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Auditor-General for Australia



6 June 2023

Mr Julian Hill MP
Chair
Joint Committee of Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Chair

Joint Committee of Public Accounts and Audit – Inquiry into Commonwealth Financial Statements 2021–22 – Department of Defence’s use of appropriations for Attack class termination payment

I am writing to provide the Committee with further information regarding the Department of Defence’s (Defence) use of appropriations for the \$832 million contract termination payment made to Naval Group for the cancelled Attack class submarine project. This matter was raised in Auditor-General Report No. 8 2022–23 *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2022* (the report). The report is being considered as part of the Committee’s current Inquiry into Commonwealth Financial Statements 2021–22. The Committee took evidence on this matter at its 31 March 2023 hearings.

As the ANAO identified in the report, Defence used non-operating funding available from *Appropriation Act (No.2) 2020-2021* (Appropriation Act No.2) for the contract termination payment, which was recorded as operating expenditure in its 2021–22 financial statements. It is not clear to the ANAO that the Parliament, in passing that Act, intended that an appropriation for non-operating expenditure be used for the purpose of funding Defence’s operating expenses.

Subsequent advice on this matter from the Australian Government Solicitor (AGS), and advice from the Department of Finance (Finance), which considered the framework established in the Australian Constitution and Appropriation Acts relating to expenditure by the Executive Government, has not found this particular use of appropriations to be inconsistent with the Appropriation Acts. This outcome raises issues about the operation of the Appropriation Acts in providing Parliamentary authority for classes of government spending.

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The appropriations framework

The Appropriation Acts are the primary controls of the Parliament over the approval of expenditure by the Executive Government, as the Executive Government may not spend money without Parliament's authorisation. This requirement is established by section 83 of the Constitution, which provides that 'No money shall be drawn from the Treasury of the Commonwealth except under appropriation made by law'. The Parliament authorises the withdrawal of money from the Consolidated Revenue Fund (CRF) for the purposes specified in the various Appropriation Acts. The Department of Finance (Finance) defines an 'appropriation' as follows in its PGPA Glossary:

Appropriation

A law of the Australian Parliament that provides authority for Commonwealth entities to spend money from the Consolidated Revenue Fund (CRF) for a particular purpose. Entities may not spend money without an appropriation authorising that expenditure and, where necessary, other legislation authorising the specified purpose.¹

The main purpose of Appropriation Act No.2 is to set out appropriations from the CRF that are not for the ordinary annual services of the government. Appropriations for the ordinary annual services of the government must be contained in a separate Act from other appropriations, in accordance with sections 53 and 54 of the Australian Constitution. Annual appropriations that are for the ordinary annual services of the government are set out in Appropriation Act No.1.

Appropriation Act No.2 relates to new administered expenses, non-operating costs and payments to states, territories and local government. It does not relate to operating expenditure such as the contract termination payment. Finance defines a 'non-operating appropriation' as follows in its PGPA Glossary:

Non-operating appropriation

Sometimes called 'capital' costs, these are appropriations included in the even numbered Appropriation Acts (for example, Appropriation Act (No. 2 or 4), which deal with appropriations other than those for the ordinary annual services of the government), and include:

'equity injections', which are provided to entities to, for example, enable investment in assets to facilitate departmental activities

a 'collection development acquisition budget' (CDAB) for Designated Collecting Institutions (such as the National Gallery of Australia) to purchase heritage and cultural assets

administered assets and liabilities appropriations, which provide funding for acquiring new administered assets, enhancing existing administered assets and discharging administered liabilities relating to activities administered by entities on behalf of the government.²

As the administering department for the Annual Appropriation Acts, Finance has established a range of resources — including Resource Management Guides (RMGs), Estimates Memoranda, Budget Process Operational Rules and the PGPA Glossary mentioned above — which are intended to support the use of

¹ Department of Finance, PGPA Glossary [internet], available at <https://www.finance.gov.au/about-us/glossary/pgpa> [accessed 4 June 2023].

