The Parliament of the Commonwealth of Australia

Report 383

- **Amphibious Transport Ship Project**
- **Implementation of Whole-of-Government Technology and Infrastructure Consolidation and Outsourcing Initiative**
- **AQIS Cost-Recovery Systems**
- **Knowledge System Equipment Acquisition Projects in Defence**

Review of Auditor-General's Reports
2000–2001
First Quarter

Joint Committee of Public Accounts and Audit

June 2001
Canberra

Contents

REPORT

DISSENTING REPORT

APPENDICES

Foreword

Report 383 is the outcome of the review by the Joint Committee of Public Accounts and Audit (JCPAA) of the Auditor-General's audit reports tabled in the first quarter of 2000–2001. Of the eleven audit reports reviewed, the Committee selected four for further examination.

Audit Report No.8, Amphibious Transport Ship Project; Audit Report No.9, Implementation of Whole-of-Government Technology and Infrastructure Consolidation and Outsourcing Initiative; Audit Report No.10, AQIS Cost-Recovery Systems, Australian Quarantine and Inspection Service; and *Audit Report No. 11, Knowledge System Equipment Acquisition Projects in Defence* were examined at public hearings in Canberra on Friday, 2 March 2001.

Audit Report No 8 focused on the commissioning of HMAS *Manoora* and HMAS *Kanimbla* which had been purchased from the US Navy in August 1994 for $61 million. On their delivery, Defence found problems with both ships, despite having engaged an inspection team to examine both carefully. On the basis of this experience, Defence acknowledged the need to have clearly established its functional requirements before proceeding with an acquisition, and to undertake a careful costing process for repair of older vessels.

Extensive maintenance work and numerous capability upgrades were performed on *Manoora* and *Kanimbla*, costing about $395.1 million and taking up to 44 months. A decision to further increase the capability of the ships is planned for 2004–05 at an expected cost between $50–$100 million. This will increase the total project cost to $445 million.

The Committee heard the difficulties inherent in trying to assess the relative advantages and disadvantages of building a new ship as opposed to acquiring the two older vessels. Defence claimed that having two ships enhanced Defence's capabilities because it is able to operate in two different locations at the same time. This has allowed Defence to increase its flexibility of operations.

Audit Report No. 9 examined the strategies developed by the Office of Government Information Technology (OGIT) and the Department of Finance for outsourcing of Commonwealth IT services. The Whole of Government IT Infrastructure Consolidation and Outsourcing Initiative 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 to realise significant cost savings.

Aggregate savings to the Commonwealth from the IT Outsourcing Initiative were confirmed in the audit report, in the Humphry Report and again at the public hearing by the ANAO.

The Committee noted the different approach to the accounting standards by ANAO and OASITO. The Committee believes that 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.

Audit Report No. 10 was undertaken by the ANAO following advice from the JCPAA that an audit of AQIS's cost-recovery systems was a parliamentary priority. The objective of the audit was to assess the efficiency and effectiveness of the management of AQIS's cost-recovery systems and provide assurance to the Parliament that the cost-recoverable programs were identifying and recovering the full costs of services provided, without cross-subsidisation.

While the audit found that overall AQIS's cost-recovery systems were mature and stable and, with some exceptions, had delivered near cost-recovery for the AQIS recoverable programs, it also found a number of inherent weaknesses in the cost-recovery systems which potentially impaired the efficiency and effectiveness of the management of those systems.

Cost recovery is a central part of AQIS's business. AQIS has been involved in cost recovery for over two decades and has been recovering 100 per cent of costs for recoverable programs for the last 10 years. The Committee considers that AQIS is taking a long time to reach an appropriate level of sophistication in its cost measurement processes and agrees with the ANAO that it is not possible to assess with any confidence how well AQIS's fees and charges reflect the actual costs incurred.

The Committee considered that being able to accurately cost its services would allow AQIS to drive its business with greater focus and efficiency and to operate with greater transparency and equity. The Committee made recommendations addressing the alignment of fees and costs, the reduction of over-recoveries and the non-meat EXDOC system project.

Audit Report No. 11 examined Defence's military and administrative information systems which combine to form the Defence Information Environment (DIE). Effective use of information is vital to Australia's defence capacity. Defence's main problem is the inability of specific functional areas to transmit information from one area to another. DIE is aware that its data needs to be developed and shared in a coherent and integrated manner with all organisational areas with legitimate needs for the data. It has appointed a Chief Knowledge Officer to bring the knowledge environment under adequate managerial control.

In order to achieve its goal, Defence has to change its existing culture so that a holistic approach can be achieved. Management of knowledge system projects in Defence is a complex and demanding task. Integrated training is essential if this change is to be implemented successfully.

The Committee is of the view that Defence's ability to develop an effective Information environment centres on Defence's ability to recruit, develop and retain skilled individuals needed in all parts of the Defence information environment. The Committee urges Defence to finalise its specific project architectural checklists as soon as possible so that these can be disseminated across all sectors and the Services, and become part of the negotiation requirements in any new project.

Bob Charles MP
Chairman

Membership of the Committee

Chair   Mr Bob Charles MP

Deputy Chair   Mr David Cox MP

Members   Senator Helen Coonan

Senator the Hon Rosemary Crowley
(until 28/06/01)

Senator the Hon John Faulkner
(until 12/10/00)

Senator the Hon Brian Gibson AM

Senator John Hogg

Senator Andrew Murray

Senator the Hon Nick Sherry
(from 28/06/01)

Senator John Watson

Mr Kevin Andrews MP

Mr Malcolm Brough MP
(until 7/3/00)

Mr Petro Georgiou MP

Ms Julia Gillard MP

Mr Alan Griffin MP (until 9/8/99)

Mr Peter Lindsay MP (from 7/3/00)

Ms Tanya Plibersek MP
(until 10/4/00)

The Hon Alex Somlyay MP

Mr Stuart St Clair MP

Mr Lindsay Tanner MP
(from 9/8/99)

Mr Kelvin Thomson MP
(from 10/4/00)

Membership of the Sectional Committee

Chair	Mr Bob Charles MP
Deputy Chair	Mr David Cox MP

Members	Mr Petro Georgiou MP	Senator the Hon Brian Gibson AM
	Ms Julia Gillard MP	Senator Andrew Murray
	Mr Peter Lindsay MP	
	Mr Alex Somlyay MP	
	Mr Lindsay Tanner MP	

Committee Secretariat

Secretary	Dr Margot Kerley
Inquiry staff	Ms Maureen Chan
	Mr Stephen Boyd
	Ms Jennifer Hughson
	Mr Ngan Thai
	Ms Maria Pappas
	Ms Nina Franklin

Duties of the Committee

The Joint Committee of Public Accounts and Audit is a statutory committee of the Australian Parliament, established by the *Public Accounts and Audit Committee Act 1951.*

Section 8(1) of the Act describes the Committee's duties as being:

(a) to examine the accounts of the receipts and expenditure of the Commonwealth, including the financial statements given to the Auditor-General under subsections 49(1) and 55(2) of the *Financial Management and Accountability Act 1997*;

(b) to examine the financial affairs of authorities of the Commonwealth to which this Act applies and of inter-governmental bodies to which this Act applies;

(c) to examine all reports of the Auditor-General (including reports of the results of performance audits) that are tabled in each House of the Parliament;

(d) to report to both Houses of the Parliament, with any comment it thinks fit, on any items or matters in those accounts, statements and reports, or any circumstances connected with them, that the Committee thinks should be drawn to the attention of the Parliament;

(e) to report to both Houses of the Parliament any alteration that the Committee thinks desirable in:
(i) the form of the public accounts or in the method of keeping them;or
(ii) the mode of receipt, control, issue or payment of public moneys;

(f) to inquire into any question connected with the public accounts which is referred to the Committee by either House of the Parliament, and to report to that House on that question;

(g)   to consider:
    (i)   the operations of the Audit Office;
    (ii)   the resources of the Audit Office, including funding, staff and information technology;
    (iii) reports of the Independent Auditor on operations of the Audit Office;

(h)   to report to both Houses of the Parliament on any matter arising out of the Committee's consideration of the matters listed in paragraph (g), or on any other matter relating to the Auditor-General's functions and powers, that the Committee considers should be drawn to the attention of the Parliament;

(i)   to report to both Houses of the Parliament on the performance of the Audit Office at any time;

(j)   to consider draft estimates for the Audit Office submitted under section 53 of the *Auditor-General Act 1997*;

(k)   to consider the level of fees determined by the Auditor-General under subsection 14(1) of the *Auditor-General Act 1997*;

(l)   to make recommendations to both Houses of Parliament, and to the Minister who administers the *Auditor-General Act 1997*, on draft estimates referred to in paragraph (j);

(m)   to determine the audit priorities of the Parliament and to advise the Auditor-General of those priorities;

(n)   to determine the audit priorities of the Parliament for audits of the Audit Office and to advise the Independent Auditor of those priorities; and

(o)   any other duties given to the Committee by this Act, by any other law or by Joint Standing Orders approved by both Houses of the Parliament.

List of abbreviations

AAS17   Australian Accounting Standard 17

ADF   Australian Defence Force

ADI   Australian Defence Industries Ltd

AEC   Australian Electoral Commission

AEW&C   Airborne Early Warning and Control

AFFA   Department of Agriculture, Fisheries and Forestry – Australia

ANAO   Australian National Audit Office

AQIS   Australian Quarantine and Inspection Services

ATO   Australian Taxation Office

C⁴ISREW   Command, control, communications, computers, intelligence, surveillance, reconnaissance, and electronic warfare

CEO   Chief Executive Officer

DCIC   Defence Capability Investment Committee

DCISC   Defence Capability Investment Sub-Committee

DETYA   Department of Education, Training and Youth Affairs

DIE   Defence Information Environment

DIEC   Defence Information Environment Committee

DMO	Defence Materiel Organisation
DoFA	Department of Finance and Administration
EA	Evolutionary Acquisition
EN	Employment National
EXDOC	Electronic Export Documentation System
IT	Information Technology
JCPAA	Joint Committee of Public Accounts and Audit
JORN	Jindalee Operational Radar Network
OASITO	Office of Asset Sales and IT Outsourcing
OGIT	Office of Government Information Technology
RAN	Royal Australian Navy
SDSS	Standard Defence Supply System
SPMM	Standard Project Management Method
TGA	Therapeutic Goods Administration

List of recommendations

Audit Report No.8, *Amphibious Transport Ship Project*

Recommendation 1 [paragraph 2.47]

The Committee recommends that the Department of Defence put in place appropriate reporting structures to ensure that all internal audits are reviewed by the Defence Audit Committee and provided to relevant internal stakeholders in a timely fashion.

Audit Report No.10, *AQIS Cost-Recovery Systems*

Recommendation 2 [paragraph 4.37]

The Committee recommends that the Australian Quarantine and Inspection Service (AQIS) improve risk management in its fee-setting activities with the aim of significantly reducing over-recoveries.

Recommendation 3 [paragraph 4.54]

The Committee recommends that the Australian Quarantine and Inspection Service implement the Australian National Audit Office's recommendation No. 6 of Audit Report No. 10, 2000-2001, namely that the Australian Quarantine and Inspection Service align fees charged to particular clients with the costs associated with servicing those clients where it is cost-effective to do so. Where this is not feasible, the reasons should be made transparent to relevant stakeholders and kept under review.

Recommendation 4 [paragraph 4.64]

The Committee recommends that the Australian Quarantine and Inspection Service conduct a thorough cost-benefit analysis of the non-meat EXDOC system project.

Audit Report No. 11, *Knowledge System Equipment Acquisition Projects in Defence*

Recommendation 5 [paragraph 5.67]

The Committee recommends that the Australian National Audit Office conduct a follow-up audit into Defence's strategies for recruiting, developing and retaining skilled IT personnel.

1

Introduction

1.1   One of the statutory duties of the Joint Committee on Public Accounts and Audit (JCPAA) is to examine all reports of the Auditor-General in terms of the significance of the program or issues raised; the significance of the findings; the arguments advanced by the audited agencies; and the nature of public interest in the report. The Committee is then required to report the results of its deliberations to both Houses of Parliament as it sees fit.

1.2   Upon consideration of the eleven audit reports presented to the Parliament by the Auditor-General during the first quarter of 2000–2001, the JCPAA selected four reports for further scrutiny at a public hearing. The public hearings were conducted in Canberra on Friday, 2 March 2001.

