2005 (No. 9)

2005

PARLIAMENT OF TASMANIA

AUDITOR-GENERAL
SPECIAL REPORT NO. 56

TT-LINE: GOVERNANCE REVIEW

June 2005

Presented to both Houses of Parliament in accordance with the provisions of Section 57 of the Financial Management and Audit Act 1990

By Authority:

Government Printer, Tasmania

Auditor-General's reports are available from the Tasmanian Audit Office, HOBART. This report and the recent titles shown at the back of this report can be accessed via the Office's home page. For further information please contact:

Tasmanian Audit Office
GPO Box 851
Hobart
TASMANIA 7001

Phone: (03) 6233 4030, Fax (03) 6233 2957
Email:- admin@audit.tas.gov.au
Home Page: http://www.audit.tas.gov.au

This report is printed on recycled paper.

ISBN 0 9756781 2 4

22 June 2005

President
Legislative Council
HOBART

Speaker
House of Assembly
HOBART

Dear Mr President
Dear Mr Speaker

PERFORMANCE AUDIT NO. 56
TT-LINE: GOVERNANCE REVIEW

This report has been prepared consequent to a review conducted under section 44 of the *Financial Management and Audit Act 1990*, for submission to Parliament under the provisions of section 57 of the Act.

Yours sincerely

H M Blake
AUDITOR-GENERAL

Contents

List of Figures

FOREWORD

This Report outlines the results of a review of the governance and decision-making arrangements in TT-Line.

TT-Line fulfils an essential role in Tasmania's transport infrastructure and in the tourism industry in both Tasmania and Australia. Whilst not a focus of this review, I believe that TT-Line carries out this role effectively.

The Company has experienced significant growth in size and complexity since its first full year of operations in 1994-95 with much of this growth having occurred in recent years. Since 1994-95 operating revenues have grown by more than 250%, total assets by 240% and passenger numbers and freight volume by more than 200%.

A section of this Report has been devoted to the many operational areas of its business that TT-Line does well. It is important to bear these in mind when considering the forty-two recommendations made in this Report.

This review identified a number of governance-related weaknesses such as the need for strategic risk assessments, improved timeliness and quality of information provided to directors and for the directors to seek independent advice when significant decisions are being made. The recommendations are aimed at assisting the Board to enhance its governance and decision-making practices as it manages TT-Line through its current difficult financial circumstances.

H M Blake

Auditor-General

June 2005

LIST OF ACRONYMS AND ABBREVIATIONS

ASX	Australian Stock Exchange
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CLERP	Corporate Law Economic Reform Program
KPI	Key performance indicator
SPOT III	*Spirit of Tasmania III*
The Minister	The Minister for Tourism
TT-Line	TT-Line Company Pty Ltd

Executive summary

EXECUTIVE SUMMARY

INTRODUCTION

In the first half of the 2004-05 financial year TT-Line Company Pty Ltd (TT-Line) reported significant financial losses due to not achieving budgeted passenger numbers. Its Board had requested additional financial support from the stakeholder Ministers. This support was announced in the Parliament in March 2005.

On 15 March 2005 the Auditor-General received a request from the two stakeholder Ministers to conduct a review of the corporate governance and decision-making processes in TT-Line. This report outlines the outcomes from this review.

OBJECTIVE

The objective of this review was to examine the corporate governance and decision-making processes of TT-Line to gain confidence that these processes are consistent with best practice governance principles and standards.

SCOPE

The review focused on processes within TT-Line in relation to corporate governance and decision-making. However, we did not assess or comment on decisions made. The review incorporated all decision-making processes, both operational and those of a capital nature.

The review covered the period 1 January 2001 to March 2005.

OPINION

Without limiting the scope of our review, we were requested to specifically examine six matters. Our opinion deals with each of these six matters below.

In some cases governance principles inherent in the six matters examined overlap.

1 Processes for, and the effectiveness of, decision-making by the Board and senior management

The decision-making processes applied require improvement.

There did not appear to be a set procedure for developing, approving and documenting policies. In particular there was no risk management policy or a code of ethical conduct.

While formal lines of reporting within TT-Line are clearly defined, the management structure inhibits a team approach to decision-making.

There was no evidence of board members obtaining independent advice on some critical issues.

2 The quality, reliability and appropriateness of information on which the Board bases key decisions

Financial information provided to the Board was accurate although it could have been more timely and more graphically documented.

Strategic planning proposals requiring important decisions by the Board were not always presented to it in a timely manner.

Whilst not questioning the quality, reliability and appropriateness of strategic information presented to the Board, there were instances when the Board should have sought independent advice prior to making decisions.

The Audit Committee played an effective role in verifying financial reports prior to consideration by the Board. However, there was a lack of analysis and consideration of significant market and financial risks.

3 The effectiveness of, and compliance with, delegations from the Board to the CEO and from the CEO to other employees

A delegation policy exists but is out of date. There is no formal documentation of delegations from the Board to the CEO or from the CEO to management.

Senior management responsibilities were documented, but were out of date.

4 The terms of reference and effectiveness of board and key management committees, with special reference to the Board and the Board Audit Committee

Expectations of TT-Line have been outlined in formal correspondence from its stakeholder Ministers. However, the Board has not documented its responsibilities, the purpose of TT-Line's operations or the basis upon which it communicates with its shareholders.

The Board does have a properly constituted Audit Committee but there is no Remuneration Committee.

5 Identification, mitigation and management of business risks, including the management of material contingent liabilities

A comprehensive operational risk assessment has been performed but not a formal strategic risk assessment.

Until recently the Board's internal audit function focused primarily on financial processes rather than broader operational matters.

6 Policies and procedures for ensuring compliance with legislation including the Corporations Law and the *TT-Line Arrangements Act 1993*.

Corporations Law requirements are complied with.

We expressed concerns over internal cross-subsidisation of loss making operations by profitable operations. This issue is one for the stakeholder Ministers, rather than the TT-Line.

Correspondence from the stakeholder Ministers setting out their expectations were not formalised by the board of TT-Line as a basis for their authority, responsibilities, and communication with shareholders.

The current depreciation methodology of TT-Line whereby the ships and fit-outs are depreciated straight line over the same useful life does not reflect the diminution of the asset over time or provide for the generation of cash reserves for future maintenance or capital replacement.

POSITIVE ASPECTS IDENTIFIED

TT-Line has, and continues to have, a most valuable role to play in infrastructure, tourism and in the Tasmanian economy as a whole. Its achievements have been significant. This review identified a number of operational areas that the management of TT-Line perform well including:

- TT-Line continues to operate an effective shipping service;
- The operational systems and processes within TT-Line are sound with key operational executives having a strong understanding and appreciation of the risks and challenges facing their area
- The executive team have appropriate experience and knowledge and have implemented strong internal systems and processes;
- The shipping and passenger services are driven by a number of key performance indicators which are achieved consistently resulting in a high standard of service delivery for both passengers and freight alike;
- The executive team demonstrated a strong commitment to service delivery, which is evidenced through customer feedback received;
- The executive management team have a strong understanding of the operational risk profile of TT-Line's operations;
- A risk assessment of operational risks has been conducted including safety and security;

- The Audit Committee has recently decided to initiate a formal risk assessment process, which will include strategic risk;
- While there is an absence of internal policies and procedures, a sound internal control environment exists within the finance and procurement divisions; and
- TT-Line's management obtained external advice in relation to strategic decisions made over the period of this review, primarily market related advice. This independent information provided a supporting case for the demand for TT-Line services in varying locations over time.

BOARD, TREASURY AND MANAGEMENT RESPONSES

Preparation of the our final draft of this report had previously benefited from comments provided by the Secretary of the Department of Treasury, the Chief Executive Officer of the TT-Line and the former Chairman of the Board.

In response to our final draft, the Chairman of the Board and the Secretary of the Department of Treasury were offered the opportunity to provide a final comment, but declined.

Former Directors of the Board were also provided with a summary of relevant findings, and given the opportunity to seek further discussions with myself.

Subsequently, the former Chairman of the Board indicated partial or total disagreement with all of the findings included in my summary and expressed the view that it was inconsistent with natural justice for former directors to be denied access to the full final draft report.

The Chief Executive Officer also expressed concern that although some recommendations had been modified in response to his previous comments, some had not. He further expressed the view that the process did not meet the requirements of natural justice by dismissing much of his response without further discussion with the executive management group and argued that it is more important that a proper process be followed rather than trying to meet an arbitrary date for publication.

Where his responses relate specifically to management performance or activities, they have been included below.

<u>Recommendation 1:</u>

Consideration should be given to locating the management team in Devonport

The views of management remain the same in regard to centralizing the management team in Devonport. The advantages of the current system outweigh the perceived advantages of the proposed centralisation.

Recommendations 2

Formal meetings of the executive management team should be held with an agreed agenda and meeting schedule.

Several meetings are already held with agenda and are minuted. It is now planned to hold a Quarterly Strategic Review meeting with all the Senior Management Team.

Recommendation 3

Management data that is relevant to more than one operational division should be easily accessible by appropriate staff.

All relevant data is already available to all operational divisions. It is planned to install a system to make all management information more easily accessible but this is just an enhancement to what already exists.

Recommendation 4

Cross-functional operational risks should be identified and monitored on a consistent basis, possibly via executive management meetings.

This occurs at monthly Safety and Operational meetings.

Recommendation 12

The schedule of board meetings should be set to allow for timely review of financial results by the Board.

The Board normally meets on the first Tuesday of a month.

At the longest period possible this is 38 days or 5 weeks from the end of a reporting period. Directors are provided with Board Papers one week before the meeting.

It is not possible to close off month end accounts, circulate financial statements for management review and report and produce Board papers in any shorter timeframe.

These reports also include information on passenger bookings and freight movements up to the date of writing the report.

These are the most reliable forecasters of future results.

Recommendation 14

For key strategic decisions, papers should be made available to the Board for a sufficient period to allow board members to critically appraise the information, and obtain independent advice where deemed appropriate.

No director stated that they wished to have additional time to consider any papers provided to them.

Recommendation 15

Board minutes should record all decisions and approvals made.

No discussions on critical issues were undertaken outside the Board other than at Shareholder presentations.

No decisions were made outside of Board meetings.

All discussions were minuted. Only the CEO's salary was dealt with by a letter from the Chairman to the CEO after discussion within the meeting.

It is not acceptable in my view for the associated finding to be based on "anecdotal evidence".

Recommendation 17

Meetings of the executive management team should be formalised with an agreed agenda and meeting schedule.

Quarterly Senior Management Meetings are now planned.

Recommendation 19

A mechanism should be developed by which costs can be reviewed and controlled at an entity level, and spending priorities assessed and prioritised.

This process already exists:

- The CEO reviews with Divisional Heads the cost performance to budget on a monthly basis;
- Divisional managers report monthly of financial and other relevant KPIs for their division; and
- The role of the CEO is to control expenditures in line with budget and ensure spending priorities are assessed and prioritised in cooperation with the CFO.

Recommendation 23

TT-Line should implement a formal sign-off of financial statements by the CEO and CFO prior to approval by the Board.

The CEO and CFO do sign off the Financial Reports prior to approval of the Board.

Recommendation 24

Executive management should be placed on contracts that include performance management clauses and formal periods of review. Where appropriate, remuneration or bonus arrangements for senior executives need to be based on performance criteria for the individual and the organisation.

It is not possible to vary the conditions of employment of current employees without their agreement. Future executive employees can be placed on performance contracts if the Board so wishes.

Many of the Incentive Schemes have in fact had a proportion of any payment based on an individual's area of responsibility such as:

- Number of passengers in Sales & Marketing;
- Cost of Advertising per passenger in Sales & Marketing;
- Cost of Hotel Services per passenger in Hotel Services; and
- Achievement of Cash Flow

However, the bulk of any payments have always been deliberately targeted at achievement of the Company's overall profit budget. This is to ensure all Divisional Heads concentrate on what is important to the overall Company.

<u>Recommendation 25</u>

Detailed statements of duties and responsibilities should be updated and brought to the attention of executive management, including the CEO.

It has not been necessary to update position descriptions as incumbents have been in place since the documents were developed.

All executives had been provided with copies of their position descriptions.

<u>Recommendation 27</u>

The formal system of performance management for the Board and senior executives should use specific performance criteria.

For management the budget does set specific performance criteria against which performance is judged. These are the KPI's.

<u>Recommendation 34</u>

There should be a comprehensive and formal risk assessment, with a focus on strategic risks.

This had already been arranged with KPMG.

<u>Recommendation 37</u>

The executive should consider all audit findings and ensure implementation of recommendations, as appropriate.

The reason the Finance Department responds is that Audit findings related to areas for which the department is responsible.

Recommendation 40

Any future strategic decisions which require cross-subsidisation of services internal to the organisation should be made at a stakeholder Minister level.

All issues relating to cross subsidisation have always been referred to the shareholders for approval. This includes the Devil Cat and the recent decision regarding Spirit of Tasmania III.

AUDITOR-GENERAL'S VIEWS ON MANAGEMENT RESPONSE

I believe that a proper process has been followed in preparation of the report and that concerned parties have been given an opportunity to comment.

The matters raised by management have been considered in the finalisation of this report.

I stand by the report's findings and recommendations.

SUMMARY OF RECOMMENDATIONS

The following table reproduces the major recommendations contained in the body of this Report. Because some of the audit criteria overlap with differing governance principles, some recommendations appear in the body of this Report more than once.

Recommendation	**Recommendation Number**
In view of his experience in TT-Line's operations, the CEO should be appointed as a board member. As a board member, the CEO will be required to attend all board meetings except for discussions where the CEO has a natural conflict of interest.	5
The Board should be provided with clear direction as to the process they should go through in relation to major acquisitions.	8
Directors should ensure they have the required information on which to base decisions, including seeking of independent advice for major acquisitions or projects. In particular, they should consider the need for independent advice on the financial projections, market research and management of market risk.	9
Procedures for the development, documentation and approval of organisational policies should be developed.	10
Presentation of financial information in board papers should include more descriptive, numerical and graphical analysis.	13
For key strategic decisions, papers should be made available to the Board for a sufficient period to allow board members to critically appraise the information, and obtain independent advice	14

where deemed appropriate.	
A formal communication policy should be developed which formalises the Chairman as the key point of contact for the Minister in relation to the operations of TT-Line.	16
Critical operational and risk management policies should be developed as a matter of priority and be approved by the Board.	18
Detailed statements of duties and responsibilities should be updated and brought to the attention of executive management, including the CEO.	25
Delegations need to be updated and approved at a board level.	26
The formal system of performance management for the Board and senior executives should use specific performance criteria.	27
Correspondence from stakeholder ministers should be the foundation of a formal outline of board responsibilities, the purpose of TT-Line's operations, and the basis for communicating with shareholders.	28
A remuneration policy should be developed incorporating the creation of a Remuneration Committee to oversee the implementation and compliance with the policy.	29
There should be a comprehensive and formal risk assessment, with a focus on strategic risks.	34
Provision of full board papers to the stakeholder ministers should be discontinued. Instead, a basis for provision of regular performance information and timely advice of significant issues should be agreed between the Chairman of the Board and the Minister.	38
Any future strategic decisions which require cross-subsidisation of services internal to the organisation should be made at a stakeholder Minister level. The level of subsidy should be clearly defined to provide a basis from which to assess the performance of management in relation to the core service, and the subsidised service. Where cross-subsidisation is selected, consideration needs to be given to the ability of the Company to maintain sufficient capital to continue to meet its statutory obligations over time, particularly in relation to asset replacement.	40

Introduction

INTRODUCTION

BACKGROUND

On 15 March 2005 the Auditor-General received a request from the stake-holding Ministers to conduct a review of the corporate governance and decision-making processes within TT-Line Company Pty Ltd (TT-Line).

TT-Line had previously reported significant financial losses due to not achieving budgeted passenger numbers. TT-Line had requested additional financial support from the stakeholder Ministers, which was announced in Parliament in March 2005.