² Ibid.

appropriations. Finance's RMG 100³ sets out that non-operating costs include equity injections to be used for specific purposes, such as investments in assets and major purchases of new and replacement assets, but does not include operating costs. Specifically, RMG 100 states that:

Appropriation Act (No. 2) appropriates amounts that are not for the ordinary annual services of the government. Amounts are set for particular purposes:

- 'non-operating' costs (sometimes called 'capital' costs) which include:
 - equity injections for specific purposes, such as to enable investment in assets to facilitate departmental activities, or for new assets and replacement assets usually valued at more than \$10 million
 - administered assets and liabilities, which provides funding for acquiring new administered assets, enhancing existing administered assets and discharging administered liabilities relating to activities administered by entities on behalf of the Commonwealth
 - payments to corporate entities (CCEs and Commonwealth companies)
- 'new administered outcomes'
- some payments to states, territories and local governments.

Risks identified in Auditor-General Report No.8 2022–23

The ANAO report identified potential risks to the controls put in place by Parliament, given the potential precedent established by making the contract termination payment from appropriations authorised by Parliament in *Appropriation Act (No.2) 2020-2021*. It is not clear that the Parliament, in passing Appropriation Act No.2, intended that an appropriation for non-operating expenditure be used for the purpose of funding Defence's operating expenditure.

Defence's use of appropriations for the termination payment highlighted an important question for the ANAO – whether the use of an appropriation originally approved by the Parliament for non-operating expenditure could be used for the termination payment made by Defence, which would be classified as operating expenditure.

Subsequent to the payment being made, Defence sought legal advice on this question from AGS, which considered that if a court considered this case, it would, on balance, conclude that no breach of s83 of the Constitution has occurred. In forming this view AGS noted that certain terms in the Appropriation Acts (such as 'equity injections', discussed below) are not clearly defined, and examples of such expenditure given in the explanatory memorandum for Appropriation Act No.2 would not be construed as limiting expenditure on the basis that it does not indicate that the amounts cannot be used for other purposes.

In its advice, AGS highlighted that its conclusion concerned the position as a matter of law. AGS also drew attention to the policy and procedures established by Finance in relation to the use of appropriations by entities. AGS advised that 'regardless of the legal position, accounting principles and Department of Finance policy might dictate that the termination payment should have been funded

³ Department of Finance, Guide to Appropriations (RMG 100) [internet], <https://www.finance.gov.au/publications/resource-management-guides/guide-appropriations-rmg-100> [accessed 4 June 2023].

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from a different appropriation’ and that AGS ‘would generally advise agencies not to use amounts appropriated as an “other departmental item” for purposes that are not in the nature of capital expenditure.’

The ANAO notes that paragraph 19 of the *Explanatory Memorandum to Appropriation Bill (No.2) 2020–2021* provides the following commentary on clause 10 of Appropriation Bill No.2, which relates to ‘other departmental items’:

Clause 10 appropriates departmental non-operating appropriations in the form of equity injections ... For example, “equity injections” can be provided to non-corporate entities to enable investment in assets to facilitate departmental activities and for Designated Collecting Institutions to purchase heritage and cultural assets.

In this context, the ANAO also notes that Schedule 2 of Appropriation Act No.2 explicitly refers to ‘Non-operating’ and ‘Equity Injections’ against the appropriation for the Defence portfolio and other portfolios, as follows:

DEFENCE PORTFOLIO

Appropriation (plain figures)—2020-2021
Actual Available Appropriation (italic figures)—2019-2020

	Payments to States, ACT, NT and local government	New Administered Outcomes	Total
	\$'000	\$'000	\$'000
DEPARTMENT OF DEFENCE			
Non-operating			
Equity Injections			8,374,247 4,015,029
Total: Department of Defence	-	-	8,374,247 4,015,029

Source: *Appropriation Act (No.2) 2020-2021*, p.31.

