

## Introduction

### Background

- 1.1 On 1 March 2006, the Joint Committee of Public Accounts and Audit (JCPAA) resolved to conduct an inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation. Full terms of reference are at page *xiii*.
- 1.2 This inquiry arose primarily from the Committee's statutory obligation to examine all reports of the Auditor-General.
- 1.3 In Audit Report No. 21, 2004-05, entitled *Audits of Financial Statements of Australian Government Entities for the Period Ended 30 June 2004*, tabled in January 2005, the Australian National Audit Office (ANAO) identified a series of significant 'audit scope limitations'<sup>1</sup> on key financial systems within Defence. These limitations resulted in the ANAO expressing an inability to form an opinion on the Department of Defence's financial statements for the period 2003-04. The ANAO had never before expressed an inability to form an opinion on a

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1 "Limitations on the scope of an audit arise when sufficient appropriate audit evidence does not exist to support a reported balance." See ANAO Audit Report No. 21, 2005-06 *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2005*, p 95.

government entity's financial statements.<sup>2</sup> The then Secretary of Defence, was also unable to attest that the financial statements for that period were 'true-and-fair'.<sup>3</sup>

- 1.4 In the following year (2004-05), again, the Secretary of Defence and Acting Chief Finance Officer could not attest that the overall financial statements were true and fairly stated and the ANAO again expressed a qualification as an inability to form an opinion.<sup>4</sup>
- 1.5 These qualifications follow a history of significant internal control issues which cast doubt on the accuracy of Defence's financial statements.<sup>5</sup>
- 1.6 In its Report 404, *Review of Auditor-General's Reports 2003-04 Third and Fourth Quarters; and First and Second Quarters of 2004-05*, the JCPAA commented that it would monitor the Department's progress in improving its financial status. The Committee also foreshadowed that this monitoring may include a more detailed Committee inquiry on Defence financial management.<sup>6</sup>
- 1.7 In addition to monitoring Defence's financial management, the ANAO, through its performance audits, has identified a series of matters impacting on the efficient and effective delivery of defence capability requirements.
- 1.8 The ANAO has conducted a large number of performance audits into Defence-related matters. The following performance audits were of particular interest to the Committee:
  - Audit Report No. 5, 2004-05, *Management of the Standard Defence Supply System Upgrade*;
  - Audit Report No. 45, 2004-05, *Management of the Selected Defence System Program Offices*;

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2 Joint Committee of Public Accounts and Audit, *Report 404 Review of Auditor-General's Reports 2003-2004 Third & Fourth Quarters; and First and Second Quarters of 2004-2005*, p 142.

3 Australian National Audit Office, Audit Report No. 21, 2004-05, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June, 2004*, p 101.

4 Australian National Audit Office, Audit Report No. 21, 2005-06, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June, 2005*, p 95.

5 Senate Foreign Affairs, Defence and Trade Committee, *Annual reports (No. 1 of 2007)*, p 8.

6 Joint Committee of Public Accounts and Audit, *Report 404 Review of Auditor-General's Reports 2003-2004 Third & Fourth Quarters; and First and Second Quarters of 2004-2005*, p 166.

- Audit Report No. 36, 2005-06, *Management of the Tiger Armed Reconnaissance Helicopter Project-Air 87*;
- Audit Report No. 10, 2006-07, *Management of the Standard Defence Supply System Remediation Programme*; and
- Audit Report No. 11, 2007-08, *Management of the FFG Capability Upgrade*.

1.9 The quote from the ANAO below summarises the issues that have typically, though not universally, been associated with Defence acquisition projects:

...outcomes have not always been as positive as expected. Recent performance audits into acquisition projects have identified significant weaknesses in project planning, including risk identification and management, as well as project costing issues. Some projects have suffered cost overruns or had scope limitations imposed for budget management reasons, and have experienced delays in implementation. Poor contract management practices have also resulted in inadequate identification and management of contractor delivery problems. Audits also identified a need to strengthen overall project monitoring and record keeping.<sup>7</sup>

## Previous reviews

- 1.10 This is not the first time management of Defence equipment acquisition has come under scrutiny. In March 2003, the Senate Foreign Affairs, Defence and Trade References Committee tabled a report entitled *Material acquisition and management in Defence*.
- 1.11 This Senate inquiry was conducted in light of a history of troubled acquisition projects across the Defence portfolio and at a time of structural reform within Defence that included the creation of the Defence Materiel Organisation (DMO).<sup>8</sup>
- 1.12 The Senate Committee published a number of findings and recommendations and set benchmarks against which to assess further performance of the DMO. Of particular relevance to the JCPAA were

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<sup>7</sup> Australian National Audit Office, sub 3, p 4.

<sup>8</sup> Senate Foreign Affairs, Defence and Trade References Committee, *Material acquisition and management in Defence* (2003), p xix.

two recommendations directed to the Auditor-General. The first requesting the Auditor-General to conduct a cultural audit (i.e., an audit of the existing culture to identify strategies for cultural change) of the DMO.<sup>9</sup> The second requested the Auditor-General to produce an annual report on progress in major defence projects to improve visibility to the Parliament.<sup>10</sup>

- 1.13 In December 2002, the Government initiated a separate review of Defence procurement. The aim of this review, the *Defence Procurement Review* (also known as the 'Kinnaird Review') was to review the problems associated with major Defence acquisition projects and to identify further improvements that could be made across the whole defence capability management process. The report of the Kinnaird Review was published in August 2003.<sup>11</sup> The Kinnaird Review is discussed in more detail in Chapter 3 of this report.

