

**June 2005 | Guideline**

**APPROVING, CONDUCTING  
AND REPORTING AUDITS  
VICTORIAN WATER BUSINESSES**

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# 1 Background

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## 1.1 Purpose of the guideline

- 1.1.1 Under the Water Industry Regulatory Order 2003, the Commission has the function of carrying out audits of certain defined matters related to water businesses regulated under the Water Industry Act 1994.
- 1.1.2 Insofar as it relates to the performance of that function, this guideline is published pursuant to section 13 of the Essential Services Commission Act 2001.
- 1.1.3 This guideline establishes a framework for the Commission to perform its required audit functions related to the regulated water industry and for the regulated water businesses to satisfy their respective obligations to undertake audits (as outlined below).
- 1.1.4 The framework is designed to:
- *ensure that audits are conducted in an independent, rigorous and comparable manner* by establishing minimum requirements for the independence and expertise of auditors, and the conduct and reporting of audits
  - *provide incentives for businesses to achieve compliance* by minimising the probability that significant non compliance will go undetected, providing regulated water businesses with an opportunity to rectify non compliance and taking any further action required to achieve compliance and
  - *maximise the cost-effectiveness of the audits* by taking a risk-based approach to defining the scope and frequency of the audits to be undertaken.
- 1.1.5 Nothing in this guideline is intended to limit the capacity of the Commission to perform its audit function under the Water Industry Regulatory Order or the manner in which the Commission may exercise that capacity.

## 1.2 Requirement to undertake audits

- 1.2.1 Under section 17 of the Water Industry Regulatory Order, the Commission may carry out audits in relation to:
- the compliance of a regulated water business with the standards and conditions of service and supply specified by the Commission in any Code or set out in the business's Water Plan, and the systems and processes established by the regulated water business to ensure such compliance
  - the reliability and quality of information reported by a regulated water business to the Commission, and the conformance of that information with any specification issued by the Commission and
  - the compliance of a regulated water business with asset management obligations imposed in any Statement of Obligations issued to it.

- 1.2.2 Under section 18 of the Water Industry Regulatory Order, the Commission must also when requested by the Minister for Water carry out audits in relation to compliance of a regulated water business with obligations that are identified by the Minister for Water and are imposed on the regulated water business under the Statement of Obligations.
- 1.2.3 The Water Industry Regulatory Order provides that the Commission may decide the scope and frequency of audits which it has the function of carrying out, provided that such audits are not conducted more frequently than once in any given financial year.
- 1.2.4 Under the Water Industry Act (or the licence issued to it under that Act), each regulated water business must comply with a Statement of Obligations, which specifies that a regulated water business must:
- when requested to do so by the Commission, arrange for an audit to be undertaken
  - ensure that the audit is conducted by an independent auditor nominated by the business and approved by the Commission
  - ensure that the audit is conducted in accordance with guidelines issued by the Commission.

## 2 STAGE 1 – ESTABLISHING THE AUDIT SCOPE

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### 2.1 Identifying audit obligations

2.1.1 The Commission will decide and issue to each business the scope of the audits to be undertaken subject to clause 2.1.4.

2.1.2 The audit scope will specify the:

- nature of the obligations and other matters to be audited
- time frame over which compliance with each relevant obligation or matter is to be audited and
- details of the process and relevant timelines for undertaking the audits and for the provision of final audit reports.

2.1.3 In determining the audit scope, the Commission will have regard to such matters it considers relevant, including:

- the risk assessment process (set out in clause 2.2 of this guideline)
- its objectives under the Essential Services Commission Act and the Water Industry Act.

2.1.4 The audit scope will include as obligations to be audited any obligations that are imposed on the relevant water business by its Statement of Obligations as identified by the Minister for Water for audit.

2.1.5 The Commission will seek to minimise the potential for unnecessary or overlapping audits by consulting with other relevant agencies — such as, the Environment Protection Authority and the Department of Human Services — to identify whether an obligation is to be audited under a separate regulatory requirement or process.

