Australian National Audit Office

SUBMISSION TO THE

JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

INQUIRY INTO

FINANCIAL REPORTING AND EQUIPMENT ACQUISITION AT THE DEPARTMENT OF DEFENCE AND DEFENCE MATERIEL ORGANISATION

Australian National Audit Office

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Inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation

Introduction

Defence is the largest of the Australian Government Departments in terms of the size of its balance sheet and combined number of APS and ADF personnel. It carries significant responsibilities in relation to military operations, capability and financial management. Defence's challenges in terms of financial reporting and equipment acquisition have been well chronicled in reports by the JCPAA, Senate Committee on Foreign Affairs, Defence and Trade and the ANAO. The Government and the Department have put in place strategies to respond to these challenges. Remedial action will take time, energy and focus to achieve results given the scale of Defence operations and the extent of issues involved.

The 2003-2004 financial statement audit identified a number of concerns around the accuracy and reliability of relevant information, particularly inventory and asset control and reporting and employee leave record maintenance. These issues were of such significance that neither the Defence Secretary nor the Auditor-General were able to form an opinion on the Department of Defence's Financial Statement. Significant efforts are being directed towards remediation and a heightened awareness in the Department around control issues is evident. Of note in 2004-2005, Defence conducted an extensive revaluation programme over Land and Buildings, Infrastructure, Plant and Equipment assets which reduced outstanding qualifications in those areas. More broadly, challenges lie in accurate data compilation, system controls and administrative discipline. These financial management issues are not solely problems of compliance with accounting requirements, but often reflect on managerial effectiveness.

The ANAO continues to devote major effort towards supporting the Defence financial remediation programme with a view to Defence achieving compliance with accounting standard requirements and improved financial and operational management.

In August 2003 the *Defence Procurement Review 2003* (Kinnaird Review) reported into problems associated with major Defence acquisition projects. The ANAO has conducted nineteen performance audits, as well as two financial statement audits, in the Department of Defence and Defence Materiel Organisation since 2003-04.

Most of the acquisition projects audited by the ANAO commenced prior to implementation of the Kinnaird Review, and in some cases will not reach finality for many years. Many of these projects are fundamental to defence capability and have substantial expenditure now, and into the future. These projects were, and continue to be, subject to the normal public sector procurement guidelines and the provisions of the *Financial Management and Accountability Act*. While the changes flowing from the Kinnaird Review provide the opportunity for new and existing projects to be managed under a new regime, it is as important that projects which pre date the Kinnaird Review are managed effectively to deliver the contractual project milestones and outcomes.

ANAO audits into procurement (nine since 2003-04) have identified a range of administrative matters which require improvement in order to more efficiently and effectively deliver against defence capability requirements. Both the

Department of Defence and the Defence Materiel Organisation have acknowledged the problems and challenges and have implemented a range of systemic improvements.

ANAO acknowledges that Defence procurement projects are generally large, technically complex, involve long lead times and are dependent on contractor performance. The DMO has reported that there are approximately 210 major projects and over 100 minor projects (under $20 million). The value of the capital plan is some $52 billion and the plan extends to 2014.

As indicated in the Kinnaird Review, and ANAO reports, outcomes have not always been as positive as expected. Recent performance audits into acquisition projects have identified significant weaknesses in project planning, including risk identification and management, as well as project costing issues. Some projects have suffered cost overruns or had scope limitations imposed for budget management reasons, and have experienced delays in implementation. Poor contract management practices have also resulted in inadequate identification and management of contractor delivery problems. Audits also identified a need to strengthen overall project monitoring and record keeping.

While audits continue to identify project management issues, this is not universally the case and performance is variable. By way of example, Audit Report No. 45 2004-05, *Management of Selected Defence System Program Offices* (SPO) found that the implementation of the records management system ranged from fully effective in the Tactical Fighter System Program Office to non-existent in the Frigate FFG System Program Office. The audit also identified that the FFG SPO and Over the Horizon Radar SPO are effectively managing their logistic support roles, and that the FFG Fleet and JORN and Jindalee OTHR systems are achieving operational availability figures specified by the Australian Defence Force. The audit noted that the varied performance highlights differences in the relative management process maturity across the SPOs audited. This conclusion is reinforced by the findings of other ANAO audits which indicate variable achievements, sometimes due to inadequate contractor performance.

The differences in achievement between SPOs suggest that achieving consistent performance, perhaps by greater sharing of information and systems of better practice between SPOs and contractors, is a continuing challenge.

The ANAO is not yet in a position to give an authoritative view on the implementation of the Kinnaird recommendations. In the 2004-05 Budget, the Government allocated $32.5 million over five years to Defence to improve capability development and acquisition processes. Given the function, size, complexity and culture issues, it is acknowledged that the reform process will take some time to complete.

Going forward, the ANAO will look more closely at the post-Kinnaird review activities in DMO. The ANAO will undertake a mix of audits, covering the detail of particular projects and systems, with emphasis on whole-of-life acquisition and support perspectives, and extending to looking across programmes for systemic improvements.

Subject to funding, the ANAO sees merit in performing regular audits of the top “twenty” projects similar to overseas approaches and as recommended by the Senate Committee on Foreign Affairs, Defence and Trade in March 2003. This would assist in gaining a better understanding of the trends over time. These audits would assess cost, time and performance trends and the extent to which risk factors that might properly have been identified (such as technical issues or contract issues) contribute to scope variations.

Following is a more detailed response to each of the terms of reference for the inquiry.

Inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation

Term of Reference 1

Progress in implementing Defence's financial remediation plans, relative to international best practice in these areas, and recommend any further measures that can be adopted

Background

The Defence Portfolio Budget Statements 2004-05 recognised a need to *"achieve a best practice planning and budget system, best practice business processes and develop a well-regulated financial environment."* This followed a Defence and Department of Finance and Administration review in 2000 of Defence's financial management arrangements. Important initiatives then being implemented by the Department included the establishment of a Financial Statements Project Board and Project Resolve to oversee, amongst other things, all key aspects of the production of the 2003-04 financial statements to ensure that they were completed successfully and on time.

The Financial Statement Project Board (FSPB) was established effective from 1 November 2003 to drive the financial remediation deemed necessary by the Secretary of the Department including in relation to the establishment of the Defence Materiel Organisation (DMO). The ANAO was supportive of the establishment of the FSPB, which provided senior executive oversight to the remediation plans being developed. The initial FSPB membership comprised the Secretary as Chair, the Chief Financial Officer (CFO) as Deputy Chair, Vice Chief Defence Force (VCDF), the Chiefs of the three forces, the Under Secretary Defence Materiel, the Deputy Secretary Corporate Services and the Head Defence Personnel Executive.

The FSPB was augmented in 2004-05 with the addition of two new members – a member from the Department of Finance and Administration and a member from the private sector, a senior partner of the accounting firm, Ernst and Young.

The ANAO noted a significant increase in activity focussed on addressing financial issues across Defence as a whole, and reported that *"The final outcome of these activities should, when properly implemented, provide wide-ranging benefits over the long term.[1]"*

Defence Financial Remediation Plans

In its Portfolio Additional Estimates Statements 2004-05 (4 February 2005), Defence acknowledged the continued progress on a range of financial management and business systems and processes improvements, although noting that more work was still required. Defence also noted that the scale of work required was illustrated by the 2003-04 financial statement audit by the ANAO and that important initiatives were underway. This included the development of the remediation strategies, three addressing structural issues common across Defence and 11 addressing specific audit findings.

[1] *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2004.* No. 21 2004-2005.

Defence's remediation activities were initially grouped into 12 remediation plans, which the FSPB approved at its February 2005 meeting. These plans have undergone further development since, and the ANAO's understanding of their status is summarised below:

Defence Remediation Plans		Status
G1	Financial Reporting Framework	General Plan – in progress
G2	Improving the ANAO Annual Audit Process	General Plan – in progress
G3	Financial Management and Systems Training	General Plan – in progress
S1	Stores Record Accuracy	Specific Plan – in progress
S2	General Stores Inventory Pricing and Accounting	Specific Plan – in progress
S3	Supply Customer Accounts	Specific Plan – in progress
S4	Explosive Ordnance	Specific Plan – in progress
S5	Military Leave Records	Specific Plan – in progress
S6	Civilian Leave Records	Specific Plan – in progress
S7	Executive Remuneration	Specific Plan – in progress
S8	Property Valuations	Specific Plan – in progress
S9	Preventing the Escalation of Category A and B Findings	Specific Plan – in progress
S10	Stockholding Controls	Specific Plan – in progress
S11	Standard Defence Supply System Items Not in Catalogue	Specific Plan – in progress
S12	Provision for Contaminated or Potentially Contaminated Land, Buildings and Infrastructure	Specific Plan – in progress
S13	Commitments and Accounting for Leases	Specific Plan – in progress

Source: Department of Defence Portfolio Additional Estimates 2005-06

The ANAO's Interim Report to Parliament of 2004-05[2], noted that *"the remediation plans require significant corporate support and ongoing assessment of both the timeliness and prioritisation of these remediation activities, vis-à-vis the pending DMO merger, and having regard to Defence's ongoing operational requirements."* The ANAO also noted that external influences, such as the introduction of the Australian Equivalents to the International Financial Reporting Standards (AEIFRS), combined with the early stage of development of the remediation plans, would require focussed prioritisation to ensure that the remediation plans which could be implemented in support of the completion of the 2004-05 financial statements were successfully completed. As noted above, all of the plans are still in progress although significant achievement was made in relation to the revaluation of the Land, Buildings and Infrastructure portfolio held by Defence by the time of signing of the financial statements for 2004-05.

As detailed within ANAO's Year-End Report to Parliament for 2004-05[3] (of which an extract is provided at Attachment A), Defence continued to apply a significant level of resources to the assessment, correction and substantiation of records in a positive response to the range of deficiencies noted in key Defence operational and financial systems. Having completed the first year of remediation activity, Defence has remediated the previously reported issues surrounding the valuation

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[2] *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2005,* No. 56 2004-2005.

[3] *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2005.* No. 21 2005-2006.

of Land and Buildings and the accuracy of the Military Employee Long Service Leave Provision.

A key aspect of the remediation process is the establishment of an overarching framework of financial controls across Defence. To that end, a project plan has been developed and officially launched by the Secretary of Defence in late June 2005. Defence expects it will take five years to reach the desired end-state. The ANAO strongly supports this initiative, recognising that it will take time and commitment of staff in Defence for the framework to achieve the intended outcomes of enhanced financial management and financial reporting in Defence and the Defence Materiel Organisation (DMO).

Defence has also acknowledged that appropriate training is required in order to achieve the successful execution of the remediation plans. In that regard, Defence has embarked on a significant skilling programme in 2004–05, including the participation of a significant number of APS and ADF staff in a range of financial management and systems training activities. The strategic objective of the training is to facilitate absorption of accrual information into the management framework. This is a very important strategy being pursued by Defence, which the ANAO fully supports.

Defence Financial Controls Framework

On 29 June 2005, the Defence Secretary and CDF launched a significant evolution to its plan to remediate the framework of financial controls across Defence (G1 – Financial Controls Framework). The goal of the revised plan is to have Defence acknowledged by Government as a proficient financial manager within the next five years. Significantly, this project will not only be responsible for driving other remediation plans, but will also be key in taking up and consolidating the outcomes of the other remediation projects ongoing across Defence. During the launch the Secretary, Mr Ric Smith noted that the adoption of a comprehensive financial framework, within Defence, would require significant cultural and behavioural change for all Defence staff, particularly those in the finance domain.

The ANAO acknowledges the potential benefit of implementing the key outcomes of the plan in an integrated and structured manner such as:

- providing intranet access to all the policies, processes and procedures required to manage all facets of Defence's financial business;
- documenting and standardising key financial processes, and standardising internal financial reporting;
- developing a financial certification framework and reengineering business skilling requirements;
- implementing a structured QA programme across various functions (to supplement the internal audit programme); and
- communication and change management processes.

