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MINISTER FOR DEFENCE  
THE HON DR BRENDAN NELSON MP

13 APR 2006

Mr Tony Smith MP  
Chairman  
Joint Committee of Public Accounts and Audit  
Parliament House  
CANBERRA ACT 2600

Dear Mr <sup>Smith</sup> Smith

On 7 November 2005, the Joint Committee of Public Accounts and Audit tabled Report 404, which details the findings of the Committee's examination of 11 performance audits by the Australian National Audit Office. This report focused on two Audit Reports of particular relevance to Defence:

- No 5 (Management of the Standard Defence Supply System Upgrade); and
- No 21 (Defence's Financial Statements 2003-04) of 2004-05.

The Committee made a total of eight recommendations to which Defence is required to respond. An Executive Minute containing the response to Recommendation 29 has already been forwarded to the Committee. I enclose Defence's response to the remaining recommendations in an Executive Minute.

Yours sincerely

  
BRENDAN NELSON  
Encl

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**Australian Government****Department of Defence****EXECUTIVE MINUTE**

OR

**JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT  
REPORT No. 404*****Review of Auditor-General's Reports 2003-2004 Third & Fourth Quarters; and  
First & Second Quarters of 2004-2005*****General comments**

The JCPAA Report 404 examined 11 performance audits by the Australian National Audit Office. Two of these reports were of particular relevance to Defence: Nos 5 and 21. These reports looked at the management of the Standard Defence Supply System Upgrade and Defence's Financial Statements 2003-04. The Committee made a total of eight recommendations to which Defence is required to respond. An executive minute containing the response to Recommendation 29 has already been forwarded to the Committee.

Defence's responses to the remaining seven recommendations are set out below.

**Recommendation 24 paragraph 8.38**

*The Committee recommends that all Defence information system projects be subject to the appropriate levels of cabinet, ministerial or departmental approval, as per Defence's own internal procurement guidelines and the 2003 Kinnaird review.*

*Where project managers fail to ensure that their project receives the adequate levels of cabinet, ministerial or departmental approval, disciplinary action should be undertaken by Defence.*

In consultation with the Chief Finance Officer Group, the Chief Information Officer on 15 February 2006 issued project approval guidelines for information systems projects managed within the Chief Information Officer Group. These guidelines require appropriate levels of cabinet, ministerial and departmental approval in accordance with Defence's in-house procurement guidelines and, where relevant, the Government's decisions on the recommendations of the Kinnaird review.

The guidelines provide clear direction on the approval process and the level of approval required based on the estimated cost of the project. The project approval document has to be physically signed and appropriately filed. Any amendments to the project will require a new project approval document to be signed.

The guidelines detail responsibility and accountability requirements. Administrative or disciplinary sanctions are available under the Australian Public Service Code of

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Conduct, Defence Instructions or the *Defence Force Discipline Act 1982* as appropriate for any procedural breaches.

These guidelines will be included, together with guidelines on Defence Capability Plan projects, capital facilities projects and minor capital equipment projects, in an instruction soon to be issued by the Chief Finance Officer.

**Recommendation 25 paragraph 8.39**

*The Committee recommends that the Department of Defence and the Defence Materiel Organisation institute a formal policy which excludes external contractors from being appointed as project managers for IT systems. Any performance bonuses paid to project managers must be directly linked to project milestones being met on-time and on-budget.*

The Defence Materiel Organisation has established a formal policy which excludes external contractors from being appointed as project managers. As there are currently several external service providers in project manager roles, the Defence Materiel Organisation is in the process of recruiting Australian Public Service staff to replace them. The project management skill-set has been removed from the list of skills which projects can acquire from external service providers through the Defence Materiel Organisation standing offer panel.

The Chief Information Officer Group, within the Department of Defence, ensures that its information technology projects are managed by Australian Public Service staff where possible. Within project management teams, if the required skills or experience cannot be sourced from Australian Public Service recruitment action, then external service providers may be engaged to meet a staffing shortfall. Like the Defence Materiel Organisation, the Chief Information Officer Group is moving to replace external service providers with Australian Public Service staff. In respect of external contracts for delivery of information technology systems, the Chief Information Group does not include project management functions as part of such contracts.

