



COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

**Reference: Financial reporting and equipment acquisition at the Department of
Defence and Defence Materiel Organisation**

WEDNESDAY, 13 JUNE 2007

CANBERRA

BY AUTHORITY OF THE PARLIAMENT

INTERNET

The Proof and Official Hansard transcripts of Senate committee hearings, some House of Representatives committee hearings and some joint committee hearings are available on the Internet. Some House of Representatives committees and some joint committees make available only Official Hansard transcripts.

The Internet address is: **<http://www.aph.gov.au/hansard>**

To search the parliamentary database, go to:
<http://parlinfoweb.aph.gov.au>

**JOINT STATUTORY COMMITTEE OF
PUBLIC ACCOUNTS AND AUDIT**

Wednesday, 13 June 2007

Members: Mr Barresi (*Chair*), Ms Grierson (*Deputy Chair*), Senators Mark Bishop, Chapman, Hogg, Humphries, Murray and Watson and Mrs Bronwyn Bishop, Mr Broadbent, Dr Emerson, Dr Jensen, Miss Jackie Kelly, Ms King, Mr Laming and Mr Tanner

Members in attendance: Senators Mark Bishop, Hogg and Watson and Mr Barresi and Miss Jackie Kelly

Terms of reference for the inquiry:

To inquire into and report on:

Progress in implementing systematic reforms in the areas of financial reporting and equipment acquisition at the Department of Defence and the Defence Materiel Organisation (DMO), as identified in ANAO financial and performance audits, the Defence Procurement Review 2003 (the Kinnaird Review) and the Senate Foreign Affairs, Defence and Trade References Committee's 2003 Report on the Inquiry into Materiel Acquisition and Management in Defence, including the following:

- Progress in implementing Defence's financial remediation plans, relative to international best practice in these areas, and recommend any further measures that can be adopted;
- Progress in implementing the Kinnaird Reforms, relative to international best practice in these areas, and recommend any further measures that can be adopted;
- Review Australia's relative achievements in procurement and financial reform relative to international best practice in these areas of defence administration; and
- Assess progress in Defence's adoption of international business accounting standards relative to international best practice in this area of defence administration.

WITNESSES

CRONIN, Mr Colin, Executive Director, Performance Audit Services Group, Australian National Audit Office..... 1

McPHEE, Mr Ian, Auditor-General, Australian National Audit Office..... 1

MEERT, Mr John, Group Executive Director, Performance Audit Services Group, Australian National Audit Office..... 1

WATSON, Mr Michael, Group Executive Director, Assurance Audit Services Group, Australian National Audit Office..... 1

WHITE, Mr Michael, Executive Director, Assurance Audit Services Group, Australian National Audit Office 1

WHITE, Mr Peter, Executive Director, Performance Audit Services Group, Australian National Audit Office 1

Committee met at 11.27 am

CHAIR—I welcome everybody to this public hearing, the committee's inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Material Organisation. The hearing provides an opportunity for the ANAO to update the committee on progress that has been made in relation to Defence's financial mediation program and plans for monitoring the top 30 Defence projects. I advise witnesses that the hearings today are legal proceedings of parliament and warrant the same respect as proceedings of the house itself and the giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament. The evidence that you give today will be recorded by Hansard and will attract parliamentary privilege.

CRONIN, Mr Colin, Executive Director, Performance Audit Services Group, Australian National Audit Office

McPHEE, Mr Ian, Auditor-General, Australian National Audit Office

MEERT, Mr John, Group Executive Director, Performance Audit Services Group, Australian National Audit Office

WATSON, Mr Michael, Group Executive Director, Assurance Audit Services Group, Australian National Audit Office

WHITE, Mr Michael, Executive Director, Assurance Audit Services Group, Australian National Audit Office

WHITE, Mr Peter, Executive Director, Performance Audit Services Group, Australian National Audit Office

CHAIR—Welcome. Do any or all of you wish to make a brief opening statement before we proceed to questions?

Mr McPhee—Thank you. I do actually have a brief statement but I am happy to pass it around if the committee would like to get into the questions. Otherwise I can make a brief summary of it if you would like?

CHAIR—Yes, as long as it is brief. There are some specific questions I would like to ask as well.

Mr McPhee—I am happy to provide a full copy to members as I speak. The Department of Defence obviously is a very significant organisation with a very important role in defending the nation. In considering this hearing we went back to a report put out by the predecessor of this committee in 1986 on an inquiry into Defence project management. It was interesting at the time that the JCPA stated that most of the lack of success of the projects was the result of ineffective Defence project management. The committee went on to identify some shortcomings in respect

of project management around project definition, project planning, contracting, contract management and implementation.

I mention these matters today just to focus on what has really changed in the circumstances when it comes to project management. I think there are some positive differences. Firstly, in terms of Defence's project management there is a better appreciation of risk management and its role in managing schedule and performance outcomes but clearly converting these into successful outcomes remains the ongoing challenge for Defence. There has certainly been an acceptance at the most senior levels in Defence that administrative performance needs to improve and appropriate arrangements and strategies have been or are being put in place to respond to these matters. Certainly, Defence is conscious of the need to develop more reliable and integrated reporting systems but there is still a lot to be done. And certainly it is true to say that substantial effort and resources have been committed to training in project management and financial management.

