Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2013–14

Victorian Auditor-General's Report | October 2014 | 2014–15:13

VICTORIA

Victorian
Auditor-General

Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2013–14

Ordered to be printed

VICTORIAN
GOVERNMENT PRINTER
October 2014

PP No 370, Session 2010–14

This report is printed on Monza Recycled paper. Monza Recycled is certified Carbon Neutral by The Carbon Reduction Institute (CRI) in accordance with the global Greenhouse Gas Protocol and ISO 14040 framework. The Lifecycle Analysis (LCA) for Monza Recycled is cradle to grave including Scopes 1, 2 and 3. It has FSC Mix Certification combined with 55% recycled content.

ISBN 978 1 925226 01 0

VAGO

Victorian Auditor-General's Office

Auditing in the Public Interest

The Hon. Bruce Atkinson MLC
President
Legislative Council
Parliament House
Melbourne

The Hon. Christine Fyffe MP
Speaker
Legislative Assembly
Parliament House
Melbourne

Dear Presiding Officers

Under the provisions of section 16AB of the *Audit Act 1994*, I transmit my *Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2013–14.*

This report provides analysis and commentary on the financial performance and position of the State of Victoria at 30 June 2014, as reported to Parliament in the *Annual Financial Report of the State of Victoria, 2013–14*. It also comments on the qualifications to the audit opinion I have issued in respect of the 2013–14 Annual Financial Report of the State of Victoria.

Yours faithfully

John Doyle
Auditor-General

16 October 2014

Contents

Auditor-General’s comments

John Doyle
Auditor-General

The Annual Financial Report of the State of Victoria, 2013–14 (AFR) is the key accountability document for informing Parliament and the citizens of Victoria about the financial transactions and financial position of the state.

The AFR discloses that the state’s 2013–14 net result from transactions was a surplus of $856.6 million, having reported a deficit for the previous three years. The surplus included unbudgeted Commonwealth grants of $1.16 billion.

The 2013–14 comprehensive result for the state was a surplus of $7.5 billion. The surplus was largely a result of increases in the value of the state's properties, specifically in the housing and health sectors.

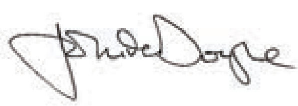
I issued a qualified audit opinion on the AFR as I do not agree with the state's decision to write down $1.58 billion of taxpayers' investments in schools buildings. The state did this write down on the basis that it believed that seven out of every 10 Victorian schools are partly economically obsolete. However those schools are continuing to deliver educational outcomes for the citizens of Victoria. Further, in our review of the practices applied across other Australian jurisdictions we found that Victoria is alone in its approach to this matter.

It is of concern that the state has written down schools that had recently received significant investments of taxpayer funds through Commonwealth and state government funding programs. This includes some schools in current capital works programs and new schools in growth areas under public private partnership arrangements (PPP). Importantly the state is contractually obligated to fund the full operating, construction and financing costs of those PPP schools over a 25-year period, despite having now determined that they are partly obsolete.

It is also concerning that the state was unable to provide sufficient appropriate evidence to fully support its key school valuation assumptions and judgements.

The state's decision to write down schools it deemed partly obsolete also significantly reduces certain state funding for the renewal and replacement of schools.

Parliament and the citizens of Victoria can nevertheless have confidence in the reliability of the AFR, except for the effect of the audit qualifications described in this report.



John Doyle
Auditor-General

October 2014

Audit team

Anna Higgs and Simone Bohan
Engagement Leaders

Timothy Maxfield
Team Leader

Kevin Chan
Jenny Tien
Audit Seniors

Ryan Ackland
Jessica Cross
Thamali Jayasekera
Laurence McGlade
Amit Patkar
Jie Yang

Team Members

Engagement Quality Control Reviewer

Craig Burke

Audit summary

At 30 June 2014 the State of Victoria controlled net assets of $131 093 million and during 2013–14 collected revenue of $60 346 million. Public accountability for the collection, spending and management of the state's resources is fundamental to good government. In Victoria the legislative framework requires the government to report on the state's finances, and the Auditor-General to audit that report.

The *Annual Financial Report of the State of Victoria, 2013–14* (AFR) is the key accountability document for informing Parliament and the citizens of Victoria about the financial transactions and financial position of the state for the past year. It is prepared by consolidating the financial statements of 279 state-controlled entities, and should conform with Australian Accounting Standards, and in the manner and form as determined by the Treasurer of Victoria, pursuant to the *Financial Management Act 1994*.

We audited the AFR and provided the opinion that—except for the effects of the following matters—the 2013–14 financial statements fairly presented the transactions and balances of the state. Our audit opinion, which was qualified, concluded that the state:

- has an accounting policy for measuring the fair value of school buildings, specifically including an economic obsolescence adjustment, that is not appropriate as it does not result in financial information that is relevant and reliable
- made an assessment of the economic obsolescence of school buildings, resulting in a significant write down of taxpayer investments in school buildings which are continuing to deliver educational outcomes, and which will result in significantly less funding for renewal of school buildings
- has not complied with AASB 127 *Consolidated and Separate Financial Statements,* as it has not prepared the financial report using a uniform accounting policy for measuring economic obsolescence adjustments to the fair value of all public sector non-financial physical assets, including school buildings
- was unable to provide sufficient appropriate audit evidence to fully support the appropriateness of some of its key valuation assumptions and judgements that it has used to adjust the fair value of school buildings due to economic obsolescence
- has not fully substantiated that the total economic obsolescence adjustment of $1.58 billion to the carrying value of school buildings at 30 June 2014 is fairly presented

- reclassified the total prior period's school building impairment of $2.15 billion as a fair value adjustment in the financial statements which means the comparative figures are not presented fairly in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, which requires the state to correct material prior period errors retrospectively by restating the comparative amounts
- made inappropriate comments in the Certification by the Department of Treasury and Finance that the underlying principle of adjusting for obsolescence has remained unchanged since 2005—however, the application of economic obsolescence under AASB 13 *Fair Value Measurement* in the current period and impairment under AASB 136 *Impairment of Assets* in prior periods, are different accounting concepts that have different recognition and measurement requirements.

Conclusion

We issued a qualified audit opinion on the state's 2013–14 AFR. Parliament and the citizens of Victoria can have confidence in the reliability of the AFR, except for those audit qualifications which concern the $1.58 billion economic obsolescence adjustment to the carrying value of school buildings at 30 June 2014, and the reclassification of the prior period's school building impairment of $2.15 billion as a fair value adjustment.

The state reported a positive comprehensive result for 2013–14, reflecting positive movements in financial assets and liabilities, and positive movements in the value of non-financial assets in the housing and health sectors.

Findings

Financial performance

The state's financial statements report at two levels:

- the State of Victoria as a whole which consolidates the results of all 279 state-controlled entities
- the general government sector (GGS) which is a subset of the state's controlled entities comprising a consolidation of the results of the 195 state-controlled entities which provide services free of charge or at prices significantly below their cost of production.

There are two key measures of financial performance and sustainability in the financial statements, the 'net result from transactions' and the 'comprehensive result'. The net result from transactions is revenue less expenditure that can be directly attributed to government policy. The comprehensive result includes other economic flows that represent changes in the value of assets and liabilities due to market remeasurements.

The state’s net result from transactions was a surplus, after having reported a deficit for the previous three years. The surplus of $856.6 million for 2013–14 is a significant turnaround from the previous year, and includes unbudgeted Commonwealth grants of $1.16 billion.

The comprehensive result for the State of Victoria for 2013–14 was a surplus of $7 460.7 million. The surplus was largely a result of gains generated on the revaluation of non-financial assets, specifically in the housing and health sectors.

For the GGS, the government measures its performance and sets fiscal targets on the net result from transactions, rather than on the comprehensive result. The government’s fiscal target is to achieve a net surplus from transactions of at least $100 million each financial year, consistent with net debt and infrastructure parameters. The net surplus from transactions for the GGS in 2013–14 was $1 976.2 million, well above the $100 million target.

Dividends

In 2013–14, the GGS received dividends of $220 million from state-controlled entities, and reported a net surplus from transactions of $1 976.2 million. In 2012–13 the GGS received substantially more dividends from state-controlled entities ($1 161 million), and in the 2012–13 AFR reported a net surplus from transactions of $316.4 million. The calling of dividends in 2012–13 had a significant impact on the GGS achieving its fiscal target of at least $100 million each financial year, consistent with net debt and infrastructure parameters. In 2013–14, when there was little risk of not achieving this target, fewer dividends were called.

Liquidity

The state’s central treasury, Treasury Corporation of Victoria, is responsible for ensuring that the state’s liquidity requirements are met at all times.

An analysis of liquidity at the state and GGS levels indicates that some entities do not have enough cash and other liquid short-term assets to settle short-term obligations. The liquidity ratio, which compares current assets with current liabilities, has improved over the last five financial years, however, it still remains below one. If entities are unable to pay debts they may call on the state to inject funds or to provide a letter of support—a letter of support is provided by the state or a state entity to an individual agency to confirm that financial assistance is available, and to enable management to prepare financial statements on a going concern basis. Liquidity is one factor when assessing going concern of an entity, and determining whether a letter of support is required. In 2013–14, 38 entities, or 14 per cent of all state-controlled entities, received a letter of support.

Borrowings

The state's borrowings increased by $3 840.4 million or 8.1 per cent in 2013–14. At the same time, gross state product increased by a smaller percentage resulting in the state having a reduced capacity to service borrowings.

As the state's debt increases, so does the interest expense incurred to service the debt. This reduces the funds available for public services, and the agility of the state to respond to revenue changes and unforseen expenditure.

Department of Education and Early Childhood Development

We issued a qualified audit opinion on the Department of Education and Early Childhood Development's (DEECD) 2013–14 financial report. The audit qualifications concerned the $1.58 billion economic obsolescence adjustment to the carrying value of school buildings at 30 June 2014, and the reclassification of the prior period's school building impairment of $2.15 billion as a fair value adjustment. These audit qualifications underpin the equivalent audit qualifications issued in respect of the AFR. In November 2013, Parliament was alerted to our concerns about DEECD's approach to impairing the value of school buildings in our *Portfolio Departments and Associated Entities: Results of the 2012–13 Audits* report.

That report highlighted that since 2006, DEECD had written down the value of school buildings as it considered that schools with more space than they were entitled to, were impaired. By 30 June 2013, DEECD had written down the carrying values of its school buildings by a total of $2.15 billion.

We nevertheless determined to issue an unmodified audit opinion on DEECD's 30 June 2013 financial statements on 11 September 2013 having received a commitment from DEECD that this issue would be resolved by the end of the 2013 calendar year and that it was appropriate to alert Parliament to this significant issue.

Notwithstanding the grace period provided to DEECD to resolve this matter, it had not been satisfactorily resolved for the 30 June 2014 financial statements, leading to the audit qualifications set out in this report.

DEECD's accounting policy for economic obsolescence results in a significant write down of taxpayer investments in school buildings which are continuing to deliver educational outcomes. This write down includes recent investments in school buildings funded from the Victorian Schools Plan (2007–08 to 2012–13) and the Commonwealth's Building the Education Revolution program (2007–08 to 2012–13).

Further, we note that some schools deemed to be partially economically obsolete by DEECD include new schools in growth areas under public private partnership arrangements or included in current capital works programs. In our review of equivalent departments across Australian jurisdictions we found that Victoria is the only state that makes an adjustment for economic obsolescence solely based on student enrolment data.

In addition to the qualified audit opinion, we found DEECD's 2013–14 financial statements required considerably greater audit scrutiny than in previous years as a direct result of our concerns related to management judgements on previous impairment estimates for school buildings, and the inability of DEECD to resolve technical accounting issues in a timely manner.

Financial report preparation by DEECD for 2013–14 was also inadequate. We formed this view based on the total number and quantum of adjustments and errors we identified during our audit of the draft financial statements. We requested 15 adjustments to the draft financial statements totalling some $850 million.

Recommendations

Number	Recommendation	Page
1.	That the Department of Treasury and Finance develops an appropriate and consistent accounting policy for assessing economic obsolescence of public sector assets that sets out definition, recognition and measurement requirements, and provides guidance on how public sector agencies should apply the economic obsolescence policy. This should be consistent with the requirements of Australian Accounting Standards.	11
2.	That the Department of Treasury and Finance works with material entities to improve the timeliness of financial statement preparation.	11
3.	That the Department of Education and Early Childhood Development maps the requirements of all applicable Australian Accounting Standards to their underlying systems and records, and identifies any gaps or limitations that prevent the preparation of a complete and accurate set of compliant financial statements.	42
4.	That the Department of Education and Early Childhood Development critically reviews its financial report preparation processes to identify areas for improvement and implements all improvements before the 30 June 2015 reporting cycle.	42

Submissions and comments received

In addition to progressive engagement during the course of the audit, in accordance with section 16A and 16(3) of the *Audit Act 1994,* a copy of this report, or relevant extracts from the report, was provided to the Treasurer and all relevant agencies with a request for submissions or comments.

The views of the Treasurer and agencies have been considered in reaching our audit conclusions and are represented to the extent relevant and warranted in preparing this report. Their full section 16A and 16(3) submissions and comments are included in Appendix F.

1 Background

1.1 Introduction

The *Financial Management Act 1994* (FMA) governs the financial administration, accountability and reporting of the Victorian public sector. It requires the annual preparation of a consolidated financial report of the state, known as the Annual Financial Report of the State of Victoria (AFR).

The AFR acquits the government's stewardship of the state's finances to Parliament. It is incorporated into a narrative report, the Financial Report of the State of Victoria, which analyses the government's expenses, revenue, assets and liabilities.

The Treasurer, pursuant to the FMA, is responsible for determining the manner and form of the AFR and also preparing the AFR in accordance with applicable Australian Accounting Standards. In 2009 the Treasurer approved a standing delegation authorising specified officers of the Department of Treasury and Finance (DTF) to sign the certification of the AFR. This certification attests, in the opinion of the specified DTF officers, to the fair presentation of the AFR on behalf of the Treasurer.

1.2 Scope of the Annual Financial Report of the State of Victoria

1.2.1 Entities included

The AFR provides the combined financial results of all state-controlled entities, that is, entities where the state has the power to govern their financial and operating policies to obtain benefits from their activities. Controlled entities include portfolio departments and state-owned enterprises.

Entities controlled by the state are classified into three sectors. Figure 1A describes each sector. A list of all consolidated entities is contained in Note 42 of the AFR.

Figure 1A
Sectors of government and explanation of their controlled entities

Sector	Explanation
General government sector	195 entities which provide services free of charge or at prices significantly below their production cost. Examples include government departments, public hospitals and technical and further education institutes.
Public financial corporations	Seven entities that borrow centrally, accept deposits and acquire financial assets. Examples include the Treasury Corporation of Victoria and Victorian WorkCover Authority.
Public non-financial corporations	77 entities whose primary purpose is to provide goods and/or services in a competitive market and who are non-regulatory and non-financial in nature. Entities include water corporations, alpine resort management boards and the Victorian Rail Track Corporation.

Source: Victorian Auditor-General's Office.

DTF produces the AFR. The controlled entities transmit their financial data through the State Resource Information Management System (SRIMS) to DTF and transactions between entities are eliminated to avoid double counting.

Of the controlled public sector entities, 48 were deemed 'material' entities for 2013–14 (49 in 2012–13). A public sector entity is classified as material when its individual financial operations are significant in the reporting of the consolidated finances of the state. Collectively, material entities accounted for more than 90 per cent of the state's assets, liabilities, revenue and expenditure. The 48 material entities for 2013–14 are listed in Appendix B.

1.2.2 Entities excluded

Local government entities, universities, denominational hospitals and superannuation funds are not state-controlled entities and therefore are not included in the AFR. Figure 1B details the rationale for their exclusion, consistent with Australian Accounting Standards.

Figure 1B
Entities not controlled by the state and the rationale for exclusion

Entity	Rationale
Local government	Local government is a separate tier of government with councils elected by, and accountable to, their ratepayers.
Universities	Universities are primarily funded by the Commonwealth and the state directly appoints only a minority of university council members.
Denominational hospitals	Denominational hospitals are private providers of public health services and have their own governance arrangements.
State superannuation funds	The net assets of state superannuation funds are the property of the members. However, any shortfall in the net assets related to certain defined benefit scheme entitlements of the state's superannuation funds are an obligation of the state and are reported as a liability in the AFR.

Source: Victorian Auditor-General's Office.

1.3 Structure of the Annual Financial Report of the State of Victoria

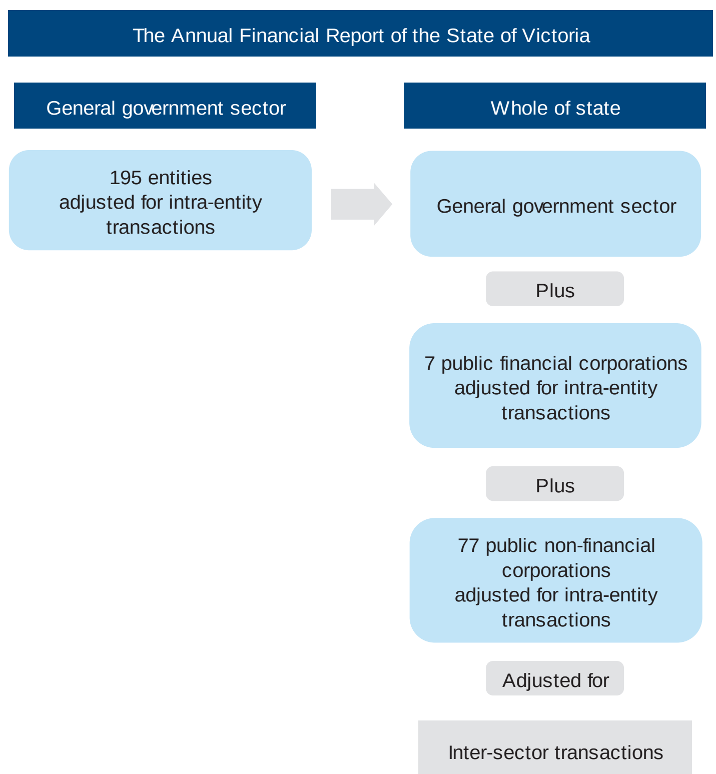
1.3.1 Levels of reporting

The AFR presents information on two aspects of the state's finances:

- state of Victoria level—consolidates all three sectors set out in Figure 1A
- general government sector level—provides consolidated information on the 195 entities.

Figure 1C shows the entities covered by each of these aspects and the items that are eliminated to avoid double counting, being intra-entity and inter-sector transactions, in the AFR.

Figure 1C
Coverage of the Annual Financial Report of the State of Victoria



Source: Victorian Auditor-General's Office.

1.3.2 Financial performance

The consolidated comprehensive operating statement in the AFR contains state revenue, expenses and other economic flows. It includes two key measures of financial performance and sustainability—the 'net result from transactions' and the 'comprehensive result'.

The net result from transactions is revenue less expenditure that can be directly attributed to government policy.

The comprehensive result, however, includes other economic flows that represent changes in the value of assets and liabilities due to market remeasurements. It includes actuarial gains and losses that primarily reflect the valuation movement in the state's unfunded superannuation liability.

1.3.3 Financial position

The consolidated balance sheet in the AFR presents the state's assets and liabilities. The notes to the AFR contain information about other financial commitments and contingent assets and liabilities not in the consolidated balance sheet. Combined, the balance sheet and relevant notes provide the state's financial position.

1.4 Audit requirements

Section 9A of the *Audit Act 1994* requires the Auditor-General to provide an audit opinion on the AFR. To form that opinion, a financial audit is conducted in accordance with Australian Auditing and Assurance Standards.

Section 16A of the *Audit Act 1994* requires the Auditor-General to report to Parliament on the AFR.

The *Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2013–14* is the third of 10 reports to be presented to Parliament during 2014–15 covering the results of financial audits. Appendix A outlines the reports and the intended time frames for tabling.

1.5 Audit conduct

The audit was conducted in accordance with Australian Auditing and Assurance Standards. Pursuant to section 20(3) of the *Audit Act 1994*, unless otherwise indicated, any persons named in this report are not the subject of adverse comment or opinion.

The cost of preparing this report was $140 000.

1.6 Structure of this report

This report is structured as follows:

- Part 2 reports on the results of the AFR financial statement audit.
- Part 3 provides commentary and analysis of the state's financial result.
- Part 4 provides commentary and analysis of the results of the annual financial audit of the Department of Education and Early Childhood Development.

2 Annual Financial Report of the State of Victoria audit result

At a glance

Background

This Part reports on the results of the *Annual Financial Report of the State of Victoria, 2013–14* (AFR) financial statement audit.

Conclusion

The Auditor-General issued a qualified audit opinion on the AFR relating to the state's valuation accounting policy for school buildings at the Department of Education and Early Childhood Development (DEECD). The audit qualifications related to a $1.58 billion economic obsolescence adjustment to the carrying value of school buildings at 30 June 2014, and the reclassification of the prior period's school building impairment of $2.15 billion as a fair value adjustment. Except for the matters described in the Basis for Qualified Opinion paragraphs of the Auditor-General's report, the Parliament and the public can have reasonable assurance that the AFR was reliable and prepared in accordance with the requirements of applicable Australian Accounting Standards and the manner and form of the financial statements as determined by the Treasurer pursuant to the *Financial Management Act 1994.*

Findings

- The Department of Treasury and Finance (DTF) improved the accuracy and timeliness of the AFR in 2013–14.
- The whole-of-government reporting system issues and deficiencies reported in 2012–13 were largely addressed and longstanding financial instruments disclosure issues resolved.
- While DTF acted in 2013–14 to improve the production of the AFR, it was not well supported by material entities, most of which did not meet a key DTF milestone.
- The Certification by DTF to the AFR inappropriately includes substantial further commentary that explains the state's approach to the adjustment of the fair value of school buildings.

