The Auditor-General
Audit Report No.11 2004–05
Performance Audit

Commonwealth Entities' Foreign Exchange Risk Management

Department of Finance and Administration

Australian National Audit Office

ISSN 1036–7632

ISBN 0 642 80806 6

Canberra ACT
14 October 2004

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit across agencies in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *Commonwealth Entities' Foreign Exchange Risk Management.*

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—http://www.anao.gov.au.

Yours sincerely

Oliver Winder
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.

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Abbreviations

ABC	Australian Broadcasting Corporation
AJF	Australia-Japan Foundation
ANAO	Australian National Audit Office
ANSTO	Australian Nuclear Science and Technology Organisation
AOFM	Australian Office of Financial Management
ATC	Australian Tourist Commission
AUD	Australian dollar
AusAID	Australian Agency for International Development
Austrade	Australian Trade Commission
BER	Budget Exchange Rate
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CFO	Chief Financial Officer
Communications Minister	Minister for Communications, Information Technology and the Arts
CSIRO	Commonwealth Scientific and Industrial Research Organisation
Defence	Department of Defence
DFAT	Department of Foreign Affairs and Trade
DFRP	Defence Foreign Exchange Risk Management Plan
DoCITA	Department of Communications, Information Technology and the Arts
DPM&C	Department of the Prime Minister and Cabinet
EFIC	Export Finance and Insurance Corporation
Finance	Department of Finance and Administration
Finance Minister	Minister for Finance and Administration
FMA Act	*Financial Management and Accountability Act 1997*
FMA Regulations	*Financial Management and Accountability Regulations 1997*
FMIS	Financial Management Information System
GGS	General Government Sector

IBA	Indigenous Business Australia
NGA	National Gallery of Australia
OPO	Overseas Property Office (part of DFAT)
Reserve Bank	Reserve Bank of Australia
Treasury	Department of the Treasury
USD	United States dollar

Glossary

CAC Act entities	Entities subject to the *Commonwealth Authorities and Companies Act 1997* (CAC Act).
Departmental items and administered items	Departmental items are revenues, expenses, assets and liabilities over which an agency has control. Administered items are those that an agency oversights or manages on behalf of the Government but does not control.
External hedge	A transaction with a party external to the general government sector that gives the effect of altering or transferring the foreign exchange risk faced by the general government sector. External hedges include structures embedded in contracts or agreements that reduce or alter the exposure to exchange rate fluctuations; and financial instruments such as forward exchange contracts, swaps and options.
FMA Act agencies	Entities subject to the *Financial Management and Accountability Act 1997* (FMA Act).
Foreign exchange exposure	An entity's exposure to loss (or profit) due to movement in the exchange rate between the AUD and a foreign currency.
Foreign exchange gain/loss	Actual gain or loss on settling a foreign exchange transaction.
Foreign exchange risk	The extent to which the future cash flows of an entity are susceptible to variations in exchange rates.
Finance's Guidelines	*Guidelines for the Management of Foreign Exchange Risk*, issued by Department of Finance and Administration, November 2002.
Budget adjustment arrangements	Under the Government's self-insurance policy, an entity may receive adjustments to its annual departmental appropriations from the Commonwealth Budget to ensure that the entity neither loses nor gains from fluctuations in foreign exchange rates.
Revised Policy	Revised Government Foreign Exchange Risk Management Policy announced by the Finance Minister on 28 May 2002.

Self insurance	The general government policy of self-insurance means that the Commonwealth accepts gains and losses as they occur, on the basis that the Commonwealth is a large organisation with a spread of assets and can expect gains and losses to even out over time.
Settlement rate	The exchange rate applicable to payment when settling a foreign exchange transaction.
2000 audit report	ANAO Audit Report No.45 1999–2000, *Commonwealth Foreign Exchange Risk Management Practices*, May 2000.

Summary and Recommendations

Summary

1. A new Commonwealth Government foreign exchange risk management framework came into effect from 1 July 2002. With one exception,[1] the Revised Government Foreign Exchange Risk Management Policy (the Revised Policy) applies to *Financial Management and Accountability Act 1997* (FMA Act) agencies and *Commonwealth Authorities and Companies Act 1997* (CAC Act) entities in the General Government Sector (GGS). The key features of the Revised Policy are:

- a general prohibition on external hedging;
- each individual entity remains responsible for managing its foreign exchange risk; and
- some entities receive budget supplementation for foreign exchange losses and are required to return foreign exchange gains.

2. Commonwealth financial management is currently undertaken in a principles-based regulatory environment. In addition, entity Chief Executives and other officials have broad responsibilities under the *Public Service Act 1999*, the FMA Act and the CAC Act.

3. The Revised Policy is given effect by:

- a Government Decision announced by the Finance Minister on 28 May 2002;
- a Finance Circular issued on 26 June 2002 which describes the major features of the Revised Policy; and
- *Guidelines for the Management of Foreign Exchange Risk* issued by the Department of Finance and Administration (Finance) in November 2002, with the agreement of the Finance Minister. The Guidelines set out principles for foreign exchange risk management and the key features of the Government decision. They also incorporate principles-based guidance in relation to exposure management and controls and include prescriptive risk identification, measurement and reporting requirements.

4. Consistent with the Commonwealth's financial framework legislation, each entity captured by the Revised Policy is responsible for the management of its foreign exchange risks. Specifically, entities are expected to:

[1] The Australian Office of Financial Management is excluded from the arrangements of the Revised Policy.

- implement foreign exchange risk management practices that are consistent with the Guidelines;
- provide, in a timely manner, foreign exchange information and reports requested by Finance; and
- certify to Finance that proper risk management practices, consistent with the Policy, are in place.

5. Finance's role relates to oversighting the implementation of the Revised Policy. At the whole of government level, this includes monitoring, analysis and reporting of foreign exchange exposures, gains and losses. Finance's role does not extend to auditing entities' compliance with the Revised Policy or detailed analysis of their risk management practices, although it is expected to review entity practices and advise Government accordingly.

Audit approach

6. An ANAO audit report tabled in May 2000 examined the foreign exchange risk management practices of four agencies with large foreign exchange payment exposures.[2] Among other things, the audit report recommended that Finance, in consultation with relevant agencies and, as appropriate, the Government, develop an overarching Commonwealth position statement on foreign exchange risk management for agencies subject to the FMA Act.

7. In response to the 2000 audit report, the Government commissioned a Task Force on Commonwealth foreign exchange risk management practices. The Task Force reported to Government in July 2000. Following the report of the Task Force, further policy development was undertaken by Finance and the Department of the Treasury (Treasury). On 28 May 2002, the Finance Minister announced the Revised Government Foreign Exchange Risk Management Policy.

8. This current audit focused on procurement practices and contracts involving foreign currencies in four entities. It also examined the overarching implementation of the Revised Policy by Finance and GGS entities. The objectives of this performance audit were to:

- examine whether agencies are effectively managing risk in accordance with the Revised Government Foreign Exchange Risk Management Policy;

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[2] ANAO Audit Report No.45 1999–2000 *Commonwealth Foreign Exchange Risk Management Practices*, Canberra, May 2000.

- assess the effectiveness of overall management of Commonwealth foreign exchange exposures;
- assess the adequacy of administrative arrangements for foreign exchange exposure reporting by agencies; and
- follow up agencies' progress in implementing relevant recommendations made in the 2000 audit report.

Audit conclusions

9. With regard to the four audit objectives, ANAO concluded as follows.

Effectively managing risk by adoption of the Revised Policy

10. The Revised Policy was to apply to FMA Act and CAC Act entities within the GGS. ANAO found that all elements of the Policy, including the Finance Circular and the Guidelines, have been applied to FMA Act entities. However, the correct procedures for consulting with, and then notifying, CAC Act entities of the Policy were not followed by some portfolio Departments. Finance has commenced action to rectify this situation. More generally, as at July 2004, Finance was preparing a Finance Circular on the processes for applying general policies of the Government to CAC Act entities.

Management effectiveness

11. In announcing the Revised Policy, the Finance Minister stated that the approach being adopted was the most effective way to minimise the cost to the Commonwealth of currency fluctuations. In terms of the key features of the Revised Policy, ANAO found as follows.

- The Revised Policy only permits hedging where the Finance Minister has granted an exemption from the general hedging prohibition. However, some CAC Act entities have continued to use financial derivatives to hedge foreign exchange exposures, despite not having the Finance Minister's approval to do so.[3] There was also no clear guidance regarding the transition to the Revised Policy provided to entities that already had hedging arrangements in place.
- Individual entities' adoption of the Revised Policy has been patchy. For example, important procedural documentation has not been updated and/or finalised in a timely manner in three of the four entities audited. Significant variability was also found in the reliability of risk

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[3] Those entities include the Australian Nuclear Science and Technology Organisation (ANSTO) and the National Gallery of Australia (NGA). See paragraphs 2.47 to 2.48 for further discussion.

identification and measurement approaches adopted by individual entities.

- A consistent approach has yet to be adopted for calculating budget supplementation for foreign exchange gains and losses. In each of the three entities examined,[4] ANAO found that application of the approach specified in Finance's Guidelines would have led to further returns to the Budget of $1.6 million for 2002–03. At the time of the audit, two of the three entities did not accept that Finance's Guidelines should be applied to their 2002–03 calculations. In both instances, the respective entity was calculating its budget supplementation consistent with its longstanding resource agreement with Finance, rather than adopting the approach outlined in Finance's Guidelines for the Revised Policy. In September 2004, Finance advised ANAO that it is working with the entities to clarify the position regarding the Revised Policy vis a vis the existing resource agreements.

Foreign exchange reporting

12. The Revised Policy requires reporting by entities to Finance of foreign exchange exposures, gains and losses, and subsequent consolidated reporting by Finance to Government. To date, there has been incomplete implementation of the reporting requirements. Finance has yet to obtain reports from all relevant entities that have exposures, gains and/or losses. In this context, Finance has undertaken to improve its reporting to Government.

Follow-up of previous audit

13. ANAO found that, for the significant majority of relevant recommendations from ANAO's 2000 audit report, they have been implemented, or satisfactory progress has been made on their implementation.

Recommendations and entity responses

14. In July 2004, Finance advised ANAO that it was going to revise parts of its *Guidelines for the Management of Foreign Exchange Risk*. In addition, ANAO has made five recommendations to improve the implementation of the Government's Revised Foreign Exchange Risk Management Policy.

15. The following general comments were made on the proposed report of this audit.

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4 The fourth audited entity does not satisfy the criteria for participating in the budget supplementation arrangements.

Finance

The Department of Finance and Administration (Finance) welcomes the work undertaken by the ANAO in examining this area and its findings. Finance notes that the report identifies scope for some improvements in the notification process for CAC Act entities and enhancements in ancillary aspects of the policy, such as reporting.

Finance supports each of the recommendations made in the report.

Since the 2000 audit report on foreign exchange, Finance has:

- issued Finance Circular 2002/01 'Foreign Exchange (FOREX) Risk Management', setting out the Government's foreign exchange risk management policy;
- published the *Guidelines for the Management of Foreign Exchange Risk Management*, November 2002;
- issued Finance Circular 2004/11 'Unwinding hedges under the foreign exchange (forex) risk management policy', clarifying the application of the Foreign Exchange Risk Management Policy to entities that had pre-existing hedging arrangements;
- developed a Finance Circular in relation to the application of general policies of the Australian Government to bodies under the *Commonwealth Authorities and Companies Act 1997* to be released in the near future;
- committed to reviewing the *Guidelines for the Management of Foreign Exchange Risk* to clarify a number of areas; and
- undertaken to provide an expanded report to Government that includes:
  - the level of foreign exchange exposures;
  - whether any agency's foreign exchange exposures have material implications for their financial health;
  - whether there are any unusual movements in the aggregate data, and the reasons for those movements;
  - whether the foreign exchange policy should be adjusted; and
  - proposed supplementation/return-to-budget arrangements for entities' foreign exchange losses or gains.

AusAID

AusAID has read this report, noting that the recommendations are for the Department of Finance and Administration to address. AusAID liaises with Finance on a regular on-going basis regarding its management of foreign exchange risks.

Defence

Defence notes that ANAO's five recommendations are primarily recommendations for action by Finance.

Defence supports improvements to the Commonwealth's foreign exchange risk management practices, and acknowledges that agencies should identify and manage their foreign exchange exposures within the Revised Government Policy. Accordingly, Defence supports all the recommendations and undertakes to assist Finance, where required, in Finance's implementation of the recommendations.

Recommendations

Set out below are ANAO's recommendations and abbreviated responses. More detailed responses are shown in the body of the report immediately after each recommendation.

Recommendation No.1

Para 2.13

ANAO *recommends* that, in future instances where general Government financial management policies are to be applied to CAC Act entities:

a) portfolio Departments adopt appropriate mechanisms to provide timely advice to their Ministers on the steps to be taken by them to consult with CAC Act entities on the application of general Government policies and, as appropriate, notify each entity that the general policy is to apply; and

b) Finance take timely action to verify that the policies have been formally applied to relevant CAC Act entities, in accordance with the provisions of the CAC Act.

Agreed: Finance, DFAT, Defence, Austrade and DPM&C.

Recommendation No.2

Para 2.34

ANAO *recommends* that Finance improve central agency consideration of entities' requests for exemption from the prohibition on hedging by:

a) amending the Guidelines to achieve consistency with the Government decision, as to whether FMA Act agencies are able to obtain a general exemption under the Revised Policy; and

b) seeking, with Treasury, to expedite consideration of requests and provision of advice to relevant Ministers.

Agreed: Finance, Treasury, DFAT and Defence.

Recommendation No.3

Para 2.49

ANAO *recommends* that Finance promote compliance with the Revised Government Foreign Exchange Risk Management Policy by:

a) clarifying the application of the Revised Policy to entities that had pre-existing hedging arrangements, including where those entities propose to enter into new arrangements; and

b) periodically monitoring non-exempted entities' compliance with the hedging prohibition.

Agreed: Finance, DFAT and Defence.

Recommendation No.4

Para 3.17

ANAO *recommends* that Finance enhance the reporting of aggregate foreign exchange exposures, gains and losses to Government by:

a) obtaining and reporting financial data in relation to all General Government Sector entities that have exposures, gains and losses;

b) where cost effective, developing a consistent estimation methodology in consultation with relevant entities; and

c) reporting foreign currency exposures that extend over more than one year.

Agreed: Finance, DFAT, Defence and Austrade.

Recommendation No.5

Para 3.37

ANAO *recommends* that Finance liaise with each entity participating in the budget adjustment arrangements, to improve the rigour and consistency of budget adjustment calculations in respect of foreign exchange gains or losses.

Agreed: Finance, DFAT, Defence and Austrade.

Audit Findings and Conclusions

1. Introduction

This chapter discusses the background to the development of the Revised Government Foreign Exchange Risk Management Policy, including the previous ANAO audit report, and the current audit approach.

