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Public Sector Risk Management

- not walking too early to the winner's circle

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Introduction

It is a fairly natural desire on the part of any member of any organisation to want that organisation to be successful in pursuing its mission. As individuals progress within an organisation there comes a dawning, sooner or later, that they have a role, a voice, and a part to play in determining the success and future of the organisation.

Effective organisations leverage this buy-in to advance their mission, to build resilience and to mitigate risk. This does not come about by chance, but by organisations harnessing measures that reinforce their values and increase staff engagement to enhance organisational performance and reputation. It is very much a journey that has been fostered by inclusive reform and continuous improvement agendas across the years.

The focus of my presentation today is the Australian Government public sector, and the critical role risk management plays in decision-making. It is important for any nation for the public sector to provide sound policy options to government and deliver on government policies and programs, efficiently and effectively. This is especially the case when government is seeking to restore the health of public finances, at a time when OECD statistics for 2012 show that confidence in national governments generally and in Australia has been on the wane.[1]

Sound policies and performance matter in building confidence in government, and public sector entities have an important role to play here in terms of the quality and cohesion of the advice they provide, and in delivering programs effectively. To perform this role effectively, public sector entities need the capability to match those expectations; and a positive risk culture is a key ingredient in this context.

Against this background, I plan to refer to the experience of the Australian Government public sector in increasing the focus on risk management to achieve better outcomes, some of the experience to date and messages for managers – particularly in not walking too early to the winner's circle.

Conditions for effective risk management

One of the very positive developments in the public sector in the last decade or two has been the improvement in governance arrangements, particularly for those entities like departments, that do not have statutory boards, but commonly have advisory boards. Generally, the enhanced governance arrangements have allowed public sector entities to better manage their responsibilities and attendant risks in an environment that encourages a stronger outcomes orientation and gives greater authority to entities to deliver programs effectively. This has required a focus on all of the essential elements of good governance including organisational capability to deliver to the standard, and to the performance, expected.

The recent enactment of the *Public Governance, Performance and Accountability Act 2013* (PGPA Act) reinforces the responsibility of the accountable authority of a Commonwealth

[1] OECD (2013), *Government at a Glance* 2013, OECD Publishing, pp 40-41. Data relates to 2012 and then shows confidence in the national government in Australia marginally ahead of the OECD average but experiencing a reduction of some 10 % since 2007 compared to the OECD average decline of 5 per cent.

entity to establish and maintain an appropriate system of risk oversight and management for the entity.[2] This will assist, in a formal way, to signal the importance of effective risk management to entity performance.

Public sector entities have appreciated for some time that risk management is no longer discretionary and needs to be integrated into their business as usual processes because, in any organisation, decisions are constantly being made. Risk management is generally employed at the enterprise level and for significant projects; and desirably will also be employed at the divisional or program management level. Clear accountabilities for performance (and risk management) need to be established, and there needs to be alignment between those holding the authority and their accountabilities.

Beyond the formal accountabilities, the goal is to develop a positive risk culture, which has been defined as the 'set of encouraged and acceptable behaviours, discussions, decisions and attitudes toward taking and managing risk within an institution.'[3]

The contrast between the more traditional risk management approaches and Enterprise Risk Management now generally adopted, which reinforces the benefits of a positive risk culture, is illustrated in the following table.[4]

Traditional risk management	**Enterprise Risk Management**
Risk as individual hazards	Risk in the context of business strategy
Risk identification and assessment	Risk portfolio development
Focus on discrete risks	Focus on critical risks
Risk mitigation	Risk optimisation
Risk limits	Risk strategy
Risk with no owners	Defined risk responsibilities
Haphazard risk quantification	
'Risk is not my responsibility'	'Risk is everyone business'

Source: KPMG as cited in Enterprising Views of Risk Management

As for many organisations, in the public sector there is still more to be done to embed risk management in organisational behaviour in a way that means all employees contribute positively to stronger outcomes through more effective engagement. This includes scanning the environment for new risks and being alert to the possible need to recalibrate previously identified risks – this applies whether an individual's responsibilities are for policy development and advice, or service delivery.

[2] Section 16(a) of the PGPA Act.
[3] *Risk Culture: From Theory to Evolving Practice* The RMA journal, December 2013-January 2014, Risk Management Association and Protiviti. Found in Protiviti's *Board Perspectives: Risk Oversight* Issue 57
[4] Banham, Russ, 2005. *Enterprising Views of Risk Management*, Drawn from an article published by the International Federation of Accountants in its *Articles of Merit Award Program*, August, p.14

Progress is being made but, as in other sectors, we are still some way from having all of the answers. The main reason for this is that people are involved – people are always part of the solution but can also be part of the problem. It is always the intersection of generally accepted approaches on the one hand, and people on the other, that create both the opportunities and the challenges for organisations and their managers. This is often referred to as the hard and soft elements of governance.[5]

The reason that entities do not include their 'most valuable asset' – their people – on their balance sheet is that they do not 'control' them in the way we control the service potential of other assets. It is the values of the organisation, the tone at the top, managers leading by example, the empowerment of employees to make decisions, and the investment in employee development, that influence the engagement of people which in turn contributes positively to organisational goals. An inclusive organisation that has effective leadership and a focus on integrity and performance as its centrepiece, and encourages internal debate and stakeholder engagement, has a strong platform to build an effective approach to risk management. This should be our goal as managers. We need to engage our people through effective leadership to bring alive the various frameworks, strategies and approaches.

