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**Some Issues in Relation to Sound
Organisational Governance and
Audit**

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SOME ISSUES IN RELATION TO SOUND ORGANISATIONAL GOVERNANCE AND AUDIT.

I. INTRODUCTION

I appreciate the opportunity to address this select group of business and community leaders on a topic that I have been commenting and reporting on for some time now, particularly in a public sector context. As you are aware, in recent times there has been a global push to establish new systems of corporate governance as a direct result of the Enron/HiH type scandals that have rocked the markets. *'The US stock exchange was the first to voice its concern when it realised that what happens on Wall Street also affects Main Street'*.¹ John Hall, the CEO of the Australian Institute of Company Directors, makes the following observation:

'As...company directors review the ASX Corporate Governance Council proposals their counterparts in Great Britain are examining the Higgs Review of the role of non-executive directors and the Smith Report on Audit Committees. In the United States, the Sarbanes-Oxley Act has been followed up by the New York Stock Exchange and NASDAQ listing requirements which address new corporate governance standards...In South Africa, ...the King Report has proposed the most comprehensive reform of corporate governance practices yet adopted....The OECD has commenced a review of the corporate governance guidelines which it introduced in 1999...In the European Union, the "Winter Report" includes a framework for corporate governance rules which can be applied across all member states...The World Bank and the OECD have established a global forum to assist the establishment of corporate governance reform world wide'.²

Against this backdrop of corporate governance reform I propose to focus my comments today on the contribution audit can make to developing sound corporate and organisational governance with a particular emphasis on the public sector.

Firstly, and by way of background, a few introductory words on my role and mandate. The *Auditor-General Act 1997* provides a strong legislative framework for the Office of the Auditor-General (and the Australian National Audit Office (ANAO)) to provide support to Parliament. The Act establishes the Auditor-General as an *'independent officer of the Parliament'* – reinforcing the Auditor-General's independence and unique relationship with the Parliament. The Act also outlines the mandate and powers of the Auditor-General and the functions of the ANAO, as the external auditor of Commonwealth public sector organisations. My mandate extends to all Commonwealth agencies, authorities, companies and subsidiaries with the exception of performance audits of Government Business Enterprises (GBEs) which may, however, be undertaken at the request of the responsible Minister, the Finance Minister or the Joint Committee of Public Accounts and Audit (JCPAA).

The ANAO's mission - to add value to public sector performance and accountability – is achieved through a two-prong approach, namely:

- the more traditional audit role of providing **independent assurance** of Commonwealth public sector financial reporting, administration, control and accountability; and
- encouraging a more efficient and effective Commonwealth public sector by suggesting **improvements to public administration and accountability** through a program of performance audits and related products, including Better Practice Guides. Increasingly, it is this second, advisory role, that is most important for a public sector which, in the proper pursuit of greater efficiency and effectiveness, is challenged by diverse governance issues which are growing in complexity.

Recent corporate collapses, both here and overseas, have led to the governance and audit environment being reconfigured for both the public and the private sectors. The ANAO is adjusting its own approach at the same time as it is responding to agencies' needs for greater guidance in an increasingly complex environment. The ANAO's approach is built on the four principles of good governance in public sector agencies, namely: transparency; integrity; accountability; and stewardship. We adhere to these principles as we aim to get the right mix of audit products to provide adequate assurance and improve administration, which also assists us to guide agencies in dealing with their own challenges.

In the last two years, scrutiny of the accounting and auditing profession worldwide has been intense. In Australia, we have seen the latest chapter of the Government's Corporate Law Economic Reform Program (CLERP 9)³ focus on strengthening the financial reporting framework, with implications for the accounting and auditing profession in both the public and private sectors. The Australian Stock Exchange (ASX) has taken an active interest in refining governance arrangements for Australian companies and recently published appropriate Guidelines.⁴ Standards Australia has released a new standard - AS 8000-2003 on good governance principles.⁵ We have also seen the Joint Committee of Public Accounts and Audit (JCPAA) release its review of independent auditing by registered company auditors.⁶

While the ANAO is integral to the changing public sector governance environment, it also stands apart from it, due to the Office's unique independent position within the Commonwealth. The ANAO shares the accounting profession's concern over issues such as independence, the role of audit committees and boards, and the harmonisation of accounting and auditing standards internationally, but importantly, it also faces unique challenges due to the particular dynamics influencing public sector administration.

Against that background, I will now discuss some of the aspects of the changing governance and auditing landscape in more detail. I will then outline how the ANAO is supporting the public sector in the changing governance environment. Finally, I will talk about establishing sound practices and developing useful solutions in relation to the issues currently challenging our audit clients, including reference to the very recently released ANAO's Better Practice Guide on Public Sector Governance.⁷

II. THE CHANGING GOVERNANCE AND AUDITING LANDSCAPE

The tectonic plates of the corporate governance world are on the move following the raft of major corporate failures in recent times exposing significant shortcomings in corporate governance arrangements. In response to this worldwide concern about corporate governance, there has been a concerted push for reform through more comprehensive corporate disclosure requirements. While primarily focusing on the private sector, the implications of the changes also impact on the public sector. I would also add the 'not for profit' sector.

The United States has recently introduced significant legislative reform in the area of corporate disclosure in response to the Enron collapse and the overstatement of earnings by WorldCom. *The US war on corporate governance has begun in earnest and the UK and Australia have joined the coalition of the willing*.⁸ While the *Sarbanes-Oxley Act* applies strictly to US companies, it will be necessary for international companies seeking access to US capital markets to comply with it. Here, while not as prescriptive as the US reforms, Australian companies will need to consider their corporate governance practices as a result of the ASX's Corporate Governance Council guidelines⁹ and the soon to be tabled CLERP 9 reforms.¹⁰ In the UK, companies continue to examine the Higgs and Smith Reviews¹¹. In South Africa, there is the King II¹² report that includes a Code of Corporate Practices and Conduct.

I will now briefly touch on the major recent reviews, programs and guidance aimed at improving governance both here in Australia and overseas. The relevant areas for Australian governance reformation are – CLERP 9, the ASX Guidelines and the Uhrig review¹³ dealing with governance arrangements for statutory authorities. I will also comment on some selected international initiatives. The other areas of interest are auditor independence and the harmonisation of Australian and international accounting and auditing standards.

Corporate Law Economic Reform Program (CLERP 9 Arrangements)

Late last year, the Treasurer and the Parliamentary Secretary to the Treasurer released the already referred to policy paper (Corporate Disclosure – Strengthening the Financial Reporting Framework) aimed at seeking stakeholder comment on Government proposals aimed at achieving further improvement in audit regulation and the wider corporate disclosure framework. This paper included the Government's response to the Ramsay report on the Independence of Australian Company Auditors¹⁴. The paper covered the following seven areas:

- i. the effectiveness of accounting standards and a proposal that Australia adopt international accounting standards by 2005;
- ii. the regulation of accounting standards and practices;
- iii. the audit function in Australia, including:
 - the market for audit and non-audit services;
 - the institutional framework for setting auditing standards and whether they should be given the force of law;

- the rules and practices governing the audit engagement including appointment and removal of auditors and related corporate governance arrangements;
 - auditor independence issues canvassed in the Ramsay report;
 - the structures for oversight of the profession, including disciplinary powers, ethical rules, external quality assurance, educational requirements, professional development, competency standards etc; and
 - liability issues, drawing on current work in the context of public liability and medical indemnity insurance, including the question of incorporation of auditors;
- iv. the present continuous disclosure regime;
- v. conflicts of interest in relation to the provision of financial product advice;
- vi. the current disclosure requirements for shares and debentures; and
- vii. ways to encourage investors to become more active in the companies they invest in.¹⁵

The Treasury received some sixty odd submissions to the CLERP policy paper. The April edition of CA Charter¹⁶ gave a snap shot of the key issues arising from those submissions it had access to, namely:

□ *An Expanded Financial Reporting Council (FRC)*

The proposed expansion of the responsibilities of the FRC drew the most varied comments. While most agreed with the principle of some form of audit oversight, there was a consistent theme regarding the need to improve the transparency and accountability of the FRC, particularly if it is to have an expanded role. Also the proposal to bring the Auditing and Assurance Standards Board (AuASB) under the auspices of the FRC caused concern given the AuASB's role in providing guidance in areas other than the auditing of general purpose financial statements. There was a concern also that the nature of auditing standards, as principles-based professional guidance, did not easily lend itself to 'black letter law'.

□ *Audit Quality*

Many submissions stressed that the proposals should only apply to listed companies and their auditors, not to all audits required under the Corporations Act. An annual declaration of auditor independence was supported, as was the enhanced disclosure of non-audit services fees, including a statement in the annual report covering the impact of specified non-audit services on audit independence. There was unanimous support for compulsory audit committees for the top 500 listed companies. However, there was only limited support for the rotation of audit partners and review partners after 5 years.