Background

1.1 Foreign exchange risk exposure is the extent to which the future cash flows of an entity are susceptible to variations in exchange rates. It embodies the opportunity for gain as well as the potential for loss. The purpose of foreign exchange risk management is to maximise the long-run return on funds that involve an actual or potential exposure to exchange rate fluctuations.[5]

1.2 The Commonwealth has a range of assets, liabilities, revenues and expenses whose values change in response to exchange rate movements. These include foreign currency assets held by the Reserve Bank of Australia (Reserve Bank) amounting to some $44.9 billion as of 30 June 2003[6] and net liabilities related to the Commonwealth debt portfolio of $6.1 billion as of 30 June 2003.[7]

1.3 There are also significant payment exposures for a number of Commonwealth entities. In total, 18 General Government Sector (GGS) entities reported foreign exchange gains and/or losses in their 2002–03 financial statements. Excluding Commonwealth debt management activities, the Commonwealth's total estimated foreign exchange payment exposure for 2004–05 is at least $3.15 billion.[8]

Audit report in 2000

1.4 An ANAO audit report tabled in late May 2000 examined the foreign exchange risk management practices of four agencies with large foreign exchange payment exposures.[9] The audit found that the Commonwealth's devolved approach to foreign exchange management, with no central agency

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5 ANAO Audit Report No.45 1999–2000 *Commonwealth Foreign Exchange Risk Management Practices*, Canberra, May 2000, paragraph 1.2, p. 32.

6 Reserve Bank of Australia, *Annual Report 2003*, p. 76.

7 Australian Office of Financial Management, *Annual Report 2002–03*, p. 107. Treasury advised ANAO in June 2004 that, as at 31 May 2004, this exposure had been reduced to $0.1 billion.

8 Figures compiled by the Department of Finance and Administration from annual expenditure data from 12 entities.

9 ANAO Audit Report No.45 1999–2000, op. cit.

guidance until the issuing of Finance Circular 2000/03[10] earlier in May 2000, had resulted in the audited agencies adopting markedly different approaches to their foreign exchange risk exposures. These agencies did not have any stated policies in relation to foreign exchange risk management or consistent management practices.

1.5 The report concluded that foreign exchange risk was not effectively and prudently managed by the audited agencies. This was because they did not have systems and procedures in place to identify their exposures; analyse the extent of those exposures; assess their impact; and take steps to cost-effectively manage the resultant risks. The report pointed out that individual agencies were responsible for managing these risks.

1.6 The ANAO recommended that the Department of Finance and Administration (Finance), in consultation with relevant agencies and, as appropriate, the Government, develop an overarching Commonwealth position statement on foreign exchange risk management for agencies subject to the *Financial Management and Accountability Act 1997* (FMA Act).

Revised Government Policy

1.7 In response to the 2000 audit report, the Prime Minister, in June 2000, asked the Minister for Finance and Administration (Finance Minister) to commission a Task Force on Commonwealth foreign exchange risk management practices. The Task Force, with representatives from relevant agencies and chaired by Finance, reported to Government in July 2000. After the report of the Task Force, Finance and the Department of the Treasury (Treasury) undertook further policy development.

1.8 On 28 May 2002, the Finance Minister announced that, after a comprehensive review, the Government had decided to revise its foreign exchange risk management policy.[11]

1.9 The Minister announced that the Government had decided to retain the requirement for agencies to individually manage their foreign exchange risk, but that they would no longer be permitted to hedge except in special circumstances. Foreign exchange gains would be returned to the Budget, and entities would be supplemented for foreign exchange losses.

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[10] Finance Circular No:2000/03: Budget Framework for the Management of Foreign Exchange (FOREX) Exposure, May 2000.

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

1.10 Finance has overarching responsibility for the Revised Government Foreign Exchange Risk Management Policy (Revised Policy). In this respect, in March 2004, Finance advised ANAO as follows:

> … Finance has several roles in promulgating the Government's foreign exchange risk management policy…
>
> In addition to its general obligation to adhere to policy, Finance is also responsible for maintaining the framework which supports the policy and for guiding agencies through the requirements of the foreign exchange risk management policy. In part, this is done through the Finance publication *Guidelines for the Management of Foreign Exchange Risk*. The Department also has responsibility to identify the Government's foreign exchange risks through the monitoring and reporting of agencies' foreign exchange exposures. The Department then advises the Expenditure Review Committee (ERC) of Cabinet on agencies' foreign exchange exposures, losses and gains.
>
> For their part, agencies also have responsibilities under the policy. These are set out in the foreign exchange risk management guidelines. We particularly note that Chief Financial Officers (CFOs) are to sign off their agency's foreign exchange reports (Guideline 3.3.7) and also certify that proper risk management practices, as set out in the guidelines, are being followed (Guideline 3.3.8).

Audit approach

1.11 The objectives of this performance audit were to:

- examine whether agencies are effectively managing risk in accordance with Revised Government Foreign Exchange Risk Management Policy;
- assess the effectiveness of overall management of Commonwealth foreign exchange exposures;
- assess the adequacy of administrative arrangements for foreign exchange exposure reporting by agencies; and
- follow up agencies' progress in implementing relevant recommendations made in the 2000 audit report.

1.12 The audit focused on procurement practices and contracts involving foreign currencies in selected entities. The following entities were selected in view of their large exposures to foreign exchange risk and the type and range of their activities involving foreign currencies: Department of Defence (Defence), Department of Foreign Affairs and Trade (DFAT), Australian Agency for International Development (AusAID) and Australian Trade Commission (Austrade).[12] Apart from Austrade, these entities were also

[12] Defence, DFAT and AusAID are FMA Act agencies. Austrade is a CAC Act entity (that is, subject to the *Commonwealth Authorities and Companies Act 1997*).

examined in the 2000 audit. Appendix 1 summarises information on the sources of each entity's foreign exchange exposures.

1.13 Finance was also included in the audit scope, given its central role in the collation, analysis and reporting of the whole of Government position on foreign exchange exposures; responsibility for substantiation of related claims from entities for supplementation from, or returns to, the Budget; and processing of applications for exemption from the restriction from external hedging. In relation to this last task, Treasury was also included in the audit, as the Treasurer is to be consulted by the Finance Minister on entities' applications for exemption from the restriction on hedging.

Conduct of the audit

1.14 The audit proceeded in two stages. The first stage involved a questionnaire being sent to audited agencies in order to identify the practices, processes, systems and controls used by them in the risk management of foreign exchange under the Revised Policy. Where relevant, agencies were also asked to detail action taken to implement recommendations agreed to under the 2000 audit.[13]

1.15 The second stage involved fieldwork in the selected agencies and included a combination of qualitative and quantitative analysis, file and documentation reviews and interviews with agency officers. Audit fieldwork was conducted between November 2003 and April 2004.

1.16 Preliminary audit findings were set out in a discussion paper sent to audited agencies on 25 May 2004 for comment by 16 June 2004. Extracts from the discussion paper were also sent to relevant CAC Act entities. Responses were received from all agencies and entities by 30 June 2004, except for Finance, which replied on 22 July 2004.

1.17 The proposed report was sent to audited agencies and relevant CAC Act entities in August 2004.

1.18 The audit was conducted in conformance with ANAO auditing standards and cost the ANAO approximately $395 000.

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[13] Chapter 4 of this report follows up recommendations in ANAO Audit Report No.45 1999–2000, op. cit.

2. Revised Policy Scope and Application

This chapter discusses the application of the Revised Government Foreign Exchange Risk Management Policy to General Government Sector entities, and exemptions for some entities from aspects of the Revised Policy.

Finance Circular 2002/01:

Key Point 1: Effective from 1 July 2002 all FMA agencies and CAC bodies within the GGS will continue to be responsible for managing their forex risk.

Finance's Guidelines:

Paragraph 2.2.1: The Government's foreign exchange risk management policy applies to all FMA agencies and CAC bodies within the general government sector (the Australian Office of Financial Management is excluded from these arrangements). The policy stipulates that these entities are responsible for managing their foreign exchange exposures; however, as a general policy they are restricted from externally hedging.

Applying the Revised Policy to GGS entities

2.1 Issued on 26 June 2002, Finance Circular 2002/01 (see Appendix 2) indicated that the Revised Policy would take effect on 1 July 2002. It stated that FMA Act agencies and CAC Act entities in the GGS would continue to be responsible for managing their foreign exchange risk but that, as a general policy of the Government, they were now restricted from externally hedging foreign exchange exposures.

Applying the Revised Guidelines to FMA Act agencies

2.2 Section 44 of the FMA Act imposes a general responsibility on each agency's Chief Executive to manage the agency's affairs in a way that promotes 'proper' (defined as efficient, effective and ethical) use of the agency's resources. In implementing that plenary responsibility, Chief Executives are subject to compliance with requirements set out in the *Financial Management and Accountability Regulations 1997* (FMA Regulations), Finance Minister's Orders issued under section 63 of the FMA Act, Special Instructions issued under section 16 of the FMA Act and any other relevant law.[14] In particular, FMA Regulation 9 requires that agency Chief Executives (or their delegates) must be satisfied that spending proposals are in accordance with the

14 Refer to subsection 44(2) of the FMA Act.

policies of the Commonwealth, and will make efficient and effective use of public money.

2.3 Subject to any legislation or Government decision to the contrary, the Finance Minister has power to determine Government policy on use of public money.[15] In June 2002 the Finance Minister provided all Ministers with a copy of Finance Circular 2002/01 and said that the Revised Policy would apply to Chief Executives of FMA Act agencies as part of their obligation to ensure the proper use of Commonwealth resources.

2.4 In approving the Revised Policy, the Government was advised by Finance that specific regulations under the FMA Act would be required in order to apply it to FMA Act agencies. This reflected legal advice received by Finance in July 2000 that requiring FMA Act agencies to manage foreign exchange risks in a specified manner without a statutory requirement would be inconsistent with Chief Executives' general Section 44 responsibility. Finance was further advised that such requirements could be mandated under the Finance Minister's Orders or the FMA Regulations.

2.5 Subsequent to the Government decision, Finance gave the issue further consideration and concluded that regulations were unnecessary as the decision could be given effect through FMA Regulation 9 and section 44 of the FMA Act. In July 2004 Finance advised ANAO that the Finance Minister was advised of this in November 2002. Finance's view was confirmed in May 2004 via legal advice. In this context ANAO considers it would have been preferable for such advice to have been obtained prior to advising the Finance Minister that regulations were unnecessary.[16]

Applying the Revised Policy to CAC Act entities

2.6 Sections 28 and 43 of the CAC Act provide a legislative process under which a responsible Minister[17] may apply general policies of the Government to Commonwealth authorities and companies.[18] Section 28 states:

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15 Section 63 of the FMA Act provides that the Finance Minister may make Orders on any matter on which regulations may be made. Section 65 of the Act identifies the matters in respect of which the Governor-General may make regulations prescribing matters, including in relation to the handling, spending and accounting for public money.

16 Finance's records indicated that internal consultation had occurred prior to advising the Finance Minister. In February 2004, ANAO sought from Finance a copy of any internal advice that regulations were unnecessary to implement the Revised Policy, and a copy of any authorisation or consent by the Government relieving Finance from the need for such regulations. Finance advised ANAO that the internal consultation, which occurred prior to briefing the Minister, was oral.

17 For the purposes of the CAC Act, a responsible Minister is the portfolio Minister, the Minister Assisting or the Parliamentary Secretary who has responsibility for the administration of the authority or company.

(1) The responsible Minister may notify the directors of a Commonwealth authority in writing of general policies of the Commonwealth Government that are to apply to the authority. The responsible Minister must consult the directors before notifying them of the policies.

(2) The directors must ensure that the policies are carried out in relation to the authority.

(3) The directors must also ensure, as far as practicable, that the policies are carried out in relation to the subsidiaries of the authority.

(4) The responsible Minister may, in writing, exempt the directors of a Commonwealth authority from subsection (2) or (3) in relation to specified activities.

2.7 Section 43 of the CAC Act is couched in identical terms except that 'Commonwealth authority' is replaced with 'wholly-owned Commonwealth company', and 'authority' is replaced with 'company'. As at July 2004, Finance was preparing a Finance Circular on the application of general policies of the Government to entities under these CAC Act provisions.

2.8 When providing the Revised Policy to other Ministers in June 2002, the Finance Minister asked that they consult GGS CAC Act entities in their portfolio with a view to applying the Revised Policy to those entities within 21 days. Ministers were to give the relevant entities an opportunity to seek exemption from the Revised Policy if they considered it appropriate to continue to hedge their foreign exchange exposures. The Finance Minister asked that other Ministers provide him with details of any comments received from the directors of CAC Act entities in response to the notification of the Revised Policy.

2.9 Under the CAC Act, directors of a CAC Act entity are not obliged to carry out a general policy of the Government until the responsible Minister has consulted with them on the appropriateness of applying the policy to the particular entity and then notified them in writing that the policy is to apply.[19] These provisions reflect the fact that authorities and companies are legal entities separate from the Commonwealth whose directors have duties similar to those of directors of public companies. The notification provisions override these general duties.

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[18] A general policy of the Government cannot apply to a CAC Act entity where it conflicts with any statutory obligation of the entity: Source – Explanatory Memorandum to the *Commonwealth Authorities and Companies Bill 1996*. The enabling legislation of the following authorities provides that the directions sections of the CAC Act do not apply to them – the Australian Broadcasting Corporation, the Australian National University and the National Registration Authority for Agricultural and Veterinary Chemicals.

[19] *Commonwealth Authorities and Companies Bill 1996*, Explanatory Memorandum, circulated by the authority of the Minister for Finance, the Honourable John Fahey MP, pp. 11–12.

2.10 The approach developed by Finance for adoption by responsible Ministers in respect to the Revised Policy did not take account of the requirement to consult prior to notification. Finance proposed an approach that involved directors being notified of the Revised Policy without prior consultation having occurred.

2.11 In addition, during audit fieldwork, no evidence was available from Finance confirming that the Policy had been formally applied to all CAC Act entities to which the Government intended it should apply, and that they were giving effect to it. In relation to this issue, Finance advised the ANAO in July 2004 as follows:

> During April and May 2004, Finance reviewed entities' progress with the notification process for a number of policies. [*On 29 June 2004*], the Chief of Staff to the Finance Minister wrote to the Chiefs of Staff of those portfolio Ministers [*who had*] not responded to date…, seeking a response to the Finance Minister's *[June 2002]* letter *[regarding the application of the Revised Policy]*.

