

PROOF



HOUSE OF REPRESENTATIVES

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

Reference: ANAO report on guarantees and indemnities

CANBERRA

Thursday, 27 February 1997

PROOF HANSARD REPORT

CONDITION OF DISTRIBUTION

This is an uncorrected proof of evidence taken before the committee and it is made available under the condition that it is recognised as such.

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STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND
PUBLIC ADMINISTRATION

Members:

Mr Hawker (Chair)

Mr Albanese

Mr Anthony

Mr Causley

Mrs Gallus

Mr Hockey

Mr Latham

Mr McMullan

Mr Mutch

Dr Nelson

Mr Pyne

Dr Southcott

Mr Willis

Mr Wilton

Matter referred to the Committee:

ANAO report on guarantees and indemnities

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WITNESSES

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Present

Mr Hawker (Chair)

Mr Causley

Mr McMullan

Mrs Gallus

Dr Southcott

The committee met at 10.26 a.m.

Mr Hawker took the chair.

CHAIR—I declare open this hearing of the House of Representatives Standing Committee on Financial Institutions and Public Administration's inquiry into the Australian National Audit Office performance audit no. 6, entitled *Commonwealth guarantees, indemnities and letters of comfort*.

The committee has already heard from the audit office and, following this hearing with the Department of Finance, the committee intends to take evidence from a number of government departments and government business enterprises.

The audit report has identified significant shortcomings in the management of guarantees, indemnities and letters of comfort by a number of government agencies. The poor management of these instruments has resulted in a number of costly claims against the Commonwealth in the past. As the Department of Finance has a central role in ensuring the departmental management of these instruments is of a high standard, the committee would be very interested to hear what the department officers have to say about this audit report.

I begin by saying that the evidence you give to the public hearing today is considered to be part of the proceedings of parliament. Accordingly, I advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt of the parliament.

[10.28 a.m.]

KENNEDY, Mr Maurice John, Assistant Secretary, Financial Management Advisory Branch, Department of Finance, Newlands Street, Parkes, Australian Capital Territory

O'BRIEN, Mr Timothy John, Director, Accountability Projects Section, Department of Finance, Newlands Street, Parkes, Australian Capital Territory

RICHARDSON, Mr Arthur Philip, Assistant Secretary, Government Business Enterprise and Commercialisation Policy Branch, Department of Finance, Newlands Street, Parkes, Australian Capital Territory

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WALLACE, Mr Dean Kingsley, Assistant Secretary, Accounting Framework Branch, Department of Finance, Newlands Street, Parkes, Australian Capital Territory

CHAIR—Thank you. Would you like to make an opening statement?

Mr Kennedy—Firstly, thank you for providing the Department of Finance with the opportunity to give evidence at the hearing. The Auditor-General's efficiency audit report on Commonwealth guarantees, indemnities and letters of comfort details Finance's position on each of the Auditor-General's recommendations, seven of which were directed specifically to this department. We have signified our agreement with the aims of all of the report's recommendations, and we are in the course of implementing remedial action to address the matters identified by the Auditor-General.

We regard the issues raised in the report as a salutary insight into an important subset of the Commonwealth's total exposure to contingent liabilities. That total exposure is unquantifiable but obviously very large. The subset covered by the audit relates to what might be termed formalised risks that will have been entered into wittingly by a minister or an official, with the ensuing contingent liability being created via particular kinds of instruments that would, if the need arose, be shown to have a status in law.

Beyond this subset, however, there are further Commonwealth exposures to potential liabilities that are perhaps even larger in their scope that realistically cannot be ignored. These are what might be termed non-formalised risks. They exist not only through the conduct of the array of day-to-day activities of the Commonwealth, but are also ever present simply because the executive government will assume certain political or public interest obligations and, in some cases, possibly legal responsibilities towards the citizens of Australia who might otherwise have no redress for detriment caused by the actions of the Commonwealth or Commonwealth entities.

These contingent liabilities can prove real enough, even if they are not capable of being tallied or recorded day by day. For example, in its ordinary activities the Commonwealth is vicariously liable for the actions of its employees. Moreover, under longstanding practice it will also accept comparable liability for the

reasonable actions of other persons performing Commonwealth functions. In this context also there is a range of standing statutory indemnities, such as for those injured by Commonwealth registered vehicles. Indeed, the Auditor-General and his staff are indemnified against being sued by any of their victims.

Under its political and public interest obligations, one would need to consider whether any government could realistically stand by and let a Commonwealth entity become insolvent to the point of destruction of the Commonwealth's usually very considerable investment in the enterprise. If the entity were a statutory authority, depending on the terms of its enabling act, the Commonwealth may well be legally liable to underwrite its debts.

In bringing these non-formalised risks into contention, I am merely seeking to demonstrate the point that across the spectrum of the Commonwealth's total exposure to contingent liabilities there are two separate dimensions to the concept of risk: firstly, the way in which the Commonwealth manages those risks; and, secondly, the accountability frameworks which the Commonwealth performance in managing those risks is made visible, to the executive, to the parliament and the public.

