



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**

THURSDAY, 8 FEBRUARY 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**

**Thursday, 8 February 2007**

**Members:** Mr Barresi (*Chair*), Ms Grierson (*Deputy Chair*), Senators Mark Bishop, Hogg, Humphries, Murray, Nash 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:** Senator Mark Bishop, Mr Barresi, Mrs Bronwyn Bishop, Ms Grierson, Dr Jensen, Miss Jackie Kelly and Mr Tanner

**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**

**BRADFORD, Mr Harry, Chief Operating Officer, BAE Systems Australia ..... 14**

**MATTHEWS, Mr Ian John, Private capacity..... 33**

**NICHOLSON, Mr Peter, AVM (Retired), Director, Government Relations, BAE Systems  
Australia..... 14**

**THOMSON, Dr Mark John, Private capacity..... 1**



**Committee met at 9.38 am****THOMSON, Dr Mark John, Private capacity**

**CHAIR (Mr Barresi)**—I declare this public hearing open. Welcome to this public hearing of the committee's inquiry into financial reporting and equipment acquisition at the Department of Defence and the Defence Materiel Organisation. Today we will be hearing evidence from the Australian Strategic Policy Institute, evidence from Mr Ian Matthews on improving defence financial management and evidence from BAE Systems Australia, which was the third largest defence contractor in Australia in 2006, with defence projects valued at \$535 million.

I advise witnesses that the hearings today are legal proceedings of the parliament and warrant the same respect as proceedings of the House itself. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament. Evidence will be recorded by Hansard and it will attract parliamentary privilege. I welcome the representative from the Australian Strategic Policy Institute.

**Dr Thomson**—I am Program Director, Budget and Management, at the Australian Strategic Policy Institute. As the Australian Strategic Policy Institute does not take positions on any issues, I will be speaking in a personal capacity today.

**CHAIR**—Thank you very much, Dr Thomson. Do you want to make a brief opening statement before we proceed to questions?

**Dr Thomson**—I would, Chairman. Firstly, I would like to thank the committee very much for the invitation and the opportunity to speak on these important issues today. You have already received a copy of the paper I wrote in the context of the ongoing Proust review of Defence management. In some ways, the terms of reference that the committee have before them are complimentary to the terms of reference to which the Proust review is working. Consequently, in my opening comments I would like to deal with the issues that were not dealt with in the paper you already have from me. In doing so I would like to divide what I am going to talk about into two chunks: financial reform and reform of procurement processes in the Department of Defence.

Firstly, financial reform: by way of background, looking at the record of Defence's audit findings over the last few years, you get the impression that things were good and then they went bad. Back in 2000-01 there was a 'no qualification' on the accounts, then there was a 'partial qualification' in the subsequent year. In 2003-04 and 2004-05 there were 'no opinion' findings—very adverse results for Defence from an audit perspective. Finally, in the 2005-06 financial report the situation improved—Defence got an 'except for' audit finding. It is worth noting that the Audit Office findings on the department's books probably do not really reflect what has been going on in terms of the underlying validity of the accounts. There are a couple of reasons for this. First of all, up until around 2000 the level of fidelity required in the accounts was much less. New accounting standards came into place and new criteria were being applied. Also, the Audit Office only really geared up and got the full level of inquiry going in 2003-04. There is no doubt that if they had applied the same sorts of rules earlier on they would have come to an adverse opinion earlier. The one thing that is clear is that there has been an improvement in the last financial year in the status of the accounts.

It is worth saying that the accounts are only one part of Defence's total package of financial management. In other areas, in terms of planning and budgeting, there have been some solid improvements over the last few years. It is worth noting, though, that they began from a pretty low base. I think that it is fair to say that in 2001-02 there was a complete breakdown in financial management in the Department of Defence—they handed back \$750 million at the end of the financial year, and it was a perilous situation. There were a variety of reasons for this, and the reasons continue on today—to some extent—to create the situation that we now face. We have seen over the last five or six years the slow introduction of a new way of presenting Defence accounts. It is now an output based approach and an approach that uses accrual accounting. When those two things first came in at the beginning of this decade, they turned out to be much larger hurdles than had been previously anticipated.

The situation in Defence today, having begun with the low base in 2001-02, is one of extensive reform. There is a financial controls framework in place, there is a big program in place to remediate the information technology systems within the organisation, and training and skilling has been pushed right through the organisation, in particular in the financial area. This is backed up by a comprehensive plan that is being run like a project. You have all seen the Defence submission. It is impressive in its comprehensiveness. Having said that, there is still a fair bit of work to go and it will be several more years before the Audit Office is fully happy with Defence. If all I was going to do was come here today and tell you that the Defence submission said good things, it would not be worth me coming here. I would like to try to put what I just told you into a broader context, and that is the broader context of financial management writ large in the Department of Defence—as opposed to financial accounting and reporting, which are subsets of it.

**CHAIR**—Can I just interrupt you for a brief moment, Dr Thomson. I appreciate that we have got two papers from the institute, which have given us some good background, however there will be quite a few questions that we are going to need to ask. We are on a tight timeframe today because we have two other witnesses. I am not sure how far into your briefing you are, but I certainly would not want opportunities for questioning to be cut off later on.

**Dr Thomson**—Let me have two more minutes, Chair, please.

**CHAIR**—Sure.

**Miss JACKIE KELLY**—It is a critique of this. You were just getting to the interesting part there. You obviously do have some criticisms of this?

**Dr Thomson**—Not so much criticisms of that. The point is, that is just a fragment of a larger whole and I think it needs to be seen in the context of the larger whole. We have seen over the last few years the Department of Defence working very hard to satisfy the Audit Office so that the department can obtain financial accounts which are not qualified. In doing so, extraordinary resources are being diverted in order to go through the warehouses, to value assets and to do all the things that are necessary to produce the accounts. To some extent this has been a good thing. There is no doubt that tight financial management, as required by the Audit Office, will reduce fraud. It will also improve inventory management. The Department of Defence needs to be ready to fight wars, and to do so it needs to know what assets it has on hand and what condition they are in. Having said that, an awful lot of what has been going on over the last few years is busy

work. It does not really matter how much value is put on one defence asset or one defence property or another; the danger is that the inordinate amount of activity that is being put towards valuing defence assets in order to satisfy essentially commercial accounting practices has diverted attention away from other issues.

I would like to outline some of the other issues that I think are more important than the issues the Audit Office has been spending a lot of time trying to get Defence to deliver. In doing so, I should note that Defence has made progress in these areas over the last few years, but I think more progress is required. The first issue is performance targets. Financial information is but one fragment of the information required, even for a commercial company. In the case of Defence, it is a very small fragment of the whole. Non-financial information about the performance of Defence has not improved significantly, at least in the public domain, over the last five or six years, and that is one area where improvement is needed.

Similarly, there is the benchmarking of the cost of capability. We have in the submission from Defence a lovely table which shows how Defence is performing on the qualification of its audit reports compared with other countries. I would like to see a table comparing the Department of Defence with other similar defence organisations in, for example, the cost per flying hour of helicopters or the cost per steaming day of vessels. There are more important things than adding up the cost of all the assets in a warehouse. One of these is, in fact, finding out just how cost effectively capability is being delivered.

Other issues will emerge over the next few years as the output structure of the Department of Defence is realigned. In the framework the Commonwealth works under, the performance information is aligned on outputs. Defence is in the process of changing those outputs, and I think we will have to look very closely at how it goes.

If, Chair, I might just have one more minute to talk about reform in Defence materiel. Broadly speaking, the Kinnaird review of Defence procurement set in place a sensible set of reforms within the organisation. They have been grabbed with some gusto, and progress is being made on a number of fronts. DMO has been set up as a prescribed agency, a two-part process has been put in place for cabinet, skilling of personnel has been pushed harder and some capability for costing of capability has occurred.

I think more needs to be done in order to get Defence procurement to where it needs to be, and there are two groups of activities that need to occur. First of all, we need more of the same. The Kinnaird reforms, by and large, pushed Defence in good directions; Defence needs to be pushed harder to continue those ongoing reforms. In particular, the approach put forward in the Kinnaird reforms concerning personnel—bringing people in from the private sector, paying people incentives and putting in place the same sorts of commercial arrangements that occur in the business world—needs to be taken further. There probably needs to be some refinement of the two-part process of project approval, and I think we are yet to fully see Defence exploit the opportunity of spending more money up front in projects to retire risk.

I will list other areas outside of what is being done that I think are important. One is the relationship with industry. Over the last few years under defence reform, Defence has become a much more demanding customer, and that has had an impact on the relationship with industry. I think that is something that needs to be looked at very carefully; it is not a matter of holding

hands and skipping through the daisies. DMO has got \$5 billion worth of taxpayers' money to spend on equipment acquisition each year and it needs to drive a hard bargain for the taxpayer.

I think there is more work to be done on the link with strategic priorities in terms of capability planning. That was the first recommendation of the Kinnaird review. Although there are quite extensive processes now detailed both for strategic guidance and for capability development in Defence, we still get surprised by one-off capability acquisitions like the C17 and the expansion of Army. If these things are not flowing through the central planning process, we have got to ask just how rigorous that process is.

I think one of the things that Kinnaird missed is imposing some contestability, some external scrutiny, on the decision-making processes in Defence. You can have all of the processes, all of the committees and all of the bells and whistles you want but, unless people can speak up, take a contrary view and argue the point, you will get an organisational position emerging out of the process. There is more work to be done on defining and taking it into account through life costs at the time of capability acquisition. I do not think there is any doubt that at the moment, despite the very generous Defence funding over the last six years, the government's current plans for Defence will require more money than is presently programmed in the 10-year budget. A lot of that money will be necessary for the operating cost of new equipment that has not been taken into account.

There are two final areas. I think public reporting of Defence projects could be made more open and more comprehensive. The National Audit Office in the United Kingdom works closely with the Ministry of Defence to produce an annual report on the top projects there. I think that is exemplary in terms of transparency, openness and informing the public of how billions of taxpayers' pounds are being spent in the United Kingdom. I think we could do well to emulate that, and I was pleased to see that the Audit Office has received some funding to do further scrutiny.

Finally, contracting, paperwork and red tape—bugbears that cut right across all government activity—are particularly acute in the case of Defence. There is a process in place at the moment to redo the contracting templates and that is being pursued cooperatively with industry. That needs to be watched closely. Defence needs to be pushed hard to minimise the amount of paperwork that is put in place, while still protecting the taxpayers' interests.

**CHAIR**—Thank you, Dr Thomson. That briefing was very useful, as are the papers that were received from the institute. I see from your bio that you have had direct involvement with the Defence department. What access to information and departments do you have that enables you to give us information and your assessment today? Can you explain the type of access that you have and how relevant it is. I guess I am trying to look at the credibility of some of the information and the accuracy in terms of the current state of play.

**Dr Thomson**—I worked in the Department of Defence from 1996 to 2002, principally in force development and resource management areas. Some of what I have said comes from my period of time there, although a lot has changed since I left Defence. In the five and a bit years since I left, as a day job I have been pretty much looking closely at everything to do with Defence management, industry and personnel issues. What access do I have beyond the public

domain? 'Limited' is the answer. The department, quite rightly, makes some things public and holds some things close, and I work in the public domain.

**CHAIR**—I make that comment because in one of your papers under the 'Contestability' heading you make the point that, no matter what changes take place, particularly in terms of bringing in outsiders, 'no external body can hope to fully understand the issues, let alone mount compelling arguments from afar—especially with Defence tightly controlling access to information and data'. It makes me wonder why we would have an inquiry if we cannot even get to the bottom of it. Your information seems to be pretty accurate from our perspective—

**Dr Thomson**—I do my best.

**CHAIR**—You also make the comment in your paper that Defence is in a constant state of financial crisis, but you acknowledged in your opening comments that there has been some improvement. Would you still use the term 'financial crisis' to describe Defence, even though there has been some improvement?

**Dr Thomson**—There has been improvement and certainly we are not in the state we were in in 2001-02. Nonetheless, every year since then, Defence has had to come back to the government and ask for more money.

The 2000 white paper was supposed to be a watershed in Defence budgeting and planning. There is a chapter in the white paper that sets out what it calls a new approach to Defence budgeting. The idea was that Defence would put forward a costed plan for the future, the government would then guarantee three per cent real growth per annum—and it did—and Defence would deliver that plan for that money.

A lot has happened since then. New demands have been placed on Defence and the government has provided new funding to meet those operational and counter-terrorism demands. In addition, the government has had to provide additional funding to Defence for personnel costs, for defence estate, for logistics and for the operating costs of new capability. Defence has been given a budget to deliver something but has had to time and time again ask for more money in order to deliver it.

I acknowledge that it is difficult to anticipate what new military capabilities are going to cost to operate, but there is a systematic error on the side of always underestimating the costs. This is a problem that needs to be addressed. Defence is not subject to market forces and has no competitors. There is no compelling reason for it to become more efficient and to reduce costs, especially if it can just ask the government for more money each time. One way in which the government can incentivise Defence to be more efficient is to hold them to their cost plan. Make them live with the consequences of their planning and budgeting processes. That will be the driver of efficiency.

