

Financial reform

Background

- 2.1 The Department of Defence is the largest of all Australian Government Departments both in budgetary and personnel terms. Defence's total departmental funding in 2008-09 is \$22,690.3 million. This represents 1.8 per cent of GDP.¹
- 2.2 Defence's total workforce is forecast to be 90,581 in 2008-09. This comprises 54,747 permanent Australian Defence Force (ADF) members, 19,915 Reservists, 14,754 civilian staff and 1,165 professional service providers.²
- 2.3 At the end of each financial year, the Chief Executive of the Department of Defence, in common with the Chief Executives of other Australian Public Service (APS) agencies, is required to prepare financial statements that give a true and fair presentation of the financial position and performance of the Department. These statements must comply with the *Financial Management and Accountability Act 1997* (FMA Act), Accounting Standards and other mandatory financial reporting requirements.
- 2.4 On the basis of an audit conducted in accordance with the Australian National Audit Office Auditing Standards, the Auditor-General is then

1 Department of Defence, *Portfolio Budget Statements 2008-09*, p 5.

2 Department of Defence, *Portfolio Budget Statements 2008-09*, p 61.

required to express an audit opinion on those financial statements. This opinion may be either unqualified³ or qualified⁴.

- 2.5 As outlined in Chapter 1, neither the Department Executive nor the Auditor-General were able to verify the accuracy of Defence's financial statements for the years 2003-2004 and 2004-2005. In the same years, the opinion of the Auditor-General was qualified, expressed as an inability to form an opinion.⁵
- 2.6 Defence's inability to meet the requirements of the FMA Act 1997 in 2003-04 and 2004-05 followed a well-documented history of uncertainty in Defence's internal control environment and ongoing qualifications in their financial statements since 2001.⁶
- 2.7 In 2005-06, for the first time in two years, the Secretary and Chief Finance Officer of Defence were able to sign Defence's financial statements on an 'except for' basis.⁷ The Auditor-General issued a qualified opinion concluding that Defence's 2005-06 financial statements were true and fair with the exception of Inventories-General and Repairable Items.⁸
- 2.8 In 2006-07, the Chief Finance Officer again certified Defence's financial statements for the year 2006-07 on a 'true and fair except for' basis⁹ and
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3 "An unqualified audit report is provided when the financial statements, in all material respects, give a true and fair view of the matters required by applicable Accounting Standards and other mandatory professional reporting requirements in Australia, and the FMOs, so as to present a view which is consistent with the entity's financial position, its financial performance, and its cash flows." Australian National Audit Office, Audit Report No. 15 2006-2007, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 41.

4 Qualified audit opinions may be expressed in three ways: an *except for opinion*; an *inability to form an opinion*; or, an *adverse finding*. See Australian National Audit Office, Audit Report No. 15 2006-2007, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 41.

5 "An inability to form an opinion - commonly referred to as a disclaimer, is expressed when a scope limitation exists and sufficient appropriate audit evidence to resolve the uncertainty resulting from the limitation cannot reasonably be obtained; and the possible effects of the adjustments that might have been required, had the uncertainty been resolved, are of such a magnitude, or so pervasive or fundamental, that the auditor is unable to express an opinion on the financial report taken as a whole." See Australian National Audit Office, Audit Report No. 15, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 41.

6 Senate Foreign Affairs, Defence and Trade Committee, *Annual reports (No 1 of 2007)*, p 8.

7 See Australian National Audit Office, Audit Report No. 15 2006-07, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 99.

8 Australian National Audit Office, Audit Report No. 15 2006-07, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 99.

9 Department of Defence, *Annual Report 2006-2007*, p 32.

on 17 October 2007, the Auditor-General issued a qualified opinion, consistent with the view of the Secretary and the Chief Finance Officer, that Defence's financial statements were true and fair with the exception of Inventories – General. This qualification is related to uncertainty around the reported balance of Inventories – General due to pricing and system-related issues.¹⁰

- 2.9 These improvements in financial management at Defence came about as a result of a number of important remediation strategies that had been put into place in 2003-2004.
- 2.10 The Committee examined the remediation program and the progress made on each of the remediation plans. The Committee also examined financial management at the Department of Defence compared to other Defence organisations overseas.

The remediation program

- 2.11 In 2003-2004, Defence commenced a comprehensive financial remediation program. This program is comprised primarily of a series of remediation plans and includes the development of a Financial Controls Framework and an extensive financial training regime as well as the development of a series of position papers on key accounting issues.
- 2.12 In November 2003, a Financial Statements Project Board (FSPB) was established specifically to drive the necessary financial remediation and report to Government on its progress. The FSPB was replaced by the Financial Management and Control Committee that monitors financial remediation and financial controls within Defence.¹¹

Remediation plans

- 2.13 Defence was required to address 141 ANAO audit findings. Ninety-five of those audit findings related to 2003-04 (this included 38 from previous years) and 46 audit findings related to 2004-05.¹²

10 Australian National Audit Office, Audit Report No. 18 2007-08, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2007*, p 91.

11 Department of Defence, sub 4.7.

12 See Department of Defence, sub 4, p 28 for detail on these audit findings.

- 2.14 To that end, Defence developed a series (16) of remediation plans. Three plans (numbered G1 to G3) relate to general financial issues and thirteen plans (numbered S1 to S13) relate to specific functional areas.
- 2.15 Up to and including the release of Defence's *Portfolio Additional Estimates Statements 2006-07*, the Department reported summary information on each plan, activities undertaken and major outcomes in a tabular format. The most recent of those tables is reproduced in the following pages.¹³

Remediation plan	Activity	Major outcomes
G1: Financial Reporting Framework		
<p>The Defence financial management system has been subject to many Australian National Audit Office (ANAO) findings over a period of years.</p> <p>The aim of the remediation activity is to provide a robust control regime for the financial management of Defence business. The financial controls framework will draw together, in a structured and integrated fashion, all of the control elements necessary to build a best practice financial management environment for Defence. It will encompass the standardisation of financial processes, reporting and data requirements, a financial staff certification strategy and a change management program. The remediation plan is Australian equivalents to International Financial Reporting Standards (AIFRS) compliant.</p> <p>Accountable officer: Chief Finance Officer</p>	<p>Develop and embed a comprehensive Defence Financial Controls Framework that includes:</p> <ol style="list-style-type: none"> Establishing the elements of the financial controls framework; Assigning responsibility to Group Heads to implement the financial controls framework; Implementing standardised processes and practices; and Establishing business skilling and competency assessment. 	<p>Achieved in 2005-06:</p> <ol style="list-style-type: none"> Identification of key controls and risks across Defence's balance sheet and document key processes and procedures; Financial training has been strengthened; and The substantive testing of employee records completed, 80 per cent of the leave controls testing program completed and analytical reviews commenced. <p>Planned for 2006-07:</p> <ol style="list-style-type: none"> Complete the identification of all risks and the assessment of the materiality of these risks; Complete the testing of leave controls and analytical reviews; Continue the implementation of a comprehensive financial management and controls framework for Defence which embeds best practice financial controls and ensures conformance and performance; and Continue to develop and implement tailored financial management training, maintaining the framework, and a robust financial risk management regime.

13 Department of Defence, *Portfolio Additional Estimates Statements 2006-07*, pp 112-127.

Remediation plan	Activity	Major outcomes
<p>G2: Improving the ANAO Annual Audit Process</p> <p>Having a clear agreement with the ANAO on timelines, methodologies and expectations of deliverables from both parties is crucial to the finalisation of the annual financial statements.</p> <p>Accountable officer: First Assistant Secretary Financial Services</p>	<p>Establish an accountable officer to manage audit activities between Defence and the ANAO. Key tasks include:</p> <ul style="list-style-type: none"> a. Negotiating an engagement plan; b. Agreeing to a consistent approach for terminology, quality and format of responses; and c. Establishing comprehensive procedures for quality assurance and clearing audit findings. 	<p>Achieved in 2005-06:</p> <ul style="list-style-type: none"> a. Defence Audit Liaison Officers network was established; b. A series of position papers on accounting treatment issues was released, and comprehensive procedures for quality assurance and clearing audit findings were established; and c. Regular meetings were held with ANAO staff to improve the relationship between Defence and the ANAO. <p>Planned for 2006-07:</p> <ul style="list-style-type: none"> a. Establish a clear agreement with the ANAO on timeline, methodologies and expected deliverables of both parties for the 2006-07 audit; b. Clear remaining ANAO findings from 2004-05 and earlier; c. Commence remediation of 2005-06 audit findings; and d. Continue to improve the relationship between Defence and the ANAO.

Remediation plan	Activity	Major outcomes
<p>G3: Financial Management and Systems Training – Financial and Business Management</p> <p>A consistent theme in the ANAO audit findings is the requirement for enhanced skills in the execution of financial management procedures and adherence to approved procedures in the use of Defence corporate information technology systems. The ANAO made some targeted recommendations with regard to enhanced training to address the lack of knowledge in accounting, financial and business management (ROMAN), transactor knowledge (PMKeyS), and the Standard Defence Supply System (SDSS). These are complemented by a number of other observations about failures in the application of policy and procedures. Accountable officers: Chief Finance Officer and Director-General Defence Education and Training Development</p>	<p>Develop, conduct and deliver business capability training to improve officers' underpinning knowledge and skills:</p> <ul style="list-style-type: none"> a. Accrual accounting; b. Diploma of Government (Financial Management); c. Graduate Certificate in Professional Management (Finance); and a. Financial management processes for Senior Executive Service and Executive Level 1 and 2 officers and ADF equivalents. 	<p>Achieved in 2005-06:</p> <ul style="list-style-type: none"> a. A new set of three induction/introductory level financial management courses was developed and rolled out, including regional delivery across Australia; b. Financial management training for the Senior Leadership Group (Service and civilian) continued to be delivered; and c. Three financial management courses were developed and delivered to Senior Officers at the Executive Level 1 and 2 (and military equivalent) levels. These programs included tailoring to meet specific Group requirements as well as being rolled out to meet regional needs. <p>Planned for 2006-07:</p> <ul style="list-style-type: none"> a. Finance and Business Training: Financial Delegations eLearning course developed; b. Complete development of Certificate IV level competency aligned courses and release during 2006-07; c. Continued development and delivery of Financial Management Training for Senior Executive Service, Executive Level 1/2 and ADF equivalents with an increased regional delivery focus; and d. Develop and pilot new courses as training needs are identified.