Defence Financial Statement Position Papers

With respect to the 2005-06 financial year, Defence have developed a series of position papers for the development of the financial statements. These papers address the treatment of various accounting issues as part of the 2005-06 financial statements process and are to be progressively endorsed by the CFO when finalised.

To date the ANAO has received four high level papers on 8 March 2006 and a further nine draft papers on 29 March 2006. The ANAO responded officially on 21 March 2006 in relation to the four high level papers, and a series of clarifying questions were provided to Defence in relation to the latter nine papers on 13 April 2006. As at 11 April 2006, a further seven papers, including key papers on general stores inventory quantities and prices, repairable items and not-in-catalogue, are yet to be received by ANAO.

The general principles espoused within these papers appear appropriate, however the ANAO has sought clarification from Defence on a number of points of reference. A summary of the position papers to be prepared and the date of receipt by the ANAO is detailed below:

Paper #	Financial Statement Position Paper Topic	Completion Status
Received/Response Sent by ANAO		
1.	AASB1 and Transition to AIFRS	Received by ANAO 8 March and response sent to Defence 21 March.
2.	Assertion validation Framework and Substantiation Methodologies	
3.	Materiality Framework	
4.	Assets Under Construction	
Received/Response Pending		
8.	Tangible Asset Capitalisation Threshhold	Received by ANAO on 29 March. The ANAO aims to respond to these around the end of April/early May. This will be dependent on any additional discussion, changes or queries which need to be addressed as part of this process.
10.	Recognition and Depreciation of Specialist Military Equipment (SME)	
11.	Leave Balances for Civilian and Military Annual and Long Service leave	
12.	Site Restoration Provisions	
13.	Specialist Military Equipment Decommissioning	
14.	Embedded Derivatives	
17.	Heritage and Cultural Assets	
18.	Reporting Entity – Consolidation of DMO	
19.	Disclosure and Validation of Executive Remuneration Note.	
Outstanding (Not Received by ANAO)		
5.	General Stores Inventory (Accounting Policy)	Outstanding position papers as at 7 April.
6.	General Stores Inventory (Controls/Quantities)	
7.	General Stores Inventory (Price/valuation)	
9.	Repairable Items	
15.	Cashflow Statement	
16.	Free of Charge Agreements between Defence and the DMO	
20.	Not in Catalogue	

These position papers will be used by the ANAO to inform the audit approach for 2005-06. Any issues or concerns will be discussed between the ANAO and Defence to ensure all are appropriately addressed.

The remediation of Defence's financial management systems and controls is a multi-year task. The Department has adopted a structured approach to dealing with the issues it faces by seeking to improve the financial management skills and understanding of staff (and military personnel), and remediate the systems and controls which contribute to the financial information presented in its financial statements.

This is a very significant task given the scale and complexity of the Department. Progress is being made but it will continue to require a strong emphasis on delivering against the various remediation plans.

Inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation

Term of Reference 2

Progress in implementing the Kinnaird Reforms, relative to international best practice in these areas, and recommend any further measures that can be adopted

In December 2002, a Defence Procurement Review (Kinnaird Review) was established to conduct a review of problems associated with major Defence acquisition projects. The foreword to the review notes that cost overruns have led to pressure on the financial resources available for Defence. In some instances, major capital equipment has been delivered to the Services many years after its planned introduction. Budgets have been balanced by reducing capability.

In August 2003 the Review found that, even though the problems have been recognised, their causes identified, and important reforms implemented, there needs to be more change and it needs to be more rapid and more fundamental in reshaping systems, structures and organisational culture.

The 2004-05 Department of Defence Annual Report to Parliament provides an update on the progressive implementation of Kinnaird Review recommendations. These include consolidation of the Capability Development Group leading to better pre-approval project definition under the two-pass approval process, achieving prescribed agency status to allow more business like operations, and the upskilling of DMO staff to improve business management.

The ANAO is not yet in a position to provide an authoritative view on the implementation of the Kinnaird reforms. However, the ANAO proposes to incorporate into the forward work programme an examination of post-Kinnaird activities in Defence and DMO in order to assess progress.

Given the scale of capital expenditure and its contribution to Defence capability, the ANAO's 2006-07 Audit Work Programme includes a proposed audit of the planning and approval of major capital equipment projects. This audit will cover the Two-Pass system and will provide valuable insight into the reforms implemented.

Inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation

Term of Reference 3

Review Australia's relative achievements in procurement and financial reform relative to international best practice in these areas of Defence administration

Background

In 2005-06, the Defence Portfolio Budget Statements forecast that the DMO will have resources of $7.13 billion. Capability acquisition resourcing will be $3.85 billion and capability sustainment activity resourcing will amount to $3.04 billion. Expenditure for the top 30 acquisition projects represents nearly three-quarters of the total planned expenditure on Major Capital Equipment in 2005–06.

During February to May 2004, the DMO undertook a due diligence analysis of its business as part of preparations for becoming a prescribed agency. The analysis was published in the June 2004 DMO Business Due Diligence Report, which reported that of 156 major acquisition projects, 30 per cent had already missed their agreed in-service date or had unrecoverable schedule slippage. A further 20 per cent, while not yet late, would require intensive management to achieve their in-service date, and the remaining 50 per cent should meet their in-service dates with normal management processes. It also reported that over the period 1981 to 2004, DMO's top 64 major acquisition projects incurred price increases totalling $11.8 billion. Some $10.5 billion, or 89 per cent, of the increases related to cost escalation associated with the price of labour and materials, and to currency exchange variations. The remaining 11 per cent, or $1.3 billion, related to real changes in the nature or scope of deliveries after the projects received initial Government approval.

ANAO Performance Audit Activities

The ANAO develops an annual performance Audit Work Programme (AWP), in consultation with the Department of Defence and the DMO. The ANAO draft programme is subsequently canvassed with the JCPAA. Through this process, the ANAO has regard to any specific concerns and issues identified by the JCPAA, Defence and the DMO in relation to the topics identified and the proposed audit scope.

The ANAO has given priority to audits that provide coverage of risk associated with weapon systems; capital facilities; training; and major information systems that support the preparedness of the Australian Defence Forces. The major information system that will be examined in 2006-07 will be the explosive ordnance computer management system (COMSARM). Previously the ANAO has audited the Standard Defence Supply System (SDSS) in 2004 and 2006 and the Personnel Management Key Solution (PMKeyS) in 2005.

Defence has entered a period of accelerated investment in the acquisition of weapon systems that offer technological advanced capabilities. The 2006-07 AWP continue a recent focus on selected DMO major capital equipment projects. There are some 210 major capital equipment projects which have an approved cost of around $50 billion. Audit of these selected projects also provides coverage of capital facilities and training aspects that are associated with the introduction into service of new and upgraded weapon systems.

In May 2003, the Senate adopted as a resolution a recommendation from the Foreign Affairs, Defence and Trade Committee's March 2003 report on materiel acquisition and management in Defence that, inter alia, the Senate request the Auditor-General to produce, on an annual basis, a report on progress in major Defence projects, detailing cost, time and technical performance data for each project, and to model that report on that ordered by the United Kingdom Comptroller and Auditor General, and to include in the report such analysis of performance and emerging trends as will enable the Parliament to have high visibility of all current and pending major projects.

In explanation of the report undertaken by the United Kingdom Comptroller and Auditor General, in 1981-82 the United Kingdom Parliament's Public Account Committee (PAC) requested the Ministry of Defence to produce an annual report informing the Committee of the progress and cost of major Defence equipment projects. Until 1991 both the major Projects summary sheets prepared by the Ministry of Defence and the associated National Audit Office (NAO) review analysing the reasons for cost, schedule and performance variations on projects were restricted to the PAC on a confidential basis. Starting in 1993, the NAO commenced tabling their analysis of cost, schedule and performance progress on the Ministry of Defence major capital equipment projects.

In June 2003, the Auditor-General wrote to the Clerk of the Senate, and advised that the proposed annual report on all major projects would be a substantial task beyond the ANAO's current available resources and commitments and may require a phased approach. In 2004-05, the ANAO applied for funding to undertake an annual report on major capital equipment projects. The then Chair of the Joint Committee of Parliamentary Audit and Accounts (Mr. Charles) advised Parliament on 11 May 2004 that:

> *The Auditor-General also advised the Committee that the ANAO would not receive additional funds in 2004-05 to allow it to undertake the audit work requested by the Senate in relation to the major Defence projects. The question of whether to provide funding to allow the audits will be deferred by the government until the 2005-06 budget to give the new Defence Materiel Organisation time to establish its procedures. In light of the government's decision, the committee has been advised that the ANAO proposes to defer consideration of the Senate's request until its audit program for 2005-06.*

The ANAO also sought funding to undertake an annual report on major capital equipment projects in 2005-06 but additional funding for this purpose was not provided.

The United States Government Accountability Office (GAO) produces an annual assessment of Selected Major Weapons Programs for Congress. The GAO March 2005 report found that the Department of Defence programmes typically take longer to develop and cost more to buy than planned, placing additional demands on available funding. These programmes increasingly compete for resources and are sometimes forced to make trade-offs in quantities, resulting in a reduction of buying power. As a result, funds are not available for other competing needs and programmes yield fewer quantities for the same, if not higher, cost.

Recent Audit Activities

The ANAO has undertaken a series of performance audits to review and examine the operations of Defence and the DMO, with specific regard to their ability to deliver major capital equipment projects to specified schedule, cost, and performance requirements. In doing so, the systems, management and governance structures, as well as the contract management practices that contribute to delivery of the project outcomes are reviewed, and where appropriate, recommendations have been made to assist with improving performance.

A summary of the issues addressed within each of the recent audit activities is outlined in Attachment B1.

Current Audits

Current audits being undertaken that relate to procurement practices and equipment acquisition within the Department of Defence and Defence Materiel Organisation are outlined in Attachment B2.

Future Audit Activities 2006-07

Potential ANAO audit activities are published in the ANAO performance audit annual Audit Work Programme. The Audit Work Programme is developed in consultation with the Department of Defence, and the DMO on an annual basis.

The ANAO draft programme is canvassed with the JCPAA for audit priorities of the Parliament. As previously mentioned, through this process, the ANAO has regard to any specific concerns and issues identified by the JCPAA, Defence and the DMO, in relation to the topics identified and the proposed audit scope.

With respect to the May 2003 Senate resolution, the ANAO has scoped the requirement to undertake to produce a report and has found that, in order to produce an annual report on progress in major Defence capital equipment projects, considerable reliance will be placed on the information provided by the DMO and the Department of Defence's Capability Development Group. In the case of the NAO report, 11 auditors were involved in preparing the 2005 report.

The ANAO has again applied for funding in 2006-07 to undertake the report as requested by the Senate. The initial due diligence stage would involve 3.5 full-time equivalent officers, rising to six officers in 2007-08. During the annual reporting phase in 2008-09, which would be the most resource intensive point of the Project, some 6.5 full time equivalent officers would be involved.

The ANAO costed the resourcing bid in its 2006-07 proposal at $724,000 in 2006-07; $914,000 in 2007-08; $970,000 in 2008-09; and $962,000 in 2009-10. The resource implications for the DMO, to prepare relevant information for audit, is not known.

The most recent draft Audit Work Programme (2006-07) includes future potential audit topics relating to DMO equipment acquisition and sustainment activities. The potential acquisition related audits for coverage in 2006-07 are outlined in Attachment B3.

Inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation

Term of Reference 4

Assess progress in Defence's adoption of international business accounting standards, relative to international best practice in this area of Defence administration

Australian Equivalents to International Financial Reporting Standards (AEIFRS)

The Australian Accounting Standards Board issued replacement Australian Accounting Standards, referred to as Australian Equivalents to International Financial Reporting Standards (AEIFRS), to apply to reporting periods beginning on or after 1 January 2005. Consequently, most Commonwealth entities that have a balance date of 30 June 2006 (including Defence), must report both their 2004–2005 and 2005–2006 financial information in accordance with AEIFRS.