**Ms GRIERSON**—Dr Thomson we are very aware of the problems and now we are looking at the solutions. Do you have any information at this stage on what Defence Management Review chaired by Ms Elizabeth Proust might recommend?

**Dr Thomson**—I am not privy to the inner workings of the Proust review. I have an opinion on what the Proust review might usefully bring down in terms of recommendations but—

**Ms GRIERSON**—If you were the newly appointed secretary, what would be the first two things you would do to improve defence management?

**Dr Thomson**—The first thing I would do would be to look at the accountabilities within Defence, to look at which individuals are responsible for delivering which capabilities within which budgets. At the moment, a lot of the key deliverables—the combat capability, for example—are nominally the responsibility of the service chiefs; however, a lot of the wherewithal to deliver that capability—such as the maintenance of their buildings, the security on their bases, the logistics for their capability and the catering that feeds the men and women of the Defence Force—is actually provided by the Defence Support Group or the Defence Materiel Organisation. If the question were: who is responsible for the cost-effective delivery of combat capability in the maritime domain? You could try and say it is the Chief of Navy, but the fact is at the moment the Chief of Navy does not have control of the resources which are necessary for him to deliver that. I would look closely at that as the first thing and put in place a plan—in tandem with the development of the management information systems necessary to support it—

**CHAIR**—We have to suspend the meeting. We will be back after the division in the House.

#### **Proceedings suspended from 10.00 am to 10.12 am**

**Ms GRIERSON**—Dr Thomson, you were just saying you would improve those accountability chains. What other key thing would you recommend to the new secretary?

**Dr Thomson**—I would take a look at the decision-making processes in Defence. At the moment, by its nature, Defence is a federated organisation and the tendency is to have fora, committees, working groups and councils of one sort or another. They meet and decisions emerge. It is necessary in an organisation as complex and diverse as Defence to have such fora so that differing views and information can be brought together for a decision to be made, but it is very important to make sure that those sorts of committees do not become lowest common denominator negotiating arenas or areas where votes are taken among stakeholders. The committee structures need to be focused around briefing forums for decision makers who will be accountable for the decisions they take.

**Ms GRIERSON**—You also said that to incentivise the efficient expenditure of the generous funding you would recommend having a costed plan and holding them to it. There is a 2000 white paper. Is it time for a new white paper?

**Dr Thomson**—That is a good question. A white paper has two parts to it as it has evolved over the last couple of iterations. On the one part, it has some statements about how the government sees the security of the nation being delivered through Defence. It talks about alliances, it talks about our commitments to international norms and treaties, so on and so forth. Post-9-11 there is a whole bunch of very interesting issues there that need to be revisited. I would be very surprised if over the next several years that does not occur. Having said that, there are some remaining uncertainties. For example, the way the Iraq conflict has evolved, the United States will be re-assessing itself and how it chooses to play a role in the broader world and our

decisions, our posture, will need to be informed by that. So perhaps there are good reasons for waiting a little while to do that.

The second part that a white paper has a bunch of decisions about what capabilities the Defence Force needs to have, and a funding line to deliver them. Even if that first group of questions and activities is a difficult one to address at the moment, there has been so much work in the second area over the last five or six years that the time is overdue to have a very close look at the structure of the ADF and the costs involved in doing so, with a view to the medium to longer term to ensure the affordability of Australia's Defence Force in light of the intergenerational effects that aging is going to bring upon us in the next decade or two.

**Mrs BRONWYN BISHOP**—I want to begin by taking issue with your whole concept of efficiency within Defence. I note that your institute is called the Australian Strategic Policy Institute, not the accountancy policy institute. You said that Defence does not have competition to bring about efficiencies. Not only does Defence operate in a market which has no competitor—and thank god we haven't; we don't want state and territory armies competing with the federal army—but we often distort the market. We are a monopsony purchaser. Very often we will do deals with the only competition that is likely to be around, overseas countries or firms, to distort the market further and we do it because we want to get the most effective capability we can to defend this nation. When we say, 'We could be very efficient, we could cut costs, we could be lean and mean' in the sort of way you are discussing—we could be totally ineffective. That is the way we found it, quite honestly, when we came to government in 1996.

**Mr TANNER**—Is this a question or a submission?

**Mrs BRONWYN BISHOP**—I am putting forward where I am coming from, if you don't mind.

**Mr TANNER**—In other words, a submission.

**Mrs BRONWYN BISHOP**—In 1996 ministers had made statements such as 'We won't be needing to go to war for 15 years' and 'We will never fight another war overseas; we will only ever do it on our land mass.' Political decision making and the shade of the government that is in power at the time make a huge difference about the sort of defence force we shape. So for me, the predominant issue you must be responsible for—and I would like to hear your comment on where your thinking on strategy is—is to make sure we have a defence force which is able to serve the interest of the nation in a way that may not be predictable at all. We must have a defence industry which is based here in Australia so we can service our own Defence Force from within our own resources. That does not mean to say that we will not have foreign firms doing business here; we must have them doing business here. The six rules I put in place for them to do business here were very effective in securing new research and investment here in Australia. Those are the aims that I think we have to have for our Defence Force.

I do not see how putting so much of your attention in the Strategic Policy Institute into how you can put strictures on to make sure that we are accounting for every 10c and making them spend less is in the interests of the nation. You say, 'If we save money, we must be more efficient; therefore, we will fight better,' which is a non-sequitur to me. How are you addressing

how we can give the best capability to our Defence Force, and supply it here, so that we are not reliant on overseas suppliers at times when it can cost lives?

**Dr Thomson**—If I could respond to that in two sections: first of all, looking at the question of efficiency and effectiveness and, second, looking at the question of industry, because I think they can be usefully disentangled. I do not draw a distinction between effectiveness and efficiency. The government has a finite amount of money to spend in total and it makes a judgement on how much money it will spend on defence. Within the budget the government allocates to Defence, if Defence delivers combat capability efficiently you will get more capability for that budget. If they deliver combat capability inefficiently, you will get less combat capability.

**Mrs BRONWYN BISHOP**—That is not the point I was making. That is a given.

**Dr Thomson**—And that is why I have an emphasis, that is why I put an imperative, on arguing for the efficient delivery of capability—because, within a given budget, efficiency delivers effectiveness.

**CHAIR**—I want to give you an extra five minutes because of the divisions, but we are going to have to move to other witnesses. There are also other members who have questions. So I ask you to cut to the chase in replying to Ms Bishop's comments and then we will move on.

**Dr Thomson**—On the industry issue, I agree completely with you. I think it is important that there be in place an industry in Australia that can support the ADF in a manner consistent with the strategic challenges that we might face and, as you said, that will involve some foreign firms—

**Mrs BRONWYN BISHOP**—Absolutely.

**Dr Thomson**—and in some cases it will require dependence on foreign suppliers for things we cannot produce here; but the driver should be the strategic challenges that we might face.

**Mr TANNER**—I assume that you have some knowledge of some of the previous evidence that we have received in considering the frigate upgrade and the Tiger helicopters.

**Dr Thomson**—I have not read the *Hansard*, but I have some understanding.

**Mr TANNER**—Do you believe there are deficiencies in the way the tendering processes are handled for these major procurement contracts? The particular contract I have in mind, which rang serious alarm bells in my mind, is the Tiger helicopters contract, in which the selection of the successful bid was very much influenced by the lowest whole-of-life maintenance component. After the contract commenced—the tender process was completed—the successful bidder came back to the government and said that the actual cost was hundreds of millions of dollars more. That suggests to me that there is a major problem with the tender process and, ultimately, that the taxpayer is entitled to place a very big question mark over how effective and rigorous tendering processes are. Secondly, of course, defeated bidders are entitled to ask how others can bid a certain amount and then come back for a second grab in a way that could have changed the ultimate outcome had it been known at the time. So that is my first question.

**Dr Thomson**—I have to concede that I do not have any experience in a Defence tender evaluation process. I have met with people who have been involved in those processes. They tend to be large, ponderous, complex enterprises. I cannot really comment on whether they are well done and on how they compare with what is done in the private sector. Having understood the situation with the Tiger helicopters, perhaps the problem is not so much one of evaluating the tenders but one of locking in a contract with the tenderer at what they bid for initially and holding them to it. It seems to me that that second step could have been a remedy for the circumstance.

There are other examples of Defence having contracts in place that they are holding people to—for example, the AEWAC project. Boeing are having a lot of trouble with that. Boeing have had to advise the market in the US that they are going to absorb the additional costs because Australia has tied them into a contract that requires them to do so.

**Mr TANNER**—Again based on the evidence we have received, it seems to me that one of the major, and possibly intractable, problems for defence procurement is the difficulty in obtaining staff who have a level of expertise and experience that is appropriate for entering into and managing multibillion dollar, highly complex procurement contracts. It would appear that some effort is being made to correct this, but I would be interested in your view: is that a problem; if so, to what extent; and are there things we as a nation ought to be doing about it, which we are not currently doing, to wrestle with the problem?

**Dr Thomson**—I think there are two things Defence can do and one thing that can be done more broadly. Defence either can train people or can buy them in from outside. Already DMO has an extensive program for professionalisation—getting people accredited in project management with the appropriate institutions and providing support for their education to do so. That will get them only so far. At some point, for some big projects I think it is prudent to bring people in from outside and pay the money that is necessary—as they have done in a couple of cases. If you are going to run a multibillion dollar project, you should have someone in charge of it who can justify running a multibillion dollar project in the private sector. Defence have gone part of the way down that track. I think they should be pushing further down that track than they already have.

Secondly, what can we do as a nation? It comes down to the broader question about the focus of education and training. We have a skills shortage across the nation in a variety of areas: in trades, in some of the more technical professions, in project management and elsewhere. There are some initiatives that have been put in place to remediate this—some are Defence specific, some are broader. There are simple tools available: for example, if you made the judgment that Australia needs more engineers, adjustments could be made to HECS payments to make it more attractive to students to study engineering rather than to study law, for instance.

**Mr TANNER**—In the frigate upgrade project, one of the rather frightening facts that emerged from the ANAO examination was that around 80 per cent of the total value of the contract had been paid to the contractors prior to any frigate upgrade being completed—prior to any delivery or proving up.

**Mrs BRONWYN BISHOP**—Same with the submarines.

**Mr TANNER**—I am sure that is right. What this effectively means is that you have an internal cost-plus process where, perhaps understandably because of the very large sums involved, the contract is being paid on the hop every month—or whatever it might be—without there being any performance measurements or benchmarks that really determine the quality of outcomes. Do you have a view on whether there is a better way of doing that so the Commonwealth does not end up in the position where it has already handed over most of the money and then has to deal with delays, cost overruns and the like, because the project is a long way from completion?

**Dr Thomson**—In the best of all possible worlds, a contractor would be paid on the basis of earned value; it would be a combination of what they had delivered and other aspects. For example, in the case of the FFG upgrade there was a sizeable acquisition of equipment ahead of time as a bulk buy from the US. If the project had run well and all six vessels had been upgraded, it would have been cost-effective. Now we have got two additional ship sets that are ours to deal with as we will, and we have only got four frigates.

To the extent that it is possible, that is the way that contractual arrangements should be put in place. The Commonwealth should only be passing over money in exchange for something that has been delivered, and taking account of those things that have been bought ahead of time.

Having said that, it has to be conceded that, at some scale, the Commonwealth is going to carry the can. There are exceptions; I gave the example of the AEWAC project, a large US firm undertaking what for them is a relatively small project—we can hold them to the contract. They have a large portfolio of projects and they can take a loss on this one and recover that loss when they sell the aircraft more broadly overseas. Where we can get a deal like that—where there is someone with deep pockets—we should be looking at putting in place a contract that holds them to the contract and makes them deliver what they said they would deliver for the money they had.

In many cases, however, pockets are not deep enough. The submarine case is an example of a large project involving relatively small Australian firms—a \$6 billion project to deliver six submarines, with the Australian Submarine Corporation half-owned by the Commonwealth and half-owned by a foreign owner—where there was no way that the Commonwealth could ratchet down the vice to extract what was necessary out of that situation.

**Mrs BRONWYN BISHOP**—We could, because we were really dealing with the Swedish government, but we didn't.

**Dr JENSEN**—In your submission you mentioned the issue of 'group-think'; I do not know if you used 'institutionalised group-think' but you raised the issue of group-think causing problems, particularly when it comes to contestability. I would like you to explore how we can go about getting rid of that group-think and introducing a contestability element into Defence.

Also, this committee has recommended, with the ANAO, that the ANAO should become more involved with larger acquisition projects. What is your view of having the ANAO—and possibly a DSTO that is somewhat decoupled from the purse strings of Defence—involved in projects in a way that is integrated with but independent of Defence?

**Dr Thomson**—I think there is great potential for the Audit Office to play a much more active and fruitful role in defence projects in terms of supporting the reporting and greater transparency, along the same lines as the British system, as I outlined before.

Things really get important for contestability when decisions are being made. It is not so much in the management of a tender process or delivery of a contract or whatever—that is a downstream thing that requires close scrutiny and some oversight. Real contestability has to come at the time of decision-making. When you decide to buy six large ships or 15 small ships, for example, you need people who can argue the case in the defence committees that provide advice to government on what to proceed with. At the moment, post Kinnaird and post the reforms to Defence of the Defence Reform Program, the internal contestability within Defence has been stripped away.

