



Auditor-General for Australia



File Reference: 206155

13 March 2009

Ms Sharon Grierson MP
Chair
Joint Committee of Public Accounts and Audit
Parliament House
Canberra ACT 2600

Dear Ms Grierson

Hearing – Defence Materiel Organisation Major Projects Report 2007-08

Please find enclosed a submission from the ANAO in relation to the above hearing.

The ANAO looks forward to appearing at the hearing on Thursday 19 March 2009.

Yours sincerely

Ian McPhee
Auditor-General



**Submission to the Joint Committee on Public
Accounts and Audit: Defence Materiel Organisation
Major Projects Report 2007-08**

Date: March 2009

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1. Background

Introduction

1.1 The acquisition of Defence equipment is a significant area of government expenditure. In 2007-08 the Defence Materiel Organisation (DMO), which is responsible for acquiring and supporting Defence's weapon systems, platforms and other materiel, spent some \$3.936 billion on both major and minor capital equipment acquisition projects.¹ These projects are often expensive, technologically advanced and managerially challenging, and require DMO to manage contracts that:

- are inherently complex and require sophisticated management processes;
- often specify substantial progress payments prior to Defence being able to test and operationally evaluate the capability being acquired; and
- involve significant risks and issues that may only be identified during the latter phase of development tests and evaluations.

1.2 Defence equipment acquisition projects are also the subject of considerable Parliamentary and public interest, as they are required to make important contributions to national security. The Senate Foreign Affairs, Defence and Trade Reference Committee in its 2003 report *Materiel acquisition and management in Defence*, found that there was relatively poor visibility on the progress of major projects as far as the Parliament and the public are concerned. The Committee recommended that the Senate request the Auditor-General to produce an annual report on progress in major Defence projects.²

1.3 In 2006, the Joint Committee of Public Accounts and Audit (JCPAA) recommended that the ANAO produce an annual report, based on data supplied by the Department of Defence and the DMO, on the progress of the top 30 capital equipment projects.³ The Government's 2007 Defence election

¹ Department of Defence, *Defence Annual Report 2007-08*, Volume 2, p.18.

² Senate Committee Report, *Materiel acquisition and management in Defence*, Foreign Affairs, Defence and Trade References Committee, March 2003, pp.xv-xvi, 78-79.

³ Joint Committee of Public Accounts and Audit, Media Alert; *Committee Recommends Funding for ANAO Annual Review of Major Defence Capital Equipment Projects*, 6 December 2006.

policy also signalled the establishment of an annual independent evaluation of the top 30 projects by the ANAO. The Government agreed and approved funding the Major Projects Report program in the May 2008 budget.

1.4 The first report, *Defence Materiel Organisation Major Projects Report 2007-08*, was tabled in Parliament by the ANAO on 27 November 2008.

1.5 The report essentially pilots an annual DMO Major Projects Report program, and was developed in conjunction with the DMO. It is intended to cover the cost, schedule and capability progress achieved by selected DMO projects, and includes the Auditor-General's formal review conclusion (Appendix 1) on information presented by DMO on nine major projects covered by the report (Appendix 2).

1.6 The report benefited from consultation with, and the strong support of, the JCPAA. From March 2006 to August 2008, the JCPAA conducted an inquiry into financial reporting and equipment acquisition by the Department of Defence and DMO. That inquiry resulted in JCPAA Report 411, *Progress on equipment acquisition and financial reporting in Defence* which, amongst other things, outlines the JCPAA's expectations that the annual DMO Major Projects Report would provide a significant and timely step toward improving transparency and accountability around major acquisition projects within Defence and the DMO.⁴

Report Development

1.7 The ANAO's focus in the pilot was to:

- develop and test the processes that enable the ANAO to obtain, in a timely and effective manner, sufficient appropriate evidence to support the Auditor-General's review opinion on information provided by DMO;
- provide advice to DMO on the Project Data Summary Sheet (PDSS) template and the PDSS Guidelines for use by project personnel; and

⁴ Joint Committee of Public Accounts and Audit, Report 411, *Progress on equipment acquisition and financial reporting in Defence*, August 2008, p.174 pp.vii-viii, xxii-xxiii, 161-175.

