The Auditor-General
Audit Report No.10 2002–03
Performance Audit

Management of International Financial Commitments

Department of the Treasury

Australian National Audit Office

ISSN 1036–7632

ISBN 0 642 80665 9

Australian National
Audit Office

Canberra ACT
3 October 2002

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Department of the Treasury 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 *Management of International Financial Commitments.*

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

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Summary

Background

1. The Department of the Treasury (Treasury) manages Australia's relations with the International Monetary Fund (IMF) and various development banks, including those belonging to the World Bank Group. Treasury provides advice to Ministers on a range of issues, including advice on the achievement of Government objectives, strengthening the international financial system, multilateral debt relief, and institutional reform in the multilateral development banks. In addition, Treasury monitors the financial position of the international financial institutions, including their financial policies and safeguards because, in the event of institutional failure, significant financial calls could be made on Australia and other shareholders.

2. In its role of managing Australia's participation in the IMF and with various development banks, and in providing certain bilateral assistance in support of economic reform and governance, Treasury is responsible for ensuring Australia's financial obligations are met in the most efficient manner consistent with government policy, and properly accounted for. In this context, Treasury's financial relationship with the development banks largely involves managing capital subscription payments, whereas financial dealings with the IMF involve more complex arrangements. In addition to IMF capital subscription payments, Treasury is also responsible for managing various other financial transactions that occur between Australia and the IMF, the latter include annual adjustments to maintain the foreign currency value of Australia's investment (called 'maintenance of value') and payment of various charges related to Australia's membership of the Fund.

3. Meeting Australia's international obligations to the various international institutions and bilateral support over the past 10 years has involved more than $3 billion[1] in capital contributions and recurrent funding. Given the scale of these contributions, sound financial and risk management practices are necessary to protect the Commonwealth's interests.

Audit objectives

4. In view of the size of Australia's investments and obligations, the audit focussed on financial management issues. The audit objectives were to:

1 All figures quoted in this report are in Australian dollars unless otherwise indicated.

- identify and quantify, on a consistent basis, the current value of commitments to international financial institutions and bilateral support packages administered by Treasury;
- assess Treasury's management of these financial commitments and related exposures; and
- identify opportunities to improve existing administrative practices, including any possible financial savings that may accrue to the Commonwealth from improved procedures and risk management practices.

Overall audit conclusion

5. In relation to the international financial commitments it administers, Treasury's management activities have focussed on facilitating the achievement of government objectives in international forums; providing advice to Treasury portfolio ministers; and implementing government decisions relating to international economic and financial issues.

6. Overall, Treasury's management of the relationship with international financial institutions has been effective. Nevertheless, the governance framework and financial management practices for administering Australia's obligations could be improved by:

- comprehensively documenting administrative procedures so as to mitigate risks associated with staff turnover and the irregular nature of transactions;
- enhancing performance measurement and reporting so as to encourage a management focus on administering international financial commitments at the lowest possible long-term cost, consistent with an acceptable degree of risk exposure; and
- explicitly identifying and quantifying financial risks in relation to proposed expenditure commitments, consistent with the emphasis on agency risk management outlined in the revised framework for Commonwealth foreign exchange risk management that was introduced with effect from July 2002.

7. ANAO has made two recommendations to address the first two improvement opportunities identified by the audit. In relation to financial risk management, no recommendation has been made as the Department of Finance and Administration announced in June 2002 that it will be developing, and releasing to agencies, principles-based guidance on foreign exchange risk management practices.

Key findings

Financial management

8. As at 30 June 2002, the market value of investments in the various institutions and bilateral loans was $8.6 billion, with liabilities totalling $6.1 billion, representing aggregate net assets of $2.5 billion. In addition to the liabilities of $6.1billion, as at 30June 2002 there were contingent liabilities of $9.6 billion, largely comprising uncalled share capital subscriptions. Assets related to Treasury's international financial commitments mainly comprise the paid-in value of shares in development banks ($822 million as at June 2002) and the shareholding in the IMF ($7.57 billion). The development bank investments are illiquid in that their value cannot be realised without withdrawing from the institutions. The IMF investment realisation is also conditional in that only part of it can be accessed, either by withdrawing from the Fund or in the event of a balance of payments need.

9. The primary legislation governing Treasury's administration of its financial commitments is the *International Monetary Agreements Act 1947*. Most of Treasury's payments to international financial institutions and bilateral loans have been made under the standing special appropriations provided by the International Monetary Agreements Act and other special appropriations. Over the last 10 years, expenditure under special appropriations totalled just over $2.9billion, of the $3.0billion paid by Treasury. The difference of $142 million (5per cent) was paid from annual appropriations. In this context, there have been occasions where Treasury has sought an annual appropriation for payments that have previously been made under a special appropriation, and vice-versa. In the future, Treasury should consider using the authority of the relevant special appropriations, as this better reflects Parliament's intent and facilitates continuity of information in the interests of greater transparency and accountability.

10. A robust control environment, a key element of which is the existence of well defined policies and procedures, assists agencies to effectively manage risk. Treasury's agency-wide Chief Executive's Instructions require each division/directorate to develop management policies, practices and procedures that are most suitable to meet their own individual needs given the nature of their operating environment. In respect of Treasury's international financial commitments, procedural documentation is not complete. More comprehensive documentation, with key procedures being part of Treasury's Chief Executive's Instructions, would strengthen the control environment. This would at least help alleviate difficulties arising from the turnover in staff responsible for administering Treasury's international financial commitments and the irregular nature of transactions which can involve significant commitments stretching over many years.

Performance management

11. Agencies require a range of performance information for internal program management purposes and external reporting and accountability. It would be expected that information for the latter purposes would be derived from performance information that agencies use for operational and program management. In this context, Treasury's performance measures and reporting in relation to its international financial commitments have focussed on facilitating the achievement of government objectives in international forums; providing advice that meets Treasury portfolio ministers' needs in administering their responsibilities; and implementing government decisions. However, Treasury's performance measures and performance reporting currently do not adequately address its financial management responsibilities, including the management of financial risk and asset and liability management. In these respects, identifying an appropriate exposure management objective and related financial performance measures could markedly contribute to improved financial management which is consistent with government policy that agencies effectively manage financial risk.

Risk management

12. The major financial risk faced by Treasury in its administration of commitments to international financial institutions is foreign exchange risk. On some occasions, Treasury analysed exchange rate risk. However, on other occasions it has not performed this analysis or the analysis performed did not adequately reflect the sensitivity of the proposed expenditure to exchange rate movements. In terms of risk treatment, Treasury has retained an open position to foreign exchange risk exposures. Based on an ex post assessment, this approach has increased the cost of payments made since 1990 by at least $23 million compared to hedging using actual interest rate differentials. In this context, it is important to point out that, while hedging provides certainty as to the 'price' of a future transaction, it may not be a costless exercise where Australian interest rates are at a premium to overseas interest rates. It is thus not always the case that hedging consistently produces a better outcome. Assessment of the lowest cost options will only ever be able to be made after the event.

13. In July 2002, a revised framework for Commonwealth foreign exchange risk management was introduced with the intention of implementing an overarching position on foreign exchange risk management and placing a greater emphasis on risk management by agencies. Under the revised framework, agencies' foreign exchange risk management responsibilities include identifying, evaluating and treating risks. Agencies may have their Budget funding adjusted if they are able to demonstrate proper risk management but they are no longer permitted to hedge their exposures. In this context, the Department of Finance and Administration announced in Finance Circular 2002/01 that it will be developing and releasing to agencies principles-based guidance on foreign exchange risk management practices.

Agency responses

14. A copy of the proposed report for this audit was provided to both Treasury and the Reserve Bank of Australia (Reserve Bank). The Bank's response stated that it was comfortable with the report's conclusions and recommendations. Treasury responded as follows:

> Treasury has managed Australia's financial commitments with respect to the international financial institutions for over five decades. We recognise the need for ongoing review of management practices and, in this regard, welcome the opportunity to benefit from an assessment of current practices by the ANAO. The report does, I believe, provide us with some useful guidance on areas where management of Australia's financial commitments can be improved.
>
> With regard to the two recommendations in the report, Treasury can agree to both. We will undertake to examine the merits of including in our Portfolio Budget Statements performance measures / reporting that address financial management responsibilities in relation to the administration of international financial commitments. We will do so, however, in the context that these international financial commitments are essentially entered into—and the facilitating investments held—for policy purposes rather than as an investment portfolio. Thus, while minimising the cost of entering into such transactions is important, we do not believe that these financial investments can be viewed solely through the prism of a simple risk-return framework.
>
> Similarly, Treasury will review the framework for its policies and procedures for the administration of its international financial commitments. This will include updating the existing operational manuals for international financing transactions and assessing the scope for expanding the Chief Executive's Instructions to include delegated authorities under the International Monetary Agreements Act and other international financial legislation. We will also look closely at the scope for better assessing and reporting on the financial risks and exposures associated with Australia's international financial commitments, while remaining consistent with the Government's overarching policies and recent guidance on departmental responsibilities in this regard.

