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JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

**Reference: Financial management and equipment acquisition at the Department of
Defence and Defence Materiel Organisation**

THURSDAY, 11 MAY 2006

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

Thursday, 11 May 2006

Members: Mr Tony Smith (*Chair*), Ms Grierson (*Deputy Chair*), Senators Bishop, Hogg, Humphries, Murray, Nash and Watson and Mrs Bronwyn Bishop, Mr Broadbent, Dr Emerson, Miss Jackie Kelly, Ms King, Mr Laming, Mr Tanner and Mr Ticehurst

Members in attendance: Senator Hogg and Mrs Bronwyn Bishop, Mr Broadbent, Ms Grierson, Mr Tony Smith and Mr Tanner

Terms of reference for the inquiry:

To inquire into and report on:

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

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

WITNESSES

GUMLEY, Dr Stephen, Chief Executive Officer, Defence Materiel Organisation, Department of Defence 2

HURLEY, Lt Gen. David, AO, DSC, Chief Capability Development Group, Department of Defence 2

PRIOR, Mr Phillip, Chief Finance Officer, Department of Defence..... 2

SMITH, Mr Ric, AO, PSM, Secretary, Department of Defence 2

WILLIAMS, Dr Ian, Chief Finance Officer, Defence Materiel Organisation, Department of Defence 2

Committee met at 11.16 am

CHAIR (Mr Tony Smith)—I welcome everyone here this morning to the committee's first public hearing for its inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation. As most of you would be aware, last year as part of its regular reviews of Auditor-General's reports, the committee investigated the Australian National Audit Office's finding of inability to form an opinion on the Department of Defence financial statements. The committee concluded that this audit finding was a culmination of a number of years of some poor record-keeping, information system failures and a failure to fully recognise the impact of accrual accounting.

At the conclusion of its review of the Defence financial statements, the committee resolved to conduct a broader review of Defence financial reforms and equipment acquisition, taking into account Defence's progress in implementing financial remediation plans and the Kinnaird reforms, Defence's reforms relative to overseas defence agencies and progress in adopting international business accounting standards. The committee's focus is, of course, on contributing to the best way forward for ongoing Defence financial reform. This is our first day of public hearings. In this morning's hearing we will take evidence from the Department of Defence and the Defence Materiel Organisation.

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

HURLEY, Lt Gen. David, AO, DSC, Chief Capability Development Group, Department of Defence

PRIOR, Mr Phillip, Chief Finance Officer, Department of Defence

SMITH, Mr Ric, AO, PSM, Secretary, Department of Defence

WILLIAMS, Dr Ian, Chief Finance Officer Defence Materiel Organisation, Department of Defence

CHAIR—I advise witnesses that the hearings today are legal proceedings of parliament and warrant the same respect as proceedings of the House itself. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament. The evidence given today will be recorded by Hansard and will attract parliamentary privilege. I welcome representatives from the Department of Defence and the Defence Materiel Organisation. This is the first of a number of public hearings. Given the nature of the inquiry, we no doubt expect to hear from you a number of times throughout the course of our hearings. Do you have an opening statement that you would like to make, talking to your substantial submission which we have received, before we open it up to questions?

Mr Smith—Thank you, Mr Chair. I do have an opening statement. Perhaps, as we have lost a little time, I will foreshorten it a little and give you some more time for questions—whatever suits you.

CHAIR—As I said, we will provide many opportunities for further hearings. If you have a prepared statement, please deliver it in full.

Mr Smith—I will make a brief opening statement about the accounting reforms that are taking place in Defence and leave the opening remarks about the issues and reforms in the Defence Materiel Organisation to my colleague Dr Gumley.

Defence and DMO, as you know, are separate accounting entities and have been since 1 July 2005. But the accounting reforms we are undertaking in Defence are being mirrored and flowed through to DMO, so what I say about Defence's accounts will largely reflect the situation in DMO too. Equally, while most of what Dr Gumley will say about procurement and acquisition occurs in DMO, Defence has a pre-DMO role in this area in defining our acquisition needs, so at times Lieutenant General Hurley or I might speak to that.

I should also say that, while Dr Gumley, Mr Prior and I are here because we are the accountable officers for our respective entities under the FMA Act, the resolution of the accounting issues we face is not one for us or for our civilian staff alone. It affects many, perhaps all, parts of our organisation, civilian and ADF alike. Our uniformed colleagues have much to

contribute as the managers in many of these areas, and our efforts have and must have the full support of the CDF and the service chiefs.

We have talked in the past about why it is that Defence has qualified audit reports and about the background to my decisions in 2004 and 2005 to reach no-opinion findings on our statements, with which the Auditor-General concurred. Our submission to this inquiry, as you will have seen, concentrates mostly on the future—that is, on the remediation of the problems identified.

Since we met last, we have added two new remediation plans, bringing the total number of those plans to 16. The new plans cover, firstly, provisions for contaminated or potentially contaminated land, buildings and infrastructure and for Defence's lease register and commitments. These two new plans were formulated not in response to any ANAO finding but as a direct result of our own people reviewing the way in which Defence does business and learning what is expected of us.

My colleagues and I are, of course, ready and willing to discuss each of those plans in detail, if that is what you wish. The plans have been further strengthened and supported in the last few months by the formulation of more than 20 detailed position papers, which articulate the accounting policies and treatments for major elements in our balance sheet. Fourteen of those are now with ANAO for review, and the remainder will be forwarded to the Audit Office in the near future. The development of those position papers has facilitated clearer discussion with ANAO on the validity of Defence's proposed accounting treatments, and we welcome that. This in turn has led to the modification of some of our remediation plans, and may subsequently lead to the development of remediation plans additional to those already in the program. Some detail on those position papers is set out in our submission at chapter 2.4, pages 45 and 46. Full versions are available to the inquiry should you wish to see them and for me to table them.

To help prepare the remediation plans and the position papers we have also engaged a range of professional accountants and advisers. We have taken external advice from a number of sources, including the independent members of both the Defence and DMO audit committees. In light of all that advice, I believe that we are doing everything possible to improve our management of accounts and our financial statements. But anything further that you can suggest or that comes out of this inquiry will be helpful to us in our endeavours and most welcome therefore.

We are committed to being benchmarked against similar organisations elsewhere in the world and to being seen internationally as a best practice organisation among similarly governed nations. To help us in this we have engaged actively with defence organisations in the UK, Canada, New Zealand and the US. Some information on their circumstances is included in our submission. Again, should you wish more information then we would be happy to assist in finding it.