### 2.2 Assessing risk

2.2.1 In assessing the risk associated with any obligation or matter, the Commission will consider the *likelihood* of non compliance (or, in the case of information, the likelihood of its being defective, unreliable, lacking in quality or not conforming with relevant specifications) and the *consequence* of non compliance (or the information being defective).

2.2.2 In assessing the likelihood of non compliance (or the likelihood of information being defective), the Commission will consider the following factors:

- any previous audit results or evidence of non compliance

- the likely or known extent of information defects
- any issues identified as part of its own regulatory and/or consultation processes and
- any complaints made or issues raised by other stakeholders — for example customers, or the Energy and Water Ombudsman (Victoria).

2.2.3 In assessing the consequences of non compliance or of information being defective, the Commission will consider the following factors:

- the consequences for achieving the Commission’s objectives and functions under the Essential Services Commission Act and Water Industry Act
- danger to public health, safety or the environment
- the impact or cost to customers or the general public
- damage to property
- loss or a reduction in the quality, reliability and security of water as an essential service
- effective commercial and regulatory decision making (for example, by basing future regulatory decisions on unreliable performance data or by customers/businesses making invalid comparisons about the businesses’ performance).

2.2.4 In applying the risk assessment process identified above the Commission will seek to achieve its objectives as set out in its constituent legislation and in Part 1A of the Water Industry Act.

2.2.5 In deciding the scope of the audit the Commission will give greater priority to auditing high risk obligations and matters identified using the risk assessment process above. It may also audit medium and low risk obligations and matters but will consider whether a less intensive or less frequent audit requirement may be appropriate.

### **3 STAGE 2 – NOMINATING, APPROVING AND APPOINTING THE AUDITOR**

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#### **3.1 Nomination**

- 3.1.1 Once the Commission has issued the audit scope, the regulated water business must nominate to the Commission for approval (by a date specified by the Commission) an independent auditor to undertake the specified audits.
- 3.1.2 The Commission will consider approving auditors for a period greater than 1 year but no more than 5 years.
- 3.1.3 In nominating an auditor, the regulated water business must provide details of:
- the proposed auditor who will undertake the specified audit
  - the proposed individuals who will undertake any relevant audit work for the auditor (that is, the audit team)
  - the proposed individual who will lead the audit team (who must be a partner or equivalent of the auditor and who will be required to sign the audit report and take full responsibility for the audit findings)
  - the work history and skills of the audit team leader and each audit team member, and the roles they will play in undertaking the audits
  - the auditor's field of work, core expertise, experience and corporate or business structure (unless the auditor has been selected from the Commission's audit panel)
  - any work undertaken by the auditor for the regulated water business in the previous two years, and any work that the auditor is currently doing or has bid for in relation to the regulated water business
  - any potential or perceived conflict of interest and the manner in which the potential or perceived conflict of interest is proposed to be managed and
  - the term of the approval requested.
- 3.1.4 In deciding whether to approve as auditor a person nominated by a regulated water business, the Commission will have regard to the following key criteria:
- demonstrated skill, experience in, and detailed knowledge of quality assurance, including operational or compliance auditing and where relevant science or engineering, asset management, information systems and customer service (in terms of both the nominated auditor and the proposed audit team)
  - detailed knowledge of the water industry (in terms of both the nominated auditor and proposed audit team)



- familiarity with the economic regulatory framework applying to the Victorian water industry
- an absence of conflicts and
- resource capacity to undertake the audits.

3.1.5 The Commission may establish a panel of auditors who it considers meet the skill, experience and knowledge criteria in 3.1.4 and the resource capacity to undertake more than one audit.

3.1.6 Panel members will need to agree:

- in principle to the terms of the tripartite contract and
- to take actions to ensure that staff maintain the necessary skill level and familiarity with the Commission's audit requirements.