In the last part of the statement I make the positive comment that the work that Defence has done on financial management remediation is demonstrating forward progress in terms of that aspect of their administrative responsibilities and the fact that the audit qualifications, while remaining on their financial statements, nevertheless are less severe than they have been in prior years is a positive sign for Defence of forward progress. Equally, I am suggesting that the committee's recommendation when adopted in relation to the top 30 projects will provide a baseline on the top 30 projects and their performance and will allow the committee, the government and Defence to gauge progress in terms of their project management. So, I am suggesting again that is a very positive development and we will see what that shows in terms of its results. I have tried to compare 20 years ago with today and there are some positives that are coming through in Defence but equally the issues that were around 20 years ago are still around in some respects and there is a lot of work still to be done by the Defence department.

CHAIR—Thank you. Can you tell me what progress has been made in regard to the Defence's financial mediation projects, the 16 mediation strategies?

Mr McPhee—I can get Michael White, who looks after the day-to-day audit of the Defence group, to provide some update on that.

CHAIR—We will hear from Defence about their progress but I am interested in your views to see if it accords with their assessment.

Mr Michael White—I think as Mr McPhee noted there was a range of qualification issues last year that were effectively remediated as part of those 16 plans by the department, including those around the civilian and military annual leave records and qualification we had had in prior years. Also to the extent of remediating the issues around explosive ordnance pricing and the completeness of infrastructure, plant and equipment, all of which were qualifications in previous years. So there has been some quite significant success from the remediation plans.

CHAIR—We heard at that hearing with the Department of Defence that their remediation plan G2, which is improving at the ANAO's annual audit process, is well and truly past remediation; it is no longer an issue of remediation; these things are now embedded and it works. Is that your assessment as well?

Mr Michael White—They have specific officers that belong to the different divisions within the department who are attached to the audit in terms of facilitating us in terms of the work that we need to do and that has worked quite well in terms of making sure the communication flows smoothly through the audit process.

Senator MARK BISHOP—Can we just have a brief status report on the progress of your negotiations with Defence on the terms of reference for the proposed review of the top 30 projects? My memory is that the Prime Minister wrote to us some time ago, indicated agreement in principle for funding, said funding would be in next year's budget, that there was no allocation in this year's budget, and he was going to write to both DMO and yourselves and ask you to try to agree to terms of reference, for want of a better description. I would just ask for a brief status report on that?

Mr McPhee—I will provide some broad comments and Mr Meert may wish to provide further detail. Our obligation is to work with DMO to develop cabinet submission for consideration in the context of next year's budget. We have already had a range of meetings with DMO to get the ball rolling on this front. We are obviously looking to draw on the UK experience and the US experience. The model that we have in mind is that DMO would prepare the base material on the status of each project and we would do an overview of that. I would also like the process to draw out some of the lessons, some of the experience, from looking at the portfolio of projects to see what seems to be a challenge and what seems to work effectively to enable us to feed back into the system some real positive messages for future projects. It is very much early days. We have communicated with DMO to start the ball rolling in terms of the form that the project reporting could take. I see it as important as not only obviously consulting with government but also this committee that is behind the recommendation for this report. It seems to me that it is very important that the report meets your needs as well as government needs in this space. So it is early days. But we will need to have something largely in place by the end of the year to allow the cabinet submission to go forward in the budget context early next year.

Senator MARK BISHOP—Deriving from that, I wrote to the committee some time ago with suggestions for a term of reference. The Chair and I have had some brief discussions here and he has indicated that he is going to be bringing forward an alternative model for the committee's deliberation next week on terms of reference for a possible inquiry around the issue essentially of uniform reporting guidelines on all capital acquisition projects. The Chair has some concerns as to my submission and he will share those with us in due course. Nonetheless, I am going to ask the secretary of the committee, with the Chair's indulgence, to forward you a copy of my correspondence and ask your organisation to perhaps provide us with a fairly urgent comment on the utility or merit of my proposed term of reference because it goes into some more detail than yours.

I would like to say to you that it is fine that the ANAO and the DMO are negotiating the details of project review and all the necessary consequences of that. One of the hideous problems that we as non-experts in this area face, I suspect on both sides of the parliament, is the different forms of reporting on projects, different forms of guidelines, the different terminology, the blow-outs in dates, the additions to projects and the deletions from projects so that if you try to get a picture of where we are at in terms of billions and billions and billions of dollars of forward expenditure, it is almost impossible to get a uniform assessment of how they are doing. Are they doing well? Are they doing poorly? Are there different reasons or acceptable reasons as to the

progress or otherwise? I am seeking to have uniform guidelines and reporting to be established and I would be very interested in the comments of your organisation at this stage, perhaps, if you care to or otherwise in more detail via a more considered response. I probably should apologise to the Chair because I have referred to our earlier discussions and I did not seek his indulgence. I hope I have not misrepresented his—

CHAIR—Whatever the opinion of the ANAO is on that reference, it does not necessarily have any weight on our decision-making that takes place.

Senator MARK BISHOP—I understand. As I said to you last week, or whenever it was, because of my sheer inability to come to grips with the different factors in a whole range of projects I believe suggests that if there were some sort of uniform approach for reporting mechanisms it would be of assistance to those of us who take an interest in this manner of review. And I would be interested in the views of your organisation because you are clearly expert and I am not.

Mr McPhee—I think that we would never be able to have a definitive view on any proposals, really. The proposals come back to this committee and to the government and hopefully there would be a conjunction of perspectives on that to say, ‘Yes, that looks about right.’ But when you drill down into this issue there are an enormous number of questions to be answered. For instance, the basic thing; what is the definition of a project for the top 30 purposes? For instance, do you take the whole-of-project cost or do you just take the capital cost? If you take the capital cost, that may give you projects that have been going for 10 years already with very little spend in the future, or do you take the top 30 being the spend from here on being the top 30 expenditures going forward?

