

The Auditor-General
Audit Report No.12 2002-03
Performance Audit

Management of the Innovation Investment Fund Program

**Department of Industry, Tourism and Resources
Industry Research and Development Board**

Australian National Audit Office

© Commonwealth
of Australia 2002

ISSN 1036-7632

ISBN 0 642 80668 3

COPYRIGHT INFORMATION

This work is copyright. Apart from any use as permitted under the *Copyright Act 1968*, no part may be reproduced by any process without prior written permission from the Commonwealth, available from AusInfo. Requests and inquiries concerning reproduction and rights should be addressed to:

The Manager,
Legislative Services,
AusInfo
GPO Box 1920
Canberra ACT 2601

or by email:
Cwealthcopyright@finance.gov.au



Canberra ACT
21 October 2002

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Department of Industry, Tourism and Resources and the Industry Research and Development Board 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 the Innovation Investment Fund Program*.

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

A handwritten signature in black ink, appearing to read 'Ian McPhee'.

Ian McPhee
Acting 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.

Auditor-General reports are available from Government Info Shops. Recent titles are shown at the back of this report.

For further information contact:
The Publications Manager
Australian National Audit Office
GPO Box 707
Canberra ACT 2601

Telephone: (02) 6203 7505
Fax: (02) 6203 7519
Email: webmaster@anao.gov.au

ANAO audit reports and information about the ANAO are available at our internet address:

<http://www.anao.gov.au>

Audit Team

Sue Sheridan
Jacqui Roessgen
Alan Greenslade

Contents

Abbreviations/Glossary	7
Summary and Recommendations	9
Summary	11
Venture Capital	11
The Innovation Investment Fund program	11
The audit	13
Audit conclusion	13
Recommendations and DITR & IR&D Board response	16
Key Findings	17
Some Elements of Corporate Governance (Chapter 2)	17
Selection of Fund Managers (Chapter 3)	19
Protecting the Commonwealth's Financial Interests (Chapter 4)	22
Monitoring of Licence Agreements (Chapter 5)	23
Measuring and Reporting Program Performance (Chapter 6)	24
Results Achieved (Chapter 7)	26
Recommendations	29
Audit Findings and Conclusions	31
1. Introduction	33
Venture capital	33
The Innovation Investment Fund program	35
Audit objective, criteria and approach	39
2. Some Elements of Corporate Governance	41
Introduction	41
Key Commonwealth bodies and other program participants	42
Roles and responsibilities	45
Strategic approach to program objectives	48
Conflict of interest management	51
Risk management and fraud control	53
3. Selection of Fund Managers	57
Introduction	57
Round 2 tender selection process	57
Value for money	59
Efficiency and effectiveness	60
Accountability and transparency	60
Probity	61
Consistency of proposals with program guidelines	62
Planning and management of the selection process	63
4. Protecting the Commonwealth's Financial Interests	66
Introduction	66
Minimising contingent liability	67
Managing payments	68
Minimising losses of investment capital	69
Linking fund manager payment to performance	70
Conclusion	71

5. Monitoring of Licence Agreements	72
Monitoring compliance with agreements	72
Monitoring performance of fund managers	74
6. Measuring and Reporting Program Performance	78
Introduction	78
Key performance indicators	78
Performance benchmarks and targets	80
Public reporting on program performance	82
Program monitoring and evaluation	84
7. Results Achieved	86
Introduction	86
The development of small new technology companies commercialising R&D	86
Developing a self-sustaining Australian early stage venture capital industry	91
Developing fund managers with experience in the early stage venture capital industry	94
Establishing in the medium term a 'revolving' or self-funding program	95
Conclusion	95
Appendices	97
Appendix 1: Audit Criteria	99
Appendix 2: Key Commonwealth IIF Program Stakeholders—Roles, Responsibilities and Accountabilities	101
Appendix 3: Partnership and Unit Trust Arrangements	108
Appendix 4: Investments and Returns - Processes	110
Appendix 5: Conditions in Licence Agreements regarding Interested Persons and Associates	112
Appendix 6: Surveys on Venture Capital	114
Series Titles	117
Better Practice Guides	118

Abbreviations/Glossary

AusIndustry	AusIndustry is a division of DITR.
ABS	Australian Bureau of Statistics
ANAO	Australian National Audit Office
CEIs	Chief Executive's Instructions
CPGs	Commonwealth Procurement Guidelines and Best Practice Guidance
<i>DITR</i>	Department of Industry, Tourism and Resources
Finance	The Department of Finance and Administration
FMA Act	<i>Financial Management and Accountability Act 1997</i>
FMA Reg	<i>Financial Management and Accountability Regulations 1997</i>
FMC	Fund Management Committee of the IR&D Board
IR&D Act	<i>Industry Research & Development Act 1986</i>
IR&D Board	Industry Research & Development (IR&D) Board
Innovation and Industry Policy Division	A division of DITR
IIF	Innovation Investment Fund
IRR	Internal rate of return
Licence agreements	The contract between a fund manager and the Commonwealth
Ministerial Directions	The directions set out the requirements of the IIF program and give direction to the Board. These are issued under the IR&D Act
R&D	Research and development

Summary and Recommendations

Summary

Venture Capital

1. The venture capital industry in Australia is well-established, with venture capital firms providing long-term, committed share capital and expertise to allow new or young businesses to grow and succeed, with the prospects of high rates of returns. The provision of venture capital to a company is generally not secured on any assets. Put simply, *venture capital may be regarded as an equity investment where investors expect significant capital gains in return for accepting the risk they may lose all their equity.*¹
2. Venture capital investments are usually for between three to seven years, and are typically in the order of \$0.5–10 million.² The recipient company benefits from capital investment, expected managerial expertise and enhanced business reputation. The venture capital firm generally obtains its return, if the company is successful, through realising a capital gain³ when it sells out the investment.
3. According to the Australian Bureau of Statistics, at 30 June 2001 there were 150 venture capital funds in Australia, with investments totalling \$2.7 billion.⁴

The Innovation Investment Fund program

4. The Innovation Investment Fund (IIF) was announced by the Prime Minister in the *More Time for Business* statement of March 1997.⁵ The program was designed to help redress the low level of provision in Australia of high risk venture capital for small new technology-based companies commercialising research and development.
5. The objectives of the IIF program are to:
 - (a) encourage the development of small new technology companies commercialising research and development (R&D), by addressing capital and management constraints;
 - (b) develop a self-sustaining Australian early stage, technology-based venture capital industry;

¹ Golis, Christopher (1999): *Enterprise and Venture Capital: A Business Builder's and Investor's Handbook*. Third edition, p xxiv.

² Pollitecon (Victor Bivell): *Australian Venture Capital Guide 2001*, eighth edition, p. 12.

³ Capital gain is the amount realised on exit less the amount invested.

⁴ Australian Bureau of Statistics (30 June 2001): *Venture Capital, Australia*, Publication No. 5678.0, Canberra.

⁵ The program was titled the Small Business Innovation Fund (SBIF) in the statement. It was renamed the Innovation Investment Fund in August 1997.

- (c) develop fund managers with experience in the early stage venture capital industry; and
- (d) establish a 'revolving' or self-funding program in the medium term.

6. The Industry Research and Development (IR&D) Board, assisted by its Fund Management Committee (FMC) has administrative responsibility for the program under the *Industry Research & Development Act 1986* (IR&D Act). The Minister for Industry, Tourism and Resources has appointed members of the Board and its committees with relevant industry, management and academic backgrounds. AusIndustry, a division of the Department of Industry, Tourism and Resources, provides administrative support. Fund managers are licensed by the Board to participate in the program for a 10-year period, following a competitive selection process. Each fund manager sets up an accredited IIF managed fund, comprising Commonwealth and private sector investments (the latter are sourced by the fund managers as a requirement of the licensing process).

7. Two selection rounds have been conducted. In 1998, five fund managers were licensed, managing funds into which the Commonwealth is investing a total of \$130 million. In 2001, a further four fund managers were licensed to manage IIF funds into which the Commonwealth is committing an investment of \$90.7 million. Five wholly-owned Commonwealth companies are the Commonwealth's investors in the IIF funds, with the funds for investment drawn from the department on the basis of limited recourse loan agreements between the IR&D Board and the companies.

8. The fund manager's role is to identify companies meeting the eligibility criteria set out in the licensing agreement with the Commonwealth, and then to invest equity capital in such companies, if they consider the investment will deliver appropriate returns. The fund manager receives a management fee of up to 30 per cent (with an average of 27 per cent⁶) of the capital committed to the fund by the private and government investors over the 10-year licence agreement.

9. The Commonwealth is the major investor in IIF funds. It provides up to \$2 of Commonwealth money for every \$1 of private investment. When a fund makes a return, the Commonwealth and the private investors expect repayment of capital, plus interest, calculated at the long-term bond rate. In addition, excess profits (that is, profits after the return of capital plus interest⁷) are typically distributed as follows⁸:

⁶ This average is based on the total maximum fee received by the nine fund managers. One fund manager's fee will be reduced if the fund is wound up prior to the 10-year period.

⁷ Interest is determined at the long-term bond rate.

⁸ The Commonwealth's share of excess profits is 10 per cent as determined by Ministerial Direction. The balance is typically distributed between the private investors and the fund manager in a ratio of 80:20 respectively, but some fund managers and private investors have varied this by private agreement.

- 10 per cent to the Commonwealth;
- 72 per cent to the private investors; and
- 18 per cent to the fund managers.

The audit

10. The objective of the audit was to determine whether the IIF program is being effectively managed by the Commonwealth to achieve the program objectives. The audit focused on whether:

- there are robust corporate governance arrangements to support effective program administration;
- the selection process to award licences is fair, and consistent with government requirements and recognised better practice;
- there are appropriate safeguards to protect the Commonwealth's financial interests;
- the monitoring of licence agreements is effective, and provides appropriate assurance on compliance and performance; and
- program performance management is sound.

The audit also assessed program results to date from available data.

11. The audit criteria were drawn from relevant legislative requirements, technical advice provided by venture capital experts, and relevant ANAO better practice guides. The audit also included interviews with program stakeholders, as well as examination and analysis of departmental documents, management information and external industry survey results.

Audit conclusion

12. Implementation of the IIF program has involved challenging and unique issues of public administration, including those arising from investment by the Commonwealth in a market traditionally regarded as high risk and the Commonwealth having dual roles of program administrator and investor. The ANAO concluded that overall management of the program is largely effective, although there are areas that warrant improvement. As well, there has been considerable development in the early stage venture capital market since the initiation of the IIF program, consistent with the program's objectives.

13. The corporate governance arrangements for the program are generally robust, with roles and responsibilities of the various parties clearly articulated in program guidelines and licence agreements with the fund managers;

appropriate arrangements to address responsibilities for financial management; and sound procedures to manage the potential for perceived and actual conflicts of interest.

14. Risk treatments have been put in place including selecting fund managers using due diligence procedures; drafting governing documents for program administration; establishing wholly-owned Commonwealth companies to limit liability against the Commonwealth; implementing conflict of interest procedures for IR&D Board and FMC members; and restricting related party transactions through licence agreements. However, risk assessments and consequential treatments have not been supported by a sufficiently systematic approach to risk management and monitoring, which would be beneficial given the unique and high-risk aspects of program administration. The governance framework for the program would also be strengthened by developing a program plan that outlines both the strategies to achieve each of the program objectives and appropriate performance measures to measure and report achievements.

15. The selection of fund managers for Round 2 was consistent with program guidelines and supported by due diligence advice and probity audit, which found that the process was fair and equitable. Value for money for the Commonwealth's investment in the IIF was increased compared to that in Round 1 by subjecting management fees and the extent of private sector investment to competition. This resulted in an increased proportion of funds from the private sector and reduced management fees.

16. There are structural, contractual and administrative arrangements in place to protect the Commonwealth from contingent liability, losses from poor performing investments, and payments outside contractual conditions. There are also incentives for fund managers to perform well. In addition, there are disincentives for very poor performance.

17. The IR&D Board monitors compliance with the licence agreements through reporting by fund managers, and by requiring fund managers to make presentations on their investment portfolios. However, the Board has limited assurance of the accuracy of fund managers' reporting—essentially because fund managers have limited information on which to support some aspects of their claims of compliance. There has been no compliance auditing in this area. Departmental compliance activity has been limited to checks of fund managers' reports when submitted. The ANAO concluded that there is a need for more cost effective assurance of fund managers' compliance with licence agreement conditions, such as greater use of external audits.

18. Fund managers also provide financial reports, valuations and economic impact statements to the IR&D Board. However, the overall reporting

requirements are limited as they do not cover fund managers' performance against some program objectives, limiting the Board's ability to monitor each fund's contribution to these program objectives.

19. Performance management of the program, as a whole, has limitations. While the IIF program includes both outcome and output performance indicators, some of the outcome indicators are currently not measured. As well, there are few benchmarks or targets across all outcome and output measures. Addressing these gaps would provide AusIndustry and the Board with better information against which to assess program performance, improve public reporting, and properly evaluate the program.

20. IIF funds have now invested more than \$140 million in some 60 small new technology companies. (Some two-thirds of this represents the Commonwealth investment.) To date, one successful investment has been achieved, that in Looksmart. This realised \$245 million from an investment of \$2.2 million. The Commonwealth's profit was \$19.8 million, after return of all capital committed to the fund plus interest (\$31.6 million). This represented a return on total capital invested by the Commonwealth, as at 30 June 2001, of 30 per cent⁹.

21. The value of the balance of the Round 1 portfolio, excluding Looksmart, produced an annualised internal rate of return of 11 per cent to 30 June 2001¹⁰. Venture capital investments are likely to result in both losses and gains due to the high risk nature of the sector, with long term results often difficult to predict at this relatively early stage of the program. However, the pattern of losses and gains for IIF investments has been broadly in line with expectations for this high-risk/high-return sector.

22. In March 2000, the then Minister for Industry, Science and Resources announced the establishment of a revolving fund using the return of capital and interest from IIF investments. To date, this has amounted to \$31.6 million from investment in Looksmart. The department has advised that it would be unlikely to favour a tendering round for the funds in the self revolving fund until they are at a level that would enable three fund managers to be licensed (some \$60 million). This, however, is a matter for Government decision.

⁹ 30 June 2001 is the most recent date for which audited data on valuations of funds are available.

¹⁰ Based on unaudited valuations at 31 December 2001, the annualised internal rate of return is -0.1 per cent.

Recommendations and DITR & IR&D Board response

23. The ANAO made two recommendations aimed at strengthening risk management and assurance of program delivery against objectives. The department and the Board agreed with both recommendations and responded as follows.

24. The department and the Board agree with the ANAO's view that implementation of the IIF program has involved complex, challenging and unique issues of public administration. The department and the Board consider that the majority of the inherent risks in the program are addressed through robust corporate governance arrangements, strong probity and due diligence processes in the selection of fund managers, and the establishment of appropriate safeguards in the governing documents to protect the Commonwealth's financial interests and to promote the program's objectives.

25. The department and the Board note that the ANAO found that each of these three critical areas has been very well managed. Corporate governance arrangements are robust, the selection process was fair and equitable, and appropriate safeguards have been established. Notwithstanding these strengths, the department and the Board acknowledge, however, that there is room for improvement in performance measurement against objectives and risk management of the program.

Key Findings

Some Elements of Corporate Governance (Chapter 2)

Roles and responsibilities

26. The department and the IR&D Board have given considerable attention to defining roles and responsibilities of the various parties involved in a number of documents and agreements, including program guidelines, licence agreements with the fund managers, a departmental Business Partnership Agreement, and loan agreements between the Board and the Commonwealth companies.

27. The ANAO found that these documents and agreements, along with legislative requirements within, for example, the *Corporations Act 2001*, provide a clear articulation of, and framework for, program administration (other than financial arrangements discussed in the following paragraphs). Roles and responsibilities were well understood by the relevant parties, and the department and the Board have acted consistently with them.

28. The IR&D Board has responsibility under Ministerial Direction for committing the expenditure of IIF program funds. However, the Secretary of the Department of Industry, Tourism and Resources is accountable, under the *Financial Management and Accountability Act (1997)* (FMA Act) for the proper use of IIF program money. The ANAO found that appropriate arrangements have been established to address these respective responsibilities for financial management, with the Secretary delegating responsibility to AusIndustry officials to draw up purchase orders consistent with the IR&D Board's licences, provided they are satisfied the money is either appropriated and available, or in the official forward estimates. The program is managed in accordance with these authorisations.

29. However, the ANAO found that there was no program-specific documentation that clearly articulated the complex financial arrangements for Commonwealth entities with responsibility for the IIF program. This can increase the risk that one of the Commonwealth entities may inadvertently act outside its authority. For example, the IR&D Board delegated to the FMC approval of drawdowns, although it does not have this function to delegate. (In practice the FMC has not exercised this delegation.) There would be merit in increasing shared understanding of the financial accountability arrangements to avoid such risks in the future through program specific documentation.

Strategic approach to program objectives

30. A strategic approach to achieving program objectives seeks to articulate the strategic direction of the program, strategies to achieve the program objectives and performance indicators for outcomes and outputs against the program objectives. This is particularly beneficial where there are some unique and high-risk issues, such as with the IIF program. While the *IIF Program, Policy and Practice Direction* issued by the Minister to the IR&D Board under the IR&D Act gives strategic direction to the IIF program, the other elements of a strategic plan are not clearly articulated.

31. In particular, the ANAO found that key performance indicators are not identified to measure and report achievements against all of the program objectives. The ANAO found that there was not a uniform view amongst those with responsibility for the program and its administration on the importance of particular program objectives over others, increasing the risk that strategies to achieve specific objectives will be overlooked. The governance framework for the program would be strengthened by including in a program plan the identified strategies to achieve each of the program objectives and the measures by which program performance will be assessed. (Current measures are assessed at paragraphs 56 to 57.)

Conflicts of interest management

32. The IR&D Board and the department recognise the potential for perceived and actual conflicts of interest, and have in place appropriate procedures to manage this. Evidence indicates that these arrangements are soundly based. For example, the IR&D Board and its FMC have documented conflict of interest guidelines and procedures. The procedures include agenda papers not being distributed to members until they confirm they are unlikely to declare a conflict of interest on an agenda item based on a short description of the item, and members being excluded from attending for the duration of an agenda item when an interest is declared and considered to be material by other members. The ANAO specifically examined the operation of the procedures for Round 2 selection and found that they were being observed.

33. AusIndustry required all employees involved in the selection of Round 2 fund managers to declare any conflict of interest. AusIndustry has also recognised the need to strengthen and systematise its conflict of interest procedures for all programs. In November 2001, it released *Conflict of Interest Guidelines* for its employees.

Risk management and fraud control

34. There is an array of risks associated with the IIF program, including the potential for investment in tax avoidance schemes; collusion between fund managers and private investors; insufficient due diligence by fund managers with respect to investments; and on-going financial viability of fund managers. Accordingly, risk treatments have been put in place, including selecting fund managers using due diligence procedures; drafting governing documents for program administration; establishing wholly-owned Commonwealth companies to limit liability against the Commonwealth; implementing conflict of interest guidelines for FMC members; and restricting related party transactions through licence agreements.

35. However, risk assessments and consequential treatments have not been supported by a sufficiently systematic approach to risk management and monitoring. Better practice indicates that a more systematic approach is necessary to provide appropriate assurance on the effectiveness of risk management. For example, as noted elsewhere in this report, monitoring of compliance of fund managers with licence agreements would benefit from consideration within a structured risk management framework.

36. In 2001, AusIndustry decided to incorporate IIF risk management into its broader risk management framework for all programs. This process has been of limited value in guiding risk management of the IIF, as it results in the IIF program receiving the lowest rating category. This would result in a very low level of compliance checking and be inconsistent with current approaches and management perceptions of risk. AusIndustry has advised that it has now commenced the development of a risk management plan for the IIF program, which will build on the earlier work and focus better on the unique aspects of the program.

Selection of Fund Managers (Chapter 3)

37. The IR&D Board called for applications from fund managers for Round 2 by 31 March 2000. AusIndustry undertook 'road shows' and targeted approaches to potential early venture capital fund managers to obtain the widest possible field of applicants.

38. Assessment of applications was conducted in two stages, with the first stage identifying a shortlist which was subject to a more detailed assessment in the second stage. The selection resulted in licensing four fund managers with funds into which the Commonwealth committed investment of \$90.7 million.

Value for money

39. The Board considered that the market had developed sufficiently by Round 2 to subject management fees and the proportion of private sector investment to competition. These factors were therefore included in the selection criteria. This resulted in greater value for money for the Commonwealth's investment in the IIF by increasing the proportion of funds from the private sector (44 per cent as opposed to 34 per cent in Round 1), and by reducing management fees (25 per cent over the 10 year life of the funds compared to 29 per cent previously¹¹).

Probity

40. A number of measures were taken to address the robustness and probity of the Round 2 selection processes. A due diligence contractor was engaged to consider, *inter alia*, the accuracy of bidders' claims and the consistency of assessments. A probity auditor assessed the processes and found that there were no issues of probity outstanding; the bidders were evaluated and ranked fairly against agreed selection criteria; and all bidders appeared to have been accorded fair and equitable treatment.

41. The probity assurance arrangements could, however, be strengthened for future selection exercises in two respects. First, there is value in a probity audit being guided by a probity plan, to ensure a common understanding between parties on the probity audit process and required outcomes. There was no such plan required or prepared for this selection. AusIndustry has responded by including the need to follow an agreed probity plan in its contract for probity audit services for selection for the recent Pre-Seed Fund program¹².

42. Second, the probity auditor's contract contained a provision for probity advice (that is, advice to those conducting the process on how to deal with probity matters which may also include identifying probity issues as they arise). There is potential for the probity auditing and advising roles to be in conflict, when combined where the advising role impacts adversely on the independence of the audit. The ANAO suggests that AusIndustry and the Board consider the extent and scope of probity advice they require and, if appropriate, separate these roles in future selection rounds.

¹¹ The Round 1 management fee was 3 per cent per annum of committed capital. Where the fund managers require disproportionately more fees in the early years of the fund, a discount rate was applied, resulting in the fund managers receiving, on average, a management fee of 2.9 per cent per annum or 29 per cent over the life of the funds.

¹² The Pre-Seed Fund will help commercialise public sector R&D activities by addressing the gap between promising scientific discoveries and commercialisation. It will do this by developing the management and entrepreneurial skills of public sector researchers and building links with the finance and business community. The fund managers were announced in May 2002.

Accountability and transparency

43. The Round 2 selection assessments and decisions were appropriately documented and recorded. For example, written reports on the assessment of bids and the selection process were provided to the FMC and the Board by AusIndustry, the due diligence contractor and the probity auditor. As well, minutes of meetings documented relevant decisions and deliberations.

Consistency of proposals with program guidelines

44. The ANAO found that the IR&D Board and AusIndustry took appropriate measures to establish consistency of funds' governing documents with program guidelines. For example, applicants were provided with a model licence agreement, trust deeds and partnership agreement; and legal advice and sign-off was obtained on the proposed structures and constituent documents of the four top-ranked applicants with respect to consistency with the program guidelines. This included legal and accounting advice on a direct investment arrangement, which addressed, inter alia, that it was not, or could not be perceived to be, a tax avoidance structure.

Planning and management of the selection process

45. AusIndustry's approach to managing selection in Round 2 was guided by the experience from conducting Round 1. The selection process achieved the planned timeframe to the point of selecting the top-ranked applicants in early September 2000. However, it was subject to unanticipated delays after this stage due to a number of practical issues arising in negotiation, many of which could not have been anticipated, with the last fund manager signing a licencing agreement in September 2001.

46. While a timeframe developed by AusIndustry assisted the management of the process, the ANAO suggests that a more in-depth project plan would be beneficial in similar selection rounds in the future. This would facilitate management through all stages of the process and reduce the likelihood of insufficient planning attention to some steps.

Protecting the Commonwealth's Financial Interests (Chapter 4)

Minimising contingent liability

47. The department and Board have put in place two main measures to manage the risk of Commonwealth liability arising from litigation or actions of the fund manager acting contrary to the conditions of a licence. First, wholly-owned Commonwealth companies with limited assets in their own right are the Commonwealth investors in the funds. Second, the licence agreements between the Commonwealth and fund managers, and other constituent documents, contain clauses limiting the liability of the Commonwealth.

