Australian Institute of Company Directors
and
The Institute of Internal Auditors - Australia

Public Sector Governance Forum

Public Sector Governance – showing the way

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for his assistance in the preparation of this address

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Auditor-General for Australia
Public Sector Governance — showing the way

I thank both Institutes for their invitation to deliver the key note address at your 2008 Public Sector Governance Forum — a subject which the Australian National Audit Office (ANAO) places particular emphasis on when planning and undertaking its audit coverage.

It is difficult to imagine a discussion on business performance or corporate sustainability without a reference to the importance of corporate governance. Yet, corporate governance is not static and, like all disciplines, needs to be refined in the light of developments in the environment, and developments directly affecting organisations.

The last time I spoke at your Forum was in September 2005 when I covered risk and risk management which forms a key plank in any sound governance framework.

My presentation today is intended to provide a broad perspective on public sector governance to act as a ‘spring board’ for the more specific aspects of governance that will be addressed in later sessions. I mainly refer to governance in the context of agencies (where the CEO generally reports to a Minister), rather than statutory authorities (where the CEO generally reports to a board) given the more limited information available relating to agency governance.

I Introduction

With the work of the ANAO, we endeavour to match the theory and the practice in forming views on matters concerning public sector governance, and in formulating recommendations. We should all learn from past events, but with a primary goal of strengthening organisational performance and protecting the organisation from untoward shocks in the future.

My presentation today is about the importance of having a clearly understood governance framework which is strategic in its outlook, focussed on the performance and conformance responsibilities of agencies, and self-evaluating in its approach. This latter aspect is critical as the challenge for most agencies is often not so much with the framework, but with its implementation. I will draw on developments in the public sector and some of the more recent work of the ANAO to highlight aspects of public sector governance that present both challenges and opportunities for agencies.

Now, it is important to keep things in perspective, and understand the significance of the role that governance can have on performance. In this context it is interesting to observe some of the literature on governance.

At one end of the spectrum, there are the sceptics who are not quite over the line on the link between governance and performance.
“For the time being, we cannot establish a cause-and-effect relationship between corporate governance and corporate performance. As long as we do not show that a relationship exists between the two, the principles of corporate governance, in the base of cases, will be the object of polite attention, or, perhaps more often, the object of generalised scepticism.”

Towards the other end of the spectrum, we have the view that

“…..good corporate governance is a necessary, but not sufficient, foundation for success. In other words, bad governance can ruin a company, but [good governance] cannot, on its own, ensure its success.”

The ANAO’s experience would support this latter position. We observe that the quality of governance and the emphasis given to it does permeate through public sector agencies, influence the organisational culture and provide a positive focus to performance management. At the same time, the view is measured because other factors such as environmental considerations and choice of strategy influence organisational performance. Through sound corporate governance, agencies effectively enhance their likelihood of success, and reduce the likelihood of failure.

II The public sector environment

The Australian Government public sector operates in an increasing challenging and complex environment. Although we commonly refer to the ‘public sector’ it is not as uniform as many members of the public might think. The Australian Government public sector includes a very wide range of bodies, some having very diverse responsibilities brought together in a way that, no doubt, was considered a good idea at the time. Commonly, governance arrangements have to accommodate the oversight of a range of functions, including policy development, regulation and the provision of services to citizens. Further, public service delivery is now characterised by increasingly complex inter-relationships between government agencies, different levels of government, and the private sector.

The traditional distinction between the public and private sectors is increasingly being blurred, with the concept of ‘integrated government’ being applied to government service delivery and the achievement of ‘public’ outcomes. Privatisation, corporatisation and outsourcing have greatly added to the changes witnessed in the past 25 years or so. The more recent overlay of ‘whole of government’ approaches introduces additional relationships and increases the complexity.

