



HOUSE OF REPRESENTATIVES

**STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND
PUBLIC ADMINISTRATION**

Reference: ANAO report on guarantees and indemnities

CANBERRA

Thursday, 21 November 1996

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STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND
PUBLIC ADMINISTRATION

Members:

Mr Hawker (Chair)

Mr Albanese
Mr Anthony
Mrs Bailey
Mr Causley
Mrs Gallus
Mr Hockey
Mr Latham

Mr McMullan
Mr Mutch
Dr Nelson
Mr Pyne
Mr Willis
Mr Wilton

Matter referred to the Committee:

ANAO report on guarantees and indemnities.

WITNESSES

BOURNE, Mr Denzil Hunter Ronald, Senior Director, Australian National Audit Office, Centenary House, 19 Centenary Drive, Barton, Australian Capital Territory	4
CRONIN, Mr Colin Douglas, Executive Director, Australian National Audit Office, Centenary House, 19 Centenary Drive, Barton, Australian Capital Territory	4
HOLBERT, Ms Frances Elizabeth, Director-Performance Audit, Australian National Audit Office, Centenary House, 19 Centenary Drive, Barton, Australian Capital Territory	4
McPHEE, Mr Ian, National Business Director, Australian National Audit Office, Centenary House, 19 Centenary Drive, Barton, Australian Capital Territory	4

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Present

Mr Hawker (Chair)

Mr Albanese

Mr Mutch

Mr Causley

The committee met at 10.33 a.m.

Mr Hawker took the chair.

CHAIR—I declare open this meeting of the House of Representatives Standing Committee on Financial Institutions and Public Administration and the inquiry into the ANAO report No. 6 entitled *Commonwealth guarantees, indemnities and letters of comfort*. I would like to take this opportunity to welcome representatives of the Australian National Audit Office to today's public hearings. The committee has chosen to take the opportunity to examine this report because of its relevance to the committee's continued interest in public sector management issues. The committee considers this to be a very significant audit which addresses what appear to be a number of important deficiencies in Commonwealth public sector financial management. There is a general concern that the Commonwealth is not aware of the level of exposure to financial losses that might arise from the use of guarantees, indemnities and letters of comfort. The committee is concerned that the information available is not adequate to allow for sound risk management.

The committee is also concerned over whether sufficient expertise exists in the Commonwealth public sector to properly price risk and there have also been a number of unforeseen problems over recent years associated with asset sales where guarantees, indemnities and letters of credit have unexpectedly impacted on the sales process resulting in a reduction in the proceeds from those particular sales. This has already been addressed by some state governments, notably in Victoria and New South Wales. The committee also understands that tighter monitoring and reporting procedures have been introduced into New Zealand and the United Kingdom. Therefore it is time for the Commonwealth to review and reform its procedures regarding the use of these instruments.

The committee does not intend to focus on the quantum of the exposure, which the audit office has estimated to be around \$222 billion, but instead I anticipate that the committee will focus on the procedures that are currently in place and how the management and monitoring of off balance sheet exposures can be more effectively managed. In this regard I note that the audit has made a number of recommendations for improvement of current procedures and the committee will be seeking to take evidence from the Department of Finance and a number of other portfolio agencies to ensure that these recommendations are not left to gather dust. In addition, the committee will be looking a little farther afield than audit was able to go and the committee will also seek data on the operations of a number of government business enterprises and statutory marketing authorities with respect to their use of these instruments.

The committee is particularly concerned about the use of financial derivatives not by the Commonwealth Bank, which is supervised by the Reserve Bank, but by other agencies which may not have the same degree of prudential supervision. The committee has also sought comment from a number of large accountancy firms and I am pleased to note that Price Waterhouse will be providing some input to the inquiry. I hope that other private sector organisations with a track record in managing financial risk will consider providing their views to the committee. This is the first public hearing of this inquiry and further public hearings will be held in the New Year, with a report being finalised by June 1997.

I would like to say to our witnesses that the evidence that you give at the public hearing today is considered to be part of the proceedings of parliament and accordingly I would advise that any attempt to mislead the committee is seen as a very serious matter and could amount to a contempt of parliament.

BOURNE, Mr Denzil Hunter Ronald, Senior Director, Australian National Audit Office, Centenary House, 19 Centenary Drive, Barton, Australian Capital Territory

CRONIN, Mr Colin Douglas, Executive Director, Australian National Audit Office, Centenary House, 19 Centenary Drive, Barton, Australian Capital Territory

HOLBERT, Ms Frances Elizabeth, Director-Performance Audit, Australian National Audit Office, Centenary House, 19 Centenary Drive, Barton, Australian Capital Territory

McPHEE, Mr Ian, National Business Director, Australian National Audit Office, Centenary House, 19 Centenary Drive, Barton, Australian Capital Territory

CHAIR—Thank you very much for coming along. Would you like to make any opening remarks?

Mr McPhee—Thank you, Mr Chairman, for the invitation to participate in this inquiry today. Overall the audit office is of the view that in most agencies there needs to be a marked improvement in the management and administrative practices associated with Commonwealth guarantees, indemnities and letters of comfort. As well, there needs to be greater public accountability at both the agency and whole of government levels through better reporting.

