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Expectation, and Perception, of Better Practice Corporate Governance in the Public Sector from an Audit Perspective

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1. Introduction

I have been asked to speak today about the expectation, and perception, of better practice corporate governance in the public sector from an audit perspective. This is an important and timely topic that I will address by answering the following questions.

- What is the role of audit in encouraging better practice corporate governance?
- What is better practice corporate governance?
- To what extent is the public sector in Australia achieving better practice corporate governance?

The audit profession, and particularly external auditors such as the Australian National Audit Office (ANAO), are pivotal to the systems of checks and balances that support democracy in Australia. Both play valuable roles in providing assurance about compliance as well as about the effectiveness of actions taken to ensure robust governance arrangements.

Particularly through its extensive program of audits over the last decade, the ANAO has assimilated extensive knowledge about what it considers to be better practice corporate governance in the public sector. While there is some debate in academic literature about the nature of better practice corporate governance and its causal link to strong organisational performance, there seems to be a general consensus amongst auditors as to what constitutes better practice corporate governance, including a view that sound corporate governance processes will lead in most cases to good outcomes.

As I will discuss later in this address, the key to better practice corporate governance in the public sector lies in the effective integration of the main elements of corporate governance within a holistic framework, which are communicated effectively throughout the entire organisation and underpinned by a corporate culture of accountability, transparency, commitment and integrity. As the public sector is often perceived to be risk averse, a particular challenge is to strike an appropriate balance between performance and conformance, with all decisions made within a risk management framework that properly weighs potential benefits as well as potential costs. Importantly, a cultural change may be necessary to see risk as an opportunity as well as something to be minimised or avoided.

As Commonwealth Auditor-General, I audit virtually all Australian Public Service (APS) agencies annually, expecting them to comply with legislation and other controls and to reach the benchmark of better practice standards of governance that I have identified (and often reported in a range of private and public sector Better Practice Guides). While governance standards have been improving quite rapidly in the APS in recent years, Commonwealth organisations generally do not uniformly attain better
practice, which in itself is continually improving. As a consequence, I make many recommendations each year for improvements in corporate governance.

**What is corporate governance?**

A recent address\(^1\) reminded me of the origins of the term governance and its perpetual relevance. It originates from the Latin word ‘gubernator’, which itself relates to Greek helmsmen or ‘kubernetes’ who steered and directed ancient sea vessels. The role of the gubernator was not to row, nor to decide who would row, or in what combination they should row. The gubernator’s role was to steer the course. The prime definition of governance, therefore, is to steer or direct.

In recent times, governance, and particularly corporate governance (or the governance of organisations), has gone well beyond the requirement for steering or directing. It has become a multi-dimensional concept with no single accepted definition. However, I generally define corporate governance to encompass how an organisation is managed, its corporate and other structures, its culture, its policies and strategies, and the ways in which it deals with its various stakeholders. In many ways, corporate governance is a combination of legal and ‘better practice’ organisational structure and management requirements, aimed at facilitating accountability and improving performance.\(^2\)

I would like to emphasise that governance has a very broad reach in organisational behaviour – going well beyond management. Managing involves administrative, supervisory and facilitating tasks associated with on-going organisational operations. Executives and managers administer and lead organisations through developing business strategies, and implementing and monitoring them on a day-to-day basis. Boards and other governance structures deal with overall organisation policy, direction and culture. They provide the ‘tone at the top’ that is essential for sound corporate governance.

Whoever governs exercises ultimate authority within organisations and is finally held accountable for overall organisational performance by stakeholders. In essence, those who govern authorise what organisations do. Executives manage organisations by virtue of the authority delegated to them by those who govern.\(^3\) Thus, management is but one part of governance. You may be interested in an outline of responsibilities of the governing body in the corporate governance framework for the public sector provided by the International Federation of Accountants’ Public Sector Committee (see Figure 1).

In short, the main point is that effective governance makes management accountable to its many stakeholders, through appropriate management structures, reporting requirements, control structures, performance measures and the many other elements of corporate governance discussed later in this paper. As an auditor, my prime interest in corporate governance focuses on these accountability arrangements and how effectively they work in practice.
### Figure 1. Responsibilities of the Governing Body

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**Source:** Corporate Governance in the Public Sector: A Governing Body Perspective 2000. IFAC Public Sector Committee, July (page 18).

### The legislative framework

Comprehensive legislative structures regulate the activities of the Australian Public Service, of Chief Executive Officers (CEOs) and their staff. They may also impose obligations on client groups. The legal framework for governance in the APS is largely derived from three main sources:

- the Financial Management and Accountability (FMA) Act 1997;
- the Commonwealth Authorities and Companies (CAC) Act 1997; and
- the Public Service Act 1999.

The *FMA Act* mainly applies to entities that are financially and legally part of the Commonwealth and do not own their own assets. These are typically ‘core’ government departments responsible for policy development but also include statutory authorities. In August 2002, the *FMA Act* applied to 17 Departments of State, five Parliamentary Departments and 58 prescribed agencies. The *CAC Act* applies to more commercial ‘non-core’ government activities, including government business enterprises. These entities are neither financially nor legally part of the
Commonwealth, with their own bank accounts and assets. In August 2002, the CAC Act applied to 84 Commonwealth authorities and 28 Commonwealth companies.

The FMA Act requires CEOs to promote the efficient, effective and ethical use of Commonwealth resources for which they are responsible. It replaced voluminous and detailed rules and prescriptions with principles-based legislation. The main purpose of the Act is to provide a framework for the proper management of public money and public property. The Public Service Act 1999 sets out values and the APS Code of Conduct for Commonwealth employees.

Thus, legislatively, and in practice, the CEO is responsible for the administration of an agency. The buck stops with them, in most cases. And it would be fair to say that with the greater devolution of authority to agencies in recent years, the responsibilities on public sector CEOs have probably never been greater. Importantly, through the recent changes to the public and private sector legislative framework, the duties of directors and officers of CAC bodies more closely align with those of company directors. This has facilitated the flow of experienced directors between the two sectors and is enhancing the quality of Australian Boards.

The formal governance framework for corporate governance goes beyond the three Acts outlined above to include the broader constitutional powers affecting public sector powers, appropriations and responsibilities as well as supporting legislation such as Administration Arrangement Orders, the Remuneration Tribunal Act 1973, any enabling legislation of an organisation and other legislation outlined in Figure 2 following.

**Complexity of corporate governance in the public sector**

The literature on corporate governance insists that corporate governance frameworks must be tailored to each organisation as ‘one size does not fit all’. Differences in corporate governance relate to the complexity of entities in terms of the nature of their outputs and the type and range of stakeholders they are accountable to. As management is a component of governance, those organisations that are larger and more multifaceted are generally more challenging to manage, thus also increasing the complexity of corporate governance.

It should be stressed that marked differences are experienced between the governance of private and public sector entities. In the public sector, quite complex relationships can exist between those with primary accountability responsibilities, especially the Parliament, Ministers, the CEO and boards. Consequently, there can be far greater management complexity in terms of stewardship, accountability and legislative requirements than is the norm in the private sector. In addition, the public sector typically has more explicit and stringent value systems that emphasise legislatively based notions of ethics and codes of conduct. For example, as observed by Professor Richard Mulgan of the Australian National University:

> ...private sector companies operating under private law are not normally held to the same common law standards of rationality and
fairness that the public law imposes on government agencies under the principles of administrative law.\(^6\)

Corporate governance is, therefore, often relatively more straightforward in the private sector as the roles and responsibilities are more clearly defined and generally involve a narrower range of active stakeholders and simpler objectives.

This is less clearly the case for Government Business Enterprises (GBEs) and other CAC agencies that are subject to the Corporations Act, the CAC Act (and for Commonwealth GBEs, Governance Arrangements for Commonwealth Government Business Enterprises) even with the added complexity of Ministerial responsibilities and oversight. In contrast, publicly-listed private companies are subject to the Corporations Act (and not the CAC Act), and tend to have much more clearly defined and unambiguous Board accountabilities and responsibilities. CAC agencies are also often required to meet broader government policy objectives, such as delivering ‘value-based’ services, or prescribed services, to selected clients, in addition to meeting financial objectives. While convergence between the two sectors is lessening such differences, it nevertheless highlights the variations in modern governance demands across organisations.

The governance of agencies subject to the FMA Act, however, often differs significantly from that of private sector corporations. The FMA Act prescribes that CEOs of FMA agencies are ultimately accountable for the performance of the agency, generally making them effectively the CEO and Chairman of the Board, in the many cases where Advisory Boards are in place. In these cases, the Boards support the CEO rather than the CEO being held accountable by the Board. Instead, the CEO is responsible directly to the Minister, who is the shareholder or citizen representative, or ‘trustee’ in the view of some political commentators.

Figure 2: Formal governance elements affecting the Commonwealth and its bodies

Source: Department of Finance and Administration (2002)
Structure of paper

Against this background, my presentation covers four major areas of interest. The following section discusses the role of audit, particularly that of the Commonwealth Auditor-General, in encouraging better practice corporate governance in the public sector. It focuses on the audit mandate, key activities and value. Section 3 outlines what auditors generally consider to be better practice governance public sector governance. This includes the existence of the major elements of corporate governance and their implementation within a holistic framework. The section provides a more detailed discussion of selected aspects of better practice corporate such as boards, audit, the control framework including risk management, and performance monitoring. Section 4 compares my perceptions of current corporate governance performance in the public sector with these better practice benchmarks and illustrates particular strengths and areas with scope for improvement.

Not surprisingly, I will speak from a public sector perspective but will often make suitable comparisons with, and observations about, private sector experiences.

2. Audit role in encouraging better practice public sector corporate governance

The Commonwealth Government and all Australian state and territory governments have recognised the importance, and potential value, of audit in improving public sector governance. There is an Auditor-General in each of the States and Territories. Each has an Office to assist in the conduct of a range of performance and financial statement reports. Most offices, such as my own, have been established to undertake the full range of audit activities to provide assurance to the Parliament as well as to assess and suggest improvements to public sector administration through performance audits.

The mandate of public sector auditors in Australia is set out in legislation and varies across the States and Territories and the Commonwealth. My position as Commonwealth Auditor-General is currently enshrined in the Auditor-General Act 1997. The Act establishes the Auditor-General as an ‘independent officer of the Parliament’ – a title that symbolises the Auditor-General’s unique relationship with the Parliament and represents an essential element of our system of democratic government. Public reports from the Auditor-General provide vital assurance as to the transparency and accountability of public sector operations, as well as providing guidance and leadership in relation to basic elements of good governance.

The Auditor-General’s mandate extends to all Commonwealth agencies, authorities, companies and subsidiaries with the exception of performance audits of Government Business Enterprises (GBEs). Performance audits of wholly owned GBEs may only be undertaken at the request of the responsible Minister, the Finance Minister or the Joint Committee of Public Accounts and Audit (JCPAA).
Commonwealth legislation also requires its agencies to have an internal audit function. These requirements go well beyond the standards required in the private sector in Australia, where even publicly listed companies are not legally required to have internal audit functions and where external auditors do not undertake performance audits. The internal auditing function of an organisation plays an important role in examining and reporting on control structures and risk exposures and on the agency’s risk management efforts to the agency governance team.

**The role of audit in improving corporate governance**

In an environment of increasingly high expectations of corporate governance in both the public and private sectors, managers need access to information on better practice leadership, management and control structures and performance measures to reach the common and ambitious proxy target of ‘world’s best practice’. Public sector audit has an important role to play in supporting such practices and therefore contributing to a world class public service. However, there is the added obligation to ensure that audit opinions, recommendations and other related information are fully explained to all stakeholders, particularly to an audit committee and the general public, who are entitled to quality explanations of management and audit approaches, judgements and decisions that are clear and transparent.