One of the problems with that model is that in the UK their approach is taking an expenditure going forward and one of the problems with that is of course that some of the big projects drop out. As they come to the end of their development there is little expenditure and they drop out. Is that what the committee or the government really want? The more you drill down into these matters there are lots of questions about how to define the projects and what sort of information you want. I guess our role is to be responsive to stakeholder input and that is why we were interested to get a bit more behind the UK approach. I understand the equivalent committee in the UK is doing some review of their approach at the moment. In fact, a report is due out in the not-too-distant future in this space to draw on their own experience having had this report now for quite some time. And we are obviously interested to see if we can understand what those issues are. The approach that the US takes is quite different. As I understand it, the UK model builds up on information provided by the Defence Department itself and provides an overview report whereas in the US situation it is the audit office that prepares the summary of the project in its own right and the Defence Department provides a paragraph of comments saying yes or no, we agree or disagree. So there are two quite different models just from those two large countries.

We happen to think it is best, as a matter of principle, to ask DMO to provide the base information. It just seems to me that they are the experts and they can put the perspectives around risk, et cetera. It seems to be the right model. Our role would be to provide a level of assurance around the integrity of the information coming forward. But the more information we

can get Defence or DMO to put in that report, it seems to me, it is better than the audit office necessarily having to go out and produce its own separate reporting over and above that.

CHAIR—One of my concerns is, notwithstanding the obvious good intent of Senator Bishop, that we are just one of a number of parliamentary committees that delves into Defence and each one of those parliamentary committees has its own requirements of what it is looking for in terms of reporting, whether it be the Public Works Committee, or any other. That is my only concern in that regard. I am happy for you to make some comments on that and perhaps on some of the wording that I am proposing as well. But let us move on from that.

Miss JACKIE KELLY—When do you expect the first performance audits of post-Kinnaird acquisition projects will be tabled in parliament?

Mr Meert—It really depends on when the DMO starts implementing Kinnaird reforms to the new projects. At this moment most of the top projects are dealing with pre-Kinnaird.

Mr Cronin—Kinnaird only came into effect in 2005-06 for projects. We have looked at a series of projects which was the fleet oiler, which was a 2004 project. The tanks, which we will be reporting on next month are a 2004 project. They did not actually go through the full two-pass approval system. Many of the projects which were in the Defence capability plan in 2003-04 were deemed to be at first pass. When you talk about going through the full two-pass approval system they start with projects with a date of approval from 2005-06.

Miss JACKIE KELLY—One of the frustrating things about this inquiry is that, whenever you try tracking what went wrong in the FFGs or the helicopters or your Defence supply system, Defence says, ‘Oh well, don’t you worry about that, that was pre-Kinnaird; we have fixed it all now. You just wait, it will be good.’ They really obfuscate. And I think it was in the FFGs matter, there were clearly two payments that were made that should not have been. There is no will at all to go chasing a rat down a drainpipe to say what went wrong; why were these payments made when they should not have been; who was adhering to the contract and who was not? Is there any value in keeping going with the three projects that we identified for this inquiry in really trying to nail down the FFGs, the Tiger and the Defence supply system?

Mr Cronin—Kinnaird is about a project approval. What you are talking about in large part is the administration of the contract. All those contracts require a certain process to be gone through. Defence often actually did not follow the process. There is a requirement under the Financial Management and Accountability Act under the chief executive instructions for you to pay when value is given to the Commonwealth. Clearly, you have paid out money; value has not been given to the Commonwealth. The question often becomes what is value? Should you pay out—

Miss JACKIE KELLY—But there is no will on the part of Defence to go back and examine that and learn from it. There is no will to incorporate that in corporate knowledge. They just keep saying, ‘Wait till after Kinnaird. Wait till after Kinnaird.’

Mr Meert—My understanding was that they had said to this committee that they had learnt from lessons, that they were undertaking—

Miss JACKIE KELLY—For 20 years they have been accepting every recommendation of every committee that has ever recommended anything—

Mr Meert—I am just saying that my understanding was—

Miss JACKIE KELLY—They keep accepting the recommendations but there is no change in culture. It is the culture within Defence that needs to change to really be culturally trying to be as transparent as possible. Is that the division bells?

CHAIR—The committee stands suspended for a short time.

Proceedings suspended from 11.46 am to 11.56 am

Miss JACKIE KELLY—Is it worth while just trying to hammer them on the minutiae of those three audits or do you just accept the post-Kinnaird response? Would you try to pursue a more open ethos within Defence?

Mr Cronin—I guess when you talk about the report, whether it is pre-Kinnaird or post-Kinnaird has nothing to do with contract management. These are massive contracts that, whenever they start, it is about the management of the contract and the huge expenditure of public funds. ARH was supposedly going to be the biggest expenditure of public funds in Defence last year. It is about their process where you are paying out large amounts of Commonwealth money: did you get value? This is the same with all the projects that you have selected. You could look at a whole range of them. Our reports in large part, whether they are recent projects or going back some years, relate to the payment of money and the management and the execution. What we always—

Miss JACKIE KELLY—I cannot get them nailed down to one single payment. They just do not want to discuss each individual payment as it goes through. How many times have we asked them for a date when each payment was made throughout, who made and who authorised it? And we get nothing. It is all, 'Oh well.' I do not know why they do not answer those questions.