Managing payments

48. A key feature of the IIF program is that funds from investors are not called upon until required, so that the Commonwealth is not providing funding in advance of need. The procedures in place in the department ensure that calls for funds are checked for consistency with licence agreements prior to payment, minimising the risk that inappropriate payments will be made.

Minimising losses of investment capital

49. With each individual investment by a fund, there is a relatively high risk of the total loss of invested capital because small, new technology firms often have few assets, other than intellectual property that is still to be market tested. This risk is balanced by the prospect of a small proportion of the fund's investments delivering high returns. The risk to the Commonwealth's capital in each fund is also mitigated by requiring the primary call on any monies received on exit from an IIF fund investment to be the capital committed to the fund. Only after all the capital committed to a fund is repaid are excess profits from individual investments distributed between the Commonwealth, private investors and fund manager.

Linking fund manager payment to performance

50. Fund managers receive a basic remuneration, irrespective of performance, in the form of a management fee to cover managers' operational expenses. In addition, fund managers receive an 18 per cent share of profits from divestment of investments. This provides an incentive for fund managers to perform well in terms of returns on investments. There is also, to some extent, a disincentive for very poor performance, since the IR&D Board may terminate a licence (and hence stop management fees) because of poor performance.

Monitoring of Licence Agreements (Chapter 5)

Monitoring compliance

51. The key means by which the IR&D Board monitors compliance with the licence agreements is through reporting by fund managers. The main compliance reports are certification that an investment complies with the terms of the licence and other constituent documents, and a six-monthly statement describing the fund's compliance with the licence agreement. The ANAO found that both requirements are complied with. The Board (through its FMC) can also require fund managers to make presentations on their investment portfolios, and has done this on two occasions. The licence agreements also provide for the Board to conduct external checks, but none has been undertaken to date.

52. In addition, fund managers are required, through their trust deeds or partnership agreement, to ensure the auditor of the fund reports on whether the conditions in the fund's licence agreement have been met. However, the reports from the auditor have only been a copy of certification by the fund manager; that is, the reports have not been supported by a compliance audit.

53. The degree of assurance that these reporting arrangements provide is therefore dependent on the accuracy of fund managers' reporting. The ANAO found that the Board can have limited assurance of this—essentially because fund managers have limited information on which to support some aspects of their claims of compliance; there has been no compliance auditing in this area; and departmental compliance activity has been limited to checks of fund managers' reports when submitted. There is a need for more cost effective assurance of fund manager's compliance with licence agreement conditions, such as greater use of external audits.

54. The FMC has advised the ANAO that it intends to undertake a review of the costs and benefits of enforcing the requirement in the licence that an external auditor audit the fund manager's compliance with the governing documents (see paragraph 51). It would be sound practice to undertake this review in the context of developing a risk management plan for the program.

Monitoring performance of fund managers

55. In addition to reporting on compliance, fund managers are required to provide financial reports, valuations and economic impact statements to the IR&D Board. The latter address sales, employment growth, product development and commercialisation, which are relevant to achieving some of the program's objectives. However, the reporting does not cover fund managers' performance against other program objectives, for example, the development of fund

managers with experience in the early stage venture capital industry. While AusIndustry has some information pertinent to these objectives, the limitations in performance information collected from fund managers reduce the Board's ability to monitor each fund's contribution to relevant program objectives.

56. AusIndustry uses this and other information, inter alia, to monitor, and report to the FMC on, fund managers' performance. However, it does not have a comprehensive information database, limiting its ability to identify and analyse issues across fund managers. AusIndustry has advised that it intends to develop such a database.

Measuring and Reporting Program Performance (Chapter 6)

Key performance indicators

57. IIF program outcome performance measures include: new technology companies supported; value and revaluations of new technology companies investment; rate of return on investment from IIF investments, individually and collectively; national interest benefits from IIF investments; and managers trained/experienced through IIF. AusIndustry only measures results for the first two of these indicators, which focus on the investment performance of funds. There is no direct measurement of the management support provided to such companies, nor is data held by the department collated into outcome measures for the last three indicators. There are opportunities to develop more informative means of assessing these indicators, having regard to current reporting responsibilities of fund managers. The rate of return can be also assessed from valuations already supplied by fund managers.

58. The specified output measures for the IIF program address quality, quantity and cost of outputs. These measures are an improvement compared with the early years of the program, reflecting a broader improvement in AusIndustry's framework for output measures for all its programs, in response to a previous ANAO recommendation.

Performance benchmarks and targets

59. The Business Partnership Agreement between AusIndustry and the Innovation and Industry Policy Division foreshadows the development of benchmarks or targets across all output measures to enable the performance of the program to be readily assessed. However, there has been limited progress in developing targets or benchmarks for both output and outcome measures. As Round 1 fund managers have now been licensed for four years, there should be

sufficient historical information to develop such benchmarks and targets. These would provide AusIndustry and the Board with better information against which to assess program performance.

Public reporting on program performance

60. Good reporting on program outputs and outcomes does more than provide for accountability to the Parliament and other stakeholders. For the IIF program, it has the added dimension of demonstrating to the broader investor community the potential benefits of investing in early stage venture capital funds, in line with program objectives.

61. There is substantial reporting on the IIF program in the annual reports of the department and the IR&D Board, consistent with formal annual reporting requirement. There is further program information on the AusIndustry website. Notwithstanding the availability of this information, public reporting on the program reflects the limitations in key performance information, targets and benchmarks discussed above.

62. Economic impact statements are collected from fund managers, including information such as state location of investee companies; changes to employment; and regional level activities in the investee companies. This information will be considered in the interim evaluation. However, reporting of some of this information, in aggregate, would also provide greater public accountability at a relatively small cost.

63. The FMC has advised that the 'demonstration effects' from the program will come from the funds making money. However, there is no information publicly available on the current valuations of investments, nor on an overall internal rate of return for the program, which would help demonstrate the advantages of this type of investment to potential investors. As the investments have now been made over four years, there are now opportunities to improve reporting in this area. The ANAO encourages the department to develop and report on relevant indicators based on, for example, invested funds across all investments, current valuations and realised returns.

Program evaluation

64. In establishing the IIF program, the Government sought, in addition to an evaluation for 2004–05, an interim evaluation report in 2001–02. The interim evaluation is currently underway, with a consultant engaged to report on the efficiency and effectiveness of the program, options for improvement, and the continuing need for the program.

Results Achieved (Chapter 7)

65. The ANAO examined available data to consider results of the program in the context of the four program objectives. Data sources included departmental performance information; ABS surveys on venture capital; the Australian Venture Capital Guide 2001; and an analysis of the Australian Venture Capital Journal (AVCJ) Survey.

66. The ANAO estimates that each fund manager from Round 1 selection is likely to have about 12 investments on average during the life of the fund. This is high by the standards of the venture capital industry generally¹³, but less than the average of 20 that was assumed by the department for larger funds in the early stages of the program.

67. Five companies have received funding from more than one IIF fund manager. One company has received funding from four IIF fund managers, receiving 4.5 per cent of total Commonwealth funds available for investment. One fund manager had 86 per cent of the fund's investments by value in companies that had been invested in by other IIF funds. This is permissible under the terms of the licence agreements. However, the extent of such co-investment limits the overall number of companies that can be assisted. Thus it is unlikely that the Round 1 fund managers will invest in the number of companies foreshadowed in the Prime Minister's statement announcing the program (more than 100 companies). In addition, while the program guidelines ensure the diversity of investments across an individual fund, high levels of co-investments limit diversity of investments across the program, as a whole. This matter warrants consideration in any future rounds or for similar innovation programs.

68. There has been one very successful realisation of IIF funds' investments to date—Looksmart, which realised a total of \$245 million from an investment of \$2.2 million. After the distribution of capital with interest, a profit of \$197.7 million was distributed amongst the Commonwealth, private investors and the fund manager, representing a total return of 199 per cent of funds invested as at 30 June 2001¹⁴. The Commonwealth received a \$19.8 million share of the profit¹⁵, consistent with the distribution arrangements for IIF funds (see paragraph 9). This profit represented a return for the Commonwealth of 30 per cent on funds invested in Round 1, as at 30 June 2001.

¹³ Australian Bureau of Statistics, *Venture Capital Surveys, Australia, 2000-01*. This publication reports that only 21 per cent of fund managers had 10 or more investment deals under management.

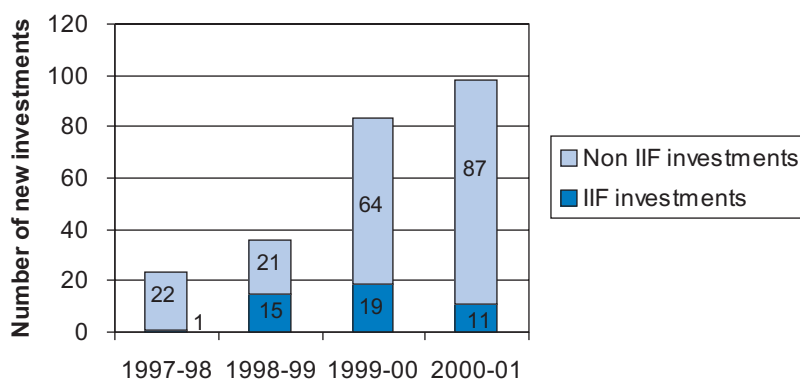
¹⁴ 30 June 2001 is the most recent date for which audited data on valuations of funds are available.

¹⁵ \$31.6 million of capital plus interest was also returned to the Commonwealth.

69. For investments other than Looksmart, the value of the Round 1 portfolio has grown, providing an annualised internal rate of return of 11 per cent to 30 June 2001¹⁶. Venture capital investments are likely to result in both losses and gains due to the high risk nature of the sector, with long term results often difficult to predict. Furthermore valuations can be subject to dramatic changes brought about by events outside the control of fund managers; the downturn in dot.com stocks in the United States in 2000 is an example of such an event. To 30 June 2001, the pattern of losses and gains for IIF investments, with some 20 per cent losing value and some 24 per cent gaining value, is broadly in line with expectations for the sector. Most losses were in the internet sector, reflecting the dot.com decline.

70. There has been substantial growth in the number of companies assisted by the early stage venture capital market—as described below. AusIndustry has advised that the number of new IIF investments will increase from 2001–2002 onwards as Round 2 fund managers begin to invest.

Number of New Investments in Early Stage Venture Capital Market

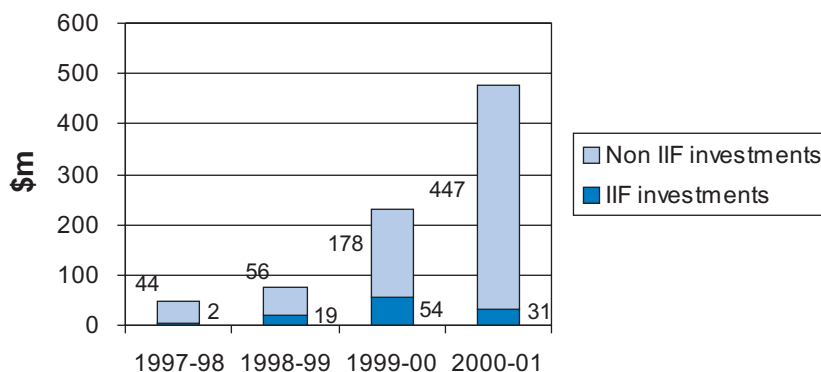


Source: AVCJ survey and departmental data

71. There has also been very substantial growth in the amounts being invested annually in the early venture capital over the same period—see below. While IIF funding made up about one-quarter of the sector in 1998–99 and 1999–2000, the continued growth in 2000–01 indicates that the market is growing outside the IIF funding. The Australian Venture Capital Guide 2001 suggests that government programs such as the IIF have been one of the drivers of the growth. Stakeholders interviewed by the ANAO generally considered that the IIF program had made a positive contribution to confidence in the market, particularly given the leverage provided to private investors

¹⁶ Unaudited valuations at 31 December 2001 show an annualised internal rate of return of –0.1 per cent.

Investment in the early stage venture capital sector (\$m)



Source: AVCJ survey and departmental data

72. There is no data available on the numbers of professional fund managers with experience in the early stage venture capital industry. However, the growth number of investment in recent years suggests that a related increase in fund managers is likely. AusIndustry has also advised that turnover of IIF fund managers who remain in the industry contributes to the spread and depth of experience in the sector, but quantification of this contribution is not possible from existing data and information sources.

73. In March 2000, the then Minister for Industry, Science and Resources announced the establishment of a revolving fund using the return of capital and interest from IIF investments. To date, this has amounted to \$31.6 million from the Looksmart investment¹⁷. The ANAO found that the resources agreement for the revolving fund is yet to be finalised with the Minister for Finance and Administration. The department has advised that it would be unlikely to favour a tendering round for the funds in the self revolving fund until they are at a level that would enable three fund managers to be licensed (some \$60 million). This, however, is a matter for Government decision.

¹⁷ The Commonwealth also received \$19.8 million as its share of profit after return of all capital committed to the fund, plus interest (see also Table 7.2).

Recommendations

**Recommendation
No.1
Paragraph 2.28**

The ANAO recommends that, in order to increase assurance that all Innovation Investment Fund program objectives are being adequately addressed, the Department of Industry, Tourism and Resources, in consultation with the Industry Research and Development Board, develop a program plan that clearly outlines strategies to achieve program objectives and performance indicators against which to measure and report their achievements against those objectives.

Agency Response: Agreed.

**Recommendation
No.2
Paragraph 2.44**

The ANAO recommends that, in order to ensure the risks for the Innovation Investment Fund program are adequately managed, AusIndustry, in consultation with the Industry Research and Development Board as appropriate, develop a risk management plan for the IIF program, including assessing program risks, and developing and implementing a comprehensive treatment plan commensurate with the risk assessment, in accordance with recognised better practice.

Agency Response: Agreed.

Audit Findings and Conclusions

1. Introduction

Venture capital

1.1 The venture capital industry in Australia is well-established, with venture capital firms providing long-term, committed share capital and expertise to allow new or young businesses to grow and succeed, with the prospects of high rates of returns. The provision of venture capital to a company is generally not secured on any assets. Put simply, *venture capital may be regarded as an equity investment where investors expect significant capital gains in return for accepting the risk they may lose all their equity.*¹⁸

1.2 Venture capital investments are usually for between three to seven years, and are typically in the order of \$0.5–10 million.¹⁹ The recipient company benefits from capital investment, expected managerial expertise and enhanced business reputation. The venture capital firm generally obtains its return, if the company is successful, through realising a capital gain²⁰ when it sells out the investment. Means of realising this gain include:

- initial public offerings, when a company offers shares to the public and lists on a stock exchange; and
- trade sales, when a larger, more established company, usually in the same sector, buys out a smaller developing company.

1.3 Venture capital provides funding for enterprises in a range of business stages. These stages have been defined in the *Australian Venture Capital Guide 2001*²¹ as:

- seed, where capital is used to develop, test and ready a product for production, or a service for commencement;
- start-up, where capital is used to fund the start-up of commercial business operations before any sales are made;
- early expansion, where capital is used to fund growth for a relatively new business that is making sales but is not yet profitable;
- development or expansion, where capital is used to fund an established and growing business that is making sales and profits; and

¹⁸ Golis, Christopher (1999): *Enterprise and Venture Capital: A Business Builder's and Investor's Handbook*, third edition p xxiv.

¹⁹ Pollitecon (Victor Bivell): *Australian Venture Capital Guide 2001*, eighth edition, p. 12.

²⁰ Capital gain is the amount realised on exit less the amount invested.

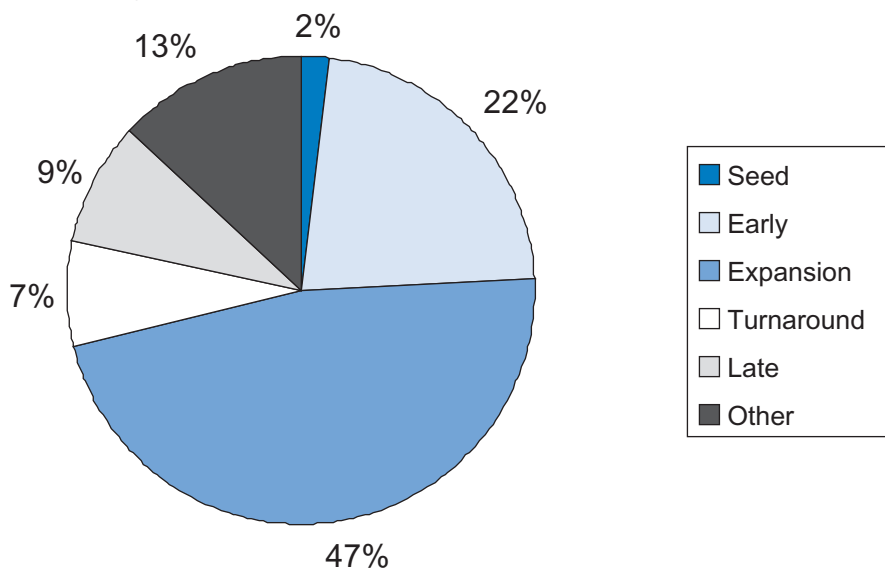
²¹ See reference at Footnote 2.

- turnaround, where capital is used to rejuvenate or rescue an established but faltering business.²²

1.4 According to the Australian Bureau of Statistics (ABS), at 30 June 2001 there were 150 venture capital funds in Australia, with investments totalling \$2.7 billion.²³ The ABS uses different categories to classify the different business stages, with its definitions of *early*, *expansion* and *late* covering the above-listed stages of *start-up*, *early expansion* and *development or expansion*.²⁴ The distribution of investment between these stages is shown in Figure 1.1.

Figure 1.1

Distribution of total Australian venture capital investment (\$2.7b) by investee stage, 2000–01



Source: Australian Bureau of Statistics.²⁵

²² Venture capital is also used for financing management buyouts, management buyins, and leveraged buyouts. Definitions of these business activities are at Appendix 6.

²³ Australian Bureau of Statistics (30 June 2001): *Venture Capital, Australia*, Publication No. 5678.0, Canberra.

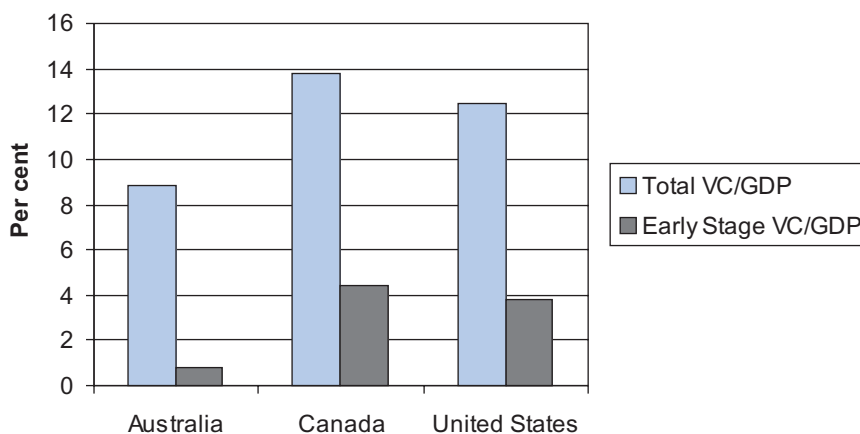
²⁴ The ABS definitions are at Appendix 6.

²⁵ The category other includes leveraged buyout, management buyout, and management buyin (see Appendix 6).

The Innovation Investment Fund program

1.5 The Innovation Investment Fund (IIF) was announced by the Prime Minister in the *More Time for Business* statement of March 1997.²⁶ It was developed following consultations by AusIndustry²⁷ with industry, and research undertaken by the Industry Research and Development (IR&D) Board, both of which indicated a need to provide high-risk venture capital to new technology-based firms in Australia. The Board drew on a 1996 Coopers & Lybrand survey which showed that, compared with the United States and Canada, Australia's early stage venture capital investment was small (see Figure 1.2).²⁸ Overseas models, specifically the Small Business Investment Companies scheme in the United States and the Yozma fund in Israel, were influential in the development of the IIF program.

Figure 1.2
Venture capital as a share of GDP, 1996



Source: Commonwealth of Australia (1997): *Investing for Growth: The Howard Government's Plan for Australian Industry*.

1.6 In announcing the Government's intention to establish the IIF program, the Prime Minister, referring to small technology-based firms, stated that the Government's financial support 'will provide more jobs and exports in this important and growing area of the economy'.²⁹ In this context, a study had found that Australian firms with venture capital invested in them experienced an

²⁶ The program was titled the Small Business Innovation Fund (SBIF) in the statement. It was renamed the Innovation Investment Fund in August 1997.

²⁷ AusIndustry is a business unit within the Department of Industry, Tourism and Resources.

²⁸ This was based on a survey, the results of which were subsequently published in Coopers & Lybrand (1997): *The Economic Impact of Venture Capital*.

²⁹ Hansard, 24 March 1997.

average 20 per cent annual employment growth compared with two per cent for other firms.³⁰

1.7 The objectives of the IIF program are to:

- (a) encourage the development of small new technology companies commercialising research and development (R&D), by addressing capital and management constraints;
- (b) develop a self-sustaining Australian early stage, technology-based venture capital industry;
- (c) develop fund managers with experience in the early stage venture capital industry; and
- (d) establish a 'revolving' or self-funding program in the medium term.

1.8 The IR&D Board has administrative responsibility for the program under the *Industry Research & Development Act 1986* (IR&D Act). The Minister for Industry, Tourism and Resources has appointed members of the Board and its committees with relevant industry, management and academic backgrounds. AusIndustry, a division of the Department of Industry, Tourism and Resources, provides administrative support. Fund managers are licensed by the Board to participate in the program for a 10-year period, following a competitive selection process. Each fund manager sets up an accredited IIF managed fund, comprising Commonwealth and private sector investments (the latter are sourced by the fund managers as a requirement of the licensing process).

1.9 Two selection rounds have been conducted. In 1998 five fund managers were licensed, managing funds into which the Commonwealth is investing a total of \$130 million. In 2001, a further four fund managers were licensed to manage IIF funds into which the Commonwealth is committing an investment of \$90.7 million. The Commonwealth channels its investment in the funds through special-purpose, wholly-owned Commonwealth companies. It invests in each of the funds under similar terms and conditions as the private investors, except for the percentage return on profits (see Figure 1.3).

1.10 The fund manager's role is to identify companies meeting the eligibility criteria set out in the licensing agreement with the Commonwealth, and then to invest equity capital in such companies, if they consider the investment will deliver appropriate returns. The key characteristics of companies eligible for investment are set out in Table 1.1.

³⁰ Coopers & Lybrand 1996 survey.

Table 1.1**Characteristics of companies eligible for investment**

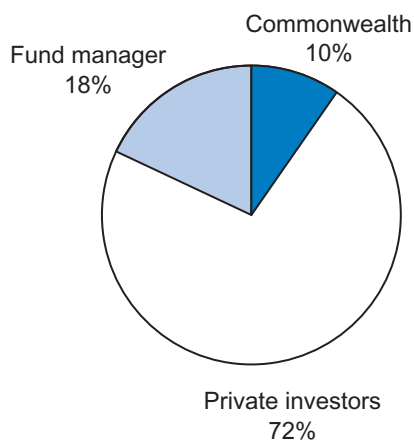
Engaged in commercialising R&D activities (or will embark on such commercialisation following the equity investment).

At the *seed, start-up or early expansion* stage of development at the time of initial investment.

Have a majority of employees and assets inside Australia at the time of initial investment.

Have an average annual revenue over the two years before investment of less than \$4 million.

1.11 The Commonwealth is the major investor in IIF funds. It provides up to \$2 of Commonwealth money for every \$1 of private investment. When a fund makes a return, the Commonwealth and the private investors expect repayment of capital, plus interest, calculated at the long-term bond rate. In addition, Figure 1.3 shows the typical distribution of excess profits (that is, profits after the return of capital plus interest³¹) across the Commonwealth, private investors and the fund manager³².

Figure 1.3**Typical distribution of profits from IIF investments**

Source: ANAO based on DITR information

1.12 These arrangements provide the **private investors** with an incentive to invest in IIF funds, since they receive proportionately more of the return (72 per cent of any excess profit compared with the Commonwealth's 10 per cent share). This facilitates the longer-term aim of developing confidence in this type of investment (see the example in Table 1.2).

³¹ Interest is determined at the long-term bond rate.