The obligation to manage risk, formalised or non-formalised, is unequivocally that of the particular body which controls or is responsible for the factors comprising the exposure. No other formulation is practicable. It has been said on a number of occasions in forums not unlike this one that Finance should have a policing role over Commonwealth bodies for a variety of matters. Successive governments have not shared that view in the main. They have determined Finance's role in Commonwealth financial management and accountability as being to set frameworks rather than to enforce them.

That said, Finance is very conscious of the fact that good frameworks are a prerequisite to good management performance. We acknowledge that we need to do more to ensure that good public policy outcomes are achieved. As part of the ongoing maintenance of the management framework, we have been working closely with the ANAO and the Attorney-General's Department in developing a comprehensive set of guidelines for Commonwealth managers on guarantees, indemnities and letters of comfort. These guidelines, which are to be issued in March, pick up the ANAO's better practice guide, appended to its audit report.

Before leaving the management framework, I should also mention that the bulk, some 99 per cent of the exposures identified in the audit, relate to guarantees. The Commonwealth's management of these exposures includes monitoring the viability of the entity in respect of which the guarantee has been given through the government business enterprise accountability and ministerial oversight arrangements, as well as via other prudential frameworks.

As we move to improve the accountability framework—that is, to make the formalised risk exposures more visible—we believe that the management of the exposures will also improve. We consider that accountability is the area that can be most improved and, hopefully, will be improved by actions Finance is taking to address the shortcomings identified in the audit. We do share the ANAO's concern that the annual summary of guarantees and other liabilities and the Minister for Finance's aggregate financial statements, which is referred to as table 13, has been incomplete despite reminders to agencies by Finance of the requirement for them to report. Finance believes that the shortcomings in reporting will soon be overcome.

The recent whole of government reporting initiative will in fact replace table 13 and will pick up material exposures identified in agencies' financial statements and present them to the parliament in a consistent way. Mr Chairman, my colleagues and I are ready to assist the committee in any way.

CHAIR—Thanks, Mr Kennedy. You opened up some questions straight away just in that statement. You talk about Finance's role. You question whether it should be a policing role and it is more to set up the frameworks rather than enforcing, but that raises the obvious question: who actually ensures that the frameworks are being met?

Mr Kennedy—Nobody ensures that the frameworks are being met. The responsibility for complying with any law, whether it relates to frameworks for this area of administration or otherwise, rests with the management of the agency concerned.

CHAIR—But does that not concern Finance that there could be liabilities out there that you are not aware of?

Mr Kennedy—As I said in the statement, there are liabilities out there that we are not aware of, many of which are not capable of being quantified.

CHAIR—But you then went on to say that you could look at 99 per cent of them in terms of guarantees and so on?

Mr Kennedy—Yes, and they are monitored in various ways.

CHAIR—But does that not leave the point that, while one per cent might sound small, if it is one per cent of \$222 billion, that is still \$2.2 billion?

Mr Kennedy—Absolutely.

CHAIR—Which is a very large sum of money to most people.

Mr Kennedy—Yes. I am contending, not that that is a small amount of money because it is not, that there is another range of contingent liabilities that do not even make it into the purview of what is covered by this audit report. I believe—and I have no empirical evidence to prove it—that were one able to tally those kinds of exposures they would prove to be a larger number than even the \$2.2 billion.

Mrs GALLUS—You could not do a statistical estimate?

Mr Kennedy—No.

Mrs GALLUS—You could not go back on past records and say, 'The probability is such and such,' and do a statistical estimate that way?

Mr Kennedy—You could but I do not know that it would provide anything. The main example is the

Commonwealth's vicarious liability for the actions of its employees. I suppose you would need to go over a fairly long period of time in order to get an average of what kind of real liabilities materialise from the actions of employees.

I also mentioned that, in the case of some statutory authorities, if the wording of the legislation is such as to give the relevant responsible minister a more than passing direction and controlling power, then that could conceivably materialise into a legal obligation on the Commonwealth to save such an enterprise if it was becoming insolvent.

CHAIR—But Mr Kennedy, we have not got an answer to the question of who is ultimately responsible for seeing these guidelines complied with. You talk about the new guidelines but we will come back to that in a minute. You say that it is not Finance's job to take the responsibility even though one would have thought ultimately it does come back to Finance because you would be the ones who are most concerned if something went wrong, initially anyway. The government of the day might ultimately. Who is actually going to make sure that these guidelines, the framework, whatever you like to call it, are actually being met? If someone is not doing the right thing, what is going to be done about it?

Mr Kennedy—I am not avoiding the answer, but that is a question that has been raised many times. Successive governments have said that the responsibility for compliance rests with the individual agencies and entities.

CHAIR—But didn't Finance send a note around in 1989 saying that you want to be informed?

Mr Kennedy—Being informed is not the same as enforcing the rules. We have an audit report that says we are not being informed.

CHAIR—Exactly, and yet you asked for this seven or eight years ago.

Mr Kennedy—That is as far as this department's mandate goes. We do not have a mandate to enforce; we have a responsibility to set up frameworks.

CHAIR—If things are not being enforced, then you are still saying, despite the audit report, that nothing is changing.

