

The Auditor-General
Audit Report No.41 2001–02
Performance Audit

Transactional Banking Practices in Selected Agencies

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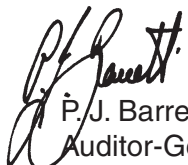
Canberra ACT
15 April 2002

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit across agencies in accordance with the authority contained in the *Auditor-General Act 1997*. I present this report of this audit, and the accompanying brochure, to the Parliament. The report is titled *Transactional Banking Practices in Selected Agencies*.

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely


P.J. Barrett
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Contents

Abbreviations	6
Summary and Recommendations	9
Summary	11
Background	11
Overall audit conclusions	14
Key findings	17
Improvement opportunities	25
Agency responses	26
Recommendations	27
Audit Findings and Conclusions	29
1. Introduction	31
Background	31
Statutory framework	34
Audit approach	37
2. Implementation of Transactional Banking	39
Background	39
Implementation processes	41
Budget outcomes	45
Audited agencies	55
Internal control procedures	57
Risk Management	60
3. Core Requirements Implementation	63
Core requirement management	63
Clearance and settlement of direct credit payments	67
4. Market testing	76
Background	76
Tender processes	77
Tender evaluation	79
Contractual outcomes	90
Index	97
Series Titles	99
Better Practice Guides	102

Abbreviations/Glossary

Abbreviations

ABA	Australian Bankers' Association
ACA	Assurance and Control Assessment
AIMS	Accrual Information Management System
ANAO	Australian National Audit Office
APCA	Australian Payments Clearing Association
ATO	Australian Taxation Office
AOFM	Australian Office of Financial Management
BECS	Bulk Electronic Clearing System
CAPS	Central Accounting and Payment Service
CAMM	Cash and Appropriation Management Module (of the Accrual Information Management System—AIMS)
CEIs	Chief Executive's Instructions
CEMTEX	Centralised Magnetic Tape Exchange
CPG	Commonwealth Procurement Guidelines
CPS	Commonwealth Payroll Service
Customs	Australian Customs Service
DEST	Department of Education, Science and Training
DHA	Department of Health and Ageing
DIMIA	Department of Immigration and Multicultural and Indigenous Affairs
DOF	Department of Finance
DTRS	Department of Transport and Regional Services
DVA	Department of Veterans' Affairs
EFTPOS	Electronic Funds Transfer Point of Sale
ERC	Expenditure Review Committee
FaCS	Department of Family and Community Services
Finance	Department of Finance and Administration
FMA	Financial Management and Accountability

FMA Act	Financial Management and Accountability Act 1997
GDES	Government Direct Entry Service
NOIE	National Office for the Information Economy
OPA	Official Public Account
RBA	Reserve Bank of Australia
REOI	Request for Expression of Interest
RFT	Request for Tender
RFP	Request for Proposal
TEP	Tender Evaluation Panel

Summary and Recommendations

Summary

Background

1. New arrangements for transactional banking endorsed by Ministers came into effect on 1 July 1999 for agencies subject to the Financial Management and Accountability Act 1997 (FMA Act). These arrangements transferred responsibility for payments and receipting from the Department of Finance and Administration (Finance) to individual FMA Act agencies. Consistent with devolved management under the FMA Act, a cash management incentive scheme was also introduced, providing agencies with an opportunity to earn interest on surplus departmental funds. The arrangements are intended to encourage agencies to manage working capital, including cash, in a more business like manner. Safeguards over the Commonwealth's aggregate cash balances necessary for effective central cash/debt management and the Reserve Bank of Australia's (RBA) central role in managing liquidity and foreign exchange have been preserved. The new arrangements were introduced as an integral part of output and outcomes based management and accrual budgeting, recognising that devolution of management is an important element in the new banking framework.
2. Transactional banking refers to the deposit and payment services provided by banks and other deposit taking institutions. By way of background, estimates of net flows through Commonwealth Government bank accounts amount to \$339 billion in 2000–2001, comprising \$170 billion in revenue and \$169 billion in payments (see Figure 1). The Commonwealth annually makes some 240 million payments. The average daily balance in the Official Public Account (OPA) in 2000–2001 was approximately \$1.48 billion.
3. In comparison to the large payment and receipt flows through Commonwealth accounts, the banking fees for the Commonwealth are relatively modest, totalling around \$10 million per annum. Centrelink bears the largest portion of these fees, due to the large volume of pension and allowance payments it makes annually. For the majority of agencies, annual banking fees are commonly under \$20 000.
4. Under the centralised banking arrangements that operated prior to July 1999, the RBA provided transactional banking services on a whole-of-government basis to Commonwealth agencies. These banking services were subject to an umbrella contractual Master Agreement between the Commonwealth, represented by Finance, and the RBA. Fees for banking services were charged by the RBA on a whole-of-government basis and paid for by

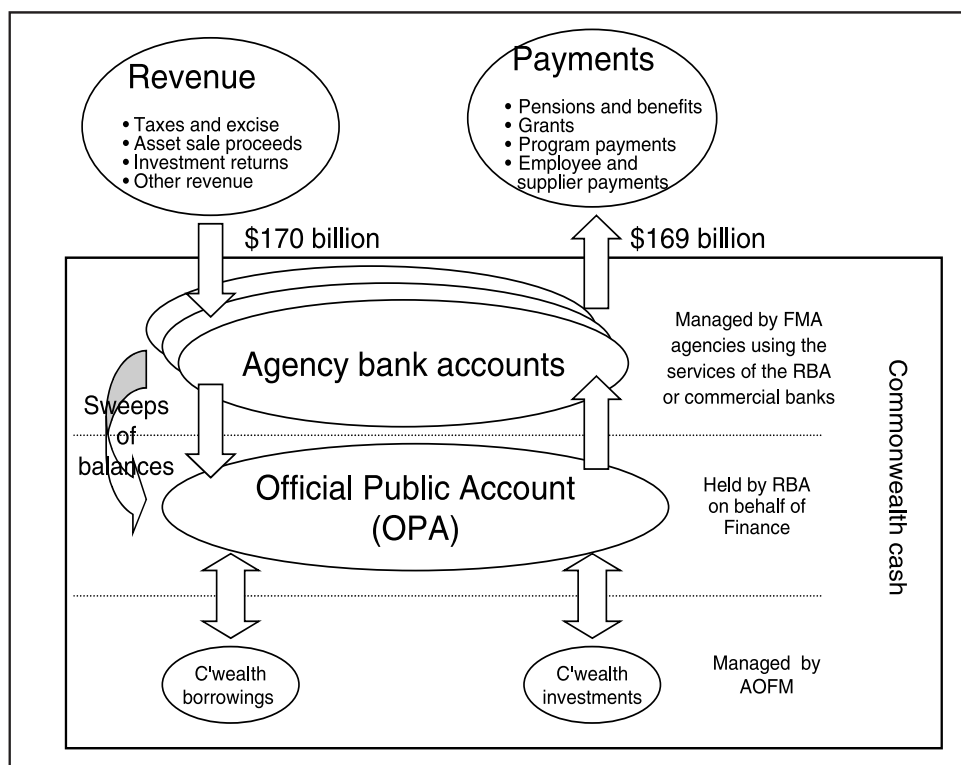
Finance. Under this arrangement, the RBA used the volume of the Commonwealth's overall business to determine its prices, not the transaction volume of each individual agency.

5. The devolution of banking control to FMA agencies results in new risks and opportunities for the Commonwealth. A single, centrally coordinated system with one banking service provider was replaced by multiple systems and potentially many banking service providers. The main financial risk to the Commonwealth is not in the management of fees payable to banks but the revenue risks created by the large flows of funds between agency accounts, the OPA and third parties shown in Figure 1.

6. Having been given direct responsibility for transactional banking, and with encouragement from the interest incentive scheme, agencies have become more aware of the time value of money and have focussed on improving their overall cash management procedures. A recent ANAO Assurance and Control Assessment (ACA) Audit on Management of Bank Accounts by Agencies found that as the audited agencies had become more settled with the new banking arrangements and their internal processes developed, the level of funds and the period of investment increased significantly reflecting, *inter alia*, more active cash management. The ACA audit also found a progressive increase in the level of cash held in term deposits compared to cash held in departmental bank accounts.

Figure 1

Cash flows under devolved transactional banking: 2000–2001



Source: ANAO analysis of AOFM and Treasury information.

7. The FMA Act and the associated orders, regulations and delegations¹ provide the framework within which agencies must manage their banking activities. The central provisions are section 8 and section 9 of the FMA Act, which provide that the Finance Minister or the Minister's delegate may enter into agreements with banks and may open bank accounts. The Finance Minister has instructed that agreements with banks must stipulate adherence to the core requirements for transactional banking services. These requirements specify, amongst other things, that agency bank accounts will be funded at the optimal time, maximising the Commonwealth's ability to earn interest. They also specify that balances in agency bank accounts will be returned or 'swept' back to the OPA overnight, maximising the funds available to the Commonwealth for overnight investment and assisting the RBA to manage banking system liquidity. The core requirements replicate the Commonwealth's pre-July 1999 framework for managing its cash flows at a whole-of-government level.

¹ The instrument amending the delegations was issued by the Minister for Finance and Administration on 31 October 2001.

Audit approach

8. The objectives of the audit were to review selected agencies' implementation and ongoing management of contractual banking arrangements; tendering for the procurement of banking services; and to identify practices that have improved administrative arrangements.

9. The audit examined Finance and a selection of other agencies subject to the new banking requirements. Finance was selected for its central role in coordinating the implementation of the changes to agency banking as well as its importance as a payment agency. The Australian Customs Service (Customs) was selected as a major receipting agency. The other audited agencies,² namely the Department of Transport and Regional Services (DTRS), the Department of Education, Science and Training (DEST), the Department of Immigration and Multicultural and Indigenous Affairs (DIMIA), primarily make Commonwealth program payments to individuals and entities.

Overall audit conclusions

10. Responsibility for managing banking operations lies primarily with agency Chief Executives, with Finance having an overarching monitoring role. To fulfil their responsibility, agency Chief Executives need to ensure that contracts with banks are effectively managed; that banks adhere to the core requirements; and that banking arrangements provide value for money. Finance was the coordinating agency for the introduction of the new banking arrangements.

11. During implementation, Finance oversaw the transition to the new arrangements. All audited agencies were able to make payments and take receipts from 1 July 1999. Finance has commented to ANAO that there have been benefits for the Commonwealth from the devolved and contestable structure, including: improved service quality and responsiveness to banking needs; better contract terms and conditions; costs savings from improved business processes; improvements in the cost effectiveness of transactional banking services; and opportunities to achieve savings from improved cash management.

12. During the development of the new arrangements, Finance did not recognise the financial risk to the Commonwealth of lost interest arising from commercial banks' standard practice of clearing low value payments the day

² Following the changes to administrative arrangements on 26 November 2001, the Department of Education, Training and Youth Affairs became the Department of Education, Science and Training and the Department of Immigration and Multicultural Affairs became the Department of Immigration and Multicultural and Indigenous Affairs. The Departments are referred to by their current names throughout this report.

before settlement (*commercial banks' settlement arrangements*).³ This risk did not arise under the arrangements for *same-day value* operated by the RBA. This longstanding practice was originally mandated by Finance and was to apply under the new arrangements. Finance '*had expectations that [same-day value] would be provided and accordingly did not consider it necessary to undertake further actions to mediate against a potential loss of interest*'. Changes to the commercial banks' settlement arrangements, which came into effect in mid January 2002, now permit them to provide same-day settlement through the Bulk Electronic Clearance System (BECS). Finance has modified the core requirements to improve the clarification that same-day value represents best practice for Commonwealth payments. These changes should eliminate these interest losses to the Commonwealth.

13. Further, there has been a substantial net transfer of benefits under the *cash management incentive scheme* to agencies in the two year period ended 30 June 2001 of some \$114 million in cash terms, rather than the Budget neutral approach envisaged for the new banking arrangements. An additional \$37 million in resources is forecast to flow to agencies under the scheme in 2001–2002. By the completion of this fiscal year the scheme will be non-budget neutral in cash terms to the extent of some \$151million (see Figure 2). Finance's variations to the interest clawback arrangements from July 2001 resulted in there being no comprehensive mechanism in place to directly recover these additional resources from agencies, in conformity with the requirement for a Budget neutral outcome. Finance has stated that other mechanisms (output price reviews and ERC decisions) ensure funding to agencies is appropriate and that interest is taken into account. While accepting that such processes can take interest revenue into account, they are not as responsive as other, more direct approaches to achieving Budget neutrality.

14. All FMA Act agencies are required to market test under the new banking arrangements but initial progress has been modest. Of the five audited agencies, only Finance had outsourced its banking to a commercial bank at 1 July 1999 and only Finance and Customs had completed market testing by January 2002. ANAO's examination of the Finance and Customs market testing processes revealed opportunities for more consistent adoption of better practices in competitive tendering and contracting, providing agencies yet to market test with an opportunity to benefit from Finance and Customs' experiences. The

³ In banking practice, *payment clearance* occurs when an agency's bank debits the agency's account and the payee's bank credits the payee's account, passing value to the payee. This is distinct from *payment settlement*, which occurs when funds are transferred between banks and funds become available to the payee. *Deferred settlement* denotes that clearance occurs the day before settlement, whereas *same-day settlement/value* denotes that clearance occurs on the same day as settlement. In banking parlance, *value* refers to the ownership and control of funds, including the ability to earn interest on those funds.

priority given by other agencies to the market testing of banking services has been influenced by the generally modest transactional banking fees involved; the perceived risks to agency outcomes; the potential transition costs involved in changing suppliers; and, in at least one instance, the costs of commercial banks' settlement arrangements.

Figure 2

Budgetary Impact on a Cash Outcome Basis of Agency Banking Incentive Scheme: 1999-2000 to 2001-2002.

Item	1999-2000 (Actual) \$m	2000-2001 (Actual) \$m	2001-2002 (Estimate) \$m
• Interest Credited to Agencies' Accounts	77.4 ¹	147.4 ²	85.8 ³
• Finance Capital Appropriation	n.a.	24.5 ⁴	n.a.
• Sub-total	77.4	171.9	85.8
• Less: Clawback of Agencies' Appropriations	55.0 ⁵	80.4 ⁵	48.9 ⁶
• Net Budget Position ⁷	(22.4)	(91.5)	(36.9)

Notes:

1. In 1999-2000, the RBA credited \$91 million to agency bank accounts (excluding \$9.9 million of interest withheld by RBA at the direction of Finance and not paid) comprising: \$70.4 million interest on term deposits; and \$20.6 million interest on overnight cash balances, which is credited quarterly. The total paid excludes \$14.2 million interest credited to Finance's Departmental Bank Account and returned by them to Consolidated Revenue on 24 March 2000; and includes \$0.6 million credited to agencies by Finance for interest earned in 1999-2000, giving the net result of \$77.4 million paid.
2. In 2000-2001, the RBA credited \$158.7 million to agency bank accounts, comprising: \$143.7 million interest on term deposits; and \$15 million interest on overnight cash balances. The net total excludes agency interest of \$11.3 million derived from early draw-downs and account classification errors and thus reduced from the amount paid to agencies.
3. ANAO estimate based on pro-rated RBA credits to agency bank accounts for the period July 2001 to March 2002.
4. Finance advice to ANAO of 5 April 2002 was that the Department was provided with a Capital Appropriation (*Appropriation Act (No.2) 2000-01*) of \$24.5 million. This covered the repayment of \$14.2 million interest earned by Finance in 1999-2000 and repaid to Consolidated Revenue; \$9.9 million of interest for the period 24 March 2000 to 30 June 2000 withheld by the RBA at Finance's direction; and other mostly interest-related adjustments of \$0.4 million. RBA has confirmed to ANAO that Finance has not requested payment of the \$9.9 million of interest withheld and Finance advised ANAO that this interest was appropriated as a capital injection in 2000-2001.
5. Finance Ministerial Briefing of 9 March 2000.
6. Finance advice to ANAO of 12 March 2002, on agency clawback of appropriations for 2001-2002.
7. Finance advised ANAO on 3 April 2002 that: *The interest paid figures include payments to Finance special accounts of \$48.6 million in 2000-2001 and \$12.8 million in 2001-2002. Special account balances (including interest earned) are quarantined from the ordinary activities of Departments. Finance notes that these interest earnings have contributed to dividend payments to Government of \$71.7 million in 1999-2000 and \$142 million in 2000-2001. Accordingly, the total 'net cash budget position' of \$150.8 million is overstated to the extent of the interest component of the dividend payments from the special account balances.*

Sources: RBA records of agency bank interest payments, Finance advice and documentation and ANAO estimate.

15. In the two audited agencies that had outsourced, ANAO found that, in comparison to the conditions prevailing under the sole source service provided by the RBA prior to 1 July 1999:

- Finance's overall annual banking costs (excluding tendering and transitional costs) increased from \$47 000 in 1998–1999 to \$85 729 in the first year of outsourcing (1999–2000), and fell slightly in the second year. Finance has steadily reduced its reliance on cheques to make payments and has actively sought its suppliers' acceptance of electronic payment methods. However, the move to a commercial bank brought with it the additional costs of commercial banks' settlement arrangements which more than offset the savings in banking fees over the first two years of outsourcing (see Figure 4.4). Changes to the commercial bank settlement arrangements that came into effect in mid January 2002 are expected to eliminate these costs.
- Customs' total banking costs in 2000–2001, the first year of outsourcing, were \$170 000 compared to \$55 000 in 1999–2000 and \$43 000 in 1998–1999. The increase was mainly due to Customs sourcing banking services from two providers in 2000–2001. The RBA fees for the interim services it provided prior to Customs moving all of its banking business to its preferred tenderer in June 2001 were substantially greater than those provided for under the previous whole-of-government pricing regime. In addition, there were costs related to commercial banks' settlement arrangements (see Figure 4.5). The transition to a new banker was completed in June 2001 and aggregate banking costs are expected to fall significantly in 2001–2002 due to the resolution of commercial banks' settlement arrangements and because services will only be sourced from one transactional banker.

Key findings

Implementation planning and outcomes

16. Finance planned a trial of devolved banking, involving up to six agencies, during 1998–99 and closely approximating the conditions under which agencies would operate from 1 July 1999. The trial did not proceed as Finance assessed that its main value had been gained from discussions with participating agencies about the operational arrangements. Finance circulated documents to all agencies that provided details of the banking framework and the specific responsibilities of agencies and instituted an extensive communications program, which included coverage of agency banking. Finance also monitored agencies' progress in implementing transactional banking and provided advice to agencies seeking guidance on the practicalities of devolved transactional banking. It implemented changes to the Accrual Information Management System and coordinated the legislative and regulatory changes accompanying the new arrangements. Finance

requested that agencies certify their readiness for implementing devolved banking by 1 July 1999 (all agencies did so), including the ability to make payments and take receipts.

17. The audited agencies began planning for implementation before Finance released formal guidance but progress was slow, except in Finance, due to uncertainty about operational arrangements. The audited agencies weighed the risk of changing providers for the making of payments to Government program customers and the States against the possible costs of transition to a new provider; the pressure from other reform initiatives; time constraints; in-house skills and experience; and (in at least one instance) the costs of commercial banks' settlement arrangements. The agencies, apart from Finance, continued existing banking arrangements with the RBA, adjusting their operational arrangements as necessary.

18. For banking, it is best practice to have written agreements that specify the rights and obligations of the respective parties. Of the audited agencies, Finance and DTRS have formalised their arrangements with their transactional bankers, DEST is in a position to finalise an agreement and DIMIA has interim arrangements in place while it market tests. Customs did not sign a written agreement with its chosen provider until ten months after completing its tender process.

19. An essential element of implementation was that agencies establish a framework of internal controls to support the banking changes. The periodic internal review of banking arrangements and risk management plans is a useful means of detecting control weaknesses and a basis for addressing them systematically. Most of the audited agencies have undertaken an internal audit review of banking arrangements and have progressed towards implementation of the recommendations made. In three of the five audited agencies, bank reconciliation processes were not properly established and two audited agencies' bank account registers were incomplete. Four of the audited agencies did not update their Chief Executive's Instructions (CEIs) and procedural instructions initially but are aware of the importance of procedural instructions and at the time of audit fieldwork were taking steps to bring them up to date.

20. Agencies desirably should have an effective risk management plan that covers banking processes. Such plans typically include: a description of the agency environment; a description of risks; a description of consequences and likelihood of the identified risks occurring; and actions to manage (by mitigation, transfer, removal or acceptance) each of the identified risks. Only one agency (DEST) had taken steps to ensure banking arrangements were addressed in its agency risk management plan at the time of implementation. Following internal audit review, three other agencies are implementing risk management plans for banking.

21. The cash management incentive scheme implemented by Finance in 1999–2000 along with devolved banking allows agencies to accrue interest on their departmental bank account balances and term deposits. Agencies' budgets were reduced by an amount equivalent to projected incentive payments, to ensure the Commonwealth's aggregate financial position was unchanged by the introduction of the cash management incentive scheme. In actual budgetary terms, agencies gained some \$14 million in cash terms in additional resources in the two year period ending 30 June 2001 and are forecast to receive an additional \$37 million in 2001–2002. (see Figure 2). Agencies' additional funding received from the operation of the cash management incentive scheme substantially exceed any financial savings that may have accrued to the Commonwealth from the operation of the scheme. This represents a substantial net transfer of benefits under the cash management investment scheme to agencies, rather than the neutral outcome envisaged.

Operationalising core requirements

22. The Finance Minister's delegations require agencies to ensure that banks adhere to five core requirements for banking services. Chief among the requirements are the daily sweeping of the balances of agency accounts back to the OPA for investment overnight and the transfer of Commonwealth funds for payments no sooner than necessary. Agencies' difficulties in operationalising the core requirements are reflected in the audit findings of initial interest shortfalls from failures by agencies to sweep accounts.