When I first joined Defence, I was sat down and told what my job was. It was very simple: my job was to ensure that the department of finance did not get too far into Defence's business. How was I supposed to achieve that? I was supposed to achieve that as part of what was called the Force Development and Analysis Division. Our job was to second-guess every decision that was going to the force development committees of the time. The division contained a number of scientists, some of whom had been accruing experience there for several decades, and there were also a lot of ex-military people in the group. It was isolated from the broader force development arena and answered to a civilian within the Department of Defence. That division provided contestability.

Was it perfect? No. The Collins project with its frailties slipped through under the radar at the time. Having said that, I still think an internal contestability function is an essential part of supporting good decision-making in the force development arena.

**Dr JENSEN**—You spoke about accountability issues within Defence, and I agree with you completely that it is very difficult to tie down who is ultimately responsible for decisions. But I think that there is another problem. I perceive that, in Defence, when a problem happens—colloquially, when the shit hits the fan—what is looked for is 'who can we blame?' rather than 'what's the problem?' and 'how can we ensure that that problem doesn't occur again?' Would you agree with that assessment, and how would you go about changing that sort of behaviour within an organisation?

**Dr Thomson**—I would have to concede, as a matter of principle, that an organisation focused on finding solutions and getting good outcomes is better than an organisation which is fixated on shifting blame and trying to make someone look bad as a result of something having gone wrong. Having said that, and acknowledging that an organisation should be culturally aligned towards looking at solutions that deliver good outcomes, good results, I think that having accountability and having individuals who are responsible are very good and healthy things. For example, in the case of the recruitment and retention of people over the last four or five years, Defence has been trying to grow. The government has some very definite plans—in particular for Army—and they are contingent upon additional numbers flowing in. The numbers have not been achieved. I put to you this question: who in the Department of Defence is the person accountable for recruitment?

**Mrs BRONWYN BISHOP**—Hopefully the minister.

**Senator MARK BISHOP**—Dr Thomson, following on from the issues raised by Dr Jensen: we have been having discussions in this committee and in other forums of the parliament about this entity called ‘Defence’. We have made reference over time to its function, its responsibilities, its individuals and its culture, and, in your last response, you asked a rhetorical question about its accountability. All of these issues have been on the public agenda for many years. Is it not properly, and in the final analysis, the entity called ‘government’—and its agent, the entity called ‘the minister’, from time to time—who is ultimately responsible for oversight and for reform, and the fact that we do not have significant, sustained improvement in reform after many years reflects on the lack of responsibility and lack of oversight by those two entities, the government and the minister, rather than the line-operators, military and non-military defence personnel?

**Dr Thomson**—Firstly, I would like to stress that there has been an improvement in Defence. My comments on this matter are put forward in the context of trying to make constructive suggestions to improve Defence further. I think there have been substantial improvements, certainly since the 2001-02 financial year, and I would not want it to be thought that I was suggesting otherwise.

Put that to one side, I will not argue against the Westminster convention of ministerial accountability. At the end of the day, the buck stops with the minister. As an employee of a politically non-partisan organisation, it is not for me to make judgements on the efficiency or effectiveness of one minister or another, but rather to play the ball and not the man and look at ways in which a minister may wish to change things to improve the situation within the department.

**Senator MARK BISHOP**—In the final analysis, accrual accounting was brought into law in 1999-2001. We are almost seven years into the implementation stage. The only agency that I am aware of that is not up to scratch is Defence. Does that not reflect upon the lack of planning in the years prior to accrual accounting becoming law and the lack of rigorous oversight in terms of direction in the last seven years? What if, in two or three years time, we still have a set of accounts qualified in some form? If that was BHP, Woolworths or Rio, they would have been struck off the register and their script determined to be worthless. I ask again, is there not sufficient oversight, direction and drive in this department?

**Dr Thomson**—I think there have been improvements in the implementation of accrual accounting. In some of the early years there were some very large lost opportunities. The scale of the problem was not recognised at the time and it will be a few more years before things are in order to the level that will satisfy the Audit Office. It is a pity we cannot re-run the last six or seven years and be further ahead than we are now.

**Ms GRIERSON**—You mentioned Boeing in that commercial example. It is very easy for commercial operators to cost the loss of revenue to their company by delays in contracts. Defence do not put an opportunity cost in their contracts. Should they?

**Dr Thomson**—There are liability clauses in some contracts and they tend to be relatively modest, in my experience. I do not know whether you would get better outcomes if you put punitive clauses into contracts, but I do know one thing: the contracts would cost more. If you wanted the provider to indemnify you against the project going pear-shaped—

**Ms GRIERSON**—The risk will become dollars.

**Dr Thomson**—they will just pile the dollars on top of the contract. With the large portfolio of contracts that Defence has, that is probably not the prudent way to proceed.

**CHAIR**—We thank you for your time, evidence and the submission that you have given to the committee, in particular the two publications. Further to your comment that there have been improvements in the defence department over the years, in one of your publications you state:

- \$625 million of previously deferred capital investment spending has been accelerated across the next four years, in recognition of improved performance ...

So there has been some improvement. You also acknowledge that there is still work to be done. If there are any other things that you would like the committee to know then please submit them to secretariat at any time.

**Dr Thomson**—Thank you very much.

[10.41 am]

**BRADFORD, Mr Harry, Chief Operating Officer, BAE Systems Australia**

**NICHOLSON, Mr Peter, AVM (Retired), Director, Government Relations, BAE Systems Australia**

**CHAIR**—I welcome representatives from BAE Systems. Do you have any comments to make on the capacity in which you appear?

**Mr Bradford**—I am here representing Jim McDowell, the chief executive officer, in explaining and expanding on our submission.

**CHAIR**—Thank you very much, gentlemen. I am not sure whether you have made presentations to parliamentary committees in the past, but I should remind you that the hearings today are legal proceedings of parliament and warrant the same respect as the proceedings of the House itself. Giving false or misleading evidence is a serious matter and may be regarded as contempt of parliament. Your evidence today attracts parliamentary privilege. Do you have any introductory comments that you would like to make before we launch into questions?

**Mr Bradford**—No, I think we are happy for you to launch into the interrogation!

**CHAIR**—I will start with the most general of all questions: what are some of the main defence projects which your organisation is currently working on?

**Mr Bradford**—I will pick a couple out: Wedgetail, where we are a subcontractor to Boeing, is one of our largest contracts; and Echidna, where we are supplying electronic warfare capability to the rotary wing fleet—that is, Black Hawk and Chinook helicopters—is another. They are two major development programs, as well as the ALR2002 electronic warfare capability program. We also have a significant volume of business in the sustainment area. For example, we supply an availability contract on the Hawk lead-in fighter. We do a great deal of work on a number of other platforms in the Defence Force, and we have a preponderance of activity in the air sector and the electronic systems sector. We have a growing capability and interest in naval and land systems.

**CHAIR**—In working through these projects and in your dealings with the Defence Materiel Organisation, has your organisation experienced any difficulties, or are there any concerns that your organisation has that this committee should be aware of?

**Mr Bradford**—I do not wish to state the obvious but complex procurements will always involve difficulties. Big, ugly, difficult projects involving a great deal of risk—often underestimated risk—are always going to create real challenges around relationship management. I think an overall perception—and I would invite Peter to comment as well—is that the reforms that are ongoing at the moment within the department are generally constructive and should continue and continue apace.

If I look at it from a helicopter view, for me the biggest challenges are around clarity of requirements; understanding what it is that the government really wants and what the defence department really wants. The Kinnaird reforms—putting effort into achieving a greater degree of clarity with requirements at an earlier stage of the acquisition process—are extremely important, and in my view there is still not enough energy applied to that activity. There is not enough funding and there are not enough resources, particularly human resources, applied to that activity.

An observation I would make is that through most acquisition cycles I have had experience with—and I have had experience with quite a few—the biggest difficulties I had were the migration of the requirement and the difficulty industry had in responding to a changing requirement. In that context the lack of visible and coherent industry policy is a very significant problem for industry, not having a high degree of clarity as to what strategic capabilities the Australian Defence Force sees it needs in the long term so that industry can appropriately invest in those capabilities for the long term.

The final comment I would make with respect to difficulties is that Defence is not a homogenous organisation. It operates in its own internal silos as any large, complex organisation does. It has different levels of maturity; in some areas the maturity is low and in some areas the maturity is high. If you are working with an area with low maturity, with low capability maturity, it is very difficult—and that happens. However, I applaud and encourage the initiatives taken in Defence around improving the level of maturity, and the more energy that can be applied to those the better.

**CHAIR**—You state in your submission that there have been some recent major equipment acquisition projects that have not complied with the processes for capability development and acquisition. Can you outline what some of those projects are and how they have not complied.

**Mr Bradford**—The most obvious one of course is the JSF, where the F35 was selected without the normal process.

**CHAIR**—Okay. That might segue nicely into Dr Jensen's questions.

**Dr JENSEN**—I wasn't going to go into the Joint Strike Fighter, strangely enough; I was going to go into the ALR2002. That is a project where somewhere around \$100 million has been spent and basically it has had to be scrapped. Without getting into blame, essentially what happened? Was the capability requirement too optimistic? Was it an issue that the required capability needed space, cooling and so on, which were inadequate in the aircraft? Was it the migration of requirements, as you said, through the life of the contract? What has actually caused that to fail, because BAE Systems is very experienced in working on these systems?

**Mr Bradford**—It is a very good question. First of all, it has not been scrapped. The ALR2002 electronic warfare system is being installed on Black Hawk and Chinook helicopters and it is in prospect for use on other defence platforms. So the technology that has been developed in the ALR2002 remains valid and effective and indeed is, I would argue, the only reason Australia has a significant capability in electronic warfare. The difficulties with the FA18 installation are complex but I will try to give you a brief view. One of the most exquisitely difficult things to do with an electronic warfare receiver is to place it in close proximity to a very high-technology,

highly agile radar, like that which we now have in the front of our FA18s. That radar presents amongst the most difficult of all environments. Both the Commonwealth and BAE Systems underestimated the technical risk involved in enabling the ALR2002 to see through that very agile, very complex radar environment to detect threats. Our view as a company was that we were well on a path to solving that technical challenge; the Defence view was that the risks around us achieving that were too high.

**Mr TANNER**—Mr Bradford, you would undoubtedly be aware of the recent decision by the Blair government to close down the inquiry by the Serious Fraud Office into your company and allegations that it paid bribes to the Saudi regime with respect to procurement contracts there. Firstly, what is the nature of the relationship between the Australian operation and the parent company? Secondly, what kinds of processes of transparency have you got in place to guarantee the Australian government and Australian taxpayer that nothing of that kind could conceivably occur—leaving aside the question of whether it did or did not occur in other areas—in any procurement contract involving Australian taxpayers' money?

**Mr Bradford**—We are a wholly-owned subsidiary of BAE Systems PLC. The company is managed in Australia by an Australian executive that reports to BAE Systems PLC. The directors of the company in Australia have the executive responsibility for managing the Australian company but do report financially, and for governance, to a UK parent. We have the most exhaustive internal processes, which are audited religiously to ensure the appropriate conduct of our business in our markets, not only in Australia but overseas. I can assure you that those processes are robust and do guarantee that our company operates ethically and within the law.

**Mr TANNER**—Who are the auditors?

**Mr Bradford**—KPMG are our external auditors.

**Mr TANNER**—I was interested in your comment about the JSF project. Can you elaborate a bit on that.

**Mr Bradford**—At least to me, the application of what I consider to be a normal Defence acquisition process was not visible on the JSF.

**Mr TANNER**—This is opportunity cost, substantive consideration of alternatives—

**Mr Bradford**—A competitive process resulting in a comprehensive evaluation. I certainly had no visibility of that process.

**Mr TANNER**—In other words, from your perspective your company did not have an opportunity to say, 'Before you go down that path you should consider this option or that option. We can do something for you better and cheaper,' or whatever. That is essentially what you are saying?

**Mr Bradford**—I am really supporting the Kinnaird review: the more effort that is applied around really hard analysis of the requirements, from the strategic proposition through to the development of capability requirements, and the more work you can put in up-front to properly

crystallise those requirements and then express them competently to industry, the better off everybody is. While I acknowledge that under some operational pressures short, very rapid decision making has to take place, as far as possible—if you want a good outcome—the thinking has to be done up-front. It takes a lot of effort and a lot of energy to do that. It is unlikely that decisions that are taken with less than that degree of care are going to be really good decisions.

**Miss JACKIE KELLY**—You mentioned that you had had experience personally in various other acquisition cycles. Could you briefly outline your experience in the whole tender process with DMO.

**Mr Bradford**—I was in the Air Force for 20 years as a pilot and test pilot and I have been in a number of roles in industry since leaving the Air Force in 1987. I have worked on a large range of projects both in acquisition cycles and in service support cycles.

