland water entities included in this report—operations by local government area



Results of our audits

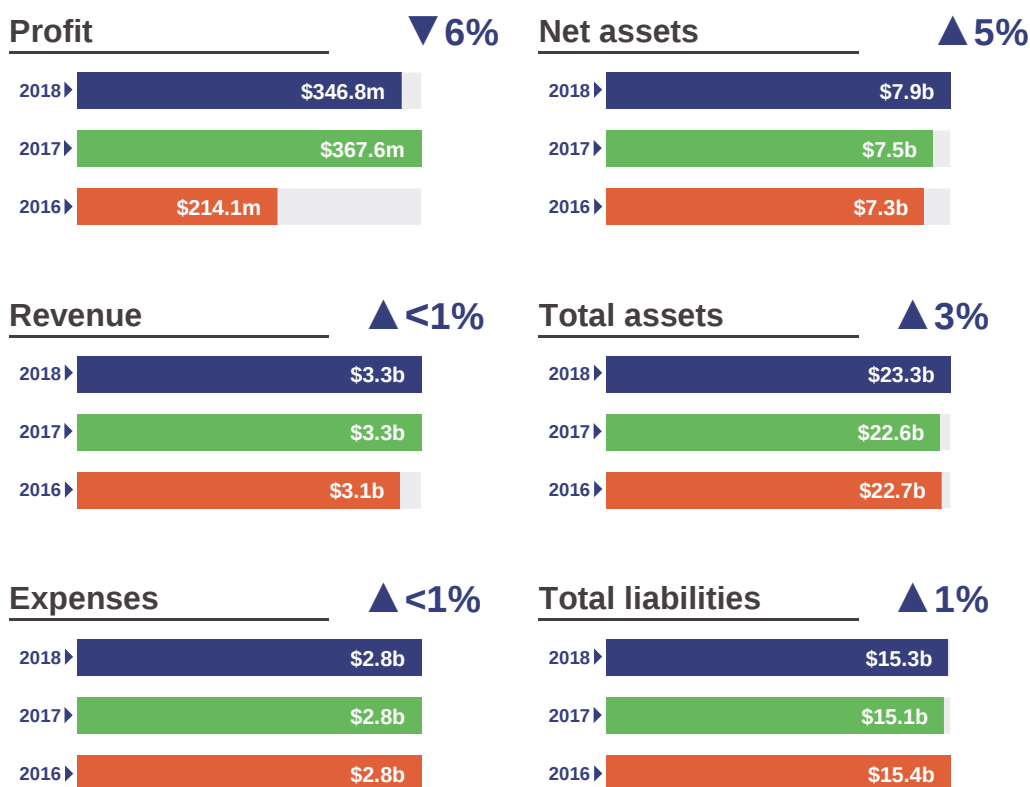
Consistent with 2016–17, we issued unmodified audit opinions on all financial statements this year within the statutory deadline of 31 August 2018. In doing so, we confirm that readers can rely upon the audited financial statements of the water entities.

All but one of the water entities had good financial reporting practices. This enabled them to produce high quality financial statements in a timely manner for 2017–18.

We express an **unmodified opinion** when the financial statements are prepared in accordance with the relevant legislative requirements and Australian accounting standards.

Financial performance, position, and sustainability

Figure B
Queensland water sector financial snapshot



Source: Queensland Audit Office.

Understanding financial performance

For the third consecutive year, the water sector has maintained operating profits. However, profits after income tax have declined slightly for three of the six water entities driven primarily by:

- Unitywater's one-off tax adjustment
- conclusion of QUU's student accommodation development stimulus program and the slowing of new building approvals since 2015–16, which decreased developer contributions.

Entities have worked towards maintaining and containing expenses through implementing cost-reduction strategies.

Dividends to the state government have increased in the current year to \$47.8 million (compared with \$8.1 million in 2016–17). The increase is mostly due to SunWater declaring dividends in 2017–18 and retaining profits in 2016–17 for future dam improvement works. Due to operating losses, Seqwater continued to make no dividend payments to the state in 2017–18.

Participation returns of water made by the distributor–retailers to their participating local governments amounted to \$166.5 million for 2017–18 (compared with \$201.8 million in 2016–17, down by \$35.3 million). The decrease is primarily a result of Unitywater paying a lower participation return of \$0.7 million in 2017–18 (compared with \$36.9 million in 2016–17). In 2017–18, Unitywater requested an amendment of its 2016–17 tax returns to align the useful lives of certain asset classes for both accounting and tax purposes. The amendment decreased Unitywater's participation returns, but increased by \$31.1 million the income tax payable to participating local governments.

Useful life relates to the number of years the entity expects to use an asset (not the maximum period possible for the asset to exist).

Understanding financial position

Assets increased by \$637.3 million, due to a net revaluation increment of \$444.4 million, investment in infrastructure assets of \$580 million, and donated assets of \$170.7 million. This was partially offset by depreciation and amortisation of \$551.5 million. Liabilities increased by \$194 million due to three reasons: the deferred tax effect of Seqwater's revaluation increment (\$126.8 million), SunWater's dividends payable (\$39.6 million), and GAWB's \$30 million borrowings to fund the acquisition of its corporate building, completion of the business case for the Lower Fitzroy River Infrastructure Project, and construction of an offline storage facility at Toolooa Bends (O'Connell).

All water entities are financially sustainable, although Seqwater's sustainability is dependent on the pricing set by the state government based on the recommendations of the Queensland Competition Authority (QCA). The QCA forecasts that Seqwater's current price path is sufficient to meet the cost to supply bulk water and repay the water grid manager debt by 2028. All water entities have state government borrowings. Each entity seeks reassurance from the Queensland Treasury Corporation that these debts will not be required to be repaid in the following year.

Seqwater's net revaluation increment of \$419 million was a significant contributor to the increase in net assets. The revaluation increment was primarily due to the current price path and an increase in the demand forecast for the period 2019 to 2026. Seqwater continued to pay interest costs for its debt for the second year in a row. Previously, Seqwater was capitalising costs associated with water grid manager debt, which increased its debt.

As part of the water sustainability programs being implemented, entities are investing in water saving and storage infrastructure programs along with the Queensland Government.

Internal controls

This year we noted an increased effort in the sector to resolve prior year deficiencies. All deficiencies identified in 2016–17 (including the two significant deficiencies noted at SunWater) have been resolved.

We assessed the control environments of five of the six water entities as effective, and we were able to rely on the internal control systems used to produce financial statements. As a result of significant deficiencies identified in 2016–17, we did not rely on SunWater's internal controls in 2017–18.



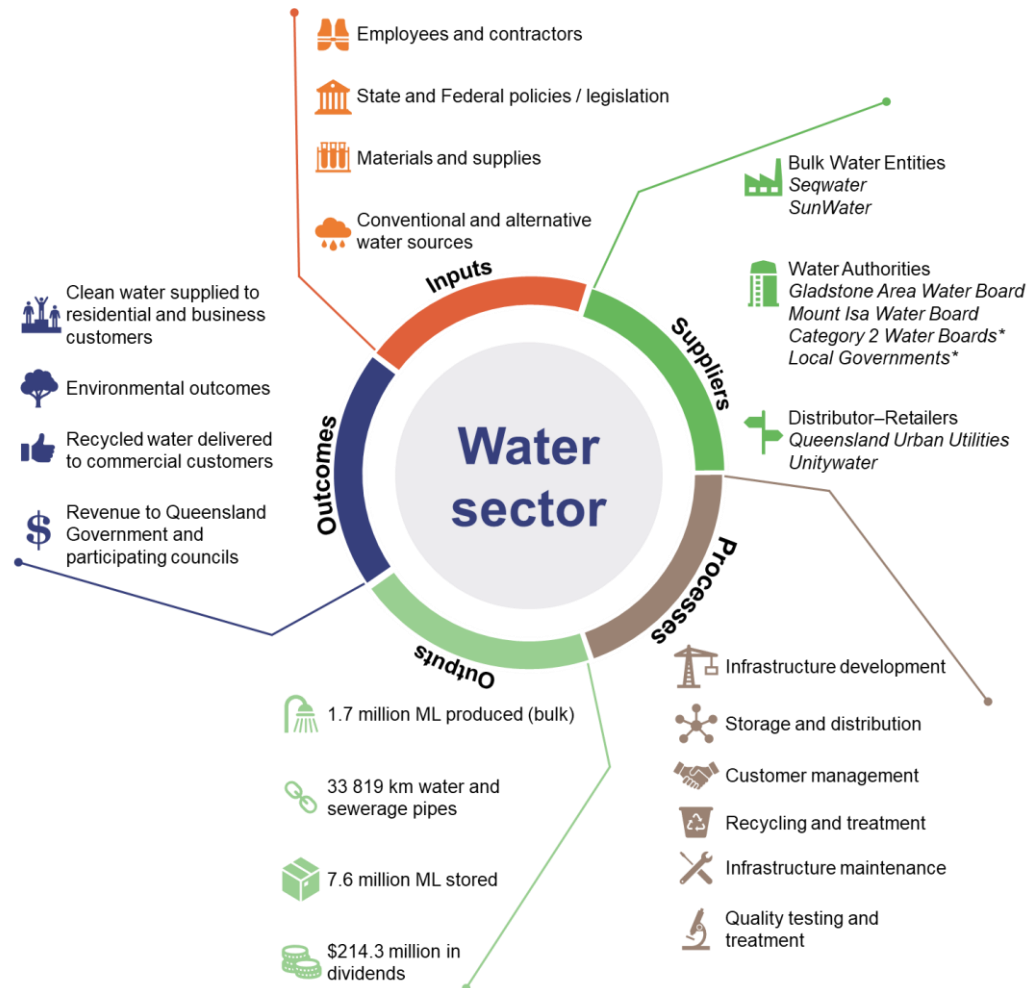
1. Sector overview

This chapter provides a sector overview to help readers to understand the audit findings and conclusions.

In Queensland, water is used primarily by households, agriculture, mining, electricity generation, tourism, and manufacturing industries. The Department of Natural Resources Mines, and Energy (formerly the Department of Energy and Water Supply) is the government department with primary responsibility for the water sector in Queensland.

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

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



Note: *Output figures exclude these entities.

Source: Queensland Audit Office.

2. Results of our audits

This chapter delivers the audit opinion results and evaluates the timeliness and quality of reporting.

Conclusion

We issued unmodified audit opinions for each of the water entities. Readers can rely on the results in the financial statements. All financial statements were prepared within the legislative timetables.

All but one of the water entities have effective year-end close processes, allowing them to produce high-quality financial statements on a timely basis. Five of the six water entities committed to continue prior year’s efforts to improve asset valuation and financial reporting practices. There were no material adjustments to the financial statements.

Audit opinion results

All water entities met their legislative deadline of 31 August 2018 (as in 2016–17). The table below details the unmodified audit opinions we issued for the 2017–18 financial year.

Figure 2A
Date of unmodified audit opinions issued for 2017–18

Element of water supply chain	Entity (trading names)	Date audit opinion issued
Bulk water suppliers	SunWater Limited	28.08.18
	Mount Isa Water Board	29.08.18
	Seqwater	30.08.18
	Gladstone Area Water Board	31.08.18
Distributor–retailers	Queensland Urban Utilities	20.08.18
	Unitywater	28.08.18

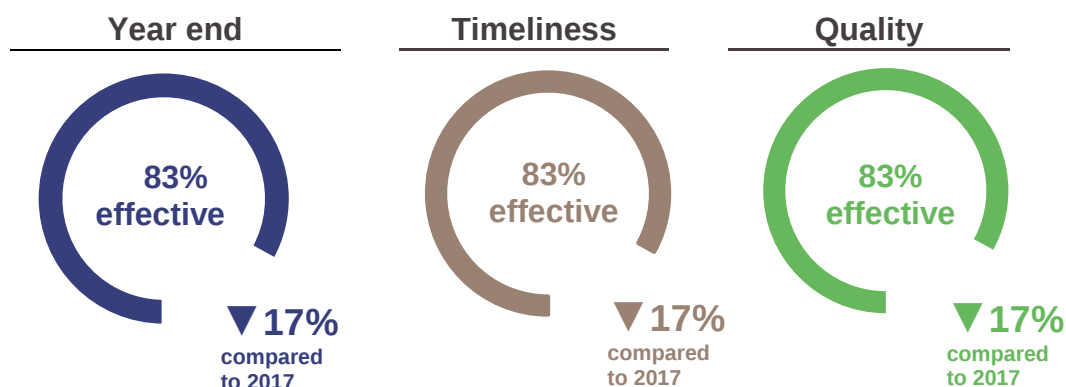
Source: Queensland Audit Office.



Financial statement preparation

Water entities generally had effective year-end close processes, producing timely, high-quality financial reports.

Figure 2B
Effectiveness of financial statement preparation processes



Source: Queensland Audit Office.

Asset valuation is a significant component of financial statement preparation for water entities. Five of the six entities demonstrated continued emphasis on improving the quality and timeliness of asset valuations. Seqwater led the water sector in the early completion of asset valuations. MIWB experienced delays in completing its asset valuation process, which had flow-on effects on the timeliness and quality of its financial statements. All other entities ensured that asset valuations were completed early, along with pro forma financial statements being provided at or before the agreed milestone dates.

Although all water entities met the statutory deadline, we encourage them to consider bringing forward audit committee (or its equivalent) endorsement and board approval of their financial statements in 2018–19. This will assist in ensuring effective resolution of potential issues that may happen between year-end and signing date.

The results of our assessment for each entity and our assessment criteria are outlined in Appendix E.