23. The RBA's settlement arrangements differ from standard commercial banking practice. As required under its December 1993 contract with the then Department of Finance, the RBA negotiated with banks to tailor the arrangements to the best advantage of the Commonwealth, ensuring same-day value on payments. In this context, unless agencies required their commercial bankers to provide same-day value on payments, there would be a significant loss of interest receipts to the Commonwealth under commercial banks' settlement arrangements.

24. Using a formula provided by the RBA to Finance in July 1999 and payment information provided to ANAO by the RBA, ANAO estimated the potential exposure to interest losses for 1999–2000 to be up to \$17.3 million if all Commonwealth agencies' banking was to be outsourced to commercial banks. This estimate is consistent with a RBA calculation of potential interest losses of up to \$17 million per year. These estimates illustrate the financial risk that the Commonwealth faced at July 1999 if all agencies moved their banking business from the RBA to commercial banks. On the basis of advice provided to ANAO by Finance, the actual losses were less than one per cent of the maximum potential

losses in 2000–2001, as the agencies with the overwhelming majority of transaction values had not outsourced their banking services.

25. Since July 1999, Finance has been examining commercial banks' settlement arrangements with representatives from interested commercial banks and the Australian Payments Clearing Association. Changes to the commercial banks' rules for Commonwealth direct entry credits, which came into effect in mid January 2002, permit banks to provide same-day value through BECS for Commonwealth Government payments. Finance has modified the core requirements to improve the clarification that same-day value represents best practice for Commonwealth payments. These changes should eliminate the potential for interest losses for agencies outsourcing banking services since July 1999.

26. Subsequent to the introduction of devolved banking, the RBA and relevant commercial banks advised Finance of instances where the balances of official accounts appeared not to be swept to the OPA daily, as specified by the core requirements. This led to interest shortfalls to the Commonwealth as interest is paid by the RBA on the overnight balances of accounts swept to the OPA but is not paid by commercial bankers on any amounts that are not swept. Altogether, interest shortfalls from failures in sweeping identified during the audit amounted to approximately \$1.3 million. Among the audited agencies, interest shortfalls amounted to approximately \$0.7 million. Finance, with agencies, has undertaken remedial action to recover these shortfalls to the Commonwealth.

Budget preparation and accountability

27. Under the new arrangements for transactional banking, Finance's administered appropriations were increased to fund interest payments to agencies. At the same time, as previously indicated, agencies' departmental appropriations were reduced with the objective of ensuring the scheme was Budget neutral. In 1999–2000, agencies' appropriations were reduced by \$55 million. In March 2000, the then Minister for Finance and Administration wrote to the Prime Minister and Treasurer advising that agencies' appropriations would be reduced by \$80.4 million in 2000–2001. In 2001–2002, no correspondence was prepared for Ministers' consideration on this issue but reductions of some \$49 million were made to some agencies' appropriation estimates. There has not been a systematic approach adopted by Finance to agency budget reductions for 2001–2002: some budgets were reduced, others were not. This represents a significant control weakness in the department's budgetary processes with a direct impact on the 2001–2002 Budget, as interest payments to agencies are expected to be \$86 million.

28. In actual cash budgetary terms, agencies gained some \$22.4 million in additional resources in 1999–2000 and \$91.5 million in 2000–2001. An additional \$37 million in resources is forecast to flow to agencies under the scheme in 2001–2002. (see Figure 2). By the completion of this fiscal year the scheme will be non-budget neutral in cash terms to the extent of some \$151 million. ANAO notes that, with the variations to the interest clawback arrangements from July 2001, there is no comprehensive mechanism in place to directly recover these additional resources from agencies, in conformity with the requirement for a Budget neutral outcome. Finance has stated that other mechanisms (output price reviews and ERC decisions) ensure funding to agencies is appropriate and that interest is taken into account. While accepting that such processes can take interest revenue into account, they are not as responsive as other, more direct approaches to achieving Budget neutrality. ANAO suggests that this aspect could be reconsidered in the light of the policy objectives for this measure.

29. In *Appropriation Act (No. 1) 1999–2000* Finance was appropriated \$53.8 million for the purpose of making interest payments to agencies, as part of the appropriation for its Outcome 2: Improved and More Efficient Government Operations. Actual interest paid by the RBA on Finance’s behalf in 1999–2000 was \$91 million. To enable the department to stay within its appropriation for Outcome 2, Finance voluntarily returned to the Consolidated Revenue Fund \$14.2 million that it received in departmental interest payments in the period July 1999 to March 2000. Finance also instructed the RBA to withhold payment of \$9.9 million in interest owing to Finance for the period April to June 2000. Finance subsequently raised a departmental receivable (or amount owing to Finance) of \$24.5 million for the interest it returned to Consolidated Revenue and the amount of interest due to Finance but not paid for the period April to June 2000. In the following year Finance was appropriated this \$24.5 million from an administered capital item in *Appropriation Act (No. 2) 2000–2001*. Finance’s actions effectively shifted the Budget impact between the financial years 1999–2000 and 2000–2001.

30. For reasons of financial transparency and public accountability, the conventional administrative practice of the Commonwealth has been for payments between agencies to be covered by an appropriation. Unlike previous years however, in 2001–2002, Finance did not seek an appropriation for agency interest payments estimated at \$86 million. The decision by Finance to move away from conventional budgetary practice in 2001–2002, by not having an appropriation to cover significant Commonwealth resourcing, raises important accountability issues. The fact that the Constitution allows transfers between agency accounts which form part of the Consolidated Revenue Fund does not detract from the need for budgetary transparency and accountability for payments between agencies to ensure public confidence in the probity of agency resourcing.

Market testing

31. All agencies are required to market test under the new banking arrangements that came into effect on 1 July 1999. Of the audited agencies, Finance and Customs have completed their market testing processes.⁴ Existing levels of banking fees are relatively modest in the audited agencies that have not completed market testing, namely DEST, DIMIA and DTRS. As of January 2002, DIMIA had completed a Request for Expression of Interest (REOI) process and advised ANAO that it was proceeding with a Request for Tender (RFT). At that time, DTRS had called for tenders and was proceeding to evaluate responses. Following the resolution of commercial banks' settlement arrangements, DEST was proceeding to market test. DEST had sought resolution of settlement arrangements before proceeding with market testing as it had estimated that losses of \$2.5 million per annum would result if it selected a commercial bank under the framework existing prior to 18 January 2002.

32. Finance was the first agency to market test for the provision of banking services. The process began in January 1999 when Finance called for expressions of interest from all banks to provide banking services. In February 1999, Finance released a RFT to the seven banks and credit card providers that lodged an expression of interest. Following evaluation of the four tenders received, a commercial bank was selected on the basis that it scored highest on the qualitative criteria and also offered the lowest cost and was therefore considered to represent the best value for money.

33. Finance's RFT sought detailed information from each tenderer on fees and charges applying to transactions, merchant and EFTPOS fees, electronic banking costs and fees and corporate/purchasing cards. However, the evaluation process did not take account of all such costs that were included in tender responses (and, subsequently, in the contract). The tender evaluation also overlooked the financial benefits then associated with the settlement processes employed by the RBA compared to those offered by commercial banks. Including all such costs, the ANAO's analysis changes the ranking of tenderers against the price criterion with the cost of the successful tenderer's proposal estimated to be some \$27 000 or 16 per cent higher than the actual lowest cost tender when all relevant costs are taken into account (see Figure 4.2). Changes to the commercial bank settlement arrangements that came into effect in mid January 2002 are expected to reduce the difference in costs.

⁴ A number of other major agencies not included in this audit have also market tested, namely the Departments of Health and Ageing, Veterans' Affairs, Defence, Family and Community Services, Prime Minister and Cabinet (including other agencies within that portfolio) and Foreign Affairs and Trade.

34. Customs engaged a management consulting firm to assist in the conduct of its tender process, which commenced in February 2000. The tender was selective, with nine institutions being invited to tender. This decision was based on the management consultant's previous experience with another department that had already market tested. Customs' evaluation committee concluded that one of the commercial bank respondents offered Customs the best banking services that were in accordance with the core protocols, as well as the lowest fees.

35. The price analysis conducted by Customs included assessment of banking fees and also took into account the costs associated with commercial banks' settlement arrangements. In assessing the costs of the RBA tender, Customs included an estimate of some \$137 000 per annum for the interest lost on receipts, as Customs considered the RBA systems did not provide for same-day processing of receipts in all regional centres. This was despite statements to the contrary made by the RBA in its tender, and in subsequent tender clarification. Customs, by including this amount, more than doubled the assessed cost of the RBA tender. Adjusting for this factor, the ANAO's analysis changes the ranking of tenderers against the price criterion with the cost of the successful tenderer's proposal estimated to be some \$21 600 or 15 per cent higher than the actual lowest cost tender when all relevant costs are taken into account (see Figure 4.3). ANAO considers it would have been better practice for Customs to have negotiated further with the RBA on this issue, seeking the RBA's agreement to a contractual clause binding it to provide same-day receipting. Customs' final decision on the successful tenderer was based on its assessment of the tenderers' price, branch representation, integrated banking and innovation opportunities.

Evaluation planning

36. It is good administrative practice for the selection basis to be determined before the tender documentation is issued, and for it to be communicated to potential tenderers through the tender documentation, so they have an informed basis on which to decide whether to tender, and the nature of the tender to prepare. The advantage of a formally documented tender evaluation plan is that it can be used to guide the evaluation process, and then used as the basis for the tender evaluation report, which is prepared as a record of how the evaluation was conducted.

37. Finance prepared its tender evaluation plan after the release of the RFT, whereas better practice suggests that this should have been done prior to release of the RFT. Finance's tender evaluation panel used a two step evaluation process as outlined in the tender evaluation plan. However, the panel deleted many of the references to mandatory criteria included in the evaluation plan and removed one criterion. Finance's probity reviewer concluded that the tender process was conducted with probity but noted, however, that several changes were made to

the tender evaluation plan after the panel had informally reviewed the tenders, suggesting that insufficient thought was given to how the tenders should be evaluated in the original plan.

38. Customs did not prepare a tender evaluation plan. In evaluating tenders, the Customs evaluation committee applied the evaluation criteria specified in the RFT, but also used additional criteria that it did not include in the RFT. The relevant Commonwealth Procurement Guidelines stated the Commonwealth's policy that agencies '*evaluate each offer applying only the evaluation criteria and methodology notified to bidders in the request for tender documentation.*' ANAO considers a tender evaluation plan would have added value to Customs' tender process.

Contractual outcomes

39. In June 1999, Finance signed a contract with its selected provider. The contract was for the provision of general banking services commencing 1 July 1999 and was for a term of one year with an extension of one to three years.

40. After market testing, Finance's overall banking costs (excluding tendering and transitional costs) increased from \$47 000 in 1998–99 to \$85 729 in 1999–2000 and fell slightly to \$79 391 in 2000–01. Finance has steadily reduced its reliance on cheques to make payments and has actively sought its suppliers' acceptance of electronic payment methods. However, the move to a commercial bank has brought with it the additional costs of commercial banks' settlement arrangements which more than offset any savings in banking fees. Changes to the commercial bank settlement arrangements that came into effect in mid January 2002 are expected to eliminate these costs.

41. Customs started taking receipts through its new bank in September 2000 and completed moving its payments business to its new banking provider in June 2001. Customs signed a contract with its new bank in February 2001, 10 months after advising the bank of the tender outcome. ANAO considers it is better practice for a signed written contract to be in place before a financial institution commences providing deposit and payment services. Otherwise the documentary trail supporting the authority for the payment of public money and contractual performance requirements, incentives and sanctions may not be clear. In the context of banking, written agreements between agencies and their banking providers also provides the basis for ensuring core requirement compliance and obtaining value for money.

42. Customs' total banking costs in the first year of outsourcing were \$170 000 in 2000–01, compared to \$55 000 in 1999–2000 and \$43 000 in 1998–99. The increase was mainly due to Customs sourcing banking services from two

providers in 2000–01. The RBA fees for the interim services it provided prior to Custom’s moving all of its banking business to its preferred tenderer in June 2001 were substantially greater than those provided for under the previous whole-of-government pricing regime. In addition, there were costs related to commercial banks’ settlement arrangements. The transition to a new banker was completed in June 2001 and aggregate banking costs are expected to fall significantly in 2001–02 due to the resolution of commercial banks’ settlement arrangements and because services will only be sourced from one transactional banker.

Improvement opportunities

43. There are some lessons from the foregoing experiences, which would benefit other agencies. Good administrative practice for an agency entering into a contractual arrangement with a transactional bank for the provision of banking services requires sound planning and management from the outset as well as:

- identifying and planning for revenue, operational and contractual risks;
- adherence to the Commonwealth Procurement Guidelines in market testing processes;
- negotiating with the preferred bidder before signing a contract to ensure that both parties understand their obligations, and to secure the interests of the agency and the Commonwealth;
- carrying out a due diligence check to ensure that the preferred bidder is, in practice, able to meet the core requirements;
- including provisions in the contract for immediate notification of non-compliance with the core requirements and recovery of losses due to non-compliance;
- regular monitoring of service delivery (including compliance with the core requirements) utilising performance indicators;
- ensuring that opportunities for more effective and efficient banking and improvements in internal processes are recognised and implemented throughout the life of the contract; and
- implementing appropriate preparations to migrate to new arrangements, if necessary.

Agency responses

44. ANAO made four recommendations, all of which were agreed to by Finance, DEST, DIMIA and DTRS. Customs agreed with the first two recommendations and agreed with qualification to the last two recommendations. The recommendations cover risk assessment planning, the monitoring and review of banking arrangements, the conduct of tender processes, and the timely execution of formal written agreements.

Recommendations

Set out below are the ANAO's recommendations arising from this report, with report paragraph references and abbreviated responses from agencies. More detailed responses are shown in the body of the report together with the findings.

**Recommendation
No. 1
para 2.52**

ANAO *recommends* that agencies regularly review their internal controls relating to banking, particularly bank reconciliation processes, bank account registers, Chief Executive's Instructions and operational procedures.

Agreed: Finance, Customs, DEST, DIMIA and DTRS.

**Recommendation
No. 2
para 2.59**

ANAO *recommends* that all agencies regularly review their risk assessment and management plans to ensure the continued effectiveness and efficiency of their banking arrangements.

Agreed: Finance, Customs, DEST, DIMIA and DTRS.

**Recommendation
No. 3
para 3.11**

ANAO *recommends* that agencies improve monitoring of core requirement compliance by their transactional banks by periodically reconciling amounts swept with their own financial records.

Agreed: Finance, DEST, DIMIA and DTRS

Agreed with qualification: Customs.

**Recommendation
No. 4
para 4.54**

ANAO *recommends* that agencies ensure a written agreement is executed before a financial institution commences providing deposit and payment services.

Agreed: Finance, DEST, DIMIA and DTRS

Agreed with qualification: Customs.

Audit Findings and Conclusions

1. Introduction

This chapter details the background to the audit: the statutory framework and statutory requirements for managing devolved banking; and the audit approach.

Background

1.1 New arrangements for transactional banking endorsed by Ministers came into effect on 1 July 1999 for agencies subject to the *Financial Management and Accountability Act 1997* (FMA Act). These arrangements transferred responsibility for payments and receipting from the Department of Finance and Administration (Finance) to individual FMA Act agencies. Consistent with devolved management under the FMA Act, a cash management incentive scheme was introduced along with the devolution of responsibility, providing agencies with an opportunity to earn interest on surplus departmental funds. The arrangements are intended to encourage agencies to manage working capital, including cash, in a more business like manner. Safeguards over the Commonwealth's aggregate cash balances necessary for effective central cash/debt management and the Reserve Bank of Australia's (RBA) central role in managing liquidity and foreign exchange have been preserved. The new arrangements were introduced as an integral part of output and outcomes based management and accrual budgeting, recognising that devolution of management is an important element in the devolved banking framework.

1.2 Transactional banking refers to the deposit and payment services provided by banks and other deposit taking institutions. Estimates of net flows through Commonwealth Government bank accounts amount to \$339 billion in 2000–2001, comprising \$170 billion in revenue and \$169 billion in payments. The Commonwealth annually makes some 240 million payments. The average daily balance⁵ in the Official Public Account (OPA) held by the RBA on behalf of Finance in 2000–2001 was approximately \$1.48 billion.⁶

⁵ The Australian Office of Financial Management (AOFM) has noted with respect to cash management: *'The challenge of Commonwealth cash management is to minimise net interest outlays through minimising Treasury Note issuance to cover cash needs whilst, at the same time, avoiding use of the Commonwealth's (more costly) overdraft facility with the RBA. The minimum issuance objective is formalised by the Commonwealth's end of year target for average cash balances. In May 1996, the Treasurer, in consultation with the Minister of Finance, determined that the year-average balance as at 30 June each year in the Commonwealth's overdraft group of accounts held with the RBA should be around a maximum of \$1.5 billion. The target is intended to place a suitable degree of discipline on cash management (and debt management more generally) by encouraging the maintenance of minimum cash balances, thereby minimising borrowings and, consequently, the Commonwealth's net interest expense.'* AOFM Annual Report 2000–2001, p. 22.

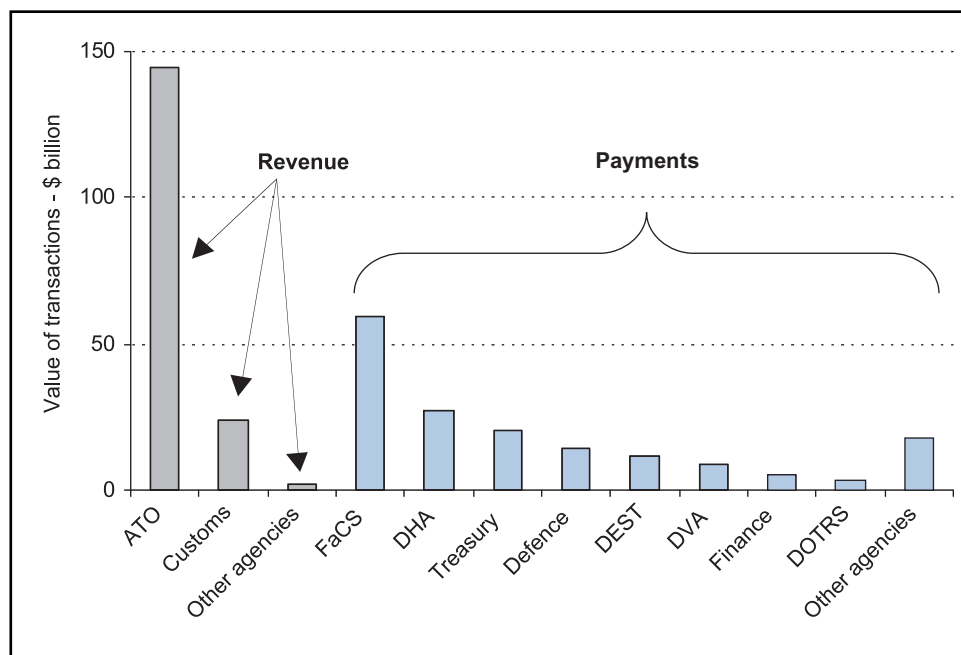
⁶ The average cash balances for 1997–98, 1998–1999 and 1999–2000 were \$1.62 billion, \$1.25 billion and \$1.43 billion respectively.

1.3 The Australian Taxation Office (ATO) and the Australian Customs Service (Customs) are estimated to have collected Commonwealth revenue of \$144 billion and \$24 billion respectively in 2000–2001 (see Figure 1.1). The incidence of payments is highly concentrated in eight agencies that account for nearly 90 per cent of Commonwealth payments. The Family and Community Services (FaCS) portfolio made \$59.2 billion in payments (mainly income support through Centrelink) in 2000–2001, Health and Ageing (DHA) made \$27.6 billion in payments, Treasury \$20.2 billion, the Department of Defence \$14.3 billion, the Department of Education, Science and Training (DEST) \$12.8 billion, the Department of Veterans' Affairs (DVA) \$8.7 billion, Finance \$5.4 billion and the Department of Transport and Regional Services (DTRS) \$3.4 billion.

1.4 In comparison to the large payment and receipt flows through Commonwealth accounts, the banking fees for the Commonwealth are relatively modest, totalling around \$10 million per annum. Centrelink bears the largest portion of these fees, due to the large volume of pension and allowance payments it makes annually. For the majority of agencies, annual banking fees are commonly under \$20 000.

Figure 1.1

Estimates of Commonwealth revenue and payments by agency for 2000–2001



Source: ANAO analysis of *Budget Strategy and Outlook 2001–02* (Budget Paper No. 1). Excludes inter-agency and inter-government transfers.

1.5 Under the centralised banking arrangements that operated prior to July 1999, the RBA provided transactional banking services on a whole-of-government basis to Commonwealth agencies. These banking services were subject to an umbrella contractual Master Agreement between the Commonwealth, represented by Finance, and the RBA. Fees for banking services were charged by the RBA on a whole-of-government basis and paid for by Finance. Under this arrangement, the RBA used the volume of the Commonwealth's overall business to determine its prices, not the transaction volume of each individual agency.

1.6 The RBA advised ANAO that:

Since devolution on 1 July 1999, fees for transactional banking services have been revised along commercial lines. This means that larger agencies that chose to remain with the Reserve Bank have gained the benefit of volume in their fees for service. In contrast, smaller agencies that continue to use the Reserve Bank for transactional banking generally have faced increased costs. Similarly, since devolution the contract terms and conditions offered by the Reserve Bank for transactional banking services have favoured the larger agencies, with smaller agencies unable to negotiate changes to a basic generic contract.

1.7 The devolution of banking control to FMA agencies results in new risks and opportunities to the Commonwealth. A single, centrally coordinated system with one banking service provider was replaced by multiple systems and potentially many banking service providers. To manage the risk associated with such a system, Finance has established a framework of core requirements that agencies are required to build into contracts with banks.