³² The Commonwealth's share of excess profits is 10 per cent as determined by Ministerial Direction. The balance is typically distributed between the private investors and the fund manager in a ratio of 80:20 respectively, but some fund managers and private investors have varied this by private agreement.

Table 1.2**An example of the distribution of returns**

Stakeholder	Capital invested ³³	Distribution of returns (based on \$15m of excess profits)		Profit on investment
		Capital + interest	Excess profit	
Commonwealth	\$20m	\$20m + interest	\$1.5m (10%)	7.5%
Private investors	\$10m	\$10m + interest	\$10.8m (72%)	108.0%
Fund manager	–	–	\$2.7m (18%)	N/A

Source: Scenario developed by ANAO, using investment and distribution ratios as outlined in governing documents typical of Round 1 funds.

1.13 There has been one successful realisation of an IIF investment to date—Looksmart, as outlined below.

Case Study 1 —Looksmart

Looksmart began business in Melbourne in 1995 as Homebase Directories, but was subsequently incorporated in Delaware, USA, moving its headquarters to San Francisco. The company built a platform of technologies and relationships that were necessary to be a successful entrant into the web navigation/integration sector. In June 1998, an IIF fund invested \$2.24m in Looksmart. In August 1999, the company listed on the US technology share market, NASDAQ, and the value of the IIF fund investment had risen within two days of listing to A\$109m. The IIF fund sold all but 10,000 of its share in Looksmart immediately prior to the listing of the company on the Australian Stock Exchange. These shares were sold for US\$37 each, realising a total, including warrants previously sold, return of \$245m.

The Commonwealth's pre-tax share from this exit was \$51.4m, comprising \$27.5m return of capital, \$4.1m in interest, and \$19.8m in profit.³⁴

1.14 The administrative arrangements for the IIF program have now been used as the model for other programs, such as the Renewable Energy Equity Fund³⁵ and Pre-Seed Fund,³⁶ which seek to promote innovation in participation with the private sector.

³³ In this example, the Commonwealth invests \$2 for every private sector \$1, typical of Round 1 funds. The proportion of Commonwealth investment in Round 2 funds was open to competition, resulting in an average Commonwealth investment of \$1.28 for every private sector \$1.

³⁴ The return of capital with interest to all investors (Commonwealth and private) totalled \$47.4m, resulting in a profit of \$197.7m. After the Commonwealth's 10 per cent share, the balance of the profit (\$177.9m) was distributed between the fund manager and the private investors.

³⁵ The REEF Renewable Energy Equity Fund program provides venture capital (equity) to assist small companies to commercialise R&D in renewable energy technologies. There is currently one licence agreement, signed in October 2000.

³⁶ The Pre-Seed Fund will help commercialise public sector R&D activities by addressing the gap between promising scientific discoveries and commercialisation. It will do this by developing the management and entrepreneurial skills of public sector researchers and building links with the finance and business community. The fund managers were announced in May 2002.

Audit objective, criteria and approach

1.15 The objective of the audit was to determine whether the IIF program is being effectively managed by the Commonwealth to achieve the program objectives. The audit focused on whether:

- there are robust corporate governance arrangements to support effective program administration (Chapter 2);
- the selection of fund managers is fair, and consistent with government requirements and recognised better practice (Chapter 3);
- there are appropriate safeguards to protect the Commonwealth's financial interests (Chapter 4);
- the monitoring of licence agreements is effective, and provides appropriate assurance on compliance and performance (Chapter 5); and
- program performance management is sound (Chapter 6).

The audit also assessed program results to date from available data (Chapter 7).

1.16 The audit criteria were drawn from a number of sources, including requirements under the *Financial Management Act 1997* (FMA Act) and Australian National Audit Office (ANAO) better practice guides (such as *Administration of Grants* (2002), *Applying Principles and Practice of Corporate Governance in Budget Funded Agencies* (1997) and *Contract Management* (2001)). These are outlined at Appendix 1. As noted below, the ANAO also received advice on audit criteria from venture capital experts.

1.17 The audit approach included:

- interviewing departmental officers, the IR&D Board and its Fund Management Committee (FMC), licensed fund managers, industry stakeholders such as the Australian Venture Capital Association Limited, and other industry experts;
- examining and analysing departmental documents;
- analysing management information and external industry survey results, such as the ABS Venture Capital Survey and the Australian Venture Capital Journal Survey;
- using experts in venture capital to advise on audit methodology (Mr Alan Cullen, Cullen Capital Pty Ltd, and Associate Professor Michael Whincop, Faculty of Law, Griffith University). These consultants were chosen because of their knowledge of venture capital practices—from extensive practical experience in the market in the case of Mr Cullen, and from academic research in the case of Associate Professor Whincop; and

- analysis of Australian Venture Capital Journal Survey data, commissioned from Howard Partners Pty Ltd, which has exclusive access to the unit record data.

1.18 The audit was conducted in accordance with ANAO auditing standards at a cost of \$350 000.

2. Some Elements of Corporate Governance

This chapter assesses the effectiveness of some aspects of the corporate governance framework for the program.

Introduction

2.1 Implementation of the IIF program has involved challenging and unique issues of public administration, including addressing issues arising from:

- investment by the Commonwealth in a market traditionally regarded as high risk;
- fund managers being contracted for long periods (the licence agreements are over 10 years);
- Commonwealth reliance on fund managers to invest the funds as specified in the contracts;
- several portfolio entities involved in administration, with their authority drawn from, and accountabilities governed by, legislation and government policies;
- dual roles of the Commonwealth as program administrator and as investor, the latter on the same basis as private investors; and
- private investors requiring particular investment vehicle structures, such as unit trusts, partnerships and direct investments.

2.2 The resulting arrangements for delivering the program are complex and involve a degree of convergence of the public and private sectors in delivering an outcome for the Commonwealth. Experience demonstrates that sound corporate governance frameworks enhance the ability to achieve required program outcomes in such an environment.³⁷ This chapter describes the *key Commonwealth bodies* and their roles and relationships with *program participants*, and assesses the effectiveness of aspects of the corporate governance framework for the program, particularly in respect of:

- *roles, responsibilities and accountabilities;*
- *the strategic approach to achieving program objectives;*

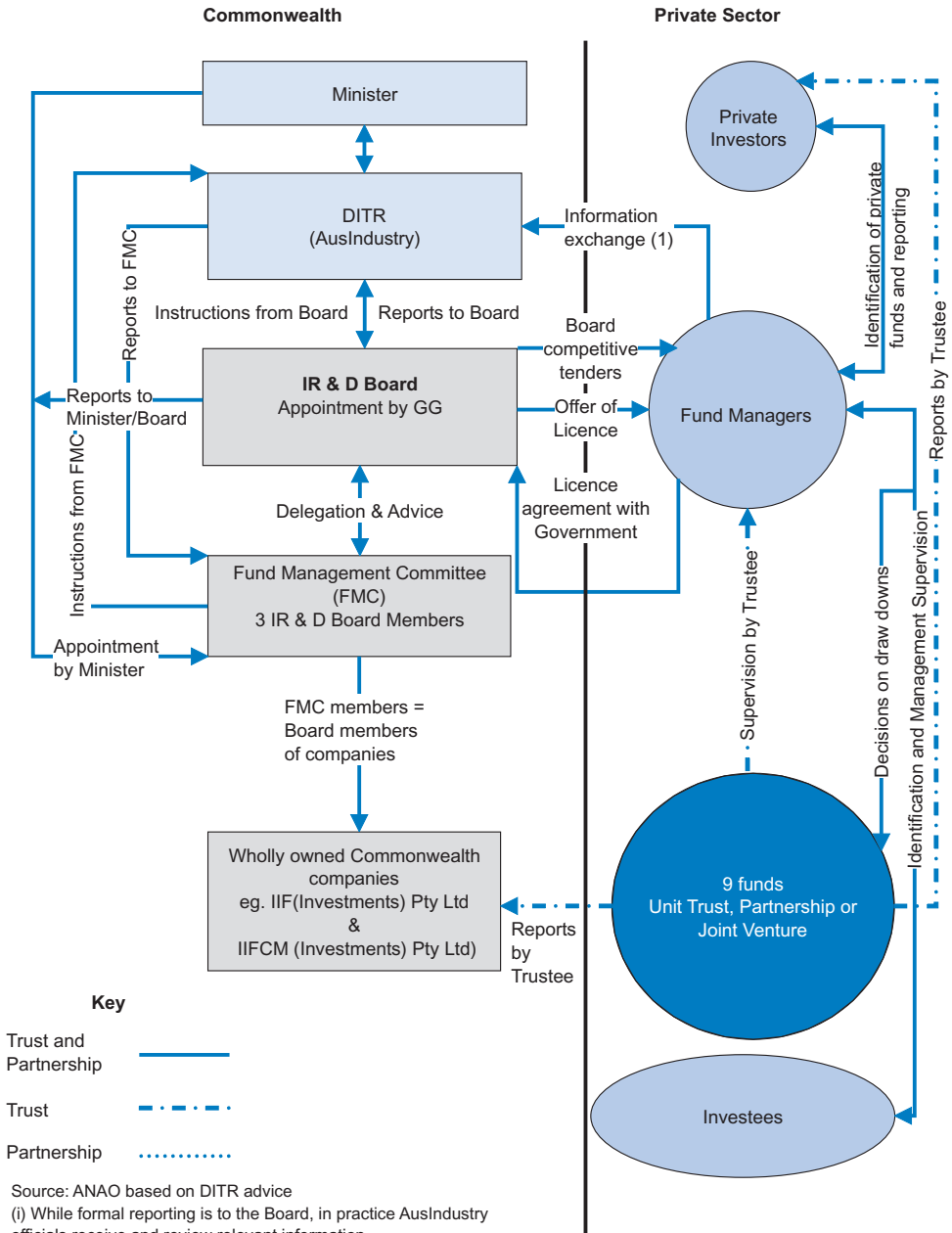
³⁷ This issue is explored further in the address to the senior staff of the Board of Audit, Tokyo, Japan, by the Auditor-General for Australia. *Auditor-General (18 October 2001): Auditing in an Environment of Public/Private Partnership and Greater Collaboration in the Provision of Public Services.*

- management of perceived *conflicts of interest* for the Board and AusIndustry; and
 - *risk management*.
- 2.3 Performance monitoring and reporting are addressed in Chapter 5 (fund managers' compliance and performance), and Chapter 6 (program performance).

Key Commonwealth bodies and other program participants

2.4 The key Commonwealth bodies, their responsibilities and relationship with program participants are summarised in Figure 2.1, with further details at Appendix 2.

Figure 2.1
IIF Accountabilities and Reporting Structures



2.5 Broadly, the **Industry Research and Development (IR&D) Board** is a statutory board established under the IR&D Act to make recommendations on, and undertake, activities relating to research and development by Australian industry. Board members are industry and research experts, most of whom are independent of the Department of Industry, Tourism and Resources (the department). The Board is responsible for delivering and monitoring the IIF program and, inter alia, is required under ministerial direction to:

- develop (and re-develop, as necessary) IIF program guidelines in line with Ministerial Directions;
- call for and assess applications for IIF licences, and grant licences in line with the assessment outcomes;
- manage the licences; and
- report annually to the Minister for Industry, Tourism and Resources on activities, including the IIF program.

2.6 The Board's **Fund Management Committee (FMC)** is charged with regulatory functions relating to the program under delegated authority, consistent with the provisions of the IR&D Act. The FMC receives direction from the Board and reports to it regularly.

2.7 **AusIndustry** is a business unit of the Department of Industry, Tourism and Resources, which provides the secretariat for the Board and the FMC. In this capacity it provides administrative support for the IIF program. This includes consulting with industry; drawing up program guidelines; advertising for applications; evaluating applications; negotiating licence agreements; and monitoring the agreements. AusIndustry, under delegation from the Secretary, also undertakes financial management tasks associated with the program (see paragraph 2.19).

2.8 Five **wholly-owned Commonwealth companies** are the Commonwealth's investors in the IIF funds. Funds are provided to the companies on the basis of limited recourse loan agreements between the IR&D Board and the companies. This arrangement:

- enables the Commonwealth to invest in unit trusts, without the funds being classified for tax purposes as public trading trusts,³⁸ and

³⁸ Public trading trusts have an income tax exempt body (such as a government department) holding an interest of 20 per cent or more, in the trust. Such trusts are treated as companies for taxation purposes, and so would not meet the requirements of private sector investors. As the wholly owned Commonwealth companies are not tax exempt bodies, the unit trusts are not public trading trusts for taxation purposes, and are therefore subject to the usual taxation treatments for unit trusts.

- limits the financial exposure of the Commonwealth, in the event of claims of liabilities against the investors, to the net assets held by the companies (see paragraphs 4.5–4.7).

The directors of the companies are the members of the FMC.

2.9 The **IIF fund managers** are licensed by the IR&D Board to manage an IIF fund, following a competitive selection process. They have the role of selecting companies eligible under the licence agreement for equity investment, and helping to manage these **investee companies** during the course of the investment. The managers are responsible to the investors (both Commonwealth and private) for growing the invested funds, and to the IR&D Board for ensuring their operations are consistent with the terms and conditions of their licences. In return, the fund managers receive an annual management fee and a share of any excess profits made from investments (see Figure 1.3).

2.10 **Private investors** are brought to each fund by fund managers as part of the licensing process. These investors invest on the same basis as the Commonwealth, except for receiving a greater share of any excess profits in proportion to their investment (the private investors receive typically 72 per cent, while the Commonwealth receives ten per cent³⁹). The requirements of the private investors determine whether an **IIF fund** is structured as a unit trust, partnership or direct investment through a joint venture arrangement.

2.11 The supervision of the fund manager to protect the interests of the investors varies according to the fund structure. This is undertaken by a trustee for funds structured as unit trusts, and, for partnerships and direct investments, by the investors themselves (including the Commonwealth-owned companies acting as the Commonwealth's investor).

2.12 The **Innovation and Industry Policy Division** of the department is responsible for providing policy advice to Government and for program evaluation. The Division gained this responsibility from AusIndustry as part of a separation of policy responsibilities from service delivery for all industry programs, implementing the Government's response to the Mortimer Report, *Investing for Growth* (December 1997).

Roles and responsibilities

2.13 Clear roles, responsibilities and accountabilities are an important aspect of corporate governance, particularly where administrative arrangements are complex. The ANAO found that the department and the IR&D Board have given considerable attention to defining roles and responsibilities in a number of

³⁹ The 18 per cent balance is the fund manager's share of any excess profits.

documents. For example, the Board has established program guidelines, acting under Ministerial Directions issued under the IR&D Act. These guidelines outline the policies and practices to be adopted by the Board in its administration of the IIF program. They set out the roles and responsibilities of the Board and the FMC in selecting fund managers and managing the licence agreements, forming a key component of the *IR&D Board Handbook*.⁴⁰ The guidelines also outline the roles and responsibilities of licence holders.

2.14 The licence agreements between the Commonwealth (as represented by the Board) and the fund managers formalise the respective roles and responsibilities of the two parties, consistent with those set out in the program guidelines. The agreements set out the requirements of the fund managers in managing the invested funds and reporting to the Board. They also set out the undertakings of the Board to make determinations, when requested, on issues such as eligibility of an investment, and the conditions under which the Board will terminate a licence agreement or impose restrictions or changes on a fund manager.

2.15 The department has established a Business Partnership Agreement⁴¹ between its Innovation and Industry Policy Division and AusIndustry, setting out their respective policy and service delivery functions.⁴²

2.16 The activities of the wholly-owned Commonwealth companies are guided by loan agreements between the Board and the Commonwealth companies (see paragraph 2.8). These agreements set out the purpose for which the loan funds can be used, namely, investing in IIF funds, consistent with the roles and responsibilities of each company as the Commonwealth's investor. The agreements, along with the company directors' generic roles and responsibilities under the Corporations Act and the *Commonwealth Authorities and Companies Act (1997)* with regard to, for example, reporting requirements and duty of care in the exercise of powers, provide sufficient information to ensure that the company directors can undertake their duties consistent with their IIF program roles and responsibilities.

2.17 The ANAO concluded that the above documents, agreements and requirements provide a clear articulation of, and framework for, the roles and responsibilities for program administration (other than financial arrangements, discussed in the following sub-section). The ANAO also found that these roles

⁴⁰ The IR&D Board Handbook aims at providing relevant legislative, program and administrative information to Board members and committees. It outlines many of the key roles, responsibilities and accountabilities of the Board and its committees, including the FMC.

⁴¹ The Business Partnership Agreement is considered further in paragraphs 6.4, 6.11.

⁴² ANAO Report No.18 (2000–01) *Reform of Service Delivery of Business Assistance Programs* (Department of Industry, Science and Resources) examined the establishment of the arrangements to separate service delivery and policy functions.

and responsibilities were well understood by the relevant parties, and that the department and the Board acted consistently with their responsibilities.

Accountability for the proper use of IIF program money

2.18 The IR&D Board has responsibility under Ministerial Direction issued under the IR&D Act for 'investment in, or provision of finance to, companies that are eligible investee companies'.⁴³ The Board draws on this direction to commit expenditure of IIF program funds. This gives the Board the status of an *approver* under the *Financial Management and Accountability Act (1997)* (FMA Act), requiring it to be satisfied that decisions are in accordance with government policies and make efficient and effective use of public monies.

2.19 However, funding is appropriated to the department for the IIF program; therefore the Secretary is accountable under the FMA Act for the proper use of IIF program money.⁴⁴ The Secretary therefore needs to put in place arrangements to ensure the proper use of Commonwealth funds consistent with the decisions and commitments of the IR&D Board. This is done by delegating responsibility to AusIndustry officials through Chief Executive Instructions to draw up purchase orders consistent with the IR&D Board's licences, provided they are satisfied the money is either appropriated and available, or in the official forward estimates. This arrangement is represented in Figure 2.2.

2.20 The ANAO found that these arrangements, while complex, address the required roles and responsibilities for financial management of the program. Overall, the program is managed in accordance with the above authorisations.

2.21 However, the ANAO found that there was no program-specific documentation that clearly articulated the complex financial arrangements for Commonwealth entities with responsibility for the IIF program. This can increase the risk that one of the Commonwealth entities may inadvertently act outside its authority. For example, there was a delegation of the IR&D Board to the FMC, authorising the FMC to approve or reject drawdowns. The Board does not have this function to delegate, and in practice the FMC has not exercised this delegation. However, this example does suggest that there would be merit in increasing shared understanding of the financial accountability arrangements to avoid such risks in the future, through program-specific documentation.

⁴³ Innovation Investment Fund program (Additional Function of the IR&D Board) Direction No. 1 of 1998.

⁴⁴ The Secretary draws on sub-section 44(2) of the FMA Act: 'If compliance with the requirements of any other law (in this case, the IR&D Act) would hinder or prevent the proper use of those resources, the Chief Executive must manage so as to promote the proper use of those resources to the greatest extent practicable while complying with those requirements'.

Strategic approach to program objectives

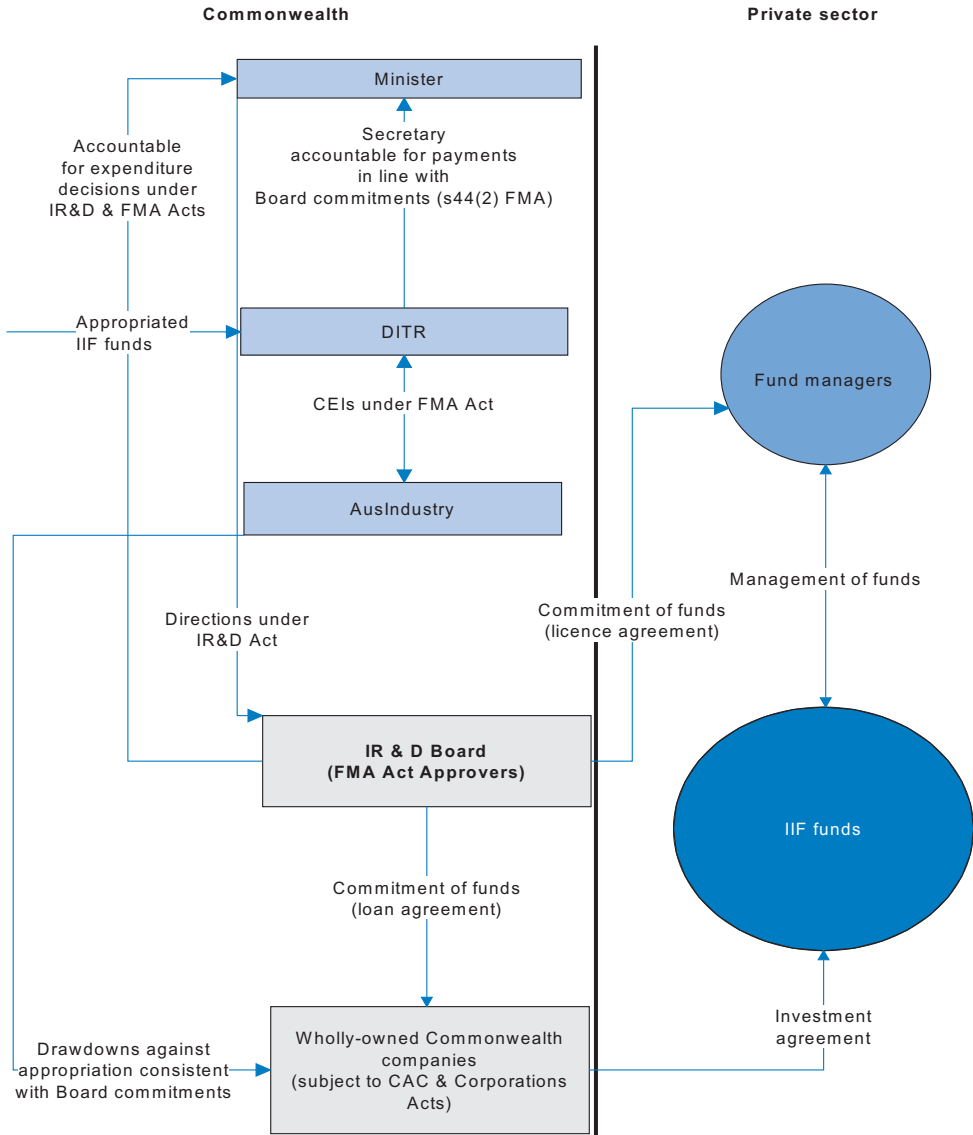
2.22 In applying corporate governance principles, executives should ensure their organisations have the ability and capacity to achieve their objectives (or planned outcomes), for example, through strategic formulation and analysis.⁴⁵ At the program level this is typically achieved by developing and implementing a strategic plan, outlining strategic approaches to achieve the objectives, and identifying relevant key performance indicators to monitor progress towards achieving the objectives. The Joint Committee of Public Accounts and Audit has in the past indicated that measurable performance indicators should be specified for each program objective.⁴⁶ More recently, the Committee reinforced its view that ‘a practical and informative performance information framework is an integral element of the new outcomes and outputs budget framework as it enables the understanding and monitoring of agency outcomes and outputs’.⁴⁷

⁴⁵ ANAO Better Practice Guide (1997): *Applying Principles and Practice to of Corporate Governance in to Budget Funded Agencies*, p. 9.

⁴⁶ JCPAA Joint Committee of Public Accounts and Audit (1998): *General and Specific Purpose Payments to the States*, Report No.362, Parliament of the Commonwealth of Australia, Canberra.

⁴⁷ Joint Committee of Public Accounts and Audit (2002): *Review of the Accrual Budget Documentation*, Report No.388, Parliament of the Commonwealth of Australia, Canberra.p. v.

Figure 2.2
Accountabilities for financial decisions and acquittals



Source: ANAO based on DITR advice

2.23 The key document that gives strategic direction to the IIF program is the *IIF Program, Policy and Practice Direction*, issued by the Minister to the IR&D Board under the IR&D Act. This direction provides the Board with the basis for awarding licences and overseeing licensed funds under the IIF program. It covers:

- the policy objectives to which the Board must have regard in developing and administering the program;
- the need for the Board to develop guidelines for the operation of the IIF program;
- matters relating to awarding licences, such as the number of licence rounds, application fees, the basis for determining the number of licences to be awarded, and the minimum criteria for assessing applicants;
- criteria for eligibility of investments by the licensed funds, including those relating to transactions where there may be a conflict of interest;
- the proportion of investment capital provided by the Commonwealth;
- reporting by licence holders;
- income distributions; and
- management fees.