1.3   The reports selected were:

- **Audit Report No.8,** *Amphibious Transport Ship Project,* Department of Defence;

- **Audit Report No.9,** *Implementation of Whole-of-Government Technology and Infrastructure Consolidation and Outsourcing Initiative*;

- **Audit Report No.10,** *AQIS Cost-Recovery Systems,* Australian Quarantine and Inspection Service; and

- **Audit Report No. 11,** *Knowledge System Equipment Acquisition Projects in Defence,* Department of Defence.

Structure of the Report

1.4   This report draws attention to the main issues raised at the public hearings. Where appropriate, the Committee has commented on unresolved or contentious issues.

1.5   Chapter 2 of the report discusses the evidence taken in relation to Audit Report No.8, *Amphibious Transport Ship Project,* and examines the accountability issues of purchasing two decommissioned US ships.

1.6   Chapter 3 of the report addresses issues raised in relation to Audit Report No.9, *Implementation of Whole-of-Government Technology and Infrastructure Consolidation and Outsourcing Initiative.*

1.7   Chapter 4 of the report discusses the evidence taken relating to Audit Report No.10, *AQIS Cost-Recovery Systems* on the efficiency and effectiveness of the management of AQIS's cost-recovery systems, and whether the cost-recoverable programs are identifying and recovering the full costs of services provided, without cross-subsidisation.

1.8   Chapter 5 of the report discusses the evidence taken relating to Audit Report No. 11, *Knowledge System Equipment Acquisition Projects in Defence,* on the role played by the recently appointed Chief Knowledge Officer and on the ability of Defence to ensure that it can centralised management to preserve system integrity and maximise synergies in its development of its knowledge edge.

1.9   In addition, the report provides an outline of the conduct of the Committee's review (Appendix A). The report should be read in conjunction with the transcript of evidence collected at the public hearing (Appendix C).

Report

1.10   A copy of this report is available on the JCPAA website at *http://www.aph.gov.au/house/committee/ jpaa/reports.htm*

2

Audit Report No. 8, 2000-2001

Amphibious Transport Ship Project

Department of Defence

Introduction

2.1   In 1993, Defence proposed that the then Government acquire a new ship for $494 million to support amphibious operations and provide at-sea training to Navy personnel. The Government rejected the proposal as too costly but gave permission for Defence to investigate less expensive options.

2.2   In 1994, a Defence Inspection Team examined four ships the US Navy was about to decommission and recommended two ships for purchase. Defence purchased the two ships for $61 million in August 1994. They were then commissioned as HMAS *Manoora* and HMAS *Kanimbla*.

2.3   Since Defence acquired these two ships, there has been extensive maintenance work and numerous capability upgrades performed on *Manoora* and *Kanimbla*. Defence had originally expected the project would cost $125 million in total and take 14 months to complete. This has since increased to $395.1 million and may now take 44 months. The main items of expenditure are:

- $31.5 million for maintenance;
- $203.8 million for modification and refit; and

■ $35.2 million for increased capability.[1]

2.4   A decision to further increase the capability of the ships is planned
       for 2004–05. If the decision is made to proceed, it is expected to
       cost between $50m–$100 million. This will increase the total
       project cost to $445 million.

2.5   In February 2000 the then Minister for Defence issued a press
       release which was highly critical of the acquisition process. The
       Minister instructed the Defence Secretary to 'recommend to me
       improvements in the management of the Department to ensure
       the experience of the [*Manoora* and *Kanimbla*] is not repeated in
       current and future acquisition projects. The entire Department
       should learn from this unfortunate, costly experience.'[2]

2.6   It was soon after the issue of the Minister's press release that the
       ANAO decided to conduct a preliminary study which
       subsequently became a performance audit. The findings were
       recorded in Audit Report No. 8, *Amphibious Transport Ship Project*,
       tabled on 7 September 2000.

ANAO audit objectives and findings

2.7   The objective of the ANAO audit was to assess the efficiency and
       effectiveness of Defence's management of the acquisition and
       modification of the ships with the main focus being on the
       modification contract. The ANAO estimated the cost of
       conducting the audit was $149 000.[3]

2.8   The ANAO noted that in 1998 and 1999, Defence conducted two
       internal audits of the project. The 1998 report focused on the
       acquisition of the ships while the 1999 report commented on the
       modification and refit of the ships. Both reports raised issues of
       serious concern, highlighting a series of inadequacies and
       deficiencies. Neither of the reports was reviewed by Defence's
       Audit Committee.[4] Defence did not respond to its internal audit
       1998 report recommendations and only limited action was taken
       in response to the 1999 report's recommendations. The ANAO

---

1   ANAO, Report No. 8, 2000-2001, p. 11.
2   ANAO, Report No. 8, 2000-2001, p. 83.
3   ANAO, Report No. 8, 2000-2001, p. 24.
4   ANAO, Report No. 8, 2000-2001, p. 77.

believed that it 'would have been in Defence's interest had closer consideration been given to the reports and their recommendations'.[5]

2.9   Defence had originally envisaged that the project was to cost $125 million and take 14 months to complete. The ANAO reported that this has since increased to $395.1 million and may now take 44 months. While the primary reason for the cost increase and time delay was the unplanned additional repair and refit and an upgrade in capability, other factors included 'an underestimation in the complexity of the design phase, Defence delays in delivering Government Furnished Equipment and no provision for certain work in the original funding proposal'.[6]

2.10   The ANAO found Defence did not properly assess the condition of the ships before purchasing them. This led to greater than expected costs in repair and refit to bring them into service. Defence also had not previously developed detailed guidance on its capability requirements. The ANAO reported 'the capability development process has effectively occurred in reverse on this project, with detailed capability guidance being developed only after modification work on the ship had begun'.[7]

2.11   Navy used a 'firm price contract' for the repairs and refit of the two ships. The benefit of these types of contracts is that it places the risk of schedule delays and cost overruns with the contractor. However, Defence knew before it signed the contracts that there would be 'extensive growth work'.[8] Consequently, the changes and increasing scope of the contracts nullified the benefits of a fixed price contract.

2.12   The ANAO has identified eight major lessons to be learnt for Defence. These are:

- Major Defence capital acquisitions, especially 'opportunity buys', should only be made after military capability needs have been clearly defined, costed and budgeted.

- To avoid the need for additional funding during projects, a 'whole-of-capability' approach should be taken during the

---

5   ANAO, Report No. 8, 2000-2001, p. 78.
6   ANAO, Report No. 8, 2000-2001, p. 14.
7   ANAO, Report No. 8, 2000-2001, p. 14.
8   ANAO, Report No. 8, 2000-2001, p. 60.

capability development process, particularly for capabilities of a joint Service nature.

- Life-cycle costing analysis is important in the early stages of the capability development process by assisting in decisions on the most cost-effective capability option.

  ⇒ It is also important in the later stages, as it allows known costs to be refined and new costs to be identified and adequately budgeted.

- To provide adequate focus on management of major projects, new military capabilities should be funded from Defence's major capital equipment funds rather than from its repair and refit funds.

- The risks inherent in the purchase of a second-hand ship call for qualified and experienced personnel to make a detailed examination of its condition.

  ⇒ The examination requires sufficient time, full access to the ship and a dry dock examination of its hull.

- Prior to the placement of any additional work after contract signature, the work should be closely examined for its overall cost effectiveness and its likely impact on budget and schedule.

- Given the high design and production risks associated with ship modifications that include repair and refit, there needs to be adequate provision for contingencies (for both general and emergent work).

- A high-level risk assessment needs to be undertaken by experienced personnel at key stages of the capability development process and any significant risks identified should be appropriately treated and closely monitored.[9]

2.13   The ANAO made five recommendations aimed at improving the management of this and subsequent acquisition projects. The Department agreed to all recommendations, one with qualification.

---

9   ANAO, Report No. 8, 2000-2001, p. 18.

Committee Objectives

2.14 The ANAO audit report provided the Committee with an opportunity to review Defence's acquisition and modification on HMAS *Manoora* and HMAS *Kanimbla*. The Committee focused on:

- acquisition and maintenance of the ships;

- value for money considerations; and

- gaps in military capability.

Acquisition and maintenance

2.15 In 1994, a Defence Inspection Team surveyed four ships the US Navy were about to decommission and recommended two ships for purchase. The Defence Inspection Team of two Navy officers engaged a commercial surveyor from the US to assist them with the task.

2.16 The ANAO reported several problems with the pre-acquisition surveys. These included:

- Over-reliance on information provided by US Navy on the condition and maintenance history of the ships;

- Pressures on the Inspection Team because of the availability of surplus funds in 1993-94 and other countries' interest in acquiring US Navy ships;

- Inability to conduct closer examination of the ships' hulls and have access to key areas of the ship because the ships were still in US Navy service at the time of the survey; and

- Inability to conduct effective sea trials and test the ships because of equipment failure.[10]

2.17 The Committee heard that Defence discovered substantial problems after the purchase of the ships. In evidence to the Committee, Defence stated:

> Upon arrival in Australia, we understand these ships underwent considerable repair and refit work at ADI, survey work and preliminary modifications. Considerable

10 ANAO, Report No. 8, 2000-2001, p. 48.

emergent work was found as cladding was removed and
previous inaccessible spaces were opened up for survey,
revealing extensive areas of corrosion.[11]

2.18   In view of the problems with the acquisition and, in particular,
inadequacies with the ship survey, the Committee asked if any
disciplinary action against RAN personnel and against the
contractors had been undertaken. Defence indicated that the
survey team could not inspect about 80 per cent of the tanks as the
ships were in a fully operational state for the trials and handover.
Consequently, the major areas of corrosion repaired during the
modification period were mainly in the water areas and water
ballast tanks, 'with some also in decks and bulkheads that was not
exposed until the deck tiles and insulation had been removed'.[12]

2.19   In view of this, Defence concluded that no 'disciplinary action was
taken because the report, noting its caveats, was not sufficiently
inconsistent with the subsequent findings of surveys to warrant
consideration of legal action'.[13] Defence informed the Committee
that the two Australian naval officers involved in the original
survey team are no longer serving with the RAN or the
Department of Defence.[14]

2.20   Defence originally allowed $8.7 million for refits and repairs,
based on US experience of what they had been spending in their
typical refits for the ships for the last two refits. Actual
expenditure on the total repair of equipment and hull was
$142 million. The ANAO reported that Defence had to use funds
'set aside for the repair and refit of other RAN ships. Navy
acknowledges that this will have a detrimental, and as yet
unquantified, impact on the maintenance levels of the remainder
of the fleet and therefore its future reliability.'[15]

2.21   When questioned by the Committee on action Defence took after
discovering the problem, Defence stated that 'Navy used its ship
repair funding to effect [the] repairs'.[16] Furthermore, 'the deputy
chief started a series of roundtable gatherings. We brought many
of the internal Defence stakeholders, people who were involved in

11   C. Neumann, *Transcript*, 2 March 2000, p. 37.
12   Defence, Submission no. 8, p. 1.
13   Defence, Submission no. 8, p. 1.
14   Defence, Submission no. 8, p.2.
15   ANAO, Report No. 8 2000-2001, p. 47.
16   T. Ruting, *Transcript*, 2 March 2000, p. 37.

the activity, together to try to get a better understanding of what was the likely direction that this activity would proceed in.' [17]

2.22   Defence has acknowledged the shortcomings in the acquisition phase of the project and the blow-out in maintenance costs. Defence attributed these failures to a split of authority and a lack of coherent high level management of the project.

> Part of the problem was, we thought, because senior level oversight of the project outcomes was rather limited to functional areas of responsibility. A number of organisations were involved, which was a problem. It was organisation bases, so again people just did what they thought in their own particular areas. There were no higher level management arrangements enabling effective control and authority to be exercised.[18]

2.23   In evidence to the Committee, Defence gave assurances that it has taken several measures designed to prevent any re-occurrence of this problem.

> One of the critical reasons for this project going bad was that there were four different players in it. It is now clearly understood within the department that there will be one player and that will be the Defence Material Organisation. It will have both through life support and contact people working on the acquisition.[19]

2.24   Defence also acknowledged the need to have fully agreed functional requirements before proceeding with an acquisition and having adequate allowances for repair of older vessels.