Key audit matters

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

Key audit matters are those areas that, in our professional judgement, pose a higher risk of material misstatement. A misstatement is material if it has the potential to influence the decisions made by users of the financial statements. These matters mostly relate to major events and transactions that occur during the period, and those areas requiring significant application of judgement and estimation.

This was the second year we voluntarily included key audit matters in our independent auditor's report for two water entities. The key audit matters covered the valuation of property, plant, and equipment and the estimation of useful lives for depreciation expense. We reported on why the key audit matters were significant and the procedures we performed to address the matters.

The full list of key audit matters reported is detailed in Appendix F.

Entities not preparing financial statements

Not all Queensland public sector water entities produce financial statements.

When entities are part of a group and are secured by a deed of cross guarantee (with other entities in that group agreeing to cover debts), they are not required to prepare financial statements. Small companies that meet specific criteria under the *Corporations Act 2001* also do not have to prepare financial statements.

Appendix C lists the entities not preparing financial statements in 2017–18.



3. Financial position, performance, and sustainability

This chapter analyses the financial position, performance, and sustainability of six water entities.

The information in an entity's financial statements describes its main transactions and economic events for the year. Over time, financial statements also help users to understand the sustainability of the entity and its industry.

Our analysis helps users understand and use the financial statements by clarifying the financial effects of significant transactions and events in 2017–18. We also analyse relevant financial ratios to highlight organisational performance issues.

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

Conclusion

The water entities are financially sustainable and can pay their debts as and when they fall due. Seqwater's sustainability continues to depend on the future returns provided through pricing set by the state government, and on the security for borrowings currently provided by the state. SunWater's sustainability depends on the future returns provided through pricing set by the state government, retained profits from non-regulated operations (industrial and urban customers), and funding of any shortfall in the dam improvement program.

Profits for the water sector have decreased marginally by \$20.8 million (six per cent) this year, because South East Queensland's development growth has slowed since 2015–16 and the student accommodation development stimulus program has ended. This affected the resulting developer contributions for urban household infrastructure received by distributor–retailers. Another factor that contributed to the decrease in profits was an increase in income tax due to the alignment for accounting and tax purposes of the useful lives of certain assets. Expenses have remained stable, and three of the six entities have profits after income tax that are greater than prior years.

The assets and liabilities of the water entities have not changed substantially from last year. Net assets have increased by six per cent from 2016–17, primarily due to Seqwater's net revaluation increment of \$419 million (before tax) on its infrastructure assets.

Understanding financial performance

Five of the six water entities achieved operating profits in 2017–18. Seqwater continues to make an operating loss largely reflecting the historical under-recovery of the cost of water. Seqwater's operating loss also reflects its past acquisition of highly geared businesses (business with a lot of debt in relation to share capital) including climate-resilient manufactured water assets. As at 30 June 2018, Seqwater had tax losses that it could use to offset against \$3.5 billion of future tax profits at prevailing income tax rates.

Figure 3A
Water sector profit after tax and returns to shareholders

		2018	2017	2016	2017–18 movement
Profit		\$347 million	\$368 million	\$214 million	Decrease due to the development in South East Queensland starting to subside
Shareholder returns		\$214 million	\$210 million	\$469 million	Modest increase due to SunWater paying a dividend offsetting the decrease in distributor–retailer returns

Source: Queensland Audit Office.

During 2017–18, dividends of \$47.8 million were declared by three water entities. SunWater declared dividends of \$39.7 million (nil in 2016–17 at the direction of its shareholding ministers); GAWB declared dividends of \$6.9 million (\$5.5 million in 2016–17); MIWB declared dividends of \$1.2 million (\$2.6 million in 2016–17).

The participation returns of water made by the distributor–retailers to their participating local governments amounted to \$166.5 million for 2017–18 (down \$35.3 million from the 2016–17 returns of \$201.8 million). This decrease was primarily a result of Unitywater paying a lower participation return of \$0.7 million in 2017–18 (\$36.9 million in 2016–17). In 2017–18, Unitywater requested an amendment of its 2016–17 tax returns to align the useful lives of certain asset classes for both accounting and tax purposes. The amendment decreased Unitywater's participation returns, but increased its income tax by \$31.1 million due to participating local governments.

Dividends are a portion of a statutory body or government-owned corporation's profits which it pays to its shareholders.

Participation returns are a portion of a distributor–retailer's profits which it pays to its participating local governments in accordance with a participation agreement.

Shareholder returns refer to either dividends (for a statutory body or government-owned corporation) or participation returns (for distributor–retailers).

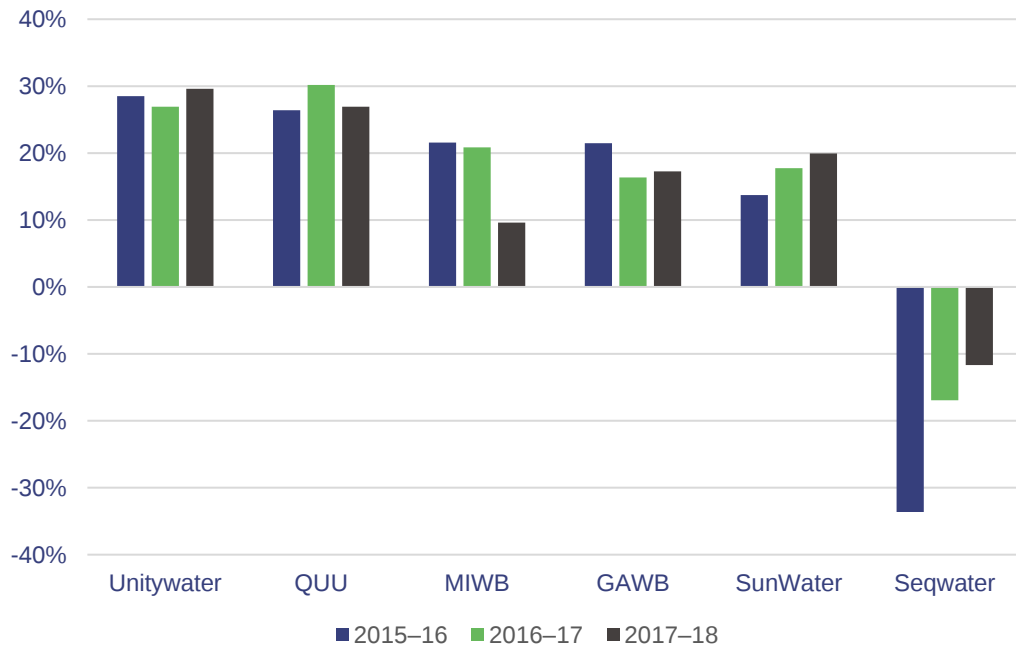
Total participation returns refer to the sum of participation returns, income tax equivalents and competitive neutrality fees paid to participating local governments.

Operating ratio

The operating ratio is a key indicator of the strength of financial performance and should be positive over the medium to longer term if an entity is to remain financially sustainable.

The operating ratio is the operating result before tax, expressed as a percentage of total revenue. It shows the capacity to meet operating expenses from operating revenue, with a positive ratio indicating that funds are also available for capital expenditure and shareholder returns.

Figure 3B
Operating ratio for water entities



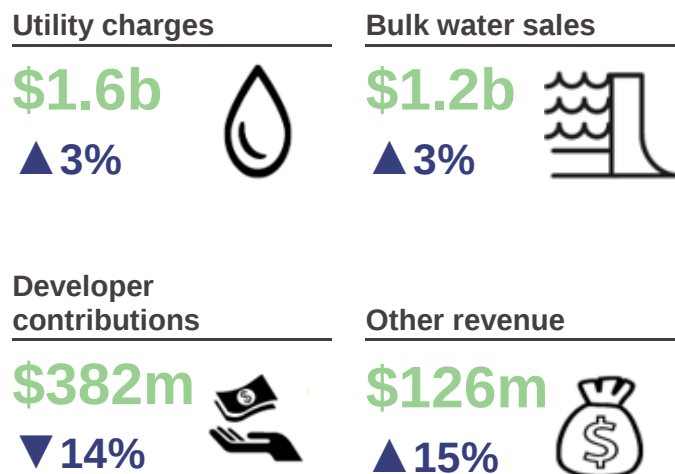
Source: Queensland Audit Office.

Operating ratios have remained positive over the past three years except for Seqwater. The reduction in operating ratio for MIWB is due to a decrease in the fair value of non-current assets recognised in the operating result.

Seqwater's ratio continues to improve year on year (increasing by five per cent in 2017–18 compared to the previous year). This improvement was achieved through increased water sales (including an increase in water demand and an increase in prices of, on average, three per cent as per the price path) and reduction in finance and borrowing costs (five per cent).

Revenue

Figure 3C
Major revenue for all entities by type for 2017–18



Source: Queensland Audit Office.

Revenue earned by the water sector predominantly comprises of utility charges, bulk water sales, and developer contributions (these account for 96 per cent of total revenue).

The water entities reported \$3.3 billion of revenue in the 2017–18 financial year, an increase of \$36.2 million (one per cent) from the previous year. Increased demand from customers (distributor–retailers and local governments) has increased the demand for water from the bulk water suppliers. Price increases for all entities have also driven increases in revenue, despite the notable decreases in developer contribution and community service obligation (CSO) revenue.

Events and transactions affecting revenue this year

Decreased developer contributions

Developer contributions come in the form of cash contributions and donated assets. Water entities use non-refundable contributions from developers to fund their asset replacement and expansion programs. Receiving infrastructure assets from developers means that entities do not have to self-fund expansion to the water supply and sewerage networks.

For the 2017–18 financial year, retail distributors reported total revenue of \$2 billion (2016–17: \$2 billion). This is made up of customer and other revenue of \$1.6 billion (2016–17: \$1.6 billion) and developer contributions of \$382 million (2016–17: \$443 million).



Figure 3D
Three-year trend for developer contributions

	2018	2017	2016	
Developer contributions—fixed assets	\$165 million	\$152 million	\$153 million	
Developer contributions—cash	\$217 million	\$291 million	\$223 million	
New building approvals ¹	25 thousand	25 thousand	31 thousand	

¹Excludes alterations, additions, and conversions.

Source: Queensland Audit Office.

Through the student accommodation stimulus program, between 1 July 2014 and 30 June 2017 QUU and the Brisbane City Council reduced infrastructure charges to encourage new developments to provide accommodation for tertiary and higher education students. The stimulus program ended in 2016–17 and, with the slowing of new building approvals since 2015–16, developer contributions decreased by \$61 million (14 per cent).

Continued support for rural water supply

SunWater receives CSO payments from the state government. In 2017–18 it received \$9 million (2016–17: \$9.5 million) in CSO payments, of which \$3.2 million (2016–17: \$3.7 million) was in recognition of rural water pricing policies and SunWater's under-recovery of costs. The remaining CSO payments were to ensure the viability of SunWater's urban water supply to Cloncurry Shire Council.

Seqwater also receives CSO payments from the state government. In 2017–18 Seqwater received \$2.1 million (2016–17: \$2.4 million) to facilitate the provision of water to rural irrigators.

For 2018–19, the state government has budgeted a total of \$10.7 million in CSO payments to SunWater and Seqwater. This amount includes CSO payments for channel irrigation schemes that may be transferred to local ownership as part of the *Water (Local Management Arrangements) Amendment Act 2017*.

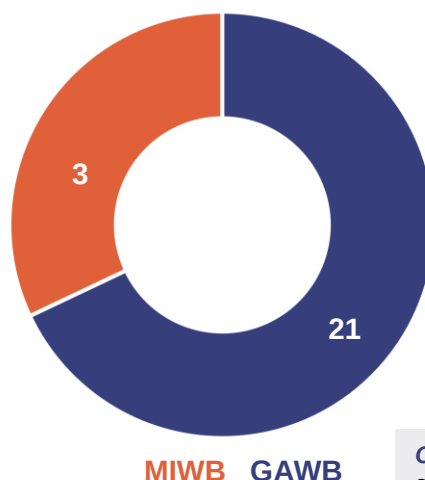
Once a scheme transfers to Local Management Arrangement (LMA), there are no further CSOs payable for that scheme.

Channel irrigation schemes means the distribution system or water infrastructure from which SunWater holds a resource operations licence.

Customer concentrations in regional areas

MIWB and GAWB provided a combined total of 51 000 ML to their customers in the 2017–18 year. Both entities have a high proportion of customers in mining and gas industries, which is consistent with industries in these areas.

Figure 3E
Customer concentration of category one water boards



Source: Queensland Audit Office.

MIWB is economically dependent on its three customers. Although GAWB also depends on a small number of customers, MIWB is more sensitive to local economic conditions affecting its customers. This means the risk of losing customers would significantly affect MIWB's ability to continue as a going concern.

Category one water boards are for-profit water authorities established under the *Water Act 2000*, which include Gladstone Area Water Board and Mount Isa Water Board.

Category two water boards are not-for-profit water authorities other than category one water authorities.

