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Audit Report No. 9, 2000-2001

Implementation of Whole-of-Government IT Outsourcing Initiative

Background to information technology outsourcing

3.1 In 1991, the then Government's Industry Statement contained a commitment to outsource information technology (IT) services across the Australian Public Service (APS) on the condition that this would result in savings. The Department of Finance implemented this policy directive by issuing instructions to government departments requiring them to market test IT service requirements.

3.2 In 1994, an independent Review Group was set up by the Minister for Finance to review the major trends in the development of computer technology. The Review Group assessed the likely impact these trends had on Commonwealth IT services. The Review Group's 1995 report entitled *Clients first: the challenge for Government information technology* led to the establishment of the Office of Government Information Technology (OGIT) and the Government Information Services Policy Board.

3.3 In 1996, OGIT released the *Exposure Draft: Framework and Strategies for Information Technology in the Commonwealth of Australia,* which was a blueprint for the future development, and use of IT in the Commonwealth. Included in the report were strategies to enable increased competition for outsourcing of Commonwealth IT services.

3.4 During 1996 and 1997, OGIT and the Department of Finance conducted a scoping study on the possible outsourcing of Commonwealth IT infrastructure. The scoping study identified significant potential savings from economies of scale, reduced tender costs to Government, and increased opportunity for rationalisation and standardisation between agencies and downstream efficiencies in contract management.

3.5 In the 1997-98 Budget, the Government announced the Whole of Government IT Infrastructure Consolidation and Outsourcing Initiative. The measure was directed at achieving long-term improvements in the structuring and outsourcing of IT services across agencies. It was designed to facilitate greater integration in the delivery of programs and realise significant cost savings.

3.6 The Government estimated that the Initiative would result in savings of approximately $1 billion over seven years. In anticipation of these savings being realised from the Initiative, reductions were made to the forward estimates of Budget funded agencies in the 1997-98 Budget.

3.7 The Prime Minister reaffirmed the policy in 1998 in a letter to all Portfolio Ministers stating that as a general Government policy 'outsourcing of IT infrastructure services should proceed unless there is a compelling business case on a whole-of-government basis for not doing so'.[1]

3.8 In November 2000, the Minister for Finance and Administration announced an independent review of the IT outsourcing initiative following the tabling of the ANAO audit report, *Implementation of Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative*, on 6 September 2000. The review was conducted by Mr Richard Humphry, CEO of the Australian Stock exchange and a former Victorian Auditor-General. The Humphry review, presented in December 2000, made ten recommendations. The Government agreed with seven recommendations and gave qualified agreement to the remaining three.

1 OASITO, Submission no. 7, p. 2.

ANAO audit objectives and findings

3.9 The objective of the ANAO audit, which cost $535,000, was to examine the 'administrative and financial effectiveness of the implementation of the IT Initiative, with the focus being on the first four tenders conducted'.[2] Specifically, the audit assessed:

- Effectiveness of the overall planning and implementation of the IT Initiative, taking into account the tendering, contracting and monitoring processes undertaken in respect of Cluster 3, DEETYA/EN, ATO and Group 5;
- Extent to which those latter processes have contributed to the achievement of the objectives of the IT Initiative; and
- Extent to which the Commonwealth's interests have been adequately protected within this context.[3]

3.10 The Government had expected the implementation of the IT Initiative would be completed by June 1999. However, due to the inability of the IT industry to absorb the volume of tenders on offer, a revised timetable was extended to December 2000. The ANAO reported that the remaining four tenders still outstanding as at June 2000, would be unlikely to meet the December 2000 deadline. OASITO now expects implementation of the initiative will be completed in 2001, some two years after the initial date.

