Chapter Four

Risk Issues at the Grains Board

Introduction

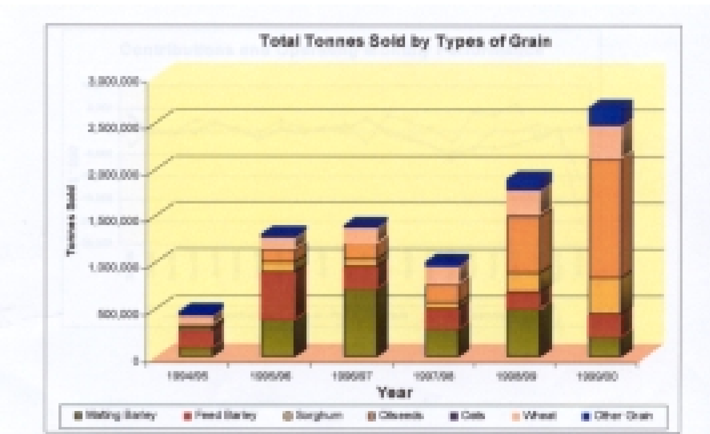
Trading grain commodities on the international market is a risky business. Trading firms must deal with currency fluctuations, price changes, and problems in markets geographically and culturally distant. Mr Haire, a trader at the Grains Board stated in evidence that grains trading "…is a high-risk business with very low margins and so it requires very careful monitoring."[1]

By increasing volumes, especially exports, the Grains Board made a risky business even more so. The circumstances required the board and executive management to provide appropriate direction and control. This chapter will examine how the expansion happened and the Grains Board's strategic approach to risk.

Business Expansion

Over recent years the Grains Board significantly increased the volume of grain it traded. In 1997/98, approximately 1 million tonnes of grain was bought. In 1998/99, almost 2 million and in 1999/2000 over 3.5 million.[2] Figure one shows the quantity of grains sold over the past five years including an 11-month period to 31 July 2000.

Figure 1: Grains Board Sales



Source: NSW Grains Board Investigating Accountants Report, PricewaterhouseCoopers, August 2000, page 15.

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[1] Transcript of hearing, 29 November 2000 at p 30

[2] PricewaterhouseCoopers, NSW Grains Board Investigating Accountants Report, August 2000 at p 15

Chapter two detailed the growth objective within the Grains Board. Employees such as John Fitzgerald, former Chief Financial Officer,[3] and Patrick Haire, a former commodity broker, indicated the underlying emphasis on growth:

> **CHAIR:** With the increase in the volumes occurring before that there was some risky trading undertaken by yourself?
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> **Mr HAIRE:**[4] You could interpret it that way, but it was encouraged that we were to grow the business through volume, not just on canola but all grains…
>
> **CHAIR:** Were you directed on these volumes?
>
> **Mr HAIRE:** Not specifically directed about the volume but it was certainly encouraged to increase the volume… to cut a long story short, the price difference today I think between New South Wales and Victoria is about $5 a tonne… It was basically encouraged—and nothing in writing I admit—to trade canola to make sure that the New South Wales price was matching the Victorian price and the South Australian price, and that was particularly relevant due to the review of the marketing powers of the Grains Board because it takes away the arguments of the detractors of the Grains Board if the price is the same in New South Wales as Victoria, and what complaint can people in the industry have about the activities of the Grains Board?
>
> **CHAIR:** So the purpose was to keep the price comparative to Victoria?
>
> **Mr HAIRE:** Absolutely, and really also slightly in front to build up the tonnage. To build up the tonnage you have to have the best price, not just the equal price.
>
> **CHAIR:** So the issue of profit and bottom line came second to this new objective, which was to establish dominance in the industry.
>
> **Mr HAIRE:** I believe so, Mr Chairman.

As outlined in chapter two, the Grains Board was expanding the volume of grain to become "more relevant" in face of the National Competition Policy review. There was evidence the Managing Director ultimately wished to build equity to fund a growers' buy-out, or merge with another entity. However, this did not have clear support from the Government. This method of avoiding the recommended deregulation involved building up an entity of substantial net worth that would be privatised, or "demutualised". Such a strategy would have likely ensured the continuing employment of the Managing Director and others at the Grains Board.

Evidence presented to the Committee suggests neither the board nor management were in control of the growth in trading volumes. Graham Lawrence suggested management had little control of the Grains Board's business expansion. He stated:

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[3] Transcript of hearing, 30 November 2000 at p 25

[4] Former Commodity Trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 33

Mr LAWRENCE:[5] In hindsight, we were overwhelmed … and really the growth in that volume of that harvest of 1999-2000 was more than we had forecast.

Mr TORBAY: So, essentially, as Managing Director responsible for the day-to-day management of the organisation, you could not control it?

Mr LAWRENCE: Let us say that what happened, a lot of which I believe was not totally controllable by the board, by myself, led us to a position different to what we had forecast. I do not know that that says the board or management did not do its job. It just says it could have done its job a whole lot better.

On the contrary, other evidence presented indicates the Grains Board actively pursued growth through extra means:

CHAIR: You may not have an opinion about this because it may not fall under your gamut of responsibility, but was too much paid for what was purchased by the Grains Board?

Mr HEDGE:[6] I do not believe anything was purchased or any good will was paid for in the Ray Brooks joint venture. My understanding is that this was a joint venture that the board entered into at the end of 1999 whereby the arrangement was that Ray Brooks would go into the Victorian market place and buy grain and, as the board's undisclosed agent, Ray Brooks would receive a commission and/or share of the profits.

Further, evidence suggests the Grains Board expanded into Victoria prior to deregulation and was in fact trading in Victorian grain illegally:

Mr COLLIER: What about labelling Queensland and Victorian grains as New South Wales product? Are you aware of that?

Mr JEFFRIES:[7] Certainly not Queensland barley.

Mr COLLIER: What about Victorian?

Mr JEFFRIES: Yes, that would have happened.

Mr COLLIER: Is that standard practice in the industry?

Mr JEFFRIES: Not necessarily, no.

Mr COLLIER: But it happened during your time at the Grains Board?

Mr JEFFRIES: Yes.

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[5] Former Managing Director, NSW Grains Board, transcript of hearing, 30 November 2000 at p 41

[6] Investigating Accountant, PricewaterhouseCoopers, transcript of hearing, 29 November 2000 at p 51

[7] Former General Manager, Marketing, NSW Grains Board, transcript of hearing, 29 November 2000 at pp 28 & 29

Mr COLLIER: Why did that happen?

Mr JEFFRIES: For a number of reasons. There are some customers who require Victorian barley or specify Victorian barley.

Mr COLLIER: But why would it be labelled as a New South Wales product?

Mr JEFFRIES: For a number of reasons. When the growers deliver into the storage system they sign a declaration saying that it is New South Wales barley and the declaration is attached to their product samples, but prior to last year the New South Wales Grains Board did not have any authority to trade Victorian barley.

CHAIR: So this activity was always legal that you know of?

Mr JEFFRIES: Not necessarily.

CHAIR: Can you explain why it was not legal, because we do not have a perfect understanding of that process?

Mr JEFFRIES: The domestic trade of Victorian barley was not (de)regulated until last year.

CHAIR: So when it occurred before last year it was illegal?

Mr JEFFRIES: Yes.

CHAIR: Who was involved in that?

Mr JEFFRIES: Certainly I was, but it was going on for a long time before I joined the Grains Board in 1998.

CHAIR: Were there any joint venturers involved in this?

Mr JEFFRIES: Yes.

CHAIR: Could you explain who was that?

Mr JEFFRIES: Ray Brooks at Barooga.

CHAIR: And that activity was legal at the time, or not?

Mr JEFFRIES: The joint venture was formed after the deregulation of the Victorian Barley Board.

CHAIR: So when that was occurring it was legal?

Mr JEFFRIES: Yes.

The Committee is of the view the Grains Board vigorously pursued expansion and was prepared to breach regulations to do so.

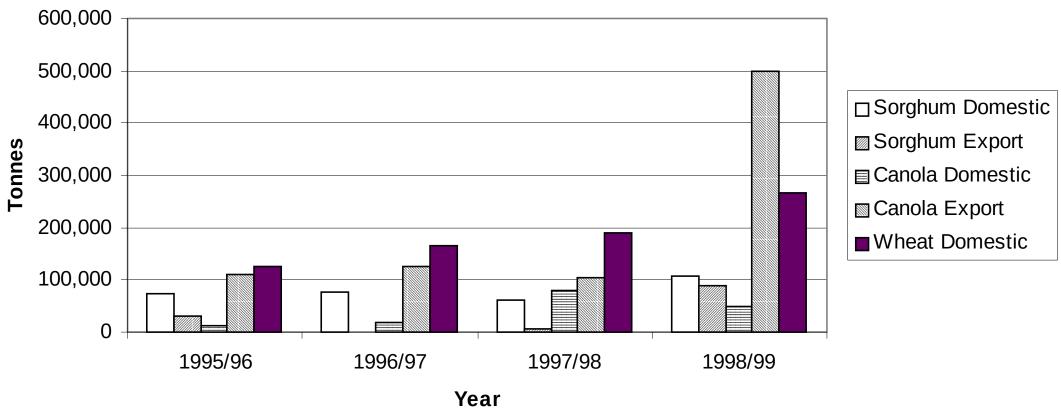
Glenn Dalton, Director of Grains, NSW Farmers Association, also argued the Grains Board was buying grain at prices higher than they would be able to sell it for. He noted "it clearly emerged that the price that the Grains Board paid was above the market price."[8] Management pursued volume at the risk of the bottom line.

This increase in volume stretched the Grains Board's credit limits. Evidence given before the Committee indicates the Grains Board was trading a significant volume of grain which was impacting on its budget. Lance Blockley, the former interim Managing Director, noted the papers presented to the board began to show grain receivals markedly ahead of budget in about March or April 2000. He stated:

> **Mr BLOCKLEY:**[9] …in March or April, the grain receivals showed up in the board papers as being markedly ahead of the budget. The commodity that is highest in my mind is canola, where the budget was in the order of half a million tonnes, whereas actual receipts were 1.2 million tonnes, so that is over twice the budgeted level.

The investigating accountant indicated the majority of growth over recent years resulted from the Grains Board's increase in the volume of canola it exported. The Grains Board was also aggressive in the wheat and sorghum markets:

Figure 2: Grains Board Sales of Sorghum, Canola and Wheat



Source: NSW Grains Board Annual Reports,1995/1996, 1996/1997, 1997/1998 and 1998/1999.

The investigating accountant also indicates that for the 10 months from 1 September 1999 to 30 June 2000, trading in wheat, sorghum and canola had contributed to the trading loss. Figure 3 illustrates the estimated trading losses for various grains.