One of the positive influences that is assisting the cause is that risk management has not only developed as a professional discipline, but has been embraced by other professions as well. Take auditing, for example, where the body of professional standards has largely been rewritten to embody risk management. This requires auditors to reduce engagement risk (i.e. the risk of an inappropriate audit opinion or conclusion) to an acceptably low level in the circumstances of the engagement.[6] In other words, while my office is dedicated to discharging its mandate and improving public administration, it is fundamentally important that in our approach to auditing we cover off the risk of forming an incorrect conclusion in our reports by adhering to professional auditing standards.

While acceptance of the importance of risk management in all professions and sectors of the economy is growing, we still have more to do to embed it in approaches so that all employees are tuned into key strategies and take a broad view of their responsibilities. As a consequence, risk management and business planning need to be integrated so that the organisation's models and approach are readily understood, at least in a general way, by all employees. Being aware of the organisation's strengths and weaknesses can only assist in refining the required strategies.

Noteworthy has been the efforts of some organisations to make the main types of business risks and risk assessments more visible, and to better describe the risk tolerances of the entity in its pursuit of its mission and strategic objectives.

For example, the presentation of business risks in the following manner provides clarity and a real focus to the full range of risks, particularly those of a strategic or hazard kind that are often missed from many risk registers:

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[5] See, for example, Edwards Meredith, Halligan John, Horrigan Bryan, Nicoll Geoffrey, 2012. *Public Sector Governance in Australia*. Australian National University E Press. Canberra. pp 75,76

[6] See framework for Assurance Engagements, para 48.

Figure 2 Risks to business

Source: PwC Global, 2012. *Sharpening strategic risk management*

The importance of ensuring greater consideration of strategic and hazard risks underlines the critical role governance boards have in risk management. For the public sector at the national level, recent changes in the makeup of the Parliament and recent international events illustrate the type of strategic and hazard risks that warrant consideration in the context of policy design and implementation.

Once risks have been identified, the business risk radar, set out below, is a particularly useful way to summarise – and communicate – the consideration of the range of more significant business risks.

Source: Ernst & Young, Australia. *The Ernst & Young Business Risk Report 2010 – The top 10 risks for global business*

With minimal change, this risk radar could be modified to suit the particular purposes of public sector entities, e.g. the strategic focus could readily be amended to accommodate the risks to the appropriateness of current policy settings, or resource levels in the out years.

Staying with the theme of improving the visibility and communication of risks, in our reports to board/entity audit committees we are starting to use more diagrams and colour coding to signal our assessment of the key judgements by management in preparing financial statements, e.g. to indicate whether, in our view, key judgements are conservative, balanced, optimistic or we materially disagree with management.

As flagged earlier, another beneficial development we have seen is leading organisations move beyond the mechanistic application of risk management models to explain, in plain english, target and tolerance statements and levels for all core risks – typically 5-8 – with each core risk having subsidiary risks. To illustrate, a core risk could relate to a public sector organisation's reputation and standing, with a target statement of maintaining high standards of integrity and service (and have a low/medium risk tolerance). Nevertheless, the organisation may be prepared to tolerate temporary strained relationships with some stakeholders or negative publicity where the organisation has made a considered position in line with its mandate (and have a medium tolerance level). In addition, because of a need to maintain public confidence in its oversight role, the organisation may decide to hold itself to quite high standards of governance (with a low risk tolerance). Nevertheless, the organisation may be prepared to tolerate employees making genuine mistakes in their role, if there are learnings from the experience (and have a low/medium tolerance level). To illustrate, the risk tolerance statement concerning governance may be presented for the information of employees as:

Governance

We will adopt approaches that maintain the confidence of [key stakeholders, including the public] in [our organisation]. We will take steps to ensure all legislative requirements are met, provide good value for money from our use of public resources, and deliver on our responsibilities efficiently and effectively.

Target level	1						*Low*
Tolerance level		2					*Low/Medium*

We will not tolerate the following:

- *conduct that is not consistent with our values or policies*
- *significant risks, which are known, or reasonably should have been known, but not brought to attention of senior management*
- *inadequate responses to agreed recommendations from internal committee processes, internal or external audit.*

We are prepared to tolerate employees making genuine mistakes in discharging their responsibilities, provided there are learnings gained from the experience.

Risk appetite statements of this kind assist in informing both management and other staff of the degree of risk an organisation is prepared to accept in the pursuit of its role and mission. To be credible, these risk appetite statements must align with the strength of the organisation's control environment and assessment of residual risks.

The message here is that by capturing the key steps in an organisation's approach to risk management, and then effectively communicating them, an organisation is much better placed to bring employees along with them. In this way, organisations are able to have an army of risk managers, rather than just a few soldiers.

