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Update on Downer's Utilities contract

On 8 December 2022, Downer announced that it had identified the historical misreporting of revenue and work in progress in one of Downer's maintenance contracts in its Australian Utilities business.

Downer announced today that the privileged and confidential investigation undertaken by lawyers retained by Downer, and forensic accountants engaged to assist the investigation, has now been completed.

Reporting of revenue in respect of all contracts with a material work in progress balance in Australia and New Zealand has been reviewed.

Downer is confident that the misreporting was specific to the contract and not replicated elsewhere.

The Contract

The contract is for the supply of maintenance, new connections, faults and capital works services for a long-term Power Utilities customer applying a schedule of agreed prices for each service type.

There are over 9000 work orders issued in any given month, the vast majority of which are completed within the same month. Some capital related work orders, however, extend across two or more months. The contract has an initial term remaining of 27 months and two extension options of 3 years each.

The contract was signed in July 2019 and, following a transition phase from a preceding long-term contract, year one of the contract commenced on 1 April 2020. The new contract was significantly larger than the preceding contract and incorporated both new geographic service areas and new services, including increased capital works.

The misreporting of the contract earnings since inception resulted in the contract's underlying poor performance, including its deteriorating performance over time, remaining unidentified. Downer is heavily focused on the remediation of the contract and a detailed recovery plan is now being actioned. The new contract management team, along with external business improvement specialists, are working closely with our operations teams and customer to improve contract performance.

Downer has agreed and documented a commercial reset of the contract with the customer and this, coupled with operational improvements, indicates the contract is not onerous.

The Utilities management team responsible for the contract has been replaced.

How did the misreporting occur?

The misreporting of revenue has come about through the misapplication of Downer's revenue recognition policy, by incorrectly assuming that:

1. work orders were completed (either in full or to an assumed percentage) at each month end, including work orders for which little work had been undertaken. The result was to overstate the extent to which work orders had progressed, and to record revenue prematurely, particularly for work orders that extended across two or more months; and

2. costs incurred in excess of the scheduled billable amount related to variations billable to the customer.

Contributing factors

At the inception of the contract in 2020, contract management carried across a method of recording revenue at month-end that had been applied to a previous contract with the same customer. That earlier contract, however, was different in breadth of service and scale to the new contract, and the need to apply a different methodology was not identified as necessary.

Reported earnings were close to expectations and project performance reporting did not indicate any material issues within the contract.

Changes to the customer's billing system and Downer's works management systems in 2021, effectively masked the underlying issues, and led to the mistaken belief that high Work in Progress was largely the result of billing difficulties caused by the new systems and processes that would ultimately be resolved with the customer and for which there was a detailed management recovery plan.

Impact on prior year results and 1H FY23

Post-tax earnings were overstated by a total of $22.2 million between April 2020 and 30 June 2022, of which $1.7 million relates to FY2020, $8.8 million relates to FY21 and $11.7 million relates to FY22.

Downer will restate comparative financial information to incorporate the correction in underlying results. As part of the 1H FY2023 results announced today, the restated prior period (1H FY2022) post-tax earnings will be reduced by $3.2 million. Note A of Downer's Condensed Consolidated Financial report for the Half Year ended 31 December 2022 shows these adjustments.

Post-tax earnings for the contract for the six months to 31 December 2022 was a loss of $12 million.

Improvements to ensure the misreporting does not occur again

Downer has a comprehensive risk management, internal compliance and control system in place, including a detailed revenue recognition policy, that aligns with AASB15, and must be followed for each contract.

The following additional control measures have been implemented across the Group:

- The revenue recognition methodology for all new material contracts now also requires the approval of the Tenders and Contracts Committee (TCC) prior to the commencement of the contract. Any subsequent adjustments will also require approval by TCC prior to implementation.

- The revenue recognition methodology and application for all new material contracts must now undergo internal audit review within six months of contract start and then periodically as part of the internal audit plan.

Authorised for release by Downer's Board of Directors.

About Downer
Downer is the leading provider of integrated services in Australia and New Zealand and customers are at the heart of everything it does. It exists to create and sustain the modern environment and its promise is to work closely with its customers to help them succeed, using world-leading insights and solutions to design, build and sustain assets, infrastructure and facilities. For more information visit downergroup.com.

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