

MBA Governance Students at
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of Management

**Corporate Governance – A More
Private Public Sector**

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CORPORATE GOVERNANCE – A MORE PRIVATE PUBLIC SECTOR?

*'I'd like to say up front that corporate governance should not be viewed as a goal to be attained, a benchmark to be met, or an ANAO audit to be survived. Rather, it is a journey that requires vigilance, constant review, and ongoing consideration'*¹

I Introduction

I was pleased to be asked by Shann Turnbull to speak at your lunchtime discussion forum on a topic that, for all of last year, enjoyed the warmth of the media spotlight and generated a deal of heat in the accounting and corporate communities as well as in the public arena. This attention has its origins largely in the corporate misadventures and losses in value for shareholders over the past two years. And as one headline comments, the '*Governance nightmare won't go away*'², referring to the fact that, already in 2004, previously unscathed companies are being caught in the governance net - namely Parmalat, Morgan Stanley (Europe), Hollinger International (Canada), Boeing, Computer Associates, and the four major accounting firms' alleged travel rorts (USA). In Australia, we have witnessed the National Australia Bank's foreign exchange problems with John Durie, in his article '*Damning insight into NAB*', claiming that '*the real issue is the failure of his [NAB Chairman, Charles Allen] board to address serious systemic governance issues at the bank*'.³ Latterly, we saw the resignation of the Chief Executive Officer, Frank Cicutto, and even more recently, the departure of the Chairman, Charles Allen.

Indeed, a business commentator⁴ in setting out what he saw as the ten key issues that managers are likely face in 2004 listed corporate governance first with the likelihood that institutional investors '*will be asking for greater involvement in the conduct of companies*'⁵, closely followed by compliance standards '*being globalised and tightened*'⁶. As one journalist observed: '*The corporate watchdog [Australian Securities and Investment Commission] believes Australian companies have been galvanised into complying with accounting and reporting rules by the emergence of corporate governance as one of the burning issues of the decade*'.⁷

On the flip side, however, in a *Chanticleer*⁸ survey of 29 'big business' chief executives there was only one reference to corporate governance albeit with a negative slant – '*misplaced corporate governance focus*'.⁹ While I understand that the two 'stand outs' – interest rates and exchange rates - would loom large in any Chief Executive Officer's (CEO's) thinking at this time, I was surprised that corporate governance was not afforded more prominence given that, in 2003, we have seen the Australian government and the regulators strengthening governance arrangements (CLERP 9 and the ASX Guidelines to name two). As a recent Business Review Weekly article observed:

'Shareholders still feel powerless to hold boards accountable and are seen to be powerless by analysts, auditors, company management and directors. However the Federal Government would be delighted that

all the categories of people surveyed overwhelmingly agreed that CLERP (the Government's reform of corporate disclosure) will improve their confidence in financial disclosure.¹⁰

While corporate governance is important and should not be underplayed, I acknowledge that it is not an end in itself. As David Gonski, Chairman, Coca-Cola Amatil Ltd, in a recent address to the NSW Division of Australian Institute of Company Directors, observed: *'Improving governance is a good thing. Taken to extreme, it could paralyse a company and lead boards to look to what will be seen as right rather than to take steps for the overall good of the company'*.¹¹ This seems to be a strong theme coming through in my scanning of media comment over the last few months. In cautioning that *'Compliance is not the endgame'* (in relation to implementing the Sarbanes-Oxley requirements) a United States (US) commentator makes the valid point that:

'Companies that focus on complying only with the letter of the law may find themselves in a quagmire of bloated controls, burgeoning expenses, and enduring headaches. But corporate leaders who embrace the spirit of the law -- strong ethics, good governance, reliable reporting -- will see a re-energized company, reassured investors, and maybe even reduced costs'.¹²

The challenge here is to achieve the 'right balance' between conformance and performance at particular points in time and over time. This *'accountability dilemma'*, as coined by the US academic Robert Behn, *'holding people accountable for performance while also holding them accountable for finances and fairness'*¹³, is an issue I will take up later. Nevertheless, there is no doubt that many Boards are spending considerable time and resources on control arrangements and systems as well as legal advice to 'ensure' conformance.

My introductory comments so far have largely focused on the private sector. However, as Senator Abetz observed, while corporate governance concepts and terminology may have originated in the private sector, *'its impact has deepened and broadened ...[and] is no longer reserved for the private sector, but also applies to other areas of society – the education sector, the not-for-profit sector, and of course, the public sector'*.¹⁴ Clearly, governance plays a crucial role in the public sector as it does elsewhere.¹⁵ Perhaps ironically, the public sector does have an appreciation of what differentiates governance from management.

Not surprisingly, I come with a public sector perspective but one which is increasingly being impacted by the growing convergence of the two sectors, including notions of public-private partnerships. My views reflect experience at the Federal Government level. I propose to restrict my comments to the following observations about related directions and experiences. However, please feel free to range more broadly during question time. My three themes are:

- The increasing convergence of the public and private sectors that is being driven by the search for a more efficient and effective delivery of government services together with the government's desire to test the delivery of government services in the market. In essence, this convergence of the two sectors is largely

driven by the increased contestability of the provision of public services, including policy advice.

- This increasing convergence of the two sectors and the introduction of the ‘so called’ New Public Management means that while we, in the public sector, may take on aspects of the private sector model, the unique requirements of the public sector must be considered and preserved as necessary. These factors impact directly on our thinking about, and development of, sound corporate governance frameworks which are increasingly results oriented. Chief among such considerations are the accountability dilemma (associated with finding a balance between performance and conformance), the requirements of transparency and fairness as well as retaining the traditional ethical standards, conduct and values that underpin public service.
- Finally, to round out the discussion, I will highlight some recent high profile, mainly Australian efforts, aimed at strengthening corporate governance arrangements in both the private and public sectors, including the Australian National Audit Office’s (ANAO’s) contribution to better practice.

II Convergence of the Public and Private Sectors

In a narrow accounting sense, an impetus to the convergence of the two sectors occurred in 1979 when a working party of two (an officer each from the forerunners to the ANAO and the Department of Finance and Administration (Finance) under the guidance of Richard Humphry, now CEO of the Australian Stock Exchange (ASX), produced the pioneering work aimed at developing a framework for the introduction of accrual accounting for government business type entities. Gradually, accrual accounting was extended to government agencies and culminated in the introduction of an accrual-based outcomes and outputs budgetary framework for managing resources in the public sector during the 1999–2000 financial year.

However, we have seen a much broader and increasing convergence of the public and private sectors both here in Australia and overseas. This convergence, from the public sector’s perspective, has occurred as a direct result of citizen demands for a more efficient and responsive delivery of government services and the introduction of a paradigm shift in public administration, the so called New Public Management (NPM). Dr Peter Shergold (Secretary, Prime Minister and Cabinet) encapsulated it thus:

‘The last decade has seen much greater emphasis placed on value-for-money in [government] service provision; explicit focus on outputs and outcomes rather than input and process; the adoption and adaptation of new information technology; improved client focus; and the introduction of systematic measurement and evaluation of corporate and individual performance’¹⁶.

Public Management, rather than public administration, is a comparatively new term and is seen as ‘different’, as the following observation draws out in contrasting the operating styles of public administrators and public managers:

*‘Unlike the traditional public administration language that conjures up images of rules, regulations and lethargic decision-making process, the very word management implies a decisive, dynamic mindset and a bias for action’.*¹⁷

The observation is considered important as the notion of ‘public management’ has underpinned public service reform in Australia and overseas, including privatisation in its broadest sense.

Perhaps the most definitive characteristic of the New Public Management (NPM) is the greater salience that is given to what has been referred to as the three ‘Es’ – economy, efficiency and effectiveness. NPM refers to the collection of tactics and strategies that seek to enhance the performance of the public sector – to improve the ability of government agencies to produce results.¹⁸ This has seen the trend toward the greater outsourcing of public (increasingly, so-called traditional) functions and the greater focus on the contestability of services in the public sector. As two Australian academic commentators have observed:

*‘NPM reform in the APS has been consistently grounded in, and developed and applied, on the basis of institutional economic theory, inspired by the rhetoric of rationalising public sector activities...Broadly, the reform programme is based on key principles [of]..separation of the contracting of services from service delivery; funding based on results (outputs and outcomes) as opposed to inputs in an environment permitting private-sector suppliers to determine the most effective and innovative ways to produce the contracted services; and a commitment to reducing the role of government in the direct provision of services’.*¹⁹

These reforms are largely based on the premise that greater efficiency and lower costs can be achieved by applying private sector practices to public sector service delivery. This premise largely revolves around the notion of market competition and associated management disciplines. Increasingly, governments have been exploring the potential benefits that can flow from private sector involvement with the delivery of government outcomes through public-private partnerships (PPPs), outsourcing, joined-up government and private financing initiatives (PFIs). Their principal features include some (or all) of the following: the delivery of services normally provided by government, the creation of assets through private sector financing and ownership control, government support through say contribution of land, capital works, and risk sharing. In some cases, this means that private sector management models have overlaid traditional public sector activity. In others, the private sector has become fully incorporated in the delivery of public services through contract, cooperative and partnership arrangements.

The convergence of the public and private sectors will continue to introduce new levels of complexity and risk to public sector agencies. Managing any new, as well as current, risks is crucial to the achievement of value for money – the primary gain from involving the private sector in the first place. As can be seen, convergence has many different dimensions and involves a wide range of stakeholders including both non-government and general community organisations. Agreeing suitable governance structures and demonstrating accountability are particular challenges in the new

business environment – issues that I will deal with shortly. However, I emphasise the point here that agencies can outsource functions (in full or in part) but Parliament insists that they cannot outsource their responsibility or overall accountability. The Government recently reinforced this view in noting that:

'Agencies remain accountable for the delivery of services, even where the service delivery is provided by the private sector. Central to the accountability principle is the need to maintain awareness of client needs and how they are being met'.²⁰

At this stage it may be useful to put some 'meat on the bones' of NPM by briefly canvass two of its initiatives - outsourcing and private funding initiatives. This will also set the scene for my second theme.

Outsourcing

Possibly the best understood and most widely used vehicle of the new paradigm has been the outsourcing of functions that, prima facie, the private sector can undertake more efficiently and cost-effectively than the public sector.



Source: Harvard Business Review, October 2003, p. 101

Outsourcing advocates point to the opportunities offered in terms of increased flexibility in service delivery; greater focus on outputs and outcomes rather than inputs; the freeing of public sector management to focus on higher priority or 'core' activities; encouraging suppliers to provide innovative solutions; and cost savings in providing services due to competition. As Dr Shergold has also observed:

'.. the monopoly which the Australian Public Service traditionally wielded over the delivery of government programmes has been broken by the growth of small businesses, community groups and religious organisations able and willing to provide publicly-funded services under contract. ... By the time I arrived [at the Department of Employment, Workplace Relations and Small Business] they were building their expertise as contract managers, overseeing the delivery of labour market programmes through a vigorously competitive network of public, private and community organisations. The CES, which enjoyed fifty years as a public service monopoly, is gone. It has been replaced by market competition'.²¹

However, more latterly, Dr Shergold also observed that ‘my only reservation about outsourcing is that we have to do it in a way which ensures that we do not lose strategic control of the process.’²²

The Department of Defence was the first government agency to embark on the significant outsourcing of its ‘non-core’ (non-combat related services) activities. This was largely driven, in the first instance, by budgetary pressures on defence outlays. The Defence Commercial Support Program, which has now been operating for around 11 years, has market tested the work of some 16,000 positions (civilian and military) in 119 separate activities with a total value of commercial and in-house work of more than \$5 billion²³. There have been other successes, for example, the outsourcing of human resource management functions in the Department of Finance and Administration²⁴, the management of Commonwealth national parks²⁵ and, closer to home, where the ANAO, for many years, has successfully outsourced audits of Government Business Enterprises and other commercial bodies. This allows us to draw on the benefit of specialist industry expertise by utilising the world-wide industry knowledge of the firms while still retaining the management and signing roles, as part of our accountability to the Parliament for public sector audit.