Mr Cronin—I think the experience overseas is that you have actually had a public series of reporting and you can actually track changes; you get a different change in agencies' behaviour. I think the UK might tell you that it in fact becomes one of their key performance indicators. Are the projects on schedule? Are they getting the requirements? It is not whether you have spent the money. You can look at two things. It is in the interests of Commonwealth agencies to spend the money but the other interest is: is the Commonwealth getting value for money? That seems to be the dominant interest. The FMA Act and the regs and the whole framework points you to that.

Miss JACKIE KELLY—But what about the key thing of making somebody, some named person, accountable for that payment? Do you know what I mean? Then they are going to make sure that it was okay, rather than, 'Oh, someone else will pick it up. It is somebody else's responsibility. I am just going to tick and flick that because it is here and I have various targets to meet this month.' How does this committee, through the inquiry that we have got underway, really bring that home to Defence? Can you give us a number of specific payments that we can actually chase down the rat hole from either of those audits?

Mr Cronin—We have already reported in terms of the FFG audit. We have reported about the payments which were made of earned value payments made before the approval of the earned value management system. Why we pay mobilisation payments—and Defence is very big at paying mobilisation payments—is that it enables the contractor to get underway, to receive money in advance which is determined to be value for money until they can get an approved earned value system. In the FFG process, within six months of the signing of the contract they started to pay out massive amounts of earned value payments before they actually had an approved earned value system. If you have not got an approved earned value system how do you know that the earned value that has been reported to you is valid? That is one example.

Miss JACKIE KELLY—But Defence will not offer us the circumstances in which that could happen. We can all sit there and say, ‘How could that happen? Why, did you have an inexperienced financial officer in charge?’ But they have produced highly qualified people again and again saying, ‘We are outstanding. We are great, we are here to fix it. That was all before my time.’

Senator HOGG—Correct. That is the argument.

CHAIR—Do you have anything on this issue?

Senator HOGG—Yes, I just want to slip in here because I think this is a very important point. The argument that keeps coming up is BMT. In fairness to Defence, a lot of departments come up with that argument and it gets glossed over purely and simply because of the system of employment within many of these departments; people move on and rightfully so. You do not necessarily want people wedged and stuck in one spot, but that then becomes the argument that the successor can use and it really raises the critical issue in my view of the career path and the career structure within Defence procurement, and now DMO itself, as to having people staying around long enough to be able to put their hand and say, ‘Yes, I have ownership of that,’ because at the end of the day in the past they have had ownership of it for a two-year posting cycle and then they have moved on. It seems to me that that gets to the essence of what Ms Kelly is talking about. Am I right or wrong?

Miss JACKIE KELLY—And we just cannot get there with Defence.

Mr Meert—There is always an accountability as you go up the chain.

Miss JACKIE KELLY—Absolutely, it ends up—

Mr Meert—I mean in the end the CEO is responsible. If you take over a major project, when you take it over you do have to get on top of that project and where it is at in terms of deliverables. I do not think you can wash your hands of the past forever. You do have to catch up with the project, know where the finances are and where the project deliveries are up to. So just because a project manager leaves does not mean it suddenly throws the whole project management regime out the door; they still expect the planes to come in because, for them, it is business.

One of the things this top 30 report will hopefully do is to give you a number of benchmarks around payments at a higher level that are around payments delivery. This will not be done

overnight but over a period of time you will get some longitudinal data which can say to you: where are the movements; you have made 70 per cent payments but you have only had 30 per cent delivery. That will trigger some questions on the specific projects. But I think you need to get it from the top first and get a handle on it because if you try to dig in too specifically it gets too complex. These are too complex. If you look at the movement on the top 30 projects, you can ask: where are the frigates? If you have made 80 per cent payments and they are still not delivered the question is: why not? Where are they?

Miss JACKIE KELLY—Similarly with the helicopters, in terms of capability: ‘Where is my battalion and it cannot fly at night?’

Senator HOGG—Or over water.

CHAIR—Have you exhausted this line, Ms Kelly?

Miss JACKIE KELLY—No, I want the ANAO to make the specific bullets for me.

CHAIR—Do you want them to recommend that there should be one person who is responsible for this?

Miss JACKIE KELLY—Dr Gumley turns up every time and says, ‘It’s me. Mea culpa. We are on top of it now; it won’t happen again.’ Yet there is no knowledge from him as to what went wrong. It is simply, ‘Oh well, you do not need to know that. That was some clerk signing off. I am not going to produce the clerk who signed off on \$20 million.’ That is not what a clerk should be signing off on.

CHAIR—But Dr Gumley says that was something in the past, it has not happened again. It is only a valid criticism if it actually has happened again.

Senator HOGG—I think Ms Kelly’s problem and my problem is that it keeps recurring. That is the problem.

Miss JACKIE KELLY—And there is no Defence culture in which they want to examine what happened in the past, incorporate it into their future and move forward genuinely, rather than say, ‘Look, this was before my time, I am not interested. Examine me, judge me on something in my time as are post-Kinnaird.’ And we are left hanging out for when the ANAO comes up with a post-Kinnaird report which all of us here will guarantee you will show all the same contract management deficiencies. And we will then be saying, ‘What about that?’, and then it will be post-Bishop.

CHAIR—I understand that. Would you like to give any more response to Ms Kelly’s request?