2.25   In audit recommendation 1, the ANAO proposed that Defence undertake life-cycle costing analysis so that all costs associated with an operation are known and are budgeted for at an early stage. Defence agreed with this recommendation. In evidence to the Committee, Defence stated that it has 'started gathering that data for a more accurate life cycle cost assessment, and are fitting an asset management and planning information system on board the ships—for our routine operation of them—that will allow us to more accurately gather a lot of this information.'[20]

---

17   Ruting, *Transcript*, 2 March 2000, p. 38.
18   Neumann, *Transcript*, 2 March 2000, p. 38.
19   M Roche, *Transcript*, 2 March 2000, p. 45.
20   T Ruting, *Transcript*, 2 March 2000, p. 39.

Value for money

2.26   The ANAO reported that a value for money judgement would
        need to take into account a range of factors including:

- Time frame and cost required to acquire and modify *Manoora*
  and *Kanimbla* relative to those required to build a large new
  ship;

- Number of personnel required to crew *Manoora* and *Kanimbla*
  relative to that required of a large new ship;

- Operating costs of *Manoora* and *Kanimbla* compared with those
  of a newly built ship;

- Value placed upon the operational flexibility and reduced
  combat risk offered by two ships with equivalent capability
  compared to that of a single new ship; and

- Expected service-life from each of the options.[21]

2.27   The audit report concluded that any 'value-for-money advantage
        apparently provided by [*Manoora* and *Kanimbla*] over the
        acquisition of a new ship has been dissipated, or at least
        significantly eroded.'[22]

2.28   The Committee heard the difficulties inherent in trying to assess
        the relative advantages and disadvantages of building a new ship
        as opposed to acquiring the two older vessels. Defence claims that
        having two ships enhances Defence's capabilities because it is able
        to operate in two different locations at the same time. This has
        allowed Defence to increase its flexibility of operations.

> The reality is that since the decision was made to buy
> these things, the actual need has been to operate in two
> discrete operational areas. We had *Manoora* in the
> Solomons three times and we had to replace her with a
> frigate or *Tobruk* when she has not been there—neither of
> which is as capable—and, of course, we had the Timor
> exercise on the other side. The availability of two will, in
> fact, work out well.[23]

---

21   ANAO, Report No. 8, 2000-2001, p. 45.
22   ANAO, Report No. 8, 2000-2001, p. 45
23   Roche, *Transcript*, 2 March 2000, p. 48.

2.29   These advantages are modified by the life expectancy and maintenance cost of the vessels. The ANAO noted that Defence expects to retire *Manoora* and *Kanimbla* by 2015. During this time, a significant risk to the ADF is 'block obsolescence'. This is a term used to describe the 'problem arising from between 2005 and 2020 when a large proportion of ADF equipment becomes obsolete in terms of its inability to be maintained or its inability to match potential threats'.[24] Defence estimates that, in contrast, a new build would have lasted until 2030.[25]

2.30   Defence was asked if, after purchasing *Manoora* and *Kanimbla*, it had undertaken a cost benefit analysis against the option of purchasing a new ship. Defence's broad response was that instead of having a new ship for 30 years, Navy got two reconditioned ships for 15 years each. Defence stated:

> It was done at the time, a couple of years ago. The view was that at the current budget cost these vessels have come in at around half the cost of a new vessel and around half the life of a new vessel. We are budgeting on a 15-year life for them. They are in the white paper to be replaced in 2015. So the equation in terms of cost per ship years is fairly close to in balance. There will obviously be increased maintenance costs—and I think that is what the chairman is getting at as they get closer to the end of their life. We are going to have to keep a very close eye on that and make sure that we manage it very carefully.[26]

2.31   Defence expects that the maintenance cost will increase. *Manoora* and *Kanimbla* will be 44 years old when their service life expires in 2015. Defence stated that towards the end of the life of the ships the 'maintenance costs are going to provide us with a bit of a challenge because the cost of maintaining a 45-year-old ship is quite different from maintaining a two or three-year-old ship'.[27]

2.32   In conclusion, Defence conceded that, had it known the full costs of bringing *Manoora* and *Kanimbla* into service, it would probably not have purchased them. It admitted that 'if we actually knew the full costs of buying the two ships in the States, for whatever reasons, would we have actually done it? I think the answer is

---

24   ANAO, Report No. 8, 2000-2001, p. 45.

25   ANAO, Report No. 8, 2000-2001, p. 45.

26   Roche, *Transcript*, 2 March 2000, p. 40.

27   Roche, *Transcript*, 2 March 2000, p. 41.

probably not, given that a single new ship was actually cancelled on cost grounds.'[28]

2.33   The Committee noted the evidence from Defence and ANAO that after the repair and refit of *Manoora* and *Kanimbla*, the ships have proved capable and have added to Defence's flexibility. However, the management and administration of the project have been deficient in important respects. The failings and oversights of the project should form the basis of lessons learnt to prevent any future occurrences.

Gaps in military capability

2.34   Defence originally estimated it would take 14 months to bring *Manoora* and *Kanimbla* into service. Instead it took 44 months, exceeding the original estimate by two and a half years. Defence has had several large projects which it has failed to deliver on time and within budget. These include the Collins class submarines and the Jindalee Over-the-Horizon Radar Project (JORN). The Committee has concerns about the effects of these prolonged project delays on Australia's strategic and military capabilities.

2.35   The Committee sought Defence's response to ANAO findings that *Manoora's* capabilities do not fully meet those specified in the Joint Detailed Operational Requirement. The ANAO reported that:

> Key deficiencies relate to the strength of the forward deck and stern door (that is, the ability to move heavy vehicles over them); heating and cooling capacity of the ship; the ability to produce sufficient amounts of potable water and transfer it ashore; and handling and stowage of watercraft in certain sea states.[29]

2.36   Defence responded:

> The strength aspects are now being investigated using an external classification society to review these. We have certainly moved a number of relatively heavy cargoes on the forward deck and the stowage arrangements for watercraft have been clarified there. There are seven deficiencies overall against the joint detailed operational

28   Neumann, *Transcript*, 2 March 2000, p. 48.
29   ANAO, Report No.8, 2000-2001, p. 40.

> requirement. It was always recognised that that was the
> final capability we would aspire to. It has not been
> funded or approved necessarily to achieve all of that at
> the outset. In terms of the potable water situation we have
> upgraded the capacity of the plant in both of the ships.
> *Kanimbla*, being the second completed, has a more capable
> system, and we are now working on some improvements
> to *Manoora's* at this point in time.[30]

2.37   The Committee notes that phase 3 of the project involves
        additional capability upgrades. This phase is yet to be approved
        but a decision is planned in 2004–05. The expected cost of this
        phase is between $50 to $100 million.

2.38   In audit recommendation 4, the ANAO proposes that 'prior to
        commencement of Phase 3 of the project, Defence assess the
        design risks associated with this Phase and consider the costs and
        benefits of letting separate contracts for design and production'.[31]
        Defence gave qualified agreement to this recommendation. When
        questioned why, Defence responded:

> We believe that, while it is possible we may do it [split the
> contracts between design and production]—and we will
> certainly look at the possibility of independent design for
> this when we get to stage 3—at the end of the day we
> might elect to put the responsibly in one place.[32]

2.39   The ANAO responded it 'had no difficulty with the Defence
        response. It is important that they do assess the risk, but if the risk
        of putting them separately is too high then clearly they should go
        together.'[33]

2.40   Should a decision be made to proceed with Phase 3, it is important
        that Defence properly manages the process and delivers the ships
        on time and within budget. Given the experiences of the past and
        the associated blow-out in costs and delays in time, there should
        be fertile grounds for Defence to apply lessons learnt to ensure
        that Australia does not have gaps in its military capabilities.

2.41   While the Audit identified certain capability deficiencies, the
        Committee is also concerned about the aspect of 'capability creep'.

---

30   Ruting, *Transcript*, 2 March 2000, p. 41.

31   ANAO, Report No. 8, 2000-2001, p. 55.

32   Roche, *Transcript*, 2 March 2000, p. 42.

33   I. McPhee, *Transcript*, 2 March 2000, p. 42.

This refers to the approach by Defence to add more capabilities to the ships than was originally planned thus adding to the cost of the refit. For example, in the original specification only one ship was to be fitted with a hospital. Defence stated:

> …one ship was going to have the hospital and the other ship was going to have the crane as a way of really only spending as much money as was available at that time. However, the need for amphibious activities in the region has changed over time, and the relative priorities of that have warranted the government making decisions to install the capabilities on both ships. So we have now two ships with basically the same capabilities. It has considerably increased the flexibility of operations to government through having those two ships, plus HMAS *Tobruk* that has subsequently being retained, as identified in the Defence white paper.[34]

Conclusion

2.42   The effective management of asset acquisitions and Defence's ability to adequately assess all the costs involved in major modifications on existing assets are fundamental to Government decisions about Australia's future military and strategic capabilities. The involvement of significant amounts of public monies makes it especially important for Defence to be rigorous in identifying and addressing risks and be vigilant about possible time delays and cost overruns.

2.43   The ANAO has correctly focused on this matter by examining the historical context and the efficiency and effectiveness of Defence's management of the acquisition and modification of *Manoora* and *Kanimbla.*

2.44   The Committee finds that Defence should have been more rigorous in its pre-acquisition survey. The lack of a comprehensive survey of the ships has lead to a blow-out of 1632 per cent in repair and maintenance costs and delayed the project by two and a half years. This is an unacceptable margin of error.

2.45   Defence should have paid closer attention to its own internal audit reports in 1998 and 1999. The ANAO report stated:

---

34   Ruting, *Transcript*, 2 March 2000, p. 44.

> The Finance Minister's Orders made under the *Financial Management and Accountability Act 1997* require each Commonwealth agency's audit committee to review audit reports involving matters of concern to senior management and to provide advice to the Chief Executive on action to be taken on matters of concern in such reports. The two [internal audit] reports on the Project were not, however, reviewed by Defence's audit committee.[35]

2.46   In relation to 'capability creep', the Committee is not generally opposed to adding new capabilities provided the costs and benefits are fully considered. The danger, however, of upgrading reconditioned ships of limited life is over capitalisation. In these types of cases, there must be a more strategic approach to developing additional capabilities. It is essential that military needs are identified first, and then military capabilities are developed to meet those needs.

Recommendation 1

2.47   **The Committee recommends that the Department of Defence put in place appropriate reporting structures to ensure that all internal audits are reviewed by the Defence Audit Committee and provided to relevant internal stakeholders in a timely fashion.**

2.48   In terms of value for money, the Committee heard that having two ships has increased Australia's military flexibility. The benefit of this flexibility is negated by the extra maintenance costs and shorter life expectancy of the ships. Defence has acknowledged that the maintenance costs will be a challenge towards the end of the life of the ships. The Committee notes that the retirement of *Manoora* and *Kanimbla* coincides with a period of 'block obsolescence'. This will be a significant challenge for Defence to manage Australia's military capabilities during this period.

2.49   Finally, the Committee cautions Defence to learn from the *Manoora* and *Kanimbla* experience. The Minister for Defence and the ANAO have listed a range of lessons to be learnt which Defence cannot

---

35   ANAO, Report No. 8, 2000-2001, p. 77.

ignore. It is essential that all proposed acquisitions of ageing Defence capital defence equipment be assessed on the basis of a rigorous risk assessment, and a thorough cost benefit analysis. Project officers involved in capital acquisitions must be experienced, and knowledge of the history behind the purchase of *Manoora* and *Kanimbla* should be required.

3

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]

---

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.

---

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:

---

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.

4

Audit Report No. 10, 2000–2001

AQIS Cost Recovery Systems

Australian Quarantine and Inspection Service

Introduction

4.1   The Australian Quarantine and Inspection Service (AQIS) is part of the Department of Agriculture, Fisheries and Forestry—Australia (AFFA). It was established in October 1986 by amalgamation of the Animal and Plant Quarantine branches of the Australian Agricultural Health and Quarantine Service, the Export Inspection Service (both within the then Department of Primary Industry), and the general quarantine function of the then Department of Health.[1]

4.2   AQIS's primary role is to contribute to and administer Australia's quarantine, agriculture and food export laws. AQIS's core services are quarantine, inspection and export certification and food safety standards activities.[2]

4.3   AQIS and its predecessor bodies have provided a mix of cost-recovered and non-cost-recovered services through a range of programs delivered in Australia and overseas. AQIS managed

---

1   ANAO, Report No. 10, 1999-2000, AQIS Cost-Recovery Systems, 15 September 2000, p. 29.
2   ANAO, Report No. 10, 1999-2000, p. 29.

twelve cost-recovered programs during 1998-99. AQIS staff in recoverable programs numbered 1741 (or 85 per cent of all staff) in 1998-99.[3]

4.4   In 1998-99, AQIS's activities were funded through a combination of government appropriations for Community Service Obligations, and the fees and charges imposed on users.[4] Under various policy decisions, AQIS has been required to recover the costs for most of its activities from users, beginning with 50 per cent cost-recovery from 1979, 60 per cent from 1 July 1988 and 100 per cent cost-recovery for recoverable programs from 1 January 1991.