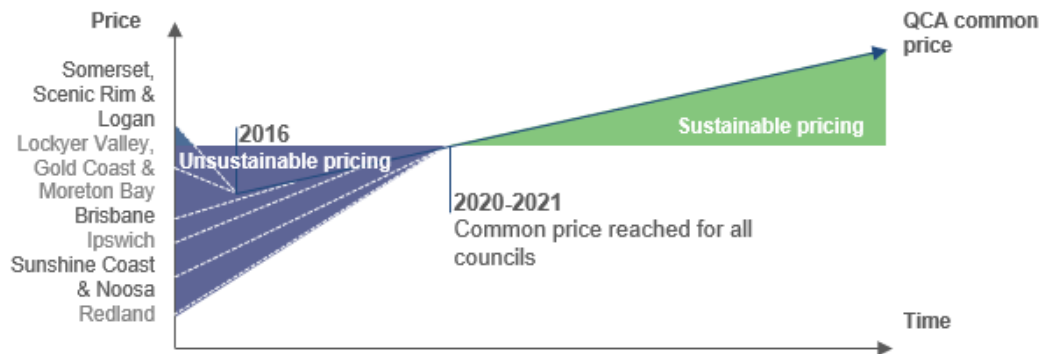
Future challenges and emerging risks

Pricing for South East Queensland

In 2008, the state government established the South East Queensland bulk water price path with the objective of all South East Queensland council areas reaching a common bulk water price. The price path operates by limiting price increases (therefore restricting Seqwater's revenue) in those council areas where the price paid for water is more closely aligned to the approved price, while slowly increasing prices for those council areas where the price of water is less than the approved price. By 2020–21, all council areas will have reached a common price for bulk water.

Seqwater has had restricted revenue and has taken on substantial debt to finance operations. Figure 3F demonstrates how this has been factored into pricing going forward. Seqwater will reach a sustainable revenue stream once the common price is reached in all council areas.

Figure 3F
South East Queensland water price path sustainability



Source: Queensland Audit Office (indicative image).

Queensland Competition Authority bulk water price reset for Seqwater

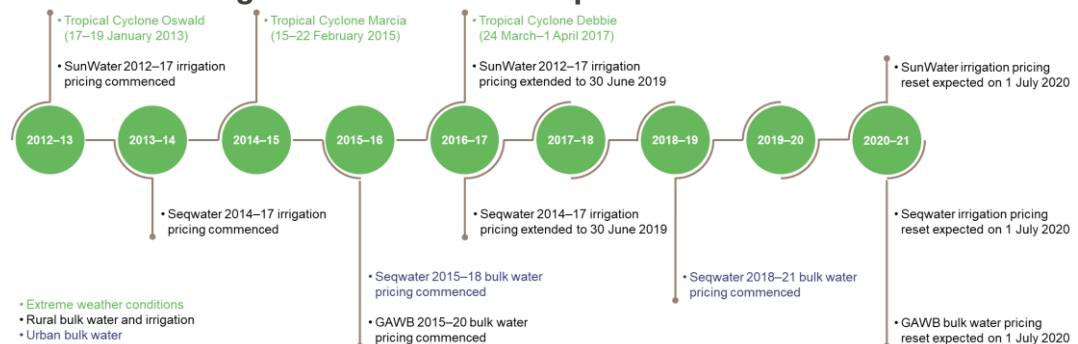
In April 2018, the Queensland Competition Authority (QCA) recommended two bulk water price path options for customers in South East Queensland for the period 1 July 2018 to 30 June 2021.

The state government has accepted QCA's second recommendation, which proposed smoothed pricing for all council areas (including Redland City, Sunshine Coast, and Noosa) setting the bulk water prices until 2021. This option increases prices on a linear path for each council between 2017–18 and 2020–21.

QCA has forecast these prices to 2028 to provide Seqwater with sufficient revenue to recover the cost of providing bulk water supply and services over the period 2008–2028 (price path period). This includes recovering the previous revenue under-recovery, known as price path debt. QCA believes their recommendations will result in Seqwater fully repaying its price path debt by 2028.

Pricing for outside South East Queensland

Figure 3G
Irrigation and bulk water price review timeline



Source: Queensland Audit Office.

The current rural irrigation price path for SunWater commenced on 1 July 2012 and currently applies until 30 June 2019. A number of extreme weather conditions and increased costs have occurred since SunWater's current rural irrigation price path commenced. Current cost targets set by the QCA in the irrigation water price path do not reflect a rise in operating costs (that is, they do not recover the costs of supply) above the consumer price index nor do they reflect any provision for flood repairs. This reflects the longer intervening periods between price path reviews for rural bulk water and irrigation prices. Costs in the channel schemes vary because of electricity usage, operational costs, and future capital expenditure, all of which have to be recovered by SunWater through the price charged to irrigators or through a government subsidy.

In 2018–19, QCA is expected to review SunWater's irrigation price path from 1 July 2019 to 30 June 2024.

AASB 15 Revenue from Contracts with Customers

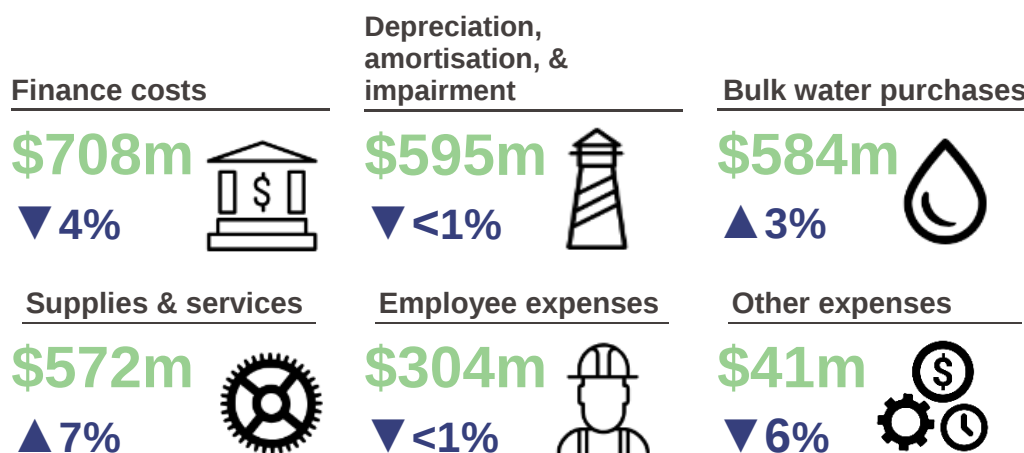
The revenue of water entities will be affected by the new Australian accounting standard AASB 15 *Revenue from Contracts with Customers* from 1 July 2018. This standard is more complex and includes more judgements than previous standards.

Water entities have various sources of revenue. These mainly include bulk water sales, utility charges, developer contributions, fees and charges, grants and subsidies, and interest income. In practice, there is divergence in the proposed accounting treatment for developer contributions, relating to up-front recognition as opposed to deferred recognition of developer contributions. Both Unitywater and QUU recognise developer contributions up-front, however QUU are reassessing their treatment under the new accounting standard.

All other water entities have finalised their accounting positions and policies and have analysed their options to determine what changes, if any, will be required. We will work with distributor–retailers on this in 2018–19.

Expenses

Figure 3H
Major expenses for all entities by type 2017–18

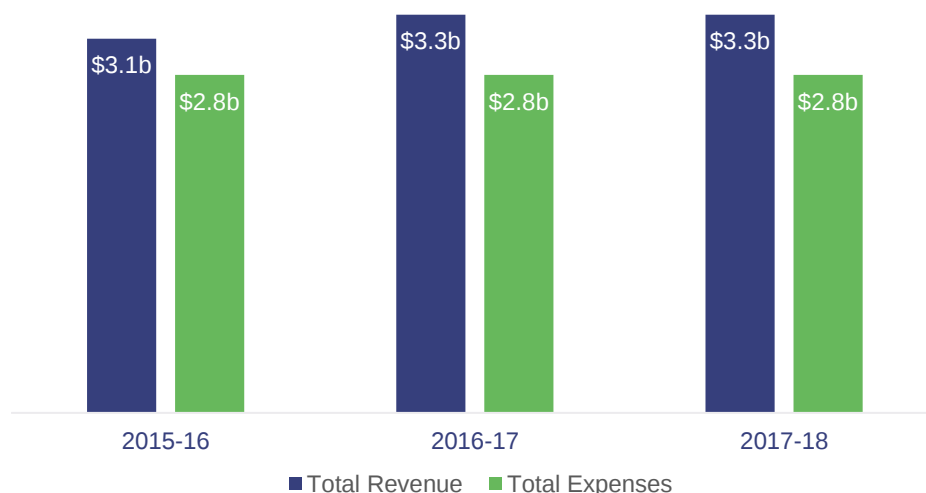


Source: Queensland Audit Office.

Expenses remained stable during the year. The water entities reported \$2.8 billion of expenses in the 2017–18 financial year, an increase of \$15.6 million (one per cent) from the previous year.

- Finance costs are the most significant expense for the water sector and have continued to decrease this year (reduced by \$ 32.8 million) in line with interest rates and the continued interest repayments by Seqwater. Seqwater incurred 72 per cent (73 per cent in 2016–17) of total finance costs for the sector as a result of the entity's highly geared financial position.
- Depreciation, although fairly constant, moves in line with the capitalisation of new projects, disposals, and revaluation of assets.
- Bulk water purchases by QUU and Unitywater have increased by \$15 million compared to the previous year, due to an increase in demand by 562 ML and bulk water price increases from Seqwater.
- Supplies and services have increased by \$39.8 million (seven per cent), which included additional costs incurred in relation to improvement-project initiatives.

Figure 3I
Revenue to expenses for the water sector



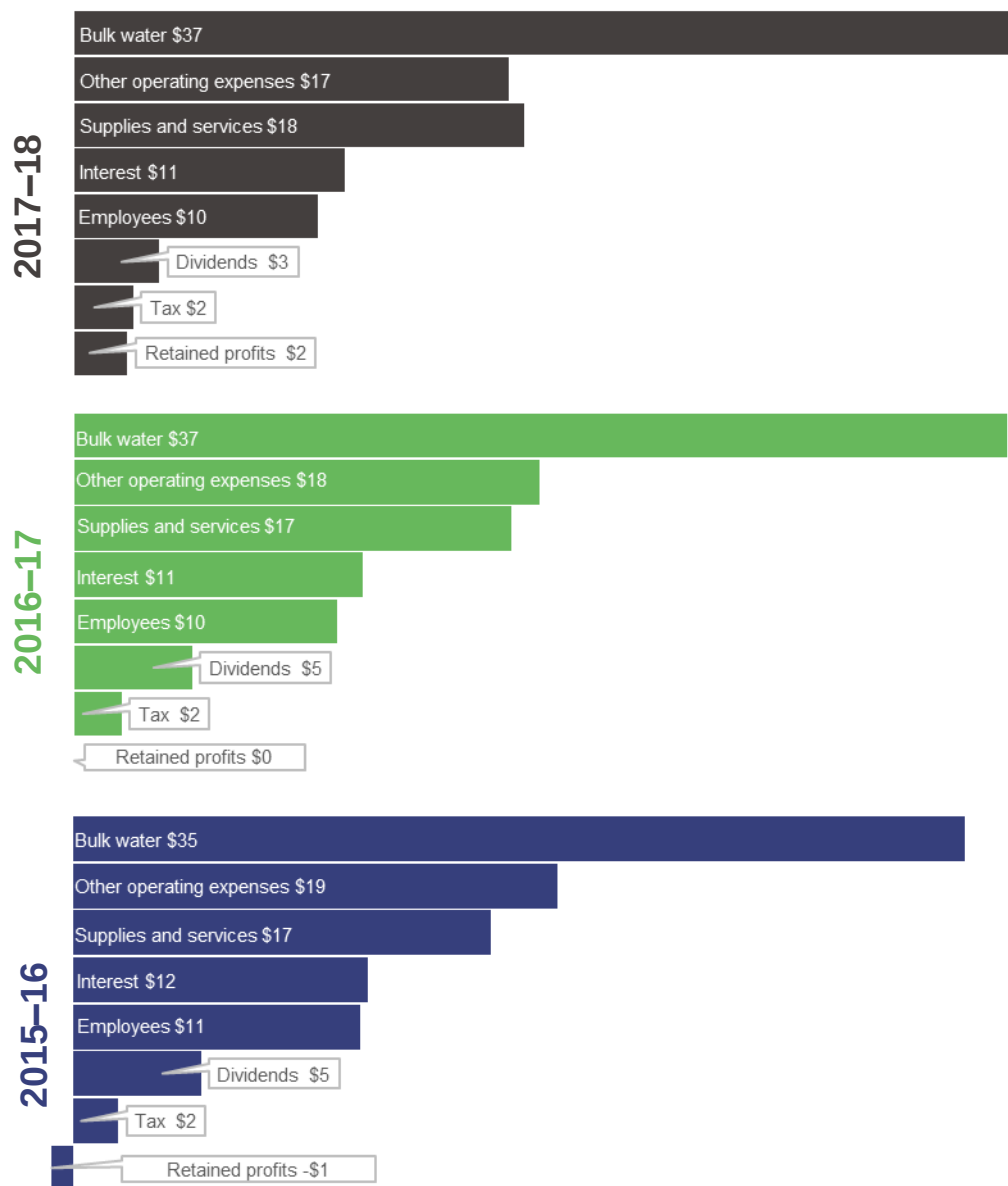
Source: Queensland Audit Office.

Although there were movements year on year on individual revenue and expense items, the water sector's total revenue and total expenses have remained stable over the past three years.

Events and transactions affecting expenses this year

Over the past two years, the combined operating costs for QUU and Unitywater have grown by one per cent. Revenue for the same period has decreased by less than one per cent, despite a decrease of 14 per cent in developer contributions over the same period. For the analysis below in Figure 3J, we have removed the developer contributions component to focus on the revenue received from customers. For every \$100 received as revenue, both entities use \$98 for operating expenses and pay \$3 to participating shareholding councils as participation returns.

Figure 3J
Expenses costs per \$100 of revenue



Source: Queensland Audit Office.

Future challenges and emerging risks

Each dam owner is responsible for dam improvement in Queensland. Bulk water suppliers must ensure they manage the risks in accordance with the provisions of the *Water Supply (Safety and Reliability) Act 2008*.