Schedule 2 of Appropriation Act No.2 specifies the appropriations for the other than ordinary annual services of the Government and contains a summary table for each portfolio. It is not evident what purpose the two headings in Schedule 2 – for ‘Non-operating’ and ‘Equity Injections’ – might have, other than to specify the purpose of the appropriation as intended by Parliament. As discussed, that purpose is described in the explanatory memorandum’s commentary on clause 10 of Appropriation Act No.2, and it is not clear to the ANAO how it has come to be interpreted otherwise (namely, that the appropriation could be used for the purpose of funding Defence’s operating expenses).

The implications of Defence’s decision and the AGS advice are that there may be ambiguity in the interpretation of specified terms in the Appropriation Acts, with the effect that they do not act as a control over expenditure of the Executive Government in a way that Parliament may have intended.

The ANAO discussed the AGS legal advice and its implications for the appropriations framework with Finance. As detailed in the report, Finance advised the ANAO that:

- it did not believe that there are strong grounds for concern that the AGS advice has broader implications for the appropriations framework or the intended operation of the annual Appropriation Acts;

- the Defence payment appeared to have been a one-off isolated instance; and
- to manage any potential risk to the legislative framework for appropriations and to ensure this scenario remains an isolated, one-off occurrence, Finance would review its policy and guidance to ensure the integrity of the appropriation framework.

Similarly, in its submission to the Committee, Finance stated that:

Finance has reviewed the legal advice and discussed this matter with the AGS, the ANAO and Defence. While Finance was not consulted by Defence in relation to the appropriation source prior to the termination payment being made, given the nature and circumstances of the payment under consideration, Finance formed the view that this is likely to have been an isolated, one-off occurrence.

While Finance does not believe there are strong grounds for concern that this instance is indicative that the controls and framework supporting the appropriation and expenditure of funds are not being followed by entities, we are working with the AGS to consider whether any clarifications are necessary in policy, legislation or guidance to ensure the continued integrity of the appropriations framework.⁴

On its face, there is a tension in Finance's advice to the ANAO and the Committee. While downplaying the framework implications of Defence's decision, there is nonetheless a desire to ensure that it remains a one-off instance.

In its later evidence to the Committee, on 31 March 2023, Finance advised that:

Mr Williamson: I think the second question is around the visibility to the parliament and the understanding, and so that point goes to we'll look at the matter and take advice on whether there are options to improve the clarity around those terms which are not currently defined. What we would need to balance in providing our advice to the government and the parliament around that is, if you start to define, do you overly constrain and prevent circumstances where that flexibility is required? So that's a balancing act.

The ANAO remains concerned that Finance has still not considered the full implications of Defence's actions, which go beyond exercising a measure of 'flexibility' at the margin, and which led AGS to say that it would generally advise agencies not to use the approach adopted by Defence.

Defence's use of appropriations also identifies a risk that compliance with the appropriations framework and subordinate policies and procedures may not be given due regard by entities. As noted in Defence's submission⁵ to the Committee's inquiry:

Defence notes the ANAO's concerns but also acknowledges the rigidity of the current appropriation framework which did not provide an opportunity for Defence to reclassify funding given the proximity of the termination decision to the end of the financial year.

... due to the nature of Defence's activities, situations may arise (such as the Future Submarines contract termination) where Defence is required to implement a government decision that is time sensitive and consequently is caught within the practicalities of the appropriation framework.

⁴ Department of Finance, *Submission to the Joint Committee of Public Accounts and Audit: Inquiry into Commonwealth Financial Statements 2021-2022*, March 2023, available from https://www.apf.gov.au/Parliamentary_Business/Committees/Joint/Public_Accounts_and_Audit/CommFinancialStatements/Submissions [accessed 4 June 2023].

⁵ Department of Defence, *Joint Committee of Public Accounts and Audit Inquiry into Commonwealth Financial Statements 2021-22: Department of Defence Submission*, March 2023, available from https://www.apf.gov.au/Parliamentary_Business/Committees/Joint/Public_Accounts_and_Audit/CommFinancialStatements/Submissions [accessed 4 June 2023].

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The sentiments expressed in Defence's submission are problematic for several reasons. First, the fundamentals of the appropriations framework are established by the Constitution, for the purpose of ensuring Parliamentary authority over the spending of the Executive Government. Government entities are expected to comply with both the letter and spirit of the framework, regardless of perceived inconvenience.

