

3rd April 2006

Submission to the Joint Standing Committee on Public Accounts and Audit.

Inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation.

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Inquiry Terms of Reference

The Joint Committee of Public Accounts and Audit shall inquire into and report on progress in implementing systematic reforms in the areas of financial reporting and equipment acquisition at the Department of Defence and the Defence Materiel Organisation (DMO), as identified in ANAO financial and performance audits, the Defence Procurement Review 2003 (the Kinnaird Review) and the Senate Foreign Affairs, Defence and Trade References Committee's 2003 Report on the Inquiry into Materiel Acquisition and Management in Defence, including the following:

- *Progress in implementing Defence's financial remediation plans, relative to international best practice in these areas, and recommend any further measures that can be adopted;*
- *Progress in implementing the Kinnaird Reforms, relative to international best practice in these areas, and recommend any further measures that can be adopted;*
- *Review Australia's relative achievements in procurement and financial reform relative to international best practice in these areas of defence administration; and*
- *Assess progress in Defence's adoption of international business accounting standards relative to international best practice in this area of defence administration.*

Opening Statement

I was employed as the Director for Specialist Military Equipment within the CFO Group of Defence during 2005. This exposure to Defence financial management highlighted significant concerns as a professional financial manager and as a taxpayer.

Defence has a significant responsibility to the Australian public in protecting them and their interests. However, they also have a responsibility to properly manage the funds they are entrusted with for this purpose. I do not want to understate the role they play. However, any dollar wasted in Defence is a dollar that cannot be used in other areas of government, such as health and education. Therefore Defence has an obligation to use taxpayer's funds efficiently and to obtain the maximum benefits from the funds employed.

The Federal and State Governments have a history of selling or contracting out organisations due to the difficulty in instilling commercial management practices and efficiencies within Government Organisations. This has also happened within certain areas of Defence, such as distribution and warehousing. However, it is not practical, or desirable, to sell off or contract out the defence of Australia. Therefore, the Government must find a way to instil these basic financial management principals in Defence or continue to waste considerable taxpayers' funds.

Defence should have financial controls above average, due its size, the value of assets employed, and the amount of taxpayers' funds used. Recent audit qualifications, and my own experience with Defence, indicate that Defence has financial systems well below the standards required.

Defence continues to operate on a spend it or lose it approach to financial management. Under expenditure of budget is considered a serious event, whereas over expenditure is accepted. A large portion of Defence's expenditure occurs in the later part of the financial year so that budgeted expenditure is achieved. How can the massive expenditure of Defence be managed for the maximum benefit of taxpayers when expenditure is encouraged and reducing expenditure is not?

Adoption of International Accounting Standards

In the area of Military Equipment and Inventory, the requirement to comply with international accounting standards did require significant change for Defence over accounting standards that had previously applied. The prime issue for Defence is their desire to conform to accounting standards at all. I do not wish to go into the technicalities of why Defence does or does not comply with specific accounting standards. Much of the non-compliance is already document in various audit reports and the annual accounts. Such areas include Impairment, Componentisation, Depreciation, Useful Lives, Valuations, etc.

Defence very much continues to work on a cash basis. The focus by the Government also concentrates on a cash basis. Accounting standards require an accrual accounting approach to financial management. Defence's continued focus on cash accounting is the prime reason for their continual failure to meet the requirements of accounting standards.

Dr Gumley is the head of DMO and responsible for the purchase and maintenance of Defence assets. In a speech to the Press Club last year he stated that Defence makes its decisions on a cash basis. He was unaware of any decisions made where accrual accounting figures had been used. In this same speech he indicated that accrual accounting was only required for commercial organisations to complete their tax returns. It was therefore not required in Defence as they did not pay tax.

Many Government enquiries deal with whether the equipment was constructed within the budget allocated, rather than whether those assets are being used as they were intended. For example, the focus may be on whether six ships were built within budget. However, the focus is not on the fact that we can only recruit and train crews for four of those ships. Therefore the money was effectively wasted on the other two. Another example would be that we have 800 specialist vehicles in the accounts, and they are all accounted for. However, 400 are parked in a holding area, as we do not have a requirement for them anymore. Accounting standards very much focus on the future benefits of assets. The current values recorded for many assets breach a number of these standards. However, to reduce the valuation of these assets in line with accounting standards would highlight to external stakeholders acquisition issues within Defence and DMO. Therefore, Defence is very reluctant to highlight such issues.