□ *Auditor Liability*

There was general support for the incorporation of audit firms and the adoption of proportionate liability.

□ Enforcement

While there was support for extending the matters on which auditors are required to report to the Australian Securities and Investments Commission (ASIC), many submissions questioned the effectiveness of the requirement. As regards the institutional arrangements for the Companies Auditor Liquidators Disciplinary Board, most submissions agreed with the proposals but rejected the notion that the Board consist of a majority of non-accountants given the technical nature of the issues raised.

It has been reported that the government will issue draft legislation shortly, still in time for the required three-month exposure period, to become law by the year's end.¹⁷ It seems likely that the draft legislation will take into account any relevant recommendations of the HIH Royal Commission, the work undertaken by the Joint Committee of Public Accounts and Audit (JCPAA)¹⁸, and other related developments overseas. This is very much work in progress as the Parliamentary Secretary, concluded in his address to the ASIC Summer School in March 2003 by stating that:

'.. 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'.¹⁹

ASX Corporate Governance Guidelines

Another element of the Australian governance reform agenda was 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 2003²⁰, 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.'²¹

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.²²

The guidelines are a comprehensive response to ‘*revelations about lamentable corporate behaviour at the tail end of the boom*’²³. Importantly, they are not mandatory and follow the UK’s ‘*if not, why not*’ approach. That is, if a company believes that some of the guidelines are inappropriate to their circumstances, it must explain the reasons to the ASX and their shareholders why the company departed from the guidelines. Where companies fail to adequately explain, ‘*the ASX says it could refer the matter to the corporate regulator, the Australian Securities and Investments Commission*’.²⁴

The guidelines call for: boards to have a majority of independent directors with the chair drawn from those directors; a majority of independent directors on the nomination committee, again with an independent chair; and, within three years, the audit committee should consist entirely of non-executive directors and have an independent chair who is not the chairman of the board. The ASX guidelines define independence in some detail. However, in short, an independent director is a non-

executive director who is not a substantial shareholder. Additional tests include directors who: have not been employed by the company within the previous three years; were not a principal of an adviser or consultant to the company within the previous three years; have no contractual relationship with the company; have not served on the board for a length of time that might affect the ability to act in the best interests of the company; or who have not been a material supplier or customer.²⁵

The corporate governance guidelines are incorporated into new listing rules. They will come into force for companies' 2004 annual reports. The ASX Managing Director, Richard Humphry, has commented that *'we are encouraging companies to road test the new rules in the financial year 2002/03 in the annual reports due later this year. It will test their capacity to meet the new guidelines or otherwise'*.²⁶

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'.²⁷

A further issue highlighted by one business commentator is:

'By creating a stark distinction between the executives and non-executive directors, by introducing specific roles for independent directors and by defining independent directors so closely, the ASX guidelines could inject new tensions into boardrooms. They could also undermine the role of the chairman, who won't be the chair of the suddenly important audit committee and who, unless they meet the strict tests of independence, would be disqualified from chairing the nominations committee and therefore shaping the board'.²⁸

The Uhrig Review

The third area of importance is 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 Minister²⁹:

'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’.*³⁰

The focus of the Uhrig review is 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, addressing the following issues:

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

In addition to analysing existing governance arrangements, the review will 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 of governance principles. As a second stage to the process, and following the review, the Government will assess statutory authorities and office holders against these principles. Reforms will be undertaken on a whole-of-government basis. I understand that the review is in its final stages and will be released shortly, as indicated earlier.

International Initiatives

*‘...the three corporate sins in the [United Kingdom] U.K. Namely **sloth**, being a loss of flair when enterprise gives way to administration; **greed**, when executives might make a short term decision because it has greater impact on their share options and bonuses, than a decision that might create longer term prosperity for the company; and **fear**, where executives become subservient to investors and ignore the drive for sustainability and enterprise’.*³¹

Turning now to the international initiatives and, in doing so, we need to bear in mind the reasons for the current wave of regulation and the corporate governance practices and standards that existed prior to what has been a turbulent two years. First, it is important to recognise that there have been differences between corporate governance practices in the United States of America (US), Australia and the UK. Many US companies have been dominated by forceful and assertive chief executive officers (CEOs) who also serve as company chairpersons, and sit on and influence the audit committee. Second, during the same period, there was a ‘hands off’ approach in the US to regulation based on the assumption that the market would ultimately lead to the weak being taken over by more effective management. This did not work in practice because the 1990s boom saw share prices far removed from company fundamentals. Rather than leading to efficiency, acquisitions simply resulted in the record loss of market capitalisation.³²

In the US, the reaction to the failures of Enron, WorldCom and others saw the introduction of the *Sarbanes-Oxley Act* (a little over 12 months ago) - a highly prescriptive and mandated regime that laid down rules and penalties for governance breaches. Intended to quickly introduce a corporate governance framework and restore investor confidence in company boards '*..the Sarbanes-Oxley Act has had a profound effect in setting the agenda for the corporate governance debates that started in the OECD countries, as each looked to see if their regulatory structure needed upgrading, and has influenced Australia's CLERP 9 proposals and the ASX corporate governance changes*'.³³

The *Sarbanes-Oxley Act* has a two fold purpose: first, to prevent, or a least quickly expose, corporate abuses involving companies with a class of securities registered under the 1934 Exchange Act; and second, it was designed to restore investor confidence by providing, amongst other things, mandatory standards for officers and directors of public companies, with stiffer penalties for individuals failing to meet those standards. The Act makes significant demands regarding the CEO, Chief Financial Officer, audit committee and board requirements, and regulation of bankers, auditors and lawyers. It also demands enhanced and accelerated disclosure; introduces new codes of conduct; and changes financial reporting requirements and the regulation of the accounting profession.³⁴

A significant requirement is that a company's audit committee must include at least one financial expert. *The Sarbanes Oxley Act* specifies that a financial expert should have knowledge through education or work experience: of generally accepted accounting principles (GAAP); preparing or auditing public company financial statements; applying GAAP; internal accounting controls; and the audit committee function. These requirements are designed to change the make-up of US company boards and the way they act. Clearly, the *Sarbanes Oxley Act* considerably raises the corporate governance bar and, moreover, raises it permanently.

In the UK, the recently tabled Higgs Report³⁵ is only slightly less prescriptive but unlike in the US, it is not a mandatory requirement. The Higgs Report can be added to those of Greenbury³⁶, Hampel³⁷ and Turnbull³⁸ as the latest in a line of reports since Cadbury³⁹ in 1992. The Higgs Report, released in January 2003, covered the independence, accountability and remuneration of company board members in the UK. The main thrusts of the report are the '*comply or explain approach*' and '*the independence of the non-executive director*', both of which have found their way into the Australian corporate environment.⁴⁰

The Higgs report goes further than the Australian ASX guidelines by creating the role of a senior independent director, regardless of whether the chair is independent. Higgs argues that, if the chairman is a non-executive, there ought to be a senior independent director whose role is threefold: to be available to shareholders if they have concerns that contact through the chairman or CEO has failed to resolve; to chair meetings between non-executive directors where the chairman does not attend; and to lead the appointment process for a chairman.⁴¹

This approach suggests that the chairman sits somewhere between, or above, executive and non-executive directors within the boardroom. The chairman is not a leader of peers but is separated from two distinct sub-sets of directors. Establishing

divisions within boards and creating potential competing power blocks might be an effective way to prevent a board being captured by a CEO or a forceful chairman, or a combination of both. However, if there is a radical change in the way boards are structured and function, there may be unforeseen consequences even if the implications of the changes in governance might appear, at this stage, to be quite subtle rather than profound.⁴² This approach does not seem to warrant consideration in the Australian context because the first two tasks at least seem to be the responsibility of the chairman.

An interesting take on the director independence theme was provided by Lord Young of Graffham, the outgoing president of Britain's Institute of Company Directors, who warned against non-executive directors doubling as watchdogs. Drawing on his experience at Salomons, during the treasury banking crisis in New York, he made the comment that:

'The most dangerous nonsense is the role we are now expecting non-executive directors to perform... I realised over those few months [at Salomons] that, as outside directors, we knew little about the business we were supposed to direct and, in truth, we were directors in name only. I have not been a non-executive director since'.⁴³

Few non-executive directors would be as self critical as Lord Young but in the UK (and here) the most contentious aspects of the new codes have been those that relate to the composition and structure of the board and, in particular, the elevation of the concept of independence.⁴⁴

You may be interested in the table included as an attachment (drawn from the April edition of the Ernst & Young corporate governance series)⁴⁵ that sets out a comparison of the corporate governance, in place or pending, in the Australia, the US and the UK (including the Smith Report on audit Committees⁴⁶). I think you will find that it provides a good overview of the current position in those countries. Similarly, another useful comparison of corporate governance in Australia, the US and New Zealand was recently published by Minter Ellison.⁴⁷

To conclude this section on international initiatives I thought it might be useful to highlight a seminal body of work from South Africa (SA). Corporate governance in SA was institutionalised by the publication of the *King Report on Corporate Governance in November 1994*. The King Committee was formed under the auspices of the Institute of Directors and chaired by Judge Mervyn E King S.C. The purpose of this report was to promote the highest standards of corporate governance in SA.

