



Australian Government

Defence

**Joint Committee of Public Accounts and Audit
Inquiry into Commonwealth Financial Statements
2021-22**

**Department of Defence
Submission**

[March/2023]

Defence Response

The Australian National Audit Office (ANAO) tabled their report on *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2022* on 14 December 2022. In the report, the ANAO raised concerns relating to:

- Whether Defence used funds in line with the Parliament’s intended application for the appropriation (paragraph 7); and
- Whether the controls and framework supporting appropriations is sufficiently robust and is being followed by entities (paragraph 8).

In order to execute a decision of Government, Defence utilised existing approved funding to settle the termination payment to Naval Group for the cancellation of the Attack Class Future Submarine program. The Government decision was for Defence to use the Future Submarine funding provision within the Defence Integrated Investment Program (IIP) for this purpose. These funds were originally appropriated to Defence through Act 2 (capital funding) mechanisms under the Annual Appropriations Acts. All of the capital components of Defence’s Acquisition Program within the IIP are funded by way of Act 2 funding mechanisms. The accounting treatment for the expenditure associated with termination payment is that it is operating in nature.

Defence sought advice from the Australian Government Solicitor (AGS) who advised, in their view, that if a court considered this case, it would, on balance, conclude that the appropriation relied on in this case (Act 2 funds) could have supported the termination payment and secondly, a court would, on balance, find that no breach of section 83 of the Constitution had occurred. 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.

Appropriation Framework - General¹

Appropriations for the services of the Government are split into two main appropriations. Appropriation Bill (No. 1) contains details of estimates for the ordinary annual services of the Government. Appropriation Bill (No. 2) contains amounts that are not for the ordinary annual services of Government. Appropriation Bill No. 2 contains: new administered outcomes, ‘non-operating’ expenditure, and payments to states, territories and local government.

‘Non-operating’ costs (sometimes called ‘capital’ costs) 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; and
- Payments to corporate entities (CCEs and Commonwealth companies).

Appropriation bill numbers are grouped into pairs, with odd numbered bills reflecting ordinary annual services i.e. operating funding (Bill No. 1,3 and 5) and even Bills reflecting non ordinary i.e. non-operating/capital (Bill No. 2,4 and 6).

Appropriation Bills are also generally developed as a part of the Budget and Mid-Year Economic Fiscal Outlook (MYEFO) update processes. Appropriation Bills No. 3 and 4 are slated to occur in line with the MYEFO and includes any Government decisions made since the previous Budget with financial impacts. This enables organisations to

¹ Department of Finance, Resource Management Guide RMG 100 *Guide to Appropriations*, available at: <https://www.finance.gov.au/publications/resource-management-guides/guide-appropriations-rmg-100>

reflect updated funding estimates as well as to seek re-classifications of funding (Capital / Operating) to reflect anticipated expenditure requirements.

Depending on circumstances, Government may elect to issue additional bills prior to the end of the financial year which provides an additional opportunity for adjustments. The decision of whether Bills will be issued, and timing is a decision of Government.

Reclassification Opportunities

The *Budget Process Operational Rules* (BPORs) allow for reclassifications of funding between operating and non-operating Bills/Acts, subject to the agreement of the Minister for Finance for items over \$20 million. Given the size of its capital budget within the IIP, Defence has a higher threshold allowing up to \$500 million of reclassifications without requiring approval from the Minister for Finance as a part of the Budget and MYEFO processes (BPORs *Attachment 4 – Defence Requirements*).

Formal reclassification processes are conducted twice a year, in the lead up to the Budget and MYEFO updates. Outside of the formal budget rounds, requests are only considered if they are urgent and unavoidable and a decision is required prior to the next formal round (BPORs *Rule 8*). To execute the reclassification process, however, requires a decision of government to issue new appropriation bills, which does not necessarily occur in every situation.

While the urgent and unavoidable rule exists to assist entities with urgent reclassification requests outside the formal processes, the only avenue to update the split in the appropriation acts is through a new appropriation bill (following Appropriation Act 1 & 2 receiving ascension the next update would be in Appropriation Bill 3 & 4 or an Appropriation Bill 5 & 6 if warranted).

Defence regularly reviews the suitability of its appropriation splits as part of both the monthly financial reporting and budgeting reporting requirements, with appropriate controls to identify and remediate any changes required.

Situations Outside the Normal

Despite the above opportunities, 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.

In accordance with the decision of the previous Government, Defence utilised existing approved Future Submarines funding to make the final termination payment resulting from the cancellation of the project. These funds were originally appropriated to Defence as Act 2 (capital) funding. It was the ANAO's view that, Defence should have utilised Act 1 (operating funding) for the termination payment given its accounting treatment.