1.8 The Joint Committee of Public Accounts and Audit (JCPAA) has recognised the risks in the new arrangements and the need to manage them.⁷ The Committee has noted that:

. . . the core requirements to be entered into with private banks appended to the manual are detailed and comprehensive. Nevertheless, as increasing numbers of agencies enter into banking agreements, Finance will need to maintain its vigilance to ensure protocols are entered into and adhered to.

1.9 The main financial risk to the Commonwealth is generally not in the management of banking fees but the revenue risks created by the flows of funding between agency accounts, the OPA and third parties. The Australian Office of Financial Management (AOFM) invests funds surplus to the needs of the OPA. It is important that receipts are transferred to the OPA as soon as possible and that funds for payments are delivered to agency accounts at the optimal time.

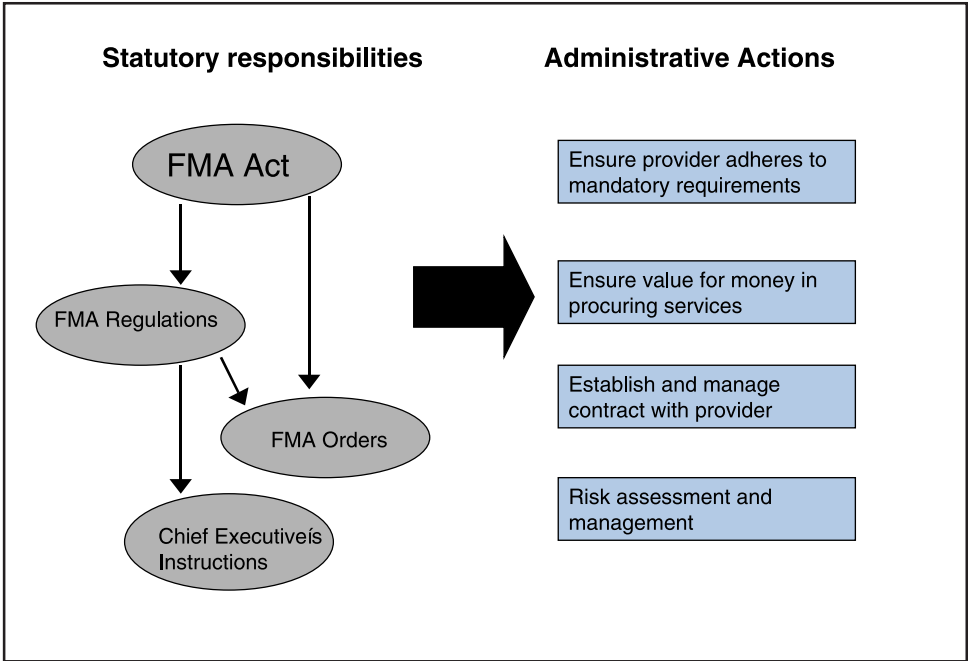
⁷ JCPAA, Report No.374, *Review of the operation of the FMA Act and CAC Act*, paragraph 2.34.

The magnitude of the financial flows involved means that even short delays can have significant financial consequences.

Statutory framework

1.10 Section 44 of the FMA Act imposes on agency Chief Executives a duty to manage Commonwealth resources effectively, efficiently and ethically. This, along with other provisions of the FMA Act, FMA Regulations, FMA Orders, the related delegations and Chief Executive’s Instructions,⁸ comprises the statutory framework governing transactional banking (see Figure 1.2).

Figure 1.2
Framework for managing transactional banking



Source: ANAO analysis.

1.11 The central provisions are section 8 and section 9 of the FMA Act, which provide that the Finance Minister or the Minister’s delegate may enter into agreements with banks and may open bank accounts. The Finance Minister has delegated his powers under sections 8 and 9 of the FMA Act to agency Chief Executives.⁹ In exercising these delegations, the Finance Minister has directed delegates to ensure that:¹⁰

⁸ Issued under section 52 of the FMA Act.

⁹ See section 62(1) of the FMA Act.

¹⁰ Issued by the Finance Minister under section 62(2) of the FMA Act.

- agreements with banks stipulate adherence to the core requirements for banking services;
- official accounts include in their title either the words ‘Official Departmental’ or ‘Official Administered’ or ‘Official Trust Account’;
- agencies notify the RBA when they open an official account and provide certain information to the RBA about the operation of official accounts; and
- agencies conduct foreign exchange transactions through the RBA, unless they agree other arrangements with the RBA.¹¹

1.12 FMA Regulation 8 provides that officials procuring goods or services must have regard to the Commonwealth Procurement Guidelines (CPG), including obtaining value for money.¹² FMA Regulation 7 provides that the Finance Minister may issue guidelines for the procurement of goods and services. Also, officials approving expenditure of public money must be satisfied that proposed expenditure is in accordance with the policies of the Commonwealth and represents efficient and effective use of public money (Regulation 9); and approval for expenditure must be received before a contract is entered into (Regulation 13).

1.13 To meet the requirements of section 44 of the FMA Act, agencies need to manage banking contracts for efficiency and effectiveness. Risk assessment and management are also integral to the proper management of a banking relationship. Figure 1.3 provides a summary of the statutory requirements that relate to management of banking.

¹¹ Banking delegations by the Finance Minister under the FMA Act, issued 27 February 2000, amended 31 October 2001.

¹² At the time, the CPG stated that: *‘the fundamental objective of Commonwealth procurement is to provide the means to efficiently and effectively deliver the Government’s programs’*. March 1998. Revised CPGs were issued on 5 October 2001.

Figure 1.3

Summary of statutory requirements for managing transactional banking

Agreements with banks

- The Finance Minister or the Minister's delegate may enter into agreements with banks.
- Agreements must be for 12 months or less, unless the Commonwealth can terminate with six months or less notice.

Bank accounts

- The Finance Minister or the Minister's delegate may open bank accounts. Account names must include the word 'official'.
- Accounts are to be entitled '[agency] Official ... Account'.

Receipts and withdrawals

- Money to be banked promptly in accordance with Finance Minister's Orders.
- Money to be banked by the next banking day, or day approved by the Chief Executive.
- Money not to be paid into a non-official account.
- Officials may transfer amounts between official accounts.

Borrowing

- Borrowing must be permitted by an Act of Parliament. Borrowing includes an advance via overdraft.
- Any overdraft borrowings must be repaid within thirty days.
- Finance Minister may borrow for short periods, up to ninety days.

Accounts and records

- Chief Executives must record receipts and expenditure on a daily basis.
- Agencies are to advise the RBA of account details when they open official bank accounts.

Core requirements

- Agencies must ensure that banks comply with the core requirements.

Value for money

- Chief Executives are to comply with the CPG. Under the CPG, value for money is the essential test against which agencies must justify any procurement outcome.
- Approvers of proposals to spend public money must be satisfied that proposals are in accordance with Commonwealth policies and will make efficient and effective use of public money.
- A person must not enter into a contract or agreement before receiving approval.

Source: ANAO analysis of FMA Act, FMA Regulations, FMA Orders, related delegations and Chief Executive's Instructions.

Audit approach

1.14 The audit examined Finance and a selection of other agencies subject to the transactional banking requirements. Finance was selected for its central role in coordinating the implementation of the banking changes as well as its importance as a payment agency. Finance operates the OPA, which is held with the RBA. The Department also operates its own agency official accounts and corporate responsibilities through which it takes approximately \$2 billion in receipts and makes \$700 million in payments per annum.

1.15 Customs was selected as a major receipting agency. The agency collected around \$24 billion in the 2000–2001 financial year in customs duty, excise, sales tax and other border-related revenue collections. Customs makes nearly 500 000 separate payments a year and takes over 250 000 separate receipts.

1.16 Other agencies selected primarily make payments to individuals and entities. DTRS's banking relates primarily to payments of grants which are estimated to be around \$3.4 billion in 2000–2001. DEST makes administered payments for higher education, school grants, vocational and international educational training payments, student assistance and youth support. In 2000–2001, payments made by DEST amounted to approximately \$12.8 billion. DIMIA receives over \$200 million per annum comprising visa fees and charges, citizenship revenues, and revenue from other immigration related functions. In 2000–2001, payments made by DIMIA amounted to over \$600 million and were mainly for the administration of immigration, citizenship and cultural diversity programs, with some payments (around \$30 million per annum) being for personal benefits and grants.

1.17 The objectives of the audit were to review selected agencies':

- tendering for the procurement of banking services;
- implementation and ongoing management of contractual banking arrangements; and
- to identify practices that have improved administrative arrangements.

1.18 This audit focuses on audited agencies' external relationships with banking service providers and the supporting administrative framework. The audit methodology involved: reviewing the legislative, regulatory and administrative policy framework for transactional banking; developing detailed audit criteria; collecting and analysing primary data, files and other records; and identifying improved administrative practices within audited agencies that may be applicable to other agencies.

1.19 Agency internal controls over cash and the impact of the cash management incentive scheme are considered in an ANAO Assurance and Control Assessment

(ACA) Audit, Audit Report No.10 2001–02 *Management of Bank Accounts by Agencies*. The main objectives of the ACA audit were to determine whether: agencies have implemented appropriate risk management strategies for the new banking arrangements which came into operation on 1 July 1999; and cash funds are being managed in accordance with the appropriate legislation, the Commonwealth's agency banking guidance, and generally accepted accounting practices. The ACA audit was undertaken in seven agencies subject to the requirements of the FMA Act. The report was tabled in September 2001. It concluded that, in respect to the day-to-day operation of bank accounts, the internal control frameworks established by agencies were generally satisfactory. However, it also found that Chief Executive's Instructions (CEIs) related to banking had not been updated in some agencies to reflect the new arrangements; that agencies' practices were not always consistent with the policies and procedures established by their internal control frameworks; and that better practice could be achieved through improvements in agencies' internal control frameworks. The ACA audit also examined the risk management processes and management accounting controls adopted in the forecasting of cash flows and operation of bank accounts and placement of funds. The ACA audit concluded that, as the seven audited agencies became more settled with the new banking arrangements and their internal processes better developed, the level of funds, and the period of investment, increased significantly reflecting, *inter alia*, more active cash management. The ACA audit also found a progressive increase in the level of cash held in term deposits compared with cash held in departmental bank accounts.

1.20 Audit fieldwork was conducted from September 2000 to June 2001. An Issues Paper was provided to agencies for comment in July 2001 followed by a Discussion Paper in August 2001. A proposed report was issued under section 19 of the *Auditor General's Act 1997* in October 2001, followed by a revised proposed report in November 2001. Finance was issued further drafts of the proposed report in January 2002, February 2002 and March 2002. The audit was conducted in accordance with ANAO Auditing Standards at a cost to ANAO of \$339 000.

2. Implementation of Transactional Banking

This chapter outlines the administrative arrangements and processes for devolving banking; discusses the implementation outcomes at the whole-of-government level and for the audited agencies; and describes the audited agencies' approaches to control and risk management.

Background

2.1 Responsibility for managing banking operations lies primarily with agency Chief Executives, with Finance having an overarching monitoring role. To fulfil their responsibility, agency Chief Executives should ensure that contracts with banks are effectively managed, that banks adhere to the core requirements and that banking arrangements provide value for money. Finance plays a significant role in the management of the transactional banking framework to achieve effective outcomes for the Commonwealth. Finance advised ANAO that its responsibilities are to:

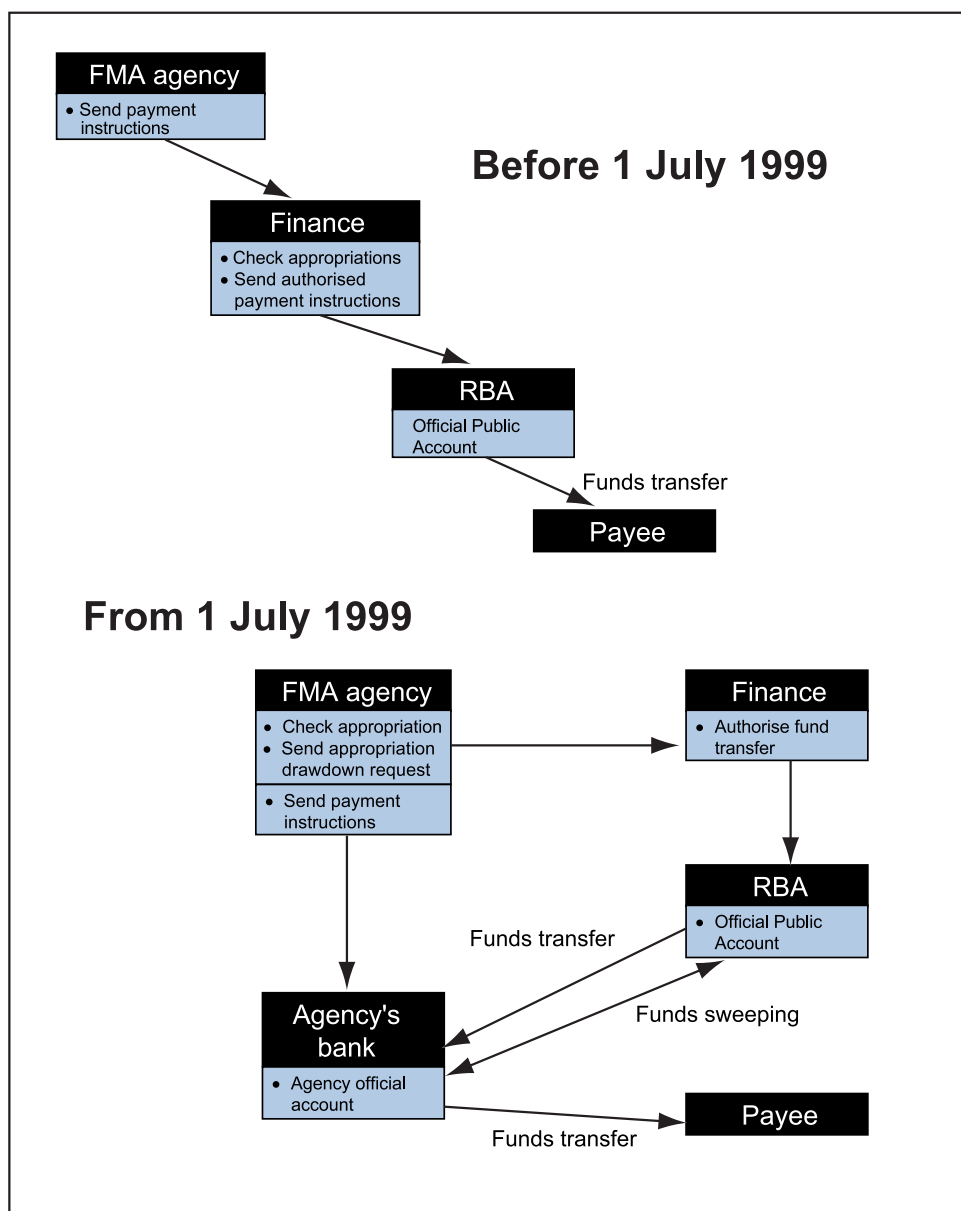
- maintain the statutory framework for banking, and make adjustments, where required, to ensure the framework maintains its effectiveness;
- assist agencies in managing their responsibilities under devolved banking. In this respect, Finance has issued (and updated where required) guidance in the Agency Banking Framework Manual, Instructions to Bankers, Instructions to Agencies and the Market Testing Toolkit that includes a model contract; and
- monitor, along with monitoring by agencies of their own activities, in order to ensure that the Commonwealth's exposure to financial loss is limited if practice in any agency (or agencies) is ineffective, and to provide a basis for evaluating the effectiveness of the new arrangements.

2.2 Figure 2.1 compares banking arrangements before, and after, 1 July 1999. Prior to July 1999, Finance provided a central payments service for agencies and the RBA provided all transactional banking services for Commonwealth agencies, except where it was impractical for it to do so.¹³ Accounts were generally held with the RBA and balances in these accounts were included in the Commonwealth Public Account (now referred to as the OPA). Some agencies held accounts with commercial banks, for example, in regional locations where the RBA could not provide receipting facilities, or if they required cheque cashing facilities.

¹³ The *Reserve Bank Act 1959* requires the RBA to act as the transactional banker to the Commonwealth, but does not require the Commonwealth to utilise the RBA's transactional banking services.

Figure 2.1

Comparison of transactional banking processes before and after 1 July 1999



Source: ANAO analysis

2.3 Amendments to the FMA Act which took effect on 1 July 1999 eliminated fund accounting¹⁴ which, among other things, removed the need for the Finance central ledger and allowed agencies to process and record transactions in their own accounting systems, thus facilitating the move to devolved accounting and banking arrangements.¹⁵ In addition, the new banking arrangements created additional processing for agencies and introduced competition to the RBA's transactional banking services. The arrangements involve new streams of payment instructions from agencies to their banks, new streams of funds transferred from the RBA to agencies' banks, and a continuing role for the RBA in sweeping the balances of agencies' bank accounts to the OPA.¹⁶ To comply with the requirements of competitive neutrality, the RBA established a transactional banking arm to provide deposit, payment and other transactional banking facilities to Commonwealth agencies and other customers.

Implementation processes

2.4 Agencies' ability to enter freely into agreements with banks including the RBA creates an obligation on them to manage their relationships with bankers effectively. Banking relationships are important and can be complex, requiring a thorough approach to planning for implementation.

2.5 The audited agencies began planning for implementation before Finance released formal guidance but progress was slow, except in Finance, due to uncertainty about operational arrangements. In December 1998, the RBA wrote to Finance outlining its Devolution Project, including system requirements for the central bank function and the RBA transactional banking business. RBA requested Finance to provide systems requirements by mid-January 1999. Following meetings to progress the issues, Finance accepted the RBA's offer to draft the system requirements. Major elements of the banking framework, including the core requirements and the system specifications for the central bank function, were finalised in February 1999.

2.6 Finance was the coordinating agency for the new banking arrangements. During implementation, Finance oversaw the transition to the new arrangements and its key tasks included:

- advising the Minister for Finance and Administration on the structure and implications of the proposed arrangements for banking;

¹⁴ Fund accounting was the classification of money in the Commonwealth's control into one of the four funds of the Commonwealth Public Account, which formed the framework for the Government's accounts.

¹⁵ *Financial Management Legislation Amendment Act 1999*, Explanatory Memorandum, pp. 1–2.

¹⁶ The investment of Commonwealth funds remains centrally controlled.

- providing guidance to agencies on the new arrangements and agency Chief Executives' responsibilities;
- developing the core requirements for banking services;
- developing, with the RBA, its role as the central bank under the new arrangements;
- managing legislative changes to the FMA Act;
- monitoring agencies' implementation of the new arrangements;
- effectively managing the risks of transition to the new arrangements in partnership with agencies; and
- upgrading its Accrual Information Management System (AIMS) to support agency transactional banking.

2.7 The key project phases of the implementation process managed by Finance were:

- July 1998: the Minister for Finance and Administration announced that, from 1 July 1999, Commonwealth transactional banking would be opened to competition;
- November 1998: Finance provided the Minister for Finance and Administration with a detailed proposal for devolved banking;
- January 1999: the Acting Prime Minister and the Treasurer agreed to the new arrangements;
- February 1999: Finance released guidance manuals to FMA agencies;
- March 1999: system requirements for the central bank function and the RBA transactional banking business were completed;
- April 1999: legislative changes supporting the new arrangements were passed as part of the *Financial Management and Accountability Legislative Amendment Act 1999* (Cth); and
- 1 July 1999: devolved transactional banking commenced.

2.8 Finance planned a trial of devolved banking, involving up to six agencies, during 1998-1999 and closely approximating the conditions under which agencies would operate from 1 July 1999. The trial did not proceed as Finance assessed that its main value had been gained from discussions with participating agencies about the operational arrangements. Finance provided draft policy and operational guidelines to agencies in November 1998, but was not in a position to provide final guidelines until the Acting Prime Minister and the Treasurer had approved the policy framework. In early February 1999, Finance circulated

the documents *Agency Banking Framework-Guidance Manual* and *Managing Agency Banking* to all agencies. These documents provided details of the banking framework and the specific responsibilities of agencies. Finance, as part of the Accrual Budgeting Project, instituted an extensive communications program which included coverage of agency banking.

2.9 In the lead up to 1 July 1999, Finance monitored agencies' progress in implementing the banking changes and provided advice to agencies seeking guidance on the practicalities of devolved banking. Finance focused its monitoring efforts on ensuring that agencies would be able to make payments and take receipts from 1 July 1999. Finance implemented changes to AIMS and coordinated the legislative and regulatory changes accompanying the new arrangements. Finance requested that agencies certify their readiness for implementing devolved banking by 1 July 1999 (all agencies did so), including the ability to make payments and take receipts.

2.10 In implementing devolved banking, Finance did not prepare, as such, a specific risk management plan. Finance has advised ANAO that:

... responsibility for implementation of Agency Banking was devolved to Chief Executive Officers. In order to reduce risks and assist with the management of implementation, Finance has provided guidance through the Banking Manual (issued prior to introduction of agency banking on 1 July 1999) and market testing toolkit (issued December 2000).

Risk management was completed at a whole of government level within the context of the Agency Banking Framework Manual addressing payment, revenue, contractual and operational risks. This document could not have been developed without an assessment of the risks.

2.11 In view of the risks posed to the Commonwealth by a shift of banking operations to individual agencies and private sector banks, and the originality of the scheme,¹⁷ ANAO considers that greater assurance for all stakeholders would have been provided by Finance developing such a plan, identifying specific payment and revenue, contractual and operational risks at the whole-of-government and agency levels and providing mitigation strategies for each material risk. One advantage of preparing such a plan prior to the introduction of the banking changes would have been an increased likelihood of Finance identifying and addressing the risks arising from commercial banks' settlement arrangements prior to 1 July 1999 (see further in Chapter 3).

¹⁷ The Commonwealth banking model, which devolves contractual banking responsibility to individual agencies, differs from those in the State jurisdictions, which are based around a central contract administered by the treasury or finance department, covering core budget-funded agencies. In addition, the account sweeping and funding arrangements incorporated in the core protocols are unique to the Commonwealth model.