- work with DMO to identify the key milestones that needed to be achieved by both organisations, to develop and prepare the report for tabling within five months of the close of each financial year.

1.8 The ANAO's review of individual PDSSs contained in the report is based on the Standard on Assurance Engagements ASAE 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* issued by the Auditing and Assurance Standards Board in July 2007.

1.9 Our review of the information presented in the individual PDSSs included:

- an examination of each PDSS;
- a review of relevant procedures used by DMO to prepare the PDSSs;
- a review of documents and information relevant to the PDSSs;
- interviews with persons responsible for the preparation of the PDSSs and those responsible for the management of the nine projects; and
- an examination of the certification and management representations by the DMO Chief Executive, sign-offs by DMO managers, and management representations from the Capability Managers relating to Initial Operational Capability and Final Operational Capability.

1.10 The ANAO did not, as part of the review process, audit the accuracy of the DMO's project management systems and internal controls used to provide the project data.

1.11 While our work is appropriate for the purpose of providing a review conclusion in accordance with ASAE 3000, our review is not as extensive as individual project performance audits conducted by the ANAO, in terms of the nature and scope of project issues covered, and the extent to which evidence is obtained by the ANAO. Consequently, the level of assurance provided by the review is less than that typically provided by ANAO's performance audits.

2. Assurance Review Report

2.1 Under arrangements with the Chief Executive of DMO, the Auditor-General has responsibility to express an independent conclusion on whether anything has come to his attention to indicate that the information in the PDSSs, that is within the scope of the review, has not been prepared, in all material respects, in accordance with DMO's PDSS Guidelines. The Auditor-General's Independent Review Report is reproduced at Appendix 1.

2.2 This first review represents a substantial step towards improving transparency and public accountability in major Defence procurement. The review should also begin to provide assistance to DMO in pursuing its agenda to improve its performance in managing major acquisition projects.

2.3 It is also pleasing that this first report has been able to demonstrate that timely major project information can be independently reviewed and provided to Parliament and the public – within five months of the end of the financial year.

2.4 The Review Report was able to provide the required level of assurance in relation to the significant majority of information presented in the PDSSs. However, two particular areas were highlighted in the Auditor-General's report.

Review Scope

2.5 Project information concerning major risks and issues (PDSS tables 4.1 and 4.2) were deemed to be outside the scope of the Auditor-General's review. For much of 2007-08, the DMO and ANAO were piloting the development of the project data collection and assurance review policies and processes, and as late as October 2008 DMO was making significant changes to the major risks and issues information presented in the PDSSs. The limited time available before the report's tabling in late November 2008 reduced the ANAO's ability to assess the method used by DMO to compile the risks and issues presented in each PDSS. As a result, this information was scoped-out of the Auditor-General's review.

2.6 The ANAO intends that future assurance reviews will include examining DMO processes used to compile the major risks and issues information. The extent to which the removal of this scope exclusion can be achieved will be a matter for ANAO consideration in light of the evidence presented by DMO for review. In this context, it is the completeness of the information presented that is the issue.

Qualified Conclusion

2.7 The information on prime contract expenditure at base date price, presented in the PDSSs at Table 2.7, was the subject of a qualified conclusion as to its accuracy. This was the result of DMO financial systems' limitations that prevented the ANAO from assessing:

- the degree of inherent risk that the financial data was misstated;
- the effectiveness of control systems employed by DMO to prevent the financial data from being misstated; and
- the impact of ANAO's assurance review procedures on detecting financial data misstatements.

2.8 The ANAO intends that future assurance reviews will include examining DMO systems and internal controls which have been used to compile the PDSS financial data, with a view to lifting the qualified conclusion when it is appropriate.

2.9 The DMO has acknowledged limitations on the type of financial management reports its system can generate, and more broadly, the inability of DMO systems to readily support the data and evidence demands of many of the data fields in the PDSS.⁵

⁵ ANAO Report No.9 2008-09, *Defence Materiel Organisation Major Projects Report 2007-08*, pp.70, 91.