Second, the appropriation framework does not prevent entities seeking a re-alignment of their appropriation funding through the budget process (and additional subsequent appropriation bills presented to the Parliament) for a given financial year. Additionally, appropriation bills presented to the Parliament include sections which credit an Advance to the Finance Minister. The advance is available to the Minister for Finance in the event that there is an urgent need for expenditure that is not provided for, or is insufficiently provided for due to erroneous omission or understatement or where expenditure was not foreseen until after the last day on which it was practical to introduce an appropriation bill to the Parliament.

Defence testimony to the Committee

In providing evidence to the Committee on 31 March 2023, regarding its use of appropriations in this case, Defence asserted that part of the termination payment may have included non-operating expenditure (in effect a capital item) and as a result may have been consistent with the requirements of the appropriation framework:

Mr Groves: ... we could have done elements of that payment initially—if they were contractor related and work was done, it could have been capitalised. The end effect within our financial statements was the same.

...

Mr Groves: Whether we capitalised it and then wrote it off or whether we expensed it all, it was the same effect. But, if we'd gone down the first path of capitalising some of it, we couldn't have done all of it. But some of it could have been and then arguably that part of the payment was not in breach or counter to what the rules were around using bill 2 funding for it. That's where it all becomes very grey and very complex and creates a whole lot of complexity.

At the hearings the Auditor-General noted that in preparing its 2021–22 financial statements, Defence considered that the payment represented operating expenditure and recognised it accordingly. In completing the audit of Defence's financial statements, the ANAO obtained reasonable assurance that the financial statements were free from material misstatement, and in particular, that the payment had been appropriately classified and recognised in the financial statements.

Following the hearings, the ANAO made inquiries of Defence to better understand its evidence to the Committee and to clarify the preparation of Defence's 2021–22 financial statements. The ANAO requested that Defence identify whether there was any element of capital or non-operating expenditure included in the termination payment, given expenditure was recorded as operating by Defence in its 2021–22 financial statements. The information provided to the ANAO by Defence included a breakdown of the payment elements. Defence's view is that approximately \$30 million, or six per cent, of the termination payment may have had attributes that could be considered those of a non-operating (capital) payment, given it was for work already completed by the contractor prior to the contract termination. Other than the breakdown of the payment, no additional information was provided to the ANAO by Defence to support the expenditure being non-operating in nature.

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The ANAO's view remains that the classification of the payment applied in the 2021–22 financial statements was appropriate. That is, the termination payment was an operating expense which would ordinarily be made from an appropriation for the ordinary annual services of the government.

For the Parliament, the handling of this payment raises questions as to whether its control framework for appropriations has been respected and whether it is at risk of further misuse. A significant precedent has been established for appropriations provided for non-operating expenses (through Appropriation Act No.2) to be used for operating expenses, with the risk of undermining the control framework's purpose in separating appropriation types. It may be that if the words in the Appropriation Bills do not clearly reflect the Parliament's intent in classifying expenditure between the bills, then further clarity may be required.

The Senate has considered the clarity of these arrangements in the past (see Odgers, Chapter 13, Financial Legislation). In summarising past reviews of the classification of expenditure between Appropriation Bills, Odgers notes that:

These instances indicated that the Department of Finance and Administration appeared to be taking a position that ordinary annual services include anything it regarded as falling within vaguely-expressed outcomes of departments, including new policy proposals, a position quite contrary to the compact of 1965 and subsequent Senate determinations.

Given the actions by the Department of Defence and the position taken to date on those actions by the Department of Finance in relation to the termination payment, the Committee may wish to consider the option of proposing that the Minister for Finance (who is assigned responsibility for the Annual Appropriation Acts under the Administrative Arrangements Order) develop clearer drafting for the coverage of the appropriation bills. Additional clarity would support the Parliament's intent and provide additional guidance to the Executive Government, including entities drawing on appropriations.

Yours sincerely



Grant Hehir
Auditor-General