Miss JACKIE KELLY—We need more detail, don’t we? We need more detail on those three projects.

Mr Cronin—The thing you need to consider is that you can have an old contract, the 1 June 1999 FFG, but it was then subject to a series of re-baselings, and the most recent was last year. Essentially, with a re-baselining you have got a whole new contractual structure. I think the

concept here is: under the new baselining have we actually paid for what we have got, so that you could actually look at a major payment event that could have occurred. I think, from memory, Thales has provided you with a list of key milestones in their submission. You could actually look at a key milestone and satisfy yourself whether that has been adequately met because a payment may have been made. So you could pick out a significant milestone and examine that. For ships there are significant milestones.

Mr Meert—And these should be documented. You cannot just rely on the individual because they do come and go, so you basically have to rely on the systems. Where is your project management data? Where are the analyses on the capability and the payments? That should be there on record. It is like the Tiger; all the acceptances should be done in a formal process. It is not a haphazard process.

Miss JACKIE KELLY—But as with the helicopter one, we were given some very interesting answers on those and we asked some very specific questions on when we were going to get the capability as in a battalion ready. But then, through the grassroots, they were coming back and saying, ‘Well, yes, but how are we actually going to fly it?’ How many pilots have you got trained up? You are only going to have two or three guys on this. It will be another two years before you are going to get crew to run these things. So you might have the helicopters but you actually do not have the capability. Do you know what I mean? They are giving us answers that—

Mr Meert—That is the definitional thing. You have to determine what you want. If you are dealing with capability as opposed to project management, capability is a different thing. Because, again, it is Kinnaird, and Kinnaird uses some good words. It is more than just a platform. It involves the people, the training and everything that makes a thing do what it is supposed to do.

Miss JACKIE KELLY—And we have paid for the training and we have not got the simulator. All of these things have been paid for but we do not have them. Because of a lack of current awareness of where that project is, Defence can just gloss over it and say, ‘Look, at the end of the day you are going to have the capability for x amount of dollars, she’ll be right and, post-Kinnaird, we will really get it right.’

Mr Meert—I think Mr Cronin made a very good point, Kinnaird is about an enhanced two-parts approval process. The two-parts approval process existed pre-Kinnaird. Kinnaird is pushing a more robust approval process. He is talking about an enhanced system with a better risk assessment to the approval process. The two-parts process preceded Kinnaird. It is not as if it was not there. Kinnaird in itself as a benchmark was more robust, but in terms of project management, once you have accepted that you need a particular platform and its capability and then you go out for tender, in terms of managing the delivery of that project that has not changed post-Kinnaird. You still require an analysis of the project delivery against schedules. You are still required to make payments to contractors based on deliverables. You still require good documentation. All of those things have not changed. I would not want to see Kinnaird as suddenly this massive change in the way you manage the project. It is a change to the way you get approval, yes, but the way you manage the project, no.

Mr Cronin—We can actually show you on an individual project the slippage, for example, over time. With more robust reporting you can actually work out what the in-year movement is occurring in terms of schedule, performance and costs. If you had a portfolio of projects you could actually track how your performance is going. Because the UK is looking at 20 second-gate projects and 10 first-gate, they can see the movement that is occurring. You will see tables in their reports which will say 14 per cent in-year slippage. Because some are exceeding expectations and some are falling behind, that would give you a year-on-year benchmark of how the organisation is performing. Then you get to the question—forget about fault—of who is to blame because at the end of the day if things are moving there is lack of capability being provided to the ADF. If you are prepared to live with long scheduled slippages you might ask yourself why you actually need this capability. And you could start throwing out some of the major policy questions which would come out of this but, on the whole, our audits are looking at contract management, the execution of a contract. In relation to the payments, are we paying and are we getting value? The committee has picked up that so much of the money has been paid out on the prime contract yet we have not got an effective capability delivered. We have contrasted that with what would happen with your house, et cetera. But it is about that execution. That is all we are reporting on. The wider question is what it means for capability for the ADF and, obviously, it has implications. That is what the top 30 project would be able to give you, an indication of what it means for capability.

Mr Meert—I think it is on record that most of the project management issues are not around budgeting, it is not about exceeding your budget. I think that has been said a number of times. Where the project management issues come in is on delivery. The key focus is on delivery and blow-outs of delivery dates as opposed to—

Miss JACKIE KELLY—What stage are you at with Defence in terms of this top 30 project?

CHAIR—I would ask you to change your question around because I think we are going down a path where we need a bit more evidence for our report and that is, Mr Cronin, you mentioned in August last year that you were looking at the criteria for monitoring the top 30 projects. Can you just elaborate on where you are at with that and perhaps provide us with more detail about these 30 projects in terms of how you are going to be assessing which ones they are going to be and what factors need to be taken into consideration?

Mr Meert—We have provided the DMO with what we saw as the project summary sheets. The project summary sheets provide the basis for the DMO report, so they are fairly important documents. Basically, they cover key areas of project management in that it will provide you with a project description, so the user of this report can see what the project is about. It will deal with the project approvals, say, first-pass, second-pass approvals, acquisition, contracting, et cetera. It will deal with the procurement strategy. It will deal with a section on the project budget, so you can see the budgeting for the project when payments were made. Then there are the historical reasons for variation from the initial approved cost. This is based on that UK model as well as focusing on in-year variations to budgeting. There are prime contractor payments and earned value management. Again, it deals with the history on the earned value payments. We will have a section which deals with reasons for variations to the contract schedule. The material acquisition design review status, so if there are reviews to the project, again, there will be a history of that. There will be test evaluation, configuration status for a particular platform and the requirement status, whether the Defence Force itself has changed its

requirements. Then there is a section on acceptance into service. Again, a lot of this depends on the definitions sitting behind those, so while the boxes are there definitions will be right. We have sent this to DMO for comment, so this forms our basis for saying to DMO this is what we think might form the basis for that top 30 report which we would then review to provide that level of assurance that Mr McPhee was talking about.