Recommendations

Set out below are ANAO's recommendations arising from this report. Report paragraph numbers and abbreviated Treasury responses are included here with more detailed responses shown in the body of the report together with the findings.

Recommendation No.1 (para 2.10)

ANAO *recommends* that Treasury further examine the merits of including in its Portfolio Budget Statements performance measures and performance reporting that addresses its financial management responsibilities in relation to the international financial commitments it administers.

Treasury response: Agreed.

Recommendation No.2 (para 2.21)

ANAO *recommends* that Treasury implement a more comprehensive framework of policies and procedures for the administration of its international financial commitments.

Treasury response: Agreed.

Audit Findings and Conclusions

1. Introduction

This chapter sets the context for the audit; summarises the international financial commitments administered by Treasury; and explains the audit approach.

Background

1.1 Through membership of various international financial institutions and bilateral financial support for certain countries, Australia makes a significant financial contribution to sustaining international economic stability and growth. The Department of the Treasury (Treasury), provides advice to ministers on advancing Australia's interests through a number of international financial institutions and international forums. Treasury also provides bilateral financial and technical assistance in support of economic reform and strengthened economic governance, in particular to Papua New Guinea (PNG).[2]

1.2 The international financial commitments administered by Treasury range from short-term bridging finance to major long-term capital injections. As of 30 June 2002, investments in the various institutions administered by Treasury were valued at $8.6 billion. Aggregate liabilities to these institutions totalled $6.1 billion. The investments are held and commitments entered into for policy purposes rather than as an investment portfolio. Nevertheless, there are financial exposures for the Commonwealth from Australia's membership of international institutions and bilateral support packages that require sound financial and risk management policies and procedures.

1.3 The more financially significant of Treasury's commitments involve contributions to the International Monetary Fund (IMF) and a number of multinational development banks (the International Bank for Reconstruction and Development (IBRD), the Asian Development Bank (ADB) and the European Bank for Reconstruction and Development (EBRD)). Treasury's financial relationship with the development banks largely involves managing capital subscription payments. Financial dealings with the IMF are more complex. While Treasury is required to manage the capital subscription payments for the IMF (otherwise known as quota increases), Treasury is also responsible for managing various other financial transactions that occur between Australia and the IMF. This includes payment of charges and an annual assessment fee, receipt of remuneration on Australia's Reserve Tranche Position[3] (being Australia's

[2] The Treasury, *Annual Report 2000–01*, p. 26. As at 31 December 2001, loans totalling $192.15 million with Papua New Guinea had yet to mature with a further $5.57 million in loan guarantees being administered by Treasury.

[3] The Report and Accounts on the United Kingdom's Exchange Equalisation Account for the period from 1 April 2000 to 31 March 2001 notes that, in effect, the Reserve Tranche Position is the amount of a country's subscription that the IMF has called and that the Reserve Tranche is a reserve asset.

membership quota less the IMF's holdings of Australian dollars), and transactions to maintain the value of the IMF's holdings of Australian dollars against the Special Drawing Right (SDR).[4]

1.4 Legislation has been passed by Parliament to establish Australian involvement in the various international financial institutions. These Acts provide for appropriations and the issue of securities to effect Australia's membership of each institution. Furthermore, a number of additional subscription, quota and share increase Acts have been passed to allow Australia to take up further shares in some of the institutions.

The International Monetary Fund (IMF)

1.5 The IMF was created by the Bretton Woods Conference in 1944 to promote exchange rate stability including by the provision of assistance to members to deal with transitory currency problems. The IMF is an organisation of 184 member countries, established to: promote international monetary cooperation and exchange stability; foster economic and employment growth; and provide temporary financial assistance to countries under adequate safeguards to help ease balance of payments adjustment. Australia officially became a member of the IMF on 5 August 1947 and is currently the 15th largest member with 1.50 per cent of the voting power.

1.6 Capital subscriptions to the IMF are referred to as quotas, which are the primary source of IMF resources. All member countries of the IMF are required to pay a quota to join the IMF with each member's quota determines its voting rights, access to IMF resources and allocation of SDRs. Quota increases generally arise from a General Review of Quotas which occur at least every five years. Not all reviews, however, result in changes to quotas. Four of the 12 reviews to date have not resulted in an increase in quotas. As of 30 June 2002,Australia's quota was SDR3.236 billion ($7.567 billion) with liabilities to the IMF totalling $5.961billion.[5]

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4 The SDR is a weighted currency unit calculated daily in terms of a basket of four currencies. As of the last revision on 1 January 2001, the currency weights in the SDR basket were 45 per cent United States dollars, 29per cent Euros , 15per cent Japanese Yen and 11per cent Pounds Sterling. The SDR is used as an international reserve asset to supplement members' existing reserve assets comprising official holdings of gold, foreign exchange and reserve positions in the IMF.

5 Comprises promissory notes of $2805.5 million outstanding with respect to the quota, Maintenance of Value liability of $2037.9million, Special Drawing Rights (SDR) allocation liability of $1100.2 million (SDR470.6million) and outstanding payments to the Poverty Reduction and Growth Facility of $17.5million (previously the Enhanced Structural Adjustment Facility).

1.7 In 2000–01 Treasury assisted the IMF in undertaking its regular Article IV consultation[6] with Australia, and also supported such initiatives as: refocussing conditionality; enhanced financial sector surveillance and crisis prevention; private sector involvement; and crisis resolution.[7]

The Heavily Indebted Poor Countries Initiative

1.8 The Heavily Indebted Poor Countries (HIPC) Initiative was introduced by the IMF and World Bank in 1996. It involves a package of measures designed to ensure that economic reform in a number of highly indebted countries, mostly in Africa, is not put at risk by crippling debt and debt service burdens. Australia's total contribution has been $59 million.

Development Banks

1.9 Multilateral development banks are international financial entities that finance economic and social development projects and programs in developing countries. Development bank operations are financed through retained earnings, paid-in capital from members and funds borrowed from capital markets using members' paid-in and callable capital as backing. The use of members' capital obligations as backing enables the banks to obtain very favorable financing terms when borrowing from world capital markets.[8] Figure 1.1 summarises Australia's shareholdings in the various development banks as at 30 June 2002.

Figure 1.1

Shareholdings in Development Banks as at 30 June 2002

Institution	Paid-in capital $m	Share capital payable $m	Uncalled share subscriptions $m	Total $m
IBRD	322	Nil	4,903	5,225
ADB	328	15	4,333	4,676
EBRD	81	21	280	382
International Finance Corporation	84	Nil	Nil	84
Multilateral Investment Guarantee Agency	8	3	47	58
Total	**823**	**39**	**9,563**	**10,425**

Source: ANAO analysis of Treasury data

6 The IMF conducts regular discussions with the authorities of member countries on economic policies, in accordance with Article IV of the IMF's Articles of Agreement which provides for the obligations of members regarding exchange arrangements of goods, services and capital among countries.

7 The Treasury, *Annual Report 2000–01*, p. 29.

8 United States General Accounting Office, *Multilateral Development Banks: Profiles of Selected Multilateral Development Banks,* May 2001, p. 11.

The World Bank Group

1.10 The World Bank Group was established in the mid 1940s to provide long-term investment for the reconstruction and development of members. The World Bank Group comprises the IBRD and the International Development Association (IDA),[9] as well as three affiliates: the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA) and the International Centre for Settlement and Investment Disputes (ICSID).[10] Together, the five institutions comprise the World Bank Group.[11]

International Bank for Reconstruction and Development (The World Bank)

1.11 The IBRD was established in the mid 1940s. It provides loans, related hedging products and guarantees to its borrowing member countries, to help meet their development needs. It also provides technical assistance and other services to support poverty reduction in these countries. Voting power is linked to members' capital subscriptions, allocated to reflect each country's quota in the International Monetary Fund, which in turn is based (in part) on each country's relative economic strength.

1.12 Australia has been a member of the IBRD since it was established. There have been three general increases in IBRD capital resources, the most recent of which occurred in 1988. Australia was allocated an additional 10734 shar es with a value of $US1.29 billion, of which 3 per cent was to be paid to the IBRD, with the remainder at call. Australia subscribed in two tranches to the additional shares allocated to it; 7880 shares in 1988 and the remaining 2854 shares in 1996.