The main roles for Commonwealth and State Auditors-General in the governance framework are to provide assurance about conformance and performance and advice on change and its impacts across the public sector. This advice draws on a broad range of audit experiences, which may range across both the public and private sectors. The statutory independence of the Auditor-General, as well as access to expertise across all Commonwealth departments and agencies, gives public audit a unique position within the accountability framework. In this regard, the ability of the Auditor-General to investigate and report, freely and fearlessly, is crucial.

Like its counterparts in the Australian States and overseas, the ANAO is engaged in identifying areas of risk, and opportunities for improvement, in setting our strategic agenda. This approach allows us to target areas of most interest and value to the Parliament, the Government and the APS. We remain responsive to the needs of a changing public sector and endeavour to ensure that better practice and lessons learned in individual agencies both in Australia and overseas are disseminated across the APS. In recent years, we have responded to the increasing trend towards New Public Management (NPM) with a series of products focussing on the challenges and opportunities inherent in the NPM approach. Recent audits have covered, among other things, outsourcing, asset sales, contract management and networked service delivery.

However, I cannot overstate the fact that the ANAO, and all other external public sector auditors, operate in an advisory capacity, rather than participating directly in decision-making by public sector managers. While I urge my officers to ‘stand in the managers’ shoes’ in order to understand the complexities of the particular business environments under review, it is for the managers themselves to decide whether or not they will act on ANAO or other advice with reference to their particular risks and opportunities.
In other words, the mere existence of independent auditors will not save agencies from the impacts of poor management or, indeed, companies from collapse. Nevertheless, recent corporate failures have focussed particular attention on audit independence and an elevation in the role and importance of audit committees, discussed later. The following are three key elements in the financial reporting framework:

- sound corporate governance by those charged with this responsibility;
- compliance with financial reporting requirements; and
- the role of independent auditors.

Each is essential for sound performance and accountability. Their relative strength, or weakness, will have significant implications for the organisation. As noted in a recent legal update on corporate governance:

*It is clear that the most rigorous and independent audit will not save a company with poor management and business practices from insolvency.*

In short, the role of audit is crucial to encouraging better practice corporate governance. The ANAO has produced a set of principles and better practice for corporate governance in both the core public sector, broadly covered by the FMA Act, and in Commonwealth authorities and companies, covered by the CAC Act. We are currently doing research aimed at updating better practice guidance in these areas.

It is our aim to ensure that ANAO audits will continue to encourage that improvement in the APS. As technology changes, as services change, and new ways of delivering services are introduced, so our auditing methodologies and practices will adapt. What will not change is our commitment to improving public sector performance and accountability.

**External audit services and products**

Public sector external auditors in Australia typically provide two main roles. I will illustrate their nature and importance by reference to the ANAO. Our first aim is to provide independent assurance. This is the more traditional ‘watchdog’ audit role. Our second role is to review performance and suggest improvements to public administration. Increasingly, it is this second, advisory, role that is most important for a public sector, which, in the proper pursuit of greater efficiency and effectiveness is challenged by diverse governance issues that are growing in complexity.

**Assurance auditing**

The Auditor-General conducts financial statement audits to express an opinion on whether financial statements of Commonwealth Government entities have been prepared in accordance with the Government’s reporting framework and give a true and fair view, in accordance with applicable Accounting Standards and other mandatory professional reporting requirements of the financial position of each entity.
as at year end, and the results of the entities’ operations and the entities’ cash flows for
the year then ended.

In addition to the audit opinion on the financial statement, the ANAO provides each
audited entity with a report that deals with the results of the financial statement audit
process. A report on the outcome is also provided to the responsible Minister. The
ANAO also now provides two cross-entity assurance reports each year to Parliament.
The first details the results of an assessment of the control structure of major entities\textsuperscript{11} while the second provides a summary commentary on the results of all financial
statement audits undertaken in the 12-month audit cycle ending in October of each
year.\textsuperscript{12}

One issue concerning assurance audits in the public sector is that of materiality. It has
to be recognised that financial statement audits aim to detect only material errors or
misstatements. Materiality is the technical term for the threshold for determining the
seriousness with which auditors regard omissions or misstatements in financial
statements. To aim to detect all errors or misstatements would be cost prohibitive.

An analysis of materiality assists us in setting our strategic audit approach from year to
year. Materiality is particularly important in relation to the issue of fraud or waste of
taxpayers’ funds, which is of concern to our stakeholders, especially Parliament, and
consequently is an ongoing focus for our work. The ANAO takes a risk-based
approach to the identification of fraudulent behaviour across the whole of government.
There is no guarantee that we will detect all incidences of fraud. However, we aim to
ensure that our approach gives us adequate coverage of areas of risk.

For 2001-02, the level of materiality adopted by the ANAO in planning for the
Consolidated Financial Statements audit was approximately 5 per cent of the average
Net Results for the Consolidated Financial Statements over the previous 3 years, or
$400m. It has to be said that this is a figure that creates some unease among a number
of Parliamentarians. We are attuned to this concern, and do our best to mitigate it by
ensuring we ‘keep our eyes and ears open’ with judicious additional review as is
deemed necessary for reasonable assurance.

**Performance auditing**

The *Auditor-General Act 1997* defines a performance audit as a ‘review or
examination of any aspect of the operations of a body or person’. The Explanatory
Memorandum to the Bill expands on the definition by saying the aim of a performance
audit is to:

*examine and report to the Parliament on the economy, efficiency
and effectiveness of the operations of the administration of the
Commonwealth and to recommend ways in which these may be
improved.*\textsuperscript{13}

In accordance with accepted auditing practice, performance audits are an independent,
objective and systematic examination of the operations of a body for the purposes of
forming an opinion on whether:
• the operations have been managed in an economical, efficient and effective manner;
• internal procedures for promoting and monitoring economy, efficiency and effectiveness are adequate; and
• improvements might be made to management practices (including procedures for promoting and monitoring performance).

ANAO performance audit reports are tabled in the Parliament. The ANAO has an annual target of 50 performance audit products, and produced 57 such reports during the 2001-02 financial year. Performance audits are conducted in all ministerial portfolios with the main concentration being directed to portfolios with significant Government outlays or revenues. All recent performance audit reports are also placed on the ANAO’s homepage at http://www.anao.gov.au, and summarised in the ANAO’s series of six-monthly activity reports which are tabled in Parliament.¹⁴

The level of assurance is also important for performance audit reports, as it relates to the degree of confidence that can be obtained from such audit opinions and reports. Performance audits often involve assessments of governance, probity and the quality of management in individual entities. While the auditor’s professional opinion in these cases is derived from compliance with rigorous standards and therefore provides a high level of assurance, it does not provide complete assurance as to the entities’ operations. This ‘expectation gap’ is a complex issue that challenges the profession as much as it challenges our stakeholders.

In considering whether performance audits should be legislatively enforced in the private sector, KPMG¹⁵ recently noted that there would first need to be reform to the liability requirements under which auditors in Australia operate (ie. either joint and several liability or unlimited liability).

**Audit product continuum**

In practice, the audit environment is more complicated than simply requiring performance and assurance audits. The ANAO attempts to provide an audit product continuum as a strategic approach to better governance. We fill the gaps between high-level performance audits and traditional financial statement audits with Better Practice Guides, AMODEL (financial reporting for agencies and statutory authorities) and Business Support Process Audit reports on a range of issues challenging the contemporary APS. Our reports are treated as authoritative. Our annual audit of the Consolidated Financial Statements and our assessment of agency control structures, for example, provide a unique overview as to the ongoing financial performance of over 200 Commonwealth entities.

For the ANAO, a key issue is getting the balance right between control and innovation.¹⁶ The aim is to get the ‘right mix’ of products and services to enhance governance. In setting its agenda for the future, the ANAO relies on intelligence garnered through the review and analysis of Commonwealth entities as well as ongoing
feedback and guidance from the Parliament and other audit clients as to the areas they see as adding most value to public administration.

I would also like to note that, under the Auditor-General Act 1997, I am required to set auditing standards with which individuals performing Auditor-General functions must comply. This gives the ANAO the flexibility to set its own agenda and to develop appropriate auditing tools for the contemporary environment. In setting the standards, I acknowledge the commonality of professional requirements between private and public sector auditors and, as such, the ANAO auditing standards are formulated with regard to the auditing standards issued by the Auditing and Assurance Standards Board of the Australian Accounting Research Foundation. Consistency with international standards, including the International Organization of Supreme Audit Institutions (INTOSAI) Auditing Standards, and those of the International Auditing and Assurance Standards Board of the International Federation of Accountants is also a consideration. My deputy is currently a member of both the national and international auditing standards boards.

3. Audit expectation of better practice public sector corporate governance

What is better practice corporate governance?

As I stated earlier, there is a strong consensus view from the audit profession about the nature of better practice corporate governance in the public sector. This involves integrating the main elements of corporate governance within a framework that best suits the objectives, legislation and operating environment of each agency. Moreover, it requires the application of effective corporate governance principles (including soft controls) by the management and staff within each organisation to implement the designated corporate governance frameworks, controls and guidelines.

Corporate governance framework and elements

As such, the elements and principles of good corporate governance can be applied within corporate government frameworks that may differ considerably according to the size, complexity, structure and legislative background of the organisations concerned. The Queensland Audit Office has identified several governance frameworks that apply to the diversity of public sector entities, including Departments; Statutory Bodies; Government Owned Corporations; Local Authorities; and Aboriginal and Island Councils. The Commonwealth can make similar distinctions, most notably between entities subject to the FMA Act and the CAC Act and GBEs.

The Queensland Audit Office has also provided a useful model to explain the corporate governance framework for public sector entities, irrespective of their particular circumstances and legislative basis (see Figure 3).
Figure 3 demonstrates that each public sector entity has an officer, be that person the CEO or Chairman of the Board, accountable to a Minister and Parliament for achieving the stated corporate objectives and also receiving input from the Minister and Parliament about the content and pursuit of those objectives. The Queensland Audit Office then distinguishes between an organisational framework, relating to management structures and standards, and an accountability framework focussed on controls, including external accountability. By necessity, there is some overlap between the elements of these management and accountability structures, as many elements, such as assurance audit and performance reporting, serve both roles.

It is fair to say that most agencies have put in place many of the elements of good corporate governance. These include corporate plans setting out corporate objectives and strategies; public sector and/or agency values; business planning; audit committees; control structures, including risk management; performance assessment; and performance monitoring (including evaluation and review).

Figure 4 presents this perception of corporate governance diagrammatically. It illustrates the inter-relationship between all the elements of governance and thus the need to integrate them effectively in order to achieve good governance. It also indicates the difficulty of balancing all these elements at any point in time, and over time, to provide the appropriate mix of conformance and performance (discussed later in this section).

There are other ways to represent corporate governance in the public sector. Again, this reflects the complexity of the governance framework and the diversity of approaches taken by individual public sector entities. Regardless of which particular framework is used, good corporate governance in both the public and private sectors at least requires:

- a clear identification, and articulation of, the definitions of responsibility;
- a real understanding of relationships between the organisation’s stakeholders and those entrusted to manage its resources and deliver its outcomes; and
- support from management, particularly from the top of an organisation.

I will now elaborate on these and other related requirements and the ways in which they might be implemented.

**Key principles that enable effective corporate governance**

The frameworks for corporate governance in the public sector can only be implemented effectively through the application of key corporate governance principles. As the Queensland Audit Office notes:

*These principles are essentially common management tools drawn together into a logical, inter-related system focussed on achieving results.*

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Source: Barrett, P 2002.
Through the findings of audits undertaken by the ANAO, and by examining the corporate governance literature, we can identify six main principles that public sector entities must adhere to in order to apply effectively the various elements of corporate governance to achieve better practice governance. Three of these elements – leadership, integrity and commitment - relate to personal qualities of those in the organisation. The other three elements – accountability, integration and transparency – are mainly a product of strategies, systems, policies and processes in place.