2.12 In December 1998 and February 1999, the RBA wrote to Finance expressing concerns about contingency arrangements for the introduction of devolved banking due to start from 1 July 1999. The issues of concern to the RBA were: whether sufficient time had been allowed to specify, construct and test computer systems and the links necessary for transactional bankers to sweep agencies' funds back to the OPA; and what contingencies were planned in the event that agencies were unable to meet the July 1999 deadline. In March 1999, Finance advised the RBA that:

I note your comment about contingency arrangements for the 1 July deadline. Details of the new banking framework have been available to most agencies since November last year and have been sufficient to formulate and implement effective strategies for the systems and other changes necessary for timely transition from 1 July. More detailed guidance was provided through the comprehensive Agency Banking Framework Guidance Manual issued on 9 February, which has led to a noticeable increase in enquiries from agencies.

2.13 In relation to banking contracts, Finance's guidance to agencies in February 1999 was that they should enter into separate agreements with their bankers. The audited agencies that remained with the RBA initially intended to use the existing Master Agreement for Banking Services between the Commonwealth Government (represented by Finance) and the RBA as the basis for individual agreements with the RBA. However, Finance, acting under legal advice, advised the RBA of its intention to terminate the Master Agreement in May 1999.¹⁸ Finance commissioned its legal adviser to draft a model agreement, for use by individual agencies, that became available in August 1999. In the interim, the audited agencies advised the RBA that they wished to receive services in accordance with the schedule provided by the RBA.¹⁹

2.14 Of the audited agencies, Finance, Customs and DTRS have formalised their arrangements with their bankers, DEST is in a position to finalise an agreement and DIMIA has interim arrangements in place while it market tests. Customs signed an agreement with the RBA in November 1999, after seeking legal advice as to the suitability of the interim service level agreement. However, subsequently, it did not sign a written agreement with its chosen provider until February 2001, ten months after completing its tender process. The Agreement for the Provision of Central Banking and Related Services between Finance and the RBA in relation to core banking services was executed on 4 August 2000.

¹⁸ The RBA received legal advice in January 1999 that the existing Master Agreement provided a sufficient basis for contracting with individual agencies, especially in view of the fact that agencies were expected at that time to market test reasonably soon after 1 July 1999. The RBA consequently did not agree to termination of the Master Agreement and it still operates.

¹⁹ Customs advised ANAO in September 2001 that, after seeking legal advice as to the suitability of the interim Service Level Agreement negotiated between Finance and the RBA, Customs signed the model contract with the RBA in November 1999.

2.15 Finding: Finance planned a trial of devolved banking, involving up to six agencies, during 1998–1999 and closely approximating the conditions under which agencies would operate from 1 July 1999. The trial did not proceed as Finance assessed that its main value had been gained from discussions with participating agencies about the operational arrangements. Finance circulated to all agencies documents that provided details of the banking framework and the specific responsibilities of agencies, and instituted an extensive communications program which included coverage of agency banking. Also, Finance monitored agencies' progress in implementing transactional banking and provided advice to agencies seeking guidance on the practicalities of devolved transactional banking. It completed substantial work to implement changes to the Accrual Information Management System and to make the legislative and regulatory changes accompanying the new arrangements. Finance requested that agencies certify their readiness for implementing devolved banking by 1 July 1999, including the ability to make payments and take receipts: all agencies did so.

2.16 In implementing devolved banking, Finance did not prepare as such a specific risk management plan. ANAO considers that greater assurance for all stakeholders would have been provided by Finance developing such a plan, identifying specific payment and revenue, contractual and operational risks at the whole-of-government and agency levels and providing mitigation strategies for each material risk.

2.17 Of the audited agencies, Finance and DTRS have formalised their arrangements with their bankers, DEST is in a position to finalise an agreement and DIMIA has interim arrangements in place while it market tests. Customs signed an agreement with the RBA in November 1999, after seeking legal advice as to the suitability of the interim service level agreement, but subsequently did not sign a written agreement with its chosen provider until February 2001, some ten months after completing its tender process. The Agreement for the Provision of Central Banking and Related Services between Finance and the RBA in relation to core banking services was executed on 4 August 2000.

Budget outcomes

2.18 The agency banking incentive scheme implemented by Finance in 1999–2000 along with devolved banking allows agencies to accrue interest from Finance on their agency daily balances and term deposits.²⁰ Key elements of the

²⁰ New arrangements for the drawdown of departmental appropriations were also introduced in 1999–2000. These are described in Part 2 of Finance's *Agency Banking Framework—Guidance Manual*.

scheme are: a reduction (or ‘clawback’) in agencies’ appropriations²¹ of the estimated amount of interest they would earn; the payment of higher rates of interest on term deposits than on current accounts;²² and penalties for the early redemption of term deposits.²³

2.19 Under the agency banking incentive scheme, Finance pays interest to agencies on overnight cash based on administratively determined rates set by Finance and higher market related rates on agencies’ term deposits. The RBA, acting as Finance’s agent,²⁴ calculates the interest owing and obtains authorisation from Finance to pay interest to agencies. The RBA transfers funds (after receiving authorisation from Finance) from the Official Interest Account (the account that records all interest paid by the RBA to agencies on behalf of Finance) to agencies’ departmental bank accounts. These transactions represent notional transfers between Commonwealth bank accounts as no payment at this stage is actually made from the Consolidated Revenue Fund. However, when interest is credited to agencies’ bank accounts, agencies are able to make payments under section 31 agreements,²⁵ as their total appropriations are increased.

2.20 The RBA’s advice to ANAO on the fiscal outcomes of the agency banking incentive scheme was that:

Under the incentive scheme Finance instituted as part of devolved banking, agencies earn interest from Finance on their departmental balances and term deposits. We understand that Finance clawed back from agencies’ budgets an amount equivalent to projected incentive payments, to ensure the Commonwealth’s aggregate financial position was unchanged by the introduction of transactional banking. However, in the first two years the scheme has been in operation, incentive payments by Finance to agencies appear to have exceeded Budget projections by a total of \$71 million, as summarised in Table 1. These figures probably need some explanation.

²¹ Constitutionally, an appropriation is an authority provided by the Parliament. This accords with section 83 of the Constitution for money to be drawn from the Consolidated Revenue Fund.

²² To encourage agencies to maximise their use of term deposits, Finance initially paid 100 basis points below the RBA cash rate target on agencies’ cash balances. From July 2000, Finance set the cash rate at 2 per cent (where it remains) compared to the RBA’s cash rate target of 6 per cent at that time. For comparison, at July 2000 the AOFM’s term deposit interest rate was 5.87 per cent and the RBA paid 5.90 per cent on cash balances held in the OPA.

²³ No interest is payable on early redemptions within the minimum term (7 days). Finance may apply a penalty where agencies continually withdraw deposits early, and interest rates for early repayment will be adjusted for the shorter term so that an agency is no better off for early withdrawal.

²⁴ Finance and RBA, *Agreement for the Provision of Central Banking and Related Services*, 15 August 2002.

²⁵ Section 31 of the *Financial Management and Accountability Act 1997* allows agencies to enter into agreements with the Minister for Finance and Administration for the purposes of items in Appropriation Acts that are marked ‘net appropriation’. Where a departmental appropriation is so annotated, section 31 arrangements allow departmental receipts to be paid into the relevant agency departmental bank accounts and held there until spent.

Finance may have clawed back these additional payments in subsequent periods. If not, the figures seem to suggest that Commonwealth outlays may have been around \$71 million higher than otherwise since transactional banking was introduced.

Table 1

Payments Under the Departmental Interest Incentive Scheme for Agencies

	<i>(A) Projected interest payments (\$m)</i>	<i>(B) Actual interest payments (\$m)</i>	<i>(B)-(A) Excess of Actual over Projected Payments (\$m)</i>
1999–2000	53.8 ¹	114.0 ²	+60.2
2000–2001	102.7 ³	113.7 ⁴	+11.0
Total	156.5	227.7	+71.2
Notes: 1. <i>Finance</i> Portfolio Budget Statement 1999–2000, Table 3.1, p. 61. 2. <i>Finance</i> , Annual Report 1999–2000, note 6b, p. 121. 3. <i>Finance</i> , Portfolio Budget Statement 2000–2001, Table 3.6, p. 58. 4. <i>Finance</i> , Annual Report 2000–2001, note 17, p. 148.			

Source: RBA advice to ANAO, November 2001.

2.21 Finance advised ANAO that there have been a number of benefits for the Commonwealth from the devolved and contestable banking structure, namely:

Agencies have achieved significant benefits through the introduction of contestability to the RBA's monopoly. Agencies have advised Finance that, stemming from market testing, they have achieved benefits including:

- improved service quality and responsiveness to their banking needs, eg through a single provider (and point of contact) for both transactional banker services and credit cards, and also through benefits of an expanded branch network. There have also been the harder to specify benefits of dealing with organisations that have as their bread and butter the need to establish productive and varied relations with their customers;*
- lower transactional banking fees, including for those remaining with the RBA;*
- better contract terms and conditions, including for those remaining with the RBA after market testing;*
- cost savings from improved business processes, including direct and indirect benefits to related business processes; and*
- better understanding of their business processes, leading to improved cash management.*

Some agencies have also advised that, because banking is an inter-connected service, they market tested a number of other activities, thereby producing similar significant synergistic benefits.

With direct responsibility for transactional banking and encouragement from the interest incentive scheme, agencies have become more aware of the time value of money and they have improved their cash management procedures (this view is supported by ANAO's Audit Report No. 10 2001–02, Management of Bank Accounts by Agencies).

2.22 In general terms, ANAO would expect benefits to the Commonwealth from greater certainty of cashflows. The underlying principle is that rates of return on short term investments of cash are usually lower than the rates paid on long term investments. Hence, moving cash into longer term investments may, over time, yield benefits to the Commonwealth. However, ANAO notes that the Australian Office of Financial Management (AOFM) was not provided with information from Finance on the investment payment of departmental funds until recently.²⁶ Timely information needs to be provided to the AOFM on agencies' term deposit holding intentions so as to inform its actual investment and borrowing decisions.

2.23 The AOFM advised ANAO that:

The AOFM agrees that timely information needs to be provided on agencies' term deposit holding intentions so as to assist in our investment and borrowing decisions. The departmental term deposit data that we currently receive from Finance does not provide this level of information and we therefore rely on our traditional outlay forecast activities to obtain regular forecasts for major departmental expenditures (e.g., public service salaries). We believe that any claimed benefit of greater certainty for Commonwealth cash management, as a result of departmental term deposits, will only materialise when the link between these term deposits and departmental expenditure (i.e., agency behaviour) is drawn explicitly to the AOFM. This view is based on our observation that the majority of agencies currently undertake departmental term deposits for relatively short periods of time, rolling them over continuously until a particular departmental expenditure occurs. From a Commonwealth cash management perspective, the AOFM is primarily concerned with the timing and magnitude of cash that will be flowing into and out of the Official Public Account (OPA). With regards to departmental term deposits, which are swept daily into the OPA, the

²⁶ The AOFM advised ANAO that: 'The AOFM notes that current Reserve Link [the RBA's transactional banking system] access only allows the AOFM to process requests to undertake term deposits with the Reserve Bank of Australia (RBA). The AOFM does not have access to review the daily departmental term deposit transactions for all Commonwealth agencies. As we understand it, such direct access could only occur by way of agreement between RBA and Finance, with Reserve Link software having to be reconfigured (at some cost to the Commonwealth). Given our reservations with the current quality of the information, from the perspective of Commonwealth cash management, we would therefore be reticent to pursue this option.'

AOFM is therefore focused on when these term deposits actually leave the OPA. It is this information set (i.e., agencies' term deposit holding intentions) that the AOFM requires when making investment and borrowing decisions. Whilst the data provided by Finance informs us as to when a departmental term deposit will mature, it does not provide any assurance or certainty that this money will leave the OPA, given the propensity for agencies to immediately 'roll it over' for a further term.

Budgetary administration

2.24 To facilitate the agency banking incentive scheme, Finance's administered appropriations were increased to fund interest payments to agencies, and agencies' section 31 agreements were amended so that interest payments from Finance could be included in agencies' departmental appropriations. At the same time, agencies' departmental appropriations were reduced with the objective of ensuring the scheme was Budget neutral, that is, that it would have no effect on Budget outlays overall. In 1999–2000 agencies' appropriations were reduced by \$55 million (see Figure 2.2) . In March 2000, the then Minister for Finance and Administration wrote to the Prime Minister and to the Treasurer advising that agencies' appropriations would be reduced by \$80.4 million in 2000–2001. The then Minister also proposed in this correspondence that, *in future years, adjustments to FMA Act agency estimates stemming from the devolved banking arrangements [would] be made prior to the Budget each year and settled in correspondence between [the Prime Minister and Treasurer].* This did not occur in respect of 2001–2002 nor did Finance advise agencies of clawback arrangements to apply in 2001–2002.

2.25 In March 2002, Finance advised ANAO that:

In 2001–2002 agencies' appropriations were reduced by \$48 million. These figures are incorporated into the 2002–2003 estimates and out years. The full amount of clawback, ie above \$48 million, for 2001–2002 cannot be readily determined because adjustments to estimates include other measures as well as interest.

Finance can confirm that agencies were instructed to claw interest back in 2000–2001. Evidence exists in the AIMS system that adjusting entries occurred. Two agencies, Defence and Finance, which earned 50 per cent of the interest, did not have the interest clawback separately identified in their AIMS journals, but they have confirmed that the clawback occurred.

Finance advised ANAO in discussions that existing interest clawback arrangements made through reductions in agency appropriations did not cease after 2000–2001, but were replaced by estimate variations and discounting agency output pricing reviews for interest revenue.

2.26 In the absence of formal advice from Finance, only some agencies²⁷ continued to have their appropriations reduced in accordance with maintaining budget neutrality in 2001–2002. As such, no correspondence was prepared for Ministers' consideration on this issue but reductions of some \$49 million were made to some agencies' appropriation estimates. There has not been a systematic approach adopted by Finance to agency budget reductions for 2001–2002: some budgets were reduced, others were not. This represents a significant control

Figure 2.2

Budgetary Impact on a Cash Outcome Basis of Agency Banking Incentive Scheme: 1999-2000 to 2001-2002.

Item	1999-2000 (Actual) \$m	2000-2001 (Actual) \$m	2001-2002 (Estimate) \$m
• Interest Credited to Agencies' Accounts	77.4 ¹	147.4 ²	85.8 ³
• Finance Capital Appropriation	n.a.	24.5 ⁴	n.a.
• Sub-total	77.4	171.9	85.8
• Less: Clawback of Agencies' Appropriations	55.0 ⁵	80.4 ⁵	48.9 ⁶
• Net Budget Position ⁷	(22.4)	(91.5)	(36.9)

Notes:

1. In 1999-2000, the RBA credited \$91 million to agency bank accounts (excluding \$9.9 million of interest withheld by RBA at the direction of Finance and not paid) comprising: \$70.4 million interest on term deposits; and \$20.6 million interest on overnight cash balances, which is credited quarterly. The total paid excludes \$14.2 million interest credited to Finance's Departmental Bank Account and returned by them to Consolidated Revenue on 24 March 2000; and includes \$0.6 million credited to agencies by Finance for interest earned in 1999-2000, giving the net result of \$77.4 million paid.
2. In 2000-2001, the RBA credited \$158.7 million to agency bank accounts, comprising: \$143.7 million interest on term deposits; and \$15 million interest on overnight cash balances. The net total excludes agency interest of \$11.3 million derived from early draw-downs and account classification errors and thus reduced from the amount paid to agencies.
3. ANAO estimate based on pro-rated RBA credits to agency bank accounts for the period July 2001 to March 2002.
4. Finance advice to ANAO of 5 April 2002 was that the Department was provided with a Capital Appropriation (*Appropriation Act (No.2) 2000-01*) of \$24.5 million. This covered the repayment of \$14.2 million interest earned by Finance in 1999-2000 and repaid to Consolidated Revenue; \$9.9 million of interest for the period 24 March 2000 to 30 June 2000 withheld by the RBA at Finance's direction; and other mostly interest-related adjustments of \$0.4 million. RBA has confirmed to ANAO that Finance has not requested payment of the \$9.9 million of interest withheld and Finance advised ANAO that this interest was appropriated as a capital injection in 2000-2001.
5. Finance Ministerial Briefing of 9 March 2000.
6. Finance advice to ANAO of 12 March 2002, on agency clawback of appropriations for 2001-2002.
7. Finance advised ANAO on 3 April 2002 that: *The interest paid figures include payments to Finance special accounts of \$48.6 million in 2000-2001 and \$12.8 million in 2001-2002. Special account balances (including interest earned) are quarantined from the ordinary activities of Departments. Finance notes that these interest earnings have contributed to dividend payments to Government of \$71.7 million in 1999-2000 and \$142 million in 2000-2001. Accordingly, the total 'net cash budget position' of \$150.8 million is overstated to the extent of the interest component of the dividend payments from the special account balances.*

Sources: RBA records of agency bank interest payments, Finance advice and documentation and ANAO estimate.

²⁷ Some large agencies had no reduction in appropriation at all, others had as little as 10 per cent applied, while others had significantly more clawback applied than their projected interest earnings.

weakness in the department's budgetary processes with a direct impact on the 2001–2002 Budget, as interest payments to agencies are expected to be \$86 million.

2.27 In *Appropriation Act (No. 1) 1999–2000* Finance was appropriated \$53.8 million for the purpose of making interest payments to agencies, as part of the appropriation for its Outcome 2: Improved and More Efficient Government Operations. Actual interest paid by the RBA on Finance's behalf in 1999–2000 was \$91 million (see Figure 2.2, note 1). To enable the Department to stay within its appropriation for Outcome 2, Finance voluntarily returned to the Consolidated Revenue Fund \$14.2 million that it received in departmental interest payments in the period July 1999 to March 2000. Finance also instructed the RBA to withhold payment of \$9.9 million in interest owing to Finance for the period April to June 2000. Finance subsequently raised a departmental receivable (or amount owing to Finance) of \$24.5 million for the interest it returned to Consolidated Revenue and the amount of interest due to Finance but not paid for the period April to June 2000. In the following year Finance was appropriated this \$24.5 million from an administered capital item in *Appropriation Act (No. 2) 2000–2001*.

2.28 In March 2002, Finance advised ANAO that: *'All agencies reflected interest revenue and expense in the year in which it was receivable or payable—ie 1999–2000. Finance's actions however resulted in the underlying cash transaction being received or paid in the year 2000–2001'*. Finance's actions effectively shifted the Budget impact between the financial years 1999–2000 and 2000–2001.

2.29 In *Appropriation Act (No.1) 2000–2001*, Finance was appropriated \$97.5 million²⁸ to fund agency interest payments and in *Appropriation Act (No. 2) 2000–2001* was appropriated \$24.5 million as an administered capital item to fund the interest accruing from 1999–2000. Finance's appropriation for agency banking incentive payments was increased further when it received \$20.6 million through Advances to the Finance Minister in the June quarter 2001. Total net interest paid for 2000–2001 amounted to some \$147 million, within Finance's total appropriation for Outcome 2.²⁹

2.30 In May 2001, Finance sought legal advice on removing the need for appropriations to authorise the transfer of such interest to agencies' bank accounts. The legal advice received by Finance confirmed that the department's proposed new funding arrangements could be implemented, (that is, no specific appropriation would be required) but noted that this raised policy issues about consistent treatment of notional transactions. Finance's legal adviser noted that:

²⁸ Finance Portfolio Budget Statement 2000–2001, Table 2.3.2, p. 37.

²⁹ In 2000–2001 total Administrative Appropriations for Finance Outcome 2 was \$215.7 million, comprising: Appropriation Act credits of \$186.1 million; Advance to the Finance Minister of \$20.8 million; Section 30A Appropriations of \$0.2 million; and the balance of 1999–2000 appropriations carried to 2000–2001 of \$8.6 million.

In my view, the payment of 'interest' to agencies by your Department is clearly a notional transaction of the kind contemplated by section 5 of the Appropriation Acts. However, as stated above, there is no constitutional need nor, as explained in my earlier advice, any other legal obligation under the Appropriation Acts to draw such amounts down from an appropriation. However, the transfer of such amounts without an appropriation will no doubt raise policy issues, given the fact that notional payments are generally drawn down from appropriations and presumably the intention is to treat all notional transactions on the same basis, unless there are special circumstances, such as were considered to exist in relation to the GST remittances considered in my earlier advice.

2.31 In 2001–2002, Finance did not seek an appropriation for agency interest payments. The bank interest earned by agencies, estimated by ANAO at \$86 million in 2001–2002, will be added to agencies' appropriations under section 31 agreements, provided for by the FMA Act.³⁰ The 2001–2002 Budget accounts for the reduction in agency appropriations of some \$49 million for clawback arrangements, but this is \$37 million less than the estimated total interest earned by agencies in 2001–2002. Finance's 2001–2002 Portfolio Budget Statements note that reporting of bank interest was transferred from Finance to the Crown from 2001–2002. However, agencies' financial statements will report the increase in agency resourcing flowing from section 31 agreements.

2.32 For reasons of financial transparency and public accountability, the conventional administrative practice of the Commonwealth has been for payments between agencies to be covered by an appropriation. Indeed, section 5 of the Appropriation Act recognises that notional transactions between agencies are to be treated as real transactions. The decision by Finance to move away from conventional budgetary practice in 2001–2002, by not having an appropriation to cover significant Commonwealth resourcing, raises important accountability issues. The fact that the Constitution allows transfers between agency accounts which form part of the Consolidated Revenue Fund without an appropriation does not detract from the need for budgetary transparency and accountability for payments between agencies to ensure public confidence in the probity of agency resourcing.

2.33 Finance advised ANAO in February 2002 that:

In establishing the agency banking proposal, the potentially conflicting objectives of genuine financial incentives for agencies to improve cash management practices and budget neutrality were canvassed. They contributed to the subsequent inconsistency with which the scheme was administered.