2.24 The direction does not include, nor is supplemented by, a plan that identifies strategies and performance indicators for outcomes against the four program objectives, which would be considered better practice particularly where there are some unique and high risk issues of program administration. The FMC has advised that it aims to balance returns with risk within a high-risk investment environment in order to maximise returns, as none of the program objectives can be achieved unless the IIF funds collectively can demonstrate a return in line with the investment risks. In actioning this approach the Board, through the FMC, has sought to:

- create new professional teams of fund managers prepared to take reasonable risks in their investment strategies to make a return; and
- ensure, to the extent possible, that there is a spread:
 - of investment across a number of fund managers;
 - across the industry sectors into which fund managers aim to invest; and
 - across investment approaches by fund managers.

2.25 The ANAO found that key performance indicators are not identified to measure and report achievements against some of the program objectives. For example, there is little performance information relating to the program objective, 'to develop fund managers with experience in the early stage venture capital industry, to part of the objective to 'encourage the development of small new technology companies commercialising research and development through addressing management constraints' (see paragraph 5.13), and to key information to inform potential investors (see paragraph 6.21).

2.26 In addition, Ministerial Directions do not give priority to one objective over another. While concentrating on particular objectives may achieve the others, there is no strategic analysis and formulation to support either of these views.

2.27 In the ANAO's view, the governance framework for the program would be strengthened by developing a program plan that outlines both the identified strategies to achieve each of the program objectives and the performance measures against their achievements.

Recommendation No.1

2.28 The ANAO recommends that, in order to increase assurance that all Innovation Investment Fund program objectives are being appropriately addressed, the Department of Industry, Tourism and Resources, in consultation with the Industry Research and Development Board, develop a program plan that outlines strategies to achieve program objectives and performance indicators against which to measure and report their achievements against those objectives.

Department and Board Response

2.29 Agreed. While the Department and the Board consider that the financial performance of the IIF funds is the key driver of the program objectives, and hence the key performance indicator, we agree that a more comprehensive approach to measuring performance against objectives would further strengthen performance management.

Conflict of interest management

2.30 The IR&D Board and its committees have program responsibilities to promote R&D activities of Australian industry, often involving grants or tax concessions of considerable value. In appointing the Board and committee members, the Government has selected people with relevant skills and experience. Inevitably, this means that many of these members have links to industry, and so there will be perceived or actual conflicts of interest arising from time to time that need to be managed. In addition, the IIF program, in common with other programs delivered by AusIndustry, often provides employees with access to commercially sensitive and potentially valuable information, which needs to be addressed by appropriate administrative procedures.

The Board

2.31 *The IR&D Board Handbook* provides conflict of interest guidelines and procedures. The handbook is supported by an induction course for Board and committee members. The handbook provides details of:

- the statutory requirements on managing conflicts of interest from the Code of Conduct from the *Australian Public Service Act 1999*, by which all members are bound as statutory office holders;
- requirement under the IR&D Act for Board and committee members to disclose at relevant meetings details of direct or indirect pecuniary interests, and for these to be recorded in the meeting minutes; and
- policies and procedures adopted by the Board on the registration of pecuniary interests, principles for determining materiality in relation to disclosure of interests, and meeting procedures to handle actual or potential conflicts of interest (see Table 2.1).

Table 2.1

Meeting procedures to minimise conflicts of interest

Step 1	Meeting agendas are sent initially to members, but each agenda paper is sent to a member only when the secretariat receives confirmation that the member is unlikely to declare a potential conflict of interest on the item, based on a short description of the item.
Step 2	Each member is required to declare a potential conflict of interest at the meeting against an agenda item if they expect one to arise.
Step 3	The members consider whether the interest is material.
Step 4	Members are excluded from attending for the duration of the agenda item if the interest is considered to be material.

2.32 The ANAO found that members of the FMC and the Board regularly put these policies and procedures into practice. Minutes reflect discussion at meetings of the materiality of a declared ‘interest’, and that members have absented themselves from relevant parts of meetings where there is an interest. Administrative practices of the FMC secretariat ensure that members do not get agenda papers until the appropriate declarations are received. The ANAO found no evidence to suggest there were any inappropriately managed conflicts of interest in either the selection of Round 2 fund managers or the management of licence agreements. For example, a successful IIF applicant company in Round 2 had an executive director who is a member of an IR&D Board committee (not the FMC); the above procedures were applied appropriately in this case.

The Department

2.33 AusIndustry required all employees involved in the selection of Round 2 fund managers to declare any conflict of interest. When such an interest exists, these declarations were required to be more detailed for the recent selection of fund managers for the Pre-Seed Fund program, following advice from a probity auditor. As no interests were declared for the selection of Round 2 fund managers, earlier application of this advice on the Round 2 IIF fund manager selection would have had no practical impact.

2.34 AusIndustry has also recognised the need to strengthen and systematise its conflict of interest procedures for all programs. In November 2001, it released *Conflict of Interest Guidelines* for all its employees (see Table 2.2).

Table 2.2

Purpose of the AusIndustry Conflict of Interest Guidelines for Employees

Outline legal responsibilities of employees with respect to conflicts of interest.
Educate employees about the meaning and occurrence of conflicts of interest.
Outline procedures for declaring a conflict of interest and considerations for assessing the materiality of the interest and any required action.
Require an annual return to declare that employees have not been involved in activities that constitute a conflict of interest.

2.35 Overall, evidence indicates that conflict of interest arrangements for the program are soundly based. Meeting procedures for the Board and its committees, provisions for employees in selecting fund managers, and recently introduced guidelines for AusIndustry employees, represent good practice in managing conflicts of interest.

Risk management and fraud control

2.36 There is an array of risks associated with the IIF program, including:

- the potential for the Commonwealth to invest in funds structured as tax avoidance schemes;
- the potential for collusion between fund managers and private investors and/or investees to defraud the Commonwealth; and
- possible lack of due diligence by fund managers with respect to investee companies, resulting in, for example, poor investment decisions or investments that are ineligible under the licence agreements.

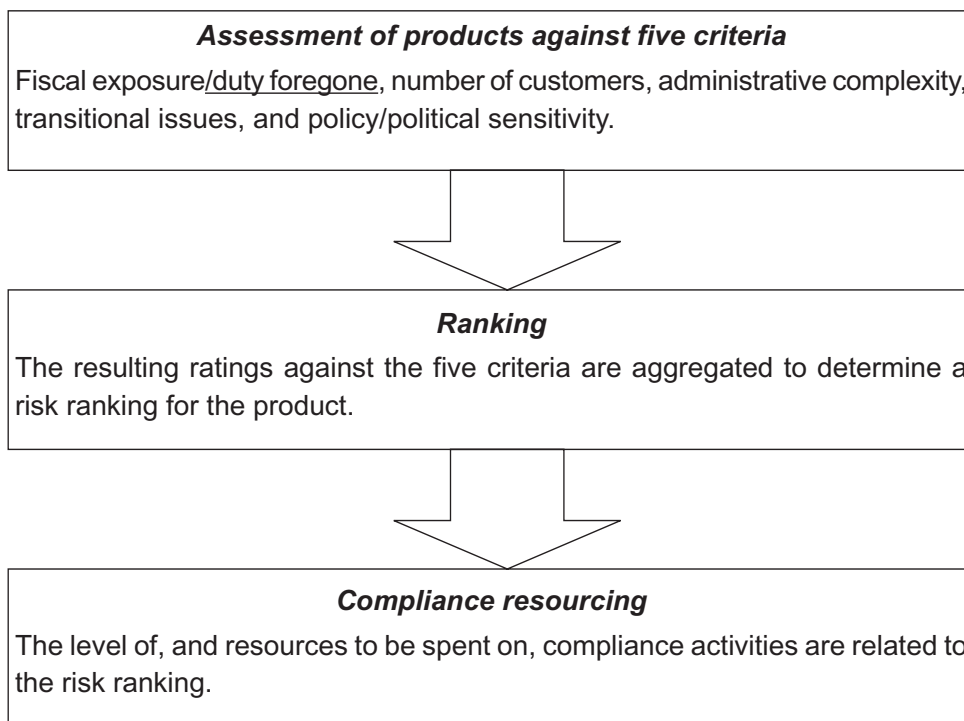
2.37 In 1998, the IR&D Board commissioned a report from a consultant, which assessed risks across each of its programs and a corresponding treatment plan for each identified risk. The report identified four high-risk areas for the IIF program, covering both business and fraud control risks.

2.38 AusIndustry advised the ANAO that following consideration of the report, the FMC agreed to review the consultant's plan with respect to the IIF program. However, since the IIF program had only just become fully operational at that time, the FMC decided to defer this at least 12 months in order to assess the effectiveness of risk management approaches already in place. In practice, a risk management plan was not implemented, although the risk register was updated in mid-2000, adding a further high priority risk (the loss of investment opportunities arising if the Commonwealth cannot draw down funds quickly enough). However, a treatment plan was not developed for this risk.

2.39 The FMC had clearly been aware of the need to address some of the risks associated with the unique aspects of the program. As previously noted, risk treatments put in place included establishing wholly-owned Commonwealth companies to limit liability against the Commonwealth; implementing conflict of interest guidelines for FMC members; and restricting related party transactions through licence agreements. However, the risk assessments undertaken have not been supported by a sufficiently systematic approach to risk management and monitoring. Better practice indicates that a more systematic approach is necessary to provide appropriate assurance on the effectiveness of risk management.

2.40 AusIndustry advised that it recognises that more could have been done to finalise a risk management framework for the IIF. However, further development of such a framework was suspended following a decision in May 2001 to incorporate risk management for the IIF program into AusIndustry's broader risk management framework, represented by the AusIndustry Product Risk and Compliance Management (APRC) Plan. The APRC plan seeks to develop a strategic approach across all AusIndustry products to risk and fraud management and related compliance activities.

2.41 Broadly APRC methodology is as follows:



Source: ANAO based on DITR information.

2.42 However, the APRC has, in practice, been of limited value in guiding risk management of the IIF program. This is because the Plan results in the IIF program receiving the lowest rating category. This would result in a very low level of compliance checking,⁴⁸ inconsistent with current approaches and management perceptions of risk. This low rating has occurred because the APRC model gives the IIF the lowest risk ratings on, for example, number of customers, policy/political sensitivities and administrative complexity (the latter, apparently, because it has Ministerial Directions to guide it). Furthermore, the APRC does not assess the likelihood and consequence of each risk. This is a key step in better practice risk management processes (Standards Australia/New Zealand - SAA/NZS HB 143:1999).

2.43 AusIndustry advised the ANAO that it recognises the limitations of the APRC Plan and previous approaches to risk management with respect to the IIF program. It has advised that it has now commenced the development of a risk management plan for the program which will build on the earlier work and

⁴⁸ If the resource formula of the APRC Plan was applied to the program, only two compliance checks could be expected over the licence period, across all the current IIF licence holders. This outcome does not match the resources and focus of the Board and the Department to date on the management of program risk.

focus better on the unique aspects of the program. In addition, the FMC has advised that it intends to undertake a review of the cost and benefits of enforcing the requirement that the auditor of the fund manager also audit the manager's compliance with the governing documents (see also paragraphs 5.5 and 5.10). Such consideration would be facilitated and strengthened by a more systematic approach to risk management, including identification and classification of risks according to impact and likelihood. It is important that there be ongoing monitoring and review of those risks to ascertain if the risks and treatments need to change.

Recommendation No.2

2.44 The ANAO recommends that, in order to ensure the risks for the Innovation Investment Fund program are adequately managed, AusIndustry, in consultation with the Industry Research and Development Board as appropriate, develop a risk management plan for the IIF program, including assessing program risks, and developing and implementing a comprehensive treatment plan commensurate with the risk assessment, in accordance with recognised better practice.

Department and Board Response

2.45 Agreed. While the Department and the Board consider that the key program risks have already been addressed through the corporate governance structure, funds selection process and financial safeguards, we agree that a more comprehensive approach would strengthen ongoing IIF risk management.

3. Selection of Fund Managers

This chapter examines the selection process for fund managers, focusing on the selection of the four Round 2 fund managers.

Introduction

3.1 There have been two competitive selection rounds for IIF licences. Round 1 resulted in five fund managers being licensed in May 1998, to invest a total of \$130 million of Commonwealth funding in IIF managed funds. The IR&D Board undertook a second selection round for licences, to allocate a further \$90.7 million of Commonwealth investment. As a result of the selection, a further four fund managers were licensed between February and September 2001.

Round 2 tender selection process

Call for applications

3.2 The IR&D Board on 10 December 1999 called for applications from fund managers for Round 2 by 31 March 2000. AusIndustry also undertook 'road shows' and targeted approaches to potential early venture capital fund managers to obtain the widest possible field of applicants.

3.3 Fund managers interested in applying were provided with the program guidelines, that include an outline of the selection criteria; the selection process; the information required from applicants; and the fee payable to be considered for selection. The program guidelines had been updated for Round 2; the main difference from Round 1 being that both the management fees and proportion of private investment in a fund were subject to competition, rather than fixed, and thus formed part of the selection criteria (this is discussed further at paragraph 3.15).

Assessment

3.4 Assessment of applications was conducted in two stages: shortlisting applicants, and identifying the selected fund managers. A due diligence contractor was engaged to assist in the assessment process for both stages.

Shortlisting

3.5 Eighteen applicants submitted written applications, accompanied by a \$5000 non-refundable fee. The FMC considered that these applications were a representative cross-section of the targeted venture capital industry, covering information technology, communications and biotechnology, amongst other sectors.

3.6 AusIndustry conducted an assessment of the written applications and also interviewed applicants. Each applicant was given a numerical score against each selection criterion, and a ranking based on a predefined weighting for each criterion. AusIndustry provided a written report of the assessment to the FMC.

3.7 The process was independently reviewed by a probity auditor. The due diligence contractor also provided advice and assistance to AusIndustry's assessment of applications by:

- reviewing the assessment process;
- reviewing specific questions prepared by AusIndustry for applicants;
- observing interviews of applicants;
- reviewing ratings and rankings of applicants;
- undertaking a sensitivity analysis of weightings, the outcome of which determined that the shortlisting was not particularly sensitive to the weightings; and
- providing a report to the FMC reviewing AusIndustry's recommendations.

3.8 Eight applicants were considered to have sufficient claims against the selection criteria to be invited to participate in stage two of the selection process.

Stage 2

3.9 Applicants invited to participate in stage two were required to provide further information, including details of privately sourced capital, management fees, and proposals to change any of the terms and conditions of the model management licence agreement and trust deed/partnership agreement. They paid a further, non-refundable \$5000 fee.

3.10 Stage two of the assessment process involved the due diligence contractor investigating and assessing the applicants against the selection criteria, and their key personnel and business plans. This was based on review of information submitted by the eight applicants for both stages of assessment, on-site interviews of applicants, and referee checks to minimise the risk of accepting a fraudulent or misleading statement of claims by an applicant. The due diligence contractor then provided a report to the FMC on each shortlisted applicant with a rating and a comparison of their relative merits.

3.11 AusIndustry, utilising legal and accounting advice, also advised the FMC on the consistency of the proposed governing documents of the top-ranked applicants with the requirements of the program guidelines.

3.12 The FMC recommended to the IR&D Board that the top four applicants in the assessment report be licensed to operate as fund managers under the IIF

program. This recommendation was conditional on successful negotiation with the four fund managers to reduce the combined value of their bids from \$110 million of Commonwealth investment to \$90.7 million, the available program appropriation. The IR&D Board accepted this recommendation and successfully negotiated with the four managers to align their bids with the appropriation. The outcome of the selection process was announced on 9 November 2000, following completion of the negotiations.

3.13 The rest of this chapter assess the following aspects of the selection process:

- value for money,
- efficiency and effectiveness,
- accountability and transparency,
- probity,
- consistency with program Guidelines; and
- planning and management of the selection process.

Value for money

3.14 While selection for both IIF rounds has been based on competitive assessment, the first (1998) selection round was based on quality of applicants; that is there was no ‘price’ factor. This was because the Board sought to encourage the best possible applicants and private sector investment in the funds by setting the management fee at three per cent per annum⁴⁹ of the money committed to the fund. Applicants were not assessed on the proportion of private sector funds they could bring to their proposed fund, resulting in most fund managers raising only the minimum required amount from the private sector (one third of the capital, with the Commonwealth providing two thirds).

3.15 For Round 2, the Board considered that the market had developed sufficiently to subject management fees and private sector investment to competition. These factors were therefore included in the selection criteria. This resulted in greater value for money for the Commonwealth’s investment in the IIF, by increasing the proportion of funds from the private sector (44 per cent as opposed to 34 per cent in Round 1), and by reducing management fees (an average of 25 per cent over the 10-year life of the funds compared to an average of 29 per cent previously). This is shown in Table 3.1 below.

⁴⁹ Where the fund managers required disproportionately more fees in the early years of the fund, a discount rate was applied, resulting in the fund managers receiving, on average, a management fee of 2.9 per cent per annum.

Table 3.1**Comparison of Rounds 1 and 2**

	Planned Commonwealth investment (\$m)	Planned private investment (\$m)	Planned total investment (\$m)	Management fee over 10 years (\$m)	Available funds for investees (\$m)
Round 1	\$130.0	\$66.5	\$196.5	\$56.4	\$140.1
Percentage	66.2	33.8	100.0	28.7	71.3
Round 2	\$90.7	\$71.1	\$161.8	\$40.7	\$121.1
Percentage	56.1	43.9	100.0	25.2	74.8

Source: ANAO analysis based on DITR information

Efficiency and effectiveness

3.16 The selection process was streamlined for Round 2 taking account of the lessons from Round 1. In particular, model governing documents⁵⁰ were incorporated into the Round two application kit, and Round 2 applicants who were shortlisting for stage two were required to provide the FMC, as a minimum, letters of intent from private investors, with underwritten arrangements as a preference. The use of a two-stage selection process also meant that fewer applicants were subjected to the second, more costly, stage. Furthermore, having an application fee for both stages helped ensure that only applicants who were fully committed to selection were considered. These changes enabled the top-ranked applicants to be identified within the planned timeframe.

3.17 The ANAO also found that assessment of Round 2 bids was well documented and based on robust analysis against published selection criteria. Applicants were ranked subject to sensitivity analysis to ensure successful applicants were those with strongest claims against the selection criteria and most able to deliver program outcomes. Quality assurance procedures reinforced this process through the use of the due diligence contractor.

Accountability and transparency

3.18 Commonwealth selection processes demonstrate accountability and transparency by, inter alia, ensuring assessment processes are consistent with published processes and selection criteria, documenting assessments made and recording decision-making. The ANAO found that these requirements were met for the Round 2 selection process, for example, by:

⁵⁰ Governing documents include licence agreements, trust deeds and partnership agreements.

- written reports on the assessments of bids and the selection process being provided to the FMC and the Board by AusIndustry, the due diligence contractor and a probity auditor; and
- minutes of meetings documenting relevant decisions and deliberations of the FMC and the IR&D Board.

Probity

3.19 A probity auditor assists in assuring integrity of a selection process by independently reviewing that process, thereby providing an agreed level of assurance to the buyer of the probity service. The probity auditor appointed for the Round 2 selection process found that:

- there were no issues of probity outstanding;
- the bidders were evaluated and ranked fairly against agreed selection criteria; and
- all bidders appeared to have been accorded fair and equitable treatment.

3.20 The use of a due diligence contractor to consider, inter alia, the accuracy of bidders' claims and the consistency of assessments (see paragraph 3.7), and the conflict of interest procedures established by the IR&D Board, FMC and AusIndustry also provided assurance of equitable and ethical practice.

3.21 The ANAO did, however, identify two ways in which the probity assurance arrangements could be strengthened for future selection exercises. First, there is value in a probity audit being guided by a probity plan, to ensure a common understanding between parties on the probity audit process and required outcomes.⁵¹ Such a plan typically identifies what parts of the process will be audited; what audit testing will be undertaken; the basis for providing clearances and sign-offs during the selection; and the nature of the formal sign-off to the decision-maker before the execution of the final contract.

3.22 It should be noted that a probity plan was not required or prepared for Round 2 of the IIF program. AusIndustry has responded to this finding by including the need to follow an agreed probity plan in its contract for probity audit services for selection for the recent Pre-Seed Fund program.⁵²

⁵¹ The ANAO has previously recommended the development of probity plans, for example in IT outsourcing tenders. See ANAO Audit Report No.9 (2000–01): *Implementation of Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative*, Recommendation No. 6.

⁵² The Pre-Seed Fund will help commercialise public sector R&D activities by addressing the gap between promising scientific discoveries and commercialisation. It will do this by developing the management and entrepreneurial skills of public sector researchers and building links with the finance and business community. The fund managers were announced in May 2002.

3.23 Second, the ANAO found the IIF probity auditor’s contract contained a provision for probity advice. A probity adviser provides advice to those conducting the process on how to deal with probity matters, and may also be engaged to identify probity issues as they arise. There is potential for the probity auditing and advising roles to be in conflict when combined where the advising role impacts adversely on the independence of the audit. This is an issue receiving increasing consideration.⁵³ The ANAO suggests that AusIndustry and the Board consider the extent and scope of probity advice they require and, if appropriate, separate these roles in future selection rounds.

Consistency of proposals with program guidelines

3.24 The IR&D Board must ensure the licence agreements and constituent documents of the investment vehicles proposed by the potential fund managers are consistent with the program guidelines. To help fund managers develop governing documents consistent with the program guidelines, the Board provided stage two applicants with a model licence agreement, trust deeds and partnership agreement, drawn up with legal advice. The applicants were then required to submit any proposed changes to the governing documents with their stage two applications. The FMC sought legal and accountancy advice on each of the proposed structures of the four top-ranked applicants. This advice included sign-off by the legal advisers against each of the constituent documents to ensure consistency with the program guidelines.

3.25 The four investment vehicles proposed by the four successful fund managers for Round 2 comprised two partnership arrangements, a unit trust arrangement and a direct investment arrangement. The partnership and unit trust arrangements were similar to the investment vehicles used by the Round 1 fund managers. However, the direct investment arrangement was new, and involved a more complicated structure. Figure 3.1 summarises this structure; it may be compared with the investment vehicles used by other fund managers (Appendix 3).

3.26 An important feature of the program guidelines is the need to ensure that IIF fund structures are not, and cannot be perceived to be, tax avoidance structures. Early in the development of the IIF program the Board addressed this responsibility by obtaining specialist legal and accountancy advice on the

⁵³ The South Australian Auditor-General has recommended that there be clear separation between the roles of the ‘probity adviser’ and ‘probity auditor’ to ensure the probity auditor’s independence from the actual [tender] process. South Australian Auditor-General’s Department (1999): *Electricity Business Disposal Process in South Australia: Arrangements for the Probity Audit and other Matters: Some Audit Observations*, part 3, p. 6.

tax arrangements for all three types of investment vehicle. This indicated that they were subject to clearly identified tax laws, with the implication that none could be perceived to be tax avoidance schemes. However, the direct involvement scheme in Round 2 raised added complications in this respect. Accordingly, the Board sought accountancy advice on the direct investment arrangement. The only issue identified in this advice was that under the proposed arrangement, the Commonwealth owned company would be subject to taxation on all the proceeds of divestments above a benchmark amount, even though it would only keep 17.83 per cent with the balance being distributed to private investors. To ensure the Commonwealth owned company would only be taxed on the amount attributable to the Commonwealth, a bare trust⁵⁴ was proposed and implemented, as described in Figure 3.1.

3.27 As a matter of procedure, AusIndustry also advised the FMC on consistency of the governing documents of all applicants with the program guidelines regarding matters such as the schedule of management fees and distributions.

3.28 The ANAO concludes that the IR&D Board has taken appropriate administrative measures to establish consistency of funds' governing documents with program guidelines.

