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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**

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

Thursday, 17 August 2006

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

Members in attendance: Senator Hogg and Mrs Bronwyn Bishop, Ms Grierson, Dr Jensen, Miss Jackie Kelly and Mr Anthony Smith

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

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WHITE, Mr Michael, Executive Director, Assurance Audit Services Group, Australian National Audit Office 1

Committee met at 11.05 am

CRONIN, Mr Colin, Executive Director, Performance Audit Services Group, Australian National Audit Office

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

MEERT, Mr John, Group Executive Director, Performance Audit Services Group, Australian National Audit Office

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

WHITE, Mr Michael, Executive Director, Assurance Audit Services Group, Australian National Audit Office

CHAIR (Mr Anthony Smith)—Welcome to the second public hearing of our inquiry into financial reporting and equipment acquisition at the Department of Defence and the Defence Materiel Organisation. Over the last several years the Australian National Audit Office has tabled a number of performance audits which have been critical of project management and acquisition practices within the Department of Defence and the DMO. In addition, for the last two financial years the Audit Office has reported that it is unable to form an opinion on Department of Defence financial statements. In layman's terms, this means the Audit Office cannot verify the accuracy of a number of major line items within Defence accounts.

The committee has reviewed a number of Audit Office performance audits and last year looked at the Defence 2003-04 financial statements audit. The committee concluded that the financial statements audit and the critical performance audits indicated a number of years of poor record keeping, information systems failure and a failure to fully recognise the impact of accrual accounting. Consequently, the committee resolved to conduct this broader inquiry into 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 their progress in adopting international business accounting standards. The committee's focus is on contributing to the best way forward for ongoing Defence financial reform.

At this morning's hearing we will take evidence from the Australian National Audit Office. I advise witnesses that the hearings are legal proceedings of the parliament and warrant the same respect as proceedings of the House itself. Giving 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 the Audit Office and particularly the Auditor-General, Mr Ian McPhee. Thank you for appearing before us. I would like to invite Mr McPhee to make an opening statement and then we will proceed to some questions.

Mr McPhee—Thank you, Chair. As the committee is aware, I have a statutory responsibility to audit the Department of Defence's financial statements and, from 2005-06, the financial

statements of the Defence Materiel Organisation. I also have a discretion to undertake performance audits in the department and in DMO. In performing these responsibilities, I am ably assisted, of course, by the people here in this room from the Audit Office and people back at the office.

Our recent financial statement audit coverage has highlighted a range of significant issues expressed as limitations on the scope of the audit, covering uncertainties relating to the material aspects of Defence assets and personal entitlements. The primary causes of the uncertainties originate from significant weaknesses within the internal control environment and systems, and the lack of evidentiary support for certain transactions and balances. These limitations in the scope of the audit and the pervasiveness of their effect led to a qualification of the opinion of the department's financial statements for 2003-04 and 2004-05—in effect, as you indicated, Chair, not expressing an opinion as to whether the financial statements presented a true and fair view.

As I indicated in my report to parliament on the audits of financial statements last year, this serious form of audit qualification is attributable to an internal control environment that requires significant and sustained improvement. Shortcomings were evidenced in a number of key operational and business support systems and processes—in particular, logistics and asset management, finance and personnel. In addition, record keeping practices needed considerable improvement. To address these matters, Defence is devoting considerable resources to the remediation of financial management issues. A commitment of some \$80 million in 2005-06 and a further \$59 million in 2006-07 was mentioned in evidence to the committee at its prior hearing on 11 May. The Secretary of the Department of Defence and senior staff have invested a lot of their own time and energy in promoting the importance of the change program. As Ric Smith has pointed out in evidence to this committee, the remediation program is expected to take some five years overall. There is much to be done to enhance the integrity of systems, processes and practices. Training is an important element of this.

The ANAO supports the remediation program and has been pleased to contribute to it to the extent that we are able, and to the extent that it is appropriate for an Audit Office to do so. In terms of our recent performance audit focus, it has been on Defence major capital equipment projects, with five reports tabled in 2005-06 and four reports scheduled for tabling in 2006-07. Audits undertaken to date have yet to examine a project that has transitioned through the new, tightened up two-pass approval system. Performance audit coverage for the past three years has included topics that focus on project management for specific acquisition projects, and also we have reviewed upgrades to existing capability. In addition, the ANAO has undertaken audits that have encompassed operational management issues, which have included the management of ammunition and a review of Army capability.

Recent audits have noted issues with the achievement of a schedule, cost and capability in the delivery of projects. The audits have highlighted a range of challenges confronting DMO in the area of project management relating to contract management, financial management associated with the stewardship of public moneys, particularly in respect of significant advance payments, contractual delivery and acceptance into service of equipment. We have also observed delays that have been caused by initial schedules that do not take sufficient account of risks, slippages in contract formulations and source selection, delays introduced by industry, as well—and that is an important point to note—changes in requirements following the contract signature to deliver a

capability, and delays caused by the late delivery of equipment by DMO to contractors. There have also been situations where capability has been traded or delayed to meet schedule.

To put our audit coverage into context, however, there are in excess of 200 DMO major capital equipment projects that have an approved cost of around \$55 billion. The ANAO has reviewed less than 10 per cent of these projects in the last decade, given our resource position. The audits at best provide a window, a small window, into a very large program of work. We are aware of the heavy investment by DMO in project management, contract management skills and training. In our forward audit program at this stage we intend to review management of specific projects such as the FFG upgrade, and of the front end of the planning and approval of projects, given this was a key focus of the Kinnaird reforms.

Finally, our submission mentions a proposal originally recommended by the Senate Foreign Affairs, Defence and Trade Committee in March 2003 for an annual report on progress with major Defence projects detailing time, cost and technical performance data for each project. Such a report would be based on information provided by DMO if it was to proceed. This proposal has not, however, been progressed due to a lack of funding support to date. We would be pleased to expand on these matters and to respond to any questions the committee may have.

CHAIR—Thank you. We will move through a series of questions, and if any of them relate to areas which your staff are involved in, please feel free to bring them in at any time. I will start with some preliminary questions that pick up from where you left off. For the benefit of committee members, could you give us a rough precis of how your counterparts approach these issues with defence departments overseas, particularly in the UK and the US?

Mr McPhee—I do not pretend to have an in-depth knowledge of how they progress these matters. I notice quite a difference in the financial statement reports provided by auditors-general or their equivalents overseas. The US seems to have a similar situation to Australia's, with a heavy disclaimer on the state of the financial statements. The UK, on the other hand, has in the last year provided a clear opinion, which indicates that the systems and processes and the compliance with the requirements set by the Treasury have been met to all material extent. The common feature, though, is that all defence departments seek to prepare financial statements to a lesser or greater degree.

Both we and the UK undertake performance audits in the area of project management work. The UK, in conjunction with the defence department, prepare an annual report on the top 20 or 30 major projects, which includes cost, time-schedule and capability. Also, the report is not just based on proformas; it actually provides some insights into and some analysis of what is driving some of the variations in projects. I think it is intended—to put it in its best light—to be a report that provides feedback on areas that may need more attention going forward. But I think the most important thing from a parliamentary and public perspective is that it provides some transparency around the state of the major projects that Defence is running. I have no doubt that Defence provides reports both internally and to government on the state of its projects, but it is uncertain as to whether that information is available to the parliament; in fact, it is not regularly provided to the parliament. Another thing is that the analysis and insight which go in to looking at the variations is a very important contribution in seeing whether the major reforms that Defence is currently implementing are taking effect and having a positive effect.