TT-Line plays an essential part in Tasmania's transport infrastructure and tourism sectors and has done so since its incorporation in 1993. As indicated in the table below, the Company has grown significantly over this period, as have the numbers of passengers and quantities of freight carried:

	1994-95*	2003-04	% Increase
Operating revenue ($m)	57.6	154.2	268%
Total assets ($m)	177.9	427.9	241%
Passenger numbers	248 303	505 587	204%
Vehicle numbers	69 433	220 608	318%
Freight TEU	24 126	51 412	213%

* TT-Line commenced operations in November 1993 and this was its first full financial year of operations. The table ignores inflationary impacts.

MANDATE

Under the provisions of section 44(b) of the *Financial Management and Audit Act 1990* the Auditor-General may:

> 'Carry out examinations of the economy, efficiency and effectiveness of Government departments, public bodies or parts of Government departments or public bodies'.

STANDARDS APPLIED

This audit has been performed in accordance with Australian Auditing Standard AUS 806 ('*Performance Auditing*'), which states that:

> 'The objective of a performance audit is to enable the auditor to express an opinion whether, in all material respects, all or

part of an entity's activities have been carried out economically, and/or efficiently and/or effectively.'

The audit has included such tests and other procedures considered necessary in the circumstances.

OBJECTIVE

The objective of this audit was to review the corporate governance and decision-making process of TT-Line to gain confidence that they are consistent with best practice governance principles and the highest commercial standards.

SCOPE

The review focused on processes within TT-Line in relation to corporate governance and decision-making, but did not assess or comment on decisions made. The review incorporated all decision-making processes, both operational and those of a capital nature.

The period of this review was from 1 January 2001 to March 2005.

CRITERIA

The minimum audit criteria, as specified by the stake-holder Ministers, were:

1. Processes for, and the effectiveness of, decision making by the Board and senior management;
2. The quality, reliability and appropriateness of information on which the Board bases key decisions;
3. The effectiveness of, and compliance with, delegations from the Board to the CEO and from the CEO to other employees;
4. The terms of reference and effectiveness of board and key management committees, with special reference to the Board and the Board Audit Committee;
5. Identification, mitigation and management of business risks, including the management of material contingent liabilities; and
6. Policies and procedures for ensuring compliance with legislation including the Corporations Law and the *TT-Line Arrangements Act 1993*.

AUDIT METHODOLOGY

This audit compared the TT-Line's governance structure and practices against current best practice principles (see Appendix 2).

In March 2003 the Corporate Governance Council of the Australian Stock Exchange (ASX) published guidelines on company disclosure and practice that list 10 key points. These guidelines require a company to:

1. Lay solid foundations for management and oversight;
2. Structure the Board to add value;
3. Promote ethical and responsible decision-making;
4. Safeguard integrity in financial reporting;
5. Make timely and balanced disclosure;
6. Respect the rights of shareholders;
7. Recognise and manage risk;
8. Encourage enhanced performance;
9. Remunerate fairly and responsibly; and
10. Recognise the legitimate interests of stakeholders.

These criteria were supported by further market research, including, but not limited to, the following best practice guides:

- Corporate Governance Series - Ernst & Young; and
- Corporate Governance Handbook for Government Business Enterprises – Department of Treasury and Finance, Tasmania.

In addition to the above, a significant review was commissioned in 2003 by the Honourable Prime Minister Mr John Howard, and the Minister for Finance and Administration Senator the Honourable Nick Minchin, and was completed by Mr John Uhrig. The results of this review, entitled *Review of the Corporate Governance of Statutory Authorities and Office Holders* has particular relevance to the application of corporate governance in a public sector context and hence has also been drawn upon by this review as a benchmark by which to assess the corporate governance within TT-Line.

This review benchmarked the processes in place and evidenced through the records of TT-Line against these principles.

Within TT-Line, the Board and board sub-committee minutes and papers form the objective and verifiable evidence of the board processes and key decisions. Accordingly, the audit reviewed the Board minutes and papers, including the Sub-Committees of the Board.

After that, further fieldwork was carried out including:

- Review of significant documentation including, but not limited to, correspondence with key stakeholders and regulatory bodies, committee and board charters, audit reports, relevant contractual arrangements and internal policies and procedures;
- Interviews with key stakeholders including members of the Board, senior management, the internal auditors and other stakeholders as deemed necessary;
- Back-testing of the accuracy of board papers as appropriate through sample testing to source financial data;
- Review of the organisational structure and management oversight in the context of the corporate governance model; and
- Review of the internal risk assessment processes and documentation.

TIMING

Planning for the governance review began in March 2005.

RESOURCES AND APPENDICES

The fieldwork was contracted to an accounting firm.

Appendix 1 provides a detailed discussion of the findings of this review. These findings have been summarised in the body of the report, which includes cross-references to Appendix 1.

Appendix 2 documents in greater detail best practice, governance and related matters.

The total cost of the audit excluding report production costs was approximately $75 000.

This page left blank intentionally

Governance - Best Practice

GOVERNANCE - BEST PRACTICE

TT-Line is a non-listed State Owned Company. At the commencement of this review, we had to determine which independent governance principles to apply in assessing TT-Line's governance practices bearing in mind its size, complexity of its operations, its importance to the State's transport and tourism sectors and its status as a public sector entity. In recent years there has been a proliferation of guidance material on governance. For the reasons set out in the remainder of this section, we chose to apply a combination of:

- The Australian Stock Exchange Council's report *Principles of Good Corporate Governance and Best Practice Recommendations*;
- John Uhrig's report titled *Review of the Corporate Governance of Statutory Authorities and Office Holders*;
- Ernst & Young's Corporate Governance series; and
- Correspondence from the then Treasurer addressed to TT-Line in 1999 titled "Shareholders' Expectations of State-Owned Companies".

CRITERIA AND BASIS FOR BEST PRACTICE ASSESSMENT

The ASX Council's report *Principles of Good Corporate Governance and Best Practice Recommendations* – these principles are generally accepted within the business community as a leading authority on corporate governance. The principles were generated as a response to recent developments in the United States, in particular the Sarbanes Oxley Act, and also in response to the growing public expectation within Australia for transparency and due process in corporate and public sector management.

In relation to this review, the ASX principles have been used as the primary benchmark by which to perform the assessment of corporate governance within TT-Line. Key elements of each of the ASX principles have been developed in conjunction with the six minimum audit criteria set out in the Introduction to this Report.

John Uhrig's report *Review of the Corporate Governance of Statutory Authorities and Office Holders* - In view of TT-Line's status as a public entity, we researched governance from a public sector perspective. In this respect, a significant review was commissioned in 2003 by the Honourable Prime Minister Mr John Howard, and the Minister for Finance and Administration Senator the Honourable Nick Minchin, and was completed by Mr John Uhrig. The primary purpose of the review was to develop a broad template of governance principles that might extend to all statutory authorities and office holders. The results of this review, entitled "*Review of the Corporate Governance of Statutory Authorities and Office Holders*" has particular relevance to the application of corporate governance in a public sector context and hence has also been drawn upon by this review as a benchmark by which to assess the corporate governance within TT-Line. Further details on the specific relevance of Mr Uhrig's work are set out in Appendix 2.

Ernst & Young's corporate governance series – this series defines corporate governance and expands on the ASX principles and other authoritative literature.

"Shareholders' Expectations of State-Owned Companies" – this correspondence details a number of expectations of TT-Line and included a brief section on governance which we have also taken into consideration.

Appendix 1 contains further specific references to the governance principles that we have applied in conducting this review.

CORPORATE GOVERNANCE DEFINITION

While there is no universally accepted definition of corporate governance, the following outlines the key elements of the definition as drawn from our research.

The ASX Corporate Governance Council defines corporate governance as:

> "…the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised".

The Council also states that:

> "governance is broader than boards and committees; it extends throughout the organisation, and includes elements of internal control, ethics, culture, risk functions, policies and procedures and internal and external audit."

John Uhrig in his review states:

> "Corporate governance encompasses the arrangements by which the power of those in control of the strategy and direction of an entity is both delegated and limited to enhance prospects for the entity's long-term success, taking into account risk and the environment in which it is operating."

This review utilises the definitions of corporate governance as outlined above in the context of the corporate structure diagram developed by Ernst & Young1 set out in Appendix 2. This appendix also includes definitions of the differing public sector entities, all of which are referred to in this Report.

APPLICABILITY OF CORPORATE GOVERNANCE TO TT-LINE AND THE PUBLIC SECTOR

The ASX corporate governance principles utilised as the key benchmark for this review are not mandatory in the Australian context, and only apply to listed entities. Their relevance and applicability to the wider community however should not be dismissed in a business environment which is increasing in expectation in relation to good governance of both public and private enterprises. John Uhrig states that:

> "given the impact that statutory authorities can have on the public, including the business community, effective governance instruments need to be in place to ensure that adequate supervision occurs" (p.36).

He further states that:

> "the community has a right to expect that [public sector] functions will be carried out in a manner that is efficient, effective, objective, and transparent".

The expectation therefore is that entities that operate in the public sector – such as TT-Line - should also apply strong corporate governance frameworks.

TT-Line operates predominantly independently from the government of the day. The *TT-Line Arrangements Act 1993* allows overall supervision by the shareholders, being the stakeholder Ministers. The Articles of Association of the Company require disclosure to the shareholders, and also allow for shareholders to give lawful directions to the directors of the company in writing which therefore must be complied with. The day-to-day operations of TT-Line however are performed

[1] Ernst & Young, Corporate Governance Series March 2004. *What is Corporate Governance?* p.4)

without influence or direction by the shareholders. John Uhrig states that:

> "the greater the organisation's independence from government, the greater is the need for robust governance mechanisms as a means of ensuring that it is discharging its delegation appropriately" (p.18).

This is particularly so for state-owned companies because they operate outside the budget sector, and while they are subject to budget scrutiny, they are not subject to Freedom of Information requirements. There is a solid argument therefore to support the applicability of accepted corporate governance principles to TT-Line's operations.

This page left blank intentionally

1 Decision-making

FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

This section of the Report deals with our findings, conclusions and recommendations made in relation to the audit criteria.

1 DECISION-MAKING

Under this criterion we considered the effectiveness of, and compliance with, delegations from the Board to the CEO and from the CEO to other employees.

In forming an opinion in this part of our review, we evaluated TT-Line against:

- **ASX Principle 1: Lay solid foundations for management and oversight;**
- **ASX Principle 2: Structure the Board to add value; and**
- **ASX Principle 3: Promote ethical and responsible decision-making.**

1.1 MANAGEMENT AND OVERSIGHT

1.1.1 Is the culture of the organisation and management transparent, focused on good corporate governance, and not dominated by any individual(s)?

Governance ensures the success of an entity through the success of its executive management.

The culture within TT-Line evidences a high commitment from management in relation to key operational tasks. However we noted that:

- The internal management structure of TT-Line is segregated into operational divisions (silos) with all key executives reporting directly to the CEO. The physical segregation of the executive management team in two locations, being Devonport and Melbourne, reinforces the management silo structure.
- Executive management do not routinely meet, however, management does meet and co-operate on areas of cross-divisional responsibility. Recent examples include yield management and improvement of terminal services information; [cf A1.2.1];
- Similarly, information and data relating to the operations of TT-Line, for example the reservations database, is held and managed solely within operating

divisions, which inhibits access to useful information by other divisions [cf A1.2.1];

- TT-Line relies on the strength of individuals rather than process, and exhibits a lack of the type of system-based controls needed for a large scale environment [cf A1.2.1]; and
- The CEO of TT-Line now has significant experience in shipping and attends most of every board meeting. However, he has not been formally appointed to the Board and does not have a vote. In our opinion, it is preferable that he is appointed to the Board so that he is held accountable for decisions in which he has been involved and so that he cannot be excluded from meetings, other than in particular circumstances such as where conflicts of interest are declared. [cf A1.5.3].

Recommendation 1

Consideration should be given to locating the management team in Devonport.

Recommendation 2

To facilitate good internal governance and decision-making impacting more than one operational division, the formal meetings of the executive management team should be held with an agreed agenda and meeting schedule.

Recommendation 3

It is essential for effective and timely decision making that management data collated that is relevant to more than one operational division is easily accessible by appropriate staff.

Recommendation 4

Cross-functional operational risks should be identified and monitored on a consistent basis, possibly via executive management meetings.

Recommendation 5

In view of his experience in TT-Line's operations, the CEO should be appointed as a board member. As a board member, the CEO will be required to attend all board meetings except for discussions where the CEO has a natural conflict of interest.

1.2 STRUCTURE THE BOARD TO ADD VALUE

1.2.1 Does the Board have the required knowledge to challenge management assertions and exercise independent judgment?

It is the responsibility of directors to ensure they have the required understanding of issues on which to base decisions. Critical decisions such as major acquisitions require enhanced levels of due diligence and may require independent advice to be sought. In particular independent advice may be necessary to review financial projections, market research and market risk management.

We found [cf A1.3.3]:

- The Board appeared to have limited understanding of some critical issues including market research and financial projections in respect of major acquisitions and projects, which limited its capacity to challenge management assertions;
- Management appeared to lack a clear direction as to the process they should go through in relation to major acquisitions. For example, we found no evidence in respect to the purchase of SPOT III that a sub-committee had been created, there was no due diligence process and independent advice was not sought; and
- The culture of the organisation does not appear to foster discussion of issues at a board level.

Recommendation 6

Board members need to demonstrate relevant experience and an appropriate specialist skill set in line with the complexity and scale of the TT-Line operation.

Recommendation 7

Protocols for communication between the Board and management should be formalised.

Recommendation 8

The Board should be provided with clear direction as to the process they should go through in relation to major acquisitions.

Recommendation 9

Directors should ensure they have the required information on which to base decisions, including seeking of independent advice for major acquisitions or projects. In particular, they should consider the need for independent advice on the financial projections, market research and management of market risk.

1.3 PROMOTE ETHICAL AND RESPONSIBLE DECISION-MAKING

1.3.1 Are ethical standards actively promoted within the organisation?

The Board is responsible for approval of the company's strategies and policies. Communication from leadership down through the organisation needs to set and reinforce clear guidelines on right versus wrong behaviour.

We found that many board-approved policies existed, however, some policies or procedures were developed by divisions in isolation. We also noted that there are a number of key policies that are not in place, including a risk management policy. Nor was there a set procedure for developing, approving and documenting policies. [cf A1.3.4]

We also found that no code of ethical conduct exists within the Company.

Recommendation 10

Procedures for the development, documentation and approval of organisational policies should be developed.

Recommendation 11

A code of Ethical Conduct should be developed, and be approved at a board level.

1.3.2 Does the Board ensure that it has the necessary information required to undertake effective decision making with care, diligence and commercial reasonableness?

It is the responsibility of directors to ensure they have the required information on which to base decisions. We reviewed decision-making documentation, with respect to some major acquisitions, and while decision-making is always easier with the benefit of hindsight, we found that:

- Independent advice should have been obtained on the data and assertions prepared to support key proposals [cf A1.3.3]; and
- There was room for improvement in the presentation and level of financial analysis.