³⁰ Finance advised ANAO that for 2001–2002 a zero expenditure for agency bank interest was incorporated in the *Interest and other financing costs/Interest* reported in Budget Paper No.1, Statement 10, page 10-4, table 1.

The scheme has not been budget neutral since its inception in that agencies have received departmental expenses in excess of the reductions applied to their appropriations. However, the additional interest revenue has derived from interest earned by the Commonwealth as a whole on cash balances.

To the extent that agencies have been subject to output pricing reviews and/or ERC decisions that have affected departmental expenses, the additional interest revenue has been taken into account in determining the revised prices of their outputs and/or prices for new or changed outputs.

2.34 In actual cash budgetary terms, agencies gained some \$22.4 million in additional resources³¹ in 1999–2000 and \$91.5 million in 2000–2001 (See Figure 2.2). An additional \$37 million in resources is forecast to flow to agencies under the scheme in 2001–2002. By the completion of this fiscal year the scheme will be non-budget neutral in cash terms to the extent of approximately \$151 million. ANAO notes that, with the alteration of the interest clawback arrangements from July 2001, there is no comprehensive mechanism in place to recover these additional resources directly from agencies, in conformity with the requirement for a Budget neutral outcome. Finance has stated that other mechanisms (output price reviews³² and ERC decisions) ensure funding to agencies is appropriate and that interest is taken into account. While accepting that such processes can take interest revenue into account, they are not as responsive as other, more direct approaches to achieving Budget neutrality. ANAO suggests that this aspect could be reconsidered in the light of the policy objectives for this measure.

2.35 Finding: Finance’s administered appropriations were increased to fund interest payments to agencies. At the same time, agencies’ departmental appropriations were reduced with the objective of ensuring the scheme was Budget neutral. In 1999–2000, agencies’ appropriations were reduced by \$55 million. In March 2000, the then Minister for Finance and Administration wrote to the Prime Minister and Treasurer advising that agencies appropriations would be reduced by \$80.4 million in 2000–2001. In 2001–2002, no correspondence was prepared for Ministers’ consideration on this issue but reductions of some \$49 million were made to some agencies’ appropriation estimates. There has not been a systematic approach adopted by Finance to agency budget reductions for 2001–2002: some budgets were reduced, others were not. This represents a significant control weakness in the department’s budgetary processes with a direct impact on the 2001–2002 Budget, as interest payments to agencies are expected to be \$86 million.

³¹ Interest revenue paid by Finance is appropriated to agencies’ accounts.

³² An output pricing review is a review of the amount paid by the Government to agencies for the delivery of agreed outputs.

2.36 In actual cash budgetary terms, agencies gained some \$22.4 million in additional resources in 1999–2000 and \$91.5 million in 2000–2001. An additional \$37 million in resources is forecast to flow to agencies under the scheme in 2001–2002. By the completion of this fiscal year the scheme will be non-budget neutral in cash terms to the extent of approximately \$151 million. ANAO notes that, with the variations of the interest clawback arrangements from July 2001, there is no comprehensive mechanism in place to directly recover these additional resources from agencies, in conformity with the requirement for a Budget neutral outcome. Finance has stated that other mechanisms (output price reviews and ERC decisions) ensure funding to agencies is appropriate and that interest is taken into account. While accepting that such processes can take interest revenue into account, they are not as responsive as other, more direct approaches to achieving Budget neutrality. ANAO suggests that this aspect could be reconsidered in the light of the policy objectives for this measure.

2.37 In *Appropriation Act (No. 1) 1999–2000* Finance was appropriated \$53.8 million for the purpose of making interest payments to agencies, as part of the appropriation for its Outcome 2: Improved and More Efficient Government Operations. Actual interest paid on Finance’s behalf in 1999–2000 was \$91 million. To enable the Department to stay within its appropriation for Outcome 2, Finance voluntarily returned to the Consolidated Revenue Fund \$14.2 million that it received in departmental interest payments in the period July 1999 to March 2000. Finance also instructed the RBA to withhold payment of \$9.9 million in interest owing to Finance for the period April to June 2000. Finance subsequently raised a departmental receivable (or amount owing to Finance) of \$24.5 million for the interest it returned to Consolidated Revenue and the amount of interest due to Finance but not paid for the period April to June 2000. In the following year Finance was appropriated this \$24.5 million from an administered capital item in *Appropriation Act (No. 2) 2000–2001*. Finance’s actions effectively shifted the Budget impact between the financial years 1999–2000 and 2000–2001.

2.38 For reasons of financial transparency and public accountability, the conventional administrative practice of the Commonwealth has been for payments between agencies to be covered by an appropriation. Unlike previous years however, in 2001–2002 Finance did not seek an appropriation for agency interest payments estimated at \$86 million. The decision by Finance to move away from conventional budgetary practice in 2001–2002, by not having an appropriation to cover significant Commonwealth resourcing, raises important accountability issues. The fact that the Constitution allows transfers between agency accounts which form part of the Consolidated Revenue Fund does not detract from the need for budgetary transparency and accountability

for payments between agencies to ensure public confidence in the probity of agency resourcing.

Audited agencies

2.39 DEST, DIMIA, DTRS and Customs adopted a minimum change approach in implementing devolved banking, focussing on ensuring they could make payments and take receipts from 1 July 1999. The audited agencies weighed the risk of changing providers for the making of payments to Government program customers and the States against the possible costs of transition to a new provider; the pressure from other reform initiatives; time constraints; in-house skills and experience; and (in at least one instance) the costs of commercial banks' settlement arrangements. In the time available, however, they advised that they were not fully able to test and document banking procedures, establish controls (such as bank account reconciliation and bank account registers) or execute contracts. In relation to the time available, Finance advised ANAO in September 2001 that:

We believe that agencies had sufficient time to implement the agency banking framework and market test, as reflected by Finance being able to successfully do so prior to 1 July 1999. Additionally, agencies have advised Finance that 4.5 months was sufficient time to implement the agency banking framework. This is proved by the successful implementation from 1 July 1999. Also, sufficient notice and detail was given of the agency banking framework in 1998 to allow agencies to acquire/build in-house skills and experience. As discussed, agencies have advised Finance that due to the early notice of the forthcoming changes in 1998,³³ they were able to begin preparations for devolved banking including the procurement/recruitment of the necessary staff and experience to transact the changes.

2.40 The audited agencies, apart from Finance, continued existing banking arrangements with the RBA, adjusting administrative systems as necessary. All audited agencies were able to make payments and take receipts from 1 July 1999. To achieve this, the audited agencies assumed extra responsibilities and tasks without interrupting continuity of payments to beneficiaries and grantees. Other agencies decided to modify their financial management systems to transmit payment information to the RBA themselves. However, DIMIA, DEST and DTRS experienced system development delays and were still testing the transmission of payment information to the RBA just before (and, in some cases, after) 1 July 1999.

³³ In November 1998.

2.41 While all agencies are required to market test under the new banking arrangements, initial progress has been modest.³⁴ Only Finance completed market testing for banking services prior to 1 July 1999.³⁵ The Department completed its tender process in April 1999 and established an implementation plan with its selected provider. Finance's banking services were undertaken by its selected provider from 1 July 1999.

2.42 The decision of the other audited agencies to take more time to market test banking services arose from their perception of the immediate risks and benefits. Customs has now completed its tendering processes. As of January 2002, DIMIA and DTRS were in the process of market testing their banking services and DEST was preparing to do so.

2.43 Finance wrote to agencies in November 1999 asking how it could provide further assistance and, as a result of these consultations, in November 2000 provided agencies with tools to facilitate market testing. The tools included a model contract for banking services, a banking services needs analysis checklist, a model request for tender and a list of institutions which, in Finance's assessment, could comply with the core requirements and would agree to the model contract.

2.44 Finding: The audited agencies weighed the risk of changing providers for the making of payments to Government program customers and the States against the possible costs of transition to a new provider; the pressure from other reform initiatives; time constraints; in-house skills and experience; and (in at least one instance) the costs of commercial banks' settlement arrangements. All audited agencies were able to make payments and take receipts from 1 July 1999. To achieve this, the audited agencies assumed extra responsibilities and tasks without interrupting continuity of payments to beneficiaries and grantees.

2.45 While all agencies are required to market test under the new banking arrangements, initial progress has been modest. Of the five audited agencies, only two had completed market testing by July 2001. The decision of the other audited agencies to market test banking services arose from their perception of the immediate risks and benefits.

³⁴ In September 2001, Finance advised ANAO that, as at 30 June 2001, 26 agencies had market tested and agencies had advised Finance in a survey conducted in 2000-2001 that, by November 2001, a further 26 were to have completed market testing.

³⁵ The former Office of Asset Sales and Information Technology Outsourcing (OASITO) and the Commonwealth Grants Commission were also included in the Finance tender.

Internal control procedures

2.46 An essential element of implementation was for agencies to establish a framework of internal controls to support devolved transactional banking (see Figure 2.3). It is good administrative practice to ensure that Chief Executive's Instructions (CEIs) and the accompanying financial procedures are adequately maintained to assist officers to properly manage Commonwealth funds. Section 45 of the FMA Act requires that agencies have a fraud control plan and it is necessary for agencies to consider the management of banking in the preparation of their fraud control plan.

2.47 Among the audited agencies, DEST demonstrated good practice. Its CEIs and financial procedures were updated to reflect the changes and it considered the fraud implications of transactional banking. The other audited agencies did not update their CEIs and procedural instructions initially but are aware of the importance of procedural instructions and, at the time of audit fieldwork, had taken, or were taking, steps to bring them up to date.³⁶

2.48 The periodic internal review of banking arrangements is a useful means of detecting control weaknesses and a basis for addressing them systematically. Most of the audited agencies have undertaken an internal audit review of banking arrangements and have progressed towards implementation of the recommendations made.

³⁶ Agency internal controls over cash and the impact of the cash management incentive scheme are considered in an ANAO Assurance Control and Assessment (ACA), Audit Report No. 10 2001-02 *Management of Bank Accounts by Agencies*. The ACA audit concluded that, in respect to the day-to-day operation of bank accounts, the internal control framework established by agencies was generally satisfactory. However, it also found that CEIs related to banking had not been updated in some agencies to reflect the new arrangements, that agencies' practices were not always consistent with the policies and procedures established by their internal control frameworks and that better practice could be achieved through improvements in agencies' internal control frameworks.

Figure 2.3

Issues to consider - internal control procedures

A robust internal control framework provides a solid base for effective cash management and core requirement compliance, as well as limiting the risk of fraud and other misuse of public money. An effective control framework for banking activities would give appropriate weight to:

- regular review of Chief Executive's Instructions and dependent administrative procedures;
- secure storage of banking records;
- providing the RBA (Central Bank) with details of all official accounts, as required under the Finance Minister's delegations;
- ensuring the management of banking is considered in the preparation of the agency's fraud control plan;
- establishing proper authorisation for opening and closing bank accounts. Authorisation for opening bank accounts needs to be managed by an agency's central treasury unit, with a very restricted number of delegates permitted to open and close accounts;
- proper maintenance of bank account registers. Agencies need to have a complete and valid register of bank accounts. Registers need to include, for each account, the account title, account number, bank and branch, purpose of the account, the date opened, signatories and the approving delegate;
- mapping of subsidiary accounts to head bank accounts. Under the new arrangements, agencies are required to open three bank accounts (where applicable): an official departmental account; an official administered payments account; and an official administered receipts account. In addition to these "head" accounts, agencies may operate additional accounts or sub-accounts, but they need to ensure that subsidiary accounts are linked to the head accounts so that sweeping can take place;
- separation of administered and departmental monies and reconciliation against appropriations. As Finance is no longer able to check agency expenditure against appropriations, it is imperative that agencies establish proper accounting practices to ensure they do not over spend their appropriations;
- regular reconciliation of accounts. Frequent reconciliation of bank statements with accounting records is essential to proper cash management;

- periodic review of accounts with a view to minimising the number of bank accounts. Agencies need to regularly review their accounts with a view to maintaining the minimum number of accounts necessary. More accounts bring more fees, more complexity and greater risks—it is all too easy to miss accounts within a complex account structure; and
- conducting periodic internal audits or reviews of banking arrangements.

Source: ANAO analysis.

2.49 In relation to other control procedures, ANAO found that in three of the five audited agencies bank reconciliation processes were not properly established and in two of the five bank account registers were incomplete.³⁷ Bank account registers are essential for ensuring that subsidiary accounts are linked to head accounts for sweeping; for optimising account structures; and, thus, for minimising fees.

2.50 Finding: An essential element of implementation was for agencies to establish a framework of internal controls to support devolved banking. The periodic internal review of banking arrangements and risk management plans is a useful means of detecting control weaknesses and a basis for addressing them systematically. Most of the audited agencies have undertaken an internal audit review of banking arrangements and have progressed towards implementation of the recommendations made.

2.51 ANAO found that in three of the five audited agencies bank reconciliation processes were not properly established and two audited agencies' bank account registers were incomplete. DEST's CEIs and financial procedures were updated to reflect the changes and it considered the fraud implications of transactional banking. The other audited agencies did not update their CEIs and procedural instructions initially but are aware of the importance of procedural instructions and at the time of audit fieldwork were taking steps to bring them up to date.

Recommendation No. 1:

2.52 ANAO *recommends* that agencies regularly review their internal controls relating to banking, particularly bank reconciliation processes, bank account registers, Chief Executive's Instructions and operational procedures.

Agencies responded to the recommendation as follows:

2.53 Agreed: Finance, DIMIA, DEST, DTRS and Customs.

³⁷ The ACA audit also found that a majority of the seven agencies included in its coverage had not undertaken bank reconciliations in a timely manner.

2.54 Specific comments by agencies are set out below:

- **Finance:** Under the transactional banking framework, the Finance Minister's delegations place responsibility with agency chief executives for opening and maintaining their agency's transactional banking accounts. Finance has fully documented procedures covering transactional banking practices. These procedures constitute a sound internal control framework and are reviewed on a regular basis.
- **DIMIA:** DIMIA will ensure internal controls relating to banking are regularly reviewed. As part of its annual audit of financial statements ANAO identified several issues relating to bank reconciliation processes and these are being addressed. DIMIA is currently conducting a review of Chief Executive Instructions and Administrative Circulars.
- **DEST:** This represents sound management practices.
- **Customs:** Internal Audit is undertaking an ongoing review of Treasury operations with a particular focus on bank reconciliations. A central bank account register is maintained and kept up-to-date by Customs Treasury Unit. Operational procedures and in particular the Treasury Framework are being reviewed in line with recent changes to the Chief Executive Instructions.

Risk Management

2.55 Risk management plans desirably should be prepared at the strategic, business and operational or process levels for an organisation. In this context, agencies need to have an effective risk management plan that addresses banking processes. Risk management plans typically include: a description of the agency environment; a description of risks; a description of consequences and likelihood of the identified risks occurring; and actions to manage (by mitigation, transfer, removal or acceptance) each of the identified risks. For banking, whether with the RBA or a private sector bank, devolved or centralised, the key continuing risks that need to be managed by agencies include:

- potential loss of interest through sub-optimal cash management;
- potential inability to obtain value for money from banking service providers;
- the risk of fraud and misuse of public money; and
- potential inability to make payments to the Commonwealth's creditors and program beneficiaries on time.

2.56 The management of these risks by agencies requires: ensuring that payments are made at the optimal time and that balances in agency accounts are available for central investment; maintaining efficient and effective receipting processes; including the core requirements in contracts and effective management by agencies to ensure adherence to the core requirements; and analysing all relevant costs in assessing value for money as part of the market testing process.

2.57 Only one agency (DEST) had taken steps to ensure banking arrangements were addressed in its agency risk management plan at the time of implementation. Following internal audit review, three other agencies are implementing risk management plans for transactional banking.

2.58 Finding: Agencies desirably should have an effective risk management plan that covers banking processes. Risk management plans typically include: a description of the agency environment; a description of risks; a description of consequences and likelihood of the identified risks occurring; and actions to manage (by mitigation, transfer, removal or acceptance) each of the identified risks. Only one agency (DEST) had taken steps to ensure transactional banking arrangements were addressed in its agency risk management plan at the time of implementation. Following internal audit review, three other agencies are implementing risk management plans for banking.

Recommendation No. 2:

2.59 ANAO *recommends* that all agencies regularly review their risk assessment and management plans to ensure the continued effectiveness and efficiency of their banking arrangements.

Agencies responded to the recommendation as follows:

2.60 Agreed: Finance, DIMIA, DEST, DTRS and Customs.

2.61 Specific comments by agencies are set out below:

- **Finance:** Under the *Financial Management and Accountability Act 1997* chief executives are responsible for the efficient, effective and ethical use of resources. The regular review of risk assessment and management plans is supported as a measure to ensure transactional banking arrangements operate with effectiveness and efficiency.
- **DIMIA:** The Department is taking steps to ensure that its risk assessment and management plan includes the recognition and management of risks involved in transactional banking processes.
- **DEST:** The Department reviews its risk assessment plans at least annually.

- **Customs:** As a result of the devolved banking process Customs understands the need to fully review its risk assessment and management policy. A complete review of the Treasury Framework has already commenced, with new guidelines complementing existing Chief Executive Instructions. The primary goals of this review are to promote consistency within the organisation in relation to dealings with the Treasury Unit, and the proactive management of risk assessment.

3. Core Requirements Implementation

This chapter describes the Commonwealth's framework for optimising its cash flows and investment in respect of banking (the core requirements); and the implementation of the core requirements for account sweeping and payment settlement.

Core requirement management

3.1 The Finance Minister's delegations approved in April 1999 and effective from 1 July 1999 required agencies to ensure that banks adhered to five core requirements for banking services, namely:

- *Funding of official accounts and transfer of value:* In principle, administered funds will be provided to the transactional banker no sooner than required to make payments. Value for time-sensitive payments will be paid away by the banker without delay;
- *Administered receipts sweeping:* The balance of administered receipts accounts will be transferred daily to an official account maintained by the Commonwealth for this purpose at the RBA. These balances are not returned to the banker;
- *Overnight sweeping of administered payments and departmental accounts:* Amounts equivalent to the aggregate of the balances in agencies' administered payment accounts and departmental accounts will be swept to the RBA overnight and returned to the banker the following morning. The zero aggregate cash balances overnight mean that the relationship between bankers and agencies of the Commonwealth does not extend to the payment of interest;
- *Group set-off:* A banker shall each day be capable of determining the aggregate of the balances of all official accounts, other than administered receipts accounts held by agencies; and
- *Information requirements: balance of official accounts:* The banker will provide daily to the RBA (Central Bank) information on aggregate balances swept and the balances of individual agency accounts as well as total debits and credits to them.

3.2 The Finance Minister amended his delegations in October 2001 clarifying a number of requirements including account sweeping, transfer of value, information reporting and establishment and maintenance of bank accounts. The amended delegations explicitly provide for same-day settlement for all departmental and administered payments made by direct entry, consistent with

the Bulk Electronic Clearing System (BECS) rule changes which operated from mid January 2002.

3.3 Finance issued a Request for Proposal (RFP) to 11 banks for listing on the banking services pre-qualification panel in July 2000. Subsequently, Finance formed an Assessment Committee to evaluate the RFP responses from banks wishing to provide banking services to Commonwealth agencies. Finance advised ANAO that:

Seven banks provided responses to the RFP. Each bank's response included a declaration and a Statement of Compliance in relation to the bank's ability or willingness to meet the requirements of the core protocols and the banking model contract. With a view to focusing core protocol compliance on individual agency business requirements, Finance advised agencies of the need to ensure compliance with the core protocols by transactional bankers through the Market Testing Toolkit, that contains the pre-qualification list.³⁸

3.4 The core requirements replicate the Commonwealth's pre-1 July 1999 framework for optimising its cash flows and investment. The first requirement (for account funding) is intended to duplicate the essential purpose of the Government Direct Entry Service (GDES),³⁹ developed and put into operation by the RBA under the terms of its December 1993 contract with the then Department of Finance (DOF).⁴⁰ GDES was commissioned in December 1993 to reduce revenue risk by retaining the Commonwealth's funds until the same day required to make payments, thus maximising the Commonwealth's ability to earn interest on its funds.⁴¹

3.5 The second and third core requirements (for sweeping) are intended to ensure that the sum of the Commonwealth's funds held in agencies' accounts is returned to the OPA for overnight investment, reducing revenue risk due to sub-optimal cash management and assisting the RBA to manage banking system

³⁸ Source: Finance advice, 15 November 2001. The relevant extract of the *Pre-Qualification Section* of the *Market Testing Toolkit* reads: 'Agencies will need to ensure that compliance with the Core Protocols and draft conditions of contract are addressed in the tender process. It will be a matter for individual agencies to ensure the capability of a selected [banker] in respect of the Core Protocols, through systems testing if necessary, prior to the signing of any contract.'

³⁹ The proprietary RBA system developed to the Commonwealth's specifications including same-day settlement used to process Commonwealth payments under bilateral arrangements with BECS members.

⁴⁰ The agreed specifications for the system required that: 'The existing arrangements for Government direct credit transactions will continue, that is, value on pay-day.' Source: Department of Finance, GDES Requirements, p. 24, 26 March 1991.

⁴¹ Clause 6.3 of the GDES contract between the Commonwealth of Australia, represented by the Department of Finance, and the Reserve Bank of Australia, states that: 'The Reserve Bank will be responsible for calculating the daily settlement value of each [batch of payments] and passing value to the appropriate Client Financial Institution on the date on which payment is due. The Reserve Bank will only debit or credit as the case may be the Commonwealth Government drawing accounts on that day for the agreed value of the [batch of payments] summary file (less the value of successful Recalls).'

liquidity.⁴² This replicates the situation prior to 1 July 1999, when almost all Commonwealth funds were held centrally and were directly available for overnight investment. The last two core requirements (for the group set-off and balance information) are needed to give effect to the first three core requirements under the devolved banking framework.