3. Future Assurance Reviews

3.1 The DMO Major Projects Report 2008-09 is expected to report on the progress of 15 projects, with the number of projects increasing to up to 30 projects in subsequent years.

3.2 This significant number of projects will allow a broader perspective on equipment acquisition performance by DMO than is currently available. This new perspective will not only be of interest to Parliament and the Government, but will also assist DMO in pursuing its agenda to improve its performance in managing major acquisition projects.

3.3 In the short to medium term, the Major Projects Report program will continue to evolve and generate a considerable body of work and challenges for the ANAO and DMO. Feedback from key stakeholders will also be important in the direction of this work.

3.4 At this stage there are areas to highlight from an ANAO perspective.

3.5 With the next report, the ANAO will undertake analysis of projects' cost, schedule and capability performance data, in-year and over project life to date. The ANAO considers that over time, suitable analysis should be able to highlight emerging performance trends with the major projects, individually and as a portfolio of projects.

3.6 In coming years, the ANAO will also be working closely with DMO to address the review scope limitations and qualified conclusion detailed earlier in this submission. This will include gaining a strong understanding of DMO's internal control environment (and particularly the financial control framework at a corporate and project level), to allow the ANAO to assess and address levels of risk of misstatement in the compilation of PDSS data.

3.7 Lessons from the first year show that the PDSS template can be improved, particularly in the area of capability performance data. Capability achievement, in terms of Measures of Effectiveness (known as Key User Requirements in the United Kingdom's National Audit Office Major Projects Report) was excluded by DMO from the PDSSs because of national security concerns. The DMO has provided an aggregated picture of capability

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performance covering the nine projects at page 87 of the Report. However, there would be considerable benefit to this important element of project status if DMO was able to report unclassified project level capability status data.

3.8 In reporting to Parliament each year, the ANAO will work with DMO to ensure the annual project review schedule is efficient so that the ANAO can complete its independent review of all project data within the agreed timeframe. As the number of projects in the Major Projects Report will increase from 15 this year to up to 30 next year, an efficient project review schedule will be critical.

3.9 Overall, the ANAO believes a strong foundation for an effective working relationship with the DMO on future annual reviews has now been established through the first report.

Appendices

Appendix 1: Auditor-General's Independent Review Report



Auditor-General for Australia



Independent Review Report on the Defence Materiel Organisation's Project Data Summary Sheets by the Auditor-General

To the President of the Senate
To the Speaker of the House of Representatives

Scope

I have undertaken a review of the accompanying Project Data Summary Sheets as at 30 June 2008 against the Guidelines for nine major capital equipment acquisition projects included in this pilot report for which the Defence Materiel Organisation (DMO) is responsible. The nine projects are:

- Airborne Early Warning and Control Aircraft – AIR 5077 Phase 3
- Armidale-Class Patrol Boats – SEA 1444 Phase 1
- High Frequency Modernisation – JP 2043 Phase 3A
- Bushmaster Protected Mobility Vehicle – LAND 116 Phase 3
- F/A-18 Hornet Upgrade – AIR 5376 Phase 2.2
- Collins Replacement Combat System – SEA 1439 Phase 4A
- Armed Reconnaissance Helicopter – AIR 87 Phase 2
- C-17 Globemaster III Heavy Airlifter – AIR 8000 Phase 3
- Guided Missile Frigate Upgrade Implementation – SEA 1390 Phase 2.1

My review encompassed information relating to the cost, schedule and capability performance of each project, but did not include an assessment of the following information.

- (a) Major Project Risks and Major Project Issues included in Tables 1.2, 4.1 and 4.2 of each Project Data Summary Sheet.
- (b) Future dates that are 'forecasts' regarding a project's expected achievement of delivery schedules and capability that are included in Sections 1, 3 and 4 of each Project Data Summary Sheet.

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By their nature, the nomination of major project risks and issues and the achievement of future dates involve uncertainty because they relate to events, and depend on circumstances, that may or may not occur. As such, a range of circumstances can cause these items to differ materially from those stated in the Project Data Summary Sheets. Accordingly, these sections of the Project Data Summary Sheets have been scoped out of the review.