Defence is not encouraged to manage its assets effectively. Due to the focus on cash, rather than financial management, Defence sees little benefit in recording assets. Recording assets actually causes Defence a lot of disadvantages, rather than advantages. The majority of audit findings relating to non-compliance of accounting standards relate to the recording of assets in some form, whether it is equipment, inventory, or buildings. Many of Defence issues would disappear if the assets were not recorded in the accounts and they therefore attempt to minimise the value and number recorded.

Accounting standards are largely worded for commercial organisations. Such organisations attempt to maximise the value of assets, as this defers the recognition of expenditure and improves profits reported. Therefore, many of the accounting standards deal with limiting what can be classed as an asset. An organisation that wishes to minimise the assets recorded can attempt to use these standards in a manner that they were not intended. Defence has made a number of submissions to the Australian Accounting Standards Board to attempt to minimise the assets they are required to record.

Australian and international accounting standards are designed to offer guidance as to good financial management rather than definitive rules as to how to record certain transactions in certain circumstances. Therefore, correct interpretation of the intent of the particular standard is important in obtaining compliance and appropriate financial management. However, Defence tends to treat these standards as legal documents and attempt to interpret each individual word in a context of what they are attempting to achieve, or avoid, rather than the intent of the standard. This is another major reason why Defence continues to miss the point and fails to comply with them.

Australian Defence was an early adopter of accrual accounting and therefore should have progressed further than some other nations in this area. For example, the USA has only recently decided to record military equipment as an asset in their accounts. Defence should be compared to the places like the UK, who have a very open reporting format and are no longer qualified. This lack of qualification in the UK, in some instances, relates to arrangements entered into with the auditors. Such arrangements centre on complying with the intent of the relevant accounting standard rather than some technicalities. Another fair comparison would be with the Victorian Government, that is recognised for their efforts in adopting accrual accounting. Australia should not be compared to the huge US Military that have had more significant issues due to their very large size and the very large number of systems being used.

Australia's financial reform relative to international best practice

When a business is purchased, the new owner will verify that the assets and liabilities exist, and they are appropriately valued. This happens within weeks or months rather than years. Defence is a large organisation, however there are many businesses in the world changing hands that are significantly larger than Defence. Therefore, should worlds best practise be judged against a limited number of similar size defence organisations in the world, or the broader business community. I would suggest that it should be the broader business community.

The only difference between organisations such as Defence and commercial organisations is the desire to implement financial management. Commercial organisations must have good financial management to survive and provide a return to its investors. There are also laws and regulations that ensure financial integrity in these organisations. Defence will obtain sufficient funds to operate from Government without such requirements.

I do not believe that lack of desire to implement reform should be an excuse to perform at a lower level. There are many excuses put forward by Defence for this lower performance. Most of these are attempts to differentiate themselves from commercial organisations. They mention their size, the unique assets they hold, etc. There are many commercial organisations larger than Defence and many also hold unique assets that are difficult to value, etc.

Dealing with some specifics in regard to financial management of Defence:

1) Inventory control

Defence has reported in their accounts that around half of their inventory is obsolete. That is, they have purchased billions of dollars in inventory that they believe offer no benefit to them. Such waste of taxpayers fund are solely related to poor inventory management.

Accounting standards require that spare parts related to an asset should be depreciated over the life of the asset they relate to. Therefore, if Defence complied with accounting standards, spare parts related to assets should not be included in this value of obsolete inventory.

Defence may attempt to blame their computer systems for the lack of inventory management, yet there are unused functions within these systems, which would allow better controls. For example, their systems allow each item of inventory, or spare part, to be linked to the piece of equipment. As this function is not used, they cannot accurately determine which parts they hold relating to a particular type of ship, etc. They only determine an approximate value in some cases based on the person responsible for purchasing that item.

Defence often associates these inventory write-offs on their need for war reserves. War reserves is a reason for larger stock holdings, but not poor management of them. The war storage related to a particular piece of equipment should be ran down as that equipment heads towards retirement. Also defence records do not separately record war storage from general stores and are therefore not managed separately.

Defence does not even know the value of spares and other inventory it holds in its warehouses at any point in time. If they do not know the value they are holding, how can they financially manage this asset? By not knowing the value of items, I am not referring to having incorrect records as to what is on hand. What I am referring to is them simply expensing the item when it is purchased into the warehouse and therefore not recognising it as an asset. Such expensing of items in warehouses, rather than when they are issued to users, solely relates to Defences wish to minimise the amount of assets they have to record in their accounts and other records. This activity has little logic attached to it. They will record a \$2 sparkplug related to a motor sitting in the warehouse, but a motor sitting in the same warehouse related to that sparkplug will not be recorded if its value is less than \$10,000.

This mismanagement of inventory has to be put into context of the broader community. The value of inventory that Defence claims is obsolete would build many major hospitals or hundreds of schools. Therefore a little effort in its management is justified.