2.12 The results of this work, together with ANAO's own enquiry of portfolio Departments, revealed that six portfolio Departments had not arranged for notification by their respective Ministers of the Revised Policy to a total of 22 CAC Act entities classified as within the GGS as at 30 June 2002[20], as follows:

- 10 entities in the Immigration and Multicultural Affairs and Indigenous Affairs portfolio[21], namely: the Aboriginal and Torres Strait Islander Commission; Aboriginal Hostels Limited; Anindilyakwa Land Council; Australian Institute of Aboriginal and Torres Strait Islander Studies; Central Land Council; Indigenous Business Australia (IBA);[22] Indigenous Land Corporation; Northern Land Council;[23] Tiwi Land Council; and the Torres Strait Regional Authority;

[20] In addition, in August 2004, the Department of Communications, Information Technology and the Arts (DoCITA) advised that, in April 2004, NetAlert Ltd (which was established in 1999) was listed as part of the GGS and, accordingly, steps are now being taken to consult with and notify NetAlert directors of the Revised Policy.

[21] The Department of Immigration and Multicultural and Indigenous Affairs (DIMIA) advised ANAO in September 2004 that DIMIA itself consulted the entities and then briefed its Minister. The CAC Act, however, requires the responsible Minister to consult and notify.

[22] The Finance Minister approved an exemption for IBA from the general prohibition on hedging but the remaining parts of the Revised Policy continue to be relevant to it.

[23] Northern Land Council confirmed to ANAO in September 2004 that it had not been consulted on the Revised Policy as required by the CAC Act.

- four entities in the Environment and Heritage portfolio[24], namely: the Great Barrier Reef Marine Park Authority; Sydney Harbour Federation Trust; the Director of National Parks; and the Australian Heritage Commission (now the Australian Heritage Council since 1 July 2003);
- five entities in the Industry, Tourism and Resources portfolio, namely: IIF Bioventures Pty Ltd; IIF (CM) Investments Pty Ltd; IIF Foundation Pty Ltd; IIF Investments Pty Ltd; and IIF Newport Pty Ltd;
- one entity in the Agriculture, Fisheries and Forestry portfolio being the Dairy Research and Development Corporation (which is now part of Dairy Australia, a public non-finance corporation);
- one entity in the Prime Minister and Cabinet portfolio being the National Australia Day Council (NADC);[25] and
- one entity in the Veterans' Affairs portfolio being the Australian War Memorial.

Recommendation No.1

2.13 ANAO *recommends* that, in future instances where general Government financial management policies are to be applied to CAC Act entities:

a) portfolio Departments adopt appropriate mechanisms to provide timely advice to their Ministers on the steps to be taken by them to consult with CAC Act entities on the application of general Government policies and, as appropriate, notify each entity that the general policy is to apply; and

b) Finance take timely action to verify that the policies have been formally applied to relevant CAC Act entities, in accordance with the provisions of the CAC Act.

Agency responses

2.14 Finance, DFAT, Defence, Austrade and DPM&C agreed.

2.15 Some respondents also made comments on the recommendation, as follows:

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[24] The Department of the Environment and Heritage advised ANAO in September 2004 that, while it had consulted with the portfolio CAC Act entities prior to the release of the Revised Policy, no formal consultation and notification had taken place in 2002. The Department has now advised that this omission is being rectified in consultation with Finance.

[25] The Department of Prime Minister and Cabinet (DPM&C) advised ANAO in September 2004 that the omission was rectified in May 2004 by the NADC being notified. The NADC response to DPM&C noted the Revised Policy.

- Finance advised in relation to 1(a) that it is finalising guidance for portfolio Departments and CAC Act entities to assist them with the consultation and notification processes under the CAC Act.
- Austrade advised that it will work closely with its portfolio Department, the Department of Foreign Affairs and Trade, in the consultation process.

Applying Finance's Guidelines to GGS entities

2.16 Finance Circular 2002/01 had noted that Finance would develop and release principles-based guidance on foreign exchange risk management practices to complement existing publicly available material on risk management.[26] Finance issued the publication *Guidelines for the Management of Foreign Exchange Risk* (Finance's Guidelines) in November 2002.

2.17 Finance's Guidelines were issued some six months after the Government's decision to introduce the Revised Policy. During those six months, relevant entities lacked guidance on implementing the Policy, but were still required to manage their own foreign exchange risk in accordance with the Revised Policy. In this context, Finance advised ANAO in July 2004 as follows:

> The key features of the Revised Policy (the prohibition on hedging, agencies' continuing responsibility for managing foreign exchange risk and supplementation arrangements) and agencies' main responsibilities were clearly set out in Finance Circular 2002/01. In addition, entities had the opportunity to seek guidance from Finance on any related matters. The Guidelines complement Finance Circular 2002/01 and provide additional, more detailed guidance on agencies' responsibilities to identify foreign currency exposures, reporting and accountability requirements.

2.18 The Guidelines set out the principles for proper foreign exchange risk management, the key features of the Government decision, and incorporate principles-based guidance in relation to exposure management and controls. However, elements in the Guidelines relating to foreign exchange risk identification, measurement and reporting are prescriptive rather than principles-based. Finance advised ANAO in July 2004 that this approach was taken to ensure consistency across entities.

Applying the Guidelines to FMA Act agencies

2.19 In May 2004, ANAO queried with Finance the authority upon which Finance's Guidelines could prescribe requirements relating to agencies' foreign exchange risk management. This was in the context that the Guidelines were

[26] Finance Circular 2002/01, Key Point 4.

promulgated by the Department after the Government policy decision and, as they address matters not covered by the decision, could not be seen as being part of the Revised Policy decision.

2.20 In May 2004, Finance obtained the following legal advice in relation to the application of the Guidelines to FMA Act agencies:

> Finance Ministers have had a longstanding and generally recognised role in relation to financial management and accountability given their responsibility for administering the Audit Act 1901 and now the FMA Act, and the specific powers conferred on those Ministers by that legislation. In light of these responsibilities and powers it is…open to the Finance Minister to formulate Government policy in relation to matters of financial management and accountability, although there may be circumstances in which it would be preferable for an FMA Regulation or Finance Minister Order to be made.

2.21 Finance advised ANAO that the Guidelines were approved by the Finance Minister on 11 November 2002. However, ANAO is not aware of any materials that Finance released to FMA Act agencies (or CAC Act entities) that indicate that Finance's Guidelines were issued under the Finance Minister's approval and were, therefore, part of the Revised Policy.

2.22 During the audit, ANAO discovered that omission of this information had unforeseen consequences. For example, DFAT relied on its existing resource agreement with Finance in calculating foreign exchange budget supplementation and returns, rather than applying the new rules set down in the Guidelines. As a result, DFAT may now be faced with a further adjustment to its departmental funding for net foreign exchange gains in 2002–03. On this issue, in September 2004, DFAT advised ANAO as follows:

> [*DFAT's*] resource agreement with Finance provides for budget adjustments relating to foreign exchange movements on a no win/no loss basis. [*DFAT*] notes that the resource agreement explicitly provides for the agreement to be amended by agreement between both parties. However, since the Guidelines were released Finance has not raised the issue of possible changes to the resource agreement. Consequently [*DFAT*] continued to calculate budget adjustments in accordance with this agreement. [*DFAT*] also notes that Finance accepted all [*DFAT's*] calculations, including those for 2002–03.
>
> [*DFAT's*] Financial Management Information System was configured to calculate foreign exchange losses and gains in accordance with the resource agreement and to eliminate the effect of foreign currency transactions [*DFAT*] processes on behalf of other agencies. [*DFAT*] considers it would be unreasonable to adjust 2002–03 calculations because, given the considerable volume of foreign currency transactions processed for other agencies, it would require considerable manual processing.

2.23 Finance advised ANAO in September 2004 that it is now working with DFAT to resolve these matters.

Applying the Guidelines to CAC Act entities

2.24 ANAO also noted that Finance's Guidelines state that they apply to all CAC Act entities in the GGS. However, ANAO also noted that the Guidelines had not been formally notified to CAC Act entities under the terms of the CAC Act. In the absence of such entities having been appropriately consulted and notified of the Guidelines as an element of the Revised Policy, it is ANAO's understanding that they are not obliged to comply with them. ANAO sought clarification from Finance as to the status of the Guidelines in relation to CAC Act entities. In September 2004, Finance advised ANAO as follows:

> The Guidelines complement the Revised Policy, by explaining the policy in more detail and assist entities with the implementation of the Revised Policy.
>
> While CAC Act entities are expected to comply with the Guidelines, it is not necessary for the additional matters covered in them to be given the force of law. This issue will be clarified in the revised Guidelines.

2.25 However, in this regard, Austrade advised ANAO in June 2004 that it considered it was not subject to the Guidelines, as it was not formally notified by its responsible Minister regarding Finance's Guidelines. As a result, budget supplementation claims, or returns to the Commonwealth, were not assessed under Finance's Guidelines, but rather under Austrade's existing resource agreement with Finance that commenced prior to the Revised Policy. Austrade indicated that it would not welcome a retrospective application of the Guidelines, given that it has already fully complied with its resource agreement.

2.26 ANAO further notes that there is a reasonable presumption that those CAC Act entities not notified of the Revised Policy should not have been expected either to comply with, or have regard to, the Revised Policy, including Finance's Guidelines. Finance advised the ANAO on 23 July 2004 that it had conducted a review to determine whether CAC Act entities have had the Revised Policy applied to them and that follow up action arising from that review was under way.

Exemptions from the hedging restriction

2.27 In announcing the Revised Policy, the Finance Minister stated that the Government had deliberately chosen to restrict access to hedging, noting that the Task Force had recommended that hedging be restricted to rare cases.[27] In that context, entities may apply to the Finance Minister for an exemption from the hedging restriction.

[27] Media Release 20/2002, op. cit.

2.28 A successful application allows the entity to make external hedging arrangements within any limits set out in the exemption. Exempted entities no longer have recourse to any budget adjustments with regard to foreign exchange losses or gains associated with the exempted activity.

2.29 The Revised Policy provided that approval to enter into external hedging arrangements may be sought on a case-by-case basis. It also provided that CAC Act entities in the GGS could also apply to the Finance Minister for a general exemption.

2.30 Finance's Guidelines indicate a wider scope for exemptions than that set out in the Revised Policy by providing scope for FMA Act agencies also to apply for general exemption from the hedging restriction.[28] Evidence of Government approval to widen the scope for general exemptions to include FMA Act agencies was not held in Finance records. It would seem desirable for Finance to amend the Guidelines to achieve consistency with the Government decision.

2.31 As at May 2004, six entities, all CAC Act entities, had sought general exemption from the restriction on hedging, or confirmation from the Finance Minister that the Revised Policy does not apply to them. The CAC Act provides that the Minister responsible for a CAC Act entity may, in writing, exempt it from ensuring the general policies of the Commonwealth Government are carried out by the entity for specified activities.[29] However, the Revised Policy includes a power for the Finance Minister to approve exemptions from the hedging prohibition. In this context, Finance advised ANAO, in July 2004, that this provision enables the Finance Minister to exempt CAC Act entities, without recourse to the responsible Minister under the CAC Act provisions.

2.32 Accordingly, with advice from Finance and Treasury, the Finance Minister has, after consultation with the Treasurer, decided the outcome of each exemption request received to date. The outcome of those requests is summarised in Table 2.1. In terms of the two exemptions approved to date, ANAO found that, while CSIRO needed to formally request an exemption for both it and its subsidiaries, the Revised Policy has yet to be applied formally to IBA and, as a result, an exemption was not actually required.

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28 Finance's Guidelines state that: 'All entities are able to apply to the [*Finance Minister*] who in consultation with the Treasurer is able to grant an exemption to the hedging restriction either on a case-by-case or general basis.' Source: Finance's Guidelines, op. cit., p. 4.

29 CAC Act, subsections 28(4) and 43(4).

Table 2.1

Outcome of requests for exemption: as at May 2004

Entity	Outcome of application
Australian Broadcasting Corporation (ABC)	Not subject to Revised Policy
Indigenous Business Australia (IBA)	Approved
Australian Nuclear Science and Technology Organisation (ANSTO) [A]	Denied
Commonwealth Scientific and Industrial Research Organisation (CSIRO) [A]	Denied
CSIRO Subsidiaries	Approved [B]
National Gallery of Australia (NGA)	Denied [C]
Export Finance and Insurance Corporation (EFIC)	Decision pending [D]

Notes:

A ANSTO and CSIRO exemption requests were submitted and processed together.

B The Finance Minister approved an exemption for CSIRO subsidiaries from the hedging restriction in limited circumstances, subject to future consultation with Finance.

C Instead of approving an exemption, the Finance Minister excluded the Capital Use Charge from NGA's minimum exposure threshold until the Charge ceased on 1 July 2003.

D Formal request to the Finance Minister for exemption was made in September 2003. The Treasurer's advice on the request was provided to Finance in late February 2004, but Finance is yet to make a final submission to the Finance Minister. Prior to the formal request, EFIC had been in discussion with Finance about the application of the Revised Policy for more than 12 months.

Source: ANAO analysis of Finance and Treasury records.

2.33 It has taken considerable time to resolve exemption requests. In this respect, Treasury commented to ANAO in June 2004 as follows:

> An application for exemption from a Government policy requires extensive, and often complex, consideration. This includes extensive research of issues relating to the structure, classification, funding, business activities (including joint venture arrangements) and past hedging practices and expertise of each agency, including by conducting discussions with stakeholders. Given that central agencies were aware that decisions on these early requests for exemption would set precedents for other agencies, additional effort was placed on assessing early requests.[30]

[30] In September 2004, Finance noted these comments, and advised that: 'Finance frequently requires considerable additional information to process requests not contained in the original application and this, together with the complexity of the matters at hand, takes time to resolve.'

Recommendation No.2

2.34 ANAO *recommends* that Finance improve central agency consideration of entities' requests for exemption from the prohibition on hedging by:

a) amending the Guidelines to achieve consistency with the Government decision, as to whether FMA Act agencies are able to obtain a general exemption under the Revised Policy; and

b) seeking, with Treasury, to expedite consideration of requests and provision of advice to relevant Ministers.

Agency responses

2.35 Finance, Treasury, DFAT and Defence agreed.

Risk management principles and controls

2.36 Development and implementation of a foreign exchange risk management program are specialist activities that require appropriate knowledge and expertise in financial markets, strong systems and rigorous internal controls.[31] ANAO's 2000 audit report found that decentralised management of foreign exchange risks, with minimal central oversight, has the potential to increase Commonwealth risk exposures, particularly where financial derivatives are used to hedge exposures.[32] In this respect, Finance advised ANAO in September 2004 as follows:

> Finance investigated the merits of centralising provision of strategic and operational advice to agencies on the cost-effective management of foreign exchange risk in the development of the Revised Policy. …the policy development process that followed the taskforce report in July 2000 identified a number of options including the development of a centralised expert capacity in foreign exchange risk management. The Government subsequently agreed to the current policy.

2.37 Although originally developed as a risk management tool, derivatives also involve risks that need to be managed. Some entities have suffered financial losses associated with derivatives.[33] Subsequent review attributed many losses, in part, to flawed corporate governance systems that did not establish effective risk management and internal controls to ensure that approved policies and risk limits were applied effectively.