All the operators have a dam improvement program in place. The program incorporates an ongoing series of inspections, engineering assessments, and comprehensive risk assessments for all referable dams, including changes in design standards, hydrologic data and methods, industry best practice, and regulatory requirements.

A dam is a **referable dam** if a failure impact assessment demonstrates there would be people at risk if the dam was to fail.

Dam improvements are a significant cost to the entities and are funded through:

- retained profits that would otherwise be paid to shareholders
- additional funding from Queensland or Australian governments
- additional borrowings
- the current and future water price.

Dam improvement is a major focus for SunWater and it commenced its program of work in 2005. SunWater retained all of its 2016–17 profits (\$36 million), and the state government agreed to provide a further \$100 million towards improvement works for Burdekin Falls Dam's future dam improvement project. The improvement works are to ensure the Burdekin Falls Dam continues to meet current design standards and can continue to safely pass excess volumes of water in extreme weather events. In 2017–18, SunWater completed improvement works to Burdekin Falls Dam's foundation drainage.

At 30 June 2018, SunWater estimated the future cost of its dam improvement program at \$1.3 billion (in 2016–17 its estimate was \$902 million). Future projects include Burdekin Falls Dam wall raising and hydro-electric power station, Paradise Dam spillway improvements, and Fairburn Dam spillway improvements. These projects are likely to significantly influence SunWater's financial performance and net flows to the government over the next 10 years.

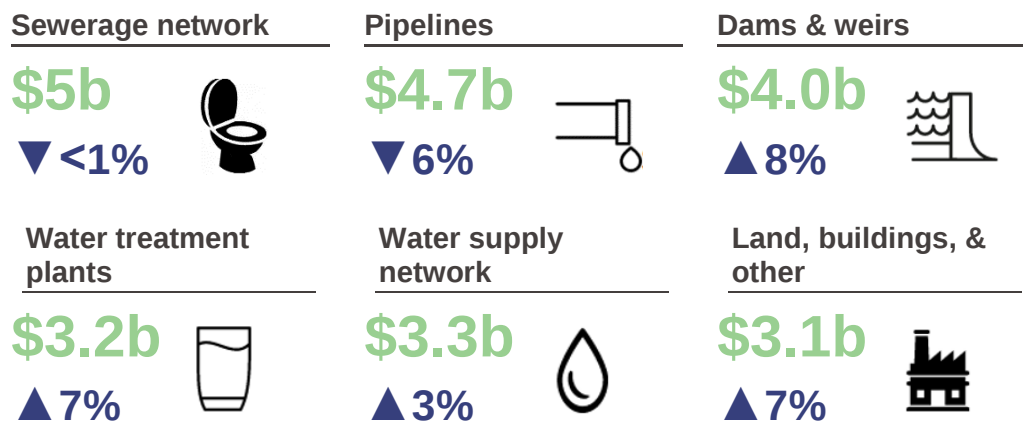
Understanding financial position

Assets increased by \$637.3 million (2.8 per cent) and liabilities increased by \$194 million (1.3 percent) in 2017–18. The combined net asset position increased by \$443.3 million (5.9 per cent), primarily due to:

- Seqwater posting a net revaluation increment of \$419 million (before tax) on its infrastructure assets, due to an increase in the demand forecast for the period 2019 to 2026
- all entities continuing to pay their interest costs and not increasing debt, except for GAWB, which increased borrowings by \$30 million to fund the acquisition of its corporate building, the completion of its business case for the Lower Fitzroy River Infrastructure Project, and construction of an offline storage facility at Toolooa Bends (O'Connell)
- water distributor–retailers constructing \$363.8 million of assets and receiving donated assets of \$170.7 million
- total depreciation, amortisation, and impairment of assets of \$595.2 million.

Assets

Figure 3K
Total assets for all entities by type for 2017–18



Note: SunWater and Unitywater report their assets at cost (what they paid for them) while the remaining entities report at fair value (what they would receive for the assets in the market), which limits comparability across the sector.

Source: Queensland Audit Office.

The water entities reported \$23.3 billion of assets at 30 June 2018 (\$22.6 billion in 2016–17), consisting primarily of property, plant, and equipment (94 per cent of total assets) used to store and provide water to consumers or to treat waste water.

Events and transactions affecting assets this year

The water sector provides vital infrastructure that helps the economy to grow. The sector manages a large number of complex, long-lived assets, almost all of which it owns and controls.

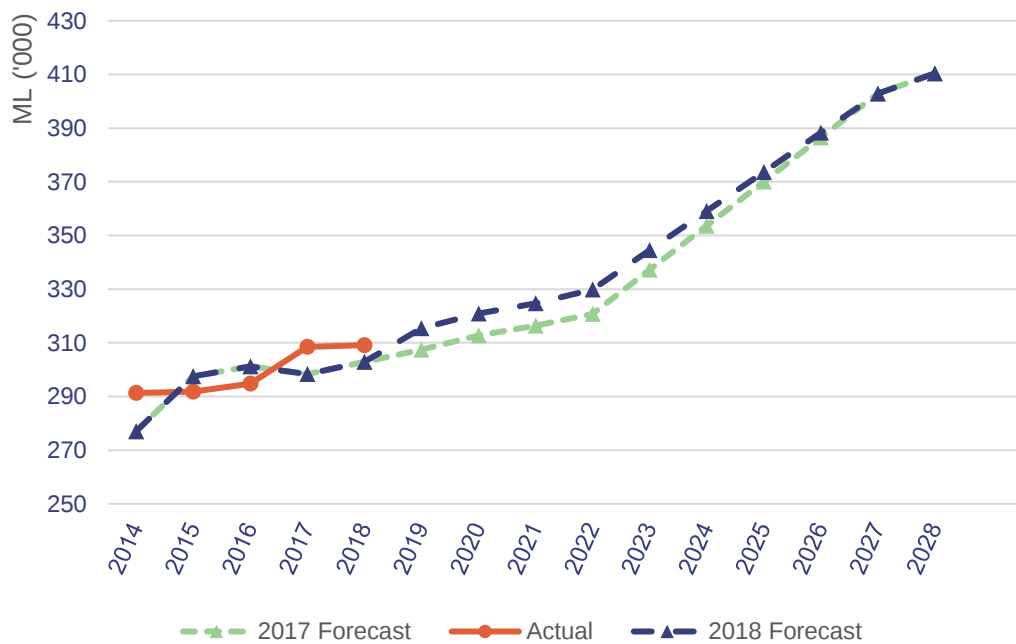
The overall increase of \$637.3 million in assets was largely due to movement in property, plant, and equipment (\$573.4 million). The major components contributing to this movement were additions (\$580 million), revaluations (\$444.4 million), and donated assets (\$170.7 million). Donated assets include \$90.3 million of water and sewerage infrastructure covering the areas of Brisbane, Ipswich, Scenic Rim, Lockyer Valley, and Somerset. These increases were offset by depreciation and impairment (\$569 million), and disposals and transfers (\$52.5 million). The most significant contribution was the \$419 million revaluation movement in Seqwater infrastructure assets; demand forecasts were the main factor for this movement. The largest movement in non-property, plant, and equipment assets was related to receivables which were higher compared to the previous year due to invoices being issued prior to 30 June 2018 remaining unpaid (but still within collection terms) at that date.

Demand inputs for measuring asset values

Forecasting demand remains a challenge for Seqwater, as historically demand for water has not reached the levels expected. Demand estimates form part of the assumptions and judgements used by management when they value their infrastructure assets and plan to recover debt through pricing.

Figure 3L shows a comparison between forecast and actual demand for water for the past five financial years, along with the projected future demand levels as per the 2017 and 2018 forecasts.

Figure 3L
Demand forecasts versus actuals

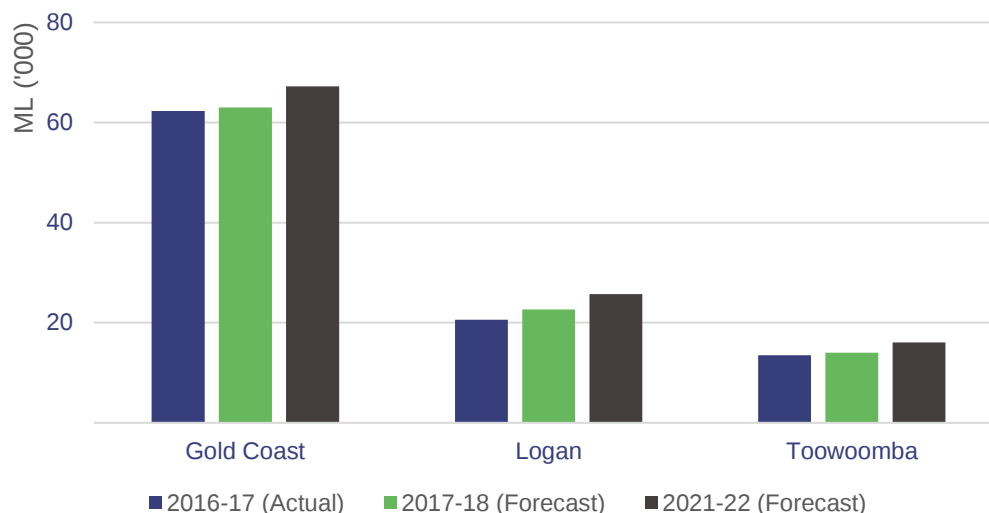


Source: Queensland Audit Office.

Seqwater's demand predictions for water consumption reflect future estimations of consumption and population growth. From 2018, Seqwater forecast an increase in demand of 51.8 ML for the period 2019 to 2026. This forecast increase was a contributing factor for the movement in Seqwater's infrastructure assets. Bulk water pricing, the other significant input into the future revenue streams produced by the assets, did not vary significantly from the previous year asset valuations.

This future demand forecast aligns with the anticipated increases reported in the 2016–17 water and wastewater performance reports by local governments in South East Queensland that manage water distribution in their regions.

Figure 3M
Water demand forecast by council



Note: 2017–18 actuals and related information on Redland City Council were unavailable as at writing of this report.

Source: Queensland Audit Office.

Figure 3M displays a weighted average annual demand increase of 3 per cent between 2016–17 and 2017–18, as predicted by the South East Queensland councils, and a further increase of 13 per cent by 2021–22.

Capital replenishment ratio

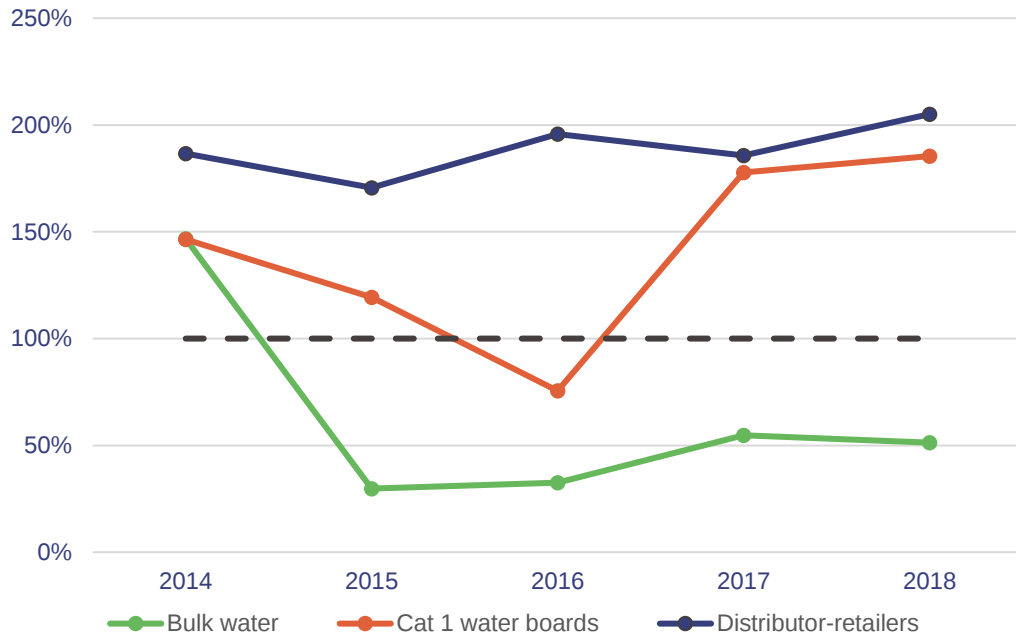
The capital replenishment ratio is a measure of investment sustainability. This ratio compares annual net purchases of non-financial assets to annual depreciation expense.

A ratio of less than 100 per cent may indicate that the size or condition of the overall asset base is diminishing.

A ratio of greater than 100 per cent means assets are being replaced or renewed at a greater rate than they are being depreciated. The ratio for the total sector has been above 100 per cent for four of the last five years.

The replenishment of assets by distributor–retailers has been consistently high, with a ratio of 189 per cent for the sum of the past five years (199 per cent). This is expected, given the strong growth in population that resulted in significant capital investment in water infrastructure assets and developer contributions.

Figure 3N
Capital replenishment ratio



Source: Queensland Audit Office.

The ratio for MIWB and GAWB (both category one water boards) has been above 100 per cent for four of the last five years, with an average of 141 per cent.

The collective ratio for bulk water entities SunWater and Seqwater has been below 100 per cent for the past four years, indicating a decreasing asset base. Seqwater's capital replenishment ratio is less than 50 per cent for all five years and the entity's reported capital commitments for 2018–19 indicate that the ratio will continue to trend below 50 per cent in the coming year. This is common for entities with large, long-life infrastructure assets such as dams, weirs, and pipelines, as these assets require significant capital investment up front and relatively low capital maintenance costs during their lives.

