

## Audit Report No. 27, 2002–2003

# ***Commonwealth Guarantees, Warranties, Indemnities and Letters of Comfort***

## **Introduction**

- 8.1 Guarantees, warranties, indemnities and letters of comfort are types of contingent liabilities which may become actual liabilities if certain events occur, or do not occur. These types of instrument are used in both the public and private sectors to facilitate operations. However, they can carry with them risks and obligations which may be called on in the future, and hence need to be managed throughout the lifetime of the agreement they cover.

## **Background**

- 8.2 Contingent liabilities can be issued in accordance with statutory responsibilities, such as the Treasurer's power to guarantee borrowings. Ministers also have the power under the Constitution to issue such instruments. Nevertheless, Parliament is not bound to provide funds to satisfy such obligations unless there is an existing standing appropriation.

- 8.3 The framework for issuing and reporting these types of instruments is comprised of two major components, namely:
- an institutional regime which includes:
    - ⇒ relevant Constitutional and legislative provisions;
    - ⇒ Finance Circular No. 1997/06 *Potential Liabilities and Losses*;
    - ⇒ departmental and agency risk management plans; and
    - ⇒ Chief Executive's Instructions; and
  - a disclosure regime which includes:
    - ⇒ the *Charter of Budget Honesty Act 1998*;
    - ⇒ the Budget Statement of Financial Risks; and
    - ⇒ annual reporting by departments and agencies.<sup>1</sup>
- 8.4 *Audit Report No. 27, 2002–2003* was a follow-up to two previous audits in 1996 and 1998.<sup>2</sup> These audits had contained a total of 22 recommendations to which agencies had agreed.<sup>3</sup>

## The audit

- 8.5 The audit specifically excluded contingent liabilities, which did not explicitly involve the Commonwealth in a legal obligation. This was because they did directly constitute legal contingent liabilities of the Commonwealth. Also excluded were other contingencies, such as uncalled capital subscriptions for multilateral financial institutions and instruments issued by Statutory Marketing Authorities and Government Business Enterprises that did not explicitly involve the Commonwealth in a legal obligation.
- 8.6 The audit commenced with a questionnaire to 17 departments and 30 agencies to gather information on all explicit Commonwealth contingent liabilities. A sample of departments and agencies were selected for interviews, file review, and further exchange of correspondence.
- 8.7 The objectives of the audit were to assess, with respect to contingent liabilities:

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1 Auditor-General, *Audit Report No. 27, 2002–2003, Management of Commonwealth Guarantee, Warranties, Indemnities and Letters of Comfort*, Canberra, January 2003, p. 12.

2 Auditor-General, *Audit Report No. 6, 1996–97, Commonwealth Guarantees, Indemnities and Letters of Comfort*, Canberra 1996; Auditor-General *Audit Report No. 47, 1997–98, Management of Commonwealth Guarantees, Indemnities and Letters of Comfort*, Canberra, 1998.

3 Auditor-General, *Audit Report No. 27, 2002–2003*, p. 11.

- the action in relation to the recommendations from *Audit Report No. 47, 1997–98, Management of Commonwealth Guarantees, Indemnities and Letters of Comfort*;
- the extent of improvement in agencies' management and monitoring of the Commonwealth's exposure;
- the changes in the size and nature of the Commonwealth's reported exposure since 30 June 1997; and
- the approach of agencies to effective risk management and control of Commonwealth exposures.<sup>4</sup>

## Audit findings

- 8.8 The ANAO found that since 30 June 1997 the total quantifiable exposures had almost halved to about \$114.9 billion. Instruments as at 30 June 2002 comprised:
- loan guarantees of \$5.9 billion;
  - non-loan guarantees of \$69.2 billion;
  - indemnities of \$39.7 billion; and
  - letters of comfort of \$110 million.<sup>5</sup>
- 8.9 Over the period the composition of contingent liabilities had changed markedly with non-loan guarantees falling by two-thirds and indemnities rising some thirteen-fold—from \$3.1 billion in 1997 to \$39.7 billion in 2002. The rise in was associated with war risk cover following the terrorist events of 11 September 2001. The audit report noted that indemnities relating to terrorism events was likely to increase further.
- 8.10 The audit revealed that there had been a significant improvement in the number of departments reporting the introduction of structured risk management since the 1998 audit. Over three-quarters of responding departments and agencies reported that they had a corporate risk management plan. However, of those that did, only four entities reported that there was an explicit link between their corporate risk management plan and the management of their contingent liabilities. The ANAO concluded that this should be rectified especially where substantial potential liabilities were involved.

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4 Auditor-General, *Audit Report No. 27, 2002–2003*, pp. 12–13.