With the implementation of AEIFRS, financial information for 2004–2005 reported under Australian Generally Accepted Accounting Principles, will be restated under AEIFRS and reported as comparative information in the 2005–2006 statements. Further, additional disclosure was required in the 2004–2005 financial statements to explain how the transition to AEIFRS was being managed, the key differences in accounting policies arising from the transition, and any known or reliably estimable information about the impacts on the financial report had it been prepared using AEIFRS[4].

The Accounting Standard AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* is the standard dealing with the transition to AEIFRS. The standard applies to first-time adopters. To be a first-time adopter, a reporting entity must adopt AEIFRS by an explicit and unreserved statement of compliance with AEIFRS in its first AEIFRS financial report or not use the exemptions provided by the AASB (as discussed below). That is, an entity must not only comply with AEIFRS in all material respects, but also make a statement to that effect.

Defence has disclosed in its 2004-05 financial statements that it had not been able to quantify the financial impact of adopting AEIFRS. Further, Defence disclosed that this would not be completed until 30 June 2006. Defence has advised that, in view of the uncertainties surrounding the financial statements, there is uncertainty whether Defence can be a so called 'first-time adopter' pursuant to AASB 1.[5] This may have particular implications for the preparation of AEIFRS compliant financial statements, including the valuation of inventory and specialist military equipment. An interpretation of the relevant standards has been sought from the AASB by Defence.

4 The requirements are contained in Australian Accounting Standard AASB 1047 *Disclosing the Impact of Adopting Australian Equivalents to International Financial Reporting Standards*.

5 AASB 1, First-time Adoption of Australian Equivalents to International Financial Reporting Standards, June 2005.

Additionally, due consideration will need to be given to the impact that AEIFRS will have on the preparation of the 2005–06 Defence financial statements, particularly:

- General Stores and Explosive Ordnances Inventory – in accordance with AASB 102 *Inventories,* inventories are to be measured at the lower of cost and current replacement cost;

- Restoration provisions – AASB 116 *Property, Plant and Equipment* requires the recognition of restoration provisions arising from the acquisition and construction of assets;

- Embedded Derivatives – In certain circumstances, embedded derivatives are to be separately reported in accordance with AASB 139 *Financial Instruments: Recognition and Measurement*; and

- Impairment of Assets – Under AASB 136 *Impairment of Assets* at each reporting date an entity must assess whether there is any indication that an asset may be impaired. If an indication exists, the entity must estimate the recoverable amount of the asset and if the recoverable amount is less than its carrying amount, the asset is to be written down to its recoverable amount.

The ANAO is working constructively with Defence and DMO in relation to these issues.

Attachment A

Inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation

Extract from the ANAO "Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2005. No 21 2005-06".

Defence Portfolio

Reporting Entity	Material Entity	Audit Report	Opinion Issued	Audit Issues
Department of Defence	**Yes**	Q, A	04 Nov 05	▲◆
Army and Air Force Canteen Service	No	✏	N/a	
Australian Military Forces Relief Trust Fund	No	✓	04 Sep 05	
Australian Strategic Policy Institute Ltd	No	✓	01 Sep 05	
Australian War Memorial	**Yes**	✓	09 Aug 05	
Defence Housing Authority	**Yes**	✓	17 Aug 05	
Defence Service Homes Insurance Scheme	No	✓	26 Aug 05	
Department of Veterans' Affairs	**Yes**	✓	26 Aug 05	
Military Superannuation and Benefits Board of Trustees No. 1	No	✓	30 Sep 05	
Military Superannuation and Benefits Scheme	No	A	29 Sep 05	◆
Royal Australian Air Force Veteran's Residences Trust Fund	No	✓	26 Aug 05	
Royal Australian Air Force Welfare Trust Fund No. 3	No	✓	04 Sep 05	
Royal Australian Navy Relief Trust Fund	No	✓	23 Sep 05	

✓: audit report not modified
E : audit report contains an emphasis of matter
Q : audit report contains a qualification
A: audit report contains additional statutory disclosure
☞: financial year end date other than 30 June 2005

✏: signed financial statements not presented for audit at this time
▲: moderate or significant issues reported previously not yet resolved
◆: new moderate or significant issues noted

Portfolio Overview

5.147 The Defence portfolio is responsible for developing, implementing and administering policies, programmes and services to defend Australia and its national interests. The portfolio is also responsible for carrying out government policy and implementing programmes to fulfil Australia's obligations to war veterans and their dependents, as well as providing a compensation claims management service to serving and former members of the Australian Defence Force (ADF).

5.148 The following comments relate only to material entities in the portfolio.

Department of Defence

5.149 The Government has established the following five strategic objectives for the Department of Defence (Defence):

- ensuring the defence of Australia and its direct approaches;
- fostering the security of Australia's immediate neighbourhood;

- promoting stability and cooperation in South-East Asia;
- supporting strategic stability in the wider Asia-Pacific region; and
- supporting global security.

Financial Statements

Statement by the Chief Executive Officer and Chief Finance Officer

5.150 In submitting the 2004–05 Defence financial statements to the Auditor-General on 3 November 2005, the Secretary of Defence and the Acting Chief Finance Officer certified that due to uncertainty regarding a number of material account balances, they could not conclude that the financial statements of Defence presented a true and fair view.

Audit Qualification

5.151 The Auditor-General's opinion on the financial statements, issued on 4 November 2005, was qualified. The audit qualification arose from a series of significant audit issues that were expressed as limitations on the scope of the audit, covering material aspects of Defence assets and personnel entitlements.[1] This qualification was expressed as an inability to form an opinion, as discussed further in this section.[2]

5.152 The qualified audit opinion is attributable to an internal control environment that requires significant and sustained improvement. Shortcomings are evident in a number of key operational and business support systems and processes, in particular logistics and asset management, finance and personnel. In addition, record keeping practices need considerable improvement. As a consequence of these matters and their pervasive effect, the audit report did not express an opinion as to whether the financial statements presented a true and fair view.

5.153 The audit report also stated that section 48 of the FMA Act had been contravened as Defence's accounts and records did not properly record and explain Defence's transactions and financial position.

Audit Scope Limitations

5.154 The audit scope limitations resulted from an inability to validate and conclude on components of the accounts, due primarily to inadequacies in Defence's key corporate systems and processes. It was not possible to validate $4.43 billion (net) of Defence's assets and $0.90 billion of Defence's liabilities covering:

- General Stores Inventory reported balance of $1.29 billion. This was as a result of material weaknesses in the internal controls over the accurate recording and stocktaking of the inventory quantities, and a lack of documentation and systems controls to confirm and safeguard the accuracy of pricing data. This qualification, in relation to uncertainties over quantities and prices, also affected the General Stores Inventory obsolescence provision of $1.19 billion.

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1 Limitations on the scope of an audit arise when sufficient appropriate audit evidence does not exist to support a reported balance.

2 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.

There are also inventories, referred to as 'not-in-catalogue', which were not reported and thus affected the completeness of the inventory record.[1] The significance of the 'not-in-catalogue' matter had not been quantified by Defence;

- Explosive Ordnance Inventory of $309 million. This was as a result of a lack of appropriate documentation to support the prices used to value that portion of the recorded balance. The amount of the balance subject to uncertainty was less than the prior year due to the acceptance of secondary evidentiary documentation in instances where primary documentation was not available. This qualification, in relation to uncertainties over prices, also affected $366 million of the Explosive Ordnance Inventory obsolescence provision;

- Repairable Items (a component of Specialist Military Equipment) totalling $2.72 billion. This was as a result of material weaknesses in the internal controls over the accurate recording, reporting and stocktaking of the asset quantities, and system controls to safeguard the accuracy of data.

  Additional uncertainty existed in relation to the completeness of the reported balance of $2.72 billion due to the cumulative effect of the methods used for setting asset recognition thresholds over a number of years. The methods adopted have resulted in some asset purchases being treated as an expense in the Statement of Financial Performance. Defence had not quantified the cumulative effect on the Statement of Financial Position. Further, there are Repairable Items, referred to as 'not-in-catalogue', which are not reported and thus affected the completeness of the Repairable Item record. The significance of the 'not-in-catalogue' matter has not been quantified by Defence;

- Aspects of Infrastructure, Plant and Equipment, and Intangibles, which are reported in the Statement of Financial Position at $5.42 billion and $415 million respectively. Within the Infrastructure, Plant and Equipment balance, uncertainty exists in relation to the measurement of certain assets with a reported book value of $103 million, as these assets have not been revalued.

  Additional uncertainty existed in relation to the completeness of the recorded balance of Infrastructure, Plant and Equipment, and Intangibles, due to the cumulative effect of the methods used for setting asset recognition thresholds over a number of years, and inadequate asset recording processes. The methods adopted have resulted in some asset purchases being treated as an expense in the Statement of Financial Performance. Defence had not quantified the cumulative effect on the Statement of Financial Position; and

- Employee Leave Provisions totalling $896 million ($443 million reported balance of the Australian Public Service employee leave provision and $453 million of the reported Australian Defence Force employee leave provision). This was as a result of inadequacies in Defence's Australian Public Service and Australian Defence Force employee personnel systems and practices, primarily relating to the capture and recording of data within those systems relating to employee leave records, and the appropriate maintenance of documentation.

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1 'Not-in-catalogue' refers to asset and inventory purchases, required by Defence to support operational outcomes, which have not been recorded on Defence's inventory and asset logistics management information system, otherwise known as the Standard Defence Supply System (SDSS).

5.155 As a consequence of the inadequacies in the Australian Defence Force and Australian Public Service leave provision referred to above, it was not possible to validate the amounts reported within the Executive Remuneration note to the financial statements.

Statement of Financial Position

5.156 The scope limitations noted above affected five line items on the Statement of Financial Position: Specialist Military Equipment; Infrastructure, Plant and Equipment; Intangibles; Inventories; and Employee Provisions. The impact in quantitative terms, affected 8 per cent of Total Assets and 24 per cent of Total Liabilities. The assessed impact on Total Assets, however, did not take into account the impact of the qualification associated with the inventory obsolescence provision, nor the effect of Defence's application of asset recognition thresholds, nor the issue of 'not-in-catalogue' assets, which could materially affect the assessed impact on total assets. The latter two impact on the completeness of the General Stores Inventory records, an aspect of Specialist Military Equipment records (Repairable Items), Infrastructure, Plant and Equipment records, and Intangibles. In addition, several notes to the Statement of Financial Position, which provide a more detailed breakdown of the Statement of Financial Position items, were also affected by the scope limitations.

5.157 Moreover, in qualitative terms, the primary causes of the uncertainties noted above originate from significant weaknesses within the internal control environment and systems and the lack of evidentiary support for the transactions and balances of Defence. Accordingly, the quantitative factors, as a whole, together with the qualitative factors, have resulted in uncertainty that was pervasive to the Statement of Financial Position.

Statement of Financial Performance

5.158 The scope limitations noted above had a material impact in quantitative terms which affected the 2004–05 Statement of Financial Performance, including total Expenses from Ordinary Activities, and the Net Deficit from Ordinary Activities. These translate to uncertainty for amounts within the following line items reported on the face of the Statement of Financial Performance: Assets Now Recognised revenue; Other revenue; Employee expenses; Suppliers expenses; Depreciation and Amortisation expense; and Write Down of Assets expense. In addition, several notes to the Statement of Financial Performance were also affected by the uncertainties.

5.159 Further, the uncertainties in relation to the 2003–04 Statement of Financial Position, which resulted in a disclaimer type of opinion, also have a significant impact on the ANAO's ability to assess the 2004–05 Statement of Financial Performance. Defence had not quantified the impact.