Effective public sector governance requires leadership from the governing Board and/or executive management of organisations, particularly the CEO. An effective framework requires clear identification and articulation of responsibility and a real understanding and appreciation of the various relationships between the organisation’s stakeholders and those who are entrusted to manage resources and deliver required outcomes. In the public sector, this necessitates lucid and unambiguous communication with the Minister and clearly stated government priorities.

Concern has been expressed that there has been more emphasis on the form rather than the substance of good corporate governance in both the public and private sectors in Australia. I want to stress that better practice public sector governance requires a strong commitment by all participants to effectively implement all elements of corporate governance. An effective framework is very much people oriented, involving better communication; a more systematic approach to corporate management; a greater emphasis on corporate values and ethical conduct; risk management; relationships with citizens and clients; and quality service delivery.

Integrity is based on honesty and objectivity, as well as on high standards of propriety and probity in the stewardship of public funds and the management of an agency’s affairs. It is dependent on the effectiveness of the control framework and on the personal standards and professionalism of the individuals within the agency. Integrity is reflected in the agency’s decision-making practices and procedures and in the quality and credibility of its performance reporting.

Accountability is fundamental to our democratic system of government. The principles of corporate governance require those involved to identify and articulate their responsibilities and their relationships; consider who is responsible for what, to whom, and by when; acknowledge the relationship that exist between stakeholders and those who are entrusted to manage resources; and deliver required outcomes. It provides a way forward to those, whether in the public or private sectors, who find themselves in somewhat different relationships than perhaps they have previously experienced. Hence, a clear understanding and appreciation of the roles and responsibilities of the relevant participants in the governance framework, importantly, those of the responsible Minister(s), Board and CEO, are key components of sound accountability.

The ‘privatisation’ of the public sector, including as part of New Public Management, involves less direct relationships between stakeholders and service providers, and greater flexibility in decision-making. As well, it strengthens the need for accountability, regardless of the manner in which that is determined. In this regard, the Joint Committee of Public Accounts and Audit (JCPAA) rejected GBE arguments that
the accountability requirements of the *CAC Act* created additional compliance costs compared to private sector counterparts and was therefore inconsistent with competitive neutrality provisions. The JCPAA stated that, where public money is concerned, there is a need for additional accountability to Ministers and the Parliament and, in view of the significant responsibility involved, was not prepared to recommend any relaxation of the accountability requirements applying to GBEs.²²

Openness, or equivalent transparency, involves providing stakeholders with complete confidence regarding the decision-making processes and actions of public sector agencies in managing their activities. Being open, through meaningful consultation with stakeholders and communication of complete, accurate and transparent information, leads to effective and timely action, thus enhancing the processes of scrutiny. Such transparency is also essential to help ensure that public bodies are fully accountable and is therefore central to good governance overall. Future trends will probably require greater transparency, as the use of the Internet and other electronic media will aid continuous disclosure, particularly of financial performance.

As I have just stated, the real challenge for corporate governance is not simply to define the various elements of effective corporate governance but to ensure that they are holistically integrated into a coherent corporate approach by individual organisations and well understood and applied throughout those organisations. If implemented effectively, corporate governance should provide the integrated strategic management framework necessary to achieve the output and outcome performance standards required to fulfil organisational goals and objectives. These are of increasing audit interest in a more results oriented public sector.

It is important to appreciate that information is the currency of good governance which underlies both the principles and frameworks of corporate governance. Therefore, it is important that public sector entities develop quality information systems that communicate widely corporate objectives and the plans and strategies to achieve them.

**Values and ethical framework**

Another foundation of corporate governance is the ethical framework in place. Good corporate governance is based on a clear code of ethical behaviour and personal integrity exercised, and shared, by any board, management and staff and communicated openly to stakeholders.

Ethical structures provide a basis for the CEO to have confidence that there is consistent ethical behaviour at all levels of the agency and that the agency and its employees:

- comply with public sector standards, codes of ethics and applicable codes of conduct;

- act with integrity in the performance of official duties and ensure due process in the use of official information, equipment and facilities;

- exercise consideration and sensitivity in their dealings with members of the public and employees; and
• identify and deal with any real or perceived conflict of interest.

This ethical framework flows from peak public service values, obligations and standards, which in turn are derived from legislation, policy and accepted public service conventions. At the Federal level, the new public service values are a key element in the Government’s public sector reform program and have been included in the Public Service Act 1999. Regulations require agency heads to integrate these values into the culture of their agency. Guidance has been provided to ANAO auditors for identifying both ethical and non-ethical behaviour. Nevertheless, as might be expected, it is a difficult area for audit review and opinion.

The NSW Independent Commission Against Corruption (ICAC) has examined research into the drivers of organisational behaviour and found that the overwhelming influence on unethical behaviour were:

- their managers behaved unethically;
- organisational values are unclear;
- ethical behaviour is not rewarded;
- sanctions for unethical behaviour are unclear; and
- there is no practical ethics training.

In short, the ICAC considers that unethical, or conversely ethical, behaviour is influenced more by leadership practices or the ‘tone at the top’ than the ethics and morals that an individual brings into an organisation. This underlines the importance of promoting and demonstrating ethical work practices in order to improve the effective functioning of an organisation. It is necessary to combine and effectively communicate clear ethical leadership with strong, clearly stated values and Codes of Conduct to achieve an ethical culture (or ‘organisational integrity’).

**Effectively implementing some important elements of corporate governance**

Many of the principal elements of corporate governance have received increased media and public focus, given the recent corporate collapses and consequent attention being given to the role of corporate governance. Most of these issues also emerge as common topics for discussion in ANAO audit reports. On this basis, I will discuss:

- the role of boards;
- audit committees and audit independence;
- the control environment – including risk management;
- performance reporting; and
- the nexus between performance and conformance.
Public Sector Boards

Before discussing Board performance, I would again like to emphasise the differences between boards in the private and public sectors and within the public sector. Boards of agencies subject to the CAC Act, and particularly of GBEs, are most similar to those in the Australian private sector, where the CEO reports to the Board, which in turn is accountable to either a Minister and/or shareholders, respectively. Professor Bryan Horrigan of the University of Canberra has provided a very lucid discussion of different models of private and public sector boards.24

The FMA Act, applying basically to the core public sector, confers legislative responsibility only on a CEO for the efficient, effective and ethical use of resources. Therefore, in the absence of legislation to the contrary, boards established by agency CEOs are only advisory, with the CEO retaining legislative responsibility for the administration of the agency. Many Budget-funded agencies have such Executive Boards, which nevertheless provide a cornerstone for building, or renewing, corporate governance of the agency. The latter is very much at the prerogative of the CEO in such situations. A public sector model discussed by Professor Horrigan is illustrated in Figure 5 following.

**Figure 5: Boards – Public Sector Model**

In some cases corporate governance arrangements are set out in Strategic Partnership Agreements which may be oversighted by a committee or board.

A good example of the latter was illustrated in a recent audit report on ‘The Strategic Partnership Agreement between the Department of Health and Ageing and the Health
Insurance Commission (HIC). The Agreement is oversighted by a joint Senior Management Committee that exercises a leadership role. As the report notes:

*The Strategic Partnership Agreement (SPA) incorporates essential elements of a governance framework for the relationship, including joint management structures, a performance monitoring and reporting framework, and protocols for communication between the policy agency and the administrative agency.*

The ANAO found that the governance framework, envisaged in the SPA, generally acts to support the co-ordinated delivery of Medicare and PBS services to users. In particular, the Management Committee regularly considered matters of strategic importance to the Health – HIC relationship. The overriding principle is to ensure an open, collaborative partnership and joint commitment to implement Government health programs.

Where Executive or Advisory Boards exist, they should be concerned about both performance and conformance issues. If boards are to add value, they must involve themselves actively and regularly in the functions of strategic planning and risk management. Thus, the Board should be primarily responsible for strategy formulation, strategic analysis and internal policy making. While the Board should not be involved in operational management, it should initiate links across program, functional or business units and actively seek out and/or endorse opportunities for adding corporate value to the agency. As well, it should set the tone for the corporate culture, along with the CEO.

In order to attain high-performing boards, Jane Bridge identified the following two critical strategies:

- develop the best possible arrangements for corporate governance; and
- find the best possible members for the board and treat them accordingly.

While these strategies are easily specified, there are many practical issues to address in their successful implementation. Nevertheless, they focus attention on two challenging issues.

**Developing effective governance structures for the board**

The complexity of public sector governance often generates tensions arising from the interaction between Ministers, Boards and the CEO. To minimise these tensions, and to allow the board effective control over the organisation it is governing, Jane Bridge also indicates that:

> it is critical that the relationship between the board, the Minister, the CEO and the central agencies is well defined and the arrangements.

In order to clarify board roles and responsibilities they need to be:
• defined in legislation;
• clarified in guidelines, charters or a Memorandum of Understanding; and
• defined with respect to;
  — appointment of board members, the chair and the CEO;
  — decision making and control; and
  — reporting arrangements.30

It does help if enabling legislation clearly identifies and defines the roles and responsibilities of all participants. However, as this often does not occur, Board charters are becoming more common in assisting to clarify the roles of Executive Boards and their members.31 In doing so, such Charters or equivalent documents can document procedures to deal with tensions created by legislation. An example may be where ministerial direction is inconsistent with obligations under the FMA Act to manage agencies affairs in an efficient, effective and ethical way.32 A further example is where the duties of directors under the CAC Act are not expressly modified to account for ministerial directions, community service obligations and other public accountability mechanisms.33

**Board independence**

Ensuring the independence of the board from management is crucial to developing effective board structures and operation. This is important in the core public sector – to determine whether board members who are likely to be also managers can sensibly be expected to report openly on what is effectively their own management performance - and be seen to be doing so by those to whom they are accountable. The Canadian Joint Committee on Corporate Governance34 identified the following four conditions that can materially assist boards in developing a culture that provides opportunity for both directors and management to feel comfortable when management positions are challenged:

• strong board members who are independent of management, provided with appropriate orientation, and who bring an appropriately diverse set of experiences, competencies, skills and judgment to the board;

• strong leadership within the board from an outside director;

• a CEO who understands the role of the board and is openly supportive of building a healthy governance culture; and

• regular meetings of the outside directors without management to build relationships of confidence, and cohesion among themselves.

The Joint Committee also noted35 that some boards are more advanced than others in developing a culture in which the board can act independently in carrying out its responsibilities. Where there are deficiencies in the four conditions noted above, or in any other conditions that compromise the independence of the board, appropriate
actions should be taken to remedy them. It is important to be pro-active rather than re-active in such situations.

In summary, the board’s relationship to management is critical to healthy governance. It is a relationship that must continue to be maintained in a positive, complementary and supportive manner. What is required is a common (shared) appreciation by management and the board of their respective roles, a mutual respect for each party in carrying them out, continuing open dialogue and communication, and strong leadership within the board.

Selection and remuneration of board members

The literature on board performance places great weight on selecting appropriate directors and, particularly in the private sector, the CEO. It also advocates choosing board members who are multi-skilled, experienced in a variety of business areas, prepared to update their knowledge, and be flexible and analytical, as well as being prepared to monitor and assess their individual or collective capabilities and performance.

In the current climate of major corporate failures both internationally and in Australia, a common identified cause has been a lack of effectiveness of board members. This can arise for a number of reasons, including: the dominance of individual Directors or the CEO; inappropriate selection, skills, induction and training; lack of performance assessment and reporting; and/or a lack of independence of directors.