It is important to point out that the audit of Commonwealth guarantees, indemnities and letters of comfort focused on explicit undertakings provided by the Commonwealth and really focused on how the Commonwealth managed the provision and recording of such instruments. It did not consider such instruments issued directly by statutory authorities and GBE's which you have indicated your inquiry will in fact consider.

As you have mentioned, Mr Chairman, the Commonwealth gross exposure for these instruments amounts to at least \$222 billion, as at 30 June 1995. There is also a large number of indemnities and some letters of comfort which have no specified financial commitment. The report presents a framework for better administrative practice premised on the current government's framework and draws on examples from a number of government agencies, including the Department of Finance and the Department of Communications and the Arts.

In addition, the report has outlined a range of possible approaches for dealing with the risk exposures from these instruments, but within a more commercially oriented framework of risk management and control. These options range from adopting risk prevention measures to outsourcing risk to the private sector. The ANAO is not necessarily advocating outsourcing risk in the form of commercial insurance; rather, we are promoting the effective management of risk by encouraging sound risk assessment and an effective treatment of the risk determined in this process.

The National Audit Office made 16 recommendations which were accepted by the 15 portfolio departments involved directly in this audit. Agencies either agreed with, or agreed in principle with, or made no comment on, the recommendations on record management, document security, reporting arrangements, improved public accountability, risk management planning, risk pricing, risk transference and proposals for

better administrative practice. Notwithstanding this overall response, Treasury and the Department of Finance did have some reservations that the audit report did not adequately reflect the control arrangements that exist in relation to the instruments in terms of risk management and prudential supervision. Also, Finance did have some reservations with regard to the options presented for the pricing and transfer of risk.

Again, the point we make is that the office is not advocating a particular preference regarding these options, but is attempting to encourage the application of a more rigorous approach to risk management overall. The value of this audit, as I see it, has been in raising the awareness of agencies about managing the exposures associated with these instruments. This awareness raising, combined with the audit recommendations and the developments we have seen with respect to accrual accounting and reporting, should see a significant improvement in administration in this area.

On another positive note, I also mention that the ANAO is working with Finance and the Attorney-General's Department to develop a better practice guide on guarantees, indemnities and letters of comfort. We plan to issue the guide under the cover of a Finance circular in the new year. Colin Cronin, Denzil Bourne and Fran Holbert were the senior audit staff who were involved with the audit, and we would be very pleased to respond to any questions you may have.

CHAIR—Thank you very much, Mr McPhee. I will start with your last comment. You said that, in issuing some new guidelines, you are working with Finance and Attorney-General's. My understanding is that there was a circular sent out about seven years ago to that very effect.

Mr McPhee—We would expect the new guidelines to be much more comprehensive and to also benefit from the findings of the audit.

CHAIR—So one of the things you would say from the audit is that some agencies were not trying to observe those guidelines at all.

Mr McPhee—The guidelines were fairly basic and were more in the nature of a reflection of the requirements at the time, such that agencies would have registers for guarantees, and things of that kind. As I recall, they were not very comprehensive. This one will draw on the material in the back of the report and will also reflect current practice.

Mr Cronin—That was the 89/11 circular. It was actually about indemnities. It is proposed that it be upgraded. For example, things like subrogation clauses were not covered in the 1989 advice. We would aim to have those included and to pick up some of the recommendations we have made in the report about where there have been deficiencies. We will also attach to the circular a revised better practice outline, which is in the last three pages of our report, so that we can actually raise the awareness of agencies, and particularly of agency heads.

There is a lot to be said for just keeping at the agencies to make them aware of what they are dealing with. We think that in fact that is why we are aiming for about March to send this out, to continue to upgrade and focus on agencies the need to take account of these things. We would also hope that in 1997-98 the Audit Office would conduct a follow-up on this audit as one option to continue to heighten agencies'

awareness of the fact that you need to manage these instruments if you are going to issue them.

Mr Bourne—Could I also add, Mr Chairman, that if this task is done the way we would like it to be done it should pick up recommendations 2, 5, 6, 7, 10 and 14 which impact on that study, so it will kill a number of birds with one stone effectively.

CHAIR—Which agencies did you find have the most difficulty with identifying their exposure?

Mr Cronin—An easier way would be to identify examples of good practice. If there were examples of good practice they tended to be in specific areas. You might have one part of the agency, for example, communications and the arts, who have an extremely good system running for the indemnification of Commonwealth exhibitions et cetera. But another part of the department was grossly deficient in certain areas. You can actually have good practices and poor practices in various parts of the agency depending on how aware they were and how used to dealing with these types of instruments. In terms of the arts, the indemnification program that runs there is extremely well managed and extremely well thought out. But at the other extreme we have the Optus indemnity which arose out of the department losing the promissory notes that were issued as part of the Aussat sale.