However, outsourcing also brings costly risks, as well as opportunities. My Office’s experience has been that a poorly managed outsourcing approach can result in higher costs, wasted resources, impaired performance and considerable public concern about the loss of intellectual capital and the resulting limited capacity to restore the capability in the event of business failure. For example, an ANAO audit of the implementation of information technology (IT) outsourcing across the public sector found that benefits realised by agencies were variable and that costs were well in excess of the amounts budgeted²⁶. A subsequent inquiry into the issues raised by the ANAO noted that:

*Priority has been given to executing outsourced contracts without adequate regard to the highly sensitive risk and complex processes of transition and the ongoing management of the outsourced business arrangement.*²⁷

A later media observation reinforced the ANAO’s findings, namely:

*‘Contracts signed under the federal government’s defunct information technology outsourcing program are running at least \$750million over budget after it was revealed that spending on the Group 8 agreement has blown out by up to \$70 million....The Group 8 contract covers the Australian Broadcasting Authority, Australian Communications Authority, Civil Aviation Safety Authority, Department of Agriculture, Fisheries and Forestry, Department of Environment and Heritage, Australian Public Service Commission and Aboriginal and Torres Strait Islander Services. The spiralling spending on the Group 8 contract mirrors documented increases in spending on at least three other major Commonwealth IT outsourcing contracts covering the Australian Taxation Office, Australian Customs Service and Health Insurance Commission’.*²⁸

Also on the issue of risk and IT outsourcing, a recent article makes the point that a key reason the approach encountered difficulty in Australia and the UK relates to the perennial issue - the proper allocation of risk, namely:

*'On the one hand, when contracting out, there is a legitimate desire to transfer "performance" risk to the service provider. On the other hand, the financial institution lending the money will want to strip out as much risk as possible for the service provider so that there is no threat to the income stream. This issue alone can be a deal breaker or it can result in the public sector giving in to the financier's demands.'*²⁹

The customer/client relationship also changes following outsourcing. It is important that the ongoing customer relationship is subject to appropriate pricing arrangements and that private sector competitors are given a real opportunity to bid for government business. In the appropriate circumstances, the use of competitive tendering and contracting promotes open and effective competition by calling for offers that can be evaluated against clear and previously stated requirements to obtain value for money. Experience has shown that it is essential to be clear about what value for money actually means, including how intangible factors (benefits and costs) will be assessed. This, in turn, creates the necessary framework for a defensible and accountable method of selecting a service provider. In addition, it should facilitate the best outcome for clients/customers who, it should be noted, are also likely to be taxpayers and citizens.

In addition to the impact of outsourcing on public accountability, the transition to outsourcing arrangements has other significant effects over the longer term. For example, there is a particular risk that incumbency advantage may reduce the level of competition for subsequent contracts. Incumbents may have greater information and knowledge about the task than either potential alternative service providers or the Commonwealth agency directly involved. The risk becomes more pervasive when the outsourced activity has a significant impact on core business, or where competition in the market is limited. There can also be a not insignificant risk associated with managing the transition from an incumbent to a new supplier. Nevertheless, if such risks are identified and treated, there can be useful net benefits to the agency which may not otherwise be available. The decisions usually boil down to a proper assessment of all the costs and benefits over an appropriate timeframe.

The imperative of ensuring that the contracting agency has appropriate contract management skills, including the capability to adequately oversight the service provider, has been stressed in recent years by both the ANAO and Parliamentary Committees. It has been recently observed that:

*'whilst constructive 'partnership' relationships with providers are beneficial, if an agency defers to the provider for advice and direction, the nature of the business arrangement is likely to change and result in the provider using that to their commercial advantage (and to the financial detriment of the agency).'*³⁰

Again, we run into the 'accountability dilemma' of just how accountable agencies can be, in the traditional meaning of the concept, if they have virtually no responsibility for the delivery of particular public services nor relevant information or experience.

Private Financing Initiatives (PFI)

PFI represents a form of government procurement involving the use of private sector capital to fund an asset (to deliver program outcomes) that would otherwise have been purchased directly by the government. Private financing is generally an option to be considered for major asset and infrastructure procurements, recognising it can provide significant benefits to the public sector by way of specialist expertise, innovation, and the opportunity to transfer (or allocate) risk to those better able to manage it. My personal preference is to talk about risk allocation, or re-allocation, rather than transfer. Finance has published principles for using private financing³¹ and, in addition, established a Private Financing Branch to assist agencies considering private financing proposals. A former Minister for Defence stated that the Government was keen to pursue the (Patrol Boat) project under private financing arrangements, but that the Government must be satisfied it would receive the best outcome for the investment of taxpayer dollars.³² While the Australian Government has yet to undertake a major procurement using private financing, the State governments have extensively used this initiative.

A key message in the United Kingdom's (UK's) 2003 HM Treasury Report - '*PFI: meeting the investment challenge*'³³ is that PFI is only used where it is appropriate and where it expects it to deliver value for money. In assessing where PFI is appropriate, the UK Government's approach is based on its commitment to efficiency, equity and accountability and on the Prime Minister's principles of public service reform. PFI is only used where it offers value for money, where it can meet these requirements, and where the value for money it offers is not at the cost of the terms and conditions of staff.³⁴ Perhaps our colleagues in State and local governments may have different experiences and views. I certainly agreed with the principles enunciated. However, reference should also be made to an interesting piece of research work by Broadbent and Laughlin in the UK which looked at both the accounting treatment of PFI and the achievement of value-for-money and risk transfer.³⁵

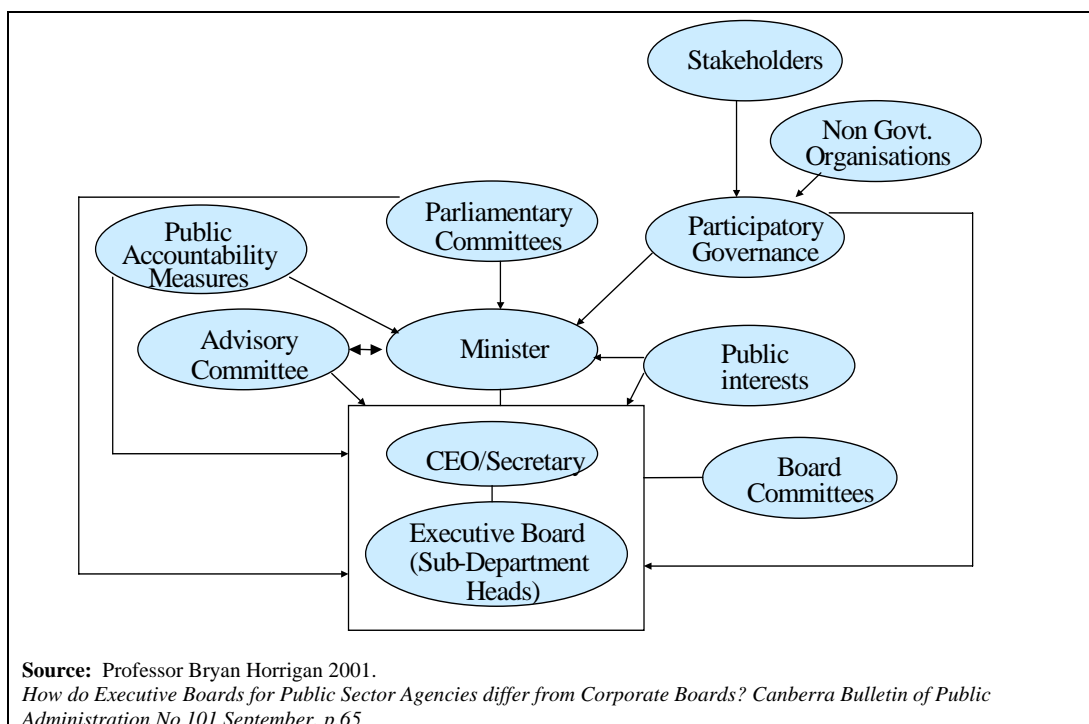
The HM Treasury Report concludes that the evidence to date suggests PFI is appropriate where there are major and complex capital projects with significant ongoing maintenance requirements. This is where the private sector can offer project management skills, more innovative design and risk management expertise that can bring substantial benefits. Where it is effective, PFI helps ensure standards are maintained, that new services start on time and budget, and that the assets built are of sufficient quality to remain of high standard over their life.³⁶

Boards in the public sector environment

Before leaving the sector convergence issue, I should canvass some basic issues relating to the use of boards in the public sector.

This is not the occasion to embark on a detailed discussion of the different models of private and public sector boards. However, for those who wish to pursue the matter further, I can refer you to an excellent article by Professor Bryan Horrigan,³⁷ University of Canberra. His public sector model is shown in Figure 1, which illustrates the structural and other relationships involved in an easily understood manner.

Figure 1: Boards – A Public Sector Model



It is worth noting that boards within the public sector face many of the same challenges as boards in the private sector, regardless of their different accountability requirements. In both the public and the private sector, boards are charged with monitoring performance, demonstrating accountability to stakeholders, setting clear values and codes of conduct, and providing leadership and guidance at the strategic level. In the public sector, there are three main forms of boards: management boards; advisory boards; and committees or boards formed under strategic partnership agreements between two or more agencies. The legislative framework under which the public sector operates is discussed in more detail later. The following is a short overview of each form of board structure:

- *Management boards* are largely associated with those agencies subject to the Commonwealth Authorities and Companies (CAC) Act, and particularly with Government Business Enterprises (GBEs). These boards are reasonably similar to boards within the private sector, with the CEO reporting to the Board, which is in turn accountable to either a Minister and/or shareholders, respectively. The general conduct of directors of corporate management boards is also subject to the provisions of the Corporations Law that is, for company GBEs but only the CAC Act for statutory authority GBEs.
- *Advisory boards* are generally associated with agencies subject to the Financial Management and Accountability (FMA) Act. The FMA Act confers legislative responsibility on a CEO for the efficient, effective and ethical use of resources. Therefore, in the absence of any legislation to the contrary, boards established by agency CEOs are advisory only, with the CEO retaining legislative responsibility for the administration of the agency. The CEO may also choose to establish an Executive Board to assist with building, and/or

renewing, the corporate governance of the agency, including strategic planning and risk analysis and treatment. Such a Board may be devolved the necessary authority and responsibility, with commensurate accountability, from the CEO.

- The *third form of board* found in the public sector is that of *the committee*, often formed under a strategic partnership agreement, which oversees corporate governance arrangements where two or more agencies have responsibility for the coordinated delivery of particular services to users. For example, the Department of Health and Ageing and the Health Insurance Commission have established a strategic partnership agreement for the management and administration of Medicare and the Pharmaceutical Benefits Scheme. The ANAO recently conducted an audit of the agreement and found that it ‘*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.*’³⁸

For the public sector, it is particularly important that establishing robust governance frameworks is given attention as the APS embeds joint, or multi, agency responsibility for program outcomes that may be spread over a number of separate agencies, including private sector partners.

The ANAO supports the traditional audit view that boards should not be involved in operational, or day-to-day, management. Rather, they should initiate strategic links across program, functional or business units and actively seek out and/or endorse opportunities for adding corporate value to the agency. As well, they should support the CEO in seeking to set the tone for the corporate culture. Fundamentally, the board’s role should be one of strategic leadership and stewardship, rather than one of day-to-day management. I note that Ann-Maree Moodie (author of “The Twenty First Century Board: Selection, Performance and Succession”- Australian Institute of Company Directors, 2001) recently opined that:

*... the role of the board as a whole, in its absolute form, is to ask questions, form opinions, debate issues and make decisions.*³⁹

Some additional challenges for public sector boards

While the pressures of the changing governance environment impact on both the public and private sectors, there are some particular challenges faced by GBEs, in particular, in negotiating the new environment. Henry Bosch has identified these as:

- complex structures, including the legislation that establishes and controls GBEs involving an elaborate set of relationships between Parliament, Ministers, boards and CEOs;
- ad hoc intervention by Minister, or other parts of government or the political process. Such intervention should, for the purposes of accountability, be clearly recorded and reported where an external direction or request to the board of a GBE is likely to have a material impact on the achievement of the organisation’s commercial goals;

- unclear or conflicting objectives, where economic objectives are often confused by the addition of divergent, and sometimes conflicting ‘community service obligation’ requirements;
- direct appointment of Chairs and CEOs by, or on the advice of, Ministers. This can work well in practice, but may challenge notions of loyalty and independence, and undermine the effectiveness of the board; and
- selection of government board members. Board effectiveness will be reduced if some directors are suspected of owing a special loyalty to those who influenced their appointments, and if it is believed that board discussions cannot be conducted in confidence.⁴⁰

III Sector Convergence – Inherent Tensions and Governance Issues

The introduction of the NPM and the impact of the private sector (that is, using the private sector to deliver government services through outsourcing, public-private partnerships and private financing initiatives) has raised significant issues such as accountability, fairness, transparency and preserving public sector values. Before I explore these important matters and address the more significant tensions that arise as a result of this convergence, it would be useful to set the scene by outlining the unique and often complex requirements of the public sector’s legal framework and governance arrangements.

Navigating the Public Sector’s Legislative Framework

The Australian government public sector has an extensive legal, regulative and policy framework (that government organisations must comply with and conform to) that regulate the activities of the Australian Public Service, Boards, Chief Executive Officers and their staff. Importantly, that framework starts with the Australian Constitution. However, the more detailed legal basis for governance in the APS is largely derived from:

- *the Financial Management and Accountability (FMA) Act 1997* which mainly applies to entities that are financially and legally part of the Commonwealth and do not own their own assets.⁴¹ These are typically ‘core’ government departments responsible for policy development but also include statutory authorities (some 17 Departments of State, five Parliamentary Departments and 58 prescribed agencies);
- *the Commonwealth Authorities and Companies (CAC) Act 1997* which applies to those Commonwealth entities which have been established as separate legal entities and can hold moneys in their own right (some 84 Commonwealth authorities and 28 companies). Some of these entities are predominately Budget-funded; others operate on a commercial basis; and
- *the Public Service Act 1999* which sets out values and the APS Code of Conduct for Commonwealth employees.

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. Thus, legislatively, and in practice, the CEO is responsible for the administration of an agency - the 'buck' stops with them, in most cases. 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.