Identifying, assessing and advising of risks

Risks related to an organisation's core business responsibilities understandably tend to get a stronger focus in approaches by organisations to risk management, including those in the public sector. Relevant here is the observation by Jim Collins in *Good to Great* that:

> *Each good-to-great company built a fabulous economic engine, regardless of the industry. They were able to do this because they attained profound insights into their economics.*[7]

Our work would indicate that not all public sector agencies have profound insights into the best way to achieve the outcomes expected by government, but to make good progress in this journey requires having a very good handle on the organisational and policy goals, delivery approaches and the risks to being successful. Our work also shows, unsurprisingly, that the risks tend to be higher for new policies/programs.

In this context, Warwick McKibbon gave some sage advice on approaches to policy development when he said:

> '*Uncertainty and risk management should be at the core of all policy design. The correct question should not be how good a policy might be in the best possible world, it should be what can go wrong if the world turns out differently to that assumed.*'[8]

The new Public Governance, Performance and Accountability Act mentioned previously provides an opportunity and a stimulus for public sector entities to strengthen their approach to risk management. Effective from 1 July 2014, non-corporate public sector entities must comply with the following nine elements in order to establish an appropriate level of risk oversight and management:

1. establishing a risk management policy;
2. establishing a risk management framework;
3. defining responsibility for managing risk;
4. embedding systematic risk management into business processes;
5. developing a positive risk culture;

[7] Collins Jim 2001. *Good to Great – Why Some Companies Make the Leap…and Others Don't*. Published by Random House, UK. p.104

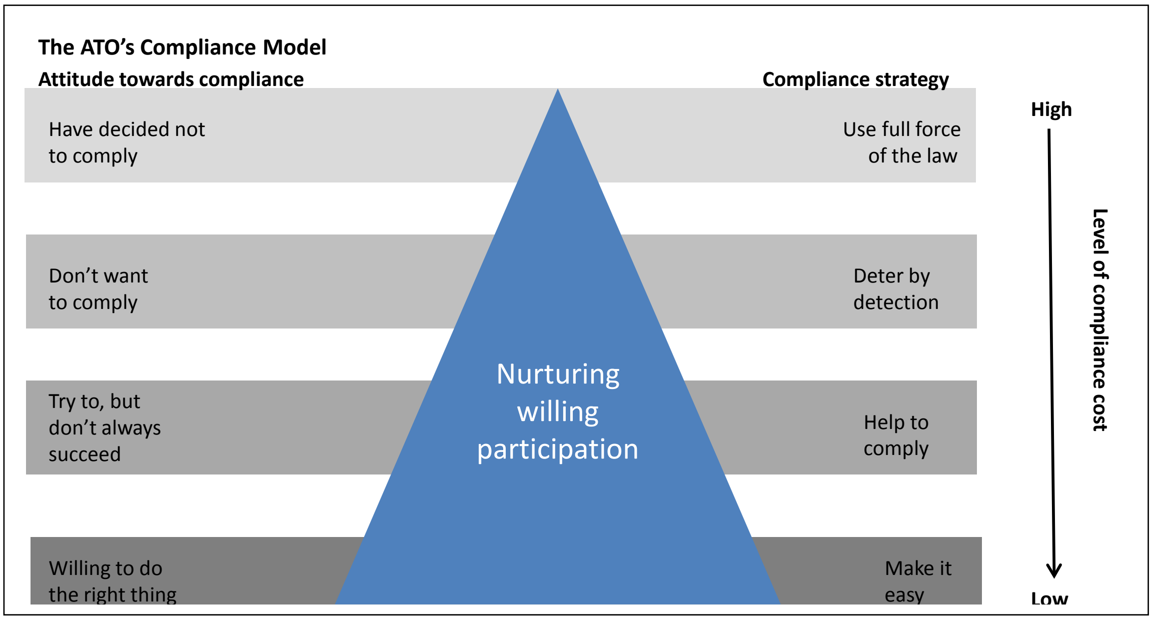
[8] McKibbin Warwick 2013. *Expect the unexpected in creating climate policy*. Article in the Australian Financial Review, 24 April. p.43

6. communicating and consulting about risk;
7. understanding and managing shared risk;
8. maintaining risk management capability; and
9. reviewing and continuously improving the management of risk.[9]

The various standards and publications issued by the Australian Prudential Regulation Authority (APRA) in its statutory role will actually be quite useful in assisting public sector agencies develop their approaches here even though for most, the standards will not be directly applicable.

The Australian Taxation Office (ATO) is one organisation that invests heavily in risk management to inform its administration of the taxation laws. The ATO assesses the risks associated with taxpayers not complying with their taxation obligations through its risk management framework. The self-assessment taxation system allows the ATO to apply a risk managed approach to revenue administration, and focus on the risks of taxpayers failing to comply with registration, lodgement, reporting and payment obligations. The ATO seeks to manage these risks and optimise the level of voluntary compliance by taxpayers through its Compliance Model strategies.[10]

The ATO's approach to compliance is illustrated below:



The ATO differentiates its approach to compliance across five major market segments including individuals, micro enterprises, small to medium enterprises, large businesses and non-profit organisations. Key compliance obligations are set out, and the ATO's risk management framework provides a structured approach to identifying and prioritising the compliance risks associated with each market. For some markets, automated profiling tools (risk engines) are used to assess compliance risks by assessing data on individual taxpayers to

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[9] Commonwealth of Australia, Department of Finance, Business, Procurement and Asset Management, *Commonwealth Risk Management Policy – Public Governance, Performance and Accountability*.
[10] ANAO Report No 16 2011-12 *The Management of Compliance in the Small to Medium Enterprises Market, Australian Taxation Office*. p.35

determine a relative risk of non-compliance. The ATO also seeks to measure the effectiveness of its compliance strategies through a compliance effectiveness methodology[11] which can then inform decisions about whether to vary letter and telephone campaigns, bulk mail outs, or approaches to reviews and audits.