Our financial reporting and equipment procurement are starting to see some benefits from all of our reform effort there. We made progress last year and will make more this year. I remain hopeful that a real breakthrough will be made in remediating our financial statements, if not this year then the next.

I will say something about the costs of all this and the training of our people. As I have said before, the remediation activities are not without costs in both money and people. In 2005-06 Defence have committed \$80 million: \$51 million in employee expenses and \$29 million in suppliers' expenses—that is, for consultants and advisers. In 2006-07 we will commit a further \$59 million: \$47 million in employee expenses and \$12 million for suppliers. This, with an estimated 422 staff years in 2005-06 and 366 staff years in 2006-07, will be the effort we direct to our remediation work.

The pressures of progressing Defence's remediation plans and of the adoption of international business accounting standards have meant that we have had to review our workforce and skilling needs. We have embarked on a major program of specialised training for our people. We have committed an amount of \$35 million over 10 years, to 2015-16, to deliver an effective financial management skilling system that meets the needs of Defence and of our people working in finance areas. Of the training courses conducted so far, we have provided training in financial management and IT systems for some 7,300 staff in 2004-05 and a further 9,400 to March this year, 2006.

Our remediation work to date has made reasonable progress. Let me summarise some of it. The valuation of land, buildings, infrastructure, plant and equipment was subject to a major disclaimer in 2003-04. In 2004-05 we were able to remove \$1.3 billion of that qualification, and we expect to remove the remaining \$103 million by 30 June 2006. With regard to explosive ordnance, we reduced the pricing uncertainty on this asset from \$845 million in 2003-04 to \$309 million in 2004-05. We expect to eliminate it altogether this year. The uncertainty over general stores inventory was reduced by \$732 million during the last financial year. As well, we have been implementing a new IT controls framework for the standard defence supply system, or SDSS, and are now in a good position to complete the remediation efforts over the next two years.

As to employee leave provisions, the qualification on military long service leave was fully remediated in 2004-05. Work is continuing on the remainder of the uncertainty. We are fully committed to the removal of all uncertainty on all leave balances, both military and civilian. When this is completed we will have eliminated the pervasiveness of the uncertainty across the entire financial statements, I believe.

As to the category A, B and C findings that arise from the ANAO's work, we have sent 71 closure packages to the ANAO and are on track to complete another 35—16 category A, 12 category B and seven category C—by 30 June this year. We will request ANAO to review those during their year-end audit.

I will say something about the adoption of and compliance with the Australian Equivalents to International Financial Reporting Standards. Our submission makes clear, I think, that we face some real challenges with the application of international accounting standards. As you will know from reading the financial pages of the press, we are not alone in that. Some highly technical issues are involved. Our inability to comply with the new standard requirement governing the valuation of our specialist military equipment could have meant that we would not have been considered a first-time adopter under AEIFRS this year. That would have precluded us from accessing much needed transitional provisions in the standards.

We advised the Australian Accounting Standards Board in October 2005 of the particulars of our situation in adopting AEIFRS and in February 2006 the board issued an amendment which allows all not-for-profit public sector utilities, Defence included, to be first-time adopters this financial year. We have also raised with the AASB some technical but important questions about the applicability of some of the new standards not only for Defence but for government reporting bodies in general. Let me cite some examples.

The accounting standards required Defence to value its inventory at the lower of cost or replacement cost. The story of our audit qualifications is that we have not been able to prove the prices of all our inventory. We are not Coles or Woolworths with their rapid turnovers of stock. As a result, cost information potentially needs to be held for very long periods for regular assessment against changing replacement costs. We have not done that well. Given the nature of Defence's inventory holdings, the reasons why we hold the inventory we do and the limitations in our existing logistics management systems, the application of this test in the new standard appears to be of questionable benefit. In the past Defence has raised provisions—that is, established values—for land and building decontamination only when we intended to dispose of the property concerned. Under the new standards Defence would be required to recognise a liability for the restoration of properties and occupiers for which a legal or constructive obligation exists. This would imply a need for us to establish the potential costs of restitution and remediation of contaminated land which we have no intention of relinquishing or changing the use of, such as our training areas.

Again, with Defence's large holdings of heritage and cultural assets technically we would be required to determine the value for the many military artefacts and items of memorabilia retained in our museums and historical collections. Many of these items have been donated. In theory those items should also be depreciated over their useful lives. As it is highly unlikely that Defence would sell those items—and anyway many are irreplaceable—reporting their assessed values is of doubtful value. Nor is it clear how determining a nominal useful life for those items for depreciation purposes would help us do our business better.

Another difficulty arising from the new standards is that Defence is required to review its supply contracts for the presence of financial instruments or derivatives that may need to be separately reported. Price and exchange variation clauses in particular may create derivatives but for the most part will not be separately reportable—and Mr Prior can elaborate on this issue should the committee wish. For Defence, the review and subsequent disclosure of these items would have uncertain use as the information provided under the accounting standards does not reflect the risks or funding arrangements relative to Defence as an agency of the Commonwealth government.

While all this information might be useful when considering investing in listed entities, I think that you will agree that the benefits that adoption of some of these new standards would make to the way that Defence has to operate are not always evident. Such requirements would add a further administrative burden and, arguably, neither enhance the achievement of our objectives nor assist readers of financial statements. With the introduction of AEIFRS and to maximise the ability to form an opinion for the 2005-06 financial statements we have worked to form a conceptual view of appropriate accounting practices and to implement those changes before the end of the financial year. As we have progressed in this task it has become increasingly evident that some issues cannot be resolved quickly because of the amount and complexity of the work

required including in the area of the uncertainty around the general stores inventory. The position papers we have prepared highlight why the difficulties exist and explain what Defence is doing to achieve compliance. This process will also aid us in meeting disclosure requirements.

In all this I want to emphasise again that, while attending to financial remediation and, indeed, to procure the reforms, Defence maintains some cash management practices and continues to deliver on its operational requirements. Our commitment to our allies and to our Pacific neighbours has not been affected by the extra activity at home. As the programs are worked through, Defence will continue to maintain our responsiveness to government requirements, carefully maintain and diligently monitor our funds and budgeting process, manage the specialised military equipment well and meet our financial obligations as and when they fall due.

I do not underestimate the scale of our problems. I would not wish to pretend that the great bulk of them were in those technical areas that I have talked of. They are more fundamental than that. But, by analysing the accounting issues, developing our position papers, ensuring that the remediation work being undertaken is enduring, and documenting and developing our financial framework, we are now repositioning ourselves to be able to take pride in our financial management. We have made good progress in scoping the problems and in mediation. But there is much work still to be done. It will take patience and perseverance. But we are determined to be recognised by the government as competent, professional and businesslike financial managers within the next five years.