3.11 The audit report noted that due to the timetable extension and the reduction in agencies' budgets in anticipation of savings for some agencies, 'budget reduction will have been in effect for up to two years before the competitive tendering process is complete'.[4]

3.12 OGIT/OASITO had expected that implementing the IT Initiative would cost $13 million. As at May 2000, actual expenditure has increased over threefold to $40.38 million. The ANAO reported that 60 per cent of these costs were attributed to a Strategic Adviser retained by OGIT/OASITO to May 2000. For the period June 1996 to June 1998, the Strategic Adviser was paid fees and expenses of $7.18 million to provide services in respect of the development and implementation of the IT Initiative. These

2 ANAO, Report No. 9, 2000-2001, p. 48.

3 ANAO, Report No. 9, 2000-2001, p.48.

4 ANAO, Report No. 9, 2000-2001, p.16.

services were not competitively tendered and the reasons for this decision were not documented.[5]

3.13 The ANAO reported that on the expiration of the July 1997 contract with the Strategic Adviser, OASITO conducted the first competitive tender conducted in association with what was, by this stage, a multi-million dollar consultancy role. It was conducted as a restricted tender, with seventeen firms provided with an Invitation to Submit Proposal on 15 May 1998 to provide strategic advice, project management and technical assistance.[6]

3.14 The audit reviewed the financial evaluation methodology undertaken in each tender reviewed. The ANAO concluded that the evaluation methodology applied in each tender 'did not include due recognition of the residual value of agency assets at the end of the evaluation period. Consequently, the direct financial savings from outsourcing achievable by agencies, in comparison to retaining internal delivery, were overstated.'[7] Based on the methodology ANAO used, it calculated the savings were understated by $2.6 million for Cluster 3, overstated by $12.85 million for ATO and overstated by $2.62 million for Group 5.[8]

3.15 The audit reviewed the contractual obligations the Commonwealth had entered into with external service providers. The ANAO concluded that the economic substance of the leases 'constitute finance leases rather than operating leases'.[9] The consequence of a finance lease is that the Government carried all the risks and benefits of owning the assets.

3.16 Following the implementation of the outsourcing agreements for Cluster 3, ATO and Group 5, the ANAO reported difficulties in the IT service delivery by the external service provider. The ANAO reported 'it has taken longer than expected to obtain the anticipated level of cost and performance visibility and, in some areas, to achieve contracted levels of service'.[10] The ANAO also reported that in Cluster 3 and Group 5 there had been 'considerably more disruption to service delivery, with significant

5 ANAO, Report No. 9, 2000-2001, p.17.

6 ANAO, Report No. 9, 2000-2001, p. 77.

7 ANAO, Report No. 9, 2000-2001, p. 20.

8 ANAO, Report No. 9, 2000-2001, p. 166.

9 ANAO, Report No. 9, 2000-2001, p. 161.

10 ANAO, Report No. 9, 2000-2001, p. 23.

shortfalls in the provision of contracted service levels during the first year of each Agreement'.[11]

3.17 The audit report identified four specific areas for improvement. These are:

- On-going strategic oversight and evaluation of IT outsourcing by Commonwealth agencies;
- Enhancing the transparency and accountability of tender processes and evaluation outcomes as they relate to tender planning and the presentation to the decision-maker of comprehensive information on recommended outcomes;
- The financial evaluation method adopted to reflect the agreed financial value to the Commonwealth from the proposed arrangements, including the appropriate treatment of end-of-period assets; and
- Overall contract management, including the governance arrangements for the management of discretionary service credits; monitoring of external service provider's performance and contractual obligations; management of security and privacy obligations; and the adequacy of invoicing arrangements.[12]

3.18 The ANAO made twenty recommendations aimed at improving the administrative and financial effectiveness of the implementation of the IT Initiative. The whole-of-government response, coordinated by the Department of Finance and Administration (DOFA), agreed with eleven recommendations, gave qualified agreement to five other recommendations and disagreed with the remaining four.