The Responsibility of the Chief Executive of DMO

The Chief Executive of DMO is responsible for the preparation and presentation of Project Data Summary Sheets for each project in accordance with Project Data Summary Sheet Guidelines (the Guidelines).

The Auditor's Responsibility

My responsibility is to express an independent conclusion based on my review.

My review has been conducted in accordance with the Australian Standard on Assurance Engagements ASAE 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* issued by the Australian Auditing and Assurance Standards Board. My review is designed to enable me to obtain sufficient appropriate evidence to form a conclusion whether anything has come to my attention to indicate that the information in the Project Data Summary Sheets, that is within the scope of my review, has not been prepared, in all material respects, in accordance with the Guidelines.

Review criteria and methodology

The criteria that have been used to conduct my review are based on the Guidelines and include whether DMO has procedures in place designed to ensure that project information and data was recorded in a consistent, complete and accurate manner for each project.

I have conducted the review of the Project Data Summary Sheets for the nine projects by making such enquiries and performing such procedures as I, in my professional judgement, considered reasonable in the circumstances including:

- an examination of each Project Data Summary Sheet;
- a review of relevant procedures used by DMO to prepare the Project Data Summary Sheets;
- a review of documents and information relevant to the Project Data Summary Sheets;
- interviews with persons responsible for the preparation of the Project Data Summary Sheets and those responsible for the management of the nine projects; and
- an examination of the statement and management representations by the DMO Chief Executive, sign-offs by DMO managers, and management representations from the Capability Managers relating to Initial Operational Capability and Final Operational Capability.

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A review of this nature provides less assurance than an audit.

Basis for Qualified Conclusion

Due to systems limitations, there is uncertainty in relation to the reported information on prime contract expenditure at base date price, presented in the Project Data Summary Sheets at Table 2.7. Consequently, I have not been able to obtain all the information necessary to be satisfied about the accuracy of the prime contract expenditure as reported. This constitutes a basis for a qualified conclusion of my review.

Qualified Conclusion

Except for the effect of such adjustments as might be necessary had the uncertainty relating to the information in Table 2.7, referred to in the above paragraph not existed, based on my review described in this Report, nothing has come to my attention that causes me to believe that the information in the Project Data Summary Sheets, within the scope of my review, has not been prepared, in all material respects, in accordance with the Guidelines.


Ian McPhee
Auditor-General

Canberra ACT
20 November 2008

Appendix 2: 2007-08 Major Projects Report projects

Airborne Early Warning and Control Aircraft	AIR 5077 Phase 3
Armed Reconnaissance Helicopters	AIR 87 Phase 2
F/A-18 Hornet Upgrade	AIR 5376 Phase 2.2
C-17 Heavy Lift Aircraft	AIR 8000 Phase 3
FFG Frigate Upgrade	SEA 1390 Phase 2
Bushmaster Vehicles	LAND 116 Phase 3
High Frequency Modernisation	JP 2043 Phase 3A
Armidale Patrol Boats	SEA 1444 Phase 1
Collins Submarine Replacement Combat System	SEA 1439 Phase 4A

Appendix 3: 2008-09 Major Projects Report projects

Air Warfare Destroyers	SEA 4000 Phase 3
Airborne Early Warning and Control Aircraft	AIR 5077 Phase 3
Multi-Role Helicopters	AIR 9000 Phase 2
Super Hornet Aircraft	AIR 5349 Phase 1
Amphibious Ships	JP 2048 Phase 4A/4B
Armed Reconnaissance Helicopters	AIR 87 Phase 2
Air to Air Refuelling Aircraft	AIR 5402
F/A-18 Hornet Upgrade	AIR 5376 Phase 2
C-17 Heavy Lift Aircraft	AIR 8000 Phase 3
FFG Frigate Upgrade	SEA 1390 Phase 2
F/A-18 Hornet Structural Refurbishment	AIR 5376 Phase 3.2
Bushmaster Vehicles	LAND 116 Phase 3
High Frequency Modernisation	JP 2043 Phase 3A
Armidale Patrol Boats	SEA 1444 Phase 1
Collins Submarine Replacement Combat System	SEA 1439 Phase 4A