3.6 Under the Finance Minister's delegations, agencies are responsible for compliance with the core requirements and are to provide an annual certificate either confirming compliance or detailing circumstances of non-compliance. The risk of loss through non-sweeping of accounts is addressed by: agencies being required to notify the RBA of the details of each official account opened and maintained in Australia; and bankers being required to notify the balance of each official account at the conclusion of the banking day.

3.7 After the introduction of devolved banking, the RBA⁴³ and relevant commercial banks advised Finance of instances where the balances of official accounts appeared not to be swept to the OPA daily, as specified by the core requirements. This led to interest shortfalls for the Commonwealth as interest is paid by the RBA on the aggregate overnight balance swept to the OPA but is not paid by commercial bankers on any amounts that are not swept. If compensation for interest shortfalls had not subsequently been recovered, the Commonwealth would not have received the interest benefit of the unswept funds.

3.8 Among the audited agencies, interest shortfalls amounted to:

- \$670 000 for Customs in the period September 2000 to November 2000 due to non-sweeping of accounts. In September 2001, Customs advised ANAO that it had advised its transactional banker of the correct account sweeping structure and that the bank's failure to comply with the core sweeping protocols and the subsequent recoupment of Commonwealth funds was resolved by Customs' banker and Finance;
- \$17 800 for Finance due to the non sweeping of two accounts; and

⁴² Sweeping of accounts (except for some administered receipts) takes place on the morning after the banking day (that is, banks hold Commonwealth cash balances overnight and can invest them). When the RBA sweeps funds from accounts held with commercial banks, it claws back an amount to compensate for the loss of interest to the Commonwealth. That is, each morning the RBA charges banks an amount equivalent to the interest the bank would have earned on Commonwealth balances if they had been held overnight in the banks' exchange settlement accounts. The applicable rate of interest is the Cash Settlement Rate, which is set 25 basis points below the Target Cash Rate.

⁴³ While the RBA is not in a position to know about the cash flows between an agency and its banker, major defects in sweeping are likely to show up as errors in the RBA's daily forecasts of the liquidity of domestic markets. Clauses 5c and 5f of the 15 August 2000 agreement between the RBA and Finance for the *Provision of Central Banking and Related Services* require the RBA to notify Finance of amounts swept and the balances of agency accounts. The RBA agrees to: '... pay interest on the aggregate overnight balances of the Core Accounts ... [and to] provide DOFA with reports on ... the conduct of Core Accounts ... data contained in the Agency account shadow file; and ... Agency interest and term deposit schemes.' Clause 10.3 requires the RBA to inform Finance of instances in which a transactional banker fails to meet its obligations with respect to the sweeping of accounts and the relevant circumstances.

- \$5 500 for DIMIA in the period July 1999 to November 1999, due to the inability of the banker to automatically sweep the balance of DIMIA bank accounts to the OPA.

3.9 Interest shortfalls in agencies not included in the audit amounted to approximately \$600 000. Altogether, interest shortfalls found during the audit amount to approximately \$1.3 million. Finance, with agencies, has subsequently recovered the interest shortfalls to the Commonwealth.

3.10 Finding: Subsequent to the introduction of devolved banking, the RBA and relevant commercial banks advised Finance of instances where the daily balances of official accounts appeared not to be swept to the OPA daily, as specified by the core requirements. This led to interest shortfalls for the Commonwealth as interest is paid by the RBA on the overnight balances of accounts swept to the OPA but is not paid by commercial bankers on any amounts that are not swept. Altogether, interest shortfalls identified during the audit amounted to approximately \$1.3 million. Among the audited agencies, interest shortfalls amounted to approximately \$0.7 million. Shortfalls in agencies not included in the audit amounted to approximately \$0.6 million. Finance, with agencies, has undertaken corrective action to recover the shortfalls to the Commonwealth.

Recommendation No. 3:

3.11 ANAO *recommends* that agencies improve monitoring of core requirement compliance by their banks by periodically reconciling amounts swept with their own financial records.

Agencies responded to the recommendation as follows:

3.12 **Agreed:** Finance, DIMIA, DEST and DTRS.

Agreed with qualification: Customs

3.13 Specific comments by agencies are set out below:

- **Finance:** Agencies should be undertaking this activity as part of their normal compliance procedures for transactional banking operations. Finance has put in place procedures for periodically monitoring the sweeping of balances by its transactional banker.
- **DIMIA:** DIMIA bank accounts not with the RBA are monitored daily to ensure that balances are swept to the RBA as required under the core protocols.
- **DEST:** The Department is with the RBA and its balances are swept daily. A reconciliation of amounts swept with its own financial records is performed on a monthly basis.

- **Customs:** Agreed in principle, however some monitoring is impractical to perform. Customs performs a monthly CAMM reconciliation to confirm the transfer of administered funds to Finance. The timing of overnight transfers cannot be monitored. Customs also reviews the administered accounts on a daily basis to ensure that the transactional banker sweeps deposits. Despite the fact that Customs has no way of monitoring the overnight sweeping of departmental accounts there have been no recent instances where this has not occurred. The transactional banker is aware of the requirement to comply with the core protocols and is doing so.

Clearance and settlement of direct credit payments

3.14 The core requirement relating to account funding⁴⁴ addresses an important issue in transactional banking. When an agency instructs its bank to make a payment, funds are not transferred automatically or instantaneously to the payee. There is a process behind the scenes in which the banks account for the transaction (debit the agency's account and credit the payee's account) and then transfer funds between each other. The account funding core requirement is intended to ensure that the transfer of funds from Commonwealth accounts takes place as late as possible, just before the start of the banking day on which the payee is entitled to the funds. This arrangement maximises the time the Commonwealth holds funds, which has interest benefits. However, before changes that took effect in mid January 2002, the core requirement did not specifically address the issue of when banks should account for the transaction. This is also critical, as accounting for the transaction as late as possible also has interest benefits for the Commonwealth. The lack of specific instructions on this point led to an issue in relation to payments via direct credit.

3.15 Under the new devolved banking arrangements, the most common payment method used by FMA Act agencies is direct credit. Approximately 220 million direct credit payments are made each year,⁴⁵ including low value program payments such as pensions and benefits, payments to employees and payments to suppliers. The key steps in making a payment via direct credit are, first, an agency transmits an electronic file instructing its bank to make a direct credit payment to a payee.⁴⁶ Second, if the payee's account is with the agency's bank, the bank debits the agency's account and credits the payee's account. If the payee's account is with a different bank, the agency's bank exchanges

⁴⁴ In principle, administered funds will be provided to the transactional banker no sooner than required to make payments. Value for time-sensitive payments will be paid away by the transactional banker without delay.

⁴⁵ RBA, *Annual Report 2001*, p. 42.

⁴⁶ Generally, payment files will include instructions for payments to multiple payees. However, for simplicity, this explanation assumes a single payee.

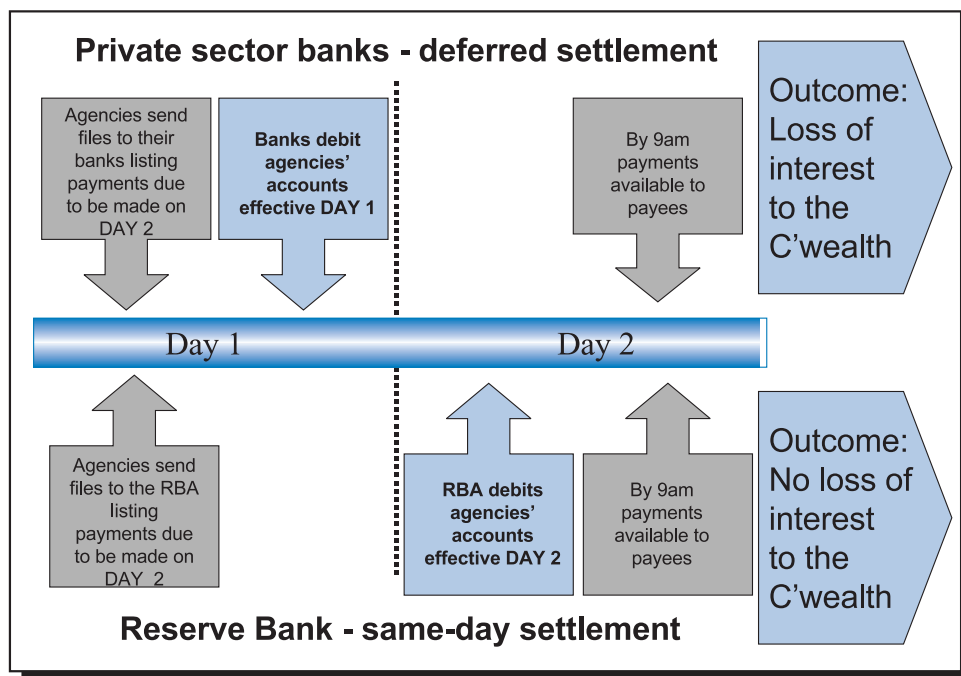
payment details with the payee's bank. This is called *payment clearance*. When a payment is cleared, the agency's bank debits the agency's account and the payee's bank credits the payee's account⁴⁷. The agency's bank transfers funds to the payee's bank. This process is called *settlement*.

3.16 The arrangements used by the RBA and by commercial banks prior to 18 January, 2002 are outlined in Figure 3.1, illustrating the differences in payment settlement arrangements between:

- the processing and settlement arrangements of the RBA's Government Direct Entry Service (GDES); and
- the practices of commercial banks who operate under the rules of the Australian Payments Clearing Association's (APCA) Bulk Electronic Clearing System (BECS).

Figure 3.1

Comparison of RBA and commercial bank payment settlement processes prior to 18 January 2002



Source: ANAO analysis

3.17 ANAO's understanding of the development of the settlement arrangements for high volume but low value Government payments is as follows: during the 1980s, the Australian Bankers' Association (ABA) ran the Centralised

⁴⁷ The payee's account is credited with effect from the date the agency's account is debited, and the payee earns interest from that date.

Magnetic Tape Exchange (CEMTEX) system in which banks exchanged high volume, low value payments via magnetic tape, along with a cheque dated the day the magnetic tape was delivered, as settlement. The cheque was cleared at least one day before the direct entry credits detailed on the tape were processed to bank accounts. Finance's long standing policy on behalf of the Commonwealth was that it was only prepared to give same-day value, which was different to the commercial banks' standard clearance arrangements. Finance negotiated to use CEMTEX but delivered the magnetic tape with a cheque post-dated to the pay day. ABA members accepted magnetic tapes of Government payments on these terms.

3.18 In the late 1980s and early 1990s when the GDES system was being developed, Finance mandated same-day settlement in the system specifications, which it put to tender, inviting major banks to submit a response. The RBA won the right to build GDES and an agreement was signed between the Commonwealth and the RBA in December 1993 for an initial period of five years, under which the RBA was paid \$1.25 million to develop GDES and bi-annual fees for the delivery of services.

3.19 To establish GDES, the RBA negotiated bi-lateral agreements with other financial institutions for the settlement of the Commonwealth's direct entry transactions on the morning of the payment date, with value being passed directly into banks' Exchange Settlement Accounts as part of the morning settlement process. Value is passed from the Commonwealth's accounts on the same day. According to advice from the RBA, this differs from BECS where value is passed to a customer's account on the day before payment day with settlement occurring as part of the overnight settlement process. The effect of this is that, under BECS, Commonwealth funds are paid away one day earlier than under GDES, with a resulting interest loss to the Commonwealth. Commercial banks that have won tenders covered by this audit did not provide same-day value prior to 18 January 2002.

Risk identification

3.20 GDES arrangements differ from standard commercial banking practice because, under the terms of its December 1993 contract to put into effect Finance's requirement for same-day value, the RBA negotiated with banks to tailor the arrangements to the best advantage of the Commonwealth. In this context, unless the Commonwealth (and its agencies) required transactional bankers to provide same-day value, there would be a significant loss of interest receipts to the Commonwealth in moving from same-day value under GDES to commercial banks' settlement arrangements under BECS.

3.21 The longstanding arrangements were originally mandated by Finance but, in developing the new transactional banking arrangements, the Department did not recognise the financial implications of the difference between the RBA's arrangements for same-day value and the payment settlement arrangements of the commercial banks. As early as March 1998, the RBA suggested to Finance that it should look at the efficiency of GDES against other services that could be provided. This problem was raised with Finance by the RBA and another agency in meetings during the first half of 1999. The issue was also raised in the RBA's 4 March 1999 response to Finance's tender for the provision of transactional banking and credit card services to Finance.⁴⁸ In its tender, the RBA stated that:

The benefit to Finance [from GDES] is that settlement for the value of payments is debited to Finance's account(s) on the actual paydate. As well as the cash management advantage to Finance, this provides the Government with a significant interest advantage which will (in part) flow to Finance following the introduction of devolved banking arrangements. This is a benefit which we believe is not generally offered by other financial institutions.

3.22 The issue of commercial banks' settlement arrangements was subsequently raised in writing by the RBA on 21 July 1999, following a meeting with Finance on 24 June 1999. At this meeting, the RBA agreed to write to Finance outlining the implications of differences between GDES and the industry procedures set out in the BECS rules. Accordingly, on 21 July 1999, the RBA advised Finance that settlement arrangements under BECS would mean that Commonwealth funds would be paid away one day earlier than under GDES. The RBA also provided Finance with a formula to calculate the interest loss to the Commonwealth from a move from GDES to BECS. In relation to this issue, Finance advised ANAO that:

In developing the transactional banking framework, Finance met with industry representatives and had a number of discussions and items of correspondence with the RBA. Finance's devolved banking team operated on the expectation that the banking industry would provide GDES-like service to the Commonwealth Government. The understanding was based on the very low settlement risk relating to Commonwealth payments and/or the view that access to GDES would occur.

As reflected in events post 1 July 1999, however, these expectations failed to eventuate. Since that time Finance has monitored the situation while working with the industry to achieve an efficient solution through changes to the Australian Payments and Clearing Association processing rules. Rule changes, effective from 18 January 2002, result in commercial banks being able to offer GDES equivalent service for Commonwealth direct entry payments as standard industry practice.

⁴⁸ Further details of the tender processes and outcome are provided in Chapter 4.

3.23 Recognising that GDES is a proprietary system developed by the RBA, greater planning was required either to ensure the RBA would grant private sector banks access to GDES or to communicate to commercial banks the need for them to consider the development of alternative arrangements that would provide same-day value for Commonwealth payments.

Risk management

3.24 Although commercial banks' settlement arrangements posed a significant risk to the success of the transactional banking initiative, at no stage prior to the 1 July 1999 commencement of devolved banking, or subsequently, did Finance estimate the likely interest loss to the Commonwealth (that is, the potential risk consequences) if a significant number of agencies had market tested and selected a bank other than the RBA to provide their banking services. ANAO considers that a properly developed risk management plan outlining a systematic approach to the implementation of devolved banking would have assisted Finance to identify and address this issue at an earlier stage (see Chapter 2).

3.25 In June 2000, the RBA calculated that commercial banks' settlement arrangements, as they operated at that time, would result in: *'a significant loss of interest receipts (of up to \$17 million a year, at current interest rates)'*. In addition, Finance's own banker raised the issue of these potential interest losses in an August 2000 letter to Finance, as follows:

In terms of the competitive tendering process we can also understand your desire to resolve this issue because of the significant Public Debt Interest benefits the GDES functionality provides to the Commonwealth Government. Provision of a service similar to the RBA's GDES will be a key factor if the commercial banks are to compete on level terms with the Reserve Bank of Australia (Transaction Banking Unit) in the tenders we expect to issue within the next couple of months. In fact, non availability could mean we are unable to submit complying tenders.

3.26 More recently, using the formula provided by the RBA to Finance on 21 July 1999 and GDES payment information provided to ANAO by the RBA, ANAO estimated potential interest losses for the 1999–2000 year to be up to \$17.3 million. This estimate is consistent with the RBA calculation of potential interest losses of up to \$17 million per year. These estimates illustrate the financial risk that the Commonwealth faced on 1 July 1999 if all agencies moved their banking business from the RBA to commercial banks. On the basis of advice provided by Finance to ANAO, the actual losses were in the order of less than

one per cent of the maximum potential losses in 2000–2001 as the agencies with the overwhelming majority of transaction values had not outsourced their banking services.⁴⁹

3.27 Nevertheless, commercial banks' settlement arrangements had the potential to have an adverse impact on the devolved banking initiative in terms of the competitiveness of commercial banks and the conduct of tenders for banking services. In this latter respect, DEST advised Finance in October 2000 that it estimated that the losses to the Commonwealth if DEST selected a commercial bank would be in the order of \$2.5 million per annum. In the circumstances, DEST was seeking resolution of settlement arrangements before proceeding with market testing. In September 2001, DEST advised ANAO that it intends to proceed with market testing as soon as Finance modify the core requirements to make it a requirement that commercial banks and payment bureaux provide same-day value. DTRS advised ANAO that: *'if we had transferred our accounts to another provider before same-day value arrangements were introduced by other banks the interest losses to the Commonwealth would have been around \$470 000 per annum.'*

3.28 Since July 1999, Finance has been examining the issue with representatives from interested commercial banks and APCA. In September 2000, Finance wrote to the RBA advising that Finance intended changing the *Instructions for Transactional Bankers* to require commercial banks to provide same-day value. The Instructions provide detailed information for bankers on Commonwealth banking processes, including the core requirements. The RBA, which is co-issuer of the Instructions, noted that the changes needed to be made to the core requirements included in the Finance Minister's delegations, on the basis that these mandate that agencies ensure compliance and carry a higher level of authority than the Instructions.

3.29 Finance has modified the core requirements to improve the clarification that same-day value represents best practice for Commonwealth payments. APCA has advised ANAO that changes to the BECS rules, which came into effect in mid January 2002, now permit banks to provide same-day value for

⁴⁹ In its 2000–2001 Annual Report (pp. 39–40), the RBA reported that, for those tenders decided during 2000–2001, it had retained the business of all agencies for which it bid. (The RBA also reported that it did not respond to a number of tenders because of special requirements stipulated by some agencies.)

Commonwealth Government payments through BECS.⁵⁰ These changes should eliminate the potential for future interest losses for agencies outsourcing banking services. To ensure success, the proposed APCA rule and core requirement changes need to be backed up by monitoring and systems testing, by both Finance and agencies.

⁵⁰ APCA advised ANAO that: *'The new BECS rules due to come into operation on 18 January 2002 will have the following effects [clause references are to the BECS procedures, set out at APCA's public website (<http://www.apca.com.au>) except for certain confidential provisions]:*

- (a) *"Commonwealth Government Payments" will be: (i) sent in Files separate from ordinary BECS files (clause 6.8(b)); (ii) sent at different Official Exchange Times to ordinary Files (subject to bilateral agreement to the contrary) (clause 1.1, definition of Official Commonwealth Government File Exchange Time and clause 4.2); and (iii) identifiable by being transmitted with a Receiving Dataset nominated for such Files (the Receiving Dataset is the receiving destination particulars for a File) (clause 1.1, definitions of Commonwealth Government Payments and Receiving Dataset and clause 6.7(f)).*
- (b) *Settlement of Commonwealth Government Payments will take place in the new early morning (7.30 am) settlement session through RITS in accordance with procedures advised from time to time by the Reserve Bank of Australia ("RBA") (clause 9.1A).*
- (c) *The PD Day for "Commonwealth Government Files" will be the settlement day (as now occurs under the RBA's GDES arrangements) rather than the day of exchange of the File in BECS (as is the case with normal BECS Files), such that Commonwealth Government Files can be future-dated by one day (normal BECS Files may only have a PD Day specified as the same day as exchange of the File and are rejected by the receiver if the PD Day is a future date to the exchange day) (clause 1.1, definition of PD Day, clause 6.5(a) and changes to DE File User Item File specifications at Appendix C1).*
- (d) *Ledger FIs (being the institutions to which Credit Items are addressed) must, with respect to Commonwealth Government Files: (i) use reasonable endeavours to make Credit Items available to Customers by 9.00 am on the PD Day (clause 6.7(a)); and (ii) nominate a Receiving Dataset for Commonwealth Government Files (clause 6.7(f)).*
- (e) *Lodgement FIs (being the institutions that exchange (ie. Transmit) Files) must ensure that Commonwealth Government Files are not transmitted with other BECS Files (except as may be bilaterally agreed between any two BECS participants) (clause 6.8(b)).*
- (f) *Nothing in the new Procedures prevents any Participating Member from exchanging both Commonwealth Government Files and other BECS Files for the same Government department or agency, such that a Government department or agency can use both future-dated Commonwealth Government Files and normal BECS Files at their option.*

The BECS rules are silent as to when institutions sending Commonwealth Government files may debit the sending customer's account (the sending customer being referred to in the BECS Procedures as the "Credit User"), and that matter is left as a proprietary issue between institutions and their customers that send direct credit payments. However, as the BECS rules specify when institutions receiving payments must make funds available to their beneficiary customers, the rules do indirectly affect negotiation between a Credit User and its financial institution as to when that Credit user's account would be debited for the amount of the payment. For both normal BECS Files, and Commonwealth Government Files, the beneficiary customer should have access to funds by 9.00 am on the day after the relevant File is exchanged. However, for normal BECS Files the beneficiary's account must be credited as at the date of exchange of the File) (ie. The day before the funds are available to the beneficiary customer); whereas for Commonwealth Government Files the credit to the customer's account is posted as at the day after the Files is exchanged. Hence, it is likely that for normal BECS Files, a Credit User's account would be debited as at the day of exchange of the File; whereas for Commonwealth Government Files the Credit User's account would be debited as at the business day next following the day the File is exchanged (which is the same date as at which the credit is posted to the beneficiary's account). However, as the BECS rules do not prescribe the date in respect of which debts must be posted to Credit User's accounts, this is a matter for negotiation between Credit Users and their financial institutions.'

