

Audit Report No. 47

Management of Commonwealth Guarantees, Indemnities and Letters of Comfort

Introduction

- 3.1 Guarantees, indemnities and letters of comfort¹ play an effective role in facilitating the business of the Government. At the same time, they involve the assumption of potential liabilities and, as such, carry with them risks and obligations which may be called on in the future.²
- 3.2 The management of the Commonwealth's exposure to such instruments has been the subject of investigations by the Australian National Audit Office, the Joint Committee of Public Accounts³ and the House of

1 A guarantee is a promise whereby one party promises to be responsible for the debt of, or performance obligations of, another should this party default in some way. An indemnity is a promise whereby a party undertakes to accept the risk of loss or damage another party may suffer. A letter of comfort is an instrument which is used to facilitate an action or transaction but is constructed with the intention of not giving rise to a legal obligation.

2 Auditor-General, *Audit Report No. 47, 1997-98, Management of Commonwealth Guarantees, Indemnities and Letters of Comfort*, p. 3.

3 Prior to the 39th Parliament, the Committee was known as the Joint Standing Committee of Public Accounts.

Representatives Standing Committee on Financial Institutions and Public Administration in recent years.

- 3.3 In 1996, the ANAO argued that there was a need for:
- a substantial improvement in most agencies' management and administrative practices with regard to off-balance sheet risk; and
 - greater public accountability at both the agency and whole of government levels through better reporting.⁴
- 3.4 Since the 1996 audit report was tabled, there have been a number of developments which affect the issuing and management of these instruments. Most notable was the issuing of the Department of Finance and Administration Circular 1997/06 which provided agencies with revised guidelines on the provision of guarantees, indemnities and letters of comfort. According to the ANAO, it provided general guidance on these instruments and was instrumental in driving significant improvements in public administration in this area.⁵
- 3.5 In its 1998 audit, the ANAO surveyed 23 agencies for the purpose of assessing the adequacy of agencies' management of these instruments in relation to:
- the size and nature of the Commonwealth's exposure;
 - the nature of agencies' management, reporting and monitoring of the instruments;
 - action taken by agencies in regard to the earlier audit;
 - the Parliamentary Committees' recommendations; and
 - agencies' approaches to risk management.⁶

4 Auditor-General, *Audit Report No. 47, 1997-78, Management of Commonwealth Guarantees, Indemnities and Letters of Comfort*, p. xi.

5 Ian McPhee, ANAO, *Transcript*, p. 45.

6 Auditor-General, *Audit Report No. 47, 1997-78, Management of Commonwealth Guarantees, Indemnities and Letters of Comfort*, p. 7.

ANAO findings

- 3.6 The ANAO found that improvements have been achieved in a number of key areas.⁷
- While the value of the Commonwealth's exposure to these instruments increased significantly in the first year after the original audit, this figure had since fallen sharply.
 - There had been a general improvement in the number of agencies implementing registers for their guarantees, indemnities and letters of comfort.
 - There had been a marked improvement in the guidance provided to agencies regarding the disclosure and reporting of these instruments.
- 3.7 The ANAO also identified the following areas where remedial action was required.
- There was a need for agencies to improve their security arrangements to ensure they have effective administrative controls of the instruments.
 - There was a need for agencies to establish comprehensive risk management strategies with direct links to management of these instruments.

Additional input from agencies

- 3.8 Of the 23 agencies originally surveyed by the ANAO, two agencies provided the Committee with follow-up information on their management of guarantees, indemnities and letters of comfort. These were the Department of Health and Aged Care and the Department of Defence. In addition, the ANAO and the Department of Finance and Administration provided information across the whole of government.
- 3.9 Discussions focused on the following issues:
- the extent of the Commonwealth's reported exposure; and
 - the management and monitoring of Commonwealth exposure.

⁷ Ian McPhee, ANAO, *Transcript*, p. 40.

Level of Commonwealth exposure

- 3.10 The ANAO informed the Committee that the reported level of exposure had fallen from \$415 billion as at 30 June 1996 to \$215 billion as at 30 June 1997. This fall mostly reflected:
- asset sales, which have enabled the Commonwealth to transfer risks to the private sector;
 - exclusion of Commonwealth superannuation liabilities from this figure; and
 - annual reductions in the Commonwealth's remaining exposure for the Commonwealth Bank.⁸

Management and monitoring of Commonwealth exposure

- 3.11 In relation to the management and monitoring of the Commonwealth's exposure to these instruments, the Committee was informed that there has been an overall improvement in the number of agencies implementing registers for their guarantees, indemnities and letters of comfort. However, it was noted that difficulties frequently arise due to the fact that most agencies have little or no exposure to these instruments. As a consequence, staff do not have the opportunity to develop a high level of expertise in this area⁹.