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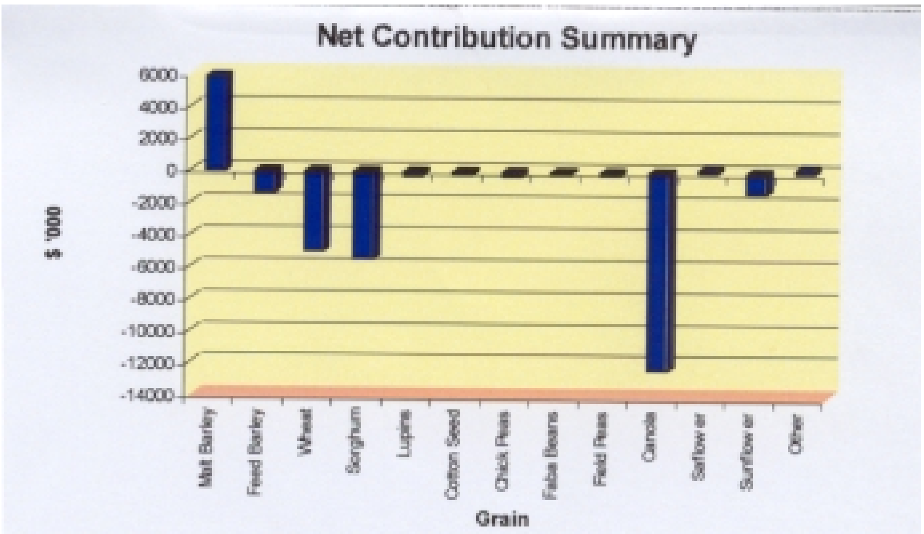
[8] Transcript of hearing, 16 November 2000 at p 2

[9] Interim Managing Director, NSW Grains Board, transcript of hearing, 1 November 2000 at p 17

Figure 3: Contribution to Profits and Losses by Grain Type



Source: Grains Board Investigating Accountants Report, PricewaterhouseCoopers, August 2000, page 17.

As the graph shows, canola yielded the largest trading loss. In discussing the canola trade in evidence, Lance Blockley noted the canola pool had a negative equity position. Of the expected realised price, 85% was paid up front to growers and this has ended up being more than the revenue realised.[10]

Further, the increase in trading has resulted in the Grains Board trading at levels and with the types of customers it has not traditionally traded with before. This has resulted in a number of unfavourable supply contracts entered into which have contributed to the Grains Board's financial losses.

For example, the administrator notes the Grains Board entered into sales contracts for lentils assuming the price would fall. This would allow the Grains Board to enter into purchase contracts from farmers at a lower and therefore more profitable price (short selling). However, prices continued to rise, and no purchase contracts were entered into leaving the Grains Board exposed for the entire volume of sales contracts.[11]

From Pool to Cash Trading

The Grains Board was to provide growers with marketing options while maintaining pools to maximise grower returns.[12]

[10] Id at p 25

[11] NSW Grains Board, Administrator's Interim Report, 24 January 2001, at p 37

[12] NSW Grains Board, Corporate Policy Manual, July 1996

The major benefits of pools are:

- to provide growers with a tool to hedge prices or average prices across many months of sales;
- to provide growers with an advance of around 85% of the value from the Grains Board upon delivery; and
- to raise finance at much lower rates than growers and negotiate more attractive freight and storage to move grain which is surplus at harvest time.[13]

Pool trading involves the price risk remaining with the grower while cash trading involves transferring it to the buyer, in this case the Grains Board. Despite the substantially reduced risks in pool trading, the Grains Board increased its cash trading. This resulted in the Grains Board being subject to commodity trading fluctuations and risks. Risks borne by farmers' pools shifted to the Grains Board as cash trading, without proper hedging, made it a commodities speculator. For the 1999/2000 financial year, the Grains Board is estimated to have lost over $90 million. Cash trading contributed significantly to this loss.

Graham Peart, former board member, discussed the Grains Board's shift from pools to cash trading:

> **Mr PEART:** [14] … To lift a business from a million to two million to three million meant that we were in considerable new areas. We moved from a board that was largely set up to run pools. The old Barley Board had virtually only run pools, but there was a lot of pressure on our board to offer farmers new ways of trading grain because that is what the competition were doing and we moved from virtually taking the growers' grain under the vesting powers and then, over the next twelve months, selling it at best to going into the marketplace at harvest and offering cash money at fixed prices and buying grain and then trying to find buyers for it while covering ourselves on both currency and the futures market, so we moved from perhaps eighty percent pools to perhaps eighty percent cash trades or various kinds of contracts, fixed money contracts, and perhaps only twenty percent pools.

The figure overleaf indicates the accumulated impact of pools and cash trading on the Grains Board's losses from 1 September 1999 to 30 June 2000.

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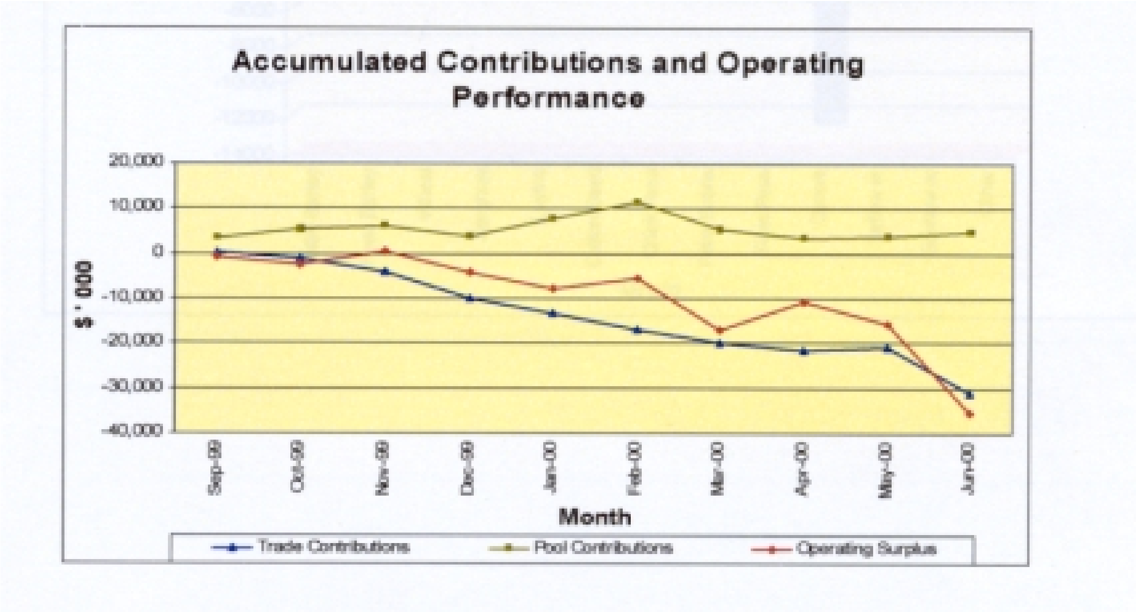
[13] New South Wales Grains Board, Annual Report 1998/99, at p 15

[14] Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 3

Figure 4: Accumulation of Losses by Pools and Cash Trading, 1999/2000



Source: Grains Board Investigating Accountants Report, PricewaterhouseCoopers, August 2000, page 16.

The investigating accountant indicated the Grains Board's losses by June 2000 completely eliminated the equity in its balance sheet and management accounts reported a negative net equity of $6.1 million prior to grower pool liabilities.[15]

Why did the Grains Board actively increase the amount of cash trading? It has been argued the Grains Board had to compete in the market place with independent buyers who offered cash for crops. Growers preferred to be fully paid for their grain up front. It was estimated independents were buying around 60% of the grains in the market covered by the Grains Board.[16]

However, the Committee is of the view the Grains Board should not have been "competing" with other buyers, but taking the role of buyer of last resort. The Grains Board should have allowed the market to operate with minimal intervention and, instead of being a competitor, it should have mopped up afterwards.

Furthermore, even if the Grains Board needed to compete to meet the demands of its own customers, cash trading should have been properly hedged against the prospective sale with an acceptable margin incorporated between the buy and sell price. The Grains Board's hedging operations are discussed in chapter five.

In hindsight, the former Deputy Chairman of the Grains Board recognised this function:

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[15] PricewaterhouseCoopers, NSW Grains Board Investigating Accountants Report, August 2000, at pp 16 & 17

[16] The Australian Financial Review, 23 February 2001 at p 64

> **MR PEART:** [17] …The grower members of the board were there to represent the interests of the grain growers and they were really to make sure the Act was carried out properly which was to trade grain, to stand in the market as the buyer of last resort to make sure there was always a residual buyer for grain produced by farmers…

Had the board applied the reflections of Mr Peart instead of pursuing expansion, the Grains Board would have continued as a smaller, but viable, business.

Equity and Bank Debt

The expansion in 1999 and 2000 stretched the Grains Board's credit limits. As the investigating accountant Peter Hedge stated "It also put them in breach of their convenants with their financiers."[18]

The Commonwealth Bank of Australia, together with Rabo Australia, had provided a loan facility of $250 million to the Grains Board. However, with the significant increase in the volume traded, there was also an increase in the short-term debt needed to be supported by the banks. This resulted in an extremely high debt to equity ratio, making the Grains Board a more risky proposition for its lenders. The Grains Board had a financial gearing ratio greater than banks while the value of its assets were more volatile than bank assets. Officers from the Commonwealth Bank discussed this issue in evidence:

> **CHAIR:** What would be the debt-to-equity ratio of the Grains Board at the peak period?
>
> **Mr LOCK:**[19] In this last year it would be in the order of—if you take the audited numbers—
>
> **CHAIR:** Yes.
>
> **Mr LOCK:** —because it seems the reality is somewhat different, but if you took the audited numbers at the peak level of borrowings in this current season, it would be roughly in the order of 12 to 15 times.
>
> **CHAIR:** Twelve to 15 times. That is more than a bank, is it not?
>
> **Mr LOCK:** Yes, it is.

The members of the board had questioned management about the financial state of the Grains Board during the last financial year, in particular whether it would have sufficient funding to accomplish the proposed budget:

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[17] Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 17

[18] Transcript of hearing, 29 November 2000 at p 46

[19] General Manager, Corporate Banking Group, Commonwealth Bank of Australia, transcript of hearing, 30 November 2000 at pp 15 & 16

> **Mr BLOCKLEY:** [20] … I can recall that I raised the question as to whether the Grains Board would have sufficient funding to accomplish such a budget, that is, the peak borrowing requirement shown in the budget was to occur in February 2000 at a level of around $140 million but that budget showed an opening borrowing position as at 1 September of zero – clearly incorrect because we had jut been presented at that meeting with the July results, which showed a commercial bill facility drawing of $159 million and, therefore, going into September we were going to have to carry-over stocks and the commercial facility to fund them. I raised with management and said that in my opinion the borrowing requirement for the budget was going to be at least $300 million, which was in excess of the $250 million facility currently provided by the Commonwealth Bank and Rabo Bank to the board.