**Miss JACKIE KELLY**—Could you name one.

**Mr Bradford**—Echidna, ALR2002, Hawk, FA18—

**Miss JACKIE KELLY**—And those were adequately managed?

**Mr Bradford**—An example of a recent protracted contract negotiation is the five-year support period contract for the Hawk lead-in fighter. We completed negotiations on the contract and signed it late last year. That was a very complex, thorough, careful and mature negotiation conducted in my view very professionally by the Commonwealth. A great deal of care was taken to ensure that all of the issues around sustainment of the platform were properly considered, that there was a balance of maturity between the parties and that there was appropriate balance of risk between the parties—that is, the risk was allocated and distributed to where it could be managed. I think that was an example of a very good procurement process. Obviously, I can point to others where the procurement process was more difficult but, as a general rule, acquisition contracts that involve development are in their nature more difficult because the risks and uncertainties are higher.

**Miss JACKIE KELLY**—Was the Hawk post-Kinnaird?

**Mr Bradford**—The original acquisition contract included an in-service support period and that was pre-Kinnaird. So, yes, the requirement definition had already been done as far as the Hawk was concerned and how the customer wished to use the platform was well understood by both the customer and us.

**Miss JACKIE KELLY**—You intimated that Kinnaird fixed a lot of things. We are looking at what they did not fix. You have had 20 years experience in the Air Force. You said ‘clarity of requirement’ was problematic as well as the ‘change of requirement’ and ‘migration of the requirement’. Can you provide some examples that occurred in either the Hawk or the Echidna contracts.

**Mr Bradford**—If we look through the acquisition process for the ALR2002, the operational requirement as it was articulated into a functional requirement specification changed continually throughout the acquisition process, so at no point was it stable. Both for the Commonwealth and

for industry that creates a great deal of difficulty because you are not quite sure what you have to build.

**Miss JACKIE KELLY**—How does that occur? Is it that in those negotiations are you dealing with different people who bring their own personalities and may want this because it is blue and their favourite colour is blue? Is it that there is input from someone higher up who says, ‘No, you’ve got to have this’? Is it the chain of command? Is it migrating personnel or inexperienced personnel?

**Mr Bradford**—There are many reasons, one being that people learn more and change their minds.

**Miss JACKIE KELLY**—Individual person’s names are not relevant, but can you give me the title of the position within Defence that you worked with to describe that statement of requirement?

**Mr Bradford**—We were being tasked by Defence Materiel Organisation.

**Miss JACKIE KELLY**—Who in that organisation?

**Mr Bradford**—Ultimately it was Shireane McKinnie. However, Defence Materiel Organisation was continually interacting with both the capability staff and the Air Force.

**Miss JACKIE KELLY**—Do you know who they were taking their advice from to articulate Defence’s statement of requirement?

**Mr Bradford**—They had a group of people and a number of stakeholders who met in committee and provided various guidance to DMO with respect to the requirement.

**Miss JACKIE KELLY**—Who were those people? Were they the FA18 pilots, the FA18 engineers—

**Mr Bradford**—I am sure the Aircraft Research and Development Unit/AOSG provided input to those people as well as the capability staff in Defence. So it was a raft of people.

**Miss JACKIE KELLY**—When they first approached you to say, ‘We’re looking for real capability to see threats,’ it was Shireane McKinnie who articulated that to you?

**Mr Bradford**—No. The development of the national electronic warfare capability program—namely, the ALR2002—started 10 years ago. As you can imagine, the view of the world 10 years ago was considerably different to the view of the world today. The evolution of requirement through that period is a natural thing to occur, as people understand more about what it is they want as the threat environment changes. The difficulty for industry though is if that requirement remains volatile through a development phase then you lack stability, and the way in which you task your engineers and development people becomes really quite difficult to deal with.

**Miss JACKIE KELLY**—Could the problem also be the timeline for acquisitions?

**Mr Bradford**—Yes.

**Miss JACKIE KELLY**—Is there any way of shortening that?

**Mr Bradford**—I think the Kinnaird review puts its finger on the pulse pretty well. It says to do the work up-front to identify and stabilise the requirement—and define it as well as you can—then you should be in a position to roll the acquisition process as quickly as it can be done, because you then have a degree of confidence and certainty with requirement. I think our submission is saying to keep that going and put more energy into that.

**Miss JACKIE KELLY**—Can we stick with the ALR2002. At what point were you satisfied you had an articulated statement of requirement, when you felt confident to go on, and then it became just a migration of requirement?

**Mr Bradford**—I am now going on memory; I don't have any notes on that with me.

**Miss JACKIE KELLY**—You can get back to us, that is fine.

**Mr Bradford**—From memory, I think we had a stable understanding of the requirement about six months before the project on the FA18 was cancelled.

**Mrs BRONWYN BISHOP**—It is good to have people appearing before us who have seen it from both sides of the fence: uniform and non-uniform. I am going to put a concrete example of the way in which a requirement changed over a particular project and I will ask you if it has improved or if it still happens. I go back to Bushranger, which BAE originally put in a tender for. The specification was that it did not have to withstand a mine and it was to have manual gears. The specification was a description of its purpose, which was basically to be a taxi around the Australian continent, or the horse that took it to water, if you like. Over time it changed, as our vision changed; we saw we would be perhaps deploying. Then the component said: 'It has to withstand a mine. And, by the way, we will require it to have an automatic transmission now because of the replacement costs.' That went over a protracted period of time. A lot of that happened before I became involved with it, but it became clearly a bad way for a contract to be dealt with. Does that still happen?

**Mr Bradford**—Yes. It is better. There is clearly discernible improvement but, yes, requirements still change.

**Mrs BRONWYN BISHOP**—The acquisition process that the DMO uses, which was very shall we say 'individual focussed' at the time this government came to office, is now more corporate focussed. Has that made a difference?

**Mr Bradford**—I think it has and is making a difference. The action that has been taken by the DMO to improve its professional capability and to lift the maturity of its capability, is vital work that must continue. I think the work around front-loading capability analysis, with maturing the actual capability of managing transactions, offers a great deal of benefit to the Australian Defence Force and the Australian government, and those initiatives must continue.

**Mrs BRONWYN BISHOP**—I want to go to Malcolm Kinnaird. His work with Defence predates this Kinnaird review. In fact, I had the pleasure of working with him in putting together the strategy. His report on the procurement process was then the next stage, if you like, so I have always had a high regard for him. When we come to the question of contracting, we heard today about how we have had so many contracts where we have paid 80 per cent of the money for 20 per cent of the work, which has been like a direct line to the bank. When you enter into contractual negotiations, what sort of legal advice do you find the Commonwealth brings with it to negotiate with you?

**Mr Bradford**—Can I answer that in two ways. First of all, we do not have any contracts where you get all the money before you deliver anything and we have not had the benefit of those contracts to my knowledge. We have had a number of contracts where we have had very high penalties for failure to perform, and indeed we have paid quite considerable penalties on occasion.

The quality of legal advice brought to contract negotiations is highly variable: on some occasions it is exceptionally good and on some occasions it is exceptionally bad. I think sometimes the legal advice lacks context and understanding of the operational—

**Mrs BRONWYN BISHOP**—Of a commercial entity.

**Mr Bradford**—Of both a commercial and an operational context.

**Mrs BRONWYN BISHOP**—Does the Australian Government Solicitor use in-house lawyers or does it outsource its legal advice?

**Mr Bradford**—You would probably have to ask Dr Gumley for a detailed response to that. I have seen both in-house and external counsel used, and they have been both effective and ineffective.

**Mrs BRONWYN BISHOP**—The stress you are placing there is: to be effective in giving that legal advice to the Commonwealth, they need to be commercially acute and have an understanding of the operational side of things.

**Mr Bradford**—Yes. I think it is no different to any other contracting environment where people need to have a mature view of the undertakings they are entering into, and that has to have a very strong alignment with the operational need so that, at the end of the day, in this case the young men and women who are putting themselves in harm's way actually have the capability they must have.

**Mrs BRONWYN BISHOP**—Interestingly, I have asked the Auditor-General if he would mind taking a look at some of the contracts that have been entered into—I think contracting from the Commonwealth side has been very bad—and, with his expertise, giving some advice generally to the Commonwealth as to the way in which contracting can be better undertaken. When I read his reports, I think a lot of the angst sometimes comes from the nature of the contract not from the nature of the delivery of the work. There seems to be almost a fashion—we will have points of achievement and we will pay large sums of money by way of progress payments—but there does not seem to be a consistency. It is almost like a pendulum that swings

to and fro. So that information is useful. Other people will say that sometimes the final contract bears very little similarity to the initial tender process. Have either of you had any experience of that being the case?

**Mr Nicholson**—No, not directly.

**Mr Bradford**—Yes. Again it goes back to this point of evolutionary requirements. It is very tempting for a monopsony to leverage its position in the market, and I think Defence does that from time to time. Sometimes people change their mind about what they want at the end of the day in the middle of an acquisition process. I think that happens.

**Mr Nicholson**—Both you and Jackie have raised the question of changing requirements. If requirements change because of operational circumstances and lessons learned as part of the feedback from operational experience—as they have recently in Iraq and, in particular, Afghanistan—

**Mrs BRONWYN BISHOP**—That is a plus.

**Mr Nicholson**—that is extremely good. We have no difficulty whatever with requirements changing during the process but that was not the case with the ALR2002. If the requirements change six months before the contract is cancelled—as with Harry's example—that is probably a little generous for the contract to change. But it was not because of an operational requirement like that.

As we have said in our submission, the important parts of the Kinnaird report have only gone halfway. The first part of establishing the Capability Development Executive—a central joint area focusing on capability requirements definition—is extremely good. But that is only part of the process. The process starts with a defence policy, issued by government, and its interpretation by the strategy staff into a military strategy, into an operational—and I do not use this in an IT sense—war-fighting architecture and a range of operational concepts. This then flows into the capability development requirements and the sorts of systems options, or the systems architecture, that may solve that. The third part is that that is then handed over to the DMO to go away and find it.

The effort has moved upstream into the capability development area with the establishment of the Chief of Capability Development, a central 'purple' staff, and some additional funding. But, as Harry has already said, there is a long way to go. In commercial practice, about 15 per cent of a project's worth would generally be spent before the project starts—that is, upfront. It is nothing like that in Defence. Furthermore—and, again, Harry has referred to this—the expertise is not just in the money but in the people; the right sort of people in the capability development area, and upstream in the strategy area. That is where the process needs to be continued and the reforms pressed home.

**Senator MARK BISHOP**—I have three issues. In your introductory remarks, Mr Bradford, you referred to the lack of a visible and coherent industry policy generally in this area. You describe that as a problem. What are the consequences of your assertion?

**Mr Bradford**—Emphasising of course that I am here giving you an industry perspective—

**Senator MARK BISHOP**—You are from industry, yes.

**Mr Bradford**—and I may not have the complete picture, I—

**Senator MARK BISHOP**—In that case, let me limit the question. What are the consequences for industry of the lack of policy and what are the consequences, from industry's perspective, for taxpayers?

**Mr Bradford**—If there is a lack of clarity in industry about what the government regards as national strategic defence capabilities, then the consequences are that you do not know what to invest in. For example, if you know that there is a clear strategy to sustain the electronic warfare capability, then you would know that you had to sustain certain capabilities in industry to support that. If you do not know that, all you can do is look at the projects that are funded for allocation to industry for competition or whatever.

If you look at a project and see a profile that is intermittent, then industry has a problem. For example, a project might be funded for three years and then not funded for three years. That project may require a capability of a standing group of 100 highly skilled engineers, but if you see three years of funding and then you see no funding and if you do not have an industry policy, a coherent national proposition, that says, 'We will support the sustainment of that capability, because we want it,' then industry has a problem.

As soon as the projects start to run down in areas which we might perceive as being important to government and there are no projects in the pipeline, we face a very stark choice—and that is usually standing people down. When you stand down people in those sorts of areas—for example, e-war, e-W—you are standing down people who have 15, 20, 25 years of very, very specific experience that is almost impossible to replace. Once you lose it, you have probably got a 10- or 15-year investment profile to get it back. That is the sort of problem that industry is presented with when there is a lack of visibility of the government's intent with regard to the sustainment of strategic capability.

**Senator MARK BISHOP**—In your opening remarks you referred to 'low capability maturity' being a problem. In your submission you also commented on problems with the implementation of the Kinnaird review. Can you comment generally on whether the level of expertise within the Capability Development Group is adequate? Does the department have people in the CDG with a sufficient level of scientific, mechanical, technical and legal expertise to negotiate on an equal basis with both your employees and employees of similar large companies?

**Mr Nicholson**—The expertise of the staff in the capability development area is extremely high; the problem is there are not enough of them. But they are not the people who are involved in these sorts of negotiations. They would never come up against the sorts of people that Harry is talking about. That happens in the Defence Materiel Organisation in the acquisition process; capability development is the process that precedes that.

**Senator MARK BISHOP**—Can you then analyse for me the utility of the personnel within the CDG? You assert that there are not enough of them. What are the consequences of that?

**Mr Nicholson**—It means that the operational requirements are not clear enough and enunciated early enough and deeply enough for handover to the DMO or for industry. One of the things that Kinnaird has suggested—and this is something which should be pushed forward—is bringing industry’s expertise in much earlier, and that is happening in some areas. The rapid prototyping development and evaluation facility that was started about two or so years ago is trying to do that. It is a consortium of some 100 companies in Australia working to bring that expertise to bear earlier. But that is not happening enough yet.