However, recent research undertaken to update the ANAO’s Better Practice Guides on Corporate Governance, has revealed more concern by CEOs and board chairmen of FMA and CAC agencies with the process for selecting Board Members than with the composition or mix of directors. While there may be opportunities provided for the chairman of the board to input to the selection of directors, the ultimate selection is often made by the Minister or Ministers. There may be scope to increase the involvement of the board chairman in the process, for example, to more fully take into account the likely mix and interaction of directors as part of a cohesive team.

Another issue that has been raised during this research is the remuneration of board members, with many examples provided of directors and chairs receiving relatively minimal remuneration for the effort and value they provide. This is an issue that may be given more attention in future discussion between government organisations and the Remuneration Tribunal, or equivalent system for setting rates of pay for directors of government boards. This is a policy matter outside the audit purview.

Performance of Boards

Directors need to assess, and contribute to, the effectiveness of the board. This promotes greater accountability of the board and individual directors; may identify weaknesses in the board skill-set; and, hopefully, may build a more collegiate approach. One effective mechanism is the implementation of a ‘corporate governance
health check’, that is, a formal annual board review with the introduction of formal performance measures. There are advantages in using an independent facilitator to assist with this process. According to Korn/Ferry International\textsuperscript{36}, the five important criteria which Australian boards regard as essential for evaluating board performance, are:

- an understanding of the company’s mission and strategic plan;
- a comprehension of the organisation’s business;
- a willingness to challenge management when required;
- a willingness to appraise the chief executive; and
- the special expertise that board members have to add value to the company.

The Canadian Joint Committee on Corporate Governance broadly supported this view, stating that:

\textit{regular assessment of the board’s effectiveness, and the contribution of individual directors, is essential to improve governance practices. The governance system should include a process for the evaluation of the work of the board, its committees, and individual directors.}\textsuperscript{37}

Professor Scissons, Vice-President of PSA International Consultants, has pointed out the difficulties inherent in undertaking governance reviews of Boards and CEOs and the often simplistic and inadequate measurement methods that are commonly used.\textsuperscript{38} He argues that more care and effort is often required in such reviews in order to receive any real value from the exercises. He advocates improvements to existing techniques, particularly, behaviour rating scales, 360-degree feedback techniques, self-assessment, selecting output and productivity measures and qualitative approaches.

**Conflict of interest of directors**

The ANAO’s recent research on Corporate Governance, referred to earlier, has also revealed that conflicts of interest by board members are one of the main corporate governance challenges facing public sector agencies, and for which there are apparently few available relevant protocols. These conflicts of interest occur most frequently regarding:

- technical advice from external independent directors on agriculture, industry or scientific boards;
- other public service representatives, especially from the portfolio agency; and
- directors with associated business interests.

A particular issue arose in the ANAO’s report on Magnetic Resonance Imaging Services\textsuperscript{39} dealing with a potential conflict of interest involving the then ex-Chairman of the Health Insurance Commission Board. The ANAO suggested that there would be considerable merit in the Board’s Charter anticipating, and providing for a system of dealing with, any conflict of interest involving a Board member.\textsuperscript{30}
The ANAO intends to produce protocols to address the issue of conflict of interest in the updated Better Practice Guide on Corporate Governance scheduled for release early next year.

**Audit committees and audit independence**

As I mentioned earlier, many recent corporate collapses (particularly Enron in the United States and HIH in Australia) have stimulated debate about the role of audit committees and the independence of auditors.

**Audit committees**

An effective audit committee, as a crucial component of corporate governance, provides a complementary vehicle for implementing relevant control systems incorporating sound risk management plans. It can assist CEOs and boards meet their statutory and fiduciary duties by: overseeing risk management; reviewing accounting and reporting structures; monitoring internal controls and performance; and ensuring compliance with controls. An effective audit committee can also improve communication and coordination between management and internal, as well as external, audit. There is no shortage of better practice guides for audit committees.\(^{41}\)

An audit committee’s strength is its demonstrated independence and power to seek explanations and information, as well as its understanding of the various accountability relationships and their impact, notably on financial performance. In particular, it can ensure that accepted audit recommendations are followed up and properly actioned, which greatly improves both internal and external audit effectiveness.

In my view, the questions about possible conflicts of interest, audit rotation and selection of auditors are central to the roles and responsibilities of audit committees as part of the corporate governance framework. One challenge is, therefore, how to strengthen those roles to enhance Committees’ effectiveness and credibility in the eyes of both internal and external stakeholders.

As with Executive Boards and/or Boards of Management, it is important that audit committees select appropriately qualified members and rotate them on a regular, ongoing basis. According to Hunt & Carey, essentials of an audit committee member include common sense, wide experience, good judgement, a general understanding of the role of an audit committee, healthy scepticism, an ability and willingness to ask difficult questions that challenge management’s actions and not to put up with unintelligible ‘techno speak’\(^{42}\).

I agree with the Canadian Joint Committee\(^{43}\) that audit committees should adopt a formal written mandate that is approved by the board and that sets out the scope of the committee’s responsibilities. Such a formal agreement should charge the audit committee with the responsibility to provide a formal sign-off on issues relating to audit independence to the Board. Central to such responsibility is an imperative to be informed about audit issues, including the work of both internal and external audit, as well as being in a position to assess both management and audit performance.
In its submission to the JCPAA Review of Independent Auditing by Registered Company Auditors\textsuperscript{44}, the ANAO noted that the integrity of the audit committee could be strengthened with legislative support. The ANAO observed enhanced corporate governance in the public sector arising from the stronger role being adopted by audit committees’, including audit committees having independent members that bring external views and experience to committee meetings.

In addition, the ANAO supports due consideration being given to Ramsay’s recommendations that the audit committee:

- comprises a sub-committee of the full board made up of non-executive directors, that appropriately represents the breadth of activity undertaken by the business;
- is responsible for recommending the Board approve the financial reports;
- actively reviews the accounting standards that may effect the financial reporting processes or requirements of the entity;
- actively reviews the operations and recommendations generated by the internal and external audit functions; and
- appoints and advises the Board on the adequacy of remuneration of external auditors.

**Audit independence**

I will briefly discuss the important aspect of audit independence, beginning by outlining its importance in the public sector, then discussing arguments pertinent to both the public and private sectors, in the wake of recent corporate collapses in both the United States and Australia.

I noted earlier that, in today’s environment, my role includes providing independent assurance on the performance, as well as the accountability, of the public sector in delivering the government’s programs and services and implementing effectively a wide range of public sector reforms. I cannot overstate the importance of the independence of the Auditor-General in this respect. As the public and private sectors converge; as the business environment becomes inherently riskier; and as concerns for public accountability heighten; it is vital that Auditors-General have all the professional and functional freedom required to fulfil, fearlessly and independently, the role demanded of them by Parliament.

The debate over audit independence is not new. Audit bodies and the accounting profession worldwide have been actively engaged in clarifying and reinforcing independence for many years. However, recent events have put the debate on to a different plane with higher level expectations being generated. While the ANAO takes a professional interest in this ongoing debate, it is also set apart from it by virtue of its statutory and functional independence. Nevertheless, there is also an operational imperative with the ANAO outsourcing a not insignificant proportion of its audit work to private sector accounting firms. As well, with the increasing use of such firms by the public sector for internal audit, we are often dependent on their work in coming to an
audit opinion on organisations’ control environments and financial statements. Under these standards, we of course have to be satisfied as to the quality of that work.

In Australia, scrutiny of auditor independence has included the Ramsay Report45, the main output of a Federal Government inquiry into the state of audit independence in Australia. The findings and recommendations from this report are currently being examined by the JCPAA at its inquiry into this topic, previously referred to. The JCPAA is examining whether government should intervene to regulate the auditing profession and will report by early October.

The Ramsay Report, which was released in October 2001, foreshadowed the current high-profile focus on audit independence worldwide.46 The report recommended that the Corporations Act 2001 be amended to include a general statement of principle requiring auditors to be independent. It also recommended that an independent supervisory board, the Auditor Independence Supervisory Board (AISB) be established to monitor implementation of, and compliance with, the new regime and international developments in relation to auditor independence. It was envisaged that the AISB would benchmark to test the adequacy of internal systems and processes of Australia’s largest auditing firms. In particular, the wide range of personal, business and financial relationships that may arise between an accounting firm and its audit client came under focus. The report’s aim was for Australia to continue to work towards achieving an audit regulatory environment that is in step with international standards.

The ANAO supports the Ramsay Report recommendation that the auditor should make an annual declaration, addressed to the board of directors, that the auditor has maintained his/her independence in accordance with the Corporations Act 2001 and the rules of the professional accounting bodies. I should note that, pursuant to that Act, the Auditor-General is a registered company auditor.

Following on from the Ramsay Report, the Treasurer recently announced a process that will review audit regulation and wider corporate disclosure frameworks as part of the Government’s Corporate Law Economic Reform Program. The first stage of this process will be the imminent release of an issues paper addressing the Ramsay Report as well as a number of other issues relevant to financial disclosure. The issues paper will consider a range of audit quality issues including a review of oversight structures for the profession as well as auditing standards, analyst independence, the disclosure framework, shareholder participation and enforcement issues. The issues paper will be the first phase in a public consultation process leading to the introduction of new legislation in Parliament in 2003.47

While the debate will continue amongst the profession worldwide, the issue of audit independence will come under further scrutiny in Australia with the JCPAA’s current review of this issue. There have been early signals that the review will have a significant impact, with the Chairman of the JCPAA commenting that:

*comprehensive and broad-ranging reforms are required. There has been too much tinkering at the edges in the past.*48
The ANAO covered audit independence, and a number of other relevant issues, in its submission to the JCPAA review. Some of the issues raised, including suggestions for the way forward included:

- underlining the independence of auditors in statute;
- improving the disclosure of ‘other services’ provided by auditors;
- encouraging the profession to tighten current guidelines on ‘other services’ work that auditors are able to undertake; and
- encouraging the wider involvement within the profession of users and preparers of financial statements and reports, particularly in the setting of auditing standards and guidelines.

These options for enhancing the independence of auditors may be pursued under the current co-regulatory model or through other forms of statutory, or non-statutory regulation. The ANAO favours an approach to improving the audit of companies via principle-based standards and policies, rather than relying on restrictive technical prescriptions. The ANAO considers that caution is warranted in the over-use of prescriptive legislation and standards that may place unnecessary restrictions on the profession to the detriment of the quality, and efficient conduct, of the audit. Principle-based standards and policies can adequately encapsulate the intention of the standard setters and regulators. As a result, where standards and regulations are principle-based rather than rule-based, it is more difficult to introduce schemes that are designed to manipulate financial results.

The Statement of Auditing Standards AUS 1 requires an auditor not only to be independent, but also to appear to be independent. For the purpose of this Statement:

(a) actual independence is the achievement of actual freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure; and

(b) perceived independence is the belief of financial report users that actual independence has been achieved.

While the Statement of Auditing Practice provides guidance to auditors when considering independence, the recently released Professional Statement F1, entitled ‘Professional Independence’ addresses the principles of independence. This standard will be mandatory from 31 December 2003.

**Independence and the profession**

As a result primarily of the Enron collapse in the United States, we have seen the acceleration of the separation of audit and consulting activities in major accounting firms. Private firms in Australia are responding to these challenges in a number of ways, with PricewaterhouseCoopers recently establishing an independent board to oversee the firm’s audit standards, quality and independence whereas Ernst & Young has stated the preference for ‘embedding strict quality control procedures in the culture
of the firm rather than necessarily having an oversight board. KPMG Australia has recently set up an ethics and conflicts committee in response to public concerns over the auditing profession at large.