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31 ANAO Audit Report No.45 1999–2000, op. cit., paragraph 2.39, p. 50.

32 ibid, paragraph 2.25, p. 48.

33 Indeed, in announcing the Revised Policy, the Finance Minister stated that: '*Hedging is not a cure for currency volatility. A private company such as Pasminco lost hundreds of millions of dollars and went into administration as a result of its hedging policy.*' Source: Media Release 20/2002. op. cit.

2.38 Finance's Guidelines provide comprehensive guidance on managing foreign exchange risk in circumstances where agencies are not permitted to hedge their exposures, as per the Revised Policy. However, for those GGS entities that are granted exemptions from the hedging restriction, or to which the Revised Policy does not apply, the Guidelines do not adequately address the risks involved in hedging foreign exchange exposures. In particular, there is no general guidance provided on:

- risk management controls required to be in place;
- the type, form and frequency of approved hedging arrangements for GGS entities; and
- the importance of hedging existing exposures rather than creating new exposures.[34]

2.39 In addition, Finance's Guidelines are unclear as to whether an entity exempted from the hedging restriction is still required to identify, measure and report to Finance those foreign exchange exposures that it has hedged. Finance has advised ANAO that entities are not required to report such exposures, as there should be no net exposure. ANAO notes that this approach presumes that hedging arrangements are always fully effective in managing the foreign exchange risk, which may not actually be the case.

2.40 Although there is an absence of documented guidance for all entities permitted to hedge their exposures, on one occasion an entity had been expected to consult Finance in the development of hedging procedures. In July 2003, the Finance Minister agreed that the Revised Policy did not apply to the ABC and that it should be allowed to continue to hedge its foreign exchange exposures. The Finance Minister advised the Minister for Communications, Information Technology and the Arts (Communications Minister) that he had consulted the Treasurer and that they both agreed with the Communications Minister's proposal to exercise his powers under section 25B(2) of the ABC Act, to develop guidelines for ABC risk management, in consultation with Finance officers. In July 2004, Finance advised ANAO that:

> The ABC has developed proposed foreign exchange risk management guidelines under section 25B(2) of the ABC Act. These guidelines are currently under review by the Department of Communications, Information Technology and the Arts (DoCITA). Once cleared by the legal services area within

[34] For example, ANAO's 1999 performance audit of Commonwealth Debt Management found that Treasury (now the AOFM) had used cross-currency swaps, not to hedge existing exposures, but to create new foreign exchange exposures as a strategy to reduce debt costs for an acceptable level of risk. Source: ANAO Audit Report No.14 1999–2000 *Commonwealth Debt Management*, Canberra, October 1999, p. 59.

DoCITA, the proposed guidelines will be forwarded to Finance for consideration.[35]

2.41 ANAO's 2000 audit report referred to a foreign exchange risk management benchmarking study that had identified 12 risk management principles that are expected to reinforce each other to promote: measurable hedging objectives; accurate and timely information on performance against the objectives; minimisation of transaction costs; rigorous error and compliance checking; and appropriate senior management oversight.

2.42 In May 2004, ANAO suggested to Finance that this study, and other more recent work on control structures for the use of financial derivatives, would form a sound basis for Finance to develop guidance for GGS entities that are permitted to hedge their exposures. This guidance could usefully be incorporated in a revision of Finance's Guidelines.[36] This would also result in the implementation of the recommendation from the 2000 audit report[37], that the merits of centralising the provision of strategic and operational advice to agencies on the management of foreign exchange risk be investigated.[38] However, Finance advised ANAO in July 2004 that:

> [*ANAO*] suggests that Finance should provide guidance on managing foreign exchange risk in circumstances where entities are permitted to hedge their exposures. Finance does not agree. The Government has clearly articulated a general policy of prohibiting entities from hedging. Exemptions have been granted in a few limited circumstances and only following involvement of the relevant portfolio Minister. Where exemptions are in place, relevant entities should choose the most appropriate mechanism to manage the foreign exchange exposure for their activities, in accordance with their legal obligations.
>
> In this regard, section 44 of the FMA Act obliges Chief Executives of FMA agencies to manage the affairs of the agency in a way that promotes the efficient, effective and ethical use of Commonwealth resources. In the case of authorities subject to the CAC Act, section 22 of that Act obliges directors and

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[35] The ABC confirmed in September 2004 that DoCITA is yet to confirm the guidelines presented by the ABC.

[36] EFIC advised ANAO in September 2004 that any revision of the Guidelines should be broad enough, or flexible enough, to accommodate the range of Commonwealth entities to which they apply: in particular, they would need to accommodate EFIC's situation as a financial institution. EFIC further advised that Finance has indicated that it would review issues regarding EFIC's treasury practices.

[37] Recommendation No.2 of ANAO Audit Report No.45 1999–2000, op. cit.

[38] Finance's view is that the Revised Policy has superseded Recommendation No. 2 of the 2000 audit report, and therefore Finance and Treasury have not directed entities to use a central agency or body as the preferred adviser. ANAO considers that Recommendation No. 2 is still relevant. Given that, under the Revised Policy, some entities have obtained permission to hedge, and other Commonwealth entities are not subject to the Revised Policy, it would seem advisable that there be consistent and relevant foreign exchange risk management guidance for those entities, just as there now is for entities that are not permitted to hedge.

senior management to exercise care and diligence in discharging their powers and duties and section 23 obliges them to act in good faith in the best interests of the authority. Directors and senior management of Commonwealth companies are subject to equivalent obligations under the *Corporations Act 2001*. Finance notes that ample advice on foreign exchange risk management is available from professional advisers.

2.43 In the circumstances, having particular regard to the risks involved in using financial derivatives, ANAO is considering including in its work program a performance audit examining Commonwealth entities' governance structures for the management and use of financial derivatives.

Compliance with the hedging restriction

2.44 The Revised Policy stated that, from 1 July 2002, entities without an exemption would be restricted from hedging. However, Finance's Guidelines are unclear on the specific implications of this restriction for relevant Commonwealth entities that already had hedging arrangements in place. In particular, the Guidelines did not make it clear whether, as from 1 July 2002, such entities would be:

- required to withdraw from existing hedging arrangements and not enter into any new hedges unless and until an exemption is obtained;
- permitted to retain existing hedges, but prohibited from entering into any new arrangements until such time as an exemption is granted; or
- permitted to retain existing hedges and allow them to run to maturity, as well as continue to enter into new hedges pending the outcome of an exemption application.

2.45 In this respect, ANAO found that markedly different approaches have been taken by GGS entities.

2.46 One entity allowed its pre-existing hedging arrangements to run to maturity. In early 2003, DFAT reported to Finance that the Overseas Property Office (OPO) had four outstanding hedging contracts that were entered into prior to the introduction of the Revised Policy, when OPO was previously part of Finance. In early 2004, DFAT reported to Finance that these contracts had been closed.

2.47 ANAO examination of GGS entities' financial statements for the year ended 30 June 2003 identified that the following CAC Act entities continued to hedge.

- The Australian Nuclear Science and Technology Organisation (ANSTO) requested exemption from the hedging restriction in October 2002. In the request to its Minister, ANSTO advised that it would continue to undertake non-speculative foreign exchange hedging to protect ANSTO from material exchange losses for foreign currency transactions undertaken in the normal course of operations. The application was sent in December 2002 to the Finance Minister, who sought advice from the Treasurer. In early June 2003, ANSTO entered into hedging arrangements for certain foreign currency transactions. On 24 June 2003, the Finance Minster advised the Minister for Education, Science and Training that ANSTO's request for exemption was rejected. Despite the rejection, ANSTO did not close out the existing hedging arrangements, as the Guidelines at that time were silent on what action should be taken re existing contracts.[39]

- The National Gallery of Australia (NGA) requested exemption from the hedging restriction on the grounds that it negotiates significant overseas purchases, particularly in the US and European markets, and has little opportunity to determine the currency of the commitment. To provide certainty for budgetary purposes, the NGA advised that it hedged significant foreign currency transactions. The exemption request was received by the Finance Minister on 21 October 2002. After deliberations with the Treasurer, the Finance Minister advised the Minister for Arts and Sport on 21 May 2003 that the application was rejected. In its 2002–03 financial statements, NGA disclosed that it entered into forward exchange contracts to hedge actual and certain anticipated purchase commitments denominated in foreign currencies (principally USD).[40]

- CSIRO was granted a limited exemption that applies to joint ventures with commercial partners involving foreign currency contracts, subject to CSIRO consulting Finance on a project-by-project basis for all joint ventures for which hedging is sought.[41] CSIRO reported that it had specific forward exchange contracts.[42] CSIRO confirmed, in May 2004,

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[39] ANSTO advised ANAO in August 2004 that Finance Circular 2004/11 *Unwinding hedges under the foreign exchange (forex) risk management policy* released on 11 August 2004 (see Appendix 3) supported its position to allow existing contracts to run their course provided that was cost effective. Finance Circular 2004/11, however, does not support ANSTO's position as it applies to contracts and arrangements existing at the time the Revised Policy came into operation, which was 1 July 2002.

[40] The value of the commitments at their hedged rate was reported as $6 450 431. Source: *National Gallery of Australia Annual Report 2002–2003*, p. 100.

[41] As at May 2004, CSIRO had consulted Finance on one occasion, seeking exemption for a 100 per cent CSIRO owned subsidiary company to be used as the vehicle for overseas partners' investment. Over time CSIRO's interest holding in the company would be diluted as new partners entered the venture. Finance reviewed the circumstances of the case but rejected the exemption application on the basis that the original exemption granted applied to CSIRO entering joint ventures, not another entity.

[42] Arrangements were to sell USD $1 450 200 at an average exchange rate of USD $0.517, and specific forward exchange contracts to buy USD $85 450 at an average exchange rate of USD $0.5093. Source: *CSIRO Annual Report 2002-2003*, p.150.

that these hedges were taken out prior to 1 July 2002, the Revised Policy commencement date. CSIRO advised that the first occasion it was required to confirm to Finance the existence of hedges taken out prior to the commencement date was in November 2003. However, Finance did not require CSIRO to terminate them.

2.48 In addition, the Export Finance and Insurance Corporation (EFIC) continued to hedge under its statutory power in accordance with the approval of its Minister as the responsible Minister under the CAC Act.

Recommendation No.3

2.49 ANAO recommends that Finance promote compliance with the Revised Government Foreign Exchange Risk Management Policy by:

a) clarifying the application of the Revised Policy to entities that had pre-existing hedging arrangements, including where those entities propose to enter into new arrangements; and

b) periodically monitoring non-exempted entities' compliance with the hedging prohibition.

Agency responses

2.50 Finance, DFAT and Defence agreed.

2.51 Finance also made comments on the recommendation, as follows:

- in relation to 3(a) Finance advised that it has issued Finance Circular 2004/11 (released 11 August 2004) clarifying the application of the revised Policy to entities that had pre-existing hedging arrangements, including where those entities saw a need to extend, renew or replace those arrangements. The Circular was distributed to the Chief Executive Officers and Chief Finance Officers of all FMA Act agencies and CAC Act bodies within the General Government Sector.[43]
- in relation to 3(b) Finance advised it will monitor non-exempted entities' compliance with the hedging prohibition via an explicit certification by the Chief Finance Officer.

[43] A copy of Finance Circular 2004/11 is reproduced in Appendix 3 of this report.

3. Identifying and Reporting Exposures

This chapter examines foreign exchange risk identification by agencies, and Finance's administration of whole of Government risk reporting arrangements.

Finance's Guidelines:

Paragraph 2.1.2: Consistent with the Commonwealth's financial framework legislation, each entity is responsible for the management of foreign exchange risks. Particularly, it is expected that all GGS entities will manage foreign exchange in a manner consistent with Finance Circular 2002/01 entitled "Foreign Exchange (FOREX) Risk Management". Further, entities must keep in mind their responsibilities under the FMA and CAC Acts.

Roles and responsibilities

3.1 Finance's Guidelines include best practice internal control procedures that are recommended to be included within an entity's internal control procedures. Entities are also informed by the Guidelines that they are required to:

- identify the risk arising from foreign currency expenditures (but not revenue);
- consider and understand the impact and sensitivity of their foreign exchange exposures;
- report exposures and transactions to Finance;
- select the best value for money alternative when negotiating payment arrangements for contracts or supply agreements; and
- maintain sufficient documentation to provide evidence that foreign exchange risk has been managed in accordance with the Finance Guidelines and to support an effective audit trail.

3.2 Effective management of foreign exchange risk by entities is also an important part of an annual budget reporting process to the Government. As part of the report to the Government, Finance is required to advise on foreign exchange gains and losses by GGS entities; provide an estimate of budget funding adjustments; and review entities' foreign exchange risk management practices.

Reporting to Government

Finance Circular 2002/01:
Paragraph 7: Finance will annually collect data detailing forex exposures, losses and gains by GGS entities for required presentation to the Government.

3.3 The Government took the decision to 'self-insure' its foreign exchange risks on the basis of advice that the size of the Commonwealth was expected to allow the risks to be spread across a large array of assets, liabilities, revenues and expenses, whose values were considered to move in counter-balancing directions in response to currency movements.[44] Finance advised ANAO, in July 2004, that the purpose of reporting exposures is to enable the Government to be briefed on the Commonwealth's aggregate exposure to foreign exchange risk under the Policy, and for emerging issues to be examined and reported to the Government, if necessary.

3.4 In that context, complete, accurate and timely identification and reporting of Commonwealth foreign exchange exposures is an important element in effective foreign exchange risk management from a whole of Government perspective. As Finance's Guidelines note:

> …Identification, measurement and timely reporting provide the Government with information on its aggregate foreign exchange exposures and can alert the Government to emerging issues.[45]

3.5 Under Finance's Guidelines, each entity is responsible for identifying all direct foreign currency exposures, including expected exposures, being ones that are contracted or reasonably expected to occur in the future. All exposures are to be reported to Finance biannually as part of the Budget and Additional Estimates process.[46] Finance is then responsible for advising the Government during the annual Budget process of GGS entities' foreign exchange losses and gains, foreign exchange exposures and estimated funding adjustments.

3.6 There have now been Budget processes for two financial years since the introduction of the Revised Policy. Finance has produced two reports for Government, in March 2003 and March 2004.

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44 Media release 20/2002, op. cit.

45 Finance's Guidelines, op. cit., p. 3.

46 The specific reporting requirements for a given Budget process have been advised to entities via Estimates Memoranda. These Memoranda have sought estimated foreign exchange exposures for departmental and administered expenditures and revenues, which is consistent with Finance's Guidelines, paragraph 3.1.2.

