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JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

Thursday, 12 May 2005

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

Senators and members in attendance: Senators Hogg and Watson and Mr Baldwin, Mr Broadbent, Ms Grierson, Miss Jackie Kelly, Mr Laming and Mr Tanner

Terms of reference for the inquiry:

Review of Auditor-General's report, first and second quarters 2004-2005

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Committee met at 9.51 am.

GOODWIN, Mr Ian Philip, Group Executive Director, Australian National Audit Office

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

WHITE, Mr Michael, Executive Director, Australian National Audit Office

EDWARDS, Brigadier Phillip, Project Director, Stocktaking Remediation Project, Joint Logistics Command, Department of Defence

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

MOORE, Mr Ken, Acting Chief Finance Officer, Department of Defence

SHARP, Mr Peter Kenneth, Acting Head, Defence Personnel, Department of Defence

SMITH, Mr Ric, Secretary, Department of Defence

SPENCE, Air Vice Marshal Christopher Geoffrey, Commander, Joint Logistics, Department of Defence

CHAIR—We now continue the hearing in public.

Mr BROADBENT—Do you benchmark the processes of Defence against similar organisations in the private sector, which may have a 10 per cent discrepancy in their stock counts when they are doing a rolling stock count over two years?

Mr Smith—I am not aware that we do. As I have said to committees, including this one, in the past: I am aware that the demands on our movement of stock and management of inventory and so on are quite different from most organisations because we keep it for so long and we move it in and out and around about. We do not just acquire it and dispose of it. There are a lot of differences. Secondly, our methodology is apparently quite different. TenixToll now manage a number of our warehouses and I was told by one of their managers, who had done logistics studies at university, that when they are taught about logistics and inventory management they are told, ‘This is the way most people do it, and this is the way Defence organisations do it.’ In those circumstances benchmarking is probably difficult, but Air Vice Marshal Spence might be able to add more.

Air Vice Marshal Spence—We do not benchmark against Coles Myer or whomever on a regular basis, but when we are looking at the processes and procedures that we apply, we certainly do look across other Defence organisations and compare ourselves with them and how they actually do their logistics business. I know from my experience some years ago when we were introducing a new module, an advanced inventory management system module into SDSS, we went out and had a look at what was best practice out there in the world. We visited the Microsofts of the world, and others, to see how we compared against them. There is that

comparison done, and we are aware of the processes and the systems that are available out in the private sector.

Mr BROADBENT—Did you get any sort of comparison out of those times when you did look at those other organisations?

Air Vice Marshal Spence—In that case we were pretty much at the leading edge with that particular advanced inventory management system. So I was comfortable at that point that we were putting into Defence something that was pretty much up there with private sector practice.

Mr BROADBENT—When you buy new equipment for a new program or new proposal does an inventory management program come with that new equipment or is it just welded into the old system?

Air Vice Marshal Spence—That might be something that Dr Gumley can address. I make the point that through-life support and logistics support for new capabilities are likely to be quite different from the way we have traditionally done them in the past. So, for example, there is probably a greater likelihood that the equipment manufacturer will have a more significant role in the logistics support for acquisitions into the future, and we will need to accommodate that within our system. Historically, we have done it all. We are on the cusp of a change in that regard and we will need to accommodate that as we move forward.

CHAIR—I will go back to some basic questions I was going to ask on this report. It concerns me that one of the 12 qualified audit options made by the Audit Office was for the Department of Defence. The qualification was expressed as an inability to form an opinion and there was a letter from Mr Smith, as the Secretary to Defence, that stated he was unable to conclude that the financial statements were true and fair. The Audit Office has reported that this is the first time they have been able express an inability to form an opinion on a government entity's financial statements. Can you state why this was so, for the record?

Mr Goodwin—You start by asking, 'Are the accounts true and fair?' and then you list your qualifications. After conducting the audit and doing very extensive stock takes, we ended up listing qualifications against the inventory line items, the repairable line items, which are part of SME, supply and issue of explosive ordnance and the leave balances. They are the big ones. That then says that the accounts are perhaps not true and fair except for those line items. When you assess both the quantitative type of the errors and the qualitative aspects of the controls, the question then becomes, 'Are those uncertainties in this case pervasive to the financial statements?' In terms of inventory and the lead balances we ended up with a scope limitation of an uncertainty, which is about missing documentation or being unable to verify the records. If you get to a point where that uncertainty is pervasive to the financial statements as a whole, then that becomes a trigger point as to whether you might end up in inability territory.