3.30 Finding: The RBA's settlement arrangements differ from standard commercial banking practice. As required under its December 1993 contract with the then Department of Finance, the RBA negotiated with banks to tailor the arrangements to the best advantage of the Commonwealth, ensuring same-day value on payments. In this context, unless agencies required their commercial bankers to provide same-day value on payments, there would be a significant loss of interest receipts to the Commonwealth under commercial banks' settlement arrangements. These longstanding arrangements were originally mandated by Finance but, in developing the new transactional banking arrangements, the Department did not recognise the financial implications of the difference between the RBA's arrangements for same-day value and the payment settlement arrangements of the commercial banks.

3.31 Under the new devolved banking arrangements, the most common payment method used by FMA Act agencies is direct credit. The arrangement used by RBA and the commercial banks prior to 18 January 2002 differed. Prior to the introduction of devolved banking on 1 July 1999, Finance did not explicitly identify the financial risk to the Commonwealth of commercial banks' settlement arrangements and so did not take steps to manage this risk prior to 1 July 1999. In particular, Finance did not quantify the impact of this risk, or assess the likelihood of the risk being realised. Finance *'had expectations that [same-day value] would be provided and accordingly did not consider it necessary to undertake further actions to mediate against a potential loss of interest.'* ANAO considers that a properly developed risk management plan outlining a systematic approach to the implementation of devolved banking would have assisted Finance to identify and address this issue at an earlier stage.

3.32 Using a formula provided by the RBA to Finance in July 1999 and payment information provided to ANAO by the RBA, ANAO estimated the potential exposure for interest losses for the 1999–2000 year to be up to \$17.3 million. This estimate is consistent with an RBA calculation of potential interest losses of up to \$17 million per year. These estimates illustrate the financial risk that the Commonwealth faced if all agencies moved their banking business from the RBA to commercial banks. On the basis of advice provided by Finance to ANAO, the actual losses were in the order of less than one per cent of the maximum potential losses in 2000–2001 as the agencies with the overwhelming majority of transaction values had not outsourced their banking services.

3.33 Since July 1999, Finance has been examining commercial banks' settlement arrangements with representatives from interested commercial banks and the Australian Payments Clearing Association. Changes to the commercial banks' rules for direct credits, which came into effect in mid January 2002, now permit banks to provide same-day value for

Commonwealth Government payments. Finance has modified the core requirements to improve the clarification that same-day value represents best practice for Commonwealth payments. These changes should eliminate the potential for future interest losses for agencies outsourcing banking services.

4. Market testing

This chapter describes the rationale for and the general approach to market testing for banking services; and discusses the tender processes and contractual outcomes of the two audit agencies (Finance and Customs) which had market tested at the time of the audit.

Background

4.1 Under the new banking arrangements, agency Chief Executives are responsible⁵¹ for managing their banking and payment functions, including implementing a market testing strategy that is in accordance with the Commonwealth Procurement Guidelines (CPG).⁵² Under the CPG, value for money is the essential test against which agencies must justify any procurement outcome.⁵³ Value for money is the basis for comparing alternatives in order to choose the most cost-effective proposal. This requires careful comparison of costs, benefits and options, noting that deciding which alternative offers best value in particular circumstances will depend on professional judgements and that the lowest-priced offer will not necessarily offer the best value for money.

4.2 A sound approach to preparing for market testing involves: developing a specification of banking requirements, including current requirements and any preferences for future requirements; analysing options and assessing risks; and obtaining sign-off by the appropriate delegate on the preferred option and the preferred approach. For many agencies, banking fees are small (less than \$20 000 per annum) and there is an issue as to whether they will recoup any net present value financial benefits gained through a formal tendering process. Other options available to agencies include leveraging off an existing contract or calling for bids from the Finance list of pre-qualified institutions.⁵⁴ Alternatively, agencies may consider clustering together to spread the costs of a full tender process and offer a higher volume of transactions in order to access lower scales of fees.

⁵¹ Source: *Agency Banking: Market Testing Toolkit* published by Finance in November 2000.

⁵² Regulation 9 of the FMA Regulations provides that a procurement approver must not approve a proposal to spend public money unless they are satisfied (after reasonable inquiry) that the proposed expenditure is, among other things, in accordance with the policies of the Commonwealth. The procurement policies of the Commonwealth are set out in the CPG, which are issued by the Minister for Finance and Administration under FMA Regulation 7(1).

⁵³ March 1998, p. 3.

⁵⁴ Finance had not produced its list of pre-qualified institutions at the time Customs tendered for transactional banking services.

Tender processes

4.3 All FMA Act agencies are required to market test under the new banking arrangements that came into effect on 1 July 1999. Of the audited agencies, Finance and Customs have completed their market testing processes.⁵⁵ The existing levels of banking fees are low in the audited agencies that have not completed market testing, namely DEST, DIMIA and DTRS. In January 2002, DIMIA advised ANAO that it had completed a request for expression of interest process and was proceeding with a Request for Tender. DIMIA advised ANAO that it adopted this approach for the following reasons:

- *DIMIA considered the provision of banking services in light of broader Government initiatives and determined that activities associated with the banking function, including reconciliation and revenue collection services, should be considered under the Government's strategy of competitive tendering and contracting of corporate services;*
- *A Request for Expression of Interest (REOI) for the provision of Banking and Revenue Services was released by DIMIA in February 2001 to test the market's ability to provide a total banking solution including, not only transactional banking, but the associated reconciliation and revenue collection services; and*
- *An RFT for the provision of banking services was delayed pending the outcome of that REOI.*

4.4 As of January 2002, DEST was proceeding to market test. DEST had sought resolution of settlement arrangements (see Chapter 3) before proceeding with market testing as it had estimated that losses of \$2.5 million per annum would result if it selected a commercial bank under the framework existing prior to 18 January 2002. DTRS advised ANAO in January 2002 that it was in the process of evaluating tenders, with a view to soon having a new contract in place for the provision of transactional banking services.

4.5 Finance was the first agency to market test for the provision of banking services. The process covered Finance's corporate responsibilities and included approximately \$1.34 billion in annual receipts and payments, credit card facilities and foreign exchange transactions. It did not include Finance's operation of the Commonwealth's central bank accounts.⁵⁶ The process began in January 1999 when Finance called for expressions of interest to provide transactional banking services from all banks. In February 1999, Finance released a request for tender

⁵⁵ A number of other major agencies not included in this audit have also market tested, namely the: Departments of Health and Ageing, Veterans' Affairs, Defence, Family and Community Services, Prime Minister and Cabinet (including other agencies within the portfolio) and Foreign Affairs and Trade.

⁵⁶ Which remain with the RBA.

(RFT) to the seven banks and credit card providers that lodged an expression of interest.

4.6 Customs' RFT estimated that it would collect around \$24 billion in 1999–2000 in customs duty, excise, sales tax and other border-related revenue collections. In terms of transaction volumes, Customs makes nearly 500 000 separate payments a year and takes over 250 000 separate receipts. Customs engaged a management consulting firm to assist in the conduct of the tender. The tender was selective, with nine institutions being invited to tender. This decision was based on the management consultant's previous experience with another department that had already market tested.

4.7 The key stages in the Finance and Customs tender processes are outlined in Figure 4.1.

Figure 4.1

Key stages in the Finance and Customs tender processes

Stage	Finance	Customs
Call for expressions of interest	22 January 1999	Not conducted
Probity sign-off on the Tender Evaluation Methodology	8 March 1999	Not undertaken
Tender Evaluation Methodology approved	9 March 1999	Not developed
Request for tenders issued	4 February 1999	18 February 2000
Tenders received	5 March 1999	13 March 2000
Amendment of Tender Evaluation Methodology	17 March 1999	Not applicable
Tender evaluation report completed	1 April 1999	11 April 2000
Probity sign-off on tender evaluation process	26 July 1999	Not undertaken
Tenderers advised of outcome	20 April 1999	18 April 2000
Contract executed	21 June 1999	23 February 2001
Services commenced	1 July 1999	4 September 2000 ^A
Note: ^A Receipting only. Customs moved payment operations to its selected provider in June 2001.		

Source: ANAO analysis of Finance and Customs records.

4.8 Finding: All FMA Act agencies are required to market test under the new banking arrangements that came into effect on 1 July 1999. Of the audited agencies, Finance and Customs have completed their market testing processes. The existing levels of banking fees are low in the audited agencies that have not completed market testing, namely DEST, DIMIA and DTRS. As of January 2002, DIMIA had completed a request for expression of interest process and advised ANAO that it was proceeding with a Request for Tender (RFT). At that time, DTRS had called for tenders and was proceeding to evaluate responses. Following the resolution of commercial banks' settlement arrangements, DEST was proceeding to market test. DEST had sought resolution of settlement arrangements before proceeding with market testing as it had estimated that losses of \$2.5 million per annum would result if it selected a commercial bank under the framework existing prior to 18 January 2002.

Tender evaluation

4.9 Tender evaluation is a key part of the market testing process. It is open to Commonwealth agencies to select a tenderer on any basis they choose, provided that they deal fairly with all tenderers in conducting the process. In this context, good administrative practice⁵⁷ includes determining the basis on which the winning tenderer will be selected before the tender documentation is issued, and devising evaluation criteria which will provide a methodology for distinguishing between tenders on that basis. The basis for selection, including the criteria and their relative importance, should be communicated to potential tenderers through the tender documentation so that they have an informed basis on which to prepare their tenders.

4.10 It is important that there be no inconsistency between what was communicated to tenderers and the evaluation methodology as significant changes, without giving reasonable notice to all prospective tenderers combined with a reasonable opportunity to alter their tenders accordingly, may require the issue of a new request for tender. It is also essential that, in evaluating tenders, agencies understand banking processes and the costs that these can generate as the potential costs to the Commonwealth through sub-optimal cash management may outweigh possible savings in banking fees. In particular, agencies should have a clear understanding of payment settlement processes and also seek to ensure that receipts are credited on the day they are presented. Agencies also need to be aware that:

⁵⁷ Which, among other things, helps manage legal risks that can arise from tender processes.

- banks' price structures may vary with the volume of transactions and that agencies are well advised to assess fees for current transaction levels and future expected transaction levels; that electronic methods of payment are between five and ten times cheaper than paper methods⁵⁸, changes to payment and receipting methods could bring efficiencies⁵⁹; and it is advisable to factor the costs of transition to a new service provider into consideration of price; and
- benefits might be achieved through market testing for transactional banking, such as better contract terms and conditions, reductions in transactional banking fees and cost savings through improved business processes, including reductions in staff resources.

Evaluation planning

4.11 The advantage of a formally documented tender evaluation plan is that it can be used to guide the evaluation process, and then used as the basis for the tender evaluation report, which is prepared as a record of how the evaluation was conducted.

4.12 Finance prepared its tender evaluation plan after the release of the RFT, whereas better practice suggests that this should have been done prior to release of the RFT.⁶⁰ Finance engaged a consultant to perform a probity review of the tender evaluation plan and the tender evaluation process. On 8 March 1999, the probity reviewer concluded that the evaluation plan was consistent with the criteria identified in the RFT and provided a reasonable basis for assessing the tenders.

4.13 Customs did not prepare a tender evaluation plan. On this point, Customs advised ANAO in September 2001 of its view that:

Evaluation methodology need not be separately documented (in a plan) or notified to tenderers where: (a) it is clear that no unusual methods will be used; (b) the requirement is straightforward; (c) innovative solutions are highly unlikely; and (d) a complex scoring system or software modelling is not going to be used.

4.14 This was the first occasion on which Customs had market tested its transactional banking business, with the RFT seeking a creative approach to developing a long-term business relationship in order to streamline its current

⁵⁸ NOIE (then the Office of Government Online), *Commonwealth Electronic Procurement - Implementation Strategy*, April 2000, p. 5.

⁵⁹ For example, Finance advised ANAO in September 2001 that it has achieved a rate of 93 per cent for creditors being paid electronically.

⁶⁰ The tender evaluation plan was endorsed by Finance on 9 March 1999, four days after the closing date for tender responses.

use of banking services and obtain internal process efficiencies. In this context, ANAO considers a tender evaluation plan would have added value to Customs' tender process.

Finance evaluation processes

4.15 The Finance RFT stated that tenders would be assessed on a value for money basis and on the specified criteria.⁶¹ Based on the evaluation criteria specified in the RFT, the plan specified a two step evaluation process as follows:

- Assessment against mandatory criteria. These criteria were drawn from information provided in the RFT, though there is no mention of mandatory criteria in the RFT.
- Having met the mandatory criteria, a comparison was to be made of each tender against the selection criteria. Cost was to be considered after an assessment had been made against the qualitative criteria.

4.16 The evaluation was conducted by an evaluation panel consisting of four Finance officials and an independent external consultant. On advice from the external consultant, the panel changed elements of the evaluation plan. Specifically, the panel deleted many of the references to mandatory criteria included in the evaluation plan and removed one criterion.

4.17 Finance received six responses to the RFT from four commercial banks, the RBA and a credit card provider. After excluding two responses considered non-compliant, the panel addressed the four remaining tenders. All four were regarded as having the same degree of compliance with the criterion concerning the requirements of the tender, including range and level of services available and ability to meet response time requirements.

4.18 To differentiate the tenders, each was scored against five of the six remaining criteria (the cost criterion was considered after an assessment against these criteria). The tender panel established a score between 1 and 10 for each criterion, with each criterion weighted equally. The Tender Evaluation Panel (TEP) rated the three commercial banks similarly, with the RBA rated well below other tenderers against the qualitative criteria. From the scoring results and prior to considering price, the panel noted that, whereas it may be preferable on a value for money test to pay a small premium for the services of the highest scored tenderer, the other two commercial banks could be preferred if they offer pricing that represented better than a small saving.

⁶¹ The criteria were: compliance with the requirements of the tender; quality control/quality assurance programs in place; capability to perform the required services consistently; risk management strategies, including Year 2000 management; successful and demonstrated experience in providing identical services; compliance with audit requirements; and cost.

Price analysis

4.19 Price analysis undertaken for the panel based on Finance's business volume at the time of the tender indicated that the highest rated tenderer against the qualitative criteria was also the significantly least cost option, some \$16 000 or 34 per cent cheaper than the next lowest tender. Accordingly, the panel concluded that the bank that scored highest on the qualitative criteria also offered the lowest cost and was therefore the best value for money.

4.20 The CPG advocates that an assessment of the best overall net outcome for the Commonwealth should take account of all relevant whole of life costs and benefits. Consistent with this principle, Finance's RFT sought detailed information from each tenderer on fees and charges applying to transactions, merchant and EFTPOS fees, electronic banking costs and fees and corporate/purchasing cards. However, the evaluation process did not take account of all such costs that were included in tender responses (and, subsequently, in the contract). On this point, Finance advised ANAO in December 2001 that:

The most significant item that you refer to is the merchant services fee that is applied to credit card transactions ... the reason why this item was omitted from the analysis was that the preferred tenderer had already established a clear pricing differential. The preferred tenderer had the lowest merchant service fee so the price differential would only have increased with the inclusion of the fee.

4.21 The tender evaluation also omitted the financial benefits associated with the settlement processes employed by the RBA compared to those offered by commercial banks, although the RBA had drawn attention to these benefits in its tender.⁶² Including all relevant costs, the ANAO's analysis changes the ranking of tenderers against the price criterion (see Figure 4.2) with the cost of the successful tenderer's proposal estimated to be some \$27 000 or 16 per cent higher than the actual lowest cost tender when all relevant costs are taken into account. However, the evaluation panel's assessment against the qualitative criteria indicates that this price differential might not have been sufficient to change the overall value for money assessment. Changes to the commercial bank settlement arrangements that came into effect in mid January 2002 are also expected to reduce the difference in costs.

⁶² In its tender, the RBA stated that: '*The benefit to Finance [from GDES] is that settlement for the value of payments is debited to Finance's account(s) on the actual paydate. As well as the cash management advantage to Finance, this provides the Government with a significant interest advantage which will (in part) flow to Finance following the introduction of devolved banking arrangements. This is a benefit which we believe is not generally offered by other financial institutions.*'

Figure 4.2**Department of Finance and Administration and ANAO analysis of tendered costs**

	Successful tenderer	RBA	Tenderer 3	Tenderer 4
Finance tender evaluation	\$	\$	\$	\$
Banking costs (Finance assessment based on current volumes)	30 810	46 589	54 909	56 519
Price ranking	1	2	3	4
ANAO analysis				
• Banking costs (Finance assessment based on current volumes)	30 810	46 589	54 909	56 519
• Costs tendered but not evaluated by Finance ^A	112 640	121 270	124 040	135 356
• Settlement costs ^B	51 114	Nil	51 114	51 114
Revised banking costs (based on current volumes)	194 564	167 859	230 063	242 989
Revised price ranking	2	1	3	4
Notes:				
^A Includes merchant fees, software and other items priced in tenders but not included in the tender price analysis used by Finance in its deliberations.				
^B Estimated by ANAO based on Finance expenditure in 1998–1999, using the methodology advised by the RBA to Finance in July 1999.				

Source: ANAO analysis of Finance data and Finance advice to ANAO

4.22 The RFT also noted that Finance was experiencing significant volume changes as a result of shifting departmental functions. Accordingly, the RFT sought costs per transaction and cost for transaction ranges of +/- 10 per cent, +/- 20 per cent and +/- 50 per cent from present levels, as well as costs for current transaction levels. This data would enable sensitivity analysis to be performed to assist the panel identify the most cost-effective response across a range of likely scenarios. One respondent indicated that fees would vary based on volume changes. However, this was not reflected in the tender price analysis. Sensitivity analysis was also not undertaken to assess the cost implications of Finance achieving its goal of greater adoption of electronic methods of payment, although some tenderers offered significantly lower costs than others for such payments.⁶³

⁶³ The RFT informed potential tenderers that less than 10 per cent of payments were being made electronically. In September 2001, Finance advised ANAO that it had achieved a rate of 93 per cent of creditors being paid electronically. In October 2001, Finance advised ANAO that, at the time of the evaluation process, the ability of Finance to achieve a level of 93 per cent of electronic payments would have been considered unlikely.

4.23 Finance advised tenderers of the outcome on 20 April 1999. Finance advised its preferred tenderer that a contract would need to be negotiated and executed before the bank could be engaged to perform services for Finance. In relation to the tender evaluation process, Finance advised ANAO in December 2001 that:

Finance is of the view that it is not inappropriate to subsequently change the evaluation plan to take into account additional information so long as the changes are not made to advantage any tender respondent. Furthermore, as is noted later in the report, the tender process overall was signed off by the probity auditor.

4.24 In July 1999 the probity reviewer concluded that:

Overall, we are satisfied that this tender process was conducted with probity. We noted, however, that several changes were made to the tender evaluation plan after the panel had informally reviewed the tenders. These included the decision not to score one of the criteria and changing many mandatory requirements to non-mandatory. While we do not consider that the changes have impacted on the probity of the process, this suggests that insufficient thought was given to how the tenders should be evaluated in the original plan. For the future, we recommend that particular attention is given to developing an appropriate evaluation plan and that the evaluation of tenders is carried out in accordance with the plan, to ensure transparency.

4.25 Finding: Finance was the first agency to market test for the provision of banking services. The process began in January 1999 when Finance called for expressions of interest from all banks to provide transactional banking services. In February 1999, Finance released a RFT to the seven banks and credit card providers that lodged an expression of interest. Following evaluation of the four tenders received, Finance advised tenderers of the outcome on 20 April 1999. A commercial bank was selected on the basis that it scored highest on the qualitative criteria and also offered the lowest cost and was therefore considered to represent the best value for money.

4.26 Finance prepared its tender evaluation plan after the release of the RFT, whereas better practice suggests that this should have been done prior to release of the RFT. Finance's tender evaluation panel used a two step evaluation process as outlined in the tender evaluation plan. However, the panel deleted many of the references to mandatory criteria included in the evaluation plan and removed one criterion. Finance's probity reviewer concluded that the tender process was conducted with probity but noted, however, that several changes were made to the tender evaluation plan after the panel had informally reviewed the tenders, suggesting that insufficient thought was given to how the tenders should be evaluated in the original plan.

4.27 Finance's RFT sought detailed information from each tenderer for fees and charges applying to transactions, merchant and EFTPOS fees, electronic banking costs and fees and corporate/purchasing cards. However, the evaluation process did not take account of all such costs that were included in tender responses (and, subsequently, in the contract). ANAO notes that the tender evaluation omitted the financial benefits associated with the settlement processes employed by the RBA compared to those offered by commercial banks, although the RBA had drawn attention to these benefits in its tender. Including all relevant costs, the ANAO's analysis changes the ranking of tenderers against the price criterion with the cost of the successful tenderer's proposal estimated to be some \$27 000 or 16 per cent higher than the actual lowest cost tender when all relevant costs are taken into account. Changes to the commercial bank settlement arrangements that came into effect in mid January 2002 are expected to reduce the difference in costs.

Customs evaluation processes

4.28 Customs received six tenders. The evaluation was undertaken by a committee comprising a management consultant and two Customs Treasury Unit staff.

Evaluation criteria

4.29 The April 2000 tender evaluation report stated that tender submissions had been analysed as to their ability to meet Customs' core requirements as stated in the RFT, fees, security, innovation and whether the particular bank understood the public sector transactional banking business and Government requirements. The evaluation report further stated that the comparison had been based on the nine evaluation criteria included in the RFT⁶⁴ and additional analysis of a further 10 criteria.⁶⁵ The evaluation report referred to these additional criteria as '*additional information outside the scope of the evaluation criteria in the Tender RFT.*' In applying additional criteria, the committee relied on a statement in the RFT that bids would be assessed against the criteria included in the RFT, but not limited to these criteria.

⁶⁴ The evaluation criteria included in Customs' RFT were: compliance with the core requirements for transactional banking; capacity to provide the required services and standard of service; understanding of Customs; provider's track record in providing banking services for like agencies; understanding of the Commonwealth's financial framework; proposed billing and reporting arrangements; and fees and other costs.

⁶⁵ The additional criteria were: presentation—quality of submission; response to information requested in the RFT; RFT meeting; response to subsequent questions; innovation; transaction service; and corporate card, electronic services and merchant facilities.