With regard to performance bonuses paid to project managers, Australian Workplace Agreements for Defence Materiel Organisation project managers may include a performance bonus component which is directly dependent on delivery on-time and on-cost. It should be noted that the majority of staff are not on Australian Workplace Agreements and are not in receipt of performance bonuses. The Defence Materiel Organisation expects to transition more project managers to Australian Workplace Agreements over the coming year.

The Defence Materiel Organisation agrees that milestone achievements should be the primary goal in most cases, but could not agree to a bonus system that relates solely to bonuses for on-time, on-cost delivery. For example, projects which are already in trouble need a variety of incentives for a new or replacement project manager to maximise a good recovery outcome. Sometimes we need to incentivise quality and capability objectives. We may also want to incentivise workforce skilling, meeting corporate goals, industry development activities or progress with financial remediation.

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The Chief Information Officer Group within the Department of Defence does not currently pay performance bonuses to project managers.

**Recommendation 26 paragraph 8.60**

*The Committee recommends that Defence continue with its planned rollout of Radio Frequency Portable Data Entry Terminals (handheld scanners) for use with the SDSS system in warehouses.*

*However, this rollout must only be undertaken when Defence is confident that the system can adequately support the new technology, to ensure that the system is not circumvented because of users' frustrations at slow processing.*

*Defence must also ensure that adequate training is provided to all personnel who will be using the scanners.*

Defence will continue to rollout the replacement Portable Data Entry Terminals (handheld scanners) as part of a larger upgrade of the hardware and software used to manage Defence warehouse functions. The performance of the new system has been successfully tested through a trial at the Defence National Supply and Distribution Centre. Conversion and sustainment training will be provided to all Commonwealth employees and civilian contractors. In addition, new business policies and procedures, to be approved by the Joint Logistics Command and the three Services, will reinforce this change.

**Recommendation 27 paragraph 9.35**

*The Committee recommends that the Department of Defence report to this Committee every six months against the milestones of the 14 remediation plans outlined in the 2005-06 Portfolio Budget Statements. These reports are to continue until the end of the 41st Parliament.*

Defence provides an update against the 16 remediation plans in the Portfolio Budget Statements, Portfolio Additional Estimates Statements and the Annual Report. Defence is available to report to the Committee every six months against the milestones of the remediation plans, if required.

**Recommendation 28 paragraph 9.41**

*The Committee recommends that Defence outline to the Committee its plan to ensure that the Julian date problem associated with the SDSS program will be fixed prior to May 2007. Defence's report to the committee should include a project plan, costings, milestones, and details of the project management team.*

**Project Methodology** - The Mincom MIMS version 4 software, which forms the core of the Standard Defence Supply System (SDSS), has a date limitation issue that will cause significant problems if not remediated by 18 May 2007. A project has been established to develop and implement a solution to this issue (known colloquially as the Julian date issue). The solution requires the application of a code change to

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Defence's SDSS system accompanied by a full conversion of the SDSS database. The cost to Defence for the remediation of the Julian date problem will be \$800,000.

The project manager is an Army captain working for Materiel Information Systems Branch in the Defence Materiel Organisation. The project team comprises staff from the Materiel Information Systems Branch, the Chief Information Officer Group and Mincom.

Under the project manager's direction, Mincom is contracted to deliver, at its own expense, the code fix and data conversion scripts; to develop a test and implementation strategy; to work with Defence to test and validate the solution and the data conversion in Defence's test environments; and, upon completion of the conversion, to supply validation and post implementation support. This team gives the optimal combination of technical and business input into the project. Defence's Management Audit Branch and the Australian National Audit Office have been engaged to provide an assurance overview of the project.