5.160 Accordingly, the quantitative and qualitative internal controls factors noted above, together with the significance of the potential effect of any financial adjustments required had the limitations of scope in relation to 2004–05 not existed, including the resultant effect on the reported Net Deficit of $870 million, and the uncertainty in estimating the potential effects of those adjustments, resulted in uncertainty that was pervasive to the Statement of Financial Performance.

Statement of Cash Flows

5.161 Due to the scope limitations noted above, which resulted in uncertainty that was pervasive to the Statement of Financial Performance and Statement of Financial Position, together with the pervasive uncertainty on the comparative Statement of

Financial Position as at 30 June 2004, there is uncertainty in the presentation of Net Cash From Operating Activities and Net Cash Used By Investing Activities, including the following line items reported on the face of the Statement of Cash Flows: Cash Used From Operating Activities–Suppliers; and Cash used From Investing Activities – Purchase of Specialist Military Equipment, Purchase of Plant and Equipment, Purchase of Software and Intangibles, and Purchase of Inventory.

Comparative Information

5.162 Due to the disclaimer type of opinion in relation to the 2003–04 Defence financial statements, the ANAO was unable to form an opinion as to whether comparative information in the 2004–05 Defence financial statements was prepared in accordance with the Finance Minister's Orders made under the FMA Act, and gives a true and fair view, in accordance with applicable Accounting Standards and other mandatory financial reporting requirements in Australia.

Audit Qualification Summary

5.163 In quantitative terms, the effects of the audit scope limitations were material to the Statements of Financial Position and Statement of Financial Performance. In qualitative terms, the primary causes of the uncertainties originate from significant weaknesses within the internal control environment and systems and the lack of evidentiary support for certain transactions and balances of Defence. Further, the uncertainties in relation to the 2003–04 Statement of Financial Position, which resulted in a disclaimer of opinion, also had a significant impact on the ANAO's ability to assess the 2004–05 Statement of Financial Performance. Finally, due to the ANAO's disclaimer of opinion in relation to the 2003–04 financial statements, the ANAO was unable to form an opinion on the comparative information in the 2004–05 financial statements.

Financial Results

Summary of entity results

Key financial measures for year	2005 $m	2004 $m
Total revenues	17 448.19	15 829.99
Total expenses	18 318.03	16 361.80
Total assets	53 799.84	52 297.57
Total liabilities	3 681.19	5 700.30

5.164 Defence controls assets with a reported value of $53.80 billion, of which $52.65 billion are non-financial assets. Defence's non-financial assets contribute 70 per cent of the General Government Sector non-financial assets. The main components are Specialist Military Equipment ($30.80 billion), Land and Buildings ($11.02 billion), Infrastructure, Plant and Equipment ($5.42 billion) and Inventories ($3.39 billion).

5.165 In 2004–05, Defence reported a net deficit of $870 million. Similarly, a deficit was reported in 2003–04. Whilst the appropriation for outputs increased significantly ($1.11 billion) during this period, this was overshadowed by movements in the write down of assets (increase of $1.65 billion) and supplier expenses (increase of $777 million). The large movement in the write down of assets was due to increases relating to: the provision for obsolescence; detailed impairment assessments for Specialist Military Equipment; stocktakes of General Stores Inventory and Repairable

Items; pricing adjustments for General Stores and Explosive Ordnance Inventory and asset revaluations.

5.166 In response to issues identified during the 2003–04 financial statement audit, Defence undertook an extensive revaluation programme of Land and Buildings, Infrastructure, Plant and Equipment assets in 2004–05 that significantly contributed to the substantial movement in assets first found revenue (increase of $428 million). The revaluation programme, which resulted in a net increment to the valuation of assets of $2.40 billion, along with additions to Specialist Military Equipment, contributed to a $270 million increase in the depreciation expense. Similarly, activities under Defence's remediation programme have resulted in a significant increase in the reported balance of Heritage and Cultural assets, from $26 million in 2003–04, to $800 million in 2004–05. Such increases were offset to a degree by the $1.08 billion reduction in the reported inventory holdings which was largely due to substantial increases in the provisions for obsolescence resulting from audit remediation activities.

5.167 Despite a reduction in employee expenses of $624 million in 2004–05, Defence continues to be a significant employer within the Australian Government with reported employee expenses of $6.17 billion. Factors relating to this decrease include a reduction in the average staffing levels from 90 825 in 2003–04 to 88 842 in 2004–05 and the factors mentioned in the paragraph below on employee provisions.

5.168 Significant reductions were reported in employee provisions (decrease of $2.16 billion) and lease liabilities (decrease of $110 million). A significant component of the reduction in employee provisions is explained by the transfer of responsibility for the military compensation scheme (reported at $1.91 billion in 2003–04) to the Department of Veterans' Affairs on 1 July 2004. In addition, there was a decrease in the provision for redundancies due to outsourcing activities in 2003–04, as well as decreases in leave provisions due to actuarial reviews, and more leave being taken than accrued.

5.169 The reduction in lease liabilities is attributable to the residual terms of finance leases reducing by a further year without the commencement of any new finance leases, in addition to a number of leases being paid out.

5.170 The scope limitations noted above and issues with the quality of some of the underlying financial data have a material impact on the Statement of Financial Position and Performance. Consequently, any analysis performed using information sourced from Defence's financial statements should have regard to these factors.

Items administered on behalf of the Australian Government

Key financial measures for year	2005 $m	2004 $m
Total revenues	745.94	862.12
Total expenses	2 793.45	2 319.50
Total assets	1 341.74	1 367.82
Total liabilities	30 443.88	29 064.00

5.171 Administered revenue decreased by $116 million, primarily due to a reduced dividend (decrease of $160 million) from the Defence Housing Authority (DHA), which has been offset to a degree by an increase in Military superannuation contributions received (increase of $53 million). The variation in dividends received from DHA is due to Defence receiving a $150 million special dividend from DHA in 2003–04, which did not occur in 2004–05.

5.172 Administered expenses increased by $474 million due mainly to an increase in employee related superannuation expenses (increase of $467 million). This increase is attributable to the results of actuarial reviews, which take into account factors such as projected personnel numbers, general wage growth and interest costs.

Summary of Significant Audit Findings and Remediation Activity

Summary of Audit Findings

5.173 The following table reflects the status of Category A and B issues raised in the interim stage of the 2004–05 audit. As the Defence financial statements were not finalised and signed until 4 November 2005, the table does not reflect new issues that arose in the final stage of the audit. While the qualitative factors of any new significant issues are discussed below, the quantum of these issues will be formally reported to Defence in the ANAO's closing report on the findings of the 2004–05 audit and to Parliament in our report on the interim phase of the audit of financial statements for 2005–06.

Ratings	Issues Outstanding at November 2004	Issues Resolved Prior to June 2005	Issue Reclassified or Merged*	New Issues to June 2005	Closing Position at June 2005
A	27	0	1	14	40
B	48	10	3	14	49
Total	**75**	**10**	**4**	**28**	**89**

* This column represents the net number of issues that have either been reclassified or merged into another issue.

5.174 Significantly, there has been a substantial increase in Category A findings, reflecting the finalisation of the 2004–05 interim audit. Separately, Defence has made progress in resolving a number of the issues previously outstanding, including preparing 'audit closure packs' for nine Category A findings and 33 Category B findings (of which 10 Category B findings have been satisfactorily resolved).[1] In addition, a further 11 audit closure packs relating to Category C findings have been provided to the ANAO, of which 10 Category C findings have been closed by the ANAO. As a number of the audit closure packs were provided towards the end of the final audit cycle, these will be assessed by the ANAO prior to issuing the closing report. However, there are also a number of closure packs which relate to balances that are subject to qualifications and therefore may not be resolved in the short-term.

5.175 The above findings are further categorised in the following table in which the outcomes of the 2004–05 audit, in terms of the balances subject to qualifications and other key issues, are summarised.

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[1] Audit closure packs refer to formal advice received from Defence when Defence considers an audit finding has been satisfactorily addressed.

Table 5.1

Audit Findings

Items subject to Audit Qualification	No. of Category A Findings*	No. of Category B Findings*	Significant audit findings noted in the 2004–05 financial statement audit
General Stores Inventory & Repairable Items – *Quantities* (covered by Defence Remediation Plans S1, S3, S10 & S11 – see Table 5.2) General Stores Inventory – *Pricing* (covered by Defence Remediation Plan S2 – see Table 5.2) Refer to paragraphs 5.180 to 5.198	16	4	• Significant weaknesses identified within the SDSS IT control environment and across a series of significant Business Process Controls, plus, a system limitation (date-boundary) issue within SDSS referred to as the 'Julian Date' was noted. • Material discrepancies identified through stocktakes. • Uncertainty over the completeness of Inventory and Repairable Item records due to certain assets not being recorded within SDSS, and also as a result of the application of certain asset recognition thresholds. • Both legacy and in-year pricing records could not be validated. • Uncertainty over the balance of the Inventory Provision for Obsolescence due to pricing and quantity issues.
Explosive Ordnance – *Pricing* (covered by Defence Remediation Plan S4 – see Table 5.2) Refer to paragraphs 5.187 and 5.192 to 5.198	4	7	• Reduction in uncertainty due to the sourcing of secondary evidentiary documentation. • Uncertainty over the balance of the Provision for Obsolescence due to pricing issues and the inconsistent application of such policy. • However, there were discrepancies in Explosive Ordnance quantities, weaknesses around the disposal process with external contractors, and warehouse management issues noted.
Military & Civilian Leave Provisions & Executive Remuneration Note (covered by Defence Remediation Plans S5, S6 & S7 – see Table 5.2) Refer to paragraphs 5.199 to 5.205	4	4	• Reduction in uncertainty over Military long service leave. • Increase in uncertainty over Civilian leave balances. • High levels of missing documentation and high gross error rates within leave balances tested. • An overpayment of certain ADF personnel arising from the Trade Pay Review remained outstanding.
Land & Buildings (covered by Defence Remediation Plans S8 & S12 – see Table 5.2) Refer to paragraphs 5.209 to 5.211	1	4	• Completion of valuation activity has removed the valuation uncertainty that was qualified in 2003–04.
Infrastructure, Plant & Equipment & Intangibles (covered by Defence Remediation Plans S8 & S12 – see Table 5.2)	-	2	• Completion of valuation activity has removed much of the uncertainty; residual uncertainty of $103 million reported in the financial statements. • Uncertainty over the completeness of the recorded balance due to the application

Refer to paragraphs 5.209 to 5.214	-	2	of certain asset recognition thresholds, and inadequate asset recording processes.
Financial Framework & Legislative Compliance (covered by Defence Remediation Plans G1 & S9 – see Table 5.2) Refer to paragraphs 5.220 to 5.221	6	6	• Section 48 breach of the FMA Act regarding the maintenance of proper accounts and records. • Financial statement close process was not sufficiently robust to meet Whole of Government reporting timetable. • Material adjustments required to financial statements provided for audit on the 17 August 2005.
Sub Total	31	27	

Areas with other Audit Findings	No. of Category A Findings*	No. of Category B Findings*	Audit findings noted in the 2004–05 financial statement audit
Suppliers	-	2	• An audit finding closure pack forwarded to the ANAO for audit review and clearance.
Leases and Commitments (covered by Defence Remediation Plan S13 - see table 5.2) Refer to paragraphs 5.218 to 5.219	1	-	• Some duplication of commitments and reconciliation weaknesses noted. • Uncertainty over the classification of a material lease.
Specialist Military Equipment Refer to paragraphs 5.206 to 5.208	4	7	• Tool-kits developed by Defence to assist project managers in their reconciliation of Assets Under Construction balances. • Management reviews to identify potential impairment indicators continue to be refined.
IT Systems Refer to paragraphs 5.215 to 5.217	3	12	• Issues surrounding user access, dual access, change management and configuration identified. • A number of previous audit findings resolved; progress made on remediation and some closure packs forwarded to ANAO for clearance.
Revenue	1	1	• No new significant issues.
Sub Total	9	22	
Total per Interim Management Letter 2004–05	**40**	**49**	

* The reported number of findings includes IT system related issues and audit issues relating to the relevant financial statement balances

Summary of Defence Remediation Activity

5.176 Many of the issues raised during the current year audit and carried over from the prior year can be categorised as management oversight and internal control matters. Defence continues to apply a significant quantum of resources to the assessment, correction and substantiation of records in a positive response to the range of deficiencies noted in key Defence operational and financial systems. The remediation plans require significant corporate support and an ongoing assessment of both the timeliness and prioritisation of these remediation activities. Defence, having completed the first audit cycle of remediation activity, has remediated the previously reported issue surrounding the valuation of Land and Buildings and the accuracy of the Military Employee Long Service Leave Provision.

