



# **Dissenting Report**

## **Audit Report No. 9, 2000-2001**

### **Implementation of Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative**

This dissenting report deals with two issues arising out of the Auditor-General's Report and the JCPAA Inquiry into the Implementation of the Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative:

1. The evaluation by the Office of Asset Sales and Information Technology Outsourcing (OASITO) of tenders and estimates of savings arising from the outsourcing initiative; and
2. The accounting treatment of embedded finance leases in the outsourced contracts, including the qualification by the Auditor-General of the financial accounts of the Australian Taxation Office (ATO) for the period ended 30 June 2000.

### **Evaluation of tenders and estimates of savings**

#### **End-of-period agency assets**

Some years ago the Department of Finance issued a general publication to government agencies called '*Value for your IT dollar*'. It was supported by Finance Circular 1993/11.

This guide provided a description of discounted cash flow techniques for evaluating competing IT proposals. It set out what is normal and appropriate practice in conducting an evaluation—to incorporate into the analysis income and expenses and the residual value of any assets remaining at the end of the evaluation period.

This is accepted methodology within the accounting profession. However, OASITO departed from this practice when it evaluated what cost savings it should attribute to the IT outsourcing initiative.

OASITO constructed the tenderer and agency cash flows on two distinctly separate bases. In-house provision was evaluated on a basis that included relatively large, sporadic cash outlays for new capital, while the tenderers' proposals were based on constant lease-based payments. The two sets of proposals had unequal lives and the value of the agencies' assets at the end of the evaluation period was ignored.

When using discounted cash flow techniques such assets would normally be valued at either their fair market value (FMV) or a deprival value (DV) based on the cost of replacing the benefit derived from the asset. For his analysis, the Auditor-General used an FMV of 50% of net book value (NBV).

On that basis the Auditor-General reassessed the savings as a result of outsourcing and found that: *'the direct cost savings from outsourcing achievable by agencies, in comparison to retaining the existing internal delivery of the services, were overstated and the true financial value to the Commonwealth of entering into the outsourcing arrangement was not revealed by the financial evaluation undertaken.'* [ANAO para. 7.13, page 154]

## **Commonwealth obligations to tenderer on termination**

One of the risks with outsourcing arrangements is the possibility of having to manage the changeover to a new tenderer, or bringing the function back in-house, at the conclusion of a contract. For that reason the original Financial Evaluation Guidelines prepared by OASITO included provision for an adjustment representing the cost to agencies of purchasing, at NBV, the assets dedicated to delivery of the contracted services. For the purposes of the evaluation the NBV was to be treated as an increase in the tenderer's price.

The Cluster 3 evaluation included an adjustment to tenderer's prices for the NBV at the end of the contract term. This overstated the cost of outsourcing because it did not offset against the NBV the FMV of those assets, which would then have been at the disposal of the agency to continue providing the service.

It is important to note that these evaluation methodologies did not reflect the Commonwealth's commercial arrangements with the tenderers, in particular in respect of the ownership of the relevant assets.

In December 1998—after tenders were received for the Group 5 and ATO contracts, but before the contracts were awarded, the Prime Minister wrote to all Portfolio Ministers advising them that *‘as a general Government policy, outsourcing of IT infrastructure services should proceed unless there was a compelling business case on a whole-of-Government basis for not doing so.’* This letter was interpreted by OASITO as meaning that the Government had taken a policy decision to outsource and that it was unlikely that any IT assets would be re-acquired to bring services back in-house. It was therefore concluded that an assumed buy-back of tenderers’ assets as part of the financial evaluation was not appropriate and that those amounts would be excluded from the savings analysis in current and future tenders. [ANAO para. 5.52, page 121]

This letter was important for another reason: according to OASITO, it had been taken to minimise the significance of one of the stipulations contained in each RFT, that *‘Achievement of substantial cost savings is a precondition to the award of a contract’*. [ANAO para. 4.36, page 95]

The Auditor-General found that: *‘the decision making process in the ATO and Group 5 tenders would have benefited from improved documentation/recording of the respective evaluation Committee’s conclusions and advice as to whether the preconditions stipulated in the RFT had been satisfied by the recommended preferred tenderer, and the factors considered in reaching that conclusion.’* [ANAO para. 5.61, page 124]

## Adjustments to savings

The Auditor-General made adjustments in respect of both agency end-of-period assets and Commonwealth obligations to vendors and found that it resulted in significant reductions in projected savings from outsourcing for the ATO and Group 5 tenders. The NPV of ATO savings was reduced from \$60.44 million to \$28.83 million and Cluster 5 from savings with a positive NPV of \$0.17 million to a negative NPV of \$5.35 million, representing an increase in costs. The NPV of Cluster 3 savings was reduced by a small amount, from \$49.94 million to \$49.06 million. [ANAO para. 7.60, page 171]

## Competitive neutrality adjustments

National Competition Policy requires the implementation of the competitive neutrality principles. In accordance with that policy, the Commonwealth Competitive Neutrality Policy Statement (June 1996) requires the removal of resource allocation distortions.