Mr Kennedy—We can improve the accountability framework but, at the end of the day, it still remains with individual agencies' management as to how diligently they comply with the requirements of the framework. Ultimately you have the Auditor-General, ultimately you have parliamentary committees, but in between those and us there is nothing.

CHAIR—So really you are still saying that there is potentially a big gap there in the knowledge of the Department of Finance?

Mr Kennedy—Yes.

CHAIR—Doesn't that concern you?

Mr Kennedy—It concerns us in so far as there is a big gap in the knowledge of the Department of Finance on compliance by Commonwealth agencies of a lot of things. But that is the system under which successive governments have seen fit to work.

CHAIR—Doesn't this come back then to the question of exposure risk—that there could be some potential risks there far greater than the government is aware of?

Mr Kennedy—I have no doubt that there would be. Being aware of the risk is one thing but it is the management of the risk that depends on whether that risk materialises.

CHAIR—But surely if you are not even aware of it—

Mr Kennedy—I am not sure that it is productive to pursue the point much more.

CHAIR—I would have thought it is fairly fundamental though.

Mr Kennedy—It is.

CHAIR—If you say we should not pursue it, who is going to pursue it? No-one.

Mr Richardson—Mr Chairman, could I make a comment which picks up on something that Mr Kennedy said in his introduction?

CHAIR—Yes.

Mr Richardson—In moving to the new whole of government financial statements that are being prepared now, much greater emphasis is going to be given to the area of contingent liabilities, and commitments that the government has made but has not yet met. Normally, these sorts of things are covered in the notes to the financial statements. I am not the expert on this—I am reporting my understanding of it—but, as I understand it, rather than having the commitments and the contingent liabilities reported in small notes at the back of the financial statements, there are going to be two new financial statements, statements in their own right, as part of the new set of statements in the whole of government reporting arrangement.

They will be a statement of contingencies, or contingent liabilities, and a separate statement on commitments that the Commonwealth has entered into. Those two things will be elevated, if you like, in status. Instead of being notes to the accounts—and if you have seen a lot of financial statements, there are reams of these things buried away—there will be separate statements on these two things as part of this new regime that is being developed at the moment. I think that will give a much greater profile and statement of importance to these issues.

Mr McMULLAN—Is it your understanding that these will appear agency by agency in their annual report?

Mr Wallace—Perhaps I could take that one on board. The financial statements of all entities, whether they are departments, other agencies, statutory authorities or companies, should be reporting these in accordance with the Minister for Finance's guidelines.

Even now, and for the last two or three years—certainly 10 years or more in the case of statutory authorities—they have been required to adhere to these guidelines. Since 1994-95 all government departments and agencies have likewise had to report under the Minister for Finance guidelines which basically require them to adhere to Australian accounting standards. The individual agency reports are therefore both produced in accordance with these and audited accordingly, with the usual audit certificate given.

The whole of government financial statements that Phil Richardson is talking about are what we have been undertaking for the last two years—to consolidate the financial statements of all Commonwealth entities. As Phil pointed out, we are proposing for the 1995-96 statements, which will be made available in the next month, to elevate the statement of contingent liabilities from the notes to a primary statement.

Mr McMULLAN—For each agency?

Mr Wallace—We would have to look at that. I doubt whether you could do it by each agency in the primary statement; you could do that in the notes but not in the primary statements.

Mr McMULLAN—The chairman is pursuing this question of the gap. I accept that that probably is an accurate description of the current circumstance, but it seems to me that in modern public administration—where the direction has been for greater devolution, and you say, therefore, that the responsibility for discharging this obligation is with the head of the agency, with guidelines set by you, responsibility devolved to the head of the agency and scrutiny by the Auditor-General and the parliament, as the system—the parliament will be able to discharge that obligation more easily if attention is drawn to the nature of, and any changes over the year in, these sorts of liabilities and other matters and contingencies into which departments and agencies have entered. I was interested to hear you say this was going to be more prominent, and I wonder if that prominence is going to be reflected in the annual report, because that goes some way to filling that gap.

Mr Wallace—I guess there are two dimensions to it. The entities' own financial statements will, certainly for 1995-96, have all been prepared. They will report in the traditional way, with the statement of contingent liabilities being a major note but not one of the primary statements. The primary statements, in a company, you would normally identify as being a profit and loss statement, a balance sheet and the statement of cash flows. In the case of government we do feel that there is a case, certainly at the whole of government level, to elevate a statement of contingent liabilities to a primary statement.

We are also looking at the possibility of having a statement of debt as a primary statement. This is because of the importance of these foci in a government context, as compared with, say, a corporate context. We are also considering, however, changing the guidelines as they apply to entities to see whether the statement of contingent liabilities ought also to be elevated to a primary statement. That gives greater focus to it. It would not necessarily give more detail about these things, but it gives the prominence of these things to the parliament and to the people—and to management, for that matter.

Mr McMULLAN—I agree with that last point. It goes very close to meeting my concern—and perhaps you have; let me just clarify. I have to say by preface that I am not absolutely certain yet whether what we have got here is a real problem, an emerging problem or description of a longstanding situation which, because it has large numbers attached, we are frightening ourselves, though it may actually be of much more manageable proportions than it appears. I am not sure that I am as alarmed as this as some. But if we do think there is a serious problem about which we have to do something more, on what you are describing, it seems to me there is the capacity in annual reports to pull out matters which are of political significance—and I do not necessarily mean partisan significance: of significance to the parliament—and have them reported separately.