It is positive and encouraging to see these developments. With current resource constraints affecting many public sector organisations and the new legislative framework, mentioned earlier, we can expect to see a stronger focus on risk based approaches as a key strategic focus to delivery on program responsibilities. Of course, this brings with it the responsibility to monitor the effectiveness of the adoption of the risk based approach, as I cover later in this paper.

We are also likely to see greater investment in raising the awareness of employees about the more significant risks that need to be managed, and that they are part of the solution. This represents a significant leverage opportunity for organisations in the public sector.

To assist in improving public administration, the ANAO will shortly be releasing its updated Better Practice Guide, prepared jointly with the Department of the Prime Minister and Cabinet, on *Successful Implementation of Policy Initiatives*. The Guide emphasises that sufficient consideration of major implementation risks—both within and external to the implementing entity—is essential during policy development, as well as during the implementation stage. This includes agreeing on the risk appetite and identifying risk treatments.

It is important that risk assessments are sufficiently ‘hard-nosed’; that is, they do not present government and other entities with an over-optimistic view of the forward outlook. It is a matter of drawing on and testing the available evidence, and adequately informing government of any significant risks to policy design or implementation. This is particularly important where rapid policy development and implementation is required. It is incumbent on public sector entities to provide well-informed, timely, accurate and candid advice to ministers, and the importance of providing ministers with a range of viable policy options has probably never been more important given the current composition of the Australian Parliament.

It is equally important that commitments and announcements are not made without consideration of the delivery implications and risks, since the commitment or announcement stage is a key point at which risk to government may arise. This will require those with responsibility for policy development to advise government about any significant delivery difficulties of a proposed policy in terms of consultation, planning or negotiation. This recognises that it is ‘ultimately [for] government leadership to promote and consolidate community support for reform’.[12]

In this context, a *Practical Guide to Policy-Making*, developed for the Northern Ireland Civil Service makes the point that:

> *‘Communication of government policy should not be regarded as an afterthought but should be an integral part of policy development.*

[11] ANAO Report No 39 2013-14 *Compliance Effectiveness Methodology*, *Australian Taxation Office*.
[12] Productivity Commission 2010, *Annual Report 2009-10*, Annual Report Series, Productivity Commission, Canberra. p.2

Often in the past, insufficient emphasis has been placed by civil servants involved in policy development on the communications strategy that every important initiative or decision will require. Policy staff should naturally think about communication aspects…Policy and the handling plans for its communication should be developed in parallel rather than sequentially.'

Approaches to engaging actively with risk are to be favoured, as the insights and analysis contribute to better approaches to policy design and implementation. We also need to be willing to converse with internal and external stakeholders along the way.

Perhaps one of the most way-out stakeholder communications ever conveyed by government was that by former President of the USA, Jimmy Carter, in his message to aliens at the launch of the Voyager spacecraft in 1977, on all our behalf:

> *This Voyager spacecraft was constructed by the United States of America. We are a community of 240 million human beings among the more than 4 billion who inhabit the planet Earth. We human beings are still divided into nation states, but these states are rapidly becoming a single global civilization.*
>
> *We cast this message into the cosmos. It is likely to survive a billion years into our future, when our civilization is profoundly altered and the surface of the Earth may be vastly changed. Of the 200 billion stars in the Milky Way galaxy, some – perhaps many – may have inhabited planets and spacefaring civilizations. If one such civilization intercepts Voyager and can understand these recorded contents, here is our message:*
>
>> *This is a present from a small distant world, a token of our sounds, our science, our images, our music, our thoughts and our feelings. We are attempting to survive our time so we may live into yours. We hope someday, having solved the problems we face, to joining a community of galactic civilizations. This record represents our hope and our determination, and our good will in a vast and awesome universe.*[13]

Perhaps it has already had a positive effect!

Jimmy Carter's words also remind us of an issue which is very topical today, particularly for companies that are expanding offshore but which history shows is also relevant for public sector organisations – namely offshore corporate governance. An article by Stephen Sharpe and Alexandra Rose[14] in the August 2014 edition of Governance Directions draws attention to the recommendations of the Report to the Board of Banking Supervision Inquiry into the Barings Bank collapse in 1995 that included:

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[13] Carter, Jimmy 1977. *Voyager Spacecraft Statement by the President*. July 29. Found at http://www.presidency.ucsb.edu/ws/?pid=7890

[14] Sharpe, Stephen and Rose, Alexandra. *Offshore corporate governance – the new frontier.* Article contained in Governance Directions Vol 66 no 7, August 2014. p.395

- management teams have a duty to understand fully the businesses they manage
- responsibility for each business activity has to be clearly established and communicated
- clear segregation of duties is fundamental to any effective control system
- relevant internal controls, including independent risk management, have to be established for all business activities, and
- top management and the audit committee have to ensure that significant weaknesses, identified to them by internal audit or otherwise, are resolved quickly.