Then there is the management of deadlines for the delivery of advice, reviews and solutions. Departments in particular are under pressure, and will come under increasing pressure on this front in the months ahead as the Government
seeks to convert policy positions into legislation and programs, and the community expects to see programs implemented.4

At the same time, the traditional views of accountability are being challenged. Professor Richard Mulgan, who has written extensively on public sector accountability, takes a broad view of the accountability of agencies and officials: the key channel being ‘the chain of ministerial responsibility, upwards through the departmental hierarchy to the Secretary and the Minister, and via the Minister, to Parliament and the public.’ But with this channel being ‘supplemented by a number of other accountability mechanisms, including the accountability of public servants directly to parliamentary committees, to independent accountability agencies, such as the Auditor-General, the Ombudsman, tribunals and the courts, as well as Freedom of Information legislation. In addition, Ministers, and to a lesser extent officials, are accountable to the public through members of relevant policy communities and the media.’5

In addition, the global environment we operate in is moving quickly, putting organisations under pressure to generate the right options. An editorial in the Australian Financial Review “A game too fast for government” (which focussed on government ‘protection’ for the car and textiles/clothing industries), expressed the view that:

‘The global economy of the 21st century is an unforgiving arena, where product lifecycles are shorter than ever, where what was new yesterday is old today – and where what was old yesterday can come up sparkling today. Few better snapshots of this unsettling phenomenon could be provided than the tidings in today’s Australian Financial Review. BHP Billiton was dismissed as “old economy” in the 1990s as commodity prices plumbed historic lows, multibillion-dollar investments came unstuck and management and board seemed adrift. Yesterday, the company announced a $US15.4 billion ($17.8 billion) net profit – the largest in Australian history….’6

It contrasted the position of BHP Billiton with Babcock & Brown:

‘Earlier, shares in Babcock & Brown, a financial engineering darling of the boom, reached new lows as the group owned up to the impact of the credit crunch on its risky business model, with a $452 million write-down in its listed power fund.’7

Delivering on expectations against the background of all of these factors can only be managed by sound governance arrangements for government agencies, programs and services. There is no other way. This places a premium on the investment in suitable organisational governance arrangements and measures to provide assurance that such arrangements are in good shape.
III Public Sector Governance — what is it?

Sound public sector governance ensures accountability to an organisation’s many stakeholders, including citizens, and to encourage performance improvement while satisfying control and compliance requirements.

The ANAO defines public sector governance as encompassing:

‘how an organisation is managed, its corporate and other structures, its culture, its policies and strategies and the way it deals with its various stakeholders. The concept encompasses the manner in which public sector organisations acquit their responsibilities of stewardship by being open, accountable and prudent in decision-making, in providing policy advice, and in managing and delivering programs’. 8

A shorthand definition of corporate governance is ‘the system by which companies are directed and controlled’.9

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. In other words, it is not a one size fits all situation — effective governance arrangements are those designed to match individual agency circumstances.

The ANAO has developed a model to show the elements of good governance and how they relate to each other as shown in Figure 1 below.

**Figure 1: 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. Consequently, the aim is not only to have the necessary elements in place, but to create positively reinforcing links between them.

These elements are dynamic factors in a governance framework which has to be well understood by all concerned. It is not someone else's responsibility. There needs to be shared ownership and commitment if the necessary integration of activities and approaches is to occur.

The overall governance outcome that we seek is stakeholder confidence in the integrity and performance of an organisation. There is a clear progression from the foundation of leadership, ethical conduct and a culture that is committed to achieving good public sector governance, through good stakeholder management and development of a risk management culture, to the performance and conformance dimensions. Further, information and decision support, and review and evaluation of governance arrangements, impact heavily on the ability of the public sector organisation to achieve desired governance outcomes.

The importance of sound information and decision support cannot be overstated.

‘Even if all the corporate governance boxes are ticked, best practice is observed and the right mix of personalities and expertise are present, the fundamental requirement of every board is access to good information.’"  

Building on the importance of information, Robert Brittlestone, managing director of management consultancy Metapraxis, proposed the following theory about non-executive directors – which could also be applied to others charged with governance:

‘Director’s effectiveness = time available x personal competence x information quality.’