4.5   In *Audit Report No. 10, AQIS Cost-Recovery Systems*, an audit initiated at the request of this Committee, the Australian National Audit Office (ANAO) sought to assess the efficiency and effectiveness of the management of AQIS's cost-recovery systems and to provide assurance to the Parliament that the AQIS cost-recoverable programs were identifying and recovering the full costs of services provided, without cross-subsidisation.[5]

4.6   The ANAO concluded that overall, AQIS's cost-recovery systems were mature and stable and, with some exceptions, had delivered near cost-recovery for the AQIS recoverable programs. However, the audit found that AQIS's cost-recovery systems contained a number of inherent weaknesses that potentially impaired the efficiency and effectiveness of the management of those systems.

> [AQIS] is not able to sufficiently assure itself, or stakeholders, that the programs are identifying and recovering the full costs of each type of service provided, without not insubstantial cross-subsidisation for some services.[6]

4.7   The ANAO made six recommendations aimed at improving AQIS's cost-recovery documentation, cost identification, performance reporting and management of cross-subsidisation. AQIS agreed to five of the six recommendations and disagreed with one.[7]

---

3   ANAO, Report No. 10, 1999-2000, p. 30.
4   ANAO, Report No. 10, 1999-2000, p. 30.
5   ANAO, Report No. 10, 1999-2000, pp. 31, 37.
6   ANAO, Report No. 10, 1999-2000, p. 16.
7   ANAO, Report No. 10, 1999-2000, pp. 25-6.

4.8   At its hearing on 2 March 2001, the Committee took evidence from
        AQIS and the ANAO on the following issues:

- identifying and attributing costs;

- recovering costs;

- setting fees and charges;

- managing cross-subsidisation, and

- consulting with industry.

Identifying and attributing costs

4.9   An essential element of an effective cost-recovery system is to be
        able to identify readily and accurately the costs to be recovered.
        The ANAO found that AQIS identified its costs through a
        customised costing methodology that traced costs to programs
        rather than to the range of activities performed by the programs in
        delivering services:

> AQIS collects costing information at a cost centre level
> within programs, but does not have accurate information
> on the costs involved in performing each type of service
> within programs.[8]

4.10   The Committee sought from AQIS an explanation as to why it was
        resisting activity based costing to strengthen the accuracy of its
        calculated costs and provide enhanced information for
        management.[9]

4.11   AQIS replied that it had the cost measurement systems it
        considered necessary, and, though they might not be ideal, AQIS
        had reservations about moving towards 'very tight time charging
        processes'. However AQIS noted that the cost-effectiveness of
        introducing an alternate system is currently under review:

> We have asked KPMG to look for us at what the
> possibilities are for our moving down a more
> sophisticated time measurement system. They have
> recently done a similar exercise in Customs.[10]

---

8   ANAO, Report No. 10, 1999-2000, pp. 18-19, 46.

9   *Transcript*, 2 March 2001, p. 4.

10   Stanton, *Transcript*, 2 March 2001, p. 4; AQIS, Submission No.1, p. 5.

4.12   While AQIS agreed that it needed to increase the sophistication of its cost measurement systems, it wished to understand how it would be assisted by adopting a very fine level of activity-based costing:

> Certainly industry is very reluctant to make the system more complex. They say they do not need it, and they are very concerned to keep their charges low. They are concerned that it will add to their charges.[11]

4.13   The Committee expressed some doubt that the cost of implementing an accurate cost measuring system would outweigh the benefits derived from such a system:

> …those activities for which you undercharge might well exceed those for which you overcharge and would put you at great risk in the market place. [The Committee] just cannot imagine that you could exist as a private sector organisation with the way that you are measuring costs, or attempting to measure costs, at the moment.[12]

4.14   In reply, AQIS stated that it did have fairly comprehensive cost measuring procedures. It further stated that while at times fees were not matched up to costs, it was because industry had decided that they wanted a simple system that was uniform across Australia.[13]

4.15   The Committee made the point that what AQIS had agreed with industry was not the issue:

> The issue is whether or not you can accurately measure your costs and therefore manage your own business as well as apportion costs to industry for cost recovery accurately.[14]

4.16   The Committee sought information from the ANAO on the cost of developing and maintaining a sophisticated cost measurement system versus the potential benefits to be derived from such a system.[15]

---

11   Stanton, *Transcript*, 2 March 2001, p. 5.

12   *Transcript*, 2 March 2001, p. 5.

13   Macdonald, *Transcript*, 2 March 2001, p. 5.

14   *Transcript*, 2 March 2001, p. 6.

15   *Transcript*, 2 March 2001, p. 16.

4.17   In reply, the ANAO advised the Committee that the Therapeutic
        Goods Administration (TGA) charged fees for particular services
        and wanted to assess the value of refining their costing
        information:

> [The TGA] started off with a method by which they asked
> their staff to record how they spend their time against a
> set of predetermined activities for a set period of six to
> eight weeks. They did that on spreadsheets – a very low-
> cost approach to seeing what it provided them with and
> whether there were benefits in it. They have since moved
> to a commercially based off-the-shelf time recording
> costing system. I think that is a very sensible way to go,
> particularly if there are concerns or doubts in the
> organisation about the value of it.[16]

4.18   AQIS claimed during the hearing that the ANAO's assessment of
        its cost recovery systems in the current audit was inconsistent
        with its findings in the Audit Report No.21, 1998–1999, *The Costing
        of Services, Financial Control and Administration Audit.* However, the
        ANAO made the point that the two audits were quite different in
        focus. While the ANAO agreed that AQIS's performance on cost
        recovery at the program level was quite good, it noted that the
        issue in the current audit was the costing of the particular service
        or fee level.[17]

Committee comment

4.19   Cost recovery is a central part of AQIS's business. AQIS has been
        involved in cost recovery for over two decades and has been
        recovering 100 per cent of costs for the last 10 years.

4.20   The Committee notes AQIS's claim that it was still in a
        continuum—from no cost recovery to full cost recovery—and that
        considerable effort had been put in over the years.[18] However, it
        appears to the Committee that AQIS is taking a long time to reach
        an appropriate level of sophistication in its cost measurement
        processes.

4.21   While the Committee heard from AQIS that it considered it had
        gone as far as it could in assigning costs to each of the services that

---

16   McPhee, *Transcript*, 2 March 2001, p. 16.
17   AQIS, Submission No.1, pp. 3-4, McPhee, *Transcript*, 2 March 2001, p. 7.
18   *Transcript*, 2 March 2001, pp. 5, 7.

it delivered to industry,[19] the Committee agrees with the ANAO that it is not possible to assess with any confidence how well AQIS's fees and charges reflect the actual costs incurred.[20]

4.22   The Committee is concerned that AQIS has held a largely unsubstantiated view that a more sophisticated costing system would not be viable. However, it notes the comment from AQIS that to date, internal AQIS calculations and considerations on the viability of such a system may not have been disciplined enough in their approach.[21]

4.23   The Committee notes the example of the TGA and considers that there would be value in AQIS's trialing something similar. While the Committee does not want to increase industry costs, it considers it important for both management and equity reasons that AQIS explore what options and value there might be, in proceeding along the path suggested in the audit.

Recovering costs

4.24   AQIS has been required to recover from industry the full costs of its recoverable programs since 1 January 1991. In any system of full cost recovery, individual programs will generate revenue recovery that exceeds or falls short of the amount required to deliver services. Under-recoveries are expected by AQIS to be recouped through future revenue collection within the program. Over-recoveries are placed in reserve accounts.[22]

4.25   The audit report noted that the administrative costs involved in returning over-recovered funds through Revenue Rebates or Industry Initiatives and by using over-recoveries to offset previous under-recoveries can be significant and depend on the method used.

> These costs are borne by industry, but have not been quantified by AQIS. The cost of managing over-recoveries highlights the importance of AQIS regularly monitoring fee levels and promptly adjusting these where necessary,

19   Macdonald, *Transcript*, 2 March 2001, p. 5.
20   *Transcript*, 2 March 2001, p. 6.
21   Stanton, *Transcript*, 2 March 2001, p. 13.
22   ANAO, Report No. 10, 1999-2000, pp. 33, 62.

> to minimise the likelihood of program over-recoveries. There are also difficulties in ensuring that those clients who contributed to any surplus receive an equitable share of the proceeds.[23]

4.26   The ANAO noted that although AQIS has a policy that a maximum of 10 per cent of annual program expenditure can be held in an Income Equalisation Reserve account, there are no limits on the amount of funds that could be held in the Revenue Rebate and Industry Initiative accounts. The ANAO noted that for some industries, the total held in reserves was significant.

> … Revenue Rebate balances are often retained for a number of years rather than being paid out promptly by means of fee discount following over-recovery, which should be a matter of concern in a fully cost-recovered situation.[24]

4.27   The Committee noted that of the six programs that had revenue rebate balances at 30 June 1997, only grains had paid out rebates over the following two years. The Committee asked AQIS to comment on the timeliness and effectiveness of its over-recovery rebates.[25]

4.28   In reply, AQIS stated that the Revenue Rebate balance of about $2 million at the end of the audit had been reduced to $151,000.

> …a lot of work has been done on that since the audit. The amounts … are reasonably small. The largest amount is in the dairy program where there is $69,000, fish has $28,000 and international mail has $54,000.[26]

4.29   The Committee asked about over-recoveries in the animal quarantine stations program which at the time of the audit had accumulated funds totalling 46 per cent of the program's annual expenditure.[27]

4.30   AQIS stated that at the end of the financial year 1999–2000, the accumulated surplus was $360 000.

---

23   ANAO, Report No. 10, 1999-2000, p. 67.

24   ANAO, Report No. 10, 1999-2000, pp. 67, 69.

25   *Transcript*, 2 March 2001, p. 12.

26   Carlton, *Transcript*, 2 March 2001, p. 12.

27   *Transcript*, 2 March 2001, p. 12; ANAO, Report No. 10, 1999-2000, p. 72.

> The program is showing a surplus at the moment of an additional $82,000. The fees for the animal quarantine stations went to our business and financial committee just before Christmas. It was decided that, because the program has a possible major restructure which may take a fair bit of capital to fund, we should let that surplus deficit sit there at the moment to see more detail about what money is going to be required for any restructure.[28]

4.31   When asked by the Committee whether AQIS agreed that it could be more timely in making decisions about rebates, AQIS acknowledged that, at the time of the audit, there had been a lot of money sitting in the rebate account.

> One of the reasons was a bookkeeping problem in that one of the larger programs which had a lot of money had agreed for that money to be transferred into the income equalisation reserve. That had been agreed with industry but the accounting within AQIS had not caught up. Some of the [other programs' rebates] had been quite slow in going out. There has been a push since then to get the money out.[29]

4.32   The Committee drew attention to the sale of a financially troubled business, where a significant issue in the sale became the quantum of unpaid fees to AQIS. This had been allowed to accumulate over a period of years and had reached extraordinary levels.[30]

4.33   In response, AQIS's CEO indicated that she was considering how AQIS could move towards up-front fees to avoid getting into situations of debt recovery.

> As to debt recovery itself, which does happen from time to time, I am also looking at those processes because, to put it in a positive way, I think we can do better at drawing attention to debt early and not continuing to provide service which increases the debt.[31]

---

28   Carlton, *Transcript*, 2 March 2001, p. 12.
29   Carlton, *Transcript*, 2 March 2001, p. 12.
30   *Transcript*, 2 March 2001, p. 11.
31   Stanton, *Transcript*, 2 March 2001, p. 11.

Committee comment

4.34   AQIS notes in its submission that it has developed, in conjunction
         with industry, low cost arrangements to return to clients any
         funds recovered in excess of requirements. However, it is clear
         that Revenue Rebate balances have often been retained for a
         considerable time rather than being paid out promptly by means
         of fee discount following over-recovery.