Recommendations

- That DTF develops an appropriate and consistent accounting policy for assessing economic obsolescence of public sector assets.
- That DTF works with material entities to improve the timeliness of financial statement preparation.

2.1 Auditor-General's opinion

The Auditor-General issued a qualified audit opinion on the *Annual Financial Report of the State of Victoria, 2013–14* (AFR) on 2 October 2014. A copy of the Auditor-General's audit opinion can be found in Appendix E. The qualified opinion was issued because the Auditor-General does not agree with the accounting policy of how school buildings at the Department of Education and Early Childhood Development (DEECD) are measured—specifically, how economic obsolescence is assessed in calculating the building's fair value. Part 4 of this report specifically comments on our audit of DEECD's 2013–14 financial statements and the basis for the audit qualification.

Under Australian Auditing Standards, when VAGO is assessing whether a misstatement in the financial report is material for the audit of public sector agencies, there are additional requirements that we need to consider. In particular, ASA 450 *Evaluation of Misstatements Identified During the Audit* requires us to consider whether issues such as public interest and accountability affect our assessment of whether the misstatement is material by virtue of its nature.

The misstatements in DEECD's financial statements are therefore considered qualitatively material to the AFR because:

- there is substantial Parliamentary and public interest in the discharge of DEECD's accountability for its management of schools
- the management and operation of school assets are a significant part of DEECD's role and legislative objectives
- the financial management of school assets is critical to whether the state and DEECD are acting with financial prudence
- the amounts involved are significant to the reader of the AFR in absolute terms, comprising a total economic obsolescence adjustment of $1.58 billion and a total prior period impairment of $2.15 billion
- the state has not complied with AASB 127 *Consolidated and Separate Financial Statements*, as it has not prepared the AFR using a uniform accounting policy for measuring economic obsolescence adjustments to the fair value of all public sector non-financial physical assets, including school buildings.

The state's accounting policy for valuing public sector non-financial physical assets, including school buildings, is summarised in note 1 to the AFR and is also set out in Financial Reporting Direction FRD 103E *Non-Financial Physical Assets* issued by the Minister for Finance pursuant to the *Financial Management Act 1994* (FMA). Further, FRD 103E references Australian Accounting Standard AASB 13 *Fair Value Measurement*.

AASB 13 provides that when assessing the fair value of non-financial physical assets there should be consideration of the existence of economic obsolescence when using the cost approach. However, it does not specify how to assess economic obsolescence, particularly in a public sector context. FRD 103E does not reference this requirement of the standard or set out the state's accounting policy in this regard, and Note 1 to the AFR only references the approach taken by DEECD which is based on student enrolment data.

Consequently, the accounting policy used by public sector agencies to assess economic obsolescence is dependent upon the policies adopted by the individual agencies, and a consistent policy has not been promulgated by the state for the purposes of the AFR. Our review of the accounting policies used by material entities found that, other than DEECD, they did not reference the requirement, or specify how to assess economic obsolescence. Consequently, the accounting policy being applied by DEECD wasn't being applied by those agencies.

The DEECD accounting policy for assessing economic obsolescence is based on a consideration of student enrolment data—as set out in Part 4 of this report. However, the valuation of the state's declared road network, for example, which also uses the written down replacement cost method for setting fair value as is used for school buildings, doesn't include any adjustment for economic obsolescence based on traffic volumes. An equivalent approach to that taken for school buildings would be to use traffic volumes to assess economic obsolescence for roads, however, this is not part of the state's accounting policies.

Further, the Certification by the Department of Treasury and Finance states that the underlying principle of adjusting for obsolescence has remained unchanged since 2005. In our opinion, the application of economic obsolescence under AASB 13 *Fair Value Measurement* in the current period and impairment under AASB 136 *Impairment of Assets* in prior periods, are different accounting concepts which have different recognition and measurement requirements under their respective Australian Accounting Standards.

Except for the matters outlined in the Basis for Qualified Opinion paragraphs of the Auditor-General's report on the AFR—see Appendix E—users can have reasonable assurance that the information in the AFR is reliable, and prepared in accordance with the requirements of the Australian Accounting Standards and in the manner and form as determined by the Treasurer of Victoria pursuant to the FMA.

The opinion was included in Chapter 4 of the state's 2013–14 Financial Report, which was transmitted to Parliament on 15 October 2014.

2.1.1 Certification by the Department of Treasury and Finance

The Certification by the Department of Treasury and Finance (DTF) to the 2013–14 annual financial report includes substantial further commentary that explains the state's approach to the adjustment of the fair value of school buildings. In our view it is highly unusual and inappropriate for this additional commentary to be included in the certification.

The purpose of the certification is to state its opinion that the financial statements present fairly the financial transactions during the reporting period and the financial position at the end of the period in accordance with AASB 101 *Presentation of Financial Statements*. We are of the opinion that commentary on the fairness of specific account balances, transactions or disclosures should be included in the notes to the financial statements and not in the certification. In particular, we do not believe it is appropriate for DTF to make direct reference to the Victorian Valuer-General in its certification.

2.1.2 Material inconsistency in the Annual Financial Report

The foreword of the 2013–14 AFR contains commentary in relation to the valuation of education assets which is materially inconsistent with Note 22(f) of the financial statements. Specifically, the Department of Treasury and Finance states that the underlying principle of adjusting for obsolescence has remained unchanged since 2005. However, Note 22(f) of the financial statements states that the economic obsolescence adjustment recognised for school building assets has been reclassified from impairment under AASB 136 *Impairment of Assets* in prior periods to economic obsolescence under AASB 13 *Fair Value Measurement* in the current period. As noted previously in Section 2.1, these are different accounting concepts which have different recognition and measurement requirements under their respective Australian Accounting Standards. As a consequence of this material inconsistency, the Auditor-General included an ‘Other Matter’ paragraph in his independent auditor's report on the AFR.

2.2 Quality of reporting

Except for matters relating to the qualification, the accuracy and timely production of the AFR improved in 2013–14. DTF is to be commended on the improvements made to its processes and quality control. Despite the low number of material entities meeting the AFR milestone, DTF was able to achieve more timely production than in previous years.

2.2.1 Accuracy

The accuracy of the draft AFR is measured by the frequency and number of material adjustments arising from the audit, and the number of drafts provided for audit. Ideally there should be no material adjustments required once a complete draft is provided for audit.

To prepare the 2013–14 AFR, DTF planned to provide three drafts of the financial statements for audit, with the first being on 28 August 2014. DTF achieved this time line. Although there were minor delays on some information provided for audit, this was a significant improvement on previous years, demonstrating that DTF has invested time in improving its AFR production processes.

There were less material adjustments required to the first draft compared to prior years, indicating that the quality control procedures adopted by DTF had improved. Further to that, we noted that the first draft provided was more complete than in prior years, with all significant disclosures present.

During the 2012–13 AFR we identified limitations with the State Resource Information Management System (SRIMS) in capturing some financial instruments disclosures relating to insurance agencies. It is pleasing to note that for the 2013–14 AFR, DTF has worked closely with the insurance agencies to implement the required functionality into SRIMS, and improve the accuracy of the disclosure. This was further evidenced by the high quality of the first draft received on 28 August 2014.

The increased functionality of SRIMS has also improved the accuracy of the consolidated cash flow statement. In order to comply with AASB 107 *Statement of Cash Flows*, and in response to previous audit recommendations, DTF formalised the process of submitting gross cash flow information through SRIMS in 2013–14. We have made additional recommendations to DTF to further improve the accuracy of cash flow information in the AFR.

2.2.2 Timeliness

The timeliness of preparation of the AFR is measured against the statutory reporting deadline established in the FMA, and against the annual production timetable set by DTF. The 2014 state election, scheduled for 29 November 2014, resulted in the length of time for the preparation and audit of the AFR being reduced, with the certification date originally set for 19 September 2014. The AFR was certified by DTF officer's, on behalf of the Treasurer, on 29 September 2014.

The qualified audit opinion on the AFR was issued on 2 October 2014, compared to 27 September 2013 in 2012–13.

The Treasurer provided the 2013–14 AFR to Parliament on 15 October 2014. This was consistent with 2012–13 (14 October 2013) and on or before the statutory reporting deadline of 15 October 2014.

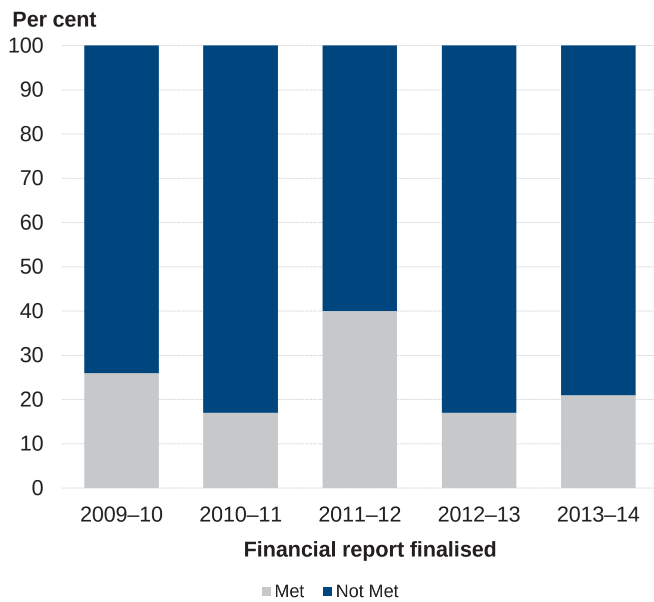
Material entities

The timely preparation and audit of the AFR depends on material entities meeting the AFR preparation timetable and the early identification and resolution of significant accounting and disclosure issues.

DTF set a milestone date of 20 August 2014 for all material entity accounts to be finalised. This date was set to allow adequate time to prepare and audit the AFR.

Figure 2A shows the performance of material entities in finalising their financial statements against the AFR milestone over the past five years.

Figure 2A
Timeliness – material entities against the Department of Treasury and Finance milestone



Source: Victorian Auditor-General's Office.

For 2013–14 only 10 of the 48 material entities (or 21 per cent) met the milestone date. The delays experienced may be partially attributed to the introduction of AASB 13 *Fair Value Measurement.* The purpose of the standard is to provide readers with more information about the inputs—observable and unobservable—used in calculating the fair value of assets and liabilities by splitting them into three levels. Each level has different disclosure requirements, with 'level 3' disclosures being the most onerous. Due to the nature and composition of the state's non-financial assets, a large number of material entities were required to report their non-financial assets as 'level 3', which significantly increased the disclosure requirements. This provided material entities with challenges in terms of the quantum of information required for the disclosure.

We encouraged material entities to prepare shell financial statements based on the DTF model financial report, which included the proposed disclosure requirements for AASB 13. The preparation of shell financial statements allows material entities to determine the presentation and disclosure requirements ahead of the preparation of the annual financial statements. We also recommend that material entities consider undertaking a hard-close process, which is typically done one to three months prior to year end. This process involves bringing forward some audit procedures meaning less work needs to be done by the entity and auditors at year end. The hard-close process does not suit all circumstances, however, it has been successfully used by a number of material entities in the past.

The late finalisation of material entity financial reports forced DTF to initially prepare the AFR on unaudited information provided into SRIMS. The important contribution that material entities make to the state's overall financial results and balances should serve as a driver for them to complete financial statements in a timely manner, as information cannot be verified in SRIMS until the audit of the financial statements is complete. Ideally all information in SRIMS provided by material entities would have been reviewed, and errors communicated back to the entity/DTF prior to the preparation of the AFR, however, this was not the case.

Recommendations

1. That the Department of Treasury and Finance develops an appropriate and consistent accounting policy for assessing economic obsolescence of public sector assets that sets out definition, recognition and measurement requirements, and provides guidance on how public sector agencies should apply the economic obsolescence policy. This should be consistent with the requirements of Australian Accounting Standards.
2. That the Department of Treasury and Finance works with material entities to improve the timeliness of financial statement preparation.

3 The state's financial result

At a glance

Background

This Part analyses and comments on the state’s financial performance and position for 2013–14 by interpreting the results reported to Parliament in the *Annual Financial Report of the State of Victoria, 2013–14* (AFR).

Conclusion

A positive net result from transactions was achieved for the state and general government sector. An analysis of the state's liquidity indicates that entities across the state do not have enough cash and other liquid short-term assets to settle short-term obligations.

Findings

- The state's net result from transactions was a surplus of $856.6 million, compared to deficits reported in the three prior years. A key contributor to the surplus was the receipt of unbudgeted Commonwealth funding of $1.16 billion relating to East West Link.
- Employee expenses increased at a rate of 1.3 per cent in 2013–14 which is less than the consumer price index (CPI) of 2.5 per cent.
- The state's comprehensive result was a surplus of $7 460.7 million, largely as a result of revaluation gains on non-financial assets—mainly land and buildings—in the housing and health sectors.
- Only $220 million of dividends were received from state-controlled entities in 2013–14 compared to $1 161 million in 2012–13.
- The state and general government sector liquidity ratio is less than one indicating that some state-controlled entities do not have enough cash and other liquid short-term assets to settle short-term obligations.
- The self-financing ratio indicates that the state is not generating sufficient cash from its operations to fund new assets and asset renewal.
- Borrowings have increased at a rate faster than the growth in gross state product, reducing the state’s capacity to service its debt.

3.1 Introduction

This Part analyses and comments on the state’s 2013–14 financial performance and position by interpreting the results reported to Parliament in the *Annual Financial Report of the State of Victoria, 2013–14* (AFR). It discusses significant transactions reported in the AFR, and the state’s net result from transactions, overall comprehensive result, short-term liquidity, financing of infrastructure, and debt sustainability.

3.2 Overall conclusion

The state achieved a net surplus from transactions—which measures the revenue and expenditure attributed to government policy. The comprehensive result for the state was also positive, reflecting net gains in financial instruments within other economic flows included in the net result and a significant gain in the asset revaluation surplus.

3.3 Financial performance

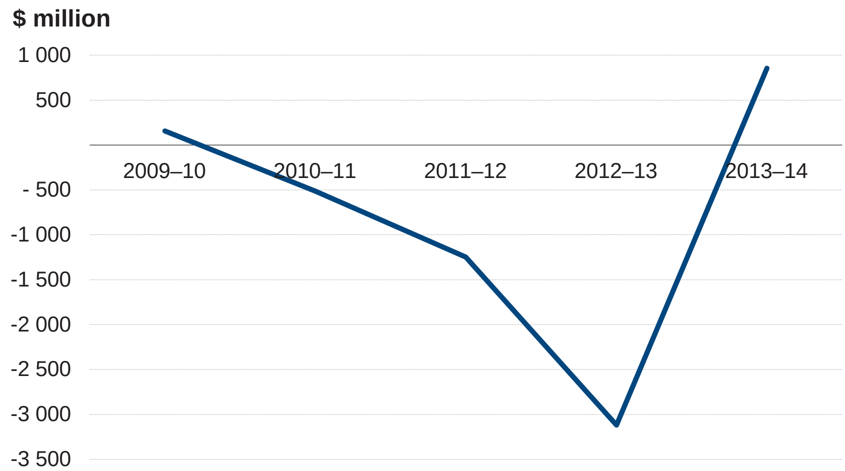
3.3.1 The state’s net result from transactions

The state's net result from transactions measures the revenue and expenses attributed to government policy in the general government sector (GGS), public non-financial corporations and public financial corporations. The comprehensive result includes changes in the value of assets and liabilities due to market fair value remeasurements. For example any gains or losses on financial instruments, which form a significant part of public financial corporations operations, are reflected in the comprehensive result and are not included in the net result from transactions.

The state’s net result from transactions for 2013–14 was a surplus of $856.6 million ($3 119.8 million deficit in 2012–13) compared to a budgeted deficit of $1 490.7 million.

Figure 3A shows that the state’s net result from transactions improved in 2013–14 after three consecutive years of decline. The improvement was caused by revenue increasing by 11.3 per cent compared to expenditure at 3.8 per cent.

Figure 3A
Net result from transactions, 2009–10 to 2013–14



Source: Victorian Auditor-General's Office.

In 2013–14, revenue increased by $6 143.3 million compared to a budgeted increase of $3 444.3 million. The increase in revenue from the prior year was primarily driven by a:

- $3 228.7 million (14.8 per cent) increase in Commonwealth funding due to an increase in the national goods and services tax (GST) pool, and other specific purpose grants for the delivery of the East West Link and projects under the National Health Reform
- $1 336.4 million (10.4 per cent) increase in the sale of goods and services reflecting an increase in volume of water sold, as well as higher water and sewerage charges
- $891.4 million (27.2 per cent) increase in land transfer duties reflecting improved property markets.

The state outperformed the original budgeted revenue predominately due to higher than anticipated Commonwealth grants revenue, and additional land transfer duties and dividends received by the public financial corporations from external organisations.

The increase in revenue was partially offset by an increase in expenditure of $2 166.9 million compared to a budgeted increase of $1 815.2 million. The increase in expenditure from the prior year was primarily driven by a:

- $1 770.9 million (7.6 per cent) increase in other operating expenses predominately due to increased purchases of services in the health sector, and a payment of $540 million relating to a legal settlement with Tatts
- $415.8 million (16.4 per cent) increase in interest expense primarily due to a full year of interest charged on the desalination plant and Peninsula Link finance leases. There was also an increase due to additional borrowings required to fund the state's infrastructure investment program.

Total expenses were within 1 per cent of the original State Budget.

Employee expenses

Employee expenses accounted for 32 per cent of total expenses from transactions in 2013–14. In the *Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2010–11,* we reported the need for the state government to closely monitor and tightly control expenditure with reference to employee entitlements. Over the five-year period from 2006–07 to 2010–11, employee expenses had grown at a rate above the consumer price index (CPI).

A number of initiatives have been implemented by government to manage employee related expenses. For example, in December 2011 the state government announced its Sustainable Government Initiative (SGI). The SGI included a 3 600 reduction in the public service workforce announced as part of the *2011–12 Victorian Budget Update*. Additional workforce reductions of around 600 positions were announced as part of the *Victorian Budget 2012–13*. The workforce reductions were completed by 31 December 2013 through natural attrition, a freeze on recruitment, the lapsing of fixed-term contracts and voluntary departure packages (VDP).

Figure 3B shows the percentage growth in employee expenses, before and after implementing the SGI, compared to CPI for the same period.

Figure 3B
Comparison of increases in employee expenses and CPI, 2006–07 to 2013–14

Financial year	Employee expenses increase (%)	CPI (%)
2006–07	6.0	2.0
2007–08	7.2	4.4
2008–09	8.0	1.2
2009–10	7.9	3.1
2010–11	6.4	4.6
2011–12	4.6	2.3
2012–13	4.1	2.2
2013–14	1.3	2.5

Source: Victorian Auditor-General's Office and Australian Bureau of Statistics.

Employee expenses increased by 1.3 per cent ($242.7 million) in 2013–14. The percentage growth in employee expenses since implementing the SGI has been significantly lower than the percentage growth over the preceding five financial years. Although the SGI was not intended to apply to frontline service delivery roles, government must make sure that the quality and quantity of public services is not compromised by resource constraints. It is too early to reliably determine if reduced employee numbers has impacted service delivery and/or the engagement of contractors and consultants. This will be considered for inclusion in a later report to Parliament.

3.3.2 The general government sector's net result from transactions

For the GGS, the government measures its performance and sets fiscal targets on the net result from transactions, rather than on the comprehensive result. The government's fiscal target is to achieve a net surplus from transactions of at least $100 million each financial year, consistent with its infrastructure and net debt parameters. The net surplus from transactions for 2013–14 was $1 976.2 million compared to a budgeted surplus of $224.5 million. The improved result is predominately due to higher than anticipated Commonwealth grants revenue and additional land transfer duties.

Dividends

The government has a policy underpinning the payment of dividends. This policy requires the government's budget position to be a consideration when determining an entity's dividend payment. Actual dividend payments are negotiated with the responsible board and portfolio minister, and are generally paid twice a year as follows:

- an interim dividend paid in April based on half-year financial results
- a final dividend paid in October based on annual financial results.

In 2012–13, the GGS received dividends of $1 161 million from state-controlled entities that operate outside the GGS, and the 2012–13 AFR reported a net surplus from transactions of $316.4 million. If dividends were not received in that year, the government's fiscal target of a net surplus from transactions of at least $100 million would not have been achieved. It should be noted that the 2012–13 GGS net result from transactions has subsequently been restated in the 2013–14 AFR to account for the requirements of the revised AASB 119 *Employee Benefits* as a change in accounting policy in accordance with Australian Accounting Standards.

In 2013–14, the GGS received dividends of $220 million from state-controlled entities that operate outside the GGS, and reported a net surplus from transactions of $1 976.2 million. The decrease of $941 million in dividends compared to 2012–13 is partially driven by decreased financial results in the state-controlled entities that are required to pay dividends. The decrease is also a result of special dividends not being required from the State Electricity Commission of Victoria in 2013–14 ($413.8 million in 2012–13).

Notwithstanding the government's dividend policy requiring that the Department of Treasury and Finance (DTF) consider a number of financial indicators when determining an appropriate dividend payout ratio, it appears that a sufficiently robust assessment of an entity's ability to pay dividends may not have been completed.

In our report *Water Entities: Results of the 2011–12 Audits,* tabled in November 2012, we observed that each of the four metropolitan water entities had borrowed to facilitate the payment of dividends and fund infrastructure programs in that year. This trend continued in 2012–13 where three of the four metropolitan water entities were required to borrow.

We further commented that the metropolitan water entities ability to repay debt from operating profits was declining. In particular, City West Water and Melbourne Water did not have the capacity at 30 June 2012 and 30 June 2013 to cover annual debt repayments from operating profits.