Remediation plan	Activity	Major outcomes
S1: Stores Record Accuracy		
<p>Defence 'self-qualified' stock quantities relating to general stores inventory and repairable items in 2003-04, following adverse stocktake results. The ANAO Office noted material weaknesses in the internal controls over stocktaking, failure to accurately record and report physical asset quantities, and inadequate system controls to safeguard the accuracy of data. This resulted in a significant range of uncertainty around general stores inventory and repairable items balances.</p>	<p>Remediate the general stores inventory and repairable items qualification by:</p> <ol style="list-style-type: none"> a. Implementing control and compliance mechanisms for the SDSS to provide assurance for the systems information for Joint Logistics Command warehouses; b. Correcting errors in stores record quantities in the SDSS; and c. Promulgating and ensuring compliance with stocktaking policy to improve stocktaking practices and reporting. 	<p>Achieved in 2005-06:</p> <ol style="list-style-type: none"> a. Defence continued to improve the processes, procedures and controls for all stock quantities, including Repairable Items; b. SDSS Information Technology controls framework implemented; c. New stocktaking practices and procedures implemented; d. Policies and procedures implemented to ensure that SDSS stock locations are verifiable; e. Performance measures developed to drive timely reconciliation of returns from Navy ships; f. The policies, procedures and practices for the movement and disposal of explosive ordnance implemented and effective; g. The instances of serial number and equipment tracking mismatch were reduced; h. The monitoring of disposed explosive ordnance discrepancies was implemented and a formal risk assessment undertaken; i. Inventory sample tool rolled out to Joint Logistic j. Command warehouses; Increased disposal volume over 2004-05 achievements; and k. \$1.036 billion Repairable Item quantities verified. <p>Planned for 2006-07:</p> <ol style="list-style-type: none"> a. Complete verification of the remainder of Repairable Items; b. Segmentation of General Stores Inventory to allow analysis and verification of an aged profile; c. Second year of the recommenced two-year cyclic stocktake; and d. Prepare for the implementation of the Military Integrated Logistics Information System as the replacement for SDSS in 2008.
<p>During the 2004-05 systems audit of the Standard Defence Supply System (SDSS), the ANAO have indicated that the control and compliance mechanisms were not adequate and did not provide assurance about the data in the system. Due to the limitation of scope for the opening balances for 2005-06 the qualification was not resolved this financial year.</p>		
<p>Full remediation of all inventory issues is forecasted for completion by 2008.</p>		
<p>Accountable officer: Commander Joint Logistics</p>		

Remediation plan	Activity	Major outcomes
<p>S2: General Stores Inventory Pricing and Accounting</p> <p>The 2003-04 Financial Statements had a limitation of scope qualification of approximately \$2,026m with regard to uncertainty around the general stores inventory balance, of which approximately \$610m relates to uncertainty around general stores inventory pricing carried over from 2002-03.</p> <p>At issue was Defence's inability to produce, in a timely manner, invoice and contract documentation to validate the prices in the SDSS. The concerns of the ANAO also included the lack of accounting policy in place to ensure the correct treatment of general stores inventory.</p> <p>Inventory pricing issues continue to be assessed in against the requirements of the AIFRS. The implementation of an even more onerous reporting requirement places greater long-term uncertainty across inventory pricing issues.</p> <p>General Stores Pricing and accounting issues are not expected to be fully resolved until 2008.</p> <p>Accountable officer: Chief Finance Officer, Defence Materiel Organisation</p>	<p>Remediate the general stores inventory pricing and accounting qualification by:</p> <ol style="list-style-type: none"> Developing a statistical model to validate legacy (pre-1997) priced items; Implementing an exception reporting regime to provide quality assurance; Establishing policies and procedures for inventory pricing controls on the Standard Defence Supply System; and Establishing policy to ensure the correct treatment of general stores inventory. 	<p>Achieved in 2005-06:</p> <ol style="list-style-type: none"> The Australian Accounting Standards Board consulted in relation to inventory accounting issues; Statistical sampling of data undertaken and identified prices potentially requiring error correction where available; Quantification of excess or insurance stock calculated; Established an exception reporting regime to provide quality assurance of in-year inventory prices; and Promulgated financial accounting general stores inventory policy. <p>Planned for 2006-07:</p> <ol style="list-style-type: none"> Remediation of the audit issue relating to Limitation of Scope – Inventory pricing carried forward from 1999-00 to continue with respect to potential surrogate price sources; Complete the financial requirements specification for the Materiel Logistics Financial Framework for inclusion in a replacement logistics system; and Review implementation to determine system and data retention impacts for multiple pricing records.

Remediation plan	Activity	Major outcomes
S3: Supply Customer Accounts		
<p>A supply customer account is a location indicator within the SDSS used to track and manage assets and accountable inventory moving through the supply chain, predominantly outside a warehouse structure.</p>	<p>Remediate the supply customer account element of the repairable item quantities qualification by:</p> <ol style="list-style-type: none"> Allocating an accountable owner to all supply customer accounts; Ensuring all supply customer account balances recorded on the SDSS are correct; and Improving business processes and controls for supply customer accounts. 	<p>Achieved in 2005-06:</p> <ol style="list-style-type: none"> Accountable owners identified for all supply customer accounts; Stocktaking completed for 89 per cent of supply customer accounts and corresponding balances corrected on SDSS; Defence recommenced its stocktaking program; Revised the repair vendor supply customer accounts arrangements to improve management and control between repair vendors and system program offices; and Provided enhanced reporting to assist the responsible managers to fulfil their obligations and improve the quality of supply customer account data.
<p>The 2003-04 financial statements had a limitation of scope qualification of \$2,857m with regard to the uncertainty around the repairable items balance, of which supply customer accounts are a subset (\$1,000m). The ANAO concerns rested with the controls and management of supply customer accounts, including repairable items, and adherence to stocktake procedures.</p>	<p>Note: These include improvements to data creation, maintenance and reporting to ensure accurate quantity, ownership and location details are entered and maintained for all supply customer accounts on the SDSS.</p>	<p>Planned for 2006-07:</p> <ol style="list-style-type: none"> Complete stocktake of remaining supply customer accounts and correct balances recorded on the SDSS; and Continue to improve business processes regarding management and use of supply customer accounts, incorporate these processes into the Defence Supply Chain Manual and transition the new controls into standard corporate governance activities of all Groups.
<p>Accountable officer: Chief Joint Logistics</p>		

Remediation plan	Activity	Major outcomes
S4: Explosive Ordnance	<p>Remediate the explosive ordnance inventory pricing qualification by:</p> <ol style="list-style-type: none"> a. Sourcing (where possible) original ordnance inventory prices; b. Developing tools to substantiate explosive ordnance inventory values when appropriate supporting documentation cannot be located to support prices; and c. Improving and integrating explosive ordnance inventory accounting and systems management processes. These changes are designed to confirm the accuracy of asset values and enable adherence to financial documentation to substantiate explosive management standards. 	<p>Achieved in 2005-06:</p> <ol style="list-style-type: none"> a. Addressed a total of \$590m of the \$845m price qualification comprising \$346m in audit approval requests sent to the ANAO and \$244m in identified provisions and other movements relating to the explosive ordnance price qualification; b. Implementation commenced of a training program to better identify and mitigate UNIX risks; c. Formulation and implementation of a compliance framework to ensure user access is managed effectively; d. Periodic reviews implemented to ensure access management is effective; and e. Improved integration of explosive ordnance asset and accounting inventory processing and reconciliation procedures. <p>Planned for 2006-07:</p> <ol style="list-style-type: none"> a. Continue the improvement in explosive ordnance inventory processing and reconciliation policies and procedures b. Implement financial reconfiguration policies to improve the pricing accuracy of complex inventory assets; and c. Continue the program of enhancing computer systems to automate accurate pricing of explosive ordnance assets.

The 2003-04 financial statements had a limitation of scope qualification of \$845m relating to uncertainty around explosive ordnance pricing. At issue was Defence's inability to produce, in a timely manner, invoice and contract documentation to validate the explosive ordnance inventory prices recorded in the explosive ordnance procurement management system, Computer System Armaments.

The qualification represented approximately 38 per cent of explosive ordnance inventory and predominantly relates to direct purchase items and items acquired as part of asset under construction contracts between 1982 and 2000.

Accountable Officer: Head Electronic and Weapon Systems Division, Defence Materiel Organisation

Remediation plan	Activity	Major outcomes
S5: Military Leave Records		
<p>The 2002-03 financial statements had a limitation of scope for military leave provisions because insufficient supporting documentation was available for leave records and, where documentation was available, unacceptable error rates existed in the recording of leave transactions. These shortcomings were mainly attributed to inadequate controls and processes within the military personnel systems and the inability to locate source documentation.</p>	<p>Remediate the military leave provisions qualification by:</p> <ol style="list-style-type: none"> a. Implementing a risk stratification and sampling methodology to quantify the risk to Defence accounts; b. Providing an accurate representation of the military leave liability by ensuring the integrity of military leave data captured and recorded in PMKeyS; and c. Applying quality assurance to business processes, record keeping strategies, reporting structures, relevant policy foundations, training initiatives and a controls framework. 	<p>Achieved in 2005-06:</p> <ol style="list-style-type: none"> a. The audit qualification on Military Leave has been removed, by validation of military leave records and balances for the financial year 2005-06. This included leave record substantiation, a review of controls and analytical review of PMKeyS data; b. The validation tasks have confirmed the integrity of military leave data captured and recorded in PMKeyS, and have demonstrated to Management's satisfaction, that Defence's 2005-06 military leave balances are materially correct; c. Application of quality assurance to key business processes, including the refinement and release of instructions on leave management, and the ongoing checking of leave records, has enhanced the management of military leave; and d. The Leave Control Review demonstrated that a robust internal control environment in and around the military employee leave processes exists.
<p>The prior year limitation had resulted in a wide-ranging military leave remediation program but Defence did not expect to resolve the problems before 2005. Defence again 'self-qualified' the military leave provision in 2003-04.</p>		
<p>Accountable officer: First Assistant Secretary Personnel Services Division, Defence Support Group.</p>		<p>Planned for 2006-07:</p> <ol style="list-style-type: none"> a. Continue to embed an ongoing regime for the testing of leave controls, and b. Continue to enhance leave management processes through ongoing refinement of management structures, operating procedures and information technology support.

Remediation plan	Activity	Major outcomes
S6: Civilian Leave Records		
<p>In 2003-04, the ANAO noted problems with civilian leave and payroll processing. The systems issues identified in the management of military leave provisions also affect civilian leave balances.</p> <p>Accountable officer: First Assistant Secretary Personnel Services Division, Defence Support Group.</p>	<p>Remediate the civilian leave provisions qualification by:</p> <ul style="list-style-type: none"> a. Implementing a risk stratification and sampling methodology to quantify the risk to Defence accounts; b. Providing an accurate representation of the civilian leave liability by ensuring the integrity of civilian leave data captured and recorded in PMKeyS; and c. Applying quality assurance to business processes, record keeping strategies, reporting structures, relevant policy foundations, training initiatives and a controls framework. 	<p>Achieved in 2005-06:</p> <ul style="list-style-type: none"> a. The audit qualification for civilian leave was removed, by validation of civilian leave records and balances for the financial year 2005-06. This included leave record substantiation, a review of controls and analytical review of PMKeyS data; b. The validation tasks have confirmed the integrity of civilian leave data captured and recorded in PMKeyS, and have demonstrated, to management's satisfaction, that Defence's 2005-06 civilian leave balances are materially correct; c. Application of quality assurance to key business processes, including the refinement and release of instructions on leave management, and the ongoing checking of leave records, has enhanced the d. management of civilian leave; and d. The Leave Control Review demonstrated that a robust internal control environment in and around the civilian employee leave processes exists. <p>Planned for 2006-07:</p> <ul style="list-style-type: none"> a. Continue to embed an ongoing regime for the testing of leave controls; and b. Continue to enhance leave management processes through ongoing refinement of management structures, operating procedures and information technology support.