Can I give you an example that would not occur in any corporate account. Suppose you pull out a list of all the consultancies and they are all detailed. If you want to know what happens in consultancies, you can go into the financial statements and find it, but it is pulled out separately and identified in minute detail because in the accountability process and senate estimates committees—as I remember, to my great cost, over eight years of my life which I do not miss one bit—people are inordinately interested in them. I just wonder if it is possible to do something similar, given that I do not now have to go to estimates committees. In relation to that requirement, which would become, as you say, also a management tool in terms of having to maintain, monitor and develop that list, could we publish something in the annual reports in a similar form. Is that what you are thinking of?

Mr Wallace—I guess there is some developmental work to be done in relation to just what form a primary statement in an entity's financial statement should take. What we would not want to do is what you have alluded to—scare the pants off people. I think one of the things that we would need to be very careful of, in changing the face of what are normally regarded as financial statements of an entity from the traditional approach governed by accounting standards, is the linkages between the various statements.

One of the important things to bear in mind about a contingent liability is that people will normally not enter into a guarantee or an indemnity unless they are fairly confident that the risk associated with that will not materialise. In the case of, particularly, the statements of assets and liabilities, those statements are of things which are more likely than not to materialise—particularly the liabilities. That is the definition that is adhered to in recognising liabilities in the statement of assets and liabilities or the balance sheet.

We would need to make very sure that readers were not scared by the elevation of these statements from a note which has been intentionally been made a note by the accounting profession over many years because of its subordinate nature. We would need to make very clear what the interpretability of these statements was and make it very clear that the likelihood of these events occurring is much less than 50 per cent. In fact, it would be very, very low in many cases.

This is why, in Maurie's opening statement, he made the distinction between accountability for and management of risks, particularly when one looks at the financial statements of an entity. The major issue to consider, particularly in a commercial environment, is its viability as a going concern, looking at the balance of assets and liabilities. In looking at the contingent liabilities, one needs to have regard to the likelihood that they will come to bear or that they will materialise, and the strength of the entity's financial position to meet those contingencies if they, in fact, do arise.

It is not a straightforward issue of elevating information for the sake of elevating it. We have to make sure the context is fully understood by users. The statements are to assist rather than to frighten people.

CHAIR—I take your point but what does concern me is that, whatever method you want to use to report these liabilities, until now some people have been complying with your guidelines and some people have not—or some agencies and GBEs have and some have not. What method have you got to ensure that the ones who are not reporting—and who, I suppose one might suggest, could be the ones that do not want to report for all sorts of reasons—are brought into line so that it is known what is actually out there, rather than saying, ‘Well, all the good ones are doing the job properly, and we are happy with them. But no-one is chasing up the ones who are not doing it’?

Mr Wallace—I think we would challenge that nobody is chasing them up.

CHAIR—But that is what the auditor’s report says.

Mr Wallace—There are two elements to that. One is that there is the audit report which is a major focus for identifying the gaps and ensuring that they are cleared up. Having identified those, there is an Auditor-General follow-through process which every minister is responsible for doing on, I think, a quarterly or a—

Mr Kennedy—Half-yearly.

Mr Wallace—Half-yearly basis. It involves comprehensive reporting of how their departments and agencies have pursued and implemented or responded to recommendations of the Auditor-General in whatever report he makes, whether it is a financial statement, an audit or a performance audit. So there is a fairly comprehensive follow-through in that regard. But, having said that, I also reinforce that distinction between the two forms of audit. There is a performance audit which the Auditor-General may choose to do selectively and, on this occasion, he has chosen to do one on guarantees, indemnities, et cetera.

CHAIR—Which is limited; it does not cover business enterprises.

Mr Wallace—Sure, but there are also the annual financial statement audits and the compliance audits which go on in association with that to ensure that legal obligations, including adherence to the Finance directions, are adhered to—by individual entities, that is.

CHAIR—But the point of the question is that that may be supposed to be being done, but who is actually ensuring that it is being done? The auditor has said it has not been done.

Mr Wallace—I think there are two parts to that. One is that, having identified the gaps, there is the Auditor-General’s report or recommendation follow-through actions. It is the responsibility of each minister to report to the finance minister on what action is being taken to take corrective action. That is an important part of the accountability process and, indeed, of the management process.

Mr Kennedy—Are you envisaging perhaps that, even if that did occur, and the agency or the

agency's minister reported to the finance minister, 'Yes, we've fixed up the shortcomings that the Auditor-General has revealed,' down the track they will slip back into noncompliant ways?

CHAIR—As I understand it, the Department of Finance issued guidelines back in 1989. In the letter that went out under Mr Shand's name, it says, 'Because of the potential financial commitment involved, ministers issuing Commonwealth indemnities will need to inform the Minister for Finance of all such indemnities.' This report comes out seven years later and says that, notwithstanding Department of Finance guidelines, some agencies and departments are not complying.