Unlike its counterparts in other countries at the time, the King Report 1994 went beyond the financial and regulatory aspects of corporate governance in advocating an integrated approach in the interests of a wide range of stakeholders, having regard to the fundamental principles of good financial, social, ethical and environmental practice. This participative corporate governance system adopted the *inclusive* approach to corporate governance, which required that the purpose of the company be *defined*, and that the values by which the company will carry on its daily life should be *identified* and *communicated* to all stakeholders. The key challenge for good

corporate citizenship is to seek a balance between enterprise (performance) and constraints (conformance).⁴⁸ This is a theme I have been commenting on for some time now, while agreeing that its resolution has a lot to do with good risk management.

The Institute of Directors in SA asked Judge King to again review corporate governance in SA and, in March 2002, the King II report was released adopting the ‘*if not, why not*’ approach. Five task teams, representing a cross-section of SA business and society in both the private and public sectors, undertook a detailed review of specified areas of corporate governance, as follows:

- *The Boards and Directors.*
- *The Accounting and Auditing.*
- *The Internal Audit, Control and Risk Management.*
- *The Sustainability Reporting.*
- *The Compliance and Enforcement.*

The King II approach saw the picture as follows:

- The responsibilities of a board under the inclusive approach will be to define the purpose of the company and the values by which the company will perform its daily existence and to identify the stakeholders relevant to the business of the company. The board must then develop a strategy combining all three factors and ensure that management implements this strategy. The board’s duty then is to monitor that implementation. The board must also deal with the well-known financial aspects. **The key risk areas and the key performance indicators must be identified, as well how those risks are to be managed.**
- The board needs to regularly monitor the human capital aspects of the company in regard to succession, morale, training, remuneration, etc. In addition, the board must ensure that there is effective communication of its strategic plans and ethical code, both internally and externally.
- The company must be open to institutional activism and **there must be greater emphasis on the sustainable or non-financial aspects of its performance.** Boards must apply the test of *fairness, accountability, responsibility and transparency* to all acts and omissions and be accountable to the company but also responsive and responsible towards the company’s identified stakeholders. The correct balance between conformance with governance principles and performance in an entrepreneurial market economy must be found, but this will be specific to each company.⁴⁹

In relation to the last point, I would comment that the balance may change according to the circumstances facing an organisation from time to time.

King II also set out the seven characteristics of good corporate governance, namely:

- i. ***Discipline.*** Corporate discipline is a commitment by a company's senior management to adhere to behaviour that is universally recognised and accepted to be correct and proper.
- ii. ***Transparency.*** This is a measure of how good management is at making necessary information available in a candid, accurate and timely manner.
- iii. ***Independence.*** This is the extent to which mechanisms have been put in place to minimise or avoid potential conflicts of interests.
- iv. ***Accountability.*** Individuals or groups in a company who make decisions need to be accountable. Mechanisms must exist and be effective.
- v. ***Responsibility.*** Responsibility pertains to behaviour that allows for corrective action and for penalising mismanagement.
- vi. ***Fairness.*** The rights of various groups have to be acknowledged and respected. Systems must be balanced in taking into account all those that have an interest in the company and its future.
- vii. ***Social responsibility.*** A well-managed company will be aware of, and respond to, social issues, placing a high priority on ethical standards. A good corporate citizen is increasingly seen as one that is non-discriminatory, non-exploitative, and responsible with regard to environmental and human rights issues.⁵⁰

Auditor independence

A particular issue that was exposed in the various reviews of corporate governance was 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.⁵¹

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.

As touched on earlier, 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).

Recently, the well known Senator Murray 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.⁵²

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.⁵³

While AUS1 provides guidance to auditors when considering independence, the recently released Professional Statement F1, entitled 'Professional Independence'⁵⁴ addresses the principles of independence with support for its application by the CLERP 9 proposals. Compliance with the new Professional Statement F1 has been required since 1 January 2003. The ANAO supports the Ramsay Report⁵⁵ recommendation that the auditor should make an annual declaration, addressed to the board of directors, that the auditor has maintained his/her independence in accordance with the *Corporations Act 2001* and the rules of the professional accounting bodies. I should note that, pursuant to that Act, the Auditor-General is a registered company auditor.

The issues relating to independence are difficult and are still to be resolved, particularly in the light of the recent report on HIH⁵⁶ (which, inter alia, reinforced independence of auditors) and the Government's intended legislative proposals following the CLERP 9 discussions, referred to earlier. The need for active ongoing discussion is clear. The Government has indicated it will consider recommendations in the CLERP 9 legislation which is expected to be introduced to Parliament in the Spring Sittings.⁵⁷ 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'.⁵⁸

There is growing pressure for the exclusion of audit firms from other activities (non-audit services) within the same organisations. For some years, there has been general acceptance of the desirability of those firms not being engaged both as internal and external auditor. The Government indicated that it will amend the law to require mandatory disclosure in a company's annual report of fees paid for the categories of non-audit services provided. As well, there will be a requirement for a statement in the annual report as to whether the audit committee is satisfied that the provision of non-audit services is compatible with auditor independence. Such amendments will impact on both the public and private sectors.

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'⁵⁹. In fact, usually the Chief Financial Officer was the primary person responsible for engaging the external auditor in these roles.

Reverting back to the auditor rotation issue, the survey also indicated that 'the vast majority of respondents did not have a policy of rotating audit firms'.⁶⁰ While the Government's proposal under CLERP 9 relates to the compulsory rotation of an audit partner (lead engagement and review partners), the reduction from a 7 to a 5 year period is seen as creating problems in Australia. With the increased outsourcing of public sector audits to the private sector, this could also be a problem for the former, particularly if the policy is not just directed to listed entities (as does Professional Statement F1). The Parliamentary Secretary to the Treasurer recently indicated that it has been decided to give ASIC a power to relieve companies of the 5 year requirement.⁶¹

The recent series of high profile Australian corporate collapses has also renewed 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. Of particular recent interest has been the focus on personal accountability of directors and senior executives whose performance bonuses may be inversely proportional to trends in share prices and company profits. 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.⁶²

This view was endorsed recently by the Chairman of the Australian Securities and Investments Commission 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.⁶³ 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.

These options for enhancing the independence of auditors could be pursued under the current co-regulatory model or through other forms of statutory, or non-statutory regulation. However, the ANAO stressed that these are matters for decision by the government and the profession co-operatively, given the level of interdependence between both parties in current arrangements.⁶⁴ A similar observation could be made about a number of related issues, some of which have not been discussed here, such

as proportionate liability (agreement reached by Federal and State Governments, announced on 4 April) and professional indemnity insurance. These are important risk management issues for both the public and private sectors.⁶⁵

International Harmonisation of Accounting and Auditing Standards

The last issue in this changing landscape 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 2005⁶⁶. 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 recently 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 sector⁶⁷. 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.^{68 69}

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.

There is no room for complacency in meeting the timetable for the adoption of international accounting standards 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. 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.⁷⁰

This is 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.

While the accounting profession as whole will be busy with this work, the public sector has the added task of considering the harmonisation 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 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’.*⁷¹

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.⁷² 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.⁷³

III. ANAO SUPPORTING THE PUBLIC SECTOR

Auditing the Public Sector

As I mentioned in the introduction, the ANAO provides independent assurance on the financial statements and financial administration of Commonwealth public sector entities to the Parliament, the Executive, Boards, Chief Executive Officers (CEOs) and the public. While, to many, this is the essence of public sector auditing, we also aim to improve public sector administration and accountability by adding value through an effective program of performance audits and related products including Better Practice Guides (BPGs).

The communication of our outputs and their outcomes through representation at a range of Parliamentary Committees, agency audit committees and Boards of government authorities and companies, is also a growing element of our value adding activities. Additionally, the ANAO seeks opportunities to contribute to the development of the accountability framework, including better practices and standards (as well as harmonisation) in public sector accounting and auditing. Involvement and communication are important drivers, supported by an intensive, and extensive, audit work program.

The ANAO is committed to providing an integrated auditing framework with the objective of delivering high quality audit products that maintain and improve the high standards and professionalism of our audits and related services. These are the means to contribute to better governance.