For CAC bodies, we have seen the duties of directors and officers of these bodies more closely align with those of company directors following the recent changes to the public and private sector legislative framework. This has facilitated the flow of experienced directors between the two sectors and is enhancing the quality of Australian Boards.⁴²

The formal framework for corporate governance goes beyond these three Acts to include the broader constitutional powers affecting public sector powers, appropriations and responsibilities as well as supporting legislation such as the *Workplace Relations Act 1996*, *Administrative Arrangements Orders*, the *Remuneration Tribunal Act 1973*, any enabling legislation of an organisation and other legislation. This formidable body of law is depicted in the following diagram.

Figure 2: Legal elements affecting governance in the Federal Public Sector



Source: Department of Finance and Administration (2002)⁴³

In addition to this legislation, government entities are subject to a variety of regulations and policies which also impact on their governance, such as the budgetary outcomes and outputs reporting regime, the growing emphasis on risk management and insurable risk, and the need for effective coordination of Whole-of-Government and inter-agency issues as well as across levels of government, including the role of the Council of Australian Governments (COAG).

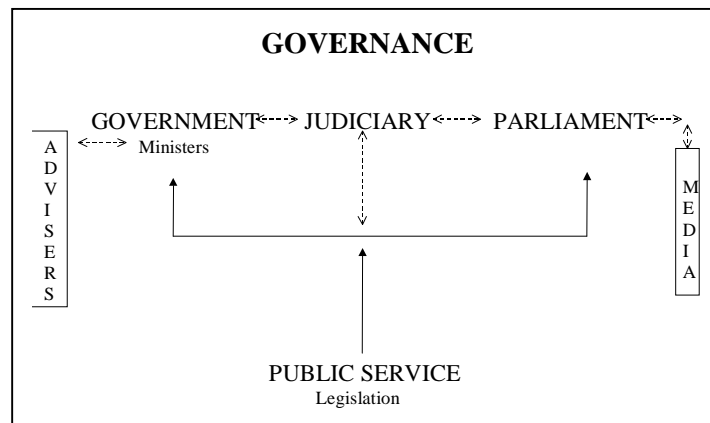
Dealing with the complexity of corporate governance in the public Sector

Increasing convergence of the public and private sectors has drawn together many common concepts and approaches to sound corporate governance. However, there are still inherent differences 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’.*⁴⁴

Public sector managers have a particular responsibility to the Government and to the Parliament to help ensure that accepted notions of responsibility, accountability and performance, including results, are being properly. This is a recognition of the supremacy of the Government and the Parliament in the governance framework. I have attempted to capture the concept of traditional accountability and interaction between the various players in the following simple diagram.

Figure 3: Governance Framework



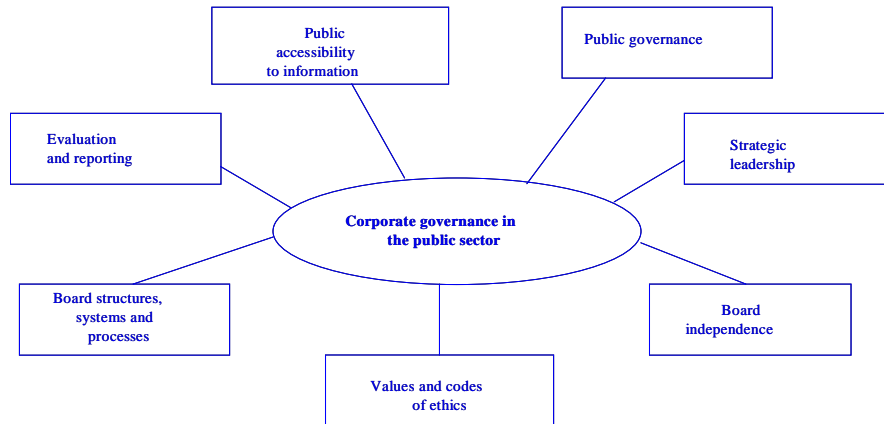
Source: ANAO⁴⁵

The executive government is held accountable by the Parliament and by the voting public through elected members. Public servants are accountable to their Ministers and through them to the Parliament. The executive is also held accountable legally by an independent judiciary or other independent quasi-judicial bodies applying administrative law to the actions or decisions of the members of the executive.⁴⁶

It would be fair to say that corporate governance is 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 less complex objectives and strategies. To support this proposition I have used the

following two diagrams to show the main components and structures of corporate governance in the federal public sector. The first, Figure 4, is drawn from the state arena but provides a good representation of the components of public sector governance generally.

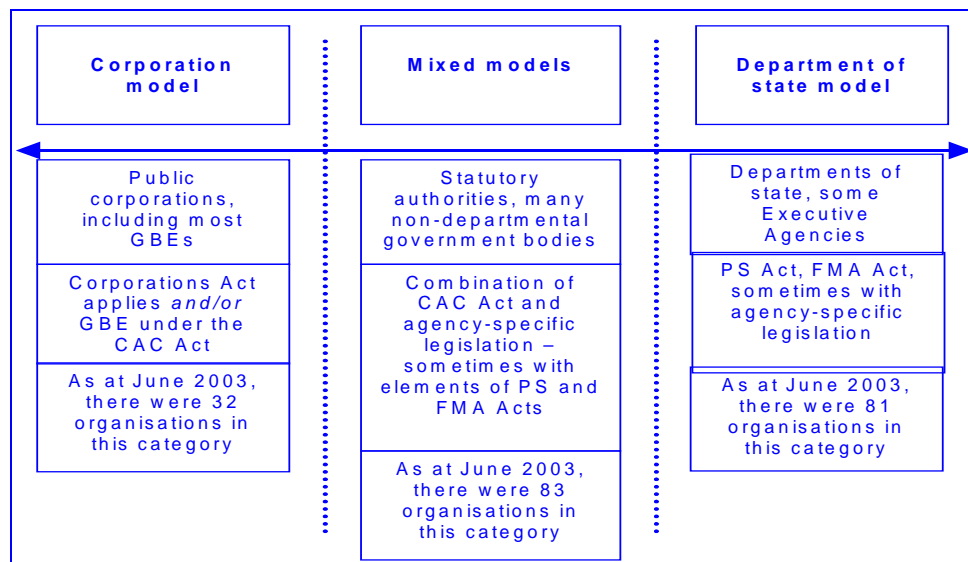
Figure 4: Components of public sector governance



Source: Victorian Public Accounts and Estimates Committee 2002, Issues Paper: *Inquiry into Corporate Governance in the Victorian Public Sector*, Melbourne, April, p. 8.

The second, Figure 5, indicates the main governance structures in the federal public sector. This comes from the ANAO’s recently released and widely acknowledged corporate governance Better Practice Guide⁴⁷ on which I will have more to say later.

Figure 5: Structures of governance in the federal public sector



Source: Department of Finance and Administration, *List of Bodies Subject to the CAC Act 1997* (as at September 2002) and *List of Agencies Subject to the FMA Act 1997* (May 2002).

For the *‘Department of State Model’* (FMA agencies) the governance arrangements differ significantly from those 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. That is, the emphasis is on accountability residing with the chief executive and, as discussed previously, while the chief executive may choose to appoint an advisory board to help with the management of an agency, these 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.

In contrast, the *‘Corporation Model’* (GBEs and Commonwealth corporations) are subject to the *Corporations Act*, the *CAC Act* (and, for Commonwealth GBEs, *Governance Arrangements for Commonwealth Government Business Enterprises*) with the added complexity of Ministerial responsibilities and oversight. Whereas publicly-listed private companies are subject to the *Corporations Act* and tend to have much more clearly defined and unambiguous Board accountabilities and responsibilities. CAC type 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 both within and across sectors of the economy.

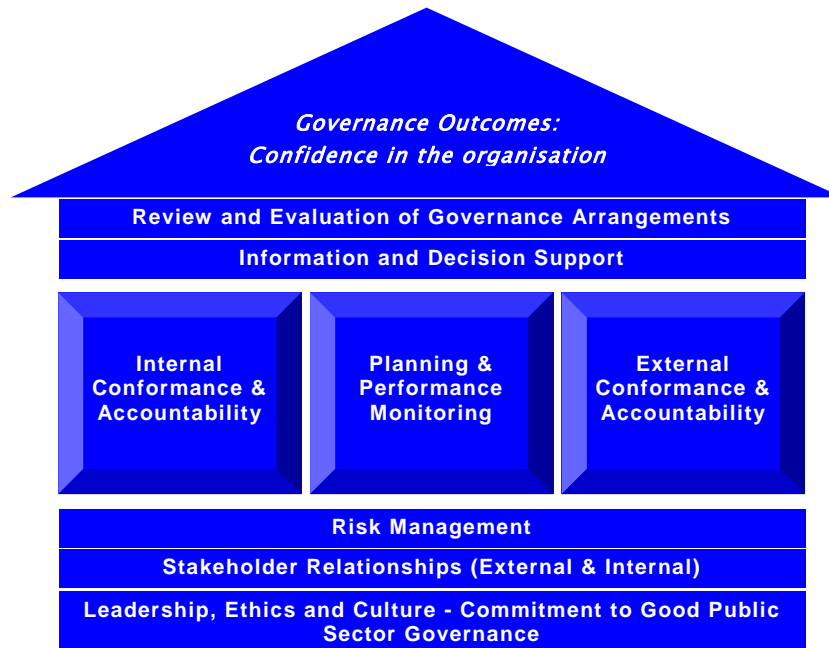
Located between these two models is the *‘Mixed Model’* which covers a large number of statutory bodies, mostly but not entirely subject to the CAC Act, that also operate under specific legislation. In many cases, this specific legislation dictates the structure, make-up, appointment arrangements, planning and reporting for the body, its board and/or its chief executive. This categorisation of Commonwealth organisations is not mutually exclusive. For example, some Commonwealth bodies subject to the CAC Act are also subject to provisions of the FMA Act relating to public money that they hold (as is the case with the Australian Securities and Investments Commission).

Most federal agencies now have procedures in place to help them comply with the legislative requirements depicted in Figure 2. However, the challenge is to draw these procedures together so that the day-to-day operations of organisations supports robust governance, which in turn supports good performance. This is not simply a culture of compliance but rather one which engenders a greater awareness of the need for sound management and record-keeping systems which are important elements of knowledge-based frameworks. These both facilitate compliance and achievement of required results.

The differences in the legislative and regulatory arrangements discussed above have a significant impact on the structures and processes of good governance. With this in mind, the ANAO has adapted a model developed by the Queensland Department of Transport to illustrate the key organisational and process elements of good governance in the public sector (see Figure 6). While each element is important and useful in itself, the relationships that are established between them are crucial to the successful performance of an organisation. Hence the aim is not only to have the necessary elements in place, but also to create positively reinforcing links between all of those elements.

With effective consultation with stakeholders—both external and internal—and good information and decision support, an organisation can establish arrangements that enable it to plan and deliver the its required outcomes and outputs as well as meeting the demands for external and internal conformance and accountability. These elements are shown in the following diagram.

Figure 6: The house of public sector governance



Source: Adapted from a model developed by the Queensland Department of Transport in its *Corporate Governance Framework for Queensland Transport and Main Roads: Final Report*, July 2001.

Implementing, maintaining and enhancing the elements shown in the diagram above maximises the chances that the organization will enjoy the confidence of its stakeholders, clients, staff and management and that it will be recognised as making sound, well informed and accountable decisions that lead to appropriate and effective actions and results. The relationships established between the various elements of good governance are crucial. Leadership, ethical conduct and the development and existence of an organisational performance culture support and sustain the framework as a whole. Without them, there would be no solid foundation to build on. In the 'House of Public Sector Governance', stakeholder relationships influence the effectiveness of all three central components of the structure, that is, the 'windows' of internal conformance and accountability, external conformance and accountability, and planning and performance monitoring. In particular, we need to engage our people and give them real ownership of the structure.

These 'windows' represent the core activities of governance for government organisations. They are the elements on which governance boards and committees are focused. Each 'window' exerts an influence on the other two as follows:

- planning and performance monitoring underpin the management framework within which external and internal conformance and accountability processes take place - accountability is integral to the performance of public organisations;
- internal conformance and accountability needs to be aligned with, and generate the information required for, external conformance and accountability; and

- external conformance and accountability establishes the base line for required internal processes, as information required for external purposes should generally form a subset of what is required internally.⁴⁸

Having provided this backdrop, I will now move on to my second theme – that we, in the public sector, need to come to terms with not only marrying private sector models and techniques with public sector accountability requirements, but also understanding commercial imperatives and organisational survival. The greater involvement of the private sector, as both a supplier and provider to the public sector, has introduced its own accountability issues as well as notions of performance.

Accountability requirements of the public sector

Public sector accountability is not a simple concept and has a touch of a ‘shibboleth’ about it. What it means and how it is supposed to work are often disputed; consequently applying it effectively can be daunting. Moreover, how can a concept founded on historical principles of Westminster-style government administration apply today, amid the complexities of the modern public sector? In response, I start with the following definition from my Canadian counterpart:

*‘Accountability is a relationship based on obligations to demonstrate, review, and take responsibility for performance, both the results achieved in light of agreed expectations and the means used’.*⁴⁹

This definition of accountability is consistent with managing for results; allows for accountability among partners who might be equal and/or independent; and includes obligations on all parties to the accountability relationship. It emphasizes the importance of accountability for results as well as for the means used to achieve them. It underlines the fact that effective accountability is not just simply about reporting performance; it also requires review (evaluation), including appropriate corrective actions, and addressing likely and/or possible consequences for individuals.