## Programs of reform

### Financial remediation

- 1.14 Since 2003, the Department of Defence has directed significant resources to a comprehensive financial remediation program to reform Defence financial management.
- 1.15 The financial remediation program consists broadly of 16 remediation plans to address the adverse audit findings of the ANAO. These plans included the establishment of a Financial Controls Framework to standardise and document the way Defence meets its financial obligations and an extensive up-skilling/training regime for Defence personnel. Defence also developed a series of technical papers to maximise the likelihood that the Auditor-General would be able to form an opinion on the 2005-06 financial statements and to address the issues raised in the adoption of the Australian Equivalents to International Financial Reporting Standards (AEIFRS).

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9 Senate Foreign Affairs, Defence and Trade References Committee, *Material acquisition and management in Defence* (2003), p 51.

10 Senate Foreign Affairs, Defence and Trade References Committee, *Material acquisition and management in Defence* (2003), p 79.

11 Department of Prime Minister and Cabinet (2003), *Defence Procurement Review 2003*.

- 1.16 The financial remediation program is examined in more detail in Chapter 2 of this report.

## Kinnaird reforms

- 1.17 The Government announced in September 2003 that it had broadly accepted the findings of the Kinnaird Review.<sup>12</sup>
- 1.18 Key reforms, outlined in the Defence submission, include the following:
- the establishment of Capability Development Group to strengthen the capability and assessment process;
  - a strengthened 'two pass' process for new acquisitions;
  - the establishment of costing centres in Defence and the Department of Finance and Administration to provide a quality assurance role;
  - the establishment of the DMO as a prescribed agency;
  - the establishment of a high-level advisory board;
  - consideration of the remuneration and tenure of appropriately skilled project managers; and
  - extending the role of Project Governance Boards to advise CEO DMO on through-life support issues.<sup>13</sup>
- 1.19 According to Defence's Portfolio Budget Statements for the year 2007-08, implementation of the Kinnaird Review recommendations is 85 per cent complete.<sup>14</sup>
- 1.20 However, the following quote from an industry representative illustrates an important point:
- ...organisational and administrative changes recommended by the Kinnaird Review have largely been put in place. What is not yet clear is whether the associated cultural and behavioural changes are proceeding apace. It is the latter changes that ultimately will determine whether the process overall produces better outcomes.<sup>15</sup>

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12 Department of Defence, sub 4, p 83.

13 Department of Defence, sub 4, pp 83-84.

14 Department of Defence, *Portfolio Budget Statements 2007-08*, p 206.

15 Raytheon Australia Pty Ltd, sub 5, p 8.

## Purpose of inquiry

- 1.21 It is five years since the commencement of the financial remediation program, the release of the Kinnaird Review recommendations and the Senate Foreign Affairs, Defence and Trade References Committee report into materiel acquisition and management in Defence.
- 1.22 While there has been some ongoing monitoring of Defence's remediation program and the Kinnaird reforms, the purpose of this inquiry was to take a more comprehensive look at the progress and key achievements in implementing the financial remediation activities and Kinnaird reforms.

## Further developments

- 1.23 Since the commencement of this inquiry there has been a change of Government which has been accompanied by a number of announcements related to the management of the Department of Defence. These announcements include the development of a new White Paper which will provide a long-term plan for the whole Australian Defence enterprise and a series of White Paper Companion Reviews.<sup>16</sup>
- 1.24 On 7 May 2008, the Hon Greg Combet MP, Parliamentary Secretary for Defence Procurement, also announced a review of Defence procurement and sustainment.
- 1.25 The Committee welcomes these developments.

## Structure of report

- 1.26 The report is comprised of five chapters. Chapters 2 and 3 document the progress made since the implementation of the financial remediation program and the Kinnaird reforms respectively and outlines the current status of those reform agendas. Chapter 4 outlines two case studies examined by the Committee and highlights the key concerns of the Committee. Chapter 5 provides an outline of the Major Projects Report.

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16 See Department of Defence, *Portfolio Budget Statements 2008-09*, p 35 for further detail.

- 1.27 The Committee makes a number of findings on the basis of the evidence it received during the inquiry. These findings, together with a recommendation are set out in full at page *xvi*.

## **Conduct of inquiry**

- 1.28 The inquiry's terms of reference and an invitation for written submissions were advertised in the national press on 18 March 2006. The Committee also wrote to a number of organisations seeking submissions.
- 1.29 The inquiry received twenty submissions and fifteen exhibits. Lists of submissions and exhibits received can be found at Appendices A and B respectively.
- 1.30 The Committee held public hearings, in-camera hearings and private briefings in Canberra and in Perth. A list of the hearings can be found at Appendix C and a list of inspections at Appendix D.