CHAIR—Have they responded?

Mr Meert—No, not yet. To be fair, we have only just sent it to them. We also provided them with an a normative glossary of terms because understanding things like even payments, we just have to be very clear that we and the committee know what these terms mean because if we then go and audit them the key for us is we do not want to generate any evidence, we just say within your own procurement guidelines, we will just get the paperwork to substantiate the data in here.

CHAIR—Are you confident with these guidelines that you will be able to pick up projects which perhaps in the past might have slipped under the radar and gone unnoticed?

Mr Meert—We are proposing more of a whole-of-life look at the projects. So when a project is on the top 30 it will stay in there. From the time a Defence service says to DMO, ‘I want you to get me a platform that does x, y and z,’ we will track it from there till the Navy accepts it. Because as long as the buyer signs it off—

Miss JACKIE KELLY—You would have picked up the FFG?

Mr Meert—It would have picked that up and it would stay on until it is signed off.

CHAIR—Is it appropriate at this stage for us to have a copy of that or do you want to wait until the DMO gets back to you and you come in with an agreed document?

Mr McPhee—I do not think there are too many sensitivities about it. I am happy to table this.

Senator HOGG—Was there something similar to that document in existence previously? If not, why not? Because it really then begs the question as to how did you perform the audits with some sort of consistency and certainty as to what you were looking for and how can we as a committee accept that there has been a consistent approach in what you have done?

Mr Cronin—The ANAO has been auditing Defence procurements since, I think, the 1980s. It is only in recent years that we have actually done so many. In the last three years we have actually been doing about four a year. In terms of that what we have looked at has tended to be the same cost schedule performance, particularly schedule and performance aspects. What we have done in recent years has been to look at the actual formation of the contract. In the past we only looked at the formation from the contract on. Since 2003-04 we have gone back from the inception of the project. Up until then we only looked at from the execution of the contract. We have had a consistent methodology which has been pretty well trialled in the ANAO. I have been in the ANAO for 12 years and it is the same thing that you do on IT outsourcing and asset sales, you are looking at contract management processes. It is about the payments. You will see in some of our audits we have drilled right down into the invoices in large terms. It does vary across the projects depending on their complexity. Looking at a highly complex process such as

the high frequency modernisation is different from what we looked at in terms of FFGs. We have been drawn down into some of the projects, but the methodology we have adopted has been fairly consistent. It has not been articulated in terms of a sheet like that but we have done that as a potential reporting arrangement for a public report.

CHAIR—Can you just give me your sense of where the relationship is between the ANAO and the DMO and Defence? How would you characterise that relationship? I keep in mind two things. One is that there has been some comment that you guys are great at identifying the problems but not the solutions and, secondly, that the top 30 projects might just simply be the tip of the iceberg in terms of the other things that you may want to review and are therefore putting organisations like the DMO under further pressure to be able to comply with your requirements?

Mr McPhee—We accept that you need an effective relationship with agencies to get an effective audit outcome. So relationship management is important to us. At the same time I guess what is even more important is the objectivity of our work. I hold very close to my heart the importance of the role that we play in providing objective reports to the parliament. It is important we do that effectively. We do not have a cosy relationship with anyone because that can impair independence and integrity of reporting. So we have a businesslike relationship with them.

I would like to think it is an effective audit relationship. We have our moments. Sometimes when information is not provided to us promptly or where people are not straightforward with us, I always tell the staff if we get messed around with access to information or my staff are not treated with respect I want to know about it and I will talk to senior executives straight away about that matter. Because the parliament provides through our legislation the right to access information and I do not want anyone to misunderstand that point. And I expect our people to be treated with respect.

Just occasionally I need to talk to senior executives and I am broadening this rather than dealing with DMO about these matters. But by and large, at any time I can call Steve Gumley, my senior people here can call their equivalents, and we have an effective relationship. Equally, they in turn can talk to us. But at the end of the day agencies will endeavour always to put the best gloss on their perspective in responding to audit matters. It is human nature and it is to be expected. But our job is to actually try and cut through that and report objectively on what is the state of affairs and then to get into constructive mode about where the improvements can be made. I am quite comfortable in terms of the relationship we have.

We have been calling Defence project management as an issue for quite some time. We have been reporting financial management for quite some time. I think I have mentioned before that one of the issues that has sometimes been raised with me by chief executives in Defence is to say, 'Sometimes your audit reports have an effect on morale in my organisation.' For instance, in the financial management area where we were heavily qualifying the department for a couple of years, they were saying, 'This is tough on morale and it is affecting recruitment,' and all of that sort of stuff. They were also saying, 'Look at those press reports that we are getting. We are getting negative press all the time. Can't you do something about it?' And I say, 'Well, actually, I have got a job to do here.' I have to call it the way I see it in terms of the quality of the administration of this department. I make no excuses about that. I cannot govern the headlines. I always use the example about audit reports. Press releases by government, by opposition, they

are the same report, one can say, 'Confirming project's performance,' and the opposition was probably saying, 'What a disaster this is.' I use that as an illustration.