CHAIR—The UK experience of reviewing the top 20 projects and having an ongoing role is really what you are seeking to do here, isn't it? If you had the resources to do that, you would have a greater capacity going forward to ensure that there was rigour in the financial statements and that there was more than an ongoing checking mechanism. Is that a fair comment?

Mr McPhee—Just to put it in context, there are substantial and significant reforms occurring in Defence. In 2003, we had the procurement review in DMO. On the departmental side, we had the financial statement remediation program. But sticking to the question you have asked, I think Defence needs time to embed the outcomes of the most recent reports and the decisions that have been taken to improve performance in DMO. There is no question about that.

I think it would be helpful to articulate some guiding principles that might capture the nature of what DMO is seeking to achieve, and no doubt DMO does this in its own way. However, I think it is important to articulate principles about delivering procurement capabilities in terms of the budget. It is important to talk about managing risk in a disciplined way; it is important to have a principle about protecting the Commonwealth interest; and it is important to have a principle about abiding by Commonwealth legislation and the financial management framework.

Having said that, though, to measure performance or for the parliament and the public to understand the progress with the reforms, I think it would be extremely beneficial to have a public report based on information prepared by DMO as to the state of their top projects. It seems to me that that would complete the loop. It would provide transparency in terms of performance. I am sure that it would act as a stimulus for stronger performance for the organisation itself—

CHAIR—Through the discipline of continuous disclosure.

Mr McPhee—Yes, through the discipline of continuous disclosure. The Audit Office would review it to make sure that the nature of reporting has integrity, as we usually do, and that would inform the parliament better than, I think, the way it currently occurs.

Senator HOGG—Has Defence or DMO expressed a view on what you have just told the committee?

Mr McPhee—The Audit Office sought resources for this a couple of budgets ago. The formal feedback we received at that time was that the Kinnaird review had just been completed and DMO needed time to settle in the processes, which I think was a fair comment. We are now two or three years hence and I think the issue is a timely one to review again.

CHAIR—You mentioned the five-year time frame. Are you comfortable that that is appropriate and achievable?

Mr McPhee—I think it is about right. There are major system changes required. There are important cultural changes required. It seems like a long time, but Defence is a huge organisation. I think, to be fair to the existing secretary and department, there has not been a stronger emphasis put on financial management than what we are seeing today. So it is a credit to the secretary and his senior colleagues, but it will take time to bed in and there are some significant issues still to be sorted out.

Ms GRIERSON—I am particularly interested in the top 20 projects. When we go through so many audit reports that we find unsatisfactory, it is something that could be, as you say, a stimulus for some cultural change. Does overseas practice specifically give that feedback on contractor performance as well? When the Audit Office or the defence department prepares that report annually on the progress, does it also give clear signals to the industry on what is going well and what is not going well, and is that a reason for resistance to it?

Mr McPhee—My recollection of the UK report is that for each of the major projects, it has several pages of information about the state of the project. Then, in the front end of that report, there is some case study work and some insights into the overall picture and the messages coming out of the overall project experience. There would probably be, in an indirect way, feedback to the industry about the state of the project. It is occasionally said to me by colleagues in Defence that our reports focus on the department's management of contracts. In many contracts they are in the hands of industry and industry's performance as well. From an audit perspective, we still look to the department to manage the contract and we are not about to start directly being critical of industry itself, but it is a factor sometimes in Defence's performance. Our position is always, 'You have to manage the contract and use the levers within the contractual arrangements to get the best performance out of industry itself.'

Ms GRIERSON—Do you think the resourcing for you to move to that, and therefore DMO and Defence to move to that, is extensive or has very much changed?

Mr McPhee—In the overall scheme of things, it is not the sort of resources that are significant. We are talking about \$1 million and a bit more per annum, building up slightly. It is not a huge cost, but it would rely on agreement of DMO to provide the base information in a particular form and we would provide the review work—that is, it would be a much more onerous task for us to do that from scratch ourselves. DMO would need to get the systems, if it does not have them in place already, to build that report.

Ms GRIERSON—So it could take quite a lot of deliberation and discussion before you could initiate a project like that, every year, because you would have to agree on which projects, and what sort of factors you were going to look at. Have you thought about the answers to some of those questions that would have to be agreed—how you choose the 20 projects, how you are going to report and what sort of indicators you are going to have?

Mr McPhee—I think we could quickly come to an agreement with DMO on the relevant criteria. Colin, do you want to add to that?

Mr Cronin—I was going to say that, yes, we have thought about that, and the type of thing we are looking at is what the forward expenditure is going to be. If it is something in the top 20 or 30 projects and they have spent 95 per cent of the money, we would not focus on it; we are not really going to bring a lot to the table if we focus on something like the Anzac shipbuilding which is at the end of its completion. We would be looking at the projects where the future is going to be, and then to try to track those through their life. Whether you have an annual or biannual report, you would track it right to the end to find out whether, once you had contractual acceptance, it had been accepted into service. So the concept here is for parliament to have a constant stream of data, looking at this management of \$55 billion worth of capital and the future direction of the ADF. Over time—as the National Audit Office has done in the UK with its

public reports since the early nineties—there builds up a plot—essentially a time series—of how things have been performing: whether they have been delivered on schedule, the quality and the cost. And you could actually see that laid out before you. As the Auditor-General mentioned, I think one of the things that has come out of the UK is that the Defence Procurement Agency in the UK has been driven by this reporting about their key performance indicators. So, over time, this becomes a driving force for the management of the organisation. And that seems to be a very positive outcome.

Ms GRIERSON—That sort of process would be very much dependent on an excellent relationship between Audit and DMO and Defence. I would like to know if that relationship is being developed here in Australia. You can either comment on it, or you can tell me how much you have been involved in negotiating the performance over five years—the secretary said it is going to take five years; we have been through 12 months at least. Have you been setting targets with Defence and DMO for that five-year period? Have you put phases of development in for that, at all?

Mr McPhee—There is no doubt that we have our moments in our relationship with the defence department, but we work pretty hard at it, and we seek to separate out the relationship stuff from the issues. You touched on the financial statement work, and for the past two years there has not been disagreement at the end of the day about what the issues are, what the judgements are on those major issues, and where progress needs to be made. We have provided comments to Defence on its remediation programs. I and my senior staff talk at Defence management programs. So, overall, we do have some relationship issues from time to time, but they are not significant enough to get in the way of matters.

I do want to make the point, though, that at the end of the day the responsibility for the accounts and project management rests squarely with Defence. In being an auditor you always have to maintain your objectivity and what we call within the profession ‘professional scepticism’. It is a nice way of saying, ‘Don’t swallow everything you are told, and look for evidence to support positions being advanced.’ We do that, so it is important that we do not get as close to and involved in the process as to obscure our judgement on these matters.

Ms GRIERSON—So have Defence delivered a five-year strategic plan on how they are going to do that, with some targets, to anybody?

Mr McPhee—They do have a remediation program and I am sure it has milestones. But I might ask one of my colleagues to comment on that.