Like all public sector agencies negotiating the challenges of the changing governance environment, the ANAO has strengthened its own business practices to respond to new demands and directions - the ANAO has responded both at the strategic and tactical levels. On the strategic level, we have given specific attention to relationship management that demonstrates integrity and transparency, as well as to well-targeted products and services that provide assurance and value for money. On the tactical level, we have focussed on ensuring that our work continuously improves as we demonstrate accountability to Parliament, in terms of our legislative responsibilities, and for our overall results to all our stakeholders. The remainder of this section provides some insights into our audit approach and the philosophy we adopt.

The Audit Work Program

As part of its commitment to transparency, we make the ANAO's annual audit work program available on our website – www.anao.gov.au. While there is little discretion about the approximately 300 financial statement audits conducted each year, the audit topics for the more than 60 performance and other audit products⁷⁴ conducted each year are generally selected on two grounds:

- the capacity of an audit to add the greatest value in terms of improved accountability, economy, efficiency and administrative effectiveness; and
- the desire to ensure appropriate coverage of entity operations within available audit resources over a reasonable period of time.

As public sector bodies do not operate in isolation from the wider community, a quite wide range of issues can impact on the sector as a whole as well on individual agencies. The ANAO recognises this and, accordingly, continually monitors the broader environment so that important issues can be identified and taken into account in the development of its annual audit work program. As well, with our direct involvement with entities in audit activity, and through regular liaison with entity management, including through audit committee activities, the ANAO is able to identify, and take into account, specific entity issues.

The themes, including the challenges that confront the public sector, continually change, reflecting a range of developments in the broader economic and social

environment. However, corporate governance, at least in recent years, has become an enduring audit theme. Annual themes are identified as a basis for selecting topics to ensure that the audit program is targeted appropriately to add value to (improve the performance of) public administration. An important part of this planning process is the early engagement of relevant stakeholders, including agency heads, and the Parliament, through the JCPAA, to ensure that the work program is optimally targeted.

Role of audit in improving corporate governance

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

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

The ANAO provides this assurance and advice through the following suite of audit products.

Assurance auditing

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

In addition to the audit opinion on the financial statement, the ANAO provides each client with a report that deals with the results of the financial statement audit process – a report is also provided to the responsible Minister. The ANAO also now provides two cross-entity assurance reports each year to Parliament. The first details the results of an assessment of the control structure of major entities⁷⁵ while the second provides a summary commentary on the results of all financial statement audits undertaken in the 12-month audit cycle ending in October of each year.⁷⁶

Performance auditing

The aim of a performance audit is to ‘*examine and report to the Parliament on the economy, efficiency and effectiveness of the operations of the administration of the Commonwealth and to recommend ways in which these may be improved*’.⁷⁷ And are best described as an independent, objective and systematic examination of the operations of a body for the purposes of forming an opinion on whether:

- the operations have been managed in an economical, efficient and effective manner;
- internal procedures for promoting and monitoring economy, efficiency and effectiveness are adequate; and
- improvements might be made to management practices (including procedures for promoting and monitoring performance).

Performance audits are conducted in all ministerial portfolios with the main concentration being directed to portfolios with significant Government outlays or revenues. The performance audit reports are tabled in the Parliament (63 in the 2002-03 financial year) and all recent performance audit reports are also placed on the ANAO’s homepage at <http://www.anao.gov.au>, and summarised in the ANAO’s series of six-monthly activity reports.⁷⁸

Performance audits often involve assessments of governance, probity and the quality of management in individual agencies. While the auditor’s professional opinion in these cases is derived from compliance with rigorous standards and therefore provides a high level of assurance, it does not provide complete assurance as to the entities’ operations. This ‘expectation gap’ is a complex issue that challenges the profession as much as it challenges our stakeholders. In considering whether performance audits should be legislatively enforced in the private sector, KPMG ⁷⁹ recently noted that there would first need to be reform to the liability requirements under which auditors in Australia operate (ie. either joint and several liability or unlimited liability).

Audit product continuum

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

For the ANAO, a key issue is getting the balance right between control and innovation.⁸⁰ The aim is to get the ‘right mix’ of products and services to enhance governance. In setting its agenda for the future, the ANAO relies on intelligence garnered through the review and analysis of Commonwealth entities as well as

ongoing feedback and guidance from the Parliament and other audit clients as to the areas they see as adding most value to public administration.

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

Cross portfolio audits

Recent years have seen an increase in the number of ‘across the board’ issues and cross-portfolio audits undertaken that compare experiences in a range of agencies and entities. For example, the ANAO has recently undertaken cross portfolio analysis of, among other things, compliance with the 2001 Senate Order on commercial-in-confidence considerations in relation to listing of departmental and agency contracts valued at \$100,000 or more on the internet.⁸¹ Other recent cross-portfolio audits include absence management in the APS⁸², the management of Commonwealth guarantees, warranties, indemnities and letters of comfort⁸³; energy efficiency in Commonwealth agencies’ operations⁸⁴; and the payment of accounts and Goods and Services Tax administration by small Commonwealth organisations⁸⁵.

Our ability to compare operations across the public sector, and sometimes with the private sector, as well as our statutory independence, are significant strengths and add value to a wide range of stakeholders. This approach is becoming more important with the greater use of a ‘whole of Government’ approach to public administration. The notion is to tailor public services to the individual recipient in a ‘seamless’ manner. Major issues of governance arise, as I will discuss later.

In terms of benchmarking services across agencies, our products currently comprise functional reviews of the major corporate support areas. The overall results of these reviews are published generically and tabled in the Parliament. At the audit client level, a customised report is provided to all entities participating in the benchmarking study. Our most recent benchmarking studies have covered the following areas: people management in public sector agencies⁸⁶ the internal audit function⁸⁷; the finance function⁸⁸; and managing people for business outcomes⁸⁹. Finally, as well as benchmarking and analysing public sector performance, we compare our own performance to that of our peers in Australia and internationally.

Overview of audit activities

In summary, our strategic approach allows us to target areas of most interest and value to the Parliament, the Government and the Australian Public Service (APS). We remain responsive to the needs of a changing public sector and endeavour to ensure that better practice and lessons learned in individual agencies both in Australia and overseas are disseminated across the APS. For many years, we also responded to the implementation of New Public Management (NPM) with a series of products focussing on the challenges and opportunities inherent in the NPM approach. Audits in recent years have covered, among other things, outsourcing, asset sales, contract management and networked service delivery.

However, I cannot overstate the fact that the ANAO, and all other external public sector auditors, operate in an advisory capacity, rather than participating directly in decision-making by public sector managers. While I urge my officers to ‘stand in the managers’ shoes’ in order to understand the complexities of the particular business environments under review, it is for the managers themselves to decide whether or not they will act on ANAO or other advice with reference to their particular risks and opportunities.⁹⁰ In short, the role of audit is crucial to encouraging better practice corporate governance. In this regard, the ANAO has produced a set of principles and better practice for corporate governance in both the core public sector, broadly covered by the FMA Act, and in Commonwealth authorities and companies, covered by the CAC Act.⁹¹ The most recent guidance is discussed more fully in the following section.

However it is worth making the point that ‘*It is clear that the most rigorous and independent audit will not save a company with poor management and business practices from insolvency*’.⁹² It is my aim, however, to ensure that ANAO audits continue to encourage improvements in the APS. As technology changes, as services change, and new ways of delivering services are introduced, so our auditing methodologies and practices will need to adapt. What will not change is our commitment to improving public sector performance and accountability.

IV. AUDIT EXPECTATION OF BETTER PRACTICE PUBLIC SECTOR CORPORATE GOVERNANCE

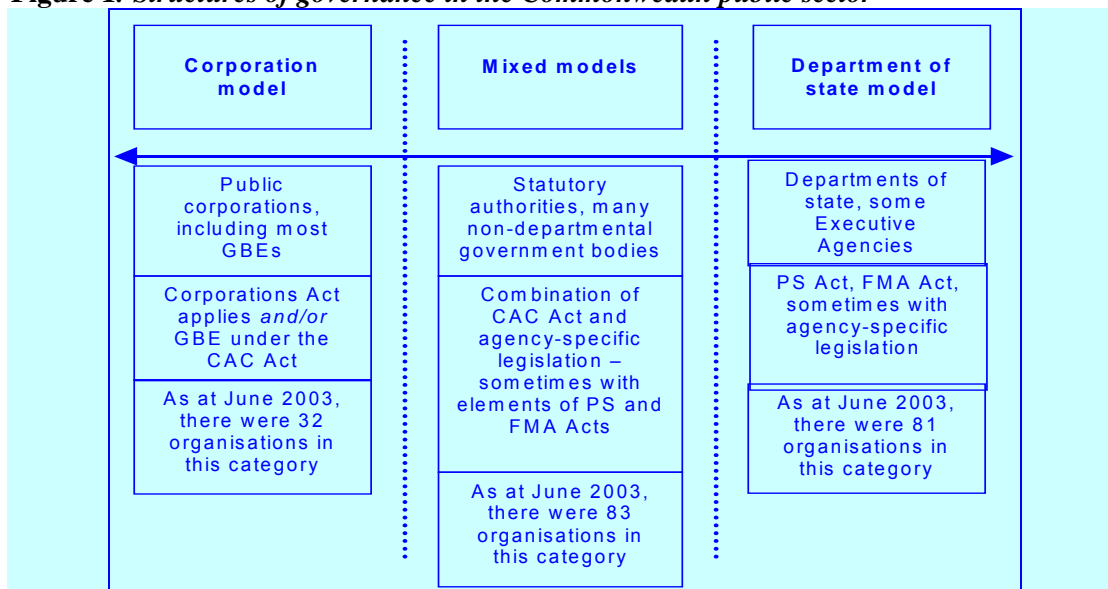
In this final section I will spend some time on the audit expectation of better public sector practice corporate governance by drawing heavily on the recently released ANAO’s updated Better Practice Guide titled ‘*Public Sector Governance – Volumes 1 & 2*’⁹³. This document was produced to assist public sector organisations to meet the current pressures, and expectations, of their governance framework, processes and practices. 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.⁹⁴ It is not a one size fits all situation, as many have noted.