The issues relating to independence are difficult and are still to be resolved. The need for active ongoing discussion is clear. As the United States Panel on Audit Effectiveness noted in its review of the current audit model:

*Independence is fundamental to the reliability of auditors’ reports. Those reports would not be credible, and investors and creditors would have little confidence in them, if audits were not independent in both fact and appearance. To be credible, an auditor’s opinion must be based on an objective and disinterested assessment of whether the financial statements are presented fairly in conformity with generally accepted accounting principles.*

In this respect, it is worth noting that President Bush signed the *Sarbanes-Oxley Act 2002* into law on 30 July, thereby introducing new laws dealing with corporate governance and disclosure, auditor independence and accounting reform. Some requirements include that: audit committees be composed of independent directors; that lead audit partners rotate every five years; and restrictions on auditors providing non-audit services to a public company contemporaneously with an audit.

The United States Securities and Exchange Commission now requires the top 1,000 United States companies to file a formal certificate of accuracy of their last annual reports in their quarterly profit reports. Similarly, the Australian Securities and Investment Commission (ASIC) scrutinised key risk areas of the accounting practices used by sharemarket-listed companies in their June 30 accounts following the corporate scandals in the United States.

Despite this increased scrutiny by ASIC, I would like to highlight the fact that at present in Australia, neither the *Corporations Act* nor the ASX listing rules oblige a company to adopt any corporate governance standards or practice. In contrast, legislated corporate governance requirements of publicly listed companies are much more stringent in the United States. In addition to recent new laws, the New York Stock Exchange submitted to the SEC for approval its new rule setting mandatory corporate governance standards and practices for listed companies. However, the ASX convened an inaugural meeting of a Corporate Governance Council on 15 August last to develop an agreed set of corporate governance standards of best practice for Australian listed companies. The Council issued an immediate initial statement to provide guidance on current governance issues to companies preparing their annual report to shareholders.

In a complementary move, Standards Australia has taken action to establish a committee to develop new national guidelines on corporate governance designed to assist all Australian organisations. The guidelines are expected to be released for public comment later this year and published early in 2003.
Conformance and compliance control structures, incorporating sound risk management, are a particularly important element of an effective governance framework because of their importance in promoting effective performance and ensuring accountability obligations are appropriately discharged.

An ANAO publication defined control as:

... a process effected by the governing body of an agency, senior management and other employees, designed to provide reasonable assurance that risks are managed to ensure the achievement of the agency’s objectives.

Box 1 outlines the main elements of a conformance and compliance framework.

**Box 1 Elements of a conformance and compliance framework**

Some of the issues that the public sector must consider in a conformance and compliance framework include:

- upholding APS values and ethics;
- guidance on policies, procedures, processes, principles and tasks;
- ensuring and maintaining privacy;
- enforcing security and fraud controls;
- ensuring legislative compliance as required;
- fiscal management;
- contract management;
- risk management; and
- quality assurance.

The existence of strong control structures within a corporate governance framework provides assurance to clients and the Parliament that an agency is operating in the public interest and has established clear lines of responsibility and accountability for its performance. This is reinforced by the interrelationship of risk management strategies with the various elements of the control culture. In contrast, weak internal controls provide an environment where there exists an opportunity to commit fraud.

The notion of a control environment has to start from the top of an agency, as with all aspects of good corporate governance. To be effective it requires clear leadership and commitment. The adoption of a sound and robust control environment at the top of an agency will strongly influence the design and operation of control processes and procedures to mitigate risks and achieve the agency’s objectives. The clear intent and message to staff should be that such processes and procedures should be designed to facilitate, rather than to inhibit, performance. This approach should be promoted as part of good management. In short, the control environment is a reflection of management’s attitude and commitment to ensuring well-controlled business operations that can demonstrate accountability for performance.
Management should review the adequacy of internal controls on a regular basis to ensure that all key controls are operating effectively and are appropriate for achieving corporate goals and objectives. The entity’s executive board, audit committee and internal audit are fundamental to this exercise. This information should be communicated through the organisation.

It is useful to point out here that audit committees provide a complementary vehicle for implementing relevant control systems incorporating sound risk management plans. I discussed audit committees and their main responsibilities earlier in this paper.

The key to developing an effective control framework lies in achieving the right balance so that the control environment is not unnecessarily restrictive nor encourages risk averse behaviour and indeed can promote sound risk management and the systematic approach that goes with it. That is, in this New Public Management environment, there is a need to balance control and autonomy – the performance/conformance debate that I have already alluded to and will discuss in more detail later.

As well, with the increased emphasis on contestability and the greater convergence of the public and private sectors, there will be a need to focus more systematically on risk management practices in decision-making that will increasingly address issues of cost, quality and financial performance. It must also be kept in mind that control is a process, a means to an end, and not an end in itself. It impacts on the whole organisation. The control environment is the responsibility of everyone in the agency and is effected by staff at all levels.

In summary, the language of a compliance program with its emphasis on – a culture of compliance, starting from the top, leadership, shared vision, ongoing commitment, effective mechanisms, continuous improvement, performance, transparency, and accountability, is also that of corporate governance.

**Risk management**

Risk management is the process by which directors (or, more importantly, the CEO and/or Executive or Advisory Board in FMA agencies) can evaluate the management of risk. Risk management can be broken into three main components:

- an active risk assessment process;
- an effective control environment; and
- self-assessment procedures.

I view risk management as an essential element of corporate governance, underlying many of the reforms that are currently taking place in the public sector. It is not a separate activity within management but an integral part of good management process, particularly as an adjunct to the control environment.
Box 2  The risk management process

Risk management establishes a process of identifying, analysing and mitigating risks which could prevent the agency from achieving its business objectives. It includes making links between risks/returns and resource priorities. Risk management includes putting control activities in place to manage risk throughout the organisation by developing fraud and risk management plans which cover activities as diverse as reviews of operating performance, information technology and management information systems, increased competition and contestability, contracting out and outsourcing, performance management and information, professional development, staff appraisal including client surveys, reconciliations of accounts, approvals and segregation of duties.

Principles of risk management

To be effective, the risk management process needs to be rigorous, structured and systematic. If organisations do not take a comprehensive approach to risk management then directors and managers may not adequately identify or analyse risks. Compounding the problem, inappropriate treatment regimes may be designed which do not appropriately mitigate the actual risks confronting their organisations and programs.

Having said that, I believe that risk management should not become essentially a procedures-based exercise. Effective risk management requires an organisation to have a risk-assessment culture whereby all major decisions are considered in terms of risk management principles such as: establishing the context; identifying and assessing risks; implementing treatments; monitoring and review. However, the emphasis should be on real actions and outcomes rather than merely following the steps. Table 1 below outlines the key elements required to establish a risk management culture.

Table 1: Key elements to engender a risk management culture

<table>
<thead>
<tr>
<th>Risk management culture – key elements</th>
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<tbody>
<tr>
<td>Executive commitment</td>
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<tr>
<td>Policy/procedures</td>
</tr>
<tr>
<td>accountabilities</td>
</tr>
<tr>
<td>Operational framework</td>
</tr>
<tr>
<td>roles &amp; responsibilities</td>
</tr>
<tr>
<td>approach, methodology structure</td>
</tr>
<tr>
<td>Training and education</td>
</tr>
<tr>
<td>Monitor &amp; review</td>
</tr>
</tbody>
</table>

Source: O’Callaghan (2002)

Management of risk in the public sector involves making decisions that accord with statutory requirements and are consistent with public service values and ethics. This means that more, rather than less, attention should be devoted to ensuring that the best decision is made. This will require placing emphasis on making the ‘right’ rather than ‘quick’ decisions. That said, with the increased convergence between the public and
private sectors, there is a need to consider a private sector point of view where the focus on cost, quality and financial performance is an important aspect of competing effectively.

**Responsibility for risk management**

Risk management is primarily the responsibility of the CEO and/or board but requires the active involvement of everyone in the organisation. Effective governance arrangements require directors to identify business risks, as well as potential opportunities, and ensure the establishment by management of appropriate processes and practices to manage all risks associated with the organisation’s operations.\(^{64}\)

In recent times there has been an increasing number of public sector agencies that have involved their Board and senior management in risk management at the organisational level and then required each program area or organisational unit, in turn, to prepare risk management plans. As indicated by Linda Nicolls, the Chair of Australia Post:

> The challenge then for senior executives is to prioritise issues, understand risks across the spectrum of business and find the right solutions quickly.\(^{65}\)

It is clearly not the responsibility of Board members to manage risk. They will oversee the processes and systems management has in place to do so, including reviewing key organisational risks and opportunities to ascertain what changes might be necessary to the strategic direction being adopted. However, it is important to bear in mind that directors of Executive Boards are personally liable for decisions and thus for risk management. Thus they must have robust oversight systems in place to protect themselves as well as the organisation. The same applies to CEOs in FMA agencies, recognising that personal indemnity insurance is available.

The Business Judgement Rule is prescribed in the Corporations Act 2001 and applies to Commonwealth bodies subject to the CAC Act, including GBEs. The Business Judgement Rule applies in certain circumstances to exempt directors from liability in respect of honest, rational and informed business judgments. An important element of the rule is that directors must inform themselves about the subject matter of the judgment to the extent that they reasonably believe to be appropriate. Important considerations here include reliance on third party advice and the extent and nature of the risk assessment undertaken.

**Integration of risk management within the broader corporate governance framework**

I also cannot over-emphasise the need to integrate the agency’s approach to control with its overall risk management approach in order to determine and prioritise the agency functions and activities that need to be controlled. Control activities to mitigate risk need to be designed and implemented and relevant information regularly collected and communicated through the organisation.\(^{66}\)
With the wide range of business risks being confronted, including in relation to business continuity, I am not alone in suggesting we need a more holistic approach to the identification and management of risk in the business environment. James Deloach, an ex-partner in Arthur Andersen, posits that an enterprise-wide approach to business risk management improves the linkage of risk and opportunity and positions the business risk management as a competitive advantage. He offers the view that current approaches are too firmly entrenched in command and control and thus rooted in the past. Such practices cannot adequately deal with an entity’s continually evolving risks and opportunities. He proposed the Enterprise-wide Risk Management (EWRM) model (see Figure 6) which:

aligns strategy, processes, people, technology and knowledge with the purpose of evaluating and managing the uncertainties the enterprise faces as it creates value.  

**Figure 6: The Enterprise-wide Risk Management Model**

This theme has been picked up in CPA Australia’s own publication ‘Enterprise-wide Risk Management’. The CPA Enterprise-wide Risk Management approach applies risk management processes, structures and culture in a way that is:

- truly holistic – considers risk right across the business (strategic, operational, compliance and financial), the hazard, uncertainty and opportunity elements of risk and the objectives and needs of all stakeholders;
- synergistic – considers links with and interrelationships between risks and structures, strategies and processes;
- integrated and aligned – with business planning, objectives, decision making and other elements of the organisation’s management framework; and
- inclusive – involves the whole organisation, from the board, to senior management and employees.
In essence, choices for managing risk at the operational or departmental level should be influenced by their potential impact on the organisation as a whole. Entities will look to manage the key drivers affecting the total ‘pool’ of risks, rather than addressing individual risks separately. The focus here is on the aggregation of risks and their comprehensive treatment.

This approach minimises the influence of the management ‘stove pipes’; leading to a more holistic, integrated, proactive and process-oriented approach being taken to manage all key risks and opportunities. In part, this reflects the fact that many risks are organisation-wide and often have at least a ripple effect. There is also the management imperative of ‘not re-inventing the wheel’.

**Importance of risk management**

Formal risk management may have been viewed as discretionary in the past but is now accepted as an essential element of sound corporate governance and management practice. The goal is to embed a culture of risk management in organisations so that consideration of risks and risk mitigation strategies becomes second nature to managers at all levels. I have been advised that an international guide to risk management terminology (ISO/IEC Guide 73) has recently been released. It is an important starting point for the development of a common language for those engaged in the management of risk.