- In the first report (March 2003), Finance advised the Government that foreign exchange gains totalling $241.6 million were expected to be made by DFAT, Austrade, Defence and the Australia-Japan Foundation (AJF)[47] in 2002–03. However, Finance did not report any information regarding the estimated exposures for 2003–04, although this information was required under the Revised Policy and available to Finance at the time the first report was compiled. Those estimated exposures totalled $2.39 billion, based on reporting by these four entities and the Australian Tourist Commission (ATC).
- In the second report (March 2004), Finance advised that five entities were projecting foreign exchange gains for 2003–04 totalling $377.4 million, being DFAT, Austrade, AJF, Defence and ATC.[48] There was a significant increase in the number of entities reporting foreign exchange risk exposures to Finance compared to the March 2003 report. Finance received reports from 19 entities, 14 of which had not previously reported.[49] In this context, Finance reported to the Government that 12 entities had estimated expenditure exposures[50] totalling $2.39 billion in 2003–04 and $3.15 billion for 2004–05.

3.7 The March 2003 report was the first time aggregate information relating to Commonwealth entities' foreign exchange risk was provided to Government. This represented an improvement in the information available to assist in the risk management of those exposures on a whole of Government basis. The March 2004 report was an improvement on the first report, as it included data from a greater number of entities. However, ANAO considers that there is scope for the reporting process set out in the Guidelines to be clarified and enhanced, so as to improve the reliability, comparability and completeness of the reporting of foreign exchange exposures to Government.

Number of entities reporting to Finance

3.8 In 2002–03, there were 171 GGS entities. In preparing the March 2003 report, Finance obtained reports detailing foreign exchange exposures from six GGS entities (4 per cent). Finance's March 2003 report to the Government

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47 For 2002–03 the estimated total comprised foreign exchange gains as follows: DFAT ($5 million), Austrade ($4.2 million), Defence ($232.3 million) and AJF ($0.1 million).

48 For 2003–04 the estimated total comprised foreign exchange gains as follows: DFAT ($19.3 million), Austrade ($9.3 million), Defence ($345.1 million), AJF ($0.1 million) and ATC ($3.6 million).

49 Seven entities reported nil estimated foreign exchange exposures for 2004–05.

50 These are exposures relating to expected expenditure over the relevant financial years excluding any expected revenue exposures. Expected revenue exposures for 2003–04 and 2004–05 were $10.77 million and $10.71 million respectively.

reported the exposures of four of those entities.[51] Similarly, the March 2004 report included data only on the five agencies with gains that were expected to be subject to budget adjustment.

3.9 ANAO recognises that many GGS entities may not have foreign exchange exposures. However, to provide assurance of the comprehensiveness of its reporting to Government, there is merit in Finance obtaining data from all entities that have gains, losses and/or exposures. In this context, ANAO found that Finance has also not obtained data from a number of GGS entities that are known to have foreign exchange risk exposures, some of which are significant, as follows:

- As part of its debt management activities, the Australian Office of Financial Management (AOFM) is exposed to foreign exchange risk due to contractual obligations in relation to cross-currency swaps, forward foreign exchange contracts and foreign currency loans.[52] As at 30 June 2003, the AOFM had foreign currency liabilities of $6.17 billion and foreign currency assets of $699 million. In June 2004, Treasury advised ANAO as follows:

  > With the termination of the AOFM's cross currency swaps completed, all foreign currency derivative exposure has now been eliminated from the AOFM's portfolio. At 31 May 2004, the AOFM's remaining exposure consisted of foreign currency denominated Commonwealth Government Securities amounting to AUD$127 million. We further note that AOFM is an FMA agency which discloses details of all foreign currency exposures in an audited Annual Report.

- Three CAC Act entities[53] are, by virtue of their enabling legislation, unable to be directed to comply with the Revised Policy. Of these entities, the ABC is known to have foreign exchange exposures related to foreign currency loans and purchases. The ABC enters into forward foreign exchange contracts, cross-currency swaps and currency options to manage its foreign exchange exposures and reported a net foreign exchange loss of $740 000 in 2002–03.[54]

- In February 2004, AusAID had yet to submit a report to Finance on its foreign exchange exposures, gains and losses for 2002–03 and 2003–04

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51 The report excluded exposures reported by the Australian Tourist Commission and the Department of Veterans' Affairs. Neither had exceeded the minimum thresholds for Budget adjustment, but both had provided estimates of their foreign exchange exposures and a summary of their foreign exchange risk management practices.

52 *Australian Office of Financial Management Annual Report 2002–03*, p. 107.

53 These entities are the Australian Broadcasting Corporation, The Australian National University and the National Registration Authority for Agricultural and Veterinary Chemicals.

54 *Australian Broadcasting Corporation Annual Report 2002–03*, pp. 133, 139, 158 and 159.

as its consultations with Finance on its specific reporting requirements had not yielded a formal response. AusAID advised ANAO that it had provided a report to Finance, on 9 August 2004, on its administered and departmental foreign exchange exposures for 2004–05.

3.10 With the exception of AusAID, the above-mentioned entities are not required to comply with the Revised Policy. Nevertheless, they remain part of the GGS. Finance's Guidelines state that it will advise Government on foreign exchange exposures, gains and losses by GGS entities. ANAO considers that there is merit in Finance providing comprehensive reporting to Government on aggregate exposures in the GGS, including those entities that are not required to comply with Finance's Guidelines. Such enhanced reporting would have regard to the genesis of the Revised Policy in advice from the Task Force[55] that, at a whole of Government level, the Commonwealth's net exposures did not warrant exposure management by individual entities.

3.11 In this context, Finance advised ANAO in July 2004 that:

> Finance notes that it has undertaken to improve the reporting of foreign exchange exposures to Government. In the future, all GGS entities will be required to report on foreign exchange exposures, gains and losses twice a year. This is an enhancement of reporting requirements under the Government's foreign exchange risk management policy. Finance will provide an expanded report to Government that includes the following:
>
> - the level of foreign exchange exposures;
> - whether any agency's foreign exchange exposures have material implications for their financial health;
> - whether there are any unusual movements in the aggregate data, and the reasons for those movements;
> - whether the foreign exchange policy should be adjusted; and
> - proposed supplementation/return-to-budget arrangements for entities' foreign exchange losses or gains.

Estimation processes

3.12 The methodologies used by reporting entities to estimate their respective foreign exchange exposures, gains and losses vary significantly. In this respect, the information obtained by Finance to provide reports to Government may not be comparable and reliable. The estimating methodologies used by the four entities examined in the audit for the financial years 2002–03 and 2003–04 are set out in Table 3.1.

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55 Refer paragraph 1.7 of this report.

Table 3.1

Reporting entities' methodologies for estimating foreign exchange exposures, gains and losses – financial years 2002–03 and 2003–04

Agency	Estimating exposures for following financial year	Estimating gains/losses for current financial year
Austrade	**Departmental** (Value of actual transactions until 31 January of current year + Estimated value of transactions in remaining current year based on historical trends) adjusted for any abnormal expenses in current year and expected funding plans or changes for following year.	As for exposures but without any adjustments.
DFAT	**Administered** International organisation payments are generally of a fixed amount and readily ascertained with reasonable certainty. **Overseas Property Office** OPO contract payments usually identified from contract payment schedules and adjusted for project progress or variations. **Departmental** Expenditure estimate based on averages derived from historical data on expenditure and adjusted for material change in current year expenditure.	No estimate is requested by Finance. No estimate is requested by Finance. Actual gains and losses from transactions to 31 January in current year + Estimate of gains/losses for remaining period in current year based on percentage of planned future spending derived from historical trends (to identify expected currencies and amounts).
Defence	**Departmental** A 'survey' of the various groups in Defence is conducted in January of the current year. Each group is asked to provide details of the amount and nature of its exposures using the Budget exchange rates, set by Treasury, to assist the groups estimate exposures in AUD equivalent terms.	Actual foreign exchange gains and losses to 31 January are extrapolated to a full financial year estimate of gains and losses based on expected currency mix and end of year expenditure projections obtained from the internal survey.
AusAID	**Administered** No estimate provided by AusAID as its reporting requirements have not been finalised with Finance. **Departmental** As for administered.	No estimate is requested by Finance. However, AusAID calculates its standard settlement variances from bank statements and original transaction details in its FMIS so that an accurate appropriation spend is recorded.

Source: ANAO analysis.

3.13 In this context, 2002–03 represented the first full year of reporting foreign exchange exposures, gains and losses in the current manner. Finance advised ANAO in July 2004 that methodologies are being revised and improved on an ongoing basis.

3.14 In that regard, it is notable that the entity with the largest foreign exchange exposures, Defence, has adopted the least reliable exposure estimation methodology. ANAO found that Defence does not have financial systems in place that enable it to estimate its exposures. Instead, the Department uses a survey approach. In addition, Defence does not reconcile its survey-based data to financial forecasts for capital procurement projects in order to obtain assurance that all current approved projects with a recognisable foreign exchange exposure have been included, and that the amounts are reasonable. Defence's response to these findings was as follows:

> Defence does not agree with this assessment. Defence considers that the survey technology does obtain inherently reliable data. Finance uses the same technique to collect Commonwealth wide exposure estimates. Surveys are acceptable methodology in gathering audit evidence. It is difficult to understand the assessment, particularly when no material errors were found by Audit. In an organisation of the size of Defence, an individual manager who has responsibility to gather and sign off on survey returns needs to have the internal flexibility to tailor exposure gathering strategies to the specific nature of the organisation and business. Use of financial systems would by and large simply automate the survey methodology.

3.15 Nevertheless, Defence advised ANAO that a number of financial and accounting system developments were under way, to provide the Department with a capability to estimate and report foreign exchange exposures, gains and losses. In terms of Defence's approach, Finance advised ANAO in July 2004 as follows:

> The impending review of Defence's accrual system will encompass discussions and a review of the methodology used by Defence. Finance understands that Defence will be amending its financial management systems and expects to have a more reliable estimation methodology in the future.

3.16 ANAO also found that the exposure data obtained by Finance is focussed on the current and following financial years. The current approach fails to capture foreign currency exposures that extend over a number of years. For example, Defence has a number of such contracts in place as part of its multi-billion dollar program of capital acquisitions, involving significant foreign exchange exposures over many years from the date of contract. Only a small part of that total exposure is reported each year to Government. This has had the effect of limiting the usefulness of the information reported to Government in terms of overall foreign exchange risk management.

Recommendation No.4

3.17 ANAO *recommends* that Finance enhance the reporting of aggregate foreign exchange exposures, gains and losses to Government by:

a) obtaining and reporting financial data in relation to all General Government Sector entities that have exposures, gains and losses;

b) where cost effective, developing a consistent estimation methodology in consultation with relevant entities; and

c) reporting foreign currency exposures that extend over more than one year.

Agency responses

3.18 Finance, DFAT, Defence and Austrade agreed.

3.19 Some respondents also made comments on the recommendation, as follows:

- Finance advised, in relation to 4(a), that it will obtain financial data in relation to all General Government Sector entities and report to Government on aggregate foreign exchange exposures, gains, and losses.
- DFAT advised the reporting of foreign currency exposures that extend over more than one year should only be undertaken where it is cost effective.
- Austrade advised it will work with Finance to ensure that Austrade meets enhanced reporting requirements once they are introduced.

Entity risk management practices

Finance's Guidelines:

Paragraph 3.3.1: Finance is responsible for advising the Government in the annual Budget process of foreign exchange losses and gains by general government sector entities during the previous year, providing an estimate of funding adjustments and reviewing their foreign exchange risk management practices.

3.20 As part of the annual Budget reporting process, Finance is required to undertake a review of entity risk management practices. As a review activity, and not an audit, this process can be expected to provide assurance that documented procedures have been developed and promulgated, not that they are necessarily being implemented. In this context, Finance's Guidelines require entity Chief Financial Officers (CFOs) to certify that proper risk management practices, as set out in Finance's Guidelines, are being followed.

3.21 All entities are required to implement foreign exchange risk management practices that are consistent with Finance's Guidelines. However, Finance has yet to review the status of foreign exchange risk management practices in <u>all</u> entities subject to the Revised Policy that have foreign exchange risk exposures.

3.22 The first report to Government, provided in March 2003 as part of the 2003–04 Budget process, commented on risk management practices in the four agencies participating in the budget adjustment arrangements. Finance advised Government that DFAT, Austrade, AJF and Defence had risk management processes/plans in place and that no external hedging had been undertaken. No review of documented risk management practices in other GGS entities was evident.

3.23 The second report to Government, provided in March 2004 as part of the 2004–05 Budget process, commented on risk management practices in the five agencies expected to return funds as part of the budget adjustment arrangements.[56] Finance stated that the five agencies' foreign exchange risk management processes were in accordance with Finance's Guidelines.[57] No review of documented risk management practices in other GGS entities was evident.

3.24 ANAO found that, in a number of respects, the annual reports provided to the Government by Finance have not been as informative as they should be for accountability purposes. They have not accurately reflected the level of compliance by entities with the Revised Policy, Finance Circular 2002/01 and Finance's Guidelines. In terms of the entities audited, ANAO found that:

- Finance had insufficient information to assess DFAT's and AusAID's risk management practices, as follows:
  - DFAT's Finance Management Manual is comprehensive in addressing management of foreign exchange risks under the Revised Policy. However, DFAT's summaries of risk management procedures, as provided to Finance, do not mention the Manual and its associated documented procedures. Indeed, the summaries provided to Finance summarise DFAT's

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56 In addition to the four entities that automatically participate in the budget adjustment arrangements, ATC was expected to exceed the one per cent cash expenditure threshold for foreign exchange gains in 2003–04.

57 This statement was made although the Defence CFO had not certified, as required, that proper risk management practices, as set out in the Guidelines, were being followed. Instead he advised, in a letter dated 20 February 2004, that Defence's 'approach' to foreign exchange reporting and risk management was in accordance with Government principles and guidelines released by Finance. He urgently sought review by, and agreement with, Finance on an estimates methodology to overcome difficulties experienced at each estimates update.

foreign exchange exposures rather than address foreign exchange risk management procedures and practices. DFAT has advised ANAO that it has now provided Finance with the Manual chapter relating to foreign exchange.

  – AusAID did not report to Finance on its exposures and risk management practices, due to ongoing discussions between the two agencies concerning the identification of exposures and timing of reporting. These discussions led to AusAID reporting its exposures for 2004–05 to Finance in August 2004.