Mr White—It is basically made up of a series of different platforms, including right from the inception of the financial statement project board through to the development of the remediation plans and down to the level of position papers, of which I think upwards of 30 have currently been developed by Defence. At the same time, those platforms and programs across the financial framework are put into play so that a set of financial statements can be developed for every 30 June. Over time, a series of items would be cleared. I am not sure that the original deadlines that were put down still exist, but there would be a series of new deadlines for each program that is developed.

ACTING CHAIR (Ms Grierson)—Do you have a view of slippage? Is there slippage on this remediation program already?

Mr White—I think it has developed over time and that the final process of the financial framework and implementation is happening now. So there probably was slippage with the initial program, but at the moment I do not think that there would be a great deal of slippage with the framework that has been put in place.

ACTING CHAIR—We will get to the outcomes of it in a while.

Dr JENSEN—Are you aware of the selected acquisition reports process for the United States Air Force, where they report on selected acquisitions and what is occurring?

Mr Cronin—The GAO reports which are—

Dr JENSEN—No, not the GAO reports but selected acquisition reports.

Mr Cronin—I am personally not aware of them.

Dr JENSEN—Basically, it sounds like this is a process that the United States Department of Defense conducts every year. It is essentially about evaluating progress for each project. The fact that no-one knows about it obviates the question about who should do something similar in Australia as far as the top 20 are concerned.

ACTING CHAIR—Is it an internal process or is it public?

Dr JENSEN—It is public. The reports are published. In terms of through-life costing, from my experience with Defence, Defence are not very good at that. They talk about through-life costing, but I have not seen much evidence of it. I would like to know your view on through-life costing as far as Defence are concerned. Do we need to have a body that is, in effect, integrated with but independent of Defence going through these things at the same time as Defence? I am not talking about an outside process, like having ANAO coming in from outside Defence and having a quick look at—as Mr McPhee said, a snapshot of a certain time. Do we need to have an ongoing process with somebody who is not specifically in Defence but may be independent of Defence—somebody who could actually evaluate progress of projects so that there is, in effect, a feedback loop?

Mr Cronin—I think that would be fine. The question that you are looking at is: where is this going to fit in terms of decision making? If it is within Defence as part of normal contract management et cetera, you would expect there to be constant reporting to management on progress, because of the quantum of money involved and the significance. You might find out whether the reporting is totally accurate. I point to this because of the history, when we in Australia look overseas. Projects generally, for the first half of their lives, seem to track well. It is in the second phase of life that all the problems seem to come out. The slippages tend to be towards the end. That requires a robust means of monitoring and reporting. You mentioned an independent office within Defence. That could be one means. The ANAO provides that with our external reporting. Our reports certainly are different. There is one means of reporting internally and there is a completely different feel when it is external. That certainly raises certain issues.

You could certainly have an independent means that reports just within Defence and government.

Dr JENSEN—I guess the thing that concerns me is that Defence are very often aware of cost blow-outs and so on quite early in the piece, but in effect they do not disclose those in the hope that down the track they will sort themselves out. I guess the AEWG is a good example of that. If we could nail those things down earlier in the process, I think there would be an advantage. What is the best way of doing that?

Mr McPhee—Dr Jensen, I draw your attention to the procurement review in 2003, which recommended that an advisory board be appointed, with immediate effect, to provide advice and support to the head of the DMO and to report to the National Security Committee of cabinet on the implementation of all Defence procurement review recommendations. Also, the advisory committee now provides advice to the CEO of DMO on matters. I think it is very important that the accountabilities not be blurred, whatever the model is. The current model of having an advisory board does not shift the accountability obligations away from the CEO of DMO. That is the first point.

The other thing is that the finance department also has a role in reviewing the costing arrangements for the projects—to try to get to the whole-of-life costing matter that you raised earlier. Again, it has to provide separate and independent advice to government on these matters. There is no question that the points you are raising have been exercising people's minds. At the moment this is the model that seems to be the favoured one. As I said, I am quite comfortable with the nature of the model itself, because it makes it very clear where the accountabilities still reside.

Dr JENSEN—To get broader than that, what about large capability acquisitions? With just about every capability you hear about large problems and big blow-outs with the budget and so on. What do you think is the major factor that is contributing to this? What examples do you think we have of how capability acquisitions are being done well? In other words, what is being done well and should we expand on those processes?

Mrs BRONWYN BISHOP—In your answer could you take in whether or not fixed price contracts add to the dilemma?

Mr Cronin—Our experience is that defence contracting is no different from other major forms of contracting. In the experience of the Audit Office, over the last decade of looking at large-scale contracts—and I am talking about IT outsourcing and privatisation et cetera—the fundamental message seems to be that if both parties understand the contract, so that you have an informed buyer and seller, and they understand what we are getting we rarely have any problems. The problem happens to be when there is confusion about what we are getting. This transmits through all sorts of major contracts. If the buyer does not have a clear understanding and the contractor does not have a clear understanding there will inevitably be a problem. That seems to have come out.

The concept of Kinnaird, where we said, 'Let's put a lot more effort into the initial planning and approval process, much more consideration and resources,' I think will pay off in the long run because we will have a much better idea of the contract and what we are getting. It will be

well thought through. We are dealing with a contract. You cannot say, 'Let's make it up as we go along. Let's have endless changes.' You are in a contractual relationship. The experience of the Audit Office over the last decade has been that the Public Service has to come to understand that we are dealing with contracts. You cannot make it up as you go. As a more commercial focus comes through, as Kinnaird comes more into play and once we move out of the transitional phase, I think there will be an improvement, because they will have that understanding of the deal. Both sides will understand the deal.

As for Mrs Bishop's question, we have looked at fixed price contracts. We have not looked at the through life, which picks up on Dr Jensen's point. Clearly, if you are skinning the contractors in the acquisition phase they will get you back in the through-life phase. We are looking at a point in time. You can see the evidence coming through. Defence has tried to fix this by locking down an acquisition contract with a through-life support contract. But, as we have seen in some of our recent audits, this has led to further problems. Dr Jensen, I think you have a good understanding of this. The acquisition phase may be one-third of the cost. Two-thirds of the cost lie in the rest of the process. We are dealing with vast amounts of money. We need to get it right. We need better arrangements. There is only so much the Audit Office can do. We are only looking at the known facts.

Dr JENSEN—Which is why I was asking about the separate body.

Mrs BRONWYN BISHOP—Has the MOD not ceased making fixed price contracts?

CHAIR—I would like to stick to the list. We are all going to get a go. Dr Jensen, finish off your section and then we will move through the list.

Dr JENSEN—My last question is on the issue of test and evaluation. It was identified that, for instance, there was a problem with the power of the Tiger helicopters in the latest ANAO report. The thing that concerned me was that Defence effectively boasts that we are currently ahead of Europe in terms of the Tiger helicopter contract. So, in effect, we are almost the lead purchaser at the moment. Yet, when I look at the ANAO report, only about \$310,000 had been spent at that stage on test and evaluation. It really concerns me that that would barely cover airfares. At an early stage, not identifying a major issue is, as you said, going to lead to problems further down the track. What can we do to ensure that adequate test and evaluation is done in the procurement process so that those issues do not come back to bite us?