Today, citizens are demanding clearer and greater accountability for the way the government makes decisions, spends their tax dollars, and uses its authority. But the traditional view and practice of accountability are challenged in a public sector where the focus is now much more on getting results; where the public sector engages in partnering arrangements within and across levels of government and with outside organizations to determine and deliver public policy; and where managers are encouraged to innovate and take reasonable risks.

In reading Dr David Watson’s paper (cited earlier) I was alerted to Robert Behn’s book – *Rethinking Democratic Accountability*⁵⁰. In holding people accountable, Behn says we usually mean accountability for one of three things: accountability for finances, accountability for fairness, or accountability for performance.⁵¹ He expands on this idea thus:

- ***Financial accountability***

This is relatively straightforward. The managers and employees of any public organization have been entrusted with something valuable: taxpayers’ money. They have the responsibility – the obligation – to

use these funds wisely. They ought to be held accountable for doing so.

- ***Accountability for Fairness***

Here government organizations and their employees should be held accountable for more than simply handling the finances properly. We also want to hold them accountable for a variety of well-established norms of democratic government – specifically for fairness.

- ***Accountability for the Use (or Abuse) of Power***

Public servants award contracts, decide benefits, impose fines and exercise a lot of discretion and we seek to hold them accountable by imposing rules and regulations. However the accountability for power can be seen as accountability for finances and fairness.

- ***Accountability for Performance***

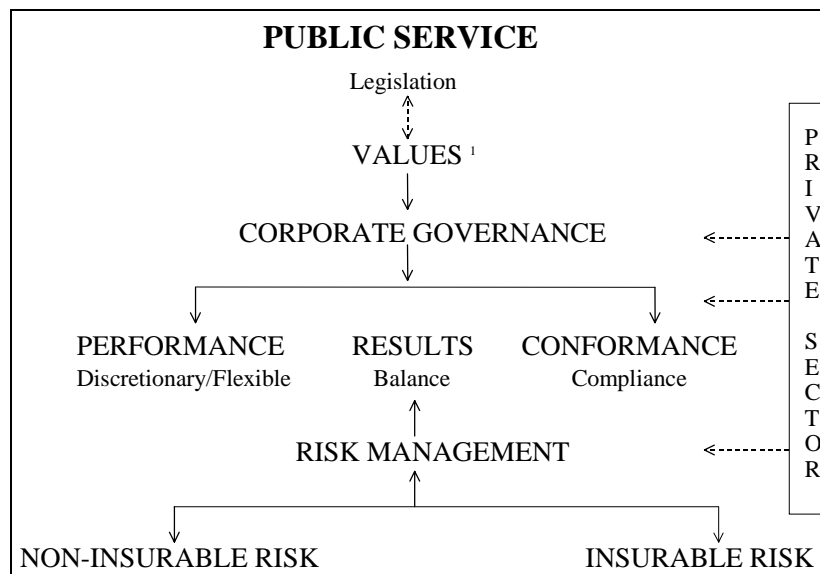
*Accountability for finances and fairness reflect concerns for **how** government does what it does. But we also care **what** government does – what it actually accomplishes. Accountability for performance ought to cover the expectations of citizens; it ought to mean accountability to the entire citizenry.⁵²*

Behn also makes the point that improved performance is important and that citizens certainly want improved performance, ‘*But we don’t think you public managers can only get that improved performance by getting rid of the rules that ensure financial probity and guarantee fairness. Okay, the rules make it a little harder. But they don’t make it impossible. They just mean that you have to be a little smarter, a little more persistent*’.⁵³ Accountability is really two tests – one for finances and fairness, the other for performance, that is, one for process, another for results. These two tests often seem to be in direct conflict raising the issue of an appropriate balance between conformance and performance.

The accountability dilemma: getting the right balance - conformance and performance

Holding people accountable for performance while also holding them accountable for use of finances and fairness creates an *accountability dilemma*. In a more privatised public sector, what is a reasonable trade-off when, inevitably in a public sector environment, the perceived needs for accountability can impact adversely on economy and efficiency. A similar observation extends to the notion of effectiveness, particularly where that concept does not apparently embrace accountability concerns such as transparency, equity of treatment and probity in the use of public resources, including the application of public service values and codes of conduct. The following diagram (Figure 6) suggests that, where the two sectors interact, some relationship has to be established in the corporate governance framework to meet demands for both conformance and performance (including in responsiveness and results) as well as in identifying and allocating risks.

Figure 6: Public/Private sector interface



¹ It is difficult, in a practical sense, to apply the wider-ranging values contained in the *Public Service Act 1999* to the private sector. Nevertheless, there are 'shared' values and codes of conduct.

Source: ANAO ⁵⁴

The apparent accountability dilemma has been extensively commented on by, for example, Professor Richard Mulgan of the Australian National University, in many articles and presentations in recent years. The following is indicative:

'Contracting out inevitably involves some reduction in accountability through the removal of direct departmental and Ministerial control over the day-to-day actions of contractors and their staff. Indeed, the removal of such control is essential to the rationale for contracting out because the main increases in efficiency come from the greater freedom allowed to contracting providers'.⁵⁵

Hence, the ongoing challenge for both private and public sector entities is achieving the 'right' balance between conformance and performance at particular points in time and over time. Many consider that this 'balance' is simply the outcome of sound risk management with proper identification, prioritisation and treatment of the myriad of risks confronting an organisation or, say, a public-private partnership. Nevertheless, the outcome is largely determined by leadership decisions, values and identified preferences and should be understood, and achieved, throughout the organisation as well as sound ethical values and good conduct practices are meant to be. The notion of 'public interest' sets the bar quite high in these respects.

It is generally accepted that a degree of trade-off exists between conformance and performance imperatives which may well be largely a result of sound risk management as suggested above. For example, an undue emphasis on compliance breeds a risk-averse culture that inhibits exploitation of emerging opportunities. At the same time, it is apparent that a solid conformance control structure, embedded in risk-management, protects an entity from '*corporate governance delinquency*'⁵⁶, and the possible severe impacts of this on individual and organisational performance. This is not simply, nor should be, a 'box-ticking' exercise of relevant principles or

better practice. Nevertheless, reference to a check list of better practice can focus the mind on issues that need to be addressed, particularly when an organisation is under pressure to perform.

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 single-minded striving for exceptional performance. At one extreme we have the following observation of Donald Savoie, a critique of the NPM ⁵⁷:

‘Public administration operates in a political environment that is always on the lookout for errors and that exhibits an extremely low tolerance for mistakes....In business it does not much matter if you get it wrong ten percent of the time as long as you turn a profit at the end of the year. In government, it does not much matter if you get it right 90 percent of the time because the focus will be on the 10 percent of the time you get it wrong’. ⁵⁸

This concern has undoubtedly encouraged a risk-averse attitude among public servants in the past, which is said to have been reinforced by Parliamentary expectations and attitudes expressed often in budget estimates examinations. It has also been observed that such an environment has largely focussed bureaucratic attention on administrative 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 in the future.

Put another way, the implied view is that the Australian Public Service (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 more 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 around. The notion is to deliver services seamlessly to citizens, including across government levels. And this is being gradually achieved, particularly with the assistance of advances in information and communications technology and software for the operation of intranets and the Internet itself.

This concept of ‘clients as citizens’ demonstrates the particular challenges faced by public sector agencies in negotiating the changing governance environment. While it may be appropriate, even desirable, for citizens to be considered as clients in terms of service delivery, with all of the advantages that private sector models may offer in this regard, it is less desirable in terms of meeting the public sector’s accountability requirements. There is generally a higher standard of accountability demanded of the public sector in relation to its clients – to whom it is ultimately responsible as citizens and taxpayers – than there is in the equivalent relationship between private sector entities and their clients. That is, there is more to client relationships than a marketing imperative. A practical comment on the perceived trade-off has been provided by the former Canadian Auditor General, as follows:

*The emphasis should not be solely on greater efficiency or on meeting accountability requirements.*⁵⁹

An appropriate compromise may have to be sought, which may involve re-consideration by the Government and the Parliament as to the appropriate nature and level of accountability of both public and private organisations where there is shared responsibility, and even accountability for the delivery of public services to the citizen. In this latter respect, I am personally inclined to support the observation of Professor John Uhr, also of the Australian National University, that:

*Accountability and responsibility are two parts of a larger whole: whoever is 'responsible for' a policy or program is also 'accountable to' some authority for their performance within their sphere of responsibility.*⁶⁰

In the Australian context, there is no suggestion on the part of the Government or Parliament that accountability expectations will be downgraded; if anything, the reforms suggest that additional authority and flexibility require enhanced accountabilities even where there may be an additional cost involved. Parliament's confidence in the accountability of public sector organisations is an on-going challenge to our corporate governance frameworks. Nevertheless, in the words of a long time academic reviewer of the changing nature of governance in Australia:

*'With the advent of entrepreneurial government and the enterprising state, expressed most obviously in extensive forms of contracting-out, (these) organizational boundaries and identities are less able to contain or limit the accountability issue. Recent changes have stretched the elasticity of our received notions of accountability to the breaking point.'*⁶¹

I take the view that accountability of public sector operations depends to a great extent on providing full information on the operations of agencies and other related bodies. In some situations, because of the nature and complexity of public sector administration in an environment of ongoing reform 'Additional transparency provisions may be a cost that we have to meet to ensure an acceptable level of accountability'.⁶² This leads to my next issue – transparency.

Transparency v Opaqueness

Openness and transparency are essential elements of accountability, which is, rightly, at the heart of an effective public governance environment making it easier for those outside government to monitor and challenge the government's performance for consistency with policy intentions, for fairness, for propriety, and for sound stewardship. As a US Supreme Court Justice, Louis Brandeis, famously remarked: '*sunlight is the most powerful of all disinfectants*'⁶³. Contemporary concerns about transparency are linked to those about integrity in public and business life. Transparency of management decisions in the public sector is a recipe for better corporate governance as summarised in the following observation:

'Transparency is ...a key element ...and in vision of open executive government as a necessary entailment of democracy and legality.

*Transparency is central to contemporary discussions of both democratic governance and public sector reform, since open access to information and the elimination of secrecy is taken to be a condition for the prevention of corruption and promoting public accountability’.*⁶⁴

Also Senator Hogg (a Member of the Committee of Public Accounts and Audit (JCPAA) when commenting on the need to maintain scrutiny of government operations made the strong point that:

*‘Public funds are not for the private purse of the government nor the bureaucrats to do what they like with. They are public funds for public purposes and should stand the test of public scrutiny by the Parliament’.*⁶⁵

What are the important elements of transparency in the public sector? I will canvass just three that are relevant to issues of governance involving both the public and private sectors in the delivery of public services.

The ability to report openly

The Auditor-General, through the ANAO, provides an independent review of the performance and accountability of the federal government public sector agencies and entities. The *Auditor-General Act 1997* provides a legislative framework for our activities and establishes the Auditor-General as an *independent officer of the Parliament* – a title that symbolises the Auditor-General’s independence and unique relationship with the Parliament. My mandate extends to all Australian government agencies, authorities, companies and subsidiaries (with the exception of performance audits of GBEs and persons employed under the Members of Parliament Act 1994 – however, performance audits can be conducted of wholly owned GBEs at the request of the responsible Minister, the Finance Minister, or the JCPAA).⁶⁶

The increasing involvement of private sector entities in public sector activities has increased the complexity of undertaking our performance audits. There are three main interrelated concerns, namely: access to information, including transparent explanations; requirements of public accountability, particularly with the use of commercial-in-confidence arguments; and the possible consequences for a firm’s reputation and market situation of any adverse comments on public sector management and administrative practices. In all three cases, there is the addition of legal complexity, which also adds to the cost of the audits.

An important element supporting my ability to report, without fear or favour, is the application of Parliamentary privilege to performance and financial statement audit reports tabled in the Parliament.

*‘The provision of Parliamentary privilege is an essential element in protecting the office of the Auditor-General so that it may provide a fearless account of the activities of executive government’.*⁶⁷

This in turn allows the Auditor-General to report freely, openly and responsibly on matters examined in the course of audits. While the ANAO is sensitive to private

sector concerns about commercial reputations, the Parliament expects full public accountability, particularly on issues of fair and ethical conduct and protection of the public interest. Conflicts of private and public interest are not new but their resolution in performance audit reports is a challenge for all parties without a genuine shared understanding of what constitutes public accountability. The ANAO is very sensitive to the notion of natural justice which it takes seriously as part of engendering public confidence in its reports. However, I stress that means natural justice for all parties involved.

Freedom of information

The essential characteristic of accountability is access to information. Virtually all accountability relies on the ready availability of reliable and timely information. Indeed, it has been said that '*information is the lifeblood of accountability*'.⁶⁸ Public access to reliable information is supported in each Australian jurisdiction by *Freedom of Information* (FOI) legislation.