Refer to recommendations 8 and 9

1.3.3 Does the Board adequately question the decisions and recommendations of the CEO and senior management?

In order for this process to be effective, it is necessary that:

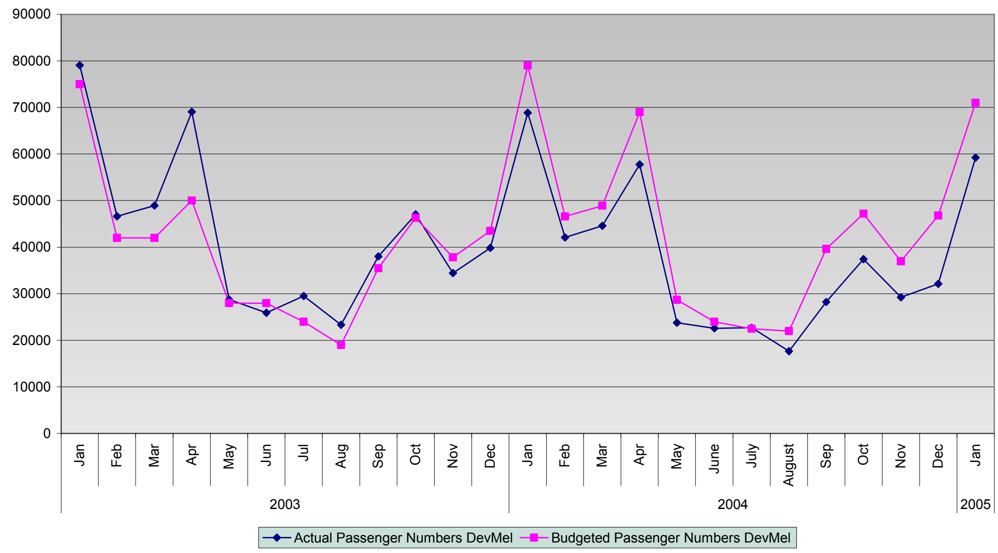
- The Board is supplied with information in a form, timeframe and quality that will enable it to effectively discharge its duties;
- Management develops a limited number of key indicators to accurately measure the performance of the Company; and
- Critical documents are provided to board members in a timely fashion that allows the Board to properly consider the information.

We found:

- The current schedule of the monthly board meetings does not allow for timely review of financial results, with reported financial information reported being up to six weeks after month end [cf A1.8.1];
- No evidence was retained of out of session discussions about critical decisions by the Board;
- The Board should have set milestones for management in relation to key projects;
- In some cases, critical documents were presented to board members on the day requiring consideration and a decision, including the 2004/05 strategic plan; and
- Financial reporting papers provided to the Board on a monthly basis included appropriate financial data, but

little descriptive, numerical or graphical analysis of the data. In particular, we consider that the use of trend analysis would be beneficial and, in particular, may have led to earlier recognition of falling passenger numbers as shown in the following graph, which indicates that, as early as October 2003, passenger numbers dropped below budget. [cf A1.8.1].

Actual versus Budgeted Passenger Numbers Dev-Melb 2003-2005



Recommendation 12
For effective management and oversight of the company, it is crucial that the schedule of board meetings be set to allow for timely review of financial results by the Board.

Recommendation 13
Presentation of financial information in board papers should include more descriptive, numerical and graphical analysis.

Recommendation 14
For key strategic decisions, papers should be made available to the Board for a sufficient period to allow board members to critically appraise the information, and obtain independent advice where deemed appropriate.

1.3.4 Are Board decisions and important discussions documented for future reference and clarity?

Under an effective governance regime, the minutes should record all decisions made by the Board. Where the Board discusses issues or makes decisions out of formal session, these discussions or decisions need be minuted and forward to the company secretary for recording.

While the Board does have formal meeting minutes recorded for each monthly meeting, there is anecdotal evidence that discussions or decisions were made with board members that were not formally minuted, relating to executive remuneration and commencement of key projects [cf A1.5.4].

Recommendation 15

Board minutes should record all decisions and approvals made.

1.3.5 Are communication and reporting lines within the organisation clearly defined and transparent?

The operations of TT-Line are directed by the *TT-Line Arrangements Act 1993*. The Act does not specifically outline the authority or role of the Minister in relation to the operations of the Company, although it does provide for communication with the Ministers as shareholders.

Our preferred model is that the Minister communicates primarily with the chairman, on both a formal and informal basis, and that communication with the CEO should only occur in conjunction with the chairman.

The Board should be responsible for providing regular performance information, and informing the Minister in a timely manner of significant issues.

We found that formal reporting lines within TT-Line are clearly defined, and supplemented by informal communication lines between the Minister, the board, and key executives.

One criticism is that executive management does not meet formally as an executive team, although they do meet informally for other purposes. [cf A1.2.1]

Recommendation 16

A formal communication policy should be developed which formalises the Chairman as the key point of contact for the Minister in relation to the operations of TT-Line.

Recommendation 17

Meetings of the executive management team should be formalised with an agreed agenda and meeting schedule.

1.4 CONCLUSIONS

Management is highly committed at an operational level, however, the management style is not sufficiently based on effective processes, and while the formal reporting lines within TT-Line are clearly defined, the management structure and the lack of formal executive meetings inhibits a team approach to decision-making and formal documentation thereof.

Similarly, the culture of the organisation does not appear to foster discussion of issues at a board level. The current schedule of monthly board meetings does not allow for timely review of financial results and financial reporting papers provided to the Board include insufficient descriptive, numerical or graphical analysis.

The Board appeared to have limited knowledge of some critical issues and there was no evidence of board members obtaining independent advice in relation to those issues.

Indicative of the lack of effective processes is the lack of a risk management policy or code of ethical conduct. There was also evidence that not all board decisions and important discussions had been documented.

This page left blank intentionally

2 Information

2 INFORMATION

This section looks at the quality, reliability and appropriateness of information on which the Board bases key decisions.

In forming an opinion in this part of our review, we evaluated TT-Line against:

- **ASX Principle 1: Lay solid foundations for management and oversight; and**
- **ASX Principle 4: Safeguard integrity in financial reporting – have a structure to independently verify and safeguard the integrity of the company's financial reporting.**

2.1 MANAGEMENT AND OVERSIGHT

2.1.1 Is there adequate oversight and review within the organisation to ensure accurate financial information and a strong internal control environment?

Documented policies and procedures within an organisation should provide the basis for the Board and executive management to direct the operations of the organisation and, in particular, the management of risk.

We found that the internal control environment within the finance division of TT-Line is sound, and that financial board papers were an accurate reflection of the base financial data of TT-Line.

However we also noted that:

- There is insufficient policy direction from the Board in relation to the internal control expectations in relation to financial information [cf A1.3.4];
- Although Division Heads receive monthly operating reports for their Division, there is no formal mechanism to review costs across the operational divisions. This creates a risk that cost decisions may reflect division priorities rather than entity priorities [cf 4.8.3]; and
- The current depreciation policy whereby the ships and fit-outs are deprecated straight line over the same useful life does not adequately

represent the diminution of the assets over time, or provide for the generation of cash reserves for future maintenance or capital replacement. [cf A1.8.4]

Recommendation 10

Procedures for the development, documentation and approval of organisational policies should be developed.

Recommendation 18

Critical operational and risk management policies should be developed as a matter of priority and be approved by the Board.

Recommendation 19

A mechanism should be developed by which costs can be reviewed and controlled at an entity level, and spending priorities assessed and prioritised.

Recommendation 20

Although compliant with current accounting standards, the current asset components of the ships should be separately identified. The component parts should reflect, at a minimum, initial fit-out, modifications to fit-out during the life cycle, and the ship infrastructure. There may also be a need to review depreciation policy to ensure accurate representation of useful lives of the asset components.

2.2 FINANCIAL REPORTING

2.2.1 Is there independent verification of the Company's financial reporting, including review by the Audit Committee?

TT-Line has internal audit arrangements in place, which ensure appropriate independence, and an audit committee charter that outlines the responsibilities of the Committee.

We did, however, note that there is a lack of documentation relating to analysis and consideration of significant market and financial risks. The audit work is confined to financial risks related to the finance division with little activity elsewhere. [cf A1.3.1.2]

Recommendation 21

The recent commitment by the Audit Committee to undertake a risk assessment process that includes financial, strategic and operational risks is endorsed.

2.2.2 Does the audit committee consist solely of independent directors, with sound understanding of financial information?

We found:

- The audit committee does consist of independent directors.
- Financial skills are evident on the Audit Committee.
- Key executives attend all Audit Committee meetings.
- Attendance at Audit Committee meetings should be controlled as appropriate to ensure effective Audit Committee discussions and communication with the internal and external auditors without the potential for executive management influence.

Recommendation 22

The CEO should not routinely attend audit committee meetings.

2.2.3 Do the CEO and CFO provide assurance to the Board in relation to the financial report?

The CEO and CFO report directly to the Board in relation to the financial report. We did note that a CEO and CFO formal sign off in accordance with CLERP 9 requirements for disclosing entities had not been implemented.

Recommendation 23

TT-Line should implement a formal sign-off of financial statements by the CEO and CFO prior to approval by the Board.

2.3 CONCLUSIONS

There is adequate oversight and review within the organisation to ensure accurate financial *information and a strong internal control* environment, although we did raise some related issues in this review.

Although there is no formal sign-off, the CEO and CFO report directly to the Board in relation to the annual financial report.

The audit committee consists of independent directors and has the requisite financial skills. Through the work of Internal Audit, the Audit Committee ensures independent verification of financial reports. We did, however, note that there is a lack of analysis and consideration of significant market and financial risks.

This page left blank intentionally

3 Delegations

3 DELEGATIONS

We considered the quality, reliability and appropriateness of information on which the Board bases key decisions.

In forming an opinion in this part of our review, we evaluated TT-Line against:

- **ASX Principle 1: Lay solid foundations for management and oversight; and**
- **ASX Principle 8: Encourage enhanced performance – fairly review and actively encourage enhanced board and management effectiveness.**

3.1 MANAGEMENT AND OVERSIGHT

3.1.1 Are senior management responsibilities clearly documented?

The system for oversight should include objective and critical judgment in relation to performance and standards against which decision-makers can be assessed.

We found:

- There are no contracts in place for key executives outlining key performance indicators or responsibilities. A CEO contract is in place primarily relating to remuneration and cessation of employment; [cf A1.6.2]
- There is a board-approved incentive scheme, whereby bonuses are paid based on reported profit. This does not necessarily reflect the performance of individual executives; and
- Most statements of duties or responsibility statements for key executives were out-of-date and executives were not aware of their existence. [cf A1.1.2.1]

Recommendation 24

Executive management should be placed on contracts that include performance management clauses and formal periods of review. Where appropriate, remuneration or bonus arrangements for senior executives need to be based on performance criteria for the individual and the organisation.

Recommendation 25

Detailed statements of duties and responsibilities should be updated and brought to the attention of executive management, including the CEO.

3.1.2 Is there a delegations policy outlining process and authority to delegate responsibilities?

We found

- The delegations policy has not been revised since its development in 1996;
- No formal documentation of delegations from the Board to the CEO, and the CEO to management; and
- An informal system of delegations was in place, which was recognised by executive management. [cf A1.1.2]

Recommendation 26

Delegations need to be updated and approved at a board level.

3.2 ENCOURAGE ENHANCED PERFORMANCE

3.2.1 Are there performance criteria, management and review of board members and senior management?

Performance management of the Board and key executives forms an important part of good corporate governance within an organisation. The process for managing and assessing performance within an organisation is therefore the driver behind a system of oversight which generates ongoing performance of the Board and management.

We found that the formal review of board and management performance is currently against budget, rather than having specific performance criteria. Informal assessments of performance are undertaken however the performance criteria are broad and generic in nature. [cf A1.6.2]

Recommendation 27

The formal system of performance management for the Board and senior executives should use specific performance criteria.

3.3 CONCLUSIONS

Senior management responsibilities were not clearly documented.

The delegation policy is out of date and there are no formal documentation of delegations from the Board to the CEO, or from the CEO to management. There is an informal system of delegations, which is recognised by executive management.

Other than a contract for the CEO, which primarily relates to remuneration, there are no contracts for other key executives. Statements of duties and responsibilities were out of date.

We also found that there is no formal review of board and management performance against specific performance criteria.

4 Board and sub-committees

4 BOARD AND SUB-COMMITTEES

This section looks at the terms of reference and effectiveness of board and key management committees with special reference to the Board and the Board Audit Committee.

In forming an opinion in this part of our review, we evaluated TT-Line against:

- **ASX Principle 1: Lay solid foundations for management and oversight;**
- **ASX Principle 2: Structure the Board to add value;**
- **ASX Principle 8: Encourage enhanced performance – fairly review and actively encourage enhanced board and management effectiveness; and**
- **ASX Principle 9: Remunerate fairly and responsibly – Ensure the level and composition of remuneration is sufficient and reasonable and that its relationship to corporate and individual performance is defined.**

4.1 LAY SOLID FOUNDATIONS FOR MANAGEMENT AND OVERSIGHT

4.1.1 Are board responsibilities clearly delegated?

Good governance will ensure there is not a concentration of power vested in a single individual, allowing actions to be taken other than in the interests of the entity itself and its owners. For an entity to succeed, all relevant parties must have a clear understanding of their roles and responsibilities in the governance framework.

We found:

- There is no formal documentation of board responsibilities. There is, however, formal correspondence from the stakeholder Ministers in relation to their expectations of state-owned companies [cf A1.1.1.1]; and
- The audit committee charter recently implemented outlines the responsibilities of the committee.

Recommendation 28 **Correspondence from stakeholder ministers should be the foundation of a formal outline of board responsibilities, the purpose of TT-Line's operations, and the basis for communicating with shareholders.**

Recommendation 25 **Detailed statements of duties and responsibilities should be updated and brought to the attention of executive management, including the CEO.**

4.1.2 Are there board committees with specified charters?

As noted above, a Board Audit Committee Charter was recently implemented.

4.2 ENCOURAGE ENHANCED PERFORMANCE

4.2.1 Is there a documented policy for performance evaluation of the Board, board committees, individual directors and key senior management?

Accountability is a core principle of governance as it clearly links power and responsibility for performance. The system for oversight should include objective and critical judgment in relation to performance and standards against which decision-makers can be assessed. A formal performance process needs to occur in order to ensure that the Government is getting the best from a board.

We found that no policy exists in relation to performance evaluation for the Board, board committees, individual directors or senior management. [cf A1.6.2]

Recommendation 27 **The formal system of performance management for the Board and senior executives should use specific performance criteria.**

4.3 REMUNERATE FAIRLY AND RESPONSIBLY

4.3.1 Is there a Remuneration Committee or defined remuneration policy?

The remuneration of key executives and the Board is a key factor in good corporate governance within an organisation. To ensure the decisions related to remuneration within the organisation are conducted in an appropriate manner, a remuneration policy should be in place outlining the approval process and basis for decisions made in relation to all facets of remuneration. A remuneration committee can be a more efficient mechanism than the full board for focusing the company on appropriate remuneration policies.

We found that there is no remuneration committee or policy. [cf A1.6.1]

Recommendation 29

A remuneration policy should be developed incorporating the creation of a Remuneration Committee to oversee the implementation and compliance with the policy.

4.3.2 *Is there independent review of senior management performance and remuneration?*

We were advised that the salary of the CEO is set by the Board after considering appropriate advice, but was not formally presented to the Board. The CEO decides remuneration of other executives, without formal presentation to the Board.

For key executives, the basis for performance management should be contracts with specific performance criteria built into the arrangement. An executive bonus arrangement is in place based on net profit before extraordinary items, with the CEO retaining the responsibility for monitoring executive management performance. This bonus arrangement is formally documented, however, the Board does not formally approve distributions under the policy. [cf A1.6.2]

Recommendation 24

Executive management should be placed on contracts that include performance management clauses and formal periods of review. Where appropriate, remuneration or bonus arrangements for senior executives need to be based on performance criteria for both the individual and the organisation.

Recommendation 30

All decisions of the Board relating to executive remuneration should be minuted and appropriate board papers filed to support the decision.

Recommendation 31

All decisions of the Board relating to the executive bonus scheme, including distribution decisions, should be minuted and appropriate board papers filed to support the decision.

4.4 STRUCTURE THE BOARD TO ADD VALUE

4.4.1 Is the majority of the Board independent?

Board members are independent from the operations of the Company.

4.4.2 Are directors suitably skilled and experienced?

For effective governance to occur, board members need to demonstrate relevant experience and an appropriate specialist skill set in line with the complexity and scale of the TT-Line operation. The skill set and experience of the board members is a primary driver of the strength of the Board in performing their oversight function. An experienced and capable board reinforces appropriate due process in decision-making and appropriate communication lines with shareholders.