Mr Wallace—In addition to the particular guidelines, which tend to be a standing document until they are updated the next time, and, of course, the financial directions which are a standing legal obligation of the chief executive officers of departments, each year in preparing the statement of contingent liabilities—certainly since the last; I think it was an efficiency audit in 1991 or 1992—we have sent out a letter so that, in preparing the aggregate financial statements of the Minister for Finance, to which the statement of contingent liabilities was an appendix, a senior officer within each department certifies or signs off a certification that they have provided full and accurate details of contingent liabilities or material contingent liabilities. I guess what you would respond to—if I can put words in your mouth at the moment—is that the recent performance audit has found that even that certification has not been sufficient in some cases.

CHAIR—It appears that way.

Mr Wallace—With the follow-through procedures that I have just mentioned on audit reports and recommendations, it is not only a warning to us, to the department, but it is also a guide to other auditors, in pursuing annual financial statement auditors, of where to look for the major risks. Without prejudging what the Auditor-General would do, I would think this would be an area, for a while, for more consistent scrutiny of what departments are doing each year. This is part of the process of the accountability through performance audits.

CHAIR—You are not suggesting that, just because the auditor has brought this report out, everything is going to be fixed, unless something more happens, surely?

Mr Wallace—No. I think Maurice mentioned earlier that you cannot guarantee anything in relation to compliance, but you can set in train processes which ensure that you have got a degree of satisfaction. There is also the issue of risk management here. If we switch our focus too sharply towards the less than one per cent of contingent liabilities identified by this audit, there is a risk that, by shifting the focus to that small proportion, the focus on the bigger liabilities of the other 99 per cent will be reduced. In terms of risk management, certainly the focus on that bigger area through such things as the GBE monitoring arrangements, which ensure that the viability of the entity is such that it can manage its own risks, is also a factor that we need to keep in mind.

Mr Kennedy—I do appreciate the committee's dilemma. The fact is that if an agency prepares financial statements that purport to reflect the true and fair view of their position, and included in those financial statements will be an amount for contingent liabilities, either in the primary statements or as a note—

Mr Wallace—In the notes—sorry, you mean under the new arrangements.

Mr Kennedy—and the Auditor-General provides a certificate that says that he accepts and agrees that the financial statements do reflect the true and fair view, I am not sure how much more can be done from the centre—the Department of Finance, for example.

Dr SOUTHCOTT—Is the Minister for Finance informed of which agencies are not reporting their liabilities?

Mr Kennedy—As Dean said, there is the half-yearly report of Auditor-General follow-ups, where every report that the Auditor-General makes we factor into a formal follow-up procedure and ministers are required to report to our minister every six months to indicate what action has been taken. So to that extent, yes, there is that. And after it comes from the minister to us we run a reality check over the assertions that have been made and, if necessary, put it on the follow-up for the next six months if we are not satisfied.

CHAIR—But haven't there been occasions when, until the privatisation starts, there have been government business enterprises—and Mr Causley will probably want to ask you about the Aussat one—where these liabilities suddenly appear and have caused, no doubt, a certain amount of embarrassment?

Mr Kennedy—That is possibly true. I will ask Mr Richardson to handle the Aussat one, the hospital pass. But the auditor's certificate is not a guarantee; it is a best endeavours. You might even bear in mind that the auditor's certificate to the Minister for Finance's aggregate financial statements over many years included that table 13, which they have now said has been incomplete. Obviously their certificates were no guarantee of that either.

Mr Richardson—Firstly, I cannot really say much about Aussat. I was not involved in the sale at all.

Mr CAUSLEY—We want to know why we suddenly lost all these promissory notes that were worth so many millions of dollars?

Mr Richardson—I have been involved in a couple of asset sales but not that one.

CHAIR—We are not blaming you, Mr Richardson!

Mr Richardson—Unfortunately, I cannot shed much light on it.

Mr CAUSLEY—How could it happen and what has been done about it? If you were in the private sector, I know what would happen. The chairman does not like my terms; they are too vernacular, I think. But they would not stop long in that position, would they? If someone lost that amount of money, they would be gone.

Mr Richardson—Yes. I do not think there is very much of use that I can say. I have not been involved in it at all. I am aware of the issue but I have not been involved in the sale. I was going to offer a comment to the chairman on another matter.

CHAIR—Please do.

Mr Richardson—In my present role I am involved in GBEs, government business enterprise policy and commercialisation policy, but I have worked in other parts of the department in the areas that oversee the individual departments. I have worked on these things that Dean and Maurie are talking about where we do follow up. Typically, where the auditor does identify that some liabilities or contingent liabilities have not been identified, in my experience anyway, in the vast majority of cases there is some system problem: the people have not been properly trained or instructions have not been issued to the relevant people within their departments. I am trying to get to your point about when a shortcoming is identified what is done about fixing it up and what is the follow-up, and it is that arrangement.

I have been on the Finance end of a department saying, ‘The auditor has found X, Y and Z deficiencies,’ and they say, ‘What we are going to do is design a code of practice to issue to people who have these sorts of responsibilities.’ They will put that in one report and then six months later they will say, ‘We drafted that, we sent it up to the departmental executive and they are still considering it.’ We will say, ‘Okay, that is still not fixed yet; we will see how they go next time,’ until the report comes through that, yes, it has been accepted, been implemented and the relevant people are now aware of their obligation.