Mr Cronin—First of all, if the government is signing up for a military off-the-shelf purchase, you would normally expected to get a military off-the-shelf purchase, meaning that it is in service with another military. A large component of the tests and evaluation has essentially been done. You are right: we are the lead acquirer of the Tiger. Obviously, the ADF had to put a lot more effort into test and evaluation. The French equivalent did a lot of the work, but essentially Australia had transitioned to the lead acquirer of the Tiger when it was initially envisaged as an off-the-shelf purchase. Test and evaluation is a recurrent theme that comes up in many of our audits—the nature of having a very rigorous test and evaluation process, contractual acceptance and the initial introduction into service and final introduction into service. We did an audit about six years ago into test and evaluation. We are now covering it off in most of our audits.

Dr JENSEN—Certainly, with the F18 Hornet upgrade, it seems that there are numerous issues there that are biting us—electronic warfare, centre barrel replacement and so on. And this is before we even get into things like Kapton wiring and lifting wing skins and so on.

Mr Cronin—With the Tiger one, the thing that did concern us was the acceptance of ARH5. The ARDU, the Air Force's test and evaluation organisation, recommended against acceptance, yet the DMO went ahead and accepted the aircraft. You do not often find that. That is fully reported in terms of the offer. Test and evaluation is a big thing and will continue to be covered in our audits going forward.

Mr TANNER—I have several questions arising from the same report that we discussed briefly in the ordinary meeting of the committee yesterday. I refer to No. 36 of 2005-06. One of the conclusions the Audit Office reached in that report was that it transpired that, in a number of respects, the four helicopters that were initially delivered were not fit for the purpose for which they were intended. Ultimately, Defence in effect accepted that and was determined to proceed. And it effectively copped a substantial cost as a result of that. Therefore there is an implicit variation in the contract.

Mr Meert was there yesterday. My first question is: can you confirm that that was the case and that Defence has implicitly accepted a variation in the contract post facto to the advantage of the French suppliers? My second question associated with that is: if that is not a unique occurrence—and I do not think it is—doesn't that raise questions about the integrity of tender processes and bids where there are post facto variations that could conceivably accrue to the benefit of the successful bidder for a particular contract and, therefore, in a sense, change the playing field for the competition? It may not have been the case in this instance, but it is a broader question that I am interested in getting your view on.

Finally, in the discussion yesterday it was pointed out that one of the legitimate problems that Defence have is that, in many of the items that they are acquiring, there are not many choices and there are not many suppliers available, and therefore the bargaining power is diminished. I repeat the question that I raised yesterday: is there any evidence of Defence or DMO applying their mind to developing some kind of more sophisticated strategy to counter that problem?

There is a factual question: is it correct that they cop variations to their disadvantage post facto in the contract? Yesterday, the answer appeared to be yes. I want to confirm that. Secondly, doesn't this kind of behaviour in a sense tend to undermine the integrity of tender processes? Thirdly, is there any evidence that Defence is developing or has developed a more sophisticated strategy to deal with what is clearly a legitimate problem of inadequate bargaining power when there are a very small number of potential suppliers for a particular item?

Mr Cronin—I will start with the last part—the more sophisticated approach. I am unaware of that. I can deal with the first two parts of your question out of the report. By way of background, Defence entered into a contract to acquire 22 Tiger helicopters. Twelve months after entering into that contract, they agreed to accept a lower capability. There is no contract change proposal that says: 'We have accepted a lower capability.' The report outlines that they have accepted a lower capability for the first seven aircraft. In chapter 4, in a series of tables, we show what the lower capabilities are. Even accepting the lower capability, Defence did not achieve that. At the

point of delivery of ARH1, 2 and 5—the three aircraft that we looked at—the contractors still did not actually hit those lower capabilities.

Ms GRIERSON—Do you mean that they were even lower than that?

Mr Cronin—Yes, they didn't—

Mr TANNER—And there was no price variation as a result?

Mr Cronin—No. we understand that the contractor will remedy the defects over time.

Mr TANNER—Against which benchmark: the initial one or the lowered one?

Mr Cronin—I think it would be against the initial one.

CHAIR—Just so that we are all clear on this—and, for members who were not at yesterday's meeting, this is an audit report that you have released that we have agreed to review, which we will be doing in time—when you say that they 'accepted a lower capability', are you saying that they accepted a lower capability on the understanding that they would get the original capability in due course?

Mr Cronin—That is our understanding.

Ms GRIERSON—And at no extra cost?

Mr Cronin—That is what we have been told.

Mrs BRONWYN BISHOP—That is the evidence the DMO gave to us.

CHAIR—Do you mean at the first hearing?

Mrs BRONWYN BISHOP—Yes, when we had them in.

Mr Cronin—That is what we understand. But, at the point of acceptance, those aircraft did not achieve what the original contract said. That is spelled out in a series of tables in chapter 4. Table 4.4 on page 64 of the ARH report—that is, report No. 36—details a series of underachievements at in-service on the revised contractual arrangements. These are the ones that were agreed 12 months after we entered the contract. It obviously has some implications in terms of contracting, because what you have in an RFT is essentially a process contract that we will have certain things. That is not something that we explored in this audit. The RFT process, in terms of the evaluation of the tenders for this \$2 billion project, was undertaken in six weeks.

Mr TANNER—In other words, you have not looked at this question specifically but it is a legitimate question for us to pursue about whether there is some kind of query about the integrity of tender processes?

Mr Cronin—We are essentially accountants/evaluation. You would have to seek legal advice in terms of what—

Mr TANNER—It is actually a commercial question as well because the difficulty that it potentially places the Commonwealth in is that it can alter the behaviour of prospective tenderers. If there is a concern that they are tendering for a project where the playing field may alter ex post facto then the approach that a prospective tenderer takes could be affected by that. It may not be that this case does lead to that conclusion, given what you have just said. Maybe Mr McPhee wants to answer my final question. There is clearly a legitimate problem with much—not all, but much—of what Defence acquires, particularly the heavy capital items, of not having too many competitors to choose from and therefore being at risk of being in an inadequate bargaining position. Do we know of any evidence that they have put their minds to working out some clever strategies to try and reduce the impact of that?

Mr McPhee—DMO are best placed to answer that question, but there is no doubt that they focus on industry development strategies and approaches to try and overcome that situation.

CHAIR—It is one to take up with DMO.

Mr McPhee—It is best taken up with DMO. The other thing I would say—and I am sure DMO will give you chapter and verse as well, Mr Tanner—is that the strengthened two-pass approach to project acquisition was intended to try and reduce the risks around the approach once you got to tender. The strengthened approach to zeroing in on the required capability and having a clear view of what the requirements are, at least in terms of the theory of the two-pass process, was intended to try and reduce the risks that you refer to. At the end of the day, as most people in Defence will tell you, some of these risks you can seek to mitigate but you probably cannot eliminate. That is one of the issues.

In some cases some of these acquisitions are very substantial and you are dealing with companies with capital which may only be several hundred million dollars. How do you manage that situation? You can run a very hard line, and you might find a business going through the back door in a sense. When situations arise it is not a trivial matter to try and manage the risks. We are not saying it is. I think we are suggesting that sometimes more discipline could be shown around the processes involved in that.

Miss JACKIE KELLY—Obviously we came to doing this inquiry due to a number of reports that we had seen coming through, like the one on the defence supply system. You are now saying: ‘That was under the old system. Don’t worry about any of them anymore. We don’t have to look at those. Just look at the ones that will be coming up this year that have been done since the Kinnaird review.’ Is that your position?