Mr Smith—I concluded an inability to form an opinion after I had taken a great deal of advice not only from our own independently chaired audit committee but also from other agencies of government—the Department of Finance and Administration in particular—and after I had consulted with private sector audit organisations and put the question, 'This is the situation we have. In the audit community, what would the judgment be?' As Mr Goodwin has said, in the end the uncertainties were so pervasive and of such a magnitude that we concluded that there

was no choice but to say we could not form an opinion. As a newcomer to this discipline I found the discussion with the audit community interesting. Some were fairly pragmatic and suggested that in years past this might not have mattered—you could have still concluded with an ‘except for’ opinion—but that in the new climate you would not be able to do that. The more modern view was to go straight to the point and say, ‘This is not acceptable.’

CHAIR—What is the asset value of Defence?

Mr Smith—It is about \$52 billion.

CHAIR—You can understand the concern of the committee and the Audit Office that the Audit Office could not validate \$7.12 billion worth of defence assets and \$1.23 billion worth of defence liabilities, including general stores inventory totalling \$2.03 billion. The Audit Office identified that as a weakness in the stocktaking, record keeping and pricing data systems, including the SDSS version 4 system.

The Audit Office say that the \$845 million for the explosive ordnance industry was due to a lack of documentation to support the prices used to value that proportion of the recorded balance and other items—we discussed this in the in camera session; \$2.86 billion was reportedly the written down value of repairable items in the general stores inventory, again due to weakness in stocktaking and record keeping; 1.39 billion of the land and building infrastructure plant and equipment balances due to some assets being excluded from revaluation processes and other deficiencies in record keeping; and \$1.23 billion for the Australian Defence Force leave provisions due to supporting documentation for leave entitlements.

Obviously, this is something that has been occurring not just in the six months or year prior to the audit; it appears to be systemic, almost from day one. Could you explain that a little and reassure this committee of the steps you are taking towards appropriate measures to end Defence’s inability to form an opinion that they are true and fair statements of the financial matters of Defence?

Mr Smith—I do understand the committee’s concern. It gave me no satisfaction at all to be the first CEO, as we say, in the Public Service that I am aware of to be unable to form an opinion on his own accounts. I was confident that there was no choice but to do that and any other decision would not have been an honest one.

I believe you are right that this is not something that has developed quickly. As I have explained before, our organisation has come off 100 years of cash accounting in which there was not the same degree of scrutiny of some of these issues as there is now. I think that is partly what the issue is here. But I would say two things in particular. Firstly, our management information systems are not as robust as they need to be in a modern corporation of the kind that we are asked to perform as. Secondly, our reporting systems—that is, the disciplines and controls that the IT systems are used to convey—are not adequately robust, and I think the ANAO has commented forcefully on that.

As you say, it is not something that has developed quickly. It is an accumulation of systems failures and cultural failures. In short, we are being asked to transition from being a public service agency and a defence organisation with relatively low standards in terms of this kind of

managerial efficiency to being an organisation, a corporation, as efficient in these areas as, say, one of the major banks or BHP. That is a massive transition for a public sector organisation to make, but it is not entirely without precedent. I have talked often to colleagues in the ANAO about the experience of Telstra, which was Telecom Australia. The old Postmaster-General's Department, now Australia Post, transitioned to adequate standards. That has to be our goal. You asked what we are doing. That is the mission: to transition this organisation to modern corporate management standards. It is a long-term goal. It will not be achieved in my time in this job—whether that lasts another month or X years. It is a very long-term project.

CHAIR—I suppose that leads to the obvious question: what milestones for achievement have you laid down over what time frame?

Mr Smith—As you know, we have these 14 plans. We call them remediation plans. Some of them are addressed very specifically at remediation and there are clear milestones and dates—for instance, for the valuations of land and buildings. But others are part of a much bigger changed management plan, particularly the financial reporting framework, plan G1. That will lead to a very different way of doing business in Defence, when it finally gets traction.

CHAIR—Is there a reluctance by the people on the ground to adapt to change or are they agents of change?

Mr Smith—I guess that there always is reluctance, particularly reluctance to adapt to change in what is not seen by many of those involved as the core business of the organisation. People are remarkably adaptable when it comes to taking on new ways of war fighting and new forms of equipment.

CHAIR—Exciting stuff.

Mr Smith—That is the business of the great majority of our people and they do it very well. This is seen in many cases as a secondary matter—and I do not mean to denigrate this, and it is not seen as secondary by me—but it does have a different place in the culture.

Miss JACKIE KELLY—Can you go into the FFR G1 program a bit more?

Mr Smith—I will ask Mr Moore to speak to that, but that is our underlying plan. That is the fundamental change management plan.

Mr Moore—Plan G1 was originally established to address a range of audit findings, most of them coming out of the 2003-04 financial statements audits—which we have to respond to—and they are issued—

Miss JACKIE KELLY—Who is designing it?