CHAIR—Dr Gumley, do you have a statement as well?

Dr Gumley—Yes. DMO engages in a complex, high-risk enterprise—acquiring, modifying and sustaining high-technology capabilities for the Australian Defence Force. We manage 210 major projects, which are defined as those over \$20 million each; over 100 minor projects; and over 100 significant fleet groupings. These include looking after F18 Hornets, Anzac frigates and the Army soldiers' weapons. The total value of the equipment being looked after is over \$30 billion. In addition, we managed 5,522 new contracts of more than \$100,000 in 2005. The rate of contract formation of about 5,000 new contracts a year is continuing. Typically, these projects involve innovation at the leading edge of technology, integration of highly complex systems and, in turn, the management of an inherent high level of risk.

Overall, we are working hard at improving the effectiveness in managing this responsibility. Whilst we expend a large and growing amount of the taxpayer's dollars each year on purchasing and maintaining military equipment, we are accountable to the government and the parliament that this money be spent wisely, using value for money principles. In addition to extensive internal audit, we receive deep scrutiny from the ANAO, who perform many audits each year on our projects. We are examined by three separate parliamentary committees and we are currently undergoing three separate independent reviews.

The success of the ADF in recent operations is one indicator that public money is being spent effectively. Vehicles, equipment and clothing provided to Australian soldiers in the Middle East are the envy of our allies. Successes are rarely publicised. Media reporting concentrates on audit reviews, always done with the benefit of hindsight. Where problems result from industry failings, the blame is still attributed to DMO. The vast majority of equipment we supply is not actually made by the DMO, so we are only as good as our contractors.

Reports of cost blowouts misreport inflation and exchange rate variations as real increases, which they are not, or focus on projects that are exceptions to the norm. This reporting fails to comprehend the true nature of our business or what might be considered reasonable best practice. For example, media reporting on the Bushmaster has concentrated on the negative. Yet the Bushmaster is operating effectively in Iraq and Afghanistan and is very highly regarded by our troops and our allies. The Bushmaster is being considered by the US, Iraq and Canada to replace their less capable operational vehicles. This is a world-class product.

Financial reporting has been covered by the secretary. I would add that Defence and DMO are working together on solutions to meet accrued financial reporting requirements, but they do take time and money. The SDSS system, designed in the late 1980s, is being replaced with a system designed to meet accrued financial reporting under the new international financial reporting standards. It comes at a cost and will take some years to implement.

As to progress in procurement reforms, I view DMO as having three stages of reform—those that saw it established in the year 2000; the changes imposed by the 2003 defence procurement review, called the Kinnaird review; and now the further measures we are taking from 2006 onwards. Significant progress has been made to date in implementing the recommendations of the Kinnaird review. In fact, we are around 80 per cent of the way through. We have successfully established DMO as a prescribed agency, achieving this on time and within budget. We have also established strong working relationships with the Defence Procurement Advisory Board. We have engaged effectively with Lieutenant Hurley, chief of the new capability development group, to put in place military workforce arrangements and we have worked with the capability development group to strengthen the two-pass approval process.

In addition, DMO has initiated its own measures aimed at transforming DMO into a more businesslike, accountable and outcome driven organisation. This continuing improvement program has six key themes: professionalisation, re-prioritisation, standardisation, benchmarking ourselves against best practice, improving industry relationships and leading reform in Defence. To take just one of those themes, our professionalisation reforms alone have been responsible for upskilling most of our 6,000 staff. This has included developing a professional certification framework for project managers and certifying to date 315 project managers, with a further 207 enrolled and progressing towards certification. Two years ago, DMO had 10 project managers with the same levels of certification. As the portfolio budget statement showed last Tuesday night, these reforms are showing very pleasing progress, with our productivity having lifted around 20 per cent in real terms, based on business activity per person in the DMO between 2003 and where we expect to be in June 2007.

Successive governments have accepted that Australia should lead our region, given the quality of our military forces. To achieve this goal, Defence is required to push the boundaries in developing new equipment. This creates built-in project management risk for DMO, which must be managed. It is unhelpful to seek an idealistic perfection in project management. What is needed is realistic best practice relative to world standards. If DMO is to provide leading edge capabilities through our war fighters and peacekeepers, we must have a healthy risk appetite. If we did not, the risk would simply transfer to the ADF in operations.

Based on comparisons with counterpart defence agencies overseas, we assess our efforts to improve acquisitions as being ahead of those in other countries, such as the US, UK and Canada.

In Australia and internationally, DMO is leading reform in project management. Our reforms are being taken up by the Australian Institute of Project Management. DMO's focus is on achieving scheduled performance; with that will come improved cost performance. When compared with other organisations carrying out similar roles, DMO is an effective project management organisation.

But we are not resting on our laurels. We will continue our reform progress to increase our performance still further. We are committed to acquiring and sustaining capability for the Defence Force to budget, on schedule and to the right levels of quality and safety. DMO is improving its record, and my aim is to meet and surpass expected performance levels.

Ms GRIERSON—Starting with the remediation plans and the importance of the SDSS and the ongoing pricing issues with it, has there been progress with the SDSS in terms of fixing pricing and achieving an acceptable tolerance?

Dr Williams—There is a couple of aspects to this, and I can deal with one side, which is the pricing dimension; the other is the controls on SDSS more generally, which Mr Lewincamp can address.

In terms of the pricing, last year we had an audit qualification on pricing, which said we had uncertainty around a substantial amount of our inventory pricing. The task of trying to confirm pricing by a very rigorous process of going back through documentation was considered to be too large. So what we sought to do was to see if we could find electronic databases which would give us a good surrogate pricing that would be acceptable. There was a major task commissioned with KPMG to try to determine whether we could get surrogate pricing. At the end of that activity, which occurred a few months ago at the end of the last financial year, it was concluded that there was no single database that could provide a reasonable surrogate that would be accepted. We looked at, for example, the US FEDLOG database; the reliability of that was not sufficient to meet the standards required.

The result of that was that we then had to more fundamentally view how we go forward. As I say, the cost of trying to locate documentation across many hundreds of thousands of items going back decades was a huge task. On top of that, with the new international accounting standards, we are now required to report the lesser of two prices. So we have a new challenge now, which is to identify a mechanism to get replacement prices for all of those items. As a result of that, what we are now focusing on—and Mr Prior could comment on this—is going back more fundamentally to look at discussions with the standards board and to ask how we should approach this task. There is no simple fix.