2) Asset Management

The basic principal of accounting for assets is to show the future benefits that the asset will provide. These principals recognise that the value to an organisation of purchasing a building for \$1m is very different to renting that building for a year at \$1m. If the price you paid for the building was based on being able to shift in immediately and use it as offices, and you later find out that it is full of asbestos and has to be demolished, the price you paid for it no longer represents its value.

Most of the attention of asset management within Defence focuses on its purchase or construction, not the ongoing value to the Australian Taxpayers. Even though the benefit of

military equipment is often difficult to determine, it still needs to be highlighted where the asset is not producing the benefits expected when it was purchased.

Accounting standards and Government reporting requirements dealing with impairment of assets covers many of the issues relating to asset valuation within Defence. The Government approves the purchase or construction of assets based on a submission from Defence on the benefit such assets will provide. There is currently little post acquisition review to determine whether those assets are actually providing the benefits used to justify their acquisition. For example, if they purchased an asset that they do not have the personnel to operate, and are unlikely to have such personnel in the near future, what is the benefit of that asset. What is the benefit of an asset if it is restricted in use, due to an inability to defend itself in war like situations? Why are assets that have been stripped for parts valued as if they are operational. This post purchase review of assets is critical for the financial management of such items, rather than simply controlling the purchase costs.

This focus on purchase costs rather than the ongoing financial management of the assets also leads to poor record keeping as to what assets exist and what they consist of. While an asset is under construction, all the components of the asset are tracked and controlled. However, these are classed as "assets under construction" and are not recorded in the asset register of Defence. Once the construction is completed, most of the financial focus on the asset ceases. The asset is generally recorded in the asset register as a single line item with little description as to what it consists of. This makes it extremely difficult to determine what assets exist and prevent assets being recorded multiple times. Defence would record a facility or piece of equipment worth hundreds of millions as a single 4 or 5 word description in the asset register. A facility is made up of buildings, air-conditioning units, office furniture, computers, computer networks, carpet, etc. Equipment, such as a large ship, also consists of many smaller pieces of equipment that can be added or removed at any time. Defence has no way of knowing if any of this equipment is removed, replaced or stolen as it does not record the detail. Such components of these major assets may also be recorded separately within the asset register and Defence would not be able to identify this duplication. Therefore they cannot verify many of the assets with significant value are intact or in their accounts.

Often when these assets are counted, it is not carried by personnel who are trained as to what the asset should consist of. Yes, they know it is a Leopard Tank or an ANZAC Frigate, but they do not know what items made up this unit when it was purchased or are recorded separately in the asset register. Such additions could consist of remote firing systems, radios, and other associated equipment.

This lack of knowledge of specialised equipment also causes issues within warehouse and other storage facilities. A large number of very high value items arrive at these facilities in a carton or wooden crate. The warehouse does not open these to determine whether the item inside is actually the item on the paperwork. The reason for this is that they do not have the technical knowledge to identify the item or whether it is operational. This also applies to stocktakes. The only time that the item, and its functionality, will be determined is when it is actually used. Such use may not occur for many years after its purchase.

Under accrual accounting, the cost of assets are written off over their useful life. To carry this out correctly, you must record the date the item was purchased and when it will cease being used. Such dates are often very inaccurate within Defence records and therefore results in these assets being incorrectly valued in the accounts as well as the expense relating to their use being incorrect for any financial year.

Kinnaird Reforms

The Kinnaird recommendations again largely centre on the control over the purchase and construction of assets. However, recommendation number 4 relates to Capability Managers dealing with the ongoing capability of Defence and its assets.

The report recognises that “Currently, Defence spends approximately as much on maintenance and consumables each year as it spends on purchasing new equipment. Over two thirds of the whole-of-life cost of Defence platforms or weapon systems is incurred after the system is introduced into service.”

The report highlights the need to record the ongoing costs associated with sustaining capabilities and reporting this information to government. It also notes that Defence was not keeping such records and “poor systems integration, inconsistent accounting practices, large decentralised operating environment with high staff turnover and inadequate training, compound these problems”. Defence provided a commitment to correct these problems by the end of the 2005 financial year. Clearly this has not been achieved.

The report also notes “Consequently, addressing these problems in a satisfactory and timely fashion is critical to the proper management of capability within Defence and to the ability of the capability managers to properly fulfil their role.”

By the end of the 2005 calendar year, Defence could not adequately track the issuing of spare parts and consumables from their warehouses. In the first quarter of the 2006 financial year, around half of consumables issued could not be tracked to the correct area within Defence. This meant that a large portion of these expenses could not be tracked to the correct division within Defence (ie, Army, Navy, or Air-force); let alone what capability the items related to. As far I am aware, there were no plans in place to track such expenses to individual capabilities.