As in any discipline, we need to be open to new ways of managing risks in a more complex and integrated world but also not lose sight of the lessons of history.

Lessons from recent history

Experience is a great teacher. We can learn from our past direct involvement in significant transactions or events, or from others and their experience.

Ric Smith, a former Secretary of Defence, made the observation that, in acquiring new military capability, the rapidly changing technological environment makes acquisition and procurement even more complex and difficult. Here, Defence faces the dilemma of looking to purchase capability which will have enduring utility, while minimising the risk of investing in unproven technology. This complexity could cause paralysis if Defence was to wait for its strategic circumstances to stabilise, or for technology advances to plateau.[15] The then Defence Secretary made the point that at some stage we need to *jump into the swimming pool* (to use a General Cosgrove analogy). That is, we need to understand the risks and actively manage them – we cannot just say the risks are too high and wear the consequences.

At the same time, it doesn't pay to be over confident that risks are under active management. One of the most illuminating examples of the importance of active risk management, quoted in a publication by Arthur Anderson: *Managing Risk, Managing Value*,[16] was the comment by Rick Buy, Executive Vice President and Chief Risk Officer, Enron in 2000:

> *A rattlesnake may bite us every now and again, but we knew it was there and how much it might hurt.*

If only we really could assess the likelihood and consequence of risks so clearly, consistently and confidently. Perhaps the lesson here is not to be over-confident in walking to the winner's circle too early, but to actively monitor risks, as neither Enron nor Arthur Anderson has survived.

[15] Smith, Ric, 2004. *Blamey Oration* presented to the Royal United Services Institute (WA)*, 27 May, p.6*

[16] See Deloach, James W, Partner, Arthur Anderson, 2000. Executive Briefing: *An Executive Summary of Enterprise-wide Risk Management. Strategies for linking risk and opportunity*.

If further support for this view was required, it is evident in the recent report of the Royal Commission into the Home Insulation Program, and our earlier performance audit[17] on the same topic. The Commissioner, Mr Ian Hanger AM QC said, amongst other things, that the responsible department, the Department of the Environment, Water, Heritage and the Arts (DEWHA) 'had next to no project management expertise' and 'many of the shortcomings in the HIP are failures of senior managers', summarised as:

> *a failure to provide candid advice to Ministers. This was most exemplified by a failure to warn candidly that the 1 July 2009 commencement date was unachievable if the HIP were to be accompanied by the usual protections and terms (including an adequate audit and compliance regime);*
>
> *similarly, a lack of candour in the briefings to Minister Garrett concerning the effect and significance of the decision to relax the requirements for training in June 2009;*
>
> *a lack of subject-matter expertise in relation to the environment in which the HIP operated, which resulted in advice being inaccurate, based on false assumptions or poorly targeted;*
>
> *a failure to provide leadership in the HIP, by which I mean to assume responsibility for the program as a whole and do what was necessary with the staff working under them to ensure that their time and efforts were efficiently directed.* [18]

While most people can be susceptible to an optimism bias, messages of this kind bring us back to earth. These issues go to the role of senior public servants and, of course, bear on how government manages risk.

My office tabled a report in June this year on the Multi-Role Helicopter Program (MRH90) – a program to acquire 47 helicopters and their support system for the Australian Defence Force at a cost of $4 billion. The program is running some 4 years behind schedule, with 27 helicopters delivered at a cost of some $2.4 billion. Essentially, the helicopters' capability requirements definition was inadequate, did not properly inform the source selection process, and led to gaps in contract requirements.

In canvassing some of the history of the project, the audit report referred to 2006 correspondence between the then Prime Minister and the then Defence Minister raising concerns that an earlier ANAO audit had identified a number of shortcomings with the management of the Tiger ARH project, and that it was unfortunate Cabinet was not made aware of these issues in the context of its deliberations on the MRH90 helicopter project, noting the same prime contractor was involved. After receiving advice from his department, the Defence Minister replied that the MRH90 is less complex than the ARH and is already entering service with both France and Germany; the ADF was not the lead customer and will not carry the attendant development risk; and Defence was confident that [the manufacturer] will deliver a timely and effective MRH90 capability for the ADF.

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[17] ANAO Audit Report No. 12 2010-11, *Home Insulation Program*, 15 October, 2010.

[18] Royal Commission into the Home Insulation Program, 2014. *Report of the Royal Commission into the Home Insulation Program*, Report by Mr Ian Hanger AM QC, 29 August. Paras 14.3.2.1 – 14.3.2.4.