Remediation plan	Activity	Major outcomes
S7: Executive Remuneration		
<p>The Executive Remuneration Note (containing information pertaining to civilian and military leave provisions) could not be reliably certified in 2004-05 because of the limitation of scope within the Australian National Audit Office 2002-03 audit report regarding military leave provisions.</p> <p>A separate limitation of scope was applied to the Executive Remuneration Note in respect of any accruals effects arising from the military leave balances. During the 2005-06 period, Defence focused on further improving the accuracy of leave records for the Senior Executive Service and military equivalents by gaining written agreement with the Auditor General on appropriate actions for remediation. These are outlined under Activities.</p> <p>Accountable officer: First Assistant Secretary Personnel Services Division, Defence Support Group.</p>	<p>Remediate the Executive Remuneration Note qualification by:</p> <ol style="list-style-type: none"> a. Accepting current leave balances, after a 30 day personnel review period, with a process of appeal; b. Requiring leave records to be subject to a 100 per cent audit confirmation for validity of movements in the last 12 months; c. Requiring performance of a 100 per cent audit of leave records accepting self confirmation where there is missing documentation; d. Providing a signed declaration from Secretary and the Chief of the Defence Force deeming the balances to be materially correct; and e. Improving the standardisation of processes and controls with mandatory quality assurance checks and the development of an explanatory manual outlining Executive Remuneration Note processes and controls. 	<p>Achieved in 2005-06:</p> <ol style="list-style-type: none"> a. Self confirmation received from all Senior Executive Service and military equivalents of their current annual and long service leave balances; b. A 100 per cent audit completed of all Senior Executive Service and military equivalents, including validity of movements in the last 12 months; c. A signed declaration gained from Secretary and the Chief of the Defence Force deeming the balances to be materially correct; d. Mandatory quality assurance checks and the Executive Remuneration Note manual developed; and e. The Executive Remuneration Note being no longer qualified as a result of the achievements outlined above. <p>Planned for 2006-07:</p> <ol style="list-style-type: none"> a. Continue to review and verify leave balances for Senior Executive Service and military equivalents.

Remediation plan	Activity	Major outcomes
S8: Property Valuations		
<p>In 2004-05, the ANAO issued a 'limitation of scope' for land, buildings and infrastructure and other plant and equipment as significant flaws were identified in associated project management, reporting practices and management review functions. The requirements to be met by the Australian Valuation Office (AVO) were not fully and adequately documented and Defence was considered to have misinterpreted the results of revaluations and incorrectly applied depreciation. A particular consequence has been the misapplication of remaining useful life data provided by the independent valuer. This affected both the valuation adopted by Defence and the reported depreciation expense.</p> <p>Accountable officer: Deputy Secretary Corporate Services/Chief Information Officer</p>	<p>Remediate the land, buildings and infrastructure and other plant and equipment qualification by:</p> <ol style="list-style-type: none"> Revising the AVO engagement letter to clarify valuation policy, procedures and outcomes; Contracting the AVO to revalue all land, buildings and infrastructure and other plant and equipment assets to fair value in accordance with policy guidance; Undertaking quality assurance on AVO site reports to ensure completeness; Entering revaluation data into the financial system (ROMAN) and completing revised depreciation calculations; Engaging a valuation contractor for the next three year cycle, i.e. 2005-06 to 2007-08; and Fully documenting the revaluation process in Corporate Services Asset Management and Accounting Manual. 	<p>Achieved in 2005-06:</p> <ol style="list-style-type: none"> The audit qualification on valuations was removed by completing all required valuations including Information Communication Technology equipment; Undertook quality assurance of valuation data and progressively load the data into the financial system (ROMAN); and AVO contracted to conduct the next three year valuation cycle; and Documented the revaluation process in the Asset Management and Accounting Manual. <p>Planned for 2006-07:</p> <ol style="list-style-type: none"> Continue the ongoing cycle of external valuations; and Implement a new stocktaking and reconciliation process.

Remediation plan	Activity	Major outcomes
S9: Preventing the Escalation of Category A and B Findings		
<p>Audit findings which could not be allocated to a General or Specific Remediation Plan were grouped under Remediation Plan S9 to ensure each finding is remediated. Any audit findings that are not resolved could escalate from Categories B and C to the most serious category, Category A. Defence has recognised the clear need to improve the outcome, focus and management of the implementation of solutions to ANAO findings.</p> <p>Accountable officer: First Assistant Secretary Financial Services</p>	<p>Prevent the escalation of Category A and B findings by:</p> <ol style="list-style-type: none"> Assigning responsibility across Defence for remediation of each of audit findings not already allocated to a remediation plan; Establishing a project-based management system for tracking and managing resolution of these ANAO audit findings; Undertaking progressive and final quality assurance of the remediation outcomes; and Reporting progress to the Financial Statements Project Board. 	<p>Achieved in 2005-06:</p> <ol style="list-style-type: none"> Audit qualification on asset thresholds was removed; and Asset purchase transactions were analysed and items were capitalised as appropriate. <p>Planned for 2006-07:</p> <ol style="list-style-type: none"> Continued review of asset capitalisation policy and introduction of new threshold; and Commence remediation of 2005-06 findings.

Remediation plan	Activity	Major outcomes
S10: Stock Holding Controls		
<p>Items first found are assets and inventory items that, because of threshold and deployment policies, are not or no longer registered in a corresponding Defence register or were previously considered consumed. Where a check of stock holdings shows that the Defence register record varies from the physical quantity, an investigation into the discrepancy is undertaken and the outcome may be an adjustment to the Defence Register record, and/or a corresponding financial adjustment. While it is accepted that the normal stock adjustment process will require a certain level of adjustment activity, current levels of adjustment are considered too high and indicate poor adherence to currently approved business processes.</p>	<p>Improve stock holding controls by:</p> <ol style="list-style-type: none"> a. Preventing or reducing the instance of items b. first found and write-offs; and Accounting for and monitoring those instances first found and write-offs considered legitimate or expected. <p>Note: The remediation activities focus on preventing errant transactions on the SDSS through improvements in policy, procedure and system process, and the introduction of the investigative reporting measures to ensure compliance.</p>	<p>Achieved in 2005-06:</p> <ol style="list-style-type: none"> a. All components of S10 Plan are complete. A closure package has been delivered to the ANAO for inclusion in the 2005-06 audit. b. Developed and implemented a suite of reports in the SDSS in relation to: <ul style="list-style-type: none"> – repair vendors – tracking of repairable items – items in transit – receipting discrepancies; and c. Enhanced the SDSS controls, by restricting the ability to change item classifications between inventory and asset, to improve adherence to the accounting guidelines. <p>Planned for 2006-07:</p> <ol style="list-style-type: none"> a. Continue to modify the SDSS to increase the rigour applied to tracking of repairable items and receipting discrepancies to improve data accuracy; b. Revise and promulgate supply chain policy relating to lost or damaged items and item tracking; and c. Enhance compliance and audit capability, to ensure that all users are complying with the SDSS business processes.
<p>Accountable officer: Chief Operating Officer, Defence Materiel Organisation</p>		

Remediation plan	Activity	Major outcomes
<p>S11: Standard Defence Supply System Items Not-in-Catalogue</p>		
<p>Defence is investigating the extent to which items may have been incorrectly accounted for in the Statement of Financial Position. This may occur when an item is purchased via the ROMAN financial system and then not recorded and managed on the SDSS. Such items are managed and tracked locally with no central visibility. This may lead to the incorrect recording and treatment of an item's value.</p>	<p>Address the potential Not-in-Catalogue issues as they may affect the financial statements by implementing measures to prevent and remediate Not-In-Catalogue items. The activities include:</p>	<p>Achieved in 2005-06:</p>
<p>Remediation of this plan is not due for commencement until all SDSS IT Controls are implemented and are operational (30 September 2006).</p>	<p>a. Clarifying and simplifying policy directives to better support effective item identification, purchasing and management process;</p>	<p>a. Baseline Count training disseminated. The schedule for Remediation and Prevention training agreed;</p>
<p>Accountable officer: Chief Operating Officer, Defence Materiel Organisation</p>	<p>b. Use the redrafted policies on Item Identification (Codification), ADF Logistics Managers' roles and responsibilities, and procurement routing rules to drive new processes and procedures that will prevent the future incidence of Not-In-Catalogue;</p>	<p>b. Reviewed and revised policies relating to Item Identification (Codification), Procurement Routing Rules and ADF Logistics Managers roles and responsibilities; and</p> <p>c. Commenced quantification of the items in Not-In-Catalogue category across Defence.</p>
	<p>c. Developing a 'self remediation' methodology for use by units across Defence to transition Not-In-Catalogue items into the SDSS and the standard financial management regime, including development of a value proposition for the management of legacy items;</p>	<p>Planned for 2006-07:</p>
	<p>d. Developing a compliance monitoring and reporting framework to assist with adherence to new policy and process;</p>	<p>a. The remediation stream of work is targeted for completion by 30 June 2007;</p>
	<p>e. Implementing an ongoing compliance monitoring and reporting regime; and</p>	<p>b. Complete baseline count activity;</p>
	<p>f. Establishing a change management structure to introduce the changes to processes and procedures across Defence, which includes the coordination of training, compliance monitoring and communications.</p>	<p>c. Commence Unit Count training;</p>
		<p>d. Remediation tools finalised for the reporting of progress and the transmission of Not-In-Catalogue for codification and tracking in SDSS;</p>
		<p>e. Prevention strategies formulated and promulgated; and</p>
		<p>f. Implementation of the prevention stream of work.</p>

Remediation plan	Activity	Major outcomes
<p>S12: Provisions for Contaminated or Potentially Contaminated Land, Buildings and Infrastructure</p> <p>Defence is required to include a provision for land decontamination in the financial statements. The ANAO unable to verify the adequacy of current procedures or the accuracy/valuation and completeness of the reported provisions for land decontamination.</p> <p>Accountable officer: Deputy Secretary Corporate Services</p>	<p>Remediate the provision for land decontamination qualification by:</p> <ol style="list-style-type: none"> a. Ensuring accounting policies reflect current reporting requirements; b. Ensuring that sufficient and appropriate policies, procedures and practices are formalised and implemented for the identification of contaminated land, valuation of required decontamination and review of procedures undertaken and assessments made; and c. Obtaining a clear understanding from the AVO regarding matters included in valuation assessments. 	<p>Achieved in 2005-06:</p> <ol style="list-style-type: none"> a. Successfully achieved the first milestone of the S12 plan by using a probabilistic model in identifying provisions and contingent liabilities for contaminated sites in the Australian Capital Territory/Southern New South Wales region; b. A review of the balance of the estate based on assessment reports and a desktop exercise was undertaken. Provision and contingencies have been identified/calculated; c. A set of procedures for the Contaminated Sites Register was developed; and d. A position paper on site restoration provision was developed and implemented. <p>Planned for 2006-07:</p> <ol style="list-style-type: none"> a. The S12 methodology progressed across the estate; and b. Continue to review estimate of provision for site restoration.

