



COMMONWEALTH OF AUSTRALIA

# Official Committee Hansard

JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

**Reference: Review of Auditor-General's reports, first and second quarters 2004-05**

WEDNESDAY, 16 MARCH 2005

CANBERRA

BY AUTHORITY OF THE PARLIAMENT



## **INTERNET**

The Proof and Official Hansard transcripts of Senate committee hearings, some House of Representatives committee hearings and some joint committee hearings are available on the Internet. Some House of Representatives committees and some joint committees make available only Official Hansard transcripts.

The Internet address is: **<http://www.aph.gov.au/hansard>**

To search the parliamentary database, go to:  
**<http://parlinfoweb.aph.gov.au>**

**JOINT STATUTORY COMMITTEE ON  
PUBLIC ACCOUNTS AND AUDIT**

**Wednesday, 16 March 2005**

**Members:** Mr Baldwin (*Chair*), Senators Hogg, Humphries, Moore, Murray, Scullion and Watson and Mr Broadbent, Ms Burke, Ms Grierson, Miss Jackie Kelly, Ms King, Dr Laming, Mr Somlyay, Mr Tanner and Mr Ticehurst

**Members in attendance:** Senator Hogg and Mr Baldwin, Mr Broadbent, Ms Burke, Ms Grierson, Mrs Kelly, Mr Laming and Mr Tanner

**Terms of reference for the inquiry:**

To inquire into and report on:

Review of Auditor-General's reports, first and second quarters 2004-05.

**WITNESSES**

<b>BENNETT, Mr Lloyd, Chief Finance Officer, Department of Defence .....</b>	<b>1</b>
<b>COCHRANE, Mr Warren John, Acting Deputy Auditor-General, Australian National Audit Office .....</b>	<b>1</b>
<b>CRONIN, Mr Colin, Executive Director, Australian National Audit Office .....</b>	<b>1</b>
<b>GOODWIN, Mr Ian Phillip, Group Executive Director, Assurance Audit Services Group, Australian National Audit Office .....</b>	<b>1</b>
<b>GUMLEY, Dr Stephen John, Chief Executive Officer, Defence Materiel Organisation, Department of Defence .....</b>	<b>1</b>
<b>McGAHEY, Brigadier David Francis, Director General, Materiel Information Systems, Department of Defence .....</b>	<b>1</b>
<b>McPHEE, Mr Ian, Auditor-General, Australian National Audit Office .....</b>	<b>1</b>
<b>SMITH, Mr Richard, AO, PSM, Secretary, Department of Defence .....</b>	<b>1</b>
<b>WATSON, Mr Michael Joseph, Group Executive Director, Assurance Audit Services Group, Australian National Audit Office .....</b>	<b>1</b>



**Committee met at 12.28 p.m.**

**COCHRANE, Mr Warren John, Acting Deputy Auditor-General, Australian National Audit Office**

**CRONIN, Mr Colin, Executive Director, Australian National Audit Office**

**GOODWIN, Mr Ian Phillip, Group Executive Director, Assurance Audit Services Group, Australian National Audit Office**

**McPHEE, Mr Ian, Auditor-General, Australian National Audit Office**

**WATSON, Mr Michael Joseph, Group Executive Director, Assurance Audit Services Group, Australian National Audit Office**

**BENNETT, Mr Lloyd, Chief Finance Officer, Department of Defence**

**GUMLEY, Dr Stephen John, Chief Executive Officer, Defence Materiel Organisation, Department of Defence**

**McGAHEY, Brigadier David Francis, Director General, Materiel Information Systems, Department of Defence**

**SMITH, Mr Richard, AO, PSM, Secretary, Department of Defence**

**CHAIR**—I open today's public hearing, which is one in a series of hearings to examine reports tabled by the Auditor-General in the financial year 2004-05. I remind people that this is a public hearing and that television and Hansard recordings are being made. This morning we will be taking evidence on Audit report No. 5: *Management of the standard defence supply system upgrade*; and Audit report No. 21, which is the ANAO's audit of the financial statements of Australian government entities. With regard to Audit report No. 21, we will be focusing on the audit of the Department of Defence in which the ANAO concluded that it was unable to form an opinion on Defence's financial statements. This is the first time that the ANAO has expressed such a qualification in recent times.