We found:

- The Government reserves the right to appoint board members to state owned companies, with the Chairman of the Board only having some input on the selection of board members. He is therefore less able to contribute in relation to his understanding of the current skill set existing on the Board [cf A1.5.1];
- There is evidence of a mismatch of director skills to the scale of the enterprise and the market risks involved [cf A1.5.1]; and
- There is no evidence of a formal process of director induction [cf A1.5.2]. However, directors had attended the relevant Australian Institute of Company Directors' course.

Recommendation 32

Based on the formally communicated guidance provided by the Department of Treasury and Finance, this review recommends a formal director induction process be developed and approved by the board of TT-Line.

Recommendation 33

It is appropriate for the Chairman of the Board to have input in relation to the appointment of a new director as they have the necessary knowledge and understanding of the skill set of the current board members.

4.5 CONCLUSIONS

Expectations of the TT-Line have been outlined in formal correspondence from the stakeholder Ministers. There is, however, no formal outline of board responsibilities, the purpose of TT-Line's operations, or the basis for communicating with shareholders.

We note with approval that board members are independent from the operations of the Company, which should ensure that they are better placed to perform their oversight role.

On the other hand, we noted some evidence of a mismatch of director skills to the scale of the enterprise, and a failure to seek independent advice. We were also concerned that the Chairman of the Board had little input on the selection of board members, and was therefore less able to contribute in relation to his understanding of the current skill set existing on the Board.

TT-Line does have a properly constituted audit committee, and its responsibilities are clearly outlined in a charter. There is, however, no remuneration committee. There is also no policy in relation to remuneration or performance evaluation. The salary of the CEO is not formally presented or approved by the Board, and the CEO decides remuneration of other executives, without formal presentation to the Board.

An executive bonus arrangement is in place based on profit, with the CEO retaining the responsibility for monitoring performance. We were critical that the performance criteria were not defined in executive contracts, and that bonus distributions are not formally approved by the Board.

5 Risk management

5 RISK MANAGEMENT

This section looks at identification, mitigation and management of business risks, including the management of material contingent liabilities.

In forming an opinion in this part of our review, we evaluated TT-Line against:

- **ASX Principle 7: Recognise and manage risk.**

5.1 RECOGNITION AND MANAGEMENT OF RISK

5.1.1 Has a full risk assessment been completed and documented?

Ideally a full risk assessment would include both operational risks, such as safety and tourism activity, and strategic risks, including market and financial risks.

We found that a comprehensive operational risk assessment has been performed and that the business plan provided evidence of some consideration of strategic risks. However:

- There has been no formal risk assessment process undertaken for strategic risk; and
- The informal risk management system was inadequate for recognition of early warning signs.

The Audit Committee has recently acknowledged this gap and has commenced the planning for a risk assessment process. [cf A1.3.1]

Recommendation 34
There should be a comprehensive and formal risk assessment, with a focus on strategic risks.

Recommendation 35
Independent external advice regarding the management of those risks should be sought. Such advice should be documented.

5.1.2 Is the Board and management's response to the identified risks documented and monitored?

We were looking for formal documentation of strategic risks through a risk assessment process.

As stated in 5.1.1, we did not find a strategic risk assessment, however, the business plan provided evidence of some consideration of strategic risks. In addition, we found that:

- Due to the lack of formal documentation of strategic risks, there was no evidence of the Board and management's response to the risks.
- The business cases presented to the Board did not include a comprehensive sensitivity analysis, capable of highlighting the potential risks in a clear and concise manner.

We were advised that the Audit Committee have noted this and are taking steps to address this issue. [cf A1.3.1]

Recommendation 36

The recent commitment by the Audit Committee to undertake a risk assessment process that includes financial, strategic and operational risks is endorsed. The risk assessment process needs to also become an executive and board tool for managing risk within the organisation.

5.1.3 Are operational and control weaknesses, noted by internal audit, addressed consistently and in a timely manner?

Effective internal auditing requires coverage of operational activities, formal reporting and management commitment to addressing control weaknesses.

We found:

- Responses to audit management reports are often non-committal and are provided by the finance division only;
- Some of the issues raised by the auditors are re-occurring; and
- The internal audit function was focused primarily on financial processes rather than broader operational processes.

Recommendation 37

The executive should consider all audit findings and ensure implementation of recommendations, as appropriate.

5.1.4 Do policies and procedures exist and are they documented and enforced?

The Board is responsible for approval of policies and procedures, to set and reinforce guidelines on standards of behaviour. It is implicit that policies and procedures in use should have been formally documented and approved, and that there is a set procedure for developing, approving and documenting policies within the organisation.

We found:

- Policies and procedures are inconsistently documented throughout the organisation;
- In some cases policies are developed at division level, but not approved at a board level; and
- There is no set procedure for developing, approving and documenting policies within the organisation. [cf A1.3.4]

Recommendation 10

Procedures for the development, documentation and approval of organisational policies should be developed.

Recommendation 18

Critical operational and risk management policies should be developed as a matter of priority and be approved by the Board.

5.1.5 Are there clear lines of responsibility for identifying and monitoring risk?

It is important that management establish and implement a system for identifying and monitoring both operational and strategic risk, throughout the organisation.

We found that there are clear lines of responsibility in relation to the identification and management of operational risks, with operational risks managed within the divisions of TT-Line. The responsibility for management of strategic risk rests with the CEO.

5.1.6 Are there internal control systems and procedures?

We found evidence of sound systems of internal control existing within the operational divisions of TT-Line. We did, however, find that there is a lack of policy direction from the Board in relation to internal control expectations. [cf A1.3.4]

5.1.7 Have significant financial risks been identified and monitored?

Management should establish and implement a system for identifying, assessing, monitoring and managing significant financial risk throughout the organisation. [cf A1.3.1]

We found:

- Significant financial risks are identified and managed informally by management; and
- Critical financial risks, in particular the exchange rate risk on the valuation of the ships and the fuel price risk, have not been formally identified, documented or reported to the Board.

5.2 CONCLUSIONS

Ideally, a full risk assessment would include both operational risks, such as safety and tourism activity, and strategic risks, including market and financial risks.

We found that a comprehensive operational risk assessment has been performed, but no formal strategic risk assessment. The business plan provided evidence of some consideration of strategic risks, however there was no analysis of sensitivity, and no evidence of management's response to the risks.

TT-Line has an internal audit function, however, it is focused primarily on financial processes rather than broader operational processes and there were concerns that findings were not always being effectively addressed.

One element of managing risk is the use of policies and procedures to set and reinforce guidelines on standards of behaviour and internal controls. Although policies and procedures existed, we found that in some cases they were not approved at a board level, and were inconsistently documented throughout the organisation.

This page left blank intentionally

6 Policies and procedures

6 POLICIES AND PROCEDURES

We considered the policies and procedures for ensuring compliance with legislation including the Corporations Law and the *TT-Line Arrangements Act 1993*.

In forming an opinion in this part of our review, we evaluated TT-Line against:

- **ASX Principle 5: Make timely and balanced disclosure – promote timely and balanced disclosure of all material matters concerning the Company;**
- **ASX Principle 6: Respect the rights of shareholders – respect the rights of shareholders and facilitate the effective exercise of those rights; and**
- **ASX Principle 10: Recognise the legitimate interests of stakeholders – recognise legal and other obligations to all legitimate stakeholders.**

6.1 MAKE TIMELY AND BALANCED DISCLOSURE

6.1.1 Are timely and balanced disclosures of material matters made to shareholder Ministers?

The Board is responsible for providing Ministers with regular performance information and providing timely advice of significant issues, including risks and associated mitigation strategies.

In our opinion, the capacity of the Parliament and the public to assess TT-Line's performance is reduced under the current format of the annual report, because non-financial performance, strategies or vision are not disclosed.

Although TT-Line is not a disclosing entity under the Corporations Act, we consider it should operate as if it were, in order to be more transparent and appropriately discharge its responsibilities to the Government and the public.

We found [cf A1.4.1, A1.4.2]:

- The stakeholder Ministers' offices are provided with full copies of all monthly board papers;
- The annual report of TT-Line, while compliant with current legislative requirements and accounting standards, does not represent best practice in relation to board reporting and accountability disclosures,

particularly in the areas of corporate governance, risk management and corporate performance; and
- There is no formal briefing process for the Minister.

Recommendation 38

Provision of full board papers to the stakeholder ministers should be discontinued. Instead, a basis for provision of regular performance information and timely advice of significant issues should be agreed between the Chairman of the Board and the Minister.

Recommendation 39

TT-Line should include those additional disclosures that would be necessary if it were a disclosing entity under the Corporations Act.

6.1.2 Is communication between the Minister, the Board and the CEO timely and balanced?

Effective communication underpins the relationship of trust among the shareholders, board, and management. It forms the glue that holds the complex corporate governance framework together.

Our preferred model is that the Minister communicates primarily with the chairman, on both a formal and informal basis, and that communication with the CEO should only occur in conjunction with the chairman. [cf A1.4.2]

We found that there was regular CEO communication with the Minister, however less involvement by the Chairman of Board.

Recommendation 16

A communication policy should be developed which formalises the Chairman as the key point of contact for the Minister in relation to the operations of TT-Line.

6.1.3 Does the Board keep the Ministers and Government informed regarding business operations, achievement of performance targets, operational or policy issues and major customer and environmental issues?

A Statement of Expectations developed in conjunction with the Minister and the Board would provide clarity in relation to the Board's responsibilities, and therefore what the Board is ultimately held accountable for.

We found that there was a formal statement of expectations from the Minister to the Board of TT-Line, however:

- There are no formal briefings of stakeholder Ministers by the Chairman of the Board; [cf A1.4.1]
- There are no specific financial, operational or strategic performance targets formally agreed with stakeholder Ministers; [cf A1.6.2] and
- There are no specific policies that have been agreed with the stakeholder Ministers.

Recommendation 38

Provision of full board papers to the stakeholder ministers should be discontinued. Instead, a basis for provision of regular performance information and timely advice of significant issues should be agreed between the Chairman of the Board and the Minister.

Recommendation 27

The formal system of performance management for the Board and senior executives should use specific performance criteria.

6.2 RESPECT THE RIGHTS OF SHAREHOLDERS

6.2.1 Is there effective communication with shareholders - including balanced and understandable information about the Company?

The principal method of communication with the Ministers (shareholders) was to send a complete set of board papers and minutes to the offices of the Ministers each month. This process does provide the Minister with information relating to the company however this process does have a number of significant negative aspects:

- The provision of full board papers to the Ministers can create the perception of a "shadow" board, which could undermine the authority and clarity of responsibilities of the sitting board, and affect the Board's willingness to document key discussions within the minutes; and
- The level of detail included within the board papers is both inefficient and ineffective in briefing the Minister on the critical issues of the company.

There were no formal briefings of the Minister on a consistent basis by the Chairman of the Board. In addition, there is no agreed basis on which to report to the Minister including specific targets, key performance indicators (KPIs), or policies to be approved.

In summary, we found:

- The sending of full board papers to stakeholder Ministers is inappropriate and ineffective. This could result in a "shadow" board and could potentially undermine accountability structures [cf A1.4.1].
- Level of analysis of financial information and operational risks within papers given to shareholders is insufficient.

Recommendation 38

Provision of full board papers to the stakeholder ministers should be discontinued. Instead, a basis for provision of regular performance information and timely advice of significant issues should be agreed between the Chairman of the Board and the Minister.

6.2.2 *Is the Board results-orientated and adaptable to change?*

Under the *TT-Line Arrangements Act 1993*, the principle objective of the Company is to manage and facilitate the operation of a shipping service to and from Tasmania in a manner that is consistent with sound commercial practice. We looked at two issues, the use of cross-subsidisation and depreciation of assets.

6.2.2.1 Cross-subsidisation

The Devil Cat service from George Town to Victoria was conducted over Bass Strait for some four years. During that time the Spirit of Tasmania service cross-subsidised the Devil Cat service by approximately $23 million. In the context of delivering a shipping service to and from Tasmania, this would seem to be consistent with the Act.

However, there is a risk that cross-subsidisation of internal services can lead to operational inefficiency and loss of accountability. There is also a substantial risk that the critical objective of capital maintenance and growth may be compromised. In the case of TT-Line, capital maintenance and growth over time is critical to allow future funding for asset replacement.

Another difficulty with implied subsidies is that they tend to become accepted as a normal way to do business. TT-Line decided to manage the downside risk of the Sydney service through a subsidy from the Melbourne service. Unfortunately, it did not have a strategy for the eventuality that the Melbourne service would also not meet its budget.

It is our view that the issue of subsidy is not one for the management or board of TT-Line but one for the stakeholder Ministers. It then does not get lost in the detail of an operating company whose primary goal is to operate commercially and therefore make profits to support future operations. [cf A1.8.2]

We found that the internal cross-subsidisation of loss making state-benefit assets by profitable operations is inappropriate and results in stripping capital from the organisation.

Recommendation 40

Any future strategic decisions which require cross-subsidisation of services internal to the organisation should be made at a stakeholder Minister level. The level of subsidy should be clearly defined to provide a basis from which to assess the performance of management in relation to the core service, and the subsidised service. Where cross-subsidisation is selected, consideration needs to be given to the ability of the Company to maintain sufficient capital to continue to meet its statutory obligations over time, particularly in relation to asset replacement.

6.2.2.2 Depreciation

The depreciation methodology applied to the key assets is critical in ensuring the ongoing ability of TT-Line to manage and replace capital. The current depreciation methodology of TT-Line whereby the ships and fit-outs are depreciated straight line over the same useful life does not reflect the diminution of the asset over time or provide for the generation of cash reserves for future maintenance or capital replacement.

In simple terms, the life of ships on the Bass Strait run has been about ten years. The depreciation charge is a major cost to TT-Line. At the start of the cycle they require a fit out which is substantially worn out at the end of that time. The fit out for Bass Strait will not suit the Mediterranean, the Baltic or South East Asia because of different climatic and route conditions. The value of the ship in international markets is the value without the fit-out. The asset should therefore be recorded in its component parts, including fit-out, subsequent modifications to fit-out, and the ship infrastructure. This analysis highlights the need for a more relevant view to the capitalisation of assets and their amortisation over time.

Recommendation 20

Although compliant with current accounting standards, the current asset components of the ships should be separately identified. The component parts should reflect, at a minimum, initial fit-out, modifications to fit-out during the life cycle, and the ship infrastructure. There may also be a need to review depreciation policy to ensure accurate representation of useful lives of the asset components.

6.3 RECOGNISE THE LEGITIMATE INTERESTS OF STAKEHOLDERS

6.3.1 Are legitimate stakeholder interests recognised?

We found that shareholder interests are recognised. The state benefit argument of the operations of TT-Line has been acknowledged by the Company and taken into consideration when assessing their operations.

6.3.2 Does the Board have a defined role and sufficient authority?

The power of the Board in a public company is derived from the ability to appoint and remove the CEO, appoint the chairman and new directors, finalise and approve strategy, define the values and culture, 'say no' to management and give final approval to the sale and purchase of significant assets. When these powers are diluted or modified, a board of directors is rendered useless.

We found that:

- There was an inherent conflict between the assessment of TT-Line as a commercial operation as opposed to a government infrastructure company providing state benefit services. This was clarified through the *TT-Line Arrangements Act 1993* and via correspondence from the stakeholder Ministers, which clearly set out the expectations of the Treasurer of the day in relation to the responsibilities of the board, and the basis for communicating with the shareholders. This communication from the Minister was not formalised by the board of TT-Line as a basis for their authority, responsibilities, and communication with shareholders [cf A1.1.1.1]; and
- There was no board charter prepared for TT-Line. The existence of such a document would assist in clarifying the authority of the board, and ensure that the board is effective in this role.

Recommendation 41

A TT-Line board charter should be developed clarifying the role and authority of the Board.