The challenge in the public sector today is for chief executives and senior executives to ensure they make ‘time available’ to implement effective governance measures in the light of the many other demands on their time. In these circumstances, it is particularly important that the governance arrangements are appropriately supported, including by senior executives.

There is a need for a disciplined approach to objective setting, planning, execution, measurement and reporting, and any further management responses required. The governance regime should give emphasis to both conformance and performance; conformance in this case covering both the requirements of legislation and government policy. There are no real short-cuts, and agencies need to support these arrangements through their corporate structures, calendar and processes.
Today, for agencies that are subject to the Financial Management and Accountability Act 1997, there are generally advisory boards in place that assist the Chief Executive discharge his/her responsibilities. Given the spread of responsibilities for many agencies, these advisory boards are a key element of agency governance arrangements. Perhaps, in the longer term, we may see these advisory boards supplemented with independent members i.e. the equivalent of non-executive directors in the corporate world. The use of independent members on agency Audit Committees, and other executive committees, has been a very positive development.

The Chartered Institute of Management Accountants and the International Federation of Accountants issued a major study in 2004 on Enterprise Governance which underlined the importance of keeping performance and conformance dimensions of governance in balance. In order to test the framework, and to test what goes right or wrong, the study examined a series of case studies focussed on governance in a wide range of companies in different countries.

There were four key factors that underpinned success or failure in the companies studied:

- culture and tone at the top
- the chief executive
- the board of directors
- internal controls.

The influence of these factors on corporate failures was a key aspect of the study.

<table>
<thead>
<tr>
<th>Table 1 – What went wrong? – corporate governance issues</th>
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<tbody>
<tr>
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<tr>
<td>Ahold (Netherlands)</td>
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<td>D Tricipovich (Italy)</td>
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<td>France Telecom (France)</td>
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* = issue had relatively minor significance in the case study
** = issue was of moderate significance
*** = issue was of major significance


Further, the study highlighted there were four key strategic issues underlying success and failure:

- choice and clarity of strategy;
• strategy execution;
• ability to respond to abrupt changes and/or fast-moving market conditions;
• ability to undertake successful mergers and acquisitions (M&A). Unsuccessful M&A was the most significant issue in strategy-related failure.  

These factors are equally important in the public sector.

It is also interesting to see where the corporate sector in Australia sees the key risk concerns. Aon Australia has been undertaking an annual risk survey for 6 years and has summarised the Top 10 risks as follows:

Table 1 2003-2008 TOP 10 RISK CONCERNS

<table>
<thead>
<tr>
<th>Rank</th>
<th>2003/04</th>
<th>2004/05</th>
<th>2005/06</th>
<th>2006/07</th>
<th>2007/08</th>
<th>Change from 2006-07 to 2007-08</th>
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<tbody>
<tr>
<td>1</td>
<td>brand + image</td>
<td>brand + image</td>
<td>corporate governance</td>
<td>corporate governance</td>
<td>brand + image</td>
<td>↑ 3</td>
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<tr>
<td>2</td>
<td>physical assets</td>
<td>corporate governance</td>
<td>systems</td>
<td>systems</td>
<td>systems</td>
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</tr>
<tr>
<td>3</td>
<td>systems</td>
<td>regulatory</td>
<td>brand + image</td>
<td>human resources</td>
<td>corporate governance</td>
<td>↓ 2</td>
</tr>
<tr>
<td>4</td>
<td>human resources</td>
<td>legal</td>
<td>human resources</td>
<td>brand + image</td>
<td>human resources</td>
<td>↓ 1</td>
</tr>
<tr>
<td>5</td>
<td>legal</td>
<td>systems</td>
<td>legal</td>
<td>legal</td>
<td>information management</td>
<td>↑ 1</td>
</tr>
<tr>
<td>6</td>
<td>corporate governance</td>
<td>human resources</td>
<td>liquidity</td>
<td>information management</td>
<td>business interruption</td>
<td>↑ 2</td>
</tr>
<tr>
<td>7</td>
<td>market structure</td>
<td>liquidity</td>
<td>information management</td>
<td>lack of innovation</td>
<td>legal</td>
<td>↓ 2</td>
</tr>
<tr>
<td>8</td>
<td>external dependency</td>
<td>physical assets</td>
<td>business interruption</td>
<td>business interruption</td>
<td>market environment</td>
<td>↑ 2</td>
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<tr>
<td>9</td>
<td>liability</td>
<td>capital structure</td>
<td>capital structure</td>
<td>impact of regulation</td>
<td>lack of innovation</td>
<td>↓ 2</td>
</tr>
<tr>
<td>10</td>
<td>liquidity</td>
<td>information management</td>
<td>lack of innovation</td>
<td>market environment</td>
<td>impact of regulation</td>
<td>↓ 1</td>
</tr>
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</table>