CHAIR—When you say losing the—

Mr Cronin—They were issued \$300 million worth of promissory notes as part of the Aussat sale. Aussat was sold for \$800 million of which \$500 million was paid up front and a series of promissory notes were issued for payment in subsequent years. These promissory notes as such represent bearer securities but when it came time to surrender them the department did not actually have them. They did not actually have the originals. To cover that shortfall an indemnity had to be issued to Optus so they could guarantee payment.

Mr CAUSLEY—Were the notes found?

Mr Cronin—Not to this stage.

Mr CAUSLEY—Who is responsible there?

Mr Cronin—Optus has paid out but the Commonwealth has indemnified Optus. This is recorded in the annual financial statements and indeed in terms of this audit. That is an example—

CHAIR—So what is the exposure because of that?

Mr Cronin—The exposure is that should these notes ever turn up, appear and be presented, and can be shown to have good title, then the Commonwealth would be potentially liable.

Mr CAUSLEY—For how much—\$300 million?

Mr Cronin—The total face value is of that order. That is recorded in the report. That is an example of where keeping records is essential so that in fact you do not give rise to such an event.

Mr CAUSLEY—Surely someone in there is responsible for the fact that they should have been safely kept.

Mr Cronin—Yes.

Mr CAUSLEY—I hope some arses were kicked.

Mr Cronin—Generally these things—

CHAIR—Put something else on the record. This is a public hearing!

Mr CAUSLEY—What—a better definition—backsides, butts?

Mr Cronin—The point you have raised is a very good one. It is relating to commercial transactions. In a commercial transaction you would generally have your lawyers there to scoop up everything. Often governments do not operate like that. The people who are signing the documents in the exchanges may be senior public servants or ministers and the lawyers are somewhat removed. Whether these actually even came into our possession we are unsure of.

Mr CAUSLEY—I find that extraordinary, to be honest.

Mr Cronin—Yes, it is quite—

CHAIR—We are talking about indemnities, as you say, in this circular of 1989. It says clearly that ministers issuing those indemnities will need to be informed by the Department of Finance. That is fairly clear, is it not, that the minister is actually assuming the responsibility? I know the case you were talking about was probably prior to 1989.

Mr Cronin—For example, when the indemnity was actually issued—and this case is relatively recent—the indemnity was well drawn up and executed and went through the Attorney-General's Department. So it is an extremely well constructed indemnity that has been issued and ministers were advised. But in terms of the nature of the indemnities, in a sense you could look on indemnities as falling into a whole stream of ranges.

We have a general indemnity provided under finance direction 21 to Commonwealth officers. In 1992 there was a finance circular No. 7 that was issued which extended indemnities, for example, to members of boards who were Commonwealth officers and extended the finance direction 21 to those. You have specific indemnities which may relate to asset sales, which you talked about before where some of the directors and indeed the organisations have sought specific indemnity cover. You also have the capacity for statutory indemnities which are, for example, in the Wheat Marketing Act. So you have a range of different types of indemnities.

As for the capacity to bind the Commonwealth, you might find for a straight indemnity it is in the nature of the minister. What you have also is the capacity to have indemnities in terms of formal contracts.

For example, if I wanted to purchase some information from the Australian Stock Exchange, to obtain that information I actually had to sign a little contract and in there was an indemnification clause. As I was unwilling to sign that clause, I did not get the information.

The nature of some of these things extend quite a long way and these indemnifications may be wrapped up in other instruments. That is one of the reasons where we are unsure that we have made a full capture of all instruments. On the ones which say 'indemnification'—a specific indemnity—to which this 89/11 circular really refers, it is a lot more complex because these instruments can be wrapped up in deeds and in contracts. It is very debatable whether we have actually got that.

Mr CAUSLEY—Is it not true at the present time that in some of these high risk areas—and we mentioned the Wheat Board for instance selling fast shipments to overseas countries where you are depending on them to pay—that that has to be approved by cabinet?

Mr Cronin—There are some specific ones there.

Ms Holbert—The legislation requires the minister to approve each of the guarantees for wheat. My understanding is that that is brought through in cabinet before the minister approves it and that Treasury's views are also sought.

Mr CAUSLEY—You would see a range of risk from medium to high. Would you see different procedures with those types of risks that should be gone through, do you think?

Mr Cronin—I think some of them have been well thought out, for example, with the authorities where they are done on a case by case. Some agencies have a statutory guarantee. For example, the Australian Industry Development Corporation has a statutory guarantee, the Australian National Railways has statutory guarantees for borrowings and the Export Finance and Insurance Corporation again has a statutory guarantee.

These may be limited to some extent. For example, the Export Finance and Insurance Corporation has an aggregate limit which is spelt out in the regulations set at about \$7.8 billion. The AIDC has a limit on its borrowings greater than a year based on 15 to one times shareholders funds, so essentially its gearing is at 15 to one. Each of the Australian National Railways borrowings has to go through the Treasurer. There is a range of different circumstances. As you mentioned, some require specific circumstances. If it is on the national account for the Export Finance and Insurance Corporation, then they have to be considered by an IDC and a decision is made by the minister after consulting with cabinet for each of the transactions brought on to the national account.