Committee Objectives

3.19 The ANAO report provided the Committee with an opportunity to review the effectiveness of agency implementation of the Government IT outsourcing initiative. A public hearing was conducted on 2 March 2001 where the Committee focused on:

- agency resistance to the IT outsourcing initiative;

11 ANAO, Report No. 9, 2000-2001, p. 23.
12 ANAO, Report No. 9, 2000-2001, p. 26.

- finance versus operating leases;
- discounted cash flow methodology; and
- savings to the Commonwealth.

3.20 The last three dotpoints address agency cost saving issues. These issues are critical because they have bearing on the quantum of savings to the Commonwealth. The ANAO, for example, noted that the 'role of financial evaluation was to provide the decision-maker with the information necessary to determine whether the relevant agencies would obtain financial benefit from making the change to outsourcing their IT infrastructure, as opposed to continuing with internal service delivery.'[13]

3.21 Where a change case did not satisfy specified preconditions then an outsourcing contract would not be awarded.

Agency resistance to the IT outsourcing initiative

3.22 The Humphry review report found that one of the key factors limiting the Initiative's success was agency resistance. The Committee drew the ANAO's attention to the Humphry review where it states:

> There has been a general lack of buy-in by senior management and an unwillingness to accept that the initiative is the most appropriate approach to IT outsourcing. This lack of buy-in is by far the most significant risk factor for implementation management. The lack of acceptance by agencies has presented the initiative with difficulties at every stage.[14]

3.23 The ANAO told the Committee that it agreed with the Humphry finding that there had been significant agency resistance to the IT outsourcing initiative. When the Committee further questioned the ANAO on why agency resistance had not been mentioned in the audit report, the ANAO responded:

> We saw no evidence of that and we were not given any evidence of [agency resistance]…Mr Humphry had

13 ANAO, Report No. 9, 2000-2001, p. 150.

14 R Humphry, *Review of the Whole of Government Information Technology Outsourcing Initiative*, December 2000, p. 9.

> different terms of reference. He was looking at future implementation risk. He had a much broader canvas in terms of looking at the whole range of agencies and he spoke to a whole different range of people. I think the reviews are focused on different elements.[15]

3.24 The ANAO also highlighted the differences between the agencies that formed part of the audit report and those in the Humphry review. The block of agencies that the ANAO reviewed had already completed and implemented outsourcing contracts with external service providers. In some cases agencies such as DIMA and AEC were very willing to participate because they needed to upgrade their computer systems. The Humphry review on the other hand looked at whole clusters, including agencies which had yet to implement the IT Initiative. These agencies were more likely to be resistant to the IT outsourcing.

3.25 The ANAO advised that the closest it got to this particular issue during its audit was when it found:

> Experience also suggests that, within the policy context, there are areas in which the structure of agency groupings could be enhanced to better support agency business requirements, including in terms of the relative size, business-focus, funding arrangements and security requirements of grouped agencies.[16]

3.26 The Committee asked whether DOFA agreed with the Humphry finding that there was significant agency resistance to the IT outsourcing initiative. DOFA noted that Humphry was an independent reviewer and his only instruction from Government was his terms of reference. He had interviewed a wide range of department heads and other Commonwealth officers. DOFA concluded that Humphry was 'a reputable rapporteur [and did] not doubt his conclusions'.[17]

3.27 The Committee considers that agency resistance is a key risk factor which limits the success of the IT outsourcing Initiative. The Committee is puzzled that the ANAO ignored the fact that some agencies were not supportive of the IT Initiative. The ANAO suggested that the agencies that it examined were supportive of the initiative. The Committee considers that it is unfortunate that

15 I McPhee, *Transcript*, 2 March 2001, p. 55.

16 C Cronin, *Transcript*, 2 March 2001, p. 55.

17 P Bowen, *Transcript*, 2 March 2001, p. 56.

the ANAO limited itself in this way because the issue of agency resistance is highly important and should have been scrutinised and reported.