**Senator MARK BISHOP**—So, whilst the expertise that exists within the CDG is more than adequate for the task, the overall number of personnel is insufficient. When the job gets handed over to the acquisition side within DMO, do we have adequate skilled people in the acquisitions unit to negotiate on an equal basis with senior employees of your company and like companies?

**Mr Nicholson**—As Harry said earlier, that is patchy: in some areas the maturity is very good and in some areas it is not. Before addressing your question, I might add that there is also a deficiency that needs to be rectified in the strategy staff—that is, even further upstream from the capability development people. That is where the military strategy and operational concepts should be formulated—taking the government’s defence policy and translating it into a military strategy, into a war-fighting architecture. Then there are the operational concepts. This is roughly how we are going to deal with this kind of problem. The capability development staff will say, ‘We’ll deal with this by using these kinds of broad systems,’ and then pass it on to the DMO. So it is by no means a seamless process yet.

Systems engineering theory says that you need to front load all of that. The more work you do there and the higher the quality of the work that is done as far upstream as possible, the better will be the final outcome because the requirements will be quite clear. A further contention of Kinnaird—which we would support strongly—is that industry, which has a whole range of expertise that we have touched upon, is brought into the process much earlier than it presently is. Most often—and this is changing in some areas—industry first becomes aware of what is happening when a request for tender hits the street.

**Mr Bradford**—I would like to add a little supplementary comment. Pete said that it is patchy. It is patchy, but I wish to acknowledge the work that is going on in DMO around development and maturity, particularly around the project management of complex projects. There is a very clear understanding of the deficiencies that exist, and there are some very determined people attempting to address that issue. I would say that the cup is more full than empty but there is a good way to go, and I think that DMO will continually be confronted with challenges in attracting and paying for the right quality of people to achieve and sustain that.

**Senator MARK BISHOP**—I hear you saying that we still have significant problems of expertise and planning at the strategy group level, at the capability development group level and on the acquisitions side of the job. This problem is partially recognised and responsible levels of government are giving attention to it but, as far as you are concerned as a company spokesperson, we still have longstanding problems in this area.

**Mr Bradford**—I do not know that I would put it in quite those words.

**Senator MARK BISHOP**—How would you put it?

**Mr Bradford**—I would say that there still remain challenges to achieve the level of capability maturity that the Australian taxpayer deserves.

**Senator MARK BISHOP**—Thank you, Chair.

**CHAIR**—That was a nice try, Mark. Further to Senator Bishop's question, you made the point, Mr Nicholson, that industry should be brought in earlier in the process, not simply when the tender hits the street; that is usually when it takes place. What is the reaction you are getting from the defence department to that type of proposition? It introduces outsiders to the military strategy level or even to the operational concepts. Would there be some proprietary concern there, perhaps a feeling that this is our domain, that outsiders should not form part of this? Has there been any reaction at all?

**Mr Nicholson**—Can I answer that in three ways. First of all, I have worked in this area—developing military strategy and operational concepts—for many years, so I know a lot about it. You can find the United States war-fighting concepts on the website. They should be publicly available; they should not be something that is hidden away, so I do not think that that is a big problem. Is there resistance? I think there probably is, but that is a sort of institutional resistance. On the other hand, a recent initiative, this rapid prototyping, development and evaluation capability, involves—and I am not sure that the number is right—something over 90, and it is about to go to 120, Australian companies in a collaborative venture with defence. I know that it has been very favourably received in defence. This rapid prototyping and evaluation is tasked via a steering group of 16 one-star equivalent officers in defence.

We are getting a very good picture across the range of very non-homogeneous customers, who are saying, 'These are the kinds of things we want to do,' and they seem to be uniformly in favour of bringing defence in earlier. They have not yet established other mechanisms to do it. There is an increasing tendency, for example, for disclosure drafts of requests for tender to come out before the final version. The one deficiency when that happens is that often the operational concept is not in there because it is not yet complete, which is the upstream problem that we have spoken about. There is no doubt that the intention, the motive and the will are there to do it; it is just not happening at the rate that we would like. We would encourage defence—not just defence but government generally, in contracting—to come in at the requirements definition stage.

**CHAIR**—Dr Jensen will have a question in a moment. In your submission you also made comment that you believe that some of the problems that still continue to exist could be resolved if we were to involve CFOs from major defence companies to assist Defence in reviewing and challenging its financial remediation plans. How would you do that without it perhaps being a conflict of interest or even compromising a relationship between, say, the CFO of BAE and the Chief of Air Force?

**Mr Bradford**—As long as you are not dealing with a specific contract or opportunity, I do not think there is any difficulty in establishing forums and effective communication at a senior level to improve the maturity of any element of government. I cannot speak for industry, but from our company's point of view we are more than content to have as much engagement as our customer community wants to improve the way both of us do business. Industry has huge resources in terms of financial management; it generally does it pretty well. We are, and we believe industry

is, up for providing some support and assistance. We would obviously not see that extending into areas where it could possibly create a conflict.

**CHAIR**—What would you be able to add to that process that an outside industry expertise organisation, such as KPMG or some other financial house, would not be able to do? You are a defence company and you are suggesting that you could provide support in terms of financial remediation plans. Surely an outside financial institution or organisation could provide a much better service to resolve those issues.

**Mr Bradford**—I am not sure that we would see that restricting your access to information and intelligence is necessarily a good thing. If you have got industry prepared to provide a forum and communication to support your development then why restrict it to above the line contractors? Why not engage more? It is always difficult because, to do that sort of engagement, you are exposing some of your own difficulties for some fresh air and debate—as I would describe it—and maybe some suggestions and ideas that industry may have to offer. I say that only as a constructive suggestion.

**CHAIR**—Okay. Last question from Dr Jensen.

**Dr JENSEN**—This initial phase of contracting is very important. For instance, I was staggered to hear that the replacement maritime patrol aircraft, the operational concepts document that Defence has drafted, is over 700 pages. That is, in all probability, more than all of US defence doctrine. It should be in the single pages. Do you think that there is too tight a drafting of some of this capability too early on? This gives a narrow focus, which means that industry may have some different ideas on how to achieve the capability that is required but cannot actually utilise them because the whole thing has been too narrowly drafted. I am thinking in this case, for instance, of the ALR2002. I was reading into what you were saying that McKinnie and her group were inadequately experienced at the beginning of the process, so this has led to a lot of changes. Was the initial contract too narrowly focused, for instance, in terms of having to place your EW system at a particular fuselage station, which maybe caused the problem; whereas, if you had looked at placing it somewhere else you may not have had that problem? Do you think that you are given, even after you have signed the contract, adequate ability to discuss enough with Defence the development of the capability rather than the narrow strictures of the contract?

**Mr Bradford**—I will ask Pete to respond to the general question in a minute. Regarding the specific assertion with respect to ALR2002, in my view it was not entirely a matter of a lack of maturity in Shireane McKinnie's organisation; it was also a lack of maturity in our organisation and a lack of clarity and consistency of requirement delivered by the capability people. So we were all complicit. Winding the clock back, if I were in the position again I would say we should not accept that tasking and we should insist that we have a more appropriate description of the requirement so that we can then task our engineers to meet it, as opposed to responding to discrete increments of tasking—that is, an incremental architecture, going to Pete's point about getting the architecture. There is quite a lot of sense in what you say about being very clear about what the outcomes are and then not overly prescribing how industry should achieve those outcomes.

**Mr Nicholson**—In the general proposition you are exactly right that it should be far less prescriptive and it should be—in the modern lexicon—architecturally based. This gets back to the very first question we were talking about. Development of that war-fighting architecture has got to start with the strategy staff. Industry might have ways to do stuff that the military has never thought of, and that is sometimes the case. That is why industry has to be brought in early. For example, in information operations, the best outfits in the world right now are the banks. They do it far better than any military organisation.

**Miss JACKIE KELLY**—Going back to that rapid prototyping and evaluation unit with the 120 companies involved, who decides which companies are on that list?

**Mr Nicholson**—There were five core companies—the primes—and that number has now grown to eight. They are the eight major companies in Australia. The rest are all SMEs. A request was put out asking for expressions of interest—

**Miss JACKIE KELLY**—From the original five?

**Mr Nicholson**—No, it was from Defence. This RPD&E is a Defence-industry collaboration, but Defence put the tender out seeking expressions of interest. There were many dozens of responses. The first tranche numbered 40 or so; the second tranche took the number to just under 100; and a third tranche is about to start.

**Miss JACKIE KELLY**—Does Defence tick off or does the group tick off?

**Mr Nicholson**—Defence ticks off.

**Miss JACKIE KELLY**—You mentioned they had 16 one-star equivalent officers. How many of those are in uniform?

**Mr Nicholson**—Most of them, I think. If necessary I can get you the complete list.

**Miss JACKIE KELLY**—What timeline are we talking about?

**Mr Nicholson**—The concept for this dates back a little under three years, and it has been in full operation for a little over two years.

**Miss JACKIE KELLY**—And with staffing stability, are you still dealing now with the people you were dealing with 12—

**Mr Nicholson**—No, we are not, but in the steering group, for example, the continuity of corporate knowledge has been excellent. Also the RPD&E has a board. Each of the major companies and two of the SMEs are represented on that board, so there is corporate continuity there.

**Miss JACKIE KELLY**—So you would like to see greater disclosure in the drafts of the requests for tender because one of your main submissions was that the final contracts bear little resemblance to the specifications that end up in the requests for tender. Is this RPEU having an impact?

**Mr Nicholson**—Yes, it is, but this is only one mechanism. This is a mechanism for dealing with short-term problems. There has to be an equivalent mechanism for dealing with the longer term, starting with the war-fighting architecture.

**Miss JACKIE KELLY**—I would like to get down to the nitty-gritty details and I will pick the ALR contract because you mentioned it. We finally had a definitive statement of requirements less than six months before Defence decided to axe it. Were the people who finally articulated that statement of requirements the same people who subsequently cancelled it? I am just trying to establish how that process occurred in Defence. Who were the people that you were talking to?

**Mr Bradford**—I think you would really have to ask Defence that question. I had very limited visibility.

**Miss JACKIE KELLY**—Can you give me a few names of people to ask in Defence, besides Dr Gumley?

**Mr Bradford**—What I can do afterwards is give you a list of the people who I recognise as being involved in that decision-making process.

**Miss JACKIE KELLY**—Over that six-month period? I really would like that person to describe how they came to the statement of requirements, the name of the subsequent person who decided that we did not need the thing anyway, and why we cancelled it. I think that is really important for getting into the background of why Defence keeps falling.

**Mr Bradford**—I will provide that. Who should I provide that to?

**Miss JACKIE KELLY**—To the secretariat.

**CHAIR**—Can I just caution that the requirement will be on those who actually had the decision-making power, not those who might have been involved in your interaction.

**Miss JACKIE KELLY**—No, I mean who you are talking to. I don't want Gumley—we all know Gumley. If you do not want to name a particular person, give me the name of the position. If you give me the position on that date, I will manage the rest.

**Mr Bradford**—As best as I am able to identify the senior people involved in that activity, I will do so.

**Miss JACKIE KELLY**—I would like a description of the statement of requirements and then the subsequent cancelling of it. You talk about pushing forward with the recommendations of the Kinnaird review. Can you expand on the problem with inadequate resourcing from project funds being used to develop and test operational and system architectures and operational concepts before first pass is evident? I think you very briefly mentioned the Joint Strike Fighter. I am not afraid to go there, because you actually had a jet in the bidding—you were backing two ponies in that tender, weren't you?

**Mr Bradford**—Yes, including the JSF.

**Miss JACKIE KELLY**—Yes, including the JSF. Do you want to elaborate on how you perceived that statement of requirements and that request for tender? You were clearly developing one bid with the Joint Strike Fighter and then you had your other bid.

**Mr Bradford**—I do not think that I was ever under any illusion that a European fighter was likely to be all that competitive, given our strategic setting. My comment was not in relation to whether we manufacture the Typhoon, rather it was said as an example that, as a general rule, you need to do the work upfront and you need to invest in that so you know what that success is, you know how to measure it and you know how to execute it. The lack of the competitive opportunities for the Typhoon—

**Miss JACKIE KELLY**—Anecdotally, a lot of people were saying that we needed a replacement for the F111 and the big boys went out with their toys and saw the biggest, fastest thing and said, ‘We will have that one.’ There was never any sort of analysis of where we were at, towards the end of the F111’s life. I think it was that rush that you were talking about and the circumstances in which it was done. It lacked that whole description of the statement of requirements—the clear enunciation of need and flagging that need with industry over time and then industry coming forward and saying that these meet your capabilities, rather than, ‘Let’s go and find the biggest toy.’

**Mr Bradford**—I was unable to see any of that happening.

**CHAIR**—Following on from that—because Mr Tanner also went down that path—do you therefore not see in this process a legitimacy for decisions to be made outside those parameters because of other considerations, such as political or foreign affairs, that may need to come into play every now and then?