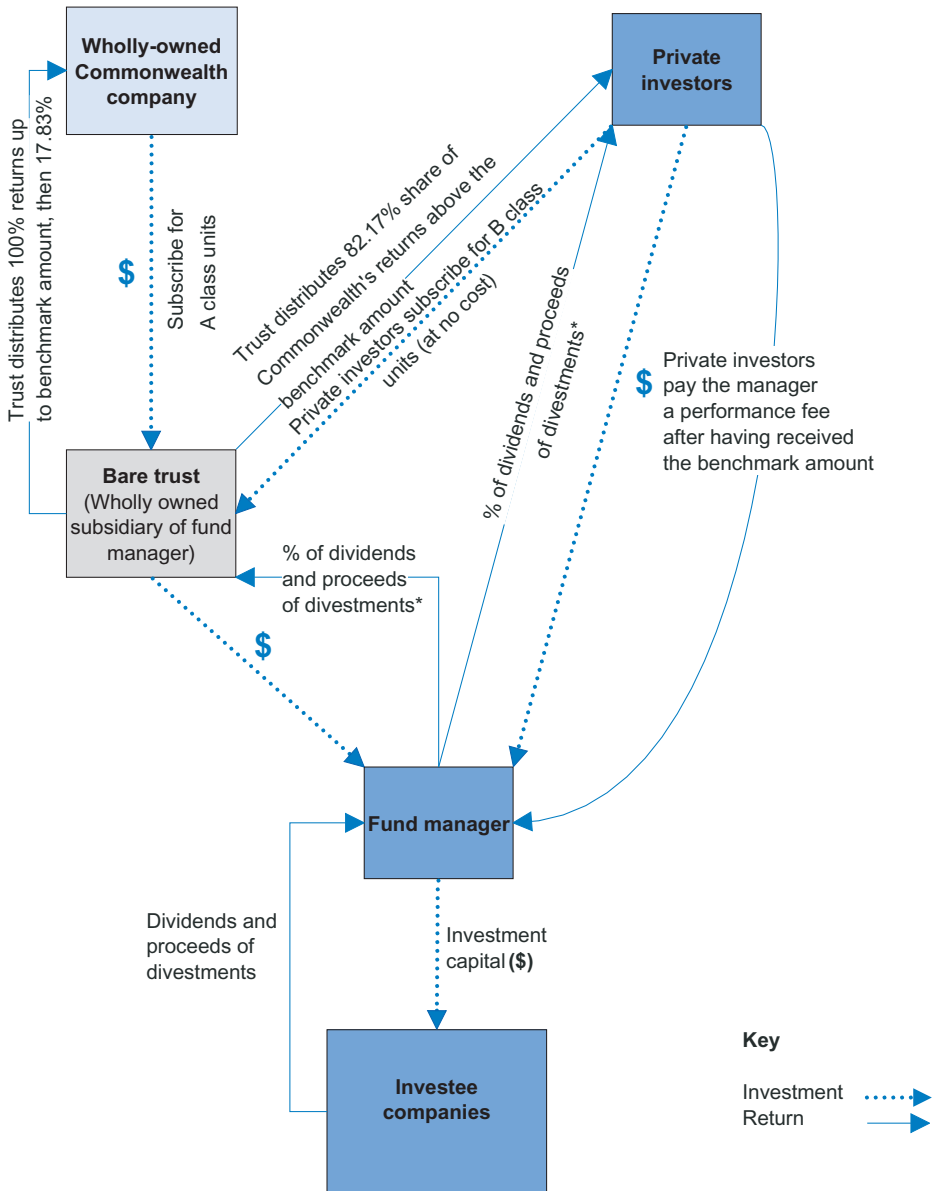
Planning and management of the selection process

3.29 AusIndustry's approach to managing selection in Round 2 was guided by the experience from conducting Round 1. In particular, it undertook analysis of the Round 1 process to address improvements in planning steps; timelines; establishment of the model governing documents; assessment process; due diligence; and applicant shortlisting. A revised assessment process was trialled on a similar venture capital program, the Renewable Energy Equity Fund program.

⁵⁴ Bare trust: also known as a simple trust, a trust in which the trustee's only active duty is the eventual conveyance of the trust property to the beneficiaries. *CCH Macquarie Dictionary of Law* (1996) Revised edition.

Figure 3.1

Round 2 direct investment arrangement: investment and distribution flows



Note: - * The percentage of dividends and proceeds of divestments returned to trust and private investors in line with percentage invested from these sources of total capital.

Source: Department of Industry Tourism and Resources.

3.30 AusIndustry developed a timeframe for Round 2 that identified a number of steps and the dates of achievement. The selection process achieved the planned timeframe to the point of selecting the top-ranked applicants in early September 2000. However, it was subject to delays after this stage. For example, before announcing the successful applicants, the Board had to negotiate with these applicants to align the fund managers' bids with the available funds. This took a further two months to November 2000. Finalising all the contracts from that point took another 10 months (see Table 3.2), due to a number of practical issues arising in negotiation, including dealing with complex taxation issues that needed to be addressed in one proposal (see Figure 3.1).

Table 3.2

Dates of signing Round 2 licence agreements

Fund	Date of signing licence agreements
Startup	5 February 2001
Nanyang	28 March 2001
Foundation	28 June 2001
Newport	19 September 2001

Source: DITR

3.31 Overall, from the call for applications in December 1999 to the signing of the last fund manager in September 2001, the selection process took 21 months, which was considerably longer than the planned maximum of 15 months.

3.32 While the timeframe that was developed for the process assisted the management of the process in the initial stages, the ANAO suggests that a more in-depth project plan would be beneficial in similar selection rounds in the future. This would facilitate management through all stages of the process and reduce the likelihood of insufficient planning attention to some steps.

4. Protecting the Commonwealth's Financial Interests

This chapter examines the arrangements in place to protect the Commonwealth's \$220 million investment in a sector traditionally viewed as high risk.

Introduction

4.1 Nine fund managers have been granted licences under the two rounds of the IIF program. These licences are contracts between the Commonwealth, represented by the IR&D Board, and the fund managers. Under the licence agreement and other constituent documents of each IIF managed fund, a fund manager manages a portfolio of eligible investments in investee companies (essentially small companies commercialising R&D). A fund can operate for up to 10 years⁵⁵. Over that period the fund managers receive management fees drawn from the fund, ranging from around \$6.7 million to a possible maximum of \$14 million.

4.2 The substantial value of the contracts; the lengthy period over which they operate; the reliance on fund managers investing Commonwealth funds in a high-risk/high-return environment; and the differing investment vehicles employed, reinforce the merit of sound arrangements to protect the Commonwealth's financial interests.

4.3 The ANAO therefore examined whether the department and the Board had put in place appropriate safeguards to protect the Commonwealth's financial interests though:

- minimising the risk of contingent liability;⁵⁶
- managing payments to the funds to ensure that investments are made only when required;
- minimising the risk of losses of investment capital; and
- linking fund manager payments to performance.

⁵⁵ Licences are up to 10 years. If all investments are divested before that time, the fund may close in under 10 years.

⁵⁶ A contingent liability is a potential liability that will arise out of a contingency, such as the possible obligation to pay damages at some future date if the judgement in a pending law suit is awarded against the entity. (*The CCH Macquarie Dictionary of Accounting*, 1991).

Minimising contingent liability

4.4 The need to manage and limit Commonwealth liability with regard to the IIF program arises from the potential for litigation from a disgruntled fund manager, private investor, investee, rejected applicant for investment, or from actions by a fund manager acting contrary to the conditions of a licence. These risks are exacerbated by the dual roles of the Commonwealth as both regulator and investor. The main steps taken to minimise the impact of litigation against the Commonwealth are the establishment of wholly-owned Commonwealth companies and inclusion of relevant provisions in the contractual arrangements. These are both discussed below.

Use of companies

4.5 Establishing wholly-owned Commonwealth companies as the investors in IIF managed funds limits the potential for Commonwealth liability. In particular, the companies have very limited assets in their own right, relying on loans from the department—and the loans themselves are company liabilities. The department has received legal and accounting advice that the damages arising from any successful litigation against the Commonwealth as an investor would be limited to the greater of the relevant company's commitments under its subscription or partnership agreements, or its assets.

4.6 Five separate wholly-owned Commonwealth companies have been established, one investing in all five funds established as unit trusts, three individually investing in the three partnership arrangements, and one investing in the direct investment arrangement.

4.7 The reason for three separate companies for the partnerships is that a partnership arrangement exposes all partners to the liabilities of other partners. This arrangement quarantines the Commonwealth assets that could be drawn upon for the liabilities of the other partners, the private investors and the fund manager as managing partner.

Contractual arrangements

4.8 The licence agreements between the Commonwealth and fund managers contain several clauses to effectively limit the liability of the Commonwealth. These include:

- recognition that the Commonwealth has a right under the licence to exercise its rights as both a regulator and an investor, irrespective of an apparent or actual conflict of interest;

- requirements of the fund manager to state specifically to other potential investors that the Commonwealth does not endorse an investment or guarantee the performance of the fund or any specific investment;
- limitations on liabilities of the Commonwealth (other than in its capacity as an investor), including limitations relating to IR&D Board determinations on issues requiring Board approvals under the licences; and
- indemnity of the Commonwealth against losses suffered by fund managers from breaches of the licence agreement.

4.9 Furthermore, other constituent documents for each fund:

- limit the liabilities of the unit holders or partners when the liabilities of the funds outweigh the assets. In the case of the partnership agreement, the directors and office holders of the Commonwealth investors are indemnified against personal liability; and
- provide that no unit holder, or partner other than the managing partner, can interfere with the decisions of the fund manager with respect to the fund, provided the decisions are in line with the constituent documents.

Managing payments

4.10 A key feature of the IIF program is that funds from investors are not called until required. The licence agreement specifies that a fund manager can call on funds from investors only to:

- make an investment in line with the conditions of the licence agreement. The licence agreement specifies that these funds must be invested in eligible companies ‘as soon as reasonably practicable after the due date for the payment of the calls’;
- reimburse specific recoverable expenses; and
- pay the manager’s management fee.

4.11 At the call for funds, AusIndustry checks that the funds are in line with the licence agreement. The checks include that management fees are due and are of the correct amount, and that no more than 10 per cent of a fund’s committed capital⁵⁷ goes to one investment. The funds are then approved and deposited in the relevant Commonwealth company account. A cheque is drawn from the company account and signed by two delegates (usually including one company director). These arrangements are described in more detail at Appendix 4.

⁵⁷ ‘Committed capital’ is the total amount of money that investors agree to invest in a fund.

4.12 Fund managers have reported that, with few exceptions, the Commonwealth has paid on the due date. On the few occasions when the Commonwealth was late in paying, the department advised fund managers in time for them to make alternative arrangements.

4.13 The ANAO concludes that these arrangements, and the procedures in place for drawdowns, minimise the risk of inappropriate payments or of making payments before they are needed.

Minimising losses of investment capital

4.14 With each individual investment there is a relatively high risk of losing all the invested capital (see for example case study 2 below).

Case Study 2—Venture Capital is High Risk Investment.

In early 1999 an IIF sought and received approval to invest US\$300 000 (approximately A\$479 000) as a minority investor in a US entity that had been set up to commercialise innovative Australian technology in the area of digital audio amplification. The overwhelming majority of the IIF funds was deployed to covering the expenses of the Australian operation as all the R&D and the vast majority of the employees were based in Australia.

There was a rapid and serious deterioration in relations between the US based majority investor/manager and the Australian founders/managers, triggered by a false perception on the part of the US managers/investors that the Australian founders had misappropriated company funds. An audit of the Australian entity clearly demonstrated that this was not the case. The relationship between the two groups proved irreconcilable and the US parent ceased to continue funding the subsidiary leaving the Australian directors with no option but to put the subsidiary into Administration and subsequently into liquidation.

The Administrator/Liquidator subsequently sold the Australian IP to the US corporation which is now seeking to commercialise it. The management of the IIF, however, formed the view that the US entity was unlikely to be able to pursue the opportunity given that the key element, that the Australian technologists had left the firm and were not reemployed by the US entity. Upon the advice of the IIF's auditors it was decided to fully provision for the loss of this investment.

4.15 This risk is mitigated by the prospect of a small proportion of investments expected to deliver high returns and by requiring that the primary call on any monies received on exit from an IIF fund investments is the capital committed to the fund by the Commonwealth and private sector investors.⁵⁸ Only after all the capital committed to a fund is repaid are excess profits from individual

⁵⁸ Plus interest at the long-term bond rate.

investments distributed between the Commonwealth, private investors and fund manager. This arrangement minimises the risk that the Commonwealth will lose its capital in each fund, irrespective of whether an individual investment is successful or not.

Linking fund manager payment to performance

4.16 Fund managers receive remuneration with respect to their role from two sources:

- a management fee; and
- a share of any excess profits after the return of investors' capital with interest.

4.17 The *management fee* is paid on an annual or quarterly basis by investors out of the fund's committed capital at an agreed rate (broadly three per cent for Round 1 fund managers, and lower for Round 2 fund managers as the management fee was subject to competition in selection) irrespective of performance. Over the life of the funds, fund managers are expected to draw up to \$97.1 million⁵⁹ (or 27 per cent) of the total Commonwealth and private investment of \$358.3 million in IIF funds. These fees are expected to cover managers' operational expenses, with the exception of a small number of expenses recoverable from the fund.⁶⁰

4.18 Upon divestment of investments, capital with interest is returned to investors. After the full committed capital of the fund, plus interest is repaid, any *excess profits* are shared between the Commonwealth, private sector investors and the fund manager, with the fund manager receiving an *18 per cent*

⁵⁹ This is a maximum amount. Fund managers can negotiate to receive a higher percentage of fees in the early years of a fund, and lower fees in the later years, with the total fees subject to a discount, consistent with the Program Guidelines. One fund manager has specified the total amount of fees that will be received, over the life of the fund, with a smaller amount received if the fund winds up before the 10-year period of the licence agreement. The fee payments are specified in the funds' constituent documents.

The rate paid is an average of 2.9 per cent per annum of total committed capital for Round 1 fund managers, based on 3.0 per cent per annum, but discounted for early payment to some fund managers. This fee, set by the Board, is recognised as being slightly higher than industry standard, but reflects:

- the anticipated greater management role that fund managers need to assume in early stage investments;
- the Board's aim of attracting high quality applications for licences; and
- the inclusion in the fee of a greater proportion of management expenses normally recoverable from investors' funds.

The Round 2 management fees were subject to competition, and averaged 2.5 per cent per annum, closer to the industry norm (see Table 3.1).

⁶⁰ Recoverable expenses include: tax paid by the manager on behalf of the a fund as a result of the fund's investment activities, audit fees, and commission and brokerage resulting from the fund's investment activities.

*share*⁶¹ (Commonwealth and private sector investors receive 10 and 72 per cent respectively). This provides an incentive for fund managers to perform well in terms of returns on investments. There is also a disincentive for very poor performance, since the IR&D Board may terminate a licence (and hence stop management fees) because of poor performance. Reasons for doing this include: the value of investments falling below a specified threshold⁶²; the fund manager failing to invest 60 per cent of the capital committed by investors in the first five years of the fund's operation; and the fund manager failing to carry out fund business in a proper and efficient manner.

Conclusion

4.19 The ANAO concludes that appropriate safeguards have been put in place to protect the Commonwealth's financial interests, having regard to industry practice. The structural, contractual and administrative arrangements in place protect the Commonwealth from contingent liability; losses from poor performing investments; and payments outside contractual conditions. There are also incentives for fund managers to perform well, and a disincentive for very poor performance.

⁶¹ 18 per cent share of profits by the fund manager is in line with industry standards.

⁶² Capital impairment occurs for a fund when the value of the investments in a fund falls below a certain level. When this occurs, the IR&D Board can place the fund and/or the fund manager on a 'watchlist'. As such, the Board can then place additional reporting and examination requirements on the manager and/or fund. A fund is in a state of capital impairment if after three years it is in a situation represented by the following formula :

$$VAI < 0.7 * CC - (D + UCC + MF)$$

where VAI is the sum of the value of investments, CC is committed capital, D is distributions, UCC is uncalled committed capital, and MF is management fees paid.

5. Monitoring of Licence Agreements

This chapter examines the monitoring arrangements to ensure compliance with the licence agreements, and tracking fund managers' performance against program objectives.

Monitoring compliance with agreements

5.1 The key means by which the IR&D Board monitors compliance with licence agreements is through *the reporting by fund managers*. The key compliance reports are:

- certification that an investment complies with the terms of the licence and other constituent documents (for example, trust deeds) within 30 days of first investing in each investee company. Fund managers advised that they based these certifications on the outcomes from the due diligence process undertaken for each new investment; and
- a six-monthly statement describing the fund's compliance with the licence agreement and stating whether the manager believes compliance will continue. If the fund manager states that the fund has not fully complied, they must report their proposals to remedy the circumstance to the Board.

5.2 The ANAO found that both requirements are complied with, although in a few cases the certification was made after the reporting dates specified in the licence agreements. (In the few late cases, the impact on compliance was not significant as the fund managers complied soon after.)

5.3 The Board (through its FMC) can also require fund managers to make presentations on their investment portfolios. To date such presentations have been required of Round 1 fund managers on two occasions and Round 2 fund managers on one occasion. At these presentations, the FMC questioned the fund managers on a number of issues specifically relating to their fund that had been brought to the Committee's attention by AusIndustry following analysis of fund managers' reports. The issues included due diligence on an investment by the fund manager,⁶³ the eligibility of an investment and valuation approaches.

5.4 The licence agreements also provide for the Board (or its nominee) to conduct external checks, but none has been undertaken to date.

5.5 In addition, fund managers are required, through their trust deeds or partnership agreement (whichever is relevant for the particular fund), to ensure the auditor of the fund⁶⁴ reports on whether the conditions in the fund's licence

⁶³ The overseas-based lead investor of an investee company wrote down the company to zero, a few months after the IIF fund had made its investment.

⁶⁴ This must be a registered company auditor.

agreement have been met.⁶⁵ The report must be provided at the end of the financial year to the unit holders/investor partners and to the Board. To date, the reports from the auditor have only been a copy of certification by the fund manager (often the same compliance statement as referred to at paragraph 5.1); that is, the reports have not been supported by a compliance audit.

Accuracy of compliance reporting

5.6 The degree of assurance that these reporting arrangements provide regarding fund managers' compliance is dependent on the accuracy of fund managers' reporting. To assess the reliability of this reporting, the ANAO examined the means by which fund managers ensure compliance with a key licence condition regarding limitations on related party transactions⁶⁶.

5.7 Most fund managers seek to identify shareholders in investee companies through due diligence processes; and expect, or have an explicit requirement for, members of their investment committee and employees who are aware of the deal to declare their interests. The ANAO found little or no documentation to support the assertions by fund managers to the Board that they had complied with these terms of the licence agreements. The exception was one fund manager (out of the seven licensed), which has a transparent and documented process to determine whether any of the interested persons or their associates has an interest in an investee company. This was initiated by the fund manager itself and is outlined in the fund's trust deed, which was approved by the Board.⁶⁷

5.8 The ANAO considers that overall the Board can have limited assurance of the accuracy of the current compliance reporting—essentially because fund managers have limited information on which to support some aspects of their claims of compliance and there has been no compliance auditing in this area. Furthermore, departmental compliance activity has been limited to checks of fund managers' reports when submitted. AusIndustry has expressed the view that there is no real incentive for fund managers to invest in investments in which their associates hold an interest; however, this would seem a weak basis upon which to draw assurance. There is a need for more cost effective assurance of fund managers' compliance with licence agreement conditions, such as greater use of special purpose audits.

⁶⁵ This is not a requirement for the Newport Technology IIF, the last fund established (at 14 September 2001), since similar certifications by fund managers are required elsewhere in the constituent documents.

⁶⁶ Ministerial Directions contain specific instructions to the Board to restrict fund managers investing in companies in which they or their associates have a financial interest. This direction is reflected in the IIF Program Guidelines and licence agreement restrictions on related party transactions involving interested persons and their associates. (See Appendix 5)

⁶⁷ The deed states that 'after information is obtained about the ownership and transactions of a proposed investee company (and annually thereafter), it circulates the information to its executive directors, executive officers and trustee, and requires these to provide written confirmation that they do not have a relationship with the investee company or the holder of another IIF licence.'

5.9 Such audits could be conducted by the Board (or its nominee), as allowed under the terms and conditions of the licence agreements. Alternatively, they could be conducted by an external auditor engaged by the fund manager; some fund managers have expressed the view that external audit of compliance with the licence agreement would be prohibitively expensive and outside the normal commercial activities expected by private investors. However, the ANAO notes that such independent audits are now required for managed investment schemes⁶⁸ (see box below).

Compliance arrangements for managed investment schemes—Corporations Act 2001 (Parts 5C.4-5)

Managed investment schemes are required to have compliance plans that set out the measures the fund manager is to apply to ensure compliance with the Corporations Act and the scheme's constitution. A copy of the compliance plan must be lodged with the Australian Securities and Investments Commission (ASIC). The fund manager must engage an independent auditor to audit compliance against the plan and lodge the audit report with ASIC.

5.10 The FMC has advised the ANAO that it intends to undertake a review of the costs and benefits of enforcing the requirement in the licence that an external auditor audit the fund manager's compliance with the governing documents (see paragraph 5.5). The ANAO considers that it would be sound practice to undertake this review in the context of developing a risk management plan for the program (see Recommendation 2, paragraph 2.44), as this will address treatment plans (such as external audits) for risks associated with the accuracy of compliance reporting.

Monitoring performance of fund managers

Reporting against program objectives

5.11 In addition to the compliance reporting, fund managers are required to provide several other reports to the IR&D Board. The ANAO found that these requirements are met, but that there is scope to clarify some reporting requirements to improve quality of information provided, as summarised in Table 5.1.

⁶⁸ Managed investment schemes, as defined under the Corporations Act 2001, are essentially retail managed funds, that is, open to public subscription. AusIndustry has obtained legal advice that they do not include IIF funds.

Table 5.1
Reporting by fund managers to the IR&D Board

Type	Contractual requirement	Audit finding
Financial reports	Annual audited financial statement required: within three months of the end of the financial year for Round 1 fund managers ⁶⁹ ; and within 60 days of the end of the financial year for Round 2 fund managers. Unaudited financial statement required at the end of the calendar year.	Reports have generally been submitted on time, and in the required format. Late reports have been submitted soon after the required dates.
Valuation of investments	Valuations of investments in the investee companies based on Australian Venture Capital Association Limited methodology: ⁷⁰ —at the at the end of the financial year with the valuations signed off by the funds' external auditors; and—at the end of the calendar year.	Valuations were submitted with the financial statements.
Economic impact statements of investments	Economic impact statements are required as part of end-of-financial-year reporting. Information reported relates to: —export and domestic sales; —import replacement activities; —employment growth (direct and indirect); —revenue growth; and —product development and commercialisation in relation to each investee company.	These statements were submitted with end-of-financial-year financial statements. There are wide discrepancies in the sales figures reported by two different fund managers from a single company in which both invest, as there has been no guidance on how the results should be determined. AusIndustry has advised the ANAO that it will clarify reporting requirements for fund managers to ensure consistency in the future.

Source: Licence agreements between IR&D Board and fund managers; and ANAO analysis of reports from fund managers.

⁶⁹ The Ministerial Directions to the Board for developing the program guidelines for Round 1 specify that these reports must be audited by the Commonwealth Auditor-General or an auditor approved by the Commonwealth Auditor-General. DITR has advised that, as a result of discussions with the selected fund managers, the FMC concluded that the use of the fund manager's existing auditor could provide equivalent levels of assurance in regard to the fund's financial statements. The Ministerial Directions to the Board for Round 2 does not include this requirement.

⁷⁰ The Australian Venture Capital Association Limited has recommended that the valuation of early stage investments is to be at cost, based on the last investment in the company, unless there is a prima facie indicator that value should be written down. In the Round One 1 licence agreements, the fund managers were required to use an independent valuer approved by the IR&D Board to provide the end-of-financial-year reports to the Board. However, in mid-1999, the FMC reconsidered these requirements for valuation, as this approach was considered costly and was not required for investor protection. The IR&D Board changed the requirement to the current approach, in line with the FMC's recommendation.

5.12 The above reporting requirements address, at least to some extent, the program objectives of:

- by addressing *capital* constraints, encourage the development of small new technology companies commercialising R&D; and
- develop a self-sustaining Australian early stage, technology-based venture capital industry.

5.13 However, the information reported does not address the objectives of:

- by addressing *management* constraints, encouraging the development of small new technology companies commercialising R&D; and
- develop fund managers with experience in the early stage venture capital industry.

5.14 The Board does have some information relevant to these objectives. In particular, it undertook a survey of investee companies to obtain information on perceptions of the management support provided by the fund manager. However, this information is now out of date.⁷¹ Furthermore, confidentiality undertakings given to respondents do not allow AusIndustry or the Board to identify individual respondents or their fund managers, limiting its usefulness for performance monitoring.