1.13 As at 30June 2002, Australia held 24 464 shares in the IBRD valued at $US2.95billion ($5.23billion). T reasury has paid for some 6per cent of the value of the shares ($322million) with the r emainder ($4.90billion) at call. [12] Australia is the 17th largest of the 183 shareholders in the IBRD holding 1.56per cent of the shares on issue with a voting power of 1.53per cent.

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[9] Membership of IDA is administered by the Australian Agency for International Development (AusAID) in the Foreign Affairs and Trade portfolio and was therefore not examined as part of this audit. Aspects of AusAID's administration of financial commitments to IDA was examined in Audit Report No.45 1999–2000, *Commonwealth Foreign Exchange Risk Management Practices*, pp. 96–100.

[10] As membership of the ICSD requires no financial contribution beyond those associated with IBRD membership, it is not examined in this report.

[11] Joint Standing Committee on Foreign Affairs, Defence and Trade, *Australia, the World Bank and the International Monetary Fund*, 1993, p. 3.

[12] There is a further contingent liability of $US42.6million ($75.3million) outstanding with respect to the IBRD.

International Finance Corporation (IFC)

1.14 Established in 1956, the IFC aims to promote growth in the developing world by financing private sector investments and providing technical assistance to governments and the private sector. In partnership with private investors, the IFC provides both loan and equity finance for business ventures in developing countries.

1.15 Australia was a founding member of the IFC. As at 30 June 2002, Australia held 47 239 shares valued at $US47 million ($84 million) which have been fully paid for. This shareholding makes Australia the 12th largest of the 175 shareholders in the IFC. The third increase to the IFC's capital was approved by its Board of Governors in 1991. Australia subscribed in 1995 to the 20578 shares allocated to it under this capital increase, with the full amount of $US21million paid between 1996 and 1999.

Multilateral Investment Guarantee Agency (MIGA)

1.16 MIGA was established in 1988. It aims to help encourage foreign investment in developing countries by providing guarantees to foreign investors against loss caused by non-commercial risks such as wars and civil instability. Australia applied to join MIGA in 1995 and is the 14th largest of the 154 shareholders.

1.17 MIGA's first general capital increase was approved by its Council of Governors in 1999. In 2000, Australia agreed to purchase the additional 1306 shares allocated to it at a paid-in cost of $US2.5million. As at 30June 2002, Australia held 3019 shares in MIGA valued at $US33million ($58million) of which $7.7million has been paid-in with the remaining $50million payable or at call.

Asian Development Bank (ADB)

1.18 The ADB was established in 1966 to assist the economic and social development of countries in the Asia Pacific region. To achieve this goal, it provides financial and technical assistance for projects and programs. The ADB's financial assistance includes loans, equity investments and guarantees. It finances these types of operations through borrowings, paid-in capital and retained earnings. Australia has been a member of the ADB since it was established.

1.19 Since its inception, there have been four general capital increases, the most recent of which occurred in 1994. Australia subscribed in 1995 to all of the 102370 additional shares allocated to it under this capital increase. The total value of the additional shares was $US1.23billion, of which 2per cent was to be paid-in with the remainder at call. Australia is the fifth largest shareholder in the ADB with 204 740 shares held, as at 30 June 2002, valued at $US2.64 billion ($4.68 billion). Of this amount, $328 million has been paid in, with a further $15 million payable, and the remaining $4.33 billion being at call.

European Bank for Reconstruction and Development (EBRD)

1.20 The EBRD was established in 1991 to assist the countries of central and eastern Europe in the transition towards market economies by investing in projects in both the private and public sectors. Australia has been a member of the EBRD since it was established and is the 22nd largest of the 61 shareholders.

1.21 The EBRD's first capital increase was approved by its Board of Governors in 1997. Australia subscribed in 2000 to the 10000 additional shares allocated to it in 1997. The total value of the additional shares is 100million Euros, of which 22.5per cent is to be paid-in, with the remainder at call. As at 30June 2002, Australia held 20000 shares in the EBRD with a total value of $382million. [13] This comprised 10000 shares valued at $US116.7million ($207million) and 10000 shares valued at 100million Euros ($175million). On a share basis, the amount paid-in is 26per cent. However, on a value basis, the amount paid-in is 21per cent, reflecting the mix of currencies.

Audit approach

1.22 The audit scope involved examination of all international financial commitments and exposures administered by Treasury. In view of the size of Australia's investment and related obligations, the audit focussed on financial management issues.

1.23 The audit objectives were to:

- identify and quantify, on a consistent basis, the current value of commitments to international financial institutions and bilateral support packages administered by Treasury;
- assess Treasury's management of these financial commitments and exposures; and
- identify opportunities to improve administrative practices, including any possible financial savings that may accrue to the Commonwealth from improved procedures and risk management practices.

1.24 The audit involved fieldwork within Treasury and the Reserve Bank including examination of Commonwealth records, discussions with relevant officers and examination of financial data. ANAO examined payments made

[13] Of this amount, $80.7million has been paid in, $20.7million is still to be paid with the remaining $280.2million at call.

by Treasury to international financial institutions in the period since 1990. Records of earlier payments were not available for audit. Because of the complex nature of some financial exposures, financial advice was obtained by ANAO from Giffnock Consulting Pty Ltd, a firm with expertise in treasury matters, including in financial risk management.

1.25 Audit fieldwork was conducted between August 2001 and March 2002. Issues Papers were provided to Treasury for comment in May 2002 followed by Discussion Papers in June and July 2002. A draft report was provided to both Treasury and the Reserve Bank in August 2002.

1.26 The audit was conducted in accordance with ANAO auditing standards at a cost to the ANAO of $315 000.

2. Financial Management and Reporting

This chapter examines Treasury's role in administering various international financial commitments as well as assessing Treasury's management and reporting of the international financial commitments and the exposures it administers.

Treasury's role

2.1 Treasury manages Australia's relations with the IMF, the ADB, the EBRD and the World Bank Group (except IDA). Treasury provides advice to Ministers on a range of issues, including advice on the achievement of Government objectives, strengthening the international financial system, multilateral debt relief, and institutional reform in the multilateral development banks.[14] Treasury also participates in the work of the Organisation for Economic Co-operation and Development (OECD), as well as other international work to improve the architecture of the international financial system. In addition, Treasury contributes to the Treasurer's involvement in the work of Asia-Pacific Economic Co-operation (APEC) Finance Ministers and to Australia's broader involvement in APEC. Treasury has confirmed to the ANAO that it administers no significant financial obligations to Australia for participation in groups other than for the IMF and the various development banks.

2.2 As mentioned in Chapter1, commitments to international financial institutions are essentially entered into, and the investments held, for policy purposes rather than as an investment portfolio. As a partly-paid shareholder in the relevant institutions, the greatest risk faced by Australia is that of institutional failure resulting in Australia, and other shareholders, being asked to pay for the uncalled portion of subscriptions in order to meet the borrowing obligations and guarantees of the various institutions. In May 2002, Treasury advised ANAO that it considers 'the risk of the contingent or at call liabilities being called as low and the risk of Australia being required to repay IMF allocations of SDRs—which comprise the bulk of payable liabilities—as low for the foreseeable future'. Treasury also noted that, whilst it considered the risk of these contingent liabilities being called as low, a key role remains for it to monitor the financial position of the international financial institutions, including their financial policies and safeguards. As well, this monitoring role is formalised in annual reports that are submitted to Parliament.[15]

[14] *Portfolio Budget Statements 2001–02*, Treasury Portfolio, p. 15.

[15] To contribute to public debate and understanding, as required by legislation, Treasury prepares annual reports on Australia's relations with the IMF and the World Bank that are tabled in Parliament by the Treasurer.

2.3 The activities of each of the international financial institutions is overseen by a board of governors. The Treasurer is Australia's representative on each board. To assist the Treasurer in his role as a governor in the various institutions, Treasury provides policy advice and briefings for the Treasurer's attendance at the meetings of Boards of Governors. As well, it makes recommendations to the Treasurer on voting decisions, including the merits of subscribing to additional shares and the mechanisms for payment for these shares.

2.4 In addition to a board of governors, each development bank and the IMF also has a board of executive directors to whom the board of governors has delegated oversight of day-to-day operations. While decisions of the boards of governors are generally made by voting, decisions of executive boards are generally made by consensus (Treasury advised ANAO that formal votes are rarely taken at the executive board level). As well as Ministerial briefings, Treasury prepares briefings for Australia's representatives (including Executive Directors) at the various international financial institutions. Treasury officials also attend meetings of the various institutions.

Performance measures

2.5 The focus of reforms in the Australian Public Service over many years has been the establishment of a performance culture supported by clear lines of accountability. Agencies require a range of performance information for internal program management purposes and external reporting and accountability. In this context, to effectively and efficiently administer international financial commitments, Treasury needs suitable information relating to financial risks as well as for asset and liability management.