I say to them if you want to understand what we are saying please read our reports, do not go to the press. The other thing about putting organisations under pressure is, I mean seriously, in Defence we devote about \$1.5 million per annum to performance audits. This is an organisation that spends up to \$20 billion each year, has a capital project platform of about \$60 billion and we have got about \$4 million to \$5 million on the financial side; with \$1.5 million on the performance audit, we would get lost in the rounding in terms of anything that goes on in Defence. Our role is to provide a stimulus for good performance in organisations. I think we actually provide a pretty good return, so I do not accept this proposition that we apply undue pressure and are unduly costly given the work we do to provide a bit of transparency about Defence performance.

CHAIR—And on the solution rather than the problem—

Mr McPhee—I guess we make judgements about what our role is. It is certainly to comment on the effectiveness of public administration and where we see areas where we believe they can be improved we make recommendations. As you know, we issue the better practice guides. We do a range of tasks, again, within the resources that we have. I think over the years our reports would show that we have actually contributed to better public administration. We are happy to provide presentations at Defence courses. We sit on various committees to try to provide our guidance. I think that Defence is a huge place and the relativities in terms of the scale of the office have to be borne in mind. I have to be careful not to be too defensive in this space. We can always do better and we will always look to do better. But I take exception to the comment that we do not make a contribution to improve performance in Defence.

CHAIR—I turn to the issue of perhaps putting them under stress in doing various performance and financial audits and running around perhaps on more than the top 30 projects. One of the comments has been that they will have multiple people going in looking for information when perhaps they could have done that all in one hit, that perhaps you could streamline your investigations and the data that you are after so that there are no repeat appearances and requests. In terms of your own efficiency and your own performance have you looked at that?

Mr McPhee—We certainly will do. You will recall that I said our estimate was about \$1.5 million to do this task. To give you a guide, our performance audits cost us \$400,000 to \$500,000. Just to head off this thing that the audit office is doing 30 performance audits at up to half a million dollars for each one with \$1.5 million, I will not be doing 30 performance audits in this space. The mathematics does not work out. But what we will try and do is absolutely take a system approach to this. We will be interested to have a look at the quality of the underlying Defence systems that would produce this report for the committee and for the government to make sure we can get some assurance, because we cannot go and look at every transaction or every assessment of capability. We just do not have the resources. We have to rely on their systems. Mr Meert has already mentioned the sort of documentation that we have already flagged that we would expect to see from Defence. And this documentation is nothing unusual, it is just part of good project management. We would expect them to perhaps organise their documentation in a way so that they will be able to produce whatever report the committee and

the government wants in a streamlined fashion in a production way and we will do the audit in exactly the same way.

Mr Meert—In relation to existing audits, just in terms of fair process we have opening interviews, mid-point briefs and exit interviews. We always give them or make them an offer of a mind map to explain the methodology we use. Frankly, none of the data is anything new. If it is there they just have to give it to us.

CHAIR—I must say though you are making a little minnow at \$1.5 million versus \$20 billion, but you pack a punch. I have one last question which we need an answer to for our report and that is: can you make a comment on where your review is at the moment in regard to the standard Defence supply system? Apparently on 29 May Defence reported that they now have controls reliance in the SDSS and they were putting this position to your office for review. Mr White, do you have a comment?

Mr Michael White—I can answer that for you. At this point in time we have not received the final position from DMO and the Department of Defence on their controls reliance for this year. Obviously being in controls reliance position they need to evaluate from 1 July through to 30 June. That is currently in train. There is a lot of work being done as we speak across a wide variety of locations in the Commonwealth. At the same time the ANAO has our IT auditors in the field evaluating the systems for, I think, the second or third round for this year to ensure that those controls that are supposed to be in place have been in place for the duration of the year. I think as we approach 30 June we would be looking to including ourselves on the results of that work. We are also looking for a response from the Department of Defence/DMO in the very near future on the results of their work for the year.

CHAIR—You expect that to be submitted soon after 30 June?

Mr Michael White—Yes.

CHAIR—Perhaps DMO you can get back to us then in writing on that.

Mr Michael White—Yes.

Mr McPhee—This goes to the issue of whether we can rely on SDSS for the purpose of preparing reliable financial statements. It is a more limited review than, say, a performance audit on SDSS. We are mainly looking at the reliability of key controls. But we will certainly provide you with an update on that.

CHAIR—Any last questions from members?

Senator MARK BISHOP—I would like to ask some questions about the high frequency communication system modernisation project, if that is appropriate?

CHAIR—In respect to our line of arguments, yes, go on.

Senator MARK BISHOP—There are three issues I wanted to ask for some information on from your members, Mr McPhee. The first is the issue of platform removal. There are a number

of projects which have apparently been reduced from either 16 or 10 down to one. Why is that? What has occurred and why has it occurred? Secondly, could you outline the detail of schedule slippage? My read of your report suggests that there are many, many years involved. And thirdly, I seek comment on the effect of that schedule slippage on capability in terms of the original intent of the project and what is the current position? Could I have a response to that? They would seem to me to be the pertinent issues in the report.