5.15 The Board also has some information on ‘the development of fund managers with experience in early stage venture capital industry’ as the appointment and replacement of key personnel require approval of the Board. Therefore, the Board has information that could determine the overall number of fund managers experienced in the sector as a direct result of the IIF program.

5.16 The limitations in performance information collected from fund managers reduce the Board’s ability to monitor each fund’s contribution to relevant program objectives. A program plan linking objectives with strategies and related key performance indicators (see paragraph 2.28) would help address this issue. (Key performance indicators for the program are discussed in Chapter 6.)

Analysis of management information on fund managers

5.17 AusIndustry collects a range of information on funds and their investments, both from the above reporting by fund managers and internal sources. These include a database containing information on the payments and the reasons for calls by individual fund managers; and spreadsheets providing statistics on individual fund managers.

⁷¹ This survey has been conducted once (April 2000), involving the 14 investee companies at the time. The number of investee companies has grown to 49 as at 30 June 2001.

5.18 This information is used, inter alia, to monitor, and report to the FMC, individual fund managers performance against:

- the percentage of funds invested (to ensure that 60 per cent of funds are committed by the fifth anniversary of the fund, as specified in the licence agreement);
- the reported value of the investments of an IIF fund (to ensure they have not fallen to a level where the fund is in a state of capital impairment); and
- whether limitations on the amount or percentage (10 per cent) of committed capital a fund can invest in a single investee are being exceeded. (Changes to this limit are subject to consent by the IR&D Board and are usually considered by the FMC in the context of the overall investment portfolio.)

5.19 However, AusIndustry does not have an information database that links these data sources, limiting its ability to identify and analyse issues across fund managers. For example, the substantial discrepancy in sales data from two separate fund managers for the same company (Table 5.1) had not been identified. It also limits the ability to monitor levels of co-investment (this occurs where two or more fund managers invest in a single company). The ANAO identified that one fund manager had 70 per cent of the fund's investments by value in companies that had been invested in by other IIF funds (that is, co-investments) and another fund had 86 per cent of its investments in such companies. Furthermore, one investee had been invested in by four separate IIF funds. The risk to the program's objectives is that such levels of co-investment reduce the spread of investments, potentially limiting the number of new technology companies that are assisted. Ready information on co-investments will enhance the Board's ability to monitor this issue and determine whether further limits are required to co-investment in subsequent selection rounds (see also paragraph 7.5).

5.20 AusIndustry has advised the ANAO it recognises that, with over 50 investments, it now requires a database to effectively manage the program. It further advised that it has been awaiting the development of a general AusIndustry database to enhance its ability to track investee companies; identify whether they are recipients of support from other AusIndustry programs; and produce regular reports. However, development of the database has been slow; and it is not yet clear as to a likely completion date.

6. Measuring and Reporting Program Performance

This chapter examines the program performance approach for the IIF.

Introduction

6.1 Sound program performance management includes:

- identifying key performance indicators to assess inputs, outputs and outcomes;
- articulating performance expectations against which to assess program performance;
- accountability through public reporting on program performance (which also serves to provide the ‘demonstration effect’ necessary to encourage development of an early stage venture capital industry outside the IIF funds); and
- a planned approach to evaluation.

6.2 These four aspects of program performance management are discussed below.

Key performance indicators

6.3 The ANAO Better Practice Guide (2002), *Administration of Grants*, indicates that a performance measurement framework is essential for program managers to assess the effectiveness of a program, and suggests that the characteristics of good performance information, include being:

- relevant—best achieved where performance information is directly related to clearly stated objectives and strategies, balanced in relation to the use of inputs and achievement of outputs and outcomes;
- interpretable—limited to a manageable number of items of key information that focus on economy, efficiency and effectiveness and enable an informed judgment on the achievement of outcomes;
- accurate—valid and reliable, requiring a mix, as necessary, of qualitative and quantitative information; and
- coherent—reported with sufficient explanation and comparisons, including targets, benchmarks and trends over time.

6.4 IIF program performance indicators are articulated in the AusIndustry Business Plan and the Business Partnership Agreement between AusIndustry and the Innovation and Industry Policy Division. These specify a range of *outcome* measures, including:

- new technology companies supported;
- value and revaluation of investment in new technology companies;
- rate of return on investment from IIF investments, individually and collectively;
- national interest benefits from IIF investments; and
- managers trained/experienced through IIF.

6.5 The ANAO found that AusIndustry only measures results for the first two of these indicators. The ANAO also notes that these two measures address the investment performance of funds. Thus they provide indicators of the *capital* support for new technology companies; however, there is no direct measure of the *management* support provided to such companies, which is part of the relevant objective⁷².

6.6 AusIndustry does have some data by which to measure results for the last three indicators;⁷³ regular calculation of results against these indicators would help monitor achievements against program objectives. For example, rate of return to date can be assessed from valuations already supplied by fund managers. However, AusIndustry may also need to supplement existing information, having regard to the current reporting requirements of fund managers. (For example, as indicated at paragraph 5.15, AusIndustry has information on appointment and turnover of fund managers' key personnel, but not on broader training and experience, which would be necessary to more fully address the last indicator *managers trained/experienced through IIF*).

6.7 The specified output measures for the IIF program address:

- quality (for example, customer satisfaction with service by staff and overall service delivery, number of key processes completed within time targets, and level of compliance with agency service charter standards);
- quantity (for example, customers reached, number of applications received by IIF fund managers, applications approved, funds committed by the

⁷² This relates to the program objective 'by addressing *capital* and *management* constraints, encourage the development of small new technology companies commercialising R&D'.

⁷³ These are:

- rate of return on investment from IIF investments, individually and collectively;
- national interest benefits from IIF investments; and
- managers trained/experienced through IIF.

Commonwealth and other investors, sectoral/State profile of investments, payments made, complaints handled, reports to the Board); and

- cost, that is, the administrative cost of customers and funds administered.

6.8 These measures are an improvement compared with the early years of the program, reflecting a broader improvement in AusIndustry's framework for output measures for all its programs, in response to a previous ANAO recommendation.⁷⁴ The output measures are related directly to AusIndustry's business priorities⁷⁵ and provide an adequate means of monitoring achievement. They are not, however, directly related to the program outcomes and objectives, as is good practice.⁷⁶

6.9 There is also scope for AusIndustry to improve the clarity of some measures. For example, 'customers' are considered to be fund managers for the quality and cost measures, but investee companies for the quantity measures. AusIndustry should also consider updating IIF customer satisfaction data, since the measures address data collected in May 2000, when only the five Round 1 fund managers were involved.

6.10 As discussed in paragraph 2.27, development of a program plan that outlines both the strategies to achieve each of the program objectives and the performance measures against their achievements would assist in strengthening the measurement framework for performance management of the program. It would also assist in consideration of the above issues.

Performance benchmarks and targets

6.11 Performance benchmarks and targets enable the success or otherwise of the performance of a program to be readily assessed. The Business Partnership Agreement between AusIndustry and the Innovation and Industry Policy Division foreshadows the development of benchmarks or targets across all *output* measures. AusIndustry intends that performance reporting will then include performance as a percentage of the benchmarks or targets. Most benchmarks/

⁷⁴ Recommendation No.3, ANAO Audit Report No.18 (2000–01): *Reform of Service Delivery of Business Assistance Programs*. Department of Industry, Science and Resources. The ANAO recommended that AusIndustry strengthen Service Level Agreements to include:

- performance measures that focus on a smaller number of measures that are linked to outputs and planned outcomes, assessable, and readily collected; and
- specification of levels of services to be provided; this might be achieved by reducing the number of Service Level Agreements.

⁷⁵ Priorities in the 2001–02 AusIndustry Business Plan are delivering programs and services, developing AusIndustry's organisational capability, and improving service to customers and stakeholders.

⁷⁶ ANAO Better Practice Guide (1996): *Performance Information Principles*, Chapter 5, and ANAO Better Practice Guide (2002): *Performance Information in Portfolio Budget Statements*.

targets are yet to be developed. (The exception is a target that all payments of investment calls are made within 30 days; this is exceeded with the average time for payment being 11 days.)

6.12 Only part of one performance outcome measure (see paragraph 6.4)—*value of investments*—has a related target. This is based on annual forecasts of draw-downs for investments and fund managers' fees and expenses, made for the Budget process and agreed with the Department of Finance and Administration. The forecasts are based on regular contact between AusIndustry and fund managers. Nevertheless there are difficulties in accurately forecasting these amounts⁷⁷, largely because of unavoidable uncertainties in timing of investment, such as the success of investees in reaching benchmarks before further capital is invested.

6.13 The ANAO notes that these forecasts are not included in the regular reporting to senior management on investments. There would be value in including forecasts against outcomes in reports to senior management, with associated explanations, to more fully inform senior managers of this aspect of program performance.

6.14 The ANAO found that no benchmarks or targets have been set against the two other outcome performance indicators that are regularly measured, namely, 'revaluations of investments and the number of new technology companies (or investees) supported'. However, there would appear to be the opportunity to develop benchmarks or targets from some available information, as follows:

- *the revaluations of investments.* Benchmarks and targets for revaluations of investments could be based on the proportion of investment increasing, decreasing and static in value, which could be related to advice received when developing the program⁷⁸. Further benchmarks and targets could be based on internal rates of return. Financial modelling undertaken at the beginning of the program suggested that IIF funds could earn internal rates of return from four to 15 per cent over 10 years. However, results to date are not tracked against this benchmark. (Actual overall internal rates of return are discussed at paragraph 7.15.)

⁷⁷ For example, based on the forecasts made at the beginning of 1998–99, cumulative program expenditure by the end of 2000–01 was 17 per cent below that forecast (\$86.4 million compared with a forecast of \$104.3million).

⁷⁸ Saunders Miller of the United States Small Business Investment Companies scheme, advised that, for early stage companies, a rule of thumb is that 20 per cent of the dollars are totally lost, and 10 per cent to 20 per cent of the dollars are big successes. 'Big successes' can mean making from 10 to 30 times your total invested capital. The balance of your portfolio is often referred to as the 'living dead'. 'You put untold hours of time into keeping them alive and at the end of the day, 10 years later, you have earned a return of eight per cent per annum'.

- the number of investee companies or investments made by fund managers. Financial modelling undertaken in December 1998 for the program assumed a total of 95 investments for the five Round 1 fund managers.⁷⁹ In addition, there is a minimum number of investee companies that an IIF fund could normally expect to invest in, based on the terms of their agreement, namely seven or eight.⁸⁰ There is therefore a reasonable basis for the development of a benchmark and target for number of investments.

6.15 The ANAO concludes that there has been limited progress in developing targets and benchmarks against which to assess performance of outputs and outcomes. As Round 1 fund managers have now been licensed for four years, there should be sufficient historical information to develop such benchmarks. These would provide departmental senior managers and the Board with better information against which to assess program performance.

Public reporting on program performance

6.16 Good reporting on program outputs and outcomes does more than provide for accountability to the Parliament and other stakeholders.⁸¹ For the IIF program it has the added dimension of demonstrating to the broader investor community the potential benefits of investing in early stage venture capital funds. Such information could facilitate the development of an early stage venture capital industry outside the IIF program, in line with program objectives.

6.17 The ANAO found that there is substantial reporting on the IIF program in the annual reports of the department and the IR&D Board, consistent with formal annual reporting requirements. There is further program information on the AusIndustry website. The annual reports include:

- cumulative number of companies invested in;
- cumulative amount of Commonwealth funding invested;
- Commonwealth funding for investments and management fees for each fund;
- percentage and number of fund managers satisfied with quality of service and administrative processes;

⁷⁹ This was based on the four larger IIF funds (that is with committed capital of \$41.25million) making 20 investments and the smaller fund (\$30million) 15 in vestments.

⁸⁰ Funds cannot invest more than 10per cent of committed capital in an investee, unless they seek approval from the Board. Approximately 70 to 80 per cent of committed capital is available for investment after the deduction of management fees and expenses.

⁸¹ NSW Audit Office (2000): *Better Practice Principles for Reporting Performance*, highlights the importance of good performance information for accountability purposes.

- meeting of timelines for payment of draw-downs; and
- case studies on investee companies.

6.18 The AusIndustry website provides details on two successful case studies and a status report on investments by the five Round 1 fund managers at 30 April 2001:

- amount invested and number of companies invested in by technology sector;
- number of investments by technology sector and stage,
- number of investee companies by fund manager;
- state location of investee companies; and
- the exit outcome from Looksmart.

6.19 Notwithstanding the availability of this information, public reporting on the program reflects the limitations in key performance information discussed previously. Development of a greater range of program outcomes, targets and benchmarks will also assist in enhancing reporting.

6.20 The ANAO also notes that economic impact statements collected from fund managers (see Table 5.1) include information such as state location of investee companies; changes to employment; value of exports; and regional level activities in the investee companies. This information will be considered in the interim evaluation; however, the ANAO considers that more regular reporting of some of this information would also provide greater public accountability at a relatively small cost.

6.21 The ANAO also considers that reporting can be enhanced to improve reporting of the 'demonstration effects'. The FMC has advised that the demonstration effect will come from the funds making money. However, there is no information publicly available on the current valuations of investments, nor on an overall internal rate of return for the program, which would help demonstrate the advantages of this type of investment to potential investors. AusIndustry considers that such reporting would be misleading, as the overall performance of a fund cannot be determined until it is wound up. It has also advised that it is waiting for the outcome of the interim evaluation (paragraph 6.24) before publishing further information. As the investments have now been made over four years, there are now opportunities to improve reporting in this area. The ANAO encourages the department to develop and report on relevant indicators based on, for example, invested funds aggregated across all investments, current valuations and realised returns.

Program monitoring and evaluation

Program monitoring by the Department and the Board

6.22 It is usual practice in program administration for the program administrator to use KPIs to monitor the interim outcomes of a program. For the IIF program, however, the responsibility for investment decisions is with the fund managers, using eligibility criteria for investment set within Ministerial Directions for the program. The Board has some limited scope to influence the outcomes of the program through, for example, discretion to vary the limit that a fund can invest in a single investee and to determine the eligibility of an investment if requested by the fund manager. However, overall the ability of the department and the Board to directly impact on the outcomes of the program are limited once the licence agreements are in place.

6.23 The key area where the Board has an impact on the program outcomes is through setting the guidelines for selection of fund managers and the conditions of the licence agreements. The ANAO found that the Board, through its FMC, had considered available performance information from Round 1 and drawn lessons from this in setting the conditions for, and selection of, Round 2 fund managers (see paragraph 3.16).

Program evaluation

6.24 In establishing the IIF program, the Government sought, in addition to an evaluation for 2004–05, an interim evaluation report in 2001–02. The aim of the interim evaluation was to provide a warning on emerging problems and report on a range of issues that would indicate to the Government the success of the program in meeting its objectives, as well as ensuring cost-effective administrative arrangements were in place.

6.25 The FMC was originally responsible for the evaluation, and developed a draft program evaluation strategy. However, this was not pursued further, as responsibility was transferred to the current Innovation and Industry Policy Division following the separation policy development and program delivery in response to the Government's December 1997 statement, *Investing for Growth*.

6.26 The Division commissioned the Australian Venture Capital Association Limited to conduct a survey in mid-1999. The survey had limited responses, raising issues about the representativeness and completeness of the information collected. Subsequently, the Division negotiated with the ABS to undertake two annual surveys of venture capital, in mid-2000 and mid-2001. These surveys collected a range of information from over 100 venture capital fund managers (see Appendix 6).

6.27 The surveys, while providing valuable information, also have some limitations. Firstly, because eligible IIF investments are in the seed, start-up and early expansion stages, whereas the ABS data does not distinguish between early expansion and the broader expansion stages. Secondly, the data does not cover the market in the two years before the survey commenced; an earlier decision to collect baseline data might have addressed this.

6.28 The interim evaluation is currently under way, with a consultant engaged to report to the evaluation steering committee on the efficiency and effectiveness of the program, options for improvement, and the continuing need for the program. The department has advised that the report is currently being finalised. The terms of reference for the evaluation cover:

- the performance of fund managers in attracting and selecting proposals;
- the degree of private sector support;
- prospects of the funds becoming self-sustaining;
- attitudinal change in the investment community towards investing in new technology-based firms;
- revenue growth in firms supported under the IIF program; and
- returns on government investment in the IIF program.

6.29 The ANAO notes that the limitations on available information available will restrict the analysis able to be undertaken in the interim evaluation. Nonetheless, as the ANAO's analysis in the following chapter demonstrates, there are reasonable indicative data and substitute indicators available to track the achievement of the program objectives.

7. Results Achieved

This chapter examines the outcomes against the program objectives achieved to date.

Introduction

7.1 The ANAO examined available data to consider results of the program in the context of the four program objectives. Data sources included departmental program performance information, based on Round 1 fund managers,⁸² the two ABS surveys on venture capital,⁸³ and the Australian Venture Capital Guide 2001.⁸⁴

7.2 The ANAO also commissioned an analysis of the Australian Venture Capital Journal (AVCJ) Survey.⁸⁵ This survey is the only source of information providing a time-series indicating the growth of the early stage venture capital market in Australia since the instigation of the IIF program. The AVCJ Survey data covers the broader venture capital market, and has been filtered to make the data as analogous as possible to the target market for IIF funds (see Appendix 6).

The development of small new technology companies commercialising R&D

Number of companies invested in by IIF funds

7.3 Table 7.1 provides the number of IIF investments and investee companies at 30 June 2002, along with an expected total number of investees for Round 1 fund managers.

⁸² Round 2 fund managers had not had sufficient time to achieve meaningful interim results.

⁸³ Australian Bureau of Statistics, *Venture Capital Surveys*, Australia, 1999–2000 and 2000–01.

⁸⁴ Politecon (Victor Bivell): *Australian Venture Capital Guide 2001*, eighth edition.

⁸⁵ The Australian Venture Capital Journal Quarterly, June 1997–98 to June 2000–01, is based on approximately 150 telephone interviews with Australian, New Zealand and Papua New Guinea based industry fund managers.

Table 7.1:
Investments and investee companies by IIF fund managers

	Round 1 fund managers		Round 2 fund managers ⁸⁶
	To 30 June 2002	Estimated for life of the funds ⁸⁷	To 30 June 2002
Number of funds	5	5	4
Number of investments	54	61	13
Number of unique investees	48	54	13
Number of investees receiving co-investments	5	6	1
Percentage of funds available for investment, already invested⁸⁸	89%	100%	15%

Source: ANAO analysis based on DITR information

7.4 Table 7.1 indicates that each Round 1 fund manager is likely to have about 12 investments on average during the life of the fund. This is high by the standards of the venture capital industry generally (the 2000–01 ABS survey showed that only 21 per cent of fund managers had 10 or more investment deals under management). However, an average of 12 investments is below the assumptions made in the financial modelling for the program in December 1998—that four larger IIF funds would make 20 investments and the smaller fund would make 15 investments.

7.5 The difference between the number of investments and investee companies in Table 7.1 is the result of a number of companies receiving funding from more than one IIF fund manager. This is permissible under the terms of the licence agreements (but subject to the constraints on individual funds that, for example, no more than 10 per cent of total committed capital is invested in a single company without Board approval). Five companies have received such ‘co-investments’. One of these has received funding from four IIF fund managers (including one Round 2 fund manager), receiving 4.5 per cent⁸⁹ of total Commonwealth funds available for investment. The extent of such co-investment limits the overall number of companies that can be assisted. It is therefore unlikely

⁸⁶ Round 2 fund managers have not been licensed for long enough to provide reliable estimates for the life of the funds.

⁸⁷ Estimate based on remaining 29 per cent of funds being invested in a similar pattern to the 71 per cent already invested.

⁸⁸ Based on \$124.8 million invested to 30 June 20/6/02, out of from a total of \$140.1 million available for investment (Round 1); \$17.6 million invested from a total of \$121.1 million (Round 2)

⁸⁹ The company has had a total investment of \$7.16 million of Commonwealth funding from the four IIF fund managers, out of from a total of \$160.53 million available for investment (\$220.7 million funding less management fees).

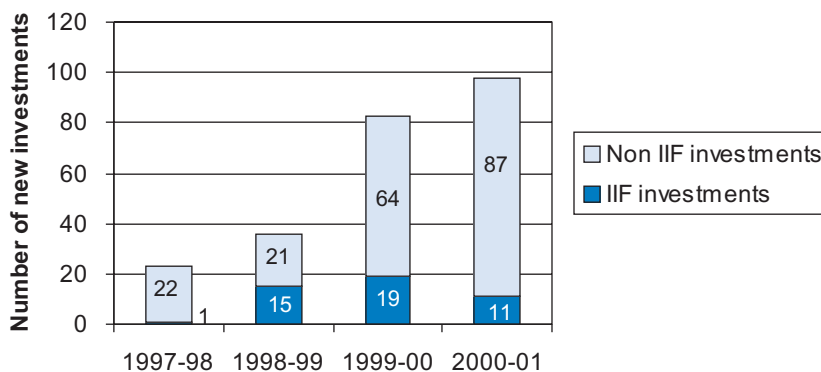
that the Round 1 fund managers will invest in the number of companies foreshadowed in the Prime Minister’s statement originally announcing the program (more than 100 companies). In addition, while the program guidelines ensure the diversity of investments across an individual fund, high levels of co-investments limit diversity of investments across the program, as a whole. This matter warrants consideration in any future rounds or for similar innovation programs.

Growth in the early stage venture capital market

7.6 There has been substantial growth in the number of companies assisted by the early stage venture capital market. Figure 7.1 shows that the number of new investments in the sector has grown by approximately 326 per cent, and the number of new investments outside the IIF by 295 per cent. AusIndustry has advised that the number of new IIF investments will increase in later years as Round 2 fund managers begin to invest.

Figure 7.1

Number of New Investments in Early Stage Venture Capital Market: 1997–98 to 2000–01



Source: AVCJ survey and departmental data

Growth in value of IIF investments

7.7 Investment in Round 1 funds commenced in 1998, with the bulk of investment undertaken in 1999–2000. As noted in Chapter 1, venture capital investments are high-risk and typically for between three and seven years, and so the total realisations from investment in Round 1 funds will not be available for a number of years. As noted previously, there has been one very successful exit to date, Looksmart, providing an early return on investment. Table 7.2 summarises the performance of funds to 30 June 2001, the most recent audited investment valuations.

Table 7.2**Performance of Round 1 IIF funds to 30 June 2001**

	Commonwealth	Total
a) Amount drawn down ⁹⁰	\$80.6m	\$120.8m
b) Management Fee	\$14.3m	\$21.5m
c) Amount invested [a)—b)]	\$65.9m	\$99.3m
Return of capital and interest ⁹¹	\$31.6m	\$47.4m
d) Distributed profit ⁹²	\$19.8m	\$197.7m
e) Percentage return on invested capital [d)/c)*100]	30.0%	199.1%
Amount invested at 30 June 2001 [c) less Looksmart investment]	\$64.4m	\$97.1m
Valuation of portfolio at 30 June 2001	\$78.1m ⁹³	\$117.9m
Annualised internal rate of return (excl Looksmart)	-	11% ⁹⁴

Source: ANAO analysis based on DITR information

7.8 As shown in the above table, for its total payments of \$80.6 million into Round 1 funds managers to 30 June 2001, the Commonwealth has received a before tax return of \$51.4 million from Looksmart, 64 per cent of its investment. The Commonwealth would also have benefited from tax revenue from the fund manager and private investors flowing from the Looksmart divestment.

7.9 More recent unaudited valuations, reported by fund managers to the Board as at 31 December 2001, indicate that investments by Round 1 fund managers of \$111.6 million (excluding Looksmart) have decreased by \$0.1m, showing an annualised internal rate of return of -0.1 per cent.

7.10 Table 7.3 analyses whether individual investments have increased or decreased.

⁹⁰ These figures do not include a total of \$2.2m of funds called by fund managers for investment and not invested as at 30 June 2001.

⁹¹ From exit of Looksmart.

⁹² The 'profit' arises from the Looksmart investment, but is the return after the repayment of all capital committed to the fund, not just that invested in Looksmart.

⁹³ Based on Commonwealth's percentage share of each investment.

⁹⁴ 'Internal rates of return' are calculated as per cent increase in valuation, annualised on an estimated weighted average length of investment of 1.9 years.

Table 7.3**Direction of change in value of IIF investments as at 30 June 2001**

	Value decreased ↓	Value unchanged	Value increased ↑
Number of IIF investments	9	25	11 ⁹⁵
Percentage of total number of IIF investments	20.0	55.6	24.4

Source: ANAO analysis based on DITR information.