Following this confident reply and subsequent developments that have contributed to the program being 4 years behind schedule at this stage, the audit report observed that:

> *If there was just one lesson to learn from the history of Defence acquisition projects, it would be the need to be respectful of the inherent risks in these complex transactions and not over-confident that they are under control. Effective project management requires a deep understanding of the project status and environmental factors that have the potential to influence outcomes. For the acquisition of the MRH90 aircraft, Defence was on the back foot from the start in its ability to confidently offer advice, in not having a sound understanding of the requirements or the estimated costs, and has been endeavouring to recover ever since, with mixed success.*[19]

A good proportion of our reports highlights areas of risk management that deserve close attention, particularly in the monitoring of initial risk assessments for any subsequent variations. Foremost amongst these areas include when programs are implemented under time pressure and when a program or acquisition involves high levels of integration or cross-agency coordination.

Staying with the experience of Defence acquisitions, our recent report on the Air Warfare Destroyer Program shows that even with the benefit of considerable effort and funds to de-risk major projects, the assessment of the severity of risks can still be difficult. In the case of the AWD, Defence sought to adopt prudent risk mitigation strategies in the design and build phases of the program, drawing heavily on industry input and experience to inform its advice to government. Nevertheless, the risks of developing a modified design, exporting the design for construction in distributed Australian shipyards and re-establishing Australia's shipbuilding capability were underestimated. This was the first time the Spanish designer, Navantia, has exported a surface ship design for construction by international shipyards, the first time the Australian Submarine Corporation has built a surface ship, and the other Australian shipyards lacked recent experience in complex warship building.[20]

One of the main reasons the project budget and schedule are at significant risk has been a continuing decline in construction productivity as it had been costing ASC, the lead shipbuilder, \$1.60 to produce work that was originally estimated to cost \$1.00;[21] and this was after government accepted in the original estimates that the premium associated with building the AWDs in Australia was \$1 billion based on Treasury estimates, then representing an effective rate of assistance of over 30 per cent for naval ship building.[22] Since the audit report was released, a subsequent government review is reported as also drawing attention to production issues in the Australian shipyards.[23]

Other recent audit reports that reinforce the importance of monitoring risks or risk based models include:

[19] ANAO 2014. Performance Audit Report No. 52 2013-14, *Multi-Role Helicopter Program*. Canberra. p.39
[20] ANAO Report No. 22 2013-14, *Air Warfare Destroyer Program*. Canberra. p.22, para 25
[21] Ibid, p.26
[22] Ibid, pp19, 20 para 18
[23] For example, see articles *Axe looms over \$8.5bn ship crisis* in The Australian newspaper, 30 July 2014, p.1 and *Destroyer could sink shipyard*, The Australian, 31 July 2014, p.1.

Managing Compliance of High Wealth Individuals by the ATO.[24]

As mentioned previously, the ATO uses two broad categories of compliance activities: voluntary compliance activities that encourage taxpayers and their representatives to understand and comply with their obligations; and active compliance activities that seek to verify information or enforce taxation law – these include risk reviews which may or may not involve taxpayer contact, and audits. While the audit concluded that the ATO had effectively carried out a range of activities and engaged with High Wealth Individuals (HWI) taxpayers well, conduct of audits and risk reviews of over 90 per cent of the HWI population (those with an estimated net wealth of $30 million or more) between 2009-10 and 2012-13, 70 per cent of these audits and 84 per cent of the reviews did not have a financial outcome. The audit concluded there is scope for the ATO to improve its risk assessments to better target active compliance activities and reduce compliance costs for both taxpayers and the ATO. Put another way, the audit highlighted the importance of the ATO analysing the outcomes of its compliance activities in order to assess the effectiveness of its risk management approach in identifying the highest risk HWIs, as well as to test the validity of the risks that led to the selection of compliance cases.

Screening of International Mail by the Department of Agriculture and the Australian Customs and Border Protection Service.[25]

This audit raised significant issues around the effectiveness of the targeting models being used to identify mail items that are more likely to carry higher risk non-compliant goods. The ANAO's analysis of Agriculture's leakage survey data indicated the department had substantially under-achieved against a target of 72 per cent of high risk quarantine material being seized by only seizing around 19 per cent between August 2012 and May 2013. In the case of Customs, it did not assess the effectiveness of its targeting strategy, instead relying on a significant increase in seizures in recent years as evidence of improved targeting processes. The ANAO's analysis of data from the agency's sampling program indicated only 13 per cent of prohibited imports were seized in 2012-13. Both Agriculture and Customs advised they were reviewing their survey and sampling methodologies following the audit.

The message here from these reports is for organisations not to undermine the investment that has been made in developing effective risk management models by taking their eye off the ball when it comes to monitoring risks and assessing whether the risk management model remains fit-for-purpose. If a statistical model is to provide a cost-effective solution, it can't be a case of 'set and forget' – the effectiveness of the model needs to be kept under review.

Going further, it is valuable to understand the reasons why some institutions (regulated by APRA) may be rated as vulnerable or weak on risk management:

- Lack of direction from board
- Risk appetite and tolerances [not] clear

[24] ANAO Report No. 35 2013-14, *Managing Compliance of High Wealth Individuals*. *Australian Taxation Office*. Canberra.
[25] ANAO Report No. 42 2013-14. *Screening of International Mail*. *Department of Agriculture, and the Australian Customs and Border Protection Service*. Canberra.

