



Australian Government

Department of Defence

Chief Finance Officer
R1-2-C001
Russell Offices
CANBERRA ACT 2600

CFO/OUT/2007/265

Dr Kris Veenstra
Secretary
Joint Standing Committee of Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Dr Veenstra,

**JCPAA INQUIRY INTO FINANCIAL MANAGEMENT AND EQUIPMENT
ACQUISITION AT THE DEPARTMENT OF DEFENCE AND DEFENCE
MATERIEL ORGANISATION - SUMMARY ON STATUS OF GENERAL STORES
INVENTORY AND REPAIRABLE ITEMS**

At the Committee hearings on 29 March 2007 discussions included a review of Defence's financial remediation activities around stores records accuracy. During that discussion the question was raised regarding the extent to which there are material deficiencies in Defence stores inventories across the country and whether these deficiencies would be resolved in the 2006/07 financial year. At that time I identified that Defence were continuing their efforts on improving Defence inventories management but I was not yet able to confirm my view as to the completeness or otherwise of the progress for the 2006/07 year. The Chair asked that at the appropriate time, Defence provide the JCPAA with a view as to progress on stores records accuracy for the 2006-07 financial year.

Given my understanding that the Inquiry is drawing to a close, I felt it timely to supply the Committee with a summary of the 2006-07 Defence assurance program for general stores inventory (GSI) and repairable items (RI) and to comment generally on progress made for 2006/07.

In general terms, progress has been good. Management is now able to assert reliance on controls, that the location of GSI and RI quantities is known and managed and that the not-in-catalogue uncertainty has been remediated.

Details of the remediation and assurance activities undertaken to achieve these outcomes are presented at Annex A and in summary include:

- Australia wide stocktake and remediation of over 63,000 not-in-catalogue items.
- Third Party Assurance over \$2.6 billion of RI quantities and 162 Standard Defence Supply System user facing controls at 48 units.

- Completion of the improved Two Year Cyclic Stocktake Program of 100% of Defence RI and GSI.
- SDSS IT Controls Framework is in place, has been monitored, tested and is providing controls reliance.
- Additional internal compliance and assurance activities are providing greater management assurance of RI quantities.
- DMO Contractor RI Confirmation Process has been completed with satisfactory results.
- Fixed Asset Movement Posting Process and Inventory Movement Posting Process have been documented and tested providing certainty around Defence's logistics and financial Management systems (SDSS/ROMAN interface).

The above actions will place management in a position to assert that the financial statements are true and fair except for some outstanding issues regarding price and quantity for logistically managed items.

We note of course that the Australian National Audit Office is currently completing its audit of Defence's financial statements for 2006-07.

Repairable Items

For 2006-07 the goal of remediation and assurance activities was clearing the qualification over the remaining \$2.6 billion RI balance after having verified \$1.0 billion in 2005-06. A comprehensive multi-layered approach was developed for both quantities and price to provide evidence on which management could rely to form its view as to the veracity of the RI balance at 30 June 2007.

Overall, the outcome of the activities to date has been positive, but because this is another major improvement, with its inherent risks, it would be better for the ANAO 2006-07 audit to be further progressed before management confirm its final position.

General Stores Inventory

During the 2006-07 financial year, a number of activities were undertaken to assist management to form a view as to the status of GSI quantities.

The results of these measures are positive and have given management increased confidence that Defence knows where its inventory is located and how it is being managed.

However, noting that there remain outstanding issues surrounding GSI prices, at this stage management is still faced with uncertainty regarding some legacy pricing and will therefore not be in a position to form an opinion about the entire GSI balance for 2006-07.

2007-08 GSI Pricing Remediation

Remediation activity has commenced with the aim of removing GSI price uncertainty during the 2007-08 financial year.

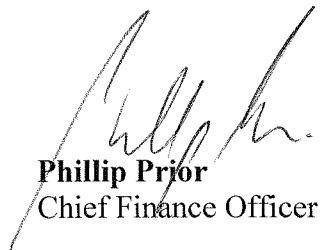
The approach proposed by Defence is to:

- Maintain and test the SDSS controls framework, to ensure new purchases are supported by appropriate pricing data.
- Review inventory holdings to identify categories which have unreliable or inadequate pricing data and supporting documentation.
- Reconstruct the prices of items that have inadequate documentation by reference to:
 - prices of like items in SDSS that have supporting documentation; or
 - independent valuation of items that have no similarity to other items in SDSS; and
 - indexing these price estimates as appropriate.

The approach to using appropriate surrogate prices is supported by the Chair of the AASB (Annex B) and our interpretation of AASB 102 *Inventories* and paragraph 86 of *The Framework for the Preparation and Presentation of Financial Statements*.

I would welcome the Committee's support and in principle endorsement of the proposed approach to GSI pricing, particularly the use of surrogates or an estimate where historical prices cannot be verified or obtained

Yours sincerely,



Phillip Prior
Chief Finance Officer

12 September 2007

Annexes:

- A. 2006-07 Remediation and Assurance Activities in relation to RI and GSI Balances.
- B. Letter to the CFO from the Chairman of the AASB dated 19 August 2005.