Mr CAUSLEY—So it is the more obscure indemnities and guarantees that we really have not caught up with.

Mr Cronin—Yes. A lot of the guarantees fall into a range of things. We have spoken about the loan guarantees. They tend to be well documented. We have a range of other non-loan guarantees and these can be very well executed. For example, the Telstra superannuation guarantee is such an instrument. It is a non-loan

guarantee, but it is also very well executed.

We have indemnities and these literally fall into a mixture of specified and unspecified amounts. We have mentioned the Optus one at \$300 million. We have others, such as the Civil Aviation Safety Authority indemnity and the CSL indemnities, which are unspecified. Then we have letters of comfort. The Australian National Line has a facility of \$180 million which has a letter of comfort, but the other letters of comfort that we have on record have no specified limits.

With all these things it is very useful to have time limits, financial limits and a range of reporting arrangements in place. Some of these instruments come up on an ad hoc basis and others come up on a regular basis, such as the Department of Communications and the Arts with its indemnification program. It does vary. Indeed, some departments appear to lose track of what is in their legislation. That is one of the problems we had in terms of reporting to us.

In the report we thought that one important thing would be to lay down an inventory of these instruments. We know that this is an incomplete inventory as contained in appendix 2, but it is probably the most comprehensive inventory produced today. As we go on in other audit activities we come across some of these instruments.

CHAIR—In your appendix 2 there are nearly three pages which are totally unspecified.

Mr Cronin—Yes.

CHAIR—That is fairly substantial, isn't it?

Mr Cronin—It is. The nature of some of these events could not be specified or was not specified by the department. There has been a number of developments since this report. For example, on the CSL, the Department of Health and Family Services has taken an AIDS cover as part of the indemnification of the blood supply for HIV/AIDS and I understand it is doing work on hepatitis.

CHAIR—That, obviously, could potentially be quite a large risk. You have mentioned the Optus one. Are there any others around that you are aware of that could have a bit of a sting in them somewhere down the track?

Mr Cronin—We cannot judge that. Most of the risks are remote in terms of coming to fruition. It is very important in terms of the need, which we stress in the report, to identify the risk. So just understand what you have actually got under your control.

Some of these events take place over many years. We have to know whether we have the paperwork and the record management systems in place to record this because many of the departments are subject to significant changes and to loss of corporate memory and probably the papers having gone. You also need to determine the actual size of the risk you are dealing with and the management of the risk. The management of the risk occurs in terms of whether you should issue this instrument and whether you should consider other options rather than the Commonwealth taking it on board. Once you have executed an instrument, you have

to track it and monitor it over its life.

CHAIR—Can I go back to the CSL case with AIDS. When you say that they have moved to quantify that, is that some form of commercial insurance?

Mr Cronin—Yes. They have now adopted commercial insurance. At the JCPA hearing last month, the Department of Health and Family Services advised that it has taken commercial insurance on AIDS and that it is examining taking out insurance on hepatitis.

We picked up the need for this in our sale of CSL audit, which was tabled last year. This audit on guarantees essentially came out of two audits we looked into last year—the sale of CSL and the Moomba to Sydney gas pipeline—where the question of guarantees and indemnities featured significantly in the sales.

Mr CAUSLEY—Are we possibly being a little bit too pessimistic about some of the unspecified risks you have noted here? The commercial world deals with this type of risk all the time. We can probably learn a lot from them.

I suppose, as lay people, we probably see it and get a little bit scared of it. Do you think we are being a little bit too pessimistic about some of it?

Mr Cronin—We do not know because it relates to what you mentioned earlier about the expertise to price risk and to consider it. We take a lot more comfort if people have systematically gone through that identification, risk assessment and management. If you have the expertise and the processes to do that, then you can take a great deal of assurance that things are well managed and are under control. If that is not in existence, then you have reason for concern.

It is very difficult to pick. We certainly have made no effort to find out where the risks are going to come from. Some of these risks are intergenerational risks and extend over long periods. There is no way of us knowing that.

CHAIR—But your suggestion is that the expertise to price the risk is not there.

Mr Cronin—We could not on a systematic basis, except in limited examples. The Department of Communications and the Arts—indemnification scheme—and I keep coming back to this example—is an extremely well-managed system for what it does. In terms of pricing the risk, the Commonwealth generally has a ‘no insurance’ policy applying. Therefore, people are not directly pricing risk as such.

In the commercial world, if you were involved in this, you would go along to insurance brokers or insurance companies, ask for a price and make a judgment whether you wished to take the risk on board or you would manage it yourself. Large companies generally self-insure or take a catastrophic event clause. On the whole, the Commonwealth bears the lot. There are isolated examples where the Commonwealth does seek insurance for certain types of activity. But that gives you a feel towards the Commonwealth as protection behind this concept of ‘We’re so big that we can bear any loss’.

Mr CAUSLEY—Lloyds thought that too.

Mr Cronin—Yes.

CHAIR—That may be a comfort for people in the Commonwealth, but is it not the point to still evaluate it? You are suggesting there are a couple of good examples where people do it, but from the work you have done in most cases the answer would be no.