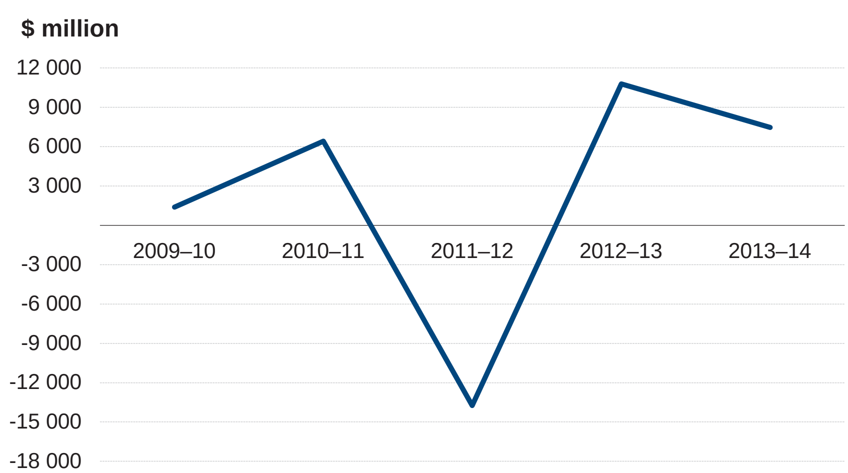
In 2013–14, borrowings at City West Water, South East Water and Yarra Valley Water increased collectively by $333.8 million. The financial position at 30 June 2014, and the ability to remain financially sustainable, of all 19 water entities will be assessed in our report *Water Entities: Results of the 2013–14 Audits*, scheduled for tabling in February 2015.

3.3.3 The state's comprehensive result

The state's 2013–14 comprehensive result was a surplus of $7 460.7 million (surplus of $10 774.5 million in 2012–13) compared to a budgeted deficit of $5 997.2 million. The variance against budget is mainly due to a $5 211.5 million revaluation gain on non-financial assets in the housing and health sectors which was not budgeted for, and higher than anticipated revenue as explained in our commentary on the net result from transactions.

Figure 3C shows there is no discernable trend in the state's net result for the past five financial years.

Figure 3C
Comprehensive result, 2009–10 to 2013–14



Source: Victorian Auditor-General's Office.

The $856.6 million net surplus from transactions forms part of the 2013–14 comprehensive result reported in the AFR. The $6 604.1 million difference, known as other economic flows, is largely due to:

- a net gain of $1 159 million on financial instruments at fair value which reflects the performance of public financial corporations in 2013–14, in particular, the Treasury Corporation of Victoria (TCV) and Victorian WorkCover Authority.
- a $5 211.5 million revaluation gain on non-financial assets—mainly land and buildings—in the housing and health sectors.

These gains were partly offset by $195.7 million in fines in the justice sector being written off during the year.

3.4 Financial position

3.4.1 Significant transactions that impacted the state's financial position

The consolidated balance sheet contains all state assets and liabilities. Some of the key movements in the balance sheet are reflected through the revaluation of land and buildings in the health and housing sectors and an increase in borrowings. Other significant transactions that impacted the state's financial position are summarised below.

Fair value of school buildings

As set out in Part 4 of this report, the state has written down the carrying value of school buildings by a total of $1.58 billion as at 30 June 2014 as an economic obsolescence adjustment. Please refer to Part 4 for additional details.

Deconsolidation of dual-sector universities

Victoria's tertiary education system is comprised of eight universities and 12 technical and further education institutes (TAFE). Four universities currently deliver higher education courses, and operate a separate TAFE division that provides vocational education and training. These universities are known as dual-sector universities.

The universities currently operating as dual-sector universities in Victoria are:

- Federation University Australia
- Royal Melbourne Institute of Technology
- Swinburne University of Technology
- Victoria University.

Universities are not controlled, for financial reporting purposes, by the state and therefore are not consolidated into the AFR. However, until 31 December 2013, the dual sector universities were required to prepare separate financial information relating to their TAFE activities for consolidation into the GGS.

The enactment of the *Education and Training Reform Amendment (Dual Sector Universities) Act 2013* from 1 January 2014 has resulted in major changes to the compliance and reporting requirements of these entities. The TAFE activities and balances are now reported solely in the four dual-sector universities financial statements, and are not required to be consolidated into the GGS. In addition, separate disclosures of TAFE activities in the dual-sector universities financial reports and audited performance statements are no longer necessary.

The legislative amendments have resulted in the deconsolidation of the financial information of the four dual-sector universities TAFE divisions from the AFR from 1 January 2014.

Consequently, the states net assets have been reduced by $847.6 million and $368.8 million of the asset revaluation reserve relating to these assets has transferred into accumulated funds. The AFR includes the financial transactions of the TAFE component of the dual-sector universities to 31 December 2013.

Sale of Rural Finance Corporation's business

The Rural Finance Corporation of Victoria (RFC) is a specialist rural lender that offers a range of financial packages to fund the acquisition, expansion and development of farm businesses, banking restructures, working capital, off-farm investments, plant and equipment, and housing.

During May 2014, the Treasurer signed a Business Sale Agreement (BSA) to sell the majority of the net assets of RFC and a licence to use RFC trade-marks to the Bendigo and Adelaide Bank Limited for an expected $1 780.8 million, or $85.0 million above the agreed carrying value of the acquired net assets. The net assets sold included the majority of the loan debtors and property, plant and equipment, less the employee provisions for staff moving to the Bendigo and Adelaide Bank Limited. RFC's borrowings associated with the loan debtors were retained and were discharged using the sale proceeds.

On 1 July 2014, the sale proceeded and the net assets sold were determined to have a final value of $1 675.3 million, being $20.5 million less than the amount set out in the BSA. This was due to the fact that loan debtors and property, plant and equipment values had changed since the original BSA was signed. The final sale proceeds on 1 July 2014 were therefore $1 760.3 million, including the $85.0 million. Certain former RFC staff members also transferred to the Bendigo and Adelaide Bank Limited at that time.

The proceeds from Bendigo and Adelaide Bank Limited were used to discharge RFC's borrowings from TCV totalling $1 310.5 million on 1 July 2014. This amount represents the full repayment of all TCV borrowings of $1 292.7 million, accrued interest of $6.0 million and break costs for the early repayment of borrowings of $11.8 million. In addition, both RFC and the state will have incurred other transaction costs as part of the sale process.

Following the settlement under the BSA, RFC will continue to exist, however, the ongoing activities are yet to be fully determined. It is expected that ongoing activities will include responsibility for certain government grant schemes, currently outsourced to Bendigo and Adelaide Bank Limited.

Under the agreement, the Bendigo and Adelaide Bank can make claims against RFC within 15 months of the completion date, for breaches of warranty. At the date of preparation of this report, RFC advised that it was not aware of any such claims having been made.

The sale has been reported in the 2013–14 AFR as an event that occurred subsequent to 30 June 2014. The impact on the financial position of the state will therefore be recognised and reported in the 2014–15 AFR.

3.4.2 Liquidity

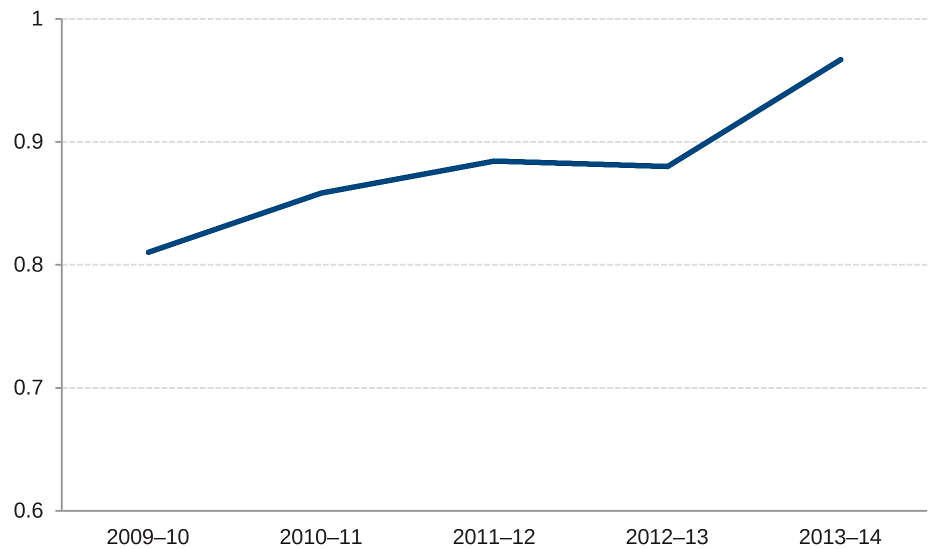
An indicator of the state's short-term financial health is its ability to pay existing short-term financial obligations as they become due. This can be measured by comparing the state’s current assets with current liabilities. A ratio of more than one means there are more cash and liquid assets than short-term liabilities. A stronger ratio indicates a better ability to meet ongoing and unexpected costs.

The AFR discloses that the state is exposed to liquidity risk mainly through maturity of its borrowings and the requirement to fund cash deficits. The state’s central treasury, TCV, is responsible for ensuring that the state’s liquidity requirements are met at all times. The state's liquidity ratio disclosed in the AFR was 1.43:1. This measures TCV's liquid assets—after discounting to reflect potential loss of value in the event of a quick sale—versus 12 months of debt and interest obligations. It is not a complete indication of the state's ability to pay all existing short-term financial obligations as they become due.

The state currently holds a triple-A credit rating as provided by Standard and Poors and Moody’s. The purpose of this rating is to assess credit risks, which evaluates the ability and willingness to meet financial obligations in full and on time. On the other hand, the liquidity ratio focuses on short term obligations, rather than financial obligations as a whole, and consequently provides a different perspective.

Figure 3D shows the state’s ratio of current assets over current liabilities over the past five years.

Figure 3D
Liquidity ratio, State of Victoria, 2009–10 to 2013–14



Note: The state's current assets include land inventories while the state's current liabilities include unearned income. Further, the state's current liabilities include some longer-term employee entitlements, and associated on-costs, that have been appropriately disclosed as current liabilities in the financial statements in accordance with Australian Accounting Standards. The AFR does not separately disclose those longer-term liabilities classified as current liabilities.

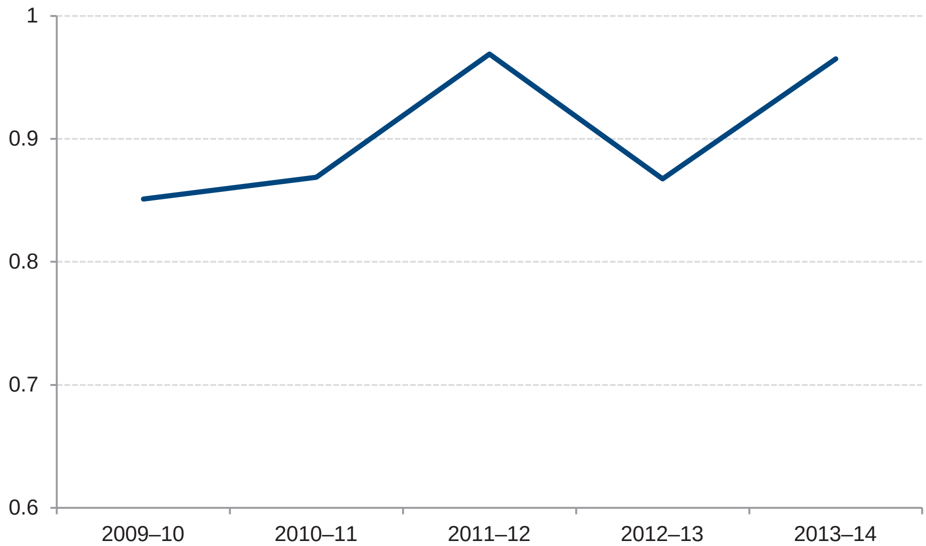
Source: Victorian Auditor-General's Office.

Figure 3D illustrates the sum of current assets compared to the sum of short-term liabilities for all state-controlled entities from the general government, public non-financial and public financial sectors, less inter-sector transactions. It shows that the state had a liquidity ratio of less than one between 2009–10 to 2013–14, meaning that there are entities across the state that do not have enough cash and other liquid short-term assets to settle short-term obligations. More analysis of individual entities' liquidity is performed in our sector based reports, which are listed in Appendix A.

If entities are unable to pay debts they may call on the state to inject funds or to provide a letter of support. A letter of support is provided by the state or a state entity to an individual agency to confirm that financial assistance is available, and to enable management to prepare financial statements on a going concern basis. Liquidity is one factor when assessing going concern of an entity, and determining if a letter of support is required. In 2013–14, 38 agencies, or 14 per cent, of all state-controlled entities received a letter of support.

Figure 3E shows the GGS's ratio of current assets over current liabilities over the past five years.

Figure 3E
Liquidity ratio, General Government Sector, 2009–10 to 2013–14



Note: The GGS’s current assets include land inventories while the GGS's current liabilities include unearned income. Further, the GGS’s current liabilities include some longer-term employee entitlements, and associated on-costs, that have been appropriately disclosed as current liabilities in the financial statements in accordance with Australian Accounting Standards. The AFR does not separately disclose those longer-term liabilities classified as current liabilities.

Source: Victorian Auditor-General’s Office.

Figure 3E shows a liquidity ratio of less than one between 2009–10 to 2013–14 for the GGS. The cash of many GGS entities is managed centrally by DTF—through TCV. These entities have responsibilities within the bounds of set funding arrangements but do not have direct control over managing their liquidity, and consequently it is managed by DTF—through TCV. The ratio indicates that in the unlikely event that all short-term obligations were required to be paid at once, the GGS entities would not have sufficient cash and liquid assets at balance date to meet these payments. Consequently, some longer-term investments would need to be liquidated or short-term borrowing raised, which may involve the payment of penalties or sacrificing interest revenue. The AFR highlights that TCV introduced an enhanced liquidity policy in 2012 to assist the state to manage its liquidity position, and that this includes liquidity crisis management plans to respond to any such crisis.

3.4.3 Self-financing

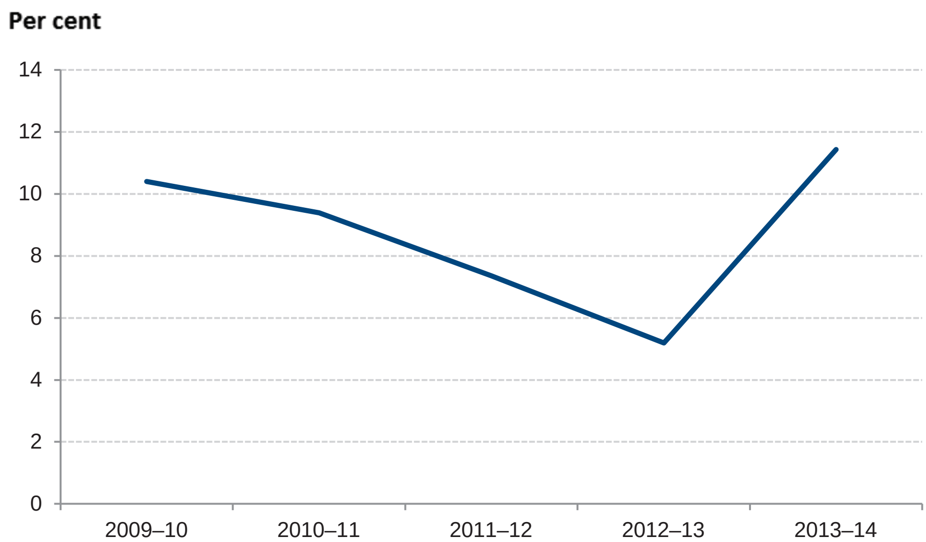
The state’s infrastructure assets include roads, transport networks, ports, and water infrastructure. In 2013–14, the value of these assets increased by 3.7 per cent, from $52 351.8 million at 30 June 2013 to $54 314.0 million at 30 June 2014.

Maintaining existing infrastructure and providing new infrastructure to achieve the state’s social, economic and environmental objectives is a significant challenge for government. The state funds infrastructure with its own cash reserves, which includes Commonwealth Government contributions, and borrowings. The state is substantially reliant on Commonwealth Government contributions, which accounted for 41.5 per cent of total revenue in 2013–14. Approximately 46 per cent, or $11.5 billion, of Commonwealth Government contributions relate to the state’s share of the GST pool, the remainder relates to grants for specific purposes such as the National Health Reform, East West Link and Regional Rail Link. The state does not have direct control over the level of specific purpose contributions it receives each year from the Commonwealth Government.

An indicator of the state’s financial performance is its ability to finance planned investments from its own cash resources, which includes Commonwealth Government contributions. In the long term, the state should generate sufficient funds from operations to maintain existing, and fund new, infrastructure. The self-financing indicator measures the net operating cash flows available to fund infrastructure, and is reported as a percentage of revenue. The indicator incorporates both own-sourced revenue and Commonwealth Government contributions. An indicator of less than 10 per cent generally shows there is insufficient cash from operations to maintain existing, and fund new assets. The higher the percentage the more effectively the state can finance its capital program from its own cash resources, which includes Commonwealth Government contributions.

Figure 3F shows the state’s ability over the past five years to fund infrastructure using cash generated by its operations.

Figure 3F
Self-financing percentage, State of Victoria, 2009–10 to 2013–14



Source: Victorian Auditor-General’s Office.

Figure 3F indicates that since 2010–11, the state has not generated sufficient cash from its operations, which includes Commonwealth Government contributions, to fund new assets and asset renewal. Although this trend has reversed in 2013–14, a rate of between 10 per cent and 20 per cent indicates that the state may not be generating sufficient cash from operations to fund new assets.

Funding capital investment will be a continual challenge for government. The total value of Victorian public sector capital projects underway or commencing in 2014–15, as reported in 2014–15 Victorian Budget Paper number 4 *State Capital Program*, is approximately $72 billion.

The nature and purpose of the state is primarily to deliver public services, however, the assets it controls, and services it provides, do not always produce sufficient revenue to cover both the cost of operations and infrastructure investment. The shortfall is often significant, and requires alternate funding to be sourced through borrowings, asset sales and Commonwealth Government contributions. For example, borrowings have increased year-on-year from $15.8 billion in 2006–07 to $51.3 billion in 2013–14, which is primarily a result of infrastructure programs in the education, transport and water sectors.

Continually borrowing to fund infrastructure investment is not sustainable in the long term. Increasing debt to fund short-term investment activity has a consequential impact on future generations who must repay that debt. The money available for public services, and the ability of government to respond to fluctuations in revenue or unforseen expenditure, is reduced when additional debt commitments require servicing.

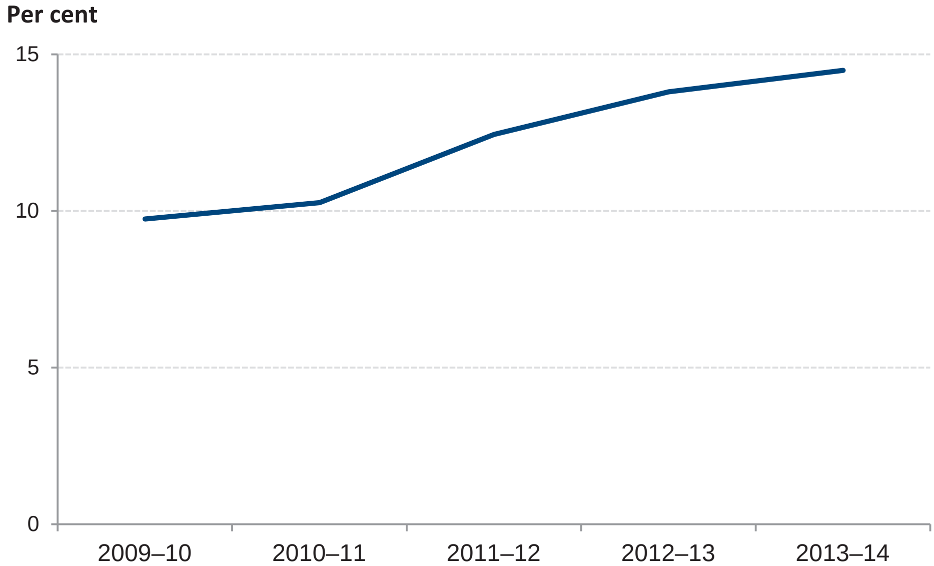
The achievement of a financially viable and sustainable state is largely dependent on expenditure management and revenue maximisation practices. These must be prudently managed, while taking into consideration what is in the best interest of the citizens of Victoria.

3.4.4 Debt sustainability

In purely financial terms, sustainable debt is the level of debt that can be repaid while balancing factors such as economic growth, interest rates, and the state’s capacity to generate surpluses in the future. Measuring the level of sustainable debt is difficult as debt is typically repaid over long periods.

The value of borrowings as a percentage of gross state product (GSP) is an indicator of debt sustainability. A low percentage indicates that the state is better able to service its debt obligations. Figure 3G shows the state’s borrowings as a percentage of GSP for the past five financial years.

Figure 3G
Borrowings as a percentage of GSP, State of Victoria, 2009–10 to 2013–14



Source: Victorian Auditor-General's Office.

Borrowings are the result of government decisions around the type, timing and funding source of capital projects and public services. Public private partnerships (PPP) contribute significantly to the state's borrowings as the related finance leases are generally recognised as borrowings when the project moves into the asset's operating phase.

Figure 3G shows that borrowings have increased at a rate faster than the growth in GSP, reducing the state's capacity to service its debt. Total borrowings increased by 8.1 per cent ($3 840.4 million) in 2013–14 compared to GSP growth of 3.0 per cent.

As the state's debt increases, so too does the interest expense incurred to service the debt. In 2013–14, interest expenditure was $2 954.4 million, or 5.0 per cent, of total expenditure ($2 538.6 million or 4.4 per cent in 2012–13). Growing interest expenses will add to the pressures on the state's net result and will reduce the cash available to fund asset investment.

Meeting its fiscal target of reducing general government net debt as a percentage of GSP over the decade to 2022 will be a challenge for government, given the trend over the past five years.