5.177 A key aspect of the remediation process is the establishment of an overarching framework of financial controls across Defence. To that end, a project plan has been developed and officially launched by the Secretary of Defence in late June 2005. Defence expects it will take five years to reach the desired end-state. The ANAO strongly supports this initiative, recognising that it will take time and commitment of staff in Defence for the framework to achieve the intended outcomes of enhanced financial management and financial reporting in Defence and the Defence Materiel Organisation (DMO).

5.178 Defence has also acknowledged that appropriate training is also required in order to achieve the successful execution of the remediation plans. In that regard, Defence has embarked on a significant skilling programme in 2004–05, including the participation of a significant number of APS and ADF staff in a range of financial management and systems training activities. The strategic objective of the training is to facilitate absorption of accrual information into the management framework. This is a very important strategy being pursued by Defence, which the ANAO fully supports.

5.179 The steps taken by Defence in 2004–05 to remediate outstanding issues and such actions are summarised in table 5.2: Defence Remediation Activities, which follows. Each of the significant audit findings is then discussed in the paragraphs following, with a detailed description of the issue, the remediation activity observed during 2004–05, the outcomes of the audit, and recommendations in order to resolve any outstanding matters.

Table 5.2

Defence Remediation Activities

Defence Remediation Plans [1]		Defence Activity in 2004–05 [2]
G1	Financial Controls Framework Refer to paragraphs 5.177 to 5.178	• Overall plan developed and endorsed. • Improvements within the internal control framework associated with output and outcome reporting.
G2	Improving the ANAO Annual Audit Process[3]	• Financial Remediation Program Office established with regular engagement with the ANAO.
G3	Financial Management and Systems Training Refer to paragraph 5.178	• Financial management training introduced for members of the Defence Senior Leadership Group and senior management staff.
S1	Stores Record Accuracy Refer to paragraphs 5.180 to 5.190	• 100% stocktake of Defence National Storage Distribution Centre (Moorebank) completed. • 100% stocktakes of other major ADF locations continuing. • Revised stocktake instructions promulgated and additional resources allocated to compliance and assurance logistics teams. • Plans to address SDSS IT security controls, the 'Julian Date' issue, and associated Business Process Controls commenced.
S2	General Stores Inventory Pricing and Accounting Refer to paragraphs 5.192 to 5.198	• Established a quality assurance programme for ongoing price verification and engaged an external contractor to analyse and stratify pricing data.
S3	Supply Customer Accounts (Repairable Items – a component of Specialist Military Equipment) Refer to paragraphs 5.180 to 5.190	• Identification and allocation of responsibility for certain military equipment asset accounts, know as Supply Customer Accounts, completed. • Defence stocktakes in progress.
S4	Explosive Ordnance Refer to paragraphs 5.192 to 5.198	• Improved reconciliation procedures implemented. • Achieved some reduction in pricing uncertainty.
S5	Military Leave Records Refer to paragraphs 5.199 to 5.205	• Remediated issues with Military personnel long service leave. • Commenced an analysis of over/under payments on cessation. • A review addressing an overpayment of certain ADF personnel in progress.
S6	Civilian Leave Records Refer to paragraphs 5.199 to 5.205	• Progressed a pilot review of the stratification of leave balances. • Performed a review of the processes over the maintenance of leave records.
S7	Executive Remuneration Refer to paragraph 5.204	• Implemented a revised Executive Remuneration Note management system. • Commenced an analysis of the effect of missing documentation on senior executive leave balances.

[1] Details of each remediation plan are outlined in the ANAO's Audit Report No.56, 2004–05 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2005.*

[2] Outlines the main activity identified in the context of the 2004–05 financial statement audit programme.

[3] Defence's timeliness and utilisation of appropriate methods in dealing with various financial reporting matters is a significant factor that Defence management need to address. To that end, the external financial reporting standards required under the FMA Act, which are well defined and based on generally accepted accounting principles, coupled with the financial management training envisioned under 'G3' in the table above, should provide the impetus in this regard.

S8	Property Valuations Refer to paragraphs 5.209 to 5.211	• Documented the property valuation process. • Provided greater clarity of requirements to the independent valuer and obtained a greater understanding of the valuers reports. • Remediated issues by conducting a full revaluation, by the AVO, of the Defence Land, Buildings, Infrastructure, Plant and Equipment portfolio, with the exception of $103 million of information, communication and technology equipment. • Commenced the tender process for valuations for the next 3 years.
S9	Preventing the Escalation of Category A and B Findings Refer to paragraph 5.220	• Progressed remediation on a large number of findings and engaged with the ANAO on their resolution.
S10	Stockholding Controls Refer to paragraphs 5.188 to 5.190	• SDSS diagnostic reports developed to assist in identification and validation of stock movements.
S11	Standard Defence Supply System Items (SDSS) 'not-in-catalogue' Refer to paragraph 5.186	• Review of relevant procurement and stockholding policy conducted. • Framework established, including surveys, data from site visits and interrogation of the general ledger data to quantify the extent of the issue.
S12	Provision for Contaminated or Potentially Contaminated Land, Buildings and Infrastructure Refer to paragraph 5.211	• Remediation plan developed and Defence has advised a review of extant policies has been performed; a priority sites investigation programme implemented; and a pilot review to be undertaken.
S13	Commitments and Accounting for Leases Refer to paragraphs 5.218 to 5.219	• Progressed the identification, recording and classification of leases. • Implemented improvements to report functionality.

Significant Audit Findings and Remediation Activity

Quantities - General Stores Inventory, Repairable Items and Explosive Ordnance

5.180 General Stores Inventory and Repairable Items are managed on the Standard Defence Supply System (SDSS). In the prior year, the ANAO reported a significant degree of uncertainty around the General Stores Inventory balance and the Repairable Item balance (which is a component of Specialist Military Equipment), due primarily to:

- significant weaknesses in the internal controls over stocktaking;
- a failure to accurately record and report physical asset quantities; and
- inadequate system controls to safeguard the accuracy of data.

5.181 In response to an internal Defence review, and issues raised by the ANAO in relation to the overall integrity of the underlying asset and inventory data within SDSS, Defence developed a series of remediation plans. As reported previously, the risks associated with these plans included whether[1]:

- the plans would fully remediate the underlying stock quantity inaccuracies by 30 June 2005;
- the SDSS control environment (both IT system and business processes) would be sufficiently robust to maintain the accuracy of the stock data, post the 100 per cent stocktakes;
- those assets not reported at balance date are able to be quantified; and
- ongoing compliance requirements are maintained beyond the remediation plan.

5.182 The ANAO's assessment of the reliability of stock balances reported within SDSS, and in Defence's financial statements, is based on both the assessed reliability of the control environment as well as year-end substantive procedures, including stocktakes.

5.183 The ANAO's assessment of SDSS controls, and the related business and accounting processes, resulted in the ANAO placing limited reliance on these controls to produce reliable quantity records for General Stores Inventory and Repairable Items for financial reporting purposes. Significant anomalies across all elements of the controls framework were identified, including:2

- weaknesses across the application access environment impacting security within SDSS. Issues identified included the existence of an excessive number of SDSS users who had full administrative access to the system, users who could perform incompatible duties within SDSS, and no process to assess whether users had been granted appropriate access to SDSS. The weaknesses identified in the security structure reduced the reliance that could be placed on many of the business process controls;
- concerns regarding the future performance of SDSS in relation to a date boundary issue (referred to as the 'Julian Date'); and
- business process compliance issues, identified by Defence, which were not fully remediated by 30 June 2005.

5.184 In view of the limited reliance the ANAO placed on the internal controls, an extensive stocktake programme covering major Defence establishments was completed. The stocktake results identified significant discrepancies for General Stores Inventory and Repairable Items, including quantities of stock that were not recorded or managed on core asset systems, and, conversely, quantities of stock which could not be located, or identified in a timely manner. Defence's own stocktakes conducted throughout the financial year had resulted in large volumes of inventory and asset adjustments being processed as part of the preparation of the financial statements.

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1 These matters were previously outlined in the ANAO's Audit Report No.56, 2004–05 *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2005.*

2 ibid.

5.185 Defence has recognised that it will take several more years, due to the size and complexity of their stock holdings, to fully remediate the underlying causes of stock record inaccuracies. Stock quantity records within SDSS are used for both financial reporting and logistics management, therefore impacting not only the reported financial balance (and associated transactions), but also the quantity of stock held and its location (key requirements for defence logistics decisions). Notwithstanding the performance of an extensive stocktake programme, the underlying controls within SDSS have not been sufficient to maintain the integrity of data subsequent to its input into SDSS. Major causes that have contributed to the inaccuracies include:

- failure to comply with defence promulgated policy and procedures;
- inaccurate stock location information within SDSS;
- unreconciled stock accounts for significant periods of time, including those which record sensitive assets; and
- weaknesses within general warehouse management practices, including inaccuracies from defence stocktakes and a lack of review of stocktake adjustments processed into SDSS.

5.186 In addition, Defence has identified, but not quantified, a category of assets, referred to as 'not-in-catalogue', which are not recorded on SDSS and has created uncertainty regarding the completeness of the recorded General Stores Inventory and Repairable Item balances. The uncertainty arising from the non-recording of these assets has impacted the integrity of the recorded balance for financial reporting purposes. In addition, there may exist a logistics management issue as the actual types and quantities of stock held have not been captured within the primary logistics system.

5.187 Records of Defence's Explosive Ordnance Inventory are maintained on the COMSARM system. The ANAO testing generally established the accuracy and reliability of the system for financial reporting purposes. However, the following issues, which represent a business risk for Defence, were noted:

- instances of explosive ordnance stock was removed for disposal through the use of specialised contractors, without documentation supporting the quantities removed and disposed; and
- inaccurate recording of stock locations within COMSARM. Stock location accuracy is required to ensure efficiency for logistics purposes and to ensure compliance with explosive licensing requirements. A number of stock quantity anomalies were also identified during the stocktake process.

5.188 Notwithstanding the continuing weaknesses surrounding the accuracy of quantities reported for General Stores Inventory and Repairable Items, the ANAO observed an overall commitment by Defence to improve warehouse and stock management practices in 2004–05. However, for stock records to be accurate in the longer term, a strong internal control framework will need to be implemented. To this end, to achieve sustainable stock record accuracy, Defence has acknowledged that a change management strategy, centred on the following elements, is required:

- establishment of a compliance and assurance framework, including the allocation of additional resources for all Defence groups to ensure conformity against revised policies, processes and procedures;

- ongoing performance management;
- enhanced accountability, including the quarterly reporting of stocktake results to the Defence Audit Committee;
- improved financial awareness; and
- the establishment of the SDSS and IT Security Control Framework project.

5.189 Regarding the establishment of the SDSS and IT Security Control Framework project, Defence has undertaken significant remediation work to address the security and control issues reported for the SDSS application. Both frameworks have now been published and training on the implementation is due to be completed by the end of December 2005. In addition, plans have been promulgated to address the Julian Date issue.

5.190 The ANAO considers the development of the SDSS and IT Security Controls Framework to be a comprehensive and robust model. The information provided to the ANAO, while un-tested, should provide Defence with the means to ensure compliance against measurable control mechanisms and confidence over the financial and operational information reported in SDSS.