2.6 Aligning the performance information that agencies use for operational and program management with the key performance indicators used for external reporting and accountability purposes can assist management to drive their business towards achieving expected outcomes. In this context, Treasury's performance measures for its administration of international financial commitments are:[16]

- the facilitation of achievement of government objectives in international forums, including strengthening the international financial system, multilateral debt relief and institutional reform in the multilateral development banks; and

[16] The Treasury, *Annual Report 2000–2001,* pp. 26 and 27, *Portfolio Budget Statements 2001–02—Treasury Portfolio,* Budget Related Paper No.1.17, p . 15 and *Portfolio Budget Statements 2002–03—Treasury Portfolio,* Budget Related Paper No.1.16, p . 18.

- providing advice that meets Treasury portfolio ministers' needs in administering their responsibilities and implementing government decisions relating to international economic and financial issues.

2.7 Performance information published by Treasury states that its advice to its portfolio ministers meets their needs in administering their responsibilities and implementing government decisions relating to international economic and financial issues.[17] These performance measures and Treasury's performance reporting are not, however, sufficiently directed to Treasury's financial management responsibilities[18] including the management of financial risk and asset and liability management. ANAO considers that Treasury should consider including such information, as appropriate, in its Portfolio Budget Statements and other performance reports.

2.8 Sound financial management practice dictates that, where financial risk exposures can have a significant effect on the business of an entity, these exposures should be adequately managed. An important consideration in this decision-making process is properly identifying an appropriate exposure management objective and related financial performance measures.[19] For budget-funded entities, financial benchmarks / performance indicators may relate to the desirability of containing costs within budget or appropriation and / or minimising volatility in costs. For example, when it was directly responsible for Commonwealth debt management, Treasury had an objective to raise, manage and retire Commonwealth debt at the lowest possible long-term cost, consistent with an acceptable degree of risk exposure.[20]

2.9 Finding: Agencies require a range of performance information for internal program management purposes and external reporting and accountability. It would be expected that information for the latter purposes would be derived from performance information that agencies use for operational and program management. In this context, Treasury's performance measures and reporting in relation to its international financial commitments have focussed on facilitating the achievement of government objectives in international forums; providing advice that meets Treasury portfolio ministers' needs in administering their responsibilities; and implementing government decisions.

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17 The Treasury, *Annual Report 1999–2000,* p. 25; The Treasury, *Annual Report 2000–01*, p. 27.

18 Finance guidelines require performance indicators to reflect the: effectiveness of contributions to outcomes; price, quality and quantity of outputs; and characteristics of relevant administered items. Source: Department of Finance and Administration, *The Outcomes and Outputs Framework*, October 2000.

19 Financial performance measures bias behaviour—and the absence of a clear benchmark may result in an approach of "monitor carefully but do nothing" being adopted, giving form but not substance to the risk management process. This default means that many of the opportunities to reduce costs or increase revenues are not evaluated.

20 Audit Report No.14 1999–2000, *Commonwealth Debt Management*, p. 44, paragraph 3.1.

However, Treasury's performance measures and performance reporting currently do not adequately address its financial management responsibilities, including the management of financial risk and asset and liability management. In these respects, identifying an appropriate exposure management objective and related financial performance measures could markedly contribute to improved financial management which is consistent with government policy that agencies effectively manage financial risk.

Recommendation No.1

2.10 ANAO *recommends* that Treasury further examine the merits of including in its Portfolio Budget Statements performance measures and performance reporting that addresses its financial management responsibilities in relation to the international financial commitments it administers.

2.11 *Treasury response:* Agreed. Treasury commented that it will examine the merits of including performance measures for its international financial commitments in its Portfolio Budget Statements, as well as reporting against these measures. Treasury further commented that any assessment as to the appropriateness/use of performance measures in this area will need to take account that these commitments are entered into for policy purposes rather than as an investment portfolio.

Legislative framework

2.12 The primary legislation governing Treasury's administration of its financial commitments is the *International Monetary Agreements Act 1947* (IMAA). The IMAA approved Australia's membership of the IMF and the IBRD and provides standing appropriations for actual payments to each institution, including permitting securities to be issued in substitution for payments to the relevant institutions. The *International Monetary Agreements Amendment Act 1997* introduced a new framework for recording financial transactions with the IMF and allowed Australia to adhere to the IMF's New Arrangements to Borrow. In addition, amendments to the IMAA in 1998 established a framework for the provision of financial assistance to countries that are undertaking economic adjustment programs with the support of the IMF. This support may be given either through loans (of which there have been two to-date)[21] or currency swaps[22] (none of which has yet been transacted under the IMAA[23]).

2.13 Separate Acts have also been passed by Parliament to establish Australian involvement in the ADB, EBRD, IFC and MIGA.[24] These Acts provide for appropriations and the issue of securities to effect Australia's membership of each institution. Furthermore, a number of additional subscription, quota and share increase Acts have been passed to allow Australia to take up further shares in the IBRD, ADB and IMF.

2.14 Most of Treasury's payments to international financial institutions and bilateral loans have been made under the standing special appropriations provided by the IMAA and other special appropriations.[25] Over the last 10 years, expenditure under special appropriations totalled some $2.9 billion, of the $3.0 billion paid by Treasury. The remaining $142 million (5 per cent) has been paid from annual appropriations (see Figure 2.1).

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[21] In 2000, the Australian dollar equivalent of the $US80 million Reserve Bank of Australia swap facility with the Bank of Papua New Guinea was converted into a longer term government-to-government loan with PNG. An additional loan of $US30 million has also been provided in three tranches of $US10 million each (a loan of $69.4 million was also provided to PNG in 1995). Proposed government-to-government loans to Korea and Indonesia of up to $US1billion each ha ve not occurred.

[22] Swaps involve each party to the contract agreeing to exchange (swap) their respective payment obligations. These payment obligations are specified by reference to the notional principal value specified in the swap agreement. For cross-currency swaps, the two sides of the contract are denominated in different currencies. There is usually an exchange of currencies for the principal amount of the swap on commencement and maturity of the transaction. Interest payments on the swap can simply involve swapping the currency in which these payments are denominated or fixed rates can be swapped to floating rates and vice-versa.

[23] However, prior to the passage of the IMAA, up $US1billion in supplementar y financing was offered to Thailand in 1997 in the form of a currency swap between the Reserve Bank of Australia and Bank of Thailand. Thailand drew down $US862 million, with the swap due to be repaid in full by July 2004.

[24] Namely the: *Asian Development Bank Act 1966*; *European Bank for Reconstruction and Development Act 1990; International Finance Corporation Act 1955*; and *Multilateral Investment Guarantee Act 1997*.

[25] This type of Bill appropriates funds for a specified purpose, for example, to finance a particular project or program set up by the Bill (the appropriation being in most cases incidental to the Bill's main intention). Around 75per cent of go vernment expenditure is covered by special appropriations, which includes items such as the age pension and Medicare benefits. Those providing funds for an indefinite period are said to give 'standing appropriation'.

Figure 2.1

Payments from appropriations for Australia's Capital Subscriptions to International Financial Institutions: 1992–93 to 2001–02[26]

Appropriations	Total $m
Special Appropriations	
International Monetary Agreements Act 1947	2,654.5
International Monetary Fund (Quota Increase) Act 1991	179.8
European Bank for Reconstruction and Development Act 1990	32.2
Asian Development Bank (Additional Subscription) Act 1995	18.2
International Bank for Reconstruction and Development (General Capital Increase) Act 1989	11.4
Asian Development Bank (Additional Subscription) Act 1983	3.6
Multilateral Investment Guarantee Agency Act 1996	2.9
Special Appropriations Total	**2,902.6**
Annual Appropriations	**141.8**
TOTAL PAYMENTS FROM APPROPRIATIONS	**3,044.4**

Source: ANAO analysis of Treasury Annual Reports 1992–93 to 2000–01 and Treasury's 2002–03 Portfolio Budget Statements.

2.15 The Joint Committee of Public Accounts and Audit (JCPAA) has recently commented on the importance of continuity of information in budget documentation to supporting transparency and accountability.[27] In this respect, there have been occasions where Treasury has sought an annual appropriation for payments that have previously been made under the IMAA,[28] and vice-versa. Treasury commented to ANAO that its capital payments to the multilateral development banks are fully documented in the Treasury Portfolio Budget Statements and, on this basis, it does not consider that there is a problem with transparency, or accountability, in relation to these payments. Nevertheless, Treasury should consider using the authority of the relevant special appropriations, as this better reflects Parliament's intent and facilitates continuity of information in the interests of greater transparency and accountability.

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[26] 2001–02 figures are estimated actuals from the 2002–03 Budget.