However, before I do this, I thought it might be useful to put the governance challenge in the public sector in context by briefly outlining the complexity of this sector as a backdrop to my comments on observed better practice.

Complexity of Corporate Governance in the Public Sector

The main governance structures in the Commonwealth public sector can be illustrated by the following Figure drawn from the Better Practice Guide.⁹⁵

Figure 1: Structures of governance in the Commonwealth 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).

The Commonwealth 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, Chief Executive Officers (CEOs) and their staff. The legal framework 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.⁹⁶ 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.
- *the Public Service Act 1999* which sets out values and the APS Code of Conduct for Commonwealth employees

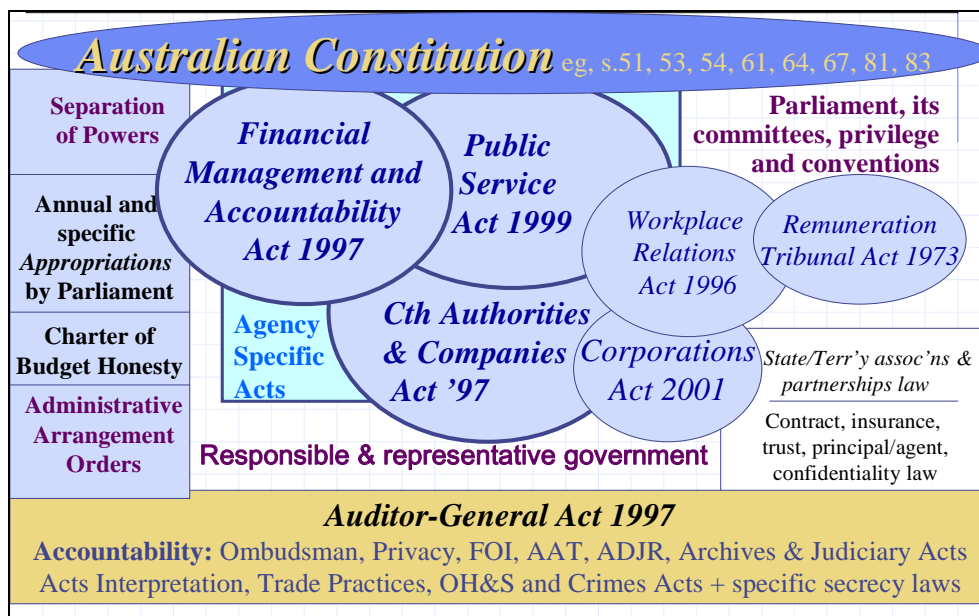
The *FMA Act* requires CEOs to promote the efficient, effective and ethical use of Commonwealth resources for which they are responsible. It replaced voluminous and detailed rules and prescriptions with principles-based legislation. The main purpose

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.⁹⁷

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 *Administration Arrangement Orders*, the *Remuneration Tribunal Act 1973*, any enabling legislation of an organisation and other legislation outlined in Figure 2 following.

Figure 2: Legal elements affecting governance in the Commonwealth



Source: Department of Finance and Administration (2002)⁹⁸

The above represents a formidable body of law. As I said earlier, in addition to this legislation, Commonwealth government entities are subject to a variety of regulations and policies which also impact on their governance, such as the 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.

While a similarly complex diagram could be developed for many in the private sector, there are marked 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’.*⁹⁹

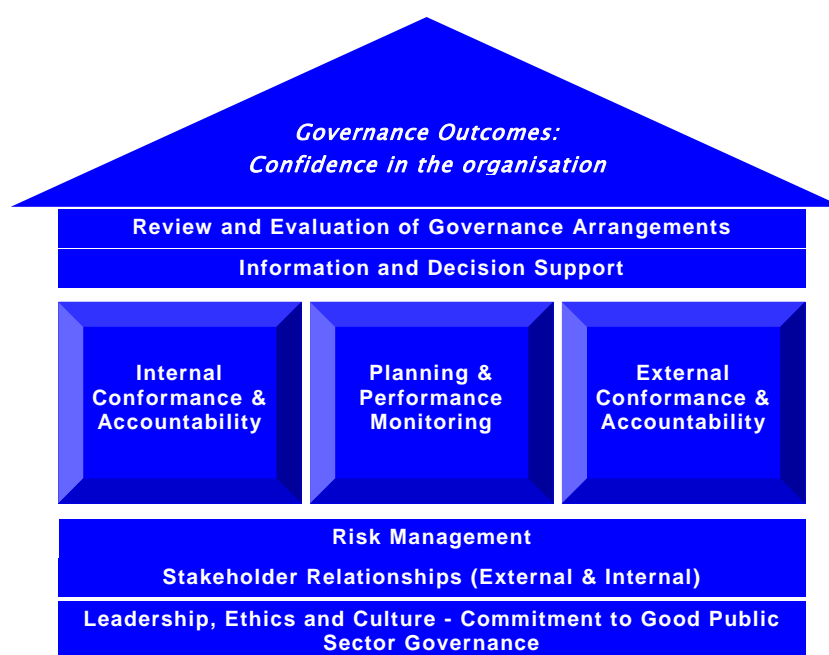
Hence, corporate governance is often relatively more straightforward in the private sector as the roles and responsibilities are more clearly defined and generally involve a narrower range of active stakeholders and less complex objectives and strategies.

This is less so for Government Business Enterprises (GBEs) and other CAC agencies that are subject to the *Corporations Act*, the *CAC Act* (and, for Commonwealth GBEs, *Governance Arrangements for Commonwealth Government Business Enterprises*) even with the added complexity of Ministerial responsibilities and oversight. In contrast, publicly-listed private companies are subject to the *Corporations Act* and 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.

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

As most Commonwealth agencies now have procedures in place to help them comply with the legislative requirements depicted in Figure 2, the next major task is to draw these procedures together so that the day to day operations of organisations supports robust governance, which in turn supports good performance. The ANAO has adapted a model developed by the Queensland Department of Transport to show the elements of good governance and how they relate to each other as shown in Figure 3 below.

Figure 3: 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.

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.

Key Elements and Principles of good corporate governance

Returning to my theme - better practice public sector governance from an auditor's perspective - the ANAO is very conscious that the public sector has the largest group of stakeholders of any group of organisations in Australia with virtually all citizens having an interest in how well the public sector performs; in how well it achieves value for money outputs; and in how accountable it is to the public and the taxpayer in particular. With the public sector having such a pervasive presence in the life of every Australian, it is important that it is proactive in the development of good governance principles and practices.

When the ANAO was thinking how best to define corporate governance in the public sector, or our preferred term 'public sector governance', we wanted to use a definition that reflected the particular governance requirements of that sector. We were also conscious that while legal frameworks and accountability structures shape governance processes, they by themselves are not enough. Public sector organisations must take action to implement their own governance best practice policies, or else attempts at achieving good governance practices become a meaningless exercise – '*the form over substance*' issue. Having the correct frameworks in place is not sufficient to guarantee good governance practices as was emphasised by Justice Owen in his report on the HIH collapse. After noting that HIH had a stated corporate governance framework, consisting of matters usually included in corporate governance

frameworks, he found himself asking rhetorically: did anybody stand back and ask themselves the simple question - 'is this right'? Justice Owen was effectively asking if the directors and senior managers at HIIH were satisfying the principles of good corporate governance.

From the ANAO's perspective, public sector governance has a very broad coverage. The concept includes how an organisation is managed, its corporate and other structures, including its culture, policies and strategies, and the way it deals with its various stakeholders. The concept of governance includes the way public sector organisations acquit their responsibilities of stewardship by being open, accountable and prudent in resource use and decision-making, in providing policy advice, and in managing and delivering programs.