**Mr Bradford**—If I answer that question as a taxpayer, it is that by all means. But my expectation is that, unless there is a dire and imminent threat that requires an immediate response, there should be an appropriate degree of care taken with any acquisition decision.

**Miss JACKIE KELLY**—And an articulation of capabilities. As you see now with the joint strike fighter, we are trying to contract in for a gap in capability that was not described when all of these things were happening, and we are going to spend another \$3 billion or \$4 billion on a gap in capability.

**Senator MARK BISHOP**—And still not overcome it.

**Miss JACKIE KELLY**—The Capability Development Group: you are obviously aware of them, you have not had many dealings with them, and you would like them to be more involved in a longitudinal process. What are your suggestions regarding the expertise of that group?

**Mr Nicholson**—It needs to be beefed up because the operational concepts are not coming out of the strategy staff in enough detail and fast enough—and I can fill you in on the detail there if you need. That is a job that the Capability Development staff now have to do. They do not have the expertise to do that plus all of the other things that they are doing, so that is effectively being subcontracted to the DMO. In fact, a lot of it has been subcontracted out to PSPs, professional service providers. The Capability Development staff just needs to be beefed up.

**Miss JACKIE KELLY**—How many people are in the Capability Development Group at the moment, and who is in charge?

**Mr Nicholson**—General David Hurley is the Chief of the Capability Development Group.

**Miss JACKIE KELLY**—How long has he been there?

**Mr Nicholson**—Approximately three years. That is one position, like Dr Gumley's, that has been fixed. It was recognised that it needs to be for a substantial period of time. I am not sure of the exact figures.

**Miss JACKIE KELLY**—He would be worth talking to. Another comment that you made in your submission was:

The DMO continues to act as the prime system integrator in many large and complex projects when this work would be better off performed by industry.

Can you flesh that out with the ALR example again or some other examples?

**Mr Nicholson**—The ALR is not a very good example at all. The air warfare destroyer is probably a good one. With the air warfare destroyer, there are separate contracts for the hull, the combat systems and the weapons. That has been pulled together by the DMO acting as a prime system integrator. So basically, rather than giving it to industry to do that, they are doing it internally.

**Miss JACKIE KELLY**—How would you give that to industry?

**Mr Nicholson**—The prime contract should be for systems integration.

**Mr Bradford**—You would run a competition and select a winner and you would say, 'Deliver the capability I have specified.' That is how you would get a prime system integrator to do that.

**Miss JACKIE KELLY**—Would that necessarily be one of the contractors from the other three contracts?

**Mr Nicholson**—No, not necessarily at all.

**Miss JACKIE KELLY**—It could be one from one contract and not the others, or would you exclude them?

**Mr Bradford**—It is difficult as you cannot do it post the event; you really have to do it up front. You have to set the competition around selecting a company that has the capability and maturity to—

**Miss JACKIE KELLY**—Would you be able to give us some examples of some cost blow-outs on the air warfare destroyer due to Defence not being able to manage the integration?

**Mr Nicholson**—No, we cannot do that. I use that as probably the most prominent example. In this sort of pressure cooker, I cannot think of other examples, but there are several. Air 7000 is another one.

**Miss JACKIE KELLY**—Seasprite?

**Mr Nicholson**—We do not have anything to do with that either. There are lots of projects where the DMO, the Commonwealth, has taken on the role as the prime system integrator, and our thesis is that that is better done by industry. Industry has the skills and the resources that the DMO does not have for systems integration.

**Miss JACKIE KELLY**—In expanding the Capability Development Group, do you see it as being uniformed personnel or civilian contractors brought in from industry?

**Mr Bradford**—A mix.

**Miss JACKIE KELLY**—Ex-service people?

**Mr Bradford**—A mix of capabilities and a mix of people. You need people with operational experience and background. You need people who have a current operational context. You need people with a science and engineering background. You need people who have an active—

**Miss JACKIE KELLY**—Arguably that is what is there but we still have the churn factor in personnel. How do you get a stable group like at Qantas, which has a small group of committed people with 15 or 16 years experience who handle all acquisitions? That group has built a huge bank of corporate knowledge from its involvement in a large number of acquisitions. There is corporate knowledge there that Defence seems unable to gain.

**Mr Nicholson**—It is difficult. As well as a mix, there has to be a certain level of experience. For example, in the capability development staff—and I will use Air Force terms because I am familiar with them—generally you will need wing commanders and squadron leaders. Anybody below a squadron leader is not going to have the experience to be able to contribute meaningfully. Because of the size of the Air Force, there are only a certain number of wing commanders and squadron leaders who can do that job. So the downsizing of the Air Force—the downsizing of all services—is part of the squeeze. That is why you would have to use ex-military people or people from other disciplines. It is a highly complex task.

**CHAIR**—On Miss Kelly's comment, where you have a mix of uniformed and non-uniformed people working together in something like the Capability Development Group and there is a bad track record of retention, is that a problem with remuneration within that group? Can you comment on that?

**Mr Bradford**—I do not think we can comment at all on the internal dynamics of the capability group. I make the general observation that, whenever I have confronted problems with retention, remuneration has rarely been the cause.

**Ms GRIERSON**—I do think that the capability group has to be explored because you start off with one group of people setting the capability requirement, you often end up with a different set

of people seeing if that has been delivered or met and you get another group of people telling you they want a change in that capability. That is part of our problem. The JSF is very important to my area. I was alarmed to read an article—I think it was this week—saying it already will not be up to the task and that the Raptor would be a more suitable fighter jet for Australia. How does industry respond when you see those sorts of articles? How do you see those things panning out? Do you see that the JSF will be influenced by that sort of article?

**Mr Bradford**—Invariably industry takes those articles with a grain of salt.

**Ms GRIERSON**—I think that is probably dangerous, but anyway!

**Mr Bradford**—I think most of us have learnt over time that you need qualified data to make a proper judgement and that, without that qualified data, conjecture is interesting but that is all.

**Ms GRIERSON**—And you are confident that the JSF will meet the capabilities required by the contract or by Defence?

**Mr Bradford**—It is not for me to say. It is for the ADF to make that determination. Really that question needs to be addressed to the ADF.

**Ms GRIERSON**—It is dangerous in that those sorts of articles undermine confidence all the time. Those sorts of arguments must reflect concern within the Defence Force and the Air Force. So you get an undermining of achievement.

**Mr Bradford**—Can I show my age and say that when I was a young man the F4 Phantom was being developed in the United States and it was described by the media as a total disaster—as a dangerous, incapable and useless piece of metal. It turned out that McDonnell Douglas built 5,000 of those, and they were very effective aeroplanes. Without any particular knowledge, I do not have any doubt that the JSF will become a fine aircraft.

**Ms GRIERSON**—Good. I do not know if you have already answered this, but in your submission you talk about stovepiping and you suggest that the DMO actually becomes an obstacle in this, rather than a facilitator of interaction. Do you want to elaborate on that? Have I got that right?

**Mr Bradford**—I am not sure I understand the question.

**Ms GRIERSON**—I will find you the reference.

**Mr Bradford**—The stovepiping was actually in relation to the question of finance officers’—

**Ms GRIERSON**—Decision making?

**Mr Bradford**—Yes. Generally the stovepiping, in another way, is related directly to projects rather than programs. For example, should there be a surveillance program that would include a whole range of different assets—the Air 7000 unmanned and manned platforms, the AEWAC and JORN—that are looked at in a more coherent manner? Generally, that is not the way that industry sees it. All we see is the DCP, the number of projects, and then a bunch of RFTs hit the

streets with a number of projects. Getting back to the industry policy question that Harry spoke about in relation to electronic warfare, if there is not a coherent electronic warfare program, if we are just looking at it project by project and there is a gap, then that makes us nervous.

**Ms GRIERSON**—When asked this question, our previous speaker, Dr Thomson, said that if you built in financial penalties in Defence contracts—like the Boeing case where Qantas is receiving its penalty payment because of its operational loss and loss of revenue—then that would put the contract price up. We have seen contracts blow out, so I wonder how you would respond to having those penalties built-in, in terms of loss of operational abilities or whatever, and whether you think that they might give more rigour to contracts, development and delivery or whether you think they would be overly burdensome.

**Mr Bradford**—That is a really good question and I will try to answer it as succinctly as I can, but I will struggle a little bit because it is something of an intricate issue. As a company, we do not object to signing a contract that says we will deliver these things and, if we end up spending \$50 million more than we are paid to deliver those things, we will do it because that is what we do. If, on the other hand, you want to put \$150 million of liquidated damages on a \$10 million contract, I am going to say I do not want to do that.

**Ms GRIERSON**—You won't tender for it.

**Mr Bradford**—It is not a commercial transaction really, and my shareholder would never support me in taking that contract. However, if you say, 'This is what I want. If you don't deliver it on this day you're going to cause me genuine damage; I will have to go and buy something else to compensate for your lack of delivery,' then I am perfectly happy to sit down in a contract negotiation and say, 'Let's understand that; let's price it.' Then I have the obligation to manage the risks so that I do not have to pay that liquidated damage. I am, in principle, okay with LDs as long as they are executed within a framework that I can control—

**Ms GRIERSON**—That you have negotiated. That might be offset by incentive payments as well?

**Mr Bradford**—You would expect, where a contract has asked for damages of that order, that there would be an opportunity to improve. The other factor that I would take into account when going to my shareholder for support would be that this development contract is risky anyway and has now got LDs, which increases the risk. My shareholder would be saying, 'You better have a decent margin on that.'

**Ms GRIERSON**—That is right. So the price would go up, yes.

**Mr Bradford**—The price would go up.

**Ms GRIERSON**—But we are becoming too used to prices going far outside those margins.

**Senator MARK BISHOP**—This morning we have discussed three themes as we have gone around the table. Firstly, there are various levels of expertise deficiency at various stages of the process, from the beginning and planning, to acquisition. Secondly, we glossed over the consequences of unilateral government decision making—for instance, in JSF. Thirdly,

underlying those discussions is a theme of more information, more certainty, less risk and less cost. My question is this: in terms of the combination of expertise deficiency, unanticipated consequences of JSF and like decisions in similar projects, and higher risk, what are the consequences for major companies, including yours, and the Australian taxpayer, who funds those decisions?

**Mr Bradford**—I think the lack of certainty, particularly around strategic capability, is a real restriction on investment. It is very difficult to convince your shareholder that you want to invest long-term in the sustainment of capability if you cannot present to them that you are confident this is what the Australian Defence Force and the Australian government are prepared to assert. The biggest impact is the risk in capability in the long term, the risk being that, when the day comes when we need the national sustainment capability to stand behind a defensive or offensive deployment of force, we may not have it.

**CHAIR**—The theme I am receiving through all of this is that the earlier industry is involved in the whole process, the less risk there is in terms of financial blow-out; also the greater the likelihood of the outcomes being achieved as originally planned and brought down in terms of strategy and operational concepts.

I thank you both for joining us today. We have gone considerably over time for a number of reasons but principally because, being a defence industry, your evidence is critical to this inquiry—and because of things that have happened in the House this morning as well. Thank you very much; your evidence is very much appreciated. If there is any other information you would like to share with us, we are always happy to receive it.

[11.58 am]

**MATTHEWS, Mr Ian John, Private capacity**

**CHAIR**—You may not have been here earlier on when I read out some of the hearing requirements. I am not sure whether you have ever presented to a parliamentary committee, but I should advise you that the hearings today are legal proceedings of the parliament and warrant the same respect as proceedings of the House itself. The giving of false or misleading evidence is a serious matter and may be regarded as contempt of parliament. The evidence you give today will be recorded by Hansard and will attract parliamentary privilege.

We have your submission, and hopefully the members have read through it. I am mindful of the time we have left. So that we have as much time as possible to ask questions, can I ask you to make some brief introductory remarks and then we will get to the questions.

**Mr Matthews**—I have an opening statement prepared, which should take only a few minutes. This inquiry and debate is largely concentrated on the cash spending of the Department of Defence. This emphasis by the government on cash expenditure continues to direct Defence's focus away from accrual accounting to cash accounting. Cash expenditure reviews have highlighted millions of dollars in areas of concern; however, they fail to highlight the billions of dollars wasted by Defence. Such waste reflects directly on whether Defence's financial management is up to scratch. Defence's accounts over the last eight years have highlighted that, as part of their equipment acquisition projects, they have spent \$2.4 billion on items that would

produce no future benefit to the government—that is, these amounts were written off from the value of assets under construction, or AUC, and not capitalised.

Relatively high capitalisation thresholds for assets have resulted in a large number of assets not being reported in the financial accounts. The 2006 accounts stated that there was a change in accounting policy to capitalise these assets that had been previously written off. You would expect that these assets would have, on average, a life of around five years. The previous five years worth of write-offs of such assets was \$1.25 billion. However, due to the change, the 2006 accounts only noted \$95 million worth of plant and equipment being capitalised; so what happened to the other \$1.15 billion?