- Important procedural documentation has not been updated and/or finalised in Austrade, AusAID and Defence, as follows:
  – As at March 2004, Austrade's 'Treasury Policy' contained only a brief statement on currency risk. It did not mention the Revised Policy, Finance's Guidelines or the prohibition on external hedging. ANAO found no evidence of the 'procedures setting out management practices for managing foreign exchange risk' in the Treasury Policy, as described to Finance in Austrade's reports. In June 2004, Austrade advised ANAO that a new 'Treasury Management Policy' had been approved by the Board and now covers the Revised Policy.
  – Since the introduction of the Revised Policy from 1 July 2002, AusAID has been developing risk management practices and amending standard contract documentation. A staff circular on the Revised Policy was issued in May 2004. A circular on contract issues arising from the Revised Policy is still subject to final approval.
  – The Defence Foreign Exchange Risk Management Plan (DFRP), which was intended to allow Defence to fully accord with the Revised Policy and Finance's Guidelines, was to be implemented in its entirety before the preparation of the 2004–05 Budget. By March 2004, the DFRP was still incomplete. Some steps have been taken: for example, Defence amended the Procurement Policy Manual and Australian Defence Contracting Handbooks in February 2004. It proposed to amend its Treasury and Banking Manual by September 2004 to incorporate the new Cash Management Module capability. It also proposed to reflect the Revised Policy in revised Chief Executive's Instructions (CEIs) to be issued in June 2004, but these changes have not yet occurred. Defence advised in September 2004 that changes to the CEIs have been delayed to

allow these instructions to be redesigned as legislative instruments as part of the whole-of-government review.

In addition, a formal agreement between Defence and Finance on foreign exchange risk management was not finalised until March 2004, nearly twenty-two months after the Revised Policy was announced.[58] On this point, Finance commented to ANAO in July 2004 that the agreement was entered into on a voluntary basis and is an enhancement as it goes over and above what is required under the Guidelines.

- The statement that hedging without an exemption has not been undertaken does not reflect the actual situation in some entities. As noted in Chapter 2, some entities without an appropriate exemption have continued to engage in hedging activities through derivative financial instruments.

3.25 In relation to the above issues, Finance advised ANAO in September 2004 as follows:

> Finance notes that it was not the intent of the Revised Policy that Finance review all GGS entities' risk management practices. The intent of the Revised Policy was that where an entity meets the thresholds for Budget adjustments some review of their foreign exchange risk management would be made and advised to the Government, to assist the Government to take a decision on the Budget adjustments proposed.
>
> Finance conducts this review by considering the certification that Chief Finance Officers provide to Finance on compliance with the policy, considering the reports provided, taking into account its understanding of entity practices and other materials that are available (such as Memoranda of Understanding).
>
> Where Finance considers that further investigation or advice is required from the entity, it will undertake further work to form a view about the risk management practices of those entities.
>
> Finance will be enhancing the certification required of Chief Finance Officers to include a positive attestation regarding whether the entity has hedged as described in the Revised Policy, an explanation of how the entity has promulgated the Revised Policy internally, and to require a brief description of the systems in place to monitor and record foreign exchange exposures, gains and losses. The Guidelines will be revised to more clearly articulate the intent of the policy and to reflect the enhanced certification.

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[58] The agreement does not settle matters. It provides for a subordinate agreement to be made on the methodology and calculation of adjustments under the budget adjustment arrangements and for clarification (by way of a separate letter) of the requirement to manage as foreign currency exposures contracts that offer pricing in AUD but are impacted directly by exchange rate movements.

Budget adjustments

Finance Circular 2002/01:

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

- $A5 million; or
- more than one per cent of the entity's departmental appropriations (in the case of an FMA agency) or total cash expenditure (in the case of a GGS CAC body).

3.26 Budget funding adjustments refer to Government decisions to either decrease or increase an entity's funding in response to movements in exchange rates. Budget adjustment arrangements involve selected entities' departmental appropriations being adjusted for movements in exchange rates between the time the Commonwealth Budget was prepared using Budget Exchange Rates (BERs)[59] and the settlement of individual transactions. In effect, these arrangements transfer foreign exchange risk for these entities to the overall Commonwealth Budget.

3.27 Budget adjustment arrangements, commonly referred to as budget supplementation, were examined by ANAO in the 2000 audit report. This report noted that budget supplementation does not obviate the need to assess and manage foreign exchange risk under legislative requirements regarding the proper use of resources and procurement and expenditure processes. However, budget supplementation substantially reduces the incentive for recipient agencies to identify and manage their foreign currency exposures, by immunising each recipient entity from foreign exchange risk.

3.28 In this context, the 2000 audit report recommended that Finance, in consultation with relevant agencies, re-examine the budget supplementation arrangements for foreign exchange risk, to encourage more effective management of foreign exchange risk on a whole of Government as well as an agency basis. This recommendation[60] was considered by the Task Force formed in June 2000. The Task Force recommended the continuation of the budget adjustment arrangements.

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59 As part of the Budget process each year, Treasury issues a set of exchange rates for major trading currencies. For the purposes of the foreign exchange policy, those rates are known as BERs for those currencies. For other currencies, an entity may obtain indicative exchange rates from the Reserve Bank or the entity's financial institution, which, subject to endorsement by Finance, become the BERs for those currencies for that entity.

60 Recommendation No.5 of the 2000 audit report.

3.29 Under the auspices of the Revised Policy, budget adjustment arrangements have been continued for four entities: Defence, DFAT, Austrade and AJF. Other entities may seek access to the budget adjustment arrangements if they satisfy criteria specified in Finance Circular 2002/01.

Reconciliation of gains and losses

3.30 Each year, as part of the Additional Estimates process, entities are required to reconcile the total cost of actual foreign currency transactions in the previous financial year with the total budgeted cost of these transactions. By comparing the AUD amounts of a transaction, as converted at both the settlement rate and BER, an entity can calculate the amount of the foreign exchange gain or loss on that particular transaction. Entities participating in the adjustment arrangements should return aggregate net gains to the Budget or may seek supplementation for aggregate net losses, as appropriate.

3.31 Finance received reports from five entities with foreign exchange gains for the 2002–03 financial year. Of these, four (Austrade, DFAT, Defence and AJF) made returns to the Budget.[61] No entities reported foreign exchange losses for the year or sought supplementation.

3.32 ANAO examined the calculation by entities of the amounts reported to Finance for the purpose of budget adjustments in the three audited entities participating in the budget adjustment arrangements. ANAO found that, in each case, the amount returned by the entity understated the amount of actual gains made in 2002–03 (see Table 3.2).

3.33 In this context, Finance advised ANAO in July 2004 that the amount returned was at this point in time an estimate, and that a final reconciliation is made on the basis of actual gains or losses after the end of the financial year. Finance further advised ANAO in September 2004 that it will provide advice on the final gain returned by Austrade and DFAT for 2002–03 as soon as possible.

3.34 As a result of a recent request from Finance, Defence has provided a formal sign-off of the 2002–03 adjustment. A formal sign-off had not been required previously.

61 ATC reported foreign exchange gains, but those gains did not exceed the minimum exposure thresholds. As such, the gains were not required to be returned to the Budget.

Table 3.2

Reported gains for 2002–03 ($m)

Agency	Entity Gain Figure	ANAO Gain Recalculation	Variation
Austrade	4.978	4.995	0.017
DFAT	12.098	13.717	1.619
Defence	258.845	258.882	0.037
Totals	**275.921**	**277.594**	**1.673**

Source: ANAO analysis

3.35 Paragraph 3.2.10 of Finance's Guidelines states that 'where there is either supplementary funding or a return to the Budget, the actual foreign exchange rate will be deemed to be the rate at which the foreign exchange funds payment occurred.' However, the returns to the Budget for Austrade and DFAT were calculated using the exchange rate prevailing when the foreign exchange transaction was entered into each entity's Financial Management Information System (FMIS). Any gains or losses arising from a movement in the exchange rate between entering the transaction into the FMIS and actually settling the transaction were not taken into account when calculating the amounts to be returned to the Budget. In terms of their variations, Austrade and DFAT advised as follows:

- Austrade advised in June 2004 that it believed it had complied fully with the Government's requirements, as set out in its resource agreement with Finance as the Revised Policy did not apply to Austrade. As a result, the calculations did not require the comparison of settlement rate to BER and no variation was required to gains returned.
- In September 2004, DFAT advised ANAO there are two reasons why it has used the exchange rate applying when the transaction (or invoice) was entered into its FMIS rather than the exchange rate when the transaction was actually settled:
  - The first reason is that this approach is consistent with DFAT's longstanding resource agreement with Finance. On this particular point, Finance advised ANAO in July 2004 as follows:

    > Finance notes that the Finance/DFAT resource agreement was entered into in August 1993, some nine years prior to the commencement of the current policy on foreign exchange. Finance notes that where the resource agreement may be inconsistent with the current policy, that the current policy

takes precedence. Further, the *Guidelines for the Management of Foreign Exchange Risk* (paragraph 3.2.10) provide guidance on the exchange rate to be used for the calculation of foreign exchange gains or losses.

DFAT advised ANAO, in September 2004, that it only became aware of Finance's view that the Guidelines took precedence over the resource agreement when DFAT requested a copy of Finance's response to the ANAO on 12 August 2004 following the earlier receipt of the ANAO proposed audit report. DFAT advised that it has written to Finance in September 2004 seeking discussions on a new resource agreement, based on the established 'no win/no loss' principle, which DFAT regards as consistent with the Guidelines. DFAT considers the within year foreign exchange gain returned to the Budget for 2002–03 was calculated in accordance with the present resource agreement with Finance.

– Second, DFAT's overseas missions process foreign currency payments on behalf of other FMA Act agencies. If the Department calculated the loss or gain when the foreign currency payment actually settled, it would include losses and gains attributable to other agencies. In 2002–03, these payments totalled approximately $320 million, which is a significant proportion of foreign currency payments made by the Department. DFAT further advised that it has been analysing options to reconfigure its FMIS so that it can attribute losses and gains to other agencies and it envisages new arrangements will be implemented for the 2004–05 financial year.

3.36 The variation for Defence involved not calculating gains for transactions in minor currencies where a BER was not set by Treasury. That is, Defence did not obtain and use BERs for all currencies in which payments were made during the financial year. In effect, this has meant that Defence's overall foreign exchange gains for 2002–03 and, consequently, the return of gains to the Budget, were understated by $37 000.[62] Defence advised in September 2004 that it accepts the basis of the adjustment and will return the amount at the next opportunity.

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62 This amount was calculated by applying BERs used by DFAT for 2002–03 to currencies for which Defence had not obtained its own BERs.

Recommendation No.5

3.37 ANAO *recommends* that Finance liaise with each entity participating in the budget adjustment arrangements, to improve the rigour and consistency of budget adjustment calculations in respect of foreign exchange gains or losses.

Agency responses

3.38 Finance, DFAT, Defence and Austrade agreed.

3.39 Some respondents also made comments on the recommendation, as follows:

- Finance advised that it has commenced working with entities to clarify the position regarding the Revised Policy vis a vis the existing resource agreements.
- Austrade advised it will work with Finance and other impacted agencies to improve consistency in relation to budget adjustment calculations.

4. Implementation of Previous Audit Recommendations

This chapter follows up the implementation of recommendations made by ANAO in the 2000 audit report.

Background

4.1 As part of the current audit, the four agencies covered in the 2000 audit (Finance, Defence, DFAT and AusAID) were asked to outline action taken to implement agreed recommendations made in the 2000 audit report. Questionnaires were sent to each agency in October 2003. Replies were received from AusAID and DFAT in December 2003, Defence in February 2004, and Finance in March 2004.

4.2 To show progress in implementing recommendations from the 2000 audit report, Table 4.1 indicates, in respect of each recommendation, the agency's recent response and ANAO's assessment (including whether the recommendation has been superseded), and identifies the location within this current report of supporting analysis for ANAO's assessment.

Table 4.1

Progress on implementing recommendations from the 2000 audit report

Rec. No.	Summary of 2000 audit report recommendation	Agency response	ANAO Assessment	Ref paras in this report
1.	Finance should:			
	(a) in consultation with appropriate agencies and, as appropriate, the Government, formulate an overarching Commonwealth position statement on foreign exchange risk management to all agencies subject to the FMA Act; and	Revised Policy satisfies the recommendation.	■	1.7 – 1.10
	(b) ensure that agencies fully understand and take appropriate action under the FMA Regulations requiring a proper assessment of foreign exchange risk as part of their procurement processes.	Revised Policy satisfies the recommendation.	■	2.2 – 2.5

Key: ■ Implemented; ▣ Superseded by Revised Policy; ◘ Satisfactory progress; □ Not implemented; ⊡ Further progress required

Rec.	Summary of 2000 audit report recommendation	Agency response	ANAO Assessment	Ref paras
2.	Treasury, in consultation with Finance and other relevant agencies, should investigate the merits of centralising provision of strategic and operational advice to agencies on the cost-effective management of foreign exchange risk.	Implemented during development of Revised Policy.	■	2.42-2.43
3.	Agencies proposing to outsource some or all of their foreign currency spot transaction services as part of the agency banking arrangements, should manage the tender process so as to ensure that the outcome complies with Commonwealth policy and delivers value for money.	Practice complies with recommendation.	■	4.4 – 4.6
4.	To encourage a greater focus on exposure management by Commonwealth agencies, Finance, in consultation with Treasury, should consider the merits of using market based forward exchange rates to prepare the Commonwealth Budget and constituent agency budgets.	Revised Policy is not to use forward rates.	■	4.11
5.	Finance, in consultation with relevant agencies, should re-examine the budget supplementation arrangements for foreign exchange risk to encourage more effective management of foreign exchange risk on a whole of government as well as an agency basis.	Revised Policy satisfies the recommendation.	■	3.27 – 3.28
6.	Defence should address foreign exchange risk in capital procurement project budgeting by:			
	(a) using forward exchange rates with cash flow forecasts to develop market based estimates of project costs;		▣	4.12
	(b) including in project budget proposals considered advice on the level of acceptable foreign exchange risk and how to best manage that risk; and	New procedures are consistent with Revised Policy.	□	4.14 – 4.16
	(c) revising the budget delegations process to ensure prudent limits are placed on foreign exchange related variations for major projects.	Revised Policy supersedes (c).	◘	4.19 - 4.24

Key: ■ Implemented; ▣ Superseded by Revised Policy; ◘ Satisfactory progress; □ Not implemented; ⊡ Further progress required

Rec.	Summary of 2000 audit report recommendation	Agency response	ANAO Assessment	Ref paras
7.	Defence should provide decision makers with a rigorous estimate of the likely Australian dollar cost and encourage cost-effective management of risk exposures by using current, wholesale market forward exchange rates rather than retail spot exchange rates to undertake financial evaluations of future foreign currency cash flows proposed by tenderers.	New procedures are consistent with the Revised Policy.	▣	4.12
8.	Defence should include provisions in future contracts where appropriate that ensure the contractor bears the cost of any foreign exchange losses that result from contractor delays or significantly inaccurate forecasts, with any currency gains to be retained by the Commonwealth.	Defence assesses suppliers' financial viability.	⊡	4.25 – 4.26
9.	AusAID should develop a foreign exchange risk management strategy for the multilateral aid program that:	AusAID's policy of 2001 superseded by 2002 Revised Policy.		
	(a) identifies all material exposures and existing currency options in multilateral aid contribution agreements;		■	Table 3.1
	(b) analyses and quantifies cost savings that can be achieved from different approaches to managing foreign exchange risk, including currency options; and		■	4.27 – 4.30
	(c) includes a payment plan for each multilateral aid contribution agreement to take advantage of currency options and minimise the Australian dollar cost of meeting the Commonwealth's financial obligations.		■	4.27– 4.30
10.	AusAID should develop and document a considered and consistent policy on foreign exchange risk in the bilateral aid program that is informed by appropriate specialist advice.	AusAID's policy of 2001 superseded by 2002 Revised Policy.	▣	1.7 – 1.10