In section II of the paper, I canvassed the changing governance landscape and corporate turbulence stimulating improvements to private sector governance guidance practices. In parallel, public sector governance has also come under the microscope. It has adopted many of the reforms initially targeted at the private sector, and also led in many other governance areas, especially related to risk management, accountability and transparency to stakeholders.

These reforms have focussed on the two main requirements of organisations:

- **Conformance** is illustrated by the organisation using its governance arrangements to ensure it meets the requirements of the law, regulations, and standards; as well as community expectations of honesty, accountability and openness.
- **Performance** is reflected by the organisation using its individual governance arrangements to enhance its overall performance through benchmarking and regular evaluation and through transparent measures that indicate the efficient and effective delivery of its goods, services or programs.

Organisations need to achieve both sets of requirements, and not to endeavour to arbitrarily trade one off against the other. Using an integrated risk management framework will help develop the right control environment and provide reasonable assurance that the organisation will achieve both, within an acceptable degree of risk. Nevertheless, as indicated earlier, a suitable balance has to be struck at any point in time and over time.

The key corporate governance principles used by the ANAO (adapted from the Nolan Committee, UK, *First Report of the Committee on Standards in Public Life*, 1995) are as follows:

- **Accountability**: where public sector organisations and the individuals within them are held responsible for their decisions and actions, and where they are subject to external scrutiny.
- **Transparency**, or openness: is required to ensure that stakeholders have confidence in the decisions and actions of public sector organisations and the individuals within them.

- ❑ ***Integrity***: is based on honesty, objectivity, and high standards of propriety and probity in the stewardship of public funds and resources.
- ❑ ***Stewardship***: reflects the fact that public officials exercise their powers on behalf of the nation, and that the resources they use are held in trust and are not privately owned.
- ❑ ***Leadership***: is one of the more crucial principles. It sets the tone at the top of the organisation, and is absolutely critical to achieving an organisation-wide commitment to good governance.
- ❑ ***Efficiency***: is about the best use of resources to achieve the goals of the organisation, and is also about being able to prove that the organisation has indeed made the best use of public resources.

It is through applying these principles, within an appropriate public sector governance framework tailored to the characteristics of each entity, that public sector entities will be more confident about conforming with all legislation and relevant policies, and moreover, also perform strongly against their specified objectives.

ANAO Guidance on Public Sector Governance – the Better Practice Guide

As I mentioned earlier, the ANAO recently released a Better Practice Guide on Public Sector Governance to provide governance options for public sector organisations to consider. Because 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.

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 Commonwealth 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’*¹⁰⁰ – 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’*.¹⁰¹ 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 *‘a great audit committee won’t make a company great but a great company will have a strong audit committee’*.¹⁰²

To conclude my comments on the Better Practice Guide, I have selected some of the more relevant current issues in public sector governance to cover in a little more depth to reflect the content and purpose of the Guide. More detail is provided in the modules of Volume 2.¹⁰³

Public Sector Governance, Legislation and the Individual Officer

Guidance Paper No. 1 (Volume 2) is designed to provide Commonwealth organisations with guidance on how governance issues affect the responsibility of the individual officer. The basic premise is that good governance is enacted through the behaviour of staff at all levels of an organisation. The leadership provided by agency

heads and senior officers plays a critical role in this regard.¹⁰⁴ For the individual officer, good intentions are hard to put into practice if the culture of the organisation works against it. The leadership provided by agency heads and other senior staff plays a critical role in determining how effective an agency will be in encouraging behaviour that supports good governance throughout the organisation. The ‘tone at the top’ largely dictates the corporate culture, including ethical behaviour within public sector values. Nevertheless, all officers contribute to governance outcomes – relating to both conformance and performance — and to do so effectively they must be fully aware of their legal and corporate responsibilities. Other principles that underpin individual’s actions are, as I outlined earlier: accountability, transparency, integrity, stewardship, and efficiency.

Every public official is the custodian of a certain measure of public power and resources, which are entrusted to him or her under our system of government. With this trust comes the responsibility for each individual to perform his or her duties according to the generally accepted principles of public sector governance. Hence, the accountability of every officer of the public service must not only be clear, it must be well understood. For individuals, the type of organisation in which they work, as well as the position that he or she occupies will determine the applicable legislative and policy regime. According to that regime, the duties, responsibilities and powers of individual officers must be clearly articulated.

Additionally, each and every officer needs to understand the legislation and performance standards relevant to his or her duties. Flowing from this understanding, each needs to know how his or her personal contribution promotes good governance and, ultimately, the achievement of corporate goals. Achieving this understanding takes time and effort for both the organisation and the individual. For this reason, the guide outlines some clear procedures that organisations may take. Simply promulgating what is required is not sufficient. Whatever initiatives are taken must be supportive of generating ‘real ownership’ by those involved.

Guidance Paper No. 8 provides a summary of legal requirements that may be applicable to CAC and FMA bodies. This guide considers over 20 potential governance requirements, such as annual reporting to stakeholders and disclosing directors interests, and indicates which officers are responsible, by type of body (eg CAC authority or FMA agency).

Conflicts of Interest

During the preparation for this Guide, the issue of the management of conflicts of interest emerged as a significant and ongoing concern to public service organisations – from the board and agency head downwards. Consequently, the guide paid significant attention to both conflicts of interest and conflicts of role. The following is a simple and practical definition to assist effective identification and management of conflict situations recently put out by the OECD:

‘A ‘conflict of interest’ involves a conflict between the public duty and private interests of a public official, in which the public official has private-capacity interests which could improperly influence the performance of their official duties and responsibilities.’¹⁰⁵

At the outset, it should be said that organisations need to be realistic about the fact that some conflicts of interest are unavoidable. However, the important point is that such conflicts should be carefully assessed and managed proactively. The principles that apply here are the same ones that go to the heart of good governance. Conflicts of interest and role need to be considered within an ethical framework that requires people to act with integrity, with impartiality, in good faith, and in the best interests of the organisation they serve. Transparency is fundamental, for example, officials must be responsible for disclosing any personal interests that could give rise to a real, or perceived, conflict of interest. From the organisation’s point of view, adherence to disclosure requirements must be monitored and enforced. Consistently requiring conflicts to be identified and dealt with properly is an essential part of building an ethical organisational culture.

Guidance Paper No. 6 suggests some procedures to help organisations and individuals cope with conflicts of interest. An example of the first two of the eleven procedures is provided in the following figure.

Figure 4: Procedures to manage conflicts of interest and conflicts of role

	Procedures or protocols to:	Assessment
1	determine which decision-makers need to make a statement of personal interest and/or may be subject to conflicts of role.	1 ف 2 ف 3 ف 4 ف
2	obtain assurance from decision-makers that they have made relevant disclosures, and that these are up-to-date.	1 ف 2 ف 3 ف 4 ف

Code: 1 Not addressed; 2 Developing; 3 Better practice; 4 Time for review.

These procedures are based around a formal protocol that grades conflicts of interest and recommends different policies depending on the severity of the grading. Important elements of the procedures also include those to review, evaluate and consider complaints.

The Guide also discusses the issue of ‘nominee’ or ‘representative’ board members. It supports the view that appointments to boards should be made on the basis of the best person to contribute to their operations, rather than just on the basis of representation. It adds that Commonwealth organisations should review policies and legislation that require supplier or client representatives on boards, with a view to advising reconsideration of the requirement if potential or perceived conflicts of interest are evident.

A recent audit of Defence Housing and Relocation Services recognised that DHA is a commercial body and that the Department of Defence is, in most respects, its client. Yet Defence had many representatives on the DHA board. The ANAO recommended, and Defence accepted, that:

‘Defence consider reviewing, and providing advice to the Government on, the provision in the Defence Housing Authority Act 1987 for Defence officers to be appointed to the DHA board, in view

*of the potential conflict of interest that such appointments create for those officers’.*¹⁰⁶

Clearly, managing conflicts of interest well is crucial for any organisation that wants to retain the confidence of the public and the Parliament.

Better Practice Statutory Boards

Better practice in statutory governing boards is important because boards provide leadership and direction to organisations and the way they function and behave markedly affects the whole organisation. Along with senior managers in the organisation, they set the ‘tone at the top’. This ‘tone’ dictates, among other things, the emphasis the organisation places on better practice governance. It fundamentally dictates the weight placed on the ethical behaviour of staff. The scrutiny of board behaviour has certainly attracted the attention of the public in recent years. The public are now more aware than ever that they have a right to expect boards that are, and are seen to be, acting in accordance with the highest standards.

In the Better Practice Guide, there are several Guidance papers that deal with aspects of this issue. Guidance Paper No. 2 deals specifically with potential conflicts in the governance of bodies subject to the *Commonwealth Authorities and Companies Act 1997*. Guidance Paper No.3 addresses issues faced by CAC agency boards.