To facilitate this, Defence would have had to seek a formal reclassification of funds between the Acts through the budget process, which was not feasible or available given the proximity between implementation date of the termination and the end of the financial year. The termination payment with Naval Group was still being negotiated in May and June 2022. Further, due to the Election and impacts on the Budget timing including Caretaker periods and change in Government, there were no Appropriation Acts 5 and 6 created to facilitate changes late in the 2021-22 financial year.

In this instance, irrespective of the Act utilised, a valid payment was made under an existing appropriation for the project in accordance with Government's decision. To reaffirm Defence's view, advice was requested from the AGS, who confirmed that the decision to use Act 2 funds for the termination payment would be viewed as being in accordance with the appropriations acts and not a breach of Section 83 of the Constitution.

If there are no opportunities for reclassifications, government decisions or additional funding, then organisations are forced to manage within existing appropriations and encounter the issues ANAO outlined in the report. Whilst the legal advice received on the Future Submarine payment determined “a court would, on balance, find that it was unlikely that a legislative breach had occurred”, this is not Defence’s preferred solution to resolving the situation. Given the size of the termination payment (\$832 million), Defence’s capacity to cover the amount from remaining operating funding was limited.

Defence suggests the rigid nature of the appropriation framework requires review in order to meet the needs of Commonwealth departments and agencies to implement strategic decisions on a more agile basis.

Opportunities for Improvement

In Defence’s opinion there are opportunities for future improvement.

Greater clarity in appropriation guidance from the Department of Finance, specifically the types of expenditure allowable under Act 1 and Act 2, particularly in relation to non-operating equity injections. As raised by the ANAO, legal advice from the Australian Government Solicitor highlighted some ambiguity between the legal position, accounting principles and Department of Finance guidance.

A broader review of the appropriation framework and appropriation acts with consideration given to consolidating current Act 1 and Act 2 appropriations for operating and capital expenditure and managing at a total Act 1 appropriation level. The separation of operating and capital expenditure in appropriation bills involves a technical accounting distinction that is limiting agility and innovation in agency procurement as well as driving considerable administrative workloads across Government for arguably little value add. As an example on accounting matters, there is increasing availability of non-traditional, non-capital related options to address entity’s cloud computing infrastructure and software options such as Software as a Service, Infrastructure on Demand as well as more diverse leasing opportunities. The historical Senate conventions as to what is “clearly definable as capital expenditure” no longer hold true and nor are capital vs operating distinctions useful for identifying what are the “ordinary annual services of Government.”

The Defence Acquisition program within the IIP is large and complex with all individual projects involving a mixture of capital and an expense components recognised under accounting rules. The exact composition of project expenditure can vary significantly from budget assumptions due to changes such as the phasing of the project, the chosen acquisition pathway and final delivery and purchasing approaches. All of these factors drive the need for constant updating of estimates and which also require constant reclassification under the appropriation budget rules with no change to the overall project approval amount.

We further note that there are also a range of alternate Parliamentary and governance processes in place that are better suited to ensure transparency and scrutiny in capital expenditure for ordinary services, including the Parliamentary Public Works Committee, the ICT Investment Approval Process and, for Defence, the reporting on the Integrated Investment Program.

The current arrangements are administratively heavy for entities to manage and are not well understood by the broader community. The classification of expenditure between operating and capital appropriations is highly technical in its application and traditionally not an area of significant public interest – particularly where the Parliament has already approved funding and there is nil impact at a total appropriation level.

The current operating and capital appropriation distinction reduces the flexibility of entities to take advantage of potential cost savings through non-traditional acquisitions of assets because of barriers in having appropriations reclassified. A consolidation of the appropriations acts would allow greater flexibility for entities to appropriately address these needs within their approved funding. This proposal would not reduce the transparency to Government, impact on financial reporting rules and financial statement process in accordance with Accounting Standards, and nor

would the proposed changes impact current requirements for budgeted financial statements (including operating and capital funding splits) to be prepared as part of Commonwealth Budget processes.

The framework imposes challenges on entities to apply at an operational level and in practice entities draw down appropriations on an arbitrary basis or entirely through Act 1 and correct the funding splits via true-up entries once more information is known. Given the quantum of Defence’s capital funding, this presents issues in management of the appropriations. The current split between appropriations is governed by the requirements of the Constitution and Senate Compact 1965, which may not reflect contemporary financial requirements and practices. The Future Submarine termination payment was large and was material enough to highlight the challenges raised in this submission.

Mr Steven Groves
Chief Finance Officer
Department of Defence