Ms GRIERSON—So we are no closer to having a framework to get the pricing right?

Dr Williams—We believe the pricing we have now is not fundamentally unsound, but we do not have a mechanism at the moment which can provide the level of confidence that is needed for the financial statements.

Ms GRIERSON—If you get it wrong, it can mean billions. I just wanted an update on that before we went on. Mr Smith, last year Defence accounts were not presented to the parliament for some time. We understand how difficult that was last year, but they were very late in being

presented. I think it was November that the actual financial statements were completed. Will they be available at the end of the 2005-06 financial year?

Mr Smith—Not at the end of the financial year.

Ms GRIERSON—What about by the end of July, as was the norm?

Mr Smith—Not by the end of July. We are working to a period in October. The annual report, as you will know, should be tabled by 31 October and we have a plan and a time line that is within that. I think I explained, perhaps in a Senate estimates committee hearing last year, what had led to it going beyond the end of October.

Ms GRIERSON—I wonder about the position papers that you outlined. I think there are quite a few of them—that is, 20 position papers—being prepared.

Mr Smith—Yes.

Ms GRIERSON—Is this a paper process between you and ANAO or is it a real dialogue?

Mr Smith—It is a real dialogue. I should say that, in an ideal world and if we had had all the expertise available, we might have done position papers first and then developed plans off them. But we needed to get on with the remediation work quickly, because some of it could be tackled short term, so we did the remediation plans. As a follow-up step, we have now developed the sorts of technical papers that explain the basis of our approach. In some of these issues, there are alternative ways of proceeding. What we have sought to do is to use the papers to reach agreement with ANAO about exactly what the problem is and which of the alternative approaches we will take to trying to achieve resolution.

Ms GRIERSON—The papers that still are not prepared obviously go to the biggest financial areas—that is, the inventory. How close are you to having those position papers?

Mr Smith—I will ask Mr Prior to respond to that.

Mr Prior—We have prepared those papers. They were signed off by me just yesterday, as a normal course. They will go to our FSPB, and there is a paper going there next week, and they will be reviewed there. Then they will go across to the ANAO during the course of the week. That is the current plan. You are quite right: they are largely about inventory. They go to a range of issues around inventory, some of which Mr Williams has referred to. They will be a very useful point of dialogue between us and the ANAO.

Ms GRIERSON—Who has been responsible for preparing those position papers and who has been involved in preparing those position papers?

Mr Prior—The CFO group of the Department of Defence has done that.

Ms GRIERSON—Have they been tested by external experts or these consultants you talked about, Mr Smith?

Mr Smith—We have used external experts in helping to draft these and address the alternative approaches, yes.

Ms GRIERSON—Yet, Mr Prior, you were saying there was very little in the way of international example that was applicable. So who has been giving guidance on these position papers, specifically?

Mr Prior—Specifically, the guidance we are seeking, as Mr Smith said, is from our external advisers. But we are also engaged in dialogue with the Australian Accounting Standards Board.

CHAIR—You are?

Mr Prior—Yes, indeed. We have sent a number of letters to the Australian Accounting Standards Board on some of these technical issues, because some of these issues have not been dealt with internationally. For instance, Dr Williams referred to the imagery matter. As you may know, international accounting standards are not applied to government bodies internationally as a general proposition.

CHAIR—Just on that point that the deputy chair was making, have the Australian Accounting Standards Board been involved to the extent that you have sought assistance when you have thought you have needed it, or have they been involved in the production of the position papers from the ground up?

Mr Prior—We are in dialogue with them. We talk to the staff of the AASB. We thought that it was best to not to put the AASB in a position where they were having to go beyond their role. Their role is to develop accounting standards, so the papers we have put to them are more in the context of their interpretation of the standards. There was a recent announcement by the standards board that the urgent issues group would fold back into the AASB. So in that context we say that we believe we have an issue of interpretation and application and then we put that forward to the AASB.

Ms GRIERSON—Can I ask again: which outside consultants have been specifically involved in the position papers on inventory?

Mr Prior—Ernst and Young.

Ms GRIERSON—So they have been completed now, ready to be passed on. Is that right?

Mr Prior—Yes.

Ms GRIERSON—Does that give you any confidence, as Secretary to the Department of Defence, that you would be able to confirm the accuracy of accounts yet, for this year?

Mr Smith—I think that merely completing the position papers does not take us to an immediate resolution this year. The position papers are about long-term accounting policy and practice, and it is on them that we build the remediation plans which will deliver us the results we want.

Ms GRIERSON—How long do you think the implementation of those could be anticipated to take?

Mr Smith—I said when we embarked on this project 18 months or so ago that I thought it would take five years. I think we will make pretty recognisable progress in less than that. I do not think we will ever remove all of the qualifications, because some of them will be removed only by the flux of time. But I think five years remains still a fair call for the great bulk of the qualifications.

Ms GRIERSON—Mr Prior, in that position paper, if there is a way ahead that develops a baseline which is accurate then we are not going to be carrying forward continual deviations and error. Are you confident that that is going to be the case, or is it still too preliminary?

Mr Prior—I think it is. I will just use the imagery as an example. Some of these issues will require some thought about the standards. As Mr Smith said, some of these issues are about the pricing of imagery that is quite old and has been with us for a long time. The records may not be there to substantiate that original cost. The issue that we have in front of the standards board is to say, 'The current requirement is not something we could meet.' We cannot create historical cost records that are not there, as Dr Williams said. The issue is how to find an appropriate surrogate measure for those cost records. Part of what we are doing with the standards board is to say, 'How do we apply the standard in these circumstances?' If the standards board were to think this through and offer a variation to the standard then that could be one of the ways forward. Part of the approach is to ask the standards board to think about these issues.

Ms GRIERSON—Mr Prior, I do not think you have presented to this committee before, have you?

Mr Prior—No.

Mr Smith—Not to this committee.

Ms GRIERSON—Have you been in your position very long?

Mr Prior—I joined the Department of Defence in January of this year.

Ms GRIERSON—Can I ask what was your prior experience?

Mr Prior—I worked in the Department of Finance and Administration for some nine years and, prior to that, with some large accounting firms external to the Commonwealth.

Mr Smith—I should say that he was also a member of the Financial Reporting Council, which is helpful to us. Ms Grierson, can I pick up an earlier point you made about whether we have sought to benchmark these position papers internationally. Given that in part the papers go to these matters of international financial reporting standards and we remain the only government seeking to apply them, that has not been possible, so I hope if we get this right that we will become a benchmark for others to come to.