Mr Moore—On behalf of the secretary, I am responsible for the G1 plan. In the narrow, it is designed to address 10 to a dozen specific audit findings in relation to running bank accounts and appropriations and so on, which is the normal role of the chief finance officer. When I arrived in this particular role there was work already under way to review whether the response to just those specific audit findings was enough. We concluded, with the secretary's agreement,

that we needed to put in place not just a plan to remediate those specific audit findings but a far broader financial controls framework and run it as a major project.

Miss JACKIE KELLY—This is the Get Well Program?

Mr Moore—It is G1. It should not be confused with the SDSS Get Well Program, which is subject to a separate consideration. This is a financial controls framework. Do we have the right business framework in place? Do we have the right financial services framework in place? Do we have the right standardised processes and controls right across the organisation so that a warehouse manager at Moorebank is operating off exactly the same set of instructions as a warehouse manager somewhere else? Do we have qualified people at all locations? Are we satisfied that, before somebody goes into a key resource management position, they have the right skills and experience and training so that they can discharge the functions of those positions properly? We are looking at all aspects of our financial—

Miss JACKIE KELLY—It will be a major project?

Mr Moore—It is a major project.

Miss JACKIE KELLY—Costing over \$20 million?

Mr Moore—This specific project does not relate to the \$20 million figure that we have mentioned before. That is to remediate all 14 plans, of which this is one. This is a subset of that \$20 million. I expect that it will take about 20 staff working for about three years directly to me to drive this new framework through the organisation. Those 20 staff will not do all the work. We have developed a very detailed work breakdown structure of what we think we need to do at the various levels of the organisation but a lot of the actual work would still remain in other parts of Defence like, mainly, Joint Logistics.

Miss JACKIE KELLY—So you are not purchasing any new IT or—

Mr Moore—No, not through G1—

Miss JACKIE KELLY—So this is 20 people. Are they uniformed or civilians?

Mr Moore—Civilians, and they would be augmented by expert advisers. We thought we had to buy some particular technical skills in but generally there will be about 20 people driving this new framework through the organisation, relying on a lot of work being done in other parts of Defence. There will be a far greater staff effort required than just the 20 project officers.

Mr BROADBENT—I have been in public meetings with Defence many times in my stint in the parliament and I have never had Defence being so forthright as today, so I would like to put my thanks on the table.

Mr Smith—I must be doing something wrong.

CHAIR—There is more to come yet.

Mr BROADBENT—In the process of what you are trying to achieve could there be further contracting out—you have already contracted out some programs? Then, because this is Defence, is there the kind of correlation that was raised before between the control of equipment as part of defence capability—the leadership wanting to have access and control, with their equipment behind them, rather than having that contracted out? There would actually be a clash of culture there—the contracting out, can be more controlled, compared to the desire for those—

Mr Smith—Learning it ourselves? There is always some tension around that issue. The closer you get to the front line the more tension there is about that. But in an area like logistics management for the most part there are no reservations now. Even Orchard Hills, our major ordnance depot, is managed by a private sector organisation and I think that another 21 of our warehouses have been taken over by TenixToll under that contract. I would see us doing more of that. I do not want to specify particular areas but I think that we will be doing more. It is all part of a necessary endeavour to get our scarcest and most important resource, that is, the trained ADF member, out of the warehouses and the back line into the front line where he or she should be.

Mr BROADBENT—That is my next question. I am not denigrating the people who are working in the stores—and I just want to make that point—but Defence are always going to put their best people in the most senior positions. Therefore, the people that are working at that level at some stage may not be the absolute cream of Defence Force people—

Mr Smith—I would say this in regard to logisticians and transport corps: they are as proud as any other corps in Defence and when they leave or retire from Defence they are in demand to go to logistics and transport management companies. Is that a fair statement?

Air Vice Marshal Spence—Absolutely. In fact Air Force—and I am purple at the moment, not blue—has recognised the value of its logisticians and ensured, for example, with the other two services that at ADFA a bachelor of business studies is available now. There was a period when that was not the case. We have also initiated a program within the Air Force to encourage retention of our people by providing professional development opportunities and a retention allowance, because we recognise that they are extremely valuable and, generally speaking, they are very attractive to outside employers. So there is that recognition there.

Senator HOGG—The thing that concerns me and always has is that the alarm bells did not ring some substantial time ago. We have to wait for Audit reports and inquiries such as this, and we have to drag Defence, seemingly, through this and a range of other issues, before any action takes place. Whilst I applaud the action that is taking place currently, what is fundamentally wrong with the systems in Defence that do not allow it to recognise the problems that seem to bedevil it in areas such as this and in stocktaking and other areas? There must be some fundamental weakness in the people that are recruited to oversee these areas. Is it a problem with the retention of people in these areas? Is it a problem with career paths and structures? Is it a problem with the salaries that they are paid? Can you dig a bit deeper and try to give us some understanding of why these things happen. I applaud the remediation program—I think that is great—but why did these problems happen and what will ensure that they do not happen into the future?