6.3.3 Should there be oversight by the Tourism Minister?

One of the stakeholder Ministers for TT-Line is the Tourism Minister. This Minister has overall responsibility for meeting the needs of all tourism operators in Tasmania. The objective of Tourism Tasmania is to maximise the number of tourists to Tasmania from all locations and from all transport mediums. TT-Line is only one part of the overall tourism strategy and infrastructure. As was seen in the use of the money allocated to the launch into the Sydney market at the time when *Spirit of Tasmania III* (SPOT III) was launched, Tourism Tasmania took a global tourism viewpoint where TT-Line considered a specific SPOT III promotion was required.

We found that there is an inherent conflict between the management of TT-Line and the tourism objectives of the State. The Tourism portfolio may be inappropriate as an oversight mechanism. [cf A1.4.3]

Recommendation 42

Consideration should be given to the second Stakeholder Minister for TT-Line not being the Tourism Minister.

6.4 CONCLUSIONS

We found that shareholder interests are recognised. The state benefit argument of the operations of TT-Line has been acknowledged by the Company and taken into consideration when assessing its operations. However, there is a potential conflict between the commercial objective of TT-Line and the tourism objectives of the State. The Tourism portfolio may be inappropriate as an oversight mechanism.

We also noted that there was regular CEO communication with the Minister, however less involvement by the Chairman of the Board and recommended that a communication policy be developed which formalises the Chairman as the key point of contact for the Minister.

While there was a formal statement of expectations from the Minister to the Board of TT-Line, there are no formal briefings by the Chairman of the Board, no agreed performance targets and no agreed policies. In addition, the annual report does not disclose non-financial performance.

We also expressed concerns over internal cross-subsidisation of loss making operations by profitable operations. In our view this issue is one for the stakeholder Ministers, rather than the TT-Line.

7 Positive aspects of the review

7 POSITIVE ASPECTS OF THE REVIEW

Whilst this review has identified a number of areas of governance that the Board and Management of TT-Line should address, it does not question the valuable role that TT-Line has, and continues to have, in the Tasmanian economy. Its achievements have been significant. In addition, this review identified a number of positive aspects, which are documented in this section.

7.1 MEETING OBLIGATIONS UNDER THE ACT

Under the *TT-Line Arrangements Act 1993*, the principal objective of TT-Line is to manage and facilitate the operation of a shipping service to and from Tasmania in a manner that is consistent with sound commercial principals. TT-Line's current operations achieve this service objective to a high standard.

The operational systems and processes within TT-Line are sound with key operational executives having a strong understanding and appreciation of the risks and challenges facing their area. The executive team have appropriate experience and knowledge and have implemented strong internal systems and processes to ensure TT-Line successfully achieves the objectives of the Act.

The shipping and passenger services are driven by a number of key performance indicators (KPI's). These KPI's are achieved consistently resulting in a high standard of service delivery for both passengers and freight alike. The executive team demonstrated a strong commitment to service delivery, which is evidenced through customer feedback received by the Company.

7.2 OPERATIONAL RISK MANAGEMENT

Due to TT-Line's focus on operations and service delivery, the executive management team have a strong understanding of the operational risk profile of TT-Line's operations. A risk assessment of operational risks has been conducted including safety, in conjunction with AMSA, and security. The management team have implemented a strong control environment surrounding these operational risks, which is further supported by the regulatory supervision of AMSA.

7.3 IMPROVEMENTS TO THE AUDIT COMMITTEE CHARTER

The Audit Committee has recently decided to initiate a formal risk assessment process, which will include strategic risk.

7.4 INTERNAL CONTROL ENVIRONMENT

While there is an absence of internal policies and procedures as discussed in 5.11, this review found a sound internal control environment exists within the finance and procurement divisions of TT-Line. Key internal controls over the major financial systems and processes within the divisions were found to be in place. This internal control environment supports the safeguard of Company finances and increases the confidence in the financial reporting generated by the Company.

7.5 STRUCTURE OF ORGANISATION AND OVERSIGHT

The current governance of TT-Line includes a governing Board, CEO, with the Ministers' offices providing high-level oversight. This structure should be appropriate to the operations of TT-Line.

The internal structure of TT-Line is also appropriate to achieve the objectives of the Act. The role of Chairman of the Board is performed by a separate individual from the CEO. The internal structure of TT-Line includes an executive management team to support the CEO in his responsibilities. While the structure is appropriate to efficiently manage the organisation, we refer to our discussion in 5.10 of this Report in relation to this issue.

7.6 LEGITIMATE STAKEHOLDER INTERESTS ARE RECOGNISED

The operations of TT-Line, while essentially stand-alone, do contribute significantly to the overall infrastructure of the State and the tourism industry. The related stakeholder interests in TT-Line have been acknowledged by both the Board and management. Over the period of the review, there is evidence of consideration of these factors, including political requirements, in relation to decisions made. It is appropriate for state owned companies to acknowledge and respond appropriately to legitimate stakeholder interests.

7.7 USE OF EXTERNAL ADVICE

Critical decisions for an organisation in some cases require the use of independent expert advice. Good governance will ensure that advice is obtained where appropriate to assist with key decisions or strategic proposals. The management of TT-Line obtained external advice in relation to strategic decisions made over the period of this review, primarily market related advice. This independent information provided a supporting case for the demand for TT-Line services in varying locations over time.

This page left blank intentionally

Appendix 1: Detailed discussion of issues raised

APPENDIX 1: DETAILED DISCUSSION OF ISSUES RAISED

This section details the outcomes from our fieldwork. It provides more detailed discussion of the major audit findings, than the body of this Report.

Issues were identified from benchmark analysis of TT-Line's decision-making processes and corporate governance against best practice.

Only the major issues identified and assessed as important to the effectiveness of corporate governance and decision making within TT-Line have been included within the body of this Report. Not all of the recommendations recorded below have been repeated in the body of this Report and some of the recommendations have changed.

A1.1 CLARITY OF ROLES, DELEGATIONS AND RESPONSIBILITIES

This section discusses the findings in relation to the:

- Role and authority of the board; and
- Delegation and clarity of executive management responsibilities.

> "The company's framework should be designed to…clarify the respective roles and responsibilities of board members and senior executives in order to facilitate board and management accountability to both the company and its shareholders" (ASX Corporate Governance Council, p.15).

> "For an entity to succeed, all relevant parties must have a clear understanding of their roles and responsibilities in the governance framework" (Uhrig, p.25).

> "The lack of clarity in relationships and responsibilities reduces the capacity of Ministers to be satisfied with existing accountability arrangements" (Uhrig, p.53).

A1.1.1 The Role and Authority of the Board

> "The power of the board in a public company is derived from the ability to appoint and remove the CEO, appoint the chairman and new directors, finalise and approve strategy, define the values and culture, 'say no' to management and give final approval to the sale and purchase of significant assets. When these powers are diluted or modified, a board of directors is rendered useless" (Uhrig, p.65).

The existence of a board to oversee the operations of TT-Line is the appropriate structure to provide good governance. In this context, the level of authority of the board, and the clarity that exists in relation to that authority, is critical to ensuring effective operation of the board. It is usual practice for public companies to adopt a charter that outlines the role of the board, the role of the executive, their interaction with one another, and the interaction of both with the shareholders.

There was no board charter prepared for TT-Line. The existence of such a document would assist in clarifying the authority of the board, and ensure that the board is effective in this role. What evolved was a range of informal networks where the CEO interacted with the Chairman, the stakeholder Ministers and their offices, and board members on an ad hoc basis according to the imperatives of the situation at hand.

A1.1.1.1 Clarity of the Board's Responsibilities and Statement of Corporate Intent

> "Optimally, the Minister seeks to minimise the extent of his or her influence with the areas of decision-making delegated to the board. The board is responsible for approval of the strategies and policies, the oversight of management and is held accountable for the statutory authority's performance in meeting its purpose determined through the board direction set by the Minister" (Uhrig, p.81).

> "…it is recommended that each Minister issue a Statement of Expectations to statutory authorities within their portfolio where the Minister has a role in providing direction. This document would outline relevant government policies, including the Government's current objectives relevant to the authority and any expectations the Government may have on how the authority should conduct its operations" (Uhrig, p.7). "The proposed Statements of Expectations and Intent would assist in ensuring clarity in purpose as well as providing a clearer basis for assessing performance" (Uhrig, p.76).

In line with a formal agreement in relation to disclosure to the Minister, John Uhrig suggests a Statement of Expectations be developed in conjunction with the Minister and the Board to provide clarity in relation to the board's responsibilities, and therefore what the board is ultimately held accountable for. It is the practice for some state-owned companies to receive from their stakeholder ministers a letter that formally sets out their expectations of the company and the board. We have obtained copies of relevant letters from the period March 1999 to March 2004 sent to the Chairman of TT-Line from the Treasurer of the day, the Minister for Infrastructure, Energy and Resources, and senior Treasury officials. This correspondence clearly sets out the expectations of the Treasurer of the day in relation to the responsibilities of the board, and the basis for communicating with the shareholders.

During the review, there were arguments made that the operations of TT-Line are of a commercial nature, as well as arguments that TT-Line is a state infrastructure asset which provides further benefits to the state as a whole, both of which have merit. Clarity in relation to the Ministers' expectations on this issue is important to ensure that the decisions made by the TT-Line board and management are congruent with the over-arching purpose of the entity. The *TT-Line Arrangements Act 1993* clearly spells out that the operations of TT-Line should be managed *"in a manner that is consistent with sound commercial principals"*. The correspondence from the Treasurer and Minister for Infrastructure, Energy and Resources in February 2001 regarding the format of business plans allows for a state-owned company to *"include those activities, services or concessions undertaken by the Company which the Board considers to be non-commercial in nature"*.

The Board of TT-Line therefore has clear communication from the Minister in relation to the expectations and the responsibilities of the board. This communication from the Minister was not formalised by the board of TT-Line as a basis for their authority, responsibilities, and for communicating with shareholders.

A1.1.2 Delegation and Clarity of Executive Management Responsibilities

> "…governance should ensure that there is a system to delegate power to appropriately skilled individuals, allowing them to make decisions consistent with the purpose of the organisation. Additionally, governance requires that there be systems and reviews established to ensure that power is limited and exercised in a responsible manner and decision-makers have clear lines of accountability" (Uhrig, p.47).

A1.1.2.1 Statement of duties and executive contracts

The CEO has a perpetual contract of employment. None of the other executives have a contract of employment. Statements of duties exist for key executives however they have not been updated during the period of the review and were not referred to by key executives as the basis for their job description

The outcome of these informal arrangements is that the organisation becomes driven by the personalities of the key individuals. While this may have been appropriate when the company was running one smaller ship and a smaller catamaran, it is not appropriate at the scale and complexity of the current operations.

A1.1.2.2 Delegation of powers and responsibilities

From our discussions with senior management we are aware that there are delegation policies in place. These policies however have not been updated for a significant amount of time.

A1.2 ORGANISATIONAL STRUCTURE AND LOCATION

This section discusses the findings in relation to the:

- Internal management structure and communication; and
- Location of executive management.

A1.2.1 Internal Management Structure and Communication

> "Governance ensures the success of an entity through the success of its executive management" (Uhrig, p.23).

The current internal management structure within TT-Line is segregated into operational divisions consisting of:

- Safety and Technical Services;
- Freight Services;
- Passenger Sales and Marketing;
- Hotel Services;
- Security and Risk; and
- Finance.

TT-Line is managed within the silos of each of these operational divisions. All internal reporting lines from the general managers of the operating divisions are direct to the CEO. Each operating division is relatively autonomous. The general managers are only accountable to the CEO. There is no formal executive and there are no interdivisional committees to consider issues which go across more than one division. In addition, information and data relating to the operations of TT-Line, for example the reservations database, is held and managed solely within operating divisions. In the reservations database example, the National Manager Passenger Sales and Marketing gets access to the database through specific requests to the CFO. This structure is time consuming and it makes it difficult for passenger sales and marketing to be responsive in a quick timeframe. There is no formal mechanism for sharing data across the organisation.

The internal organisational structural issues outlined limit the ability of the company to respond quickly to the emergence of unanticipated adverse outcomes.

A1.2.2 Location of Executive Management

The head office is currently split between Devonport and Melbourne. Five of the executive team including the CEO are located in Melbourne at Station Pier. The other three including the CFO and the Company Secretary are located at Devonport. It important that the executive team of an organisation the size and scale of TT-Line, is all in the in one physical location in order to ensure effective communication is maintained. The logical place for this is Devonport. The current situation reinforces the silo nature of the internal structure as discussed in A1.2.1.

A1.3 STRATEGIC AND RISK MANAGEMENT

This section discusses the findings in relation to the:

- Risk management;
- Long-term strategic planning;
- Major acquisition process; and
- Internal policies and procedures.

A1.3.1 Risk Management

> "Management should establish and implement a system for identifying, assessing, monitoring and managing material risk throughout the organisation" (ASX Corporate Governance Council, p.44).

> "…governance should have a strong focus on the management and oversight of risk, particularly in the areas that are essential to the success of the entity" (Uhrig, p.25).

The risk management of an organisation can be loosely divided into strategic risk management and operational risk management where:

- Strategic risk management is the identification of the key risks of the organisation and the development of strategies to address those risks; and
- Operational risk management considers the implementation of those strategies within the organisation.

Overall responsibility for risk management within TT-Line rests with the CEO. The organisation structural issues discussed in A1.2.1 reinforce this responsibility. This review found that the overall operational risk management within TT-Line is sound.

Operational risk management is only as good however as the strategic risk management within an organisation.

A1.3.1.1 Strategic Risk Management

The strategic risk management at TT-Line has been considered through a review of the annual and longer term business plans prepared by TT- Line.

The risks identified in those documents are focussed on the operational issues which preoccupy the business, specifically safety, the Bass Strait Passenger Vehicle Equalisation Scheme, tourism activity, freight competition and passenger competition. These issues are crucial and their proper management is of fundamental importance.

While a number of strategic risks have been mentioned in the business plans of TT-Line, there has been no documentation of strategic risks through a formal risk assessment process. While the business plans consider operational risks in detail, these documents do not inform either the board of TT-Line or the stakeholder

Ministers how TT-Line manages the significant market risks it faces with respect to interest rate risk, currency risk or credit risk. Some examples of these risks are detailed below.

- Credit Risk

  TT-Line has significant borrowing from TASCORP denominated in Australian dollars ($A) with the primary security being the assets of the company by virtue of a deed of charge. The market for these ships is denominated in Euros principally or the US dollar ($US). As the $A moves in value against these currencies the security value of these assets also moves. This is a significant market risk for TT-Line because it impacts on their depreciation policy, their ship replacement policy and their loan to valuation ratio. The advice received from TASCORP regarding currency risk we understand related to the purchase of the ships and their funding, but did not address the above issues.

- Market risk associated with the success of discount airlines.

  Previous discount airlines in Australia have had a short-term life. It is now apparent that the new participants are not short term. They have effectively reduced the cost of flying and opened up a new option to many people. However, this group of people make up a large part of the existing demographic of TT-Line. TT-Line was not prepared for the risk that discount airlines would survive and did not have strategies to counter it.

- Market risk associated with selling reservations at fixed prices out twelve months in advance.

  TT-line sells reservations at fixed prices up to twelve months in advance. While they may not receive the cash until much later, the prices at which reservations are sold are fixed. Significant costs associated with those reservations are also fixed, for example, payroll costs are subject to an agreement and depreciation is a fixed charge.

  There are however, significant costs which are subject to market forces, which can be managed. Three of these are: currency risk associated with oil prices, pricing risk associated with the $US price of oil, and interest rate risk for the working capital component of the borrowings of TT-Line. The management of these costs becomes essential where prices for future revenues are fixed.

A1.3.1.2 The Role of Audit and the Audit Committee

As noted above, while a number of the strategic risks have been mentioned in the business plans of TT-Line, there has been no formal documentation of strategic risks through a risk assessment process. In recent months, the audit committee of TT-Line have noted this and are taking steps to address this issue. Similarly, there is no formal monitoring or reporting on the management of strategic risks to the board. This will need to be incorporated into the risk management processes to be implemented by the audit committee.