Ms GRIERSON—So do we. I would like to come back to the AEIFRS, but I know my colleagues have questions they would like to ask.

Senator HOGG—I have a follow-up question. You said that it seems as if there is an ongoing relationship between yourselves and the standards board. Can you give us an idea of the state of play: when you expect responses out of them, and what responses you have to date?

Mr Prior—We have four letters with the standards board at the moment across a range of topics. We sent those off, I think it was, a couple of weeks ago. I am expecting to go down to Melbourne and talk to the standards board over the next couple of weeks. Then they will have to fit that into their program of meetings and so on to put those issues in front of the fuller board. It really is in their hands as to how long it takes for them to work their way through those issues. I would like a speedy response, of course, but these matters are going to take a little while for them to work their way through.

Senator HOGG—When you say you have four letters, can you give us some insight as to what the four letters cover?

Mr Prior—I can. Of the current letters to the board, one topic is embedded derivatives. One letter is on the conceptual framework around the definition of assets for the public sector. Another one is on the concept of inventory for the public sector. Another letter is on the recognition and depreciation of heritage and cultural assets within the public sector.

Senator HOGG—Are these issues that you are raising on behalf of Defence peculiar to Defence or are they issues that are likely to occur in other departments of the Commonwealth? So you can answer it fully, what relationship have you with other departments on these issues?

Mr Prior—We are in constant dialogue with the Department of Finance on these matters. We believe that these are issues that will go across other government agencies, not just the federal government but state governments, and other not-for-profit organisations—Red Cross and so on. There are imagery issues. Red Cross holds images of blankets, and they have images of emergency supplies. They will have these valuation issues in front of them as well. Our thinking is that they will cut across other enterprises. So our correspondence to the standards board is that it is about a conceptual issue with the standards and how they apply to a sector within the community. We have raised them because they are very much at the forefront of our financial statement issues.

Senator HOGG—So given the fact that you are—if I can describe it in this way—at the cutting edge of this debate, is it likely that the government will step in to take a whole-of-government view, and therefore that Defence will not be the lead agency?

Mr Smith—It is hard to say that, but I think that Finance is happy to see us take these issues forward. They have a great respect for Mr Prior. They advise on the papers and the letters.

Senator HOGG—I was not trying to cast aspersions on Mr Prior's ability. I was thinking that this might in some way delay the process if it has ramifications for other areas of government. The government may well step in and say, with no disrespect to either Defence or Mr Prior, that they wish someone else to be the lead agency in this debate.

Mr Prior—As Mr Smith said, they are happy to work with us and let us take the lead at this time. We are progressing it. They are aware of it. They agree these are issues that need to be progressed. Looking at those particular issues, we are probably the most significant agency with the most significant occurrence or incidence of those issues, so we have a very strong interest in it. So it is not unreasonable for us to be out there with this. The Department of Finance very much is in line with our discussion and thinking of these things. So they are happy. There is an overhead. There is a degree of work required to progress and develop these issues. They are not simple issues. To that extent, we have to deal with them anyway. That seems to be the way it will go.

Mr BROADBENT—Mr Prior, have you aged a lot since January?

Mr Prior—No, I have aged—

Mr BROADBENT—My question is to Mr Smith and Mr Gumley, and is about best practice. Mr Smith, on the benchmarking you did, how do we rate against comparably governed countries around the world? Mr Gumley, how do you assess whether you compare favourably with other organisations performing similar roles around the world? You talked about remediation, but aren't we really looking at new technology and new processes? Wouldn't this have happened anyway in the effluxion of time? This is our opportunity to introduce new accounting programs and procedures et cetera, because we do not do what we used to do anymore, and in the future—say in 10 years time—we may not even be doing what we are doing now. End of story.

Mr Smith—Let me take the last question first. What we are doing is much more than remediation—absolutely. It is not only a management change but a culture change, aimed at causing people to say: 'Accounting for things accurately and counting things accurately is part of what I am employed to do; it is not just something I do if there's time at the end of the day.' There is that aspect to it, and then there is technology, as we have talked about in this committee before. One of the reasons our people were reluctant to do, as it were, the right thing in counting and recording assets was that the technology was not user friendly and our people were not trained. It is a major set of changes altogether, and whether we should have made them earlier or not is not for me to judge. Rather, I need to deal with what we have.

On your question about benchmarking, as you will see from our submission, it is a little bit difficult to do. Even with the four similar countries we have chosen, no-one is exactly the same. In terms of tidiness of accounts—if I can put it that way—New Zealand is probably best off, but then they have a small force and it is divided between a Ministry of Defence and a New Zealand Defence Force. I think I am right in saying that the chief of their defence force is a chief accounting officer. They were well advanced on the financial reform process through the 1990s anyway.

Mrs BRONWYN BISHOP—I do not think New Zealand is a good force to benchmark against.

Mr Smith—I would like to achieve the tidiness that they have achieved.

Mrs BRONWYN BISHOP—If we were about the size they were, you probably could do it. I do not think we aspire in that direction.

Mr Smith—Canada is of all of them most like us in size and nature and so on. I will ask Mr Prior to correct me if I am wrong on this, but my understanding—

Senator HOGG—He won't.

Mr Smith—He has often so far this year. My understanding of this is that the Canadians are still audited on an accrual basis at a whole-of-government level but not by individual agencies, so they have not yet been exposed on the sorts of issues that we were so much exposed on. Their CFO was out here two weeks ago to talk to Mr Prior to find out what is coming at him. I had a discussion with my counterpart there about six months ago and said, 'When you come to be audited against accrual standards on an agency basis, this is what you should expect.' He said to me, 'Why are you so involved in this?' I said, 'Because our parliament is passionately interested in the subject, and you can expect yours to be, too.' In that regard, we are ahead of them, but they have not yet had to meet the same requirement. Is that a correct summation?

Mr Prior—That is correct, yes.

Mr Smith—The UK situation I find very difficult to understand. They had many qualifications and so on—as we had—in many of the same areas until the accounts before last. Suddenly, they disappeared. Perhaps you could explain your understanding of what happened there.

Mr Prior—I think, as Mr Smith said, the accounts of the UK department of defence have now been cleared. They have a clear opinion from their auditors. They did go from a situation which is similar to ours on a range of fronts. They do not face as many complexities, in some ways, as us. I will give two examples. First, they do not have long service leave. So in employee provisions they do not have that issue of record keeping, because they do not have a long service leave obligation. Second, in the notes to the accounts of the department of defence they have made a statement that they will not account for embedded derivatives because they do not believe they are in the business of having financial instruments. Therefore, they take a policy position that they will not do that. To some extent some of their accounting issues were dealt with in a different way, but it is not clear to us exactly how they dealt with some of their record-keeping issues, and it may well be that they have a different approach to record keeping than we have. They have similar record-keeping issues to what we have.