Finance leases versus operating leases

3.28 There is widespread disagreement about the application of Australian Accounting Standard 17 (AAS17). The Humphry Report commented that there is a 'lack of definitive guidance inherent in the AAS 17'[18] This disagreement was reflected in the Audit. The ANAO and DOFA / OASITO could not agree on the application of the Australian Accounting Standard 17 (AAS17). The accounting standard has instructions on the correct classification of finance leases and operating leases. The accounting treatment differs significantly depending on which type of lease is used and therefore the projected savings of the IT outsourcing initiative.

3.29 DOFA and OASITO have chosen to classify the leases as operating leases while the ANAO considers that the leases should be treated as finance leases.

3.30 In explaining to the Committee the determining factor between a operating lease and a finance lease, the ANAO noted a judgement had to be made about where the majority of risk and benefit due to ownership rested. If the majority of the risks associated with ownership lay with the agency, then the lease should be treated as a finance lease. However, if the majority of the risk associated with ownership lay with the external service provider, then the lease should be treated as an operating lease. The ANAO stated:

> [AAS17] is an accounting standard where the preparers of accounts and auditors have to take a decision about where substantially all the risks reside. If at the end of the day it is determined that an agency carries substantially all the risks, the transaction relating to the lease should be accounted as a finance transaction which affects your balance sheet in terms of both asset and liability disclosures. If, on the other hand, the risks are still with the lessor in the books of an agency, it would be an

18 R Humphry, *Review of the Whole of Government Information Technology Outsourcing Initiative*, December 2000, p. 22.

> operating lease and the only impact is an expense going through the particular operating statement. It obviously changes in a commercial world the leverage in terms of balance sheets of enterprises.[19]

3.31 When the Committee inquired about the difference in savings had DOFA and OASITO classified the lease as a finance lease as opposed to an operating lease, the ANAO responded that in total, the projected savings would be $12.87 million less than what was reported.[20] Irrespective of these calculations, OASITO rejected the ANAO's view and maintained that the leases were operating leases. OASITO stated:

> …we have a specialist leasing firm and two other accounting firms that have advised us that if there is a lease it is an operating lease and not a financing lease. We are not the experts. We go and ask the experts for the answers. They are the answers that we got, and those answers are reflected back through the whole-of-government response to the audit report.[21]

3.32 Similarly, DOFA had also received advice on the issue of whether these leases should be categorised as finance or operating ones. The context of seeking the advice was in relation to preparing the whole-of-government consolidated financial statements:

> …our advice supported the advice that OASITO had on this issue, and in the whole-of-government financial statements these transactions have been treated as service agreements and not as finance leases.[22]

3.33 DOFA also noted that the ANAO had never qualified the consolidated financial statements due to misclassification of operating and finance leases. The ANAO responded that it had in fact qualified a particular individual agency because of the treatment of leases. However it had not qualified the consolidated financial statements because 'when you consolidate and aggregate up all the Commonwealth's assets and liabilities, this issue was not material in that context'.[23]

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19 McPhee, *Transcript*, 2 March 2001, p. 57.
20 Cronin, *Transcript*, 2 March 2001, p. 58.
21 D Yarra, *Transcript*, 2 March 2001, p. 58.
22 Bowen, *Transcript*, 2 March 2001, p. 58.
23 McPhee, *Transcript*, 2 March 2001, p. 63.

3.34 The Committee sought to determine whether there would be any benefit if agencies were to come to the ANAO with both their brief and the tender in response, and seek the ANAO's opinion as to the nature of the leases involved. The ANAO responded:

> I think agencies will be much more alive to the contractual conditions they sign up to and probably make sure the risks reside with the lessor rather than with the agency. I think that will be an outcome of this process. I think many of these issues have not been understood going into the transaction, and it is certainly not uncommon practice for agencies or certainly for entities in the private sector to consult with their auditors in advance on complex transactions and see if there is concurrence on the accounting treatment for those.[24]

3.35 Humphry did not seek to adjudicate on the matter of finance versus operating leases and concluded that the 'debate over cost savings has tended to obscure other benefits that can arise from properly implemented outsourcing, such as wider access to technology and technical skills, strategic partnerships in a dynamic technical environment and the opportunity to manage capital expenditure more effectively.'[25]

Conclusions

3.36 The Committee notes that the ANAO maintains that the leases entered into by the agencies should be classified as finance leases. In contrast, OASITO and DOFA claim that, based on accounting advice from secondary sources, the leases should be recognised as operating leases.