Mr Smith—That is a very good and complex question, or at least the answer is complex, I think. It is certainly the case that, when I was asked to come to Defence and did what I thought was the necessary reading, I did not appreciate the magnitude of this problem. In looking back across Audit reports over a number of years, it might have been possible to join the dots and say there was a bigger problem than just superficial year-by-year problems. But it took me, I will readily admit, a year or 18 months to understand that I was dealing not just with things that could be handled with bandaid solutions but with an underlying problem of management strength. Whether others who had been in the organisation longer recognised that earlier, I do not know; I just speak of my own experience. In a lot of ways, I have been assisted in understanding the nature of the problem by Dr Gumley. He has a substantial private sector background; that is the benchmark now. He has been able to say, ‘This is the symptom, but it must mean the problem is this.’ That has been valuable to me.

As to the reference to people, I do not think we have a problem with retention, although I must say retention is a problem in any area of financial management in the public sector. Skilled people are in great demand and they are moving all around the Public Service. All of us have greater expectations on us now and the competition for people is pretty tough. So there is that issue, though our key people have been fairly stable. As I have said before, we have to do a lot of training of our own because we are the biggest user of these people in the public sector. Perhaps Ken could say more about the issue. He has been with it, on and off, for longer.

Senator HOGG—Could you touch on the issue of career paths. I was involved in another inquiry which was purely around retention and recruitment within the Defence area. The career path structure for people within Defence was something that did come up fairly often.

Mr Smith—Civilian staff?

Senator HOGG—Both civilian staff and Defence personnel themselves. Some of them, particularly the uniformed, were no sooner into the job than they moved on and, of course, there was a lack of continuity. For some of them, they could not see themselves being stuck in dead ends, so to speak, that were not seen as the avenues to promotion—and I am not being critical of those people with their aspirations to achieve higher rank. They had no sooner arrived than they were gone and, therefore, the continuity was not there. That is the sort of thing that I am getting it. Have you done any analysis of this? It seems to me that this may be a problem. I would like the Audit Office, if this has become apparent to them in their audit process, to comment as well.

Mr Smith—There is no question that churn within the organisation compounds our problems. Defence personnel rotate in a measured and deliberate way. Civilian personnel rotate quite a lot, but that is because of the tight market and the opportunities that they can get elsewhere. There is no question but that churn is an issue.

Senator HOGG—That brings me back to the issue of your ability to compete with the marketplace and thereby retain the quality of staff you need to run what is a massive organisation. This is not a criticism; I am just trying to tease the issue out because I think it is something that needs to be done.

Mr Smith—In the DMO we have certainly addressed that—

Senator HOGG—Yes, I accept that.

Mr Smith—and Dr Gumley can talk about that. In that sense, I am sort of using DMO as a test bed, a lead, for the rest of Defence.

Senator HOGG—With respect, Dr Gumley's organisation would probably not be your problem. The problem is over here in Mr Moore's area—although I am not blaming him.

Mr Smith—When I started in Defence, I thought that he would be the problem!

CHAIR—Have you discussed this with him? Perhaps this is something that should be heard in camera!

Dr Gumley—I will make a point regarding what we found in DMO. It is an analogy but I think, Senator Hogg, that it picks up on your point. We found that there was too much churn with the project managers on the major projects, so we now have a new military staffing policy in DMO where there are four-year rotations for the middle and senior people, instead of two-year rotations.

Ms GRIERSON—Are they all on performance based contracts, as part of the culture of change that we have? 'Contracts' is not the right word, because it is not commercial.

Dr Gumley—No. Military people do not have contracts.

CHAIR—If they misbehave, they put them on the frontline!

Ms GRIERSON—I think the performance indicators for operational people are fairly overt and hard to avoid, but in the Department of Defence—

Dr Gumley—In DMO we are moving to have, for example, more performance measures. I am not absolutely convinced that performance pay always gets you there; often it is feedback and recognition—other things—that get you there with regard to performance. So we are moving that way in DMO. This is what we did with the project managers, and it also applied to the engineers. Eventually, we are going to end up with something similar for the finance people. We are going to have to do that in order to stop the churn.

CHAIR—I think there is probably a huge issue there, as you are saying, in the rotation. We explored that in earlier hearings. A two-year posting is not long enough for somebody to settle in and get to know the area—to know the base, to know the personalities—and to manage their job within that hierarchy.

Mr Smith—I make a point in response to what Ms Grierson was saying. There are ADF personnel as project managers, but even in those cases they do not have the same kinds of performance agreements that a civilian would have.

CHAIR—Does the Audit Office have a view on that?