Source: Aon Australia

It is noteworthy that corporate governance has dropped from No 1 concern in 2005/06 and 2006/07 to be No 3 concern in 2007/08. ‘Systems’ and ‘human resources’ have stayed near the top, and ‘legal’ risks have reduced over the years.

On this latter point, with the move towards more principles based legislation being administered by agencies in Australia in the last 15 years, there has been a general reduction in the very detailed requirements with an intention to focus on those matters essential to the achievement of the objectives of the legislation. While there is scope to do more to streamline legislation, particularly subsidiary legislation, agencies should clearly operate on the basis that both legislation of policy parameters provide a ‘bright line’ within which programs should be administered. By establishing a suitable control regime on this front, agencies are able to focus on the performance and other dimensions of their responsibilities with confidence.

I might add that, at any stage, should there be uncertainty as to the intent of legislation or government policy, it is incumbent on agencies to take steps to resolve the uncertainty. This is particularly important with the increasing use of ‘whole-of-government’ approaches to the resolution of many of today’s difficult
policy challenges. Similarly, if agencies are aware of unnecessary ‘red tape’, then this should be brought to the attention of the administering agency.

The formal governance structures of any organisation need to be supported by leadership, ethics and a culture that delivers on the organisational goals. These less tangible qualities are central to success, and need to be reinforced positively by all public sector organisations. We should not forget the words of Commissioner Cole in his report on the Australian Wheat Board14 - “The conduct of AWB and its officers was due to a failure in corporate culture”.

Further, Professor Ian Ramsay points out that the disconnect between what the AWB claimed its corporate governance policies were and what was unearthed by the Cole inquiry highlighted the need for all investors to look critically for evidence of “substantive” governance structures.15

When one looks at the AWB policy on ‘Corporate ethics and conduct’ in their annual report, it says, ‘The boards of AWB Limited and AWB are committed to clearly promoting and demonstrating that their business affairs and operations are at all times being conducted legally, ethically and in accordance with the highest standards of integrity and propriety’. It’s a common statement in annual reports but it just shows the importance of digging deeper to determine the quality of substantive governance rather than purely assessing companies on what’s in the annual report.16

In other words, we all need to be clear about our goals and targets, and how we expect them to be delivered on and, importantly, follow through so that our conduct reflects our corporate standards. The public service values are a sound platform for us all to build upon; chief executives and senior executives have a key leadership role here in showing the way, in setting the example.

More broadly, through organisational leadership and investing in staff development, we are able to positively influence the culture of the organisations we work in so that there is a close match between the image we convey in our corporate documents and the reality of the way we work on a daily basis. And we need to monitor the effectiveness of our arrangements over time. In this context, I expect we will see Audit Committees taking a stronger interest in the well-being of agencies’ governance arrangements; that is, they are working as expected, and improvements are being made in the light of agency, APS or private sector experience.

IV Governance issues in a challenging, more complex APS environment

The ANAO’s work highlights there are at least 6 elements that make a difference in agencies being successful in implementing government policy and delivering public services:
1. **Ensuring the governance formalities are in place:**
   - an executive board to support the CEO.
   - key subcommittees and an Audit Committee that are rigorous in discharging their responsibilities.
   - ‘balanced scorecard’ reporting and summary reporting on major projects.