CAC agency directors, like the directors of private corporations, govern the authority, or corporation, through their work on the board. But they are also accountable to a Minister or Ministers, and to Parliament, as well as being subject to scrutiny by the Australian National Audit Office, and other external bodies. Consequently, in addition to directing the actual business of the agency, there is a weight of responsibility on CAC agency directors to get their accountability structures and procedures right.

In this respect, public sector boards can learn from the private sector. It is a well-established part of good governance in the private sector that boards have a Charter against which the performance of the board as a whole, and that of individual members, is regularly assessed. The Charter should of course be tailored to the circumstances of the organisation – for example, a small organisation with a narrow range of concerns, and little exposure to risks of conflicts of interest, will probably need a less detailed and comprehensive board charter than a larger organisation with greater risk exposure.

The Guide offers suggestions for better practice protocols to help public sector boards develop Charters. Most importantly, boards need to include information on:

- ❑ functions, powers and board membership;
- ❑ roles and responsibilities of members;
- ❑ role of the chair;
- ❑ processes for identifying and measuring conflict of interest;
- ❑ basic meeting procedures;
- ❑ clear policies on member remuneration; and
- ❑ policies on board performance review.

On the latter point, the Guide also provides a number of better practice protocols for organisations to follow to help them assess: whether current board arrangements are tailored to best deliver value to the particular agency; whether arrangements can be improved; and how to go about determining these issues.

Cross Agency Governance

This is an important aspect of public administration as governments seek to address increasingly complex and wide-ranging policy and operational issues in ‘*joined-up government*’ or more collaborative type arrangements. Better practice in this area of public administration is still developing and, to some extent, so is the better practice in corporate governance. However, the specifics of the governance arrangements need to match the scale, nature and complexity of the task or activity. A key determinant is the extent to which the activity falls primarily within the province of one agency or falls more or less across two or more agencies.

In ‘lead agency’ arrangements, it may be the case that the lead organisation has primary policy responsibility (that is, rather than only an operational or service delivery role), effectively becoming an actual or de facto purchaser of services from one or more other agencies to facilitate implementation. Such arrangements are particularly common in the social welfare area. Partnership or joint venture forms may also involve parties that are predominantly concerned with policy matters joining forces with one or more other agencies that have an operational focus in delivering or overseeing the delivery of programs.

Where more formal mechanisms are contemplated (for example, service level agreements, contracts, joint boards or committees) it is important that the associated documentation clearly articulates:

- the objectives of the arrangement, including desired outcomes, and timeframes;
- the roles and responsibilities of the parties, including their capacity to contribute, and positions on governing boards or committees;
- the details of the activity, including specifications of services or projects to be undertaken;
- resources to be applied by the parties and related budgetary issues;
- the approach to identifying and sharing the risks and opportunities involved;
- agreed modes of review and evaluation; and
- agreed dispute resolution arrangements.

Guidance Paper No. 7 provides the elements of better practice as well as setting out the forms of cross-agency governance. The arrangements are likely to be more complicated with the involvement of various levels of government and/or the private sector where there is a real ‘partnership’ involvement.

Performance Management and Reporting

Performance management and reporting is the single issue that entails most ANAO performance audit recommendations and suggestions. I believe this audit attention occurs not just because of the difficulty of the outputs and outcomes framework but because organisations are often loathe to commit to indicators that they may not have full control over and may reflect badly on them if they show a drop in performance at any time, or over time.

The ANAO recognises the imperfections and/or limitations of many performance indicators and the difficulty of ascribing causality. However, the internal and external benefits in developing relevant performance indicators, and their positive impact on policies, behaviours and ultimately performance justify the effort to get them right.

In summary, I would again emphasise that the public sector generally has in place appropriate governance frameworks, elements and policies. However, sound implementation is the key to success. It is timely to draw on the sentiment of Justice Owen, expressed earlier, that good corporate governance has at its heart accountability, stewardship and the effective management of risk. And that it is reliant on people with integrity who exercise an independence of judgement.

While these broad statements tend to simplify the nature of corporate governance, we know that many complexities arise in practice. These often involve managing complex relationships between the various major stakeholders, be they between directors, senior executives and Ministers, or with other government agencies, firms, clients or the general community. In many cases, protocols can assist public sector governance by clearly specifying roles, responsibilities and policies and by providing effective review and complaint mechanisms. Board charters are especially useful in this respect and their principles can be applied to many situations.

V. CONCLUDING REMARKS

As the governance and accountability environment becomes more complex, the ANAO performs a crucial function in providing assurance on performance across the public sector as well as providing practical guidance with our latest Better Practice Guide – Public Sector Governance a significant front row contributor. This is important as agencies increasingly find new methods to deal with common issues, and form alliances and partnerships, including with the private sector, to deliver government services. Consideration of the corporate governance procedures underpinning these new more complex administrative arrangements, and promotion of better practice examples, is a key feature of many ANAO audit reports.

To deal successfully with the challenges, we have to learn from each other. This requires a continuing open dialogue, and sharing of experiences from both the private and the public sector, in Australia and overseas. As the auditor for the Commonwealth, the ANAO will continue to play our part in contributing to broader debates over accounting and governance. In addition, we will continue to assist agencies in dealing with the challenges facing them. This is important so that Parliament can obtain maximum value from agencies' financial statements, as well as

be assured as to the effectiveness of agencies' governance and accountability arrangements.

The public service in general, and the ANAO in particular, is characterised by an emphasis on operational transparency, integrity, accountability and proper stewardship of public resources. This provides an excellent platform on which to build the new directions in accounting and auditing, and should, in turn, provide the level of assurance required by stakeholders, Parliament and the public. Harmonisation of national accounting and auditing standards with international standards and/or the adoption of the latter standards reflects the realities of global pressures and the greater convergence of various sectors of the economy. The pressure is very much on improved performance and achieving required results. However, this still should not be at the expense of due process, or the public interest, or at the expense of high level values, ethics and professional codes of conduct.

Corporate governance is set to remain amongst the hottest issues for a long time to come as evidenced by headlines such as, 'Governance: there's no escape'.¹⁰⁷ Drawing on Don Argus' observation *that 'any new standards or guidelines [and I include the ANAO's new Corporate Governance BPG] should not simply become a question of ticking the box'*.¹⁰⁸ Achieving an appropriate balance between conformance and performance is at the heart of sound governance. This very much depends on the governing body and the 'tone at the top'. While results are of importance, it is often how we achieve those results, and our credibility (and trust) with our stakeholders, that will ultimately determine our success whether we are in the public or private sectors.

COMPARISON OF CORPORATE REFORMS

ATTACHMENT

Australia	United States	UNITED KINGDOM
The chairperson should be an independent director. Where this is not the case, a lead independent director could be appointed.	The chairperson should be an independent be an independent director. Where this is not the case a lead independent director should be appointed	The chairperson should be an independent director.
The same individual should not exercise the roles of chairperson and CEO and the CEO should not go on to become chairperson of the same company.	The same individual should not exercise should not exercise the roles of chairman and the CEO	The same individual should not exercise the roles of chairperson and CEO and the CEO should not go on to become chairperson of the company.
A majority of the board should be independent	A majority of the board must be independent	At least half the board, excluding the chairman should be non-executive independent directors. There should also be a strong executive representation on the board.
The company should have a nomination committee comprised of a majority of independent directors	The company must have a nomination committee comprised solely of independent directors	The company should have a nomination committee comprised of a majority of independent directors. If the chairman is a member he or she should not be the chairperson of the committee.
The CEO and the CFO should formally state to the board that the company's financial reports present fairly, in all material respects, the company's financial condition and operating results in accordance with relevant accounting standards. (Recommendation 4.1)	The CEO and CFO must certify in each annual and quarterly report, in addition to the truth and fairness of the report, that they are responsible for and have designed, established, and maintained disclosure controls and procedures, and that the report presents conclusions about the effectiveness of these based on their recent (within 90 days prior to filing date) evaluation. They must also report that they have disclosed to the audit committee and external auditor any significant deficiencies and material weaknesses in internal control over financial reporting, and any fraud (material or not) involving anyone having a significant role in those internal controls. Finally, they must certify that they have disclosed in the report significant changes that have occurred that affected internal controls over financial reporting, and whether any corrective actions were taken if any significant deficiencies and material weaknesses were identified. (Section 302 SOA).	There is no requirement for the CEO and CFO to certify or assert to the board that the financial statements present fairly the company's financial condition and operating results. The audit committee is charged with monitoring the integrity of the financial statements.
The CEO and CFO should formally state to the board that the statement given about the integrity of the financial statements	As well as the certification requirement each annual report must contain an internal controls report stating:	There is no requirement for the CEO and CFO to assert to the board that the financial statements are founded on

(as required by Recommendation 4.1) is founded on a sound system of risk management and internal compliance and control, which implements the policies adopted by the board, and that the company's risk management and internal compliance and control system is operating efficiently and effectively in all material respects.