Internal and external audit functions also have a role to play in risk identification and assessment within an organisation. The internal and external audit programs have been primarily focused on financial processes and risks over the period of the review. Recent changes implemented by the audit committee and board for internal audit will incorporate a risk management approach which will expand the area of audit coverage to operational risks, rather than just financial risks.

The review of internal and external audit reports to management over the period of the review indicated that responses to audit findings were obtained from the finance division of TT-Line. In some instances, this resulted in a lack of ownership in addressing the issue noted as it fell outside the responsibilities of the finance area. Where audit findings are formally reported to management, a formal response should be made, and committed to, by the executive management team. This will ensure appropriate ownership for issues identified and will ensure that the proposed management approach is practical and thorough, and committed to.

A1.3.2 Long Term Strategic Planning

> "The board is accountable to shareholders for the responsibilities delegated to it, including the financial success of the company. The board is responsible for: approving the strategic goals developed by management, ensuring management achieves its strategic and other goals…" (Uhrig, p.27).

A1.3.2.1 Strategy and Planning Documents

The ship and route strategy pursued by management over an extended period forms the core long term strategic planning of the organisation. This strategy was conducted by management and subject to regular updates to the board. In the context of our comments regarding policy development, in section 4.3.3.1 below, this process is appropriate as long as the board is adequately informed and management operate within defined guidelines given by the board.

The company prepares a three-year rolling business plan each year. We have commented above regarding the risk management issues not addressed by this plan. The annual plan is basically the annual budget.

A1.3.3 Major Acquisition Process

> "It is the responsibility of directors to ensure they have accurate and sufficient knowledge on which to base their decisions" (Uhrig, p.29).

> "Corporate governance best practice recommends that directors, in the furtherance of their duties, should have access to independent advice at the company's expense" (Ernst & Young, Implementation Handbook, p.22)

The role of the board is to interact with management and with the stakeholder Ministers. This is achieved in the first instance through involvement in policy development and in particular how it will interact with the risk management framework.

If the project is significant enough to require shareholder approval then the level of board due diligence on the proposal should be enhanced. The board have to satisfy themselves that the proposal will not compromise the risk management framework that they already have in place, and the financial projections are adequately tested. It is not unreasonable for the board to seek independent advice on any element of the proposal but in particular on the financial projections, the market research and market risk management. The most effective way for this due diligence to occur is the formation of a board sub-committee, which includes external parties who provide the requisite external independent expertise. This committee should meet regularly through the submission development process and drive the acquisition process. The TT-Line board should formalise the major acquisition process, particularly in relation to the board's level of due-diligence and management of the acquisition process.

We note in relation to the acquisition process of Spirit III, that the board received independent advice obtained by management in relation to marketing and operational issues. They did not however obtain independent advice at a board level to test the advice obtained by management, nor did they obtain independent advice on the financial projections and models.

Having made these observations it is important to understand that it is not the role of the board to usurp the role of management. Management has the primary responsibility to manage the project. The role of the sub-committee is to ensure that the board has all the information it will need to approve the project if that is the decision they decide to make.

The final role of the board is for the Chairman to brief the stakeholder Ministers and seek their approval. Clearly this is completed in conjunction with the CEO. The role of the stakeholder Ministers is to approve the project at agreed milestones. That is, at agreed milestones the Chairman should brief the stakeholder Ministers and either confirm or approve the actions taken as the circumstances require.

At TT-Line, these principles were not adopted. While the form of the process in regard to the relationship between management, the board, and the stakeholder Ministers existed, it was not robust enough to manage the many large and complex risks involved.

It is important for the board to remember that any reviews by Treasury Tasmania and Tourism Tasmania are prepared for Government from their perspective, not the perspective of TT-Line. They are the advisers to the stakeholder Ministers, not the board of TT-Line.

On any major acquisition the Board of TT-Line should appoint independent advisers to confirm the advice of management. In particular, these advisers should assist the board to be assured that the risk management structure they have in place will not be compromised by the acquisition.

The role of management may be described as:

- Policy development;
- Proposal development;
- Submission development; and
- Implementation.

All of these roles are achieved through interaction with the board. It is important the protocols for communication with the board and management are observed.

A1.3.4 Internal Policies and Procedures

> "The board is responsible for approval of the strategies and policies…" (Uhrig, p.81)
>
> "Communication from leadership down through the organisation needs to set and reinforce clear guidelines on right versus wrong behaviour" (Ernst & Young, What is Corporate Governance, p.6). "…The board [should] confirm its responsibility (via its charter) for … establishing policies and processes to ensure the integrity of the corporation's internal control and management information systems" (Ernst & Young, Implementation Handbook, p.24).

Documented policies and procedures within an organisation provide the basis for the board and executive management to direct the operations of the organisation, in particular, the management of risk.

A policy and procedure manual for TT-Line was not provided at the commencement of the review. Subsequently, a number of policies have been provided. In addition, evidence was found of documented policies within the operational divisions of TT-Line however some of these policies were developed by the divisions in isolation indicating a lack of consistency in developing and documenting policies and procedures within the organisation. There is no set procedure for developing, documenting and approving policies within the organisation.

There are a number of key policies that are not in place within the organisation including a risk management policy, and a policy in relation to procurement.

A1.4 INTERACTION WITH STAKEHOLDER MINISTERS

This section discusses the findings in relation to:

- Disclosure to the Minister;
- Communication between the Minister, the board, and the CEO; and
- The appropriateness of the Tourism portfolio oversight.

> "In circumstances where statutory authorities operate with a degree of statutory independence, Ministers will be unable to provide direction in relation to day-to-day operations. This independence distinguishes to some extent the governance arrangements of statutory authorities from those of a closely held company. Given the impact that statutory authorities can have on the public, including the business community, effective governance instruments need to be in place to ensure that adequate supervision occurs" (Uhrig, p.35-36).

The operations of TT-Line are primarily commercial in nature and the company operates with a degree of statutory independence. The authority and interaction between the Ministers, the board, and management of TT-Line is therefore central to effective governance of the entity, particularly in relation to appropriate supervision.

A1.4.1 Disclosure to the Minister

> "The board is responsible for informing the Minister in a timely manner of significant issues impacting on the authority, including risks and associated mitigation strategies" (Uhrig, p.83)

> "It is important that disclosure is continuous. This will involve statutory authorities providing Ministers with information on key aspects of performance. A cultural commitment to continuous disclosure supports the 'no surprises' approach that ensures Ministers and departments are aware of critical issues as they occur. This ensures the opportunity for serious issues to be handled in consultation with the Minister and the department and to limit damage that might otherwise occur" (Uhrig, p.75).

> "…boards can only provide effective governance when they have the full power to act. Where a board is created and not given adequate power, not only will it be unable to provide effective governance, but it also introduces an additional layer of participation in the governance framework, potentially clouding accountabilities" (Uhrig, p.40).

TT-Line communicated with the State Treasurer and the Minister for Tourism, Parks and Heritage as the stakeholder ministers for the company. The communication channels with the stakeholder ministers for TT-Line were ad hoc during the period of review. The principal method of communication with the Ministers was to send a complete set of board papers and minutes to the offices of the Ministers each month. They did not receive any papers tabled at the board meeting unless they were subject to special presentation. This process does provide the Minister with information relating to the company however this process does have a number of significant negative aspects.

The provision of full board papers to the Ministers creates the perception of a "shadow" board which could undermine the authority and clarity of responsibilities of the sitting board. The perception of alternative decision-making authority other than the board potentially weakens the accountability for outcomes within the organisation. This process can also affect the board's willingness to document key discussions within the minutes due to the increased potential of board papers becoming publicly available.

The level of detail included within the board papers is both inefficient and ineffective in briefing the Minister on the critical issues of the company. The board papers are extensive, and while time consuming to read and analyse, sections of the papers are not relevant or of sufficient importance for the Minister to be made aware of.

The timing of the board meetings and distributions of the papers was not timely in ensuring the Minister was appraised of critical issues as they occurred. While there is evidence of formal communication regarding key strategic decisions as they occurred, financial indicators are only communicated through the board papers.

There were no formal briefings of the Minister on a consistent basis by the Chairman of the Board. In addition, there is no agreed basis on which to report to the Minister including specific targets, performance KPI's, or policies to be approved. There were no other formal briefings of the Ministers in relation to the financial performance of the Company until the recent disclosure of significant operating losses.

> "…the Minister receives for endorsement the corporate plan, already approved by the board, reflecting strategies, risk management and projected performance (or other relevant matters) and may either require further explanation or indicate where the plan may be inconsistent with general government policy and objectives.
>
> While the board has been delegated the necessary power to act, the Minister needs to be kept informed of the authority's operations and ensure performance is acceptable. Key performance indicators and regular reporting arrangements need to be agreed and implemented to ensure that the Minister is adequately informed of the authority's operations" (Uhrig, p.81).

A1.4.2 Communication between the Minister, the Board, and the CEO

> "Effective communication underpins the relationship of trust among the shareholders, board, and management. It forms the glue that holds the complex corporate governance framework together" (Ernst & Young, What is Corporate Governance, p.6).

The operations of TT-Line are directed by the *TT-Line Arrangements Act 1993*. The Act does not specifically outline the authority or role of the Minister in relation to the operations of the Company, although it does provide for communication with the Ministers as shareholders. In addition to the Act, the Chairman of the Board has received formal communication from the stakeholder Ministers over the period of the review in relation to their expectations of the board, and the basis for communicating with the Ministers. The interaction and communication between TT-Line's board and management, and the Minister is paramount to effective governance.

> "In dealing with the statutory authority it is expected that the Minister communicates primarily with the chairman, on both a formal and informal basis. There may also be circumstances where the Minister considers it necessary to communicate with the CEO. However, this should only occur in conjunction with the chairman, otherwise there will be a reduction in the ability of the board to provide effective management oversight" (Uhrig, p.82).

> "Where a board is restricted in its ability to act, whether through formal limitations or through informal relationships which bypass the board, it will fail to perform an effective governing role, thereby reducing the performance of the authority and providing effective supervision of management…….. Where a CEO establishes

> regular contact with the Minister, the relationship between the Minister and the chairman becomes superfluous, as it would in a private sector closely held company. The inability of the board to either prevent this from occurring or add value to this relationship makes the board's task of effective oversight of the performance of management difficult if not impossible…… The accountability process is further complicated in a number of ways by the existence of a board with less than full governing powers. In such cases, the board will often become captured and tend to become an ally of the CEO, rather than an objective critic and fail to provide governance. Management may use a board to obtain agreement for activities that may not otherwise be agreed by the Minister and then use the justification of 'board approved' to explain why actions are occurring. In these circumstances a board that lacks one of the key sources of power will not be effective in holding management accountable" (Uhrig, p.66).

> "In an authority where the day-to-day relationship with the government is primarily between the CEO and the Minister (rather than between the chairman and the Minister) the board's ability to influence is lessened. Conversely, the influence of the CEO with the board and the Minister is increased, creating the potential for a CEO to use the support of one to exert pressure on the other" (Uhrig, p.6).

This review found anecdotal evidence that the CEO had regular communication with the stakeholder Ministers on routine and non-routine matters. There were no regular briefings of the stakeholder Ministers by the Chairman. This situation changed as the Ministers and their advisers changed. While briefings of the Ministers occurred with the Chairman in relation to special projects and decisions, it appears that the Chairman played a less central role in communicating with the Ministers than the CEO over the period of the review. In addition to this, the review found that while all directors received the same information at board meetings, between meetings, the directors did not receive the same information. Different directors received different information depending on their level of interaction with the CEO.

To ensure the lines of communication support the oversight structures put in place for TT-Line, a formal communication policy should be developed which formalises the Chairman as the key point of contact for the Minister in relation to the operations of TT-Line. In line with 4.1.1, where a board has clarity on its role and authority, the communication lines will align themselves to this structure.

A1.4.3 Appropriateness of Tourism Portfolio Oversight

One of the stakeholder ministers for TT-Line is the Tourism Minister. This Minister has overall responsibility for meeting the needs of all tourism operators in Tasmania. The objective of Tourism Tasmania is to maximise the number of tourists to Tasmania from all locations and from all transport mediums. TT-Line is only one part of the overall tourism strategy and infrastructure. As was seen in the use of the money allocated to the launch into the Sydney market at the time when Spirit III was launched, Tourism Tasmania took a global tourism viewpoint where TT-Line considered a specific Spirit III promotion was required. Such potential conflicts of interest suggest that TT-Line should come under some other ministerial responsibility.

A1.5 EFFECTIVE BOARD OPERATION

This section discusses the findings in relation to:

- Specialist versus generalist board members;
- Board induction and training;
- The inclusion of the CEO as a board member;
- Documentation of key decisions in board minutes; and

- Management attendance at board and committee meetings.

A1.5.1 Specialist versus Generalist Board Members

> "Information collected by the review indicated several factors which reduce the effectiveness of boards. These include issues about clarity of purpose, the extent of the delegation power to the board, and the skills and experience of the directors" (Uhrig, p.40).
>
> "In getting the best from boards, appropriate experienced directors are critical to good governance. Representational appointments to boards have the potential to place the success of the entity at risk" (Uhrig, p.100). "For governance boards, representational boards fail to produce independent, critical and objective thinking " (Uhrig, p.43).

The TT-Line board is appointed by the Government. As previously noted, TT-Line is a unique business within the Australian context. The increased complexity and scale of the TT-Line operations over the period of review have highlighted the need for the board to have the necessary skill set to provide appropriate oversight of management and strategic planning. Directors with generalist skills are not able to provide the level of critical analysis for organisations with large-scale operations. The board therefore needs to be constructed in a way that provides the organisation with appropriate industry experience necessary to independently assess information from management. The skill set and experience of the board members is a primary driver of the strength of the board in performing their oversight function. An experienced and capable board also reinforces appropriate due process in decision-making and appropriate communication lines with shareholders.

A recent CPA poll suggested attributes of board members must include:

- Industry experience 44%
- Financial acumen 38%
- Network and contacts 10%
- Previous board experience 8%

The results of this poll support the need for board members to have appropriate industry experience to enable them to adequately discharge their responsibilities.

A1.5.2 Board Induction and Training

> "All boards should have orientation programs for new members. While the details of the programs will vary between organisations, they should be aimed at fully informing a new director on the main governance and operational aspects of the entity, including thorough provision of governance documentation relating to the statutory authority. New directors should gain first hand experience of operations and meet with senior management and key external stakeholders" (Uhrig, p.102).

In order to support directors in achieving the necessary level of knowledge and understand in which to assess information provided by management, directors should undertake appropriate actions to ensure they are sufficiently informed and trained. We are aware that all of the directors of TT-Line have undertaken the Australian Institute of Company Directors course which we support. In addition to this however, directors, through the CEO, need to ensure they have a thorough understanding of the key drivers and risks of TT-Line as an entity. An orientation program for new directors would assist in ensuring this knowledge is obtained.

Through correspondence we have received during this review written by the Acting Secretary of the Department of Treasury and Finance to the Chairman of

TT-Line in April 2005, we are aware that Cabinet approved the introduction of a Director Induction Framework. This framework includes guidance on professional training of directors, and the induction of new directors including checklists and handbooks to assist state-owned companies and GBE's in fulfilling their responsibilities.

A1.5.3 Inclusion of CEO as a Board Member

The inclusion of the CEO as a board member is now common practice in the Australian business environment. Due to the responsibilities of the role, the CEO's knowledge of the operational aspects of the business is essential to effective board decision-making. Where the CEO is not a board member, they are not required to attend meetings and do not have formal authority to ensure that critical operating issues are considered during board discussion and decision-making. The current CEO of TT-Line attends most of every board meeting and every audit committee meeting. In the context of these two factors it is important that the CEO is appointed formally to the board. Under the current arrangements, it is arguable that the CEO is effectively operating as a board member.