2006-07 Remediation and Assurance Activities in relation to Repairable Items (RI) and General Stores Inventory (GSI) Balances

In respect of both RI and GSI, the following activities were undertaken during the year:

- Stocktake and remediation of over 63,000 not-in-catalogue items.
- Completion of the Two Year Cyclic Stocktake Program.
- Testing of the Standard Defence Supply System (SDSS) IT controls to confirm management reliance.
- Logistics Compliance and Assurance Team (LCAT) targeted stocktaking throughout the year in areas of possible risk.
- Full documentation of the process and controls around the monthly Fixed Assets Movement Posting Process (FAMPP) and Inventory Movements Posting Process (IMPP) between SDSS, Defence's financial systems and ROMAN

Each of these are discussed more fully in the following paragraphs.

Stocktake and Remediation of Not-in-Catalogue Items

A project was established to locate all items of supply not under management of an approved asset management system in Defence units and warehouses and migrating them to SDSS and the Fixed Asset Register in ROMAN. A total of 740 repairable items valued at \$10.3m and 3,835 GSI items valued at \$6.6m were identified and taken on charge.

Completion of the Two Year Cyclic Stocktake Program

Defence's improved two year cyclic stocktake program was conducted over the period 1 July 2005 to 30 June 2007. The program counted 100 percent of all inventory holdings (including RI, GSI and explosive ordnance) during that period.

The overall results of the stocktake program returned a non-material error rate. Cumulative write on and write off actions during the period resulted in a total reduction of \$2.945 million across all inventory types and this is reflected in Defence's financial position at 30 June 2007.

Testing of the SDSS IT Controls Framework (SITCF) to Confirm Management Reliance.

The SITCF design is based upon an internationally recognised standard, CoBIT for Sarbanes Oxley. Development of the SITCF was a management initiative and addresses Category A and B findings from the Australian National Audit Office (ANAO) in financial years 2004-05 and 2005-06.

Compliance was measured against the 784 controls which comprise the SDSS IT Controls Framework V9.0. Of these:

- 157 (20%) across all functions, can be characterised as **'system' or preventative controls** and represent a low risk of breakdown;
- 398 (54%) of controls are **specialist** based, enacted by a small number of system specialists and represent a low to moderate risk of breakdown.

- 229 (29%) of controls are ‘**user facing**’, performed by a large number of users across Defence Groups. The number of users, geographic locations and business priorities make these controls a moderate risk.

The results from compliance testing lead DMO and Defence to the conclusion that controls reliance surrounding SDSS existed throughout the 2006-07 financial year. The conclusion was based upon:

- High level of SITCF compliance across the financial year; with the final compliance result assessed as 97.4 percent. This result was consistent with ANAO test results and supported by the outcome of KPMG’s external experts testing;
- Absence of any evidence of systematic non-compliance;
- Establishment of documented policy and procedure;
- Training was in place and accessible; and
- Processes were in place to monitor, manage and remediate breakdowns.

Logistics Compliance and Assurance Team (LCAT) Targeted Stocktaking

In addition to the two year stocktaking program, the LCAT team conducted separate internal sampling at Defence sites. This sampling was based on a new tool called Defence Asset and Inventory Sampling System (DAISS), which allows statistically valid samples to be drawn by management to test the veracity of our quantities. The results were consistent with the two year stocktake program and confirmed to management that the stocktake program was being conducted effectively in those locations.

Documented and tested the Fixed Asset Movement Posting Process (FAMPP) and the Inventory Movement Posting Process (IMPP) processes between SDSS and ROMAN

These processes reflect the requirement for a manual interface between SDSS and Defence’s financial management information system, ROMAN.

Defence engaged external experts in late 2006 to review the FAMPP and IMPP processes and procedures in detail and prepare comprehensive documentation including flow charts and the reconciliations performed.

As a result of the review, the controls environment was improved and systematically tested monthly from February 2007 as part of the Defence Financial Controls Framework. The FAMPP and IMPP are now reliable, controlled processes that are fully reconciled from SDSS to ROMAN.

2006-07 Remediation and Assurance Activities Specifically Related to Repairable Item Balances

Third Party Assurance over \$2.6 billion of Repairable Items and SDSS User facing Controls

External experts were engaged in April 2007 to draw a statistical sample of \$2.6 billion of RI and sighting those items to confirm their existence. Overall, the external experts came to the statistical conclusion that the underlying balances in the RI population were within a

tolerable range and from a management assurance perspective were not materially misstated.

In addition, for selected high materiality locations, which represented 70% of the total of RI by value, the external experts assessed whether key 'user facing' controls (being internal controls over users' access and input) contained in the SITCF were operating in the year ended 30 June 2007. Testing revealed controls were operating effectively.

DMO Contractor RI Confirmation Process

RI held with contractors are operated and managed through Supply Customer Accounts (SCA) on SDSS rather than through warehouses. Accountability and assurance is provided under a spot-check regime instead of the two year cyclic stocktake program. This difference is due to the extremely high turnover nature of RI being processed between DMO and the contractor (repairer) environment.