4.35   In particular, the Committee notes the audit report conclusion that
         clients using the animal quarantine stations, mainly dog and cat
         importers, have paid fees well in excess of costs for a number of
         years.

4.36   AQIS has agreed to the audit recommendation to provide more
         information on the status of over-recovered funds in the annual
         Report to Clients. AQIS has also agreed to review more regularly its
         fees in relation to the costs incurred for the Animal Quarantine
         Stations program. However, it appears to the Committee that
         AQIS has been very slow to make improvements in this area. It
         needs to improve its risk management strategies and its fee setting
         policies so as to reduce over-recoveries.

Recommendation 2

4.37   **The Committee recommends that the Australian Quarantine and
         Inspection Service (AQIS) improve risk management in its fee-setting
         activities with the aim of significantly reducing over-recoveries.**

Setting fees and charges

4.38   About 90 per cent of AQIS's trading revenue is collected from
         fees-for-services. In the main, the remainder is collected from
         registration and quantity charges that are raised under taxing
         legislation.[32]

4.39   In most program areas, fees and charges are determined in
         consultation with relevant industry representatives, by taking into
         consideration existing fee and charge levels, the expected volume

---

32   ANAO, Report No. 10, 1999-2000, p. 75.

of chargeable transactions and expected costs for the forthcoming year.[33]

4.40   AQIS seeks to set fees-for-service at levels considered appropriate by AQIS and industry; they are not necessarily set with a view to match closely the cost of each type of service provided by a program. The cost of providing one service may be offset by revenue generated by another service within the same program.

> Accordingly, AQIS collects costing information on a program basis and by location (through a total of 430 cost centres). Consequently, it does not have readily available data at an activity level within many of its programs that would enable assessment of the alignment between AQIS' costs and the many different fees it imposes.[34]

4.41   The audit found that AQIS systems' provision of limited costing information below program level resulted in AQIS using estimates of its costs, often based on staff utilisation, to discuss and agree fees and charges with Industry Consultative Committees. [35]

4.42   The audit report stated that:

> …AQIS' systems provide limited assurance of the apportionment of the staffing costs for the 15 per cent of AQIS employees, and the majority of State/Territory employees working for AQIS, that share their time either across recoverable programs or between recoverable and non-recoverable programs. The ANAO therefore concludes that, as presently operating, AQIS' systems do not provide assurance of the apportionment of staffing costs to the recoverable programs, as the subjective staffing attributions are not supported by a satisfactory assurance mechanism which monitors the sensitivity of estimates against cost outcomes.[36]

4.43   AQIS stated at the hearing that it was committed to continued refinement and improvement of all its functions, including those related to setting and recovering fees within the cost recovery framework the government had set.[37]

---

33   ANAO, Report No. 10, 1999-2000, p. 77.
34   ANAO, Report No. 10, 1999-2000, p. 81.
35   ANAO, Report No. 10, 1999-2000, p. 42.
36   ANAO, Report No. 10, 1999-2000, p. 54.
37   Stanton, *Transcript*, 2 March 2001, p. 3.

4.44   AQIS's CEO acknowledged that AQIS needed to look in more detail at the 15 per cent of its staff working across different programs and across different groups.

> I have been in this position for four months and I certainly think there are changes to be made. I am not satisfied that we have a good enough system.[38]

4.45   The Committee sought information on AQIS's priorities for change and the expected timing of them.[39]

4.46   The AQIS CEO advised that her priorities were to look at those programs where she believed there was still improvement to be made.

> Horticulture has been a good example. That review is nearing completion now. We are hoping to have a new fee structure for horticulture in the near future which will be more transparent, more equitable and so on. The vision beyond that really is a matter of, once we believe that these programs are pretty much up to speed in terms of their basic costing information and so on, trying to work towards a simpler set of fees – which I do not for a minute believe means that you do not need more detailed information; you do. The more detailed the information, the better able you are to set a simpler fee structure in the end.[40]

Committee comment

4.47   The Committee notes that an independent client satisfaction survey conducted in early 1999 revealed that 69 per cent of AQIS's clients considered its charges were too high.[41] The audit report makes it clear that information at a detailed level is generally not available to see whether there is a good match between fees and costs. The Committee considers that AQIS needs to collect information at a more detailed level to better align fees and for the services it provides.

---

38   Stanton, *Transcript*, 2 March 2001, pp. 4, 11.
39   *Transcript*, 2 March 2001, p. 11.
40   Stanton, *Transcript*, 2 March 2001, p. 11.
41   ANAO, Report No. 10, 1999-2000, pp. 94-5.

Managing cross-subsidisation

4.48   Under full cost-recovery, revenue raised from fees and charges
        should offset fully the costs of service provision. Cross-
        subsidisation occurs when one group of users pays for more than
        the cost of the services they receive, and the surplus is used to
        offset the cost of services provided to other users (who pay less
        than the cost of the services they receive).[42]

4.49   AQIS noted at the hearing that it operated under the fundamental
        principle that there be no cross-subsidisation between industry
        groups (programs). AQIS maintains that cross-subsidisation
        within user groups is legitimate provided there is a rational basis
        for discrimination between users in the group.[43]

4.50   AQIS told the Committee that it seeks to operate on a system of
        nationally uniform fees and charges and that fees and charges set
        and collected should be consistent between locations. The audit
        concluded that there was minor cross-subsidisation between
        AQIS's programs, but that there was some cross-subsidisation
        between clients and between locations.

> The risk of cross-subsidisation is inevitably a matter of
> considerable interest to clients. Any suspicion of cross-
> subsidisation may undermine client perceptions of the
> fairness of the fees and charges. AQIS' practice of limited
> measurement of the costs of its services and not aligning
> its fees and charges with its costs at this level means that
> it is only able to provide limited assurance to clients
> regarding cross-subsidisation.[44]

4.51   The audit found that AQIS's approach to setting fees-for-service
        means that costs borne by individual clients are not necessarily the
        same as the cost to AQIS for providing the service.

> Misalignment between activity costs and revenue sources
> can result in inequitable fees and charges …[as]
> illustrated in the [June 1999] report of the Quarantine and
> Exports Advisory Council.[45]

---

42   ANAO, Report No. 10, 1999-2000, p. 84.
43   Stanton, *Transcript*, 2 March 2001, p. 2; AQIS, Submission No. 1, p. 21.
44   ANAO, Report No. 10, 1999-2000, p. 91.
45   ANAO, Report No. 10, 1999-2000, p. 81.

Committee comment

4.52   The Committee notes the Quarantine and Exports Advisory
        Council's Review and Evaluation of the AQIS Horticulture
        Exports program found that some clients were paying very high
        proportional costs associated with AQIS's fees and charges while
        others did not contribute at all to the program's cost. The
        Committee is also aware that AQIS has responded to the review.[46]

4.53   It is apparent to the Committee that more transparent costing
        information would assist AQIS to explain the basis for its fees and
        charges. Moreover, the Committee considers that until AQIS has a
        better knowledge of the costs associated with servicing its clients,
        it cannot consider management options such as the contracting
        out of some remote services.

Recommendation 3

4.54   **The Committee recommends that the Australian Quarantine and
        Inspection Service implement the Australian National Audit Office's
        recommendation No. 6 of Audit Report No. 10, 2000-2001, namely that
        the Australian Quarantine and Inspection Service align fees charged to
        particular clients with the costs associated with servicing those clients
        where it is cost-effective to do so. Where this is not feasible, the reasons
        should be made transparent to relevant stakeholders and kept under
        review.**

Consulting with industry

4.55   AQIS places considerable emphasis on developing and
        strengthening its relationship with its clients and has operated a
        client feedback program since 1994 that enables industry to report
        directly to senior management, with guaranteed confidentiality,
        about how AQIS performs its role. AQIS has also been surveying
        its fee-paying clients since 1995.[47]

---

46   ANAO, Report No. 10, 1999-2000, p. 129.
47   ANAO, Report No. 10, 1999-2000, p. 93.

4.56   AQIS now has industry consultative committees[48] for all but one of its recoverable programs and considers that it works in close collaboration with industry. All committees have had their terms of reference, scope and membership reviewed. Each committee now has representation from AQIS, the major client groups and industry peak bodies and is the principal advisory forum for policy, strategic issues, costs of the program and fees and charges.[49]

4.57   The ANAO concluded that the revised consultative mechanisms were generally appropriate.

> Overall, they appeared to be working well and provide a sound framework for the continuous improvement of open communications between AQIS and its clients.[50]

4.58   However, in reviewing the effectiveness of AQIS's consultation with its clients, the ANAO noted that a number of affected industries expressed some dissatisfaction with AQIS's handling of the introduction of the non-meat EXDOC system.[51]

Non-meat EXDOC

4.59   EXDOC is the AQIS Electronic Export Documentation System. It is designed to replace a number of manual transactions with electronic processing for documents and certificates. The system has been in place in the Meat Industry since 1992. In 1997, the decision was taken by AQIS to extend EXDOC to a number of non-meat programs, to commence by the end of 1998. The audit report noted that AQIS considers this initiative to be an important element in giving effect to the Government's commitment to implementing electronic commerce initiatives.[52]

4.60   The ANAO noted some issues covering the management of the project and the adequacy of industry consultation, which have implications for cost-recovery.

---

48   Industry Consultative Committees have been established for all programs except Animal Quarantine Stations because there is no easily identifiable industry for this program.

49   ANAO, Report No. 10, 1999-2000, p. 95.

50   ANAO, Report No. 10, 1999-2000, p. 95.

51   ANAO, Report No. 10, 1999-2000, pp. 95-6.

52   ANAO, Report No. 10, 1999-2000, pp. 95-6.

> Estimates of the cost of the EXDOC non-meat development have escalated considerably from $0.75 million at initial planning in 1996, to $1.2 million in September 1997 and $4 million in January 1999. Some $2.7 million of this had been spent to 30 June 1999. There has been no cost-benefit study for the extension of EXDOC to non-meat industries since a report completed in December 1997. The report of the study did not clearly show the costs of developing, maintaining and operating the system over its intended life. The capital cost used in the calculations appears to be $1.2 million. The report showed (for an undefined 12–month period only), negative net benefits to industry of $0.3 million, offset by projected benefits to AQIS of $0.68 million. It is not clear whether industry was informed of the findings of the report at the time. Given the increase in the capital cost of the project since then, the costs would now appear to outweigh considerably the benefits.[53]

Committee comment

4.61   The Committee notes that the Industry Consultative Committee minutes record concerns raised by industry about the huge increase in costs of the non-meat EXDOC project without consultation by AQIS. One industry representative was quoted as saying that the redevelopment was an 'extreme embarrassment' and that it was not a partnership, but a costly program that had been imposed on industry.[54]

4.62   The Committee notes ANAO's comment that even at this stage in the non-meat EXDOC system project, the conduct of a thorough cost-benefit analysis would be beneficial, to provide full transparency and accountability to industry.[55]

4.63   The Committee is aware that EXDOC costs are major recovery costs for industry. The Committee is particularly concerned about ANAO's statement about EXDOC that 'the costs now appear to outweigh considerably the benefits' and makes the following recommendation:

---

53   ANAO, Report No. 10, 1999-2000, p. 96.
54   ANAO, Report No. 10, 1999-2000, p. 96.
55   ANAO, Report No. 10, 1999-2000, p. 97.

Recommendation 4

4.64   **The Committee recommends that the Australian Quarantine and
         Inspection Service conduct a thorough cost-benefit analysis of the non-
         meat EXDOC system project.**

5

Knowledge System Equipment Acquisition Projects in Defence

Department of Defence

Introduction

Background

5.1   Defence's military and administrative information systems combine to form the Defence Information Environment (DIE) and are known as knowledge systems. Australian Defence Force (ADF) command and control depend on a wide range of information and administrative system technologies to assist the analysis of requirements, allocation of resources, integration of effort, management of logistics and coordination, and monitoring of ADF behaviour. Defence's total knowledge system consists of a vast 'system of systems'. It is necessarily decentralised across all Defence outputs but it needs centralised management to preserve system integrity and maximise synergies.