Mr Smith—As to the United States—again, this is the obverse of Mrs Bishop's point—if New Zealand is small then the United States is so large that it is unfair on them to compare us. I would say, though, that we are in front of them. I do not think they have had auditable accounts at any time that we have been able to establish. I think their aspiration date is 2014. Their CFO told me that she expected to invest \$1 billion in getting there. Many of their problems are in exactly the same areas as ours—inventory, valuations, personnel records and so on. You can understand that it is a massive undertaking for them. So in simple terms I guess we are in front of the United States, but it may be unfair to claim too much credit for that.

CHAIR—Obviously there is a requirement for skilled staff to perform this sort of duty. You have mentioned Mr Prior's background. What progress have you made on putting a dedicated team in place and coping with some of the difficulties in attracting staff with the particular expertise needed, in both financial management and defence particularly?

Mr Smith—It has been pretty challenging. It was evident to me early on that we could not expect to recruit anything like the number of people needed to do this in Canberra—indeed, perhaps anywhere in Australia—and that we would have to train our own people. When I say ‘fairly early’, perhaps I should have realised that in year 1, not in year 2 or 3. But we have put in a huge effort—bigger, of course, than anyone else in the Commonwealth, but that is what you would expect. We will not make many people into trained accountants, but we will make them into much more skilled financial managers. This ranges through everything from training in the proper use of SDSS and why it matters, which is available right across the force, to higher levels of technical skill. We run some scholarships that will lead people to formal qualifications, and we have programs to enable people to regenerate or upgrade their qualifications, to keep their chartered accountant or CPA qualifications alive. I think we would probably have the biggest program in the country running on that at the present. You may like to elaborate, Phil.

Mr Prior—No, I think that sums it up. The other thing I would add is that there is also an incredible shortage of skilled accounting folk in the country generally. That is one of the challenges we face to our training program.

CHAIR—It is something that we on this committee are aware of in other contexts.

Mr Smith—Absolutely. We have some positions that we are still not able to fill, with the trained people and the kind of money we can offer. But we just keep at it. Of course the obverse happens: we skill up our people and they achieve a bit and somebody poaches them, but that is a measure of success, I guess.

Mrs BRONWYN BISHOP—As a strong advocate of governments needing to accrual account when I first came into this parliament, I always knew that Defence was one of the more difficult ones in accepting full accrual accounting. The concept of modified accrual accounting, which I think the Canadians use, I think is defective. So it is a question of adapting the system, I think, as best to meet the difficulties that Defence encounters while staying within the concept of full accrual accounting.

Having said that, I did not quite get the answer to the question on inventory valuations. You explained how you have attempted to find some method of putting a value on existing inventory. I can accept that. If you have a notional value and say, ‘This is the ground floor; we will move on from there,’ how do you solve the problem of accurately valuing new acquisitions?

Dr Williams—There are a few dimensions to it. One of the parallel issues we need to address is the systems on which we record the data. The inventory pricing is recorded on SDSS and at the moment it has two deficiencies. One is a set of controls that are not adequate to avoid some corruption of the data. That is being addressed by Mr Lewincamp, and we are fairly well advanced in getting a set of controls in place that the audit office would believe are acceptable. Even having done that, under AEIFRS we require the two prices and to select the lesser of purchase and replacement. SDSS does not have the capacity to do that, so fixing that is really an issue for the replacement system. From a systems point of view we will have great difficulty complying in the next few years.

Mrs BRONWYN BISHOP—Basically you will select a price which you think equates as best you can, and then use standard.

Dr Williams—At the moment we have a weighted average price, which is based on previous purchases. We can provide that with what we believe is a reasonable degree of reliability but we cannot establish, to the level of confidence that would be expected, that it is totally accurate. We are trying to ensure that the data that is being input at the moment is reliable. We run off regular reports which identify any variations in pricing that occur. Where they occur we go back to the relevant fleet manager and require that they go and investigate those examples and where they identify there is an error to correct that.

Mrs BRONWYN BISHOP—What percentage of those new acquisitions would be foreign or overseas sourced?

Dr Williams—I do not have a precise figure but a reasonably large proportion would be from overseas.

Mrs BRONWYN BISHOP—That indeed would give you a difficulty in meeting that standard, would it not?

Dr Williams—It could do. Once again, we have the additional issue of the exchange rates and things which must be factored in. Our financial systems are fairly—

Mrs BRONWYN BISHOP—Which is where your derivative question comes in.

Dr Williams—Yes.

Mr Smith—If the system is robust enough, when the data is entered it should sustain. Alternatively, and in parallel, we will keep the records—even foreign acquisitions, of course. Historically that is what we have not done.

Mrs BRONWYN BISHOP—Moving to the DMO and the work that Dr Gumley is doing, which I think is good work, I begin by asking about what has been a very fundamental problem in purchasing and has resulted in huge amounts of money paid for work that was not done. We have had examples of contracts which have allowed 80 per cent of the money to be paid for 20 per cent of the work. Dr Gumley, I think you have put in place a new system of benchmarking for payments for new programs. Can you outline the differences between the old method and the new method?

Dr Gumley—Back in the 1990s the fad was earned value management, which was a way of paying contractors as they go to do the work. That is no different if you are building a house—the builder expects to get monthly payments and so on as the work is completed. Earned value management is not a bad system but if it is used in isolation quite often the milestones do not get met. So although the contractor has put the effort in he has not always completed the task. We are finding out that the better system is a combination of earned value management and milestones. If they do not meet the milestones the earned value payments stop. It is really a difference between the question of how much you have spent to date and how much you have got to spend to finish. A number of our difficult contracts from the 1990s were structured around the older techniques and now we are looking to get a better commercial balance moving forward in the new contracts.

Mrs BRONWYN BISHOP—Thank you. Going to the Kinnaird review—and the outcomes, as you have said, have been positive and have been put in place—I would like to ask some specific questions about the new selection of project managers, both military and civilian, being on merit and the fact that you, Dr Gumley, have the power to reject someone whom it has been suggested you should take on. How is that affecting uniform postings? Have you rejected any people where it was proposed that they be posted into positions? Are we lengthening the period of postings, making back-to-back postings to allow for more continuity, or are we still doing short two- or three-year postings?