If I sense your concern correctly, it is that follow-up. Finance has no right and role to go in and start looking through papers and systems in departments; the Auditor-General has a role in doing performance audits and financial statement audits. But, where the deficiencies are identified, the obligation is then on the auditee to report every six months on what they are doing about it. The shortcomings do not get crossed off by Finance until we are satisfied that a plausible, reasonable and adequate response has been made.

Mr Kennedy—Even that is no guarantee.

CHAIR—How long could this go on? If they just keep deferring reporting, what happens?

Mr Kennedy—Our minister reports to the Prime Minister.

Mr CAUSLEY—In the system that I came from in New South Wales I was responsible as minister. If something went wrong, I would get a letter from Treasury to say, ‘This has been identified. What are you doing to fix it?’ I would go to the departmental head and say, ‘That must be fixed,’ and Treasury would follow it through until it was.

Mr Richardson—That is very similar: the departments submit reports to their ministers; their minister writes to our minister submitting the report; and then our minister forwards it down to the department for analysis. The responsibility is through the ministers but the Department of Finance, on behalf of the Minister for Finance, does that follow-up action. If people are just stonewalling, once we are satisfied they really are not doing anything, we will take the action.

Mr CAUSLEY—The Premier then got involved, and the Prime Minister would get involved in this particular instance.

Mr Richardson—Yes.

Mr CAUSLEY—Could I go back to this area of where you were saying that we do not want to frighten everyone with the risks that might be involved? I agree with Bob McMullan that some of them might be real and probably some might be never realised. Surely, unless these risks are transparent and they are identified as potential risks, are we not in a situation where we probably have an attitudinal problem of, ‘Oh well, this is government. Why worry? The taxpayer is going to pay for this anyway. It is not like the private sector.’ Whether it is departments or ministers who make decisions we say, ‘Oh well, we will cover it with taxpayers’ money.’ Isn’t there an attitudinal problem there? We tend to do this, whereas if we were in the private sector we would have a keener knowledge of these risks and take due care of them.

Mr Wallace—I think the purpose of the disclosure requirements in the financial statements is precisely to do what you are suggesting; namely, to make these things far more transparent. I guess the point I was making to Mr McMullan was that, in making these disclosures and in the suggested case that we are looking at in elevating contingent liabilities to a primary statement status, I think we need to make the readers aware that we are not distorting people’s perception of the total picture because we are doing something to the public sector statements that is not done to private sector statements. Their contingent liabilities are contained in the notes. What I am saying is that in elevating them to a higher status as a primary statement we need to make sure that people are given the understandability of the structure of the total financial position.

Mr CAUSLEY—Could it be a risk rating or something like that?

Mr Wallace—In that sense, it would be the ideal if we could risk rate each element of it but at least draw attention to the fact that these contingent liabilities and, by definition, the likelihood of them materialising is much less than those items appearing in the liabilities column of the statement of assets and liabilities.

Mr CAUSLEY—Do you think there was an attitude in the past, either innocently or otherwise, that this is government so it is different?

Mr Kennedy—I do not think I have ever heard anybody say, other than in jest, that it is only taxpayers’ money. I think there is an attitudinal problem but I do not think the attitude derives from ‘it is only taxpayers’ money’. I think the attitude probably derives from security of tenure. I think in an environment where you, as an officer, are accountable for your performance, for your judgments and your decisions, that would have a remarkable effect to focus the mind and to change attitudes and culture in an organisation.

Mr CAUSLEY—On this area of following up—I was a minister in the Greiner government and we did change the accounting practices of New South Wales—I believe the follow through probably became more enthusiastic in that regime than it was in the past. I might be wrong in this, so tell me if I am wrong. Do you think that maybe the Minister for Finance and probably subsequently, if necessary, the Prime Minister should be more enthusiastic in following up some of these issues?

Mr Kennedy—I do not think a lack of enthusiasm is a problem. If you want a performance indicator it will be found not in the enthusiasm of the Minister for Finance or the Prime Minister but rather in the squeals from the agencies concerned who are being followed up. Those squeals still occur with monotonous regularity.

Mr CAUSLEY—I am well aware of that.

Mr Kennedy—In a sense, that is how we know it is working.

CHAIR—We might move on because time is our enemy as usual. The defence department were rather reluctant, because of their size and geographic dispersion, to have a central register for all their indemnities. Would you like to comment on that?

Mr Kennedy—The typical sort of indemnity that the Department of Defence issues is where there is to be an exercise, even a small army reserve exercise, that may involve use of military vehicles going across somebody's property or using fire roads or whatever the indemnity is: if we damage it we will fix it. If we knock over your fence or run over your cow or whatever, we will fix it.

Those indemnities typically are not high value exposures. I can understand Defence saying that a centralised register would not only be administratively cumbersome but also provide an administrative overhead that would produce not much benefit. So I can understand Defence thinking in those terms.