Remediation plan	Activity	Major outcomes
S13: Commitments and Accounting for Leases		
The ANAO were unsatisfied with the methods used by Defence to recognise and record leases and commitments.	Remediate the audit finding issued for Commitments and Accounting for Leases carried forward from 2002-03 by:	Achieved in 2005-06:
Accountable officer: Chief Finance Officer	<ul style="list-style-type: none"> a. Defining the criteria for recording commitments; and b. Establishing a lease register that identifies cashflows, revenues, expenses, liabilities, receivables and commitments. 	<ul style="list-style-type: none"> a. A quality assurance process implemented which ensures that a new lease register is established that identifies cash flows, revenues, expenses, liabilities, receivables and commitments; b. The Benalla Munitions facility lease has been assessed to be a finance lease. This will not have any impact on the underlying cash statement. Quality assurance process is now in place to ensure that the commitments schedule is complete and auditable; c. Ongoing progress made in enhancing the schedule of commitments in relation to completeness and measurement criteria; and d. Master Lease Register completed to support reporting of the Schedule of Commitments with all leases correctly reported and classified.
		Planned for 2006-07:
		<ul style="list-style-type: none"> a. Schedule of Commitments completed with ANAO audit concerns from prior years fully addressed; and b. Continued refinement of quality assurance process for the Schedule of Commitments and Master Lease Register.

- 2.16 Since the publication of this information, Defence has reported progress on these plans less comprehensively in its Portfolio Budget Statements and Annual Reports. The Committee sought evidence as to the current status of these plans through both public hearings and questions on notice. This evidence is considered below.

Update on remediation plans

G1: Financial Reporting Framework

- 2.17 In June 2005, the Department of Defence launched the Financial Controls Framework Project (now referred to as the Financial Management Framework Project). The purpose of this project is to establish an internationally-recognised best practice internal control framework in Defence and the DMO.¹⁴
- 2.18 The framework, reported as being in its first year of application as at March 2007,¹⁵ is described as a formal structure within which Defence can manage its financial risks, such as the risk of non-compliance with the FMA Act 1997, the risk of procurement fraud and incorrect staff salary payments.¹⁶
- 2.19 Through the Financial Controls Framework, Defence is able, in its words, to effectively manage its financial risks by:
- documenting the key financial management processes in Defence;
 - documenting the key financial management risks;
 - identifying, documenting and categorising controls to manage the risks;
 - assigning traceable accountabilities for the controls;
 - implementing a comprehensive training regime to support financial management; and
 - establishing a single system of monitoring and maintenance to ensure that the controls framework retains its relevance and integrity.¹⁷

14 Department of Defence, sub 4, p 13.

15 Mr Phillip Prior, transcript, 29 March 2007, p 7.

16 Department of Defence, sub 4, p 13.

17 Department of Defence, *Annual Report 2005-2006*, p 64.

- 2.20 The core of the framework is based on the identification of 'controls'¹⁸ to manage compliance risks associated with both internal (e.g., Chief Executive Instructions) and external (e.g., legislation) financial management obligations.¹⁹
- 2.21 To identify the risks, financial management obligations are subdivided along functional lines such as employee provisions, inventory, land and buildings and so on. Each risk is then assigned one or more controls to either prevent the risk from occurring or to indicate when an undesirable event has occurred.²⁰
- 2.22 In its primary submission to the inquiry, Defence anticipates that the financial controls framework, benchmarked against similar private sector organisations, would contain up to 5,000 internal controls of which 1,000 would be considered to be key.²¹
- 2.23 In a supplementary submission to the inquiry, the Committee was informed that as at May 2007, 1,169 key controls had been identified to manage the financial risks to the Defence Balance Sheet with some of these controls used in multiple locations. In total there are 38,417 instances of these controls in use across the country.²²
- 2.24 Defence also acknowledged in a submission to the inquiry that a controls framework will be insufficient to achieve best practice financial management. Defence advised that regimes to monitor both the level of conformance with the framework and the financial management performance of Defence were being developed.²³
- 2.25 According to the Chief Finance Officer of Defence, this framework is now embedded in the organisation:

We monitor our controls, we have identified our key financial risks and we report on those monthly. I review and monitor those as they are done by people in my organisation. The internal audit group then come in behind us and do their audit spot checks and so on to ensure that those control assessments that we make are

18 Department of Defence, sub 4, p 13, defines controls as: "...specific actions or activities that are implemented to mitigate the likelihood of these occurring and can be either automated within financial management systems or manually applied."

19 Department of Defence, sub 4, p 13.

20 Department of Defence, sub 4, pp 13-14.

21 Department of Defence, sub 4, p 14.

22 Department of Defence, sub 4.3, Attachment A.

23 Department of Defence, sub 4, p 14.

valid. From my point of view, I think that that control framework is now in place and working.²⁴

- 2.26 In its interim phase of the audit of financial statements for the year ending 30 June 2008, the ANAO reported the following:

The 2006-07 financial year was the first year that independent testing and control-self assessment over the majority of identified controls was completed. Over 750 control tests were performed with 89 per cent identified as being fully effective across significant balance sheet accounts. Subsequently a control effectiveness statement was issued to assist the Secretary and the CFO of Defence in their signing of Defence's 2006-07 financial statements.²⁵

Committee comment

- 2.27 The Committee is satisfied from the evidence obtained that this framework is now well established and the monitoring process is ongoing. However, the Committee notes and echoes the following comments of the ANAO:

Defence's commitment to implementing the Financial Management Framework and a continued focus on developing its internal control environment, has resulted in a gradual improvement to the level of outstanding audit findings. Critical to the ongoing success of these activities is the need to maintain an enterprise-level focus on remediation activities and the implementation and maintenance of control activities.²⁶

G2: Managing the ANAO Annual Audit Process

- 2.28 As outlined in the remediation plans above, this plan recognises the importance of having clear agreement between the ANAO and Defence on issues related to the finalisation of the annual financial statements.

24 Mr Phillip Prior, transcript, 29 March 2007, p 15.

25 ANAO Audit Report No. 44 2007-08 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2008*, p 111.

26 ANAO Audit Report No. 44 2007-08 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2008*, p 120.

- 2.29 Understandably, the degree to which parties are able reach agreement will be largely determined by the nature of the relationship between them. The Committee heard from a number of witnesses that the relationship between Defence and the financial audit staff at the ANAO was a healthy and collaborative one. Mr Phillip Prior, the current Chief Finance Officer (CFO), Department of Defence stated:

I think that we have a very healthy relationship with the ANAO, a strong professional relationship. We submit our financial statement plan for the year to the auditors early in the financial year, and we discuss it and work through it together. We have a very mature process of sharing information at the highest strategic level for our financial statements.²⁷

- 2.30 Dr Stephen Gumley, Chief Executive Officer (CEO), DMO, reaffirmed this view:

The relationship with the Audit Office on the financial audits, I think, is excellent at the moment. I am delighted with the co-operation on financial audits. They audit our processes and they do a bit of green-pen ticking of individual transactions to check that the processes are working. There is an open dialogue on financial audits. It is going well. We make some mistakes and they find them, and that is fine. We correct our mistakes and so on.²⁸

- 2.31 From an ANAO perspective, Mr Michael White indicated that having specific officers within Defence who facilitate the audit process had:

...worked quite well in terms of making sure the communication flows smoothly through the audit process.²⁹

- 2.32 And, the Auditor-General stated:

...on the financial statement work...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.³⁰

27 Mr Phillip Prior, transcript, 29 March 2007, pp 17.

28 Dr Stephen Gumley, transcript, 9 May 2007, p 22.

29 Mr Michael White, transcript, 13 June 2007, p 3.

30 Mr Ian McPhee, transcript, 17 August 2006, p 6.

Committee comment

- 2.33 On balance, the Committee was in agreement with Mr Prior's assessment that this plan was past remediation and was now embedded.³¹ The Committee is gratified that the relationship between Defence and the ANAO in relation to financial matters has been described in positive terms. The Committee hopes this cooperation between the ANAO and Defence will continue to develop over time.
- 2.34 However, the Committee notes that the relationship with the Audit Office in terms of performance audits (i.e., audits which can review or examine any aspect of the operations of the person or body³²) was not described by Defence in the same positive terms. This issue is raised further in Chapter 5.
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G3: Financial Management and Systems Training – Financial and Business Management

- 2.35 This plan was developed in recognition of the need for Defence to enhance the skills of staff in the execution of financial management and adhere to approved procedures in the use of corporate information technology systems.³³
- 2.36 The Committee notes and is in agreement with Defence's view on the need for financial skilling right across the Department:
- In some way every member has the potential to impact on Defence's financial statements, for example, through the management of leave balances, the acquittal of business travel or the efficient and effective use of the Defence suppliers' budget. It can therefore be said that all Defence staff undertake financial activities. While some will clearly identify themselves as having a financial management function, others currently do not recognise themselves as having a financial role or responsibility.³⁴
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31 Mr Phillip Prior, transcript, 29 March 2007, p 17.

32 Australian National Audit Office, *Planned Audit Work Programme 2007-08*, p 10.

33 Department of Defence, sub 4, p 32.

34 Department of Defence, sub 4, p 17.

2.37 The Committee also notes that Defence has invested considerable funds and effort into its financial skills training program. For example:

A dedicated Financial Training Branch has been established under the Defence Chief Finance Officer to identify and develop training for, the learning outcomes that are emerging from all of our initiatives, reforms and in the financial management environment.

An amount of \$35m has been allocated over ten years (to 2015-16) to deliver an effective financial management skilling system that meets the needs of Defence and its people working in the finance domain.³⁵

2.38 At the inquiry's first hearing on 11 May 2006, the former Secretary of Defence, Mr Ric Smith indicated that training in financial management and IT systems had been provided to approximately 7,300 staff in 2004-05 and 9,400 to March 2006.³⁶

2.39 This training falls into the following categories: *financial management training* (training support provided to the Senior Leadership Group and senior officers); *financial information systems training* (training in corporate financial management systems such as ROMAN and BORIS); *finance and business training* (such as accrual accounting and finance induction); *tertiary financial training* (including 2 tertiary training courses); and *e-learning*.³⁷

2.40 Since 2004-05, training expenses have increased from an actual \$2.267 million in 2004-05 to an estimated \$3.786 million in 2006-07.³⁸ Similarly, the number of people who have undergone financial training has also increased:

I think we have trained something like 10,000 people in financial management in this current year – the year to date. Last year, 2005-06, 14,610 people were put through financial management training programs. This year from February to date there have been 10,331 people.³⁹

35 Department of Defence, sub 4, p 21.

36 Mr Ric Smith, transcript, 11 May 2006, p 4.

37 Department of Defence, sub 4, p 16.

38 Department of Defence, sub 4.3.

39 Mr Phillip Prior, transcript, 29 March 2007, p 16.

- 2.41 In its Annual Report for the year 2006-07, Defence further reports:
- During the year 18,916 people were provided with finance-related training.⁴⁰
- 2.42 The Committee notes that Defence, like other public sector organisations, continues to face a number of challenges as a result of the current skills shortage and the consequent competition amongst agencies for staff with the appropriate level of expertise. This issue is also addressed in Chapter 4.