3.1.7 If a regulated water business fails to nominate or obtain approval of a person as auditor within the specified timeframe, the Commission may (but without being obliged to do so) either appoint an auditor from its audit panel or conduct the audit itself, without limiting or qualifying any liability of the regulated water business.

## **3.2 Approval of auditors**

3.2.1 If the Commission is satisfied that the nominated auditor and audit team members satisfy the key auditor selection criteria, it will provide the regulated water business with written notice of the Commission's intention to approve of the auditor, which may be conditional. Formal approval will only be provided of a person nominated as auditor by a regulated water business:

- if the Commission has given notice of its intention to approve the person as auditor with respect to the business
- any conditions applicable to that notice have been satisfied (or waived by the Commission) and
- a deed in a form satisfactory to the Commission has been delivered to the Commission duly executed by both the auditor and business (an audit deed).

3.2.2 If under the preceding paragraph approval of a person as auditor is provided, that approval will take effect upon the Commission's execution of the relevant audit deed.

### 3.3 Appointment and termination of approval

- 3.3.1 Each regulated water business must ensure that no person nominated by it as auditor commences an audit until approval of the person as auditor has been provided (as outlined in 3.2.1). Such a person cannot commence an audit before the Commission's receipt of a duly executed audit deed.
- 3.3.2 Once approved, the primary duty of care of the auditor is to the Commission.
- 3.3.3 A regulated water business must not:
- require or seek changes to be made to an auditor's report that conflict with the auditor's professional judgment and auditors primary responsibility to the Commission including, for instance, requiring a change to be made that would, in effect, remove or obscure any adverse finding of the auditor; or
  - unreasonably withhold payment or terminate any contract with the auditor over a disputed audit finding.
- 3.3.4 If the auditor believes that an event described in the clause 3.3.3 has occurred, the auditor must advise the Commission as soon as possible after the event has occurred.
- 3.3.5 Once approved, the audit firm must:
- notify the Commission immediately of any change to the audit team members
  - ensure that no member of the audit team performs fee earning work for the relevant water business and that no work is undertaken that either influences any members of the audit team or could reasonably be considered to give rise to a material risk of any members of the audit team being influenced in relation to the relevant audit
  - minimise the risk of conflicts of interest arising or being seen to arise — for example, an approved auditor will be required not to do, and not to have done in the 12 months preceding its appointment, work which would create, or could be seen to create, a conflict of interest
  - notify the Commission of and manage any conflicts of interest or perceived conflicts of interest that arise in accordance with any protocols agreed with the Commission.
- 3.3.6 The audit deed elaborates on these requirements and qualifies their application in the context of work undertaken in connection with the audit, certain financial auditing services under the Corporations Act and work undertaken under protocols agreed with the Commission.
- 3.3.7 The Commission's approval of an auditor to conduct audits will end upon the expiry or termination of the relevant audit deed.

- 3.3.8 The Commission's approval of an auditor constitutes an approval of that auditor only for the purpose of conducting audits for which the nominating regulated water business is obliged under its Statement of Obligations to arrange and for no other purpose.

### **3.4 Briefing the auditors**

- 3.4.1 Prior to the commencement of each audit the Commission will brief auditors (either individually or jointly) to ensure that the Commission's audit scope and requirements are clearly understood.
- 3.4.2 Representatives of the audit team must attend the briefing. Water businesses may also attend the briefing.

## 4 STAGE 3 - CONDUCTING THE AUDIT

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### 4.1 Audit methodology

4.1.1 To ensure that the audits are comparable, an auditor undertaking an audit must employ a methodology that satisfies the following minimum requirements.