An officer of the Commonwealth Bank advised the Committee about the nature of its loans to the Grains Board. The credit needs of the Grains Board would mostly be determined by seasonal factors:

> **Mr LOCK:** [21] In New South Wales, harvesting of winter crops commences in the north of the State in late October and concludes in the south of the State in January, sometimes early February, depending on conditions. The Grains Board takes ownership of this grain as it is harvested and delivered into silos and pays growers normally within three to four weeks. However, the grain is sold over an extended period of time. Some pools take up to two years or more to close. To meet its payment obligations to growers, the Grains Board borrows from the Commonwealth Bank and the loan is progressively repaid as the board receives the proceeds of sale of the inventory.

Evidence provided to the Committee indicates that for the 1998/99 season the total facility, which was the Commonwealth Bank and Rabo combined, was $200 million. Initially there was an increase of $50 million requested for the 1999/2000 crop. Therefore, the facility went from 200 to 250 and then in late January or early February 2000 it increased to $350 million.[22] Figure five overleaf shows the Grains Board's equity and the bank facility available to it.

It appears the Grains Board was able to increase its borrowings, regardless of its equity. Capitalisation issues were not considered as the growth, including its level of indebtedness, expanded exponentially. It was prepared to take on new risks and activities without assessing whether they were appropriate and how they were to be managed. Further, the organisations with which it dealt were pleased to assist the Grains Board in its growth. There was no moderating restraint on the organisation, from outside or within.

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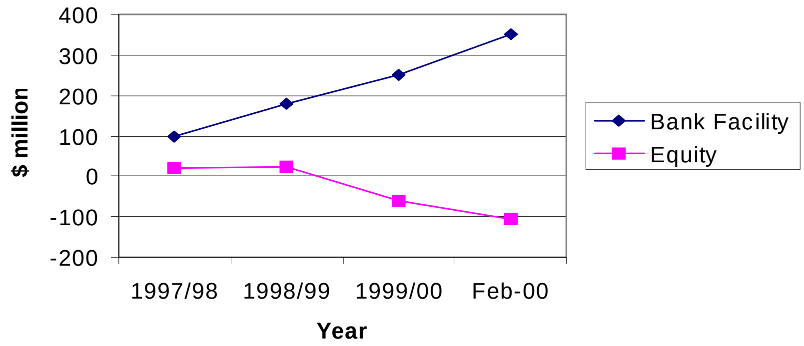
[20] Interim Managing Director, NSW Grains Board, transcript of hearing, 1 November 2000 at p 14

[21] General Manager, Corporate Banking Group, Commonwealth Bank of Australia, transcript of hearing, 30 November 2000 at p 55

[22] Id at p 57

Figure 5: Grains Board Equity and Bank Facility



Source: NSW Grains Board Annual Reports 1997/1998 and 1998/1999, NSW Grains Board Administrator's interim report, and evidence given before the Committee

Approach to Risk Management

The Grains Board's expansion increased its financial risks and market risks, including exposure to export commodity markets and foreign exchange movements. Similarly, the growth in volumes increased operational risks, including the accuracy of its stock and accounting systems.

Generally, risk management is the strategy used by a firm to prepare it for future problems or opportunities. The strategy developed should depend on the chances of something happening, as well as how severe or beneficial the event might be. Worldwide preparations in 1999 for the Year 2000 bug are an example of risk management.

Best Practice – Risk Management Standards

[Risk management is] the culture, processes and structures that are directed towards the effective management of potential opportunities and adverse effects.

The organisation's executive shall define and document its policy for risk management… The risk management policy shall be relevant to the organisation's strategic context and its goals, objectives and the nature of its business.

Management will ensure that this policy is understood, implemented and maintained at all levels of the organisation.

Risk management is recognised as an integral part of good management practice. It is an iterative process consisting of steps, which, when undertaken in sequence, enable continual improvement in decision-making. [23]

[23] Standards Australia, Risk Management AS/NZS 4360:1999 at pp 1, 4 & 5

The Grains Board was in an inherently risky business and compounded those risks through aggressive growth. Therefore, risk management should have been a priority for the Grains Board and an integrated part of the growth strategy. However, neither the board, nor growers, nor the Government, appeared to scrutinise how the Grains Board managed its risk.

For example, the Committee found debtor risk was not managed effectively. The Audit Office had advised the Grains Board to make provisions for doubtful debts for Water Wheel:

> **Mr KHEIR:**[24] … We were able to see at 31 August 1999 that the board had actually provided $420,000 by way of a doubtful debt provision for Water Wheel. So, within the accounts was a provision for $420,000. That was arrived at after we reviewed board papers put up by management to suggest that Water Wheel was facing problems in paying its debts. We basically requested that provision be made for that. A $420,000 provision on a balance of about $960,000 is quite significant.
>
> We cannot understand how then it has progressed from knowing there was doubt about this company at 31 August 1999, reflected in the accounts, for the company to then continue to run up a debt of something like $5 million or $6 million. The board was aware of it because the papers went up to the board. When I hear board members saying, "Well, we were not aware" or "We were not advised and we did not know", all these things seem to have happened very swiftly during the course of the 1999/2000 year. It seems to have been that something caught board members completely unaware which I find hard to fathom and, as I say, there were examples there where such things as a doubtful debt was allowed to go on. If systems were not capable of meeting the volume of grain for the 1999/2000 year, I would be asking, why did we not cease making deals that would run the risk of the Grains Board incurring substantial losses if we knew those systems were not capable of giving us the information we were after.
>
> ……………………………………………………………….
>
> It was around November 1999 when that board paper went up. At that stage the accounts had not been signed off by us as auditors and we asked for the provision to be made in the accounts, and the board agreed.
>
> **CHAIR:** That is when you knew definitely the board was aware. By that time would it be fair to say the grain had already been stored back in the Water Wheel silo?
>
> **Mr KHEIR:** It may have been there for a period before that, but the question that I thought was appropriate that I heard earlier today was why they did not send in the trucks. If you know you have a problem there, you are providing 50 per cent of your debt by November 1999, you have got to say to yourself, “I have got a risk here with this stock being on someone else’s premises. They are just going to take it and not pay.”

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[24] Director of Audit, the Audit Office of New South Wales, transcript of hearing, 30 November 2000 at pp 82 & 83

The Grains Board had been alerted to the fact Water Wheel was a major debtor risk. However, the Grains Board continued to allow Water Wheel possession of Grains Board grain and trust it to pay as the grain was drawn down, all without bank guarantees.

Another instance of the board's approach to risk management was the Audit Office's review of the Grains Board's treasury operations. The review stated Grains Board staff did not comply with all of the procedures and risks of error and fraud remained:

> **Mr KHEIR:** [25] … The third one was authorisation of deal dockets. We found that deal dockets for foreign exchange documents were not prepared and authorised by section X, Y, Z of the board's approved policies. Senior finance and admin is aware of such issue and suggested that an amendment of the board's policies is required to reflect the dynamic nature of the foreign exchange market. The implications that we expressed to the board was that deal dockets which are not prepared and signed under the appropriate delegated authority gives rise to operational risk within the Grains Board. That is, the inadequacy of such authorisation procedures may expose the Grains Board to potential losses as a result of errors and/or fraud. Management responded, "Yes, you also reported this at the end of 1997-98," and the board considered an amendment to the procedures and agreed that they would do it. This was in 1999.

It appears from this evidence management found the procedures inconvenient, and persuaded the board to relax them. Until the creation of the risk management committee in March 2000, it appears the board did not give proper weight to risk management. The risk committee is further examined in chapter five.

As discussed in chapter three, the Director-General of the Department of Agriculture had the responsibility of oversighting the Grains Board's operations. The Committee raised with the Director-General the issue of whether the members of the board should have had a risk management committee before March 2000:

> **CHAIR:** … for nine years you have had the Grains Board without a risk management committee.
>
> **Dr SHERIDAN:** [26] And for nine years it appeared that the Grains Board was going extremely well, and that the risk management approaches were being adopted by the board itself.

And further:

> **CHAIR:** … every other organisation which is in the same business has got an equity committee, a risk management committee and an effective audit committee. As I mentioned to you earlier, people were concerned about how well the audit committee was functioning. There was no risk management committee, no equity committee.

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[25] Director of Audit, Audit Office of New South Wales, transcript of hearing, 30 November 2000 at p 79

[26] Director-General, NSW Department of Agriculture, transcript of hearing, 16 November 2000 at p 19

> **Dr SHERIDAN:**[27] Mr Chairman, people were concerned but the people who were concerned were not passing that information on to my staff or me.
>
> **CHAIR:** I am asking you why did you not make that evaluation?
>
> **Dr SHERIDAN:** I made the evaluation that I believed that they were going well, that their structure was okay and there was no reason to change that—neither did the Consultative Committee.

Essentially, the Director-General's response was that because the Grains Board had managed its affairs in the past, it would so in the future. However, risk management requires an active consideration of the changing nature of current and future events and how best to respond. Through its growth, the Grains Board's circumstances were rapidly changing. The Director-General's oversight role required a more active assessment of the Grains Board's risk profile and risk management practices than simply relying on its past performance.

Conclusions

Best Practice: Management will ensure the risk management policy is understood, implemented and maintained at all levels of the organisation.

- In its review of the Grains Board's treasury operations, the Audit Office advised there were serious breaches of trading and foreign exchange procedures. The board and management were slow to ensure compliance. The Grains Board continued to purchase grain despite being over budget. It vigorously pursued growth and was prepared to breach regulations in order to do so.

Best Practice: Risk management is the culture, processes and structures that are directed towards the effective management of potential opportunities and adverse effects.

- Despite the Grains Board's rapid growth and changing circumstances, the Director-General of the Department of Agriculture assumed the Grains Board's reasonable performance in the past indicated adequate risk management in future.

Best Practice: Risk management is recognised as an integral part of good management practice. It is an iterative process consisting of steps which, when undertaken in sequence, enable continual improvement in decision-making.

- From evidence it appears management found some procedures inconvenient, and persuaded the board to relax them. Until the creation of the board-sponsored risk management committee in March 2000, it appears the board did

[27] Id at p 20

not give proper weight to risk management. The board was explicitly warned about Water Wheel's status as a credit risk, but allowed the company to stay in possession of Grain Board stock.

Best Practice: The organisation's executive shall define and document its policy for risk management… The risk management policy shall be relevant to the organisation's strategic context and its goals, objectives and the nature of its business.

- It appears the Grains Board was able to increase its borrowings, regardless of its equity. It was prepared to take on new risks and activities without assessing whether they were appropriate and how they were to be managed. Further, the organisations with which it dealt were pleased to assist the Grains Board in its growth. There was no moderating restraint on the organisation, from outside or within.