3.37 This places the Committee in a difficult position. In adjudicating on this matter, one option for the Committee is to commission independent expert advice. However, the Committee does not believe that this would help to end the divergence of views. The Committee, therefore, concludes that it takes seriously any suggestion that agencies are involved in accounting practices that may overstate financial outcomes. It is essential that agencies adhere to the Australian Accounting Standards to ensure agencies provide a true and fair view of their financial position.

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24 McPhee, *Transcript*, 2 March 2001, p. 67.

25 ibid., p. 22.

Discounted cash flow methodology

3.38 The Committee heard that the ANAO and OASITO disagreed on the method OASITO used to calculate discounted cash flows. The issue in question is whether the residual value should be included as part of the calculation. An assessment of residual value is essential because it can influence agency cost savings. The reason why the ANAO is focusing on this is because in its view 'the financial evaluation methodology adopted in the Cluster 3, ATO and Group 5 tender evaluations did not capture all of the relevant costs.'[26]

3.39 In particular, the ANAO commented that 'the methodology applied did not appropriately recognise end-of-period agency assets, and the costs arising from the Commonwealth's obligations in respect to the assets expected to be used by tenderers in delivering the services.'[27] In explaining the importance of factoring in end-of-period asset values, the ANAO gave the following example:

> …where the agency cost baseline includes an expectation that the agency will spend say, $9 million, in the final year of the evaluation period to purchase assets with a three-year economic life, the agency cost baseline would be inappropriately inflated as against the tenderers' lease prices, unless the two years of service potential yet to be derived from those assets at the end of the evaluation period was incorporated in the financial evaluation in the form of residual value.[28]

3.40 The Committee notes that there is a relationship between residual value and the type of lease. For example, if an agency had an operating lease, the issue of a residual value would not normally apply. In contrast, if an agency has a finance lease then the issue of a residual value would apply. The ANAO has made its comments on the basis that the leases are finance leases and therefore residual value will affect the level of savings. Excluding the residual value inflates the projected savings to the Commonwealth. The ANAO reported:

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26 ANAO, Report No. 9, 2000-2001, p. 152.

27 ANAO, Report No. 9, 2000-2001, p. 152.

28 ANAO, Report No. 9, 2000-2001, p. 153.

> The evaluation methodology applied in each tender also did not include due recognition of the residual value of agency assets at the end of the evaluation period. Consequently, the direct financial savings from outsourcing achievable by agencies, in comparison to retaining internal delivery, were overstated.[29]

3.41 The quantum of this overstatement was $28.08 million in total. This is made up of $3.83 million for Cluster 3, $18.76 million for ATO and $5.49 million for Group 5. The ANAO noted that DOFA has published a guideline titled *Value for Your IT Dollar,* which includes instructions on how to calculate discounted cash flows. The guidelines specify that residual value should be included as part of the calculations.

3.42 OASITO accepted the premise of the report but stressed the need to consider the assumptions underlying the evaluations. OASITO believed that the Government IT outsourcing policy necessitated a departure from the DOFA guidelines.