The growing recognition and acceptance of risk management as a central element of good corporate governance (and as a legitimate management tool to assist in strategic and operational planning) has many potential benefits in the context of the changing public sector operating environment. Such an approach encourages a more outward looking examination of the role of the organisation, thereby increasing customer/client focus, including a greater emphasis on outcomes, as well as concentrating on resource priorities and performance assessment as part of management decision-making. The risk management framework is also a useful means for management to be assured of this approach, including being able to defend their decision-making publicly.

The ANAO fosters the view that the intuitive, and often reactive, approach to managing risk that has characterised public sector management in the past will not be sufficient. We all know that reacting ‘after the horse has bolted’ is often quite costly and damaging to the credibility of agencies and Ministers. A more strategic approach is required to stay contestable in such an environment. This is a significant management challenge.

**Monitoring and reporting - performance assessment**

Appropriate performance information is an essential element of the governance and operations of public and private enterprise organisations. As a consequence, over the last decade many of the developments in relation to performance information such as the Balanced Scorecard and Triple Bottom Line have been adopted, or adapted, by
organisations. Within the APS, agencies have devoted considerable resources to developing outcome/output/performance information frameworks consistent with the Department of Finance and Administration (Finance) guidelines and associated with the implementation of accrual budgeting.

The identification and reporting of appropriate performance indicators, both financial and non-financial, is a key plank within this new accountability framework and a central element of supervision.

The New Zealand Controller and Auditor General’s recent report on ‘Reporting Public Sector Performance’ lays down the challenge to CEOs, boards, managers and central agencies to embrace more comprehensive and effective performance reporting. In accordance with the framework outlined in Figure 7, my New Zealand counterpart sees performance in public sector terms as follows.

- Results – what an agency achieves, its actual outcomes, the impact of government activities on the community, and how the community is better or worse off as a result of these activities.
- Interactions with the public – process of the agency and the delivery of goods and services (outputs) to the public.
- Costs – inputs, the resources met by the taxpayer that are applied to the task. Costs also include any decline in the agency’s capability.

Figure 7 – Elements of a Comprehensive Model of Performance Reporting


I would also like to comment on key performance measures, which must be drivers of performance and aligned to agency objectives and vision statements. These indicators must also be reliable, accurate, relevant, regular, comprehensible and timely. I also advocate that public sector agencies use benchmarking where possible, as it helps to define which performance indicators are critical in measuring operational efficiency and often also provides clear evidence of what achievements are possible. In so doing it can aid in setting meaningful performance targets.
Where targets have been set, it is essential to closely compare them with actual performance. Where agencies have not met valid targets and, moreover, as a matter of good governance, public sector agencies should undertake on-going evaluation and review of key projects and programs. We should be mindful of the so-called performance paradox where there is a weak correlation between performance indicators and actual performance.71

My discussion of monitoring and reporting has focussed on better practices to monitor the performance of organisations to achieve the objectives they have been set, particularly outputs and outcomes in the public sector. Such measures bring management - including directors and CEOs - to account for their efforts in leading, directing and managing the organisation and implicitly for their stewardship of the organisation’s assets. These measures therefore cover the main elements of corporate governance, with the exception of the control environment. The ‘measurement’ of controls is undertaken primary through internal and external audits and Quality Assurance programs, with the results provided in formal reports. The results are generally opinions of compliance or adherence to better practice, together with recommendations for improvement, rather than similar to the discrete measures that relate to organisational performance. These audit and Quality Assurance programs are typically undertaken on a sequential basis over a period of years so that up-to-date annual reporting of controls is not available in the frequency of performance measures.

**Focus on results**

The focus on results has also heightened the importance placed on rigorous performance information systems capable of quantitatively and qualitatively measuring results and demonstrating achievement. This is a major issue worldwide. Under the accrual budgeting framework in Australia, agencies are required to define inputs, outputs and outcomes. Under the Commonwealth legislative framework, agencies are also required to demonstrate the efficient, effective and ethical use of resources. Performance information is therefore essential to the achievement of statutory accountability requirements defined by the Parliament.

The ANAO reviews performance information as a matter of course in most performance audits. This includes review of the *appropriateness* and comprehensiveness of the relevant performance measures. In addition, a Better Practice Guide was produced in 199672 and has been recently updated in relation to performance information in Portfolio Budget Statements73. While recognising that good performance information involves time and cost considerations, the benefits of cost effective performance information include the capacity to better manage risks; to adjust programs to meet changing client needs; and to demonstrate to Parliament that Commonwealth resources have been used efficiently and effectively.

However, performance information in itself does not automatically transform governance and lead to stronger performance. Performance information is one element of integrated management arrangements and the performance information arrangements may have little impact on performance and/or governance if all the elements of governance are not in place, or appropriate leadership is absent. When considering issues related to performance information and its measurement and
management, as appropriate, the ANAO emphasises the importance of clear objectives, risk management, corporate strategies, a strong controls environment and the measurement and review of outcomes and outputs.

As previously mentioned, within the current legislative framework, agencies have considerable scope to tailor their operations to produce their outcomes and outputs efficiently and effectively. Accordingly, many agencies have changed their organisational structures so that they better reflect the agency outputs that lead to subsequent outcomes. As well, agencies have considerable scope to develop outcome/output measurement and management frameworks that best meet their needs.

Nevertheless, we know from experience that performance assessment is not easy, a point stressed by the Commonwealth’s Management Advisory Committee, comprised of departmental Secretaries and particular Agency heads, as follows:

>This is an area where there are no right answers or simple solutions. Neither organisational nor individual performance can be measured by itself. It will always be a composite of measurables and judgements. There also needs to be a credible performance management system in place that is based on ethical behaviour and trust.74

**Nexus between conformance and performance**

In view of my earlier comments on conformance, control structures, risk management, performance reporting and results, it is useful to talk about some of the background and issues related to achieving a suitable balance in the nexus between conformance and performance. Does conformance entrench a risk-averse management culture and inhibit exploitation of emerging opportunities? Or, on the other hand, does a solid conformance control structure provide a tensile framework that strengthens and protects an entity from ‘corporate governance delinquency’, as rather colourfully described by Senator Murray, a prominent member of the Australian Senate?

This tension is observed by Richard Norman in the ‘Ying and Yang’ of Management75, where he states:

>**All organisations face a central problem of autonomy and control.**
>Too much autonomy and too little control can undermine coordination and prevent the delivery of a consistent service and product. Too much control at the center can undermine motivation among those who are furthest from the source of power. The challenge is to balance the control necessary for a united strategy with sufficient autonomy to foster initiative and responsiveness.76

I think most would agree that, in the past, the tendency in the public sector has been to focus primarily on ensuring conformance with legal and procedural (including budgetary and financial) requirements rather than striving for exceptional performance (see Figure 8). This has encouraged a risk-averse attitude among public servants. It has been observed that such an environment has largely focussed bureaucratic attention on process rather than on achieving the stated objectives of governments. It is also said
that there needs to be a cultural change in the public sector if public servants are to focus more on achieving required results and to be accountable for their performance including effective management, rather than avoidance, of risks.

**Figure 8: The performance conformance nexus**

Put another way, the implied view is that the APS could have been more effective in constructing robust control structures aimed at assuring achievement of defined outputs and outcomes, as well as being more responsive in providing efficient client-oriented services. Attention is now being given to addressing government programs and services directly to public sector clients, as citizens, and not the other way round.

In the private sector, with every aspect of corporate governance increasingly being put under a virtual microscope, we have seen more rigorous regulation, no doubt resulting in a tendency for boards to focus more on compliance to cover off the legal, regulatory and other risks that were most apparent. However, before the latest spate of corporate collapses, concerns were being expressed that companies were concentrating too much on that end of the spectrum and should have been focusing more on performance goals, that is, the drive for profits and other required corporate results.

For example, a prominent Chairman of three major Australian corporate boards has recently challenged boards’ ‘obsession’ with conformance rather than performance and their predisposition to be risk averse. In his words:

... there’s just been too much concentration in recent times on the conformance, the governance, the ticking of the boxes, who comes to meetings and I think it’s far from clear that that adds value, improves the performance of companies, delivers benefits for shareholders and

... having lots of due diligence and advisors around you when you’re making decisions doesn’t necessarily make the best decision.
Indeed, there has been an increasing emphasis on the strategic role of the board, in particular the need for the board to be aware of the major trends impacting on the organisation and its major risks and opportunities. Ian Dunlop, CEO of the Australian Institute of Company Directors (AICD) has observed that the compliance or conformance responsibilities that have dominated boards’ thinking remain critically important and must be performed to impeccable standards, but in essence they are ‘hygiene’ issues. The real added value for boards is at the strategy level. This requires boards to be forward looking, proactive, innovative, and not risk averse.  

The notion of corporate governance that emphasises both performance and conformance can sit easily in today’s public sector context. As I noted earlier, the challenge is to strike the appropriate balance that suits the circumstances of an individual organisation at particular periods.

As the public sector continues to move to a more private sector orientation, we are increasingly seeing a growing adoption, or adaptation, of private sector approaches, methods and techniques in public service delivery. Consequently, there is an issue of trade-offs between the nature and level of accountability and private sector cost efficiency, particularly in the delivery of public services and in the accountability regime itself.

In summary, the challenge for any organisation is to get the right balance between performance and conformance at any point in time and over time.

4. Audit perception of better practice public sector corporate governance

So far I have outlined the role of audit, particularly external audit, in encouraging better practice corporate governance in the public sector, through its dual roles of assurance and performance improvement. I have also outlined what I consider to be a consensus of audit perception on better practice corporate governance in the public sector. I will now briefly discuss the extent to which the Australian public sector, and particularly the APS, is achieving these standards of better practice corporate governance. However, I will focus the discussion on noteworthy areas and common themes emerging from our audit reports that highlight where weaknesses have arisen in public administration which agencies should take account of in their core governance arrangements.

In particular, I will discuss:

- the application of corporate governance principles;
- board issues;
- monitoring and reporting – performance assessment;
- control structures; and
risk management.

I would first like to highlight some of the strengths of corporate governance in the APS. As I have stated earlier, I consider that virtually all Commonwealth government entities have, at least structurally, the main elements of corporate governance in place and have improved their efforts to integrate them in a holistic framework. Further, I am of the view that the APS Code of Conduct and other values systems have provided a sound basis for an ethical public service, dedicated to achieving organisational objectives. The role of internal audit, and the existence of independent external audit, have also provided the APS with a stronger capacity than the private sector to examine controls and performance and to report frankly and fearlessly about management to Ministers and the Parliament. In general, the public sector does have greater accountability and transparency than the private sector, contributing to improved governance, albeit in a more complex environment.

Applying corporate governance principles

Integration of the elements of corporate governance

Our audits show that more work is still required in the APS to present the elements of public sector governance in a meaningful way so that people in the organisation can readily understand and accept both their purpose and the manner in which the various elements combine to achieve required organisational performance and discharge expected accountability obligations. Success in these respects can do much to integrate these elements effectively into a sound governance framework. This often requires improvements to the operational alignment of strategic and business plans, as well as refinement of the organisational structure and improvements in channels of communication.

Corporate/strategic planning

The issues of operational alignment of strategic and business plans have drawn considerable audit comment over the years, highlighting the fact that there is significant scope to improve strategic planning, mainly to improve performance through more appropriate accountability and performance monitoring mechanisms but also to assist in the effective implementation of controls.

The following extracts from audit reports give a flavour of the main points to consider when developing a strategic planning framework. The extracts are illustrative only. They are not meant to single out any particular agency for comment but to identify recurring themes.