[27] Joint Committee of Public Accounts and Audit, *Review of the Accrual Budget Documentation*, Report 388, June 2002, pp. 21–31.

[28] For example, Treasury's *Portfolio Budget Statements 2000–01* (p. 10) stated that it would receive $1729.9million in special appropr iations in 2000–01 which, among other things, would fund a capital payment to the EBRD. However, Treasury's *Portfolio Budget Statements 2001–02* (p. 10) stated that the capital payment for that year to the EBRD would be funded from Appropriation Bill No.2.

2.16 Finding: The primary legislation governing Treasury's administration of its financial commitments is the *International Monetary Agreements Act 1947*. Most of Treasury's payments to international financial institutions and bilateral loans have been made under the standing special appropriations provided by the International Monetary Agreements Act and other special appropriations. Over the last 10 years, expenditure under special appropriations totalled just over $2.9 billion, of the $3.0 billion paid by Treasury. The difference of $142 million (5 per cent) was paid from annual appropriations. In this context, there have been occasions where Treasury has sought an annual appropriation for payments that have previously been made under a special appropriation, and vice-versa. In the future, Treasury should consider using the authority of the relevant special appropriations, as this better reflects Parliament's intent and facilitates continuity of information in the interests of greater transparency and accountability.

Control environment

2.17 A robust control environment assists agencies to effectively manage risk. A key element of a robust control environment is the existence of defined policies and procedures. The existence of up-to-date policies and procedural documentation provides suitable guidance on which to manage and process transactions and exposures. Policy and procedural documentation is also a useful training tool for new or inexperienced staff and helps prevent control breakdowns where, for example, there is high staff turnover and lack of relevant knowledge and expertise.

2.18 Treasury's Chief Executive's Instructions (CEIs), which were issued in December 2001, establish its financial administrative framework, as required under the *Financial Management and Accountability Act 1997* (FMA Act). The CEIs do not specifically address the administration of Treasury's international financial commitments. Instead, the CEIs require each division / directorate to develop management policies, practices and procedures that are most suitable to meet their own individual needs given the nature of their operating environment.[29] In this context, in May 2002, Treasury advised ANAO that the administration of payments:

- is comprehensively filed, with past recorded transactions providing a detailed chronology of procedure;
- follows detailed payment requests received from various international financial institutions;

[29] The Treasury, *Chief Executive Instructions*, 19 December 2001, p. 9–4.

- is processed in consultation with Treasury's Accounting and Financial Management Unit and Budget Policy Division as well as the Australian Office of Financial Management and the Reserve Bank with clearance sought from the Treasurer's office; and
- is based on transactions manuals that exist for both the IMF[30] and multilateral development banks.[31]

2.19 These processes address a number of the elements of a financial management framework. However, they are incomplete (for example, there is no guidance provided on capital budgeting, appropriate financial analysis methodologies or approved risk management strategies). As well, they have not been formalised under the authority of the departmental CEIs. ANAO considers that more comprehensive documentation, with key procedures being made part of Treasury's Chief Executive's Instructions, would considerably strengthen the control environment given the turnover in staff responsible for administering Treasury's international financial commitments and the irregular nature of transactions which can involve significant commitments stretching over many years.

2.20 Finding: A robust control environment, a key element of which is the existence of well defined policies and procedures, assists agencies to effectively manage risk. Treasury's agency-wide Chief Executive's Instructions require each division / directorate to develop management policies, practices and procedures that are most suitable to meet their own individual needs given the nature of their operating environment. In respect of Treasury's international financial commitments, procedural documentation is not complete. More comprehensive documentation, with key procedures being part of Treasury's Chief Executive's Instructions, would strengthen the control environment. This would at least help alleviate the difficulties arising from the turnover in staff responsible for administering Treasury's international financial commitments and the irregular nature of transactions which can involve significant commitments stretching over many years.

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30 An IMF Transactions Manual dated 1999 outlines administrative steps to be taken to process and record different IMF transactions. However, this Manual does not document any risk management policies and procedures and is incomplete and dated. Treasury advised ANAO that a new version of the Manual is under preparation.

31 A manual on Australia's transactions with the ADB, EBRD and World Bank was produced in December 2001 consistent with a 1996 internal audit recommendation that policies and procedures be documented with respect to the administration of payments to multilateral development banks.

Recommendation No.2

2.21 ANAO *recommends* that Treasury implement a more comprehensive framework of policies and procedures for the administration of its international financial commitments.

2.22 *Treasury response:* Agreed. Treasury commented that some steps are already in place to address the ANAO's concerns, including the updating of operational manuals. However, the Treasury will consider further improvements to the control framework including the insertion of policy objectives into the operational manuals and expanding the Chief Executive's Instructions to include authorities delegated under Acts relating to international financial transactions. It also intends to look closely at how to better assess and report on the financial risks and exposures associated with Australia's international financial commitments, while remaining consistent with the Government's overarching policies and recent guidance on departmental responsibilities in this regard.

Risk management

2.23 Prudent management of financial risks involves considered assessments of returns, costs and risk. The major financial risk faced by Treasury in its administration of commitments to international financial institutions is foreign exchange risk. Credit risk also exists in relation to the loans to Papua New Guinea.

2.24 Treasury is exposed to foreign exchange risk in relation to its investment in the IMF (which is revalued according to movements in exchange rates with gains paid to Treasury and losses payable to the IMF) as well as in capital subscription and other payments to, and receipts from, the various international financial institutions. In preparing advice to the Government on proposals to commit funds to international financial institutions, Treasury prepares an initial estimate of the cost of the proposed expenditure at then-current spot exchange rates. On occasions, Treasury has also sought to analyse exchange rate risk and assess ways of managing it. However, on other occasions it has not performed this analysis, or the analysis performed did not adequately reflect the sensitivity of the proposed expenditure to exchange rate movements (see Figure 2.2). There is also not a process in place by which Treasury, as part of a process of continuous improvement, conducts ex-post analyses of the efficiency and effectiveness of its management of each subscription, and reports as appropriate to the Treasurer on any significant issues arising (including cost variations from the initial estimate).

Figure 2.2

Estimated and Actual Payments to international financial institutions between 1988 and 2001

	Risk analysis undertaken by Treasury	Treasury initial estimate of costs	Actual cost
MIGA 1998 General Capital Increase (GCI) to 1,306 shares at a paid-in cost of $US 2.49 million.	Treasury sought advice as to which currency to make payments in but did not otherwise analyse exchange rate risk.	$3.92m	$4.85m
IMF 1998 Brazil loan of SDR 74.7 million	None	No costs budgeted	$6.09m
IMF 1997 Eleventh General Review of Quotas with SDR 225.80 million to be paid in SDRs or currencies of other members.	None	$476.67m	$500.08m
EBRD 1996 GCI for 10 000 shares valued at Euros 22.5 million Subscriptions could be paid in Euros, USD or Yen over a 10 year payment period.	Treasury sought advice on which currency option to use to minimise the $A cost and considered the use of derivatives. The Euro option was chosen as the cheapest alternative based on then-current exchange rates. The savings against the initial estimate arose primarily from Treasury budgeting in US$ but paying in Euros. The estimated savings would have been $2.1 million greater had Treasury covered the Euro payment exposure.	$46.28m	$39.23m [A]
IBRD 1988 GCI – 1996 Subscription to 2,854 shares at a paid-in cost of $US 10.33 million	None	$13.63m	$15.53m
MIGA 1995 Initial Membership Subscription to 1,713 shares at a paid-in cost of $US 1.85 million.	None	$2.45m	$2.91m
IFC 1991 GCI involving 20,578 shares at a paid-in cost of $US 20.58 million.	None	$27.16m	$29.80m

ADB 1994 GCI 102,370 shares. Shares could be priced using either a US$ value or a SDR value over four, five or six years.	Analysis detailed the choices among instalment payment options available based on the US$ spot rate at the time (no analysis of the SDR option was undertaken). Net present value analysis was also conducted with different figures for exchange rate, discount rate and valuation options. In addition, Treasury examined the implications of a US 2 cent variation in the $A/$US exchange rate. However, the exchange rate actually fell by more than US 20 cents from 0.7311 to 0.5275 adding $5 million to the cost of the subscription. Treasury's analysis suggested costs could fall or increase by less than $1 million.	$34.30m	$38.80m
IMF 1990 Ninth General Review of Quotas with payments to be made in two currencies.	None	$325.00m	$360.17m
EBRD 1990 Initial Membership Subscription to 10 000 shares with 30 million European Currency Units to be paid in five annual instalments.	Subscriptions could be paid in Euros, USD or Yen. Treasury considered which option was the cheapest at then-current exchange rates and assumed no change in exchange rates over the next five years. This assumption did not hold.	$45.00m	$47.40m
IBRD 1988 GCI—1988 Subscription to 7880 shares at a paid-in cost of $US 28.52 million.	None	$35.65m	$38.62m
Total		**$1,010.06m**	**$1,083.48m**

Note: [A] Cost estimated using actual cost of payments already made and, for future payments, the most recently available spot exchange rate. At this time, Euros 11.8 million remains payable between April 2003 and June 2009 and an average movement in the Australian dollar of as little as one cent would increase or decrease the overall cost of the subscription by some $400,000.