5 Auditor-General, *Audit Report No. 27, 2002–2003*, p. 13.

- 8.11 The audit found that while there was a high degree of awareness amongst entities to the Finance Circular<sup>6</sup> concerning contract vetting, authorisation, subrogation, time limits, financial limits and termination clauses, there had not been high levels of compliance with the guidelines it provided. This was especially so in relation to capping liabilities and incorporating termination clauses and time limits. The ANAO considered this potentially exposed the Commonwealth to unnecessary risk, and issuing entities should raise awareness of the importance of sound procedures in the preparation and management of these instruments.<sup>7</sup>
- 8.12 The ANAO made three recommendations to which the audited agencies agreed.<sup>8</sup>

### The Committee's review

- 8.13 Four agencies involved with the audit were invited to give evidence to the Committee at a public hearing on Wednesday, 30 April 2003. The agencies were:
- the ANAO;
  - the Finance;
  - the Department of the Treasury (Treasury); and
  - the Department of Transport and Regional Services (DoTARS).
- 8.14 The Committee took evidence on the following issues:
- the accuracy of agency registers of contingent liabilities;
  - the management of risk associated with raising a contingent liability; and
  - accountability to the Parliament.

### The accuracy of agency registers of contingent liabilities

- 8.15 During audit fieldwork, the ANAO found that many entities had out of date or inaccurate registers. Inaccuracies ranged from omissions of instruments to inclusions of items which were found not to be contingent liabilities.<sup>9</sup>

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6 Finance Circular 1997/06 *Potential Liabilities and Losses*.

7 Auditor-General, *Audit Report No. 27, 2002–2003*, pp. 13–14.

8 Auditor-General, *Audit Report No. 27, 2002–2003*, pp. 19–20.

9 Auditor-General, *Audit Report No. 27, 2002–2003*, p. 43.

- 8.16 The Committee questioned agencies at the public hearing concerning the accuracy of their contingent liability registers.
- 8.17 DoTARS responded that it had a 'central indemnity register which contains copies of all current and past indemnities' which was believed to be complete. In one or two instances of old indemnities the original certified document had not been located, but the department had a copy.<sup>10</sup>
- 8.18 Treasury told the Committee that it had a comprehensive electronic records register. While this held copies of all documentation, the originals were located in program areas. However, the current updating of Treasury's chief executive instructions would ensure that all original documents would be consolidated in a central location.<sup>11</sup>
- 8.19 Finance reported that it kept a register of contingent liabilities which was reviewed on a quarterly basis and presented to the management board for review. It was updated and reviewed annually as part of the preparation of the department's financial statements.<sup>12</sup>
- 8.20 However, after the hearing Finance advised the Committee that several contingent liabilities and their supporting documentation were unaccounted for. They had been lost during the merger of the former Department of Administrative Services and Office of Asset Sales and Commercial Support/Office of Asset Sales and Information Outsourcing into Finance.<sup>13</sup> Later, a further submission advised that all but one of the 73 contingent liabilities held by Finance had been located. The missing indemnity related to the sale of Australian Airlines in 1991.<sup>14</sup>

### The management of risk associated with raising a contingent liability

- 8.21 The Committee questioned witnesses as to how their agencies attempted to improve their risk profile before signing the documents which created a contingent liability.
- 8.22 DoTARS outlined its risk management procedures relating to the contingent liabilities arising from the September 11, 2001 terrorist attacks. The indemnities were all risk managed in accordance to the elements outlined in Finance Circular 1997/06 which recommended:
- a financial limit;

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10 Mr Jeremy Chandler, *Transcript*, 30 April 2003, p. 66.

11 Mr Bede Fraser, *Transcript*, 30 April 2003, p. 67.

12 Mr Dominic Staun, *Transcript*, 30 April 2003, p. 66.

13 Finance, *Submission No. 8*, p. 1.

14 Finance, *Submission No. 17*, p. 1.

- a time limit;
  - subrogation so that the Commonwealth can pursue recovery against third parties; and
  - termination clauses.<sup>15</sup>
- 8.23 DoTARS also told the Committee that the nature of the September 11 event resulted in some of the assessment being conducted in parallel rather than prior to the issuing of indemnities. However, an additional way was used to manage the risk. The major reason for the indemnities was the withdrawal of cover by the insurance market, but as cover returned the department had 'moved to having a large offsetting insurance policy in front of the Commonwealth's step-in and payments under the indemnity.'<sup>16</sup>
- 8.24 Finance told the Committee that some of its indemnities were not capped. This was because in some cases it had not been possible to establish a financial limit. Finance provided as an example, the costs arising from redressing any environmental pollution when railways and associated land had been sold. However, in this instance the purpose of the indemnity had been confined.<sup>17</sup>
- 8.25 A supplementary submission from Finance advised that recently three uncapped indemnities had been issued:
- to the board members of Bankstown Airport Ltd, Camden Airport Ltd and Hoxton Park Airport Ltd against claims and costs arising from the conduct of directors in relation to the sale of those airports;
  - to the board of the Australian Submarine Corporation (ASC) for claims associated with the execution of a services agreement between the ASC, Defence, Electric Boat Corporation and Electric Boat Australia; and
  - to the Chief Executive Officer of Employment National to protect against civil claims relating to employment and conduct as an officer.<sup>18</sup>
- 8.26 Treasury drew attention to two of the contingent liabilities of the department which were uncapped:
- in relation to collapse of the HIH Insurance Group, the indemnities covered the subsidiary of the Insurance Council and its employees relating to liabilities arising from their managing the assistance scheme;

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15 Mr Simon Clegg, *Transcript*, 30 April 2003, p. 67.