Provision for Obsolescence

5.191 Significant increases in the Provision for Obsolescence for both General Stores Inventory and Explosive Ordnance were reported in 2004–05. Approximately 48 per cent of General Stores Inventory and 19 per cent of Explosive Ordnance Inventory are provided for through the obsolescence provision at 30 June 2005. Such provisions are normally made by an entity for those assets it has previously acquired that are no longer considered likely to provide a benefit to the organisation. The respective provisions at the end of 2004–05 were $1.19 billion and $465 million. In respect of both General Stores Inventory and Explosive Ordnance, there was insufficient evidence to support significant components of the provisions and other components were contrary to Defence's stated policy for provisioning. Further, the Explosive Ordnance provision included instances of items belonging to non-Australian Defence Forces (that had been recorded as part of Defence's assets), and items purchased in 2004–05 that were assessed as obsolete in the same year.

Pricing - General Stores Inventory and Explosive Ordnance

5.192 Pricing information to support the reported value of General Stores Inventory and Explosive Ordnance Inventory are recorded in the SDSS and COMSARM systems, respectively. In 2003–04, the ANAO reported that there was a lack of documentary evidence to support the value reported for General Stores Inventory ($2.03 billion) and a portion of the value reported for Explosive Ordnance ($845 million). In addition, the controls to protect and maintain the ongoing pricing data recorded in SDSS for General Stores Inventory were found to be inadequate. The ANAO also identified instances of inventory being recorded at zero-value and at notional prices, including such items purchased in the 2003–04 financial year.

5.193 Defence developed specific remediation plans to address issues surrounding the overall integrity of pricing data within SDSS and COMSARM. As reported previously, certain risk factors associated with these remediation plans included whether the:

- plans would fully remediate the underlying valuation uncertainties across legacy records by 30 June 2005;

SDSS control environment would be sufficiently robust to safeguard the accuracy of prices to comply with Defence's own accounting policies;

application of a statistical model would correlate to Defence's experience, where Defence acknowledges that pricing records may not exist; and

recording and reporting of changes to valuation requirements as a result of AEIFRS would be achieved (that is the comparison of 'cost' and 'replacement cost').

5.194 The ANAO's assessment of SDSS controls, and the related business and accounting processes, resulted in the ANAO placing limited reliance on these controls to produce reliable pricing records for General Stores Inventory; that is, SDSS has inadequate system controls to assure price information is correctly entered into SDSS and subsequently safeguarded. The ANAO also identified a large number of stock items recorded at zero-value, a number of which were created in the current year. In addition, other stock items are recorded at a very low notional value and some items had negative balances.

5.195 During 2004–05, results of price remediation activities completed by Defence (including internal Defence quality assurance procedures) for General Stores Inventory was that the value of a relatively small component of the inventory could be substantiated. The balance, however, could not. Defence advised that it was not possible to recalculate the Weighted Average Cost at 30 June 2005 with an acceptable level of assurance using the available data. That said, the progress noted previously regarding the SDSS and IT Security Control Framework, should contribute to providing adequate controls to protect records within SDSS once they have been verified.

5.196 More progress is being made in remediating Explosive Ordnance pricing information within the COMSARM system. The value of items subject to pricing uncertainty has reduced from $845 million in 2003–04 to $675 million (being the net balance of $309 million plus $366 million relating to the provision for obsolescence) in 2004–05. The reduction is largely due to the remediation activity undertaken by Defence that is directed at locating supporting documentation for legacy prices.

5.197 Regarding General Stores Inventory and Explosive Ordnance Inventory, Defence has indicated that in 2005–06, emphasis will be given to:

- ensuring financial specifications for a replacement logistics system are adequately defined;
- furthering remediation of pricing information, including use of surrogate price sources (however, Defence has noted that cost and effort may curtail this work); and
- directing efforts to eliminate gross errors in pricing, such as zero prices, suspect and notional prices.

5.198 The ANAO acknowledges Defence's efforts to remediate these issues. Nevertheless, due to time and resource constraints associated with the various remediation plans in place (including tightening system controls and underlying business processes), implementation of AEIFRS reporting requirements (including quantifying the AEIFRS impact on the Defence financial statements), Defence will face significant challenges to fully remediate the pricing issues by 2005–06 year-end.

Military and Civilian Leave Processes

5.199 For the last two years, the ANAO has observed and reported inadequate controls and processes within Defence's personnel systems due to insufficient supporting documentation being available, and unacceptable rates of errors where documentation did exist. As a result, there was uncertainty about the accuracy and completeness of the entire balance for Military leave provisions, together with issues noted within Civilian leave recording practices. These issues also impacted on the accuracy of the disclosures made in respect of Executive Remuneration. The ANAO has previously noted that Defence had developed a range of remediation plans to resolve the internal control issues in relation to leave records and provisions, including for executive officers.[1]

5.200 PMKeyS is Defence's human resource management information system. It is used to process payroll and leave for Civilian employees and leave only for Military personnel. During 2004–05, the ANAO reported significant control weaknesses to Defence on:

- processing of Civilian payroll transactions being subject to insufficient checking, authentication, segregation of responsibilities and review; and
- system users being granted unapproved access resulting in the risk that appropriate segregation of duties is compromised, for processing of both Military and Civilian personnel transactions.

5.201 Remediation activity in 2004–05 substantiated Defence's liability for long service leave for Military personnel. However, shortcomings in supporting documentation remain in respect of the liability for annual leave of Military and Civilian personnel.

5.202 In respect of the Military annual leave, work undertaken by Defence noted in various draft reports that Military members cannot rely on the PMKeyS balances and identified the number of members with errors in their reported balances as between 41 per cent and 64 per cent across the three Services. Final Defence reports issued for two of the three services confirmed that individuals cannot have confidence that PMKeyS leave balances are correct, due to the high level of gross errors in the sample results. Moreover, there were high levels of missing documentation (being an average of 17 per cent of the transactions tested). Such high levels of missing documentation cast significant uncertainty over the movements in leave balances recorded on PMKeyS, as leave transactions cannot be validated, particularly as the impact of missing documentation had not been robustly quantified by Defence.

5.203 The ANAO has previously reported Category A findings in relation to Defence's internal control environment regarding leave application processing. In respect of Civilian leave balances, Defence's analysis identified average missing documentation in the order of 16 per cent for Civilian annual leave. As mentioned above, missing documentation is a significant concern, as it prevents the validation of transactions in the system. Further, the Civilian long service leave balances of the individuals tested, that had taken leave, were not without some anomalies that require further validation to substantiate the balance. Notably, inadequacies were also found in the project management of the preparation of this component of the financial statements, with agreed methodologies not being applied. As a consequence, the planned validation exercise being conducted by Defence was not

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1 ibid.

completed for Civilian annual leave and long service leave balances in the 2004–05 financial statements. Defence has advised that in 2005–06 further sampling of leave records may be undertaken, supplemented by the verification of balances. This will involve pursuing missing documentation and reviewing processing controls, including the conduct of audits on records of Military personnel who cease service.

5.204 Due to the limitation of scope associated with the Military and Civilian leave provisions, the Executive Remuneration Note (containing information pertaining to Military and Civilian leave provisions), for which disclosures are required regardless of their materiality, as required by the FMOs, could not be reliably certified. During 2003–04, Defence actively pursued the resolution of this matter by focussing on the Star Rank/ Senior Executive staff and by reviewing all appropriate documentation. However, given the continuing lack of supporting documentation noted above, Defence's analysis in 2004–05 suggests the possibility that approximately 16 per cent of executive staff may be recorded in an incorrect remuneration band.

5.205 In the 2003–04 financial statements, Defence recognised $9.7 million in Other Receivables related to the overpayment of ADF personnel, referred to as the Trade Pay Review. This issue arose due to administrative errors associated with members either not being trained to the level corresponding to their remuneration, or incorrect payments being processed. Further to comments made previously regarding inadequate management oversight with respect to personnel transactions, this issue was not detected in a timely manner by Defence's review processes. Defence has been working since March 2004 to scope and rectify the issue. No revision was made in 2004–05 concerning the recoverability of this receivable and the issue is still to be resolved.

Assets Under Construction (AUC)

5.206 Defence's commitment to the acquisition of Defence platforms and major items of equipment is significant, and will necessarily span a number of years. As a result, accounting for these acquisitions is complex and requires specialist skills. A robust AUC management framework is therefore critical to ensure the completeness and accuracy of the reported AUC balance.

5.207 Significant efforts were made by Defence in 2004–05 to develop tool kits to assist project managers in managing projects effectively and efficiently. Whilst ANAO acknowledges that this was a major improvement compared to prior years, the following issues were identified during project reviews:

- inconsistencies in project management across various divisions and concerns about the adequacy of quality assurance processes;
- staff with non-financial background being involved in project accounting;
- the retention and management of relevant documentation varied across the various divisions; and
- management reviews to identify potential impairment indicators within AUC, where applicable, required further improvement.

5.208 These issues were the main factors that resulted in a number of significant audit adjustments during the audit of the AUC balance, particularly relating to impairment assessments. As a consequence, adjustments were processed during the preparation of the Defence financial statements.

Land and Buildings; Infrastructure, Plant and Equipment

5.209 During the 2003–04 audit, significant weaknesses were identified in the control environment surrounding the valuation of Land and Buildings and Infrastructure, Plant and Equipment that gave rise to uncertainties over aspects of the reported values. The uncertainties were the consequence of items not being revalued due to the application of predetermined thresholds, certain finance lease assets not being revalued, and other asset valuation matters due to insufficient management oversight, analysis and review. These matters were reported in Audit Report No.21 2004–05, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2004.*

5.210 In response, Defence developed a remediation plan to address the issues raised and these were reported in ANAO Audit Report No.56 2004–05 of 2004–05. The 2004–05 audit found that the plan was largely executed, with the exception of the revaluation of information, communication and technology equipment, which will now be completed in 2005–06.

5.211 Notwithstanding the progress made regarding asset valuations, there remains scope to further strengthen associated management oversight, analysis and review functions. Regarding the move to AEIRS this should include:

- determining and monitoring the frequency of independent valuations noting that AEIFRS requires that each year the reported value is not materially different from its fair value;
- identification and valuation of decontamination provisions and contingencies. With the application of AEIFRS from 2005–06, Defence will face greater reporting requirements in respect of these; and
- the application and monitoring of asset capitalisation thresholds (as detailed below).

Asset Purchases Not Capitalised

5.212 Consistent with accepted management practices Defence has adopted threshold amounts for the capitalisation of asset purchases. That is, assets acquired at less than a predetermined threshold were expensed. In adopting such an approach, Defence should monitor the impact of these policies and ensure compliance with relevant accounting standards and other mandatory requirements, including the application of materiality. In finalising its financial statements, such analysis by Defence to support the adopted capitalisation thresholds was limited.

5.213 As such, uncertainty continues to exist over the completeness of the recorded asset balances for Repairable Items, Infrastructure, Plant and Equipment, and Intangibles. Further, it was noted that insufficient descriptions were being entered into the financial management information system (FMIS) for a significant number of transactions (for example, in 2004–05 Defence noted that some 90 000 transactions had insufficient descriptions entered into the FMIS). Such practices limit the visibility management has over the nature of transactions and the ability to appropriately manage, recognise and report transactions and assets held.

5.214 The ANAO has held preliminary discussions with Defence over measures that will assist the remediation of this issue. Steps that need to be considered include:

- reconfiguring the current general ledger structure to facilitate future analysis of capitalisation thresholds;

ensuring transactions are processed with appropriate descriptions; and

regularly analyse related information and monitor and review the capitalisation thresholds that are being applied.

ROMAN (General Ledger)

5.215 ROMAN, which is Defence's FMIS is generally stable, and is critical to the financial reporting and management of the Department. Nevertherless, weaknesses were reported in ANAO Audit Report No.56 2004–05 and the 2004–05 Interim Report to Defence. Many of the issues reported by the ANAO concern the administration of user access, reliance on process controls managed by a large number of Defence groups, Accounts Payable data integrity, dual access to both DMO and Defence company codes, management of interfaces to ROMAN, and reliance on control environments external to the FMIS where significant issues related to reliability have been identified.