Over the last eight years \$2.4 billion in inventory has been written off. This represents money spent on items that ended up being of no benefit to Defence. Such write-offs highlight poor inventory management. Even after writing off this inventory, the value of holdings still increased by a further \$1.5 billion; therefore, nearly \$4 billion was spent during this period to increase inventory levels. As this represents four years worth of inventory expenditure, such increases are clearly excessive. Of the assets that have been recorded in Defence accounts, Defence have written off \$4.5 billion worth of items either that they could no longer locate or that are of no future benefit to them. By Defence's own admissions in their accounts, this highlights that they have potentially wasted \$12 billion in taxpayers' funds. This is the result of poor financial management and it needs to stop. How many hospitals, schools and environmental projects could be funded by \$12 billion?

There are a number of other areas in the accounts that highlight poor financial management. Depreciation on specialist military equipment has doubled since the year 2000, even though the value of the equipment has only increased by 10 per cent. The Kinnaird report highlighted the need to have controls over expenditure on repairs and maintenance. Over the last eight years Defence has spent \$8.7 billion on repairs and maintenance; \$1.6 billion was spent in 2006 alone. This was more than three times the amount spent in 1999. Therefore, not only are the assets being purchased not lasting as long but Defence has to spend large sums of money to enable them to last as long as they do.

From 1999 to 2003, consultants and professional services fees increased from \$84 million per year to \$261 million per year. At this point, Defence stopped reporting such figures separately in their accounts; however, the figures they have reported since 2003 have indicated that expenditure continues to increase. This means that over the last eight years Defence has spent around \$2 billion on consultants and professionals. Since 2003 only a fraction of their expenditure has been disclosed. For example, in 2003 the old reporting disclosure listed expenditure at \$261 million in consultants and professional services. In the 2004 accounts, the new reporting format listed 2003 expenditure as only \$38.8 million in external legal fees and \$14.8 million in consultancies. Therefore, their new reporting format only includes one-fifth of what they were previously reporting as expenditure in this area.

Finally, I would like to make a couple of observations with regard to the burden on Defence in complying with accounting standards. Firstly, I would like to support the Auditor-General's comments to this inquiry that indicate that the issues with Defence are not so much about complying with the standards but about the management issues that the standards have highlighted. The accounting standards represent what the world's governments and financial

communities believe to be the world's best practice in financial management. They are not designed to place unfair burdens on those complying with them. It is only once Defence embraces them, rather than attempting to discredit them, that the financial management in Defence will improve.

Secondly, Defence have used two standards in an attempt to highlight unfair burdens on them. The first relates to the costing of munitions and the difficulty in obtaining original invoices et cetera. As you have pointed out, the accounting standards took such circumstances into account and Defence was never required to find the original invoices. They only had to come up with an estimate of replacement cost. Defence decided to go down this expensive and time-consuming route in finding invoices in an attempt to belittle the standards. The second standard relates to the valuing of inventory at the lower of cost or replacement value. Defence could comply with this accounting standard without changes to their existing system and with minimal cost. Their current approach is based on a very narrow definition of the goalposts and not knowing the actual application of the rules.

Focus on the financial management within Defence must start from the top—that is, the government. Defence have shown that they do not have the ticker to do it themselves. Their accounts were first qualified for inaccuracies in inventory and specialist military equipment in 2002, and four years later the issues are still not fixed. A corporate organisation would have months to correct such issues, not years. Therefore, I, on behalf of the taxpayers, plead that the government do something to hold Defence accountable for their financial management of our funds.

**CHAIR**—Thank you very much, Mr Matthews. I have only just joined the committee and I have not had a chance to meet with you—I understand you met the committee in a private capacity on 8 December—so I know very little about you. What makes you qualified to speak on the issues before this committee in terms of what is happening in Defence today as opposed to when you were in Defence a number of years ago? Do you still have contact within Defence? Are you working on a contract basis with Defence? Or is it simply based on your history when you were there?

**Mr Matthews**—I worked with Defence virtually up to the time that this inquiry started, so my experience is current up to the beginning of the inquiry. I finished at Defence in November-December 2005 and the inquiry started early in the following year.

**Mrs BRONWYN BISHOP**—How long were you there?

**Mr Matthews**—About 12 months. I held the position of director for specialist military equipment. I was employed to sort out their issues concerning their financial accounting and other matters. I have 30 years experience in process improvement dealing with these sorts of issues in the commercial world.

**CHAIR**—You were employed full time during that 12 months with Defence?

**Mr Matthews**—Yes.

**CHAIR**—What is your current job? Do you have any ongoing work with Defence?

**Mr Matthews**—No, I have no ongoing work with Defence.

**CHAIR**—And your current work?

**Mr Matthews**—Is with Myer Ltd dealing with the implementation of a stock merchandise system similar to what you would refer to as SDSS.

**CHAIR**—What were the circumstances behind your leaving the Defence job?

**Mr Matthews**—I was employed to be involved in the remediation programs and to help out the CFO area in dealing with those areas. There was a change in the CFO and senior management, and they decided they did not want to be as involved as they had been.

**CHAIR**—I asked that for my own purposes because I am not aware of your background. Thank you for coming in as an individual citizen and making your presentation.

**Mrs BRONWYN BISHOP**—Are you an accountant?

**Mr Matthews**—Yes, a CPA.

**Mrs BRONWYN BISHOP**—A lot of your submission reads like an accountant's.

**Mr Matthews**—Sorry about that.

**Mrs BRONWYN BISHOP**—No, that is fine. You seem to be very concerned with inventory and the accounting standards. I was a great proponent of accrual accounting for government because I think it is very important for forward planning and the like, but I always knew it would be a huge problem for Defence. Right at the back, where you mention how disappointed you are, you say:

I could identify billions of dollars of questionable financial transactions and could not obtain support from very senior managers for further investigation or correction.

Are you making an allegation?

**Mr Matthews**—No, I am stating a fact.

**Mrs BRONWYN BISHOP**—Is that an allegation of impropriety?

**Mr Matthews**—No, I am stating a fact that there were billions of dollars worth of incorrect transactions identified in regards to recording of assets and I could—

**Mrs BRONWYN BISHOP**—Are you saying it was fraud?

**Mr Matthews**—No, what I am saying is that there were billions of dollars worth of incorrect transactions recorded in the accounts of Defence.

**Mrs BRONWYN BISHOP**—So you are saying the way they were recorded was wrong. When I read that statement I thought you were making some sort of a serious allegation.

**Mr Matthews**—Their assets were overstated by several billion dollars.

**Mrs BRONWYN BISHOP**—Did that mean that they overvalued something like an M113? Did they overvalue that?

**Mr Matthews**—No, it was sloppy accounting. They duplicated records of assets in their attempts—

**Mrs BRONWYN BISHOP**—And this was of enormous importance to you?

**CHAIR**—Are you saying this is based on expertise, not on deliberate—

**Mr Matthews**—It is important with regard to having correct accounts and the correct costing—

**Mrs BRONWYN BISHOP**—So that you have got a correct inventory and assets. That is what you are concerned about?

**Mr Matthews**—It is knowing the cost of defence to the Australian taxpayer by using accrual accounting. Accrual accounting is all based around a balance sheet. If the balance sheet is wrong—

**Mrs BRONWYN BISHOP**—But you know and I know that the point that you just read out in your statement was that there had been an agreement that they could go to a replacement cost, which is not what the new accounting standards require. They require that you provide what the initial cost was, what the replacement cost was—

**Mr Matthews**—No, they do not. I can go into the technicalities of accounting standards. What they are attempting to do is not required under the accounting standards. They are attempting to go down to item level, identifying what they paid for it and what the current replacement cost is, and that is not what is required.

**Mrs BRONWYN BISHOP**—That is in your view.

**Mr Matthews**—It is the commercial view. Coles Myer does not keep the accounting cost by item; it never has and never will. We adjust the inventory levels for what is required for accounting records.

**Mrs BRONWYN BISHOP**—And Coles Myer has a policy of just-in-time ordering?

**Mr Matthews**—It is close to it, yes.

**Mrs BRONWYN BISHOP**—We would not want to run the Defence Force on just-in-time ordering, would we?

**Mr Matthews**—No. I am not saying it is just in time. I did not say that they had just-in-time ordering; it was close to it, in that they hold minimum inventory—

**Mrs BRONWYN BISHOP**—When you say that one half of the inventory is obsolete, what is the age of that?

**Mr Matthews**—That was determined by Defence people responsible for that inventory, and they came up with a figure that half their inventory was of no value to Defence.

**Mrs BRONWYN BISHOP**—That was for its current operations.

**Mr Matthews**—No, that it had no value to Defence, in that it—

**Miss JACKIE KELLY**—It had 10,000 items that had not been used in 10 years.

**Mrs BRONWYN BISHOP**—Or more than 10 years.

**Mr Matthews**—What they are saying is that it is not an asset to this organisation.

**Mrs BRONWYN BISHOP**—But how old is it?

**Mr Matthews**—It has no value.

**Mrs BRONWYN BISHOP**—So it has obviously been bought at a time previously, when it was thought to have value.

**Mr Matthews**—As I just said in my opening statement, they have written off \$2.4 billion worth of inventory. They held about \$2.5 billion worth of inventory in 1999 and they have effectively written the whole lot off. Since that time they have written off \$2.4 billion worth of inventory. We are not talking about things 10 years old. There is no inventory management there. If the Leopard tanks have just left service Defence do not know what spare parts they hold for them, so they keep on buying them. Then the Leopards disappear and they are left with all these spare parts that have no value. There is no requirement to keep five years worth of Leopard spare parts for an asset which is leaving in six months time, yet they continue to do it; so then they—

**Mrs BRONWYN BISHOP**—So you are saying that they bought spare parts for the Leopard knowing that it was going to be phased out?

**Mr Matthews**—I was using that as an example. I am not stating that as a fact but I am saying they do not know what parts—

**Mrs BRONWYN BISHOP**—Let me give you an example: the F111. We originally said we would fly the F111 until 2020. We then said we would phase it out in 2010. Then somebody said, 'No, maybe 2012,' then 'maybe 2013,' and then 'maybe another date'. If you are managing the inventory for an F111 and we are the only country flying it in the world, what is the inventory value? How do you place a value on it and how do you determine what is a correct ordering of inventory for that plane?

**Mr Matthews**—You have picked quite a good example with the F111—

**Mrs BRONWYN BISHOP**—Of course I have picked a good example.

**Mr Matthews**—If Australia wanted some spare parts for the F111 from America and America said, ‘You either take the lot or nothing,’ and we got container after container after container of F111 spare parts—

**Mrs BRONWYN BISHOP**—We had a big option, didn’t we? Would you have said that efficiency tells you to take it out of service, that we do not need it because it is going to become obsolete?

**CHAIR**—Just let him finish.

**Mrs BRONWYN BISHOP**—All I am saying is that the principles that you apply at Coles Myer we cannot apply to our Defence Force.

**Mr Matthews**—I believe that you can and that it is very appropriate to.

**Mrs BRONWYN BISHOP**—You and I are going to have to differ.

**Mr Matthews**—There is a difference with inventory management. If I know that I have to have three years worth of inventory, there is a difference between managing it to that—

**Mrs BRONWYN BISHOP**—You still have not answered me on the F111.

**Mr Matthews**—With the F111 we got a lot more components than we needed; we only wanted a certain number. Under the impairment provisions of accounting standards, all the stuff we did not want and would never use has no value so you only value the stuff which you have got. Under the government accounting standards, it does not matter if you got it for nothing, you value it at its fair value. So then you would go through and value it. But those F111 spare parts were not—and probably still are not—in the accounts of Defence. They were not recorded in most of the systems because they were still sorting through them. That is what happens when they buy new capability. They buy \$5 million worth of spare parts and they simply record it as ‘\$5 million worth of spare parts’ because they do not go to the trouble of actually registering each item. So it sits in the accounts as simply that.

**Ms GRIERSON**—I know you are particularly concerned about the inadequacy of the financial management systems in terms of tracking and valuing assets and inventory, and we have seen the inadequacies on the ground and with the personnel involved; reconciling assets with those inventories is a major problem. The F111 is a very good example in that when you cannot find a wing on that inventory you have a serious problem. When you find that a few stolen rocket launchers are actually assets of the defence department you have a very serious problem. Can you comment on this problem of reconciling assets with inventory in our defence department.

**Mr Matthews**—That is when you come into difficulty. Defence does not use the accounting definition of ‘inventory’ for a start. Within Defence accounting, ‘spare parts for major capital

assets'—which is what most of Defence calls its inventory—is not actually 'inventory', it is part of 'plant and equipment'. So the rules about lower of cost or replacement cost do not apply to the majority of what you class as inventory anyhow.

The problem is not as big as what people make out. I was at Moorebank one day when they were receiving goods. There were trolleys with about six or seven wooden boxes on them and they were just about to put them away. I said, 'How do you check what you have been billed for is in those boxes?' and they said, 'We don't.' I said, 'Why not?' Their logical answer was, 'We wouldn't know whether what is on that description is in that box, even if we could see it.' That is what happens with stocktaking as well. The item number is written on the box and the box is put up on the shelf. It is never opened. When they do a stocktake, all they ever do is check there is a box there.