Each APS staff member needs to understand clearly how their individual governance behaviour can be exposed under *FOI* requirements, and by the investigations of organisations such as the Ombudsman, the ANAO, the Privacy Commissioner and the Administrative Appeals Tribunal. In this regard, good record-keeping and good audit and management trails are not 'bureaucratic' in a pejorative sense. To the contrary, they are a valuable management requirement. They are also evidence of sound governance processes and practices. In particular, they demonstrate transparency and accountability to stakeholders. One important issue is the uncertainty of any responsibility of private sector providers under the legislation, particularly when they are holding public records.

Commercial in Confidence

The greater involvement of the private sector also gives rise to concerns about the extent to which commercial interests are being protected at the expense of eroding transparency and accountability. The issue here was the common practice in the public sector of classifying most federal government contracts as *commercial-in-confidence* which drew Parliamentary criticism that this allowed public servants to effectively 'hide behind' these *commercial-in-confidence* provisions when questioned on the basis of the contractual arrangements entered into with the public sector. As one academic commentator noted:

*'While [Commercial-in-Confidence] may be good for business, it is inimical to the fragile processes of participatory democracy.'*⁶⁹

The increased convergence of the public and private sectors, demonstrating transparency, accountability and the ethical use of resources therefore had the potential to inhibit public confidence unless governments took a proactive and consistent stance on the scrutiny of contracts involving public funds.⁷⁰ This issue was raised by the Senate Finance and Public Administration References Committee during its inquiry into the Commonwealth Government's IT outsourcing initiative, as follows:

*‘Placing limitations on the free flow of information has the effect of bypassing parliament; reducing public scrutiny of important government decisions or programs; denying citizens access to information about programs affecting them; and restricting citizens’ access to remedies in the event of poor service delivery’.*⁷¹

This issue has now largely been solved by the Senate, in 2001, making an Order that required Ministers to table letters of advice that all agencies, which they administered, had placed on the Internet lists of contracts of \$100,000 or more by the tenth day of the Spring and Autumn sittings of Parliament. The list was to indicate, among other things, whether the contracts contained any confidentiality provisions and a statement of the reasons for the confidentiality. The Government subsequently agreed that agencies would comply with the spirit of the Senate Order. The Senate Order sought to invoke the reverse ‘onus of proof’ principle by placing the responsibility on those who wish to keep the information confidential to argue that the confidentiality is warranted. This has been described as follows:

*‘In order for the court to be persuaded to protect a government secret, the government must establish that it is in the public interest that the information not be disclosed. Further, the courts have been sceptical of governments wishing to keep matters secret so that the onus on the government is a heavy one’.*⁷²

The Government advised that information regarding individual contracts would not be provided where disclosure would be contrary to the public interest, legislative requirements or undertakings given.⁷³ Subsequent amendments to the Senate Order were aimed at strengthening and clarifying the Order.

The Senate Order requested the Auditor-General to undertake twice-yearly examinations of agency contracts required to be listed on the Internet and report as to whether there had been any inappropriate use of confidentiality provisions. My most recent audit report on this matter, tabled in Parliament on 11 September 2003⁷⁴, found that the majority of agencies had complied with the Senate Order but there was scope to improve the presentation of their internet listings.

A related issue arising out of contracting with the private sector for the provision of government services provides was the concern of securing ANAO access to contractors records and premises – this was reflected in the report of the Joint Committee of Public Accounts and Audit (JCPAA) in 2000.⁷⁵ In the interest of securing access to premises and records, the ANAO has been encouraging the inclusion in contracts of model access clauses, as has the latest version of the Government’s Procurement Guidelines. These clauses give the agency and the Auditor-General access to contractors’ premises and the right to inspect and copy documentation and records directly related to the contract. The inclusion of access provisions within agency contracts is particularly important in maintaining the thread of accountability with government agencies’ growing reliance on partnering with the private sector and on contractors’ quality assurance systems.

Ethical Standards

The following observation by Dr Peter Shergold would have general acceptance:

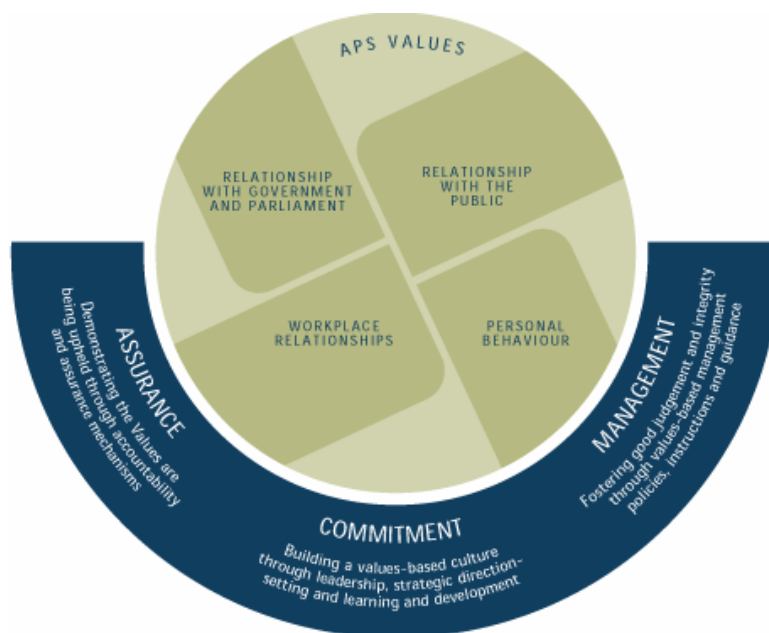
*‘But, as we change the structures of bureaucratic endeavour, so must we maintain the traditional ethical standards, conduct and values that underpin public service. We need to share with others our belief that Australia’s public ‘bureaucracies’, and the APS in particular, are essential to our democratic polity and civil society. Indeed, I would argue that public services are a foundation of the national institutions upon which Australia’s distinctive commitment to a “fair go” have been built’.*⁷⁶

In launching the APS Values and Code of Conduct (27 August 2003) Andrew Podger (Public Service Commissioner) made the following significant points:

- The link between ethical and effective organisational performance is critical to public service organizations. Strong, clearly stated values can guide people through choices, so that making ethical decisions the path of least resistance, and making ethical practices a priority is not just about functioning with integrity or being credible; it is also about optimising the efficient functioning of an organisation.
- Leadership is crucial to the successful operation of a values-based management system. Leadership is the factor most frequently cited as the key to successfully implementing a values strategy from start to finish.
- Values need to be ‘hardwired’ into systems and processes and leadership behaviours, that is values need to become second nature to employees, not just management rhetoric.⁷⁷

The diagram below illustrates the APS Value Framework.

Diagram 7: The APS Values Framework



Source: Australian Public Service Commission ⁷⁸

For completeness and to emphasise their importance in sound corporate governance in the public sector, I have reproduced the APS Values and Code of Conduct below. They are comprehensive and have the force of law. While some would argue that you cannot 'legislate for ethics', their importance is, in my view, largely one of helping to create a 'culture of public service' that fulfils all of the public's expectations as citizens.

The APS Values⁷⁹

The Australian Public Service:

- *is apolitical, performing its functions in an impartial and professional manner;*
- *is a public service in which employment decisions are based on merit;*
- *provides a workplace that is free from discrimination and recognises and utilises the diversity of the Australian community it serves;*
- *has the highest ethical standards;*
- *is openly accountable for its actions, within the framework of Ministerial responsibility to the Government, the Parliament and the Australian public;*
- *is responsive to the Government in providing frank, honest, comprehensive, accurate and timely advice and in implementing the Government's policies and programs;*
- *delivers services fairly, effectively, impartially and courteously to the Australian public and is sensitive to the diversity of the Australian public;*
- *has leadership of the highest quality;*
- *establishes workplace relations that value communication, consultation, co-operation and input from employees on matters that affect their workplace;*
- *provides a fair, flexible, safe and rewarding workplace;*
- *focuses on achieving results and managing performance;*
- *promotes equity in employment;*
- *provides a reasonable opportunity to all eligible members of the community to apply for APS employment;*
- *is a career-based service to enhance the effectiveness and cohesion of Australia's democratic system of government;*
- *provides a fair system of review of decisions taken in respect of employees.*

The APS Code of Conduct⁸⁰

APS employees are required, under the Code of Conduct, to behave at all times in a way which upholds the APS Values. The Code of Conduct requires that an employee must:

- *behave honestly and with integrity in the course of APS employment;*
- *act with care and diligence in the course of APS employment;*
- *when acting in the course of APS employment, treat everyone with respect and courtesy, and without harassment;*

- *when acting in the course of APS employment, comply with all applicable Australian laws;*
- *comply with any lawful and reasonable direction given by someone in the employee's Agency who has authority to give the direction;*
- *maintain appropriate confidentiality about dealings that the employee has with any Minister or Minister's member of staff;*
- *disclose, and take reasonable steps to avoid, any conflict of interest (real or apparent) in connection with APS employment;*
- *use Commonwealth resources in a proper manner;*
- *not provide false or misleading information in response to a request for information that is made for official purposes in connection with the employee's APS employment;*
- *not make improper use of:*
 - (a) inside information, or*
 - (b) the employee's duties, status, power or authority,**in order to gain, or seek to gain, a benefit or advantage for the employee or for any other person;*
- *at all times behave in a way that upholds the [APS Values](#) and the integrity and good reputation of the APS;*
- *while on duty overseas, at all times behave in a way that upholds the good reputation of Australia; and*
- *except in the course of his or her duties as an APS employee or with the Agency Head's express authority, not give or disclose, directly or indirectly, any information about public business or anything of which the employee has official knowledge.*

The Australian Public Service Commission has noted that public service values and code of conduct are robust enough to govern the behaviour of all public servants. However, the Commission also notes that relevant values should also be applied to outsourced service providers and partners, particularly those providing services to the public.⁸¹ I understand some of the latter have volunteered to do so but it does raise the question as to how this can be made a reality in any enforceable sense. While I understand the potential conflicts that can occur for a private sector person, particularly where a firm's reputation and commercial viability could be at stake, I would like to think that considerations of public, rather than private, interest would prevail.

To conclude, I turn to Professor Jennings, Arizona State University, who, in conducting a post-mortem of the recent era of corporate collapses in the United States, made this observation:

*'But the reality is that the tangible aspects of financial collapse begin with a severe erosion and eventual ruination of corporate and personal ethics. In other words, companies collapse ethically long before suffering financial demise'*⁸²

or put another way, 'Where there are ethics and integrity, there should also be more profitable performance'.⁸³

IV Initiatives to Improve Corporate Governance in Both the Public and Private Sectors

In response to the corporate governance failures in recent major corporate collapses we saw, during 2003, a number of high-profile efforts to improve corporate governance in Australia. These included the Australian Stock Exchange (ASX) Corporate Governance Council's *Principles of Good Corporate Governance* released in March 2003⁸⁴, the HIH Royal Commission report in May 2003 and Standards Australia release of a new standard - AS 8000-2003 on *Good Governance Principles*⁸⁵ in July 2003. The Senate passed two bills to amend the *Corporations Act 2001*. The *Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Bill 2003*⁸⁶ was introduced into Parliament on 4 December 2003 and John Uhrig completed his review into corporate governance of statutory and office holders⁸⁷. Also the ANAO published a *Better Practice Guide on Public Sector Governance* in July 2003.

Overseas, there has been the recent release (12 January 2004) of the *Review of the OECD Principles of Corporate Governance – Invitation to Comment* and the OECD's *Survey of Corporate Governance Developments in OECD Countries* (9 December 2003) as part of an assessment of OECD Principles of Corporate Governance requested by Ministers in 2002. Both publications can be found at the OECD's website - www.oecd.org.

I will now briefly touch on these major recent initiatives and two related areas of interest - auditor independence and the harmonisation of Australian and international accounting and auditing standards. While you may be quite familiar with all of these aspects, it is nevertheless interesting to consider them here in the light of the foregoing discussion and their implications.

The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 - (CLERP 9 Arrangements)

The Corporate Law Economic Reform Program (CLERP) was initiated in 1997 as a vehicle for the ongoing review and reform of Australia's corporate and business regulation to ensure that it is up-to-date, responsive and promotes business activity. Since that time, substantial changes have been made to the Corporations Act and the corporate regulatory framework more generally, particularly in the areas of accounting standards, fundraising, directors' duties, takeovers and financial services reform. The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003* is the next stage in the government's reform agenda reforms.

The policy proposals contained in CLERP 9 were developed in consultation with a range of stakeholders, including ASIC, and build on the recommendations contained in the Ramsay Report (Independence of Australian Company Auditors) which was released in October 2001 and the 1997 report of the MINCO Working Party (Review

of the Requirements for the Registration and Regulation of Company Auditors).⁸⁸ A discussion paper⁸⁹ — *Corporate Disclosure: Strengthening the financial reporting framework* — was released in September 2002 and proposed a range of measures designed to enhance audit regulation and the general corporate disclosure. Over 60 submissions were received by the time the consultation period ended in November. Since then, there has been consultation with a broad range of stakeholders to discuss the proposals.