Mr Cronin—I will refer you to a number of pages. Table 3.4 on page 54 is about finances and table 3.2 on page 48 is about the actual physical numbers of platforms. If I take you to table 3.2 to start with which relates to the removal which you are concerned about, this was a contract entered into in December 1997. In 2004 there was the removal of the mobile platforms. This relates to two things. The FFG has eight platforms. So the number 10 refers to the numbers of platforms. Down the bottom of that table you get 10. With the re-baselining which was executed by 2006, you have that reduced down to one platform. That one platform is one Chinook helicopter. So that is the number of platform types. The Chinook helicopter is a platform type. A grouping of FFGs is a platform type. The number of platforms is the numbers of vessels, ships, aircraft, et cetera that were going to be upgraded. If we looked at the FFG, the number of platforms to be upgraded was four. You will see that second from the top.

Senator MARK BISHOP—Yes.

Mr Cronin—If you go across to 2006 the prime contract, they have all gone so there will be none of those upgraded. What is in brackets, as you will see, for example, the Sea Hawk helicopters, what we were initially going to get was one Sea Hawk upgraded and we were going to get 15 kits which were then going to be upgraded. In 1997 the number of platforms to be upgraded was 17. We were going to get 39 follow-on modification kits and the total number of platforms was 10. What we have got by 2006 is one platform, so that is one Chinook helicopter, five modification kits, which you will see on that are five. We were initially going to get 39 modification kits. Therefore, the number of platform types is now one. Before it was 10, so we are getting one of the Chinooks which is a platform type. So, the contract has been reduced down. The effect of that reduction is seen over on page 54 in table 3.4. The totality of the reductions is \$16.09 million, which is right down the bottom. But if we look at the main removal of what are the highly complex systems, you will see that amount is \$13.76 million. What we have there is removed six platform types, i.e. FFGs and F111s. We have the removal of 10 platforms, so that is the ships, et cetera, and we have the removal of 36 modification kits. So, for that removal, we get a reduction in the cost of the contract by \$13.76 million, which is base date dollars.

Senator MARK BISHOP—Base?

Mr Cronin—Base date, which is August 1996 prices. You will see that up in the heading. Does that answer your question?

Senator MARK BISHOP—It does. That tells me we had an original prime contract for 10 platforms and a whole range of platform types. It has been reduced to one in the nine years later in the prime contract—

Mr Cronin—Yes, which is the one Chinook helicopter.

Senator MARK BISHOP—That is 10 down to one. The net cost of the project has been reduced by only \$16 million due to the changed scope between 1997 and 2006 and we know there has been \$100 million cost blow-out because of other matters. If we were paying \$500 million for 10 platforms across many platform types, nine years later we are only getting one platform and a cost reduction of only \$16 million, are we not paying a huge amount more than we originally were, and why is that?

Mr Cronin—The \$500 million-odd relates to the project, of which this relates to the prime contract within it. One of the important things to always look at is the prime contract as opposed to the total cost. We are focusing on the prime contract. So out of the prime contract have been taken all this mobile equipment which is essentially the receivers, in terms of the handsets, and you have got some reduction. What they are then going on to say is they have yet to move into contract for another eight platform types, so between now and 2010 they will move into contracting for these and they expect delivery in 2010.

Senator MARK BISHOP—Okay. What you are telling me then is the original prime contract in 1997 provided for 10 platform types over many platform vessels?

Mr Cronin—Yes.

Senator MARK BISHOP—In 2006 the prime contract was renegotiated down to one platform and the other eight platforms are to be renegotiated some time in the future, but their delivery date is at this stage going to blow out to 2010?

Mr Cronin—That is what they are reporting including in the current PBS that around 2010 they are expecting delivery.

Senator MARK BISHOP—And have those future contract negotiations commenced?

Mr Cronin—They are dealing with the prime contractor. As far as we are aware they have not entered into contract. The second part related to the schedule less slippage. This is in two parts. There is a table 1 in the summary which is on page 16. The core communication system is reported as 35 months late. We were reporting at the time of audit that the final communication system—this is the FIC system—was 43 months later. I notice in the PBS that they are now talking early 2008, so the number for the final communication we reported it as November 2007, so it is obviously now some time in 2008, taking the PBS. The other matter relates to the mobiles. It was initially envisaged that, between the acceptance of the core communication system in November 2001 to the final communication system in 2004, the mobiles would be provided in that time slot. So in terms of full capability they are running many years late.

Senator MARK BISHOP—And the final matter, the effect on capability?

Mr Cronin—The effect on capability is some of the platforms which were to be upgraded will no longer be in service, so by 2010 the F111s will be out of service. There has obviously been a delay in providing capability to the ADF. As to whether this means there are work-arounds, we are not in a position to comment on that. But you are obviously speaking of significant schedule slippage. If you can sustain schedule slippage of this length of time I guess one of the questions you would ask would be did you actually need the capability in the first

place or did you need it at such a level? They are matters you would have to take up with Defence.

CHAIR—We will leave it at that because that is exactly right. They are matters for Defence, not for yourselves. I just want to make the point: are the figures you are referring to all based on 1996 dollars?

Mr Cronin—Yes, August 1996.

CHAIR—That is a very important point from my perspective when we start looking at the cost reductions that have taken place. Once again, Ian, it has been a pleasure having you and your entire team up here going through the grilling.

Is it the wish of the committee that we authorise this correspondence from the Audit Office to DMO in regard to the top 30 projects criteria as an exhibit? There being no objection, it is so ordered.

Resolved (on motion by **Miss Jackie Kelly**):

That this committee authorises publication, including publication on the parliamentary database, of the transcript of the evidence given before it at public hearing this day.

Committee adjourned at 12.40 pm