A1.5.4 Documentation of Key Decisions in Board Minutes

> "The board is responsible for approval of the strategies and policies, the oversight of management and is held accountable for the statutory authority's performance in meeting its purpose determined through the board direction set by the Minister" (Uhrig, p.81).

> "Within the broad strategic direction set by the Minister the board independently approves strategy developed by management, oversees its implementation and ensures risk is adequately managed" (Uhrig, p.83).

The review of the board minutes of TT-Line indicated instances where key decisions were not minuted. In particularly, the payment of executive bonuses and increases in the CEO salary package were not noted as approved by the board. While it is common practice for the board minutes to contain minimal content, it is imperative that key decisions requiring the approval of the board are documented. These decisions should include approval of key projects to be undertaken by management. While this review found anecdotal evidence of discussions with board members by key executives in relation to the commencement of research into future expansion options, there is no formal board approval documented in relation to the commencement of key projects over the period of the review.

During the review assertions were made that directors had discussed particular issues informally, or prior to an official board meeting. These discussions should be documented. Where the Company Secretary is not present, a director should record the appropriate minute and ensure the Company Secretary records the minute as appropriate.

A1.5.4.1 Annual review of executive remuneration

We are advised that the salary of the CEO is set by the board after considering appropriate advice. This consideration was completed without any executives including the Company Secretary in the room. The decision was only minuted on one occasion and there are no board papers available to support the decisions. There are letters from the Chairman to the CEO advising of the decision.

Remuneration of other executives is decided by the CEO. It is not formally presented to the board.

A1.5.4.2 Management Incentive Scheme

The management incentive scheme was set up some years ago. The incentive payment is payable as long as the company achieves a pre-determined net profit before extraordinary items. The management incentive scheme was set up some years ago. The incentive payment is payable as long as the company achieves a pre-determined net profit before extraordinary items. The incentive scheme has been approved by the Chairman of the Board. Payments made under the scheme were authorised by the Chairman in August each year after the audit was completed but before the final accounts were signed. The payments were not minuted by the board.

A1.5.5 Management Attendance at Board and Committee Meetings

The CEO and the CFO attended all board meetings during the period under review. They both made extensive presentations and informal briefings at those meetings. At the start of each meeting the directors would meet without these two executives being present.

In relation to the audit committee, the CEO and the CFO attended all meetings. Based on the minutes of the meetings, they were both active in those meetings. The attendance of the CEO at the audit committee meeting is not best practice. The audit committee should have scheduled times within their meeting where they are able to discuss issues privately, and times where there is a direct communication line between the auditors and the audit committee without management being present. This process reinforces the authority of the board and removes the possibility of undue influence of the CEO on particular outcomes.

A1.6 PERFORMANCE MANAGEMENT AND REMUNERATION

This section discusses the findings in relation to the:

- Remuneration of key executives and the board; and
- Performance reviews of the board and management.

> "In well-governed companies, management and employees clearly understand their respective roles and responsibilities, are provided clear guidelines and metrics (KPI's) by which their performance will be measured, and are aware that their incentives are driven based on performance against these KPI's" (Ernst & Young, What is Corporate Governance, p.6).

A1.6.1 Remuneration of Key Executives and Board

> "Particularly for larger companies, a remuneration committee can be a more efficient mechanism that the full board for focusing the company on appropriate remuneration policies which are designed to meet the needs of the company and to enhance corporate and individual performance" (ASX Corporate Governance Council, p.54).

The remuneration of key executives and the board is a key factor in good corporate governance within an organisation. To ensure the decisions related to remuneration within the organisation are conducted in an appropriate manner, a remuneration policy should be in place outlining the approval process and basis for decisions made in relation to all facets of remuneration. A remuneration committee should be established by the board to provide an oversight mechanism for the application of the policy. This committee should be active in the setting of remuneration policy and the review of remuneration applications put forward by management.

A1.6.2 Performance Reviews of Board and Management

> "The performance of the board and key executives should be reviewed regularly against both measurable and qualitative indicators" (ASX Corporate Governance Council, p.47).

> "Accountability is a core principle of governance as it clearly links power and responsibility for performance…The system for oversight should include objective and critical judgement in relation to performance and standards against which decision-makers can be assessed" (Uhrig, p.26).

> "A formal performance process needs to occur in order to ensure that the Government is getting the best from a board" (Uhrig, p.102).

Performance management of the board and key executives forms an important part of good corporate governance within an organisation. The process for managing and assessing performance within an organisation is therefore the driver behind a system of oversight which generates ongoing successful performance of the board and management.

In relation to the board of TT-Line, there is currently no formal mechanism to review the performance of the board as a whole, or individually. There are no set objectives or required outcomes for board members by which their performance could be objectively assessed. The letter of expectations written to the board by the stakeholder Minister could assist in the development of these objectives and outcomes.

In line with our recommendations in A1.1.2.1, good corporate governance requires that the basis for performance management for key executives be included in employment contracts with specific performance criteria built into the arrangement. The current executive team, with the exception of the CEO, are not under contract. Performance management is undertaken through the budgetary review process, and a process of informal reviews conducted by the CEO. The executive performance reviews are not systematic, or based on a set of criteria or expected outcomes. The remuneration of key executives is not formally linked to individual performance outcomes. The bonus arrangement in place is currently paid based on reported profit which is not in all circumstances reflected of management performance. Section 4.5.4.2 discusses the management bonus arrangement in more detail.

The CEO of TT-Line is currently employed on a perpetual contract. The contract does not include any set periods of review or any reference to formal performance review by the board.

A1.7 EXTERNAL REPORTING

This section discusses the findings in relation to public communication and annual reporting.

A1.7.1 Public Communication and Annual Reporting

> "The annual report is the primary vehicle for statutory authorities for disclosing relevant performance and governance information to Ministers, the Government, the Parliament and other stakeholders" (Uhrig p.75).

> "The corporate governance framework in Australia, [including the Corporations Act, common law, accounting standards and ASX guidance], establishes minimum requirements for public companies to ensure they meet the basic requirements of shareholders and requires disclosure of information on financial and non-financial matters. A good board will have a strong commitment to transparency, disclosure and accountability and will aim in its governance arrangements at achieving

> outcomes rather than simply meeting minimum standards required by law" (Uhrig, p.29).

> "Openness and disclosure of relevant information is essential to the effectiveness of accountability frameworks……Good reporting should assist statutory authorities to demonstrate their cultural approach towards particular issues and should reflect a commitment to particular values. For instance, the review considers that informative and balanced reporting demonstrates a commitment to accountability, openness and integrity. Good reporting will articulate organisational values, and show how they have been applied in the conduct of activities and the achievement of performance" (Uhrig p.75).

Recent developments in the area of annual and corporate reporting have placed a greater emphasis on corporate reporting other than financial information. In particular, listed companies within Australia are now required to make disclosures in relation to their internal corporate governance structures and their compliance with the ASX Corporate Governance Principles. In addition, CLERP 9 developments now require a formal sign-off by the CEO and Chief Financial Officer (CFO) with regards to the true and fair nature of the financial report for disclosing entities.

The annual reports of TT-Line over the period of review are compliant with relevant legislation and accounting standards and have been independently audited. They do not however, represent best practice in relation to board reporting and accountability disclosures. As TT-Line does not meet the definition of a disclosing entity under the Corporations Act, they are not required to make the full range of comprehensive disclosures. The need for the operations of state-owned companies to be transparent in discharging their responsibilities may indicate that it is appropriate for them to act as disclosing entities. The capacity of the Parliament and the public to assess TT-Line's performance is reduced under the current format of the annual report. Only the financial performance of the company is disclosed with no non-financial performance targets, strategies or vision being discussed.

As a representation of best practice, the concept of CEO and CFO sign-off on the financial statements has also not been implemented to date. Disclosing entities are required to implement the sign-off for financial years commencing on or after 1 July 2004.

A1.8 FINANCIAL MANAGEMENT AND INTERNAL REPORTING

This section discusses the findings in relation to the:

- Timing and content of board reporting;
- Cross-subsidisation of state-benefit assets;
- Cost review mechanism; and
- Capital management and depreciation.

A1.8.1 Timing and Content of Board Reporting

> "Management should supply the board with information in a form, timeframe and quality that will enable the board to effectively discharge its duties" (ASX Corporate Governance Council, p.48).

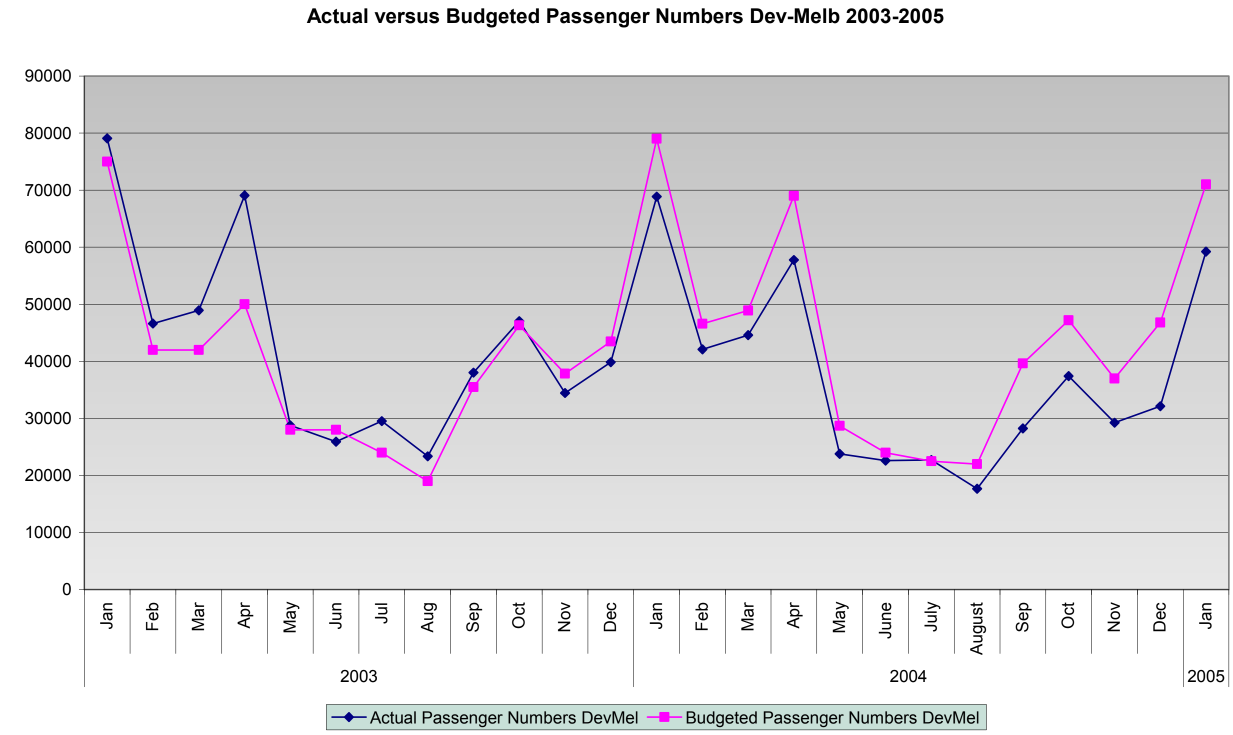
> "The board is responsible for ensuring that management develops relevant indicators to accurately measure the performance of the authority. The KPI's should be limited in number to those seen to be crucial to success and presented in a format that can be independently verified if required. Key performance indicators should be limited to those seen to be crucial to success and include both financial and non-financial measures" (Uhrig p.84, 86).

As the key oversight mechanism for the organisation, the Board relies on the reporting from management in order to be informed regarding decisions to be made. This review highlighted that, in some cases, critical documents were presented to board members on the day requiring consideration and a decision. We were informed that the 2004/05 strategic plan was presented to the board on the day of the meeting and approved on the day. These timeframes are insufficient for a board to consider the information included in the papers presented.

The current schedule of the monthly board meetings does not allow for timely review of financial results. The current board meetings are held at the beginning to middle of the month. The financial information reported relates the month preceding the month just completed, and is therefore up to six weeks after the financial information date. This does not allow the timely review of financial results and delays the ability of the board to respond where necessary.

In relation to the financial reporting to the board on a monthly basis, the papers include critical financial data as would be deemed appropriate, but little information or analysis of the data. The presentation of the financial data is in tabular format with little analysis or graphical representations. The assumption appears to be made therefore, that the board members are able to process and analyse the financial data to the same extent as management. Due to the time constraints on board members in relation to considering all papers for the monthly meeting, this assumption is inappropriate. The board papers prepared by management should be constructed in such a way that critical issues and analysis are highlighted for the board members' attention. The content of the monthly management reports would be greatly enhanced through the use of trend analysis of both KPI's and key financial numbers, and the use of graphical representations of data. Detailed objective analysis highlighting the critical information for the board should also be included to ensure key issues are evident. The inclusions of trend analysis and KPI's in the board reports may have highlighted early warning signals to the board in relation to passenger numbers on a more timely basis.

As an example of the power of graphical presentation of data, we have constructed the graph below which is based on information in the board papers which compared actual passenger numbers to budget passenger numbers on the Melbourne Devonport route. The graph very clearly shows that the trend changed from exceeding budget to being less than budget as early as October 2003. This trend has continued consistently since then. The CEO report and the board papers show the first comments on this trend in March/ April 2004. Board members did not focus on the issue until much later. A graphical or other analytical comparison such this chart could have caused the board to focus on the issue much sooner.



A1.8.2 Cross-subsidisation of State-Benefit Assets

A1.8.2.1 Cross-subsidisation of the Devil Cat Service

Under the *TT-Line Arrangements Act 1993*, the principle objective of the Company is to manage and facilitate the operation of a shipping service to and from Tasmania in a manner that is consistent with sound commercial practice. In the absence of any further guidance from the stakeholder ministers the board must make its own judgement on how it meets this responsibility. The Devil Cat service from George Town to Victoria was conducted over Bass Strait for some four years. During that time the Spirit of Tasmania service cross-subsidised the Devil Cat service by approximately $23 million. We have been informed that this was completed on the advice of the Government of the day. In the context of delivering a shipping service to and from Tasmania, this would seem to be consistent with the Act.

The difficulty of cross-subsidisation of services internal to the organisation however, is that there is a point at which operational inefficiency using the original business plan overtakes the intended level of subsidy. Issues arise relating to cost allocation between both services. If the level of subsidy is not clearly and unequivocally defined at the commencement then there can be no true accountability regarding the management of the service. Similarly, the subsidy needs to be externally derived rather than internally derived to assist in the clarity of the subsidy arrangement.

A1.8.2.2 The Subsidy Precedent

The second difficulty with implied subsidies is that after they are done, they become accepted based on that precedent. TT-Line considered that it would manage the downside risk of the Sydney service through a subsidy from the Melbourne service. They did not have a strategy for the eventuality that the Melbourne service would also not meet its budget.

To understand the probability that this downside relating to the Sydney service would occur, we need to review the decision making process. The financial projections included in the business case submitted to the board and to the Stakeholder Ministers for SPOT III projected 278 trips with occupancy of 63.5% in a full year. The residual percentage related to predominantly winter sailings. The upside for the business plan was in the low season, not in the peak season. This suggests a high probability that the downside would occur and that a subsidy would be required.

It is our view that the issue of subsidy is not one for the management or board of TT-Line but one for the stakeholder Ministers. It then does not get lost in the detail of an operating company whose primary goal is to operate commercially and therefore make profits to support future operations.

A1.8.2.3 Capital Maintenance

One of the objectives of all corporate entities is to maintain or grow their capital over time. Through this they are able to continue to meet their primary objective over time. The difficulty with cross subsidisation within an organisation is that this objective gets compromised. This may develop to the stage where the primary objective can no longer be achieved. In the case of TT-Line, capital maintenance and growth over time is critical to allow future funding for asset replacement.