- Corporate Plans have not clearly informed stakeholders of the corporate objectives, priorities, strategies, policies, expected results (including targets), contained actual measures of corporate performance (including quantitative targets), nor generally set higher levels of performance for the Corporation. The new Corporate Plan 2001–04 represents a significant improvement on the previous Corporate Plan. The changes, when fully implemented, have the potential to produce real improvement in the governance and performance.

- potential to produce real improvement in the governance and performance.
in the Corporate Plan, there are limitations in the links between the statutory objectives and corporate objectives, and the extent to which the ensuing strategies can be seen to be giving effect to the statutory objectives.\textsuperscript{82}

the corporate plan does not clearly communicate the necessary link between ... performance and the provision of quality client service. From a customer service perspective, the corporate objectives do not set a strategic focus for managers and employees that links the overall performance of the business directly to meeting the needs and expectations of the clients.\textsuperscript{83}

there is evidence of different work cultures associated with different functions, suggesting the need to strengthen the strategic linkages between ...organisational units to ensure ... operates as a single coherent and consistent organisation.\textsuperscript{84}

linkages between the ... corporate objectives and its statutory responsibilities are not sufficiently clear for effective management. ... needs to ensure that as part of its corporate planning framework, the corporate objectives are carried through into operational action and are supported by an effective performance information framework.\textsuperscript{85}

Effective corporate governance is supported by alignment of planning at different organisational and program levels to ensure that strategies and operations give effect to the outcomes and outputs required.\textsuperscript{86}

**Accountability: clear definition of roles and responsibilities**

An important element of accountability involves identifying and articulating who is responsible for what, to whom, and by when. Two observations from ANAO Audit Report No 50 1997-98 provide some indication of the issue:

clear definition of roles and responsibilities at the start of the implementation process was particularly important given the complexity of the issues involved and the wide range of tasks which had to be completed ... Such action would strengthen the accountability and effectiveness of the governance arrangements for managing the transition. It would also minimise risk exposure and the possibility of duplication and waste, as well as unnecessary frustration on the one hand and insufficient oversight and control on the other, thereby assisting with the effective and efficient implementation of reforms.\textsuperscript{87}

While terms of reference were provided .. they do not clearly spell out the Team’s role and reporting responsibilities or specify the collective responsibility and accountability for decisions and required action, other than a requirement to represent the interests of industry and Government. This lessens the effectiveness of the accountability framework for the operations of the body.\textsuperscript{88}

A more recent observation is as follows:

Two organisations, however, had either not clearly assigned responsibility and accountability for GST or had assigned responsibility to an individual at an inappropriate level within the organisation. Inadequate or inappropriate allocation of responsibility for GST means:

- formal process level risk assessment may not be initiated;
- the impact of legislative changes may not be appropriately assessed and acted upon;
- staff are unclear as to who they should contact for advice on technical GST issues;
- inappropriate decisions relating to GST technical issues may be implemented;
policies and procedures may not be updated on a timely basis; and
— there is no focus for the continuous improvement of GST processes.

Some organisations had documented responsibilities and task descriptions for both managers and GST processing staff; however, most organisations had not.89

I previously discussed the importance of clearly defining the roles and responsibilities of all parties to a Strategic Partnership Agreement. ANAO Audit Report No 5 2002-03 examined the Strategic Partnership Agreement between the Department of Health and Ageing (Health) - Health Insurance Commission (HIC) and found that:

the ... relationship would benefit from a greater clarity of each agencies accountability obligations. In particular, the ... relationship would benefit from a more explicit treatment and understanding of Health’s obligations for ensuring the efficient and effective expenditure of departmental resources, which fund the majority of HIC’s operation.

Challenges to transparency

As I discussed earlier, a key element of public sector governance and accountability is openness or transparency. With the greater involvement of the private sector, concerns have been expressed about commercial considerations, particularly in maintaining competitive advantage. The ANAO has found that value for money results from public-private sector partnerships can be particularly difficult to demonstrate where commercial-in-confidence provisions of contracts apply.

The ANAO has undertaken a number of audits in this area to date in response to Parliament’s concerns. One report, entitled The Use of Confidentiality Provisions in Commonwealth Contracts90, found that there was a lack of consolidated government-wide guidance available to agencies on the use of confidentiality provisions in contracts. The audit found a number of weaknesses in the ways in which agencies generally deal with the confidentiality provisions in contracts. There was a lack of clarity in terms of the specific information that should be regarded as commercial-in-confidence in contracts, and agencies were addressing commercial-in-confidence issues in a less than rigorous, or risk-managed, way. This was threatening accountability and frustrating Parliamentary Committees and other forums of review91. The ANAO made a number of recommendations in the report aimed at enhancing the management of commercial-in-confidence issues in contracts.

Aside from commercial-in-confidence issues, in recent years the ANAO has grappled with the issue of access to the records of third party contractors involved in public sector service delivery. The JCPAA has stated that standard access clauses should be included in all government contracts unless there are strong reasons not to92. The ANAO and the Department of Finance and Administration developed a set of standard access clauses, which the Minister for Finance and Administration approved as part of the revised Procurement Guidelines issued in September 200193.

A related issue is that of Cabinet confidentiality and collective responsibility for administrative decisions. In its audit of the Federation Fund program94, the ANAO
found that reasons for Ministers selecting, or not selecting, particular Federation Fund projects were generally not available. Successive governments have supported the conventions of Cabinet confidentiality and collective responsibility by the practice of not disclosing the deliberations of, or reasons for, decisions by Cabinet and its committees.

The lack of documentation surrounding the Ministerial appraisal process and the lack of information on reasons for decisions highlights a tension between the standards expected for public administration and the normal Cabinet conventions. In the case of the Federation Fund, this precluded the ANAO from forming an opinion as to whether the proposals selected by the Government were likely to represent best value for money in terms of the program objectives. This is a tension for Government and the Parliament to resolve. As public sector auditors, we will be guided by the accountability standards that Parliament indicates are appropriate.

**Board Issues**

My earlier discussion outlined the differences between boards of CAC (especially GBEs) and FMA agencies, with the former typically being management and the latter mainly advisory. I stated that, regardless of the nature of the board, their main responsibilities should include: setting corporate strategy and mission; control, supervision and monitoring of top management; and reviewing and approving the use of resources.

A number of audit reports have highlighted areas where a board’s performance in these three areas could be improved. In particular, a number of recent audit reports have highlighted the need for better monitoring of the performance of the board. Some examples of recent audit findings about boards are as follows:

- *The Board’s capacity to monitor and evaluate the performance of the Corporation, in particular as to how well it is meeting its Charter obligations, could be improved.*  
  
- *There is also scope to improve performance reporting to the Board, and to comply more fully with requirements for reporting on performance of outcomes against objectives in its annual report. ...should adopt a more structured and strategic approach to evaluating its key programs and activities.*

- *There is a risk that the Board is unable to demonstrate satisfactorily that it is fulfilling its statutory responsibilities. ... a number of areas in which the ... Board could improve its operations and practices in order to be able to demonstrate that it is fulfilling these responsibilities. These areas include improving measurement, monitoring and reporting on the Commission’s performance against its objectives; management of delegations; the Board’s strategic role in determining ...policy and recording of Board activities and decisions. To assist the ... in addressing these issues, the ANAO, in consultation with legal/corporate expert advisers, has developed a suggested checklist on aspects of the operations of the Board and corporate governance generally.*

- *The ANAO expected that, as part of its control system, the Board would be briefed regularly on KPIs to inform the Board on how well the Commission is performing against its objectives, targets and strategies contained in or derived from its Strategic and Annual Operational Plans. Such information has not been provided on a regular basis. ...the Board should be provided with*
key performance information on a regular basis to contribute to greater accountability and assurance of outcomes.  

A number of senior executives are new to the public sector. As a consequence, there is scope for a better appreciation of specific features of the Commonwealth’s accountability framework. Their understanding of their responsibilities appears to be focused on their relationship with the Managing Director. They see the Managing Director, and of course the Board itself, as having exclusive responsibility for the public accountability aspects of their work and do not perceive any major role for themselves in this framework outside their line responsibilities to the Managing Director. This would appear to be an insufficient base for the achievement of corporate governance standards suggested by publicly funded status. There is scope for senior staff to obtain a fuller understanding of the Board’s statutory obligations which they must support, and to better understand the relationship between the corporation, and the Commonwealth’s accountability framework.

Monitoring and reporting – performance assessment

While acknowledging the difficulties in developing and reporting adequate indicators of performance, a number of audits have found substantial shortcomings in many important areas of performance reporting and that progress has generally been slow in achieving satisfactory standards of performance information as agencies adjust to the new budgeting and accountability framework.

For example, the ANAO conducted a cross-portfolio audit to assess performance information in the Portfolio Budget Statements 2000-2001 and Annual Reports for 1999-2000. The Report concluded that, overall, performance information in the Portfolio Budget Statements should be improved to enable agencies to establish and demonstrate the links between outcomes, outputs and performance indicators. It stated that:

* A common limitation in the performance information in all 10 audited agencies’ PBS and annual reports related to effectiveness indicators which did not actually measure outcome performance.

The Report also noted:

* it was important to track overall outcomes achieved across the layers of government and through the various partnerships with other agencies, including non-government bodies, as well as the particular contribution made by the specific Commonwealth agency to the outcome.

Overall, the Report also concluded that it would be difficult for Parliament and other stakeholders to assess agency performance with reasonable assurance.

In a similar way, the Senate Finance and Public Administration Legislation Committee expressed concern about the transparency and accountability of Portfolio Budget Statement performance information, in its second and third reports on The Format of the Portfolio Budget Statements (October 1999 and November 2000 respectively).
The JCPAA also recently expressed concerns in its Review of the Accrual Budget Documentation\(^{103}\), the chairman of the Committee stating that ‘Agency progress in providing performance information is patchy and some agencies had no targets against which to measure agency performance’. The Committee made 11 recommendations in the report to improve the transparency and accountability of government agencies and the government’s accounts. Key recommendations include the requirements that outcome statements should have more detail and performance measures should be accompanied by a comparative standard.

The ANAO in Audit Report No.18, 2001–02, Performance Information in Portfolio Budget Statements, also raised issues about performance measurement and, particularly, effectiveness indicators that did not actually measure outcome performance. Another important issue was data quality and whether the data had appropriate relevance, accuracy, timeliness, accessibility, interpretability and coherence.

**Control structures**

I noted earlier that an important element of corporate governance is an organisation’s control structure, which is intrinsically perceived to be more about conformance (assurance) than performance (results). The control structure should be tailored to each organisation’s specific situation and adapted over time as the organisation’s risk profile changes.

The various public sector reforms have impacted directly on entities’ internal control structures, including business and accounting processes and financial systems. These ‘house-keeping’ matters can be overlooked, with the considerable emphasis being given to outputs and outcomes as part of the reform agenda. ANAO Audit Reports No.52 of 1999–2000\(^{104}\) and No.23 of 2000–2001\(^{105}\) have highlighted implementation and internal control issues where organisational improvements were required.\(^{106}\)

Finally, the ANAO’s most recent control structure assessment found considerable improvement in the quality of control procedures over business and accounting processes over the past year. However, the challenge for entities now is to further embed sound financial management practices into their operations to improve:

- the understanding of accrual accounting, budgeting and reporting across entities so that there is greater appreciation of the financial issues relating to core operating activities;
- the timeliness and consistency of financial reporting so that both the executive and operating areas have increased access to relevant, trend based information;
- the analysis of costs and overheads which support large core operational activities; and
- decision support by implementing improved performance measurement processes and analysis in key operating areas by better linking financial and non-financial information.\(^{107}\)
A number of other perennial issues continue to be identified in audits as having scope for improvement, including aspects of: fraud control; confidentiality of information; and program or project management, as indicated by the following examples.