OASITO used a weighted average cost of capital (WACC) in an attempt to achieve a fairer representation of government investment in those services. OASITO did not apply a standard regime in making these calculations.

The Cluster 3 competitive neutrality (CN) adjustment was for a nominal rate of return using a WACC of 12.89%, but instead of applying it only to agency assets, it was applied to the total projected agency costs for delivering the relevant services. This was apparently done on the advice of DOFA to OASITO, on the basis that it represented '*a fairer representation of government investment in those services*'.

The effect of this advice was to substantially overstate the cost of agency provision of the service. In July 1998 OASITO correctly revised its methodology to apply a cost of capital only to the asset base.

In respect of the ATO tender, the CN rate of return adjustment was calculated on the basis of a nominal rate of return on agency hardware and software assets using a WACC of 12.87%. For the Group 5 tender the adjustment was calculated on the basis of a real return of 10.89% on agency assets. These rates were provided by separate external consultants.

The Auditor-General calculated an appropriate, consistent adjustment for each of the evaluations using an indicative rate of return on agency assets based on the 5 year Commonwealth bond rate applying at the time of selection (the financing cost of Commonwealth assets) plus a 3% risk premium. The Auditor-General believed this was appropriate because of the low business risk for the external service providers associated with assets under the outsourcing agreements.

This reduced the NPV of the CN adjustments for all agencies, for Cluster 3 by \$19.77 million, for the ATO by \$7.95 million, and for Group 5 by \$1.15 million. That represented a substantial reduction in estimated savings from outsourcing. [ANAO Fig. 7.4, page 176]

## Comment

The failure of OASITO to apply the accepted methodology, as set out in the Department of Finance's own instructions to departments, to account for the value of assets in the tender evaluation is a great concern. As a result, the evaluation of tenders and the estimation of savings were less than rigorous.

Had OASITO conducted a properly rigorous evaluation and applied the RFT requirement that '*Achievement of substantial cost savings is a precondition to the award of a contract*', then it would not have proceeded with the

Cluster 5 contract because, at the tender evaluation stage, there would have been a clear indication that the preferred tender was more expensive than continuing to perform the work in-house.

Another area where OASITO's processes were less than rigorous was its—and DOFA's—failure to provide a consistent and appropriate standard for competitive neutrality evaluation.

None of OASITO's attempts to justify to the Auditor-General its treatment of end-of-period assets give any cause for confidence:

- First, in October 1999 advising that there was no documentation of its consultation with any advisers with respect to this matter;
- Second, in March 2000 that the advice it had received was verbal;
- Third, in April 2000, that it had instructed an accounting firm to develop a methodology that would eliminate the need for assumptions about the sourcing decision for future periods; and
- Fourth, the same advice in April 2000 said that accounting firm had also been asked to develop a further approach that addressed specific future sourcing scenarios.

OASITO's assurance—that *'in order to give the decision maker maximum transparency, for further evaluations we intend to adopt the "Scenario sensitivity analysis" approach'*—has little value unless that sensitivity analysis is conceptually sound, is undertaken on a consistent basis, and rigorous.

OASITO used the Prime Minister's letter to justify ignoring end-of-period asset values. Government policy does not provide a basis for designing financial evaluation methodologies. Rather, rigorous evaluation methodologies should be applied to determine the cost implications of government policies and to provide decision makers with information on which they can make properly formed decisions about value for money in conformity with the Commonwealth Procurement Guidelines.

The disjunction between evaluation methodology and the substance of commercial arrangements, noted above, is a major cause for concern. Rigorous analysis at an early stage that focuses on all relevant issues, including end-of-period asset values, competitive neutrality adjustments, and the need to contemplate alternative arrangements for supply of the service for a subsequent period should form the basis for both the development of an appropriate RFT and the criteria on which tenders are evaluated.

## The accounting treatment of finance leases

Australian Accounting Standard 17 (AAS17) defines operating leases as being those where the lessor effectively retains substantially all the risks and benefits incident to ownership of the leased asset. Where substantially all the risks and benefits pass from the lessor to the lessee, the lease is classified as a finance lease, regardless of whether legal ownership is transferred or not.