4 Department of Education and Early Childhood Development

At a glance

Background

The Department of Education and Early Childhood Development (DEECD) is a large public sector entity whose purpose is to provide educational outcomes to the community. DEECD spent $11 billion in 2013–14, and managed assets totalling $17 billion at 30 June 2014, making it a material public sector entity for the state.

Findings

- DEECD's accounting policy for economic obsolescence results in a significant write down of taxpayer investments in school buildings which are continuing to deliver educational outcomes. This write down includes recent investments in school buildings using funding from the Victorian Schools Plan (2007–08 to 2012–13) and the Commonwealth's Building the Education Revolution program (2007–08 to 2012–13).
- Schools deemed to be partially economically obsolete by DEECD include a number being delivered under Public Private Partnership arrangements.
- Our audit opinion on DEECD's 2013–14 financial report was qualified with respect to a $1.58 billion economic obsolescence adjustment to the carrying value of school buildings at 30 June 2014, and the reclassification of the prior period's school building impairment of $2.15 billion as a fair value adjustment.
- The qualification comprised three grounds, as the:
  - accounting policy adopted to fair value school building assets, specifically including an economic obsolescence adjustment, was not appropriate
  - key valuation assumptions and judgements were not be supported by sufficient appropriate evidence
  - reclassification of previously reported 30 June 2013 balances does not accord with Australian Accounting Standards.

At a glance – *continued*

Findings – *continued*

- DEECD's accounting policy also results in significantly less 'depreciation equivalent' funding for the renewal or replacement of school buildings, including school refurbishment, rehabilitation or rejuvenation. Seven out of every 10 schools were subject to an economic obsolescence adjustment.
- Victoria is the only Australian jurisdiction that we have identified which makes an adjustment for economic obsolescence solely on student enrolment data.
- Our concerns over DEECD's management estimates and judgements meant the audit risk relating to these significant audit areas increased. Australian auditing standards require us to apply increased audit scrutiny across all areas of the financial statements.
- Financial report preparation by DEECD was inadequate. We requested 15 adjustments to the draft financial statements totalling some $850 million, and identified a further four areas of concern.

Recommendations

- That the Department of Education and Early Childhood Development maps the requirements of all applicable Australian Accounting Standards to their underlying systems and records, and identifies any gaps or limitations that prevent the preparation of a complete and accurate set of compliant financial statements.
- That the Department of Education and Early Childhood Development critically reviews its financial report preparation processes to identify areas for improvement and implements all improvements before the 30 June 2015 reporting cycle.

4.1 Background

Public sector entities are entrusted with taxpayer's money to provide public services. The preparation of a timely and accurate financial report is a key mechanism by which a public sector entity is accountable to taxpayers for the stewardship of public funds and assets.

The Department of Education and Early Childhood Development (DEECD) is a large public sector entity whose purpose is to provide educational outcomes to the community. It spent $11 billion in 2013–14, and managed assets totalling $17 billion at 30 June 2014.

DEECD is material to the state's Annual Financial Report. This means that DEECD's transactions and balances need to be completely and accurately recorded for the results of the state to be considered complete and accurate.

4.2 Concerns over the valuation of school buildings

In November 2013, Parliament was alerted to our concerns about DEECD's approach to impairing school buildings in our *Portfolio Departments and Associated Entities: Results of the 2012–13 Audits* report.

That report highlighted that since 2006, DEECD had written down the value of school buildings as it considered that schools with more space than they were entitled to were impaired. By 30 June 2013, DEECD had written down the carrying values of its school buildings by a total of $2 149 million. This write down includes taxpayer funds provided through the Victorian Schools Plan (2007–08 to 2012–13) and the Commonwealth’s Building the Education Revolution program (2007–08 to 2012–13), which together invested $4.4 billion in school building assets.

DEECD's approach to impairment meant that a portion of school buildings that were still providing educational outcomes and available for community use were not recognised in DEECD's, and consequently the state's, financial statements. We requested in that report to Parliament, that DEECD review its impairment policy.

We had previously raised our concerns with DEECD's impairment approach in 2012 when the impairment charge for that year was $615 million, significantly more than had been charged in previous periods and material to that year's comprehensive income statement. These concerns were raised through our 2012 final management letter where we recommended that DEECD review its impairment policy.

We nevertheless determined to issue an unmodified audit opinion on DEECD's 30 June 2013 financial statements on 11 September 2013 having received a commitment from DEECD that this issue would be resolved by the end of the 2013 calendar year and that it was appropriate to alert Parliament to this significant issue.

Notwithstanding the grace period provided to DEECD to resolve this matter, it had not been satisfactorily resolved for the 30 June 2014 financial statements.

4.3 DEECD's approach to the fair valuation of school buildings

Following our recommendations that DEECD review its previous approach to the impairment of school buildings, it changed its approach, and introduced a new economic obsolescence adjustment for the year ending 30 June 2014 in order to determine the fair value of school buildings.

An explanation of the two approaches taken by DEECD and an illustrative example of the 2014 approach are set out below.

The change in approach from 2013 to 2014 resulted in a $559 million increase in the fair value of school buildings, which had been previously written off as impaired.

DEECD's previous approach to impairment

School buildings were valued on depreciated replacement cost (DRC) basis. The Valuer-General conducted a valuation of all school buildings and determined what the cost would be to replace the existing school buildings based on current costs and condition.

Subsequent to the DRC valuation, DEECD determined that the value of certain school buildings were impaired. That means that it had determined that those schools had more space than they were entitled to based on current student enrolments, and therefore they were written down in accordance with AASB 136 *Impairment of Assets*.

DEECD's current approach to economic obsolescence

School buildings continue to be valued based on a DRC basis. However, the measurement of replacement cost differs from the previous approach as it includes an adjustment for the assessed level of economic obsolescence.

DEECD's current approach to determining the cost to replace school buildings is not based on what currently exists, but it is determined based on the size of school that would be required using the higher of current student enrolments or forecast long-term (seven year) enrolments.

The DEECD valuation policy is based on the premise that it would not replace the existing area of a school if the current or forecast future student enrolments do not support a school of the current size. The difference between what DEECD deems to be the required school space, and the actual school space, is considered by DEECD to be economically obsolete in accordance with AASB 13 *Fair Value Measurement*.

We undertook an analysis of equivalent departments in other Australian jurisdictions and found that no other state recognised an economic obsolescence type adjustment based solely on student enrolment data.

Illustrative example of DEECD's 2014 valuation approach

Apollo Parkways Primary School in the northern suburbs of Melbourne is a large primary school of approximately 800 students. The total size of the school buildings in area is 7 662 square metres.

The school has a current student enrolment that provides an entitlement of 5 669 square metres. Future demand for student enrolments in seven years' time is predicted by DEECD to decline, providing a projected entitlement of 2 415 square metres.

In applying its fair value approach at 30 June 2014, DEECD determined that it would not replace the current area of Apollo Parkways Primary School if they were to replace the school buildings. DEECD therefore valued the replacement cost of the school based on a school of 5 669 square metres, being the higher of the current and projected student enrolments. This results in a reduction in area of 33 per cent over that currently existing at Apollo Parkways Primary School. The value of the school buildings were written down by a total of 26 per cent, after taking into account the remaining useful life of the existing buildings, which equates to a write down of $2.4 million.

This write down has been made notwithstanding that the school introduced an enrolment cap in 2006 as a result of growing demand for places at the school. From 2014, a cap has also been placed on prep enrolments and waiting lists are in place for most year levels at Apollo Parkways Primary School.

The following commentary sets out why we disagree with DEECD’s economic obsolescence write down of $2.4 million or 26 per cent in the asset’s value.

Firstly, the economic obsolescence assessment of the school’s assets is not appropriate because it:

- relies solely on the number of students enrolled—this is too narrow
- ignores other services that the school currently facilitates—such as before and after school care programs
- ignores common areas used by children regardless of how many students there are, and assumes that children do not need 26 per cent of a library or gym.

Secondly, DEECD is unable to fully support the assumptions and judgements used in the calculation of the $2.4 million write down of the school given:

- their student enrolment forecast estimates declining student enrolments, however, the school has capped actual enrolments and there are waiting lists
- every asset on the school site has been reduced by 26 per cent
- the relationship between area and replacement cost is not linear, however, there has been a 26 per cent reduction in value
- existing assets that were recently funded from previous capital investment programs, such as the Victorian Schools Plan and the Building the Education Revolution, are written off by 26 per cent

- the school received capital funding of $3.6 million over 2009–10 and 2010–11 that has been partially written off by 26 per cent, or $936 000
- if the school receives further capital investment in the future, this will also be partially written off.

Further examples of written down schools are illustrated in Section 4.5.

4.4 Qualifications to the DEECD audit opinion

We issued a qualified audit opinion on DEECD's 30 June 2014 financial report on the basis that:

- DEECD's accounting policy for measuring the fair value of school buildings, specifically including an economic obsolescence adjustment, is not appropriate as it does not result in financial information that is relevant and reliable. Any adjustment to the fair value of the school buildings due to economic obsolescence should not be based on student enrolment data alone.
- Key valuation assumptions and judgements used in the DEECD model that calculates the economic obsolescence adjustment are not supported by sufficient appropriate evidence.
- DEECD's reclassification of previously reported 30 June 2013 balances relating to impairment charges does not accord with Australian Accounting Standards because DEECD has not corrected and disclosed prior period errors.

Each basis of qualification is discussed in more detail below.

Accounting policy is not appropriate

AASB 13 defines fair value, sets out a framework for measuring fair value, and requires disclosures about fair value measurements.

Specialised assets with no active market can be valued based on their depreciated replacement cost—that is the cost approach to fair valuation. When applying depreciated replacement cost, the guidance appendix to AASB 13 provides that the replacement cost to be used is based on the cost to construct a substitute asset of comparable utility adjusted for obsolescence. Obsolescence is defined as encompassing physical, functional (technological) and economic (external).

AASB 13 does not define economic obsolescence nor provide guidance on measuring the various elements of obsolescence being physical, functional and economic.

There is no authoritative Australian Accounting Standard or other Australian professional guidance on how economic obsolescence should be assessed for public sector assets. Therefore, the way economic obsolescence is assessed and measured is a matter of judgement.

The Minister for Finance issues financial reporting directions pursuant to the *Financial Management Act 1994* (FMA). The minister has updated Financial Reporting Direction (FRD) 103E *Non-Financial Physical Assets* which specifically assists public sector entities with their implementation of AASB 13 for the 2013–14 financial reports. However, FRD103E provides no requirements or guidance relating to the concept of economic obsolescence or its application to public sector assets.

When considering the future economic benefits of assets, the conceptual framework requires that the future economic benefits be valued in terms of an asset’s ability to meet the objectives of a not-for-profit public sector agency. Therefore, the converse must also hold that economic obsolescence would be measured with reference to whether an asset is meeting a public sector agency's objectives.

DEECD have made the judgement that economic obsolescence should be assessed solely on student enrolment data.

Accordingly we have formed the opinion that economic obsolescence should be assessed based on whether an asset is or is not delivering the strategic objectives of a public sector entity.

The Secretary, in correspondence to us, has stated that the purpose of DEECD is to achieve educational outcomes. We do not accept that educational outcomes are solely determined by enrolments, both current and forecast, as this is too narrow. The existence of schools is also for the achievement of educational outcomes for the community. Therefore, as long as a school is providing a level of education to children the school’s assets are enabling DEECD to meet its objectives and are, therefore, not economically obsolete.

Further, the DEECD fair value approach does not differentiate between teaching and communal spaces. Communal assets will be used by a school for their intended purpose, regardless of the number of students at a school. For example, any number of students can use the library, gym, and halls. These communal school assets will provide educational outcomes for the community regardless of how many students are enrolled in a school and therefore should have different indicators of economic obsolescence in the pursuit of DEECD's objectives.

Lastly, the assessment of the demand for services should include the full range of services provided by the assets to meet all the objectives of the entity, including community service obligations.

Key valuation assumptions and judgement in the DEECD approach are not supported

DEECD could not substantiate with sufficient appropriate evidence that its economic obsolescence adjustment totalling $1.58 billion to the carrying value of school buildings at 30 June 2014 is a reasonable estimate.

The model developed by DEECD to calculate the economic obsolescence adjustment has a number of key assumptions and areas of management judgement.

To form an opinion on the DEECD approach, we were required under the Auditing Standards to evaluate and seek evidence to support all key assumptions and judgements in the model. Each one, by itself, is fundamental to the fair value calculation.

We found that DEECD could not fully support the appropriateness of some of its key valuation assumptions for assessing economic obsolescence, principally that:

- **A seven year student enrolment forecast period is appropriate.** DEECD forecasts demographic demand for each school in yearly intervals up to 2031—which was introduced in 2014. DEECD has chosen to adopt the seven-year long-term enrolment forecasts (to 2021) as an indicator of future enrolments. DEECD was unable to provide sufficient appropriate evidence to support why a seven-year forecast is the most appropriate forecast period to use for assessing economic obsolescence.
- **A 10 per cent loading is sufficient***.* This assumption means that those schools over the assessed entitlement, which includes a 10 per cent loading, will be subjected to a valuation adjustment for economic obsolescence. The 10 per cent loading is intended to allow for possible fluctuations in the current and forecast enrolment figures used to establish school space entitlement, conducting the valuation on a school site basis (including common areas) versus a building basis, and including buildings with community uses (such as halls and gymnasiums) in the economic obsolescence adjustment. DEECD was unable to provide sufficient appropriate evidence to support whether a 10 per cent allowance was appropriate.
- **Economic obsolescence adjustments made on a whole-of-school-site basis are appropriate versus conducting the valuation on a building basis.** A consequence of adopting a whole-of-school-site basis is that all buildings on a site are written down regardless of age or condition if DEECD determines there is excess space. A further consequence is that common areas such as libraries, corridors, halls, gyms, staff rooms and offices are also written down, and portions of school classrooms are written down. DEECD was unable to provide sufficient appropriate evidence to support why this is an appropriate method to assess economic obsolescence adjustments.

- **Economic obsolescence adjustments are made solely based on student enrolment data, however, some decisions to invest in schools are not.** We identified that there are current school investment programs where the decision to invest was not made based on enrolment numbers for the school and some instances were identified where investments had been made in schools that had been partially written down as economically obsolete. This means that buildings built through investment programs such as the Victorian Schools Plan (2007–08 to 2012–13) and the Building the Education Revolution program (2007–08 to 2012–13) are written off regardless of whether the investment objectives are being met as the investment decisions were not solely based on enrolments. Consequently DEECD was unable to provide sufficient appropriate evidence to support why solely using student enrolments is an appropriate method to assess economic obsolescence.

In addition, our review of DEECD's approach identified other concerns such as:

- **The relationship between area and replacement cost is linear within the DEECD approach.** This means that it assumes it would cost 10 per cent less to build a school building 10 per cent smaller. This does not reflect the economies of scale associated with any building project.
- **Economic obsolescence adjustments have been applied to heritage assets.** Heritage assets by their nature are required to be replaced with the same structure in all aspects including size, materials and building technique and are valued on a reproduction cost basis rather than replacement cost basis. Therefore, they are not by definition economically obsolete.
- **The approach applied by DEECD in its 2013–14 financial statements differs from its policy which requires an adjustment for economic obsolescence only when excess space is greater than 10 per cent.** The DEECD policy requires an adjustment for economic obsolescence when the excess space is considered permanent. Permanency has been determined under the policy to be anything greater than 10 per cent over entitlement. However, the fair value calculation for 2013–14 has instead applied a 10 per cent loading to allow for possible fluctuations in current and forecast enrolment figures, conducting the valuation on a whole-of-school-site basis and including buildings with community uses.
- **The approach applied by DEECD in its 2013–14 financial statements also differs from its policy as it uses long-term enrolment forecast data and not the new demographic demand forecast for each school.**

Taken in totality, the inability of DEECD to provide sufficient and appropriate documentation to support its adjustments to the valuation of these assets, has meant it was not possible to determine that the $6.50 billion value assigned to these assets at 30 June 2014, after taking into account the economic obsolescence adjustment totalling $1.58 billion, is fairly stated in accordance with AASB 13.

As a consequence, we could also not determine that the related depreciation charge, accumulated depreciation and the property, plant and equipment asset revaluation reserve reported for 2013–14 were fairly stated.

Incorrect reclassification of prior period impairment charges

Note 1 (F) and (W) to the DEECD financial statements states that DEECD has revised its accounting policy for 2013–14 in light of AASB 13 and now recognises adjustments for schools having space in excess of teaching requirements as an adjustment to fair value, rather than as previously disclosed as an impairment adjustment. This has resulted in a reclassification of the relevant comparative information.

This is a departure from AASB 13 which requires that it is applied prospectively from the beginning of the reporting period when it is initially applied, which in this instance is the year ending 30 June 2014.

Further, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, determines how corrections to what has been reported in previous years should be treated and disclosed. It requires that errors, such as impairment charges wrongly recognised under AASB 136 in prior periods, should be disclosed as a prior period error using a ‘third balance sheet’ rather than as a reclassification on adoption of a new accounting policy under AASB 13 as DEECD has done.

DEECD's declaration to its 2013–14 financial report

DEECD's accountable officer’s and chief finance officer’s declaration to its 2013–14 financial report includes substantial further commentary that explains DEECD's approach to the adjustment of the fair value of school buildings. In our view it is highly unusual and inappropriate for this additional commentary to be included in the accountable officer’s and chief finance officer’s declaration. As described in the Standing Directions of the Minister for Finance under the FMA, the purpose of the declaration is for the accountable officer and chief finance officer to state their opinion that the financial statements present fairly the financial transactions during the reporting period and the financial position at the end of the period in accordance with AASB 101 *Presentation of Financial Statements*.

In particular we do not believe it is appropriate for the accountable officer and chief finance officer to make direct reference to the Victorian Valuer-General in their certification that the financial statements are presented fairly. While it is reasonable for them to seek assistance in carrying out their financial reporting responsibilities, the accountable officer and chief finance officer should take responsibility for the fairness of the financial statements.

We are of the opinion that commentary on the fairness of specific account balances, transactions or disclosures should be included in the notes to the financial statements and not in the declaration. Consequently, when we were first supplied with DEECD's accountable officer’s and chief finance officer’s declaration we wrote to DEECD requesting that the additional commentary within the certification concerning the fair value of school buildings be removed from the certification and that it was best placed in a note to the financial statements. However, DEECD refused to make this change.

Within the accountable officer’s and chief finance officer’s declaration, DEECD also asserts that previous Auditors-General had agreed to a ‘similar adjustment’ to the fair value of school buildings in prior periods. We do not agree with this assertion—similar adjustments were not agreed to in prior periods, as outlined in Section 4.2.

As noted in his qualified audit opinion on DEECD’s financial report, the Auditor-General disagrees with DEECD’s assertion that economic obsolescence under AASB 13 and impairment under AASB 136 represent a consistent notion. These are different accounting concepts, which have different recognition and measurement requirements under their respective Australian Accounting Standards.

4.5 Further illustrative examples of the application of DEECD's approach to economic obsolescence

To further demonstrate our concern with the practical application of the DEECD approach to economic obsolescence, we provide comment on the following illustrative examples identified during our audit.

Gisborne Secondary College

Gisborne Secondary College is receiving $3.5 million in funding during 2013–14 and 2014–15 to create a new community sports centre, and repurpose existing spaces into a performing arts space. The community sports centre is being delivered in conjunction with the Macedon Ranges Council and the master plan for the development envisages that this centre, and the new performing arts spaces, will be available for both the school and broader community use.

At 30 June 2014, the school buildings at Gisborne Secondary College were subject to an economic obsolescence write down of $1.39 million. This was because the total area of the school was 12 037 square metres, which is more space than the school is entitled to under the DEECD approach based on current enrolment (9 199 square metres) and long-term forecast enrolment (10 070 square metres). This means, in DEECD's view, that there is an excess of space at this new school in the order of 20 per cent, based on the long-term forecast enrolments.

According to the DEECD demographic demand forecast model, enrolment demand for the school will drop over the next seven years, which is contrary to the long-term forecast entitlement data used in the fair value calculation.

Therefore, DEECD is investing $3.5 million into the school while at the same time writing off $1.39 million because its fair value model has determined that the school has space that is economically obsolete. This is contradictory and raises questions over the appropriateness of the DEECD approach to economic obsolescence and/or the basis used for making investment decisions. Under the current approach, the $3.5 million invested in the school may by written down next year if DEECD deem that the current or forecast future student enrolments do not support the current school size.

New schools built as private public partnerships

DEECD currently has 12 schools that are open and operating under a public private partnership (PPP) model. These new schools are in growth areas whereby the private sector has built and will maintain the buildings for a 25-year period, and DEECD makes quarterly payments, including interest, to the PPP operator.

Our analysis shows that the fair value of seven of the 12 PPP schools was written down at 30 June 2014 in DEECD's financial statements as they were deemed to have excess space, and therefore were in part economically obsolete.

For example, the fair value of Mernda Central Primary School was $9.09 million but it was written down by $2.28 million (25 per cent) to a fair value of $6.82 million at 30 June 2014. Similarly, Kororoit Creek Primary School was written down by $2.88 million (18 per cent) to a fair value of $12.97 million at 30 June 2014.

Writing down new schools built under the PPP model, which commits the state for 25 years, suggests that DEECD are either over investing in new schools, or that their approach to economic obsolescence isn't appropriate, or both. DEECD's current approach to economic obsolescence calls into question whether public money is being wasted building new schools, and paying interest and other costs for these schools over a 25 year period, when DEECD has subsequently determined they are in excess of what is required now and into the future.

4.6 Depreciation equivalent funding impact

Writing down the fair value of school buildings under the DEECD approach to economic obsolescence causes a consequential decrease in annual depreciation charges. Based on a total economic obsolescence adjustment of $1.58 billion at 30 June 2014, we have estimated that the reduction in annual depreciation could be in the range of $27 million to $40 million using DEECD depreciation rates.