**Project Milestones** - The key milestones are as follows:

- a. Project Initiation - Completed 5 December 2005
- b. Mincom to deliver code to Defence - Completed 5 December 2005.
- c. Initial planning study - Completed 9 December 2005.
- d. Two full test conversions - Completed 19 January 2006.
- e. Formal user acceptance testing - Completed 28 February 2006.
- f. Conversion complete - Due 22 April 2006.
- g. Project completion - 29 May 2006.

**Recommendation 30 paragraph 9.60**

*The Committee recommends that Defence and the ANAO conduct ongoing consultations to discuss areas of disagreement such as pricing within the SDSS system. Defence should aim to resolve the issue of pricing of items within SDSS by June 2006.*

Frequent discussions are held with the Australian National Audit Office on a range of issues, including issues impacting on pricing within the Standard Defence Supply System (SDSS) system. This includes formal meetings at the senior level and extensive consultation at the working level.

Detailed work was carried out in 2004-05 to stratify inventory prices and seek statistically validated prices, or to find surrogate pricing sources where original records were unavailable or price confidence levels were not achieved. For general stores inventory, no reliable surrogate pricing database was identified that would be accepted by the auditors. This was due to the age of certain stock and SDSS process control weaknesses that limited the confidence that could be placed on price data generally.

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Defence recognises that further work to cleanse existing price data may be nugatory if done ahead of the implementation of SDSS system and process controls, and it will not be possible to resolve inventory pricing issues by June 2006. Work is progressing towards achieving reliable SDSS controls that are acceptable to the Australian National Audit Office by June 2006.

The inventory stratification work conducted during 2004-05 revealed that it may not be possible to reliably price some legacy items at all, and some legacy items may need to be accepted as an ongoing (and gradually declining) uncertainty.

The new Australian Equivalent to International Financial Reporting Standards (AEIFRS) requirement for inventory to be valued at the lesser of purchase cost and current replacement cost adds significant new challenges for both data collection and information system recording of prices. Planning for a SDSS replacement system has commenced and this is addressing the need for AEIFRS compliance on inventory pricing.

As a result of the ongoing legacy item issue and the need for an AEIFRS compliant inventory system, the resolution of inventory pricing uncertainties will be a longer term issue.

**Recommendation 31 paragraph 9.68**

*The Committee recommends that for Project JP 2077:*

- *the project must be managed from within the Defence Materiel Organisation;*
- *all appropriate cabinet-level, ministerial-level and departmental approvals must be sought prior to implementation of various phases of the project;*
- *the project must include defined project milestones;*
- *no project management bonus payments are to be made to any DMO personnel if the project milestones are not met on-time, and on-budget;*
- *there must be continued input from on-the-ground users of the logistics system; and*
- *the project must include sufficient upgrades to the technological hardware supporting the new logistics system to ensure that it will run efficiently.*

The various phases of JP2077 are being conducted under the Defence Capability Life Cycle Management framework. A key requirement under this framework is First and Second Pass consideration of capability proposals prior to implementation of various phases. Cabinet-level, ministerial-level and Defence senior committee approvals are obtained as part of this process. A project team has been established within the Defence Materiel Organisation which will continue to manage the implementation of JP2077.

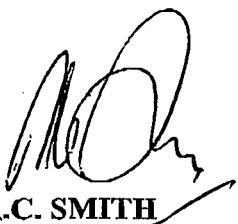
All JP2077 capability proposals presented to Government for Second Pass consideration will include an Acquisition Business Case which provides schedule information for key project milestones.

The Chief Executive Officer of the Defence Materiel Organisation is the delegate for the payment of any performance bonuses within the Defence Materiel Organisation. Performance bonuses may be paid under the terms of an individual workplace agreement.

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There will be continued input from on-the-ground users of the logistics system via a comprehensive user engagement process. A dedicated stakeholder management cell has been embedded in the project and includes Service Liaison Officers who will engage the full spectrum of key stakeholders and user community representatives.

JP 2077 Phase 2B.1 includes the upgrade of the Standard Defence Supply System (SDSS) through the acquisition of Mincom's Ellipse software. The project will acquire additional information technology hardware and infrastructure to ensure that the system will run efficiently.

**R.C. SMITH**

Secretary

Department of Defence