I welcome the witnesses from the Australian National Audit Office, the Department of Defence, and the Defence Materiel Organisation to provide evidence on Audit reports Nos 5 and 21. I remind witnesses that the hearing today is a legal proceeding of the parliament and warrants the same respect as the proceedings of that House itself. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of the parliament. The evidence given today will be recorded by Hansard and will attract parliamentary privilege.

I will run today's session using a roundtable format with witnesses from the three agencies appearing together. However, I ask participants to remember that only members of the committee can put questions to witnesses if this hearing is to constitute a formal proceeding of the parliament and attract parliamentary privilege. If other participants wish to raise issues for discussion, I ask them to direct their comments to the committee. It will not be possible for participants to respond directly to each other. Also, given the short time available to us today,

statements and comments by witnesses should be relevant and succinct. Perhaps each organisation would like to make a brief opening statement to the committee.

**Mr Cochrane**—We are happy to let the two reports talk for themselves.

**Mr Smith**—I would like to suggest an approach to this hearing which follows from what we discussed when I called on you last week. As an aid to the discussion and the questioning which members will have, we have prepared a set of 14 slides which set out the main issues in relation to Defence's financial statements and the plans we have in place to try to remediate the problems that we face. We will speak very briefly to each of those and I expect that committee members will have questions about them as we go along. That is an approach which I hope will allow us to address both the SDSS report and the financial statements as we go—though, of course, if you would prefer a different approach we can do that.

At the outset, let me say firstly that, yes, the Auditor-General reached a no-opinion finding—as did I before him—in relation to our financial statements, and I certainly understand the unprecedented and grave nature of that step. I thought it was a necessary step and one that had to be taken in honesty. I should make two points—and, although I have addressed them both in other committees, I believe it is worth reiterating them to this committee. First, the problems we face do not relate to cash management, to our internal budget processes or to quantities of specialised military equipment or explosive ordnance. The issues are not about lost money, weapons or ammunition. Second, our problems have not affected Defence's operational performance. This was demonstrated yet again in our post-tsunami operations in Sumatra and elsewhere immediately after Christmas—operations which, incidentally, imposed heavy demands on inventory management, and those demands were met outstanding well.

*A PowerPoint presentation was then given—*

**Mr Smith**—I just thought it was worth stating here the nature of this body that we are dealing with. Defence is, by any standards, one of Australia's very largest corporations. I will not run through the figures on the slide, but I will make two points. Firstly, we are, as I said, a very large corporation. We are being asked to achieve corporate standards of accounting performance, and we are being asked to achieve them off a 104-year-old Public Service base. Secondly, those figures that are cited on the slide do reflect most of the Commonwealth's assets. Many of its liabilities are in those categories.

Moving to the next slide, the major audit issues leave aside the particular qualifications for the moment, but the themes, as it were, that run through the audit qualifications relate to data management: to corporate and financial reporting systems, record keeping and asset and inventory management. There are two kinds of systems, in short: firstly, our management and reporting systems—what we report to whom, how often and how accurately—and, secondly, our IT systems, which should support those processes. There are shortcomings, which we acknowledge, in each. I take it that if senators want to open up any questions they will as we go.

**CHAIR**—I would prefer you to finish your statement and then we will come back with questions.



**Mr Smith**—Moving to the next slide, the major qualifications, as you will know from our annual report and the Auditor-General's report, relate to general stores inventory, explosive ordnance, repairable items, land and buildings infrastructure, plant equipment and military leave. Other qualifications like executive remuneration might follow from those. If you would like any further explanation of them, I can offer it or we can proceed.