Dr Gumley—Under the new military staffing policy, we have extended the general project management postings from two to three years, with a number of them being four years. So that is an improvement. I have rejected a couple of military people coming in as project managers. But that should not be taken in the negative. We do have some excellent military project managers, and some of them are doing absolutely outstanding jobs. For example, right now I am considering whether or not I want a particular project manager, based on his experience and background.

One of the alternatives is to look in the wider community. Just as Mr Prior talked about a shortage of accountants, there is also a general shortage of project managers in this country. Project management is a growing sector of the economy. It drives the mining, the oil and gas and the resource extraction industries. We are competing in many cases for very much the same sort of people, so we cannot always afford the most expensive. People like BHP and other companies can always afford a much higher set of salaries than a public sector organisation like Defence could ever afford.

That said, we now have the ability with AWAs to choose some really good project managers. We have attracted some from the private sector, and that has worked very well. So even where we are with the skills situation in Australia at the moment, I am relatively comfortable that we are working okay with project management and working very hard at growing our own. That is why we have 300 of our own people going through project management courses. I remember reporting to one of the parliamentary committees when I first started that a measure of our success would be when the private sector comes to us and starts pinching our best people. Regrettably, that is happening now.

Mrs BRONWYN BISHOP—With regard to the statement that Australia has a national skills shortage, I think we all have to understand that that is because we had near full employment, which is a very good thing. We do not have the great pool of people to choose from, so the question of training your own becomes even more important and it is very good to see that you are doing that. But with regard to choosing on merit, do you use a common system of choice for uniforms and civilians, or is there a different system of merit choice for uniforms and the civilian stream?

Dr Gumley—For the majority of projects we use a common system of choosing on merit, but there are some that we call military preferred positions where quite often the three armed services put up different candidates for those positions. There are some that can be purely military. In other areas such as some of the classified projects, we also have to use a restricted set of people. But probably for 85 per cent of the projects, it is a common merit selection.

Mr Smith—For instance, if we have a project manager position that is, say, SES band 1 or military one star, we advertise that position in the press. The services then put forward their preferred nominee, and that person is compared with the best of the applicants that we have attracted from the media advertisement. It might be someone from the Public Service or it might be someone from industry. Sometimes the military person in that competitive process shows up as the best; sometimes he or she does not.

Dr Gumley—I can give an example where we do not use that selection, and that is when we are doing rapid acquisition for operations. Sometimes you have to move so quickly that you will take the best and most proficient Army colonel or whomever you can find, and you will put a good team around him and get on with the job.

Mrs BRONWYN BISHOP—One of the most serious criticisms made in the Kinnaird report was the one that said that, on occasions, poorly defined and inaccurately costed projects were being put to government and then passed on to the DMO to acquire. In other words, the initial work had not been properly done. That is very relevant, I would have thought, to, again, the preparation work of the similar sorts of people. Firstly, I would like you to address that question about how we are improving that so that government is presented with a more realistic picture. Secondly, is there an argument to be made—which would be difficult to reconcile with the concept of having every member of the ADF as combat personnel—that there ought to be a stream of people to whom they can go about project management? And General Hurley might like to comment on that too.

Dr Gumley—Mrs Bishop, I will give General Hurley the opportunity to answer the first part of your question, but I will answer the second part. I notice there was a press comment in the last couple of days about how all the military should be about filling operational units. If that happened, we would very quickly have a degradation of national capability, because in some areas—for example, artillery guns—you would not expect to find technical experts and so on in the private sector. In fact, you would hope that you would not. There are some areas where it is very much a military discipline. The Americans have an acquisition stream; eventually Australia will evolve to have more people within acquisition. Some of my very best military project managers are those who have had initial training in the acquisition organisation, have gone back to operational units and then come back in with a lot more operational experience, and it helps us enormously in dealing with the practical problems of running projects.

CHAIR—Before we progress to the second answer, I remind members we have about eight or nine minutes left. We are committed to finishing at 12.30. It will not surprise you that my inherently bipartisan nature means I want everyone to ask a question. I know Bronwyn has a couple more, and I know Lindsay Tanner has one or two. All of us, of course, have more questions, but we will have further hearings where we will progress a range of those.

Mr Smith—Perhaps General Hurley could address that issue about costing, because I think it is important.

Mrs BRONWYN BISHOP—Yes. I have only one more question, and then I will cede.

Lt Gen. Hurley—You will recall that a number of the major recommendations that came out of the Kinnaird review were in relation to establishing my group, the Capability Development

Group. This consolidated a number of diverse elements in the department that used to work in preparing capability proposals, business cases to go to government. We have grouped that together over the last two years, so in a sense I develop the business cases for government in a division called the Capability Systems division, which is primarily a military staffed organisation. I have an independent contestability division that looks at those arguments separately, to take a different view, to present arguments within the department to confirm the thoughts that are coming out from the Capability Systems division. I am responsible for our policies for simulation, I am responsible for our policies for test and evaluation, and I am responsible for oversight of interoperability and integration across the whole Defence Force to take a joint purview of what we are doing.

In the sense of how we move forward, again you will be aware that we have instituted a very strong 'entry into the Defence Capability Plan', first pass and second pass approval process, both internally in the department, through SCONS, and in the NSC. That is in the cabinet handbook, and we stick to that.

Mr Smith—SCONS is the Secretaries Committee on National Security.

Lt Gen. Hurley—You will be aware, in doing that work, the Kinnaird review said that we are to present a number of options to government at both first and second pass, and included in those options will be a military off-the-shelf comparator, or live option for a particular capability.

In terms of improving the way we do business, my organisation is primarily military—over 50 per cent—and most of my people will only come in for about a two-year period. They are subject matter experts, that is why they are there. Some of them will have project management skills and engineering skills and so forth, but not all. To overcome that, I am quite closely related to DMO. I essentially purchase skills off them to help me develop projects. So we project manage from a gleam in the eye through to handover, and obviously the project management plan continues in DMO.

I have developed my own cost estimation personnel within the organisation, who sit as part of the divisions that provide that early advice in conjunction with DMO and industry. I have an independent costing organisation that checks that and, as you are also aware from the Kinnaird review, the department of finance now has an independent costing function that we closely relate with throughout the journey to government approval.