Mr Cronin—I think that would be a reasonable assessment of what we have seen. People have not adopted a terribly commercial approach in granting these. These are things which are of economic benefit for the other side in the negotiations. From the Commonwealth side, it has often been something that is subsidiary to achieving another objective.

Mr CAUSLEY—You were saying that the risks are sometimes forgotten in the corporate knowledge of departments. It would not be impossible to assess those risks and put them on computer so that you have a databank of what the risks might be, would it?

Mr Cronin—That is what we advocate—maintaining registers and maintaining documentation. We think that is quite achievable and we do not believe it would involve a great deal of administrative expense.

Mr ALBANESE—To what extent, given the failure of some of the departments to keep records, are these lists seen to be comprehensive?

Mr Cronin—I would not describe them as fully comprehensive. One of the problems we have had is getting the material from the departments. As we say in here, we have reported what the departments have told us. We have repeatedly gone out—and Denzil Bourne can give you the dates on which we have gone to the departments; I think we went three times—

Mr Bourne—Yes, we went out three times. The first one was the census we sent out in September—I think it was on 14 September last year. We asked for confirmation of the figures on 8 February 1996 and again on 3 July 1996 because in the first instance we were starting to get some conflicting information in fieldwork, particularly in regard to numbers and the actual instruments. So we asked for that confirmation. Every time we asked for that, we would turn over something that was slightly different, which gave us the impression that there was more out there. But it was outside the scope of the audit to follow that up.

Mr McPhee—If I could perhaps give a little confidence more in the future than in the past, the move to commercial accounting, accrual accounting and reporting could be expected to make a significant difference in this area because, when the Commonwealth used to cash account, you only worried about the cash in and the cash out, and guarantees, indemnities, assets and liabilities were something outside the accounting framework. As we now move to accrual reporting, all departments are doing that.

We would expect the agencies to have in place now the systems to capture these issues. I think part of the problem in the past has been that the relevant program areas in departments have been dealing with particular issues which, to achieve their objectives, required a guarantee or an indemnity. And that was done, and properly authorised, say, with the minister, et cetera, but there was little communication between the program area and the central finance area which is generally responsible for tracking the financial

consequences of agency decisions. As we get a stronger framework we would expect to see departments get a better handle on this.

Mr CAUSLEY—So we are catching up?

Mr McPhee—I believe we are catching up. I would not want to overstate it, but the framework is now in place in departments and, with the awareness raising of this report and Finance circulars, et cetera, I guess we should be more confident into the future than we might have been in the past.

Mr CAUSLEY—And as some of the government enterprises are sold off I suppose the risk has shifted?

Mr McPhee—The risk will change. Often, of course, some of these issues arise. The guarantees, the indemnities are part of the sale issue itself, and there are issues for the Commonwealth as to how to settle those issues to free itself of the commitments.

Mr MUTCH—I was wondering what role, if any, you have played in the assessment of exposure of the Commonwealth for the upcoming Olympic Games?

Mr McPhee—None as yet. I think I can be fairly direct on that. We prepare audit plans into the future, and it is an area that we have got as background planning information, but we have done no work.

Mr MUTCH—Have they asked you?

Mr McPhee—No.

Mr MUTCH—For instance, in terms of having additional athletes and so forth as has just been announced, the exposure is considerably increased, and you have got the whole security exposure as well.

Mr McPhee—I need to draw a distinction. The work that we looked at were the explicit guarantees and commitments. I think what you are talking about are potential obligations and—

Mr MUTCH—Yes, what is happening.

Mr McPhee—We have not explored that. The Commonwealth has got contractual commitments clearly into the future which we have not sought to cover in this audit.

Mr MUTCH—Do you see that as a role that you should be pretty heavily involved in?

Mr McPhee—We do look at commitments as part of our financial statement audits. It is not an area generally of particular concern, it is more the finance areas do follow the contractual arrangements and there is less of a risk there than in some of these guarantees and indemnities areas.

CHAIR—You talk about records management and significant deficiencies in agencies' compliance

with the Department of Finance guidelines and directions and, in your recommendation No. 4, you talked about the need for agencies to develop a risk management plan for management of off balance sheet liabilities and about an explicit link between a risk management plan for off sheet liabilities and corporate risk management, et cetera. When it came to the responses of some of the departments, Finance just said it agreed in principle. Are we meant to read anything into that sort of response?

Mr Bourne—I would not like to comment on what they were trying to get at there, but perhaps I could explain what we did that prompted that response. We sent out what I guess you would call a separate survey and asked if agencies had a corporate risk arrangement and whether or not there was a direct link between that corporate risk arrangement and the specific management of the guarantees, indemnities and letters of comfort. In answer to that—and there was a lot of judgment applied as to how you interpreted the answers—we got the return from 20 or so agencies. Four said that they did have a corporate risk policy, for want of a better term, and three of them said that they linked it to the detail management of their guarantees, indemnities and letters of comfort.