Under the current state appropriation funding arrangements, DEECD is provided depreciation equivalent funding that can be used for the renewal or replacement of school buildings, including school refurbishment, rehabilitation or rejuvenation. Where the depreciation charged is understated, this will mean that the funding available to DEECD from this funding source will be reduced by the same amount.

Consequently, writing down the value of school buildings for economic obsolescence will reduce the money available to renew or replace schools from this funding source. This would be of concern both to those school communities needing refurbishment and to the public at large.

Using the information in the 2014–15 State Budget, we have calculated that on average $6.3 million is spent to upgrade or refurbish a school to modern standards. Therefore, the opportunity cost of reducing the depreciation equivalent funding is that between four and six schools may not be funded for a refurbishment, rehabilitation or rejuvenation using this funding source each year.

4.7 Financial reporting issues

DEECD's 30 June 2014 financial statements were signed by the Secretary on 19 September 2014.

Our final audit commenced on 21 July 2014 and was completed when the audit opinion was issued on 2 October 2014. The protracted time frame for the final audit was a result of the significant issues encountered, including but not limited to the audit qualification matters, and additional audit testing performed on the 2013–14 financial statements.

The 2013–14 financial statements required increased audit scrutiny than in previous years as a direct result of audit concerns related to management judgements on previous impairment estimates for school buildings, and the inability of DEECD to resolve technical accounting issues in a timely manner.

In particular, concerns over management estimates and judgements, and its accounting for assets, meant the assessed inherent risk over these significant audit areas was increased. We responded to this increased inherent risk, as required by the Australian Auditing Standards, with increased testing and the adoption of a higher level of professional scepticism than had been applied in previous years. This resulted in increased scrutiny across all areas of the audit. This change in audit approach and increased testing is required by the Australian Auditing Standards.

The consequence of increased audit risk, increased professional scepticism and increased audit testing was that VAGO identified a significant number of audit adjustments to the financial statements, and management letter issues that had not been previously raised. DEECD needs to make significant improvements to the quality of their financial reporting including identifying in particular any gaps in the underlying records supporting the financial report.

4.7.1 Adjustments to the financial statements

The frequency and value of errors in draft financial reports are a direct measure of the quality of the reports submitted for audit. Ideally, there should be no errors or adjustments required as a result of an audit. Where errors are detected we request they be adjusted. While some errors may appear small in isolation, in aggregate, they may tell a story about the quality of the financial report preparation process, and the quality of the underlying systems and records on which they are prepared.

In undertaking the audit of the 30 June 2014 financial statements of DEECD, we found many instances where the requirements of Australian Accounting Standards, the FMA and the financial reporting directions issued by the Minister for Finance had not been fully assessed and the relevant requirements reflected in the financial report.

We requested 15 adjustments to the financial statements, including changes to disclosures in those statements. The total value of these adjustments was $851 million. We identified a further four adjustments that DEECD elected not to make to the financial statements, and in two instances the amount to be adjusted was not capable of reliable measurement.

A summary of the requested adjustments is included in Figure 4A.

Figure 4A
Adjustments to the 30 June 2014 DEECD financial statements requested by VAGO

Balance affected	Amount adjusted ($ million)	Reason for adjustment
Unearned income	113.5	Unearned income from schools was overstated, and income from transactions understated, because the revenue recognition principles adopted did not accord to AASB 118 *Revenue* and AASB 1004 *Contributions*.
Receivables	102.4	School receivables were overstated and income from transactions was overstated because DEECD could not demonstrate they had the legal right to receive the funds.
Provision for doubtful debts	11.7	With the removal of school receivables, a provision for doubtful debts was no longer required.
Unearned income *30 June 2013 comparatives*	98.8	Unearned income from schools was overstated and income from transactions understated because the revenue recognition principles adopted did not accord to AASB 118 *Revenue* and AASB 1004 *Contributions*.
Receivables *30 June 2013 comparatives*	93.7	School receivables were overstated and income from transactions was understated because DEECD could not demonstrate they had the legal right to receive the funds.
Assets held for sale or distribution	51.5	DEECD incorrectly recorded amounts held for sale at fair value, which exceeded the carrying amount. This did not accord to AASB 5 *Non-current Assets Held for Sale and Discontinued Operations.*

Figure 4A
Adjustments to the 30 June 2014 DEECD financial statements requested by VAGO – *continued*

Balance affected	Amount adjusted ($million)	Reason for adjustment
Intangible assets	3.0	Intangible assets were understated as some intangible assets were incorrectly recorded in the property, plant and equipment works in progress balance.
Cash and deposits	0.4	Cash and deposits were understated as we identified a bank account that was not on DEECD's general ledger. As a consequence, this bank account was excluded from the financial statements but also was not subject to regular controls such as bank reconciliations.
Disclosure amendments		
Property, plant and equipment at fair value	207.9	The specialised assets disclosure was overstated as DEECD had incorrectly applied the disclosure requirements of AASB 13 *Fair Value Measurement* to leased assets—school PPP's and motor vehicle finance leases.
Service concession (PPP) related commitments	99.8	Present value amounts were not disclosed in accordance with the requirements of the Department of Treasury and Finance model financial report, issued pursuant to the FMA.
Statutory payables	49.2	Loans under section 37 of the FMA to TAFE institutes were incorrectly classified as taxes payable.
Assets pledged as security to finance leases	12.9	Based on DEECD's fair value policy and valuation of school buildings, the fair value of the assets that secure the schools PPP arrangements were overstated as the value of seven of the 12 schools under finance lease were written down at 30 June 2014 as surplus to requirements.
Capital commitments	5.7	Capital commitments were overstated as they did not reflect actual contract values.
Remuneration of executive officers	0.4	A contractor with management responsibilities was not disclosed in the financial report. This does not accord to FRD 21B *Disclosure of responsible persons, executive officers and other personnel in the financial report*.
Remuneration of executive officers	0.2	The remuneration for six executives was overstated.
Total adjustments	**$851.15**	

Source: Victorian Auditor-General's Office.

Figure 4B summarises differences we identified that remain unadjusted.

Figure 4B
Unadjusted audit differences identified on the 30 June 2014 DEECD financial statements

Balance affected	Amount unadjusted ($million)	Reason for adjustment
Property, plant and equipment—Asset Disposals	50.7	We did not receive a complete list of asset disposals to verify and support the amount reported in the financial statements. Our testing of the information available identified items that were not disposals.
Depreciation expense	1.1	Depreciation expenditure was understated because finalised work in progress was not capitalised when it was completed, and consequently no depreciation was charged during the financial year.
Cash flow statement—payments for and proceeds from investments	Unknown	Payments for school investments and proceeds from school investments are not separately disclosed in the cash flow statement as required by AASB 107 *Statement of Cash Flows*.
Heritage assets	Unknown	Heritage assets are not identified as a separate asset class of assets and disclosed in the financial report as required by AASB 101 *Presentation of Financial Statements*.

Source: Victorian Auditor-General's Office.

We conclude that the financial report preparation at DEECD is inadequate based on the total number and quantum of adjustments and errors we identified.

We encountered significant problems in obtaining appropriate audit evidence to support information in the financial report. In several instances supporting documentation or calculations could not be provided or were not provided until further follow-up requests were made. The quality of supporting documentation provided was sometimes inadequate and further investigation was required in order to obtain source documentation. This in part forms one area of audit qualification in respect of the documentation available to support DEECD's key assumptions underpinning its economic obsolescence adjustment to the fair valuation of school buildings.

Recommendations

3. That the Department of Education and Early Childhood Development maps the requirements of all applicable Australian Accounting Standards to their underlying systems and records, and identifies any gaps or limitations that prevent the preparation of a complete and accurate set of compliant financial statements.
4. That the Department of Education and Early Childhood Development critically reviews its financial report preparation processes to identify areas for improvement and implements all improvements before the 30 June 2015 reporting cycle.

Appendix A. VAGO reports

Figure A1
VAGO reports on the results of the 2013–14 financial audits

Report	Description
Technical and Further Education Institutes: Results of the 2013 Audits	The report provides the results of the audits of 27 entities in the TAFE sector. The report addressed their financial reporting and financial sustainability, internal controls relating to travel and accommodation expenditure, and risk management practises, governance and oversight. *Tabled in Parliament in August 2014.*
Information and Communication Technology Controls 2013–14	The report provides an analysis of common themes relating to IT audit findings and the maturity of IT controls across selected entities and highlights key and emerging issues observed as part of the IT audits. *Tabled in Parliament in October 2014.*
Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2013–14 This report.	This report provides the result of the audit of the state's annual financial report. It addresses the quality and timing of financial reporting, explains significant financial results for the state and analysis of the results of the annual financial audit of the Department of Education and Early Childhood Development.
Portfolio Departments and Associated Entities: Results of the 2013–14 Audits	The report provides the results of the audits of approximately 210 entities. The report will address financial performance and financial sustainability, the internal audit function at portfolio departments, and internal controls relating to the collection of public transport and traffic fines. It will also include comment on the annual attestation of compliance with the prudential insurance standard and on significant state projects. *Proposed to be tabled in Parliament in February 2015.*
Public Hospitals: Results of the 2013–14 Audits	The report provides the results of the audits of approximately 110 entities in the public hospital sector. The report will address their financial performance and financial sustainability, their internal audit functions, and their management of asset maintenance for public private partnership-operated hospitals. *Proposed to be tabled in Parliament in February 2015.*
Local Government: Results of the 2013–14 Audits	The report provides the results of the audits of approximately 102 entities in the local government sector. The report will address their financial and performance reporting, financial sustainability, oversight arrangements for grants, and creditor management practices and governance. *Proposed to be tabled in Parliament in February 2015.*

Figure A1
VAGO reports on the results of the 2013–14 financial audits – *continued*

Report	Description
Water Entities: Results of the 2013–14 Audits	The report provides the results of the audits of 20 entities in the water sector. The report will address their financial and performance reporting and financial sustainability. It will also address governance arrangements relating to gifts, benefits and hospitality, audit committees, and the capital project delivery of their recently expired five-year water plans. *Proposed to be tabled in Parliament in February 2015.*
Universities: Results of the 2014 Audits	The report provides the results of the audits of 64 entities in the university sector. The report will address their financial reporting and financial sustainability, internal controls relating to travel and accommodation expenditure, and risk management practises, governance and oversight. *Proposed to be tabled in Parliament in May 2015.*
Technical and Further Education Institutes: Results of the 2014 Audits	The report provides the results of the audits of 27 entities in the TAFE sector. The report will address their financial reporting and financial sustainability, internal controls relating to travel and accommodation expenditure, and risk management practises, governance and oversight. *Proposed to be tabled in Parliament in May 2015.*
Information and Communication Technology Controls 2014–15	The report provides an analysis of common themes relating to IT audit findings and the maturity of IT controls across selected entities and highlights key and emerging issues observed as part of the IT audits. *Proposed to be tabled in Parliament in June 2015.*

Source: Victorian Auditor-General's Office.

Appendix B. Material entities

Figure B1
Material entities for 2013–14

General government sector
Alfred Health
Austin Health
Barwon Health
Country Fire Authority
Department of Education and Early Childhood Development
Department of Environment and Primary Industries
Department of Health
Department of Human Services
Department of Justice
Department of Premier and Cabinet
Department of State Development, Business and Innovation
Department of Transport, Planning and Local Infrastructure
Department of Treasury and Finance
Eastern Health
Linking Melbourne Authority
Melbourne Health
Metropolitan Fire and Emergency Services Board
Monash Health
National Gallery of Victoria, Council of Trustees
Victoria Police
Parks Victoria
Public Transport Victoria
Roads Corporation (VicRoads)
Royal Children's Hospital
Victorian Commission for Gambling and Liquor Regulation
Western Health

Figure B1
Material entities for 2013–14 – *continued*

Public non-financial corporations	
Barwon Region Water Corporation	
City West Water Corporation	
Coliban Regional Water Corporation	
Goulburn-Murray Rural Water Corporation	
Grampians Wimmera Mallee Water Corporation	
Melbourne Water Corporation	
Places Victoria	
Port of Melbourne Corporation	
South East Water Corporation	
State Electricity Commission of Victoria	
V/Line Passenger Corporation	
Victorian Rail Track (VicTrack)	
Yarra Valley Water Corporation	
Public financial corporations	
Rural Finance Corporation of Victoria	
Transport Accident Commission	
Treasury Corporation of Victoria	
Victorian Managed Insurance Authority	
Victorian WorkCover Authority	
Other entities	**Certification required for:**
Legal Services Board and Commissioner	Monies held in trust
Residential Tenancies Bond Authority	Monies held in trust
Senior Master of the Supreme Court	Monies held in trust
State Trustees Limited	Monies held in trust

Source: Victorian Auditor-General's Office.

Appendix C. Milestone dates

Figure C1
Material entity milestone dates

Material entity	Department of Treasury and Finance AFR production milestone for finalising the financial report including audit opinion	
	Met	Not met
General government sector		
Alfred Health	●	
Austin Health	●	
Barwon Health	●	
Country Fire Authority		●
Department of Education and Early Childhood Development		●
Department of Environment and Primary Industries		●
Department of Health		●
Department of Human Services		●
Department of Justice		●
Department of Premier and Cabinet		●
Department of State Development, Business and Innovation		●
Department of Transport, Planning and Local Infrastructure		●
Department of Treasury and Finance		●
Eastern Health	●	
Linking Melbourne Authority	●	
Melbourne Health	●	
Metropolitan Fire and Emergency Services Board	●	
Monash Health		●
National Gallery of Victoria, Council of Trustees		●
Victoria Police		●
Parks Victoria		●
Public Transport Victoria		●
Roads Corporation (VicRoads)		●
Royal Children's Hospital	●	

Figure C1
Material entity milestone dates – *continued*

Material entity	Department of Treasury and Finance AFR production milestone for finalising the financial report including audit opinion – Met	Not met
General government sector – *continued*		
Victorian Commission for Gambling and Liquor Regulation		●
Western Health	●	
Public non-financial and Public financial corporations		
Barwon Region Water Corporation		●
City West Water Corporation		●
Coliban Region Water Corporation		●
Goulburn-Murray Rural Water Corporation		●
Grampians Wimmera Mallee Water Corporation		●
Melbourne Water Corporation		●
Places Victoria		●
Port of Melbourne Corporation		●
Rural Finance Corporation of Victoria		●
South East Water Corporation		●
State Electricity Commission of Victoria		●
Transport Accident Commission		●
Treasury Corporation of Victoria	●	
V/Line Passenger Corporation		●
Victorian Managed Insurance Authority		●
Victorian Rail Track (VicTrack)		●
Victorian WorkCover Authority		●
Yarra Valley Water Corporation		●
Other entities		
Legal Services Board and Commissioner		●
Residential Tenancies Bond Authority[(a)]		●
Senior Master of the Supreme Court		●
State Trustees Limited		●
2013–14 number	**10**	**38**
per cent	**21**	**79**
2012–13 number	**8**	**40**
per cent	**17**	**83**

(a) The Authority does not have an audit committee.
Source: Victorian Auditor-General's Office.

Appendix D. Glossary

Accountability

Responsibility of public sector entities to achieve their objectives, with regard to reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties.

Acquisition

Establishing control of an asset, undertaking the risks, and receiving the rights to future benefits, as would be conferred with ownership, in exchange for the cost of acquisition.

Asset

A resource controlled by an entity as a result of past events, and from which future economic benefits are expected to flow to the entity.

Audit Act 1994

An Act of the State of Victoria that establishes the:

- operating powers and responsibilities of the Auditor-General
- the operation of his office—the Victorian Auditor-General's Office (VAGO)
- nature and scope of audits conducted by VAGO
- relationship of the Auditor-General with the Public Accounts and Estimates Committee as the representative body of Parliament
- Auditor-General's accountability to Parliament for discharge of the position's responsibilities.

Audit risk

The risk of an inappropriate audit opinion being expressed when the financial report is materially misstated.

Capital commitment

A contractual agreement to undertake capital expenditure at some set time in the future which has not yet become a liability.

Clear audit opinion – financial report

A positive written expression provided when the financial report has been prepared and presents fairly the transactions and balances for the reporting period in accordance with the requirements of the relevant legislation and Australian accounting standards.

Also referred to as an **unqualified** or an **unmodified audit opinion**.

Consumer Price Index

A measure of changes, over time, in retail prices of a constant 'basket' of goods and services representative of consumption expenditure.

Credit risk

The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Deficit

Total expenditure exceeds total revenue resulting in a loss.

Depreciated replacement cost

The cost to replace an asset with an equivalent current service capacity. It is calculated as the cost of an asset after applying depreciation and consideration of economic obsolescence.

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.

Economic obsolescence

The loss in value of an asset caused by factors which are external to the asset itself. Such factors often relate to the economics of the industry in which the business operates or the business in which the asset is employed.

Eliminations

Removing the effect of inter-entity transactions for the preparation of consolidated financial statements.

Entity

A body, whether corporate or unincorporated, that has a public function to exercise on behalf of the state or is wholly owned by the state, including—departments, statutory authorities, statutory corporations and government business enterprises.

Equity or net assets

Residual interest in the assets of an entity after deduction of its liabilities.

Expense

Outflows or other depletions of economic benefits in the form of incurrence of liabilities or depletion of assets of the entity, other than those relating to contributions by owners, that results in a decrease in equity during the reporting period.

Financial instrument

Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial Management Act 1994

An Act of the State of Victoria that establishes the financial administration and accountability of the public sector, as well as annual reporting to the Parliament by all departments and public sector entities.

Financial report

Structured representation of the financial information, which usually includes accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period in accordance with a financial reporting framework.

Financial sustainability

An entity's ability to manage financial resources so it can meet spending commitments, both at present and into the future.

Financial year

The period of 12 months for which a financial report (and performance report) is prepared.

Fiscal targets

Targets set by the government in order to meet short and medium term economic objectives.

General government sector

The general government sector comprises all government departments, offices and other bodies engaged in providing services free of charge or at prices significantly below their cost of production. General government services include those which are mainly non-market in nature, those which are largely for collective consumption by the community, and those which involve the transfer or redistribution of income. These services are financed mainly through taxes, other compulsory levies and user charges.

Governance

The control arrangements in place at an entity that are used to govern and monitor its activities, in order to achieve its strategic and operational goals—it includes the oversight role of the board of management at public hospitals.

Inherent risk

The susceptibility of a balance or disclosure in the financial report being misstated before consideration of any related controls.

Investment

The expenditure of funds intended to result in medium- to long-term service and/or financial benefits arising from the development and/or use of infrastructure assets by either the public or private sectors.

Legislative framework

Sets out the legal functions and powers of the state government entities as detailed in the relevant legislation.

Liability

A present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow of resources from the entity.

Liquidity risk

The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

Management letter

A written report issued to management which communicates significant matters relating to or arising from the financial audit of an entity.

Material entity

Those entities that are collectively deemed to have a significant effect on the transactions and balances reported in the state's annual financial report.

The selection of these entities follows a detailed analysis of the financial operations of all controlled entities of the state and takes into account any major risk factors that are attached to specific entities or portfolios.

Net result

Calculated by subtracting an entity's total expenses from its total revenue, to show what the entity has earned or lost in a given period of time.

Professional scepticism

An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Public financial corporation

A subsector comprising public sector corporations which are engaged in providing financial intermediation services or auxiliary financial services. Central borrowing authorities of state governments are included in this subsector.

Public non-financial corporation

A subsector comprising public sector corporations which are mainly engaged in providing market non-financial goods and services. Includes corporations which aim at covering most of their expenses from revenue.

Public private partnerships (PPP)

An infrastructure procurement method used by the state government. The aim of a PPP is to deliver improved services and better value for money primarily through appropriate risk transfer, encouraging innovation, greater asset utilisation and an integrated whole-of-life management, underpinned by private financing.

Qualified audit opinion

A qualification is issued when the auditor concludes that an unqualified opinion cannot be expressed due to one of the following reasons:

- disagreement with those charged with governance
- conflict between applicable financial reporting frameworks
- limitation of scope.

A qualified opinion is expressed as being except for the effects of the matter to which the qualification relates.

Revaluation

Recognising a reassessment of values for non-current assets at a particular point in time.

Revenue

Inflows of funds, or other enhancements or savings in outflows of service potential, or future economic benefits in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners which result in an increase in equity during the reporting period.

Risk

The chance of a negative impact on the objectives, outputs or outcomes of the entity.

State controlled entity

A public body which is classified as a general government sector entity as defined and listed in the Annual Financial Report of the State of Victoria.

Surplus

Total revenue exceeds total expenditure resulting in a profit.

Sustainable government initiative

The reduction of the number of public sector employees in non-service delivery and back office roles by approximately 3 600 workers.

Third balance sheet

A financial statement required to be presented if an entity makes adjustments which have a material effect on information in the balance sheet at the beginning of the comparative period. Adjustments can result from retrospective application of an accounting policy, restatement or reclassification of items.

Triple-A credit rating

The highest possible rating assigned to the bonds of an issuer by credit rating agencies. An issuer that is rated AAA has an exceptional degree of creditworthiness and can easily meet its financial commitments.

Unqualified (or unmodified) audit opinion

See ‘clear audit opinion’.

Appendix E. Auditor-General's opinion on the 2013–14 Annual Financial Report of the State of Victoria

Figure E1
Independent auditor's report

VAGO

Victorian Auditor-General's Office

Level 24, 35 Collins Street
Melbourne VIC 3000
Telephone 61 3 8601 7000
Facsimile 61 3 8601 7010
Email comments@audit.vic.gov.au
Website www.audit.vic.gov.au

INDEPENDENT AUDITOR'S REPORT

To the Treasurer

The Financial Report

The accompanying financial report for the year ended 30 June 2014 of the State of Victoria (the State) and the Victorian General Government Sector has been audited. The Annual Financial Report comprises a consolidated comprehensive operating statement, consolidated balance sheet, consolidated cash flow statement, consolidated statement of changes in equity, notes comprising a summary of significant accounting policies and other explanatory information contained in Chapter 4 of the Annual Financial Report, and the certification by the Department of Treasury and Finance. The financial report is the consolidated financial statements of the State, comprising the State of Victoria and the Victorian General Government Sector and the entities they controlled at the year's end or from time to time during the financial year as disclosed in note 42 to the consolidated financial statements.