5.2   Effective use of information is vital to Australia's defence capacity. The Government's national defence policy identifies the highest capability development priority as 'the knowledge edge' so Australia may use its relatively small force to maximum effectiveness. The knowledge edge depends on effective

exploitation of intelligence and surveillance capabilities, communications, information warfare, command and headquarters systems, logistic and business applications, as well as on command and control structures and decision processes.[1]

5.3   On 1 July 2000, Defence appointed a Chief Knowledge Officer to manage the Defence information environment in a holistic approach to knowledge edge development.[2] However, many knowledge system elements now in service were selected prior to this appointment, on the basis of individual functionality and not on the basis of their architectural compliance with the broader system of systems.

> There is little information collated centrally about these systems because, for decades, Defence's various functional groups decided on, and funded, their administrative systems to suit their own purposes.…Defence records indicate there are some 150 different systems in the logistics organisations alone.[3]

5.4   Defence is pursuing the knowledge edge by investing extensively in knowledge system acquisition projects. Approved and planned projects that will have a substantial impact on the DIE have a total estimated value of almost $8.5 billion.[4] Under the Defence Capacity Plan, the Government anticipates it will spend about $1.3 billion per year on the maintenance of its information capabilities.[5] While the Chief Knowledge Officer is not the sponsor of all these new projects, nevertheless Defence now requires that every new project is examined by the Defence Capability Investment Committee, of which he is a member.[6]

Scope of audit

5.5   In Audit Report No. 11, 2000–2001, *Knowledge System Equipment Acquisition Projects in Defence,* the audit objective was:

---

1   Department of Defence, *Defence 2000—Our Future Defence Force*, Commonwealth of Australia, October 2000, pp. 55, 94-95.

2   Defence, Submission no. 3, p. 1.

3   ANAO, Report No. 11, 2000–2001, *Knowledge System Equipment Acquisition Projects in Defence,* 15 September 2000, p. 25.

4   ANAO, Report No. 11, 2000–2001, p. 13.

5   Dept of Defence, *Defence 2000*, p. 97.

6   P Nicholson, *Transcript*, 2 March 2001, p. 23.

- to assess Defence's arrangements for higher-level management of its knowledge system projects and their coherence with Defence's other knowledge systems; and

- to provide a degree of assurance about its ongoing capacity for efficient and cost-effective management in this area.

5.6   The focus of the audit was on Defence's strategic-level management of equipment acquisition projects which relate to the development of Defence's knowledge edge and its ability to adopt a much more coherent and integrated approach to knowledge systems management prospectively rather than just emphasising current system compatibility issues.[7]

Audit findings

5.7   ANAO found that Defence's new arrangements for a Chief Knowledge Officer, supported by revised governance and accountability arrangements, is establishing the processes needed for effective program management of the $4.5 billion in knowledge system projects that he sponsors. The Chief Knowledge Officer thus becomes Defence's chief representative on knowledge system development matters in terms of setting direction and ensuring proper progress is achieved. The Vice Chief of the Defence Force and the former C[4]ISREW [8] organisation form part of an Owner Support Executive, which 'support the governance role, and are focused on Government and its role of owner of the enterprise rather than as a customer'.[9]

5.8   The situation is much less clear for the many other projects, estimated to cost some $4 billion, that will contribute to, or depend on, the DIE. ANAO believes that existing processes are not sufficiently robust to allow the Chief Knowledge Officer to scrutinise all relevant projects and, where appropriate, to challenge a perceived lack of coherency between projects and the DIE.[10] Institutional, organisational and procedural difficulties in Defence remain and these need to be overcome if Defence is to achieve total integration and smooth communication.

---

7   ANAO, Report No. 11, 2000–2001, pp. 25–26.

8   **C[4]ISREW** stands for 'command, control, communications, computers, intelligence, surveillance, reconnaissance, and electronic warfare'. ANAO, Report No. 11, 2000-2001, p. 24.

9   ANAO, Report No. 11, 2000-2001, p. 31.

10   ANAO, Report No. 11, 2000–2001, p. 46.

5.9   ANAO maintained that from an information coherency
        perspective, Defence's business systems are the area of greatest
        concern to the Chief Knowledge Officer. Business and other
        administrative systems assist in financial, personnel, logistics and
        information management functions. Defence uses some 150
        different logistics systems and many personnel and administrative
        information management systems. Business processes allow
        managers to acquire information systems to satisfy their
        individual functional requirements. As a consequence, the degree
        of commonality and ability to exchange information between
        these systems are limited.[11]

5.10   Defence is adopting a Standard Project Management Method
        (SPMM) for some 200 major equipment acquisition projects.
        However, progress to date indicates that not all acquisition
        projects have been converted to SPMM yet. Moreover, there
        appear to be problems in achieving effective application of the
        SPMM.[12] ANAO concluded that some action may be warranted
        not only to ensure that SPMM in Defence does not come in too
        many variations, but also to remove any confusion about the role
        of SPMM and any associated Project Boards, Integrated Product
        Teams, Integrated Acquisition Teams and Integrated Project
        Teams.[13]

5.11   The military and civilian workforce that supports the DIE is
        spread across a wide range of projects and endeavours. Shortages
        of skills in one area are addressed by denying essential skills to
        another. The DIE is therefore vulnerable to shortages in staff with
        the appropriate skills and experience. Statistics indicate that the
        three Services encounter difficulties in recruiting and retaining the
        skilled personnel needed to support the DIE.[14]

5.12   ANAO made seven recommendations designed to address these
        issues. Defence agreed to all the recommendations except
        Recommendation 7, which it accepted with qualification.
        Recommendation 7 focused on a holistic approach to the training
        and professional development of DIE staff, following a formal
        workforce planning and assessment.   The Secretary of the

---

11   ANAO, Report No. 11, 2000–2001, p. 48.
12   As at April 2000, for example, there were 64 acquisition projects subject to the SPMM
     but only two of these were assessed as controlling their projects well using the
     SPMM. ANAO, Report No. 11, 2000–2001, p. 52.
13   ANAO, Report No. 11, 2000–2001, p. 53
14   ANAO, Report No. 11, 2000–2001, p. 55.

Department has indicated that aspects of the audit report would serve as action statements in this area for Defence.[15]

5.13   The Committee examined the following issues at its public hearing on Friday 2 March 2001:

- Defence's Knowledge Systems;
- The Role of the Chief Knowledge Officer
  ⇒ Included projects
  ⇒ Excluded projects
  ⇒ Defence Capability Investment Committee
- Integration Authority
- Standardised Project Management Method (SPMM);
  ⇒ New acquisition methods;
- DIE staffing profiles.

Defence's Knowledge Systems

5.14   At the public hearing, Defence acknowledged that considerable data, potentially useful to various groups in the organisation, was already collected. It is aware that its data needs to be developed and shared in a coherent and integrated manner with all organisational areas with legitimate needs for the data.[16] This need for better coherency between information systems is particularly so in respect of data in Defence's various administrative systems. Much of that data is collected at considerable cost but accessible only by personnel with detailed knowledge of, and experience with, a particular system and application.[17] As ANAO emphasised in its report:

> …each of the three Services has specialised electronic warfare systems that relate to specific platforms and weapons systems, but often do not account for the increasingly joint nature of military operations. Defence has recognised this by initiating a force-level electronic-warfare project, known as Project Bunyip, as a first step to

---

15   Defence, Submission no. 3, p. 4.
16   Nicholson, *Transcript*, 2 March 2001, p. 21.
17   ANAO, Report No. 11, 2000–2001, p. 29; Nicholson, *Transcript*, 2 March 2001, p. 22.

overcoming the segmentation and limited inter-
operability of current capabilities in this area.[18]

5.15   Defence said that the biggest problems with information
integration and cohesion relate to its administrative programs:

> Because they have been developed in a stovepipe to fulfil
> a particular function. For example, there is a system
> called ROMAN, which is designed for a financial system
> but not designed to exchange information necessarily
> with the personnel system, which is called PMKEYS. So a
> lot of our work at the moment is to in fact enable that to
> take place. Each of these projects was conceived to fulfil
> the information requirements of a particular business
> process, say personnel.[19]

5.16   The main problem is the inability of specific functional areas to
transmit information from one area to another—such as from the
financial system to the personnel system or the logistics support
system. One of the first integration moves under the new
architecture will be the changes being made to the personnel
system so that its chart of accounts can interact with the financial
system's.[20]

5.17   This inability to communicate electronically became most obvious
during the East Timor deployment. Defence told the Committee
that:

> The magnitude of the problems were that many of those
> sorts of things could not be tracked electronically in the
> way they would be tracked in barracks electronically. We
> are working to actually provide that sort of information
> for deployed forces through a concept which we are
> calling the Defence management support environment.[21]

5.18   Defence went on to say that the consequences of not being able to
track the information were 'inefficiency, more than anything else'.

> It took longer to do things. There were no show-stopping
> operational aspects in those failures, because there were
> manual systems in place, and we put in place interim

---

18   ANAO, Report No. 11, 2000-2001, p. 42.
19   Nicholson, *Transcript*, 2 March 2001, p. 22.
20   Nicholson, *Transcript*, 2 March 2001, p. 27.
21   Nicholson, *Transcript*, 2 March 2001, pp. 20–21.

> electronic systems for the operations. But we recognised that this should be a standing part of our business.[22]

5.19 In effect, Defence patched together an intranet so that commanders could track personnel movements, produce deployment planning sheets and track logistics. However, as Defence told ANAO, 'even where the systems were physically compatible, substantial work would be required before the information could usefully be shared'.[23] ANAO concluded that the East Timor experience confirmed the need for the Chief Knowledge Officer to scrutinise Defence's business and other administrative systems and assess their coherency with the DIE.[24]

5.20 As the Chief Knowledge Officer confirmed:

> The main problem is coherency between those systems— in particular, not being able to exchange information between the systems. We are working to overcome that now by, in the first place, recognising that administrative systems, which we have in the past have considered to be non-operational, are in fact integral to our operations, and that is this concept of the Defence management support environment. The second way to do that is to put in place a very rigorous governance mechanism to make sure that all projects that come under this administrative rubric are in fact examined for their coherency within the environment.[25]

5.21 While the Committee agrees, it cautions that improved coherency between information systems and projects should not be an end in itself. The main outcome should be the enhanced ability of front-line personnel, under central military command, to apply military force with precision and in a timely manner under a wide range of possible circumstances.

---

22 Nicholson, *Transcript*, 2 March 2001, p. 21.
23 ANAO, Report No. 11, 2000-2001, p. 48.
24 ANAO, Report No. 11, 2000-2001, p. 49.
25 Nicholson, *Transcript*, 2 March 2001, p. 21.

The Role of the Chief Knowledge Officer

5.22   Projects sponsored[26] by the Chief Knowledge Officer are under
         'fairly tight control' through the specified requirements that need
         to be met.[27] The sponsorship ensures that technical decisions
         which may affect the DIE's integrity and coherence are addressed
         in the wider context of the knowledge edge. As explained by
         ANAO in its report:

> The new arrangements will help make clear that, during
> acquisition, the Chief Knowledge Officer is the customer
> for projects that he sponsors.   When acquisition is
> complete, responsibility for management of the products
> accepted into service will pass [from the Chief Knowledge
> Officer] to the Output Executives. It will also help to
> reduce the hiatus associated with moving a project from
> proposal to acquisition and on into service.[28]

Included projects

5.23   An example of a sponsored project discussed at the public hearing
         was JORN. The Chief Knowledge Officer is sponsoring a project
         to put improved software into JORN after it is delivered. He
         maintains a watch on the JORN software until it is delivered to the
         system which the Chief of Air Force actually operates. During this
         period the Chief Knowledge Officer defines requirements such as:

> …the period of operations that we will need to be able to
> run the radar, the extent of the range of surveillance, the
> number of tracks that we might want to detect at any one
> time and, broadly, how we want to use the radar in terms
> of overall Defence capability. The Chief Knowledge
> Officer decides that through the investment analysis
> processes that we have. When they are agreed, those
> requirements are handed to [the Electronic Systems
> Division] in the case of JORN.[29]

5.24   The Electronic Systems Division is accountable for delivering a
         JORN system which is consistent with the requirements set by the

---

26   These are listed in Appendix 1, ANAO, Report No. 11, 2000-2001, p. 61.
27   R McNally, *Transcript*, 2 March 2001, pp. 23, 29.
28   ANAO, Report No. 11, 2000-2001, p. 50.
29   S McKinnie, *Transcript*, 2 March 2001, p. 29.