One of the problems was that we did not follow up all that information. But when we went in and looked at some of the people who claimed that they had this linkage and they had the corporate risk policy in place, we found that a lot of it was really talking about fraud—fraud risk abatement, I suppose—and it was not precisely the sort of information that we were getting at. I suppose you would have to ask the Finance Department what they meant by that, but essentially I think that there was some misunderstanding about what we meant when we asked, ‘Do you have a corporate risk policy, an umbrella policy, and was there that linkage’, because I think some people actually interpreted that as being fraud.

CHAIR—Isn’t this a sort of fundamental point? All of this accountability has to come back to Finance, doesn’t it?

Mr McPhee—I would not agree with that, Mr Chairman, in that they have got responsibility for the framework but it is the agencies themselves who are responsible for monitoring and reporting.

CHAIR—If they are not doing it, who is then?

Mr McPhee—This has always been—and I do not want to speak for the Finance Department—a problem for the Finance Department in a sense in that they say we are responsible for setting the finance directions and reporting frameworks, but they do not take responsibility for agencies doing the right thing in terms of meeting the requirements. They clearly need to be aware of where there is an adherence to the rules and take action in response to that, but they have always argued before that they do not take direct responsibility for this.

CHAIR—What you are really saying is that there is a whole gap there?

Mr CAUSLEY—Shouldn’t it be highlighted in audit or somewhere like that?

Mr McPhee—I think it really goes back to where the accountability lies. I think the right model of accountability is to place it as agency heads’ responsibilities to manage, monitor and report the indemnities.

Finance has a responsibility to promote good practice and get the framework right, but I think it would be a mistake to suggest this issue is Finance's problem directly. It has to go home to the agency heads or else the whole accountability framework does break down.

Mr CAUSLEY—But didn't we hear earlier that there is no real penalty? If it was in the private sector I am pretty sure I would know what would happen.

Mr McPhee—Exactly. That is a framework issue, that is correct. That is right. Whether the risk should be priced and whether the framework should be changed is one thing, but I do not think you can take it away that the fundamental responsibility for monitoring and reporting, which is what this report is about, is where it has failed. There has not been the ongoing monitoring; there has not been the ongoing reporting. That responsibility, even within the existing Finance framework, resides very clearly with agency heads, and I would suggest that is where it should reside.

CHAIR—Okay. But how do we then know if an agency is not complying?

Mr McPhee—We will look at it in terms of our financial statement audit coverage. Finance also are expected to get returns each year on guarantees—and indemnities too, Colin?

Mr Cronin—Yes.

Mr McPhee—Each year Finance send out to each agency a return saying, 'Please advise your guarantees and indemnities'. The problem is that it has not been comprehensive.

CHAIR—I just want to get this clear: are you saying the questionnaire was not comprehensive or the response wasn't?

Mr McPhee—No, the responses—on the basis of what we have found—have not been comprehensive.

CHAIR—Why was no-one following it up?

Mr McPhee—It is a good question, but it relies on agencies having the right information for Finance. Finance, from their perspective, would not be aware of the full range of guarantees and indemnities that ministers, for which our agencies work, have entered into, so it very much relies on agencies having the systems in the first place to inform Finance.

CHAIR—Going back to that circular in 1989, it said that because of the potential financial commitment involved, ministers issuing Commonwealth—this is indemnities, I agree—indemnities will need to inform the Minister for Finance of all such indemnities. I assume that is not happening?

Mr McPhee—I would expect it would occur. This is just speculation, but I would expect it would occur. But the problem is, as I said, the program area dealing with the issue would be dealing with the equivalent area in finance, but neither of them are probably talking to the finance areas who have the

responsibility for putting these returns in later on. If I could make myself—

CHAIR—It is almost contradictory, is it not?

Mr McPhee—No, it is not. In departments you have a range of program areas looking after particular aspects. They communicate with the minister saying that it is important to give this company or situation a guarantee; the minister signs it. Prior to the minister signing it, there was probably consultation with the equivalent area in Finance. That has occurred and that has probably been all properly done, but what I am raising is the issue of whether anyone has taken the time to communicate that decision back to the central area in the department which is responsible for recording the financial details for the department.

Mr CAUSLEY—Under the Senior Executive Service in New South Wales and the agreement with the heads of departments there, as a minister I had a performance agreement with my head of department and I would demand certain things be done. There was a reporting system every six months, not just to me as minister but to the Premier's Department. Would you see that as a way of getting this reporting under control to make sure the departments were reporting these things through?

Mr McPhee—It could be one way. I think the framework needs to be enhanced and it needs to be sheeted home to agency heads that they have responsibilities in terms of ongoing monitoring and reporting. That could be part of it.

Mr CAUSLEY—Under the system, if there were a continual lack of performance in not reporting then I could ask my head of department, 'Why should you not lose your position?' They had a right of appeal, but that was the position if they were not performing.

Mr McPhee—Exactly. That would be a question you could ask.

Mr MUTCH—Should you not be auditing the finance department to ensure that they are keeping proper records of all this anyway and following up themselves?

Mr McPhee—In fact the audit office has raised the issue of this particular table which covers guarantees and indemnities in the past and suggested to Finance that it has not been comprehensive. They did take action to follow up.