The original General Government Sector budget estimates disclosed in Note 32 were subject to a review by my office as required by Section 16B of the *Audit Act 1994* upon which I issued an unqualified review report on 2 May 2014.

The Treasurer's Responsibility

The Treasurer of Victoria is responsible for the preparation and fair presentation of the financial report in accordance with applicable Australian Accounting Standards, and the manner and form of the financial statements determined by the Treasurer of Victoria as required by the *Financial Management Act 1994*, and for such internal control as the Treasurer determines is necessary to enable the preparation and fair presentation of the financial report that is free from material misstatement, whether due to fraud or error.

For some years, the Treasurer of Victoria has not signed the certification of the financial report and has delegated this responsibility to specified officers of the Department of Treasury and Finance. Consequently, the Treasurer has not signed the certification of the 2013–14 financial report.

Auditor's Responsibility

As required by the *Audit Act 1994*, my responsibility is to express an opinion on the financial report based on the audit, which has been conducted in accordance with Australian Auditing Standards. Those standards require compliance with relevant ethical requirements relating to audit engagements and that the audit be planned and performed to obtain reasonable assurance about whether the financial report is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial report. The audit procedures selected depend on judgement, including the assessment of the risks of material misstatement of the financial report, whether due to fraud or error. In making those risk assessments, consideration is given to the internal control relevant to the entities' preparation and fair presentation of the financial report in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the consolidated entities' internal control. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of accounting estimates made by the Treasurer of Victoria as well as evaluating the overall presentation of the financial report.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified audit opinion.

Independence

The Auditor-General's independence is established by the *Constitution Act 1975*. The Auditor-General is not subject to direction by any person about the way in which his powers and responsibilities are to be exercised. In conducting the audit, the Auditor-General, his staff and delegates complied with all applicable independence requirements of the Australian accounting profession.

Auditing in the Public Interest

Figure E1
Independent auditor's report – *continued*

Independent Auditor's Report (continued)

Basis for Qualified Opinion

As set out in Note 1(M) and the Certification by the Department of Treasury and Finance, the State measures the fair value of school buildings at depreciated replacement cost adjusted for economic obsolescence where floor space is assessed to be permanently in excess of teaching requirements by reference to long term enrolment trend data.

I disagree with the appropriateness and application of this accounting policy. The State's policy for measuring fair value of school buildings, specifically the economic obsolescence adjustment, is not appropriate as it does not result in financial information that is relevant and reliable. It is my opinion that any adjustment to the fair value of the school buildings due to economic obsolescence should not be based on student enrolment data alone. Further, the State has not complied with AASB 127 *Consolidated and Separate Financial Statements* as it has not prepared the Annual Financial Report using a uniform accounting policy for measuring economic obsolescence adjustments to the fair value of all public sector non-financial physical assets, including school buildings.

The State's approach to the assessment of economic obsolescence of school buildings results in the significant write down of taxpayer investments in school buildings which are continuing to deliver educational outcomes and significantly less funding for the renewal of school buildings.

The State was also unable to provide me with sufficient appropriate audit evidence to fully support the appropriateness of some of its key valuation assumptions and judgements that it and the Victorian Valuer-General have used to adjust the fair value of school buildings due to economic obsolescence.

Consequently, the State has not fully substantiated that the total economic obsolescence adjustment of $1.58 billion to the carrying value of school buildings at 30 June 2014 is fairly presented. It is therefore not practicable to determine whether this adjustment to the fair value of school buildings, and consequential adjustments to the related depreciation charges, the accumulated depreciation and the property, plant and equipment revaluation surplus reserve are fairly stated.

Note 22(f) to the financial statements and the Certification by the Department of Treasury and Finance discloses that the State has reclassified the prior year impairment to fair value under AASB 13 *Fair Value Measurement* to represent the economic obsolescence adjustment for school buildings. This contrasts with the State's prior period accounting policy which recognised and measured the impairment of school buildings in accordance with AASB 136 *Impairment of Assets*. In my opinion, reclassifying the total prior period's impairment of $2.15 billion as a fair value adjustment in the financial statements means the comparative figures are not presented fairly in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*, which requires the State to correct material prior period errors retrospectively by restating the comparative amounts.

Further, I disagree with the statement in the Certification by the Department of Treasury and Finance that the underlying principle of adjusting for obsolescence has remained unchanged since 2005. In my opinion, the application of economic obsolescence under AASB 13 *Fair Value Measurement* in the current period and impairment under AASB 136 *Impairment of Assets* in prior periods, are different accounting concepts which have different recognition and measurement requirements under their respective Australian Accounting Standards.

Qualified Opinion

In my opinion, except for the effects of the matters described in the Basis for Qualified Opinion paragraphs above, the financial report presents fairly, in all material respects, the consolidated financial positions of the State of Victoria and the Victorian General Government Sector as at 30 June 2014 and their consolidated financial performance and cash flows for the year then ended in accordance with applicable Australian Accounting Standards, and the manner and form of the financial statements determined by the Treasurer of Victoria as required by the *Financial Management Act 1994*.

2

Auditing in the Public Interest

Figure E1
Independent auditor's report – *continued*

Independent Auditor's Report (continued)

Other Matter

Without further qualification to the audit opinion expressed above, I draw attention to the commentary in relation to the valuation of education assets on page 3 of Chapter 1 of the *2013–14 Financial Report*, which contains a material inconsistency with Note 22(f) of the financial statements. In Chapter 1, the Department of Treasury and Finance states that the underlying principle of adjusting for obsolescence has remained unchanged since 2005. However, Note 22(f) of the financial statements states that the economic obsolescence adjustment recognised for school building assets has been reclassified from impairment under AASB 136 *Impairment of Assets* in prior periods to economic obsolescence under AASB 13 *Fair Value Measurement* in the current period. As noted in my Basis for Qualified Opinion above, these are different accounting concepts which have different recognition and measurement requirements under their respective Australian Accounting Standards.

Matters Relating to the Electronic Publication of the Audited Financial Report

This auditor's report relates to the financial report published in Chapter 4 of the 2013–14 Annual Financial Report for the State of Victoria and on the website of the Department of Treasury and Finance. The Secretary of the Department of Treasury and Finance is responsible for the integrity of the Department of Treasury and Finance's website. I have not been engaged to report on the integrity of the Department of Treasury and Finance's website. The auditor's report refers only to the subject matter described above. It does not provide an opinion on any other information which may have been hyperlinked to/from these statements. If users of the financial report are concerned with the inherent risks arising from publication on a website, they are advised to refer to the hard copy of the audited financial report to confirm the information contained in the website version of the financial report.

MELBOURNE
2 October 2014

John Doyle
Auditor-General

3
Auditing in the Public Interest

Appendix F.

Audit Act 1994 section 16 — submissions and comments

Introduction

In accordance with section 16A and 16(3) of the *Audit Act 1994*, a copy of this report, or relevant extracts from the report, was provided to the Treasurer and all relevant agencies with a request for submissions and comments.

The submissions and comments provided are not subject to audit nor the evidentiary standards required to reach an audit conclusion. Responsibility for the accuracy, fairness and balance of those comments rests solely with the agency head.

Responses were received as follows:

RESPONSE provided by the Treasurer of Victoria

The Treasurer of Victoria

1 Treasury Place
GPO Box 4379
Melbourne Vic 3001
Australia
Telephone: (+61 3) 9651 6255
Facsimile: (+61 3) 9651 0759
DX 210759

RECEIVED
10 OCT 2014
VICTORIAN AUDITOR-GENERAL'S OFFICE

Mr John Doyle
Auditor-General
Victorian Auditor-General's Office
Level 24, 35 Collins Street
MELBOURNE VIC 3000

Dear Mr Doyle

RESPONSE TO THE AUDITOR-GENERAL'S REPORT ON THE ANNUAL FINANCIAL REPORT OF THE STATE OF VICTORIA, 2013-14

Thank you for your letter of 26 September 2014 inviting a response to your Report on the Annual Financial Report of the State of Victoria, 2013-14 (the Report) prior to its finalisation and transmission to Parliament.

I welcome the opportunity to comment on the Report and I am pleased it affirms the strong fiscal outcomes achieved by the Government for the State and the general government sector in 2013-14. It notes the achievement of a net result from transactions of $1 976 million by the general government sector; an overall net result of $857 million by the State; a strengthened balance sheet position, with State net assets totalling $131 billion; and a triple-A credit rating for the State affirmed by both Standard and Poor's and Moody's.

It also acknowledges the robust processes in place for the preparation of the State's Annual Financial Report and commends the continuous improvements made by the Department of Treasury and Finance (DTF), supporting the integrity of the Report. I am assured that DTF, as recommended in the Report, will continue to seek improvements in both financial reporting and associated processes, and will continue to engage with public sector agencies to further improve future reporting outcomes.

The Report provides a high-level analysis of certain aspects of the State's finances, for example, liquidity, dividends, self-financing and debt sustainability, and draws certain conclusions on the basis of the analysis presented. Particular care needs to be taken in interpreting this analysis as the ratios used have limited relevance in the public sector environment, and the analysis lacks sufficient context upon which to base informed conclusions. My comments on each of these aspects are further detailed below.

RESPONSE provided by the Treasurer of Victoria – continued

Finally, the Report comments on a technical disagreement between yourself and the Department of Education and Early Childhood Development (DEECD) and DTF related to the valuation of school building assets, as reflected in the qualified audit reports issued by the Auditor-General on DEECD's financial statements and the AFR. I note that this qualification of the *Annual Financial Report of the State of Victoria 2013-14* (AFR) is based on a qualitative assessment of materiality as the impact of this issue on the AFR, in quantitative terms, is immaterial with the valuation adjustment representing less than one per cent of the relevant asset class's total value. I reiterate the firm position held by the State on this matter outlined in the AFR, which supports the issue of financial reports which fairly and most meaningfully present the financial position and affairs of DEECD and the State.

Liquidity

The Report suggests that, based on an analysis of liquidity at the State and general government sector levels, some entities do not have enough cash and other short-term assets to settle their short-term obligations.

It is important to note that the analysis presented in the Report is based on a generic liquidity ratio (current assets divided by current liabilities) which, while it has a general purpose use as a high level indicator of liquidity, can be misleading if used as a sole indicator to form conclusions of an entity's liquidity. It is, at best, a rule of thumb for high level analysis, but has limited relevance to the general government sector and the State as a consolidated reporting entity in light of the diverse range of entities and operations being consolidated, and the complex funding and cash management arrangements in place between entities and sectors.

As acknowledged in the Report, the Treasury Corporation of Victoria (TCV) has final operational responsibility for ensuring that the State's liquidity requirements are met at all times, and TCV itself operates with a high level of liquidity as disclosed in the AFR. Note 33 (j) of the AFR shows that "at 30 June 2014, the whole of Victorian government liquidity ratio stood at 143 per cent". This high level of State liquidity is one of the key considerations supporting the State's triple-A credit rating by the two rating agencies.

This centralised approach to funding state entities and managing liquidity takes advantage of the State's excellent access to funding. Under this funding framework, general government sector entities are primarily funded centrally to meet their obligations as they fall due. This minimises debt and cost to the taxpayer by ensuring that money is not dispersed until it is needed. It also ensures that, backed by appropriate letters of support if requested, entities would not be required to sacrifice long-term assets or to incur interest penalties in the unlikely event that their short term obligations became due at the one time.

More specifically, the State's capital adequacy and prudential supervision framework for TCV largely mirrors the APRA framework for financial institutions. I consider this a more sophisticated, useful and appropriate tool to manage the State's liquidity risk.

2

RESPONSE provided by the Treasurer of Victoria – continued

Even if it were accepted that the use of a generic liquidity ratio had some merit in the context of the State's accounts, the application of an unadjusted methodology produces an anomalous outcome due to the inclusion of non-cash related items in the measure, such as unearned income. If the audit methodology was adjusted for this non-cash liability, both the State and general government ratios would be above one, even ignoring any further adjustment for the portion of the current long service leave provisions (presented in accordance with Australian accounting standards) that are not expected to be settled within the next 12 months.

It is generally accepted that when determining an appropriate liquidity ratio for organisations, consideration must be given to the nature of the business, as well as the timing of cashflows and the relevant cash management and funding arrangements in place. The robust and highly integrated liquidity funding and support arrangements in place at the State and general government sector levels provide a high level of confidence to the public, business partners and financial markets that obligations will be met by the State and its entities as and when they fall due.

Dividends

The Report draws particular attention to the level of dividends received from government-owned businesses (which averaged 1.4 per cent of total revenue over the last two years, and only 0.4 per cent for 2013-14), and presents alternative fiscal outcomes by the general government sector excluding dividend revenues to highlight the impact of this revenue source on the achievement of the key fiscal targets.

It needs to be recognised that dividends from government-owned businesses are one of many sources of government revenue. Once set, dividends may be adjusted in relation to the timing of payments and ability to pay, in the context of the government managing a broad range of competing budget priorities.

Dividends are determined by the Treasurer after consultation with the Board of Directors of each entity and the portfolio Minister as required by legislation and following careful consideration of the relevant commercial parameters pertaining to each government entity, as set out in DTF's Corporate planning and performance reporting requirements publication, established in 1998 and updated in 2009. These considerations include reported profit and operating cash flow, gearing and interest cover, liquidity and working capital requirements, and planned capital expenditure. The benchmark ratios for dividend payments, subject to consultation, are 50 per cent of net profit after tax and, combined with income tax equivalents, 65 per cent of pre-tax profits.

Payment of dividends by the metropolitan water businesses in 2013-14 were covered by the operating cash flow of each business, and the remaining operating cash flow was used to assist in funding their capital expenditure program. As part of their daily cash management, a business can initially use temporary TCV borrowings to fund a dividend payment. However, over the course of the year, all dividend payments to the government were covered by cash flows from operations.

3

RESPONSE provided by the Treasurer of Victoria – continued

Self-financing and debt sustainability

The Report presents high level commentary and trend analysis on the financing of capital works and borrowing levels. It is important to acknowledge that these are managed in the context of a fiscal strategy that is clearly articulated by government in Budget Paper No. 2 each year.

The fiscal outcomes for 2013-14 indicate that the government is on track to meet its target of reducing net debt to GSP over the decade to 2022 and of ensuring that infrastructure investment is managed responsibly and affordably consistent with the 1.3 per cent of GSP (as a rolling 5-year average) parameter.

Infrastructure investment cash outflows are, by their nature, generally uneven when measured on an annual basis and the government's investment strategy ensures that sufficient cash is generated over the longer term to meet its commitments, while carefully managing the level of debt incurred. Use of an indicator such as a 10 per cent cash to annual investment funding (as used in the Report) is therefore of limited relevance as a measure of long-term sustainability.

Valuation of school building assets

As outlined in the Report, qualified audit reports were issued on the 2013-14 DEECD financial statements and the AFR related to the valuation and reporting of school building assets. The Government, DEECD and DTF disagree with the basis of this qualification, as articulated in Chapter 1 of the *Financial Report* and the *Certification by the Department of Treasury and Finance* presented in Chapter 4 of the *Financial Report*. Further comments follow on key dimensions of the audit qualification and the related Auditor-General commentary.

Appropriateness of accounting policy for measuring the fair value of school buildings, specifically including an economic obsolescence adjustment

> The State's accounting policy for valuing its non-financial physical assets, including school buildings, is based on (and in accordance with) Australian Accounting Standard AASB 13 *Fair Value Measurement*. School buildings are specialised assets and are valued under the 'replacement cost method' as they are restricted to provide education services. AASB 13 is very clear that economic obsolescence needs to be considered when valuing assets under the replacement cost method to take into account over-design and over-capacity which may permanently exist.
>
> The State's fair valuation methodology takes into account long-term student enrolment data to determine the economic obsolescence or permanent excess capacity in schools. This approach to valuation reflects the key objective the State intends to achieve through use of its school assets – to educate Victoria's children. Current and forecast student enrolment data provides information on the capacity required of the school buildings to fulfil this objective, and the enrolment data used as part of the valuation is consistently tested and applied by the State for key planning, project and funding initiatives.

4

RESPONSE provided by the Treasurer of Victoria – continued

The student enrolment data is used for determining the replacement cost of the school buildings recognised on the state's balance sheet, as this more appropriately reflects the cost that the State would incur to replace its assets should it be deprived of those assets, as intended by Australian accounting standards.

The underlying principle and methodology used to assess and adjust for economic obsolescence or permanent excess capacity with reference to student enrolment data is also supported by the Victorian Valuer-General, the State's valuation specialist, and external accounting expert advice. Without the appropriate valuation adjustment, the State's school building assets at 30 June 2014 would be stated at around $1.6 billion in excess of the benefits the State expects to attain from their use – contrary to the "value in use" requirements of Australian accounting standards.

With respect to funding, investment decisions in relation to school assets are made on the merits of the department's bids for funding new or upgraded facilities as part of the annual budget cycle, consistent with the government's financial management objectives and its infrastructure investment strategy across all budget sector portfolios.

Directing funding towards identified surplus capacity would reduce the State's capacity to fund other assets that are in need and where permanent surplus capacity does not exist. It is therefore not financially prudent to ignore the known economic obsolescence given the identified surplus capacity in the school system, as identified by VAGO in a previous audit report to be around 38 per cent.

This interrelationship between valuation and associated impact on funding further highlights the importance of appropriately reflecting the identified economic obsolescence and surplus capacity in the valuation of the State's school buildings. It directly impacts on the government's ability to make prudent funding allocation and investment decisions.

Use of uniform accounting policy for measuring economic obsolescence adjustments to the fair value of all public sector non-financial physical assets, including school buildings

The State applies its accounting policy for measuring and reporting the fair value of its non-financial physical assets consistently to all of its public sector non-financial physical assets, taking into account the specific characteristics and considerations as appropriate and relevant to the assets. The State's accounting policies for non-financial physical assets, including schools, are prescribed in Financial Reporting Direction (FRD) 103E *Non-Current Physical Assets.*

The identification of economic obsolescence is not a policy, but is a factor or input when considering the valuation of assets, as prescribed by Australian Accounting Standard AASB 13. In other words, all public sector entities are required to have considered economic obsolescence when valuing their assets under the replacement cost method. The application of this consideration has not resulted in the identification of any permanent excess capacity for other departments or

5

RESPONSE provided by the Treasurer of Victoria – continued

agencies and hence there has been no economic obsolescence adjustments made to other public sector non-financial physical assets.

The absence of economic adjustment in other departments or entities does not lend itself to the conclusion that the State has not considered excess permanent capacity across other public sector non-financial physical assets. Therefore, it cannot be said that the State has prepared its financial report using a non-uniform accounting policy for measuring fair value of those assets. It is notable that all material entities (except DEECD) have received clear audit opinions from the Auditor-General on their application of AASB 13, which required them to consider economic obsolescence, where applicable, taking into account the specific characteristics and considerations as appropriate and relevant to measure the fair value of their non-financial physical assets.

Comments in the Certification by the Department of Treasury and Finance that the underlying principle of adjusting for obsolescence has remained unchanged since 2005

Presentation of prior period's school building impairment of $2.15 billion as a fair value adjustment, rather than "an error"

While the concepts of obsolescence and impairment can be different in certain circumstances, for determining the fair value of schools, the underlying principle of adjusting for obsolescence, as identified through reductions in student enrolments at individual schools, has remained unchanged since 2005-06.

Prior to 2013-14, the State (through DEECD) has adjusted for the identified economic obsolescence through the impairment accounting standard AASB 136 *Impairment*, as the objective of the standard is to ensure that assets recognised on the balance sheet do not exceed their recoverable amount. Even for assets carried at fair value, under AASB 136 an entity is still required to assess for impairment if indicators of impairment exist, particularly between valuations.

For not-for-profit entities, the recoverable amount of a school is generally determined through value in use, which is its depreciated replacement cost. Adjustments for obsolescence were previously made to the book value of the relevant school assets when determining their depreciated replacement costs, as indicators of impairment included changes in the environment in which the school assets are dedicated, identified through reductions in student enrolments at individual schools.

In 2013-14, Australian accounting standard AASB 13 *Fair Value Measurement* was applied for the first time. The standard makes explicit reference to the consideration of economic obsolescence when determining the depreciated replacement cost of an asset. Under this new standard, the State (through DEECD) have continued the principle that reductions in student enrolments at each individual school are indicators of obsolescence which should be adjusted for when determining the depreciated replacement costs of schools.

On this basis, the State as part of its updated accounting policy now recognises economic obsolescence adjustments directly to fair value, rather than as

6

RESPONSE provided by the Treasurer of Victoria – continued

impairment adjustments in previous years. The valuation methodology has also been further refined during 2013-14 to include consideration of updated student enrolment data projections. However the underlying principle in determining the obsolescence adjustment with reference to enrolment data has remained unchanged.

Accordingly, the principle of obsolescence for school assets has been consistently applied by DEECD and the State, as audited, since 2005-06. Therefore, it would not be appropriate for the prior year obsolescence adjustment to be presented as an error rather than a reclassification, given that the substance of the change is only to reclassify this adjustment in accordance with DEECD's updated methodology – having no impact on balance sheet aggregates.

Following due consideration of the various aspects referred above, I continue to be of the view that DEECD's accounting policy and valuation methodology for measuring the fair value of its school buildings fairly represents the realisable benefits these assets provide towards achieving the government's objective of providing educational outcomes to the Victorian community.

I believe that the approach taken by DEECD in measuring the fair value of its school buildings without taking into consideration the identified permanent excess surplus capacity and economic obsolescence would otherwise result in the presentation of financial information which does not provide reliable and accurate information to users.