Mr McPhee—We are saying that we intend to put more focus on the projects that have come through the strengthened two-pass system going forward. But some of these projects are still in progress, so it is not as though the world has changed overnight. We are not suggesting that our findings do not have relevance going forward; we just intend to reshape our program to start looking at the two-pass process and how effective that has been, given the importance of that reform. We would like to progress to looking more at whole-of-life cost issues because of the point that was made earlier about the capital costs sometimes only being a third of the total

project costs. Instead of continuing to hammer individual projects on a project-by-project basis, we want to develop our audit strategy to shift with the new world and see how effective some of these new reforms have been.

Miss JACKIE KELLY—Colin's point was that you are really only focusing on the bean-counting part of it—the cost, when money is paid over for part of the project that has been completed et cetera. You do not actually look at the personnel involved, their experience in managing those types of things or the turnover of personnel, which seems to have been systemic in all of the reports we have seen before and might be something that we are going to see again and again. It seems it does not matter how many times we review Defence—

Mr McPhee—We spend about \$1.4 million a year on our performance audit program in Defence, so it is not a large amount of money. We try to get the maximum return for our investment, hence our project selection approach. But I think we have an obligation, too, to acknowledge the reforms that are in place and to see just how effective they have been. That is why we want to change our program. While I take the point about the bean-counting aspect of it—there is a bean-counting aspect of our work—we do look at the capability and the trade-offs and issues as well. More importantly, going forward, we will be looking at capability, schedule and cost. We will be looking to see whether the new approaches DMO is taking are actually having an effect in terms of better project management.

Miss JACKIE KELLY—There was a report recently that Defence had spent \$9 million with a set of accountants trying to get their books in order. For two years running they have had qualified reports.

Mr McPhee—I cannot comment on how much value for money Defence is getting for its \$80 million, but there is no question about the need to invest in better systems, more training and better processes. That is absolutely necessary, and I look forward to the day when Defence has got streamlined systems, wonderful accounts, no issues and I can take some of the resources off—

Miss JACKIE KELLY—One of the key things to that is the defence supply system. They cannot tell you how many assets they have on hand. It is a qualified report. We do not know what they have got. So that defence supply system is a critical part of Defence coming up with some robust account for stock in hand, what it has got, write-downs. We had evidence from one fellow that Defence just wrote down \$600 million one year, \$1.2 billion the next and \$2.4 billion the next. It just writes this stuff off. None of that is worth inquiring into? What is to prevent Defence just fudging things?

Mr McPhee—I could put my whole office in Defence. My \$64 million budget is less than what Defence was spending last year on remediation of its financial systems, just to put things in context. I could put my whole office in Defence but do I not think that would be—

CHAIR—So you are saying your entire budget for the Audit Office is less than the entire amount being spent—

Miss JACKIE KELLY—They have spent another hundred million on the defence supply system. Another hundred million went into this project after it had been fixed up twice.

Mr McPhee—I make judgements about where to get most improvement in the public sector, as well as doing the statutory audit opinions on financial statements. So we run pretty lean and mean in our shop. I would like to do more—and, to be fair to the government, they have been supportive in some areas when I have sought new resources. But there is a limit to how much we can do. One of the risks is that, if we spread ourselves too thinly, we will not do an effective job. The thing that is important to our work is having support for the positions we take. So, in dealing with these major projects, we rely on a small group of people to actually get in and understand what is going on. We rely on a good interaction with Defence, and we have that. While we can always do more and look at training in personnel matters, the judgement to date has been that where we can get most impact and most effect is in the project management area of the department.

Miss JACKIE KELLY—So it would be worth while for this inquiry to talk to the supply side of things to find out what their issues with the project management are, because it is obviously a two-way street here.

Mr McPhee—I think it is always important to talk to the other side as well. I think stakeholders, industry perspectives, are always pretty important, absolutely.

Miss JACKIE KELLY—So it is worth while pursuing personnel involved in the whole life cycle of the project. You see a lot of it in projects. If you look at the SPOs, the offices that have had a high turnover in personnel tend to have projects going off the track. With projects that are on line, you could almost bet that the CEO in that SPO has been there for the entire life of the project.

Mr McPhee—There is something in that. You might recall that we did an audit report a few years ago now of various SPOs, and the performance in some was very good and the performance in the others was at the other end of the spectrum. That is not just to do with underlying systems but has lots to do with people's experience—how long they have been there.

Miss JACKIE KELLY—But your reports do not go into that.

Mr McPhee—In that case, we looked at four SPOs and tried to draw out the aspects that seemed to make the difference. We thought that was valuable. We try and bring out in our reports where Defence might put the emphasis going forward. That is what we endeavour to do. In that SPO report—from memory—we did that.

Mr Cronin—In part. There are other issues that come into play there. For example, in the defence reforms in the late 1990s it was proposed that the amount of civilians to military personnel was going to be much different. It was going to be something like nine to one. It has never come out like that. At best, it is 75 to 25. Personnel have a big impact. The fact that we changed the SPO system and diversified them all around Australia had a big impact. That is unlike the UK. If you go to Abbey Wood in the UK, the defence materiel agency is essentially co-located on one giant site. We have a decentralised model; the UK has a highly centralised model. The transfer of knowledge, corporate understanding and processes is obviously much easier in a concentrated location than it is when you are spread out across Australia.

CHAIR—What is the situation in the US? On that big continent, is it more similar to Australia or more similar to the UK?

Mr Cronin—The Americans are on such a scale that we just cannot comment.

CHAIR—What about just on that point?

Mr Cronin—I do not know. We have generally tended to follow the UK model in terms of the whole process of procurement with SMART 2000. The process—

CHAIR—That is okay if you do not know.

Mr Cronin—The US is worlds different.

Miss JACKIE KELLY—On one occasion we had evidence from an ex-employee about a drive within Defence where they had gone outside and grabbed some people from Coles Myer and tried to get things online. There was a change of personnel at the top and that section was lopped. You are looking for some sort of consistency from Defence so that when you have a change in personnel good projects going forward are not just—

Mr McPhee—Dr Gumley is best placed to comment on his strategies dealing with training. He is putting a lot of investment into making sure staff have the right skills et cetera. He would be best placed to deal with those.

Miss JACKIE KELLY—How far back does the list of reports that you have there go, Colin? Do they just go back to 2003 or are you going back—

Mr Cronin—2004.

Miss JACKIE KELLY—What major defence contractors do you think that it would be worthwhile talking to to get an insight in terms of how they felt?

Mr Cronin—There are two types. You have to look at those who are involved in doing upgrades and those who are going to be introducing new platforms. I am subject to the views of others, but the aviation ones that are at the top end of innovation include the people doing Air 87. They would be worth talking to. ADI is obviously pervasive across many of the upgrades and right across defence. That is another perspective. Obviously, Tenix are involved in quite a number. In these audits, we send contractors copies of the reports for their comments to us, because they have an interest in the reports prior to them being tabled. We do not have a lot of interest in terms of the contractors because our audits are specifically of DMO and Defence. The audits are not of contractors. Any of the major ones would be good to talk to, and I would split it into upgrades and new platforms coming through.