Chapter Five

Failure of Management Systems, Procedures and Structures

Introduction

The board and executive management play a key role in strengthening an entity's internal controls. An effective control environment needs appropriate management systems, procedures and structures that support the organisation's objectives, minimise its risks and maximise its opportunities.[1]

Best Practice – NSW Treasury

An effective control environment requires:

- risks are analysed frequently;
- internal controls help separate and co-ordinate duties;
- information systems provide data related to key risks, for example, market, credit, operational, reputation risks; and
- the board monitors the management of key risks.[2]

However, the Committee found the Grains Board operated with inadequate and inappropriate systems and procedures. This chapter considers the difficulties encountered with trading and stock activities. It considers the risk management practices of the Grains Board and how their inadequacy contributed to these problems.

The chapter also considers deficiencies in areas such as stock control, accounts receivable, trade debtors and joint ventures. Finally, the type of information, the way its was provided to the board, and the structure of the organisation are considered in how they contributed to the Grains Board's financial loss.

Much of the evidence provided to the Committee indicated problems with the accounting systems and practices were the responsibility of Mr John Fitzgerald, the Chief Finance Officer, who was also responsible for information systems design and maintenance.

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[1] Standards Australia, Risk Management AS/NZS 4360:1999, at p 1

[2] See NSW Treasury, Risk Management and Internal Control: Volume 1, September 1997, including p 11

Comprehensive Problems with Management Information Systems

Evidence presented to the Committee indicates members of the board had a number of difficulties with the Grains Board's information systems. Firstly, the information being provided to the Board was inadequate and often incomplete. One of the board members stated in evidence that due to the structure of the information systems the accounts were often incomplete and therefore inaccurate for many months:

> **Mr TORBAY:**…what you seem to be putting to the Committee is that the reporting was unreliable, you could not rely on that as a board member because it was simply as a matter of process, but it was not really real, it could have been anything?
>
> **Mr PEART:** [3] Well, finalisation of the accounts of every pool was always open until the pool closed, so when the chief financial officer said, you know, what would you like it to be, the budget says 2.5 million, depending on whether we close the pool rapidly or whether we bring the costs to account, it will come in between 2 and 2.8, I can make it 2.4 because that is what the budget was.
>
> **Mr TORBAY:** But you could not rely on the accuracy, it was sort of open-ended?
>
> **Mr PEART:** It was open-ended until the auditors came in and audited the accounts at the end of each year.

This indicates managerial controls and the management information systems were providing board members with manipulated reports. This is further indicated by Don Hubbard, former Chairman of the Board. According to evidence, there was a fatal three to four months gap between grain purchases beyond budget and reporting to the board their full implications. He said:

> **Mr HUBBARD:** [4] …most of the volume had been traded in November-December,…but because of the back office functions not working properly, it was not falling out of the system until much later.

It is apparent members of the board had difficulties with the financial position reported, indicating problems with the systems generating the financial information.

Senior management also indicated the board did not receive adequate reports on the Grains Board's financial position. The former Chief Financial Officer suggested information on future risks might not have been given to the board:

> **Mr FITZGERALD:** [5] I reported on a regular basis to the general manager.
>
> **CHAIR:** The problem is that your reports did not reflect the future liabilities that were going to come on line. They did not report the fact that the risk profile of the

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[3] Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 15

[4] Former Chairman of the NSW Grains Board, transcript of hearing, 16 November 2000 at p 44

[5] Former Chief Financial Officer, NSW Grains Board, transcript of hearing, 30 November 2000 at p 26

> organisation was changing very rapidly. That financial information essentially was not being fed through to the board, was it?
>
> **Mr FITZGERALD:** Well, on reflection, perhaps it was not.

The investigating accountant found the systems did not produce satisfactory information:

> **Mr COLLIER:** The adequacy of the computer systems?…Could they produce the information that you were looking for?
>
> **Mr HEDGE:** [6] The information that was in the system was not satisfactory for our purposes. Whether the actual system itself could cope with the volumes of trading that the board had undertaken in the last 12 months is something we did not specifically look at, but certainly one of our questions was why are these problems this year and not evident in prior years? One of the hypotheses is, when you look at the volumes of trading that were undertaken this year as compared to prior years, one might question whether the system was just not able to cope with this year's volumes.

Commodity traders commented they could not determine their trading positions from the information generated by the system:

> **Mr HAIRE:** [7] The computer systems really were, in hindsight, unsatisfactory because, firstly, they were separated; the trading system and the accounting system were not the same system; and the style of the reports should be totally automatic and state of the art so that once information is in the system any person within that organisation or any employee – certainly ones authorised to do so – right through to senior management and the board should have access, to the minute, to the kind of information involved.

In addition, evidence presented to the Committee indicates there were difficulties with the computer systems over two years ago:

> **Mr GLACHAN:** Recently there has been a dramatic increase in trading volumes. Were the [computer] systems that the Grains Board had in place adequate to cope with those increased volumes?
>
> **Mr WOODS:**[8] From my experience when I was there which, as I said, is over two years ago – they have increased volume enormously since then – I did not think the systems were good enough then…

This evidence indicates the board and executive management, while having knowledge of problems, failed to understand and invest in systems and controls.

Growers also found financial control problems while dealing with the Grains Board:

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[6] Investigating Accountant, PricewaterhouseCoopers, transcript of hearing, 29 November 2000 at p 48

[7] Former Commodity Trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 31

[8] Former Commodity Trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 4

> **Mr BARRON:** [9] … I received a cheque from the Grains Board for $50,000, or roughly $50,000, at harvest time, which was not due to me and eventually at the end of harvest I received a letter saying, look, we paid you a bit too much, can you pay it back, which I did, but it just emphasises the issue that the place was out of hand.

However, the Managing Director and Chief Financial Officer resisted suggestions to improve the systems. This means they must bear substantial responsibility for the inadequacies of the systems. For example, Mr Fitzgerald, former Chief Financial Officer, defended the information systems vigorously, implying traders were responsible for information problems:

> **CHAIR:** None of the information that has been produced, according to the evidence we have received, was reconcilable or reliable.
>
> **Mr FITZGERALD:** [10] I do not know how to answer that. If I was there at the time with them I could probably show them that it was. What I am saying to you, I suppose, is that in my experience at the place, the traders never trusted the system. Now, that may well have been because it gave unreliable data, but I would say that that was not the case. The case was they did not want to deal with it. They did not want to take the time to find out what it was…

In fact Mr Fitzgerald strongly refuted claims the systems were inadequate:

> **CHAIR:** What we do not understand is why did you defend this system given that there was so much criticism? Even the investigating accountant's report was highly critical of the systems that were in place, the information systems, the ZEUS system, which you created, essentially, over time.
>
> **Mr FITZGERALD:**[11] Yes.
>
> **CHAIR:** It seems that you defended it to the hilt even though there was overwhelming and compounding views that this system was not coping, it was not up-to-date and, in the end, it has been proven that it was not. The fact that all these losses have been incurred proves that it was not, and a lot of people were saying that, to the extent that traders had to create their own spreadsheets to know exactly what their positions were.
>
> **Mr FITZGERALD:** I do not accept that, full stop, period. The system did not cause losses. Losses were caused by buying grain, trading grain, not by the system.

The Committee is of the view primary responsibility for the failure of systems and procedures must ultimately rest with the board of the Grains Board that ceased on 30 June 1999. This board changed very little from the initial board appointed in 1991. It oversighted the direction and control of the Grains Board when objectives, strategies, systems and internal control practices were established and consolidated.

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[9] Grain Grower, Ungarie, transcript of hearing, 13 November 2000 at p 48

[10] Former Chief Financial Officer, NSW Grains Board, transcript of hearing, 30 November 2000 at p 11

[11] Id at p 27

It is not clear whether the post 30 June 1999 board identified deficiencies in the information systems in a reasonable time.

The Managing Director was responsible for the flow of information to and from the board and for the day-to-day management of Grains Board activities. This involved working closely with the Chief Financial Officer. The Committee is of the view that collectively they must take significant responsibility for the poor state of operating systems and reporting.

Accounting Treatments

It would appear some accounting treatments applied by the Grains Board would either distort, or allow for the manipulation of, the financial position. These practices involved the closing of pool accounts and the allocation of pool costs.

In relation to pool accounting, witnesses stated the accounts were not transparent and were open to distortion by the Chief Financial Officer:

> **Mr PEART:** [12]…finalisation of the accounts of every pool was always open until the pool closed, so when the Chief Financial Officer said, you know, what would you like it to be, the budget says $2.5 million, depending on whether we close the pool rapidly or whether we bring the costs to account, it will come in between 2 and 2.8, I can make it 2.4 because that is what the budget was.

Traders had similar suspicions:

> **CHAIR:** Were trading losses for any of the grains traded ever carried forward by keeping the pool positions open and delaying closure and final payment?
>
> **Mr WOODS:** [13] I do not know that. That was my suspicion, yes.
>
> **CHAIR:** So in order to present the accounts in a better financial position, you would leave the pool open?
>
> **Mr WOODS:** I do not know whether particularly the pool, but I was of the opinion, and I certainly was of the opinion, that we were deferring liabilities.

Members of the board indicated the Grains Board's accounting practices for pools was unusual. This suggests accounting did not conform to best practice.

> **Mr PEART:** [14] PricewaterhouseCoopers approved the accounting system we had and they kept saying to the audit committee, well, there is nobody else quite like you with these open pools still selling grain two years or two and a half years later. I mean as

[12] Id at p 15

[13] Former commodity trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 13

[14] Ibid

> the grain got down to very small amounts we would say, right, we will value it, we will assume we will sell it for that, we will close the pool and finalise the accounts…

Evidence presented to the Committee indicates the allocation of pool costs was unusual and distorted the Grains Board's trading performance:

> **Mr BLOCKLEY:** [15] …In November, it was clear we were looking at a significantly adverse variance to the budget in terms of profitability, and all of the new members of the board were concerned about that because in most businesses you are operating monthly variances against actual to budget and that is the way you monitor the progress of the business.
>
> The response of management, that is Mr Fitzgerald and Mr Lawrence, was that this variance occurred because all of the storage and handling costs associated with the accumulated grain were posted to the profit and loss statement at the time of receipt, so that although that storage and handling cost would be incurred over a long period of time, it was allocated to the income statement fully in the month when the grain was received.
>
> The new board members, particularly Geoff Babidge, myself and Barbara Clark who all had some financial capacity questioned whether that was the appropriate way of accounting for the business of the board … We requested that management … undertake a review of how those costs were allocated, initially internally, and subsequently at a later board meeting PricewaterhouseCoopers was requested to undertake a review.