Many of the items received into warehouses are expensed at the time they are purchased. Therefore they have no value in the accounts and such expenses cannot and are not accurately tracked to capabilities. They can only be tracked to the inventory manager looking after the group of items. Such groupings are generally centred on platforms, however certain areas of the platforms, such as weapons and electronics, may be under different inventory managers. For Navy assets, the inventory manager’s group of items tend to concentrate on components (eg. Propulsion systems), rather than platforms.

Many of the spare parts that are repairable are only repaired once they are returned to the warehouse. A new or repaired item is issued to the unit involved prior to the old item being received back. As such items are treated as assets rather than consumables, no expense is charged to the unit when the item is issued. The repair cost of the old item does not get charged to the unit or the capability. Many of these items are not repaired for some time, or may never be repaired. However, Defence values these broken and unusable items in that balance sheet as if they were new.

Again Defence’s approach is based on cash accounting. Once the spare part is purchased, there is little desire to track the expense to the cost of providing the capability.

This non-compliance with the Kinnaird recommendations is not system related. The systems have the capability to track and allocate such costs. The shortfalls are simply based around the desire to use this functionality or to maintain the accuracy of data within those systems.

Financial Remediation Plans

Even though Defence may not embrace the financial management principals of accrual accounting, they do not desire the political ramifications of qualified financial accounts. Therefore, a significant focus has been placed on the remediation plans. However, without grasping the concepts of financial management contained in accounting standards, they are having an extremely difficult time in achieving the desired results. Again Defence concentrates too much on the words and fails to understand the underlying issues.

Even though the completion dates for these plans may have been communicated differently externally, internally there was the requirement and expectation to have them completed as part of the 2004/05 accounts. This was achievable in many cases, but was not achieved due to poor planning and understanding of the issue at hand.

I will only deal with the remediation plans that I had some involvement with.

S1 deals with the accuracy of stock records. Defence spent large sums of money conducting stocktakes. However, they failed to concentrate on the reasons that were causing the stock records to become incorrect in the first place. Even though the stock records became more accurate due to the stocktakes, they were only accurate for the time of the count. The records quickly became inaccurate again and the auditors continue to conclude that they could not rely on their accuracy.

The focus by Defence was on the letter of the audit comments and dealt with the symptoms, rather than the cause of the issue. This caused the plan not to be completed within the planned timeframe. They are now starting to deal with the causes, but not before wasting millions of dollars on stocktakes. Many of the stocktakes were repeated through already planned activities.

S2 deals with the pricing and accuracy of General Stores inventory. Again the remediation plan largely concentrates on the accuracy of previous records rather than the causes for those errors. Therefore errors are continuing to occur while old records are being analysed. Failure to identify a way forward on this plan also resulted in lack of completion within the planned timeframe.

S3 deals with Supply Customer Accounts (SCAs). These are largely records that track assets within Defence. Each military unit is a SCA and assets issued to them are recorded in this area. The system also tracks assets that are currently in the hands of external contractors.

Even though most Defence assets are recorded in the SCA system, less than 20% of the value of these assets are directly linked between the SCA system and the financial records. Even though Defence conducted stocktakes of the assets at the SCAs, there was no plan to actually check the results against what was recorded in the financial records. Due to the lack of training and specialised staff, and lack of interest in the units, the stocktakes often proved to be inaccurate.

The plan failed to deal with other areas that were included in the reconciliation of the 20% of assets to the financial records. Such areas included the Repairable Item Tracking File (RITF) and items ordered but not yet shipped to the unit. Therefore the results remained questionable for the few items that were reconciled to the financial records.

The intent of this remediation plan was to increase the accuracy of the financial records relating to military assets. It has largely failed on this intent to-date.

S4 deals with the valuation of explosive ordnance. The accounting standards dealing with the transfer of Government accounting to accrual accounting took into account that many records may no longer be available for the valuation of assets and inventory. It therefore allowed reasonable estimates to be used where the records were not readily available. Defence developed an estimate for old explosive ordnance that was basically flawed. The ANAO highlighted this flaw and would not sign off on the valuation. Defence was not required to spend millions of dollars attempting to find original records. They were only required to come up with the current cost of these items and how old they were. The only reason that Defence would not be able to obtain this figure would be if the ordnance that is no longer available through manufacture or purchase. In such cases it would be questionable as to what benefit such items offer Defence.