Committee comment

- 2.43 The Committee welcomed comments from the CFO of Defence, that while he no longer saw training as a remediation activity, he did not assume that Defence's investment in training would taper off. For example, as new reporting requirements emerged there would be a corresponding requirement for training:
- We do not rest on our laurels...We try to look ahead and plan the future needs of our people across the organisation. When some of the base training starts to embed and become absorbed, we then try to develop more plans that take us to a further level.⁴¹
- 2.44 However, the Committee is concerned about the extent to which this significant investment in financial skills training will impact on Defence's culture around financial management over the longer term. For example, while an increasing number of staff may be equipped with financial skills, to what extent do they believe they play a role in the financial management of the Department? The Committee's concern with the culture underlying the problems with Defence's financial management is echoed in the following comments made by the current Secretary of the Department, Mr Nick Warner to the Lowy Institute in June this year:
- Financial management encompasses a lot more than our financial statements...[a]nd the real problem is not actually the numbers themselves – it's the flawed behaviour, systems and processes that produce the wrong numbers.⁴²

40 Department of Defence, *Annual Report 2006-07*, p 32.

41 Mr Phillip Prior, transcript, 29 March 2007, p 18.

42 Mr Nick Warner, *256,800 Paper hand towels: Mending Defence's Broken Backbone*. Speech to the Lowy Institute for International Policy, 10 June 2008, p 5.

- 2.45 The Committee considers that such a large investment in financial training should be accompanied by an appropriate evaluation strategy to ensure a commensurate return on the investment.
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S1: Stores Record Accuracy

- 2.46 The purpose of this plan is to remediate the significant range of uncertainty that existed around Defence's 'self-qualified' stock quantities related to general stores inventory and repairable items.⁴³

- 2.47 Mr Prior provided an update on this remediation plan on 29 March 2007, as follows:

We have a two-year rolling stocktaking process in place and it has been in place for some years. It is now at a mature state. I see regular reports now about our stocktaking effort...I see what I expect to see – that is, information flowing about the results of stocktakes, which are done on a regular basis. So information is flowing through. We are getting closer and closer to the point where we think we have a stocktaking process which is now business as usual. Does that stocktaking process identify stock movements and adjustments? Yes, it does, as it should do. We have a stocktaking process which, as I understand it...is down at the bin level. It is down at a very low level. We have well in excess of 150 million individual items and we are counting down at the bin level across 1,100-odd warehouses.⁴⁴

- 2.48 At that hearing, Mr Prior was unable to provide the Committee with a current estimate of the extent of material deficiencies in stores inventories across Defence. Since that time, however, the Committee has received a further submission from the Department of Defence which reports progress on stores accuracy for the 2006-07 financial year as follows:

In general terms, progress has been good. Management is now able to assert reliance on controls, that the location of [General Stores Inventory] and [Repairable Items] quantities is known and

43 Department of Defence, sub 4, p 33.

44 Mr Phillip Prior, transcript, 29 March 2007, p 19.

managed and that the not-in-catalogue uncertainty has been remediated.⁴⁵

- 2.49 However, consistent with the ANAO's audit findings for the period ended 30 June 2007⁴⁶, Defence's submission 4.5 sets out that some uncertainty surrounding General Stores Inventory remains:

During the 2006-07 financial year, a number of activities were undertaken to assist management to form a view as to the status of GSI quantities.

The results of these measures are positive and have given management increased confidence that Defence knows where its inventory is located and how it is being managed.

However, noting that there remain outstanding issues surrounding GSI prices, at this stage management is still faced with uncertainty regarding some legacy pricing and will therefore not be in a position to form an opinion about the entire GSI balance for 2006-07.⁴⁷

- 2.50 The Committee notes that future issues related to General Stores Inventory will be dealt with by an *Inventory Tiger Team*. Defence's *Portfolio Budget Statements 2007-08* sets out the work of the team as follows:

...this team was established to assist in the removal of uncertainty around General Stores Inventory and Repairable Items. The approach is focused on establishing controls reliance and substantiating quantities and prices.⁴⁸

- 2.51 The Committee also welcomes the comments of Mr Nick Warner, the current Secretary of Defence in reassessing the approach to ordering and maintaining stock levels and his desire to modernise the warehouse management system.⁴⁹

45 Department of Defence, sub 4.5, p 1.

46 For further detail see, Australian National Audit Office, Audit Report No. 18 2007-08, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2007*, pp 94-95.

47 Department of Defence, sub 4.5, p 2.

48 Department of Defence, *Portfolio Budget Statements 2007-08*, p 204.

49 Mr Nick Warner, *256,800 Paper hand towels: Mending Defence's Broken Backbone*. Speech to the Lowy Institute for International Policy, 10 June 2008.

S2: General Stores Inventory Pricing and Accounting

- 2.52 As outlined in the remediation plan tables above, this remediation plan arose as a result of Defence's inability to produce, in a timely fashion, documentation to validate the prices of general stores inventory recorded in SDSS which lead to qualifications in the 2003-04 and 2004-05 Financial Statements.⁵⁰
- 2.53 At the hearing on 29 March 2007, the Committee was advised that Defence was still working through three significant components to S2. These included: inventory pricing in light of the Australian Equivalents to International Financial Reporting Standards (AEIFRS); legacy invoices; and 'the one dollar problem'.
- 2.54 With regard to inventory pricing in light of the AEIFRS, one of the difficulties associated with this remediation plan has been that inventory pricing issues are assessed against the requirements of the AEIFRS. That is, under the AEIFRS (i.e., AASB 102 *Inventories*), Defence is required to record inventory at the lower of cost or current replacement, and, because Defence holds a large amount of inventory that has been held for many years, it is difficult to determine its replacement cost.
- 2.55 On the basis of concerns raised about the application of AASB 102 *Inventories*, in March 2007 the Australian Accounting Standards Board (AASB) released an exposure draft entitled *Proposed Amendments to AASB 102 – Inventories Held for Distribution by Not-for-Profit Entities* (Exhibit 3). Defence indicated at the hearing on 29 March 2007 that if approved by the AASB, this amendment would mean Defence could revert to recording inventory at cost.
- ...given that [approval] all happens, that problem we had with pricing will go away, and we can revert to recording our inventory just at cost. Moving forward, that means that that is now something that we can get on and do.⁵¹
- 2.56 The Committee received an update on 4 June 2008 as follows:
- AASB 2007-5 Amendments to Australian Accounting Standard – Inventories Held for Distribution by Not-for-Profit Entities [AASB
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50 Department of Defence, sub 4.5, p 34.

51 Mr Phillip Prior, transcript, 29 March 2007, p 25.

102] was released by the Australian Accounting Standards Board (AASB) in May 2007 with an application date for reporting periods beginning on or after 1 July 2007. The amendment required not-for-profit entities to measure inventories held for distribution at cost, adjusted where applicable for any loss of service potential.

Defence adopted this amendment early from 1 July 2006 as permitted by the then Department of Finance and Administration...⁵²

- 2.57 With regard to legacy invoices, records associated with some inventory held in Defence go back many years and in many cases are not readily available. For example, as at March 2007, in the Standard Defence Supply System (SDSS), there were close to \$100 million in general stores that have had neither receipts nor issues against them since 1993⁵³ calling into question the current value of those items.
- 2.58 Additionally, the 'one dollar problem' has arisen because SDSS was originally set up as a logistics management system. This meant the focus was on the quantity rather than the price of inventory and staff were instructed to enter either "zero or one as the value"⁵⁴ of each item.
- 2.59 Defence is working with the AASB and the ANAO to develop a method of determining legacy priced items. In a submission to the inquiry, Defence outlines its approach to addressing GSI pricing uncertainty as follows:

Defence has developed a comprehensive plan to substantiate and, where necessary, remediate pricing where historical prices are unable to be verified. The execution of this plan will require extensive internal and external resources. Concurrently, Defence is working with the AASB to obtain relief from the requirement to demonstrate verifiable prices for legacy GSI. In the meantime Defence has commenced work, in consultation with the ANAO, to execute the GSI legacy pricing plan outlined below.

At the top level, Defence has segmented GSI based on the likelihood that documentation exists to support the GSI price records in the Defence logistics system. This has resulted in pre-2000 and post-2000 segments.

The pre-2000 segment has been further divided into:

52 Department of Defence, sub 4.7.

53 Mr Mark Jenkin, transcript, 29 March 2007, p 26.

54 Mr Mark Jenkin, transcript, 29 March 2007, p 28.

- Items that are Potentially Surplus or Obsolete. These items have had no issues since 2000 (116,000 stockcodes valued at \$178 million) and are being reviewed. It is anticipated the majority of these items will be fully adjusted for the loss in service potential and subject to disposal action. These items will not require any pricing substantiation.
- Items which were last received pre-2000 but have had issues post-2000 (194,000 stockcodes valued at \$562 million). Defence has engaged the Australian Valuation Office (AVO) to substantiate the prices on the Defence logistics system. Where the AVO is unable to substantiate the price, it will provide an estimate of the current replacement costs of the stock item. Defence will then consider the need to index to the date of purchase using the relevant Australian Bureau of Statistics index to obtain an appropriate surrogate purchase price. The current replacement cost is considered to be the most appropriate and reliable estimate of cost for GSI that cannot be substantiated with existing documentation.

For the post-2000 segment (166,000 stock codes valued at \$1.5 billion), Defence has adopted an Acceptance Testing approach based on advice from expert statisticians. A sample of purchase records has been selected from materiel procurement sites across Defence. Purchasing documentation is to be collected for each record and compared with the electronic record on the Defence logistics system. This process will identify those areas where procurement practices are sound and any areas that require remediation. Appropriate adjustments can then be made to the financial record.

The overall outcome of this work is expected to provide Defence management with sufficient assurance that the GSI balance is not materially misstated.⁵⁵

- 2.60 The Committee notes, and is supportive of, discussions that are still taking place between the AASB, the Auditor-General and Defence regarding the resolution of these issues. The Committee also notes the ANAO's report on the status of this work as follows:

Defence has recently commenced comprehensive programs to assess GSI quantities and legacy pricing issues that contributed to the qualification of the 2006-07 financial statements. Key activities involved in the program include a third party assurance process over GSI quantities and a statistical sampling program over GSI

55 Department of Defence, sub 4.7.

pricing. These strategies and the results stemming from them are under review by the ANAO.⁵⁶

- 2.61 The Committee will monitor progress on this remediation plan.
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S3: Supply Customer Accounts (SCAs)

- 2.62 Supply customer accounts are used to track and manage assets and accountable inventory through the supply chain.⁵⁷ The aim of this plan was to improve management of these assets.