Miss JACKIE KELLY—And you would only do it on the contracts that the ANAO has looked at since 2004?

Mr Cronin—No, you could do it on anything. We have such a small snapshot from DMO. There is no doubt that innovative things are going on out there which we may not have picked up

on. I think we have covered less than 10 per cent of the top major capital acquisition projects and we have done just under a third of the top 30.

Miss JACKIE KELLY—But, as you say, there is \$55 billion worth of capital acquisitions—even \$1 billion saving is a couple of new hospitals.

Mr Cronin—Yes. Dr Jensen’s point about ‘through life’ actually multiplies by another factor of two or three.

Miss JACKIE KELLY—So it is worth while looking at projects that come under the \$20 million mark so you get down to the \$10 million projects?

Mr Cronin—We have an audit coming out next month on Army minors, because that provides enormous capability particularly into the Army.

Miss JACKIE KELLY—It must be a very long-running inquiry, I suppose. I will leave it there for now.

Mrs BRONWYN BISHOP—The evidence that I was looking for from Dr Gumley was not given in this hearing. It was given in a roundtable defence industry forum, when he made an explanation concerning the Tiger and the reasons that they accepted the aircraft, with rectification required—about 60 points, I think, you said there were. Because they are that lead purchaser, they made a decision to take it. In your report at 4.28, you say:

The target date of 2 September 2005 for the award of the Australian Military Type Certificate was not met. The ANAO note that the Special Flight Permit was extended until ... October. The DMO advised the ANAO that: the Australian Military Type Certificate Board met on 29 August ... and recommended issue of the Australian Military Type Certificate. The clearance/sign-off by the delegate, plus paperwork, took a little longer.

That tends to say to me that in your discussions with the DMO they did explain to you why they took early delivery.

Mr Cronin—When you say ‘they took early delivery’—

Mrs BRONWYN BISHOP—When I say ‘early’ I mean as opposed to not the chronological date regarding fixing defects that had to be dealt with, I suppose, is the best way to put it, and they took it because there was work they could usefully do. But that does not appear in the report.

Mr Cronin—The concept is that they took delivery of ARH—the ones we looked at—in terms of the contract. ARH1 and ARH2 were accepted in terms of the contract. ARH5 was accepted one month early of the contract. Yes, there were deficiencies and, indeed, for ARH5 the test and evaluation group, which is part of ARDU, recommend they do not accept that aircraft. DMO accepted that aircraft, I think, two days after the sign-off from ARDU. They took it.

Mrs BRONWYN BISHOP—And took responsibility?

Mr Cronin—Yes.

Mrs BRONWYN BISHOP—Did they explain to you why they did that?

Mr Cronin—They considered that it was appropriate.

Mrs BRONWYN BISHOP—But you as the Audit Office must have asked them why they did that—

Mr Cronin—Yes.

Mrs BRONWYN BISHOP—and they must have given you an answer?

Mr Cronin—There were many answers given, actually.

Senator HOGG—Just give us a little of what they said.

Mr Cronin—I think they would prefer not to do it again. They took delivery of the aircraft. We are talking about ARH5.

Mrs BRONWYN BISHOP—They would clearly prefer not to do it again because they got a hell of a beating up from you, and the reports that came up started to make the aircraft, which is a very good aircraft, look bad and that is not good for us, so that is why I look in your report for reasons that are given. It is not in the national interest for a report to have an aircraft seen as a bad purchase when, in fact, it will meet the capability required.

Mr Cronin—If we go, for example, to table 4.3, on page 62 of the report, you will see at the point of acceptance they had airworthiness issues—

Mrs BRONWYN BISHOP—About icing up?

Mr Cronin—There was a whole stream of things where there were issues, and these are not just small things. These relate to airworthiness.

Mrs BRONWYN BISHOP—My memory tells me there were 60 of them.

Mr Cronin—Essentially, when you look at the types of things that you have, you have to ask: ‘Did you actually have a fully functional capability?’ And clearly there were problems.

Mrs BRONWYN BISHOP—To go to war then? Absolutely not. Is that what you would expect?

Mr Cronin—You could only use this essentially for test pilot purposes.

Mrs BRONWYN BISHOP—Correct.

Mr Cronin—You took it so you could train people. The report points out that in fact the training lagged significantly because there were not the operational facilities available. In fact, Defence told us in February 2006 that the ARH1, which was accepted in December 2004, was

going in for a nine-month retrofit. The aircraft was accepted in December 2004 and by February 2006 it was going into the workshop for major retrofits. The first seven aircraft that we will accept will be with known deficiencies, meaning they are less than what we are contracted to get. That is what the report points out. As an office, we are looking at: 'What did you contract to get? What did you pay? What did you actually get?' And that is what the report points out.

Mrs BRONWYN BISHOP—But we are not exactly buying a pound of peas. When Dr Gumley came before us, he said, when asked whether he had a statement—and I think it is a fair comment:

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 ... 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.

There are no two ways about it. When you are acquiring new capability, you are accepting risk. It is not something where you can be risk averse if you want the best. The four options for Defence to buy were the Tiger, which we bought, the much cheaper Italian Augusta, the Cobra and the Apache, which was even more expensive again. They judged that the Tiger would best meet their capability.

CHAIR—We will have to suspend the hearing for a short period of time. There have been constant quorum calls in the House, which require all government members to be there.

Proceedings suspended from 12.13 pm to 12.24 pm

CHAIR—Sorry for the delay. There have been periodic quorums called through the morning, which those of you familiar with parliament will know are called by the opposition. In the event of another quorum call, we will conclude the hearing today and we will reconvene it on another day.

Mrs BRONWYN BISHOP—I think I was making the point that Defence is a very complex business and risky, and it cannot be risk averse. However, there are other things it can do, and I go right back to the first time I ever joined this committee, back in 1987. I remember going in the early days across to Adelaide to take a look at the submarines. I remember taking a look at the command and control system, which was the only intellectual property we owned. I was told that this was going to be the best thing we could export, that it was terrific. In fact, that control and command system has never worked, ever. It has now been replaced. The boats, which we own no intellectual property in and for which we paid 80 per cent of the money for 20 per cent of the work early on, are very good boats.

The point I am trying to make is that, if we are doing risky things, we have to have a very firm contract framework within which to do them. To my way of thinking, we still have not achieved it. Somehow we have to get them to use more skilled negotiators who are up to negotiating against a very large multinational company which can use the very best legal expertise it wishes. The international procurement market is worth \$1 trillion. We are 0.6 per cent of it, so we are always going to be looking for the best deal we can broker with our size.

What worries me is when we come out and audit, because we have imposed accrual accounting on Defence. As I said in a hearing back when Dr Gumley was there—he was a long-term advocate of accrual accounting in government—I always thought Defence would have a problem fitting in it because it just does not meet the paradigm. So when we get a request from the Australian Accounting Standards Board as to why we are not fitting a particular accounting standard, Defence's reaction to that will be to go and spend a squillion trying to meet that standard. Does that in fact achieve anything for our capability, for the efficiency of Defence, or ought we to be finding with you a different way to make sure that we are getting good accountability but that we are in the end getting what we need, which is capability? We do not need our auditing process to make our Defence Force look bad.