Mr Goodwin—Yes. To put this in some context, the scope limitations that we had on our qualification, which ultimately gave rise to the inability, had their genesis in internal controls and record-keeping practices that required significant improvement. It is about management controls rather than technically complex accounting matters. I would add to that that, where we had qualifications this year, we had audit findings in each of those areas, to varying degrees, in previous years. Those findings that became extreme last year had been raised in various forms and degrees in prior years. To the extent that they are raised with management and not necessarily executed, inevitably when we find that people give their response on previous management letters our staff go back in the following year and they might find that they are dealing with a different person. So accountability—that is, owning the problem and fixing it—becomes an issue.

We have an analogy in our office—and analogies can be dangerous. We say that, in any given cycle of a new employee, the first six months might be spent learning the job; in the next 12 months—up to 18 months after they arrive—they get on top of the job; and it is only after that that they might add value to the job. So, if you move on after two years, you lose the knowledge and—and this is the proposition being valued—you also lose the accountability. I guess that is what we have seen in previous closing reports.

CHAIR—And the last three months is usually spent working out where they are going on the next posting and what they are going to be doing. So the critical performance time is even shorter.

Mr Smith—You have to distinguish between ADF people for whom the churn is a part of the career pattern and civilians for whom it is part of the market.

CHAIR—Are you saying that most of this will be alleviated as you go more and more towards private market control of the stock systems of Defence?

Mr Smith—Some of it will. The civilian work force responds to the market, which is very tight. In that regard, I think even ANAO faces a quite high turnover of staff. I read—I think it was in the APS survey—that something like 20 per cent of staff turn over each year, so it is not a problem for civilians that is unique to Defence.

Senator HOGG—Coming back to the issue of your ability to compete in terms of the salaries and packages that you offer to people, it is not much use if Mr Moore has 20 people assigned to his group to try to remediate turnover rates if, because of the demand that is out there for their skills, you cannot offer people the packages to retain them. Do you have that flexibility?

Mr Smith—Yes, I do. There have been a few instances in the past year in which Mr Moore or his predecessor has come to me and said, ‘We know who we want but they will only come here if you can pay a bit more,’ and I have done that through AWAs.

Senator HOGG—Do you actively go out into the market and headhunt the people that you need?

Mr Smith—Yes.

Air Vice Marshal Spence—On the military side, clearly you do not join the military to make money. The retention side of that is very much about making it an opportunity for people to grow, develop and enjoy professionally what they are doing. We are working very hard at making sure we provide our military people with the right sets of opportunities and training. By doing that, even though they might not by comparison be remunerated as well as somebody who is working for Toll, in the broad, their enjoyment of their life and job is probably higher. We have to focus on that. In defence of my logistics colleagues, I find that the people I have are of a very high standard. The majority of my commanders are tertiary qualified. They have a very good understanding of logistics and I think they are doing a very good job.

On the matter of churn, we can control the military side of the house—I can negotiate with the chiefs of service to have individuals for a shorter or longer time, depending on the circumstances. The military does recognise this issue of short-term postings and the disadvantages that accrue from them. We are trying to manage that. On the public service side, I have less control, because the public servant is almost entirely in control of his or her destiny. A public servant can choose to leave.

CHAIR—Are there many people who exit the military to jump across to the better pay scales offered by the private contractors or consortia?

Air Vice Marshal Spence—There are certainly a number of people who would move across to the new employer, but not necessarily for the better pay scales, because that is not always the case.

CHAIR—What about the greater freedom?

Air Vice Marshal Spence—Perhaps for the stability or predictability—that sort of thing.

Mr Smith—Am I right in saying that when TenixToll took over there were a number of ex-military people in its upper management?

Air Vice Marshal Spence—Yes. And a significant number of ex public servants as well.

Proceedings suspended from 10.28 am to 10.37 am

CHAIR—Could you update the committee on the progress of the stock-take program as a result of the audit finding?

Air Vice Marshal Spence—Yes, and I will probably be reiterating some points I have made previously. We have put a project framework around the S1 remediation project. We have completed a 100 per cent stocktake at DNSDC at Moorebank. I think you will be visiting there next month to see that location.

CHAIR—That is correct.

Air Vice Marshal Spence—We are in the midst of a 100 per cent stocktake at Bandiana, the second largest of our warehousing sites, and we will be concluding that toward the end of this year—in around September. That will give us baselining on our stock in those two locations. We

have initiated a logistics compliance and assurance team within Joint Logistics Command. That team has established a program of visits to all of our business sites over a 12-month cycle. The aim of those teams going out there is to work with the business units and the various contractors we have out there—TenixToll, Tenix and others—to assure us that the processes and procedures are being applied correctly by both the business units and the contractors.

We have drafted a revised defence instruction on stocktaking. We have to do some minor changes to that in the next week or so, and then it will be promulgated to give people a good understanding of the way that we expect stocktaking to be done in the future. There are already some changes as to how we do stocktaking. We are working with the DMO on the introduction of some new IT enhancements in the warehouse.