16 Mr Simon Clegg, *Transcript*, 30 April 2003, p. 67.

17 Mr Jeremy Chandler, *Transcript*, 30 April 2003, p. 68.

18 Finance, *Submission No. 14*, p. 7.

- to the Housing Loan Insurance Commission to meet the liabilities arising from the 'old book' policies that the Commonwealth wrote; and
  - to the provisional liquidator of United Medical Protection Ltd and Australasian Medical Insurance Ltd (UMP-AMIL) guaranteeing 'certain aspects of the UMP-AMIL operations.'<sup>19</sup>
- 8.27 The Committee has noted in the previous chapter that the uncertainty surrounding two of these indemnities had resulted in the qualification of Treasury's financial statements and the Commonwealth's Consolidated Financial Statements in 2001–02.
- 8.28 The Committee considers that the issuing of uncapped contingent liabilities should be kept to a minimum. Where such liabilities are issued they should be subject to thorough risk management processes which should be well documented for accountability purposes.

### Accountability to the Parliament

- 8.29 The audit report drew attention to the parliamentary accountability procedures for the issuing of indemnities adopted by the United Kingdom Parliament.
- 8.30 Where an Act did not outline reporting arrangements and the potential liability could exceed £100 000 (A\$270 000), Treasury approval must be sought before laying a 14 day disallowable minute before the House of Commons. A copy of the minute must also be sent to the Public Accounts Committee and the relevant departmental select committee. If a Member of Parliament objects in writing, Parliamentary Question or Early Day Motion, the guarantee 'is normally not given until the letter or question has been answered.'
- 8.31 In cases of special urgency and a guarantee has to be provided before 14 days, an explanation has to be contained within the minute. As well, if a contingent liability raised commercial confidentiality, national security, or where knowledge of a guarantee could prompt claims from third parties, the matter may be reported in confidence to the Chair of the UK Public Accounts Committee.<sup>20</sup>
- 8.32 The Committee commented that the UK model provided the opportunity for the UK Parliament to become involved at an early stage in the creation of contingent liabilities. This contrasted with the system in Australia where contingent liabilities were reported after the event.

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19 Mrs Bernadette Welch, *Transcript*, 30 April 2003, p. 69.

20 Auditor-General, *Audit Report No. 27, 2002–2003*, pp. 27–8.

**8.33 Finance responded:**

In the Budget papers and also in the Mid-Year Economic and Fiscal Outlook, the [Australian] Government sets out a statement of all contingent liabilities greater than \$20 million within the year or \$14 million over the forward estimates period. ... and that is consistent with the Charter of Budget Honesty. Then ... departments in their own agency reports disclose all material contingent liabilities and even remote contingencies in their accounts. ... The UK approach is slightly different and it is arguably a more timely approach, but it is not necessarily as comprehensive, on the face of it, as ours.<sup>21 22</sup>

**8.34** Finance also highlighted the opportunity in the UK for urgent indemnities to 'bypass' the 14 day disallowance period. It commented that the department fully accepted the view that in Australia 'these instruments need to be controlled' and added that it was up to the Parliament to eventually decide to support any contingent liability by an appropriation.<sup>23</sup>

**Committee comment**

**8.35** The Committee notes that the audit report identified some 341 contingent liabilities existing in 2002. All but eighteen are greater than the reporting threshold used in the UK and 190 are either unlimited or unspecified.<sup>24</sup>

**8.36** In its *Report 350* the then Joint Committee of Public Accounts (JCPA) recommended that:

Full statements of off-balance sheet contingent liabilities associated with guarantees, indemnities and letters of comfort should be a mandatory inclusion in annual financial statements of departments except where disclosure may adversely affect the Commonwealth's interests.<sup>25</sup>

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21 Mr Ian McPhee, *Transcript*, 30 April 2003, p. 70.

22 The requirement for agency annual reports to contain a list of contingent liabilities arose from the Government response to the Committee's recommendation in its

23 Mr Ian McPhee, *Transcript*, 30 April 2003, p. 71.

24 Auditor-General, *Audit Report No. 27, 2002-2003*, pp. 69-84.

25 JCPA, *Report 350, Review of Auditor-General's Reports 1996-97 First Quarter*, Canberra, 1997, Recommendation 2, p. 27.



- 8.37 The Government accepted the JCPA's recommendation and added to the reporting requirement 'any other relevant material contingency that may result in gain or loss to an entity.'<sup>26</sup>
- 8.38 Notwithstanding the reporting mechanism currently in place in Australia, the Committee considers there is merit in the earlier involvement of Parliament in the issuing of indemnities. The procedure in the UK seems a good model to follow. However, the Committee believes that the threshold adopted in the UK is too low and should instead be that currently in place for the Government's statement of contingent liabilities in the Budget papers and the Mid-Year Economic and Fiscal Outlook.

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### **Recommendation 6**

- 8.39 **The Commonwealth should adopt procedures for notifying the Parliament of the issuing of indemnities based on the procedures used by the United Kingdom Parliament.**

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26 Department of Finance, *Finance Minute to Report 350*, September 1997, p. 12.