A1.8.3 Cost Review Mechanism

> "There may also be a number of issues that require multiple decision-makers including efficiency, technical capacity, risk management..." (Uhrig, p.24).

The CFO prepares comprehensive analysis of all of the operations of TT-Line in almost any form that is required. On a monthly basis executive management receive their operating report for their division. They receive further information regarding their division only as requested. The general manager's do not meet as an executive to consider these operating reports. The responsibility for cost analysis and management in any division rests with the General Manager, and through them to the CEO. There are no cross-divisional cost review teams. In this context, cost control and management at an entity level is impaired. In an operating environment where future revenues have a level of uncertainty and capital maintenance is critical to ensure service capacity into the future, cost control and management at an entity level is paramount. This will ensure that conflicting priorities for spending in each of the divisions is prioritised at an entity level and therefore controlled.

A1.8.4 Capital Management and Depreciation

The depreciation methodology applied to the key assets of TT-Line is critical in ensuring the ongoing ability of TT-Line to manage and replace capital. Depreciation of key assets should represent the diminution of the asset over time, and also provide for the generation of cash reserves for future maintenance or capital replacement. The current depreciation methodology of TT-Line whereby the ships and fit-outs are deprecated straight line over the same useful life does not reflect sophisticated capital management in a financial context.

In simple terms, the life of ships on the Bass Strait run has been about ten years. The depreciation charge is a major cost to TT-Line. At the start of the cycle they require a fit out which is substantially worn out at the end of that time. The fit out for Bass Strait will not suit either the Mediterranean, the Baltic or South East Asia because of different climatic and route conditions. The value of the ship in international markets is the value without the fit-out. The asset should therefore be recorded in its component parts. The component parts should reflect, at a minimum, initial fit-out, modifications to fit-out during the life cycle, and the ship infrastructure. As stated above this is a simplistic view but is more sophisticated than the present model. This analysis highlights the need for a more relevant view to the capitalisation of assets and their amortisation over time.

Appendix 2: Best practice governance

APPENDIX 2: BEST PRACTICE GOVERNANCE

A2.1 CRITERIA AND BASIS FOR BEST PRACTICE ASSESSMENT

As noted previously in this Report, in addition to the ASX principles, a significant review was commissioned in 2003 by the Honourable Prime Minister Mr John Howard, and the Minister for Finance and Administration Senator the Honourable Nick Minchin, and was completed by Mr John Uhrig. The primary purpose of the review was to develop a broad template of governance principles that might extend to all statutory authorities and office holders. The results of this review, entitled "Review of the Corporate Governance of Statutory Authorities and Office Holders" has particular relevance to the application of corporate governance in a public sector context and hence has also been drawn upon by this review as a benchmark by which to assess the corporate governance within TT-Line.

John Uhrig's review was asked to consider the governance structure of a number of specific statutory authorities and best practice corporate governance structures in both the public and private sectors. Specifically, the terms of reference of the review were to examine and report on improving the structures and the governance practices of Commonwealth statutory authorities and office holders, with particular attention being paid to those that impact on the business community. The review incorporated:

- An analysis of existing governance frameworks, including relating to outsiders and how internal authority is shared, exercised and appropriately limited;
- Existing government stewardship including selection processes for board members, and the relationship between statutory authorities and Ministers, Departments, the Parliament and the public, including business.
- Determination of best practice corporate governance structures existing within the public and private sectors, and opportunities to improve the governance arrangements for statutory authorities and office holders; and
- Governance going forward, primarily focused on the development of a template of governance principles and policy options that the Government may wish to extend to statutory authorities and office holders.

John Uhrig has extensive corporate experience with key current and former appointments including the Chairman of Westpac Banking Corporation, Chairman of Rio Tinto Ltd and the Managing Director of Simpson Holdings Ltd.

A2.2 CORPORATE GOVERNANCE DEFINITION

While there is no universally accepted definition of corporate governance, the following outlines the key elements of the definition as drawn from the research of this review.

The ASX Corporate Governance Council's "Principles of Good Corporate Governance and Best Practice Recommendations" defines corporate governance as:

> "…the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised".

The Council also states that:

> "governance is broader than boards and committees; it extends throughout the organisation, and includes elements of internal control, ethics, culture, risk functions, policies and procedures and internal and external audit."

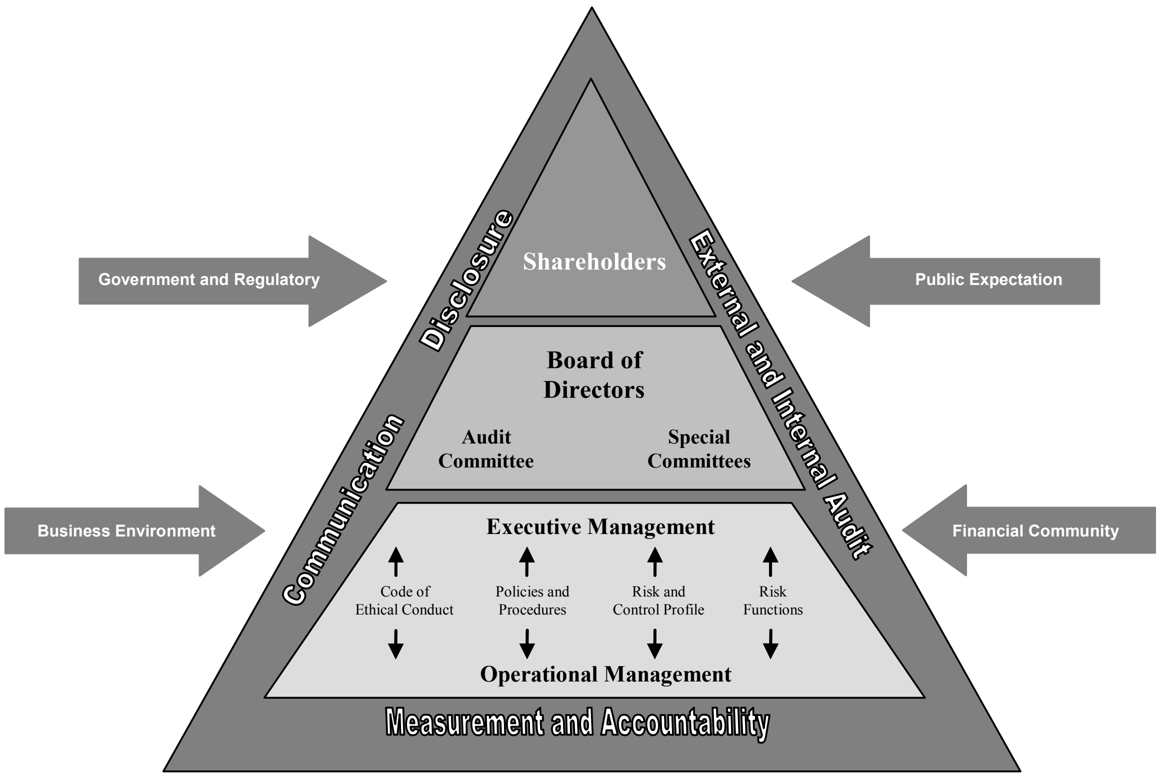
John Uhrig in his review states:

> "Corporate governance encompasses the arrangements by which the power of those in control of the strategy and direction of an entity is both delegated and limited to enhance prospects for the entity's long-term success, taking into account risk and the environment in which it is operating."

To assist in defining corporate governance, Ernst & Young comment that governance is often defined as:

> "the systems or processes adopted to direct and manage the business and affairs of a company, or the systems and processes for ensuring proper accountability, probity and openness in the conduct of an organisation's business" (What is Corporate Governance? p.3)

In their series on corporate governance, Ernst & Young note that the foundation for an effective governance model is the corporate structure including the shareholders, board and management. The following diagram developed by Ernst & Young depicts elements of the governance framework.



This review utilises the definitions of corporate governance as outlined above in the context of the corporate structure diagram developed by Ernst & Young2.

A2.3 DEFINITIONS OF PUBLIC SECTOR ENTITIES

For the purposes of this report, it is important to clarify the definitions of the differing public sector entities, all of which are referred to in this report.

Under the *Government Business Enterprises Act 1995*, a "government business enterprise", commonly referred to as a GBE, is a statutory authority specified by the Act. Entities classified as GBE's are specifically listed in the Act.

The *Public Interest Disclosure Act 2002* has the following definitions for other public entities:

Statutory Authority:

> "means a body or authority, whether incorporated or not, that is established or constituted by or under an Act or under Royal Prerogative, being a body or authority which, or of which the governing authority, wholly or partly comprises a person or persons appointed by the Governor, a Minister or another statutory authority but does not include an Agency".

State-owned Company:

> "means a company incorporated under the Corporations Act that is controlled by the Crown, a Government Business Enterprise or a statutory authority or another company that is so controlled".

TT-Line is a state-owned company which has its own enabling legislation being the *TT-Line Arrangements Act 1993*.

While the legislative framework and basis for operation differs for each type of entity, it is useful to review research on corporate governance in relation to all types of public sector entities. This review incorporates research in relation to both statutory authorities and GBE's, the principles of which can be applied across state-owned companies.

APPLICABILITY OF CORPORATE GOVERNANCE TO TT-LINE AND THE PUBLIC SECTOR

The ASX corporate governance principles utilised as the key benchmark for this review are not mandatory in the Australian context, and only apply to listed entities. Their relevance and applicability to the wider community however should not be dismissed in a business environment which is increasing in expectation in relation to good governance of both public and private enterprises. John Uhrig states that:

> "given the impact that statutory authorities can have on the public, including the business community, effective governance instruments need to be in place to ensure that adequate supervision occurs" (p.36).

He further states that:

> "the community has a right to expect that [public sector] functions will be carried out in a manner that is efficient, effective, objective, and transparent".

The expectation therefore is that entities that operate in the public sector should also have strong corporate governance frameworks in which they operate.

[2] Ernst & Young, Corporate Governance Series March 2004. *What is Corporate Governance?* p.4)

In relation to TT-Line as a state-owned company, it has both public and commercial responsibilities. This review acknowledges the state benefit argument in relation to the operations of TT-Line which significantly contribute to both the infrastructure and tourism industry within the State. These sometimes conflicting responsibilities add a layer of complexity to the operations of the Company. In addition, TT-Line is a unique business in Australia which has undergone significant change and expansion over the last six years. This increasing scale and complexity of the operations of TT-Line, and the specialist nature of its operations, therefore requires specific expertise and governance structures to ensure its success.

TT-Line operates predominantly independently from the government of the day. The *TT-Line Arrangements Act 1993* allows overall supervision by the shareholders, being the stakeholder Ministers. The Articles of Association of the Company require disclosure to the shareholders, and also allow for shareholders to give lawful directions to the directors of the company in writing which therefore must be complied with. The day-to-day operations of TT-Line however are performed without influence or direction by the shareholders. John Uhrig states that:

> "the greater the organisation's independence from government, the greater is the need for robust governance mechanisms as a means of ensuring that it is discharging its delegation appropriately" (p.18).

This is particularly so for state-owned companies because they operate outside the budget sector, and while they are subject to budget scrutiny, they are not subject to Freedom of Information requirements. There is a solid argument therefore to support the applicability of accepted corporate governance principles to TT-Line's operations.

John Uhrig further reinforces the applicability of private sector corporate governance to the public sector by stating:

> "many of the concepts of governance are similar across the private and public sectors, for example, clarity of purpose and accountability. The rationale for establishing governance practices is also comparable, in particular, to the focus on achieving success and managing risk" (p.17).

Uhrig acknowledges the political influence on public sector entities however, commenting that:

> "generally, governance arrangement for statutory authorities should strike a balance between providing flexibility to enable authorities to undertake their legislated functions and the policies of the government of the day…" (p.18).

There is a considerable body of work that has been completed in the Australian business community and public sector relating to corporate governance.

Len Scanlan, former Queensland Auditor-General, noted that better governance is achieved by a focus on:

- Clarity of roles and responsibilities throughout the organisation;
- Robust systems of accountability through control, monitoring and review, including internal reporting and use of internal audit and an audit committee;
- Effective communication;
- Transparency through strong external reporting;
- Ensuring a systematic and integrated risk management system in place;
- Ethical structures and resource management structures; and

- Effective strategic planning.

This review has utilised the full body of work in relation to corporate governance by both the public and private sectors. As TT-Line has responsibilities to both the government and the public, strong corporate governance equalling accepted best practice within the community has been deemed the appropriate benchmark for this review. While the benchmark assessment has primarily been made against the ASX corporate governance principles as a leading authority in this area, the review has considered, where appropriate, the applicability of these principles to TT-Line in the public sector context.

Recent reports

RECENT REPORTS

2001	SPECIAL REPORT NO. 35	SOFTWARE LICENSING
2001	SPECIAL REPORT NO. 36	COLLECTION OF RECEIVABLES AND LOANS IN TASMANIAN GOVERNMENT DEPARTMENTS
2001	SPECIAL REPORT NO. 37	ARCHIVES OFFICE OF TASMANIA
2001	SPECIAL REPORT NO. 38	THE IMPLEMENTATION OF GOODS AND SERVICES TAX IN GOVERNMENT AGENCIES AND LOCAL GOVERNMENT ENTITIES
2001	SPECIAL REPORT NO. 39	BANK ACCOUNT RECONCILIATIONS
2002	SPECIAL REPORT NO. 40	ENVIRONMENTAL MANAGEMENT AND POLLUTION CONTROL
2002	SPECIAL REPORT NO. 41	KEEPING SCHOOLS SAFE
2002	SPECIAL REPORT NO. 42	FOLLOW UP OF PERFORMANCE AUDITS
2002	SPECIAL REPORT NO. 43	ORAL HEALTH SERVICE: SOMETHING TO SMILE ABOUT?
2002	SPECIAL REPORT NO. 44	MANAGING COMMUNITY SERVICE ORDERS
2003	SPECIAL REPORT NO. 45	BUSINESS NAMES AND INCORPORATED ASSOCIATIONS: WHAT'S IN A NAME?
2003	SPECIAL REPORT NO. 46	LEAVE IN GOVERNMENT DEPARTMENTS
2003	SPECIAL REPORT NO. 47	PUBLIC SECTOR WEB SITES
2003	SPECIAL REPORT NO. 48	GRANTS TO THE COMMUNITY SECTOR
2003	SPECIAL REPORT NO. 49	STAFF SELECTION IN GOVERNMENT AGENCIES
2003	SPECIAL REPORT NO. 50	POLICE RESPONSE TIMES
2004	SPECIAL REPORT	EX-GRATIA PAYMENT TO THE FORMER GOVERNOR MR R W BUTLER AC
2004	SPECIAL REPORT NO. 51	SPECIAL PURPOSE AND TRUST FUNDS: DEPARTMENT OF HEALTH AND HUMAN SERVICES
2004	SPECIAL REPORT NO. 52	INTERNAL AUDIT IN THE PUBLIC SECTOR
2005	SPECIAL REPORT NO. 53	FOLLOW UP OF PERFORMANCE AUDITS: 2000 - 2001
2005	SPECIAL REPORT NO. 54	COMPLIANCE AUDITS: 2004 - 2005
2005	SPECIAL REPORT NO. 55	GUN CONTROL IN TASMANIA

Future projects

FUTURE PROJECTS

Details of performance and compliance audits that the Auditor-General is considering or is working on are:

PERFORMANCE AUDITS

PUBLIC HOUSING – MANAGEMENT OF HOUSING STOCK	CURRENTLY UNDER WAY
ASSET MAINTENANCE – BRIDGES	BEING PLANNED

COMPLIANCE AUDITS

FRINGE BENEFITS TAX	CURRENTLY UNDER WAY
PAYMENT OF ACCOUNTS IN GOVERNMENT AGENCIES	CURRENTLY UNDER WAY
DELEGATIONS	CURRENTLY UNDER WAY
BUILDING SECURITY	BEING PLANNED