Source: ANAO analysis of Treasury data

2.25 Under the *Financial Management and Accountability* (FMA) *Regulations 1997*, agencies are required to assess and, where possible, manage foreign exchange risk. The obligation to manage foreign exchange risk exposures was reinforced in May 2002 when the Minister for Finance and Administration announced a revised Commonwealth Foreign Exchange Risk Management policy that took effect from 1 July 2002.[32] The policy announcement states that the Government has decided to retain the requirement for individual agencies to manage their foreign exchange risk exposures but that agencies will no longer be permitted to hedge except in special circumstances.[33] Prior to this announcement, the extant Commonwealth Policy was outlined in Finance Circular 2000/03 (see Appendix1) which informed agencies that they had responsibility for managing foreign exchange risk within the constraints of their annual Budget allocations and that they may enter hedging arrangements to protect against exchange rate movements.

2.26 Finance Circular 2000/03 was the extant Government policy for much of the period of this ANAO audit. In this context, Treasury has had a long-standing practice of retaining an open position to foreign exchange risk exposures[34] with no hedging of exposures in relation to the international financial commitments it administers. Based on available documentation,[35] ANAO estimates that maintaining an open position has increased the cost of payments made by Treasury since 1990 by at least $23 million. This calculation is based on information available at the time of Treasury's initial management decisions, with calculations performed in accordance with Finance Circular 2000/03 (see Appendix2). Whilst some of these costs have been paid through special appropriations and so have not been subject to Parliament's annual Budget deliberations, on other occasions Treasury has had to obtain additional funds, either through the Additional Estimates process[36] or through the Advance to the Finance Minister.[37]

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32 Senator Nick Minchin, Minister for Finance and Administration, *Revised Government Foreign Exchange Risk Management Policy*, Media Release 20/2002, 28 May 2002.

33 Prior to this date, agencies were permitted to arrange hedging transactions for their foreign currency payments and receipts in order to protect against adverse movements in exchange rates creating budget uncertainty.

34 The only known exception involves the Royal Australian Mint, an operating arm of the Treasury, which, as part of its joint venture with the Perth Mint in the Sydney 2000 Olympic Coin Program, entered into a foreign currency hedge on 25 June 1997 to the value of $US34 million for the purpose of reducing the risk of foreign currency exposure on overseas sales. The currency hedge matured on 29 June 2001. Source: The Treasury, *Annual Report 2000–2001*, p.174.

35 Records of payments prior to 1990 were not available.

36 For example, as a result of exchange rate movements the *Treasury Portfolio Additional Estimates Statements 2001–02* included additional funding of $0.179million in Appropriation Bill (No.4) 2001–02 to cover payments to the EBRD and MIGA.

37 In 2000–01, Treasury obtained $559638 from the Advance because the depreciation of the Australian dollar meant there was insufficient funds to make a payment to the EBRD.

2.27 The calculation of $23 million in additional costs is based on an ex post assessment compared to hedging using actual interest rate differentials. In this context, it is important to point out that while hedging provides certainty as to the 'price' of a future transaction, it may not be a costless exercise if Australian interest rates are at a premium to overseas interest rates. It is thus not always the case that hedging consistently produces a better outcome. Assessment of the lowest cost options will only ever be able to be made after the event.

2.28 Finance Circular 2000/03 was withdrawn with effect from 30June 2002. Following the Government's May 2002 announcement, it was replaced by Finance Circular 2002/01 (see Appendix2). The r evised framework applies to all entities within the General Government Sector and is intended to implement an overarching position on foreign exchange risk management and place a greater emphasis on risk management by agencies. Under the revised framework, agencies' foreign exchange risk management responsibilities include identifying, evaluating and treating risks. Budget supplementation[38] may be provided to agencies with significant foreign exchange exposures that are able to demonstrate proper risk management. The Department of Finance and Administration has announced that it will be developing and releasing principles-based guidance on foreign exchange risk management practices.

2.29 Finding: The major financial risk faced by Treasury in its administration of commitments to international financial institutions is foreign exchange risk. On some occasions, Treasury analysed exchange rate risk. However, on other occasions it has not performed this analysis or the analysis performed did not adequately reflect the sensitivity of the proposed expenditure to exchange rate movements. In terms of risk treatment, Treasury has retained an open position to foreign exchange risk exposures. Based on an ex post assessment, this approach has increased the cost of payments made since 1990 by at least $23million compar ed to hedging using actual interest rate differentials. In this context, it is important to point out that, while hedging provides certainty as to the 'price' of a future transaction, it may not be a costless exercise where Australian interest rates are at a premium to overseas interest rates. It is thus not always the case that hedging consistently produces a better outcome. Assessment of the lowest cost options will only ever be able to be made after the event.

2.30 In July 2002, a revised framework for Commonwealth foreign exchange risk management was introduced with the intention of implementing an overarching position on foreign exchange risk management and placing a greater emphasis on risk management by agencies. Under the revised framework, agencies' foreign exchange risk management responsibilities include identifying, evaluating and treating risks. Agencies may have their

Budget funding adjusted if they are able to demonstrate proper risk management but they are no longer permitted to hedge their exposures. In this context, the Department of Finance and Administration announced in Finance Circular 2002/01 that it will be developing and releasing to agencies principles-based guidance on foreign exchange risk management practices.

2.31 In relation to the issue of financial risk management, Treasury commented to ANAO in September 2002 that it believes that assessments as to the appropriate use of hedging in certain circumstances is an issue that needs to be decided at a 'whole of government' level. As indicated in Treasury's response to Recommendation No.2, Treasury further commented that it will, however, look closely at the scope for better assessing and reporting on the financial risks and exposures associated with Australia's international financial commitments.

Financial reporting

2.32 The international financial commitments administered by Treasury range from short-term bridging finance to major long-term capital injections. As at 30 June 2002, the market value of investments in the various institutions and bilateral loans was $8.6 billion with liabilities totalling $6.1 billion, representing aggregate net assets of $2.5 billion (see Figure 2.3). In addition to the liabilities of $6.1 billion, as at 30 June 2002 there were contingent liabilities of $9.6 billion, comprised primarily of uncalled share capital subscriptions. The uncalled share capital only becomes due and payable if requested by the relevant institutions.

[38] Agencies are to return gains to the Budget when exchange rates rise and will receive funding when costs increase due to a rate fall in order to ensure they can continue to deliver outputs.

Figure 2.3

Assets and Liabilities administered by Treasury on behalf of the Government for the year ended 30 June 2002: ANAO Summary

	$m
Assets:	
• Shareholdings in international financial institutions [A]	8,389
• Financial loans to Papua New Guinea	192
Total Assets	**8,581**
Liabilities:	
• Promissory Notes:	
• Share capital	2,829
• IMF Maintenance of Value payments [B]	2,038
• IBRD Maintenance of Value liability [C]	75
• IMF Special Drawing Right allocation liability [D]	1,100
• Other	32
Total Liabilities	**6,074**
Net Assets	**2,507**

Notes:

A The development bank ($822 million) and IMF shareholdings ($7.567 billion) are held for policy purposes rather than as an investment portfolio. In terms of Government Finance Statistics reporting, the full value market value of the IMF quota is included as an investment in the General Government Sector Balance Sheet with the historic value of the development bank shareholdings reported as equity. The current market value of the IMF quota (both paid-in and unpaid) is taken into account when calculating Commonwealth net debt (see Budget Paper No. 1 2002-03, 2-17, Table B2), but the paid-in shareholdings in the development banks are excluded from this calculation.

B Members of the IMF are required to maintain the value of the IMF's holdings of their currency in terms of the SDR. Whereas Australia's Maintenance of Value receipts from the IMF are taken in cash, payments to the IMF are made by way of Promissory Note resulting in a liability for the Commonwealth. As of 30 June 2002, three Promissory Notes totalling $2,038 million were outstanding.

C In 1991, Australia entered into an agreement with the IBRD to avoid future Maintenance of Value payments to the IBRD. This agreement resulted in a Promissory Note to the value of $US 42.6 million being issued to the IBRD.

D The IMF allocates Special Drawing Rights (SDRs) to members, creating both a reserve asset for the member and a liability of the member to the Fund. Treasury holds no SDRs having previously sold its holdings, and, as a result, reports its SDR position as a liability (amount payable to the IMF) in its financial statements.