Key: ■ Implemented ◘ Satisfactory progress ⊡ Further progress required
▣ Superseded by Revised Policy ☐ Not implemented

Rec.	Summary of 2000 audit report recommendation	Agency response	ANAO Assessment	Ref paras
11.	AusAID, in consultation with relevant agencies, should upgrade its financial management of foreign currency payments in the bilateral aid program to ensure value for money by obtaining wholesale market exchange rates for its foreign currency transactions and conversions.	Procedures amended to use competitive rates.	■	4.5 – 4.6
12.	Where a contract requires the contractor to bear foreign exchange risk, AusAID procedures should require: (a) rigorous examination of all claims by contractors for foreign exchange losses; and (b) where payment for foreign exchange losses is proposed, sign off that payment may properly be made in accordance with Commonwealth policies on expenditure of public moneys.	Claims procedures have been expanded.	■	4.7 – 4.9
13	DFAT should develop a foreign exchange risk management strategy for administered contributions to international organisations that: (a) identifies all material exposures and existing currency options; (b) analyses and quantifies cost savings from different approaches to managing foreign exchange risk, including currency options; and (c) includes a payment plan for contributions to each international organisation to enable DFAT to cost-effectively administer Australia's payment obligations for an acceptable level of risk exposure.	DFAT identifies material exposures, monitors payments, but cannot hedge.	(a) ■ (b) ■ (c) ■	(a) Table 3.1 (b) 4.31 – 4.32 (c) 4.31 – 4.32

Key: ■ Implemented ▣ Superseded by Revised Policy ◘ Satisfactory progress ☐ Not implemented ⊡ Further progress required

Rec.	Summary of 2000 audit report recommendation	Agency response	ANAO Assessment	Ref paras
14	Finance should develop a considered foreign exchange risk management policy with explicit consideration given to: (a) revising project budgeting processes to develop market-based estimates of likely project costs by using forward exchange rates; and (b) the level of acceptable foreign exchange risk and how to manage this risk.	Revised Policy supersedes (a) and satisfies (b).	(a) ⧈ (b) ■	(a) 4.12 (b) 4.17-4.18
15	Where foreign exchange risks arise in future development projects, Finance should: (a) adopt a consistent approach to cost-effectively managing financial risks; (b) improve its financial administration practices to ensure that payments are made and received promptly to protect the Commonwealth's interests; and (c) appropriately account for the receipt and disbursement of Commonwealth financial resources.	Present practices accord with Revised Policy.	■	Table 3.1 and Appendix 1
16	Finance, in consultation with Treasury, should review governance arrangements for the issue of debt and like instruments on the Commonwealth public credit to ensure a consistent approach that promotes value for money and public accountability.	Implemented	■	Appendix 4

Key: ■ Implemented ⧈ Superseded by Revised Policy ◘ Satisfactory progress □ Not implemented ⊡ Further progress required

Foreign exchange transaction services

4.3 The 2000 audit report included recommendations relating to maximising value for money in foreign exchange transaction services provided by transactional bankers (Recommendation No. 3) and foreign currency conversions performed by contractors to AusAID as part of its invoicing procedures (Recommendation No. 11).

Transactional banking arrangements

4.4 The agencies concerned in this recommendation were AusAID, Defence and DFAT. In their subsequent decision to engage the Reserve Bank as transactional banker, these agencies had used the Bank as a benchmark in view of its role as the Government's banker and its spot rates, which were more favourable than those of commercial banks.

4.5 ANAO examined sample foreign exchange transactions by AusAID, Defence and DFAT, through the Reserve Bank, and by Austrade through Westpac, as its transactional banker. Using the relevant published Reserve Bank daily foreign exchange rates as a benchmark for comparison, ANAO's examination indicated that the settlement rates used were competitive and delivered value for money.

4.6 Particularly noteworthy was the approach taken by AusAID in like-for-like pricing of banking tenderers based on exchange rate margins. In addition to the fees for standard services, AusAID required tenderers to provide indicative point margins above a specific industry standard benchmark for foreign exchange transactions. The pricing table was based on the previous year's volume of foreign currency transactions and included 21 currencies. Having conducted a like-for-like assessment of tenders, AusAID was able to identify a cost saving of approximately $400 000 per annum based on foreign exchange margin variations between tenderers.

Contractor conversions

4.7 The basis of payment documentation for AusAID's minor contracts has been amended to include a conversion based on the exchange rate applicable on the actual date of the foreign exchange transaction. Standard project implementation contracts have also been amended to state that the contractor must make foreign exchange transactions at arm's length and at commercially competitive rates. Supporting documentation is to be retained and may be audited by AusAID.

4.8 Where the contractor is entitled to reimbursement for expenditure in a currency other than AUD, the contractor must invoice AusAID for the equivalent AUD amount as recorded by the contractor in its general ledger, converted at an exchange rate calculated in accordance with appropriate accounting standards.

4.9 During the current audit, AusAID commented that it was not possible for it to enforce commercially the use of Reserve Bank wholesale market rates, and that its approach was consistent with practice by similar agencies around the world. AusAID was confident that the contract provisions requiring the contractor to maintain appropriate records verifying the exchange rates used for the reimbursement were sufficient, and that it would actively audit selected contractors for compliance.[63]

Budgeting

4.10 Exchange rate risk in Commonwealth budgeting processes was addressed in four recommendations. These were Recommendation No. 4 (relating to the annual Commonwealth Budget) and Recommendation Nos. 6, 7 and 14 (all relating to budgeting for capital projects).

4.11 ANAO found that Recommendation No.4 was implemented as the Task Force gave consideration to the merits of using market-based forward exchange rates. In this respect, the Government decided to retain the existing approach of using an average spot rate. This requirement is reflected in Finance's Guidelines, which state that, where pricing is available in alternative currencies, entities must select the pricing alternative that achieves the best value AUD outcome at that time, using current, rather than forecast, foreign exchange rates for all pricing analysis, including those over multiple years.[64]

4.12 ANAO further found that the Revised Policy superseded Recommendation Nos. 6(a), 7 and 14(a), given the decision to retain the use of spot rates for all evaluations.

Project risk assessments

4.13 The 2000 audit report noted that exchange rates are volatile and it is unrealistic to assume on long-term contracts that there will not be significant foreign exchange gains or losses.[65] The 2000 audit found that project budgets prepared in relation to overseas property developments and Defence capital equipment procurements did not take into account the possible effect of exchange rate changes on the project cost.

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63 AusAID has advised that no contractors have yet been audited under the new contract provisions.

64 Finance's Guidelines, op. cit., paragraph 3.2.6, p. 10.

65 ANAO Audit Report No.45 1999–2000, op. cit., p. 69.

4.14 Recommendations 6(b) and 14(b) recommended that relevant agencies (now Defence and DFAT[66]) include in capital project budget proposals advice on the acceptable level of foreign exchange risk and how best to manage that risk. Such information can be valuable for decision makers given that capital projects can involve large, long-term foreign exchange exposures. Decision-makers should be aware of the possible impact that foreign exchange risk could have on the eventual project cost.

4.15 In terms of the implementation of Recommendation No. 6(b), ANAO considers that the Revised Policy requires agencies to identify and manage their foreign exchange risks, albeit they are not permitted to hedge unless they have obtained an exemption. In this context, ANAO considers the Revised Policy does not supersede the Recommendation, and allows Defence to include in project budget proposals considered advice on acceptable levels of foreign exchange risk and address ways of managing that risk within the context of each project and in accordance with the overarching Revised Policy.

4.16 Defence advised in June 2004 as follows:

> Defence agreed the original recommendation *with qualifications*, those being generally that new processes would be adopted to meet any new requirements arising from new Government directions on forex management. The new Government directions are the Revised Government Foreign Exchange Risk Management Policy and the measures required to ensure compliance are set out in the Agreement with Finance. The Agreement complies with Finance's Guidelines, taking into account Defence's specific circumstances.
>
> Defence's responsibilities in identifying, assessing and managing forex risks are outlined in paragraphs 8 to 17 of the Agreement. Defence considers that it complies with those requirements as agreed. Paragraph 8 of the Agreement deals with identifying foreign exchange risks. Paragraph 13 of the Agreement permits that value for money assessments will be made in "currency-neutral" terms. It is considered that compliance with the Agreement would constitute full implementation of the revised requirements pertaining to identifying the foreign exchange risk.

4.17 In terms of the implementation of Recommendation No. 14(b), DFAT advised that OPO applies the Commonwealth Procurement Guidelines to contract tendering and requires a value for money analysis, which includes foreign exchange risks as a factor for consideration.

4.18 DFAT's position in relation to foreign exchange risk management and management of the overseas property portfolio is that, as OPO operates in an environment where there is often little option with regard to currency choice

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[66] Recommendation No.14 (and also No.15) in the 2000 audit report was originally directed at Finance. Responsibility for the Commonwealth's overseas property portfolio was transferred from Finance to DFAT in November 2001.

and supplier choice in most overseas locations, there is little scope to manage changes in cost due to foreign exchange variation in most contracts. However, DFAT advised that all cost proposals over $AUD 500 000 are reviewed by OPO's international construction experts as part of OPO's outsourcing alliance. Where possible, most of a project's budget is paid in AUD and most construction materials are sourced from Australia, thereby reducing the risk of forex exposure.

Project budget increases

4.19 Recommendation No. 6(c) sought to address ANAO's finding that Defence was able to approve significant increases to its own project budgets without recourse to the original approving authority. This was of particular concern in an environment where the original approving authority was not being provided with advice on the extent to which estimated project costs are subject to exchange rate risk.

4.20 For reasons other than that audit recommendation, Defence has subsequently changed the process for updating project budgets to adjust for price and exchange rate movements. Project budgets are now adjusted through a periodic Global Update process that applies Finance's advised price and exchange rate parameters to Defence's project plans. Any resulting budget adjustments are approved by the 'Head - Materiel Finance' within Defence.

4.21 Under these arrangements, projects are still entitled to seek, via written submission, additional budget adjustments where a 'loss' against actuals can be demonstrated.[67] Any gains acquired by a project under this process must be recognised and offset before any loss adjustments are considered.

4.22 The system of global adjustments was introduced on the basis it would be more efficient than the previous one based on individual submissions. However, this process does not provide a feedback loop to Ministerial decision makers, to seek their approval of significant changes to the original approved project budget.

4.23 Defence advised in June 2004 as follows:

> Defence agreed the original recommendation *with qualifications* … Paragraph 13 of the Agreement [with Finance] allows source selection and contracting decisions being made on an AUD-equivalent basis (ie in currency neutral terms). Consequently, cost variations of projects including any necessary forex funding adjustments are reviewed under the normal funding approval process

[67] Relevant losses are those not covered by the original project budget as adjusted through the Global Update to maintain the project budget's purchasing power. Losses can occur in circumstances not envisaged in the original contracts. For example, the cost of an Australian sub-contractor to an overseas principal contractor may change due to exchange rate and other price movements and these are usually not recognised in the original contract negotiations or final contract conditions.

and there is no necessary requirement to impose "prudent" limits on foreign exchange related variations for major projects.

4.24 ANAO considers there has been satisfactory progress on introducing controls over increases in project budgets due to foreign currency movements.

Delay costs

4.25 Defence's contract templates for complex and strategic procurements now contain provisions aimed at ensuring that the contractor meets cost and schedule requirements. Most major contracts are to be on a firm or variable price basis that cannot be varied unless it is in accordance with clauses allowing for variations in exchange rates or the cost of labour and materials, or where Defence agrees to a contract change proposal. The contracts also aim to ensure the contractor meets the contracted schedule by means of the following provisions:

- liquidated damages provisions that are triggered where the contractor fails to meet a milestone;
- stop payment milestones, which entitle the Commonwealth to withhold all future payments where particular milestones are not achieved;
- a performance security and/or deed of substitution and indemnity; and
- termination rights for failure to progress at a rate to facilitate the due and proper completion of the contract within the timeframes specified in the contract.

4.26 Although Defence has made progress in implementing Recommendation No. 8, in its advice to ANAO, Defence accepted that its current position could be strengthened. Defence advised ANAO as follows:

> To incorporate requirements placed on Defence following the issue of Finance's Guidelines, amendments are being made to guidance on the Australian Defence Contracting (ASDEFCON) suite of contracting templates. These amendments will minimise the risk to Defence of contractor delay impacting adversely on the amount to be paid to the contractor under exchange rate variation claims. Relevant sections of the Defence Procurement Policy Manual have also been amended to take account of the new requirements relating to the Guidelines.

Multilateral aid and contributions to international organisations

4.27 Currency options are agreements that give the purchaser the right, but not the obligation, to buy or sell foreign currency at a certain level on or before an agreed date. A form of currency option arises in the multilateral aid program where Australia's contribution obligations to international organisations permit AusAID to pay in a range of currencies. Currency options have also existed in some of DFAT's contribution obligations to international organisations.

4.28 Recommendation Nos. 9 and 13 were that AusAID and DFAT develop appropriate foreign exchange risk management strategies for their payments to international organisations. The recommendations included the suggestion that AusAID and DFAT analyse and quantify cost savings that could be achieved from different approaches to managing foreign exchange risk, including savings from exercising currency options. In particular, the 2000 audit report noted that, by choosing to specify commitments in a predetermined foreign currency amount and entering into forward cover for the exposure generated, the lowest cost outcome could be achieved for the Commonwealth without increasing its foreign currency exposure.[68]

4.29 AusAID advised in June 2004 as follows:

> Following on from AusAID's detailed discussions with Finance in October 2002, clause 3.2.6[69] was amended to take into account multiple year payments stating that entities must use current, rather than forecast foreign exchange rates for all pricing analysis. Finance at no time during these detailed discussions suggested that these multilateral payments should be forwarded to the Finance Minister for specific exemption. The only comment made at the time in relation to Ministerial approval was "*in regard to multilateral commitments: writing in AUD may be the option that is preferred at the Ministerial level. It is as always, open to Ministers to seek to have different treatment in respect of a programme*". Indeed, the Task Force recommended that hedging be restricted to rare cases only. AusAID's regular multilateral payments constitute a normal part of aid delivery and are not considered rare.

4.30 In March 2003, a multi-year international aid donor contribution for the Commonwealth was assessed by AusAID in accordance with paragraph 3.2.6 of Finance's Guidelines. The decision was to have the donor contribution denominated in USD rather than AUD as it provided the best value AUD at that time.