4.30 In September 2001, Customs advised ANAO that: *'all additional criteria used can easily be seen as amplifications of the original criteria and amount to no more than an attempt to document those amplifications—primarily of the tenderer's capacity to provide the service and the standard of service.'* In December 2001 Customs further advised ANAO that:

... Customs did not prepare a formal evaluation plan. In evaluating tenders, the Customs evaluation committee applied the evaluation criteria specified in the RFT, but also used additional criteria that it did not include in the RFT. Customs evaluation committee did not want to be restricted to the evaluation criteria in the RFT in case the need arose for tenders to be assessed on additional criteria. Therefore, upon receiving advice from Customs Accredited Purchasing Unit, the committee chose to include the following statement in their RFT: "In seeking to obtain the best value for money the evaluation committee will examine each offer in accordance with (but not limited to) the following criteria, which are listed in no particular order."

4.31 ANAO considers that better practice is for bidders to be informed of all criteria so that the openness and transparency of the process is enhanced and to provide bidders with the opportunity to present a comprehensive bid that best meets the business needs of the agency tendering. In this context, the CPG in force at that time stated that it was Commonwealth policy that agencies *'evaluate each offer applying only the evaluation criteria and methodology notified to bidders in the request for tender documentation'*.⁶⁶

4.32 The Committee did not prioritise or weight the evaluation criteria. It is not always necessary to do this, depending on the circumstances. On this point, Customs advised ANAO in September 2001 that:

Weightings can assist to describe the relative importance where there are many 'desirable' evaluation criteria. However, where it is obvious that all the criteria are important, weighting can detract from the overall message—to not fail on any criterion. In the banking RFT, all non-price criteria, taken together, outline what the tenderer must address to be highly ranked and then to be compared on the final criterion of price. It was this holistic view that led to the exclusion of tenders that did not meet the basics.

4.33 There is a hierarchy discernable in the Customs evaluation criteria, for example, *'capacity to provide the required services and standard of service'* is likely to be more important than *'presentation—quality of submission.'* The hierarchy is also evident in the fact that tenders considered to be non-compliant with the core requirements were not considered in the final comparison of possible providers. ANAO considers that better practice in this case would have been

⁶⁶ Commonwealth Procurement Guidelines, March 1998.

for Customs to identify to tenderers those criteria that were mandatory⁶⁷ and then consider prioritisation of the remaining criteria. In this respect, the approach outlined in Finance's evaluation plan provides greater transparency for the benefit of tenderers and the evaluation team than that taken by Customs.

4.34 The evaluation committee's analysis indicated that one of the commercial bank respondents offered Customs the best transaction banking services that were in accordance with the core protocols, as well as the lowest fees. This tenderer was selected over the others based on price, branch representation, integrated banking and innovation. It was recommended that Customs enter into contract negotiations with the preferred tenderer to clarify the terms of issues such as foreign currency rates pricing. In April 2000, Customs wrote to the selected bank advising that it had been successful, subject to the clarification of minor issues such as foreign currency rates and the transfer of payroll.

Price analysis

4.35 In its assessment Customs considered transactional fees and also took into account the costs associated with commercial banks' settlement arrangements. However, Customs did not assess the cost of the RBA's receipting processes on the basis of information provided by the RBA. Figure 4.3 summarises Customs' price analysis and its effect of the ranking process against the costs and fees criterion.

⁶⁷ For example, ability to comply with the core requirements is a critical criterion.

Figure 4.3**Australian Customs Service and ANAO analysis of tendered costs**

	Successful tenderer	Tenderer 2	RBA
Customs tender evaluation	\$	\$	\$
• Banking fees and associated costs	143 219 ^A	151 719 to 196 385 ^A	121 617
• Loss of same-day value on receipts	Nil	Nil	136 986
Total Costs	143 219	151 719 to 196 385	258 603
Price ranking	1	2	3
ANAO analysis			
• Total banking costs assessed by Customs	143 219 ^A	151 719 to 196 385 ^A	258 603
• Same-day value on receipts	Nil	Nil	(136 986)
Total revised costs	143 219	151 719 to 196 385	121 617
Revised price ranking	2	3	1
Note: ^A Includes \$30 274 related to commercial banks' settlement arrangements. From 18 January 2002, changes to the payment clearance procedures of commercial banks and the core banking requirements mean that this cost should not be incurred. Further information on the new procedures is provided at paragraph 3.29.			

Source: ANAO analysis of Customs data

4.36 To take receipts, the RBA offered Customs its Business Deposit Service (called RAPS). RAPS allows RBA account holders to deposit funds over the counter at branches of the Commonwealth Bank of Australia (CBA) and through Australia Post. The tender response provided by the RBA to Customs states that RAPS deposits through the CBA are credited to RBA accounts on the same day as deposited. RAPS deposits through Australia Post are credited to RBA accounts on the next business day. However, in its evaluation of tenders, Customs concluded that RAPS did not process receipts on the same day as deposits are received by CBA in all regional centres, resulting in lost interest. This conclusion is at odds with the RBA's tender response.

4.37 Customs advised ANAO that, notwithstanding the RBA's statement, its experience with the RAPS service was that the system did not provide for same-day processing of receipts in all regional centres. Customs raised this issue with the RBA during the tender process and the RBA maintained that RAPS provided same-day value on receipts. In assessing costs, Customs included an estimate of some \$137 000 per annum for the interest losses on receipts. Including this amount more than doubled the assessed cost of the RBA tender, which changed the ranking of tenders on the costs and fees criterion. ANAO considers

it would have been better practice for Customs to have clarified this issue with the RBA and sought the RBA's agreement to a contractual clause binding it to provide same-day receipting.

4.38 In relation to transition costs, Customs' tender evaluation report notes that using the first ranked bidder would *'require system changes and added costs.'* However there was no estimate of these costs included in the price assessment. Customs advised ANAO that these costs would have been incurred regardless of provider, and therefore these costs did not need to be factored in. ANAO notes that Customs did not include this justification in its evaluation report.

4.39 Finding: Customs engaged a management consulting firm to assist in the conduct of its tender process, which commenced in February 2000. The tender was selective, with nine institutions being invited to tender. This decision was based on the management consultant's previous experience with another department that had already market tested. Customs' evaluation committee concluded that one of the commercial bank respondents offered Customs the best transaction banking services that were in accordance with the core protocols, as well as the lowest fees. This tenderer was selected over the others based on price, branch representation, integrated banking and innovation.

4.40 Customs did not prepare a tender evaluation plan. It is good administrative practice for the selection basis to be determined before the tender documentation is issued, and for it to be communicated to potential tenderers through the tender documentation, so they have an informed basis on which to decide whether to tender, and the nature of the tender to prepare. In evaluating tenders, the Customs evaluation committee applied the evaluation criteria specified in the RFT, but also used additional criteria that it did not include in the RFT. The relevant Commonwealth Procurement Guidelines state that it is Commonwealth policy that agencies *'evaluate each offer applying only the evaluation criteria and methodology notified to bidders in the request for tender documentation.'* In this context, ANAO considers a tender evaluation plan would have added value to Customs' tender process.

4.41 The price analysis conducted by Customs included assessment of transactional fees and also took into account the costs associated with commercial banks' settlement arrangements. However, Customs did not adequately account for transition costs. Further, in assessing costs of the RBA tender, Customs included an estimate of some \$137 000 per annum for the interest losses on receipts, as Customs considered the RBA systems did not provide for same-day processing of receipts in all regional centres. This was despite statements to the contrary made by the RBA in its tender, and in

subsequent tender clarification. Including this amount more than doubled the assessed cost of the RBA tender, which changed the ranking on the costs and fees criterion. ANAO considers it would have been better practice for Customs to have clarified this issue with the RBA and sought the RBA's agreement to a contractual clause binding it to provide same-day receipting.

Contractual outcomes

4.42 After a preferred tenderer has been selected, it is important that agencies test for compliance with the core requirements before finalising transition arrangements or contractual agreements. Although Finance has pre-qualified institutions, it is still the responsibility of agency Chief Executives to ensure that banks adhere to the core requirements. Systems testing would provide certainty about the technical capacity of banks to adhere to the requirements.

4.43 A signed written contract that accurately reflects the understanding of all parties to the contract, and constitutes the entire agreement between the parties, is a fundamental tenet of sound contracting processes. Otherwise, the documentary trail supporting the authority for the payment of public money and contractual performance requirements, incentives and sanctions may not be clear. In the context of transactional banking, written agreements between agencies and their banking providers provides the basis for ensuring core requirement compliance and obtaining value for money. Written agreements reduce the opportunity for disputes and, at a minimum, should specify:

- the services required;
- performance standards and monitoring arrangements;
- performance reporting requirements in relation to core protocol compliance;
- remedies for under-performance (such as service credits, reimbursement of losses or some other form of liquidated damages);
- mechanisms for resolving disputes;
- bases for varying the contract;
- arrangements for winding up the relationship;
- arrangements for termination in the case of persistent breaches; and
- indemnities.

Finance

4.44 In June 1999, Finance signed a contract with its selected provider. The contract was for the provision of general banking services commencing 1 July 1999 and was for a term of one year with an extension of one to three years. The contract provides for monitoring and management arrangements in line with better practice that include: reporting on achievement of service levels (quarterly and annually); quarterly progress meetings; immediate reporting of significant problems; and dispute resolution mechanisms. Finance's banking provider has not provided the agency with quarterly and annual performance reports to date. On this point, Finance advised ANAO in September 2001 that:

[Finance's] banking provider has been able to provide the agency with quarterly and annual performance reports however both Finance and the provider have managed the contract in a more immediate manner. Both parties have been satisfied with the management of the contract, however both have agreed that quarterly and annual reports will be prepared for the purposes of documentation.

4.45 The financial outcomes of market testing for Finance are shown in Figure 4.4. After market testing, Finance's overall annual banking costs (excluding tendering and transitional costs) increased from \$47 000 in 1998–1999 to \$85 729 in the first year of outsourcing (1999–2000) and fell slightly in the second year. Finance's banking fees increased slightly in 1999–2000 due to higher transaction levels than those recorded in the previous year. They have decreased in 2000–2001 as Finance steadily reduced its reliance on cheques to make payments and actively sought its suppliers' acceptance of electronic payment methods. In addition to banking fees and charges, Figure 4.4 takes into account:

- the costs of commercial banks' settlement arrangements following the move from the RBA to a commercial bank. As outlined in Chapter 3, changes to the commercial bank's settlement arrangements, which came into effect in mid January 2002, should eliminate these costs; and
- transition and set-up costs advised to ANAO by Finance in September 2001 comprising probity advice on the tender process and fees for the independent member of the Tender Evaluation Panel of \$15 957 and system modifications costs of \$25 000 (see Figure 4.4).

Figure 4.4**Actual expenditure for the Department of Finance and Administration:
1998–1999 to 2000–2001**

Item	1998–1999	1999–2000	2000–2001
Pre-outsourcing costs	\$	\$	\$
Banking fees	47 000	-	-
Settlement costs	N/a	-	-
Transition and set-up costs	N/a	-	-
Total Costs	47 000	-	-
Outsourcing costs			
Banking fees	N/a	51 000	39 000
Settlement costs	N/a	34 729	40 391
Sub-total	Nil	85 729	79 391
Transition and set-up costs	15 957	25 000	-
Total Costs^A	15 957	110 729	79 391
Note: ^A Excludes savings relating to staff arising from the devolution to agencies of responsibility for devolved banking estimated by Finance to amount to \$30 000 in 1999–2000, \$75 000 in 2000–2001 and \$90 000 in 2001–2002.			

Source: ANAO analysis of Finance records.

4.46 Finance further advised ANAO that: *‘the increased costs have been offset by staff savings that accrue from devolved banking responsibilities to agencies’*, amounting to \$30 000 in 1999–2000, \$75 000 in 2000–2001 and \$90 000 in 2001–2002. In addition, Finance advised ANAO in March 2002 that benefits from their selected transactional banker *‘include cost (staff) savings due to the improved business processes (stemming from innovation) associated with a commercial transactional banking infrastructure.’* These benefits accruing from innovation were not quantified in Finance’s 1999 tender evaluation.

4.47 Finding: In June 1999, Finance signed a contract with its selected provider. The contract was for the provision of general banking services commencing 1 July 1999 and was for a term of one year with an extension of one to three years. The contract provides for monitoring and management arrangements in line with better practice.

4.48 After market testing, Finance’s overall annual banking costs (excluding tendering and transitional costs) increased from \$47 000 in 1998–1999 to \$85 729 in the first year of outsourcing (1999–2000) and fell slightly in the

second year. Finance has steadily reduced its reliance on cheques to make payments and has actively sought its suppliers' acceptance of electronic payment methods. However, the move to a commercial bank brought with it the additional costs of commercial banks' settlement arrangements which more than offset any savings in banking fees over the first two years of outsourcing. Changes to the commercial banks' settlement arrangements that came into effect in mid January 2002 should eliminate these costs.

Customs

4.49 Customs started taking receipts through its new banking provider in September 2000 and completed moving its payments business to its new banking provider in June 2001. Customs signed a contract with its new bank in February 2001,⁶⁸ 10 months after advising the bank of the tender outcome. It is also seeking a memorandum of understanding with its bank in relation to performance reporting against agreed indicators. On this issue, Customs advised ANAO in September 2001 that:

Offers had been invited with the RFT, the bank had made an offer and it had been accepted, albeit with some matters to be resolved. The conduct of the parties then demonstrates that a contract was in place that would be recognised by the courts. The written instrument merely formalised the arrangement. The lack of a written contract for 10 months did not stop the monitoring of service provision, nor would it have hindered seeking remedy from the bank for underperformance.

4.50 Customs decided to combine remedial changes to its financial management information system with implementing devolved banking through its new banker. The combination was intended to produce efficiencies. Customs planned to start the systems project in June 2000 and finish it in December 2000, however it continued until April 2001. Problems with software development and project coordination were the main causes of the delays and additional cost.

4.51 Customs' total banking costs⁶⁹ in the first year of outsourcing, 2000–2001, were \$170 000 compared to \$55 000 in 1999–2000 and \$43 000 in 1998–1999 (see Figure 4.5). The increases were due in part to the costs of commercial banks' settlement arrangements but were due mainly to increased banking fees arising from interim payment arrangements made with the RBA prior to Customs' preferred tenderer delivering Customs' payment business. In this respect, Customs advised ANAO in September 2001 that:

⁶⁸ Customs' contract with its bank is based on an earlier draft version of the model contract established by Finance but it does not include the clause providing for reimbursement of losses (for example, if accounts are not swept) included in the final version of the model contract.

⁶⁹ Comprising bank fees and interest costs. Excludes payments to a non-bank payment processing service.

Transactional fees have increased markedly due to the RBA revised fee structure. Customs was charged an excessive monthly flat fee which, according to the RBA, is calculated to fully cover all costs, both direct and indirect, and a profit margin calculated in terms of the Competitive Neutrality guidelines. In other words, the RBA would not cross-subsidise any agency beyond a reasonable transition period from its remaining customer base.

The transition to a new banker was completed in June 2001 and Customs' aggregate banking costs are expected to fall significantly in 2001–2002 due to the resolution of commercial banks' settlement arrangements and because services will only be sourced from one transactional banker.

Figure 4.5

Financial outcomes (excluding tendering costs) for the Australian Customs Service 1998–1999 to 2000–2001

Item	1998–1999	1999–2000	2000–2001
Pre-outsourcing costs	\$	\$	\$
• Banking fees	43 000	55 000	-
• Settlement costs	N/a	N/a	-
Total Banking Costs	43 000	55 000^A	N/A^A
Outsourcing costs			
• Banking fees	-	-	26 500
• Banking fees from interim arrangements with the RBA	-	-	137 500
• Settlement costs	N/a	N/a	6 000 ^B
Total Banking Costs	-	-	170 000

Notes: ^A Figure 4.5 does not include fees for payment and payroll processing to a non-bank payment service provider, amounting to \$93 000 in 1999–2000 and \$80 700 in 2000–2001. This service ceased from June 2001.

^B Settlement costs for June 2001 only. The annualised figure based on this amount is \$72 000.

Source: ANAO analysis of Customs records.

4.52 Finding: Customs started taking receipts through its new bank in September 2000 and completed moving its payments business to its new banking provider in June 2001. Customs signed a contract with its new bank in February 2001, ten months after advising the bank of the tender outcome. ANAO considers it is better practice for a signed written contract to be in place before a financial institution commences providing deposit and payment services. Otherwise, the documentary trail supporting the authority for the payment of public money and contractual performance requirements, incentives and sanctions may not be clear. In the context of transactional

banking, written agreements between agencies and their banking providers provides the basis for ensuring core requirement compliance and obtaining value for money.

4.53 Customs' total banking costs in the first year of outsourcing, 2000–2001, were \$170 000 compared to \$55 000 in 1999–2000 and \$43 000 in 1998–1999. The increase was mainly due to Customs sourcing banking services from two providers in 2000–2001. The RBA fees for the interim services it provided prior to Customs' moving all of its banking business to its preferred tenderer in June 2001 were substantially greater than those provided for under the previous whole-of-government pricing regime. In addition, there were costs related to commercial banks' settlement arrangements. The transition to a new banker was completed in June 2001 and aggregate banking costs are expected to fall significantly in 2001–2002 due to the resolution of commercial banks' settlement arrangements and because services will only be sourced from one transactional banker.

Recommendation No. 4:

4.54 ANAO *recommends* that agencies ensure a written agreement is executed before a financial institution commences providing deposit and payment services.

Agencies responded to the recommendation as follows:

4.55 **Agreed:** Finance, DIMIA, DEST and DTRS.

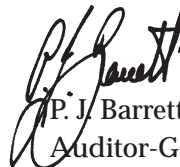
Agreed with qualification: Customs.

4.56 Specific comments by agencies are set out below:

- **Finance:** The Finance Minister's delegations require agency chief executives to ensure that agreements for transactional banking services require the transactional bank to comply with the core requirements set out in the delegation. Finance's agreement with its transactional banker requires compliance with the core requirements ("core protocols").
- **DIMIA:** DIMIA has written agreements in place with each of the financial institutions with which it conducts transactional banking and will continue to ensure that this is the case in future.
- **DEST:** A signed contract should be in place prior to the commencement of services.
- **Customs:** Agree in principle only, however it is not always practical to do so when significant business process changes must be implemented. Customs' banker was advised of its success in April 2000. At this point,

Customs and the successful banker worked on details that would form the basis of the contract between the two parties. Constructing a contract in this way worked to the advantage of Customs as the final outcome was a signed contract with the transactional banker that best suited the needs of Customs.

Canberra ACT
15 April 2002



P. J. Barrett
Auditor-General

Index

A

AOFM 6, 13, 31, 33, 48, 49

Appropriations 20, 45, 46, 49, 50, 51, 52, 53, 58

B

Banking costs 16, 17, 22, 24, 25, 82, 85, 91, 92, 93, 94, 95

BECS 6, 15, 20, 64, 68, 69, 70, 72, 73

Budget neutrality 15, 21, 50, 52, 53, 54

Budget preparation 20

Budgetary processes 20, 50, 54

C

cash management incentive scheme 11, 15, 18, 19, 31, 37, 57

Clawback 15, 21, 46, 49, 50, 52, 53, 54

Control weakness 18, 20, 50, 54, 57, 59

Core requirements 13, 14, 15, 19, 20, 25, 33, 35, 36, 39, 41, 42, 56, 60, 63, 64, 65, 66, 72, 73, 85, 86, 87, 90, 95

Customs 6, 14, 15, 17, 18, 22, 23, 24, 25, 26, 27, 32, 37, 44, 45, 55, 56, 59, 60, 61, 65, 66, 67, 76, 77, 78, 80, 85, 86, 87, 88, 89, 90, 93, 94, 95, 96

D

DEST 6, 14, 18, 22, 26, 27, 32, 37, 44, 45, 55, 56, 57, 59, 60, 61, 66, 72, 77, 79, 95

DIMIA 6, 14, 18, 22, 26, 27, 37, 44, 45, 55, 56, 59, 60, 61, 66, 77, 79, 95

DTRS 6, 14, 18, 22, 26, 27, 32, 37, 44, 45, 55, 56, 59, 61, 66, 72, 77, 79, 95

E

Evaluation criteria 24, 78, 81, 85, 86, 89

Evaluation planning 23, 80

F

Finance 6, 11, 12, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 23, 24, 26, 27, 31, 32, 33, 34, 35, 36, 37, 38, 39, 41, 42, 43, 44, 45, 46, 47, 48, 49, 50, 51, 52, 53, 54, 55, 56, 58, 59, 61, 63, 64, 65, 66, 67, 69, 70, 71, 72, 73, 74, 75, 76, 77, 78, 80, 81, 82, 83, 84, 85, 87, 90, 91, 92, 93, 95

Financial benefits 22, 76, 82, 85

Financial risk 12, 14, 19, 33, 71, 74

Financial savings 19

Financial transparency 21, 52, 54

G

GDES 7, 64, 68, 69, 70, 71, 73, 82

I

Interest shortfalls 19, 20, 65, 66

M

Market testing 5, 15, 16, 22, 24, 25, 39,
43, 47, 56, 57, 60, 64, 72, 74, 75,
78, 79, 80, 91, 92

O

Official Public Account 7, 11, 31, 48

R

RBA 7, 11, 12, 13, 15, 16, 17, 18, 19, 20,
21, 22, 23, 25, 31, 33, 35, 36, 37,
39, 41, 42, 44, 45, 46, 47, 48, 51,
54, 55, 56, 58, 60, 63, 64, 65, 66,
67, 68, 69, 70, 71, 72, 73, 74, 75,
81, 82, 85, 87, 88, 89, 90, 91, 93,
95

Risk Management 5, 18, 38, 39, 43, 45,
59, 60, 61, 71, 74, 81

S

Same-day value 15, 19, 20, 69, 70, 71,
72, 74, 75, 88

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