Mr McPhee—Let me try and tackle the two issues that you raised. If Defence took a decision, which is in their right, to accept helicopters at a different performance standard we would say that, in terms of due process and because of the magnitude of that decision, we would expect to see a record of why that is the case and what risks were being managed, because it is such a substantial change. We would also expect to see the contractual arrangements varied to protect the Commonwealth's interest. That is not unreasonable.

Mrs BRONWYN BISHOP—The first part is most certainly not unreasonable, which is why I asked the question.

Mr McPhee—Yes, it is not unreasonable. So we understand the risks. We understand that Defence cannot off-load the risks and need to manage them. Issues will come up all of the time in these major projects, and the contracts do allow a level of discretion over changes. But we say: if you are making substantial changes, protect the Commonwealth's interests. We raise the question about that.

In terms of the accounting standards, while I have sympathy in some areas with Defence's financial reporting practices, particularly around the pricing of inventory, the one thing I would be cautious about is not rolling all of Defence's issues in as a problem with accounting standards per se. I think the accounting standards have actually highlighted that Defence has some underlying systems issues. It is a signal that attention needs to be given not so much for financial reporting purposes but because Defence needs to know the quantities of inventory it has, where they are, where all the repairable items are and all of that. I know you are not suggesting the accounting is the only issue, but the accounting standards and reporting are highlighting a problem. In themselves the financial reporting issues are a problem for Defence—

Mrs BRONWYN BISHOP—That is right.

Mr McPhee—but they are pointing to an underlying, more significant matter, the integrity of their systems.

Mrs BRONWYN BISHOP—That is precisely why I asked that question about fixed price contracts, with which we are now besotted. What happens is people say, 'We can meet that fixed price, this is what we'll do,' and as soon as they enter the contract they are on about modifications. Perhaps there is a need for you to start making some advice as to whether or not having fixed price contracts for complex purchases of major platforms and other capabilities is realistic. I would think that that is something that you could advise upon.

Mr McPhee—We might, going forward, in some of our audits have a look at the nature of the contract and the rationale for why a fixed price or other contract was put in place, and report on that. I think that would be quite useful. We will take that on board.

Mrs BRONWYN BISHOP—I suspect that there was a swing of the pendulum against the fixed price contracts that we had for the horizon network and the submarines.

Mr McPhee—Yes.

Mrs BRONWYN BISHOP—I think we need your guidance about a better way to proceed.

Senator HOGG—I want to briefly address the issue that seems to be in both DMO's and your submission in respect of the cultural change that is necessary. It is interesting that in another inquiry, another committee, of this parliament, the same thing was said of Defence—that a cultural change is necessary. What do you mean by a cultural change? Can you define the sort of culture that you think should be there so that when we need to look at this in the future we have some idea as to whether or not this culture is emerging? It is a handy throwaway line that seems to be used ad nauseam—that a cultural change needs to be brought about.

Mr McPhee—In fact, I recall hearing the Secretary of Defence saying there are four cultures in Defence—the service ones plus the civilian ones. Taking your point, I think the message is that they are seeking to get more consistent performance from the department through the staff being tuned in to what is important to the defence department. I do not pretend to be anything in the way of a management expert but I think having some simple principles, some very simple messages, clearly articulated that staff can understand and readily remember is very important. Defence and DMO would want to refine them, but that is why I think, in terms of, say, DMO, they need some simple messages about procuring capability to cost and schedule, managing risks in a disciplined fashion, protecting the Commonwealth interest and adhering to the financial management framework—four very simple things that anyone can remember.

Senator HOGG—The unfortunate part about that is that Defence would jargonise it and that it would become completely not understood by anyone.

Mrs BRONWYN BISHOP—They will understand and if you know the language you will understand.

Mr McPhee—The message has to be understandable by staff no matter where they are, so they obviously need some sort of attention to put them in a format that is appropriate. There may be other principles. I am not suggesting they are necessarily the only ones.

Senator HOGG—Have you thought this through to its fullest extent? You mentioned four items there.

Mr McPhee—They are the things that I think in our work actually matter.

CHAIR—They are bread and butter.

Mr McPhee—They are bread and butter stuff.

Miss JACKIE KELLY—Can you give me them again?

CHAIR—You will get them from the *Hansard*.

Miss JACKIE KELLY—I just wanted to show you that you have repeated that ad nauseam since 1994.

Mr McPhee—Quite frankly, if the Audit Office says it and no-one else says it, it is not going to have any effect. Senior people in Defence need to have a clear message, emphasise it consistently and often, and let the staff know what is important to the organisation and to the standing of the department. This is not rocket science. But it is very important to get the message through to the staff about what is important.

I have heard it said in other forums that the standing of the department, importantly, depends now on its financial management performance and getting on top of these issues that are on its plate. I think you can make these things far too complicated, and then most people in the department will not understand or the message will not register. Whatever the messages are, the most important thing is that they are commonly pronounced, said with force and said by the people who matter. I am sure those sorts of message are going out at the moment, and Defence would be best placed to tell you what the messages are, but I think that is the most important way to get change.

Senator HOGG—Is, therefore, the UK scenario in respect of procurement a driver for changing the culture or is it a driver of something else? Is it a driver just purely as a management tool?

Mr McPhee—It could be a driver for culture or it could be seen as a compliance reporting exercise. It depends on the attitude the department takes—the senior people and even the minister—to the value of that sort of a report. If it is seen to be something that actually drives behaviour in the department then it will have an important place in terms of the financial management and performance of the department. If it is seen as an end-of-year exercise that someone in the back of DMO produces and the Audit Office comes along and ticks then it will have little effect.

Mrs BRONWYN BISHOP—The MOD has management streams; we do not. That is a decision we have taken. It is to do with size; it is to do with complexity; but it is also about the decision they have taken that they want people who are commanding to also be able to manage. Whether or not you make an assessment about whether there is a need for streaming is a question that I do not know whether you have looked at.

Mr McPhee—No.

Mrs BRONWYN BISHOP—I know that it is a hot-potato issue.

Mr McPhee—Yes.

CHAIR—I would like to go back to where we began. We talked about some of the broader issues—Mrs Bishop raised some of them before, as did Miss Kelly. What we are really talking

about here with the defence department is two issues: rectification, which is a big task, and maintenance. You, very admirably, have been quite subtle about the concept of extra resources so that you could have an ongoing examination of Defence. Let me be less subtle. The cost of a million dollars a year into the future would be a very small price for the Commonwealth to pay in terms of ensuring that things stay on track—to get to that point, and I hope I do not misquote you in the future, where you said we have ‘streamlined systems, wonderful accounts and no issues’.

Mrs BRONWYN BISHOP—Also, it is important that it be done so that it is constructive and that we still meet our aim of capability and the ability to deploy, because if we put in place a million dollars of investment to try to fix it up so we have a wonderful financial system and we lower morale and have a lesser capability to fight then we will not have done a good job.

CHAIR—But if we do it in the right way, as they do in the UK, and for a million dollars, I would have thought that that would actually be good for Defence, good for the parliament and, importantly, good for the taxpayers.

Mr McPhee—I agree with that, Chair. I would not have put the proposal forward last year if I did not believe that it was actually worth doing. Picking up from the committee’s inquiry today, I think what you are also asking for—and this is a dimension we probably need to look at—is a bit of international experience being brought to bear here too, either through DMO, the Audit Office or both.