SunWater's capital replenishment ratio, on the other hand, was greater than 100 per cent for three of the five years (263.8 per cent for the five-year period), indicating a growing asset base. This trend will continue in the short to mid-term, with SunWater undertaking several significant infrastructure projects.

Cash pooling arrangement for government-owned corporations

In the 2016–17 State Budget, as part of its Debt Action Plan, the state government announced measures to reduce general government debt, which includes arrangements with government-owned corporations (GOCs) to better use the cash they hold. As a result, GOCs were required to forecast cash flows for a 12-month period and advance any surplus cash to the state government. If the requirements of the entities change, they are entitled to recall the cash, where necessary, and receive market-based interest on their deposits.

There is no impact on total assets, as the movement of cash has been recognised in receivables as an advances facility. SunWater is the only water entity affected by this arrangement. As at 30 June 2018, total cash advanced to the facility was \$55.3 million.

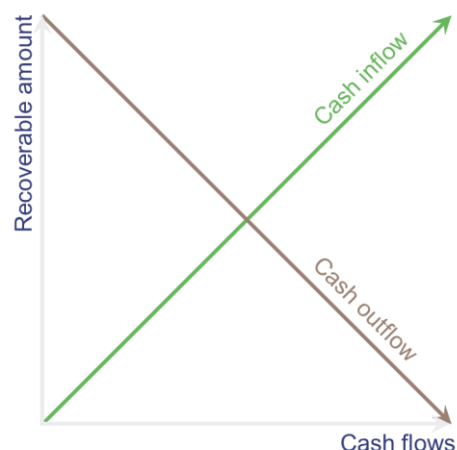
Future challenges and emerging risks

Impact of pricing on asset valuations

For water entities, future cash inflow estimates are affected by irrigation pricing and demand for water. Future cash outflows include costs expected to be incurred to operate the asset. Generally, higher future cash inflows or lower future cash outflows result in higher recoverable amounts. Lower future cash inflows or higher future cash outflows result in lower recoverable amounts.

At the end of each financial reporting period, SunWater estimates the recoverable amount of its infrastructure assets. This recoverable amount results from the future cash inflows and outflows expected from infrastructure assets, after considering the time value of money.

The current price path for SunWater's regulated irrigation pricing is in effect until 30 June 2019. SunWater expects QCA to begin reviewing irrigation prices in early 2018–19, and subsequently to recommend a future price path to relevant ministers. SunWater expects the pricing set by QCA to have minimal impact on its asset valuations.



Maintaining water security in South East Queensland

In response to severe drought and anticipated population growth, the state government commissioned construction of the Gold Coast Desalination Plant (GCDP) and the Western Corridor Recycled Water Scheme (WCRWS). Seqwater manages and maintains \$3 billion of climate-resilient manufactured water assets including GCDP and WCRWS. At full capacity, GCDP and WCRWS can produce 313 ML per day (the GCDP producing 133 ML and the WCRWS producing 180 ML), which is approximately one-third of daily water produced by Seqwater in 2017–18. Seqwater carries debt of \$2.8 billion associated with these assets, along with ongoing maintenance responsibilities.

In 2017–18, the GCDP produced 2 803 ML of water (six per cent of total capacity), representing one per cent of total water supplied by Seqwater. GCDP provides water supply during drought and flood or when major works are required on other assets in the water supply network (such as supplementing the Mount Crosby water treatment plant between May and August 2018 during the filter upgrade project).

GCDP currently operates in a hot standby mode, which means it is operated at a level required to maintain the plant in a state of readiness to deliver 33 per cent of capacity within 24 hours and 100 per cent within 72 hours.

WCRWS remained in care and maintenance mode throughout 2017–18, since reaching a fully decommissioned state in March 2015. This decommissioned state encompasses the entire WCRWS, including the three advanced water treatment plants, approximately 220 km of pipelines, and nine pumping stations. A small part of Luggage Point (i.e. QUU water recycling at the sewerage treatment plant) remains operational as part of the care and maintenance mode; remobilisation was commenced in January 2018 and completed by the end of June 2018. At that time, Luggage Point was capable of producing 23 ML per day of purified recycled water, which represents one-third of its production capability.

Figure 30 details the costs to maintain and operate the manufactured water assets in 2017–18 and a comparison with the previous year.

Figure 30
Manufactured water assets—annual maintenance and operating costs



Source: Queensland Audit Office.

Due to the unpredictable nature of climate change, Seqwater has developed a drought response plan that is ready for implementation if the trigger point is reached.

The first trigger point is 70 per cent of the combined volume of 12 major water grid storages.

At 60 per cent, GDCP would be required to operate at up to maximum capacity, and recommissioning of the WCRWS would commence.

The supply level for Seqwater's 12 dams that contribute to the water supply system was approximately 81 per cent as at 30 June 2018 (76 per cent as at 30 June 2017).

Seqwater will need to fund the costs of these responses if they are required.

Trigger points

70%—increase general water efficiency messaging

60%—plant up to full production

60%—scheme recommission commences

20%—contingent infrastructure construction commences

Townsville water security plan

Prior to March 2018, Townsville City water supply levels had been less than 30 per cent for more than two years, due to below-average rainfall. This led to a risk of water shortages and tight water restrictions. The state government, as part of the 2018–19 State Budget, committed \$225 million over four years to implement the findings of the Townsville Water Security Taskforce interim report.

SunWater is providing support to the Townsville City Council in the implementation of the Houghton Pipeline Duplication Project. SunWater will also increase the capacity of the Burdekin Houghton Main Channel. The completion of this project will allow SunWater to pump additional bulk water from the Burdekin Houghton Water Supply Scheme into the Ross River Dam during periods of very low rainfall.

Regional water security

In October 2017, SunWater, GAWB, and Building Queensland completed the business case for the Lower Fitzroy River Infrastructure Project (LFRIP). The business case investigated the construction of a new weir at Rookwood (Rookwood Weir), capable of supplying 76 000 ML per annum of high-priority water for customers. The project includes upgrades to and construction of roads and bridges and associated infrastructure. The 2018–19 Queensland State Budget allocated \$66 million in 2018–19 and a total of \$352 million for Rookwood Weir construction costs (these costs will be shared equally between the Queensland and Australian governments). Both governments are working constructively to finalise partnering arrangements for the LFRIP. In July 2018, the state government confirmed that SunWater would be the sole proponent to construct and operate the Rookwood Weir.

SunWater is undertaking a preliminary business case due for completion in 2018–19 for the potential raising of the Burdekin Falls Dam wall.

National Water Infrastructure Development Fund

The National Water Infrastructure Development Fund (NWIDF) is an initiative of the Australian Government to start the detailed planning necessary to build or augment existing water infrastructure. Through the Department of Natural Resources, Mines and Energy (formerly the Department of Energy and Water Supply), Queensland entities have been allocated 15 feasibility studies totalling up to \$24.8 million under Part 1 of the scheme.

Of the 15, the following four feasibility studies involved SunWater both directly and indirectly:

- Bundaberg Channel Capacity Upgrade feasibility study—SunWater has completed these works and finalised its report during June 2018
- Burdekin Haughton Channel Capacity Upgrade feasibility study—SunWater finalised its report in June 2018
- Lower Fitzroy River Infrastructure Project business case—SunWater was selected as the sole proponent to construct and operate the Rookwood Weir.
- Nullinga Dam and other options feasibility study—Building Queensland has commenced developing the Nullinga Dam and other options detailed business case in consultation with SunWater and the Department of Natural Resources, Mines and Energy and expects completion during the second quarter of the 2019 calendar year.

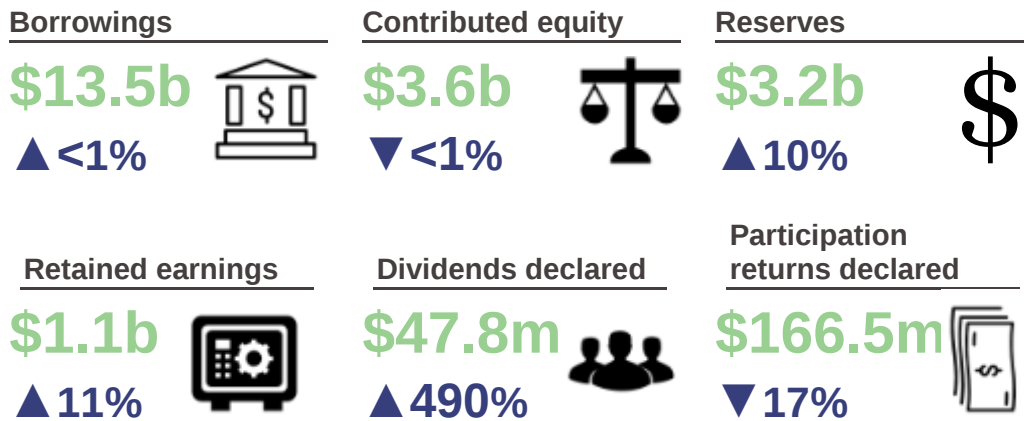
Part 2 of the scheme relates to providing funding contributions to co-fund the construction of water infrastructure projects. SunWater was granted funding from the NWIDF in June 2018 for two water supply schemes: Mareeba–Dimbulah (\$11.63 million) and Nogoia Mackenzie (\$3.01 million). These schemes are intended to improve operating efficiency and reduce water losses. SunWater expects completion of the Mareeba–Dimbulah scheme by June 2021 and the Nogoia Mackenzie scheme by June 2022.



Debt and equity

The water sector holds \$13.6 billion in borrowings and \$7.9 billion in total equity. Debt in the water sector is made up of borrowings from the state government.

Figure 3P
Major components of debt and equity for all entities in 2017–18



Note: Contributed equity is net of other transactions with owners.

Source: Queensland Audit Office.

Borrowings and contributed equity remained relatively consistent with the previous year. Reserves grew by 10 per cent in 2017–18, mostly due to a revaluation increment on Seqwater's assets. Retained earnings increased by 11 per cent because of the profit withheld by the water distributor–retailers. Dividends increased because SunWater declared a dividend of \$39.7 million, compared to no dividend in 2016–17. Participation returns decreased by 17 per cent because Unitywater paid out a \$0.7 million return. The decrease in Unitywater's participation return was offset by an increase of \$31.1 million in income tax due to participating local governments (this resulted from Unitywater's request to amend its 2016–17 tax returns to align the useful lives of certain asset classes for both accounting and tax purposes).

Contributed equity is the investment in the entity by shareholders.

Reserves represent the valuation increases above the historical cost of the entity's assets.

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

Events and transactions affecting debt and equity this year

Movement in debt

The entities' borrowings across the sector increased by \$30.4 million in 2017–18. GAWB increased borrowings by \$30 million to fund the acquisition of its corporate building, the completion of the Lower Fitzroy River Infrastructure Project business case, and construction of an offline storage facility at Toolooa Bends (O'Connell). MIWB paid \$815 000 in borrowings back to the state government.

All other entities in the sector have not significantly increased their debt this year and have paid interest costs for all debt.

Seqwater has a highly geared capital structure with a gearing ratio of 85 percent at 30 June 2018 (86 per cent at 30 June 2017). This is a result of historical under-recovery of operating costs and significant capital investment in previous years.

Figure 3Q shows a breakdown of the debt held by Seqwater for the past three years, which has not moved materially during this time.

Figure 3Q
Seqwater borrowings year on year

Facility	30 June		
	2018 \$000	2017 \$000	2016 \$000
Water grid manager debt	2 157 527	2 157 978	2 148 880
Drought assets debt	5 407 999	5 408 178	5 410 472
Non-drought assets debt	1 860 071	1 860 182	1 861 050
Total	9 425 597	9 426 338	9 420 402
Loan interest payable	41 014	41 755	35 819
Loan principal	9 384 583	10 064 335	10 064 335
Redraw facility	–	(679 752)	(679 752)

Note: Seqwater's redraw facility was cancelled effective 30 April 2018. The balance of the facility was applied against the loan principal.

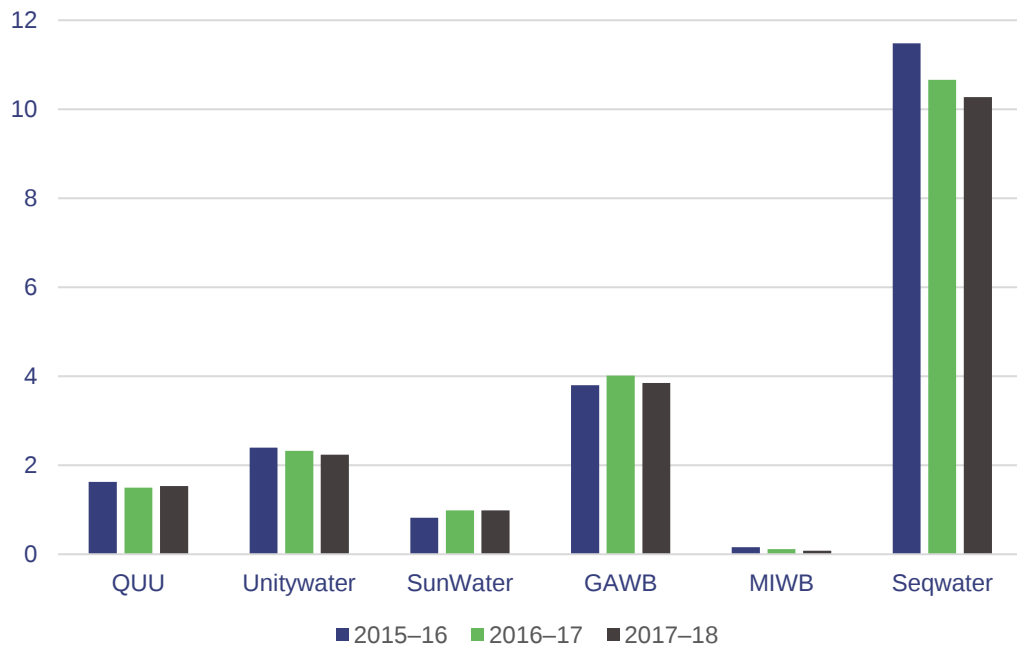
Source: Queensland Audit Office.