The Treasurer released the draft *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003*⁹⁰ for public comment on 8 October 2003. The Bill also implements recommendations of both the HIH⁹¹ and Cole⁹² Royal Commissions and takes account of relevant recommendations of the Joint Committee of Public Accounts and Audit Report 391 (Review of Independent Auditing by Registered Company Auditors).⁹³

The period for public comment closed on 10 November 2003. Again, over 50 submissions were received from a broad range of stakeholders. The Business Regulation Advisory Group (BRAG), made up of senior representatives from the business community established specifically to advise the Government on proposals arising out of CLERP, was consulted on both the policy proposal paper and the Bill.⁹⁴

The underlying objective of the reforms contained in the Bill aims to improve the operation of the market by promoting transparency, accountability and shareholder activism. To this end, the Bill sets up a framework with the following features⁹⁵:

Improving the reliability and credibility of financial statements through the enhanced auditor independence by:

- Expanding the role of the Financial Reporting Council (FRC) be to cover oversight of the audit standard setting process and monitoring and advising on auditor independence.
- Requiring auditors to meet a general standard of independence and make an annual declaration that they have maintained their independence.
- Requiring disclosure of all non audit services with the fees applying to each work item and a statement why there is no compromise to audit independence.
- Introducing and/or enhancing restrictions on certain employment and financial relationships ie a ‘cooling off’ period of two years before an audit partner can become director or employee of a corporate client.
- Requiring auditors to rotate after five years (and up to seven years where ASIC relief has been granted).
- Requiring auditors to attend company Annual General Meetings (AGMs).
- Giving the Australian Securities and Investments Commission (ASIC) a power to impose conditions on auditors’ registration.

Improved enforcement arrangements by:

- Enhancing the operational capacity of the Companies Auditors and Liquidators Disciplinary Board (CALDB) by appointing a deputy chair and facilitating concurrent hearings. In addition, the majority of members will be non accountants.

- Establishing a Financial Reporting Panel (FRP) to resolve disputes between ASIC and companies regarding the application of accounting standards.
- Auditing standards being made legislative instruments in the same way as Australian Accounting Standards Board (AASB) accounting standards.
- Protection will be available for employees and others who report suspected breaches of the law to ASIC and internally within the company.
- Strengthening the obligations for auditors to report suspected breaches of the law to ASIC.

Measures to better allocate and manage risk by:

- Auditors being able to incorporate, and, a regime of proportionate liability will be introduced. Incorporation will protect auditors who are not responsible for loss caused by another auditor in the audit firm. Proportionate liability will ensure that liability rests with all defendants in proportion to their contribution to the plaintiff's loss. The proportionate liability reforms are of general application and are not confined to auditors.

Better disclosure to shareholders and improved shareholder activism by:

- Improved presentation of disclosure documents and the operation of the secondary sale provisions.
- Enhancing disclosure requirements applying to director and executive remuneration and shareholders will be better equipped to hold directors accountable for their decisions regarding remuneration.
- Shareholders having greater ability to ask auditors questions regarding the conduct of the audit and the content of the audit report.
- Improving mechanisms for shareholders to participate and vote in general meetings.

Better enforcement mechanisms for continuous disclosure by:

- Increasing the maximum civil penalty for a contravention of the continuous disclosure (and other financial services civil penalty) provisions by a body corporate will be increased.
- Persons involved in a contravention of the continuous disclosure regime by a body corporate will be subject to civil penalties.
- ASIC being given the power to issue infringement notices specifying payment of a financial penalty in relation to contraventions of the continuous disclosure regime.
- A specific duty on analysts to manage conflicts of interest.

The draft Bill has received in-principle support from the two major accounting bodies⁹⁶ and the Australian Institute of Company Directors⁹⁷. However, there were some reservations expressed. These centred on shareholders having a direct say on executive salary packages (as it is considered that boards should unambiguously maintain responsibility for setting executive remuneration), auditing standards having the force of law, practical limitations on compulsory audit partner rotation to avoid penalising smaller firms, spot penalties, and the limiting of whistleblower protection to employees who report suspected incidents to ASIC. While clarity in direction is generally appreciated, concerns have been voiced about 'rushing into overly

prescriptive legislation’ and the use of a system of ‘black letter’ law as an approach to achieving good corporate governance⁹⁸.

Since the Bill’s introduction into Parliament there has been criticism of the reduction of ‘cooling-off period’ from four to two years (for auditor partners taking up positions with their clients). As one commentator observed: ‘*HIH Royal Commissioner, Justice Neville Owens considered that a two years’ cooling off period might not be sufficient to arrest a reasonable apprehension that former partners retain an influence over members of the audit team*’⁹⁹. However, the Institute of Chartered Accounts, the National Institute of Accounts and CPA Australia endorsed this change. There was also critical comment from the Business Council of Australia which indicated that it ‘*would continue to pressure the Government to drop a move to give shareholders a non-binding say on executive remuneration and the new power of the Australian Securities and Investments Commission to make on the spot fines*’.¹⁰⁰

Notwithstanding the scope of the latest CLERP 9 reforms, it is very much still work in progress. As the former Parliamentary Secretary concluded in his address to the ASIC Summer School in March 2003:

*‘.. CLERP 9 won’t be the end of corporate law reform in Australia. I have already started work with Treasury officers and other stakeholders in developing a further number of chapters in the CLERP program. There is still a lot of work to be done to ensure that we keep improving Australia’s corporate regulatory environment with a view to making this a world-renowned place to do business with, a well informed market place with high levels of participation and a place that is very welcoming to international capital’.*¹⁰¹

ASX Corporate Governance Guidelines

A second leg of the Australian governance reform agenda has been the establishment of the ASX Corporate Governance Council to develop a practical guide on best practice in corporate governance. The Principles of Good Governance and Best Practice Recommendations, released in March 2003¹⁰², ask all listed companies to formulate and abide by detailed schedules of best practice covering board structure, financial reporting, remuneration, audit committees and ethics. As one commentator observed:

*‘...the Australian Stock Exchange Corporate Governance Council released its report “Principles of good corporate governance and best practice recommendations”. In doing so it signalled the beginning of a new era in corporate governance which will be characterised by attempts to define best practice and a challenge to corporations to meet the standards or explain why not.’*¹⁰³

The ASX Corporate Governance Council Guidelines recognise that there is no one rigidly defined governance model by setting out key themes which underlie good corporate governance generally. These themes flow into the following ten key principles which, in turn, are underpinned by twenty-eight specific best practice

recommendations. The ten principles are summarised below, namely that a company should:

1. ***lay solid foundations for management and oversight*** – recognise and publish the respective roles and responsibilities of the board and management;
2. ***structure the board to add value*** – have a board with an effective composition, size and commitment to adequately discharge its responsibilities and duties;
3. ***promote ethical and responsible decision making*** – actively promote ethical and responsible decision making;
4. ***safeguard integrity in financial reporting*** – have a structure to independently verify and safeguard the integrity of the company’s financial reporting;
5. ***make timely balance sheet disclosures*** – promote timely and balanced disclosure of all material matters concerning the company;
6. ***respect the rights of shareholders*** – and facilitate the effective exercise of those rights;
7. ***recognise and manage risk*** – establish a sound system of risk oversight and management of internal control;
8. ***encourage enhanced performance*** – fairly review and actively encourage enhanced board and management effectiveness;
9. ***remunerate fairly and responsibly*** – ensure that the level of remuneration is sufficient and reasonable and that its relationship to corporate and individual performance is defined; and
10. ***recognise the legitimate interests of stakeholders*** – recognise legal and other obligations to all legitimate stakeholders.¹⁰⁴

While these guidelines are focused at the private sector and seen as a comprehensive response to ‘*revelations about lamentable corporate behaviour at the tail end of the boom*’¹⁰⁵, they also provide broad pointers for the public sector, for example the themes of management, ethical decision-making, managing risk, and enhanced performance are particularly apposite. It would therefore be a mistake for those in the public sector to dismiss such guidance as only that applying to listed corporations.

The response to the ASX rules has been overwhelmingly positive. However, there has also been some disquiet regarding the lack of consultation, being too prescriptive – *one size fits all*, increasing the cost of governance, lacking teeth, and requiring independent directors and Chairpersons. Senator Campbell summed it up well:

‘This guide has been criticised by one side that it is too prescriptive and by others that it lacks teeth. What is important is that, in particular, for smaller companies it will give them a chance to go through a corporate governance review which is not bad for a

*company. The corporate governance guidelines are not supposed to have teeth. It is meant to be a process that encourages companies to review their corporate governance procedures and then report to the marketplace’.*¹⁰⁶

The Uhrig Review

An initiative of interest to both the public and private sectors was the review led by Mr John Uhrig AC into the corporate governance of statutory authorities and office holders, with particular attention being paid to those that impact on the business community. As Senator Minchin observed, following the announcement of the review by the Prime Minister¹⁰⁷:

*‘Good corporate governance is crucial to the performance of both the private and public sector entities. We have seen in recent times the effect poor corporate governance has had on organizations in the private sector. Statutory authorities and office holders can have a major impact on business, especially in the areas of tax and regulation. The community is entitled to expect that statutory authorities and office holders will operate with the highest levels of good governance’.*¹⁰⁸

The focus of the Uhrig review was on a select group of agencies with critical business relationships, including the Australian Taxation Office, the Australian Competition and Consumer Commission, the Australian Prudential Regulation Authority, the Reserve Bank of Australia, the Australian Securities and Investments Commission, the Health Insurance Commission and Centrelink. The review addressed the following issues:

- existing governance frameworks;
- existing Government stewardship;
- good governance; and
- governance going forward.

In addition to analysing existing governance arrangements, it was anticipated that the review would also address the selection process for board members and office holders, the mix of experience and skills required by boards, their development requirements, and their relationship to government. An expected outcome of the review is the development of a broad template, or templates, of governance principles and practices to apply to various statutory bodies.

In acknowledging the receipt of the Uhrig Report the Prime Minister said he expected the Government’s response to include a timetable for the implementation of the second stage to the review, which would involve assessing the performance of statutory authorities and office holders against the principles established by Uhrig.¹⁰⁹ Reforms will be undertaken on a whole-of-government basis. I understand that the government is yet to formally consider its findings, principles and recommendations. This delay has drawn the following observation from the private sector:

‘While the Government has been trying to put the corporate government squeeze on the nation’s boardrooms, it is far less forthcoming about its own corporate governance procedures. The Uhrig Report into how government departments deal with corporate governance matters has been gathering dust for three months’¹¹⁰

However, at the time of preparing this address, I understand that the Government’s response is imminent.

You may have noticed a recent article by Vivek Chaudhri and Paul Kerin (Melbourne Business School) about Telstra in the Australian Financial Review which, among other things, suggested, in Society’s interests, a somewhat more radical approach than might be recommended by John Uhrig as follows:

- *Privatise all GBEs*
- *Fully privatise mixed ownership companies*
- *If the regulatory/incentive levers are not right, fix them*
- *Publicly commit the government to a policy of exerting no “indirect political interference” over any commercial entity.¹¹¹*

I offer no comment on the suggestions except to note that it might be interesting to compare them with the Uhrig report.

Standards Australia

In July 2003, Standards Australia issued a set of five corporate governance standards to provide the business community with greater access to good governance principles. While these standards do not require compulsory compliance, they are proving very popular. Mark Bezzina (Standards Australia) comments that they *‘seem to have struck a chord, and have been at the top of our most popular standards’*.¹¹² The suite of standards (AS 8000-2003) cover the following areas¹¹³:

- Good Governance Principles – introduces a corporate governance framework that provides strategic guidance on how a business operates and interacts with its staff, customers and the community.
- Fraud and corruption control – establishes anti-fraud and corruption control policies.
- Organisational codes of conduct – establishes a code of conduct to improve staff morale and the way management operates the business.
- Corporate social responsibility – developing the extent to which a business goes beyond legal requirements in dealing with social and environmental responsibilities.
- Whistleblower protection program for entities – a system that enables employees and others involved with the business to inform management or owners of the business about improper or illegal practices of others without attracting negative repercussions for themselves.

The ANAO's Public Sector Governance Better Practice Guide

On the public sector side, my Office recently published an updated Better Practice Guide to assist public sector organisations to meet the current pressures, and expectations, of their governance framework, processes and practices. The guide defines public sector governance to include:

'how an organisation is managed, its corporate and other structures, its culture, its policies and strategies and the way it deals with its various stakeholders. The concept encompasses the manner in which public sector organisations acquit their responsibilities of stewardship by being open, accountable and prudent in decision-making, in providing policy advice, and in managing and delivering programs'.¹¹⁴

In my introduction to the Guide, I make the point that it is not prescriptive and has no legislative status. Governance arrangements must be tailored to individual agency circumstances, based on a risk management approach that considers potential benefits and costs associated with activities that contribute to meeting specified objectives.¹¹⁵ It is not a one size fits all situation, as many have noted - effective governance arrangements are those that are tailored to match individual agency circumstances, the guide attempts to provide an appropriate range of options. I should mention that the guide is generally available both in hard copy, and from the ANAO website, as indeed are earlier guides.