We are in a global situation these days and so, instead of trying to work things out from first principle, I think we should be open to opportunities available from overseas as well. As I said before, the model relies heavily on DMO developing the initial material. We would need to work with them and obviously take into account their perspectives on management of risk et cetera.

Mrs BRONWYN BISHOP—Can I tell you one thing: with the way the DMO is structured now, we would never buy the sprite—and that has to be a big plus. We have definitely moved forward. I did everything in my power to stop us buying it, but it is too late. It would not be bought now.

Mr McPhee—The other thing, as I said earlier, is that both the department and the DMO are going through major reforms. I think they are soundly based. The reports that have set the scene for these reforms are important. It is important not to come in over the top with further major reform proposals. But, from my perspective, I think a bit of transparency about progress being made would be a good thing.

Miss JACKIE KELLY—I am just waiting for the Kinnaird review recommendations to come through. If they are followed then obviously you should not have any problems, which is what you are assuming, that this will all—

Mr McPhee—The issue is always in the execution. There are plenty of people, including auditors, who can tell you what the framework should be and how to progress management issues; but it is in the execution, and that goes to training and culture, which we touched on earlier. Defence are investing probably more than they ever have before in training and people development issues, which I think is absolutely essential.

Miss JACKIE KELLY—But they still rotate people every three years. The maximum you will stay in any one job is three years.

Mr McPhee—Yes, but they are endeavouring to slow that down. As you know, in DMO, in a sense—

Miss JACKIE KELLY—They have not.

Mr McPhee—I do not know what the outcome has been, but the theory—

Miss JACKIE KELLY—They can stay there for five years, but they do not.

Mr McPhee—Okay. The theory has been to at least slow that down. It is a fair point, though.

Miss JACKIE KELLY—I am just looking at this one here on the amphibious transport ship project. I was going to marry it up with the Kinnaird one and just say that we keep repeating ourselves. It says major defence capital acquisitions should only be made after military capability needs have been clearly defined, costed and budgeted. So, again, capability needs to be defined early on. The writing of the statement of requirement is botched. You do not express any view on that?

Mr Cronin—Yes, we do. Our audits now extend from the inception of the project right throughout. So we now cover off: inception of the project, the approval process—for example, in SDSS we went through the fact that SDSS upgrade did not follow cabinet rules—through to the RFT, to the contract and then through to the contract administration.

Miss JACKIE KELLY—But you never ever looked at that statement of requirement—and so far we have not been able to get a copy—to ask: was that going to fix Defence's problem? Was that electronic system, which now has the extra handheld piece as a part of it, going to do what Defence thought it was going to do? There is never any backward assessment of the statement of capability requirements, asking, 'Did they get it right?' and sharing of that corporate knowledge right throughout Defence, saying, 'When you are writing a statement of requirement, at least adhere to it and ensure that your contract documents reflect what the capability was that you sought to acquire.'

Mr McPhee—That is part of the two-pass process, though.

Mr Cronin—Yes, that is true, and we now have the capability manual. We understand that that is guidance. You are asking whether it was obligatory for all people to have that. The manual sets out all these things that you should do, and you have run through them. As we understand it, the manual is only guidance and it is not a requirement per se. One of the things you could do to address your problem is to ensure that the manual is actually a requirement—that you must do all those processes. As we understand it, as it has been explained to us recently, that manual is only guidance. Guidance is where you have this grey area. You are saying to Defence, when you look at the Kinnaird recommendations, the strengthened two pass and everything else: 'You will have all this documentation. It will all be completed, it will all be approved, it will be endorsed—you will follow that. You have got a systematic way of going forward. You have got an audit trail. Everyone is on song about what it is we're getting, so there shouldn't be any

problem. The capability managers will clearly understand what they will get at the end. DMO will understand their process. You will have a really good basis on which to contract and to manage the contract—that is, what the Auditor-General refers to as the execution—to go through to the ultimate delivery of the capability, the proper payment of funds, the closure of the report and the life moves on.’ So we have a lot of the ingredients; we constantly get back to the question of the execution of the process.

Miss JACKIE KELLY—Like helicopters being received with no alteration of the contract documents whatsoever, no exercising of the waiver and no documentation to say, ‘We’re aware that they are below capability and they are going to be fixed later for this fixed price.’ Do you know what I mean? Should people be pulled out and told: ‘This was the position that was responsible for that occurring. Everyone in Defence who is ever in that position again has got to know about this’? Do you make an example of someone or at least highlight it publicly to say, ‘This is where it was’? It just seems that no-one ever wants to name names, it is very vague and no-one is ever made responsible for anything—from a \$1,000 blow-out to a \$1 billion blow-out. There has never been anyone who has been responsible for anything. There has got to have been someone who should have done something on that contract to say, ‘This needs to be changed if we’re to receive them.’

Mr Cronin—I understand fully where you are coming from. As an office we are looking at making systematic improvements, and I think what the UK Audit Office has found is the benefit of having an annual report looking across major projects. We are just giving you snapshots of individual projects. When you look at the top 30 projects, you are covering probably 80 per cent plus of the total spend. You are in the very heart. You have constant reporting, and that really starts to drive what management does. It is not that you have a one-off bad experience; every year you are going to get a report. You are going to get parliament looking at it and questions are being asked: ‘Why did this happen?’ If you go back to why the public accounts committee in the UK started this, they got a nasty shock when a major project went off the rails. They were presented with it and they said, ‘How come we didn’t know about it?’ That initially started a process by which the department of defence reported to the committee for 10 years in a closed session. That has now moved to a public reporting phase.

Miss JACKIE KELLY—Did that reporting include any ability for the committee to oversee the documents so that they knew that, throughout the contract life, rights were being exercised and obligations adhered to?

Mr Cronin—I do not know that. If the ANAO were to do an audit, we would be vouching that we had seen things. As you are probably aware, the audits on these things are fairly thorough. That is why we have been trying in the past three years to develop a lot of expertise around the top 30 projects.

Miss JACKIE KELLY—Let’s take the defence supply system statement of requirement. Do you think that has any sensitive documents that this committee could not see?

Mr Cronin—If there were, you could take it in camera anyway. I would be surprised.

Miss JACKIE KELLY—Is there anything in that that an ordinary supply officer in the Army should not have as part of his basic training course? ‘If you’re ever in this position, this is what a

statement of requirement looks like. Here's one that went badly wrong and here's how not to do it in the future. This is a case study of defence contracting gone wrong. Everyone learn about it on recruit training.' Is it that sensitive?

Mr McPhee—I would not have thought so. We all learn from positive experiences and negative ones.

Miss JACKIE KELLY—Do you think Defence's culture of secrecy over every titbit of procurement is helpful? Some of this stuff you would have to be able to buy down at Bunnings. Why do they make it so sensitive, which really hampers corporate knowledge?

Mr Cronin—The way I would look at this is that you are dealing with the largest contracting agency in the Commonwealth—in Australia. It is probably the largest importer of capital goods into this country year on year.

CHAIR—Sorry, I will have to cut you off there. I said when we resumed that we would have to conclude at the next quorum or division, so we will do that now. We will get you back, as we had planned anyway, for some further hearings in the next fortnight. On behalf of the committee, I thank you.

Resolved (on motion by **Mr Anthony 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 12.49 pm