At the other end of the spectrum, you might have an indemnity that the Commonwealth issues through the Department of Defence, say, to Australian Defence Industries for the transportation of ordnance on public roads. Certainly they should have some record of that kind of indemnity, not on a truck by truck basis but that that does exist and that it is a standing indemnity.

Dr SOUTHCOTT—What is the state of the Department of Defence reporting to you at the moment?

Mr Kennedy—I do not think they are any better or worse than other agencies.

Mr CAUSLEY—You would have seen the speculation about Garden Island though, would you not?

Mr Kennedy—Garden Island or Cockatoo Island?

Mr CAUSLEY—Cockatoo Island, where all the ammunition is stored, and the speculation about what might have happened if there was an explosion there.

Dr SOUTHCOTT—You have raised a point there which says that perhaps it is reasonable that they cannot record what their indemnities are for running over someone's fence or whatever, but there are other areas where they should be able to report centrally on their indemnities. Is that what they are doing?

Mr Kennedy—Certainly. While as a matter of theory you could say that it is almost impossible to price an indemnity if it is open ended, in practice you can make a judgment. I think materiality does come

into it. It should be open to Defence to keep a central register of indemnities that would be material if they happened. I am not talking worst case; I am talking reasonable judgment.

If they happen to run over a flock of prized sheep or something, then that indemnity could materialise into very large numbers. That is a worst case thing, but certainly for the kinds of events that a reasonable person would say, 'Well, if that happens, that is going to cost a bit of dough,' I think it is eminently reasonable for Defence to attempt to maintain some kind of a register to allow the management of those risks to be better handled.

Dr SOUTHCOTT—The state government has ended up with some very large exposures on their government guarantees. They related to banks and building societies. It is hard to see where the Commonwealth—the Commonwealth being a lot larger anyway—would have a similar exposure. Can you think of any area where the Commonwealth could potentially have that large sort of exposure where they would have to use their government guarantee?

Mr Kennedy—In relation to financial institutions.

Dr SOUTHCOTT—I cannot see that it would have it for financial institutions.

Mr Saunders—The Commonwealth has a recorded exposure in the case of the Commonwealth Bank and other institutions such as AIDC. It is large but, particularly in the case of the Commonwealth Bank, very unlikely. In the case of the Commonwealth Bank, that liability will exist for very many years and it is a very large number, but the chances of it being called in are microscopic.

CHAIR—Would you say the same about the AIDC?

Mr Saunders—I would not put myself up as an expert in this matter, but I think that particular exposure is under control but it is not—

CHAIR—Does Mr Richardson want to comment on that?

Mr Saunders—In fact, because of my previous role in that task force on asset sales it is probably fairer for me to comment rather than Mr Richardson. I think the AIDC exposure is probably larger than the Commonwealth Bank exposure but not something of great concern.

Mr CAUSLEY—I am interested in that because it depends on management, does it not?

Mr Saunders—Yes.

Mr CAUSLEY—Westpac nearly went under because of management decisions. So why would you say that the Commonwealth Bank was more secure than Westpac?

Mr Saunders—Well, the Commonwealth Bank's principal exposure is to do with the deposits and where, on the sale, the Commonwealth has guaranteed at call deposits for three years and term deposits to

maturity. It is also exposed as to various other undertakings and obligations of the bank but it is certainly not exposed in terms of the shareholders' funds, and it seems to be that by any assessment that there is—

Mr CAUSLEY—But the taxpayers guarantee government banks, don't they?

Mr Saunders—I have outlined the nature of the Commonwealth's guarantee of an ex-government bank in the case of the Commonwealth Bank. It is an obligation that is decreasing. It has got a long tail but it is decreasing, and those numbers look large but in fact the burden of that on the Commonwealth is quite small in a probability sense.

Dr SOUTHCOTT—Who supervises the AIDC?

Mr Saunders—The AIDC is an entity under the Industry, Science and Technology portfolio. The AIDC itself is a statutory corporation and it has a subsidiary AIDC Ltd, which the Commonwealth effectively now owns a 100 per cent of again. We previously had sold some 20 per cent of it and now we have brought it back with a view to getting things in order and being able to make the changes necessary to dispose of it.

Dr SOUTHCOTT—I am just not sure I got the answers.

Mr Saunders—There is an act under which was established a corporation, the Australian Industry Development Corporation, and it was under that corporation that it carried on its business for many years. But when, in the 1980s, the government decided to in effect inject more equity into the AIDC, a subsidiary company was formed, AIDC Ltd, and some of the shares in that were floated off. In that way, more capital was raised.

Dr SOUTHCOTT—The Reserve Bank supervises the Commonwealth Bank and the other banks and they are subject to prudential requirements: what does the AIDC have like that? Is there a body that is supervising organisations like the AIDC?

Mr Saunders—It is certainly not supervised in the way that the banks are supervised. So it is not subject to those prudential requirements; it is up to the owner to establish its prudential regime.

Mr Wallace—I might add that there is under the AIDC Act, a statutory—if you like—gearing requirement that it must adhere to. As Peter mentioned, the other elements of the management of the risk are the appointment of an expert board and there is the Minister for Industry, Science and Technology's portfolio oversight. In addition to that, because it is a GBE, you have the GBE monitoring arrangements as a basis for general oversight of its operations.