7.11 At 30 June 2001, the pattern of 20 per cent of investments losing value and 24 per cent gaining value, is broadly in line with expectations for this sector (see footnote to paragraph 6.14). Most of the nine investments decreasing in value were in the internet sector, with losses largely attributable to the dot.com share decline which commenced in early 2000. Case Study 3 provides such an example.

Case Study 3—Write-down of an Internet Retailer

In late 1999, an IIF fund invested \$2.89 million in an Internet retailer which initially specialised in toys and sporting goods and has since extended its range of products to include books, jewellery, electrical goods, and homewares. The investment was bought by an Australian listed company in late 2000 with consideration being in the form of shares, which were to be issued over a one year period. Subsequently, the buyer appointed an administrator in April 2001 prior to the investors receiving any shares. The fund manager wrote down its investment in the Internet retailer to zero as the fund management considered the status of buyer to be unclear. The Internet retailer has been acquired by a third party from the administrator.

7.12 Case Study 4 below provides an example of an investment that has increased in value.

Case Study 4—Good Growth for Communications Industry Investment

In 1999 an IIF fund invested \$2.03 million in a first-to-market application service provider at the forefront of time sensitive wireless data transfer technology, to enable the company to expand and capitalise on its product. The company leverages off the convergence of mobile telephone and IT systems so that field based staff can send their electronic paperwork to the office via handheld or laptop computers using mobile telephones. The IIF funding has provided multiple benefits for the company, enabling it to develop sales strategies and client contacts, receive an R&D Start grant for refinement of its technologies for export, attract other Australian investors and subsequently capture a sector of the domestic market and the emerging European mobile data market. As at 30 June 2001, the IIF investment had increased over three fold in value from

⁹⁵ This includes Looksmart, even though it has exited as an IIF investment.

\$2.03 to \$6.88 million (most recent valuation).

The company, with a staff of just over 40 is securing contracts across Europe expected to be worth tens of millions of dollars in revenue.

7.13 Overall, the above data suggest that program results to date have been consistent with the IIF program objective to encourage the development of small new technology companies commercialising R&D.

Developing a self-sustaining Australian early stage venture capital industry

7.14 An important element of developing a self-sustaining Australian early stage venture capital industry is to be able to demonstrate the possibility of good returns *vis a vis* other investments. In considering this, the ANAO examined internal rates of return and absolute and relative growth in the amount invested in early stage companies.

Internal rates of return

7.15 The internal rates of return⁹⁶ for the IIF program to 30 June 2001 and from the ABS Venture Capital Survey 1999–2000⁹⁷ are shown in Table 7.4.

Table 7.4

Annual Internal rates of return—IIF Round 1 fund managers and early venture capital market

IIF funds (Round 1) to 30 June 2001	Internal rate of return (excl. Looksmart) ⁹⁸	11%
	Internal rate of return (incl. Looksmart)	140%
ABS Survey Results (1999–2000)	Weighted averaged internal rate of return—seed stage investments	55%
	Weighted averaged internal rate of return—early stage ⁹⁹ investments	135%
Source: ABS, and ANAO analysis based on DITR information.		

7.16 To date, the IIF investments (including Looksmart) have an internal rate of return broadly consistent with industry standards. AusIndustry has advised that the valuations of investments before exit are difficult to assess, and can be

⁹⁶ 'Internal rates of return' are calculated as the per cent increase in valuations (including return where applicable), annualised weighted by value of amount invested.

⁹⁷ Commensurate figures were not available from the 2000–01 survey.

⁹⁸ Based on an estimated weighted average length of investment of 1.9 years.

⁹⁹ For definitions of the 'seed' and 'early stage' investments as used by the ABS see Appendix 6.

subject to dramatic changes brought about by events outside the control of fund managers. These have included the downturn in the value of some of the internet investments (see paragraph 7.11) during the downturn in the United States dot.com stocks in 2000, and the impact on the United States economy generally following 11 September 2001.

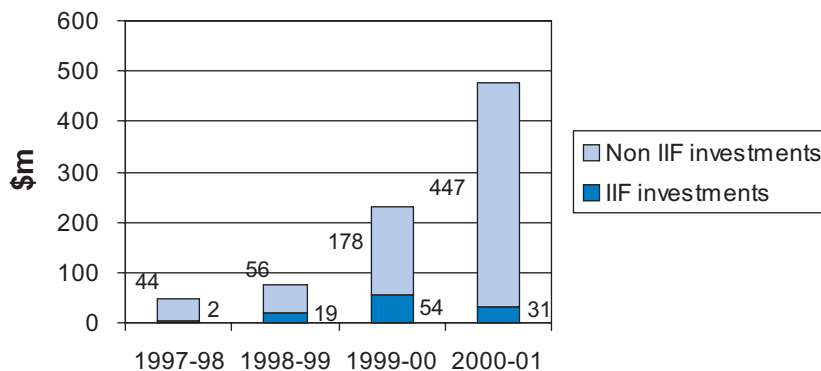
Growth in the amount invested in early stage companies

7.17 There has been very substantial growth in the amounts being invested annually in the early venture capital sector up to 30 June 2001. Figure 7.2 illustrates the growth, indicating the contribution of IIF investments. (In the context of the decline in IIF investments in 2000–2001, AusIndustry has advised that it expects investment to increase in subsequent years with the availability of funds from Round 2 fund managers.)

Figure 7.2

Total investment in the early stage venture capital sector: 1997–98 to 2000–01 (\$m)

Source: AVCJ survey and departmental data



7.18 It is notable that, while IIF funding made up a significant proportion of the sector in 1998–99 and 1999–2000 (about one-quarter), the continued growth in 2000–01 indicates that the market has grown outside the IIF funding. These data do not indicate the extent to which the IIF program has contributed to the growth of non-IIF investments; *The Australian Venture Capital Guide 2001* suggests that government programs such as the IIF have been one of the drivers of the growth of the venture capital market.¹⁰⁰ Stakeholders interviewed by the ANAO generally considered that the IIF program had made a positive contribution to confidence in the market, particularly given the leverage provided to private

¹⁰⁰ Other drivers identified in *The Australian Venture Capital Guide 2001* are growing awareness among institutional investors of venture capital as an asset class; increasing numbers of private investment companies in the sector; growing interest in technology investment; and the desire of industries and regions to increase economic activity.

investors (see paragraph 1.12).

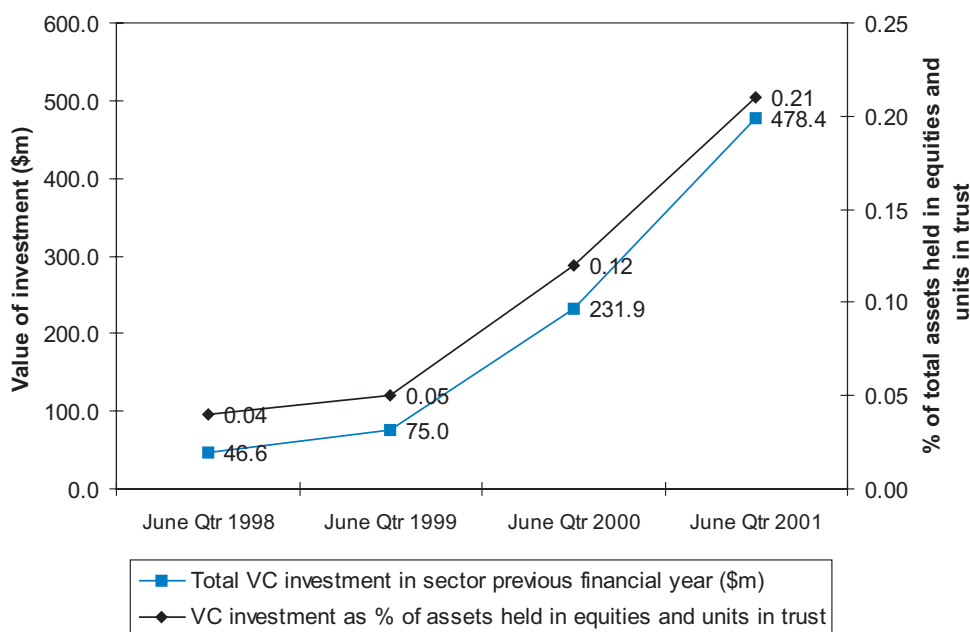
Proportion of overall investment in equities and unit trusts into early stage venture capital

7.19 There has also been marked growth over the four years to June 2001 in the proportion of managed funds held in equities or units in trust that have been invested in the early stage venture capital market. Figure 7.3 compares the value of managed fund investments in equities and unit trusts (from the ABS data¹⁰¹) with investments in the early stage venture capital market (from AVCJ survey data).

Figure 7.3

Investment in the early stage venture capital sector (\$m); and percentage of total investment in equities and units in trust: 1997–98 to 2000–01

Source: ABS and AVCJ survey data



7.20 Figure 7.3 is consistent with Figure 7.2, showing considerable growth in interest by the market in investing in early stage venture capital during the period in which Round 1 fund managers were active.

Developing fund managers with experience in the

¹⁰¹ Australian Bureau of Statistics: *Managed Funds—June Quarter 2001 (5655.0)*.

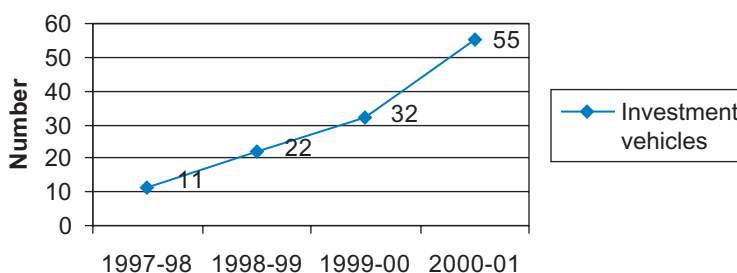
early stage venture capital industry

7.21 There is no data available on the numbers of professional fund managers with experience in the early stage venture capital industry. However, the growth in the number of investments in recent years described above suggests that a related increase in fund managers with experience in this sector is likely. Furthermore, the number of investment vehicles or funds which have a majority (by value) of their investments in early stage venture capital has also risen—see Figure 7.4—also pointing to a consequential increase in the number of investment fund managers with experience in the sector.

Figure 7.4

Number of investment vehicles with majority of investment in the early stage venture capital sector

Source: AVCJ survey data



7.22 An increase in the number of investments is likely to increase the number of fund managers, as each early stage venture capital investments require considerable input from fund managers, as shown by the ABS Venture Capital Survey.

Table 7.5

Days per month spent by a fund manager with an investee, by stage

	Seed stage investee	Early stage investee	Weighted average ¹⁰²
1999–00 survey	3.1	5.4	5.1
Source: ABS Venture Capital Survey			

7.23 On average, some three to five professionals work for IIF funds. AusIndustry has advised that turnover of these IIF fund managers who remain in the industry contributes to the spread and depth of experience in the early stage venture capital sector, but quantification of this contribution is not possible from existing data and information sources.

Establishing in the medium term a ‘revolving’ or self-

¹⁰² Based on 1999–2000 ABS figures of 51 current investments at seed stage, and 170 investments at early stage.

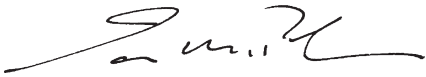
funding program

7.24 In March 2000, the then Minister for Industry, Science and Resources announced the establishment of a revolving fund using the return of capital and interest from IIF investments. To date, this has amounted to \$31.6 million¹⁰³ from the Looksmart investment. The ANAO found that the resources agreement for the revolving fund is yet to be finalised with the Minister for Finance and Administration. The department has advised that it would be unlikely to favour a tendering round for the funds in the self revolving fund until they are at a level that would enable three fund managers to be licensed (involving some \$60 million). This, however, is a matter for Government decision.

Conclusion

7.25 Available time-series data collected across the period indicates that there has been substantial growth in the sector of the market in which IIF funds invested over the four years to the end of 2001. In addition, the results of the IIF funds to date are generally consistent with market performance as indicated by the time-series data. As a result, the ANAO concludes that the results to date are consistent with the requirements of the program objectives. The current interim evaluation should provide to Government more detailed consideration of these issues.

Canberra ACT
21 October 2002



Ian McPhee
Acting Auditor-General

¹⁰³ \$27.5million of the return of capital and \$4.1million in interest. The Commonwealth also received \$19.8 million as its share of the profit; that is a total return from Looksmart of \$51.4 million.(see Case Study 1 after paragraph 1.13).

Appendices

Appendix 1

Audit Criteria

The audit criteria is drawn from ANAO Better Practice Guides, such as Administration of Grants (2002), Applying Principles and Practice of Corporate Governance in Budget Funded Agencies (1997) and Contract Management (2001), as well as requirements under the FMA Act. The audit criteria are whether:

- there are robust corporate governance arrangements to support effective program administration, in particular:
 - clearly defined and understood roles, responsibilities and accountabilities, including those relating to the requirements of the FMA Act;
 - a clearly defined strategic approach to achieve and monitor performance against policy objectives;
 - effective arrangements that minimise the risk of conflicts of interest;
 - sound risk management, including fraud control, consistent with recognised better practice; and
 - effective communication arrangements;
- the selection process to award licences is fair and consistent with government requirements and recognised better practice. In particular, whether the assessment process:
 - is consistent with the requirements under the FMA Act;
 - is supported by an effective project management approach; and
 - effectively uses consultants to ensure quality outcomes;
- the management of licence agreements is effective, and provides appropriate assurance on compliance and performance, in particular:
 - the Commonwealth's financial interests are protected by:
 - o minimising the risk of contingent liability;
 - o managing cash flows of payments to funds;
 - o having contract conditions that minimise the Commonwealth's liabilities; and
 - o linking payments to fund manager performance; and
 - monitoring arrangements ensure compliance with licence agreements and track performance of fund managers; and

- program performance management is sound and the interim outcomes achieved, in particular:
 - key performance indicators are identified and monitored to measure inputs, outputs and outcomes against program objectives and related strategies;
 - meaningful performance expectations are identified to assess program performance and to report achievements against targets over time;
 - there is a planned approach to evaluation to ensure that benchmark data is collected at an early stage of the program and at relevant points to ensure the information for evaluation is available when required;
 - there is complete and informative reporting on the program's progress for accountability and demonstration; and
 - the results to date are consistent with the program objectives.

Appendix 2

Key Commonwealth IIF Program Stakeholders—Roles, Responsibilities and Accountabilities

INDUSTRY RESEARCH AND DEVELOPMENT BOARD (IR&D Board)

1. The IR&D Board is a statutory board established under the *Industry Research and Development Act 1986* (IR&D Act) to administer specific Commonwealth government programs. These include the R&D Tax Concession Program, the R&D Start Program, the Commercialising Emerging Technologies (COMET) Program, the Pre-Seed Fund and the Biotechnology Innovation Fund (BIF), as well as the Innovation Investment Fund (IIF). The Act under which the Board was established aims to promote the development of Australian industry and improve the commercial success of R&D outcomes. The IR&D Board, whose 12 members are appointed by the Governor-General, is directly accountable to the portfolio minister. The current Executive General Manager of AusIndustry is an *ex-officio* member of the Board.

2. To give effect to the Government's decision that the Board be responsible for delivering and monitoring the IIF program, the Minister issued directions to the Board, under the provisions of the IR&D Act. To date, there have been four key sets of Ministerial Directions to the IR&D Board on the IIF program:

- i) Direction 1 of 1996: R&D Start Program (additional function of the IR&D Board);¹⁰⁴
- ii) Direction 1 of 1996: R&D Start Program (additional function of the IR&D Board)(Amendment 1 of 1997);
- iii) Direction 1 of 1997: Policies and Practices of the IR&D Board in relation to the IIF program; and
- iv) Direction 1 of 1999: Policies and Practices of the IR&D Board in relation to the IIF program Round Two.

3. These directions require the IR&D Board to administer the IIF program. The administration of the program, as specified in these directions, includes:

¹⁰⁴ The IIF is an off shoot of the R&D Start Program. One of the foci of the R&D Start Program was the commercialisation of R&D outcomes. The Government considered that the best way to achieve this was to establish venture capital funds administered by experienced fund managers, selected by a committee of the IR&D Board. The funds were to have \$2 of government money to every \$1 of private sector money raised by the fund managers themselves. The alternative considered by Government considered were loans as an alternative, but it was recognised by Government that such an alternative would be less likely to provide a return on public funds.

- awarding licences and overseeing IIF licensed funds under program guidelines drawn up by the Board that take into account restrictions on the type of investments to be made with program funds, and the obligations of fund managers;
- authorising payments for investments in eligible companies. This function has been subsequently allocated to the wholly-owned Commonwealth companies through a loan arrangement between the IR&D Board and the specific-purpose, wholly-owned Commonwealth companies (see paragraph 14 for more details); and
- monitoring and evaluating fund managers' performance in investing and providing finance to early stage companies based on new technology. The function of program evaluation was subsequently allocated to the Innovation and Industry Policy Division of the department (see paragraph 11 for more details).

4. The current key roles and responsibilities of the IR&D Board with respect to the IIF program, as identified by the ANAO on advice from the department, are to:

- develop (and re-develop, as necessary) program guidelines in line with Ministerial Directions, which, in turn, form the key document for the call for applications for IIF licences;
- call for applications for IIF licences;
- evaluate the applications on a competitive, comparative basis;
- offer licences to fund managers subject to successful negotiation of licence agreements and constituent documents for the funds in line with the call for applications;
- sign licence agreements on behalf of the Commonwealth, and agree to constituent documents for the funds;
- receive half-yearly and annual reports from licence holders, and copies of all documentation sent to investors by the fund manager, trustee or related trustee;
- monitor compliance of licence holders with the licence agreement;
- develop and implement risk management and fraud control strategies for the IIF program; and
- seek information from the licence holders for overall program monitoring and evaluation, on behalf of the Innovation and Industry Policy Division of the department.

5. The IR&D Board reports annually to the Minister on its activities, including the IIF program. The requirement for the Board to report is specified in the Board's governing legislation, the IR&D Act. This legislation specifies the items that the Board is to report on for each activity specified.

FUND MANAGEMENT COMMITTEE (FMC)

6. The Fund Management Committee (FMC) is a committee of the IR&D Board constituted under section 22 of the IR&D Act, and acting under delegated authority from the Board. Its seven members are appointed by the Minister for Industry, Tourism and Resources. The FMC is responsible for assisting the IR&D Board administer the IIF program. In effect, the FMC is charged with the regulatory functions relating to the program, such as:

- ensuring that program is operating within the intent of the Ministerial Directions and program guidelines;
- monitoring fund managers and their investment practices against their obligations under the governing documents and against objectives of the program, for example, by considering regular reports from the managers; and
- under delegated authority from the IR&D Board, making decisions on discretionary issues in the guidelines, such as limitations on investment.

7. The FMC provides regular reports on the program to the Board, and seeks from it final decisions based on its recommendations. There is an overlap of three members on the Board and the FMC, including the Executive General Manager of AusIndustry.

AUSINDUSTRY

8. AusIndustry is a business unit within the Department of Industry, Tourism and Resources. It was implemented to help Australian businesses become more innovative and internationally competitive, by providing them with a range of commercial incentives and information services.

9. The IR&D Act provides for the Board and its committees to be assisted by Australian Public Service officers. In the case of the IIF program, the FMC is assisted by officers of the Venture Capital Program Section of AusIndustry. The section acts as a secretariat for the FMC, and undertakes work on its behalf. This includes consulting with industry, drawing up program guidelines, advertising for tenders, evaluating tenders, negotiating tender contracts, monitoring contracts, and providing support for FMC meetings. In effect, for much of the section's work, it is directed by, and reports to, the FMC, rather than directly within the department.

10. AusIndustry also undertakes financial management tasks associated with the program. In particular, it:

- draws up purchase orders, consistent with the terms and conditions of the licence agreements signed by the IR&D Board;
- checks that requests from fund managers for the drawdown of funds are consistent with the terms and conditions of the licences; and
- if consistent, pays the request for drawdowns in the form of a loan to the relevant Commonwealth company, in line with the loan agreements between the IR&D Board and the Commonwealth companies. (The Commonwealth companies, in turn, invest in the funds consistent with the request from fund managers.)

INNOVATION AND INDUSTRY POLICY DIVISION

11. The policy function¹⁰⁵ of the IIF program was originally allocated to AusIndustry. As a result of the Government's response to the Mortimer Report, *Investing for Growth* (December 1997), the Government announced the separation of program delivery from policy development. For the IIF program, the IR&D Board was provided with assistance for program delivery by the Venture Capital Program Section in AusIndustry, while the policy development and program evaluation moved to the Innovation and Science Division (now the Innovation and Industry Policy Division). The separate roles and responsibilities of AusIndustry and the Division with respect to the IIF program are articulated initially through a Service Level Agreement, implemented on 31 August 1999, and more recently through Business Partnership Agreements.

WHOLLY-OWNED COMMONWEALTH COMPANIES

12. The nine IIF funds into which the Commonwealth invests are based on the following types of investment vehicles:

- *Unit trusts* (five funds): In unit trusts, equity is provided in the form of subscribed units for the investors. Unit trusts are normally not a separate entity for tax purposes. Normally, losses that the trust incurs are trapped within the trust and are available for deduction against future income of the trust. Capital gains on exits, passed onto unit holders, are regarded as income for unit holders for tax purposes. The exception to this arrangement is when one of the unit holders with a holding of 20 per cent or more of the units is a tax-exempt body, such as the Commonwealth of Australia. In such a case, the unit trust is known as a 'public trading trust'. A public

¹⁰⁵ That is, policy development, on-going policy advice to Government, and program evaluation.

trading trust is taxed as a company rather than as tax exempt, with the unit holders meeting their tax liabilities. Contingent liability is limited to any unpaid or uncalled capital on issued units;

- *Partnerships* (three funds): A partnership is an association of persons carrying on a business in common as partners. For tax purposes, any capital gains, losses and income flow through directly to the partners. In a partnership, each partner is jointly and severally liable for the other partners; and
- *Direct investment* (one fund): In a direct investment, the fund manager enters into agreement directly with each investor to invest in the fund. The tax arrangements are the same as for partnerships.

13. The Minister, acting on advice from the department, which had sought legal and accounting advice, agreed to the establishment of Commonwealth-owned companies as a conduit for the Commonwealth's investment into IIF funds, and obtained agreement from the Treasurer for this action. The companies were required because:

- as the Commonwealth investment in unit trusts is greater than 20 per cent of total funds, direct investment from the department would result in the trusts being classified as public trading trusts for tax purposes. To facilitate the tax requirements of the private investors, investment by the Commonwealth through the wholly-owned Commonwealth companies allows the standard unit trust tax arrangements to remain; and
- the establishment of separate Commonwealth companies as the investment conduits, for the unit trusts collectively, each of partnerships, and the direct investment, limits the exposure of the Commonwealth to claims of liability against the partnership or the Commonwealth to the assets of individual companies, rather than those of all the Commonwealth investments.

14. The funding of the companies for investment in IIF funds is through limited recourse loans, with the IR&D Board acting on behalf of the Commonwealth. Under this loan agreement, the companies have access to a loan facility from which they can draw funds. The loan agreement acknowledges that the company's capacity to repay the loan depends entirely on the company receiving a return from the fund, and the amount of that return. The loan agreement also limits the ability of the Commonwealth to recover any loan amounts from a company in excess of returns.

15. The operating revenue of the companies was initially provided as a small annual grant¹⁰⁶ to the companies from the Commonwealth (in the order of \$10 000). The loans from the Commonwealth are accounted for as company liabilities, and their investments in the fund investment vehicles as assets.

16. The companies' shareholders are the Minister for Industry, Tourism and Resources and the Secretary of the Department of Industry, Tourism and Resources. These shareholders hold shares, not in their own right, but as nominees of the Commonwealth. The value of each of the shares is \$1, with the shareholders having no residual responsibility for the companies' debts.

17. The directors of the companies are the members of the FMC, with the company secretary functions contracted out to an employee of a firm of chartered accountants.