Mr MUTCH—Have you done a report on that?

Mr Bourne—During the course of the audit, certainly. I suppose the practical manifestation of that is that this exercise that we are undertaking right now with A-G's to revise 1989/11 and include the better practice guide that is in chapter 6 is also going to try and sweep up some of the aspects of management of guarantees and letters of comfort. This is an awareness exercise. I suspect a lot of the problem is lack of awareness, for whatever reason, but this project is definitely an attempt to alleviate that situation.

CHAIR—We have a slight problem. We have a division to go to now, but I did want to come back to that point about previous audits. Could you just take that on notice for the moment and identify what was

said in previous hearings.

Short adjournment

CHAIR—After that division we will resume our discussion on previous audits.

Mr McPhee—In paragraph 6.4 we make brief reference to the issue which we had raised previously concerning the accuracy of table 13 in the Minister for Finance's Aggregate Financial Statement. Table 13 is the table that deals with guarantees and indemnities. It was raised by the audit office in 1992-93 on the basis of that footnote. Finance, at the time, wrote to all agencies letting them know the audit office's concerns and seeking their assistance to get an accurate picture on the guarantees and indemnities.

They did that but the reality was, as we say in the last sentence in 6.4:

. . . that there were still major shortcomings in the reporting by agencies.

Essentially that means that the agencies themselves did not have a handle on the guarantees offered and indemnities issued within their own portfolios.

CHAIR—Given that, whose responsibility is it to chase it up? You have done reports and found shortcomings. Finance has written and yet still nothing is happening. Who is responsible?

Mr McPhee—There are a number of parties with responsibility. Under the new legislation to replace the Audit Act, one of the provisions in the Financial Management Accountability Act is to make it very clear that the head of the agency is responsible for the efficient administration of his or her department. In a sense the framework is seeking to tighten up who is responsible for what. Finance, as it becomes aware of issues, then issues circulars exhorting departments to enhance their performance. Finally, we have a responsibility to report in terms of what we find either during our financial statement audits or part of this process. I understand your frustration.

CHAIR—Which ministers, or which individual? That is how it ends up.

Mr McPhee—It is a question of the agency having the responsibility to report on these. Their responsibility is very clear. Under the reporting guidelines issued by the Minister for Finance, the Finance Directions and the circulars have supported this obligation on agency heads, but we have not seen it happen. It is obviously not an area that has been given priority.

CHAIR—Have you a list of these major shortcomings that you mention in that paragraph, or the agencies involved?

Mr Cronin—Agencies are required to fill in, and it is generally by an SES officer, a declaration saying that this is a listing of the Commonwealth undertakings which is used to compile table 13 by the Department of Finance. In the course of this audit, as Mr Bourne pointed out earlier, we went repeatedly to the departments asking for additional information to confirm it. We frequently found indemnities and

guarantees which were not reported to us in the survey, and this was an example. Whoever was filling out the surveys within the departments and telling us had not spoken to the line departments, or else who they had spoken to had forgotten about it. It is one of those things that drops off the table. A lot of these things are of longstanding interest. For example, the indemnification of the directors of the Wheat Board was not reported to us. Whether people just forget about it or—

Mr CAUSLEY—It was a pretty big one.

Mr Cronin—In terms of the directors, yes. It is unique to have the statutory indemnities. Our office has the statutory indemnity. We were very interested in finding that. In fact, we found that in preparing for this hearing. Those sorts of things pop out. Maybe there is a problem within the departments concerning how this is circulating within the departments. There may be an internal structural problem. Responsibility lies with the program areas. As to whether the people responding to the Department of Finance and to us come out of a central area or wherever, there is some kind of inherent problem.

Repeatedly, we went back to departments and said, ‘We have found this. Would you confirm?’ Generally, they were very good. When we pointed it out they would confirm. It certainly was not a commercial approach. In the commercial field you would have these locked down quite specifically. One of the problems they do have is the fact that the Commonwealth does not keep contract registers. Anything that is in contracts, unlike a private firm where you have a company seal, et cetera, we do not have that. It would be debatable whether many departments could, at any time, locate all their contracts.

Mr CAUSLEY—You are not painting a very good picture of the Public Service in Canberra. It almost comes to that word ‘recalcitrance’ in many ways. We spoke earlier about the new act. What are the sanctions under the new act? If you write to people such as Finance and Finance writes to the departments—they require certain reporting systems to be in place—what if they tell you to go take a walk in the park? What do you do then?

Mr Cronin—They generally do comply with us in terms of writing back to us.

Mr CAUSLEY—Is there any sanction? You say they generally do comply.

Mr Cronin—The departments will respond to us—

CHAIR—Yes, but they are not doing anything.

Mr Cronin—The standard of the response is one of the things that did concern us about the report. Indeed, the report consumed a lot of hours just in identifying what was out there. It took many more hours than we expected because we were not prepared to accept the responses that initially came back to this department. We continued to probe the departments to test the numbers, to test the requirements. In that process, as Mr Bourne pointed out, we went back three times. So there were iterations. If everything was working well, we would have got it in that one census. That did not come to pass, and this is indicative of shortcomings in the reporting by agencies.