Dr SOUTHCOTT—I come from South Australia and I understand all three of those reasons as being very important.

Mr Wallace—Like performance audits, the experience in other jurisdictions has probably been salutary to others as well.

CHAIR—What do you see as the pros and cons of the greater use of commercial insurance in some of these guarantees and indemnities? There has been some suggestion on this.

Mr Kennedy—It was mentioned earlier in a slightly different context. Guarantees and indemnities are issued because the issuer believes that they will not materialise. Over a period of time, the cost of insurance would even out or be slightly more expensive, given that there is a profit margin for the insurer. Over time, it would be theoretically slightly more expensive than carrying your own risk.

CHAIR—When you say that, presumably the government does have exposure from time to time, as we know. You have mentioned the potential at Aussat, and there has been other cases when the Gulf War started and so on. Can you say with total confidence that it would definitely be more expensive?

Mr Kennedy—No, not at all. I am saying that theoretically, if premiums are based on claims experience, then in theory over time—and that might be a very long time—insurance should be more expensive than carrying your own risk because the cost of insurance includes a component for profit of the insurer.

Mr Saunders—There is a con to that, which is—

Mr Kennedy—You mean other than a pro.

Mr Saunders—You asked for the pros and cons. The counter argument is to ask the question: does the policy of non-insurance influence the behaviour of the people who are carrying out the actions, and would the incentives and signals be better if there was an insurance regime in place? That is an issue which all bodies which self-insure or non-insure have to consider. You are probably aware that large corporates often bear a lot of their insurance risk on their own balance sheet and they may choose to reinsure only the largest part of that risk. There may be some who do not reinsure anything or, if they do, they do it through captive companies which have more to do with tax than anything else.

It is an issue for the Commonwealth about whether it wishes to continue to get the benefits of not paying insurance premiums to outside parties and to pool its own risk, or whether it wants to give up that economy and require its operating units to take out insurance.

Dr SOUTHCOTT—Has that idea been explored at all—the idea of GBEs or departments looking at insurance rather than pooled risk?

Mr Saunders—I should clarify that that policy does not apply to GBEs. They are making their own decision—they are either insuring or not insuring.

CHAIR—But if they have a government guarantee they are at an immediate advantage, are they not?

Dr SOUTHCOTT—Why do they need to insure if they have got a government guarantee?

Mr Saunders—They typically do insure or they typically do take a measured judgment about whether

they should insure particular risks or carry particular risks or carry particular ones on their own balance sheet.

Mr Wallace—A guarantee is not meant to replace good commercial judgment. It is meant to be a position of last resort.

CHAIR—It gives the GBEs a big advantage. You can borrow at lower rates, which may lead to commercial decisions that may or may not be influenced by that.

Mr Wallace—They do pay a borrowing premium these days which is meant to offset that advantage they would otherwise have in the marketplace.

Mr Richardson—That issue of the borrowing premium is under examination in the context of the competitive neutrality exercise that is under way at the moment.

CHAIR—I was going to say that there would be a lot of small businesses that would like to be able to borrow at the same rate.

Mr Richardson—Yes. That is being examined now.

Mr Saunders—Perhaps we should clarify that there are a minority of GBEs which have an explicit guarantee of their borrowings. Most of them do not have a formal guarantee and no doubt lenders take account of who owns them.

CHAIR—Even with the State Bank, I think there is an expectation there, however it is dealt with.

Mr Wallace—If you look at the legislation under which EFIC is established, it is a fairly good example of what I just mentioned. The guarantee is not meant to replace good commercial judgment. In fact, EFIC is required by its legislation to maintain adequate capital and also to exercise commercial judgment. In other words, there is meant to be a wedge between commercial activity and the guarantee. The guarantee is a fall-back.

CHAIR—EFIC is a particular case and they are doing a job that probably you could not get done commercially in most cases because you would not get someone to take that insurance.

I am very conscious of the time and I think I am going to have to wind this up. Before I do, two things. Firstly, could we get some written answers to each of the points that were raised in the audit report as a response to what is being done for each of the recommendations that were in that audit report? Secondly, would you be willing to accept written questions on any matters that members might wish to pursue?

Mr Kennedy—Certainly. I do not have any problem on the second one. On the first one, do you want something over and above the Finance responses that are reported in the report?

CHAIR—No, an update.

Mr Kennedy—An update. That is fine.

Mr Wallace—Could I clarify or go further on one point on this issue of the Commonwealth accepting its own risk. One of the incentives in place to ensure that departments do not take risk lightly is that they are required, in effect, to meet what is the equivalent of an insurance excess payment by absorbing most of the risk within their running costs and appropriation. Some risk will lay outside of the running cost system but certainly the bulk of the risk and, for example, Murray's defence examples will all be required initially to be absorbed within the existing budget of the organisation without supplementation. That does give some incentive to act responsibly in respect of risk because they will be expected to bear the cost within their own budget to the maximum extent possible.

CHAIR—Can I thank everyone for their attendance.

Resolved (on motion by Mr Causley, seconded by Dr Southcott):

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.

Committee adjourned at 11.34 a.m.