Security

- 3.12 On the matter of security of the administrative arrangements concerning these instruments, the Department of Health and Aged Care informed the Committee that it conducts spot checks to enforce standards, and that it is currently implementing improved security procedures:

We have issued guidelines on the way that documents should be stored. We have also had undertaken for us recently a major review of our security arrangements and we are putting in new security procedures following that review. We have just let a tender for that. That includes an information and training exercise

8 Auditor-General, *Audit Report No. 47, 1997-78, Management of Commonwealth Guarantees, Indemnities and Letters of Comfort*, pp. xii-xiii.

9 Colin Cronin, ANAO, *Transcript*, p. 46.

for staff. But we do not have rules about the sorts of cabinets that should be used, what things have to be locked up and where.¹⁰

- 3.13 The Department of Defence maintains that its existing policy and security procedures are adequate.¹¹

Risk management

- 3.14 In relation to risk management, the ANAO argued that agencies have not generally placed sufficient emphasis on establishing comprehensive risk management strategies with direct links between their corporate risk management plan and their strategies for management of these instruments.¹²
- 3.15 The Department of Defence informed the Committee that it has been the practice with respect to acquisitions over \$20 million for an equipment acquisition strategy to be developed which identifies major risks and produces a risk management plan to manage them.¹³
- 3.16 As a further step in implementing ANAO recommendations, the Department of Defence plans to conduct a corporate-level evaluation assessment of risk management arrangements within the Defence Organisation. The evaluation '...aims to determine the additional measures, including an overall corporate policy, that may be necessary as part of an effective corporate risk management strategy.'¹⁴

10 Mark Johnston, Department of Health and Aged Care, *Transcript*, p. 43.

11 Department of Defence, Submission No. 1, p. 2.

12 Ian McPhee, ANAO, *Transcript*, p. 40.

13 Department of Defence, Submission No.1, p. 2.

14 Department of Defence, Submission No.1, p. 2.

Review and evaluation

- 3.17 The audit report drew attention to the need for regular review and evaluation of registers of guarantees and indemnities. There was evidence of instances in which agencies failed to delete instruments that were no longer in effect. On this issue, Mr Colin Cronin commented that the ANAO:

...found evidence, particularly in the previous audit, where instruments relating to an assets sale had been issued for which the Commonwealth had no record. When the other side produced a piece of paper which amounted to a guarantee, the Commonwealth had to pay tens of millions of dollars to extract that from them for the asset sale to proceed. It was simply that we did not have a record and so we had no idea what was going on.¹⁵

- 3.18 In relation to the ANAO's recommendation that agencies establish procedures to ensure effective review and evaluation of their financial exposures, the Department of Health and Aged Care informed the Committee that it maintains a register of guarantees and indemnities. This register is reviewed annually in the department's annual financial statements. The department is also examining the feasibility of establishing a contract register linked to the new financial management system.¹⁶

- 3.19 In agreeing with this recommendation, the Department of Defence indicated to the Committee that it also maintains an indemnity register. The department pointed out that:

In the Chief Executive Instruction on *Indemnities and Insurance*, Defence personnel are advised of the need to review indemnities periodically. The policy also emphasises the importance of undertaking a risk assessment and of limiting the financial amount and duration in order to minimise the Commonwealth's exposure to risk.¹⁷

15 Colin Cronin, ANAO, *Transcript*, p. 49.

16 Mark Johnson, Department of Health and Aged Care, *Transcript*, p. 38.

17 Department of Defence, Submission No. 1, p. 2.

Committee comments

- 3.20 The Committee welcomes the improvements in agencies' management of guarantees, indemnities and letters of comfort which have been made since the tabling of the original ANAO report.
- 3.21 The Committee acknowledges that the Commonwealth's financial management arrangements provide a useful framework for improved visibility and management of such instruments. It also notes that there has been significant improvement in the level of guidance provided to agencies concerning these instruments. However, it is clear there remains scope for improving compliance with these guidelines.
- 3.22 The Committee notes the ANAO's observation that the implementation of the managed fund policy from 1 July 1998 should provide an effective means of improving the management of all of the Commonwealth's normal insurable risks, and supports the monitoring of the outcomes of this policy.

Recommendation 1

- 3.23 **The Committee recommends that the ANAO monitor the outcomes of the managed fund policy.**

Bob Charles MP
Chairman
24 November 1999