Finally, former board members indicated Mr Fitzgerald, Chief Financial Officer, was capable of fixing the year end profit through accounting manipulation:

> **Mr PEART:** [16] I had always had some concerns about John Fitzgerald because he was never a very serious accountant. He was a Mr Fix-it as well. … As the board would come towards the end of the financial year people would anxiously say to the Chief Financial Officer: What is our profit going to be for this financial year? He would always say: What would you like it to be?

The Grains Board's unusual accounting treatments made it difficult for the board to ascertain its correct financial position. The board, therefore, was less effective.

Difficulties with Trading

Evidence from senior commodity traders indicated the co-ordination and control of trading operations was very difficult. Evidence was presented the Grains Board did

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[15] Interim Managing Director, NSW Grains Board, transcript of hearing, 1 November 2000 at p 14

[16] Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 14

not have trading systems comparable with other commodity trading organisations and the Grains Board's systems were well below state-of the art.[17]

Further, traders were frustrated about inaccurate figures for trading stocks:

> **Mr JEFFRIES:** [18] I guess from an accounts point of view there are a lot of people who questioned a lot of figures and did not necessarily agree with some of the stock positions or the accounting figures. Certainly, every one of us who ran a trading book had arguments basically on a weekly basis about what their positions were and where the stocks were…the systems were not up to date.

Traders indicated they were discouraged from viewing the accounts for each of the trading books:

> **Mr HAIRE:** [19] We were not happy in any way shape or form about…the way our systems, our accounting and reporting systems reported… It was only this year when Mr Peter Jacobs came on board as our Chief Financial Officer that we first got to see a copy of the accounts for each of our trading books. Prior to that we were strongly discouraged from viewing them…so we used to keep our own trading positions on spreadsheets.

The senior commodity traders were not the only people suggesting the trading systems were inadequate. Both the investigating accountant and the administrator indicate the systems were poorly maintained, resulting in an estimated $45 million foreign exchange loss.[20]

Foreign Exchange Losses

The Grains Board's administrator argued unfavourable foreign exchange movements widened exposure on significant sales denominated in foreign currencies. In evidence, management attempted to defend the Grains Board's foreign exchange practices:

> **Mr FITZGERALD:**[21]… I remember once a couple of years ago they rang him [Mr Lawrence] in the countryside to tell him we had lost $18 million on foreign exchange or $20 million on foreign exchange, and the external auditors sent a special team in after that to have a really good look at our foreign exchange, and I do not think they found there was too much wrong with it…

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[17] Transcript of hearing, 29 November 2000 at p 30

[18] Former General Manager, Marketing, NSW Grains Board, transcript of hearing, 29 November 2000 at p 33

[19] Former Commodity Trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 40

[20] Investigating Accountant, PricewaterhouseCoopers, transcript of hearing 29 November at p 50, and p 10 of the Administrator's report

[21] Former Chief Financial Officer, NSW Grains Board, transcript of hearing, 30 November 2000 at p 29

However, in chapter three (*The Board*) the Audit Office was extensively quoted finding major problems in the Grains Board's foreign exchange procedures and ineffectiveness in implementing its recommendations.

Traders were of the view the board's and management's inability to co-ordinate trading operations was a major factor behind the foreign exchange loss:

> **Mr WOODS:** [22] My opinion is that, one, the marketing team did not have control of the stocks; two, that the management did the foreign exchange without any consultation to stocks. In the year I left $4 million worth of currency was put into the 1996-97 annual report as abnormal losses. No currency losses were put into the 1997-98 report, but those losses were approximately $16 million, I think, or around that sort of figure, and that is why the pool revenue was down 79 to 80 per cent, or whatever I said before. So to be able to lose what the value of your retained earnings are, I would have thought would be an enormously bad management decision.
>
> **Mr TORBAY:** So you are basically saying there was incompetence?
>
> **Mr WOODS:** Not incompetence. If you are trading, the trading of the currency is part of the trading of the grain, and trading the stocks is part of knowing what your stocks removed from your trading division and your currency hedging removed from your trading division, all it becomes is a gamble. I do not know whether it was incompetent but I would assume that a board that lets currency losses go to the level of retained earnings is, or to me it would be, a very dangerous thing to do. I do not think you will see BHP let currency losses go to more than a certain percentage.
>
> **Mr TORBAY:** But the point I am putting to you is that if, as you indicated, the management procedures and reporting procedures were poor, that can happen because of incompetence or can it happen deliberately, or both. What are you putting to the Committee?
>
> **Mr WOODS:** Currency losses were due to incompetence. If the board agreed to those – which they did – currency measures put in place and they lost that much money, it is certainly incompetence.

The currency practices continued to occur after the Audit Office had conducted a specific review of the Grains Board's treasury activities, including currency risks.

The Committee received evidence Mr Lawrence, the former Managing Director, had insufficient understanding of the complicated operation of currency hedging. This is of particular concern given Mr Lawrence's pivotal role in the organisation:

> **Mr WOODS:** [23] I explained to Mr Lawrence one day that if the price of currency goes down the price of our grain goes up, so by putting currency on, all you are doing is losing any gain you had in the drop, anyway. You put it on currency to hedge against the currency going up. That is why you put it on currency. So if the currency

[22] Former Commodity Trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 7

[23] Id at pp 7 & 8

> had gone down from 70 cents to 68 cents you would have sold your currency at a loss of a couple of million dollars. If it went back up 68 cents you would have bought it again. If it kept going down to 52 you have lost nothing. You have made all that money because the grain is now worth a great deal more.

Concerns were expressed by traders that a conflict of interest arose in relation to bank advice to the Grains Board on currency transactions:

> **Mr WOODS:**[24] …My question to Graham also was that the banks are advising us what to do with currency. I asked him who was on the other side: "When we buy this currency who is selling it to us?" He said, "The bank", and I said, "Well, that gives you a fair enough answer, I would have thought."
>
> **Mr COLLIER:** You saw a conflict of interest there, did you?
>
> **Mr WOODS:** I saw a conflict. If our bank is advising us on what to do with currency and they are on the other side of it, yes, I saw a conflict of interest there.

Mr Lawrence needed to have commodity hedging explained to him. Further, currency trading occurred separately to commodities trading. These clearly indicate Mr Lawrence did not have the necessary experience and knowledge to fulfil his duties as Managing Director.

The Committee is of the view the Grains Board did not have control of its currency transactions. The Committee is also of the view risk management practices could have prevented these currency losses and trading difficulties. Further, these losses on foreign exchange continued to occur following a highly specialised and comprehensive review of the Grains Board's treasury operations conducted by the Audit Office. This indicates both management and the board failed to properly monitor risks and operations even *after* these were specifically brought to their attention.

Risk Management

Where an organisation relies on a particular activity, it is modern practice for a board to assign specific responsibilities to a committee to oversight it. In the case of the Grains Board, this key activity was trading.

A risk management committee has formal responsibilities to develop, review, approve and monitor risk management strategies and exposure in co-ordination with the board. Specific functions of a risk management committee include the setting of policy for the marking to market of all trading positions on a periodic basis, and the review of position limits and credit policies set by the board.[25]

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[24] Ibid

[25] See Kendall, Robin, Risk Management for Executives, 1998, pp 41-71.

Best Practice – Grains Board's Competitors

At least three Grains Board competitors have board-level risk committees. They are Graincorp, AWB Ltd (formerly the Australian Wheat Board), and Grainco.[26]

Evidence presented to the Committee suggests the lack of an effective risk committee to monitor trading operations was a major contributor in the Grains Board's financial loss. Senior commodity traders argued a committee to monitor trading operations should have been established earlier than it was:

> **CHAIR:** Was it an acceptable situation that the trading committee was only formed this year? Should the trading committee have existed far earlier than that?
>
> **Mr JEFFRIES:**[27] Quite possibly. Meetings in relation to trading happened basically on a daily basis with individual traders.

The risk committee was only formed after a crisis in canola trading:

> **Mr HAIRE:**[28] In my opinion, Mr Chairman, it should of happened a lot earlier. The trading committee was formed as a result of my disclosing losses in canola trading to the board meeting at Gunnedah prior to the annual general meeting in February.
>
> **Ms HODGKINSON:** This year?
>
> **Mr HAIRE:** This year. I disclosed an estimated loss, in my opinion, of $13 million, and as a result of that the board thought it was a very serious matter and decided to form the trading committee. I think the marketing team welcomed this development because it gave us an opportunity to canvass a lot of very serious matters regarding risk management and the size of our activities for the overall control and management of these activities within the organisation, because our trading activity at the Grains Board had shifted from very much a pool focused activity at the start of the Grains Board's activity until in the last few years, and myself probably one of the main ones, where most of the grain trading was via cash trading, and this has a very different sort of risk profile and management requirement and systems requirement. I guess we felt as individual traders that we carried a lot of responsibility and that obviously the other parts of the organisation were not keeping up.

Mr Haire also suggested that as traders bore the responsibility for transactions, the Board breached its duty by not monitoring the trading operations of the Grains Board:

> **CHAIR:** …all equivalent trading organisations in Australia have a pretty active risk committee?

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[26] See Graincorp 1999 Annual Report, AWB Ltd Annual Report 1998/99, and Grainco Australia Ltd Company Report 2000.

[27] Former General Manager, Marketing, NSW Grains Board, transcript of hearing, 29 November 2000 at p 30

[28] Former Commodity Trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 30

> **Mr HAIRE:** [29] Absolutely…Both private and I think there have been changes in the Wheat Board in recent times to address these sorts of issues…because it is a high risk business with very low margins and so it requires very careful monitoring.
>
> **Ms HODGKINSON:** And you think it was sort of an abrogation of duty of the board of directors and the chief executive officer not to have this risk committee in place earlier?
>
> **Mr HAIRE:** You could interpret it that way. Certainly from a personal point of view it was unsatisfactory that I had to bear so much risk.

Although some of Mr Haire's comment may be seen as explaining away some responsibility for the losses he had incurred in canola trading, it is also evident traders needed effective guidance on risk prior to the establishment of the risk committee in March 2000.

Once established, it appeared from evidence the trading committee worked very well. Senior commodity traders noted the new arrangements allowed them to raise such issues as the computer systems which facilitated the organisation's trading operations. The discussions at the risk committee also gave the board a better understanding of the issues facing the organisation:

> **Mr HAIRE:** [30] …The computer systems really were, in hindsight, unsatisfactory...
>
> **Mr COLLIER:** Mr Haire, did you raise those concerns with anybody?
>
> **Mr HAIRE:** Yes, we did. Once the trading committee started, Mr Collier, very much so, very vigorously, we did raise those issues.
>
> **Mr COLLIER:** When was that?
>
> **Mr HAIRE:** That was starting from the first trading committee in March. Each trading committee that we had from that moment forward we saw as a fantastic opportunity to express these concerns that we had directly to the board members that were present on that committee.