I trust this information is of assistance.

Yours faithfully

Michael O'B

HON. MICHAEL O'BRIEN MP
Treasurer

9 /10 /2014

7

Auditor-General's response to the Treasurer of Victoria

Given the nature of the rebuttals below, it is clear to us that the Treasurer has not been adequately advised on these matters.

Liquidity

The Response notes that the liquidity ratio used in this report, while having a general purpose as a high-level indicator of liquidity, can be misleading and has little relevance to the general government sector and the state. Further, the Response has suggested adjusting the liquidity ratio to exclude some items. These comments are incorrect and inappropriate. The liquidity ratio used in this report is accepted around the world as a valid indicator of liquidity for reporting entities. Adjusting the ratio in the way suggested by the Response would distort the outcome because it would remove key short-term liabilities of the state. The ratio has identified that some state entities do not have enough cash and other liquid short-term assets to settle short-term obligations. The reliability of this indicator is borne out by the fact that 38 state entities received a letter of support in 2013–14. Further, the liquidity ratio used by the state, also mentioned in this report, isn't a complete indicator of the state's ability to pay all existing short-term financial obligations as it is only concerned with short-term debt and interest obligations. It does not consider other short-term liabilities of the state, such as payables. Refer to pages 21 to 23 of this report.

Dividends

The Response comments on the process applied to set dividends, that they may be adjusted in the context of competing budget priorities and that state entities can initially use temporary borrowings to fund a dividend payment. It is a significant concern that certain metropolitan water entities had borrowed to facilitate the payment of dividends during 2011–12 and 2012–13. Further, the state's dividend policy requires the government's budget position to be a consideration when determining an entity's dividend payment. This has led to significant fluctuations in dividend payments year on year and can create difficulties for entities. Consequently it appears that a sufficiently robust assessment of an entity's ability to pay dividends may not have been completed. Refer to pages 17 to 18 of this report.

Valuation of school building assets

We are concerned that the Response considers that the $1.58 billion valuation adjustment to school buildings is not material to the citizens of this state. The Response states that this adjustment represents less than 1 per cent of the relevant asset class's total value, which is the state's total physical non-financial assets. In fact, the adjustment amounts to 5.9 per cent of the $26.9 billion of buildings for the general government sector disclosed in Note 22(b) of the AFR. Furthermore, as the state's auditor, it is the Auditor-General's responsibility to determine what is material in accordance with both Australian Auditing Standards and the *Audit Act 1994*.

Auditor-General's response to the Treasurer of Victoria – continued

Valuation of school building assets – *continued*

We do not agree with the Response that Australian Accounting Standard AASB 13 *Fair Value Measurement* is very clear that economic obsolescence needs to be considered when valuing assets under the replacement cost method to take into account over-design and over-capacity which may permanently exist. The concept of economic obsolescence is included in the application guidance of AASB 13 and it provides no further direction in relation to the definition, measurement or calculation of economic obsolescence. Notwithstanding this, the state and DEECD have elected to adopt this policy solely for the purposes of valuing school buildings, and are the only jurisdiction in Australia to do so. Specifically there is no requirement to take into account over-design and over-capacity when valuing these assets. Any adjustment for economic obsolescence is a matter of professional judgement rather than mandatory.

The Response comments that the enrolment data used as part of the valuation of school buildings is consistently tested and applied by the state for key planning, project and funding initiatives. This is incorrect on two counts. DEECD's long-term enrolment data has not been tested for accuracy. Further, school investment decisions are not always solely based on student enrolment data. Refer to page 35 of the report.

The Response states that without the appropriate valuation adjustment, the state's school building assets at 30 June 2014 would be stated at around $1.6 billion in excess of the benefits the state expects to attain from their use—contrary to the 'value in use' requirements of Australian Accounting Standards. We not only disagree with this assessment but it is technically incorrect. The requirement to determine the calculation of an asset's 'value in use' under the Australian Accounting Standards is defined in AASB 136 *Impairment of Assets*, but DEECD has elected to make an adjustment for economic obsolescence in accordance with the application guidance of AASB 13 *Fair Value Measurement*. Nowhere in the DEECD accounting policy relating to the fair value of fixed assets is the term or method of calculation for 'value in use' defined. As noted in the Auditor-General's audit opinion on the state's AFR, the application of economic obsolescence under AASB 13 and impairment under AASB 136 are different accounting concepts which have different recognition and measurement requirements.

The Response states that it cannot be said that the state has prepared its financial report using a non-uniform accounting policy for measuring the fair value of non-financial physical assets. We disagree. As already noted in pages 6 to 7 of this report, we evaluated the accounting policies relating to economic obsolescence under AASB 13 for all of the state's material entities and DEECD was the only entity to develop and apply a specific accounting policy relating to economic obsolescence.

Auditor-General's response to the Treasurer of Victoria – continued

Valuation of school building assets – *continued*

The Response incorrectly states that the underlying principle of adjusting for the obsolescence of school buildings remains unchanged and has not changed since 2005–06. This underlying principle has changed, as evidenced by the fact:

- the state's and DEECD's accounting policy relating to the valuation of school buildings applicable for the 2012–13 financial year makes no reference to economic obsolescence as part of their valuation methodology
- that DEECD agreed to review their accounting policy in respect of this matter subsequent to the 2012–13 financial year
- that the different Accounting Standards applied in respect of this accounting policy contain different accounting concepts which have different recognition and measurement requirements.

Refer to Section 2.1 of this report.

Section 4.2 of this report sets out our concerns over the valuation of school buildings, but the Response does not accurately reflect the history in relation to this issue. Had we not raised these concerns in relation to this accounting policy in 2012–13 financial year then the state and DEECD would have continued incorrectly impairing the value of school buildings, potentially by an amount in excess of the $2.15 billion already written down by 30 June 2013, rather than the $1.58 billion economic obsolescence adjustment applied to school buildings in 2013–14.

RESPONSE provided by the Secretary, Department of Education and Early Childhood Development

Department of Education and Early Childhood Development

Office of the Secretary

2 Treasury Place
East Melbourne, Victoria 3002
Telephone: +61 3 9637 2000
DX 210083
GPO Box 4367
Melbourne, Victoria 3001

RECEIVED 07 OCT 2014 VICTORIAN AUDITOR-GENERAL'S OFFICE

COR005959

Mr John Doyle
Auditor-General
Victorian Auditor-General's Office
Level 24, 35 Collins Street
MELBOURNE VIC 3000

Dear Mr Doyle

I refer to your letter dated 29 September 2014 forwarding a draft extract of your *Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2013-14,* concerning the Department of Education and Early Childhood Development (Section 4).

I attach a response to your report setting out the reasons for the Department's approach and why we do not consider there to be a reasonable basis for your qualification of the Department's valuation of schools, or your criticisms of its financial reporting.

Your report provides no new argument in support of the qualification. It repeats concerns that have been frequently and thoroughly answered by my department over the past year. Your report does not respond to, or acknowledge, these answers or the large volume of evidence and expert opinion that has been provided in support of them.

As you are aware, our valuations reflect expert advice from the Valuer-General of Victoria and a top-tier accounting firm. You have not responded to this advice, and have asked to have a reference to the Valuer-General's advice removed from my declaration of 19 September 2014 on my department's accounts. I have declined to remove the reference because the Valuer-General's calculations were a key input to those accounts.

The write-down of under-utilised schools has been accepted by previous Auditors-General since 2006, and you do not clearly explain how you came to the opposite conclusion to your predecessors.

It is of particular concern that to avoid your qualification would have required my department to overstate its accounts, and reduce our accountability for efficient investment in schools.

Your report cites examples of school valuations which, in your opinion, reveal shortcomings in my department's valuations. Over the past year, we have explained the application of our valuation method to many schools that have been raised by your office, and are pleased that you have decided not to raise those schools again in your report. Unfortunately, your office did not afford my department reasonable time to provide a considered explanation of these new cases. We will provide those explanations after further analysis.

Your criticisms of my department's financial reporting is also of great concern. Your claim to have identified 15 adjustments totalling $851 million is highly misleading. There are in fact 4 adjustments with a net impact of only $6.1 million. Other adjustments were for disclosure purposes only, and had no financial impact.

Victoria

This original has been printed in black and white on recycled paper to reduce cost and environmental impact.

RESPONSE provided by the Secretary, – Department of Education and Early Childhood Development – continued

Importantly, these adjustments largely reflect different opinions on accounting treatments. Because your office sought the adjustments late in the audit, there was no time to substantiate our original accounting treatment across 1500 schools. We accepted your changes as a pragmatic concession that enabled our accounts and your opinion to be finalised without further qualification or delay. We do not believe that the original accounts were in error.

My department has been open and timely in responding to your many requests for information and consultation on this year's financial report. I remain satisfied with the integrity and quality of our accounts. Equally, I remain committed to continuous improvement and will consider any refinements to our school valuations, and other elements of our financial reports, in future.

The attached 'Response to chapter 4' responds in more detail to your report.

Yours sincerely

Richard Bolt
Secretary

7 October 2014

Auditor-General's response to DEECD

The Department of Education and Early Childhood Development (DEECD) response to this report suggests that it does not fully appreciate its financial reporting responsibilities, nor our role as external auditor. It is the responsibility of all public sector entities to prepare financial statements that not only comply with the applicable financial reporting framework but are also supported by underlying accounts and records as required by the *Financial Management Act 1994*, and to demonstrate that compliance to audit. DEECD was unable to:

- provide sufficient appropriate evidence to fully support the appropriateness of some of its key school valuation assumptions and judgements that it has used to adjust the fair value of school buildings due to economic obsolescence
- prepare quality draft financial statements for audit review
- comment within a week on the few illustrative school examples included in this report. It should be noted in this regard that while the report only includes three illustrative cases of schools deemed by DEECD to be partly economically obsolete, there are some 1 100 such schools in total.

DEECD's response does not clearly set out the role of the Valuer-General (VGV) in this matter. The VGV valuation advice states 'VGV understands that DEECD have adjusted the valuations due to possible changes in enrolments and intended to adjust the assessed value of the improvement [buildings] for economic and functional obsolescence based on school enrolments. This has occurred rather than the valuer assessing the oversupply of the improvements [buildings] or a reduction in demand for the service provided'. Nevertheless VGV's advice did set out its support for the use of enrolment data to adjust asset values for functional and economic obsolescence and highlighted that it had relied on enrolment data provided by DEECD. Further, the VGV advice demonstrated its support for DEECD's assumptions for assessing economic obsolescence, but not all. In particular VGV stated that schools should be valued on an individual building basis, rather than on a whole-of-school approach, however it accepted that this information was not available and that some buildings considered surplus currently form part of other buildings.

DEECD's response includes some inaccuracies and other matters requiring comment, as set out below in further audit comments against the attachment to DEECD's response.

DEECD has not directly responded to the audit recommendations made in this report, and it is difficult however to understand how they could not accept those recommendations and still fairly present their financial statements in accordance with the *Financial Management Act 1994*.

DEECD's response to Part 4

Summary of VAGO's concerns and DEECD's response

The Victorian Auditor-General's Office (VAGO) has qualified the Department of Education and Early Childhood Development's (DEECD's) accounts for 2013/14 because DEECD applies a test of economic obsolescence in determining the fair value of schools, which results in write-downs of the depreciated cost of some schools. In VAGO's opinion, these adjustments – which are based on current and long-term forecasts of student enrolments – are not supported in principle or by sufficient appropriate evidence.

VAGO has also expressed concern that DEECD's declaration on its 2013/14 accounts includes an explanation of its reasons for making fair value adjustments, and cites the opinion of the Valuer-General Victoria that such adjustments are appropriate.

Finally, VAGO has raised unrelated concerns about DEECD's financial reporting, on the grounds that it required 15 adjustments of DEECD's draft financial statements, which it says totalled $851 million.

DEECD does not accept VAGO's qualification, nor VAGO's criticisms of DEECD's declaration and financial reporting. DEECD's responses are summarised here and detailed below.

Fair value of schools

DEECD adjusts the fair value of schools for economic obsolescence in compliance with the prevailing accounting standard (AASB136 Impairment of Assets from 2005/06 to 2012/13 inclusive; AASB13 Fair Value Measurement for 2013/14). It has done so since 2005/06, which has been accepted by previous Auditors-General.

This valuation method increases accountability for the investment of public funds in schools, by providing a measure of their potential educational benefits. To make no adjustment for obsolescence would overstate DEECD's asset accounts.

These obsolescence adjustments are based on current and long-term forecasts of student enrolments because the amount of potential educational benefit of a school is proportional to student numbers.

Auditor-General's further comment

It is not correct that DEECD has adjusted the fair value of school buildings for economic obsolescence since 2005–06, and it is not correct that previous Auditors-General have accepted such adjustments. Refer to comments on page 37 of this report.

We have not stated that there should be no adjustment for economic obsolescence. We disagree with the DEECD approach to measuring economic obsolescence and this report sets that out. On pages 36 and 37 of this report we explain our view that economic obsolescence for a public sector asset should measure whether or not it is meeting the objectives of the entity.

Declaration of DEECD's 2014 accounts

DEECD's declaration of its 2014 accounts summarises its reasons for adjusting school values on the basis of economic obsolescence because DEECD is obliged to explain why it does not accept VAGO's qualifications.

DEECD has cited the view of the Valuer-General Victoria (VGV) because VGV has statutory responsibility for property valuation across the Victorian Government. VGV's opinion is supported by advice from a top-tier accounting firm. Nonetheless, DEECD's Accountable Officer and Chief Finance Officer take full responsibility for its accounts.

Auditor-General's further comment

DEECD has not stated why, or under what authority, it was 'obliged' to explain its position regarding the qualification in the accountable officer's and chief finance officer's declaration. On page 40 of this report, we have outlined the requirements of the *Financial Management Act 1994* (FMA) as they relate to this declaration and maintain it is inappropriate for the comments and references made by DEECD to be included.

The accountable officer's and chief finance officer's responsibility for the financial statements is absolute and should not reference the Valuer-General and 'top-tier accounting firm' support.

Preparation of DEECD's financial report

DEECD rejects VAGO's criticism of its financial reporting. The adjustments made at VAGO's request reflect legitimate differences in accounting method or the application of new standards, not errors on DEECD's part.

VAGO's $851 million valuation of those adjustments creates a misleading impression of their significance. The adjustments arise from only four issues and have a net impact of only $6.1 million on the State's ledger.

Auditor-General's further comment

DEECD's draft financial statements contained several errors and omissions and required substantial adjustments as set out on pages 39 to 42 of this report. To downplay the significance of the adjustments by netting off their impact, and to overlook other substantial disclosure errors/omissions and its failure to provide audit with sufficient appropriate evidence to support the financial statements, suggests that DEECD does not fully appreciate its primary legislative responsibility for the fair presentation of its financial statements.

DEECD did not provide evidence nor demonstrate to audit the validity of their accounting practices relating to unearned income, receivables, provision for doubtful debtors and assets held for resale. The Accounting Standards relating to recognition and measurement of these items are not new. Consequently, we reject DEECD's assertion that there are legitimately different methods of accounting for and disclosing these item.

DEECD have responded that some of the adjustments requested by audit were due to new Accounting Standards, not errors. DEECD are required to prepare their financial statements in accordance with Australian Accounting Standards, regardless of when they are issued. If a standard is applicable for the first time, it is DEECD's responsibility to be aware of the requirements and apply all requirements without error or omission. To suggest that an adjustment made to the financial statements is not an error or omission because the requirements of a new standard were not correctly applied by DEECD is rejected.

The adjustments made for intangible assets, financial instruments disclosures, assets pledged as security on finance leases, capital commitments, and remuneration of executive officers were requested because they were incorrect.

Another example is a $400 000 bank account that was identified by audit which was not on the DEECD ledger or in its draft financial statements. The fact that DEECD can operate a bank account outside of its ledger, and outside of their system of internal control which applies to all other bank accounts, presents a significant fraud risk. It is also contrary to the requirements of the FMA to keep proper accounts and records.

Audit conduct

DEECD has serious concerns about the conduct by VAGO of this year's audit.

DEECD has previously responded to VAGO's queries of its fair value method, sometimes on several occasions. Those responses have not been acknowledged or addressed by VAGO in its final report. Instead, VAGO has repeated the criticisms and expressed its concern that no resolution has been reached.

DEECD considers that no resolution can be reached on the basis of the arguments set out by VAGO. Although DEECD will continue to refine its approach, it would need to be presented with new arguments or unambiguous accounting literature supporting VAGO's position if it is to consider a fundamental departure from its approach to valuation of school building assets.

DEECD is also concerned that it was given insufficient time to substantiate the accounting methods that were the subject of VAGO's criticism of its financial reporting, apart from school valuations. VAGO raised its concerns unexpectedly, at a late stage in the audit. DEECD was effectively compelled to adopt new practices, because it was impractical to substantiate its approach so as to avoid a further qualification.

Auditor-General's further comment

The Auditor-General has no concerns about the conduct of the audit and DEECD have presented no valid basis to conclude otherwise.

We reviewed all information from DEECD on the fair value issue. Our approach has been outlined in this report on page 36. We acknowledge in the report that there is no authoritative Australian Accounting Standard or other Australian professional guidance on the issue of economic obsolescence in the public sector and as such there is no unambiguous professional accounting literature on the issue.

DEECD should have systems and records underlying their financial statements that enable substantiation of all transactions and balances, whether asked for this information by audit or not. This is a requirement of the FMA which specifically states that the accountable officer of a department 'must ensure that there are kept proper accounts and records of the transactions and affairs of the department and such other records as sufficiently explain the financial operations and financial position of the department'.

DEECD should assure itself that financial statements accord to Australian Accounting Standards and are supported by the underlying systems and records before being provided to audit. The DEECD response acknowledges that they could not substantiate their approach to a number of areas subject to audit. However DEECD should be able to respond to requests for supporting documentation with a reasonable period. This did not occur.

DEECD did not produce shell financial statements for audit review, and did not perform a hard close at an interim stage of the financial year. We recommend that material entities prepare shell financial statements and consider undertaking a hard-close process on page 11 of this report. DEECD also did not provide timely asset information for audit before the final audit commenced notwithstanding requests being made at two earlier audit visits. As such, there was no earlier opportunity for audit to raise a number of the issues that arose in the year end audit.

Economic obsolescence

Pursuant to an economic obsolescence test, DEECD has written down the value of those schools which are currently, and forecast to remain, under-utilised.

VAGO's principal criticism of DEECD's valuations is that they "result in a significant write-down of taxpayer investments in school buildings which are continuing to deliver educational outcomes" and are not supported by sufficient appropriate evidence.

DEECD does not accept this criticism. DEECD rigorously applies a depreciated replacement cost method to write down the carrying value of any school which has enrolments that are forecast to remain significantly below capacity. This adjustment is made to reflect the useful value of the school to the State – a school with substantial empty space provides less economic benefit (education outcomes) compared with a school at capacity. The excess space is not required to enable DEECD to fulfil its objectives.

This method has been discussed and agreed with the VGV, which has statutory responsibility for valuing public assets, and by a top-tier accounting firm.

The valuations that result from this method are conservative. They comply with Australian Accounting Standards. In doing so, they provide Parliament and the Victorian public with a higher level of accountability for public funds than if DEECD were to make no adjustment for obsolescence. Not to do so would be to overstate DEECD's accounts, in serious breach of its responsibilities.

To illustrate this, a school which is designed for 1000 students may currently have, and only ever be expected to have, 500 students enrolled. A similar school built for 1000 students that has 1000 students enrolled is clearly providing greater economic benefit to DEECD. That is why the school which is predicted to never have enrolments of more than 500 would not be replaced at its current scale (ie: for a capacity of 1 000).

Auditor-General's further comment

We have a different view on measuring economic obsolescence as outlined on page 32 of this report. Our concerns with the DEECD approach are demonstrated in examples on pages 31 and 37 of this report.

The VGV valuation was based on data and some critical assumptions supplied by DEECD. DEECD fails to explain that it supplied the VGV with all the data and some critical assumptions which the VGV explicitly relied upon when forming his expert valuation.

DEECD uses an example of a school that has 50 per cent excess capacity. However, only 9 per cent of all schools deemed partly obsolete have excess capacity of greater than 50 per cent, therefore, this is an extreme example that does not apply to the majority of schools.

Auditor-General's further comment – continued

Nevertheless, using the example provided by DEECD, if a school has 500 students but has the building space for 1 000 students, this would not mean that only half of the gym, library, principals office, hallways and toilets were being used by the school. The school would continue to use all common facilities that support the functioning of the school and therefore those facilities would be contributing to the delivery of educational outcomes.

Change of accounting standards

VAGO has criticised DEECD for changing its valuation method between its 2012/13 and 2013/14 accounts. It asserts that DEECD should have admitted that in doing so, it was correcting an error.

An adjustment for under-utilisation of schools has been made by DEECD and its predecessors since the introduction of International Financial Reporting Standards. This has been reflected in all financial reports from 2005/06, and has been accepted by the previous two Auditors-General.

The principle that under-utilisation should trigger a write-down of a school's value has not changed in the 2013/14 accounts. Only the classification has changed, reflecting a change in accounting standards.

In DEECD's 2012/13 financial report, DEECD adjusted school valuations using an impairment method under AASB136 Impairment of Assets. Independent accounting advice from two top tier firms confirmed that this adjustment was appropriate.

In accordance with VAGO's recommendation, DEECD reviewed its previous approach to the impairment of school buildings, to inform its 2013/14 financial report. This review concluded that an updated accounting policy would be appropriate because a newly adopted standard – AASB 13 Fair Value Measurement – meant that the adjustment better aligned with the concept of economic obsolescence in that standard.

In the context of AASB13, excess space in a school is 'economically obsolete' because it is not required to enable DEECD to fulfil its objectives. It is valued by the VGV accordingly.