18. The generic responsibilities for all the wholly-owned Commonwealth companies have been outlined in their constitution or their articles of association. These documents set out the legal framework within which the companies operate. The two companies established to meet the requirement of Round 1 funds have objects outlined. In particular, the Memorandum of Association of IIF Investments Pty Ltd and the Constitution of IIF (CM) Investments Pty Ltd identify the objects for which the companies were established to be:

- (a) invest in licensed funds as defined in the R&D Start Program policies and practices of the IR&D Board in relation to the Innovation Investment Fund Program Direction No.1 of 1997; and
- (b) undertake any other related business or activity that may be undertaken by a natural person.

19. Objects are now not required under the Corporations Act. There are a number of means by which the directors of all the companies know about the operating parameters for the companies:

- primarily through their positions as members of the FMC; and
- for each of the companies, from a paper from an official within AusIndustry to each of the company directors, recommending that the directors approve delegations for the various functions of the company. This paper provides the directors with some indication of the roles and responsibilities expected from the company.

20. The company directors also have an indication of their roles and responsibilities from legislative requirements under the Corporations Act and *Commonwealth Authorities and Companies Act (1997)* (CAC Act), for example:

¹⁰⁶ After IIF Investments Pty Ltd received substantial income from the exit of Looksmart from the AMWIN Unit Trust, this grant was no longer required for this company.

- directors' duties to their company, for example, the statutory duty of care and diligence in the exercise of their powers and discharge of their duties, and to exercise powers for their proper purpose; and
 - the requirement for financial reporting and to issue annual reports.
21. The practical effect of the companies understanding their purpose, role, responsibilities and accountabilities are reflected in the following examples:¹⁰⁷
- the investment agreements entered into by the companies that are consistent with the type and structure of the investment vehicles and the terms and conditions of the licence agreements;
 - the loan agreements entered into by the companies with the IR&D Board, acting on behalf of the Commonwealth. These agreements appropriately limit the use to which the money can be put, consistent with Ministerial Directions and the program guidelines. (Initially, the IR&D Board was allocated responsibility as Commonwealth investor. With the creation of the companies, in a practical sense they reallocated this responsibility to the companies through the loan agreements);
 - receipt of requests from the trustee or fund manager for money to be paid into the funds for investments, management fees or management expenses in line with the licence agreement; request of funds from AusIndustry on a loan basis; and authorisation of payment to the funds;
 - consideration of a breach of trust deeds brought to the attention of the IR&D Board by the relevant fund manager in a half-yearly compliance report; and
 - preparation, and tabling of, annual reports and other reporting obligations under the Corporations and CAC Acts.

¹⁰⁷ The effectiveness of the management of the Commonwealth-owned companies in undertaking their roles in respect of IIF was not in the scope of the audit. Rather the ANAO examined the overall impact of their roles, responsibilities and accountabilities on the effectiveness of the program management.

Appendix 3

Partnership and Unit Trust Arrangements

Figure A3.1

Diagram of typical partnership arrangement

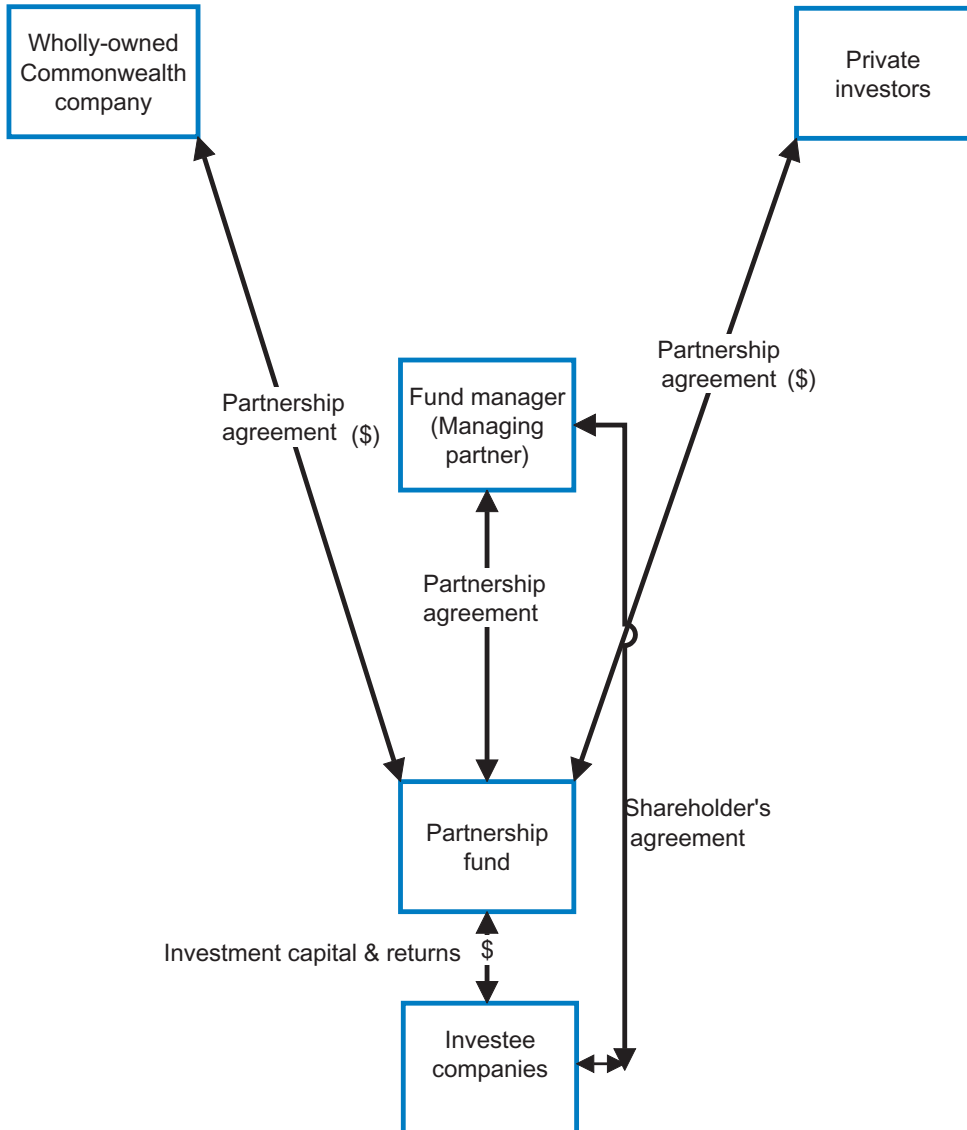
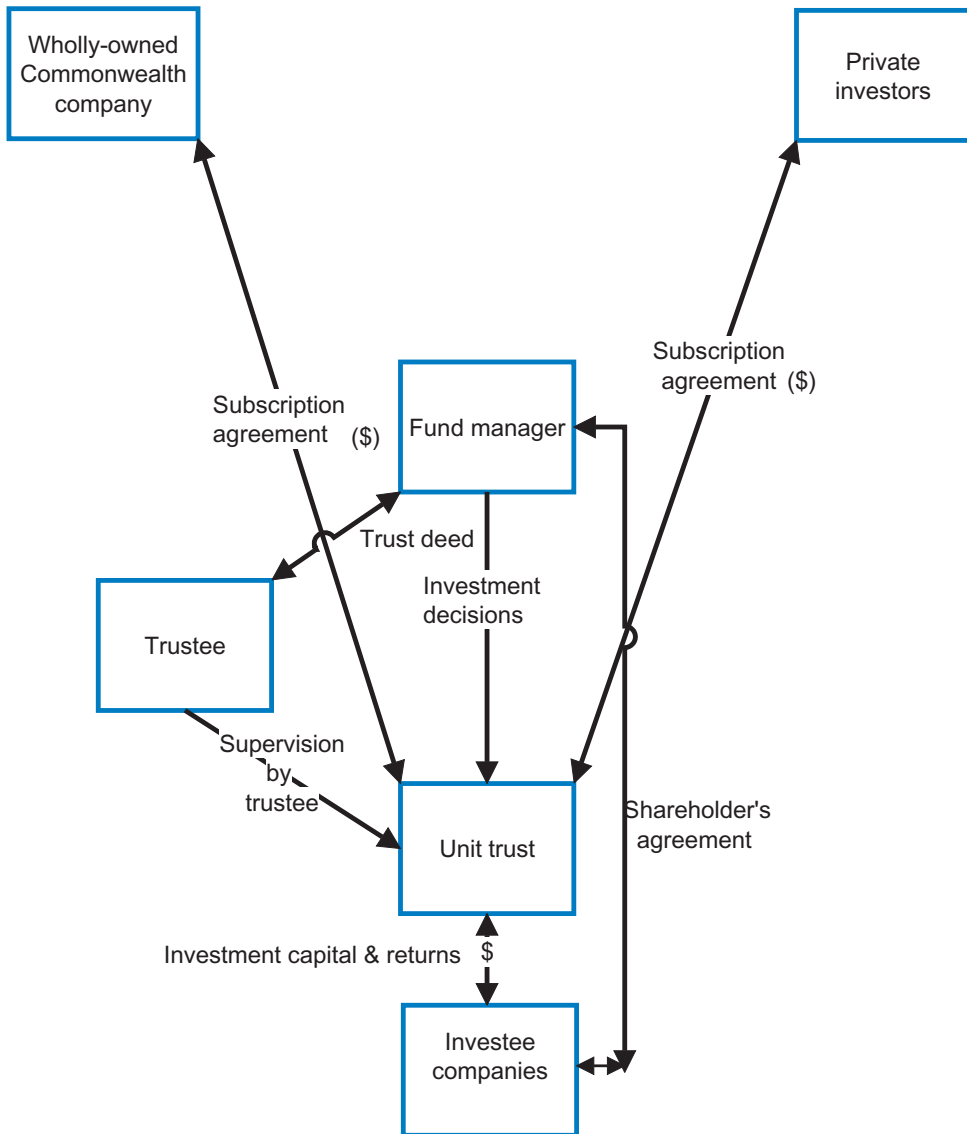


Figure A3.2
Diagram of typical unit trust arrangement

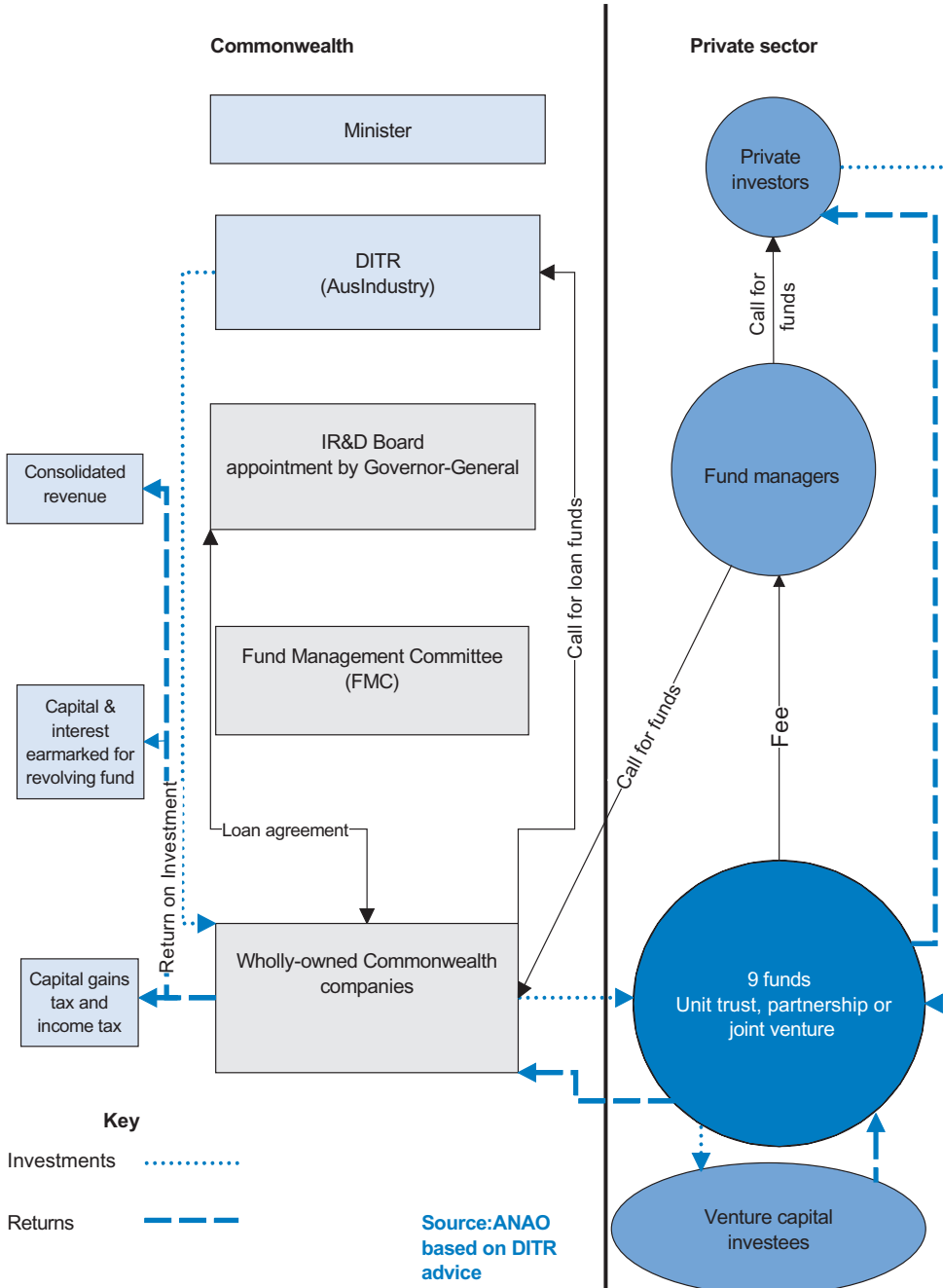


Appendix 4

Investments and Returns - Processes

Figure A4.1

Flows for investments and returns for IIF monies.



'Call for funds' (the investment process)

1. A fund manager identifies an investee company and determines the amount required to be invested in the company.
2. The fund manager, in accordance with the ratios contained in the governing documents, makes a call to all investors in their fund requesting the appropriate amount by a due date.
3. All 'calls for funds' are sent to the principal place of business for all the Commonwealth companies, which is the Venture Capital Programs (VCP) section of AusIndustry.
4. Customer service managers within the VCP section of AusIndustry check the call against the requirements of the governing documents of individual funds.
5. If satisfactory, the manager of the VCP section writes to the Business Services Group of the Department of Industry, Tourism and Resources requesting they draw down the call amount into the relevant Commonwealth company.
6. At the same time, the manager of the VCP section also writes to a director of the Commonwealth company advising that an eligible call has been received and requesting their signed agreement to the payment of the call.
7. Within a few days of the payment of the call, AusIndustry confirms that the required amount has been paid into the Commonwealth company and that a director of the relevant Commonwealth company has approved payment of the call.
8. Once confirmed, a cheque is drafted and, in accordance with the Commonwealth company's delegations, a director and one other individual (including another director) sign the cheque to pay the call. The Commonwealth companies have delegated the relevant section and branch heads to sign cheques. However, it is the company directors' preference that whenever possible at least one director signs a cheque involving a call.
9. Once the cheque is signed it is dispatched to the nominated individual. AusIndustry also advises the manager that this has occurred.

Appendix 5

Conditions in Licence Agreements regarding Interested Persons and Associates

1. In the licence agreement, interested persons and their associates are defined as follows:

Interested Person ¹⁰⁸	(a) the Manager (b) an Associate of the Manager (c) the Trustee (d) an Associate of the Trustee (e) a Related Trustee
Associate	(a) Director (b) Secretary (c) Other officer (d) Employee (e) Agent, or (f) Close or secondary relatives of the above, of the Manager or Trustee or a related company as defined under s50 of the Corporations Law; or (g) A person who has, or proposes to have, influence or control over the conduct of the affairs of the fund (these would include the investors in the fund).
Close Relative	(a) A spouse or de facto, either current or former in the last 2 years, (b) Father, mother, guardian, brother, sister, son or daughter (c) Father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law, or daughter-in-law
Secondary Relative	(a) Grandparent, grandchild or other ancestor or lineal descendant, not a close relative (b) Uncle, aunt, nephew, niece or cousin (c) Spouse or de facto of any of the above.

2. The licence agreements make the following limitations on transactions involving Interested Persons or associates. The fund manager cannot:

- (a) lend money to, or invest in or with, an Interested Person;
- (b) lend money to, or invest in, another IIF Management Licence holder, an associate of another IIF Management Licence holder or another Licensed Fund
- (c) invest IIF funds in a company which then discharges a debt owed to an Interested Person without Board approval;

¹⁰⁸ This is a shortened, simplified version of what is in the licence agreement.

- (d) invest IIF funds in a company to enable the company to buy property from an Interested Person;
- (e) invest IIF funds in a company that owes money to an Interested Person (other than an investor) without Board approval or unless the Interested Person is providing arm's length services to the board of the company;
- (f) invest more than a total of 20 per cent of the value of the IIF fund in companies that have as other investors a common Interested Person (other than an investor in the IIF fund);
- (g) invest IIF funds in a company that has as another investor an associate of an IIF investor (other than the Commonwealth companies), unless the level of the investment committed by the associate is less than 10 per cent of the value of the fund;
- (h) invest IIF funds in a company that is controlled by an investor in the IIF fund (other than the Commonwealth companies) without Board approval;
- (i) borrow from an investee company or an associate of an investee company, and must ensure that the manager's associates do not borrow from such entities. This condition also applies to the Trustee where one exists;
- (j) receive remuneration or compensation from (proposed) investee companies or their associates, unless it relates to the provision of management services;
- (k) dispose of an IIF funds investment to an Interested Person without Board approval; and
- (l) along with Associates of the Manager (but not the Commonwealth companies), own more than 50 per cent of equity in another IIF fund without Board approval. This condition also applies to the private investors and their associates.

Appendix 6

Surveys on Venture Capital

ABS Survey on Financial Information Venture Capital (1999–2000 and 2000–01)

1. The ABS, in its survey on venture capital in the years ending 30 June 2000 and 2001, collected the following information from 100 (107 in 2001) venture capital fund managers, managing 127 (150 in 2001) investment vehicles:

- type of legal entity (listed company, unlisted company, trust, other);
- registration of the fund with programs: Pooled Development Fund (PDF), IIF, Building on IT Strengths (BITS) Incubator Program, Renewable Energy Equity Fund (REEF);
- membership of the Australian Venture Capital Association Limited;
- valuation approach;
- source and amount of capital committed and drawn down;
- assets and liabilities of the fund;
- inflows and outlays between the fund and investors in the previous financial year;
- inflows and outlays between the fund and investee companies in the previous financial year;
- other transactions for the fund such as management and performance fees;
- information on each investee company, including:
 - location (overseas and Australia by postcode);
 - status of deal;
 - stage at initial investment and currently (seed, early, expansion, late, turnaround, leveraged buyouts/management buyouts/management buyins);
 - Australian and New Zealand industry and activity category code for investee;
 - age of business;
 - valuation of, and investment in, investee company;

- internal rate of return;
- days per month spent with investee company; and
- type of expertise provided (for example, financial, marketing, administrative, strategic/management).

2. Definitions of venture capital stages:

Seed: product is in development, usually in business less than 18 months;

Early: product in pilot production, usually in business less than 30 months;

Expansion: product in market, significant revenue growth;

Turnaround: funding to enable an established but faltering business to be rejuvenated or rescued;

Late: funding for a new product or product improvement, continue revenue growth; and

Other: includes leveraged buyout—a buyout that is funded with both equity and debt; management buyout—funding to enable a current management team to buy out a business; and management buyin—funding to enable a new management team to buy into a business.

3. The ABS surveys do not break down results to exclude categories ineligible for investment by IIF funds. These are businesses engaged in:

- re-lending or re-investing;
- passive businesses;
- real estate businesses;
- mining operations; or
- the acquisition of land used or intended to be used for agricultural, horticultural or forestry purposes.

Quarterly Australian Venture Capital Journal Survey

4. The quarterly Australian Venture Capital Journal Survey surveys 135 firms that invest in venture capital opportunities. 120 of these firms are based in Australia, 14 in New Zealand and 1 in Papua New Guinea (PNG). Most of the NZ-based firms prefer to invest in Australian ventures, along with ones in New Zealand. The PNG-based firm prefers to invest in the Pacific Islands.

5. The definitions of the stage of venture capital used in the survey that are consistent with the stages of development in firms eligible for IIF investment are:

Seed capital: this is defined as funding to develop, test and ready a product for production or a service for commencement;

Start-up capital: funding to commence commercial business operations; and

Early expansion capital or development capital: funding for an established and growing business.¹⁰⁹

6. In the analysis undertaken on behalf of the ANAO, only those investments involving seed, start-up and early expansion/development capital were included. In addition, to most closely reflect the eligible investees for IIF funding, investments in agribusiness, services—business/financial, and resources/mining were excluded from analysis.

7. In determining the number of funds investing in the early stage venture capital industry, the ANAO identified those funds with the majority of their investments by value in the seed, start-up and early expansion/development stages, excluding those in agribusiness, services—business/financial and resources/mining. A number of these funds had investments in a year that were proportionately very small compared to the overall amount invested in the sector. For example, of the 75 funds with the majority of their investment in the included sector, the value of 20 of the funds had a total investment in the sector of one per cent by value of the total invested by all these funds. Therefore, for each year, the funds that together contributed only one per cent of the total invested in the sector were excluded to ensure that the growth in the number of funds was not distorted by very small funds.

¹⁰⁹ Pollitecon (Victor Bivell): *Australian Venture Capital Guiden 2001*, eighth edition, p.12.

Series Titles

Audit Report No.1 Performance Audit
Information Technology at the Department of Health and Ageing
Department of Health and Ageing

Audit Report No.2 Performance Audit
Grants Management
Aboriginal and Torres Strait Islander Commission

Audit Report No.3 Performance Audit
Facilities Management at HMAS Cerberus
Department of Defence

Audit Report No.4 Audit Activity Report
Audit Activity Report: January to June 2002
Summary of Outcomes

Audit Report No.5 Performance Audit
The Strategic Partnership Agreement between the Department of Health and Ageing and the Health Insurance Commission
Department of Health and Ageing and the Health Insurance Commission

Audit Report No.6 Performance Audit
Fraud Control Arrangements in the Department of Veterans' Affairs

Audit Report No.7 Performance Audit
Client Service in the Child Support Agency Follow-up Audit
Department of Family and Community Services

Audit Report No.8 Business Support Process Audit
The Senate Order for Department and Agency Contracts (September 2002)

Audit Report No.9 Performance Audit
Centrelink's Balanced Scorecard

Audit Report No.10 Performance Audit
Management of International Financial Commitments
Department of the Treasury

Audit Report No.11 Performance Audit
Medicare Customer Service Delivery
Health Insurance Commission

Better Practice Guides

Administration of Grants	May 2002
Performance Information in Portfolio Budget Statements	May 2002
Life-Cycle Costing	Dec 2001
Some Better Practice Principles for Developing Policy Advice	Nov 2001
Rehabilitation: Managing Return to Work	Jun 2001
Internet Delivery Decisions	Apr 2001
Planning for the Workforce of the Future	Mar 2001
Contract Management	Feb 2001
AMODEL Illustrative Financial Statements 2001	May 2001
Business Continuity Management	Jan 2000
Building a Better Financial Management Framework	Nov 1999
Building Better Financial Management Support	Nov 1999
Managing APS Staff Reductions (in Audit Report No.49 1998–99)	Jun 1999
Commonwealth Agency Energy Management	Jun 1999
Corporate Governance in Commonwealth Authorities and Companies—Principles and Better Practices	Jun 1999
Managing Parliamentary Workflow	Jun 1999
Cash Management	Mar 1999
Management of Occupational Stress in Commonwealth Agencies	Dec 1998
Security and Control for SAP R/3	Oct 1998
Selecting Suppliers: Managing the Risk	Oct 1998
New Directions in Internal Audit	Jul 1998
Controlling Performance and Outcomes	Dec 1997
Management of Accounts Receivable	Dec 1997
Protective Security Principles (in Audit Report No.21 1997–98)	Dec 1997
Public Sector Travel	Dec 1997

Audit Committees	Jul 1997
Core Public Sector Corporate Governance (includes Applying Principles and Practice of Corporate Governance in Budget Funded Agencies)	Jun 1997
Management of Corporate Sponsorship	Apr 1997
Telephone Call Centres	Dec 1996
Telephone Call Centres Handbook	Dec 1996
Paying Accounts	Nov 1996
Asset Management	Jun 1996
Asset Management Handbook	Jun 1996
Managing APS Staff Reductions	Jun 1996