4.31 In relation to Recommendation No. 13, DFAT advised that its previous practice of preferring to make payments for contributions to international organisations in AUD was replaced by new internal rules following the release of Finance's Guidelines in November 2002. The new rules provide that where

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68 ANAO Audit Report No.45 1999–2000, op. cit., p. 99.

69 Finance's Guidelines, op. cit. paragraph 3.2.6 provides that where pricing is available in alternative currencies, entities must select the pricing alternative that achieves the best value AUD outcome at that time, using current rather than forecast foreign exchange rates for all pricing analysis, including those over multiple years.

pricing is available in alternative currencies, approvers must consider, in the value for money procurement analysis, which currency achieves the best AUD outcome. Where a value for money analysis is not affected by alternative pricing options, the approver must select the currency which gives the best AUD outcome.

4.32 ANAO considers that Recommendation Nos. 9 and 13 have been implemented.

Canberra ACT	Oliver Winder
14 October 2004	Acting Auditor-General

Appendices

Appendix 1: Sources of audited entities' foreign exchange exposures

Austrade

1. Austrade's foreign exchange exposures arise from departmental expenditure. Administered activities are undertaken solely in AUD. As at 30 June 2003, Austrade operated in 93 locations in 56 countries with foreign exchange exposure at each of these overseas posts as operational expenditure for each post is transacted in the local currency.

2. In addition, telecommunication services to Austrade's overseas posts are covered by a series of contracts. Approximately 60 per cent of Austrade's expenditure on these contracts is transacted in a foreign currency, primarily USD.[70]

DFAT

3. As at 30 June 2003, DFAT managed 84 overseas posts, as well as offices in each State and Territory of Australia.[71] Foreign exchange exposure arises from operations in those posts as DFAT buys, sells and holds over 60 foreign currencies to fund its day-to-day overseas operations.

4. In addition, DFAT makes payments to international organisations and peacekeeping operations to meet Australia's obligations.[72] All foreign exchange exposures relating to payments of this type arise from administered expenditure.

5. DFAT also reports estimates of foreign exchange exposure arising through the operations of the Overseas Property Office (OPO), which is part of DFAT. This exposure relates primarily to overseas construction projects. At the time of audit, OPO managed 13 projects with payments in foreign currencies.[73]

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[70] At the time of this audit, Austrade was negotiating a new telecommunications contract. Tenderers were requested to provide pricing in fixed Australian Dollars (AUD), effectively eliminating foreign exchange exposure from the new contract on signature.

[71] Department of Foreign Affairs and Trade Annual Report 2002–03, p13. DFAT advised in August 2004 that, as at 30 June 2004, it now managed 85 overseas posts.

[72] As a signatory to the Charter of the United Nations and a Member of the UN Organisation, Australia is obliged under international law to make financial contributions to the UN Budget. Article 17 of the UN Charter states that the 'expenses of the Organisation shall be borne by the Members as apportioned by the [UN] General Assembly'. The rate of financial contribution for UN peacekeeping operations and other international organisations is based on the same scale as for the regular UN budget.

[73] DFAT advised ANAO in February 2004 that, in addition to the 13 construction projects involving foreign exchange, OPO incurred some foreign exchange exposure from minor purchases (such as furniture and landscaping) relating to the projects.

6. OPO's operations are represented by DFAT in its outcomes and outputs statement as Outcome 4 and OPO records all receipts and payments through the Overseas Property Special Account. As DFAT receives no annual appropriations for this outcome, under the foreign exchange risk management policy DFAT is unable to include any foreign exchange gains or losses incurred by OPO in its estimates and reconciliations of foreign exchange gains and losses for the purposes of budget adjustments.[74]

Defence

7. Most foreign exchange exposure in Defence arises from acquisition of major military equipment and systems through the Defence Materiel Organisation. Some minor foreign exchange exposure also arises for Defence through the Defence Cooperation Program, which provides opportunities for interaction with, and defence assistance to, security forces in South East Asia and the South Pacific in support of Australia's defence relationships[75], and through Defence's foreign currency holdings.

AusAID

8. AusAID is exposed to foreign exchange risk because of its obligations under Australia's development cooperation policies and programs. Most of the exposure concerns AusAID contracts let for bilateral aid to assist nations in South East Asia and the Pacific. Exposure also arises from multi-lateral programs, in which AusAID pays Australia's aid contributions to the World Bank, Asian Development Bank and United Nations development agencies. The foreign exchange exposures arise primarily from AusAID's administered activities.

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[74] DFAT advised ANAO in February 2004 that, for the 2002–03 financial year, OPO incurred a net foreign exchange loss of $410 382.

[75] ANAO Audit Report No.32 2000–2001 *Defence Cooperation Program,* April 2001.

Appendix 2: Finance Circular 2002/01

FINANCE CIRCULAR No:2002/01

DEPARTMENT OF FINANCE AND ADMINISTRATION

To All Departments of State, Parliamentary Departments and Prescribed Agencies

Foreign Exchange (FOREX) Risk Management

Introduction

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

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

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

Key Points

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

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

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

3. For GGS entities whose Budget funding has in the past been adjusted for movements in forex exposures, these arrangements will continue to apply.

Budget funding adjustments[1] will also be applied for any GGS entity which has annual actual or expected net forex gains or losses of greater than:

- $A 5 million; or
- more than one per cent of the entity's departmental appropriations (in the case of an FMA agency) or total cash expenditure (in the case of a GGS CAC body).

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

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

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

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

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

Action Required

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

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

Contacts

If you have any queries in relation to this Circular, please contact ed.lekawski@finance.gov.au.

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

FOOTNOTES:

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

Appendix 3: Finance Circular 2004/11

Australian Government
Department of Finance and Administration

Finance Circular No. 2004/11

To all FMA Act agencies and CAC Act bodies within the General Government Sector

Unwinding hedges under the foreign exchange (forex) risk management policy

Purpose

This Finance Circular applies to all agencies subject to the requirements of the *Financial Management and Accountability Act 1997* (FMA Act) and those bodies under the *Commonwealth Authorities and Companies Act 1997* (CAC Act) within the General Government Sector (GGS)[1].

This Finance Circular advises entities of the process for unwinding forex hedging arrangements that are in place at the time entities become subject to the Australian Government's forex risk management policy.

Target Audience

This Finance Circular is relevant to Chief Finance Officers and other staff dealing with forex issues.

Background

1. From 1 July 2002 the Australian Government put into effect an overarching forex risk management framework that applies to forex exposures arising from entities.
2. In accordance with the policy, the Australian Government has taken a decision to self-insure its forex exposures.
3. The policy sets out the Australian Government's decision to restrict entities from external hedging.

1. FMA Act agencies and GGS CAC Act bodies are collectively referred to as entities throughout this Finance Circular.

4. For further information regarding the forex risk management policy, including exemptions from the restriction on hedging, refer to the Finance Circular 2002/01: Foreign Exchange (Forex) Risk Management[2].

Treatment of existing hedging arrangements

5. A number of entities may have had, or continue to have, hedging arrangements in place at the time that the policy came into effect. The correct treatment of these arrangements is as follows:
   - Entities should not renew, extend or replace any hedging arrangements;
   - Entities should review any existing hedging arrangements and where it is considered cost effective these arrangements should be terminated; and
   - Where hedging arrangements are not terminated, they should be allowed to run their course, but not be extended or replaced at that time.

6. Entities that have a demonstrable need to renew, extend or replace any existing hedging arrangements may seek an exemption from the hedging prohibition.
   - Any applications for an exemption should be supported by a robust argument (ordinarily a demonstrable business need).
   - The Minister for Finance and Administration (Finance Minister), in consultation with the Treasurer, is able to grant an exemption to the hedging restriction on a case-by-case basis (that is, for an individual project).
   - The Finance Minister, in consultation with the Treasurer, is also able to agree to a general exemption in respect of GGS CAC Act bodies from the policy restricting external hedging.

Contacts

7. If you have any queries, please contact Finance and Banking Branch at finframework@finance.gov.au or visit our website at www.finance.gov.au.

Michael Culhane
Branch Manager
Finance and Banking Branch
Financial Management Group
11 August 2004

2. Available from www.finance.gov.au

Appendix 4: Finance Circular 2004/03

Australian Government
Department of Finance and Administration

Finance Circular No. 2004/03

To all Agencies under the Financial Management and Accountability Act 1997

Promissory Notes, Bills of Exchange, Commercial Bills and Other Securities of a Similar Nature

Purpose

To advise Financial Management and Accountability Act 1997 (FMA Act) agencies of government policy in relation to promissory notes, bills of exchange, commercial bills and other securities of a similar nature.

Key points

1. Promissory notes, bills of exchange, commercial bills and other securities of a similar nature affect the indebtedness of the Australian Government.
2. Under the Administrative Arrangements Order, the Department of the Treasury has responsibility for borrowing money on the public credit of the Commonwealth and has in place standard debt issuance arrangements.
3. Accordingly, agencies should not use promissory notes, bills of exchange, commercial bills and other securities of a similar nature unless specifically provided for under legislation or authorised by the Minister for Finance and Administration. Finance Leases are not covered by this Circular. These types of debt instruments are defined in Attachment A.
4. In the main there will be few agencies with outstanding debt instruments in the nature of those mentioned above. It would be expected that, in the future, they would generally only be issued by a few agencies that have specific statutory authority. Where agencies issue these instruments, agencies should comply with the issuance and management requirements set out in Attachment B.

5. In considering what statutory authorities may exist, agencies should bear in mind that the Finance Minister has delegated investment powers to certain Chief Executives pursuant to section 39 of the FMA Act. These investment powers allow those Chief Executives to invest amounts from specific Special Accounts in accordance with the authorised investments detailed in section 39(10) of the FMA Act. These investments include certain government securities and bills of exchange.

Contacts

6. If you have any queries, please contact the Foreign Exchange Team at finframework@finance.gov.au.

Michael Culhane
Branch Manager
Finance and Banking Branch
Financial Management Group
30 April 2004

Definitions

Promissory notes are defined under section 89 of the Bills of Exchange Act 1909 as 'an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to the order of a specified person, or bearer'.

Bills of exchange are defined under section 8(1) of the Bills of Exchange Act 1909 as 'an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a sum certain in money or to the order of a specified person, or to bearer'.

Commercial bills are bills of exchange (defined above) which are issued specifically by merchant banks or large corporations.

Securities are documentary evidence of ownership of financial assets (i.e. equity) or an acknowledgement of debt for repayment at some time in the future. Examples of equity securities include ordinary shares, preferred ordinary shares and trust units. Examples of debt securities include bonds, floating rate notes, commercial bills and promissory notes. Securities can have characteristics of both equity and debt. A comprehensive legal description of securities is provided under section 92 of the Corporations Act 2001.

Finance Lease means a lease under which all the risks and benefits incidental to ownership of property are transferred to the lessee. The lessee's obligation to make payments under the lease arrangement continues even if the property is lost, destroyed or disposed of. Legal ownership of the asset may or may not eventually be transferred to the lessee at the end of the lease.

Attachment B

Requirements for Issuance and Management of Debt Instruments

Agencies are required to:

a. consider whether the instruments should be reported in the Statement of Risks in the Budget Papers;
b. consider whether there is a need to update Budget estimates;
c. consider whether notes are correctly incorporated into all relevant financial reports;
d. control the issuance of instruments;
e. maintain a register of all instruments;
f. periodically review all instruments for their effectiveness;
g. make the existence of the instrument known when required;
h. produce the instrument in an accessible, usable and meaningful form for access by someone else as required;
i. preserve the authenticity of the instrument over time;
   1. ensure that the instrument is not disposed of unlawfully[1];
   2. account for the management of the instrument while it is under their care;
   3. ensure adequate security and storage of the instrument; and
   4. control access.

Agencies may wish to review the information produced by the National Archives of Australia relating to Commonwealth Record keeping – Custody. This information can be viewed online at:
http://www.naa.gov.au/recordkeeping/custody/summary.html.

Control and Retrieval

Agencies should ensure that each debt instrument is labelled with a unique number or title which identifies it. Additional information should also be recorded so that instruments can be located when there is a need to know about the matters documented within them. This additional information is termed "metadata" and agencies are urged to review the publication produced by the National Archives of Australia entitled Recording Metadata Standard for Commonwealth Agencies (1999). This publication can be viewed online at:
http://www.naa.gov.au/recordkeeping/ control/rkms/summary.htm.

1. The vast majority of Commonwealth records are temporary in nature. Although they have value to the Australian community, to the individuals and organisations who do business with the Commonwealth, and to Commonwealth agencies themselves, this value only lasts for a finite period of time. *Temporary records* need to be kept for certain minimum periods and the *Archives Act 1983* or other Commonwealth legislation controls their eventual destruction.

This information should be maintained in a register of all debt instruments to assist in transparent reporting and disclosure. The register should contain the details of the instruments including their status and the scope and nature of the risks involved. Prudent and efficient management clearly dictates the need to maintain such registers in order to provide the information required for the purposes of audit and financial reporting.

Agencies should put in place procedures to ensure that all such instruments are captured by the register.

Disposal

Agencies should regularly review their register of debt instruments to determine whether an instrument can be destroyed or should continue to be maintained. The register of debt instruments should also contain a sentencing category which determines the useful life of the instrument (eg. one year, indefinite etc.). The register should also discuss how the documents will be disposed of. The National Archives has produced an Administrative Functions Disposal Authority which is available from their website at http://www.naa.gov.au/recordkeeping/disposal/authorities/gda/afda/pdf/establishment.pdf. The Administrative Functions Disposal Authority authorises the disposal of records of administrative functions commonly performed by most Commonwealth agencies.

Security and Storage

An integral part of sound risk management is maintaining adequate physical security of these instruments and associated documents. This will assist in enhancing agencies' records management procedures. Agencies must also ensure adequate physical security of instrument stationery.

Loss, misplacement or destruction of these instruments, or the debt instrument stationery, is likely to place the Commonwealth at a disadvantage, and increase the level of risk.

Agencies should ensure that instruments which may be called upon in the future for evidentiary purposes should be accorded special attention to ensure their continued visibility and accessibility.

In ensuring adequate physical security of relevant documents, both electronic and paper, agencies should consider:

- the long term and/or indefinite nature of some of the obligations; and
- the use of special security storage, such as the Commonwealth Security System provided by the Attorney-General's Department for valuable, long term or otherwise significant instruments.

For the preservation of any debt instrument, agencies should have regard to the Guidelines for Implementing the Standard for the Physical Storage of Commonwealth Records which is produced by the National Archives of Australia (http://www.naa.gov.au/recordkeeping/storage/standard.html).

Access

Agencies should ensure that only appropriate staff have access to debt instruments. The register should list the relevant staff within the agency who may access these documents. Agencies should also be aware of their obligations under the *Freedom of Information Act 1982* and the *Archives Act 1983* which both give the public a statutory right to access records.

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