The state government has set the future prices for Seqwater, which should now allow for repayment of water grid manager debt by 2027–28.

Debt to revenue ratio

For the sector, debt as at 30 June 2018 was over 4.1 times revenue, which is consistent with the previous year. Figure 3R shows the debt to revenue ratio for the past three financial years by entity.

Figure 3R
Debt to revenue ratio for water entities



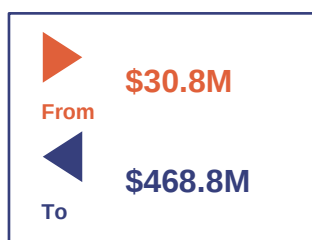
Source: Queensland Audit Office.

The debt to revenue ratio assesses an entity's ability to pay the principal and interest on borrowings, as and when they fall due, from the funds the entity generates—the higher the ratio, the more difficult it is to service and repay debt.

Seqwater continues to have a significantly higher debt to revenue ratio than all other water entities, attributed to the loans it acquired from the merger with other bulk water entities.

The majority of loans held with Queensland Treasury Corporation have variable interest rates. The risk of interest rate movements can have a significant impact on interest payments and, therefore, the ability of Seqwater to pay other ongoing operating expenses in future. In terms of sensitivity, a movement of just one per cent in interest rates would result in a corresponding increase in borrowing costs of approximately \$3.1 million per annum.

Flows from and to governments



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

Flows to and from government affect an entity's ability to meet its expense commitments, replace and grow its asset base, and repay debt. Water entities pay dividends, participation returns, income tax equivalents, and competitive neutrality fees to local and state government. The water entities receive community service obligations, borrowings, and state government grants for selected activities.

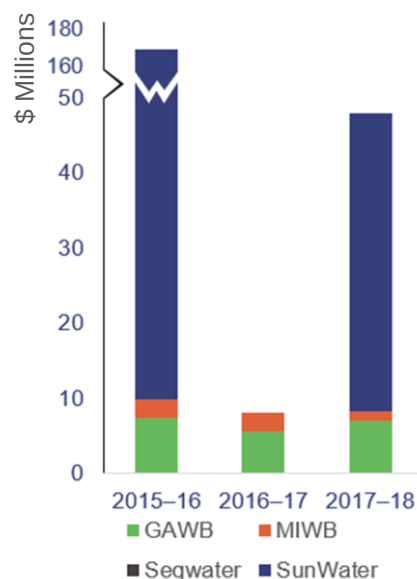
We assessed the effect of net flows on the financial results of these entities. The water sector recorded net flows to the government of \$438 million in 2017–18 (2016–17: \$394.9 million). The increase in the current year is primarily due to higher income tax equivalent recognised by Unitywater, reflecting its one-off tax adjustment and higher profit before income tax of \$206 million (2016–17: \$180.3 million).

Declared dividends and participation returns

Water entities declared a total of \$224.7 million in dividends to the state government over the past three years. SunWater contributed 88 per cent of the total, the majority being a special dividend from retained earnings declared in 2015–16. Seqwater has not declared any dividends due to continued losses.

During 2017–18, three water entities declared dividends totalling \$47.8 million (up from \$8.1 million in 2016–17). The significantly higher dividends are primarily due to SunWater retaining its 2016–17 profits to contribute to future dam improvement projects.

Figure 3S
Trend of declared dividends

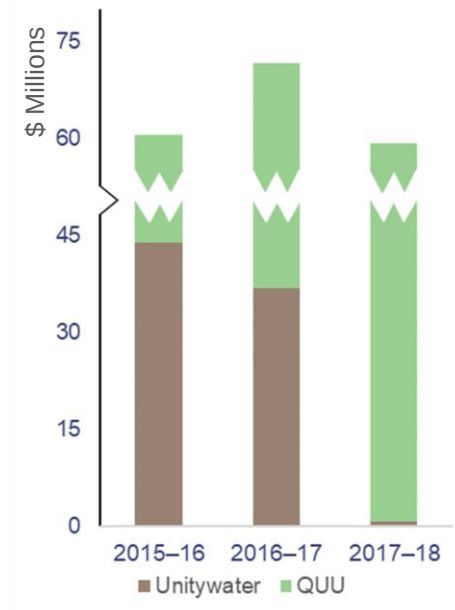


Source: Queensland Audit Office.

Participation returns are declared to local governments by QUU and Unitywater, in accordance with the participation agreements. QUU's participation returns are based on a percentage of net profit after tax, excluding any non-cash donated assets. Unitywater's participation returns are based on the five-year forward estimates provided to participating councils. Figure 3T shows that water distributor–retailers declared a total of \$538.5 million in participation returns over the past three years.

Total participation returns declared in 2017–18 were \$166.5 million, a decrease of \$35.2 million from the previous year. QUU's declared participation return was \$165.8 million, an increase of \$0.9 million from the previous year. Unitywater's declared participation return of \$0.7 million was significantly less than the \$36.9 million declared in 2016–17. In 2017–18, Unitywater requested amendment of its 2016–17 tax returns to align the useful lives of certain asset classes for both accounting and tax purposes. The amendment resulted in Unitywater's decreased participation returns but increased by \$31.1 million the income tax due to participating local governments.

Figure 3T
Trend of participation returns



Source: Queensland Audit Office.

Future challenges and emerging risks

AASB 16 Leases

The introduction of AASB 16 *Leases*, for reporting periods beginning on or after 1 January 2019, will introduce a single lease accounting model for lessees. This will result in almost all operating leases being recognised on the balance sheet, as the distinction between operating and finance leases is removed. Under this standard, most leases previously not reported as assets and liabilities will be brought onto the balance sheet. The timing of recognition of expenses will also change.

In 2017–18, the water sector, as lessees, collectively reported future operating leases of approximately \$98.9 million. Some of these will be brought onto the balance sheet as right of use asset and corresponding liability when this standard becomes effective. The water entities will continue their assessment on the impact of this standard in 2018–19.

Local management arrangements

The state government legislated the *Water (Local Management Arrangements) Amendment Act 2017* to facilitate the future implementation of LMA for up to eight of SunWater's channel irrigation schemes (infrastructure to distribute water from its source to irrigators). The arrangements investigate the potential transfer of distribution schemes, such as channels, pipes, and drains, out of public ownership to irrigator ownership. They will not consider bulk water supply assets, such as major dams. The state government has agreed a number of high-level principles which govern the transfer to LMA, including that:

- the benefits of implementing local management outweigh the costs of implementation
- there is strong support from customers for the transfer to local management
- the schemes demonstrate that they will be financially viable under local management.

Four of the channel irrigation schemes (St George, Theodore, Emerald, and Eton) have either completed transferring to, or commenced agreeing terms to transfer to, LMA arrangements at no cost to the recipients of the assets. Five special purpose entities controlled by the Department of Natural Resources, Mines and Energy (formerly the Department of Energy and Water Supply) have been established to facilitate the transfer.

Of the remaining four irrigation schemes, both Burdekin–Haughton and Mareeba–Dimbulah have submitted revised business proposals for the state government to consider, with Bundaberg and Lower Mary withdrawing from the process.

The respective investigation boards for the Bundaberg and Lower Mary channel irrigation schemes concluded that they would not meet the first principle governing an LMA project (that the long-term benefits to the state government of introducing LMA should outweigh the costs of implementation). As a result, these schemes will continue to be owned and managed by SunWater.

Figure 3U
Status of transfer process

Channel irrigation schemes	Status at 30 June 2018
St George Distribution System	Transferred to Mallawa Irrigation Ltd on 30 June 2018
Theodore Distribution System	Scheduled to transfer to Theodore Water Pty Ltd on 30 September 2018
Emerald Distribution System	Targeted to transfer by 31 March 2019 assuming final terms of transfer are agreed by the respective boards and support for transfer of more than 70 per cent of the water allocation
Eton Distribution System	
Burdekin–Haughton Distribution System	Revised business proposals have been submitted to the state government
Mareeba–Dimbulah Distribution System	
Bundaberg Distribution System	Withdrew from the transfer process in December 2017 as a result of the detailed investigations
Lower Mary Distribution System	

Source: Queensland Audit Office.

4. Internal controls

This chapter assesses the effectiveness of the internal controls designed, implemented, and maintained by entities in the sector as they relate to our audit.

Through our analysis, we aim to promote stronger internal control frameworks. We also aim to mitigate financial losses and damage to public sector reputation by initiating effective responses to identified control weaknesses.

Conclusion

We assessed the control environments for each entity. In most cases we found it was suitably designed to prevent, or detect and correct, material misstatements in their financial statements and non-compliance with legislative requirements. For those entities, the control environment supported our reliance on their internal control systems. As a result of significant deficiencies identified in 2016–17, we did not rely on SunWater's internal controls in 2017–18. Management has since resolved these issues.

We did not identify any new significant internal control deficiencies in the sector. We are satisfied that management has implemented corrective action to rectify the deficiencies that have been raised in prior years.

The risk of undetected fraud or errors within financial systems and entities' financial reporting remained stable from prior years.

Our audit of internal controls

We assess internal controls to ensure they are suitably designed to:

- prevent, or detect and correct, material misstatements in the financial statements
- achieve compliance with legislative requirements
- use public resources effectively.

Where we identify controls that we plan to rely on, we test how effectively these controls are operating to ensure they are functioning as intended.

We are required to communicate to management any deficiencies in internal controls.

Our rating of internal control deficiencies

Our rating of internal control deficiencies allows management to gauge relative importance and prioritise remedial actions.

We increase the rating from a deficiency to a significant deficiency when:

A **deficiency** arises when internal controls are ineffective or missing and are unable to prevent, or detect and correct, misstatements in the financial statements. A deficiency may also result in non-compliance with policies and applicable laws and regulations and/or inappropriate use of public resources.

- we consider immediate remedial action is required
- there is a risk of material misstatement in the financial statements
- there is a risk to reputation
- the non-compliance with policies and applicable laws and regulations is significant
- there is potential to cause financial loss including fraud
- management has not taken appropriate, timely action to resolve the deficiency.

Control deficiencies categorised by COSO component

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

The framework identifies five components that need to be present and operating together for an effective internal control system. Appendix H explains these components.

Figure 4A shows control deficiencies (categorised by COSO component) reported to the entities for the 2017–18 financial year.

Figure 4A
Summary of internal control deficiencies for the six entities

 Control environment <i>Structures, policies, attitudes, and values that influence daily operations</i>	 Risk assessment <i>Processes for identifying, assessing, and managing risk</i>	 Control activities <i>Implementation of policies and procedures to prevent or detect errors and safeguard assets</i>	 Information and communication <i>Systems to capture and communicate information to achieve reliable financial reporting</i>	 Monitoring activities <i>Oversight of internal controls for existence and effectiveness</i>
No deficiencies identified	No deficiencies identified	Three deficiencies	No deficiencies identified	No deficiencies identified

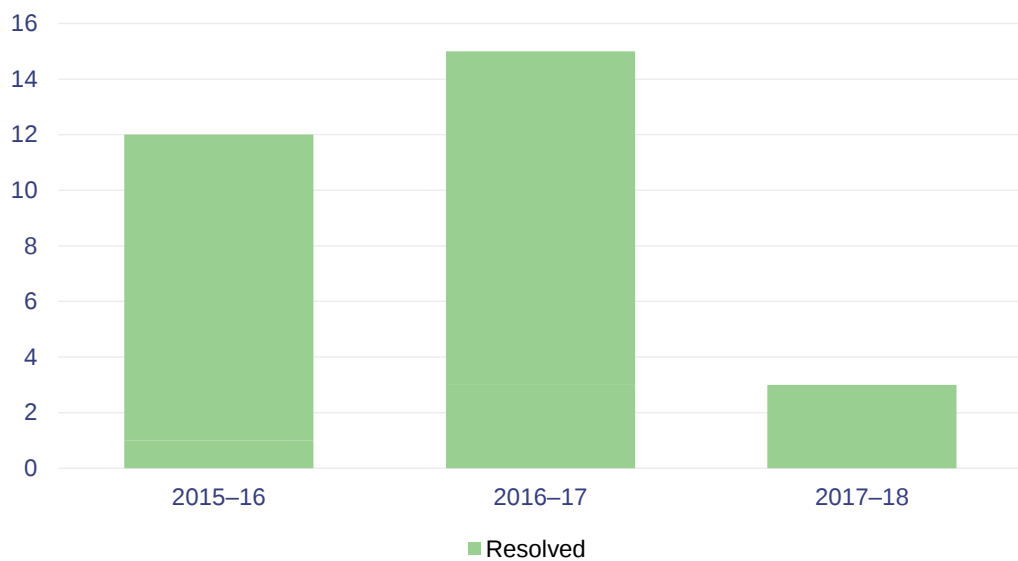
Source: Queensland Audit Office adapted from Committee of the Sponsoring Organizations of the Treadway Commission (COSO) internal controls framework.

Status of internal control deficiencies

Management and those charged with governance are responsible for the efficient and effective operation of internal controls. An audit committee (or its equivalent) may be established to assist those charged with governance to obtain assurance over internal control systems. An audit committee is responsible for considering audit findings, management responses to those findings, and the status of audit recommendations.