**Ms GRIERSON**—Would a descriptor of the asset or a photograph as some sort of labelling help?

**Mr Matthews**—But then the person checking it would have to determine whether it is serviceable or not.

**Ms GRIERSON**—We saw the people managing it at Moorebank and a lot of them were of a very low skill level.

**Mr Matthews**—There are some differences with the commercial world. In regards to Coles Myer, people know it is a packet of Cornflakes, it is a dress or whatever. In Defence they do not know that, and what I put as a proposal to them is that they cycle their technical staff through the DCs so that they can do reviews.

**Ms GRIERSON**—Are their internal reviews and audits inadequate?

**Mr Matthews**—Yes, because the auditors do not know what they are looking at and they will open up a wing for an F111 and it then costs \$10,000 to have the carton resealed and recertified. Again, I bring the commercial side back into it. The buyers of Coles Myer will spend time out in the stores reviewing the product, looking at how it is going and things like that. It would be reasonable for Defence buyers to spend time in the warehouses to review what they have. When you walked around Moorebank did you notice a lot of red tags on things?

**Ms GRIERSON**—Yes.

**Mr Matthews**—That means the item is unserviceable. They are valued and recorded in the books as new items but they do not even work. I saw one item there, which was a pair of binoculars, and all that was left was the metal casing—no lenses, nothing left. Yet they were still recorded as a brand-new pair of binoculars. You talk about inventory management. Inventory management is about determining the levels that you want and maintaining them. I am not saying that there should be two weeks worth of stock. That might be appropriate on things like nuts and bolts—

**CHAIR**—Mr Matthews, I have not been to Moorebank, but it is my understanding that some of the warehousing services that Defence has are subcontracted out.

**Mr Matthews**—The operations of the warehouse—

**CHAIR**—The operations of the warehouse are subcontracted out?

**Mr Matthews**—the physical handling of the inventory, is contracted out to Tenex Toll.

**CHAIR**—Wouldn't the contractor have a responsibility to employ best practice management in that operation?

**Mr Matthews**—No. They do not purchase the stock; they only store it and pick it up.

**CHAIR**—Yes, but your concern, which you have articulated so well, is that often they do not know what is there. So it is not the purchasing; it is identifying what it is that they have. You made the point that, even after carrying out stocktakes, they have no idea of exactly what is in a box and how many are in a box.

**Mr Matthews**—In the contract, Tenex Toll are responsible for shrinkage but, at the time that I left, Defence was yet to enforce that part of the contract. From previous experience—being in warehousing for about 20 years—those sorts of clauses are virtually impossible to enforce. For example, at Moorebank, even though they are responsible for the operations of the warehouse, the security of the warehouse complex is Defence's responsibility. So if stock disappears, whose fault is it—is it Tenex Toll's or is it Defence's for having poor security?

**CHAIR**—Can't that simply be resolved by the type of contract the defence department enters into with that contractor?

**Mr Matthews**—You would have to make them responsible, and that was another shortfall I picked out in reporting to Defence in regard to Moorebank: with security being Defence's responsibility and the operation being Tenex Toll's responsibility, you will never enforce the shrinkages. Trucks leaving the operation are not secured and, coming from a distribution background, I know how truck drivers manage to relieve loads from the backs of their trucks—it disappears.

**Ms GRIERSON**—So you are suggesting that, because the system is sloppy and not well controlled, there is opportunity for theft and those shrinkages or loss are increasing?

**Mr Matthews**—It comes back to this account—

**Ms GRIERSON**—Yes or no? You answered yes or no?

**Mr Matthews**—Sorry, yes. And in regard to accrual accounting—and this is where I come back to making people responsible—because the person at the other end is not responsible for the cost of the item, even if he spends twice what he is supposed to he will not get into trouble. If an item does not turn up at the other end, he will simply order another one.

**Ms GRIERSON**—So there is too much fat in the system and, because no-one can have confidence in it, they overorder? Is that possible?

**Mr Matthews**—They spend to budget. The reason your inventory has increased by \$1½ billion, I believe, is that they spend to budget. They get into more trouble for underspending budgets than overspending them.

**Ms GRIERSON**—Yet, if they could find efficiencies, they could divert those funds very meaningfully?

**Mr Matthews**—Yes, and that is what it comes down to. With business systems and development and process improvement—which, as I said, I have spent 30 years doing—I just hate waste—

**Ms GRIERSON**—It has to be factored in.

**Mr Matthews**—When I saw Defence write off \$1 billion worth of assets not one question was asked about why they were written off, what happened or anything else like that. Because it is accrual accounting—it is not cash accounting—they simply were not interested. It was just, ‘We did a stock count and we were \$1 billion worth of assets short. That’s life.’

**CHAIR**—While the total assets of the defence department have increased dramatically during that time.

**Ms GRIERSON**—\$55 million in total value.

**Miss JACKIE KELLY**—Who was Lloyd Bennett?

**Mr Matthews**—I am pretty sure he was CFO at the time that I was employed, but it later became Chairman Moore.

**Miss JACKIE KELLY**—So he was trying to create some corporate knowledge on accrual accounting; he was trying to get together a centre of excellence?

**Mr Matthews**—Previously in one of your hearings, Defence made the comment that they cannot get the accountants they need in Canberra and I think that they made the comment that there is probably not enough in Australia to do it. They came to the conclusion that in Canberra there is not the corporate knowledge and the expertise, so they advertised for these positions to be based outside Canberra to attract the appropriate people.

**Miss JACKIE KELLY**—So they were trying to get some accountancy expertise in inventory. Specialist military equipment was your area of expertise?

**Mr Matthews**—Yes. The original position was advertised to encompass the lot and they later split it.

**Miss JACKIE KELLY**—Between you and Alan Fredricks?

**Mr Matthews**—Yes.

**Miss JACKIE KELLY**—Is Alan still there?

**Mr Matthews**—No. They removed both our roles at the same time. They downgraded the asset area in Canberra as well so they got rid of most of their asset people.

**Miss JACKIE KELLY**—So the Audit Office looked at the SDSS and found it was not really functioning, the Get Well Program was put in and it looks like we are now going to the MILI System instead. So Defence is still struggling with its accounting. One of the core reasons that the Audit Office has been unable to render an opinion on Defence's accounts is that Defence has to self-report or self-assess on inventory. That has been a key failing with Defence. I am just countering Bronwyn Bishop's point that this is not important. It is of fundamental importance to the Audit Office's view of Defence's finance.

**Mr Matthews**—SDSS is a convenient scapegoat. These issues arise not because of SDSS but because of Defence's approach to financial management. With the current SDSS you could get audit sign-off.

**Miss JACKIE KELLY**—So why are they spending—I'll find the figure for you later—on MILI?

**Mr Matthews**—You would have to ask them.

**Ms GRIERSON**—And we shall. We will do that.

**Miss JACKIE KELLY**—Yes, we will have to do that. What is the key information that Defence needs to be getting out of the system to get to audit sign-off on inventory?

**Mr Matthews**—I cannot speak for the auditors, but in regards to, say, munitions, the only reason that became an audit issue was that under the standard they were required to do an estimate. When accrual accounting came in, certain leeway was given to government organisations because they knew they would not have records going back years. So they actually recommended using current replacement cost. The auditors asked them to go away and estimate the value of it. Defence came back and used the value in what they call FEDLOG, which is their price list of munitions from the US and other places. All the auditors said was: 'You don't buy at that price. You usually buy x per cent below that price because you are a preferred customer or whatever, so you cannot use the FEDLOG.' All they had to do was take ANAO up on what they said and value their stuff at x per cent below FEDLOG and that would have been a reasonable estimate and that would have passed. That is all they had to do.

What happened—and I was involved in the thing at the time—was the person responsible for the munitions area believed he could get some more invoices and, rather than doing an estimate, he went away and had a bit more of a look. That was supposed to be only a short-term thing but it somehow dragged on, and they have spent millions of dollars doing it. But there was no requirement ever to do that.

**Miss JACKIE KELLY**—Who was the person responsible there?

**Mr Matthews**—I forget his name in all honesty.

**Miss JACKIE KELLY**—Okay, but was it an Army, Navy, Air Force—a uniformed position—or civilian person?

**Mr Matthews**—No, it was a public servant, but he was attached to the munitions area. He was not in the finance area; he was in the munitions area.

**Miss JACKIE KELLY**—The ordnance area?

**Mr Matthews**—Yes, somewhere—

**Miss JACKIE KELLY**—Out of one of the supply depots? Was he senior or a very junior person?

**Mr Matthews**—He was a senior person.

**Miss JACKIE KELLY**—Was he fairly senior, like a senior officer, or just officer level?

**Mr Matthews**—Probably EL1 or EL2 level.

**Miss JACKIE KELLY**—Tell me about Di Fielding?

**Mr Matthews**—She took over from Graham Dunlop, who had employed me. He was the First Assistant Secretary Financial Services, and Di took over.

**Miss JACKIE KELLY**—She dismantled it, or was it the CFO after her?

**Mr Matthews**—No, she was not the CFO; she was the first assistant secretary, so she reported to the CFO. She and Ken Moore, who was the CFO, dismantled it.

**Miss JACKIE KELLY**—Ken Moore came after Lloyd Bennett?

**Mr Matthews**—Yes.

**Miss JACKIE KELLY**—Why did Di Fielding dismantle it—on whose advice?

**Mr Matthews**—I had conversations with her. Di was approaching retirement age. She had been in the Public Service all her life, and cash accounting was what she knew. The comment made by her to me was that, between her and Ken, they were going to make sure that all the assets in the balance sheet were written off, which effectively means going back to cash accounting.

**CHAIR**—Can I just interrupt here. I understand the questions Miss Kelly is asking, and, although there is parliamentary privilege in your evidence, I need to caution you that unless you have direct knowledge of anything—

**Mr Matthews**—She made the statement to me.

**CHAIR**—I am just making an overall statement here about it.

**Mr Matthews**—That is why I was a bit cautious about saying—

**CHAIR**—Unless you have direct knowledge, you should be cautious about your answers.

**Mr Matthews**—I was. I thought about it before—what I was going to say.

**Miss JACKIE KELLY**—Her background was in cash accounting. She preferred cash accounting. You can write off \$2 billion worth of stock and keep the auditors happy—only she did not keep the auditors happy.

**Mr Matthews**—At the time, they also made submissions to the Australian Accounting Standards Board to virtually write off all inventory as well. They were trying to write off all the military assets, all the inventory—all those sorts of areas, as far as I am aware.

**Miss JACKIE KELLY**—That would be helpful to keep the ANAO happy, but it is not very helpful to a commander who wants to know how many serviceable items he has to take to Timor or Iraq.

**Mr Matthews**—There is a difference between financial value of inventory and actually knowing what is there and what is serviceable. It could have no value, and they would still know what was there.

I might quote something from the UK. They do their accounts brilliantly, I must say. They have adopted accrual accounting. The emphasis for their accrual accounting is that they are out to save money or improve things, where Defence is maybe not so much along those lines:

Analysis of figures for the Royal Navy is revealing. Under the old cash based regime, the Navy's budget was some £1.7 billion, of which around 76 per cent was accounted for by salary costs. Under the new resource based approach, the figures look markedly different. The true cost of the Royal Navy, including non-cash elements such as cost of capital employed and depreciation, is some £4.7 billion. Of that, manpower accounts for about 28 per cent.

When you are talking about financial management and maximising capability, if you are looking at figures which say that 76 per cent of your cost is labour then the only focus for reducing the costs of Defence is in labour. Accrual accounting highlights that that is not the point, that is not the fact; that there are a lot of expenses going through that might have been purchased a couple of years ago but are part of your costs of operation and are what you need to focus on. That is the reason for having those things.

**Miss JACKIE KELLY**—You are quoting from the British Navy's annual report from last year?

**Mr Matthews**—No, this is from the Treasury for the UK government, from one of their reports.

**Miss JACKIE KELLY**—I am going to highlight that for Mrs Bishop.

**CHAIR**—Is that it? Just one more question and then we will wrap it up.

**Miss JACKIE KELLY**—I have got stacks. In terms of duplicated assets, written-down values, useful lives, impairment—all of these terms that Defence uses—

**Mr Matthews**—Just on impairment: helicopters are recorded in their accounts as being helicopters when they are stripped for parts—and things like that. They admitted to the F111s sitting up on the runway all stripped for parts, because people had seen them, but they still did not admit to all of the other equipment they have got sitting around stripped for parts but still listed in the accounts as, for example, a fully functional helicopter.

**Miss JACKIE KELLY**—Yes, I would like to chase up a lot of those issues.

**CHAIR**—I will wind it up by saying thank you very much for coming in and for the evidence that you have given to us today. I appreciate your time and also the submission that you made. I acknowledge the serious concerns that you have, particularly about inventory management in the defence department. I would also like to acknowledge that some of these issues have certainly been very much picked up by the Audit Office, and the defence department has remediation plans in place. You have expressed comment about remediation plans in your submission, and we will have an opportunity to explore these issues further with other witnesses, including the DMO. Once again, thank you very much. If there is any other information that you have, we would be more than happy to receive it.

**Miss JACKIE KELLY**—I will get the secretary to give Mr Matthews a few suggested questions that we would like some answers to.

Resolved (on motion by **Senator Bishop**):

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 12.36 pm**