> Chief Knowledge Officer who is kept informed about any areas
> where software may not be able to meet capability. Depending on
> the extent of the problem, the Chief Knowledge Officer will decide
> what is acceptable. If it is a major capability issue, it will be
> referred to the Defence Capability Investment Committee for
> consideration of acceptability and a decision on the type of action
> to be taken.[30]

Excluded projects

5.25   In contrast, Defence told the Committee that the Chief Knowledge
        Officer does not have any responsibility for the combat control
        systems on the Collins submarines—'primarily because that
        system is an integral part of the platform' and was in place before
        the Chief Knowledge Officer was appointed.[31]

5.26   When the Committee asked how the Collins submarines were
        going to interact with the rest of the knowledge system in
        Defence, Defence responded:

> As far as its ability to communicate outside to the Defence
> information environment is concerned, it has a
> communications suite which was specified to be able to
> interface with various parts.…That was not designed to a
> communications architecture, which is the way we are
> now doing business; it was designed the way the sponsor
> thought he would operate the submarine at the time of
> specification.[32]

5.27   Among other large approved major projects which impact on the
        DIE but which are not sponsored by the Chief Knowledge Officer
        are the Airborne Early Warning and Control (AEW&C) project
        (AIR 5077)—whereby four AEW&C aircrafts will be acquired,
        with a further three later in the decade—and the Rotary Wing for
        Land Force project (AIR 87)—whereby two squadrons (20-24
        armed reconnaissance helicopters) are planned to be operational
        from 2004–5.[33]

5.28   ANAO indicated that, in addition, minor capital projects that cost
        less than $20m each or that do not have identified implications for

---

30 McKinnie, *Transcript*, 2 March 2001, p. 29.
31 Nicholson, *Transcript*, 2 March 2001, pp. 29, 30.
32 Nicholson, *Transcript*, 2 March 2001, p. 30.
33 ANAO, Report No. 11, 2000-2001, p. 61; Defence, Defence 2000, pp. 82, 86.

Defence policy or for the joint Services are also excluded from the sponsorship of the Chief Knowledge Officer. Most of these projects are initiated by the three Services yet each Owner Support Executive does not have a detailed watch over the relevant projects. Many technical decisions taken in these projects can have serious impact on the DIE integrity and coherence—if not immediately then perhaps later on. As ANAO commented: 'Cutting corners on DIE coherence is a temptation to project managers under time and cost pressures and must be avoided through adequate managerial control'.[34]

Defence Capability Investment Committee

5.29   In effect, the Chief Knowledge Officer is only 'the guardian of the environment'[35] since he does not sponsor all Defence projects and he does not own any systems.[36] Instead, the Defence Capability Investment Committee, chaired by the Vice Chief of Defence Force, tries to ensure that new projects outside the Chief Knowledge Officer's sponsorship are compatible, meet the same criteria that are needed for knowledge systems, and accord with the DIE architecture. The highest level compatibility is virtually complete. The next architectural levels are now being developed.[37]

5.30   The Defence Capability Investment Committee has two sub-committees—the Defence Capability Investment Sub-Committee (DCISC) which looks at capability systems and the Defence Information Environment Committee (DIEC) which looks at knowledge systems.[38] Should any conflicts arise, then the DIEC is the forum for achieving resolution. The DIEC applies a checklist—which is still in the draft stage—to detail how all projects are to be scrutinised so that they accord with the DIE architecture and support communication cohesion.[39]

---

34   ANAO, Report No. 11, 2000-2001, p. 51.
35   ANAO, Report No. 11, 2000-2001, p. 46.
36   Nicholson, *Transcript*, 2 March 2001, p. 31.
37   Nicholson, *Transcript*, 2 March 2001, p. 24.
38   Nicholson, *Transcript*, 2 March 2001, p. 23.
39   Nicholson, *Transcript*, 2 March 2001, pp. 23–24.

Committee comments

5.31   The Committee expressed its concern about the ability of Defence's information systems to interface across all its Service sectors so that all high level officers are able to access the same information when needed. While the Committee acknowledges that one logistics program was able to communicate successfully with other Defence information systems, the JCPAA was aware of many other programs than did not. Given Defence is in an acquisitions environment as a result of the *Defence 2000* white paper and as a result of a series of Government announcements following the white paper, the Committee questioned the degree of confidence with which, at the end of those acquisitions, Defence would have the maximum possible inter-operability, given the historic problems accompanying the development of inter-operability to date.

5.32   Defence acknowledged that the logistic support system—Standard Defence Supply System (SDSS)—is successful because it is operating at a relatively low level.[40] It agreed that difficulties arise when 'the control that we are trying to get on those sorts of stovepipe systems is at a higher level to make sure that the finance can talk.'[41]

> When it [SDSS] is used for its purely functional purposes for logistic support of a submarine when no-one outside that system needs to know that sort of detail, then we do not get involved. In fact, the principle that we use is that the business process owner is responsible for that. There is some level at which he must exchange information with other systems, and that is when we become involved. That is what the architecture is all about.[42]

5.33   Defence informed the Committee that communication across all three arms of Defence down to a reasonable level—the sub-unit level—has now been achieved and fundamental blockages have been removed. Wider bandwidth has facilitated the smooth dissemination of information across Australia. As technology improves, communication and information dissemination will improve.[43]

---

40   Nicholson, *Transcript*, 2 March 2001, p. 30.
41   Nicholson, *Transcript*, 2 March 2001, p. 30.
42   Nicholson, *Transcript*, 2 March 2001, p. 30.
43   Nicholson, *Transcript*, 2 March 2001, pp. 24–26.

5.34   Defence emphasised that the information architecture ensures that new acquisitions will be able to interact to a high degree 'in a combat effective way' with other Defence information systems, since 'every project passes through one of these two sub–committees' or the main committee. No project will proceed unless it actually satisfies specific checkpoints or 'unless there is compelling argument for it not to reach it'.[44]

5.35   The Committee urges Defence to finalise its specific project architectural checklists as soon as possible so that these can be disseminated across all sectors and the Services, and become part of the negotiation requirements in any new project. The Committee furthermore urges Defence to educate its staff so that they become aware of the importance of the Defence Knowledge Improvement Plan as a detailed guide for enhancing the Defence information environment.

Integration Authority

5.36   Formulating and adopting strategies and plans to manage all Defence knowledge edge issues in a coherent and integrated way is a challenging task. ANAO described in Appendix 3 of its report, the difficulties experienced by the UK, USA and Canada.[45] It concluded that the UK, USA and Canadian defence organisations have responded to difficulties in achieving coherent and integrated information systems:

> …by establishing a group responsible for knowledge system policy and development; and by establishing business processes that focus on managing operational, systems and technical elements. The aim is to allow systems related to the knowledge edge to evolve and be updated as coherently as practicable.[46]

5.37   The UK Ministry of Defence recently addressed the need for formal management of integration issues during acquisition by establishing an Integration Authority in its Defence Procurement Agency. The Integration Authority's purpose is to maintain technical visibility of all relevant projects under procurement and

---

44   Nicholson, *Transcript*, 2 March 2001, p. 33.
45   ANAO, Report No. 11, 2000-2001, pp. 64–68.
46   ANAO, Report No. 11, 2000-2001, p. 68.

to bring to the Ministry's attention any developments that could adversely affect information coherency. The ANAO sees merit in Defence adopting the UK Integration Authority (Defence Procurement Authority) arrangement to work closely with the Chief Knowledge Officer.[47]

5.38   In its submission, Defence maintained that since the UK Integration Authority was still evolving, it should be monitored rather than just adopted.

> Defence has not yet formed a view that organisational change is required to achieve the integration function.…Any lessons learned [from the UK Integration Authority] will be fully considered.[48]

5.39   At the public hearing, Defence explained that it has 'started looking in more detail at how the Integration Authority in the UK is operating, and we are currently trying to come to grips with how that is working'.[49]

> Our initial understanding is that the Integration Authority is in part working as a small organisation but is also using integrated project teams—IPTs—types of arrangements, processes and tools as part of the mechanisms that they are developing. The use of integrated product teams in the UK Procurement Agency is one of the principles that underpins how they are approaching the acquisition of new systems.[50]

5.40   In the meantime, the Defence Materiel Organisation (DMO) has already established several positions with an integration function focussed on providing materiel support during project definition and development.[51]

> …we are looking at our role with the Defence Information Systems Group…at what processes of governance we need to have in place that will ensure that the architectures being defined by [the Chief Knowledge Officer] are going to be implemented. What we are suggesting there is that it is highly likely that we may

---

47   ANAO, Report No. 11, 2000-2001, p. 51.
48   Defence, Submission no. 3, p. 3.
49   McKinnie, *Transcript*, 2 March 2001, p. 31.
50   McKinnie, *Transcript*, 2 March 2001, p. 31.
51   Defence, Submission no. 3, p. 3.

actually have a solution which is a combination of organisational restructurings, but we are hoping that we might be able to capture that as we are going through the current DMO establishment processes as well as tools to assist people in implementing the architectures as they are defined.[52]

5.41   When questioned further by the Committee on the ability of the various systems used in Defence to interact smoothly with each other, Defence replied that 'the biggest push we had in relation to pushing the knowledge edge as a capability, and building integrated command and control systems, integrated surveillance systems and integrated intelligence systems', occurred in 1997, following the Defence White Paper.[53] A total of 177 personnel had been trained for the Integrated Acquisition Teams.[54]

5.42   The Committee still has strong reservations that integration and total interaction were always being taken into account when Defence was planning or negotiating new projects. This had implications for 'through–life support costs', already a costly item for projects such as JORN and the Collins submarines. Defence stated that it was looking at 'a number of cost estimating models and trialing the use of some of those models from the US and other sources' to see if they will provide more accurate whole-of–life costs.[55] Defence maintained that the new architecture together with specific checkpoints for all projects will help ensure that integration and interaction are being considered.[56]

Standardised Project Management Method

5.43   A standard project management method—effectively and consistently applied—provides an important foundation for good program management. It can establish for each project in a portfolio of projects, a specified set of concepts and project management processes that becomes the minimum requirements for a properly run and managed project. ANAO stated that the

52   McKinnie, *Transcript*, 2 March 2001, p. 31.
53   T McKenna, *Transcript*, 2 March 2001, p. 32.
54   ANAO, Report No. 11, 2000-2001, p. 75.
55   McKinnie, *Transcript*, 2 March 2001, p. 32.
56   Nicholson, *Transcript*, 2 March 2001, p. 33.

most significant business process in Defence is its Standard Project Management Method (SPMM) based on the UK Central Computer and Telecommunications Agency's system and its approach to program management.[57] The Defence Materiel Organisation (DMO) is providing training in its SPMM for Defence personnel engaged in major acquisition projects. At the time of the audit, 603 staff members had been trained but this was less than 50 per cent of the total staff involved.[58]

5.44 The Knowledge Staff and the DMO are establishing the major organisational structures and business processes needed to interface with program management. It is endeavouring to convert all 200 or so major acquisition projects to SPMM. However, ANAO reported that 'as at April 2000 there were 64 acquisition projects subject to the SPMM but only two of these were assessed as controlling their projects well using the SPMM.'[59]

5.45 Defence informed the Committee that:

> As of November 2000, there were 105 Major Capital Equipment acquisition projects in the DMO subject to the Project Management Methodology (PMM). The ongoing evaluation of the effectiveness of the PMM has revealed monitoring and control to be a major weakness in the PMM implementation. In particular, PMM Project Boards have been identified as being inadequate in their governance and assurance roles and are being reviewed.[60]

5.46 The Committee noted ANAO's comment that:

> …further action appears desirable to not only ensure that SPMM in Defence is not applied in too many variations, but also to remove any confusion about the role of SPMM and any associated Project Boards, Integrated Product Teams, Integrated Acquisition Teams and Integrated Project Teams.[61]

5.47 The Committee endorsed ANAO's recommendation 'that Defence carefully monitor its adoption of the Standard Project Management Method (SPMM) to ensure that core and essential

---

57 ANAO, Report No. 11, 2000-2001, p. 52.
58 ANAO, Report No. 11, 2000-2001, pp. 53, 75.
59 ANAO, Report No. 11, 2000-2001, p. 52.
60 Defence, Submission no. 9, p. 1.
61 ANAO, Report No. 11, 2000-2001, p. 53.

elements have a high degree of consistency across Defence.'[62] The Committee further noted that Defence agreed with this recommendation and is reviewing the effectiveness of its project management methodology while progressively implementing improvements in its applications.[63]

5.48   Defence assured the Committee that new arrangements for SPMM Project Boards to provide governance functions along with new operating arrangements should be established by June 2001. Other improvements to processes, systems and training were being identified and progressively implemented.[64] While the Committee accepts that progress is being made, it reiterates its belief that there should be a high degree of consistency in project management across Defence. This can only result if Defence trains its staff to a high degree of efficiency and effectiveness.