We have analysed the appropriateness and timeliness of remedial action undertaken to resolve any audit matters we have identified. Figure 4B presents the status of internal control deficiencies reported over the last three years at 31 August 2018.

Figure 4B
Resolved control issues reported to management over the last three years



Source: Queensland Audit Office.

All six entities addressed their identified control deficiencies by the agreed dates. We found that, overall, the sector has improved in the timely resolution of control deficiencies. Proactive and timely resolution of control deficiencies indicates a strong control environment.

In 2017–18, Unitywater undertook a review to improve internal controls across its 'asset capitalisation to dispose process' to address gaps and identified weaknesses. This resulted in a number of changes over controls and the overarching control framework underpinning the process.

As a result of significant deficiencies identified in 2016–17, we only assessed the design and implementation of SunWater's internal controls in 2017–18. Management has since resolved these issues and we will reassess our audit approach in 2018–19.

Appendices

A.	Full responses from agencies	38
B.	Water entities	41
C.	Entities not preparing financial reports	43
D.	Legislative context	44
E.	Our assessment of financial statement preparation	46
F.	Key audit matters	49
G.	Key financial information	50
H.	Our audit of internal controls	51
I.	Glossary	54



A. Full responses from agencies

As mandated in Section 64 of the *Auditor-General Act 2009*, the Queensland Audit Office gave a copy of this report with a request for comments to the:

- Premier and Minister for Trade
- Deputy Premier, Treasurer and Minister for Aboriginal and Torres Strait Islander Partnerships
- Minister for Natural Resources, Mines and Energy
- Director-General, Department of Natural Resources, Mines and Energy
- Chief Executive Officers for:
 - Gladstone Area Water Board
 - Mount Isa Water Board
 - Queensland Urban Utilities
 - Seqwater
 - SunWater
 - Unitywater
 - Queensland Competition Authority
- Under Treasurer, Queensland Treasury.

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

This appendix contains their detailed responses to our report.

Comments received from Chair, Gladstone Area Water Board



Mr Brendan Worrall
Auditor-General
Queensland Audit Office
PO Box 15396
CITY EAST QLD 4002

29 October 2018



Dear Mr Worrall,

RE: 2018-19 Water Sector: 2017-18 results of financial audits

Thankyou for the opportunity to respond to the draft 2017-18 results of financial audits.

GAWB is pleased to have received an unmodified audit opinion for the 2016-17 financial year, confirming that GAWB has complied with the Australian Accounting Standards and relevant legislation. I also note that GAWB controls are rated as Effective, a reflection of our attention to governance.

I would also like to acknowledge the professionalism of your team in the management of this recent audit.

Yours sincerely


Denis Cook
Chair

Page 1 of 1

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Comments received from Acting Under Treasurer, Queensland Treasury



Queensland Treasury

Our Ref: 04666-2018
Your Ref: 11980

30 OCT 2018

Mr Brendan Worrall
Auditor-General of Queensland
Queensland Audit Office
PO Box 15396
CITY EAST QLD 4002



Dear Mr Worrall 

Thank you for your letter of 16 October 2018 regarding the Queensland Audit Office (QAO) draft report Water: 2017-18 results of financial audits (the Report) and the opportunity to provide comments. The draft report presents a useful overview of the water sector entities in Queensland.

I note that unmodified audit opinions were provided on all financial statements for 2017-18 for the water sector entities. I welcome the QAO's advice that all water entities are financially sustainable, noting that a range of factors underpin this sustainability.

It is pleasing to note the sector's continued improvements acknowledged in the Report. For example, continued improvement to asset valuation and financial reporting practices; the resolution of internal control deficiencies identified in 2016-17, and the entities continued focus on implementing cost reduction strategies.

I understand QAO officers and Queensland Treasury and the Department of Natural Resources, Mines and Energy officers have discussed the draft Report. I appreciate the QAO's constructive engagement and consultative approach.

If you would like to discuss any of the comments please contact Mr Michael Mamczur, Acting Director, Shareholder and Structural Policy Division on (07) 3035 1490 or michael.mamczur@treasury.qld.gov.au.

Yours sincerely



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Website www.treasury.qld.gov.au
ABN 90 856 020 239

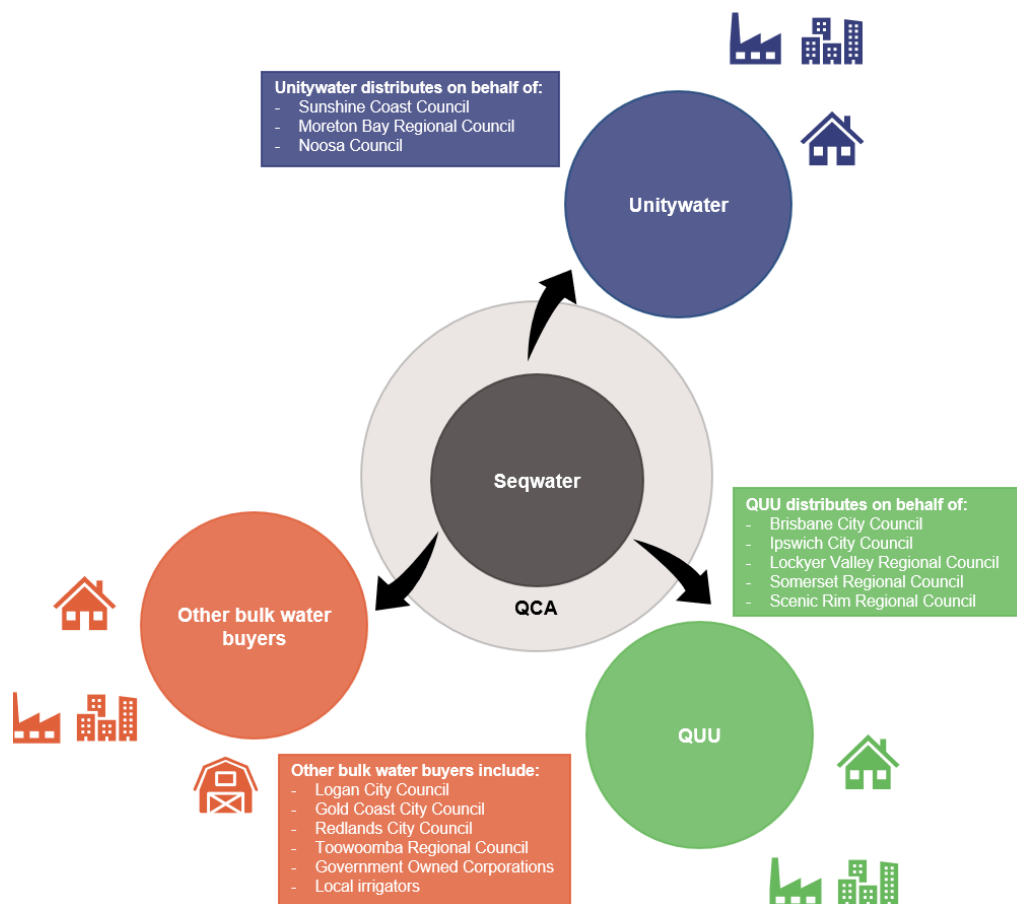
Water entities

South East Queensland

Figure B1 shows that, within South East Queensland, Seqwater sells treated bulk water to 12 local council regions, either through distributor–retailers (Unitywater and Queensland Urban Utilities (QUU)), or directly to councils (e.g. Gold Coast City Council and Logan City Council) who operate their own retail operations. Seqwater also provides bulk water directly to certain large corporations and irrigators. Water distributor–retailers (or councils that operate their own) then on-sell water to households or businesses.

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

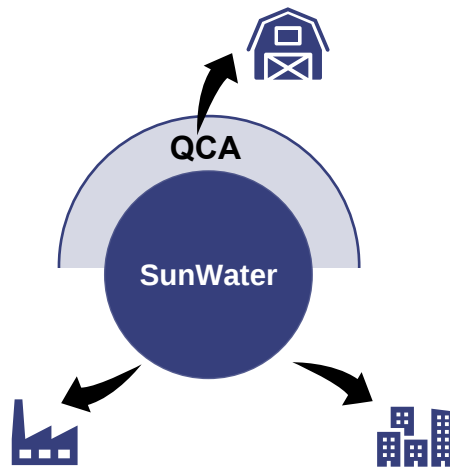
Figure B1
South East Queensland water distribution



Source: Queensland Audit Office.

Outside South East Queensland

Figure B2
Outside South East Queensland bulk water supply



Outside of South East Queensland, SunWater operates a significant amount of the bulk water infrastructure that supplies councils, irrigators and industrial customers. Unlike Seqwater, SunWater (Figure B2) does not retain exclusive rights to sell the water under management. Public and private sector entities purchase and sell water entitlements to one another. This passes the risk of drought and other water shortages onto the carrier of the water allocation entitlement.

Source: Queensland Audit Office.

Figure B3
Outside South East Queensland retail water supply



Source: Queensland Audit Office.

Figure B3 shows that retail customers' water is sourced, treated, and distributed by local government-owned infrastructure or a variety of water boards. The water boards are split into category one boards, which are for profit entities, and category two boards, which are not for profit. Category one boards include Gladstone Area Water Board (GAWB) and Mount Isa Water Board (MIWB); category two covers all others. These boards also provide bulk water to large irrigators and industrial customers.

B. Entities not preparing financial reports

The Auditor-General will not issue audit opinions for the following controlled public sector entities for the 2017–18 financial year, as they have not produced a financial report.

Public sector entity	Reason for not preparing financial reports
Bulk water supplier	
Controlled entities of SunWater Limited	
North West Queensland Water Pipeline Pty Ltd	Deed of cross guarantee ASIC order
Eungella Water Pipeline Pty Ltd	Deed of cross guarantee ASIC order
Burnett Water Pty Ltd	Deed of cross guarantee ASIC order
Distributor–retailer	
Controlled entity of Northern SEQ Distributor–Retailer Authority (trading as Unitywater)	
Unitywater Properties Pty Ltd	Non-reporting

Source: Queensland Audit Office.



C. Legislative context

Framework

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

Entity type	Entity	Legislative framework	Legislated deadline
Statutory bodies	Queensland Bulk Water Supply Authority (trading as Seqwater)	<i>Financial Accountability Act 2001</i> <i>Financial and Performance Management Standard 2009</i>	31 August 2018
	Northern SEQ Distributor–Retailer Authority (trading as Unitywater)	<i>Financial and Performance Management Standard 2009</i>	
	Central SEQ Distributor–Retailer Authority (trading as Queensland Urban Utilities)	Unitywater and Queensland Urban Utilities only: <i>South-East Queensland Water (Distribution and Retail Restructuring) Act 2009</i>	
	Gladstone Area Water Board		
	Mount Isa Water Board		
Government-owned corporations (GOC)	SunWater Limited	<i>Government Owned Corporations Act 1993</i> <i>Corporations Act 2001</i> <i>Corporations Regulations 2001</i>	31 August 2018

Source: Queensland Audit Office.

Accountability requirements

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

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

Queensland Government financial statements

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

These financial statements are used by a broad range of parties including parliamentarians, taxpayers, employees, local governments, 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 and in accordance with relevant legislative requirements.

We express an unmodified opinion when the financial statements are prepared in accordance with the relevant legislative requirements and Australian accounting standards. We modify our audit opinion when financial statements do not comply with the relevant legislative requirements and Australian accounting standards 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. An emphasis of matter does not change the audit opinion.



D. Our assessment of financial statement preparation

In assessing the effectiveness of financial statement preparation processes we considered three components—the year-end close process, the timeliness of financial statements, and the quality of financial statements.

We assess financial statement preparation processes under the following criteria.

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. This year we assessed processes for year-end financial statement preparation against the following key targets:

- prepare pro-forma financial statements by 31 March
- resolve known accounting issues by 30 April
- complete non-current asset valuations by 31 May
- complete early-close processes
- conclude all asset stocktakes by 30 June.

These targets were developed based on advice previously issued by the Under Treasurer in 2014, and better practice identified in other jurisdictions.

Rating scale	Assessment criteria—year-end close process
● Fully implemented	All key processes completed by the target date
● Partially implemented	Three key process completed within two weeks of the target date
● Not implemented	Fewer than two key processes completed within two weeks of the target date

Timeliness of draft financial statements

We assess the timeliness of draft financial statements by considering whether entities prepared financial statements according to the timetables set by management. This includes providing auditors with the first complete draft of financial statements by the agreed date. A complete draft is one that management is ready to sign and where no material errors or adjustments are expected.

Rating scale	Assessment criteria—timeliness of draft financial statements
● Timely	Acceptable draft financial statements received on or prior to the planned date
● Generally timely	Acceptable draft financial statements received within two days after the planned date
● Not timely	Acceptable draft financial statements received greater than two days after the planned date

Quality of draft financial statements

We assess the quality of financial statements in terms of adjustments made between the first draft of the financial statements and the final version we receive. This includes adjustments to current year, prior year, and other disclosures. This is an indicator of how effective the review of the financial statements is at identifying and correcting errors.

Rating scale	Assessment criteria—quality of draft financial statements
● No adjustments	No adjustments were required
● No significant adjustments	Immaterial adjustments to financial statements
● Significant adjustments	Material adjustments to financial statement components



Result summary

This table summarises our assessment of the six entities' financial statement preparation processes

Entity	Year-end close process	Timeliness of draft financial statements	Quality of draft financial statements
Seqwater	●	●	●
SunWater	●	●	●
Unitywater	●	●	●
QUU	●	●	●
GAWB	●	●	●
MIWB	●	●	●

Source: Queensland Audit Office.