- Board over-reliance on management/actuaries
- Deficiencies in controls, monitoring and reporting
- Risk culture not embedded
- KPIs not aligned with RMF
- Compliance risk management culture
- One person in multiple roles (e.g. CFO, CRO)
- Responsibility for risk management not clear
- Underqualified risk management function. [26]

APRA's work to encourage risk management amongst regulated institutions is valuable. In summary, APRA has indicated that for an institution's risk management framework to be effective, there must be a strong risk culture that is consistent with the company's espoused values and its risk appetite:

- the risk appetite must be clear and unambiguous; it must be widely used in the management and governance of the institution;
- the institution's espoused values must be clear and consistent with the risk appetite and business strategy (and vice versa);
- the values must be embraced at all levels of the institution, and all significant decisions and actions must be consistent with those values;
- the decision-making process must be clear and consistent across the institution and it should embrace constructive and credible challenge. It also must be completely consistent with the risk appetite and business strategy.[27]

In terms of an ideal position for an organisation that is seeking to link risk and the achievement of organisational and policy goals, James Deloach[28] observed that:

> *The firms that avoided significant fallout from the global financial crisis demonstrated a comprehensive approach to viewing firm-wide exposures to risk; shared quantitative and qualitative information more efficiently across the firm; and engaged in more effective dialogue across the management team. They had more adaptive (rather than static) risk measurement processes and systems that could rapidly alter underlying assumptions to*

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[26] See Laughlin, Ian, Member of the Australian Prudential Regulation Authority. *Stay Ahead of the Risk: Risk governance and risk culture*. Presentation to the Institute of Actuaries of Australia, Sydney, 20 may.
[27] Ibid.
[28] See Deloach, James W, Partner, Arthur Anderson, 2000. Executive Briefing: *An Executive Summary of Enterprise-wide Risk Management. Strategies for linking risk and opportunity.*

reflect changing circumstances. Management also relied on a wide range of risk measures to gather more information and different perspectives on the same risk exposures with more use of scenario analysis. In other words, they exhibited strong governance systems with the information being passed upwards to the board.

Getting the balance right

We all understand that there is a balance to be struck in managing risks; organisations accept that they have choices in the development of their risk strategies – essentially to avoid, retain, reduce, transfer and/or exploit risks; and, in the public sector, we need to be conscious that managing public moneys carries responsibilities that do not necessarily attach to private funds. So there is an expectation that public sector organisations will have reasonable standards of governance, management (including risk management) and accountability in place. At the same time, there are reasonable expectations that public sector entities will pursue more cost-effective policy outcomes and productivity improvements to drive public resources further.

In the public sector, entities are commonly viewed as being risk averse. I would add that in my experience ministers are generally more risk averse, often with good reason, which explains the attitudes of entities.

On the subject of risk aversion, I was interested to read recently David Jensen, Ernst & Young's digital strategy leader saying:

Bankers are some of the most risk-averse people. They do need to be looking at collaboration. They need to be looking at how to build an internal culture around innovation and their digital activities.[29]

This was against the background that banks are spending billions of dollars on new IT systems to capitalise on the demand from customers for more online and mobile banking products, but are being challenged by start-ups offering new ways to solve problems such as payments and peer to peer lending. The key message here is that partnering arrangements may give organisations a jump-start to stimulate innovative solutions to core responsibilities.

When my office published a Better Practice Guide on *Innovation in the Public Sector: Enabling better performance, driving new directions* some years ago, we made the point that innovation inevitably involves a degree of risk because it changes the *status quo* or contributes towards an alternative future. As such, an appetite for risk and risk management is essential; and risk avoidance is an impediment to innovation.

The implementation of risk management procedures is a necessary part of decision-making processes adopted by agencies to enable them to maximise opportunities for new and innovative solutions. However, the key accountability features and related risk management processes adopted during an innovation cycle should be fit-for-purpose. That is, the degree of oversight and specific mitigation activities should be commensurate with the value, complexity and sensitivity associated with a particular initiative.

[29] Article in The Australian newspaper – Business section. *Start-ups key as change batters the big four*. August 4, 2014.

Innovation in the public sector can be categorised in various ways. A risk-based classification embodies a spectrum of risk tolerances and includes:

- refining existing processes (regular innovation);
- using existing ideas, processes or products in new areas (niche-creation innovation); and
- radical change of both the product/service and the market (transformative innovation).

If an initiative is judged to be of low risk, an agency's internal instructions could specify a relatively straightforward process that complies with minimal requirements. As innovation risks increase, internal instructions could provide additional guidance such as the need to:

- engage with the community;
- use models, pilots and prototypes;
- engage ministers in the decision-making processes surrounding risks, innovations and experimentations;
- test ideas on a small sample of the population; and
- where possible, link the use of innovative approaches to choice rather than compulsion in the first instance.