**CHAIR**—Please proceed.

**Mr Smith**—We have developed 14 remediation plans. I use that term 'remediation plans', but I think that what we are doing is much more than just remediation. It is in fact a transformation of Defence financial management of which these remediation plans are a part. The first are general plans—we call them G1, G2 and G3—and they are followed by 11 specific plans numbered S1 to S11. The financial controls framework requires the development, over the next three years, of different forms of reporting from what we have used in the past, in particular monthly balance sheet reporting. Lloyd, would you like to speak more to that?

**Mr Bennett**—It is making sure that we have more explicit accountability on all of the items on the balance sheet and that people are abreast of all the movements in those areas.

**CHAIR**—The acoustics in this room are pretty ordinary; can I ask that people speak up please.

**Mr Bennett**—Certainly. What we are trying to do is to introduce some of the balance sheet disciplines that make sure all the accountable officers understand their responsibilities and explain all the movements and discrepancies in all the balance sheet items. We are also supplementing that with a number of improved control procedures.

**Mr Smith**—G2 is a plan to ensure that we work more effectively with ANAO on the annual audit process. ANAO has had some concerns about that that I have been made very aware of, such as the timeliness and timing of some of our reporting, the quality of the data we give them at particular points during the closure processes and so on. Last year I met at least weekly with Mr Watson, Mr Goodwin and others from ANAO. I do not mind doing that again if I have to, but it reflects in some part a breakdown in our processes that that became necessary, and we are seeking to address that.

G3 is financial management and systems training. As I said, we are coming off 104 years of a particular form of financial management. I think our people are confident in cash management, but we frankly do not have the depth of skills required of an organisation of our size for what is now asked of us, so we have set up extensive training programs. We are probably involved in training more financial managers internally than any other organisation in the Commonwealth. I am taking a punt on that, but I think it is probably the case. So that is the third general plan.

Then, moving to the next slide, we have 11 specific plans. I have grouped them here according to the subjects. The first six relate to inventory in its various forms—prices, quantities, controls and so on—and we can speak in more detail about each of those should you wish. On stores record accuracy, for instance, we have a massive stocktaking project under way, directed by Brigadier Phil Edwards, who is here with us. We have general stores inventory pricing issues, which are issues of doctrine or policy which have yet to be resolved. We have some important

policy issues in relation to ordnance as well. We have some issues of stock-holding controls and assets not in catalogue—that is, that have not been properly inventoried as they have been acquired.

The next slide is intended to show you the size and scale of what we are doing here with inventory management. That is Moorebank, which some committee members would have visited. Overall, our Joint Logistics Command occupies some 31 sites around Australia. There are 148 warehouses, all up; that excludes warehouses that hold explosive ordnance. There are 1.5 million stock codes. Those warehouses employ between them 711 civilians and 409 military personnel.

There is also a contractor work force, which I think at Moorebank is about 160 people. Moorebank includes 125 hectares of land, 39 separate warehouses and 1.2 million cubic metres of storage and, I am told, 320,000 stock codes in 800,000 locations. What we have got going on there now is a 100 per cent stock take. It began on 7 October; it should be finished by 31 March. While that will certainly address a chunk of the problem, we do understand that the issue then—that is, between 31 March and 30 June—was how well tracked the movements of inventory items will be. That is what determines the final finding. We have sample audit work going on during the course of that 100 per cent stock take.

On the next slide, the first three of those specific plans, S5, S6 and S7, relate to personnel matters, the management of leave records. The issues here go in part to contemporary management of those leave records but in part to the historical management of them and finding the baseline from which we can move forward. We have to be able to document decisions in a better way than we seem to be able to do. The S8 plan is property valuations, where we had particular problems, as you know, last year. The Australian Valuation Office does our valuation work but it seems that they were not adequately tasked by us to meet the standards required. They have been re-tasked with a new contract, which I believe meets the current requirements, and they are to finish that valuation work by 30 June. S9 is an important plan preventing the escalation of current category A and category B findings into more significant qualifications—that is, so that today's itches did not become tomorrow's carbuncles. We have been, in the past, at times tardy in addressing some of those category A and category B findings.