- 2.63 The Department of Defence *Annual Report 2005-2006* reports:

All remediation actions in relation to this plan have been completed. All SCAs now have a responsible officer and improved management processes are in place.⁵⁸

- 2.64 The Committee is satisfied on the basis of that report, that this remediation plan is closed.
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S4: Explosive Ordnance

- 2.65 The purpose of this plan is to ensure appropriate substantiation of explosive ordnance (EO) pricing and establish and implement policies for the correct recording of EO.

- 2.66 The removal of the explosive ordnance qualification was reported to the Committee by Defence on 29 March 2007.⁵⁹

- 2.67 The ANAO describe the activities leading to the lifting of this qualification as follows:

In 2004-05, there was uncertainty surrounding the pricing of a portion of the EO balance, as Defence was unable to provide sufficient supporting documentation to support the recorded

56 ANAO Audit Report No. 44 2007-08 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2008*, p 116.

57 Department of Defence, sub 4, p 36.

58 Department of Defence, *Annual Report 2005-2006*, p 66.

59 Mr Phillip Prior, transcript, 29 March 2007, p 29.

value...In 2005-06, Defence remediated this balance and reduced the uncertainty due to several actions, firstly, by writing down the value of inventory to the lower of cost and current replacement cost in accordance with AASB 102 *Inventories*, and secondly, use of 'best estimate' values where primary documentation was not available. These actions, together with the corrections of prior year errors under AEIFRS, resulted in the uncertainty in relation to the balance being mitigated for 2005-06 and the comparative year.⁶⁰

- 2.68 While the Committee welcomes the closing of this remediation plan, it is keenly aware that issues relating to EO are of great consequence to the Government, Defence and the Australian public. Matters relating to the theft of M72 rocket launchers featured at different points during the inquiry. The Committee therefore makes note of and welcomes the comments of Mr Warner that accountability for the complete oversight of EO management has been given to the Vice Chief of the Defence Force. The Committee also notes that the following activities are high on Defence's agenda in light of its recent audit of security policy and practices applying to weapons, munitions and explosives:⁶¹

...revising EO accounting procedures, improving physical security at weapons and EO storage facilities, and consolidating the myriad of publications in this area into a single, easily understood and accessed reference point.⁶²

S5: Military Leave Records and S6: Civilian Leave Records

- 2.69 As a result of insufficient documentation and unacceptable error rates in processing military and civilian leave, the aim of these plans is to ensure the integrity of leave data recorded in PMKeyS (i.e., Defence's primary information management system supporting personnel management).
- 2.70 The ANAO reports that Defence has now successfully remediated issues concerning the accuracy of civilian and military annual leave balances
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60 Australian National Audit Office, Audit Report No. 15 2006-07, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 105.

61 The Hon Dr Brendan Nelson MP, *Further strengthening of security for weapons, munitions and explosives*, media release, 25 September 2007.

62 Mr Nick Warner, *256,800 Paper hand towels: Mending Defence's Broken Backbone*. Speech to the Lowy Institute for International Policy, 10 June 2008, p 8.

and civilian long service leave⁶³ and that any future issues related to this remediation plan will be managed through the Leave Tiger Team (see section 2.92).

S7: Executive Remuneration

- 2.71 Concerns over military and civilian leave meant that the Executive Remuneration Note, which is included in Defence's financial statements, could not be reliably certified.⁶⁴
- 2.72 The ANAO concluded on the basis of a review conducted in 2005-06 that the uncertainty reported in 2004-05 with regard to leave provisions, the associated impact on leave expenses and the Executive Remuneration Note was mitigated.⁶⁵ This remediation plan is therefore complete.
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S8: Property Valuation

- 2.73 The purpose of this plan is to address the flaws identified by the ANAO in project management, reporting practices and review functions around Defence's land, buildings and infrastructure assets.
- 2.74 In its *Annual Report 2005-2006*, Defence reported that all land, building and infrastructure findings were completed by 30 June 2006 and have been quality assured.⁶⁶ As a result, the qualifications relating to land and buildings, and infrastructure have been removed.⁶⁷ This remediation plan is therefore complete.
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63 Australian National Audit Office, Audit Report No. 15 2005-06, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 102.

64 Department of Defence, sub 4, p 39.

65 Australian National Audit Office, Audit Report No. 15 2005-06, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 106.

66 Department of Defence, *Annual Report 2005-2006*, p 67.

67 Department of Defence, sub 4.7.

S9: Preventing the Escalation of Category A and B Findings

- 2.75 This plan contains audit findings that had not been allocated to a General or Specific remediation plan to ensure remediation of all audit findings. Defence recognises that any audit findings not resolved could escalate from Categories B and C to Category A (the most serious) and it acknowledges the need to improve the “outcome, focus and management of the implementation of solutions to ANAO findings”.⁶⁸
- 2.76 The most recent publicly available update from Defence specifically in relation to this plan is contained in the *Department of Defence Annual Report 2005-06* is as follows:
- Remediation action has been completed for over 90 per cent of the findings allocated to this plan in 2004-05.⁶⁹
- 2.77 Additionally, the Committee notes ANAO reports that Defence have made progress in reducing its high risk audit findings. For example, category ‘A’ findings decreased from 16 (at the end of the 2007 interim audit) to 9 (at the conclusion of the 2007 final audit).⁷⁰
- 2.78 The ANAO make the following comment:
- When the 2006-07 result is compared with comparative reporting periods, it is evident that Defence’s focus on financial remediation has had a positive impact on the department’s internal control environment and quality of financial reporting.⁷¹
- 2.79 However, the Committee also notes ANAO advice that:
- A continued focus is required on the remediation of the moderate and lower risk issues which, in aggregate, have trended upwards over the past couple of reporting periods.⁷²

68 Department of Defence, sub 4, p 40.

69 Department of Defence, *Annual Report 2005-06*, p 67.

70 Australian National Audit Office, Audit Report No. 44 2007-08, *Interim Phase of Audit of Financial Statements of General Government Agencies for the Period Ended 30 June 2008*, p 114.

71 Australian National Audit Office, Audit Report No. 44 2007-08, *Interim Phase of Audit of Financial Statements of General Government Agencies for the Period Ended 30 June 2008*, p 114.

72 Australian National Audit Office, Audit Report No. 44 2007-08, *Interim Phase of Audit of Financial Statements of General Government Agencies for the Period Ended 30 June 2008*, p 115.

S10: Stock Holding Controls

- 2.80 The purpose of this plan is to improve stock holding controls of 'first found' (i.e., items of asset or inventory that do not have a corresponding record on an authorised Defence register) and write off items and the monitoring of legitimate occurrences.⁷³
- 2.81 The Committee is in receipt of no information that states explicitly that this individual remediation plan is complete, however, the Committee infers from the objective of the plan and the update provided in the Department's *Annual Report 2005-06* that the remediation plan is in fact finalised:
- New policies and processes have been implemented and the monitoring of First Found and Write Off items has been improved.⁷⁴
-

S11: Standard Defence Supply System Items Not-in-Catalogue

- 2.82 The objective of this remediation plan is to reduce the number of not-in-catalogue items held by Defence. To that end Defence has implemented procurement policies, processes and procedures to ensure that items being purchased are codified and loaded onto SDSS.⁷⁵ Defence report that during 2006-07:
- ...uncertainty around...not-in-catalogue issues was removed.⁷⁶
- 2.83 The Committee is therefore satisfied that this remediation plan is complete.
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73 Department of Defence, sub 4, p 41.

74 Department of Defence, *Annual Report 2005-2006*, p 67.

75 Department of Defence, *Annual Report 2005-2006*, p 67.

76 Department of Defence, *Annual Report 2006-2007*, p 32.

S12: Provisions for Contaminated or Potentially Contaminated Land, Buildings and Infrastructure

- 2.84 The objective of this remediation plan is to ensure an appropriate provision for the remediation of contaminated sites.⁷⁷
- 2.85 The last publicly-available comprehensive report on this plan indicates that:
- A position paper on this issue has been developed which has enabled the determination of a provision for the 2005-06 financial statements. All extant policies have been reviewed to ensure current reporting requirements are being met. New processes in relation to updating of the contaminated sites register are being developed.⁷⁸
- 2.86 The Committee assumes that on-going work relating to this plan will be undertaken by the Site Restoration Provision Project (see section 2.92 below).
-

S13: Commitments and Accounting for Leases

- 2.87 This remediation plan addresses a range of audit findings including issues related to a proposed finance lease on a munitions facility and the master lease register.⁷⁹
- 2.88 The purpose of this plan was to ensure that the Schedule of Commitments and the accounting for leases are completed in accordance with relevant Defence policy and meet the accounting standard.⁸⁰
- 2.89 In its 2005-2006 Annual Report, Defence reports the following:
- In accordance with the remediation plan, a new quality assurance process has been introduced that has substantially improved the completeness, accuracy and auditability of the schedule. The
-

77 Department of Defence, *Annual Report 2005-2006*, p 67.

78 Department of Defence, *Annual Report 2005-2006*, p 67.

79 Department of Defence, sub 4, p 41.

80 Department of Defence, *Annual Report 2005-2006*, p 67.

master lease register has been significantly modified to capture more detailed information relating to cash flows, revenues, expenses, liability, receivables and commitments.⁸¹

Committee comment

2.90 The Committee is aware that a significant period of time has elapsed since the commencement of the inquiry and as such it expects that the remediation plans would now be nearing completion. Indeed, the Committee heard evidence on 29 March 2007 from Mr Prior that Defence will no longer be reporting on many of the 16 remediation plans:

...going forward we will not report on many of these remediation plans. My intention is to fold these activities now into the ordinary course of business, so, to the extent that leave has now been settled with the auditors, there is not much point in continually reporting it – it is done.⁸²

2.91 Additionally, in a submission dated 5 June 2008 the Committee was advised that the last remaining area of qualification is pricing and system issues relating to General Stores Inventory.⁸³

2.92 That Defence sees the remediation program as being in its final stages is further reaffirmed by the dedication of only one page to *Financial Reform* in the *Portfolio Budget Statements 2007-08*. The focus of future financial statements remediation outlined in this document is as follows:

- Financial Controls Framework Project – this project draws together, in a structured and integrated fashion, all of the components needed to build a best practice financial management environment for Defence. The framework provides all staff with a common understanding of the what, why, when and how of financial management in Defence.
- Inventory Tiger Team – this team was established to assist in the removal of uncertainty around General Stores Inventory and Repairable Items. The approach is focused on establishing controls reliance and substantiating quantities and prices.
- Leave Tiger Team – in 2005-06, this team was able to confirm civilian and military annual and long service leave entitlements were materially correct, resulting in removal of the previous audit qualification. The task for the team in 2006-07 and beyond is to continue improving business processes and

81 Department of Defence, *Annual Report 2005-2006*, p 67.

82 Mr Phillip Prior, transcript, 29 March 2007, p 41.

83 Department of Defence, sub 4.7.

controls around leave entitlements to avoid future qualifications.