New acquisition methods

5.49   In this technological age, the timeliness in the incorporation of new systems affects the capabilities and effectiveness of Defence's knowledge capabilities. Defence has often experienced long delays in its acquisition of projects, many of which involved long time-scales in their development. The result was that 'systems are often fielded with obsolete equipment; require expensive upgrades shortly after delivery; and are delivered late because time was spent implementing requirements that changed during the course of the project.'[65]

5.50   Defence has adopted the Evolutionary Acquisition (EA) strategy to try to overcome these disadvantages. Evolutionary Acquisition (EA) is defined as:

>   The incremental specification, design, implementation, testing, delivery, operation and maintenance of systems. The delivery of each incremental release increases the overall capability of the system until it is complete. In this way users of the system get early access to functionality and are encouraged to provide feedback on functionality and performance. The feedback is used in

---

62   ANAO, Report No. 11, 2000-2001, p. 54.
63   Defence, Submission no. 3, p. 3.
64   Defence, Submission no. 9, p. 1.
65   ANAO, Report No. 11, 2000-2001, p. 54.

> subsequent increments to shape the development of the
> system as it evolves to its final form.[66]

5.51   However, ANAO reported that there was widely held view
among Defence staff that EA guidance was poorly developed and
therefore its full potential was not being realised. Acquisition staff
had limited experience in EA and were 'still evolving' the means
for separating EA costs from in-service upgrades.[67]

5.52   In its submission, Defence agreed with ANAO's recommendations
and added:

> The Defence Materiel Organisation is developing greater
> experience in Evolutionary Acquisition and will continue
> to learn. This experience will be used to assess the
> appropriateness of Evolutionary Acquisition methods for
> acquisition of new systems at the time of procurement
> approval.[68]

DIE staffing profile

5.53   In the *Defence 2000* white paper, the Government stated that one of
its major projected outcome is for:

> …the establishment of a single collocated Theatre
> Headquarters, and the development of two deployable
> headquarters to provide on the spot command for two
> deployed forces simultaneously; a single integrated
> command support system linking all ADF elements; and
> an integrated personnel, logistics and financial system
> based on e-business principles.[69]

5.54   However, Defence encounters difficulties in recruiting and
retaining the highly-skilled personnel needed to support the
Defence Information Environment (DIE) in the civilian, single
Service or in the joint domains. The military and civilian
workforce that supports DIE is spread across a wide range of
projects and endeavours. The competitive employment market for
IT specialists, and intelligence specialists, policy officers and

---

66   ANAO, Report No. 11, 2000-2001, pp. 84–85.
67   ANAO, Report No. 11, 2000-2001, pp. 54–55.
68   Defence, Submission no. 3, p. 3.
69   Defence, *Defence 2000*, pp. 96–97.

project staff, means that many Defence employees are enticed to jobs in the wider community.[70] As described by ANAO:

> In practice, it has been necessary to address shortages of skills in one area by denying essential skills to another. Defence's information environment is vulnerable to shortages in staff with the appropriate skills and experience.[71]

5.55   ANAO recognises Defence's difficulties in this area but considers that, in view of the substantial risks to knowledge projects and the importance of maintaining the DIE at a high level of capability, there is a need for more formal and holistic planning and management of the DIE workforce.[72] ANAO recommended that:

> … Defence undertake formal workforce planning and management assessments of the Defence Information Environment workforce to ensure that training, postings, career prospects and professional development are carefully planned and that a holistic view, at least in a strategic sense, is taken in relation to these matters.[73]

5.56   In its submission, Defence indicated that the Chief Knowledge Officer, with other stakeholders, commenced a scoping study into the education and training of staff in February 2001, with a reporting date of June 2001. Defence also maintained that 'the degree to which centralised control is required is unclear'.[74] Any action should await this report.

5.57   At the public hearing, Defence said that its major problem was retaining staff rather than recruiting them, although that aspect is a problem as well.[75] This is why it hoped its scoping study will help in identifying 'the magnitude of the problem and ways to fix it'.[76]

> …for the first time we will be looking at all those sorts of people as a whole rather than separately in their own streams, as they have been in the past.[77]

---

70   ANAO, Report No. 11, 2000-2001, p. 55.
71   ANAO, Report No. 11, 2000-2001, p. 55.
72   ANAO, Report No. 11, 2000-2001, p. 56.
73   ANAO, Report No. 11, 2000-2001, p. 56.
74   Defence, Submission no. 3, p. 3.
75   Nicholson, *Transcript*, 2 March 2001, p. 34.
76   Nicholson, *Transcript*, 2 March 2001, p. 33.
77   Nicholson, *Transcript*, 2 March 2001, p. 33.

5.58   Menawhile, the Chief Knowledge Officer is developing a 'Defence Knowledge Improvement Plan' as a detailed guide for enhancement of the Defence Information Environment over the next ten years.[78]

5.59   Defence went on to explain that while some degree of central supervision is necessary in the knowledge area, it intends in the first instance:

> …to focus on what are the issues and, in particular, what are the common competencies across all the different areas that are needed to see whether, for instance, we want to do some common training in those areas.[79]

5.60   The Committee agrees that information gathered from the scoping exercise is an important first step in the organisation of Defence's information capabilities supporting the defence of Australia. The appointment of the Chief Knowledge Officer and the establishment and acknowledgment of the importance of the knowledge edge provide a clear focal point across the whole Defence portfolio.

5.61   However, in order to achieve its goal, Defence has to change its existing culture so that a holistic approach can be achieved. Management of knowledge system projects in Defence is a complex and demanding task. Integrated training is essential if this change is to be implemented successfully. Acknowledging this fact, Defence told the Committee:

> …as we post, say, a Navy person out of Navy into the Defence Information Systems Group, while he or she is in the Defence Information Systems Group he or she may need some additional training so they are ready to go back to the Navy on their next posting, and we need to make sure that all of those sorts of mechanisms are coordinated properly. It is still very early days, but we really did want to approach it with a pretty open mind.[80]

5.62   Furthermore, the Committee was assured by Defence that it does not underestimate the challenges of developing its knowledge edge. Defence argued it was demonstrating its awareness and commitment since:

---

78   Defence, Submission no. 3, p. 4.
79   McKenna, *Transcript*, 2 March 2001, p. 33.
80   McKenna, *Transcript*, 2 March 2001, pp.33–34.

a.   it has a plan for coherent development of all elements of its information environment,

b.   it is putting in place the governance, architecture and compliance mechanisms to oversee this development,

c.   it is continuing to improve its approach to the 'knowledge edge' through a substantial research effort and better acquisition procedures, and

d.   it is starting to understand the people issues associated with knowledge improvement and managing the Defence Information Environment, as part of the high priority that Defence as a whole will be putting into personnel in 2001.[81]

Committee comments

5.63   Having considered the evidence available, the Committee believes that the Chief Knowledge Officer and his staff are embarking on ground-breaking work. The Chief Knowledge Officer requires clear lines of responsibility and accountability—commensurate with his program management responsibility—to be established. The Committee expects that the corporate governance and accountability changes announced in June 2000 will provide this support, in spite of the number of acquisition projects which will not be sponsored by the Chief Knowledge Officer.

5.64   The existence of the Defence Capability Investment Committee and the requirement that all projects be assessed in terms of their contribution to the knowledge edge will hopefully ensure that all tasks critical to knowledge system development, such as the even application of a standardised project management method and improvement in acquisition methods, be monitored carefully by those responsible. The Committee is mindful that many knowledge system elements now in service were originally selected on the basis of individual functionality and not on the basis of their architectural compliance with the broader system of systems.

5.65   Building a knowledge system based on a coherent architectural framework is necessarily long-term and challenging, given the

81   Defence, Submission no. 3, p. 4.

rapid advances in technology, ADF's wide-ranging tasks and Defence's evolving organisational relationships and business processes. ANAO has reported that the Chief Knowledge Officer and his staff have made a creditable start on developing some foundation management concepts and processes necessary to monitor and control knowledge system program risks. However, ANAO concluded that:

> The Chief Knowledge Officer and his staff have much to do to bring the Defence information environment under adequate managerial control.[82]

5.66   The major concern the Committee has about Defence's ability to develop a knowledge edge which has adequate coherence, centres on Defence's ability to recruit, develop and retain skilled individuals needed in all parts of the Defence information environment. The Committee believes it appropriate that ANAO conduct a follow-up audit after June 2001, when Defence's scoping exercise is completed and Defence will have developed strategies to assist its recruitment, development and retention of skilled personnel.

Recommendation 5

5.67   **The Committee recommends that the Australian National Audit Office conduct a follow-up audit into Defence's strategies for recruiting, developing and retaining skilled IT personnel.**

Bob Charles MP
Chairman
27 June 2001

---

82   ANAO, Report No. 11, 2000-2001, p. 57.

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.

David Cox
Julia Gillard
30 July 2001

A

Appendix A — Conduct of the Committee's review

Selection of audit reports

The Auditor-General presented eleven reports in the first quarter of 2000-2001. These were:

❑ Audit Report No. 1 Performance Audit

Commonwealth Assistance to the Agrifood Industry

❑ Audit Report No. 2 Performance Audit

Drug Evaluation by the Therapeutic Goods Administration - Follow-up Audit

❑ Audit Report No. 3 Performance Audit

Environmental Management of Commonwealth Land - Follow-up Audit

❑ Audit Report No. 4 Audit Activity Report

Audit Activity Report: January to June 2000

Summary of Outcomes

❑ Audit Report No. 5 Performance Audit

Fraud Control Arrangements in the Department of Industry, Science and Resources

❑ Audit Report No. 6 Performance Audit

Fraud Control Arrangements in the Department of Health and Aged Care

❑ Audit Report No. 7 Performance Audit

The Australian Taxation Office's Use of AUSTRAC Data

❑ Audit Report No. 8 Performance Audit

Amphibious Transport Ship Project

❑ Audit Report No. 9 Performance Audit

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

❑ Audit Report No. 10 Performance Audit

AQIS Cost-Recovery Systems

❑ Audit Report No. 11 Performance Audit

Knowledge System Equipment Acquisition Projects in Defence

The Joint Committee of Public Accounts and Audit discussed the above audit reports and considered whether the issues and findings in the reports warranted further examination at a public hearing. In making this assessment the Committee considered, in relation to each audit report:

- The significance of the program or issues canvassed in the audit report;
- The significance of the audit findings;
- The response of the audited agencies, as detailed in each audit report, and
- The extent of any public interest in the audit report.

Following this consideration, the Committee decided to take evidence at public hearings on the following audit reports:

❑ Audit Report No.8, *Amphibious Transport Ship Project*;

❑ Audit Report No.9, *Implementation of Whole-of-Government Technology and Infrastructure Consolidation and Outsourcing Initiative*;

❑ Audit Report No.10, *AQIS Cost-Recovery Systems;* and

❑ Audit Report No. 11, *Knowledge System Equipment Acquisition Projects in Defence.*

The evidence

The Committee held public hearings in Canberra on 2 March 2001. The transcript of evidence taken at the hearings is reproduced at Appendix C.

B

Appendix B — Submissions and Exhibits

Submissions

No.	Individual/Organisation
1.	Australian Quarantine and Inspection Service (AQIS)
2.	Department of Defence
3.	Department of Defence
4.	Department of Immigration and Multicultural Affairs
5.	Department of Finance and Administration (DOFA)
6.	Australian Apple & Pear Growers Association Ltd
7.	Office of Asset Sales and IT Outsourcing (OASITO)
8.	Department of Defence
9.	Department of Defence

Exhibits

1. Department of Defence
   Inspector-General's Report to the Minister for Defence on Project JP 2027 - Amphibious Transport Ships (LPAs)

2. Department of Defence
   Costs of Alternative Procurement Options

C
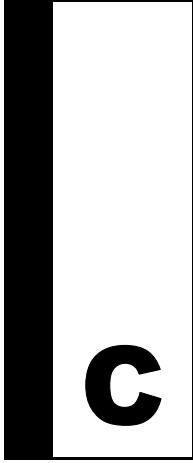
Appendix C — Transcript of evidence