> Our view was that we applied government policy, the policy being that you should outsource, that outsourcing will happen, that it will happen as a once and for all change and that there was no reversion to in-house provision. That is the assumption that we used for the purposes of the evaluation, and we combined that assumption with the pure cash approach that we adopted in our methodology, which has not been challenged by our expert advisers or by the Audit Office. That resulted in our not including the value of end of term assets.[30]

3.43 The ANAO disagreed with OASITO, stating that government policy is not relevant when choosing the methodology in preparing discounted cash flow:

> Whatever government policy was or was not in regard to IT outsourcing and how that should be extended, should not really impact on how you construct the in-house case, if you could just continue business as usual.[31]

3.44 OASITO advised the Committee that the methodology it used is supported by expert advice. ‘That advice indicates that the way

29 ANAO, Report No. 9, 2000-2001, p. 20.

30 Yarra, *Transcript*, 2 March 2001, p. 60.

31 T. Long, *Transcript*, 2 March 2001, p. 61.

we approached the cash analysis is correct and robust, and we followed it.'[32]

3.45 The Committee questioned whether the ANAO examined OASITO's expert advice. The ANAO said:

> We examined their advice. We had a great deal of difficulty understanding it, for the simple reason that we viewed an evaluation as essentially a technical exercise and it does not really involve questions of policy. It is essentially a straight up and down technical measurement approach.[33]

3.46 The issue of whether or not to include residual value is significant. The ANAO noted that in the request for tenders, the external service provider had to demonstrate to the agency that it could achieve significant savings by outsourcing its IT services. The ANAO stated that, by not including the residual value, OASITO was 'making outsourcing much more attractive than in-house provision'.[34]

Savings to the Commonwealth

3.47 The IT Outsourcing Initiative resulted in aggregate savings to the Commonwealth. This fact was confirmed in the audit report, in the Humphry Report and again at the public hearing by the ANAO.

3.48 The Humphry review reported that there is 'broad agreement that, in the aggregate, the Initiative has delivered significant savings.'[35] The ANAO confirmed this view stating that:

> …various clusters have made significant savings and others have not. While I agree with the comment that, in aggregate, savings have been achieved, you cannot universally apply that to each cluster.[36]

3.49 The savings to the Commonwealth are real regardless of the methodology used to calculate the savings—methodology only

32 Yarra, *Transcript*, 2 March 2001, p. 61.

33 Cronin, *Transcript*, 2 March 2001, p. 61.

34 Cronin, *Transcript*, 2 March 2001, p. 66.

35 Humphry, *Review*, p. 10.

36 McPhee, *Transcript*, 2 March 2001, p. 57.

determines the size of savings. The Committee notes that if OASITO had classified the leases as finance leases and included the residual value as part of their discounted cash flow calculations, the nominal savings to the Commonwealth would still have been $82.48 million. DOFA advised the Committee that an important consideration is not just financial savings, but value for money. DOFA stated:

> The Government's *Procurement Guidelines* are very clear on this, and that is that value for money must be demonstrated. I think if we are not careful we will lose sight of the fact that there can be value for money from procurement, whether IT or whatever it is, that does not necessarily involve lower cost. It can involve better service, more effective provision of service to the end user and greater flexibility in how a department or company will operate. I think it is a little bit simplistic to be concentrating only on savings. Value for money is the principle.[37]

3.50 In response, the ANAO commented that it did not:

> …disagree generally with what [DOFA] is saying. I just make the point that the government's stated objectives were to realise significant savings from this exercise and that is the reason it featured in the report. But I agree there is a whole lot of industry development and other advantages seen from this exercise, but you do have to have regard to the government policy objectives.[38]

3.51 The Committee asked the ANAO whether it agreed that agencies had deliberately selected accounting standards to manufacture the best case scenario in terms of cost savings. The ANAO responded:

> I could not say that; I do not know the motivation. We did encourage agencies, where we believed the leases were finance leases, to treat them that way. As I said before, it is very important to look at each contract.[39]

37 Bowen, *Transcript*, 2 March 2001, p. 62.
38 McPhee, *Transcript*, 2 March 2001, p. 62.
39 McPhee, *Transcript*, 2 March 2001, p. 64.

Conclusion

3.52 The correct treatment of accounting standards is fundamental to transparent reporting and budget honesty. Agencies should adopt consistent accounting standards which also are consistent with the proper management of risk to the Commonwealth.