Those plans, G1 to G3 and S1 to S11, are driven under the title of Project Resolve by a body called the Financial Statements Project Board, which I chair and which includes the CFO, of course, Dr Gumley, the Vice Chief of Defence Force and all the service chiefs. It is very necessary for me to have their support, their buy-in, for these remediation projects. The irony in this—and one of many—is that I am accountable under the FMA Act but the people who do much of the work are not, in turn, accountable to me. So we have to get the full support of the whole team, as you will appreciate, to make this work as it has do.

The next slide covers timelines, resourcing and effort. We have a major commitment to this remediation and transformation work—at least \$12 million worth in this financial year, in terms of contracts with consultants and advisers, and at least 600 staff-years. It is probably more than that if you filter it right down the line to clerks and privates on bases and in facilities devoting more of their time to this work than they might otherwise have done previously. It is a large resource commitment but we could say that it could always be larger. What are the trade-offs? What do we cease doing in order to spend more on this? I note that the United States Department

of Defense, the Pentagon, has committed a billion dollars to similar programs. I do not imagine that we will be doing anything like that.

The information system upgrades are reflected in this next slide. I know that you have a particular interest in these following the ANAO report. There is the SDSS Upgrade Project and the SDSS get-well program, which is something that Dr Gumley and I initiated last year when we realised that the upgrade program was not going to deliver all that we wanted in quite the time that we wanted it to. We will certainly come back to that.

There are further challenges. These are given on the next slide. They involve implementing the Australian Equivalent of International Financial Reporting Standards—a very big challenge for us. It would be a challenge anyway but, coming off the base that we are starting from, it is a bigger challenge than usual. There are also some issues of doctrine or policy that are quite challenging for Defence because of the particular nature of military equipment and so on. The second challenge is to prescribe the Defence Materiel Organisation. You will know that the government's objective was to have the DMO listed in the list of prescribed agencies, which is attached to the FMA Act, on 1 July this year. We are on track to do that, but there is and will remain a lot to be done as we approach that date.

We come to the next slide, the second last one. I always think it is worth making these comparisons. It is fair to criticise Defence's performance over a number of years in these areas, but we are not alone: the United States have not submitted auditable accounts for I do not know how many years. They have an objective to do it by 2007. They will not achieve that. In relation to the United Kingdom and Canada, I think that their qualifications are very similar to ours. Perhaps the decisions about whether an opinion could be formed or not were taken in a less rigorous environment in some of the above cases.

Finally we come to the last slide. We are committed to making a very substantial improvement to these financial and operating systems. As I said, it is more than just remediation. I made the mistake in my first year or so here of believing that these were things that could be the subject of quick fixes simply by the application of more effort, energy and focus. That is not the case, in many cases, the issues are underlying ones. Some of them, like the valuations, we should be able to address quickly and resolve. With others it will take some time to put in place the reporting systems which will deliver the sorts of controls and disciplines that are at the heart of ANAO's reporting on us. We will continue to devote resources and priority to these issues but we always have to be conscious of what the trade-off is in the resources we are committing. We are available to take questions. Mr Bennett and Dr Gumley are here. I also have here the head of our personnel executive, Rear Admiral Adams and Brigadiers McGahey and Edwards, who can address particular interests that members might have.

**CHAIR**—Thank you very much, Mr Smith. I think it would be fair to say on behalf of all the committee members that one of our primary objectives is to make sure that those that engage in overseas theatres are not short of anything they need to protect their lives or carry out their job effectively and efficiently. But there are a number of concerns that our committee members have in relation to the management of our facilities, whether it be as to stock levels or the financial processes that you go through in your department.