Source: ANAO analysis of Treasury data

2.33 The figures presented in Figure 2.3 above differ from Treasury's reporting of its international financial commitments. The main difference relates to Figure2.3 r eporting all assets and liabilities at their 30 June 2002 market value. Treasury's reporting involves a mixture of current and historic market valuations, actual historic costs and notional costs for assets. As well as the different stated accounting approaches, ANAO noted instances, which are not material in a financial statement context, where Treasury reporting departed from its stated accounting policy. Treasury's stated accounting policy is to report the IMF investment at its current market value and investments in development banks at their actual cost except where cost records are not readily obtainable, in which case a notional cost is to be established.[39] However, there were variations as follows:

- In four instances, Treasury had reported its investment in a development bank capital subscription at a historic market value, being the value of the investment at exchange rates applying to the first instalment payment rather than at the exchange rates applying to each instalment payment. The historic cost model of valuation seeks to measure assets in terms of the nominal dollars that it cost to acquire the asset.[40] In this context, the total actual historic cost in Australian dollars of these four subscriptions was $9.9 million greater that the value reported by Treasury in its financial statements.
- In two instances, Treasury reported its investment in a development bank capital subscription at a notional cost although cost records were readily available. This variance resulted in the asset value reported by Treasury for these two subscriptions being $7.4 million greater than the actual historic cost in Australian dollars.

2.34 In relation to these variations, Treasury advised ANAO in September 2002 that Note 1.29 to the 2001–02 financial statements (Accounting Policy) has been revised to clarify Treasury's current accounting treatment of investments in the development banks. Treasury further advised that it had reflected in its 2001–02 financial statements one instance where notional cost was used rather than actual cost but that adjustments were not made in one other instance because of the immaterial nature of the inconsistencies. In relation to those instances where historic market valuations had been used, Treasury advised that, to ensure more accurate measurement of investment balances its accounting approach will be revised in 2002–03 to ensure the value of all capital subscriptions are recorded at the exchange rate applying to each instalment payment.

2.35 Treasury's reported assets largely comprise the paid-in value of shares in development banks and the shareholding in the IMF. The development bank investments are illiquid in that their value cannot be realised without withdrawing from the institutions. Whilst reported development bank assets includes only the paid-in component, Treasury's IMF shareholding (or quota) represents both the paid-in component and the uncalled and unpaid component. As the uncalled component has not been paid-in, it does not represent a realisable asset in the event of withdrawal from the IMF.

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[39] This notional cost is to be established at 30 June 1993 by reference to the institutions' financial statements and exchange rates at that time. Source: The Treasury, *Annual Report 2000–2001*, p. 177.

[40] Statement of Accounting Concepts SAC4 *Definition and Recognition of the Elements of Financial Statements*, paragraph 129.

2.36 Realisation of the Reserve Tranche Position is also conditional as it can only be accessed by withdrawing from the IMF or in the event of a balance of payments need.[41] Furthermore, withdrawing from the IMF would require Australia to pay any amounts due to the IMF.[42] In July 2002, Treasury advised ANAO that, should Australia withdraw from the IMF, the IMF would pay to Australia the value of the reserve tranche position less the SDR allocation.[43] This advice suggests that, as at 30 June 2002, the realisable value of the IMF investment was $A1.89 billion. However, this figure does not include outstanding Promissory Notes[44] issued to the IMF valued at $4.84 billion as of 30 June 2002. Treasury advised ANAO that Australia would not be called upon to pay the value of the outstanding promissory notes.[45] In September 2002, Treasury advised ANAO that the IMF had confirmed that, should Australia withdraw from the Fund, the Articles of Agreement would, in effect, result in the cancellation of any outstanding promissory notes.

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41 The Reserve Bank of Australia includes the Reserve Tranche Position in its calculation of Australia's holdings of international reserves (see Table H.4 *Reserve Bank Foreign Exchange Transactions and Holdings of Official Reserve Assets* in the monthly Reserve Bank Bulletin).

42 ScheduleJ of the IMF' s Articles of Agreement.

43 Treasury also advised that charges and remuneration would also need to be calculated by the IMF. The net value of these is not likely to be large.

44 The *Bills of Exchange Act 1909* (Section 89) states that Promissory Notes are a financial instrument that involves an unconditional promise to pay a sum of money at a future date to a specified person or the bearer. Section 51.(xvi) specifically empowers the Commonwealth to issue Promissory Notes. According to Quick and Garran (1901), negotiable instruments such as Bills of Exchange and Promissory Notes, come under a branch of the law of contracts and, when drawn according to legal forms, signed by the parties intended to be bound, and duly stamped as required by revenue laws, are regarded as incontestable acknowledgements of debts.

45 These Promissory Notes are reported as administered loan liabilities in Treasury's financial statements.

2.37 Finding: As at 30 June 2002, the market value of investments in the various institutions and bilateral loans was $8.6 billion, with liabilities totalling $6.1 billion, representing aggregate net assets of $2.5 billion. In addition to the liabilities of $6.1billion, as at 30June 2002 there were contingent liabilities of $9.6 billion, largely comprising uncalled share capital subscriptions. Assets related to Treasury's international financial commitments mainly comprise the paid-in value of shares in development banks ($822 million as at June 2002) and the shareholding in the IMF ($7.57 billion). The development bank investments are illiquid in that their value cannot be realised without withdrawing from the institutions. The IMF investment realisation is also conditional in that only part of it can be accessed, either by withdrawing from the Fund or in the event of a balance of payments need.

Canberra ACT
3 October 2002

P. J. Barrett
Auditor-General

Appendices

Appendix 1

Finance Circular 2000/3: Budget Framework for the Management of Foreign Exchange (FOREX) Exposure

To All Departments of State, Parliamentary Departments and Prescribed Agencies

Introduction

This Circular notifies agencies which come within the scope of the *Financial Management and Accountability Act 1997* (FMA Act) of their responsibilities and opportunities for managing FOREX exposure.

Key Points:

- An agency's FOREX exposure may be incorporated into estimates construction on the basis of exchange rate parameters issued by Treasury at the time the budget estimates are finalised.
- Agencies have responsibility for managing FOREX risk within the constraints of their annual Budget allocations.
- In consultation with the Reserve Bank of Australia (RBA), FMA agencies may enter hedging arrangements with the RBA or a private sector provider to protect against exchange rate movements for their FOREX transactions.

Definitions:

Foreign exchange rate: the price of an Australian dollar expressed in terms of another currency.

Foreign exchange rate exposure: this is the exposure to movements up or down in the price of the Australian dollar relative to the price of another currency in which a fixed financial obligation is expressed (eg under contract).

Foreign exchange spot rate: is the market rate for the exchange of one currency against another for settlement in two business days time.

Foreign exchange forward rate: is the market rate for the exchange of one currency against another for settlement at a future date or a span of future dates.

Foreign exchange forward contracts: represent an obligation on one party to purchase foreign exchange at a predetermined rate and date (or range of dates) by the transfer of value in the $A equivalent to effect that purchase.

A *foreign exchange payment* involves three mechanisms:

- *purchase*—which is the exchange of $A for the foreign currency at the spot rate;
- *delivery*—which is the transfer of a payment or payment instruction in the foreign currency;
- *settlement*—which is the final discharge of obligations between the parties in respect of the foreign currency purchased.

Budget Issues :

1. Except for a limited number of agency specific arrangements, foreign exchange risks have traditionally been borne by agencies. The changed arrangements outlined in these Guidelines apply immediately to all agencies not currently covered by budget funded FOREX guarantees. Where such guarantees currently exist, the relevant Agency Advice Unit contacts will discuss transitional arrangements to move agencies away from these guarantees.

2. The key principle of the arrangements for the management of FOREX exposure is that these arrangements will be budget neutral.

3. In terms of estimates and appropriation management the following arrangements will apply:

- All resourcing to agencies from the Budget will be provided through appropriations in Australian dollars.
- Where payments are made or revenue is received in foreign currency terms, the actual level of resourcing may be calculated taking into account the impact of exchange rates, subject to the normal agreement of costings by the Agency Advice Unit.
- The exchange rates to be used will be the relevant Treasury parameter ***at the time the budget estimates are finalised***.