5.216 In response, Defence has undertaken remediation activities and provided closure packages to the ANAO for a number of prior year findings. The closure packages have been evaluated, and included for testing in the ANAO's work program for the 2005–06 audit cycle.

5.217 Notwithstanding the progress that has been made in relation to access management, there continue to be issues surrounding the high number of users with access to systems, including dual access between the Defence and the DMO general ledgers. The ANAO has been involved in discussions over measures that will assist the remediation of these issues.

Leases and Commitments

5.218 In 2003–04, the ANAO reported one Category A finding on the identification and recording of leases and commitments. Issues included the completeness, accuracy and classification of recorded leases. As a result, Defence has implemented a remediation plan, which includes a review of lease classifications. To that end, discussions between the ANAO and Defence are ongoing regarding certain lease transactions.

5.219 Regarding commitments, issues included the recognition criteria Defence applied and an inadequate audit trail. As a result, Defence has implemented a remediation plan and has made significant progress from the prior year in the preparation of the Schedule of Commitments. This was particularly notable in the areas of planning, report functionality, and the purging of invalid items. However, the ANAO identified a number of significant errors, including duplicate reporting of Commitments and inaccurate disclosure of future year payments. The errors remained unidentified by Defence due to the lack of effective quality assurance processes and weaknesses within the reconciliation process. Further, issues continue to exist regarding the completeness and accuracy of lease information incorporated into the Schedule of Commitments. Adjustments were made for errors identified during the 2004–05 audit. Remediation activities in 2005–06 should focus on strengthening the reconciliation and quality assurance processes.

Remediation of Audit Findings

5.220 In ANAO Audit Report No.56 2004–05, it was reported that increased management focus was required on clearing ANAO and Defence Management Audit Branch audit findings. During the completion of the audit, it was noted that progress has been made in terms of removing the possibility for management to extend completion dates in reporting progress against audit recommendations. However, subsequent advice to the Defence Audit Committee, by Defence Management Audit Branch, stated that there has been some deterioration with respect to the unsatisfactory implementation of recommendations. Specifically, 33 per cent of Level 1 (high risk) and 40 per cent of Level 2 (medium risk) recommendations were not satisfactorily implemented during the April to June 2005 quarter, despite being reported by management as having been completed. Further management attention of this issue is required to ensure the adequate and timely resolution of audit findings. Importantly, this is being actively monitored by both Defence's Management Audit Branch and the Defence Audit Committee.

Financial Statement Close Process

5.221 Defence completed its financial statements process and signed the financial statements on 3 November 2005. As in prior years, this was significantly later than the Government deadline of 30 July 2005 for clearance of financial information to Finance and adversely impacted on the Whole of Government reporting timetable. The delays were primarily caused by:

- weaknesses surrounding the Defence management quality assurance framework;
- a significant number of revisions to the financial statements, through multiple sets of draft accounts, from 17 August through to signing. Material movements in both the balances reported and changes to the presentation and disclosure within the accounts occurred during this period; and
- weaknesses in Defence's project management of Defence resources and deliverables.

Defence Material Organisation (DMO) as a Prescribed Agency

5.222 Consistent with a Government decision following the Defence Procurement Review (Kinnard) in 2003 the DMO became a prescribed agency, effective from 1 July 2005. Efforts to achieve this objective have been ongoing for over a year. The ANAO understands that many of the key decisions around the separation of DMO from Defence have been made and are now being implemented. Defence and the DMO will transact at arms-length with a significant number of service agreements underpinning their relationship and defining expectations and responsibilities. Nevertheless, some of the accounting implications associated with the business model have recently been revisited regarding Inventory and Assets Under Construction. As a result, both Defence and DMO may need to reverse/ re-transact a number of months of transactions associated with inventory in the respective financial systems. As noted in ANAO Audit Report No.56 2004–05, the accounting for various Defence assets, between Defence and DMO, should reflect the actual management and control structures that Defence and DMO will have in place.

5.223 Defence advised in September 2005, that the Defence Committee had substantially revised the planned Defence/ DMO allocation of Balance Sheet responsibilities, such that DMO had responsibility for managing Assets Under Construction while Defence takes responsibility for the management and control of General Stores Inventory, Fuel and Explosive Ordnance.

Australian Equivalents to International Financial Reporting Standards (AEIFRS)

5.224 Defence has disclosed in their financial statements that it has not been able to quantify the financial impact of adopting AEIFRS. Further, Defence disclosed that this will not be completed until 30 June 2006. Defence has advised that, in view of the uncertainties surrounding the financial statements, there is uncertainty whether Defence can be a so called 'first-time adopter' pursuant to AASB 1.[1] This may have particular implications for the preparation of AEIFRS compliant financial statements, including the valuation of inventory and specialist military equipment. An interpretation of the relevant standards has been sought from the AASB by Defence.

Conclusion

5.225 The ANAO continues to place limited reliance on aspects of Defence's internal control environment, due primarily to the lack of robust detective and preventative controls surrounding both core systems and processes used to derive the reported financial statement balances. The system and process concerns reported during the 2004–05 financial statements audit are pervasive in their breadth and depth, and span a broad cross-section of the financial statements. However, Defence has put in place significant remediation programmes to address, *inter alia*, the various matters raised in this and previous ANAO reports.

5.226 The remediation activities being undertaken cover a number of Defence's core information systems and business processes and are thus critical to improving the integrity of Defence's financial information. Just as important are those aspects of the programmes that will enhance the training and supervision of personnel undertaking financial and related transactions. The remediation activities will continue to require significant management and corporate support, and ongoing assessments of both the timeliness and prioritisation of these activities.

5.227 The remediation plans have been designed to remediate control and institutional processes over time. Defence, having completed the first audit cycle of remediation activity, has successfully remediated the previously reported issues surrounding Land and Buildings revaluations and the accuracy of the Military Employee Long Service Leave Provision. This is a significant milestone in light of the number of issues Defence is addressing, including the introduction of AEIFRS.

[1] AASB 1, *First-time Adoption of Australian Equivalents to International Financial Reporting Standards*, June 2005.

Attachment B1

Inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation

Recent Performance Audits

Wedgetail Airborne Early Warning and Control Aircraft (AEW&C): Project Management: Audit Report No. 32 2003–04

In July 1999, the then Minister for Defence announced that The Boeing Company (Boeing) was the preferred tenderer for the project. It was envisaged at the time that the first of seven aircraft would be delivered in 2004-05 with a total cost of the project estimated to be over $2 billion.

In December 2000, the contract was awarded to Boeing. The Wedgetail Project has an approved budget of $A3.43 billion as at December 2003. It is to provide the Australian Defence Force (ADF) with an AEW&C capability based on four Boeing 737 AEW&C aircraft and associated supplies and logistic support. The Airborne Surveillance and Control Division of the DMO manages the Wedgetail Project. By November 2003, Defence had spent $A 1.107 billion on the Project.

Conclusive evidence as to how effectively Defence has performed its Wedgetail acquisition management responsibilities will be some years off given that, at the time of the audit, the AEW&C systems were still in their early development phase, with first system integration scheduled for late 2005.

Defence's Project Bushranger: Acquisition of Infantry Mobility Vehicles: Audit Report No. 59 2003–04

The initial phase of the project procured 268 unprotected Land Rover vehicles and 25 support vehicles, delivered in service by mid 2000 at a project cost of $57.69 million, in order to cover the interim period until protected vehicles could be procured.

The second phase of Project Bushranger involved the trial and evaluation of protected vehicles by the then Defence Acquisition Organisation (DAO), for an approved cost of $11.6 million. Requests for Tender (RFT) were issued in September 1995, and trial vehicle contracts were signed with ADI Limited (ADI) for the Bushmaster vehicle, and Australian Specialised Vehicle Systems (ASVS) for the Taipan vehicle, in late 1997.

The Production Contract Option was executed on 1 June 1999 with ADI, for the supply of 370 Bushmaster vehicles by December 2002. Shortly after the Production Option was exercised, a range of problems emerged with design enhancements, cost, and schedule slippage in the contract, leading to renegotiation of the Contract in July 2002 for the supply of 299 vehicles.

This legacy procurement project incorporated minimal incentives for effective contractor performance. The large advance payment made by Defence, combined with systematic scope creep in the initial stages of the contract, resulted in a minor transference of contractual risk. Accordingly, the project was initially characterised by unwelcome surprises surrounding cost, time, schedule, performance and the risk of litigation.

The ANAO found that despite the project having a lengthy demonstration phase, the requirement definition had not been fully developed at the time the Production Option was exercised. The outcome, combined with overly optimistic projections on deliverables, has been a nominal vehicle unit cost increase of 39 per cent, a forecast slippage of 49 months in delivery, and the need for Defence to commit significant management resources to turn around this project.

Significant under achievement in performance occurred in the initial contract on unit cost, delivery schedule and recoverability, which arose from a combination of Defence transference of capability and overly optimistic timeframes. Defence has managed the overall cost increase associated with the contract renegotiation within the approved project budget. This has been achieved by decreasing capability through the reduction of the number of vehicles by one-fifth, and reducing requirements, such as those relating to systems engineering funding, which has decreased by 93 per cent. Further, the ability of the vehicles to self-recover has been diminished, through the reduction of the number of vehicle winches.

Management of the Standard Defence Supply System Upgrade: Audit Report No.5 2004–05

In July 2000, the SDSS Project was initiated with an approved budget of $15.87 million with the main aim of delivering a Standard Supply Chain System across Defence by June 2002. The Project was to combine the implementation of a new version of the operating software with improvements to the management of the Defence supply chain and supporting infrastructure. This enhancement, once rolled out, was intended to deliver an integrated system with which Defence could manage its spares inventory, accounting for over 1.6 million categories of stores, valued at some $1.9 billion.

The ANAO found that the Project has not delivered value for money to Defence. The Project exhibited extensive scope reduction and, based on scheduled final deliverables being accepted in June 2004, operated with an extended schedule in excess of 200 per cent of the planned schedule. SDSS *version 4* was to provide Defence with improved finance functions, tighter controls over data integrity and transaction processing, and improved reconciliation and reporting. The Project has failed to materially deliver many of the outcomes for which it was funded.

As at the completion of ANAO fieldwork in April 2004, the initial scope of the Project remains incomplete. Cumulative cost escalations [excluding $5.1 million in contract deliverables from legacy training and e-Procurement projects] have required a further allocation of $34 million to what had originally been approved as a $15.87 million project. By November 2003, the Project had already exceeded its initial approved budget by more than 200 per cent.

The Project was raised as a Minor Capital Equipment acquisition project from operating funds to provide major systemic changes to the entire Defence logistics management environment. This decision was taken irrespective of the Equipment Acquisition Strategy, which estimated the cost associated with implementing the stated upgrade outcomes as being $27 million which would, at the time, have required the Project to be approved by Cabinet, and managed as a Major Capital Equipment procurement activity. Defence governance procedures have recently been strengthened to ensure that all strategic capability procurement exceeding designated limits will be referred for Ministerial consideration.

Technical risks, as well as risks associated with scope amendments, were not broken down in terms of their respective scope, schedule and cost impacts in order to be easily understood by members of the Project Board. The organisational risks associated with delivering the Project were not adequately managed. End users remain discontented with the performance of the delivered product, which did not meet 40 per cent of the critical success factors defining successful Project delivery.

The contractual construct chosen for the Project was deficient. The decision to retain a contracted PMO, on hourly rates, for a high-risk software development and roll out programme during Phase 2 of the Project, proved to be inappropriate, and did not shift adequate risk to the PMO. A large proportion of the costs associated with the delays experienced by the Project were consumed by the PMO. The PMO had no direct contractual authority over any of the internal Defence suppliers to the Project, and limited contractual control over commercial suppliers, yet was expected to accept responsibility for the management of deliverables.