Given that in 1986 this committee did a review much along the same lines, this would appear to be *deja vu*. What concerns the members of our committee is that very little if anything seems to be achieved. There is a range of concerns my colleagues will put to you and seek your qualified responses on. Accountability is critical no matter what department in government you are. Just because the Department of Defence, in particular our military, serve such an important role in our nation there is no reason why they should be exempt from being accountable in a management sense.

Broadly, we need to be reassured that there is a genuine desire in Defence to fix the problem, to correct all the issues and to make progress. Looking at the history of the SDS System I have concerns that no real inroads are being made other than into the taxpayers' pockets. We have seen projects put up without the due process of approval, as reported to us, and projects for which the financial requirement should have had cabinet approval yet did not even have ministerial approval. We have seen a project blow out by massive factors to just under \$50 million. We have seen a program called Get Well being implemented at a cost of around \$10 million, again without a ministerial sign off because it is being done in segments which bring it in under the radar.

We have concerns about whether the project is going in the right direction and whether the steps that will be taken will remedy the faults that are there and deliver the results that the financial reporting aspect requires, that the Audit Office wants, and that people within the organisation itself would seriously like to know are being corrected. Again, our concern is that any of these issues of supply may affect any of our people at the front line. We are determined to get to the bottom of this issue and watch, observe and listen to how you intend to address that. Perhaps you could start by responding to those comments.

**Mr Smith**—Certainly. I will respond to four points there. I want to make clear that we are not seeking any exemption from accountability. I am not aware that that has ever been suggested. I certainly am clear about where my accountability is. As I said, there is a certain irony in that because not all of the people required to deliver my results are accountable to me, but we make that work. Secondly, I can assure you that there is a commitment to try to resolve these issues but I cannot assure you that that will be done next year or the year after. It is a long haul that we are in for. I cannot assure you, either, that all issues will be resolved. There will come a point when we will say, 'This is an issue of importance to accountants but it does not seem to affect our operations and is therefore not worth \$100 million to fix.' That might have to be a management decision. I am not isolating any particular project or proposal in that regard, but if that is the kind of decision we have to take as a management decision—do we spend \$100 million or do we bear a scar on our accounts—then the good management decision might be the second one.

Thirdly, I have no evidence that the issues flagged here affect the front line and I have the assurances of the chiefs on that matter. Finally, on SDSS, you have suggested that we are not making progress. I am not going to go back in the history of SDSS, which goes back as I understand it to the late 1980s, but I believe that it now has considerably more functionality than it had through the 1990s. It is not a Formula One motor car but from our point of view it should serve well as a street car.

**CHAIR**—In the qualifying statements, it was concluded that you were unable to put in a statement that it was a true and fair record of the reporting. Before your time, were all the audit

reports that were put on the table to this parliament true and fair records of the financial position of the Department of Defence?

**Mr Smith**—I believe, with the qualifications identified, that the one which I signed before this one was. I cannot account for the others but I have to assume the same since the Auditor-General would have signed them as well.

**CHAIR**—There is an issue of valuations and of knowing what stock control you have. I understand that in today's terms there is about \$7.1 billion worth of assets and \$1.2 billion worth of defence liabilities that cannot be validated. How far back in history does this go? Have we had false statements put to the parliament as to the accuracy of the financial position of the Department of Defence?

**Mr Bennett**—Last year we had a unique conflation of events in terms of the poor performance of SDSS in year as a result of some of the upgrade activities and low morale in the warehouse et cetera. A number of issues hit the books last year as a result of that. The way that flowed through the accounts could be described as the pervasiveness and magnitude of the error and therefore that led us, roughly speaking, to the conclusion that we could not conclude around the accounts. Those events happened last year. In other years, on all the evidence we have before us, they would have been true and fair, except for—

**CHAIR**—Due to commitments of committee members we will have to suspend the hearing for today and reconvene at a later date.

Resolved (on motion by **Ms Grierson**):

That this committee authorises publication of the transcript of evidence given before it at public hearing this day.

**Committee adjourned at 12.58 p.m.**