Mrs BRONWYN BISHOP—I have one last question of Dr Gumley. He mentioned how successful Bushmaster is now and that it is a really good vehicle and outperforms competitors—and it is. But the history of that project is one that I would like to think we would not see again. It began with several competitors, and the requirements that we asked for were that (a) it did not have to withstand a bomb blast; and (b) it could either have automatic transmission or a geared function. There were three competitors and halfway through we changed our mind. Suddenly we did want it to withstand a bomb or a mine explosion, and then we decided that it was really more efficient to have automatic transmission than to have gearboxes that would go clunk. With our new procedures—and let us face it, Bushmaster took more than a decade to get there—can we be assured that that will not happen anymore, that the initial work that is done on what the requirement is and what is put to government is properly thought through and that the timeline between saying that we want it and having it ready is greatly diminished as a result?

Dr Gumley—Kinnaird was all about putting more effort into the front end to precisely handle the issues you are talking about. General Hurley's group write the specifications, with assistance from our people, of course, and we make it a much tighter process end to end. It is also good commercially for us, because unless variations show up during the contract the better the value for money government gets. So it saves government money doing this, as well as letting the war fighters get their equipment earlier.

Mr TANNER—I want to go the question of inventory accounting and the statement you have made with respect to the difficulties the department faces with respect to dealing with the new accounting standards. Firstly, with the sentence, 'The story of our audit qualifications is that we are not able to prove the prices of all our inventory,' to what extent is that the case relative to the problem of not knowing what we have and where it is? My impression from other inquiries and sources is that the inventory problem is perhaps as much to do with simply being able to track materials and identify whether a particular part is also being counted as part of a substantive thing as well. That is the first question.

Mr Smith—There are two issues. One was inventory quantities and the other was inventory pricing, and I will get Dr Williams to speak to them.

Dr Williams—First of all, it is worth clarifying that the issue is often a question of whether we can account for all our items. It probably should be looked at more in terms of record keeping. In other words, are we keeping our records up to date? There are occasions on which items will be sent off on an operation and the paperwork may not have been done to reflect it. So the discrepancy between our documentation and the physical count does not reflect things being lost. I think that is an important point. A fairly major stocktaking activity was done last year, and with respect to inventory it reached levels of reliability not far short of what would be acceptable in the accounting standards but not quite to the level wanted. So we are talking of the order of some per cent, not tens of per cent of problems.

On the pricing issue, again it should not be assumed that the figures that appear—billions of dollars—reflect that that is an error in the data but, rather, that that is the amount around which we cannot give confidence. So the actual, if you like, error—if it is the case—is much less than that; it just reflects that we cannot be precise around that group of items. If you want more detail on the stocktaking, that is done by the Joint Logistics Command and Air Vice Marshal Christopher Spence could probably give you more detail.

CHAIR—It was one of these issues. The interesting thing about that was that it varied a lot from one warehouse to another. In some warehouses you would have an error rate in the single digits; in other warehouses there might be a 12 per cent, 14 per cent or more error rate against the actual stocktake. We have often found that the people running the warehouse knew where things were but it was not properly recorded against where they were.

Mr TANNER—In other words, the story of the audit qualifications is not only about valuation; it is also about—

Mr Smith—Quantities, as we call it.

Mr TANNER—quantities and what is actually where and so on. The other question I have—

Mr BROADBENT—It would also depend on what was in each of those warehouses.

CHAIR—We will come back to all these issues in greater detail.

Mr TANNER—The statement with respect to the applicability of the new accounting standards, where you raise concerns about their appropriateness for the Defence department, says that one of the reasons why you question their benefit is because of the limitations in our existing logistics management systems. That strikes me as a little circular. It seems to me that that in itself is hardly a reason for saying that there is something wrong with the accounting system. I wonder whether you could comment on that. I am also puzzled by the reference to Coles and Woolworths and their rapid turnover of stock. I would have thought that it was harder to run inventory control when you have rapid turnover of stock.

Mr Smith—Just on that, what you get is one-way movement of stock. A lot of our problem comes from in-out movements and then recording them again where they go to, as well as recording them when they come back.

Mr TANNER—It does come in to Coles and Woolworths as well. They do move from DCs to stores and, in some cases, back again.

Mr Smith—But generally it is a straight line, as against in-out, overseas, back et cetera—just on the first part of the issue.

Mr Prior—In terms of the pricing issues in SDSS, it goes back to the notion of comparing cost with replacement cost. Coles and Myer, for instance, have the best—the standard applying to the private sector is cost versus market value, not replacement cost, which is a different issue. So, with stock rapidly turning over, to know what the current market value of a tin of baked beans is means knowing what your last sale was. That comparison is happening all the time. We do not have stock moving so fast, so we have to stop and say, ‘For all our inventory, let’s find the replacement costs for it.’

Mr TANNER—Do you accept my point, though, that inadequacies in your system are hardly a reason why an accounting standard is inappropriate?

Mr Prior—I accept that but I do not think that that was the point that was being made. It was more to say that there is a complexity and a cost as well. There is a conceptual issue but, even if you address a conceptual issue, you then have a problem with the systems as well.

Mr TANNER—On the copy of the opening statement I have it seems to be pretty clear. The reasons for our view that the new standard appears to be of questionable benefit, or the application of this test in the new standard appears to be of questionable benefit, include ‘the limitations in our existing logistics management systems’.

Mr Prior—That is because it will cost substantial amounts to change the current system to one that will accommodate the two costing systems side by side.

Ms GRIERSON—Mr Prior, you should know that this committee looked at the SDSS system and were never confident that it was going to cope with just getting to a benchmark situation, let alone dealing with the AEIFRS, so we will need to explore that.

CHAIR—That is a good point on which to conclude for today and on which to begin at a later date.

Senator HOGG—Mr Prior, just before we wrap up, can the four letters to the standards board be made available to the committee?

Mr Prior—To be fair to the standards board, I should—

CHAIR—Do you want to take it on notice?

Mr Prior—Just to be clear to the board, I may have accidentally misled you. I sent off three letters on 1 May this year. A letter on the embedded derivatives was sent off before I arrived in November last year, and there is ongoing correspondence about that. I will be talking to the standards board about that matter, because, even though they have—

Senator HOGG—All right—even if you have to make it available on a confidential basis to the committee at this stage so that we can get some sort of flavour for what is happening between you and the standards board.

Mr Prior—I do not see that there will be a problem with that, but I would like to call the standards board.

Senator HOGG—But if it can go on the public record that would be preferable.

Mr Smith—This is very dense material.

CHAIR—That is okay. This is the committee of Joint Public Accounts and Audit. On behalf of the committee I thank you for being here today at our public hearing. We will see you at the next one in June.

Resolved (on motion by **Mr Tony Smith**):

That this committee authorises publication, including publication on the parliamentary database, of the transcript of the evidence given before it at public hearing this day.

Committee adjourned at 12.34 pm