4.1.2 As a minimum, auditors should:

- *analyse documented procedures* to assess whether they are consistent with the regulatory definition of the obligation or matter the subject of audit. Documented procedures include anything that guides staff in complying with the obligation or acting in relation to the relevant matter — for example, training manuals, customer service manuals, and procedures for generating, entering and reporting regulatory information.
- *interview responsible staff* to assess whether they understand and comply with the documented procedures.
- *analyse information systems* to assess the extent to which they produce information that complies with regulatory definitions. This will require an examination of:
  - system design and security and
  - the design of queries and calculation formulae that are used to generate regulatory information.
- *analyse quality controls* (such as complaints feedback mechanisms and internal audits) to assess whether non compliance and information defects are systematically identified and corrected.
- *identify changes in systems and documented procedures* that may indicate that data accuracy or reliability has varied significantly over the audit time frame, and which may lead the auditor to conclude that the current performance level is not representative of the performance level that would be achieved if assessed over the time frame.
- *analyse relevant data* in the regulated water business's information system to:
  - ensure that the data in the system matches the data previously reported to the Commission and
  - identify any missing data or unusual figures or trends that might suggest errors in data entry or manipulation.
- *analyse a sample of cases or data*. The auditor must establish the extent to which there has been actual compliance (insofar as compliance is the subject of audit) or the extent to which relevant information is free of defect; it is not enough to ensure only that procedures are robust.

- *in cases of significant non compliance or significant information defects*, assess the regulated water business's plan to ensure future compliance and the supply of non-defective information and timeframe by which it is expected to achieve this. In particular, whether the plan is adequate and will be effective. Significant in this context means:
  - for information - a confidence grade worse than B or an accuracy grade worse than 2 (as defined in Part 5)

- 4.1.3 An auditor must investigate any question identified in the audit scope.
- 4.1.4 An auditor may have regard to internal audit assessments, but in arriving at a conclusion in relation to an audit matter must not rely on it exclusively. Where an auditor has previously audited a matter, it should exercise professional judgment as to the depth of inquiry required.
- 4.1.5 In performing the audit, the auditor should have regard to relevant Australian Standards for Assurance Sampling, Compliance and Risk Management.

## 4.2 Generic issues

- 4.2.1 In auditing the quality, reliability or conformity of regulatory information with specification an auditor should address the following generic issues:
- Is the information generated in accordance with documented policies, practices and procedures?
  - Are the policies, practices and procedures fully understood by relevant staff?
  - How accurately do those procedures and the information reflect the Commission's information specifications?
  - Is the information based on sound information systems and records?
- 4.2.2 In auditing compliance an auditor should address the following generic issues:
- Is the matter reflected in documented policies, practices and procedures?
  - Has the matter been fully understood by staff?
  - Has the matter been delivered as specified (insofar as it is a matter to be supplied or performed)?
  - Is the matter the subject of effective compliance monitoring (such as, records of service delivery) and quality control (such as, complaints feedback, internal audits)?
  - Does the culture appear to support compliant behaviour?
  - Does the organisational structure support compliant behaviour and outcomes?

## 5 STAGE 4 - ASSESSING AND REPORTING ON COMPLIANCE

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### 5.1 Standard compliance grades

- 5.1.1 The auditor must assess compliance using standard confidence and compliance grades.
- 5.1.2 In relation to regulatory information, the grades to be used focus on the *reliability* of the procedures used to generate the information and the *quality* of the data.
- 5.1.3 The auditor must determine the data quality by having regard to:
- the systems and processes used to generate the data and
  - the methods used, if any, to extrapolate or estimate data.
- 5.1.4 The auditor must assign a two part confidence grade (eg - B2, DX) to each category of relevant information (including each category, if any, identified by the Commission in the audit scope provided by it) as follows:

<i>Grade</i>	<i>Reliability assessment</i>
A	All data is based on sound information systems and records, and on documented policies, practices and procedures which are: <ul style="list-style-type: none"> <li>• consistent with the Commission’s information specifications; and</li> <li>• fully understood and followed by staff.</li> </ul>
B	Most data conforms with grade A. Data which does not has a minor impact on overall data integrity. For example, a minority of data may be based on: <ul style="list-style-type: none"> <li>• information specifications which are significantly, but not substantially different to those published by Commission or</li> <li>• procedures which are not fully understood by staff or</li> <li>• minor variations from documented procedures or</li> <li>• estimation or extrapolation of data which conforms with Grade A or</li> <li>• reliance on unconfirmed reports.</li> </ul>
C	In many cases, but not all, data is based on: <ul style="list-style-type: none"> <li>• information specifications which are significantly, but not substantially different to those published by Commission or</li> <li>• procedures which are not fully understood by staff or</li> <li>• estimation or extrapolation of data which conforms with grade A or B or</li> <li>• reliance on unconfirmed reports.</li> </ul>
D	Other data

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




<i>Grade</i>	<i>Accuracy (per cent)</i>
1	± 1
2	± 5
3	± 10
4	± 25
5	± 50
6	± 100
X	For small samples where an accuracy cannot be calculated or error would be more than 100%

**Compliance**





5.1.5 The auditors must assess compliance using the following two step grading system


**Step one**

Harvey balls must be used to indicate the quality and presence associated with each of the following areas, for example:

<i>Policies</i>	<i>Practices</i>	<i>Procedures</i>	<i>Systems</i>	<i>Training/Skills</i>
				

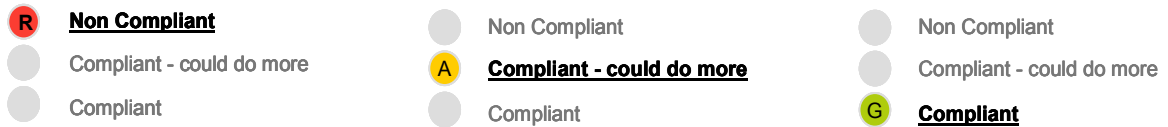
**Key**

<b>Grade</b>	<b>Description</b>	<b>Action</b>
	<i>Non Compliance</i>	Serious action required, specifically <b>&lt;&lt;auditor's comments&gt;&gt;</b>
	<i>Non Compliance</i>	Full revision of all systems, processes etc, specifically <b>&lt;&lt;auditor's comments&gt;&gt;</b>
	<i>Non Compliance</i>	Significant revision of systems and processes required, specifically <b>&lt;&lt;auditor's comments&gt;&gt;</b>
	<i>Compliant but need improvement</i>	Revision of some systems and processes required, specifically

		<<auditor's comments>>
	<i>Full compliance</i>	No further actions required.

### ***Step two***

A traffic light system must be used to indicate overall compliance taken into account all five areas for which the separate harvey balls have been given.



### ***Audit of asset management obligations***

5.1.6 In auditing compliance with asset management obligations and other obligations contained in the Statement of Obligations, the auditor must address in writing each of the issues identified by the Minister for Water that are specified in the audit scope.

#### ***Level of confidence***

5.1.7 Unless otherwise indicated by the Commission, the auditor must assess compliance grades to a 90 per cent level of confidence, based on statistical methods where possible. In determining the size of statistical samples an auditor should have regard to the Australian Standard for Assurance Sampling.

## **5.2 Reports**

5.2.1 An auditor must prepare a report that addresses all of the issues identified in the audit scope issued by the Commission.

5.2.2 At a minimum (unless directed otherwise by the Commission) the audit report should contain the following:

- *An executive summary* identifying key issues arising from the audit that reflects any current standard reporting format issued by the Commission
- *A description of the audit scope and methodology*, which must reflect the audit scope provided by the Commission and the requirements of this guideline



- *A brief description of the systems and procedures* that have been established to comply with each obligation, including the identification of relevant documentation and responsible staff
- *A discussion of compliance* addressing each generic issue and each concern specific to a matter identified by the Commission in the audit scope issued by it
- *grades for each matter included in the audit scope* (excluding the asset management requirements) and for the performance indicators, the audited performance figures. The report should also identify the reasoning for a final audit grade where non compliance is identified
- Where non compliance has been identified and the regulated water business has a plan to mitigate the risk of it continuing or occurring in the future:
  - a description of the plan, including the timeframe proposed to achieve compliance
  - an evaluation of the adequacy of the plan, including a projected grade or level at the conclusion of the plan.