The calculation has been applied in the most practical way across all schools, excluding specialist and language schools. Therefore, given the high volume of schools, the adjustment best represents the value of the total school portfolio and may result in some outliers. However, a more forensic method of assessing the value of individual schools would not be expected to materially change the total valuation.

Upon the introduction of AASB13 in the current financial year, it was determined that the adjustment should give effect to the concept of economic obsolescence as required by this standard. However, the principle on which this adjustment is based – recognition of under-utilisation – remains the same as in previous years.

Additionally, the review of the new standard prompted DEECD to refine its valuation to reflect the permanency of obsolescence. In prior years, the adjustment was based on current enrolment data, but the 2014 valuation uses newly available forecasts to determine if obsolescence will be sustained in the long-term (up to 10 years). As VAGO has noted, this has resulted in a $559 million increase in the fair value of school assets for 30 June 2014, relative to the method used for the 30 June 2013 report.

Contrary to VAGO's assertions, the 2013 valuation was not in error. It was consistent with AASB136 and was confirmed with expert advice from two top tier accounting firms. The 2014 valuation was based on a new standard that prompted the use of new enrolment forecasts, and was also confirmed with expert advice, from VGV and a top tier firm.

The presentation of the prior year comparatives in the 2014 report was also confirmed by expert advice.

Auditor-General's further comment

DEECD has acknowledged in this response that their method of calculating economic obsolescence may result in some outliers however a 'more forensic model' would not lead to a materially different outcome. This position has not been demonstrated to VAGO and we have not been provided with evidence that shows such a conclusion is valid.

DEECD has changed the presentation and reporting of the 2012–13 comparative figures from what had been previously reported. We disagree with the DEECD approach as outlined on page 36 as it does not accord to the Australian Accounting Standards.

DEECD states that the presentation of the prior year comparatives was confirmed by expert advice. DEECD has not supplied expert advice to VAGO that analyses the requirements of AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* and applies the requirements of this standard to the accounting treatment adopted.

Use of enrolment data

VAGO questions the use of student enrolment data to measure obsolescence. Its principal argument against this is that educational outcomes are achieved by a school of any enrolment level, and that no other State adjusts for obsolescence solely on the basis of enrolments.

Whilst it is true that a school of any enrolment produces educational benefits, DEECD's task is to value schools on the amount of educational benefit they have the potential to provide. It is clear that the potential level of educational benefit will be proportional to the current and forecast number of students in the school.

In developing its advice to governments on investment in capital works at schools, DEECD uses a detailed planning method to ensure that the proposed project delivers facilities that are aligned with the needs of the current and future school community, and in particular expected enrolments. It is therefore consistent with DEECD's method of estimating economic obsolescence.

There are exceptional circumstances where factors other than enrolments have influenced Government's investment decisions. These factors include economic and community circumstances which go well beyond the remit of DEECD and which only the Government of the day can decide upon. Recent examples include the rebuilding of schools in communities affected by the 2009 Black Saturday fires, and the Building the Education Revolution (BER) program where school buildings were built as part of a Commonwealth initiative to stimulate the economy following the 2008 global financial crisis.

As an example, the BER program left some schools with buildings that are well above entitled space in some instances. VAGO has previously acknowledged this, in its February 2013 report on Implementation of School Infrastructure Programs, which states:

"Based on the number of students enrolled in Victorian Government schools, the school building portfolio is currently 38 per cent surplus to requirements. Prior to VSP and BER, the level of excess space was approximately 15 per cent, indicating that these programs have more than doubled the amount of surplus space in Victorian Government schools."

In determining the surplus space in schools in this report, VAGO used enrolment data, consistent with DEECD's valuation method.

Of the other Australian jurisdictions, the education departments of Queensland, Tasmania and the ACT all consider unused space as measured by enrolments as a factor in determining fair value, although all three vary in their methodology. Victoria and Tasmania appear to be the only states where this has resulted in a significant adjustment. That Victoria is different to most States does not mean that Victoria's approach is incorrect.

Auditor-General's further comment

It is pleasing in DEECD's response that they acknowledge there are exceptional circumstances where factors other than enrolments drive some investment decisions. This supports our view that not all investment decisions are based solely on enrolments.

The *Building the Education Revolution* (BER) program invested $2.545 billion into school buildings. Under DEECD's fair value policy, the additional space provided by these investments has meant that not only has the value of these new buildings been partially written down, but so too have other buildings on a school site. The implication of their fair value policy is they should not have accepted all the funding and agreed to the investment program. As it stands DEECD did accept the funding, built the new buildings and has now partially written off some of these buildings as economically obsolete. DEECD's approach takes no account and places no value on whether the buildings provided under the BER are being used by schools and the community as intended.

DEECD has referenced an earlier VAGO report as having used enrolment data consistent with DEECD's valuation method. The inference drawn by DEECD in regard to that report isn't valid. A key conclusion of that report was that major issues existed within DEECD's school building portfolio and asset management processes. Further, that report concluded that due to recent investments in schools the majority of school buildings were in a satisfactory operational condition but that there was ongoing underfunding of school maintenance. Consistent with that conclusion, this report highlights that DEECD's accounting policy for assessing economic obsolescence results in a $1.58 billion write down of taxpayer's investments in school buildings that are continuing to deliver educational outcomes and also significantly reduces certain state funding for the renewal of schools.

Contrary to DEECD's response, we have not identified any other jurisdiction that makes an adjustment for economic obsolescence solely based on student enrolment data.

Seven-year enrolment forecast

VAGO has asserted that DEECD has not provided sufficient appropriate evidence to justify its use of a seven-year enrolment forecast.

In determining which forecast period to use as representative of the 'long term', DEECD adopted a forecast that was sufficiently long-term to indicate permanent obsolescence, while being sufficiently short-term to be reliable.

In reaching this decision, DEECD considered current enrolment data, and forecasts over 7 years and 10 years.

DEECD judged 2021 (the 7 year forecast period) as the best balance of permanence and reliability. Additionally, with the availability of annual data under the newer Demographic Demand Forecast (DDF) model, the Department also asked the VGV to test the fair value result using 10 year forecasts; it found only a small difference of $16m.

The use of the actual fair value based on 7 years forecast data resulted in the least amount of economic obsolescence out of each of the three calculations; current, 7 years and 10 years.

We have further examined forecasts beyond 10 years at a system level and concluded that the forecasts level out considerably, suggesting there would be little further accuracy to be gained by taking a longer term view.

Forecasts are necessarily subject to some uncertainty, so adjustments to fair value will occur in future as new forecasts are factored into the fair value of schools. This is a common feature of forward-looking asset valuations, and is preferable to making no adjustment for obsolescence, which would provide a less accurate and accountable valuation than one based on forecast enrolments.

Auditor-General's further comment

As DEECD states, forecasting is subject to uncertainty. Further to this, DEECD while having used a long-term enrolment forecast model for some 20 years, has advised VAGO that those forecasts have not been specifically tested for reliability. As a result, DEECD was not in a position to provide audit with evidence on the known or expected level of variation or 'uncertainty' in their forecasting.

DEECD has concluded that there is a difference of $16 million between using a seven and 10-year forecast. However this isn't a valid comparison as the two forecasts also used different data sets, that is, the seven-year forecast was based on DEECD's long-term enrolment data set while the 10-year forecast used the newer demographic demand forecast data set.

Ten per cent allowance for uncertainty

VAGO has asserted that DEECD has not provided sufficient appropriate evidence to justify its use of a 10 percent error margin as the basis for its valuations.

As stated in the VGV disclosure report, the 2014 fair value calculation incorporates a 10 percent tolerance threshold primarily to allow for the impact of possible fluctuations in current and forecast enrolments. This is based on DEECD's judgement that this is a reasonable margin for uncertainty.

VAGO asserted that DEECD's policy required a 20 percent margin, but this assertion is incorrect. The policy requires 10 percent as is consistent with the actual calculation.

Auditor-General's further comment

The 10 per cent required in the DEECD policy has a different purpose to the 10 per cent loading applied in the VGV valuation advice. DEECD's policy requires an economic obsolescence adjustment when excess space is considered permanent, which it considers to be anything greater than 10 per cent. However the VGV valuation advice has instead applied a 10 per cent loading to allow for possible fluctuations in current and forecast enrolment figures, conducting the valuation on a school site basis and including buildings with community uses. Refer to page 35 of this report.

DEECD have stated that the 10 per cent allowance was 'primarily' to allow for possible fluctuations in current and forecast enrolments. This is not consistent with the VGV valuation advice.

DEECD is correct, however, that its policy does not require a 20 per cent margin. This has been removed from the report.

Relationship between entitled area and cost

VAGO expresses concern about the assumption that the relationship between the entitled area of a school and its replacement cost is linear.

DEECD has accepted VGV's advice that the linear assumption is valid, because it is practical, cost effective, and is not expected to significantly impact on fair value, in part because of the 10 per cent allowance for uncertainty.

Auditor-General's further comment

The VGV's valuation advice makes no explicit comment regarding the linear approach adopted in the economic obsolescence adjustment.

As explained above, the 10 per cent allowance made by the VGV is for three specific concerns and the impact of a linear approach was not one of them. The assertions made by DEECD are therefore not supported by the VGV valuation advice.

Valuation of community uses, and common and heritage facilities

VAGO criticises the treatment of particular classes of buildings and uses – common facilities (libraries and gyms), community use (after-hours care and community sport), and heritage buildings – on the grounds that the resultant write-downs of individual buildings lead to perverse outcomes.

It is important to clarify that the depreciated replacement cost method does not allocate a write-down to individual buildings. It derives a fair value for the whole school, by establishing the entitled space needed to cater for the forecast enrolments, and deducting depreciation to reflect the age of the actual assets of the school. It is not meaningful or necessary to allocate this write-down to particular buildings.

For this reason, DEECD, drawing on VGV's advice and its own judgement, has determined that valuing school sites (rather than buildings) will provide the most appropriate, consistent and conservative valuations.

In response to VAGO's observations on the three categories of buildings:

The entitled space that is calculated for fair value purposes makes provision for common facilities that would meet the needs of a school with that forecast enrolment.

DEECD does not separately value community use of school facilities, because community use only affects a minority of school assets for a minority of time, is secondary to the educational purpose of the school, and does not require the school to maintain assets above entitlement. It is not within DEECD's remit to invest in assets that are predominantly or substantially for a non-educational purpose.

Where DEECD co-invests in facilities with another party to enable shared use, DEECD's share of investment seeks to reflect the expected educational benefits, and fair value will be estimated on the same basis. The non-educational value will be reflected in the accounts of the other party. The $1.5 million co-investment by Macedon Ranges Shire Council in the Gisborne Secondary College development highlighted by VAGO will be treated this way.

Because fair value of a school is not allocated to individual buildings, it is not correct to infer that DEECD is effectively writing down heritage buildings. This would only become an issue if the entitled space needed to meet current or forecast enrolments were less than the area of a school's heritage buildings.

Only 42 school sites have heritage listed assets, representing 2.8 percent of the total sites assessed for economic obsolescence. Of the 42, only 22 (1.5 percent) have an obsolescence adjustment. Generally, only one building on a school site will be heritage listed, so its impact on fair value will be minimal.

Auditor-General's further comment

The statement that the VGV advised that valuing on a school site basis will provide the most appropriate, consistent and conservative valuations is incorrect. The VGV valuation advice states that the assets should be valued on an individual building basis. However, it accepted that this information was not available and that some buildings considered surplus currently form part of other buildings.

We disagree with the comments in the DEECD's response around the proposed accounting treatment for co-investment buildings. DEECD should recognise and account for assets based on control.

Auditor-General's further comment – continued

We have not inferred that heritage assets are written down as asserted by DEECD in its response. It is a statement of fact that these assets are partly written down. As the write down is performed on a school site basis, any school site that is over entitlement that has a heritage building will cause a portion of that building to be written down.

DEECD have stated in their financial statements that they do not have the asset information required to disclose heritage assets as a separate class of asset. Therefore, the value of these assets is unknown and could not be demonstrated to audit. It would be expected that these buildings, being valued on a reproduction cost basis, would have a higher fair value than buildings valued using depreciated replacement cost. DEECD's assertion that they represent only 1.5 per cent of the obsolescence adjustment cannot be verified in the absence of reliable fair value information for heritage assets.

Valuations of particular schools

During the audit, VAGO presented many examples of schools that it believed cast doubt on the appropriateness of DEECD's valuations. DEECD responded to each of these to explain the validity of its valuations. DEECD is pleased that VAGO has decided not to re-raise any of those examples in its report. However, VAGO has raised for the first time three new cases to which it has not given DEECD a reasonable opportunity to respond before the finalisation of the report.

DEECD will assess and explain to VAGO the application of the valuation method to each school it has raised for the first time (Apollo Parkways PS, Gisborne SC and the PPP schools).

DEECD will continue to refine its methodology to address the implications of any unusual and anomalous cases, though it has no evidence that the schools raised in the report require such changes.

Auditor-General's further comment

We have provided examples in this report to illustrate and provide practical context to the economic obsolescence issue. We have previously provided examples to DEECD which are discussed below. We could provide more examples if needed as our analysis shows that:

- 1 110 (or 7 out of every 10) schools were partly written down as economically obsolete. The medium write down was 26 per cent
- 71 per cent of existing schools (excluding special development schools) which have received funding for capital works in 2013–14 and/or are receiving funding in 2014–15 were partly written down as economically obsolete at 30 June 2014.

Auditor-General's further comment – continued

We have previously raised schools rebuilt after the bushfires and those built under the BER program as examples of investments not made solely based on enrolment. Rather than prove these invalid, DEECD has acknowledged in their response and in their financial statements that these investment decisions were not based on enrolment.

We have previously raised with DEECD, as an example, a new high school to be built in the inner suburbs of Melbourne at a budgeted cost of $20 million. In April 2013, DEECD commissioned an expert to conduct a demographic study to predict enrolment demand for a new high school in this area. This study found that there was not enough students currently in the catchment area to support the need for a new high school, and that there was not forecast to be an increase sufficient enough to support the need for a new school. It is therefore difficult to conclude that the decision to invest in a new school in the inner eastern suburbs was based solely on enrolment. Further, we have reviewed five of the existing six schools within the catchment area nominated in the study and identified that all were deemed to have excess space and consequently were partly written down. We maintain that this is a valid example that disputes the DEECD position that school investment decisions are made solely based on enrolments.

DEECD was provided with six working days in which to respond to the relevant parts of this report, including the three illustrative cases. This is one day more than the *Audit Act 1994* provides.

Impact on depreciation equivalent funding

VAGO expresses concern that the writing down of school valuations due to economic obsolescence reduces DEECD's annual depreciation expense.

While this is true, it has no implications for the level of funding that Government provides for the maintenance and upgrade of schools.

Government does not limit DEECD's funding for school facilities to depreciation equivalent levels. The State budget cycle considers departments' bids for facilities funding on their merits, and in light of government's priorities and financial capacity.

Auditor-General's further comment

As explained on pages 38 to 39 of this report, lower depreciation charges reduces the depreciation equivalent funding provided to DEECD year on year. DEECD can apply to government for more funding than what is received as depreciation equivalent funding, however it will be competing against the needs of other public service entities for the limited pool of additional funding available.

Explanation in DEECD's declaration on its 2013/14 accounts

VAGO has criticised DEECD for explaining its valuation method in the declaration by the Accountable Officer (the Secretary) and the Chief Finance Officer on its 2013/14 accounts, and for citing the support of the VGV in that explanation.

DEECD agrees with VAGO's assertion that the purpose of the declaration is for the Accountable Officer and Chief Finance Officer to state their opinion that the financial statements present fairly the financial transactions during the reporting period, and the financial position at the end of the period, in accordance with accounting standards.

Because VAGO has called into question the fairness of DEECD's accounts, it is appropriate that DEECD explain how it has reached a different conclusion. It is also appropriate that DEECD disclose any expert advice that it has relied on.

The VGV is a statutory office with government-wide responsibilities for property valuation. It is appropriate that DEECD place substantial weight on his views when valuing schools.

Auditor-General's further comment

Refer to earlier comments under *Declaration of DEECD's accounts*.

On pages 36 to 37 of this report, we have outlined the requirements of the *Financial Management Act 1994* as they relate to DEECD's declaration and why it is inappropriate for the comments and references made by DEECD to be included. We had recommended that this additional commentary is best placed in the notes to the financial statements.

Preparation of DEECD's financial report

VAGO has also described DEECD's preparation of its financial report as "inadequate" because draft reports included "errors" which led to 15 adjustments totalling $851 million. DEECD rejects this criticism.

In some cases, VAGO has adopted a different accounting approach to DEECD, and insisted that DEECD adopt its approach. In doing so, DEECD does not accept that its previous methods were incorrect, as evidenced by the fact they were accepted in previous audits. However, they were raised too late in the audit for DEECD to substantiate their application to 1500 schools. DEECD had no realistic alternative but to adopt VAGO's view where it had no in principle objection to VAGO's method.

Further, most adjustments were simply the reclassifications of disclosures that did not impact on the net financial outcomes reported by DEECD. Some of these disclosure adjustments were made as the result of new requirements under AASB13. In such cases, it is reasonable to expect several disclosure drafts as DEECD comes to terms with new requirements, and it is not reasonable to refer to the changes as "errors".

Importantly, the adjustments that VAGO values at $851 million arise from only four issues. These have a net impact of only $6.1 million on the State's ledger, as set out in the table below.

VAGO's figures create a misleading impression of the significance of the adjustments.

Adjustments to the financial statements

Issue summary		Balance affected	Amount adjusted ($million) Operating Statement (+ve means increase in net result)	Amount adjusted ($million) Balance Sheet (+ve means increase in net assets)	Disclosure adjustment
1. Schools balances restated from accrual accounting to cash accounting (original accounting consistent with treatment in prior years)		2013 Unearned income (schools)	98.8		
		2013 Liabilities - YTD		98.8	
		2013 Income (schools)	-93.7		
		2013 Schools receivables - YTD		-93.7	
	(a)	2014 Unearned income (schools)	14.7		
		2014 Liabilities - increment		14.7	
	(b)	2014 Income (schools)	-8.8		
	(b)	2014 Schools receivables - increment		-8.8	
		Total impact on net result from transactions	11	11	
	(c)	2013 Provision for doubtful debts YTD		11.8	
		2013 Net gain/(loss) on financial instruments	11.8		
		2014 Provision for doubtful debts - increment		1.5	
		2014 Net gain/(loss) on financial instruments	1.5		
		Total impact on other economic flows	13.3	13.3	
2. In 2013 VAGO requested for the first time that assets held for sale be valued at fair market value. This year VAGO has requested the Department reverse it.		Assets held for sale or distribution		-51.5	
		Assets Not Previously Recognised	-30.4		
		Revaluation reserve		21.1	
		Total impact on other economic flows	-30.4	-30.4	
3. Reclassification within asset classes		Intangible assets		3	
		Property, plant and equipment at fair value		-3	
		Total impact on balance sheet		0	
4. Recognition of unpresented cheques		Cash and deposits		0.4	
		Payables		-0.4	
		Total impact on balance sheet		0	
		TOTAL IMPACT OF LEDGER ADJUSTMENTS	-6.1	-6.1	
Disclosure amendments		Property, plant and equipment at fair value	0	0	207.9
		Service concession (PPP) related commitments	0	0	99.8
		Financial instruments disclosure - Statutory pay.	0	0	49.2
		Assets pledged as security to finance leases	0	0	12.9
		Capital commitments	0	0	5.7
		Remuneration of Executive Officers	0	0	0.4
		Remuneration of Executive Officers	0	0	0.2

(a) The 2014 balance was 113.5 but after the reversal of the prior year balance (98.8 above) the remaining adjustment was 14.7
(b) The 2014 balance was 102.5 but after the reversal of the prior year balance (93.7 above) the remaining adjustment was 8.8
(c) The 2014 balance was 13.3 but after the reversal of the prior year balance (11.8 above) the remaining adjustment was 1.5

Auditor-General's further comment

Refer comments above under *Preparation of DEECD's financial report*

DEECD's financial statements should inform the Parliament and the public about the department's financial performance and position. The Accounting Standards require financial disclosures to fully inform users of the financial statements. To omit or include erroneous disclosures could mislead the users of those statements.

Our role as auditor is to provide assurance to the users that the information contained in the financial statements is presented fairly. So while DEECD might not consider a number of these adjustments as errors, the Accounting Standards do. Therefore, disclosures must be accurate and comply with the financial reporting framework so as not to mislead the users of the financial statements.

Auditor-General’s reports

Reports tabled during 2014–15

Report title	Date tabled
Technical and Further Education Institutes: Results of the 2013 Audits (2014–15:1)	August 2014
Coordinating Public Transport (2014–15:2)	August 2014
Managing the Environmental Impacts of Transport (2014–15:3)	August 2014
Access to Legal Aid (2014–15:4)	August 2014
Managing Landfills (2014–15:5)	September 2014
Management and Oversight of the Caulfield Racecourse Reserve (2014–15:6)	September 2014
Effectiveness of Catchment Management Authorities (2014–15:7)	September 2014
Heatwave Management: Reducing the Risk to Public Health (2014–15:8)	October 2014
Emergency Response ICT Systems (2014–15:9)	October 2014
Public Sector Performance Measurement and Reporting (2014–15:10)	October 2014
Mental Health Strategies for the Justice System (2014–15:11)	October 2014
Information and Communications Technology Controls Report 2013–14 (2014–15:12)	October 2014

VAGO’s website at www.audit.vic.gov.au contains a comprehensive list of all reports issued by VAGO.

VAGO

Victorian Auditor-General's Office

Auditing in the Public Interest

Availability of reports

All reports are available for download in PDF and HTML format on our website www.audit.vic.gov.au

Or contact us at:

Victorian Auditor-General's Office
Level 24, 35 Collins Street
Melbourne Vic. 3000
AUSTRALIA

Phone: +61 3 8601 7000
Fax: +61 3 8601 7010
Email: comments@audit.vic.gov.au