• program management should ensure that appropriate controls are in place to safeguard assets and account for liabilities and that decisions are made in accordance with legislative and executive financial authority and public sector values and Codes of Conduct.

• Many existing fraud control indicators were not able to be assessed or measured because terms such as quality, timely and effective had not been defined specifically for each indicator. As well, targets and standards had not been included, where necessary, as a basis of comparison and assessment.

• ... there was no audit trail for management purposes. This is an important issue for all agencies as systematic monitoring, and documenting the outcomes of that monitoring, will assist with ensuring appropriate accountability for fraud control. In this way, the Department would have been able to consistently ascertain whether fraud control arrangements were working in practice so that early action could be taken to resolve any problems cost effectively.

• While systems for the control and accountability of contracts are sound, improved financial monitoring and internal reporting of expenditure on contracts could minimise future breaches of delegations and overspending, as well as assisting in end-of-year reconciliations.

• ...all organisations covered by the audit were not adequately protecting the confidentiality of sensitive information in accordance with the Commonwealth’s security classification system, related Government policy and standards, and recognised best practice. ... the more common and serious breakdowns related to risk assessments and planning, allocation of responsibility, IT&T networks, security clearances, staff training and awareness, and monitoring and review activities. ... there was a high risk of unauthorised access to sensitive information within most of the organisations examined. This was particularly so in relation to ... contractors and clients.

• Overall, ... has the necessary supporting structures to facilitate effective contract management, including guidance; central coordination and advice; and appropriate training. However, guidance mostly does not set minimum standards nor requirements, leading to a variety of approaches to managing contracts, often not related to specific contract features.

Many ANAO findings about performance monitoring and review of contractors suggest the adoption of more systematic approaches. However, ANAO Report No.59 2001-02, AusAid Contract Management, suggested that:

formal reporting by contractors is often excessive, impacting on the cost and quality of projects. AusAID has recently implemented some measures aimed at reducing contractor reporting.

Risk management

An effective risk management process is rigorous and systematic. A number of Commonwealth Government agencies, such as the Australian Customs Service (ACS) and the Australian Taxation Office (ATO), were early implementers of such an approach. The ATO was among the first APS agencies to introduce formal risk management principles to its strategic planning framework. The ACS Executive gave risk management a high corporate priority, the organisation had refined its risk
management processes and developed a good infrastructure to support corporate risk management.\footnote{116}

While there have been considerable advances in risk management by many public sector agencies in recent years, further audit observations have focussed on the need to improve: the strategic direction in setting the risk management focus and practices; transparency in the risk management process; and effective management information systems. Relevant audit findings include:

- Contingency planning should be based on a systematic risk assessment, updated regularly, and more focused on the protection of Australian travellers and residents overseas.\footnote{117}

- Risk management has not yet been applied in a sufficiently comprehensive and integrated manner to the management of ... operations to produce more cost effective outcomes. The use of risk management principles needs to develop from the ... corporate and strategic planning and link directly into its operations. The results of the ... risk management planning also need to be reflected in resource allocation decisions.\footnote{118}

- Most agencies surveyed have undertaken some identification and analysis of ... risks but few agencies have done so as part of an overarching corporate risk management plan.\footnote{119}

- As a representative .. and facilitator, could have drawn to the attention of the Team the benefits of a more systematic and structured approach to these issues. Such an approach would ensure the early identification of strategies to counter the risks associated with slippages in timetable and cost over-runs, and provide greater assurance regarding the achievement of effective implementation of the objectives.\footnote{120}

- Reflects the importance of risk identification and treatment as an integral part of management at all levels of an organisation.\footnote{121}

The above observations indicate the need for managers to be proactive, rather than reactive, to risk. In the more commercial environment being experienced in the APS, managers also have to better understand notions of insurable and non-insurable risk, with the latter generally constituting around 70 per cent of all risks. Interestingly, in a survey of risk management in the public sector by PricewaterhouseCoopers, on behalf of CPA Australia, about 70 per cent of organisations surveyed said that audit reports were key drivers of risk management activities.\footnote{122} The accompanying Better Practice Guide observed that:

> Risk management is a critical element of corporate governance. Corporate governance responsibilities for performance and conformance cannot be achieved without an effective risk management platform.\footnote{123}

5. **Concluding remarks**

Public sector external auditors, such as the ANAO, play an essential role in ensuring the accountability of public sector agencies, and helping these agencies improve their
performance. A core external audit responsibility in this regard is to assess corporate governance arrangements in public sector agencies.

As I stated at the outset, there is a large authoritative body of knowledge, including a consensus audit view, about better practice corporate governance in the public sector. It begins with a framework to integrate the well-known elements of corporate governance, such as: management and accountability structures and strategies; agency controls (including risk management) and performance monitoring and reporting. More importantly, it requires application of the principles of corporate governance – integrity, openness, accountability, integration, leadership and commitment. In addition, these principles and ensuing actions must be effectively communicated throughout all levels of the organisation and to all stakeholders to ensure they are well understood and accepted by all concerned. What is needed is ownership and commitment. They cannot be presumed. Consequently, there needs to be a heavy emphasis on people, and their knowledge and skills, in ensuring robust corporate governance frameworks.

Such arrangements have to be dynamic and flexible to meet the needs of all participants, including those of the general public. They require a holistic approach as the concepts and systems are interrelated. Weak links can severely constrain effective functioning. This is especially important for audit functions and monitoring board or other governing performance. Thus, corporate governance must embrace both the strategic and operational imperatives identified by management and Boards. Moreover it must provide an appropriate balance between conformance and performance, constantly adapting to varying operating conditions and other organisational imperatives over time.

Virtually all public sector entities have, at least in some form, the required elements of corporate governance in place. Moreover, many of these entities have provided examples of better practice governance. However, analysis undertaken by the ANAO and other bodies suggest there is still considerable scope for continued improvement. The main areas the ANAO has recently identified include:

- operational alignment and integration of business plans and strategies;
- board issues;
- monitoring and reporting;
- the control environment, including risk management; and
- aspects of outsourcing, contracting-out and asset sales.

While there are no easy solutions to raising corporate governance standards, I suggest that, if organisations adopt the frameworks, practices and attitudes I have discussed today, they would go a long way towards ensuring better practice corporate governance in the Australian public sector.

I would like to conclude by noting that the governance landscape has changed, with the convergence of the public and private sectors, in particular, continuing to introduce new levels of complexity and risk to public sector agencies. This will provide new
challenges to corporate governance within public sectors agencies. Nevertheless, a key tenet of governance remains unchanged: that is, that sound business processes lead to good outcomes and robust accountability. These are matters of audit assurance both for the proper use of public resources and the results being achieved.

I have no doubt that the greater focus on audit independence and the role and effectiveness of audit committees will greatly improve such assurance and the corporate governance approach being taken in both the public and private sectors. As the private sector becomes more integrated with the public sector through public-private partnerships including in the direct delivery of public services, there will be greater sharing of techniques and approaches and even frameworks. I expect the audit profession to make a significant contribution to the effectiveness of such developments, particularly in the governance arrangements.
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7 This is one essential difference between management consultancies and the public sector audit approach. Our ‘observer status’ as public sector auditors reduces the risk of conflict of interest issues arising in the course of our work. Nevertheless, that does not absolve us from any responsibility for our views and actions.


13 The Auditor-General Bill 1996.


16 It should be observed that risk management can minimise the uncertainty surrounding innovation, by requiring the assessment of a range of options in terms of the likely opportunities for improved service delivery and program outcomes, and what needs to be done to manage the risks associated with each option. See, for example, Northern Ireland Audit Office 2002 Investing in Partnership: Government Grants to Voluntary and Community Bodies, Belfast, 16 May.


19 Ibid. Appendix A.


23 Independent Commission Against Corruption, 2002. An Ethical Approach to Corporate Governance in the Public Sector. Address by Grant Poulton to the IIR Conference on Corporate Governance in the Public Sector, Canberra. 13August.


26 Ibid. p.13

27 Ibid. p.39


29 Ibid. p.3

30 Ibid. p.3


33 Ibid p.52


35 Ibid. p.14


40 Ibid., pp 122-128


44 ANAO 2002, Submission to the JCPAA Review of Independent Auditing by Registered Company Auditors, Canberra.
The Council strongly recommended:

- voluntary and full disclosure of the existence and conditions of all share and options schemes, together with details of performance hurdles.
- the establishment of audit committees with appropriate expertise by at least the top 500 companies
- the following ‘minimum requirements’ for audit committees:
  - a majority of independent directors;
  - an independent director who is not the chairman of the board as chair;
  - no management representatives as members;
  - a public charter;
  - responsibility for appointing the external auditors;
  - a full analysis of the total fees paid to external auditors, including a break down of fees for non-audit activities;
  - disclosure of when the audit firm was last appointed and the dates of rotation of the audit engagement partners
  - at least twice yearly meetings between auditors, the audit committee and the full board without management in attendance, to ensure full and frank discussion of audit issues;
  - greater voluntary disclosure by companies and meaningful management discussion and analysis in financial reports, particularly of capitalisation policies and practices;
  - disclosure of the extent of contractual arrangements, such as leases, which carry financial obligations for future years;
  - disclosure of measures in place to ensure provision of equal access to material information through the Continuous Disclosure regime.


Ibid., p.5.


50
Auditing, Vol.26, No.2, April (p.13). The author provides examples of signs, signals and patterns indicating fraud which may be encountered during an audit such as Weak Management with its failure to enforce existing controls, inadequate oversight of the control process, and failures to act on fraud; and Loose Internal Controls with inadequate separation of duties involving cash management, inventory, purchasing/contracting and payments systems which allow the perpetrator to commit fraud. p.13.


63 O’Callaghan, P 2002. Avoiding Corporate Governance Failures by Establishing a Risk Culture, Presentation to the IIR Conference on Corporate Governance in the Public Sector, Canberra, 13 August.

64 Department of Finance and Administration 1999, Submission to the JCPAA Inquiry into Corporate Governance and Accountability Arrangements for Commonwealth GBEs. Submission No. 4, Canberra, 2 July.


69 Ibid, p. 5


76 Ibid. p.67.


78 Wallis, S. 2000, Interview with Sally Neighbour: Company Chairman of AMP and Coles-Myer discusses over-emphasis on Corporate Governance, Lateline, ABC TV, 3 July.


80 ANAO Report No.40, 2001-2002 Corporate Governance in the Australian Broadcasting Corporation, Canberra, 8 April, p.18.

81 Ibid. p.20

82 Ibid, p.20.

84 Ibid.

85 ANAO Report No. 26, 1997-98, Strategic and Operational Management – National Registration Authority for Agriculture and Veterinary Chemicals, Canberra, 23 December, p.xiv.

86 ANAO Report No.9, 1998-99, Accountability and Performance Information – Australian Sport Commission, Canberra, 28 September, p. 38


88 Ibid.

89 Ibid, p.37.


91 See, for example, Senate Finance and Public Administration References Committee in William de Maria, 2001, Commercial-in-Confidence: An Obituary to Transparency?, Australian Journal of Public Administration, vol. 60, no. 4, pp. 103-104.


93 The clauses are available on the ANAO’s website, http://www.anao.gov.au See also Department of Finance and Administration 2002, Commonwealth Procurement Guidelines – Best Practice Guidance, Canberra, February, p.3.

94 ANAO, 2001, Report No. 11, Administration of the Federation Fund Programme, Canberra, 19 September.


97 Ibid.


Ibid, p.17.


ANAO Report No. 26, Strategic and Operational Management, 1997-98, Canberra, 23 December, p. xii.