### 5.3 Signed statement

- 5.3.1 An auditor must include in its final audit report a statement, signed by the leader of its audit team, that:
- the audit report findings accurately reflect the professional opinion of the auditor to the level of confidence specified in these guidelines
  - the auditor and team members have observed the requirements of this guideline and the relevant audit deed in conducting the audit, making audit findings and preparing the report and
  - the audit report findings have not been unduly influenced by the water business and/or any of its associates.

### 5.4 Reporting procedures

- 5.4.1 The auditor must complete the audit report in the timeframe specified by the Commission.
- 5.4.2 The auditor must provide the water business and the Commission with a copy of its final audit report as soon as it is completed. An auditor may provide a water business with a copy of a draft audit report to enable the business to identify (and correct) any factual inaccuracies.
- 5.4.3 Auditors are required by the audit deed to keep all draft reports and all records used in arriving at an audit finding. The Commission may request the auditor to

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provide copies of any such draft reports or other relevant material provided by the auditor to the regulated water business.

- 5.4.4 The final audit report must be provided to the Commission in both hard copy and electronic forms.
- 5.4.5 The auditor must be available to brief the Commission on its audit findings if requested.

## 6 STAGE 5 - RESPONDING TO THE AUDITS

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- 6.1.1 A regulated water business must ensure that its board considers the auditor's report as soon as possible after it is received.
- 6.1.2 Within 30 business days of receiving the final audit report, the regulated water business must provide to the Commission a written statement that indicates:
- the actions that the regulated water business proposes to take in response to the audit findings and
  - specifically where the auditor has identified non compliance, the actions that the regulated water business proposes to take and the timeframe by which it will achieve compliance.
- 6.1.3 In response to an audit report, the Commission may (without limiting its powers and rights under legislation, an audit deed or otherwise):
- obtain and analyse the auditor's record of its contacts with the relevant regulated water business — for example, to obtain more details of reported non compliance or to investigate whether significant changes have been made to drafts of the report
  - require further auditing to be undertaken (whether by the relevant auditor or another) where it considers the report is or may be unsatisfactory in a material respect — for example, where the Commission has independent information contradicting an assessment made by the auditor
  - require that the relevant regulated water business arrange for another auditor approved by the Commission to undertake any such further auditing work
  - conduct its own audit of the full audit report(s) where:
    - it is not satisfied that the individual audits provide adequate assurance that the audits of the water business produce results that are validly comparable or
    - it requires better information on which to assess whether compliance or other action should be taken
  - require termination of any contract by which the auditor was engaged to conduct the relevant audit
  - remove a firm from the audit panel if it has failed to follow the audit guideline or has not observed the necessary level of independence.
- 6.1.4 Where the audit identifies non compliance, the Commission may (without limiting its powers and rights):
- require action to be taken by a regulated water business to address any non compliance or to mitigate the risk or consequences of future non compliance

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- review provisions of regulatory instruments that appear to be unclear, inadequate, excessive or trivial and/or
  - exercise the enforcement powers available to it under relevant legislation.
- 6.1.5 The Commission will report publicly and/or comment on the results of any audits undertaken (and the steps if any to achieve compliance). This may include but is not limited to reporting the results of the audit as part of its performance reporting function.

## **7 AMENDMENTS**

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- 7.1.1 The Commission may amend or revoke this guideline.
- 7.1.2 The Commission will not make material amendments to this guideline until water businesses and other stakeholders have had an opportunity to comment on the nature of any proposal to amend or revoke the guideline and those comments have been considered, in accordance with the Commission's Charter of Consultation and Regulatory Practice.