CHAIR—Is that in relation to SDSS Get Well?

Air Vice Marshal Spence—No.

CHAIR—It is another one?

Air Vice Marshal Spence—It is separate from SDSS but is certainly related to it. These are the personal data entry terminals that the warehouse staff can carry around with them. When they pick up something or return it to a location, they will be able to input it at the time and be told at that time whether it matches what the record says. If it does not, we can immediately instigate an investigation process. We are taking the human element of it into account there.

Miss JACKIE KELLY—Coming back to Senator Hogg's questions on churn, retention and corporate knowledge, you have said in prior evidence that there are 1,162 warehouses in the defence system and that a 100 per cent physical stocktake is taken on those warehouses every two years. Do you have corporate knowledge available of the discrepancies found in stocktakes over the last 10 years?

Air Vice Marshal Spence—I would have to take that on notice to get the detail of the results.

Miss JACKIE KELLY—It seems to me that that information would be a good benchmarking system, given that your 100 per cent stocktakes every second year are quite different from what the Audit Office find. If you build in what the Audit Office are finding and make those sorts of adjustments, that would give you a trend and some benchmark as to how effective things like the SDSS are. Even with churning of staff, someone could come in with 15 months experience and say, 'We might have 29 per cent now, but it was 35 per cent six years ago.' That is a good thing rather than a bad thing.

Air Vice Marshal Spence—Sure. I am expecting that we will see some improvement compared to last year when ANAO returns and looks again and that we will continue to see those improvements in 12 months time when we have the processes bedded in and our relationship with the contractors squared away.

Miss JACKIE KELLY—I put it to you that, if you were to go back to the early nineties, you would find that you had similar stocktaking results. Can we see the warehouse trends and results of the stocktakes back to the 1990s? I think the committee would find that interesting.

Mr Smith—Could you see if we have those historical records?

Air Vice Marshal Spence—Yes.

Mr Smith—Thank you.

Senator HOGG—I want to raise the issue of internal audits. From where I sit, it would seem that your internal audit process is not rigorous enough or that the internal auditors themselves are not rigorous enough to put their foot down and say, ‘This needs to be done or that needs to be done.’ Is that a fair criticism?

Mr Smith—I think it is fair to say that a lot of the issues that ANAO takes up and has pursued over the years have been drawn to the attention of ANAO by the internal audit process. Our internal auditors, if I can put it this way, are often more with ANAO than they are with the management of our organisation.

Senator HOGG—That is something I was not aware of. Does that pose a problem in the culture within Defence itself that, because there is that perception—and it may well be real—it causes people not to address the issues as readily as they should?

Mr Smith—I do not know that it causes them not to address the issues. The issue for us always is to have the internal or external reports taken as action saying: ‘This is a serious matter. We need to go away and address it as a priority.’ And that has not always happened.

Dr Gumley—I think it is fair to say that culturally there are some elements of audit fatigue starting to creep in. There are audit on audits on audits and the same people at the bases are having to—

CHAIR—I suppose they would not have to do if they got it right in the first place.

Dr Gumley—That is a fair comment, but culturally we are talking about the sort of people who actually have to do the work. These people are under a lot of pressure between now and 30 June, as everything has to be counted and checked and recounted and discrepancies reported. So there is an enormous load on the organisation at the moment.

Air Vice Marshal Spence—In relation to this auditing activity, I see this as a collaborative endeavour.

Senator HOGG—Internal or external?

Air Vice Marshal Spence—Both. I see it as a collaborative endeavour. Whilst ANAO has to maintain its independence clearly, we are working with them and they are working with us to get the outcomes that we need. The same applies with the MAB. Our relationship with both of those organisations—

Mr Smith—MAB is our internal auditor.

Air Vice Marshal Spence—Our relationship with both of those organisations is one of collaborative endeavour—we are working together. There is a degree of independence that has to be maintained, but right now we are in a healthy position in terms of the relationship.

Senator HOGG—What I fear is that in a lot of these reports that we see through the ANAO which are done in the defence area we get ‘agree, agree, agree and agree’ and then we come back and even though Defence have agreed with the external audit the problem does not seem to be resolved. Therein lies our problem and our dilemma. Our frustration as a committee is that you have got your internal audit process, which draws your attention to the problem, you have got the external audit process which draws your attention to the problem and then you say ‘agree, agree, agree’ and nothing happens. That is why I am asking whether there is enough rigour in the process. Is there enough attention given, rather than just saying, ‘Yes, we agree but we cannot do anything, for a range of reasons—personality, financial or whatever they might be.’

Mr Smith—There is a point there. We do seek to monitor the follow-up on audit reports—in particular, the SDSS audit report is something that I have personally sought to monitor.