- Site Restoration Provision Project – considerable work has been done to identify and record an appropriate provision for the restoration of contaminated Defence sites. While present obligations can be identified and reported appropriately, full technical assessment of all sites is an ongoing task.⁸⁴

- 2.93 Similarly, Defence's *Portfolio Additional Estimates Statements 2007-08*, the *Annual Report 2006-07* and the *Portfolio Budget Statements 2008-09* dedicate very little space to the status of the remediation program or financial reform.
- 2.94 The Committee welcomes the extensive work that has been undertaken on the remediation plans, largely under the direction of Mr Phillip Prior, the Chief Finance Officer, and appreciates that Defence is keen to incorporate the outcomes of its remediation activities into its usual business practice. However, the Committee makes note that determining the status of the individual remediation plans over the course of the inquiry was not as straightforward as it would have hoped. There still being no one document that provides a definitive statement on the status of each plan.

Position papers and adoption of the AEIFRS

- 2.95 From 1 January 2005, all reporting entities in Australia were required to adhere to new international accounting standards, the AEIFRS.
- 2.96 Where previously, financial reporting was subject to Australian Generally Accepted Accounting Principles (AGAAP), the purpose of the AEIFRS is to:
- ...increase the transparency and comparability of financial statements on a global basis through the full adoption of the International Financial Reporting Standards (IFRS).⁸⁵
- 2.97 The Australian Accounting Standards Board (AASB), the Commonwealth agency responsible for developing and issuing accounting standards in Australia, issued the first standard, AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards*, to facilitate compliance with the standards and

84 Department of Defence, *Portfolio Budget Statements 2007-08*, p 204.

85 ANAO Audit Report 21 2005-06, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2005*, p 22.

provide relief to first time adopters of the standards (e.g., exemptions to full retrospectivity in the application of new accounting policies).⁸⁶

2.98 The Committee was informed by Defence that reporting 2005-06 financial information in accordance with the AEIFRS held particular challenges for Defence given its size and nature. For that reason, Defence wrote to the AASB in late 2005 seeking transitional relief and in March 2006, the AASB amended AASB 1 as follows:

Aus3.2 In rare circumstances, a not-for-profit public sector entity may experience extreme difficulties in complying with the requirements of certain Australian equivalents to IFRSs due to information deficiencies that have caused the entity to state non-compliance with previous GAAP. In these cases, the conditions specified in paragraph 3 for the application of this Standard are taken to be satisfied provided the entity:

- (a) discloses in its first Australian-equivalents-to-IFRSs financial report:
 - (i) an explanation of information deficiencies and its strategy for rectifying those deficiencies; and
 - (ii) the Australian equivalents to IFRSs that have not been complied with; and
- (b) makes an explicit and unreserved statement of compliance with other Australian equivalents to IFRSs for which there are no information deficiencies.⁸⁷

2.99 As a result of this amendment, Defence was able to avail itself of relief in relation to:

- The ability to use the AGAAP carrying amounts of property, plant and equipment at 1 July 2004 as deemed cost on transition to AIFRS.
- Simplified transitional arrangements for decommissioning, restoration or similar liabilities.
- Simplified transitional arrangements for leases embedded in arrangements/contracts existing at 1 July 2004.⁸⁸

86 ANAO Audit Report No. 48 2005-2006 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2006*, p 28.

87 Australian National Audit Office, Audit Report No. 48 2005-2006 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2006*, p 28.

88 Department of Defence, sub 4, p 49.

2.100 However, in its primary submission to the inquiry, Defence outlined a number of key challenges that remained. These are summarised as follows:

- *Embedded derivatives*: Defence will be required to identify, value and recognise embedded derivatives where such derivatives exist in existing contractual arrangements;
- *Restoration provision*: Defence will be required to provide for restoration and decontamination in relation to contaminated sites;
- *Decommissioning*: Defence will be required to provide for the decommissioning costs expected to be incurred at the end of life of items such as specialist military equipment. Provisions will be required to be booked on acquisition of those items;
- *Heritage and Cultural Assets*: Defence will be required to value and recognise heritage and cultural assets; and
- *Inventory*: Defence will be required to record inventory at the lower of cost and replacement cost requiring maintenance of two records of value for inventory items.⁸⁹

2.101 Defence developed a series of 'position papers' to clarify key accounting issues related to these and other matters. In addition to seeking agreement on the application of the AEIFRS, the purpose of these conceptual papers was to maximise the likelihood that the ANAO would be in a position to form an opinion on the 2005-06 financial statements. The former Secretary of Defence, Mr Ric Smith, succinctly described the purpose of developing the position papers as follows:

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.⁹⁰

2.102 The proactive nature of these position papers also aligns with the views expressed in BAE Systems Australia Limited's submission:-

Given the recent history of qualified audit opinions/no opinions being expressed by ANAO it would be sensible for Defence to agree with ANAO upfront what the goals, priorities and expected outcomes of the Financial Remediation Project (FRP) should be and the interim milestones for achievement.⁹¹

89 Department of Defence, sub 4, p 49-51.

90 Mr Ric Smith, transcript, 11 May 2006, p 9.

91 BAE Systems Australia Limited, sub 2, p 8.

2.103 At the time of its submission, Defence had prepared 21 position papers to assist with the 2005-06 financial statements. The topics on which papers had been prepared by the Department were listed in Submission No 4 as follows:

- AASB 1 and Transition to AIFRS;
- Assertion Validation Framework and Substantiation Methodologies;
- Materiality Framework;
- Assets Under Construction;
- General Stores Inventory (Accounting Policy);
- General Stores Inventory (Controls/Quantities);
- General Stores Inventory (Price/valuation);
- Tangible Asset Capitalisation Threshold;
- Repairable Items;
- Recognition and Depreciation of Specialist Military Equipment;
- Leave Balances for Civilian and Military Annual and Long Service Leave;
- Site Restoration Provisions;
- Specialist Military Equipment Decommissioning;
- Embedded Derivatives;
- Cashflow Statement (other than derived);
- Free of Charge Agreements between Defence and the DMO;
- Heritage and Cultural Assets;
- Reporting Entity - Consolidation of DMO;
- Disclosure and Validation of Executive Remuneration Note;
- Not-in-Catalogue; and
- Assets Now Recognised/Written-Off/Written-Down.⁹²

2.104 As at 30 June 2007, the ANAO reports that the number of position papers they had received was now over 30.⁹³

92 Department of Defence, sub 4, pp 45-47.

2.105 The ANAO is supportive of these position papers. For example, in relation to financial statement preparation for 2005-06, the ANAO states:

The development of these position papers and the consultation process between Defence and ANAO to address and resolve any technical issues and points of clarification arising was viewed as a contributing factor to the successful completion of the financial statement preparation and associated audit.⁹⁴

2.106 And, further, in relation to the 2006-07 financial statements:

The ANAO supports Defence's initiative in using the position paper process as a basis for resolving accounting issues to the 2006-07 financial statements.⁹⁵

Committee comment

2.107 The Committee is very supportive of the ongoing development of positions papers to clarify key issues and facilitate dialogue with the ANAO. However, the Committee also concurs with the view expressed by the Auditor-General that while sympathetic to the challenges Defence faces in adopting the AEIFRS, the underlying causes of Defence's financial management issues should not be construed 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...the accounting standards and reporting are highlighting a problem.⁹⁶

Summary of progress on remediation program

2.108 There is little doubt that the senior leadership at Defence is pleased with the progress that has been made in relation to financial reform, as illustrated by the following quote from Mr Nick Warner, the current Secretary of the Department of Defence:

93 Australian National Audit Office, Audit Report No. 51 2006-07 *Interim Phase of the Audit of Financial Statements of General Government Sector Agencies for the Year Ending 30 June 2007*, p 112.

94 Australian National Audit Office, Audit Report No. 15 2006-07 *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006*, p 102.

95 Australian National Audit Office, Audit Report No. 51 2006-07 *Interim Phase of the Audit of Financial Statements of General Government Sector Agencies for the Year Ending 30 June 2007*, p 112.

96 Mr Ian McPhee, transcript, 17 August 2007, p 19.

I have been enormously pleased with the quality of the financial work that is done in the department...I think great strides have been taken there in the last few years...⁹⁷

2.109 In particular, there has been significant progress made on the remediation plans. On 13 June 2007, the Committee was advised by representatives from the ANAO as follows:

...there was a range of qualification issues last year that were effectively remediated as part of those 16 plans by the department, including those around the civilian and military annual leave records and qualification we had had in prior years. Also to the extent of remediating the issues around explosive ordnance pricing and the completeness of infrastructure, plant and equipment, all of which were qualifications in previous years. So there has been some quite significant success from the remediation plans.⁹⁸

2.110 Perceptions further afield are also positive on this front. Dr Mark Thomson, although giving evidence in a private capacity, a former Defence employee and now Program Director with the Australian Strategic Policy Institute, stated:

The situation in Defence today, having begun with the low base in 2001-02, is one of extensive reform. There is a financial controls framework in place, there is a big program in place to remediate the information technology systems within the organisation, and training and skilling has been pushed right through the organisation, in particular in the financial area. This is backed up by a comprehensive plan that is being run like a project.⁹⁹

2.111 Early in the inquiry, the Auditor-General too highlighted the efforts of senior management in financial reform:

...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...¹⁰⁰

97 Mr Nick Warner, Senate Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 30 May 2007, p 46.

98 Mr Michael White, transcript, 13 June 2007, p 2.

99 Dr Mark Thomson, transcript, 8 February 2007, p 2.

100 Mr Ian McPhee, transcript, 17 August 2006, p 4.

2.112 At the public hearing on 13 June 2007, Mr McPhee went further:

...I make the positive comment that the work that Defence has done on financial management remediation is demonstrating forward progress in terms of that aspect of their administrative responsibilities and the fact that the audit qualifications, while remaining on their financial statements, nevertheless are less severe than they have been in prior years is a positive sign for Defence of forward progress.¹⁰¹

2.113 However, it should be noted that not all the evidence gathered in relation to progress on Defence's financial reform agenda is positive. Mr Ian Matthews, a former Director for Specialist Military Equipment with Defence during 2005, provided the following comment on Defence's financial remediation activities:

In summary, the remediation plans are like a football match where the players are yet to work out where the goals are. There is a lot of activity going on, certainly a lot of hand balling, but there are not many goals being scored.¹⁰²

He added further:

There are a lot of good people within Defence putting a considerable amount of effort into these plans. Many are achieving good results in difficult circumstances. However, often these goods results are either overturned or ignored by senior management.¹⁰³

2.114 The Committee also received a confidential submission from another Defence employee who was similarly sceptical about Defence's overall commitment to financial reform.¹⁰⁴

2.115 Despite some evidence expressing scepticism about the Department's capacity for financial reform, the Committee is satisfied that Defence's objective position in relation to its financial statements has improved significantly since the implementation of the financial remediation program. The Committee acknowledges the extensive effort of the Department to significantly improve what had clearly been an unacceptable state of financial affairs in previous years.

