



Appendix D –
Correspondence from the Mr Ian McPhee,
Auditor-General to Mr Robert Oakeshott,
Chair, Joint Committee of Public Accounts
and Audit



23 January 2012

Mr Robert Oakeshott MP
Chair
Joint Committee of Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Mr Oakeshott

Major Projects Report – Presentation of Financial Data for 2011–12

The Defence Materiel Organisation (DMO) has provided the Australian National Audit Office (ANAO) with an updated draft proposal on the presentation of financial data for the Major Projects in the light of recommendation 7 of the Committee's Report 422 *Review of the 2009–10 Defence Materiel Organisation Major Projects Report*.

By way of background, presentation of financial information for projects in 'base date dollars' has been a requirement of the Guidelines since the inception of the Major Projects Report (MPR), and also the subject of considerable debate and discussion. While it has been generally understood that presenting information in base date dollars is not ideal for all projects, it has been well aligned to the contract management for others.

For example, the Fast Frigate Guided (FFG) upgrade project which received second pass approval in June 1999, has not maintained records or systems that readily support the provision of financial data in the base date dollar format. Conversely, some current projects such as AWD Ships and LHD Ships have contracts specifying base dates, with contract payments made and recorded on this basis. However, for the MPR's up until 2010–11, a common financial presentation, that provided all of the data required by the Committee, providing a consistent format for all projects in the MPR has not been available.

From 1 July 2010, the DMO transitioned to a budgetary framework whereby the financial information is presented on an 'out-turned' basis, and has proposed that the MPR for 2011–12 adopt this framework. Being conscious of the move to the out-turned budgetary framework and its alignment with the requirements of the Commonwealth's budgetary framework, including Defence's, there are clear benefits in the budgeting information in the MPR being transitioned to an out-turned presentation, provided sufficient disclosures are maintained to allow assessments to be made of project performance against budget. With adequate reflection of those disclosures previously considered desirable, i.e. budget at first and second pass approval, indexation amounts, foreign exchange and real adjustments, it is possible to provide the Committee with a consistent format for all projects. This should also facilitate the efficient compilation and review of the Project Data Summary Sheets (PDSSs).

Based on the submission provided by the DMO, but allowing for the above, the ANAO has developed a template for the Committee's consideration (Attachment A). This template is

based on the DMO proposal but highlights the additional disclosures (in light type) the Committee may wish to consider. Further explanation of the ANAO proposal is set out hereunder.

- *Disclosure of both First and Second Pass Approval*

Our understanding is that the Committee's interests lie in gaining a full picture of a project's budget and expenditure over time, not just those areas of the DMO's responsibility. In order to fully disclose a project's budget and expenditure, both first and second pass approvals (where existing) would need to be included, and as they are formal government milestones, this allows for consistent reporting across the various publicly available documents. We understand this aligns with the DMO's approach.

- *Disclosure of itemised indexation amounts for budget and expenditure*

While we appreciate the benefits for the DMO and Defence moving to an out-turned dollar presentation, the proposal by the DMO is to report project indexation at an aggregated level, in both the budgetary and expenditure sections of the PDSSs. This will lead to issues of comparability, and in essence is a reduction in information for the 14 projects in the 2010–11 MPR, which have successfully provided base date dollar information. However, if appropriate disaggregation of the presented amounts is maintained, this should be overcome. We have been advised by the DMO that this is in alignment with the new management processes implemented to support reporting in out-turned dollars.

- *Foreign Exchange and Real Adjustments*

The DMO proposal makes no suggestion of changes to the previous presentation of these two areas of significance in a project's budget and expenditure presentation, and the ANAO concurs with this position.

- *Other Additional Disclosures*

To enhance the financial presentation further, the ANAO also recommends the Committee consider additional descriptors as presented within the table at Attachment A. These descriptors are designed to assist the reader in the review of the financial information presented within each PDSS.

If the Committee agrees with the proposal to remove the requirement for base date dollars, the ANAO would suggest consideration of the amendments included at Attachment A. These amendments will allow for one consistent presentation of the financial information included within the PDSSs, provide the same level of data as under the base date dollar regime, and improve the readability of the MPR across all projects.

Additionally, as the 2010–11 MPR included 14 projects reporting in both base date and out-turned dollar formats, it may be worth considering whether the DMO's proposal for a transitional year is necessary, as it will provide no more information for readers than that reported in the previous year.