This clearly demonstrates had the board-sponsored risk committee been established earlier, the financial loss for the Grains Board may have been less.

Prior to the board-sponsored risk committee being established, a risk management committee was in place which consisted of the Managing Director, the General Manager Marketing, the Senior Manager Operations and the Chief Financial Officer. However, there were no Board representatives.[31]

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[29] Ibid

[30] Id at p 31

[31] Transcript of hearing, 16 November 2000 at p 39

In relation to this previous risk committee, the former Chairman of the Grains Board, Mr Don Hubbard, claimed the organisation's policies and procedures manual set out the procedures for the risk management committee. Mr Hubbard stated no audit report had suggested these procedures were inadequate. Mr Hubbard's responses are viewed as attempts to deflect responsibility for obvious failings of the board:

> **Mr HUBBARD:** [32] If I can make this point, it is wrong to say it did not have a risk management committee. If you look at the policies and procedures manual, there is a risk management committee.
>
> **CHAIR:** How well did it function?
>
> **Mr HUBBARD:** Well, that is the point. It took us some time to work out that that was not functioning because that was a senior risk management committee [ie, did not include board members] and I think I would point to the fact that it had never been raised in any audit report that I have seen that that was a material risk.

However, at least three of the Grains Board's competitors had risk committees. It was standard industry practice. The Chairman and the board should have been aware of these standards. They were best placed to create a risk committee. The Chairman did not need an audit report to be told a risk committee was necessary.

In addition, the Audit Office had been active in raising deficiencies in the risk management structure with the board. The Audit Office were also concerned about the lack of action in respect of their suggested improvements:

> **Mr KHEIR:** [33] They dealt with a number of them but there were three important ones that were still outstanding as at 31 August 1999. We reported those again. The most important of those was that the board have a policy that risk positions must be reported to the risk committee and the board weekly and that this should detail any open positions which breached limits. However, this was not being done, and in addition, we said that the risk limits themselves that they were operating under needed revising. What we were saying to them was that we found they were operating under risk limits which were approved as at September 1995, and we said these were the same as those approved in the October 1998 version. This is irrespective of the change in activity since this time, as can be observed in the various graphs that we attached where we showed the volume of activity had increased substantially yet the risk limits had been the same as were applicable in 1995.
>
> **CHAIR:** And there were very low levels of compliance?
>
> **Mr KHEIR:** Yes.
>
> **CHAIR:** And the third one?

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[32] Former Chairman of the NSW Grains Board, transcript of hearing, 16 November 2000 at p 39

[33] Director of Audit, Audit Office of New South Wales, transcript of hearing, 30 November 2000 at p 79

Mr KHEIR: The third one was authorisation of deal dockets. We found that deal dockets for foreign exchange documents were not prepared and authorised by section X,Y, Z of the board's approved policies. Senior finance and admin is aware of such issue and suggested that an amendment of the board's policies is required to reflect the dynamic nature of the foreign exchange market. The implications that we expressed to the board was that deal dockets which are not prepared and signed under the appropriate delegated authority gives rise to operational risk within the Grains Board. That is, the inadequacy of such authorisation procedures may expose the Grains Board to potential losses as a result of errors and/or fraud. Management responded, "Yes, you also reported this at the end of 1997-98", and the board considered an amendment to the procedures and agreed that they would do it. This was in 1999.

CHAIR: But they had not done it?

Mr WHITE:[34] Not at the time of issuing that report.

Mr KHEIR: So we reported it in 1998 and then again in 1999 because it had not been addressed, along with the risk limits and the authorisation.

The Committee is of the view the absence of an effective risk committee, until March 2000, meant there was a lack of oversight of trading operations, including key internal controls and policies. Responsibility for the existence and effective operation of a risk committee rests completely with the board.

Stock Control

Stock recording and control was a fundamental activity for the Grains Board. However, as illustrated earlier in this chapter, commodity traders had doubts about the accuracy and completeness of stock records. The Grains Board’s Chairman, Mr Don Hubbard, was also concerned about the stock system’s inability to highlight excessive grain purchases in late 1999. Evidence presented to the Committee suggests there were good grounds for these concerns.

Rudimentary stock control via reconciliations were not conducted effectively. For example, internal auditors noted the backlog of grain reconciliations which needed to be performed:

Mr WETMORE:[35] Mr Chairman, in this recently completed audit, which we did in May of 2000, stock reconciliations were part of the rotational audit plan that had been established that Mr Ellis has referred to, so it did come up for audit in this current cycle…we reported on a deficiency in the area of stock reconciliations when we completed the May 2000 internal audit.

Mr GLACHAN: How serious was that deficiency?

[34] Assistant Auditor-General, transcript of hearing, 30 November 2000 at p 79

[35] Internal Audit Partner, PricewaterhouseCoopers, transcript of hearing, 30 November 2000 at p 3

> **Mr WETMORE:** It recorded the fact that many of the grains reconciliations had not been performed going back to. We tabled which months reconciliations had been performed and the fact that during the harvest season there was a tendency to let these reconciliations slip and that they had a large backlog to make up.

The lack of reconciliations during the time of high stock turnover supports the doubts about the quality of information being presented to the board.

The controls over grain stock were also raised by the Audit Office in Management Letters to the board for 1997, 1998 and 1999. Inadequate stock reconciliation processes had been a matter of on-going concern:

> **Mr KHEIR:** [36] …over the last three years we have had major observations in management letters about the stock and inventory situation and the records in those areas where we have actually been critical of the reconciliation process.
>
> We have pointed that out to management in three separate letters over the last three years and, actually, in the 1997 management letter we got them to adjust their stocks by about $3 million for errors in that area, so they have been communicated through the management letters, stock reconciliation problems and so on, but at the end of the day we can point out those flaws in the system, and we have done so, and it is up to management to correct the systems.

The poor state of stock recording and reconciliation has also been confirmed by the administrator of the Grains Board. In his report of 24 January 2001 he stated there were significant variances between quantities held in bulk storages and quantities recorded in Grains Board records.[37]

Growers also observed poor stock management:

> **MR HAMMOND:**[38] We know that they have got stacks of grain in a bunker out at Hermidale which is several thousand tonnes of high quality – well not high quality it was high priced grains, high protein, high screening, bought three seasons ago and as I understand it is still there. They have got 10,000 tonnes of sunflower in a shed up in central Queensland which has been through one Summer and if it goes through another Summer it will be worth absolutely nothing because of the dangers to the oil content of the whole thing.
>
> These acts should not have been allowed to happen. Any worthwhile grain manager would have liquidated those grains long before now.

Therefore, concerns over stock control had a long history. The lack of action to correct or compensate for flaws in the stock system were a contributing factor to the Grains Board "unknowingly" operating outside its budgeted zone.

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[36] Director of Audit, Audit Office of New South Wales, transcript of hearing, 30 November 2000 at p 63

[37] NSW Grains Board, Administrator's Interim Report, 24 January 2001 at p 23

[38] Rural Marketing and Supply Association (RMSA), transcript of hearing, 13 November 2000 at p 55

Accounts Receivable

Another system of fundamental importance to the operation of the Grains Board's trading activities was accounts receivable or trade debtors.

The Committee heard evidence the Grains Board had not conducted reconciliations or implemented adequate bank guarantees. Further, certain stock loans to purchasers lacked security. Based on this evidence, the Committee concluded incomplete information about debtors added to the difficulty of determining the financial position of the Grains Board.

For example, management was unable to determine the age and amounts debtors owed the Grains Board. Ad hoc debtors' spreadsheets, which provide information to the board were not reconciling with debtors' records in the accounting system:

> **Mr BLOCKLEY:** [39] … since becoming the interim Managing Director in August of this year, I now find out that the aged debtors' report that was provided to the board each month was not generated by the accounting system of the board but, indeed was an Excel spreadsheet that was developed by the debtors clerk separate to the computer system and which in fact bore no relation to the accounting system that could have generated that report. So, it throws into question the aged debtors reports that the board members were being provided and the accuracy of those reports.

This situation was refuted by the former Chief Financial Officer, who claims:

> **Mr FITZGERALD:** [40] … monthly reconciliations were done of debtors, accounts receivable, but maybe…they were not done to a standard that someone else thought, but they were done. We knew what the debtor position was.

Despite Mr Fitzgerald's rebuttals, members of the last board were of the view the reporting on debtors was problematic. Inaccurate reporting had severe implications for the assessment of credit limits and debtors' management. The former Chairman of the Grains Board argued:

> **Mr HUBBARD:** [41] …if I can explain this real issue about the debtors area because this is what happens when your debtors area is wrong, I think the credit limit that we extended to Water Wheel was something like $600,000. How on earth can an organisation get into you for $6.5 million or $7 million when you have a credit limit on them of $600,000? Again, it is a function of the accounts receivable not being reconciled.

The Audit Office also noted the Grains Board had a policy of bank guarantees for trade debtors. However, this policy was not being adhered to:

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[39] Interim Managing Director, NSW Grains Board, transcript of hearing, 1 November 2000 at p 15

[40] Former Chief Financial Officer, NSW Grains Board, transcript of hearing, 30 November 2000 at p 17

[41] Former Chairman of the NSW Grains Board, transcript of hearing, 16 November 2000 at p 36

Mr KHEIR: [42] … we were just saying, "You have a policy in place to have bank guarantees. You have not got any bank guarantees for all these debtors, and in total they are $10 million."

Mr WHITE:[43] "You are carrying a greater risk."

Mr KHEIR: "The risk is that if these debtors go bad or strike trouble, you will not be able to collect the debts." We were not saying that they were doubtful or not collectable. We were drawing attention to the fact that, "You have got a policy to have bank guarantees in place and you have not taken that on board."

Credit limits for trade debtors were exceeded without authorisation and approval by the board. Lance Blockley notes Water Wheel and Seedex had stock on consignment at their premises and used the stock without the knowledge of the Grains Board. The amounts owed by these companies were discovered to be beyond credit limits once the Grains Board had found they had used the stock.[44]

In relation to trade debtors who used the Grains Board's stocks, the Committee found a number of significant accounts were poorly managed. With regards to Water Wheel Pty Ltd, the Grains Board had supplied $4 million worth of stock even though it only had a $1 million credit limit. Further, Water Wheel was an unsecured creditor.[45]

Evidence presented to the Committee also indicates the Water Wheel account had been given 'special treatment'. Former Chief Financial Officer, John Fitzgerald, indicated Water Wheel were treated differently to other debtors:

Mr FITZGERALD: [46] Water Wheel was a very important, very large, account that was being managed by senior staff in the organisation.

Mr COLLIER: They were debtors, though, were they not?

Mr FITZGERALD: Sure. Absolutely, they were debtors.