101 Mr Ian McPhee, transcript, 13 June 2007, p 2.

102 Mr Ian Matthews, sub 1, p 9.

103 Mr Ian Matthews, sub 1, p 9.

104 Name withheld, sub 10.

Defence Management Review (DMR)

2.116 The Committee notes that since the establishment of the remediation program, Defence's financial management has also received attention in the *Report of the Defence Management Review 2007*, released on 5 April 2007.¹⁰⁵

2.117 Chapter 7 of that report provides a number of recommendations that underscore Defence's obligation to maintain the current focus on financial management. These are set out as follows:

The Review team recommends that Defence:

R30 Maintain the focus on financial management and financial systems reform. [7.6]

R31 Ensure that Defence develops and maintains the skill-sets and capabilities to enable a robust resource management system in an environment where resource certainty is reduced. [7.16]

R32 Maintain a focus on the real long-term cost of Defence. [7.16]

R33 Use the proposed audit and risk subcommittees to keep the senior leadership focused on financial reform and risk management. [7.17]

R34 Encourage the ANAO, in reviewing Defence, to adopt a performance-oriented approach and contribute its expertise and skills to the resolution of issues it identifies.¹⁰⁶

2.118 The Committee notes evidence provided by Mr Nick Warner, Secretary, Department of Defence, to an Additional Budget Estimates hearing before the Senate Standing Committee on Foreign Affairs, Defence and Trade on 20 February 2008 that implementation of the DMR's recommendations agreed to by Defence is now in train:

We have implemented a third of the fully or partially agreed Defence management review recommendations and CDF and I aim to have the remaining two thirds implemented by 1 July this year.¹⁰⁷

105 The Hon Dr Brendan Nelson, *Defence Management Review*, media release, 5 April 2007.

106 Department of Defence, *Report of the Defence Management Review 2007*, p 65.

107 Mr Nick Warner, Senate Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 20 February 2008, p 19.

...

...16 of the 52 fully or partially agreed review recommendations have been implemented and the rest are well underway.¹⁰⁸

2.119 On 10 June 2008, Mr Warner further reported:

All of the agreed 52 recommendations of the Proust Review will be implemented by the end of this year.¹⁰⁹

Committee comment

2.120 The Committee reiterates the importance of Defence maintaining a focus on financial management and financial systems reform as recommended by the Defence Management Review (R30). This involves the Department ensuring that it regularly report progress on its financial remediation and financial systems reform agenda clearly and comprehensively until such time as Defence has reached its goal of being recognised by the Government as "...highly competent, professional and business-like financial managers within the next five years".¹¹⁰

2.121 With regard to R34, the Committee also makes note that the Auditor-General corresponded with the then Minister for Defence, the Hon Dr Brendan Nelson MP in April 2007, in particular in response to Recommendation 34 which he perceived to be implicit criticism of the ANAO.¹¹¹ Mr McPhee wrote:

It is not clear from the report the basis on which this comment was made. As you know, the ANAO has a statutory role to report on Defence financial statements and performance. In addition, it contributes to better public administration through recommendations in its reports, publications of Better Practice Guides, and its newsletter, *AuditFocus*. In the case of Defence, my office has made many recommendations for performance improvement which have been accepted and implemented by the department. Further, the ANAO has contributed significantly to the work of a range of Defence committees; has made presentations to Defence courses; and has been available to assist, as appropriate, in improving the administration of Defence.¹¹²

108 Mr Nick Warner, Senate Standing Committee on Foreign Affairs, Defence and Trade, Estimates, transcript, 20 February 2008, p 20.

109 Mr Nick Warner, *256,800 Paper hand towels: Mending Defence's Broken Backbone*. Speech to the Lowy Institute for International Policy, 10 June 2008, p 13.

110 Department of Defence, sub 4, p 12.

111 Mr Ian McPhee, correspondence, 13 April 2007.

112 Mr Ian McPhee, correspondence, 13 April 2007.

- 2.122 The Committee strongly supports the key contribution the ANAO makes in providing objective reports to Parliament across a wide spectrum of public administration matters including those related to the Department of Defence.

Defence Business Improvement Board

- 2.123 At the same time the Defence Management Review was announced, Defence also announced the establishment of a Defence Business Improvement Board (DBIB). The DBIB is comprised of four non-Defence members and four Defence members.
- 2.124 Under its terms of reference the DBIB is to foster continuous productivity improvement within Defence and to report to the Secretary and the Chief of the Defence Force (CDF) on Defence corporate support improvement issues.
- 2.125 The Committee notes that the Defence Management Review provided direction, in the form of a report recommendation, on the work program of the DBIB as follows:

The Defence Business Improvement Board concentrate on specific improvement initiatives that emerge from this Review, specifically:

- Defence governance structures, including Charters [Recommendation R7];
- improvements to [Customer Supplier Agreements] and [Service Level Agreements] [Recommendation R10];
- improvements to costing [Recommendation R12];
- the level of staffing of the HR function [Recommendation R24];
- the impact of churn on senior positions, and identification of those that need longer tenure [Recommendation 27]; and
- business skilling [Recommendation R29]. [9.12]¹¹³

- 2.126 The Committee believes the DBIB may provide the forum for what one industry representative, BAE Systems Australia Limited, describes as an independent CFO 'peer review':

It may be helpful to involve CFO from some of the major defence companies in Australia to assist Defence in reviewing/challenging its remediation plans, in monitoring progress against plans and

113 Department of Defence, *Report of the Defence Management Review 2007*, p 82.

generally providing an independent sanity check/sounding board.
We would be happy to be involved if requested...¹¹⁴

- 2.127 The Committee draws this point to the attention of the DBIB for their consideration. Additionally, the Committee believes Defence should draw upon the expertise not only of Defence industry but also non-Defence industries to modernise their management systems.

International comparisons

- 2.128 One of the Committee's interests in conducting this inquiry was to determine how Australia's Department of Defence fared against comparably governed countries in terms of financial management.
- 2.129 In its submission Defence provided a number of tables comprising information as to international comparisons. These included an overview of the financial reporting challenges facing four selected international defence organisations (i.e., New Zealand, the United Kingdom, the United States and Canada) and a series of tables outlining each country's respective financial reporting requirements (see Appendix E).
- 2.130 To demonstrate its progress in financial reform compared to the four nominated overseas defence organisations, Defence provided the following analysis:
- To date, only Australia and New Zealand have decided to implement IFRS in the public sector. While the public sector will be required to implement the requirements in New Zealand, this compliance will not be required until 30 June 2008. Australia is required to implement AIFRS (the Australian equivalents to the International Financial Reporting Standards) in 2005-06.
 - In the United States, the Department of Defense has self-disclaimed its own financial statements for many years, and in response the Comptroller General has decided not to audit the Department due to continued Department-wide control weaknesses across significant financial and administrative areas. It is unclear when the Department of Defense will produce auditable financial statements.
 - The Ministry of Defence in the United Kingdom has undertaken a number of initiatives to improve its financial management and reporting. These initiatives were undertaken with a view
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to improve the reliability of financial statements and to remove audit qualifications it had received in previous years. The Ministry of Defence has been successful in improving its financial management and reporting, and has subsequently obtained an unqualified audit opinion from the Comptroller and Auditor General. Defence currently has programs in place that are consistent with those the Ministry of Defence has undertaken over the last few financial years.

- The Department of National Defence in Canada prepares financial statements on a stand alone basis but financial statements are audited by the Auditor General of Canada on a whole-of-government level. The Department of National Defence is not required to apply full accrual accounting or implement IFRS. It is not clear when full accrual accounting will be applied or when IFRS will be implemented.
- The maintenance of appropriate financial and administrative records in respect of inventory is a key challenge for each defence organisation and is indicative of the complex nature and extent of the operations of defence organisations.¹¹⁵

2.131 It appears from this evidence that comparisons between Defence organisations internationally are not easy to make. This is complicated by the sheer scale and diversity of the business conducted under the umbrella of the Defence organisation. However, Defence argues that the financial reporting requirements for the Australian Department of Defence are at least, if not more, significant than those in other comparable countries.¹¹⁶ For example, Australia appears to be the only Defence organisation required to prepare financial statements as a stand alone agency, implement AEIFRS, in the face of five specific accounting challenges (i.e., challenges maintaining inventory records, required to maintain employee leave entitlements records for long term, required to report embedded derivatives, required to provide for restoration and decontamination, and required to recognise and value heritage and cultural assets) (see Appendix E).

2.132 The difficulty in making international comparisons with regard to financial management is reaffirmed by the Auditor-General in response to questioning about audit practices of his overseas counterparts:

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

115 Department of Defence, sub 4, p 62.

116 Department of Defence, sub 4, p 62.

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.¹¹⁷

- 2.133 Notwithstanding the information provided above, the Committee was in receipt of no independent, objective evidence that speaks to relative best practice in financial management across Defence organisations internationally. However, the Committee agrees with the view that the problems experienced by Defence in this country are not restricted to the Australian context. The Committee also agrees that comparisons between Defence organisations internationally are difficult to make given the diverse nature and responsibilities of the organisations involved.

Conclusions

- 2.134 The Committee commends Defence for the considerable effort that has been made in the remediation program including the remediation plans, the development of the financial controls framework and the extensive financial training regime that has been established. It is clear this work has resulted in a significant improvement in Defence's financial statements position for the years 2005-06 and 2006-07. The Committee recognises that this outcome has been achieved in the context of a number of complexities, in particular during the Department's transition to the AEIFRS.
- 2.135 However, without detracting from the substantial and positive progress that has been made towards improving the Department's financial management practices, the Committee is somewhat disappointed in the lack of consistency in reporting financial reform progress, in particular with regard to documenting the completion of individual remediation plans. This point is made against a background of persistent concerns raised during the inquiry about a lack of transparency and consistency in reporting information across Defence more generally and is addressed further in Chapter 5.

117 Mr Ian McPhee, transcript, 17 August 2006, p 3.

- 2.136 Additionally, the Committee believes that more attention should be paid to measuring the results of the significant investment that has been made into financial training. For example, it seems clear that one important element of the Defence's remediation program is to ensure a cultural shift so that all Defence employees recognise and appreciate the important role they play in bringing the financial management of the Department up to a standard of excellence. Measuring such a shift requires more than the simple computation of the number of people who have undertaken financial skills training.
- 2.137 Overall, the Committee agrees with the cautiously optimistic views expressed by the ANAO and those reported by the Defence Management Review that while significant strides have been made in financial reform, Defence must not take its 'eye off the ball'. Defence must build on its gains and retain a strong focus on developing a robust financial management framework to take the Department into the future.