FOREX Under Agency Banking

4. From 1 July 1999, the transactional banking services provided by the Reserve Bank of Australia (RBA) were opened to competition with the private sector. The Government decided that from 1 July 1999 the RBA would continue to directly service major foreign currency transactions on behalf of agencies financially part of "the Commonwealth" but that agencies could seek competitive provision of FOREX to the maximum extent consistent with the Bank's continued ability to attain exchange rate management objectives. Within this framework the delivery (and settlement) of FOREX payments overseas is contestable. The

Finance Minister's banking delegations to Chief Executives require consultation with the RBA which gives the RBA some choice over whether it purchases the foreign currency and delivers payments on behalf of the agency, only purchases foreign currency, or allows the agency to arrange the purchase and delivery through an alternative provider. This may be in respect of an individual payment or (more likely) as part of a standing arrangement or threshold.

5. Similar competitive arrangements operate with respect to forward contracts for the purchase of foreign exchange such as may be entered into by agencies for hedging purposes. These contracts may be authorised by Ministers in accordance with their inherent executive powers under the Constitution.

Managing FOREX—Role of the RBA

6. The RBA is involved in exchange rate management as part of its exercise of monetary policy as a central bank and undertakes market operations in foreign exchange on behalf of the Commonwealth. The Commonwealth has a large volume of FOREX transactions each year, mostly reflecting foreign currency payments associated with purchases of defence equipment and payment by (or through) the Department of Foreign Affairs and Trade. In the past, the RBA has undertaken these transactions on behalf of the Commonwealth by passing them through directly to the market or drawing on their FOREX reserves.

7. Under the agency banking arrangements effective from 1 July 1999, agencies are required to consult with the RBA International Department (Mr Mike Sinclair on (02) 9551 8420) in relation to the handling of FOREX transactions. This includes hedging transactions.[1]

8. Following consultation with the RBA International Department, an agency may choose to seek hedging contracts directly from the market. This will depend on the value of an agency's transactions and the particular currencies involved.

- The primary consideration for the RBA International Department will be any potential for the agency's FOREX purchases to undermine the market operations undertaken by the Bank in pursuance of its exchange rate management role.

9. The RBA has advised that where the RBA International Department handles the FOREX transactions for an agency:

- hedging activities will be managed within the normal foreign currency services. This hedging will be undertaken using basic forward FOREX contracts;

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[1] Part A-6 of the Agency Banking Framework—Guidance Manual and the Finance Minister's banking delegations to Chief Executives (Finance Circular 1999/1) refers.

- it may decide to provide hedging cover on a transaction by transaction basis where settlement dates are known to agencies. It may also provide general cover for a total amount of foreign currency over a given period, potentially up to a full year;
- agencies will only be able to set up hedging transactions for an individual underlying payment / receipt once in a fiscal year.
    - In the event that commitments or timing of payments / receipts change during the year, the RBA can adjust forward FOREX contracts to meet the changes but reductions in hedges would need to be closed out at the then current market rate. This could result in a cost or benefit to the agency depending on exchange rate movements over the intervening period.

10. It is not envisaged that agencies would be able to "trade" into and out of hedging transactions for particular commitments.

Further information:

This guidance material will be incorporated into the Department's *Agency Banking – Guidance Manual.*

Financial Framework Branch
Department of Finance and Administration
May 2000

Attachment

How does Hedging Work? :

Forward FOREX rates contain two elements:

Current Spot Rate plus *Forward (or swap) Margin*.

An outright forward FOREX transaction replicates what would otherwise be done through cash and spot FOREX markets. For example, if an agency wished to hedge FOREX risk of US dollar payments expected to be made over the next 12 months, it could:

- (theoretically) draw down the budget allocation immediately. This would be equivalent to borrowing Australian dollars for 12 months at the current market rate of (say) 5.2%;
- sell the Australian dollars on the spot market at the current rate (say 0.66 for a US dollar);
- invest the US dollars for 12 months at the current US deposit rate for 1 year (say 5.65% pa); and
- At the end of 12 months, or at intervening periods, draw on the US dollar deposit to meet US dollar payments.

This eliminates the exchange rate risk, but also earns the difference between the US deposit and the opportunity cost of investing in Australia (so if the current cash rate in Australia is 5.2%, the return is 0.45% pa).

The Forward Margin is equivalent to the interest rate differential between the two currencies for the relevant maturity, expressed in exchange rate points. This interest differential is the forward margin available for hedging. When local interest rates are lower than the overseas rates, as in the example above, there is a discount for those buying FOREX to avoid foreign exchange exposure. On the other hand, exporters or those receiving foreign exchange pay a premium for their forward sales of US dollars because they give up the high interest rate currency.

Banks cover their forward positions initially by offsetting differing customer interests but with any net positions they would need to actually undertake the physical transactions outlined above. In quoting forward rates, banks price off these physical transactions.

The following illustrates the calculation of the forward rate:

$A1,515,151.15	@	0.6600 *[Spot Rate]*	=	**US$1,000,000**

$1,515,151.15 borrowed at 5.2% pa on 365 day basis = $78,787.88 interest paid		$1,000,000 invested at 5.65% pa on 360 day basis = $57,284.72 interest received
$1,515,151.15 + $78,787.88 = $1,593,939.03	0.663316 *[Forward Rate]*	$1,000,000 + $57,284.72 = $1,057,284.72

Forward Rate = $1,057,284.72 divided by $1,593,939.03 = 0.663316
Forward Margin = 0.663316 minus 0.6600 = 0.003316

Forward contract for US$1 million = $1,000,000 X 0.663316 (*forward rate*) = A$1,507,577.08 = A$7,574.43 less than the equivalent spot transaction.

Appendix 2

Finance Circular 2002/01: Foreign Exchange (FOREX) Risk Management

To All Departments of State, Parliamentary Departments and Prescribed Agencies

Introduction

This Circular notifies *Financial Management and Accountability Act 1997* (FMA) agencies and *Commonwealth Authorities and Companies Act 1997* (CAC) bodies (collectively "entities") within the General Government Sector (GGS) of their responsibilities for managing forex risks.

Forex risk for Commonwealth entities is generally the exposure to movements up or down in the price of the Australian dollar relative to the price of another currency, where movements impact on the value of a financial transaction (e.g. contract price).

Risk Management may be defined as the culture, processes and structures that are directed towards the effective management of risks.

Key Points

1. Effective from 1July 2002 all FMA agencies and CAC bodies within the GGS will continue to be responsible for managing their forex risk. However, as a general policy of the Government these GGS entities will be restricted from externally hedging forex exposures.

    o GGS entities are still expected to risk manage forex exposures within the Government's general policy of self insurance.

2. The restriction on external hedging can be exempted on a case by case basis where an entity has applied and received approval from the Minister for Finance and Administration to enter into external hedging arrangements. CAC bodies in the GGS may also apply to the Minister for a general exemption.

3. For GGS entities whose Budget funding has in the past been adjusted for movements in forex exposures, these arrangements will continue to apply. Budget funding adjustments[1] will also be applied for any GGS entity which has annual actual or expected net forex gains or losses of greater than:

    o $A5 million; or

- o more than one per cent of the entity's departmental appropriations (in the case of an FMA agency) or total cash expenditure (in the case of a GGS CAC body).

4. The Department of Finance and Administration (Finance) will be developing and releasing to GGS entities, principles based guidance[2] on forex risk management practices. This guidance will complement existing publicly available material on risk management (such as the Australian-New Zealand Standard on Risk Management).

5. In the case of Budget supplementation[3] for forex losses, adjustments to compensate for the losses will be subject to the Government being satisfied that the entity has demonstrated proper forex risk management consistent with the principles established by Finance.

6. Consistent with paragraph 2 above, GGS entities that have been granted approval to hedge will no longer have recourse to any Budget adjustments with regard to forex losses or gains associated with the exemption. That is, where a GGS entity is allowed to externally hedge forex exposures it will not receive additional Budget funding on the basis of adverse movements in the exchange rate.

7. Finance will annually collect data detailing forex exposures, losses and gains by GGS entities for required presentation to the Government.

8. Budget Finance Circular 2000/03, *Budget Framework for the Management of Foreign Exchange (FOREX) Exposure*, is withdrawn effective 30June 2002.

Action Required

1. GGS entities continue to be responsible for the management of their forex risks and are expected to demonstrate proper forex risk management practices.

2. GGS entities are to consult with Finance prior to entering into expenditure commitments where forex exposures in total exceed the equivalent of $A100 million.

Contacts

If you have any queries in relation to this Circular, please contact Ed Lekawski of Finance and Banking Branch by phone on (02) 6215 3340 or by email at ed.lekawski@finance.gov.au.

Jonathan Hutson
A/g General Manager
Business Services Group
26 June 2002

1. Budget funding adjustments refer to Government decisions to alter (either decrease or increase) an entity's funding in response to movements in foreign currency exchange rates.
2. The guidelines will assist entities in addressing issues of forex risk management.
3. Supplementation refers to entities being given additional funding due to an increase in their Budget-funded expenditures caused by an adverse movement in the foreign currency exchange rate.

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