Mr COLLIER: They were treated differently from other debtors?

Mr FITZGERALD: They were a very big and important account and they were not just your one where you expected to wait for an invoice to come in.

Mr COLLIER: The question was: They were treated differently from other debtors?

MR FITZGERALD: Yes. I believe so, yes.

[42] Director of Audit, Audit Office of New South Wales, transcript of hearing, 30 November 2000 at p 71

[43] Assistant Auditor-General, transcript of hearing, 30 November 2000 at p 71

[44] Interim Managing Director, NSW Grains Board, transcript of hearing, 1 November 2000 at p 17

[45] Transcript of hearing 30 November 2000 at p 48

[46] Former Chief Financial Officer, NSW Grains Board, transcript of hearing, 30 November 2000 at p 18

Water Wheel Pty Ltd, which is currently in voluntary administration, is being investigated by the Australian Securities Investment Commission (ASIC) for allegedly trading while insolvent.[47] It is estimated Water Wheel owes the Grains Board $3 million for grain provided on consignment. Indications are little, if any, of this amount will be repaid.[48]

Mr Lawrence took control of the account despite the board members' concerns about dealing with Water Wheel:

> **Mr ROBERTS**: [49]…Then the Water Wheel thing started up and that was not long, as I understand it, before our board term expired. I was rather concerned for getting involved with them.
>
> **ACTING-CHAIR**: So it was only a business relationship? Was it a personal relationship or was it strictly business - Grains Board business and Water Wheel business?
>
> **Mr ROBERTS**: As I understood it at the time it was a business relationship. I do not know of any close personal relationships that existed between the two personalities.
>
> **ACTING-CHAIR**: Your advice to him in relation to that company was 'Do not get involved with the company' not 'Do not get involved with the individual', is that it?
>
> **Mr ROBERTS**: I would not have differentiated between the two; one and the other were both the same as far as I am concerned because Elliott was director of Water Wheel and whatever Water Wheel did would be Elliott.
>
> **ACTING-CHAIR**: Did the chief executive take your advice? Obviously he did not.
>
> **Mr ROBERTS**: The results have indicated that he did not.

Seedex was another account which resulted in financial loss for the Grains Board. Comments made by Graham Lawrence suggest management were not in control of the Seedex account:

> **Mr LAWRENCE:** [50] …Seedex was in the market buying anything up to 30,000 tonnes of a range of oilseeds a year. Some they bought from the Grains Board. It was a highly competitive arrangement. Some they bought from other people and some they bought themselves. During the course of customer relationships it became apparent that there might be a deal that would be better for the Grains Board to do their 30,000 tonnes in total through one contract to get an exclusive arrangement with Seedex.

[47] Australian Financial Review, 20 February 2001 at p 16

[48] NSW Grains Board, Administrator's Interim Report, 24 January 2001 at p 21

[49] Former Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at pp 75 & 76

[50] Former Managing Director, NSW Grains Board, transcript of hearing, 30 November 2000 at p 49

> The General Manager, Marketing, put up a proposition that went to the board. There had been credit checks done through Dun and Bradstreet and through the banks and all of them turned out to be very positive. As a result, we started the same sort of business with Seedex that we were doing with all our clients, that is, supplying seed which we took from our silos and some which they had already bought, sold back to us for delivery to them at a later stage and payment by them at a later stage. Once again, a standard price, where we were making a margin on the finance and on the purchasing of the grain and basically Seedex, in much more or a much less professional manner if that is possible, straight out defaulted. They took the stocks, processed the oil, got the revenue and put it somewhere else and told us that they had no money.

Deputy Chairman Graham Peart had prior business dealings with Mr Ray Papp of Seedex:

> **Mr PEART:**[51] … he [Ray Papp] owed in this district something like $100,000 to farmers who he did not pay. I reported to the board that I had found him to be a scoundrel. We were trying to get rid of very big volumes of canola. We again sold $4.5 million of canola with a letter of agreement that as he processed each load we would be paid cash back. In the rush of that harvest no one was administratively in charge of it, none of it was collected …

Total losses relating to grain trading with Seedex are likely to exceed $6 million.[52]

The Audit Office stated management of the Grains Board had been alerted through management letters about the failure of internal procedures in relation to bank guarantees for debtors. Evidence indicates the Audit Office advised the Grains Board that extending customers' credit beyond their capacity to meet the debt increased the risk of default:

> **Mr KHEIR:** [53] A very important point we raised in the management letter was that credit limits were being exceeded. We said that during the course of our examination of year end debtors we noted that some customers had exceeded their credit limits as prescribed by management, and we listed about 10 debtors, including Water Wheel, Seedex, and others where the credit limits had been succeeded substantially, and we said that the implications are that customers may have been extended credit beyond their assessed capacity to meet the debt to the board, thereby increasing the risk of default.

This suggests management had knowledge of the risks but did not, or could not, take control of their trade debtors accounts.

The Audit Office also voiced concerns from 1997 to 2000 about the reconciliation of debtors accounts. The management letters to the board included such issues as the monthly reconciliation of the debtors, the lack of bank guarantees, credit limits

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[51] Former Deputy Chairman of the NSW Grains Board, transcript of hearing, 13 November 2000 at p 24

[52] NSW Grains Board, Administrator's Interim Report, 24 January 2001 at p 21

[53] Director of Audit, Audit Office of New South Wales, transcript of hearing, 30 November 2001 at p 69

being exceeded, and inappropriate year end cut-off procedures for accounts receivable.

In 1997, the Audit Office commented on the issue of bank guarantees for debtors. The Audit Office noted the value of debtors exceeded $12 million whilst respective bank guarantees held by the Grains Board covered only $110,000. This raised concerns that in the event of default, the Grains Board may not be able to obtain recourse to the amounts owed by the debtors. The Audit Office recommended procedures be put in place to ensure bank guarantees are maintained for large debtors to guard against potential bad debts.

However, the Grains Board argued it was not practical to insist all large debtors provide bank guarantees against amounts owed to the NSW Grains Board, even though it was official board policy. It also stated the 'track record' of the NSW Grains Board in obtaining money owed to it was evidence bank guarantees were not required.[54]

In 1999, the issue of credit limits being exceeded was outlined in the Audit Office's management letter to the Grains Board. The management letter notes some customers of the Grains Board had exceeded their credit limits as prescribed by policy. Customers would have been extended credit beyond their assessed capacity to meet the debt to the Board, thereby increasing the risk of default.[55] The management letter dated July 2000 indicated under "Comment by Management" that the recently appointed Chief Finance Officer would be responsible for a review of credit limit procedures.

Initial press comment in July 2000 about the source and extent of the Grains Board's losses focused on the bad debts relating to Water Wheel and Seedex companies and currency losses. The losses were reported to be in excess of $8.5 million. The Administrator's report of 24 January 2001 estimated the trade debtors position at 31 October 2000 as a book value of $42 million less provisions of $18 million, resulting in a total trade debtors of $24 million.[56]

Joint Ventures

The Grains Board entered into joint ventures in order to improve its market position and broaden its range of activities. These activities included: grain acquisition; fuel distribution; oil seed crushing and oil marketing; and grain storage.[57] The Committee received evidence the Managing Director, Mr Lawrence, was heavily in favour of these investments:

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[54] See the Management Letter for 1997 issued by the Audit Office to the Grains Board

[55] See the Management Letter for 1999 issued by the Audit Office to the Grains Board

[56] NSW Grains Board, Administrator's Interim Report, 24 January 2001 at pp 21 & 22

[57] PricewaterhouseCoopers, NSW Grains Board Investigating Accountants Report August 2000 at p 13

> **Mr WOODS:** [58]… we had a seminar over at Surry Hills, where all the staff were invited from the country, from the city—everyone was there. Mr Lawrence got up and said, "You all participate, you are all part of a team, you are all here. We are going to do all this sort of stuff." We spent the day playing the various games and going through various scenarios. At the end of the day Mr Lawrence said, "Well, that's decided. We're going to build storages, then. That is our strategy." I said that I did not think that was our strategy because none of us agreed on it in any way, shape or form. He said, "Oh, no, we definitely agreed on it"…

It appears unprofitable joint ventures outside the Grains Board's direct control contributed to the Board's financial loss. In some joint ventures, the Grains Board assumed responsibility for a greater proportion of losses incurred than potential profits realised. The Grains Board's administrator notes these arrangements were part of the cause for the financial loss. In addition, the following observations were made about the joint ventures:

- The Grains Board contributed significant funds in joint ventures, but had little involvement in day-to-day trading decisions;
- The Grains Board experienced difficulty in obtaining accurate accounts or information to assess the performance of joint ventures;
- The Grains Board entered into agreements allowing for the Grains Board to share 60% of all profits but absorb 100% of any losses;
- The Grains Board advanced seasonal funding to joint venture partners which were unsecured loans; and
- The Grains Board provided funds to directors of companies they had entered into joint venture arrangements with.[59]

Joint ventures contributed to inaccuracies in the stock and accounting systems. The Grains Board's systems did not include up-to-date information on the stocks held by the joint ventures. The investigating accountant found the Grains Board relied on information supplied by their joint venture partners. This could result in the true commercial and legal position of the stock associated with joint ventures being uncertain.[60]

Joint ventures and investments by the Grains Board totalled $28.5 million.[61] The valuation of these joint venture investments has also been questioned.

The Audit Office raised concerns over the value of an investment in Bulk Grains Storage Pty Ltd. The company was purchased from a Grains Board joint venture

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[58] Former commodity trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 8

[59] NSW Grains Board, Administrator's Interim Report, 24 January 2001 at pp 24-32

[60] PricewaterhouseCoopers, NSW Grains Board Investigating Accountant's Report, August 2000 at p 34

[61] NSW Grains Board, Administrator's Interim Report, 24 January 2001 at p 24

partner, The Brooks Joint Venture.[62] Representatives from the Audit Office commented on the acquisition of bulk grain storages:

> **Mr WHITE:** [63] …When that acquisition occurred in December of 1996, and I have mentioned to you that there were appropriate board papers that went up discussing the acquisition, the consideration was $3.5 million. When that was presented in the financial statements for 31 August 1997, my colleagues identified and discussed with the board that the $3.5 million could not be shown simply as an investment, that this actually was comprised of goodwill. That was because the basis of what the original consideration was made for was not robust when certain valuations were made by 31 August 1997, so therefore, if you are getting less in a tangible asset, the intangible asset goes up. Whilst the accounting treatment was appropriately reflected in the financial statements, we also took through the audit committee, via the management letter, our concerns about what type of transaction this was. We did not go so far as to say that this was a bad buy but we certainly drew the implication that it could be considered a bad buy for the amount of goodwill that was paid for that particular investment.