The guide is aimed at all levels in an organisation. While it provides guidance specifically to those working at the top, it also seeks to assist people working at all levels of an organisation to more fully understand the principles of better public sector governance and to know more about how to apply them. The Guide therefore attempts to cover the full range of public sector-specific governance issues as well as providing more detailed guidance on specific aspects of governance that are of particular concern to public sector organisations.

A theme running through the Guide is the basic principle that actions are more important than words. The ANAO is trying to make the point that corporate governance is largely the exercise of common sense. Its application depends on circumstances and context, and a range of other intangibles: such as judgements about and interpretation of what is appropriate for individual organisations. The basic message is that the intent and spirit of the law are just as important as the letter of the law. Accordingly, when it comes to public sector governance, better practice requires that governance structures be supported by the application of core governance principles which reflect, importantly, public sector values and codes of conduct.

The guide is in two parts. The first deals with overall frameworks, processes and practices, while the second is in module format, and discusses governance options for specific issues in more detail. The plan is to have a guide that is a living document, with ongoing relevance to the national debate. In future, the guidance modules in Volume 2 can be updated as governance arrangements continue to evolve and other aspects of governance gain prominence. Overall, the goal is to retain the fundamental

emphasis on practice designed to assist agencies to actually make a difference to what they do.

To ensure that the Guide focused on current issues of concern to the public sector, the Office conducted interviews with senior federal public sector agency heads and board members. Their responses to questions about what they considered were the important and emerging governance issues, and which issues they required guidance on, strongly influenced the contents and nature of the guide. We also consulted widely in drafting and finalising the Guide.

This new Better Practice Guide is different to the previous two we produced, which had more specific purposes. The first guide, published in 1997, dealt with the application of corporate governance in public sector agencies, and in particular made the case for the establishment of executive boards for agencies. It predated the *Financial Management and Accountability Act 1997* and the *Commonwealth Authorities and Companies Act 1997*. The ANAO issued the second guide as a discussion paper in 1999, which was designed to assist members of the boards and senior managers of CAC Act bodies to evaluate their governance frameworks and make them more effective. With the publication of the third, and current guide, the scope has widened again, as I have already mentioned.

As a series, these publications demonstrate the ongoing interest in and contribution to debate on good governance by the ANAO. I particularly want to draw your attention to the framework, processes and practices of good corporate governance outlined in Part 3 of Volume 1 of the guide. A key element is risk management which is also covered there. I also refer you to my recent paper – *Strategic Insights into Enterprise Risk Management*¹¹⁶ – for a fuller treatment of the issue. To reinforce the issue, Don Argus believes that governance is about the management of risk including operational, financial, environmental, social, legal and sovereign. *Boards need to understand the risk/reward equation. There is no simple answer and it is wrong to generalise because industries and entities have different risk appetites*.¹¹⁷ In that context, the Argus definition of corporate governance includes the need to ensure that entities control and report on material business risk. He believes, for example, that *a great audit committee won't make a company great but a great company will have a strong audit committee*.¹¹⁸

OECD Principles of Corporate Governance

I have singled out an initiative from Europe, published before the collapse of the Italian dairy giant, Parmalat, which has focused attention on many aspects of corporate governance, regulation and off-shore accounts.¹¹⁹ The OECD is inviting public comment on a new draft of the revision of its *Principles of Corporate Governance* that were adopted by OECD governments in 1999. This follows a request from OECD governments for reinforcement of the Principles in response to recent corporate scandals. Since they were adopted in 1999, the *OECD Principles* have been a reference for corporate governance initiatives around the world. The Financial Stability Forum named them as one of the Twelve Key Standards for Sound Financial Systems, and they underpin the corporate governance component of the World Bank/IMF Reports on Standards and Codes (ROSC).¹²⁰

The OECD Principles are the result of a consensus between participating governments on minimum requirements for best practice. Although they are non-binding, they provide a reference for national legislation and regulation, as well as guidance for stock exchanges, investors, corporations and other parties. OECD Secretary-General Donald J. Johnston said '*Recent events have highlighted a number of areas in which the Principles can appropriately be strengthened...Once a new text is agreed, it will be up to governments, companies, investor groups and others to implement the recommendations and the OECD will follow this process closely*'.¹²¹

The OECD Principles already cover many of the issues that have been at the centre of recent corporate scandals. They include recommendations on high quality standards of accounting and audit, the independence of board members and the need for boards to act in the interest of the company and the shareholders. The document, in addition, sets more demanding standards in a number of areas. It specifies that investors should have both the right to nominate company directors and a more forceful role in electing them. It states that shareholders should be able to express their views about compensation policy for board members and executives and submit questions to auditors. It calls on institutional investors to disclose their overall voting policies and how they manage material conflicts of interest that may affect the way they exercise key ownership functions, such as voting.

The document also identifies the need for effective protection of creditor rights and an efficient system for dealing with corporate insolvency. It calls on rating agencies, brokers and other providers of information that could influence investor decisions to disclose conflicts of interest and how they are being managed. It also calls on boards to be more rigorous in disclosing related party transactions and to protect so-called "whistle blowers" by allowing them confidential access to a contact at board level.

It is anticipated that a final revised version of the Principles will be submitted to OECD governments for approval at the annual meeting of the OECD Council at Ministerial Level on 13-14 May 2004.¹²²

Auditor independence

A particular issue that was exposed in the various reviews of corporate governance has been that of audit independence, which is at the heart of an effective governance framework. The debate over audit independence is not new, although it has attained an increased profile in the wake of the recent corporate difficulties and collapses in Australia and internationally. 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 onto a different plane with higher-level expectations being generated, particularly in relation to compliance.¹²³

As previously canvassed, the new CLERP Bill has measures to promote auditor independence. The Bill seek to put in place a broad regulatory framework governing audit oversight and independence arrangements. In doing so, the Bill retains the co-regulatory approach in relation to auditor independence. Under the current requirements, while the Corporations Act contains some provisions directed at relatively specific employment and financial relationships, the professional rules issued by the professional accounting bodies contain more comprehensive requirements. The Ramsay report recommendations envisage the inclusion of a

comprehensive legislative framework of auditor independence requirements in the Corporations Act which would be supplemented by the auditor independence rules in the professional codes of conduct. The Bill incorporates the recommendations of the Ramsay report (as refined in the CLERP 9 policy paper) and the relevant recommendations in the HIH Royal Commission (HIHRC) report. The objective is to establish best practice requirements on auditor independence in Australia.¹²⁴

The Bill introduces the following key auditor independence reforms:

- A general requirement of auditor independence.
- A requirement that auditors make an annual declaration that the auditor has complied with the auditor independence requirements of the Corporations Act and of any applicable codes of professional conduct.
- The introduction of restrictions on specific employment and financial relationships between auditors and their clients.
- The imposition of mandatory waiting periods before partners of audit firms, directors of audit companies and audit personnel may join an audit client as a director or in a senior management position.
- A requirement for the compulsory rotation of auditors after a fixed number of years.
- A requirement for an auditor to attend the AGM of a listed company at which the audit report is tabled and to answer reasonable questions about the audit.
- A strengthening of the oversight arrangements of an audit firm's procedures and processes, and the audit standard setting process. In particular the Financial Reporting Council (FRC) will assume responsibilities for overseeing the audit standard setting process and auditor independence.
- A requirement for listed companies to disclose in their annual directors' report the fees paid to the auditor for each non-audit service, as well as a description of each service. In addition, the annual directors' report of each listed company must include a statement by directors whether they are satisfied that the provision of non-audit services does not compromise independence.¹²⁵

Many of these requirements are contained in rules of professional bodies and apply to members of those bodies only. The majority of the above proposals will apply to all registered company auditors regardless of membership of professional bodies. The audit committee requirements will apply to all public companies. The fee disclosure requirements will apply to public companies, registered managed investment schemes and large (and certain small) proprietary companies.¹²⁶

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 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.

The independence of the Commonwealth Auditor-General is a key feature of our democratic system of government. Three elements are crucial to reinforcing the independence of the Office: the powerful *Auditor-General Act 1997*; direct financial appropriation as part of the Budget process; and the ability of the Auditor-General to develop and set professional standards for his/her Office. In practice, the latter are largely those set by the Australian Auditing and Assurance Standards Board (AASB).

Senator Murray, who has taken a particular interest in a number of these issues, outlined what he considered to be the four fundamental pre-conditions for more generic auditor independence as follows:

- the appointment process must be objective, on merit, and not influenced by improper considerations;
- security of tenure has to be guaranteed for a known and viable period;
- ending the appointment must be subject to known and proper criteria, not capricious or improper considerations; and
- remuneration has to be sufficient to ensure that the task can be properly fulfilled, sufficient to prevent improper inducements being attractive, and sufficient to cover reasonable risk arising from the task.¹²⁷

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.*¹²⁸

While AUS1 provides guidance to auditors when considering independence, Professional Statement F1, entitled 'Professional Independence'¹²⁹ addresses the principles of independence. Compliance with the new Professional Statement F1 has been required since 1 January 2003. The ANAO supported the Ramsay Report¹³⁰ 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 was personally pleased to see this incorporated into the CLERP 9 Bill. I should note that, pursuant to that Act, the Auditor-General is a registered company auditor.

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.¹³¹

In my view, the questions about possible conflicts of interest, audit partner 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 their effectiveness and credibility in the eyes of both internal and external stakeholders. However, I note that an ASIC survey of auditor independence found that ‘it was not normal for the level of non-audit services to be given consideration by the board or the audit committee’¹³². In fact, usually the Chief Financial Officer was the primary person responsible for engaging the external auditor in these roles.

The Big Four accounting/auditing firms have taken a range of actions to enhance the perception and the reality of the independence of their auditing roles from their other consulting/advising activities, most dramatically in creating separate and distinct bodies and/or introducing independent oversight. The latter can be illustrated by two different approaches taken by PriceWaterhouse Coopers (PWC) and KPMG Australia. PWC has created an Audit Standards Oversight Board to assess its systems relating to the monitoring of control, independence and professional education in respect of financial statements audits of publicly listed companies.¹³³ KPMG Australia’s Ethics and Conflicts Committee has initiated independent reviews of its processes and policies in respect of independence, conflict resolution and quality controls.¹³⁴ These are illustrative of the seriousness with which the Profession is addressing the ‘independence’ issue.

The recent series of high profile Australian corporate collapses has certainly brought attention to the issue of the particular roles and responsibilities of both private and public sector auditors in the Australian context. Citizens are more aware of governance issues than ever before. The public expects that auditors will alert shareholders or other stakeholders to the fundamental soundness (or otherwise) of business entities. It should also be noted, however, that the mere fact that auditors are independent will not save companies from collapse or agencies from the impacts of poor management. 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’.¹³⁵

This view has also been endorsed by the then Chairman of the Australian Securities and Investments Commission (ASIC) who noted that, when it comes to a company’s compliance and accounting standard, ‘*the final buck stops with the board*’ rather than with company auditors.¹³⁶ Auditors do, however, have a very important role to play in terms of providing advice that draws on their broad range of experiences, which may range across the public and private sectors. Any concern and/or suggestions should be conveyed in the audit management letter and/or discussed directly with the board of directors, who actually appoint the auditors in the private sector. One issue is whether, how, and to what extent, should the contents of such a letter be conveyed to other stakeholders.

However, I cannot overstate the fact that the ANAO operates 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. 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 to the Parliament for our views and actions.

The ANAO, in its submission to the JCPAA Review (Report No 391), indicated that there is a range of steps that could be taken to strengthen the independence of auditors and provide greater public confidence in their performance and the role that they have in adding credibility to financial reports prepared by companies, including:

- underlining the independence of auditors in statute;
- enhancing the role of audit committees in corporate governance;
- 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;
- encouraging the rotation of auditors after a suitable time period, for example, seven years; 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.

Clearly, the thrust of these suggestions have been taken up by Government. However, I would like to emphasise the point regarding the importance of an effective audit committee to, not only to good governance arrangements generally, but also in the private sector, to strengthening auditor independence. In order to maintain independence, most authoritative commentators recommend that, in the private sector, either the audit committee comprises only independent directors, or includes at least a majority of independent directors. The fundamental position is that an audit committee should be in a position to discuss matters with auditors freely and frankly without the constraint of having senior management on the committee. As Chris McRostie, the chief executive of the Institute of Internal Auditors, has commented:

*‘To maintain independence from management and ensure all information gets to the board, the internal auditors should be hired, fired and remunerated by a board audit committee that doesn’t include management. Only 38 per cent of chief audit executives now report directly to the audit committee’.*¹³⁷

Professor Keith Houghton, now at the Australian National University, has a similar view:

*‘Increasingly audit firms are recognizing that management may be a stakeholder, but it is not the ultimate client’.*¹³⁸

For many years, I have been ‘gently’ advocating that public sector agencies should similarly appoint independent members to their audit committees, including giving consideration to the selection of an independent member to chair those committees. At the very least, I would suggest that the Board Chair or agency CEO should not chair the committee. The ANAO has such an independent chair for its own audit committee.