E. Key audit matters

This table summarises the key audit matters reported for two of the water sector entities:

Key audit matter	Entity
Valuation of infrastructure assets	Seqwater SunWater Limited
Estimation of useful lives for depreciation expense	Seqwater SunWater Limited

Source: Queensland Audit Office.



F. Key financial information

The following tables display an overall snapshot of the key financial information of the water entities for the past three financial years.

2017–18 Entity	Assets	Liabilities	Revenue	Expenses	Net profit (loss)	Shareholder returns	Finance costs	New borrowings	Repayments of borrowings
Seqwater	11 695 512	9 980 948	913 512	1 020 030	(75 701)	–	509 469	–	–
SunWater	1 012 721	562 426	287 747	230 310	39 661	39 661	14 723	–	16
Unitywater	3 777 942	1 858 898	696 248	490 211	119 405	713	77 523	37 002	37 000
QUU	5 902 274	2 550 041	1 348 322	985 199	253 281	165 801	96 112	–	–
GAWB	768 463	371 544	71 019	58 742	8 683	6 948	9 940	30 000	–
MIWB	163 351	30 328	22 284	20 141	1 516	1 213	93	–	815

2016–17 Entity	Assets	Liabilities	Revenue	Expenses	Net profit (loss)	Shareholder returns	Finance costs	New borrowings	Repayments of borrowings
Seqwater	11 386 146	9 892 007	880 294	1 029 246	(105 513)	–	538 936	–	–
SunWater	996 551	541 539	287 927	236 874	36 048	–	15 194	40 000	1 548
Unitywater	3 619 542	1 819 190	669 523	489 199	135 507	36 888	79 848	78 876	78 878
QUU	5 800 676	2 536 456	1 382 101	965 270	291 449	164 872	97 561	–	–
GAWB	721 748	339 938	60 506	50 621	6 870	5 496	8 902	11 500	–
MIWB	158 310	31 044	22 536	17 841	3 282	2 626	175	–	732

2015–16 Entity	Assets	Liabilities	Revenue	Expenses	Net profit (loss)	Shareholder returns	Finance costs	New borrowings	Repayments of borrowings
Seqwater	11 538 627	9 938 975	818 347	1 093 077	(195 593)	–	551 814	114 364	–
SunWater	1 224 802	805 838	296 305	255 623	29 009	289 009	20 536	–	21 751
Unitywater	3 498 677	1 796 944	650 411	465 157	136 310	43 865	80 789	102 757	105 209
QUU	5 633 490	2 496 246	1 269 089	934 110	232 231	126 365	94 292	471 282	471 282
GAWB	672 322	317 271	61 613	48 531	9 110	7 289	8 831	–	–
MIWB	153 842	28 338	20 417	16 025	3 063	2 463	200	–	698

Note: Amounts are in \$'000s.

Source: Queensland Audit Office.

G. Our audit of internal controls

Internal controls are designed, implemented, and maintained by entities to mitigate risks that may prevent them from achieving reliable financial reporting, effective and efficient operations, and compliance with applicable laws and regulations.

In undertaking our audit, we are required under the Australian auditing standards to obtain an understanding of an entity's internal controls relevant to the preparation of the financial statements.

We assess internal controls to ensure they are suitably designed to:

- prevent, or detect and correct, material misstatements in the financial statements
- achieve compliance with legislative requirements
- ensure appropriate use of public resources.

Our assessment determines the nature, timing, and extent of the testing we perform to address the risk of material misstatement in the financial statements.

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 addresses the risk of material misstatement and facilitates an efficient audit.

Where we identify deficiencies in internal controls, we determine the impact on our audit approach, considering whether additional audit procedures are necessary to address the risk of material misstatement in the financial statements.

Our audit procedures are designed to address the risk of material misstatement, so we can express an opinion on the financial statements. We do not express an opinion on the effectiveness of internal controls.

Internal controls framework

We categorise 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 identifies five components for a successful internal control system. These components are explained in the following paragraphs.



Control environment



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

The control environment is defined as the structures, policies, attitudes, and values that influence day-to-day operations. As the control environment is closely linked to an entity's overarching governance and culture, it is important that the control environment provides a strong foundation for the other components of internal control.

In assessing the design and implementation of the control environment we consider whether:

- those charged with governance are independent, appropriately qualified, experienced, and active in challenging management. This ensures they receive the right information at the right time to enable informed decision making
- policies and procedures are established and communicated so people with the right qualifications and experiences are recruited, they understand their role in the organisation, and they also understand management's expectations regarding internal controls, financial reporting, and misconduct, including fraud.

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 how management agrees risks should be identified, assessed, and managed.

To appropriately manage business risks, management can either accept the risk if it is minor

or mitigate the risk to an acceptable level by implementing appropriately designed controls. Management can also eliminate risks entirely by choosing to exit from a risky business venture.

Control activities



- General information technology controls
- Automated controls
- Manual controls

Control activities are the actions taken to implement policies and procedures in accordance with management directives and ensure identified risks are addressed. These activities operate at all levels and in all functions. They can be designed to prevent or detect errors entering financial systems.

The mix of control activities can be categorised into general information technology controls, automated controls, and manual controls.

General information technology controls

General information technology controls form the basis of the automated systems control environment. They include controls over information systems security, user access, and system changes. These controls address the risk of unauthorised access and changes to systems and data.

Automated control activities

Automated controls are embedded within information technology systems. These controls can improve timeliness, availability, and accuracy of information by consistently applying predefined business rules. They enable entities to perform complex calculations when processing large volumes of transactions. They also improve the effectiveness of financial delegations and the segregation of duties.

Manual control activities

Manual controls contain a human element, which can provide the opportunity to assess the reasonableness and appropriateness of transactions. However, these controls may be less reliable than automated elements as 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 information technology systems.

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 in which responsibilities are communicated.

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

Monitoring activities



- Management supervision
- Self-assessment
- Internal audit

Monitoring activities are the methods management uses to oversee and assess whether internal controls are present and operating effectively. This may be achieved through ongoing supervision, periodic self-assessments, and separate evaluations. Monitoring activities 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 responsible for implementing controls and resolving control deficiencies. These two functions work together to ensure that internal control deficiencies are identified and then resolved in a timely manner.



H. Glossary

Term	Definition
Accountability	Responsibility of public sector entities to achieve their objectives of delivering reliable financial reporting, effective and efficient operations, compliance with applicable laws, and reports 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.
Asset valuation	The process of determining the fair value of an asset.
Audit committee	A committee intended to provide assistance to the accountable officer or statutory body in discharging their obligations. Duties and responsibilities can involve oversight of all or a combination of the following: ▪ effectiveness and reliability of internal controls ▪ quality and integrity of accounting and reporting practices ▪ effectiveness of performance management ▪ legal and regulatory compliance ▪ auditor's qualifications and independence ▪ performance of the internal audit function and external auditors.
<i>Auditor-General Act 2009</i>	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.
Audit opinion	A written expression of the auditor's overall conclusion on the financial statements, based on audit evidence obtained.
Australian accounting standards	The rules by which financial statements are prepared in Australia. These standards ensure consistency in measuring and reporting on similar transactions.

Term	Definition
Australian Accounting Standards Board (AASB)	An Australian Government agency that develops and maintains accounting standards applicable to entities in the private and public sectors of the Australian economy.
Bulk water suppliers	Water entities that provide bulk water services to water service providers.
Capital expenditure	Expenditure to acquire assets or improve the service potential of existing assets that is capitalised to the balance sheet.
Category one water board	For-profit water authorities established under the <i>Water Act 2000</i> , including Gladstone Area Water Board and Mount Isa Water Board.
Category two water board	Not-for-profit water authorities other than category one water authorities.
Contributed equity	Investment in an entity by shareholders.
Control environment	The structures, policies, attitudes, and values that influence daily operations. A component of internal control that provides the foundation for other elements of internal control.
Controlled entity	Entity controlled or owned by one or more public sector entities.
Community service obligations (CSO)	Government payments to 'for-profit' entities to provide services that are not sustainable otherwise.
Deficiency	Arises when internal controls are ineffective or missing and are unable to prevent, or detect and correct, misstatements in the financial statements. A deficiency may also result in non-compliance with policies and applicable laws and regulations and/or inappropriate use of public resources.
Depreciation	The systematic allocation of a fixed asset's capital value as an expense over its expected useful life, to take account of normal usage, obsolescence, or the passage of time.
Distributor–retailers	Entities established under the <i>South-East Queensland Water (Distribution and Retail Restructuring) Act 2009</i> with the function to purchase and distribute water, perform water and wastewater services, charge customers for relevant services, manage customer enquiries, service requests and complaints, perform functions relating to trade waste and seepage, and perform particular planning and development assessment functions under the <i>Planning Act 2016</i> .



Term	Definition
Dividends	A portion of a statutory body or government-owned corporation's profits which it pays to its shareholders.
Drought assets	Assets that were constructed in response to severe drought, such as the Gold Coast Desalination Plant and Western Corridor Recycled Water Scheme. These assets do not form part of the integral water source and/or core supply of water.
Emphasis of matter	A paragraph included with an audit opinion to highlight an issue that the auditor believes the users of the financial statements need to be aware of. The inclusion of an emphasis of matter paragraph does not modify the audit opinion.
Fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
<i>Financial Accountability Act 2009</i>	An Act of the State of Queensland that establishes accountability for the administration of the state's finances and financial administration of departments and statutory bodies, as well as annual reporting to parliament by departments and statutory bodies.
Financial and Performance Management Standard 2009	Subordinate legislation of the State of Queensland that provides a framework for an accountable officer of a department, or a statutory body, to develop and implement systems, practices, and controls for the efficient, effective, and economic financial and performance management of the department or statutory body.
Financial statements	Report on an entity's financial performance over a period of time and financial position at a point in time, prepared in accordance with a financial reporting framework. It includes a profit and loss statement, balance sheet, cash flow statement, statement of changes in equity, and accompanying notes disclosing how amounts have been recognised and measured.
Financial sustainability	Entities' ability to repay their liabilities as and when they fall due during the next financial year.
Fraud	Any act or omission, including a misrepresentation, that knowingly or recklessly misleads, or attempts to mislead, a party to obtain a financial or other benefit or to avoid an obligation.

Term	Definition
Going concern	An entity expected to be able to pay its debts as and when they fall due, and to continue to operate without any intention or necessity to liquidate or wind up its operations.
Governance	The arrangements in place at an entity to plan, direct and control its activities to achieve its strategic and operational goals.
Impairment	When an asset's carrying amount exceeds the amount that can be recovered through use or sale of the asset.
Internal audit	An appraisal activity established or provided as a service to the entity. Its functions include examining, evaluating, and monitoring the adequacy and effectiveness of internal control, and reporting deficiencies to management.
Legislative deadline	In this context, the date prescribed by legislation for a public sector entity to finalise its financial statements or annual report.
Management	Those with the executive responsibility for conducting an entity's operations.
Materiality	Relates to the size or nature of the item or error judged against the circumstances of its omission or misstatement. Information is material if its omission or misstatement could influence the economic decisions of users.
Misstatement	A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.
Megalitre (ML)	One million litres. A standard Olympic-size swimming pool contains 2.5ML or 2 500 000 litres of water.
Modified audit opinion	A modified opinion is expressed when financial statements do not comply with the relevant legislative requirements and Australian accounting standards, and as a result, are not accurate and reliable.
Net assets	Total assets less total liabilities.



Term	Definition
Non-current assets	An entity's long-term investments, where the full value will not be realised within the financial year. These assets are capitalised rather than expensed, meaning that the cost of the asset can be allocated over the number of years for which the asset will be in use, instead of allocating the entire cost to the financial year in which the asset was purchased.
Participation returns	A portion of a distributor–retailer's profits which it pays to its participating local governments in accordance with a participation agreement.
Price path	A mechanism used to adjust the building blocks of an entity's revenue requirement.
Public sector entity	A department, statutory body, government-owned entity, local government, or a controlled entity.
Referable dams	A dam is referable if a failure impact assessment demonstrates there would be people at risk if the dam was to fail.
Revaluation movement (increments or decrements)	The act of recognising a reassessment of the carrying amount of a non-current asset to its fair value as at a particular date, but excludes recoverable amount write-downs and impairment losses.
Risk management	The systematic identification, analysis, treatment, and allocation of risks. The extent of risk management required will vary depending on the potential effect of the risks.
Significant deficiency	A deficiency, or combination of deficiencies, in internal control that requires immediate remedial action.
Surplus	Total income exceeds total expenses resulting in a profit.
Total participation returns	The sum of participation returns, income tax equivalents, and competitive neutrality fees paid to participating local governments.
Unmodified audit opinion	An unmodified opinion is expressed when the financial statements are prepared in accordance with the relevant legislative requirements and Australian accounting standards.
Useful life	The number of years the entity expects to use an asset (not the maximum period possible for the asset to exist).

Auditor-General reports to parliament

Reports tabled in 2018–19

1. **Monitoring and managing ICT projects**
Tabled July 2018
2. **Access to the National Disability Insurance Scheme for people with impaired decision-making capacity**
Tabled September 2018
3. **Delivering shared corporate services in Queensland**
Tabled September 2018
4. **Managing transfers in pharmacy ownership**
Tabled September 2018
5. **Follow-up of Bushfire prevention and preparedness**
Tabled October 2018
6. **Delivering coronial services**
Tabled October 2018
7. **Conserving threatened species**
Tabled November 2018
8. **Water: 2017–18 results of financial audits**
Tabled November 2018



Report cost

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