The growing interest internationally in the case for a shift towards government adopting more preventative measures to avoid or limit downstream demand for services is well worth following as governments grapple with the best way to manage their responsibilities, and balance the seemingly insatiable demands on their budgets. Professor Malcolm J Prowle of the Nottingham Business School, who has written on this topic, has used the following examples:

- **Health –** advisory and support services to those trying to reduce weight or smoking
- **Children and families** – the provision of parenting programmes designed to improve parenting skills and outcomes for children
- **Elderly** – actions to improve safety in the homes of elderly people thus reducing the likelihood of accidents
- **Criminal justice –** targeted support to young offenders deemed to be at risk of further offending.[30]

These examples really draw attention to the fact that outcomes can be achieved through various strategies; and if we can effectively manage the downside risks there is likely to be better outcomes for the community, and benefits for government budgets from such preventative approaches.

[30] Prowle, Professor Malcolm J. *The preventative services agenda: Focussing on the delivery of value for money*.

At a specific policy development and/or program delivery level, our work shows that risks to outcomes increase significantly when policies are developed on the run, high levels of integration are involved, multiple agencies are involved, or programs are required to be implemented under time pressure. When faced with challenges of this kind, organisations firstly need to recognise the elevated risks, and then manage them. And, when things are not going to plan, managers are expected to step up, roll up their sleeves and manage the circumstances, and keep key stakeholders engaged on the recovery plan.

We also need to reflect on the way to communicate successes of the organisation's approach to risk management, as a response to the information asymmetry generally applying. As I have indicated elsewhere:

> *…risk management…is one of those disciplines [that] if done well, will generally not be visible for all to see. Sadly, only risk management failures attract attention, and headlines. Thus an organisation's leadership needs to compensate for this asymmetry by reinforcing the positive outcomes of risk management action.*[31]

We also have to develop the ability to learn from failures. It may not come easily, and may take time, but we cannot deny the logic of learning from experience which may include failures.

In this context, I was interested to read an article by Cassandra Wilkinson recently that makes the point that society needs to accept that bright new ideas don't always succeed immediately; that failure is part of trying and success is rare without it. The article also made the point that:

> *Changing our attitude to failure is not about letting people off the hook for poor effort or malpractice. It's simply an acknowledgment that sometimes best efforts and good ideas run up against changing circumstances, superior competitors of the unforeseen limits of the founder's ingenuity*.[32]

Staying with the theme of the need, at times, of accepting higher levels of risk, Glenn Stevens, the Governor of the Reserve Bank of Australia, in his usual measured way, has recently been underlining the importance of entrepreneurs in restoring the dynamic of growth in the economy.[33] The Governor said that in general the policies adopted to avert the potential catastrophe five years ago from the global financial crisis were very effective. But he went on to say 'fostering a strong recovery has been much more difficult'. In essence, he indicated this reflected the nature of the shock policy makers have been dealing with, and the limits to what monetary policy alone can achieve. Of particular interest to this audience was that he was essentially questioning whether we have flattened risk-taking in some parts of the economy too much; and indicated that if some increased risk in the financial sector is part of the process of getting more genuine entrepreneurs in the economy to take the sorts of risks that are part and parcel of restoring the dynamic of growth, that is probably a trade-off worth making.

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[31] McPhee, Ian, Auditor-General for Australia, *Effective Risk Management*, paper presented to the Department of Parliamentary Services, Canberra, February 2011, p.3.

[32] Wilkinson, Cassandra 2014. *Innovators have the right to fail*. Article contained in The Australian newspaper. 12 July

[33] Stevens, Glenn 2014. *Challenges for Economic Policy*. Address to The Anika Foundation Luncheon, Sydney, 22 July.

Concluding comments

The ultimate goal for all organisations is to build risk management into the organisational fabric and culture so that we have better performing and more resilient organisations. Necessarily this requires sound governance to deliver to the required standard, and to the performance, expected. Being alert to these considerations, and being aware of the organisation's natural strengths and weaknesses, allows organisations to compensate for soft spots as part of their governance and risk management strategies.

All organisations want to manage the risks to achieving objectives and convert opportunities to advantage. As government policy development increasingly has regard to building resilience in communities to manage the demand for services in more stringent fiscal times, different approaches to public administration and service delivery will be required because such approaches necessarily involve different strategies and greater community engagement, thereby changing risk profiles.

Organisations will need to continue to improve their intelligence gathering and manage the uncertainties. Most public sector organisations appreciate the benefits of applying risk management approaches but have more work to do to embed risk management particularly risk monitoring into the culture of the organisation, and to assess the effectiveness of their approaches to risk management over time. Various audit reports have shown that 'set and forget' approaches are not good enough today.

Management at all levels has a role here in leading by example, improving the way in which risk management approaches and risk tolerances are communicated and monitored, and emphasising continuous improvement and sharing of best practices. For some organisations, there will be a need to grow their capability and to better capture the learnings from their experience and that of others to get the balance right. The clear message, though, is that we need to engage our people to bring alive the various frameworks, strategies and approaches that we have in place.

At any time, risk management is a good investment. However, in an era when public sector resources are tight, confidence in government has been on the wane, and policy stances and delivery models continue to evolve, effective risk management is essential. It deserves ongoing support from those with governance responsibilities in the public sector so that it becomes part of the culture and organisations are able to deliver on their core responsibilities, efficiently and effectively. Because new risks can be expected to emerge or there can be significant changes in known risks, the message for managers here is do not walk too early to the winner's circle.