2. **Providing leadership:**
   - support from the top.
   - get to the substance of issues not just the form.

3. **Understanding your organisation** (or virtual organisation) its goals and its environment:
   - legislation and policy framework.
   - stakeholders, products and services, people, business systems.
   - self awareness.

4. **Investing in a sound planning approach** to drive the agency forward and obtain ownership of the goals and strategies:
   - a Corporate Plan (3 years).
   - a Business Plan (1 year).
   - operational and project plans as required.

5. **Investing in risk management** at the enterprise, divisional and project level — the goal is to develop a culture that manages risks as part of day-to-day management.

6. **Measuring, monitoring and evaluating performance:**
   - measure KPIs
   - self-evaluating; self-regulating.
   - it is everyone’s responsibility.

These elements broadly align with the key factors identified by IFAC/CIMA as underpinning success or failure in company performance.

Our audit reports are a useful resource for managers in the APS for the lessons they impart. Indeed, 32 out of 44 performance audit reports tabled in 2007-08 had findings or recommendations with a corporate governance flavour.

In broad terms, deficiencies in governance affects organisational or program performance, conformance with requirements, and/or organisational standing:

- Delayed projects mean services or capability is not being delivered as expected, and this can have knock-on effects for citizens, industry, or other parts of the responsible organisation.\(^{17}\)
- Lack of adherence to statutory or policy requirements in the delivery of core business programs may affect program deliverables, introduce inequities or undermine confidence in the program.\(^{18}\)
• Sub-standard reporting to stakeholders on performance may mask suboptimal outcomes, and impair the quality of debate and decision making. ¹⁹

• Failure to address systemic issues in an agency can affect the standing of agencies, and lead to externally imposed reviews or solutions.

By delving further into some of our audit reports, there are quite a few more concentrated messages for public sector managers:

• good process delivers good outcomes;
• investment up front is more cost-effective than ‘recovery action’;
• sound risk management (at the enterprise, divisional and project levels) is no longer discretionary;
• project methodologies are designed to facilitate risk management;
• regular reporting and monitoring allows for performance expectations to be confirmed or adjustments to be made where required;
• in contracting out, ensure the incentives for the private sector are appropriately aligned to the programme or project objectives; and
• be alert to cost-shifting in other jurisdictions where federal programmes complement state or local government programs.

The APS has had some high profile failures in public administration across the years. The underlying causes never seem to be that exotic; rather organisations have become conditioned to poor practices, and the governance arrangements in place have not been alert to the extent of the problem. As I observe the APS today, the challenges are not so much around the governance framework but its implementation.

Commissioner Owen (HIH Royal Commissioner) distinguished between the adoption of a model of corporate governance and its practice in the following terms:

There is a danger it [corporate governance] will be recited as a mantra, without regard to its real import. If that happens, the tendency will be for those who pay regard to it to develop a ‘tick in the box’ mentality….the expression ‘corporate governance’ embraces not only the models or systems themselves but also the practices by which that exercise and control is in fact effected. ²⁰

Further, the Business Round Table’s publication — Principles of Good Governance observed that:

Good governance is far more than a "check-the-box" list of minimum board and management policies and duties. Even the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice. ²¹
I was interested to read an article in The Australian a short time ago about the ANZ Bank’s response to the Opes Prime situation. The article made the point that:

‘ANZ is looking to achieve a “holistic” settlement of all issues surrounding its involvement in collapsed broker Opes Prime, as the bank examines its exposure to a number of other fringe businesses built up during the boom years…….They were born out of a similar desire to boost the revenue bottom line.’

A bank source was quoted as making the noteworthy observation that “it’s a question of making sure we understand what we’re doing, the risk involved and whether we should be in the business in the first place”. The article further suggested that staff didn’t understand the reputational risk, the fundamental nature of the business; and when this was realised, management actions were too slow to address the problem and the follow-up on decisions was poor.

This is a sobering assessment which we can all benefit from. These are not unique issues – perhaps the combination is unique – but we need to be willing to evaluate our own approach and learn from all relevant experience to strengthen our governance arrangements.