The process involved a judgmental sample being extracted across the entire contractor environment as at 29 April 2007, being 219 contractors with RI value of \$223 million. The contractor environment was divided into high, medium and low based on value of holdings from which nine contractors were selected: three from each category with holdings totalling \$80 million. The contractor with the largest holding of \$47 million was selected. A further statistical sub-sample of the high and medium selected contractors was drawn for the purpose of conducting physical RI counts at the contractor premises.

For each contractor selected a 100 percent confirmation spot check was conducted requiring contractors to provide written confirmations of RI holdings including the identification of any additional items found. The confirmation process was blind, in that contractors were only advised of the types of RI held not the quantities.

The overall conclusion from the process was:

- Contractor written confirmations and physical counts demonstrated positive assurance over the management of RI quantities under the control of contractors. The error rate by quantity was 6 percent, which translated to 2 percent by value. Discrepancies are still being investigated and indications are these rates will fall considerably; and
- Two situations were identified during the physical counts which highlighted processes not being followed but were isolated cases that had minimal impact upon the overall results. Corrective action has been taken and follow up is scheduled to ensure proper processes are complied with.



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19 August 2005

22 AUG 2005

CFD/M/2005/12

Mr Ken Moore
Acting Chief Financial Officer
Department of Defence
R1 - 2 - C001
Russell Offices
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Dear Ken

Inventories

Thank you for your letter dated 8 August 2005 and for meeting with us in July.

The following are the collective personal views of a number of the AASB's staff and reflect to large degree the discussion we had in July.

AAS 2 and AASB 102

We agree that the Department has inventories as defined under AASB 102 *Inventories*. However, the items described in your letter are not inventories as defined under AAS 2 *Inventories* because the definition refers to "sale". Nevertheless, it has been accepted practice in the public sector to use the principles in AAS 2 to the extent that they are appropriate in accounting for inventories that are not for sale and are current assets by analogy. This is on the basis of the requirements in section 4 of AAS 6 *Accounting Policies*. In particular, paragraph 4.1.2 notes that, in the absence of a specific standard, in selecting accounting policies consideration is given to the requirements and guidance in other Australian Accounting Standards or other authoritative pronouncements dealing with similar or related issues. Non-current assets would be treated at cost or revalued amount under AASB 1041 *Revaluation of Non-Current Assets*.

Measuring inventory

Your inventories are not the inventories referred to in AAS 2 as they will not be sold or consumed in the production of goods and services available for sale. Nevertheless, it has been accepted practice in the public sector to adopt an approach using AAS 2 so as to achieve sensible outcomes, and the lower of cost and current replacement cost would be the logical measure for consumable inventories that are not held for sale, as referred to in AAS 2, paragraph 8.1.6.

Under AASB 102, based on the information you have provided, it seems fair to assume that the replacement cost of inventories that are not obsolete would be equal to or above cost. Accordingly, if cost information were available the inventories would be measured at that cost. In the absence of complete records, we consider that the Department is obliged to

ascertain its best estimate of the cost of inventories, which might involve various techniques to satisfy the reliable measurement recognition criterion. One technique would be to establish the replacement cost of the service potential embodied in the inventories and adjust back, perhaps by deflating, to the estimated actual cost. If the inventories are technically obsolete and would be replaced by items that are not the same, cost could be determined by adjusting the replacement cost of assets that would provide the same or similar service potential as the inventories held. It would be appropriate to disclose the method used to determine the estimates of cost.

Writing down to zero

It would be appropriate to write inventory down to zero only when the service potential it embodies is of no value to the Department. The inability to substantiate cost is not a reason of itself that justifies a write off. A best estimate of cost would need to be made and this would satisfy the reliable measurement recognition criterion.

Uncertainty

It would be appropriate to put the Department's best estimates of inventories in the financial statements and make disclosures regarding measurement uncertainty. In particular, this is consistent with AASB 101 *Presentation of Financial Statements*, paragraph 116, which requires the disclosure of key sources of estimation uncertainty.

SME platforms

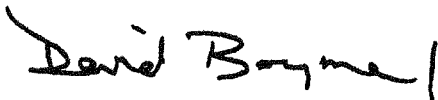
Inventories supporting Specialist Military Equipment (SME) platforms seems to best fit into the notion of spares. AAS 4 *Depreciation*, paragraph 7.1, requires spares purchased specifically for a particular asset, or class of assets, and which would become redundant if that asset or class were retired or use of that asset or class were discontinued, to be considered to form part of the historical cost of that asset or class. The depreciable amount of those spares is progressively expensed over the useful life of the asset or class of assets.

AASB 116 *Property, Plant and Equipment* comments that major spare parts and stand-by equipment qualify as property, plant and equipment when an entity expects to use them during more than one period. Guidance paragraph 9 to AASB 116 carries forward the message underlying the requirement in AAS 4, paragraph 7.1.

When the spares are used, we would expect that their carrying amounts would be expensed (unless the act of using the spare extends the life of the SME platform, in which case the spare would be capitalised to the platform). The cost of any replacement spares would be recognised as assets and depreciated over the remaining lives of the relevant SME platforms.

I hope that the above thoughts are useful in helping you to manage the accounting issues that you face.

Yours sincerely



David Boymal
Chairman