It is also important to recognise that the introduction of out-turned dollar reporting will, in all likelihood, raise some issues for those projects that currently manage in base date dollars, i.e. those projects with variable price contracts. However, we understand that the DMO is providing project managers with tools to assist with this transition.

On a separate issue, the Committee will recall that the recent amendments to the *Auditor-General Act 1997*, following your inquiry, provided that the Committee may identify an assurance review as a priority. A review so identified is a priority assurance review (subsection 19A(5)). The main consequences of the Committee identifying a review as a priority review is that it allows the Auditor-General to use the information gathering process under the Act rather than relying on the agreement of the entity being audited (section 31).

While the DMO has always provided high levels of cooperation to allow our review of the MPR and access has never been a problem, this is an issue the Committee may wish to consider given its influential role leading to the development of the MPR, and its ongoing interest.

If the Committee was to agree to our review of the MPR being a priority review, this would result in a consequential change in our current agreement with the DMO pursuant to section 20 of the Act.

We would be happy to discuss these matters with you or your staff. The relevant ANAO contact officer is Mr Michael White who can be contacted on 02 6203 7393.

Yours sincerely

A handwritten signature in black ink, appearing to read 'I. McPhee', with a long horizontal flourish extending to the left.

Ian McPhee
Auditor-General

Section 2 - Financial Performance

Date	Description	ANAO PROPOSED out-turned dollars \$m 2011-12 Format	Contractor	Notes
2.1 Project Budget History				
Nov-03	Original Approved	3.1		1
Sep-04	Real Variation – Scope	4.8		2,3
Nov-05	Real Variation – Scope	29.6		4
Jun-07	Government Second Pass Approval	2,920.8		
Oct-08	Real Variation – Transfer	9.3		5
	Total Nominal Budget	2,967.6		
Jun-10	Price Indexation to 30 June 2010	350.0		
Jun-12	Price Indexation (out-turned)	[80.8]		6
Jun-12	Exchange Variation	-273.4		
	Total Indexation & Exchange Adjustments	157.4		
Jun-12	Total Budget	3,125.0		
2.2 Project Expenditure History				
Prior to Jul 11	Prime Contract Payments	952.1	BAE Systems	
	Other Contract Payments / Internal Expenses	59.2	Other	7
		1,011.3		
FY to Jun 12	Prime Contract Payments	541.1	BAE Systems	
	Other Contract Payments / Internal Expenses	16.4	Other	8
		557.5		
Jun-12	Total Expenditure	1,568.8		
Jun-12	Remaining Budget	1,556.2		
	Remaining Budget attributable to:			
	Remaining Indexation	[71.3]		
	Remaining Nominal Budget	[1,484.9]		
Notes				
1	This project's original DMO budget amount is that prior to achieving Second Pass Government approval.			
2	In the 2009-10 MPR, an amount of 0.1m was reported as a Real Variation due to a Budgetary Adjustment for an Administration savings harvest. It should have been rounded to 0.0m and is therefore no longer being reported.			
3	To fund a risk reduction activity for the Project to obtain design data and develop designs to meet Australian essential requirements.			
4	First Pass approval.			
5	Transfer of funding for technical studies from DSTO.			
6	Up until July 2010, indexation was applied to project budgets on a periodic basis. The cumulative impact of this approach was \$350m. In addition to this amount, the impact on the project budget as a result of out-turning was a further \$78.4m having been applied to the remaining life of the project. The out-turned calculation is adjusted annually to reflect actual movements in the index.			
7	For base date calculations against "Other" expenditure, calculations have been made using a proportional adjustment. This proportional adjustment involves the average between base date calculation of the disclosed major contract(s) and their constant price and applying to the "Other" expenditure.			
8	Other expenditure comprises: Operating Expenditure, Offer Definition, Consultants, Foreign Military Sales, Contractor Support and Minor Capital expenditure not attributable to the Prime contract. For base date calculations against "Other" expenditure, calculations have been made using a proportional adjustment. This proportional adjustment involves the average between base date calculation of the disclosed major contract(s) and their constant price and applying to the "Other" expenditure.			

Notes:

1. Out-turning indexation is the allowance within the budget for price increases that apply from 2010-11 until the project's estimated completion date.
2. Numbers in "[]" are not actual numbers and do not represent the result of calculations performed by the ANAO. These figures would differ in a real world scenario.