The Committee is of the view that had these joint ventures been acquired through a more transparent process, for example involving competitive tendering for the services involved, many of the joint ventures would not have occurred. The monopoly position of the Grains Board allowed it to charge and extract economic rents (higher than competitors) from its handling activities and further consolidate its market dominance.

Further, the Committee received evidence of expected industry rationalisation in many of the activities undertaken by the joint ventures, due to excess capacity within the industry. In all likelihood, the horizontal and vertical integration pursued by the Grains Board was not commercially responsible. It appears many of the joint ventures were motivated by efforts to establish market dominance and to create paper profits through book entries, rather than profit maximisation and other proper commercial considerations. The Committee took evidence that joint ventures required growth to be profitable:

> **Mr MACINTOSH:** [64] There was a very definite push to volume rather than possibly commercial viability.
>
> **Mr COLLIER:** How do you account for that?
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> **Mr MACINTOSH:** I would think that was because the board was involved in other joint ventures in bulk storage. If you own storage assets, then the one thing you have to put through storage is volume, otherwise it simply does not pay.

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[62] The Brooks Joint Venture's objective was the accumulation of grain in South Australia and Victoria. Its carrying value in the Grains Board's books was approximately $16 million.

[63] Assistant Auditor-General, transcript of hearing, 30 November 2000 at p 82

[64] Former General Manager, Marketing, NSW Grains Board, transcript of hearing, 29 November 2000 at p 21

> **Mr COLLIER:** Did Mr Lawrence or any other member of the board explain to you at any time why the emphasis was on volume rather than profit?
>
> **Mr MACINTOSH:** I did have a conversation with Mr Lawrence on one occasion why we should do it. The answer to that was, "Well, we own assets and we have to put grain through the storages."
>
> **Mr COLLIER:** Did that satisfy you?
>
> **Mr MACINTOSH:** As a trader, it never satisfies me if it is not what I feel is commercially viable.

The administrator of the Grains Board also indicated the joint ventures and investments are likely to realise considerably less than their book values.

Reporting to the Board

The Committee found the monitoring of key trading activities by the board would have been improved if regular reports had been uncomplicated and highlighted significant issues, including departures from policy.

Best Practice – Professional Accounting Associations

Information provided to the board must be timely and of high quality. It should enable board members to support, stimulate and challenge management.[65]

However, the Committee received evidence that board papers relating to important decisions were received just prior to meetings. This allowed little time for members to give matters due consideration. There were also claims the papers were too voluminous and uninformative, making the job of understanding them more difficult:

> **Mr BLOCKLEY:** [66] In November, I raised the issue of having a new Chief Financial Officer. My belief was that the level of reporting that we were receiving on the financial activities of the board was voluminous but not very informative and that a different style of reporting was required and I felt that the answers of Mr Fitzgerald to the questions placed by board members was sometimes flippant and sometimes skirting around the issues.

Such practices have limited the effectiveness of the board.

[65] Australian Society of CPAs and Institute of Chartered Accountants, Beyond the Gap: Report of the Financial Reporting and Audit Expectation Gap Task Force, 1996 at p 10

[66] Interim Managing Director, NSW Grains Board, transcript of hearing, 1 November 2000 at p 15

The Grains Board's last Chairman, Mr Don Hubbard said "…given the nature of the management reports that were put in front of us, we thought we were managing the change in an orderly fashion."[67]

Mr Hubbard also said: "I would ask any of you to look at the reports presented to the board. It was not clear that those volumes were being traded."[68]

The two systems used to control and monitor accounts receivable have already been discussed. The reports to the board were based on the debtors clerk's spreadsheets that were not reconciled to the accounts receivable data base.[69]

Further evidence indicated management displayed an indifferent attitude when presenting to the board and its committees. The Audit Office noted:

> **Mr WHITE:** [70] … when I have spoken to my colleagues over a period of time who were interacting with the audit committee, both the old audit committee, the audit committee belonging to the board pre-30 June 1999 and the one post-1 July 1999, we found instances at times when we were asking Mr Fitzgerald to table the management letters as you would expect at audit committees. Mr Fitzgerald seemed always reluctant to give our management letters a good hearing. So we would find practices where the management letters would only be virtually turning up at the day of the meeting and we were saying to the audit committee, "How would you be able to give these appropriate consideration?" Certainly you could after the meeting but not prior.

In relation to day-to-day reporting, commodity traders were less than satisfied:

> **Mr HAIRE:** [71] … It was a matter of how the reports were structured and what they reported, because the thing with grain trading is that it is not a simple apples-for-apples exercise. There are different currencies, different positions, like in terms of CIF or FOB or track. In the case of canola, we had three years worth of canola trading simultaneously. You can have old crop, current crop and the new year's crop all in one position report. How can you manage that or report that accurately? They should be separated and the currency should be put in and matched off against the contracts, and the same for the futures. This system did not in any way, shape or form come close to identifying these issues.
>
> **Mr COLLIER:** So the reports that went to the board, you are saying, were not accurate?
>
> **Mr HAIRE:** From that point of view they were not accurate, no. How could they be accurate?

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[67] Transcript of hearing, 16 November 2000 at p 33

[68] Id at p 32

[69] Id at p 37

[70] Assistant Auditor-General, transcript of hearing, 30 November 2000 at p 71

[71] Former Commodity Trader, NSW Grains Board, transcript of hearing, 29 November 2000 at p 33

The Committee believes much of the management reporting at the board and operational levels was clearly inadequate for the purposes of monitoring and directing the Grains Board's core activities.

Organisational Structure

Similar to the difficulties the Grains Board experienced with management practices and systems, the Grains Board's structure did not align well with the expansion of its business.

The Grains Board's dominant activity of trading was compartmentalised from the rest of the organisation. This resulted in functional areas (such as commodity broking, treasury, finance and stock control) not being effectively linked with each other. This made the whole Grains Board dysfunctional.

This aspect of the Grains Board's organisation was clearly illustrated by Ian Macintosh, a former General Manager, Marketing:

> **Mr MACINTOSH:** [72] I had come from a European-based multinational company that quite simply gave and had structure in it that I felt should be the way forward. The Grains Board was very much separated responsibilities. For instance, marketing was dealt purely by marketing. They had no input on logistics, finance or how those logistics would run, and I felt that as General Manager, Marketing, I was responsible for marketing the grains of the board and there should be a more encompassing and certainly a better structure, that all of those divisions should be under basically one heading rather than a number of headings and that was not going to happen so the best thing to do was to leave.
>
> **CHAIR:** Essentially, you were concerned about the financial and operating structure of the Grains Board?
>
> **Mr MACINTOSH:** I would not say concerned about the financial and operating structure. It was the structure that was in place. You had a general manager for logistics, a manager of finance, a Managing Director and they were all individual divisions. If you are marketing grain, then to do that properly and to achieve the goals of the board which was to increase grower shareholders' values, all of those things needed to be encompassed in one effort rather than several different divisions within one.
>
> **CHAIR:** Were you concerned about the structure in the sense that it had a purpose other than efficiency and effectiveness? For instance, was it structured in such a way that Mr Lawrence had complete control?

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[72] Former General Manager, Marketing, NSW Grains Board, transcript of hearing, 29 November 2000 at p 19

> **Mr MACINTOSH:** Again, it is an opinion. I did not see anything to the contrary, but Mr Lawrence had ultimate say in everything, so at the end of the day that control stopped there.

Similar concerns about structure and co-ordination were raised by commodity traders Messrs Woods[73] and Haire.[74] As indicated earlier in this chapter, this situation improved in March 2000 when a board-sponsored committee replaced the management risk committee.

A further instance of structural problems was there was no separation of duties between the IT and financial functions. It had been raised by the external auditors in 1997 and 1998 with the board, who accepted the status quo. Representatives from the Audit Office commented on this issue:

> **Mr WHITE:**[75] Can I give you just a very simple but a very important example, and it was to do with the then Chief Financial Officer, John Fitzgerald. We have highlighted for a number of years that Mr Fitzgerald had a lack of segregation of duties, if I can use that phrase. He was the master of a whole lot of activities at the Grains Board, and we were saying, "This is unusual for this practice to occur. We recognise in terms of staffing that you are not going to have the types of structures you would anticipate for larger organisations, but being Chief Financial Officer, being the chief, in effect, of the IT systems, company secretary or a type of role like that, he had a lot of roles, and usually for good controls you are looking for a segregation of those roles so that there are cross-checks and balances." Now each time management said we are not of a size to do that, the audit committee would see that type of recommendation from us, see management's response and then take a view on it. Because they left Mr Fitzgerald in that role, one can only conclude that they were happy to take that type of risk.

It is the Committee's opinion the Grains Board's organisational structure did not allow for the effective co-ordination of core activities. Rather, the structure resulted in operational information reaching a limited number of people. The board and management had been warned of these risks, but chose to ignore them.

Conclusions

Best Practice: An effective control environment requires that information systems provide data related to key risks, for example market, credit, operational, and reputation risks.

- The poor information systems meant the information provided to the board was inadequate and often incomplete. There was a fatal three to four months gap between the purchase of grain beyond budget and this being reported to the

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[73] Transcript of hearing, 29 November 2000 at pp 2 & 3

[74] Id at p 30

[75] Assistant Auditor-General, transcript of hearing, 30 November 2000 at pp 65 & 66

board. Traders were forced to run their own spreadsheets to keep track of their stock. The reconciliation of accounts receivable was considerably delayed. Accounting treatments in relation to the closing of pool accounts and the allocation of pool costs allowed the manipulation of the financial position. The Grains Board relied on information provided by its joint venture partners.

Best Practice: At least three Grains Board competitors have risk committees. They are Graincorp, AWB Ltd (formerly the Australian Wheat Board), and Grainco Australia Ltd. An effective control environment requires the board to monitor the management of key risks.

- As traders bore the responsibility for transactions, the board breached its duty by not monitoring the trading operations of the Grains Board. The board-sponsored risk committee was only formed in March 2000 after a crisis in canola trading. The board had prior knowledge Seedex and Water Wheel were credit risks, yet allowed these accounts to exceed their credit limits. The Grains Board contributed significant funds to joint ventures, but had little involvement in day-to-day decisions.

Best Practice: Information provided to the board must be timely and of high quality. It should enable board members to support, stimulate and challenge management.

- The investigating accountant found the Grains Board relied on information supplied by their joint venture partners. Board papers relating to important decisions were received just prior to meetings. Further, they were voluminous and uninformative, making the job of understanding them more difficult.

Best Practice: An effective control environment requires that internal controls help separate and co-ordinate duties.

- The Grains Board's dominant activity of trading was compartmentalised from the rest of the organisation. This resulted in areas such as commodity broking, treasury, finance and stock control not being effectively linked with each other. Placing the Chief Financial Officer, Mr Fitzgerald, in charge of both the computer systems and the finances meant there was no separation of duties between these important functions.