Our audit reports have identified a range of other influences which can make a positive difference to performance. These include:

- the interest of the CEO in good governance and good practices;
- being clear on expectations (and accountabilities);
- having the right skills (number and level);
- putting the blowtorch on critical assessments;
- encouraging a culture of self-evaluation/self regulation;
- having effective engagement with stakeholders;
- encouraging Internal Audit to review key systems and projects;
- having an effective Audit Committee; and
- having a process to review and refer relevant ANAO findings and recommendations to programme managers.

Because, for most of us, it is impossible to remember all of the individual messages – in reality the list is infinite in the modern world - managers must be guided by a governance framework that suits their organisation and is readily understood. However, the framework should, in some way, at least cover off the 6 key elements referred to earlier.

Far from being a brake on progress, good governance is an enabler for the best outcomes, consistent with legislation and government policies, for the Australian community.

Finally, a caution that we be careful not to see corporate governance as an end in itself. CIMA has observed that:
An organisation can be viewed as consisting of corporate governance processes on the one hand (a so-called framework of accountability) and value-creating activities such as strategic decision-making on the other. Both elements are necessary, since focusing on performance without having adequate checks and balances is like building on sand. But recently we may have overlooked the need for firms to ensure that corporate governance does not become an end in itself – ie, a set of rules that actually constrains the value-creating activities of the business.'

V Concluding comments

The theme running through my presentation today is that ‘Good governance is far more than a “check-the-box” list of minimum board and management policies and duties. Even the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice’. Sound governance must be integral to managing an organisation’s operations.

While the most recent improvements in public administration have come from a closer focus on results rather than process, the ‘way things are done’ remains critical. The public service has a particular responsibility for the public interest in upholding the law and ensuring due process, impartiality, fairness and openness. This should be reinforced through both actions and training.

Good public administration doesn’t come about by chance. It requires vision, coordination and effective delivery on the part of all agencies. This requires:

- The Australian Public Service to have appropriate administrative arrangements in place to provide the right incentives to agencies to be highly performing within the framework of legislation and government policy;
- effective agency leadership and governance; and
- program managers developing and pursuing clear strategies to achieve outcomes but, just as importantly, having measurement systems to be able to gauge success, and report performance.

Public sector agencies commonly have both significant responsibilities for program delivery and policy advice. While these responsibilities are obviously interconnected, the span of control can be very broad, underlining the importance of sound governance arrangements which focus on both performance and conformance responsibilities.

While in a legal sense the chief executive of FMA agencies is responsible for the efficient and effective operation of the agency, in practice governance arrangements have evolved to support the chief executive’s role, particularly the
use of advisory boards. Senior executives have a very important role in supporting CEOs and ensuring sound governance arrangements are followed in their areas of responsibility, recognising that the challenge in the APS is generally not the governance framework but its implementation. Because attention to those matters isn’t always seen as the most glamorous part of public administration, providing the leadership and setting the right tone is critical to success.

As the challenges in public administration increase in terms of providing advice on complex policy issues, the better targeting of existing programs, delivering services better, and keeping stakeholders and staff informed of developments, the importance of effective governance increases. In this context, I expect we will continue to see more support being given to governance processes within agencies (particularly to improve information quality and decision support), and Audit Committees taking a stronger interest in the implementation of governance arrangements.

All CEOs and senior executives have a responsibility to show the way here, and reinforce the critical importance of sound governance to the delivery of government programs. In this way we can encourage a culture that supports the formal governance arrangements that have been adopted by public sector agencies.

Thank you
Notes and references

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3  Kirby, The Hon Justice Michael AC CMG, *Public Funds Beget Public Accountability*, University of Canberra, Corporate Governance ARC Research Project Corporate Governance in the Public Sector Dinner, High Court of Australia, Canberra, 9 March 2007, p. 7
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16  Ibid
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20  Lipton, Phillip, Professor, *The demise of HIH: corporate governance lessons*, Keeping Good Companies, June 2003, p. 277
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