International Harmonisation of Accounting and Auditing Standards

The last issue I want to discuss is the reform of the accounting and auditing environment relating to the harmonisation (or adoption) of international accounting standards. Company boards and audit committees should be well aware of the decision announced by the Financial Reporting Council (FRC) in July 2002 to work towards implementing the International Financial Reporting Standards (IFRS) in Australia for the financial years commencing on or after 1 January 2005¹³⁹. The FRC is established under the *Australian Securities and Investments Commission Act 2001* and is the peak body responsible for the broad oversight of Australia’s accounting standard setting process for the private, public and not-for-profit sectors.

The FRC supports the Australian Accounting Standards Board (AASB) and the AASB’s work towards harmonising its standards with those of the International Accounting Standards Board (IASB). The FRC has required the AASB to refer to the adoption of international standards. Following the statement by the FRC, the AASB announced its convergence (now adoption) strategy, which includes the decision to continue to issue one series of sector-neutral Standards applicable to both for-profit and not-for-profit entities, including the public sector¹⁴⁰. No one pretends that the transition will be easy. Some critics have raised issues about the costs involved, as well as the resulting quality of accounting information and its contribution to good corporate governance.^{141 142} The two major accounting bodies in their submission on the CLERP 9 draft bill suggested that the proposed Financial Reporting Panel (FRP) should be under the auspices of the FRC and its powers include ‘a mechanism for offering assistance where there are accounting standards interpretation issues before financial statements are finalised (a HIH recommendation).¹⁴³

From a private sector viewpoint, a single set of high quality accounting standards, which are accepted across major international capital markets, would greatly facilitate cross-border comparisons by investors; reduce the cost of capital; and assist Australian companies wishing to raise capital or list overseas. From a public sector perspective, it would aid transparency and accountability. In particular, over time, such standards would facilitate an improved comparison between the operations of the public sector and private enterprise for those functions and services that could be provided by either group, whether in partnership or separately. A single set of high quality auditing standards would also enhance the reputation and credibility of the auditing profession and help restore public confidence in it. This has also been of major concern to the International Federation of Accountants (IFAC) which commissioned a recently released report entitled ‘Rebuilding Public Confidence in Financial Reporting.’¹⁴⁴

There is no room for complacency for more than 20,000 reporting entities in Australia in meeting the timetable for the adoption of international accounting standards (now

referred to as the International Financial Reporting Standards (IFRSs)) by 1 January 2005. For accounting purposes, this effectively means that organisations will have had to make the shift to the new framework by 1 July 2004 (1 January 2004 for those reporting on a calendar year basis).¹⁴⁵ Indeed, the former Chairman of the Australian Accounting Standards Board expressed the view that boards and audit committees should have a standing agenda item dealing with the transition, especially given the proposed requirement for comparative figures for the first reporting period.¹⁴⁶ I note that ASIC's Chief Accountant was recently reported as indicating there will be no relief for Australian companies in these timing requirements.¹⁴⁷ A recent survey of public and private Australian organisations showed that less than half of the respondents had identified the main changes that will affect their organization.¹⁴⁸ However, there may be some relief if there is a dispensation from the requirement for comparatives at the outset.¹⁴⁹

This is also a major issue for the public sector. It will be a significant challenge for agencies to meet these tight timeframes, and will depend in large part on the extent to which agency audit committees have come to terms with the implications of the revised standards for corporate governance and reporting. At the Federal Government level, the onus is particularly on the Department of Finance and Administration, in conjunction with the ANAO, to provide suitable guidance material, as well as organise timely awareness-raising web-based and face-to-face information sessions, such as implementation workshops (the workshops were held in the last week in November and the first week in December with an update due in April/May 2004). We have also benefited from the research and material provided by the big 4 Accounting/Auditing firms.

While the accounting profession as whole will be busy with this work, the public sector has the added task of considering the harmonisation (or convergence) of Government Financial Statistics (GFS), used in the Federal Budget, with Australian Generally Accepted Accounting Principles (GAAP). These initiatives indicate the gradual acceptance of the notion of 'one set' of standards or at least one standards setting body. The aim of this work is the development of an Australian accounting standard for a single set of government financial reports to reduce existing levels of confusion, and to aid comparability and transparency. The recommendation from the Budget Estimates and Framework Review for the harmonisation of GFS was taken up by the FRC in December 2002, when it announced the broad strategic direction for public sector accounting standard setting. The FRC announced:

'The Board should pursue as an urgent priority the harmonisation of Government GFS and GAAP reporting. The objective should be to achieve an Australian accounting standard for a single set of Government reports which are auditable, comparable between jurisdictions, and in which the outcome statements are directly comparable with the relevant budget statements'.¹⁵⁰

The Financial Reporting Council has set the broad strategic direction for the Australian Accounting Standards Board in relation to this project. The Board issued a timetable in June 2003 for the project with an Exposure Draft planned for May 2004. This will not affect the 2003-04 financial statements. Moreover, the Board also recently set up a GAAP/GFS Convergence Project Advisory Panel which was asked to provide comments on a recently available Consultation Paper by 31 January last.

The AASB will consider the Panel's comments in making its final decisions for inclusion in the Exposure Draft. Some convergence issues were recently outlined at the CPA Australia National Public Sector Convention.¹⁵¹

Turning briefly to the area of auditing standards, under the CLERP 9 proposals the Government is seeking to expand the responsibilities of the FRC to oversee auditor independence requirements in Australia, including auditing standard setting arrangements. The latter will be achieved by reconstituting the existing Australian Auditing and Assurance Standards Board (AuASB) with a government appointed Chairman under the auspices of the FRC. Auditing standards will have the force of law on the same basis as accounting standards.¹⁵² The Professional bodies have some difficulties with these latter proposals, noting that auditing standards already have the force of law through the Companies Auditors Liquidators Disciplinary Board (CALBD) under the Corporations law. As well, 'Australianising' auditing standards having specific Corporations Act backing would undermine the aim of harmonisation with International Auditing Standards.¹⁵³

The issue again is the degree of common interest and commitment of the two sectors and the implications this may have for various elements of sound corporate governance. I have no doubt that there is still scope for mutual learning and understanding as well as for actual sharing, particularly if we are to see genuine public-private partnerships that will contribute to efficient, effective and ethical – and accountable – services to citizens.

V. Final Concluding Thoughts

The corporate form has existed for centuries (for example, the well known East India Company – circa, 1600). One might think that, given its long history, the issue of how corporations should be governed should have been reasonably settled some time ago. But, for as long a corporations have existed, there have been complaints about corporate governance and agitation to improve it.¹⁵⁴ Over the centuries there have been considerable changes in corporate law and associated regulation. However, in today's rapidly changing public and private sector environments, the rising demands for corporate accountability, transparency, new risks associated with a globalisation, e-commerce and evolving information technologies have propelled corporate governance into the 'main stream' of public, political and business awareness. Organisations now face intense public scrutiny of their business workings to a degree not seen before – investors and citizens expect more than just compliance with the new 'rules'. They simply want better governance. Leadership and the right tone at the top based on strong values and ethical conduct are keys to success.

An underlying theme of this presentation is that governments play an important and distinct role in setting the proper legal and regulatory framework for corporate governance. However, while I consider that regulatory and other pressures are leading to better corporate governance frameworks (notwithstanding the recent spate of corporate collapses) the critical issue is sound implementation – that is, the ability of organisations to develop and imbed good corporate governance practices within the raft of legal and regulatory provisions in areas such as corporations law, securities regulation, disclosure and accounting standards. An important lesson is the need for the successful integration of the various elements of a corporate governance framework.

In particular, I have endeavoured to highlight that the various public service reforms over the past twenty years at the Federal Government level have narrowed the differences in governing and managing both the public and private sectors. As well, the increasing involvement of the private sector both as a supplier to, and provider of, government services has created greater convergence of the two sectors. This has also been depicted as 'governance has been democratised'¹⁵⁵ Going further, we have reached the point in a number of areas of government where both quasi and actual public-private partnerships or other similar kinds of cooperative relationships, are raising difficult accountability and performance questions that need to be addressed.

In my view, this challenges traditional attitudes about the conduct and provision of public administration as the following indicates:

'What has not been sufficiently appreciated has been the extent to which this competitive environment has come about as a result of more groups and individuals, within and outside the public sector, being able to contribute to the process of governance. It is this widening of the circle of democratic involvement which has shaken irrevocably the old bureaucratic structures and, with it, the unchallenged authority wielded by its mandarins. As the framework of governance continues to expand, so will the need for new approaches to public administration'.¹⁵⁶

It is safe to say that everyone wants to achieve results. Without being too pedantic, it is necessary to know exactly what results are expected by the various stakeholders. As well, it is often very important as to how those results are achieved. There is also the old saying 'where you sit is what you see'. This has led many to observe that 'perception is the reality'. I doubt that anyone would seriously question the view that such issues are likely to result in more debate and complexity in a political, as opposed to a business, environment. Some might simply observe that the risks are different as might be their treatment. Nevertheless, I contend that the inherent nature of the political environment and its impact on public administration not only require different governance approaches to those used in the private sector but they also require the private sector participants to understand and accommodate such differences in their own governance arrangements if they are to operate effectively and successfully in the public sector. But it is not a one-way street. And that is the challenge to Government and the Parliament.

Performance is an all-encompassing concept in the public sector. In brief, it covers equity, efficiency, economy, effectiveness and appropriateness issues. The last mentioned is often regarded as part of the effectiveness assessment referring to the extent that programs and/or outcomes are still relevant and 'appropriate' to the purposes and objectives identified. Accountability is also an all-encompassing concept and raises questions of to whom, for what and for whose result. I referred earlier in this address to Robert Behn's 'accountability dilemma' reflecting the need to achieve the 'right balance' between conformance and performance. I contend that this dilemma is further complicated by the Parliament's and Government's insistence on holding agencies accountable for performance where the services are primarily, or wholly, being delivered by the private sector. That, in itself, complicates the governance relationships and approaches taken by both sectors even where there is an

increasing sharing of, and commitment to, sound corporate governance concepts, principles and practices.

However, interestingly, both sectors are focussing more on personal accountability, reinforced by legislation, recognising that there are differences, for example, in personal liabilities. This suggests a conundrum where there are shared governance arrangements, for example, in genuine public-private partnerships, or other similar kinds of participating relationships. Is shared accountability a practical option, or can we contemplate some kind of *primus inter pares* (first among equals) governance framework? The simplest model might be hierarchical but, given Parliament's, and the Government's, view about agency accountability, this places a particular onus on the private sector partner, or corroborator and its own particular accountability to its stakeholders.

Many might argue that the so-called conundrum is really a contractual, rather than a governance, issue. In many cases, that is because there are relatively few public-private partnerships, particularly at the Federal Government level. Nevertheless, the questions raised do have a close similarity to those being discussed for so-called relational contracts. The latter go beyond the terms of a contract to the relationships, including trust and confidence, between the parties to the contract. Nowhere is this more evident in risk sharing or risk allocation between those parties and the notion of a 'shared result'. Such notions are not readily accepted by die-hard NPM devotees who insist on more market type accountability linked to clear measurable performance and results. They also share the conviction that 'what's not measured does/should not get done'. Such clarity is difficult in many public sector services, notably welfare, but, increasingly, also in the private sector where sustainability issues are receiving greater executive management attention. The latter is reflected in the following observation in the recently revised draft OECD Principles of Corporate Governance referred to earlier:

*...factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which it operates can also have an impact on the reputation and the long-term success of a company.*¹⁵⁷

I also note that Professor John Hewson, Dean of this School, recently observed that "our actions need to match the now established expectations of major markets such as Europe, where sustainability is a driving force."¹⁵⁸

Sector convergence and sharing of common approaches, concepts, principles and better operational and reporting practices, combined with similar demands from many of the same, or similar, stakeholders, tend to highlight essential, or real, differences between the two environments. Focussing on these differences can give decision-makers a better perspective on their substantive nature and therefore of their importance and impact. Depending on the absolute nature of the latter, it might be possible to mitigate the differences without unduly undermining their integrity. This is not a question of compromise but one of perspective and judgement. There are quite fundamental differences between the public and private sectors but experience has shown that some are more apparent than real in a changing governance environment, such as the application of risk management. Nevertheless, the decisions

are the prerogative of the Government and the Parliament, as representatives of the citizens.

To conclude, I will return to where I commenced, with some insightful observations by Senator Abetz:

*A culture of good governance shifts the focus from a [purely] compliance environment where staff tick boxes to satisfy auditors, to an environment based upon attitudes and proactive behaviours. Good governance is based on a clear code of ethical behaviour that is collectively expressed by a board, management, and staff, and importantly, also communicated openly to stakeholders. The ethical framework for the public sector flows from the public values, obligations and standards.*¹⁵⁹

and

*Whether you are working in the public or the private sector, good corporate governance is paramount to the sustainability, credibility, and success of your organization. Travelling the road of good corporate governance won't guarantee success, but not travelling upon it, will almost certainly guarantee failure.*¹⁶⁰

The latter is a challenge for all sectors of the economy but presents particular issues for Boards, Committees and Chief Executive Officers where those sectors interact in quasi, or actual, partnering type relationships, or simply working together.

It is people like you to whom we look for ideas and possible solutions so that the general public can have real confidence and trust in our governance frameworks, whether within individual organisations or shared.

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