Mr CAUSLEY—So does it require a direction from the Prime Minister?

Mr McPhee—I think a strong recommendation by your committee might help in terms of bolstering the monitoring and reporting in this area. In our recommendations we have sought to provide the framework for the future. We have sought to give the steer as to what needs to be done. Basically Finance has come back agreeing or agreeing in principle. As you say, there may be some questions about what ‘in principle’ means in some cases, but they are fundamentally not disagreeing with anything we have said and have indicated they would take all this on board.

As I said, we are seeking to issue the best practice guide. We are getting positive responses from both Finance and agencies on all our recommendations, which we see as very important for the future. But I think your point is more fundamental. You are saying, ‘We have issued circulars in the past, the rules have been in place in the past, but they still will not comply.’

Mr CAUSLEY—Exactly.

Mr McPhee—Quite frankly, if you have concerns about whether this will be picked up in a serious fashion as a priority, which I think is another issue, then it is clearly open to your committee to come in with a very strong suggestion.

CHAIR—I think we ought to employ the script writer from *Yes, Minister*. They would get a whole new series of—

Mr CAUSLEY—Don’t laugh about it.

Mr Bourne—Again, with this project that is in place right now we recognise that is a problem. One of the mechanisms we hope will be applied that may help raise awareness and add a little bit of weight to the problem is that, when these revised guidelines in the better practice guide go out, the senior people from the three agencies involved in it will actually sign off on a covering letter. That is the intention at this stage. We are not suggesting that that is going to be a panacea, but we are simply saying that will go some way to overcoming what I think your concern is.

Mr McPhee—I think the other issue is that the Finance circulars and Finance tend to be focused on by Finance people within an agency. What we are talking about here is the need to communicate effectively with the program managers. When a Finance circular goes out, it tends to go through the—

Mr CAUSLEY—Surely that is the departmental head’s job?

Mr McPhee—It is the departmental head’s position to ensure that people are properly informed. All I am saying is that it is an issue which I think has been a problem to be grappled with over the reform period. It is getting to the program managers about changes which are occurring. We need to get these sorts of proposals to many more people than just Finance people.

Mr CAUSLEY—Forgive me for going back, but it is the old story about the buck stopping with the

minister. I found when the buck stops with the departmental head there was a change of attitude, because there was nowhere to run. If in fact you require them to do certain things, then they drive that down through the department.

Mr McPhee—And we are. Agency heads sign off on the financial statements, which are expected to show notes in respect of these guarantees and indemnities. So they do have a very direct responsibility through their financial statements.

Mr CAUSLEY—Could I just go a little bit wider because I do not think we can ignore this point. The chairman mentioned in his opening statement the processes put in place in Victoria and New South Wales which have improved the situation. We cannot ignore what goes on in the states because at the end of the day, I suppose, Australia is responsible for what goes on. How comfortable are you with the states' reporting systems with the indemnities and guarantees that are there, particularly with New South Wales and Victoria—the big states?

Mr Cronin—The aspect we looked at in Victoria and New South Wales was the managed insurance funds that they run. We comment on that in our report. In terms of this report, we were quite impressed by how they went about assessing risk, identifying it, pricing it and seeking commercial cover if need be, and we comment quite favourably. One of the things that really stood out was this concept of having somebody who was a risk management consultant who reviewed contracts, reviewed exposures and decided before you entered into one what you should do or indeed whether you should enter into it. They have a very systematic approach and an extremely commercial approach. It really is built around the concept of being prepared to lay off risks that are too large for the budget sector or any one agency to bear. It is a fairly systematic—

Mr CAUSLEY—It is a relatively new phenomena in both those states?

Mr Cronin—Yes, and it has obviously brought about a major change in culture in the organisations. We note some of that in our report. It gets back to what the chairman said about the issue of pricing risk. This process of deliberately pricing risk, managing it and sending into an organisation those price signals for what they are about to undertake in a sense is the most appropriate means for managing. If you have that going, you will get the reporting going, you will get the management going. We do outline in this report some activities in relation to how you might go about introducing a pricing regime. It is one of the areas where departments can literally issue a free lunch. It is one of the last remaining bastions where the government largesse can prevail without any direct financial benefit at a particular point in time but with potentially some future call on government revenue.

CHAIR—That is pretty significant. Unfortunately we are going to have to vacate this room in a minute, but I want to ask you whether you would be happy to talk to the committee again, on or off the record, somewhere down the track in this inquiry.

Mr Cronin—Yes, indeed.

Mr McPhee—If you wanted us to appear with other agencies as well, Mr Chairman, if you wanted to have a round table discussions on solutions or the way forward, we would be more than happy to do that as

well.

Resolved (on motion by Mr Causley):

That this committee authorises publication, including publication on the parliamentary database, of the proof transcript of the evidence given before it at public hearing this day.

CHAIR—I thank you very much for coming along. I think this has been quite a fascinating hour or so, and I hope we can work together for the benefit of everyone.

Committee adjourned at 11.43 a.m.