S9 relates to dealing with issues identified by the ANAO before they become formal audit issues. Even though the plan mentions preventing “B” and “C” findings becoming “A” findings, the intent of the plan was to prevent any issue becoming a formal audit issue. The success to-date in preventing new issues can be summarised by the record number of new audit findings raised for the 2004/05 financial year. This continues to highlight the lack of understanding of financial reporting requirements. This will continue to result in significant new audit issues being raised.

S10 deals with controlling and monitoring assets that are first found or written off. After over 8 years of recording such assets, Defence should have minimal first founds and write-offs occurring. However, 2004/05 resulted in significant amounts being recorded in these areas. Such first founds or write-offs could have occurred by an adjustment being made in SDSS or directly in the asset register. The reason for the adjustment is often not recorded and therefore the reasons for these high levels of adjustments are often guesswork. There was a lot of activity in stocktaking assets recorded in SCAs, however such adjustments were made in SDSS.

As the 80% of the value of assets are not reconciled between SDSS and the financial records, the financial impact of those adjustments was not able to be determined. That is, an item could be added in SDSS that is already in the financial records or an item could be written off in SDSS that was not in the financial records. An adjustment could have also been carried out in the financial records without the adjustment being made in SDSS. A piece of equipment could have been recorded against the wrong SCA. For it to be corrected, the process used relied on both units picking up the error and adjusting their records accordingly. This would have been recorded as a first found in one unit and a write-off in another. The records would have become more inaccurate if only one unit found the error.

Defence has yet to determine a method of verifying that all assets are properly recorded in the accounts. This will continue to cause first founds and write-offs as they tinker around the edges, rather than set up a process to complete the counts accurately.

Based on the 2005 calendar year, this remediation plan has not achieved its objectives and was not likely to in the near future.

S11 deals with Not In Catalogue (NIC) assets. A catalogued item is an asset or consumable item that has been uniquely identified and has had a reference number associated to it. This reference number applies to all items that are the same as each other.

This is a remediation plan that has the possibility to have the most detrimental impact on the accuracy of Defence's financial accounts. As mentioned previously, many billions of dollars in assets are poorly described or broken up within the financial records. When it comes down to individual pieces of equipment, Defence has little knowledge as to what is actually recorded in their accounts. Therefore they have little knowledge as to what is or is not in their accounts. So for a complex piece of equipment or military installation, there are often no records that list the components of that asset.

The remediation plan, in simple terms, relies on all units within Defence being given a blank sheet of paper and asks them to record any items that are not currently catalogued. This has many flaws and has a significant risk of duplicating assets recorded and/or not recording assets that exist. Ten people could describe a piece of equipment ten different ways. Therefore there is a risk that an asset that is currently recorded could be recorded again with a different description.

The item may not be listed individually within their records, but may be included in the value of a larger asset within the accounts. Examples of this are where Defence purchased a new platform and significant spare parts associated to that platform. Due to the number of spare parts, there has been a tendency not to record them individually, but include them in bulk in the value of the platform. Therefore listing these items now would duplicate their value in that listed for the platform and again for the items now listed as spare parts. Another example would be with larger assets like ships or military installations that often only have a single item listed in the asset register. As items are later brought on-board the ship or added to an installation, it is impossible to know what is already included in the accounts and what is not. Therefore under the currently planned action for this remediation plan, there are significant risks with either ignoring items in these locations or adding them when they are already included.

Before such a remediation plan takes place, Defence must adequately record the components of the assets already recorded in their accounts to determine whether the items still actually exist and also to determine what items are not currently recorded.

In summary, the remediation plans are like a football match where the players are yet to work out where the goals are. There is a lot of activity going on, certainly a lot of hand balling, but there are not many goals being scored. This all relates back to the same cause of Defence financial issues, that is, a lack of financial management skills and desire to financially manage past cash payments.

There are a lot of good people within Defence putting a considerable amount of effort into these plans. Many are achieving good results in difficult circumstances. However, often these good results are either overturned or ignored by senior management.

Summary

I was severely disappointed during my time with Defence. From a professional point of view, the disappointment centred on the lack of basic financial controls and the lack of desire by very senior management to correct it. I could identify billions of dollars of questionable financial transactions and could not obtain support from very senior managers for further investigation or correction. From a taxpayers point of view, the disappointment centred on the waste of funds that was occurring and the alternatives for which those funds could be used.

I do not wish for my comments above to reflect badly on the many Defence staff that continue to put in considerable effort in rectifying these issues. My comments are more directed to the senior management of Defence that have lacked the direction and desire to enable the work by others to achieve the desired results.

I hope the inquiry has success in correctly the financial management within Defence and achieve what I was not able to do in my time there.

Regards,

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