- Management's responsibility for establishing and maintaining adequate internal control over financial reporting.
- Management's conclusions about the effectiveness of internal control over financial reporting as of the end of the financial year, based on management's evaluation.
- That the external auditor has attested to and reported on, management's evaluation(Section 404 SOA)

a sound system of internal control. The audit committee is charged with reviewing the company's internal financial control system and risk management system as well as monitoring and reviewing the effectiveness of the company's internal audit function. The full board must ensure that a review of the group's system of internal control is conducted at least annually.

The board should establish an audit committee with a minimum of three members, and should have a formal operating charter. There should be no executive directors on the committee and there should be a majority of "independent directors". All members should be financially literate and one should have

All listed companies are required to have an audit committee consisting solely of independent directors. The chair of the audit committee must have related financial management expertise and at least one member should be a "financial expert".

The company should have an audit committee (mandatory for listed companies) and should consist of all non-executive independent directors. The chairperson should be an independent director and should not be the chairperson of the board. There should be at least three financially "financial expertise". literate members, one of whom must be a financial expert.

The company should have a formal induction process for new directors as well as an on-going continuing education process.

The company must have a formal induction process for new directors as well as an on-going continuing education process. The NYSE listing rule amendments (2002) call for the establishment of a directors' education institute.

All new directors should receive induction on joining the board and should continually update and refresh their skills and knowledge.

Performance evaluation of the board, its committees and individual directors, and key executives should be undertaken regularly.

The board should conduct a self evaluation at least annually to determine whether it and its committees are functioning effectively.

Performance evaluation of the board, its committees and individual directors, should be undertaken at least once a year. The board should state in the annual report whether such performance evaluation is taking place and how is conducted.

The company should have a remuneration committee comprising at least three members, with a majority of independent directors.

The company must have a compensation committee consisting solely of independent directors.

The company should have a remuneration committee, which should consist of at least three members and should be comprised exclusively of independent directors.

Establish a code of conduct to guide directors, CEO, CFO and executives as to practices necessary to maintain confidence in the company's integrity and procedure for reporting and investigating unethical behaviour.

Companies required to disclose whether they have adopted a code of ethics for senior officers, and if the company has not done so, the reasons for failing to do so.

Not addressed in the Combined Code (current or pending version)

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- ⁷² Commonwealth Treasury 2002. *Corporate disclosure: Strengthening the Financial Reporting Framework*, CLERP Paper No 9, Op.cit. pp.1-2. These sentiments were recently re-affirmed by the Parliamentary Secretary to the Treasurer in an address to an ASIC Summer School in Sydney. Op.cit.
- ⁷³ ICAA (Technical Focus – Corporate Disclosure) 2003, *CLERP 9 – where we stand*. CA Charter magazine. February, pp. 40-44.
- ⁷⁴ In 2002-03, the ANAO published 63 audit reports and 5 Better Practice Guides. performance audits products, 8 information services products (including BPGs and benchmarking . This is in addition to the issue of 290 financial statement audit opinions.
- ⁷⁵ ANAO 2003, *Control Structures as part of the Audits of the Financial Statements of Major Commonwealth Entities for the year ending 30 June 2003*, Report No. 61, Canberra, 30 June.

⁷⁶ See, for example, ANAO 2001, *Audits of the Financial Statements of Commonwealth Entities for the Period Ended 30 June 2002*, Report No. 25, Canberra, 23 December.

⁷⁷ The Auditor-General Bill 1996.

⁷⁸ ANAO 2003, 'Audit Activity Report: July – December 2002' Report No. 29, Canberra, 7 February

⁷⁹ KPMG, 2002. *Review of Independent Auditing by Registered Company Auditors*. Submission to the JCPAA Review of Independent Auditing by Registered Company Auditors, 16 August.

⁸⁰ It should be observed that risk management can minimise the uncertainty surrounding innovation, by requiring the assessment of a range of options in terms of the likely opportunities for improved service delivery and program outcomes, and what needs to be done to manage the risks associated with each option. See, for example, Northern Ireland Audit Office 2002 *Investing in Partnership: Government Grants to Voluntary and Community Bodies*, Belfast, 16 May.

⁸¹ ANAO 2003, *The Senate Order for Departmental and Agency Contracts (Spring 2002 Compliance)*, Report No. 32, Canberra, 5 March.

⁸² ANAO 2003, *Absence Management in the Australian Public Service*, Report No. 52, Canberra, 20 June

⁸³ ANAO 2003, *Management of Commonwealth Guarantees, Warranties, Indemnities and Letters of Comfort*, Report No. 27, Canberra, 30 January.

⁸⁴ ANAO 2002, *Energy Efficiency in Commonwealth Operations – Follow up Audit*, Report No. 24, Canberra, 20 December.

⁸⁵ ANAO 2002, *Payment of Accounts and Goods and Services Tax Administration by Small Commonwealth Organisations*, Report No. 22, Canberra, 12 December.

⁸⁶ ANAO 2003, *Managing People for Business Outcomes, Year Two*' Report No. 50, Canberra, 18 June

⁸⁷ ANAO 2002, *Benchmarking the Internal Audit Function Follow-on Report*, Report No. 13, Canberra, 23 October.

⁸⁸ ANAO 2002, *Benchmarking the Finance Function Follow-on Report*, Report No. 62, Canberra, 26 June.

⁸⁹ ANAO 2002, *Managing People for Business Outcomes*, Report No. 61, Canberra, 25 June.

⁹⁰ This is one essential difference between management consultancies and the public sector audit approach. Our 'observer status' as public sector auditors reduces the risk of conflict of interest issues arising in the course of our work. Nevertheless, that does not absolve us from any responsibility for our views and actions

⁹¹ ANAO 2003. *Public Sector Governance – Volumes 1&2 Better Practice Guide*, July, and ANAO 1997. *Applying Principles and Practice of Corporate Governance to Budget Funded Agencies*. Canberra, ANAO 1999 *Principles and Better Practices – Corporate Governance in Commonwealth Authorities and Companies*, Canberra, May.

⁹² Blake Dawson Waldron 2002, *Corporate Governance Update: Audit Independence*, March.

⁹³ ANAO 2003, *Public Sector Governance – Volumes 1&2, Better Practice Guide*, Op.cit.

⁹⁴ Ibid, p. iii

⁹⁵ Ibid, Vol. 1 p. 12

⁹⁶ Department of Finance & Administration, 2002. *Overview of Formal Elements of Governance in the Commonwealth*. Address by Marc Mowbray-d'Arbela to the IIR Conference on Corporate Governance in the Public Sector, Canberra, 12 August.

⁹⁷ Narracott, M., 2001, *Corporate Governance in Australia*, *International Financial Law Review*, pp 35 – 42.

⁹⁸ Department of Finance and Administration, 2002. Op.cit.

⁹⁹ Mulgan, Richard 2000 *Comparing Accountability in the Public and Private Sectors*. Australian Journal of Public Administration Vol 59 No 1. March. p.89.

¹⁰⁰ Barrett, Pat, 2003, *Strategic Insights into Enterprise Risk Management*, June, found at www.anao.gov.au

¹⁰¹ Arbouw, John, 2003, 'Conversation with a chairman Don Argus' Company Director, Vol 19 No 5, June p.10

¹⁰² Ibid, p. 10

¹⁰³ Volume 2 of the Better Practice Guide on Public Sector Governance has 8 Guidance Papers, namely:

- No.1 Public Sector Governance and the individual Officer
- No. 2 Potential Conflicts in the Governance of CAC Bodies
- No. 3 CAC boards
- No. 4 Executive Boards in the FMA Agencies
- No. 5 Monitoring Boards Performance
- No. 6 Conflicts of Personal Interest and Conflicts of Role
- No. 7 Cross Agency Governance
- No. 8 Summary of Current Legal Requirements that may be applicable to CAC and FMA Bodies

¹⁰⁴ ANAO, 2003, Better Practice Guide, Public Sector Governance, Volume 2, Guidance Paper No. 1, Op.cit., p. 1

¹⁰⁵ OECD 2003. *Recommendation of the Council on Guidelines for Managing Conflict of Interest in the Public Service*. Paris, June. p.4

¹⁰⁶ ANAO Report No. 51, 2003, 'Defence Housing and Relocation Services', Canberra, 19 June, p. 17

¹⁰⁷ Durie, John (Chanticleer) 2003, 'Governance there's no escape', The Australian Financial Review, 24 July, p. 64

¹⁰⁸ Arbouw, John, 2003, 'Conversation with a chairman Don Argus' Op.cit, p.10