Ms GRIERSON—Mr Moore, you have the task, then, of taking these improved systems and making them work for financial purposes. You must be concerned that the a 10 per cent discrepancy in inventory has a huge financial implication—if we quantify it at a 10 per cent of everything it is massive. Can you explain to me how you are going to deal with some of the major issues that came out? They are: valuations, and how we are going to put a value on these items; how you are going to reconcile civilian leave provisions, which are inconsistent; and how you are going to reconcile the problem that there are no invoices for some of these items. To me, there are small controls in the system but huge problems in terms of how we get some valuations right. Which system are you going to use and how do you integrate with DMO, which is now a prescribed agency? How are the accounts going to work? What are the implications?

Mr Moore—I will start with the DMO first. Our portfolio budget statements, which were tabled on Tuesday, separate the two agencies for the first time. We on track—

Ms GRIERSON—Is that a good thing on a bad thing?

Mr Smith—I think it is a good thing.

Mr Moore—There are more qualified officers than me that could comment on that.

Ms GRIERSON—We will see.

Mr Moore—We have taken a number of management decisions on how we will split the financial assets and liabilities of Defence, if you like, that remain on Defence’s book or go across to the DMO. We are putting in place a whole range of agreements between Dr Gumley and Mr Smith and people who work for them, including on the acquisitions side for all those projects to acquire new equipment. We will have the ability right down to the individual project level to see progress against milestones and we have agreed with government on the funding arrangements—how much of that would be passed through the Defence appropriations and how much would go across to the DMO.

The same thing will happen on the sustainment side, the logistics budget. We will also have this ability of seeing progress in the DMO right down to the product line level. So there has been a lot of work conducted up until now to do that. We are not that far off 1 July and it is all not complete. All the agreements have not been signed, though a lot of them have been drafted. Our view is that a demerger of this magnitude is a huge undertaking in any organisation. It has been made all the harder by the state of our financial statements and some of the limitations of scope and qualifications on the Defence books in 2003-04, and we expect some of them will remain for 2004-05—and I will get onto that later—and will actually be transferred in 2005-06 into the DMO. We have to consolidate both sets of agencies from 2005-06, which is something we have not had to do before. The auditors will be interested in the management decisions on assets and inventory between Defence and DMO and we have to comply with their testing that we have got that right. But we have made a call and we have put that call into the portfolio budget statements.

Getting back to some of your more general questions, we have got 95 audit findings, two dozen or so category As, which are very significant findings. The remediation plans that we have published in the portfolio budget statements provide you some detail of how we are addressing those findings. For example, the valuation of land and buildings is remediation plan S8, and Mr Henderson is here if you want to draw down on that particular remediation plan. We have assigned responsible officers to try and remediate as much as they can for the 2004-05 financial statements. I have to say that there is no way in the world that Defence will be able to remediate all 95 findings this financial year, noting that some of those findings are already a number of years old. The ones relating to systems where we just cannot fix the current versions of our corporate systems will take the next upgrade to fix, whether it be for the standard defence supply system or our personnel system. Some of those are taking some years to correct.

I have got a time horizon of what can we do for 2004-05. Can we get out of being unable to form an opinion to an 'except for' or a clean set of statements? If we cannot do that for 2004-05, when can we get that? I have to have a look at that longer term strategy. If you look at SDSS, you see that it is not just a box and the software; it is all the processes and procedures that surround it. So it is not just an issue of making sure we have a very robust piece of software; we have to put through to all SDSS users standardised operating procedures and so on for the way they use it. We think we are on an up to three-year journey. Some things can be done short term to fix it but some of these other fixes are longer term. I have to keep my eye on what is possible in the short term and what will take us three years to get through, and not only is it this raft of the 95 findings we have already got but we can expect probably some more out of the next statements too.

CHAIR—By the same token I do not think the committee wants to sit here at another audit inquiry into Defence and find there has not been significant movement forward on the areas identified. It would appear when we go back in history and other audits, particularly you have raised SDSS, that things do not seem to have moved on in a better direction. They seem to have moved backwards despite the consumption of many millions of dollars in taxpayers' money. So I am glad you have identified areas and you are taking a timely and responsible approach to it, but the committee, the government and the Audit Office all want to see things addressed, outcomes delivered and a resolution to the problems.

Mr Moore—And so do we. I shall relate a little personal experience. I have been in and out of Defence financial statements for nearly 10 years. When we first went to accrual reporting in the

nineties it was a snapshot of the organisation on 30 June and it was largely seen that those funny people in the financial community in the organisation were primarily responsible for getting that snapshot right. Having come back into the financial statements and into the chief finance officer group after a break of about four years, I notice the traction across the organisation. There is now a deep-rooted understanding that it is not just the CFO group who can fix all those audit findings. That is what you will see in these audit remediation plans. We have appointed responsible officers, whether it be Alan Henderson, the Deputy Secretary, Corporate Services, for revaluing the land and buildings part of the organisation, or Mr Peter Sharp, from personnel on the leave records. There is a recognition throughout the organisation that it has to be a collaborative effort, no matter where you sit, to fix the problem.