An entity that enters into a finance lease for an asset is required to bring this onto its balance sheet as it is the economic equivalent of borrowing to acquire the asset. Similarly the concepts for the ABS's Government Finance Statistics require that '*Lease liability under a finance lease arrangement is treated as a long term loan*'. [ANAO para. 7.23, page 157; ABS, *Government Finance Statistics Australia Concepts, Sources and Methods*, 1994 page 32]

The Auditor-General examined the substance of the IT outsourcing contracts against the relevant tests:

1. Is the lease non-cancellable?
2. Is the lease term for 75 percent or more of the economic life of the leased asset?
3. Is the present value of the minimum lease payments equal to or more than 90 percent of the fair value of the assets at the inception of the lease?
4. Economic substance.

On the basis of the application of these tests, the Auditor-General found that these three IT outsourcing contracts contained embedded finance leases for the assets employed in providing services to the Commonwealth.

The assets in question had a nominal value at the end of the period of \$5.2 million for Cluster 3 agencies, \$25.7 million for the ATO, and \$5.2 million for Group 5 agencies. The total value of these embedded finance leases was therefore a minimum of \$36.1 million. [ANAO Fig. 7.3, page 166]

The Department of Finance and Administration had however treated these leases as operating leases. DOFA responded to the Auditor-General, stating that it had obtained advice on this issue from a number of accounting firms, a law firm and a leasing firm, all of which had concluded that the service agreements do not contain embedded finance leases.

DOFA provided the ABS with data for the Government Finance Statistics that treated these contracts as operating leases. DOFA told the Auditor-General that '*The Australian Bureau of Statistics has indicated that it will follow*

*this treatment for Government Finance Statistics.*’ Since the classification of the leases was not questioned until the issue was raised by the Auditor-General that statement may indicate no more than that the ABS had accepted DOFA’s classification of the contracts. The ABS does not examine all transactions submitted to it by government for inclusion in the GFS.

## Qualification of ATO Financial Statements

The Auditor-General qualified the ATO’s 1999/2000 financial statements because of the materiality of the finance lease issue in relation to the IT outsourcing contract. The Auditor-General said:

*The recognition of the lease as an operating lease in the Agency financial statements represents a departure from Australian Accounting Standard AAS17 Leases, which requires leases to be classified as finance leases where substantially all of the risks and benefits incident to ownership pass from the lessor to the lessee. The effect of this departure is to understate assets by \$70.9 million and liabilities by \$62.2 million on the Agency balance sheet, and overstate expenses in the Agency operating statement by \$8.7 million.”* [Audit 23/2000, *Audits of the Financial Statements of Commonwealth Entities for the Period Ended 30 June 2000*, page 38]

## Comment

Because DOFA and OASITO failed to recognise that these three IT outsourcing contracts contain embedded finance leases, the decision maker would not have been advised of the significant level of financial risk carried by the Commonwealth under the contracts.

DOFA and OASITO’s subsequent reluctance to accept the Auditor-General’s judgment—which was an issue of sufficient materiality to require qualifying the ATO’s financial statements—indicates a continuing failure to properly deal with financial risk in the outsourcing arrangements.

DOFA’s and OASITO’s predilection to seek the advice of paid advisers rather than accept the opinion of its auditors is a cause for alarm. Recent commercial history is littered with examples where auditors failed to warn of impending financial failure. The discovery that a previously conservative financial institution like the Department of Finance and Administration chooses to ignore the Auditor-General should not go unnoticed. This has wider implications, given the Department of Finance and Administration’s central role in the financial administration of the Commonwealth.

A significant implication of the misclassification of the contracts as operating leases and not finance leases, is that net government debt has been understated in the GFS by a minimum of \$36.1 million.

## **Recommendations**

We recommend that:

1. The Department of Finance and Administration should re-establish a rigorous evaluation regime for outsourcing proposals. That regime should be based on conceptually sound and accepted accounting principles, using consistent bases for comparison between competing proposals, including in-house provision of services, in particular with respect to the treatment of end-of-period agency assets and competitive neutrality adjustments.
2. These more rigorous evaluation techniques should not only inform the design of RFTs and the evaluation of tenders, but also take into account the need to maintain a competitive environment, including in-house options, for the future provision of services.
3. When an outsourcing RFT requires achievement of savings before award of a contract it would be wise not to proceed if savings cannot be demonstrated, unless there is some compelling reason to the contrary, in which case that reason should be properly documented.
4. Agencies note that government policy is not an excuse for compromising the rigour or integrity of financial evaluation techniques and that proper assessments of comparative costs, savings and risks should be presented to decision makers with a clear audit trail.
5. The Department of Finance and Administration should reacquaint itself with the Australian Accounting Standard AAS 17—Leases, and should take proper account of AAS 17 and the Auditor-General's views about the materiality of risks associated with leases, to ensure that those leases are properly classified for presentation in the Government Financial Statistics.

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