Ms GRIERSON—I go back to the points we made. We know we are getting accounts—we are working on a 10 per cent discrepancy anyway. How are you going to put values on that? It is all based on the assets you own. How are you going to put values to it?

Mr Moore—We have to comply with the accounting standards of how we value our assets and our inventory.

Ms GRIERSON—So what methodology is going to be applied?

Mr Moore—We attempt to do that. For specialised military equipment, as an example, which has not been the focus of major audit findings but it is a very large chunk of our balance sheet, under the Australian accounting standards we have complied with the appropriate costing methodology for that. One of the challenges ahead of us in trying to clean up and validate our inventory quantities and pricing is that we have to move to the Australian equivalents of the international financial reporting standards, which are looming very large. We are working with both the National Audit Office and the department of finance—

Mr Smith—And some private consultants.

Mr Moore—and private consultants, and we have identified our major issues on—

Ms GRIERSON—Don't claim any bonuses yet.

Mr Moore—Accepting our difficulty with accurately pricing according to Australian accounting standards, moving to what is called AEIFRS, we are proposing to go to the Australian Accounting Standards Board to seek some guidance on these new standards and how they think we might be able to apply them in Defence.

Ms GRIERSON—I am interpreting that to mean that there is not really a clear methodology in place yet or an understanding that advice is being sought on how to do the valuations. Do you have an opinion or some advice on that? Did you recommend a particular methodology for valuations?

Mr Goodwin—There are two aspects to the valuation issue. There is the current accounting regime which we all have to operate in—Australian GAAP. The defence department, in recognition of that inventory, in their own accounting policies say that they will accord that a weighted average cost. That in itself is not a technically complex issue. The issue that we have

from an audit perspective is trying to verify that weighted average cost. I am making the distinction between now and AEIFRS. As for the current issue on pricing, the department has a policy of weighted average cost. We try to substantiate that. Because we have some concerns around SDSS from prior audit findings we have to validate it, and we are unable to validate it. As I have said, it is about a control issue rather than a technical valuation issue. Going forward, though, under AEIFRS, as Mr Moore said, SME has not been a valuation issue to date under the current regime because they are recorded at deemed cost. That is in accordance with the finance minister's orders and the like. There is an issue going forward about whether those should be measured at fair value under AEIFRS, which has a market value connotation. That is one of the things that will need to be thought through.

Ms GRIERSON—What deviation could the Audit Office live with? I should not ask that question. There is going to be a problem in deciding that we have got to a point that is acceptable. I do not think you will ever get to an optimum point, knowing how big this is. I guess you have to work that out.

Mr McPhee—Ms Grierson, just from my reading of the papers and the letter we sent the committee yesterday, in some areas like explosive ordnance we did find discrepancies, say, in stocktaking, but they were not sufficient for us to say that they were material in terms of the financial statement context. There are some acceptable standards on which materiality is based, and we will weigh up the outcomes of our sample approach to see the level of discrepancy and our confidence in the controls in the system.

Ms GRIERSON—Leave provisions and executive remunerations would be a major concern to everybody. Mr Moore, how is that being handled, to make sure that those discrepancies found will not prejudice peoples' outcomes and opportunities?

Mr Moore—I will provide you with an overview, and then I will ask Mr Sharp to come to table, as he is actually running the remediation plan. What we have done so far, getting back to Senator Hogg's question about our management audit or internal audit process, is that following last year's results on both military and civilian leave records we have engaged our internal auditors to conduct an audit activity on our leave records to determine the error rate. Their report on long service leave has been passed to the National Audit Office, and they are currently reviewing that, as I understand, for both the military and civilians. That internal audit activity indicated quite a low error rate, but that will have to be validated by the external auditors. Annual leave has been split into military—and that has been split amongst the services—and civilians. Different results are coming through that internal audit activity which we will progressively pass to ANAO. On top of that, the head of Defence Personnel Executive is commissioning a different sampling activity, and I will ask Mr Sharp to explain that.

Mr Sharp—I am standing in for—

CHAIR—Too late! As you can hear, the bells are ringing for a division in the House of Representatives. I will have to adjourn the hearing because, by the time we get through a division, the time allotted for this hearing will have elapsed. I will foreshadow with you now that it looks like there will be a problem with us going to Moorebank on the 24th because it is the last week of the Senate before it changes. So we will be in contact and liaise with Defence as to

when we will go there. Our intention will be not only to have an inspection but to continue the hearings at Moorebank, if there is a facility available there.

Mr Smith—Okay. We will have some O-rings ready for you!

CHAIR—Yes. We want to see O-rings—all three billion of them!

Committee adjourned at 11.02 am