Significantly, the system was found to be ineffective in its ability to manage Defence stock holdings to the extent originally envisaged, and restricted Defence's ability to fully account for them. The system did not adequately alert appropriate Defence logistic management staff that strategically important stock holdings have fallen below levels able to support Defence operational requirements. Reports of this nature are not automatically routed to materiel managers responsible for replacing used stores. Without appropriate workarounds, these shortcomings compromise Defence's ability to assure operational Force Element Groups that the stores, necessary to implement their stated operational requirements, can be delivered, as required, to support specified levels of operational readiness.

The Armidale Class Patrol Boat Project: Project Management: Audit Report No.29 2004–05

In October 2002, the Government approved a Capital Acquisition Project, Project Sea 1444, with an acquisition Project Budget of $436.8 million, to provide a replacement Patrol Boat capability. The approved Project Budget has increased by $17.6 million, as a result of price and exchange variations, to $454.4 million, in September 2004.

Following a competitive tender process, Defence signed a contract with Defence Maritime Services Pty. Ltd. (the Contractor) in December 2003, worth $552.86 million, to deliver and maintain 12 Armidale Class Patrol Boats (ACPBs) for 15 years, with a five year extension option.

The ANAO found that the contractual construct employed by the Defence Materiel Organisation (DMO) is a sound approach that will encourage the Contractor to deliver reliable, fully capable ships for use by the RAN. The DMO has sought to allocate significant risks associated with cost, and meeting a delivery schedule, to the Contractor, by rewarding timely delivery with a milestone payment regime, and discouraging schedule slippage by the capacity to invoke liquidated damages for delays against agreed ship delivery dates. The Project had met all contractual milestone payment dates as of August 2004.

The Project has adopted a whole-of-life, capability life cycle approach, which will maximise partnering benefits with the Contractor over the contracted life-of-type of the capability. The ANAO found that, to mitigate the risks associated with performance over the period of the Contract, the Contractor is responsible for delivering the training of crew, non operational maintenance, and general upkeep of the vessels, against a fixed cost, performance based contract. The payment to the Contractor for ship availability is at risk in the event that system failures, or platform non-availability, prevent the RAN from undertaking prescribed operational activities.

Management of Selected Defence System Program Offices (FFG Upgrade Project): Audit Report No.45 2004–05

The ANAO found that the DMO has implemented significant organisational change since 2000. The formation of the Capability Development Group (CDG), together with increased CDG-DMO Integrated Project/Product Team collaboration based on the two pass Government approval process, should in the future result in improved capital equipment acquisition contract work definitions, and more accurate project cost and schedule estimates.

DMO's System Program Office (SPO) structure should enable accountability to be effectively aligned to system acquisition and logistics support management. It also exploits the system engineering synergies between product design, development and logistics support. However, there remains scope for further improvement in the areas of DMO's standardised Business Process Model, project scheduling and status-reporting system, and within the technical integrity management systems within DMO's Maritime and Electronic and Weapon Systems Divisions.

The FFG Upgrade Project initially aimed to regain the original relative capability of six FFGs, and to ensure they remained effective and supportable through to the end of their life in 2013–21. How effective the Upgrade Project has been will not be known until acceptance of the Upgrade Software currently scheduled for May 2007.

In November 2003, the Minister for Defence announced changes to Defence capability. These changes included the acquisition of three air warfare destroyers and the strengthening of the FFGs' air warfare capability by complementing the FFG Upgrade anti-ship missile defence system with the long-range Standard Missile-2 (SM-2) missiles. Related offsets include the early retirement of the two oldest FFGs in 2005 and 2006, when the last of the new ANZAC class frigates are delivered. Defence assessed the savings attributable to the withdrawal of these two FFGs would be $678 million over ten years. On a one-year basis, that represents less than two per cent of the estimated annual total operating expenses of the Navy, which in 2004–05 was reported to be $4.65 billion.

The retirement of the two FFGs requires a contract amendment covering the reduction of FFGs to be upgraded from six to four. This amendment had not been finalised by March 2005, despite being decided in November 2003. In 2002, DMO estimated that the unit cost of the upgraded FFGs to be $235 million for each of the six upgraded FFGs, or $353 million each if only four were upgraded. This indicates that upgrading only four FFGs would yield no savings in the FFG Upgrade Project. DMO records also state that unless FFG fleet tasking was reduced significantly, there would be marginal change in fleet operating costs if less than six FFGs were upgraded.

The FFG Upgrade Project was not proceeding satisfactorily and required continued Defence Senior Executive attention, in order to prevent further loss of Navy capability. The FFG Upgrade Project has experienced extensive schedule slippage, and as of November 2004, 78 per cent of the contracted payments had been made without a satisfactory design and development disclosure process in place, nor agreement on important elements of the project's Tests and Trials programme. ANAO considers that further slippage is likely on the lead ship, HMAS Sydney, which may have flow on effects for overall Navy capability.

The ANAO found that in the period 1999 to mid-2003, the FFGSPO financial records did not provide a reasonable level of assurance for the orderly, efficient and accountable measurement of the use of Australian Government resources. The ANAO is concerned that legislative and administrative requirements concerning the keeping of accounts and records may not have been met for a significant period, prior to mid-2003, in relation to this project.

The FFGSPO's plans, key performance indicators and the regulatory compliance system were either under review or in the early stages of implementation, despite the Upgrade Program being nearly six years old. This, when combined with problems related to the project's software safety and testing programme, is likely to result in delays in the technical certification of the Upgraded FFGs and, as a result, delays in their acceptance into service.

Management of the M113 Armoured Personnel Carrier Upgrade Project: Audit Report No.3 2005–06

The upgrade project for the M113s essentially comprised of two major stages. The first stage commenced in 1992 and culminated in the awarding of a contract in mid 1997 for a minimum vehicle upgrade. In accordance with the 2000 Defence White Paper, a second stage of the project commenced in 2002 for a major upgrade of the M113 fleet of vehicles.

In July 1992, Army proposed a minimum upgrade of the M113 fleet to improve firepower, night vision, fighting, habitability and survivability capabilities. Phase 1 was to consist of upgrading 537 vehicles to an A2 standard to be delivered from 1996 to 1998 at an approved cost of $39.9 million (April 1993 prices). Phase 2 of the Project was to upgrade the remaining vehicles to the same standard with final delivery to be in late 2000.

The ANAO found that the Project has undergone extensive scope changes and chronic schedule delays since its inception. The M113 family of vehicles was originally to undergo a minimum upgrade as detailed above. The Project changed and is now to perform a major upgrade of 350 M113 vehicles comprising about two thirds of the current in-service fleet. The M113 Major Upgrade Project was approved at a cost of $552 million in June 2002. The ADF is yet to receive any upgraded vehicles. The upgraded vehicles will not start to enter into service until late 2006 with the last vehicle to be delivered in late 2010. The vehicle has a planned end of life of 2020. The new contracted vehicle, while consistent with the currently approved project scope, is substantially different to the vehicle originally envisaged by the Army.

The Minimum Upgrade Phase of the Project suffered from poor project management practices; ineffective project planning; inadequately defined project objectives; and suffered technical problems with the T50 turret. Combined with an inability to successfully integrate the components of the vehicle, this resulted in a failure to deliver capability to the ADF.

The ANAO found that the three year delay between the approval to combine the phases in June 1999 and entering into a contract for the major upgrade of 350 M113 vehicles was characterised by an inability of Defence to successfully manage changes in requirements. By February 1999, before Contract suspension, some $9.7 million had been spent from the Minimum Upgrade Prime Contract. After the decision to sole source, some $27.8 million was paid for tasks performed by the Contractor towards developing an acceptable combined upgrade proposal and for postponement costs.

The ANAO considers that the new Major Upgrade Contract, executed in July 2002, has provided an improved framework for Defence to advance the Project. The System Program Office is taking an active role in managing the Project. Nevertheless, there is still some doubt as to whether the upgraded vehicles will meet their in-service date of late 2006. The Contractor is now putting in place a process of fast tracking production whereby they commence producing vehicles at their own risk before they have passed Defence formal testing. The ANAO considers that this approach involves a high level of risk for the delivery of Army capability. Notwithstanding the Contractor's liability for this risk, it will require close management by both the Contractor and Defence.

Upgrade of the Orion Maritime Patrol Aircraft Fleet: Audit Report No.10 2005–06

Australia's Air Force operates 19 *Orion* maritime patrol aircraft, which entered service in 1978 and 1984–1986. The refurbishment of the *Orion* fleet was approved in late 1992 with a value of $719.34 million, and a contract was signed in January 1995. Project Air 5276 is a multiphased project aimed at upgrading the aircraft's combat systems to ensure its military effectiveness, and extending the aircraft's life through to its planned withdrawal from service in 2015.

The *Orion* Upgrade Project met its performance objectives. The modified aircraft have achieved, and in a number of roles exceeded, the expected operational performance. The capability enhancements allow the aircraft to cover a given surveillance area in greater detail and in a third less time.

The ANAO found that the long delays in the Project (some four years in the delivery of the upgraded aircraft) meant that equipment met contractual requirements but some equipment was already obsolete at the time of installation in the aircraft. Defence, the Contractor and subcontractors underestimated the unique features of the design and production work to be undertaken, and the complications involved in integrating a range of different new systems, both with each other and with the retained aircraft systems. These complexities were made more difficult to manage in the absence of a fully developed software testing facility, which had been a pivotal part in the Project's planning. Nevertheless, the Upgrade Project has met its performance objectives and the upgraded aircraft have played a significant part in Australian border protection and coalition operations.

In the purchase and modification of three second-hand *Orion* (TAP-3) aircraft, the ANAO found that, in Defence's decision making on the method of procurement, insufficient attention was paid to the financial and technical constraints in contractual commitments under the US Foreign Military Sales system. These constraints were insufficiently considered as an integral part of a comprehensive sourcing analysis before Defence decided on a method of procurement. The delays in the delivery of refurbished aircraft ranged from 9 to 25 months.

The acquisition of the Advanced Flight Simulator highlights the importance of having at hand appropriately skilled personnel to ensure that projects can be started and progressed in a timely manner. Against planned timelines, the delivery of an essential training capability was over two years late, and the tactical training capability was three years late. The ANAO found that the current inability to use the AFS for a number of high risk and high airframe fatigue-inducing training sequences means that the AP-3C *Orions* have to be used for that training, resulting in higher risks and costs, including the consumption of airframe fatigue life. The Air Force expects to be able to keep the *Orions* operating until their planned withdrawal from service, and Defence is undertaking further work with the Contractor to increase the AFS's capabilities.

Acceptance, Maintenance and Support Management of the JORN System: Audit Report No.24 2005–06

The Jindalee Operational Radar Network (JORN) Project received Government approval in April 1990. The Project has an approved budget of $1.24 billion, of which $1.14 billion had been spent by September 2005. The JORN system is based on advanced over-the-horizon radar technology that uses radio energy refracted from the ionosphere to detect and track airborne and surface objects over the horizon at ranges between 1 000 to 3 000 kilometres. It consists of two radars: one near Longreach, Queensland and the other near Laverton, Western Australia; and a network control centre located at the Air Force's Edinburgh Base near Adelaide, South Australia.

In June 1996, the ANAO reported the JORN Project to be experiencing significant project management and systems engineering difficulties. The Project's Prime Contractor at the time, Telstra Corporation Ltd (Telstra), had rescheduled JORN's completion from the contracted date of June 1997 to 1999, and was proposing a revised completion date of June 2000. In February 1997, Telstra relinquished its JORN Project management role to RLM Management Pty Ltd (RLM), and in October 1999, JORN's contracted delivery date was rescheduled to December 2001. In April 2003, RLM successfully completed JORN's development and in May 2003 JORN achieved Final Acceptance by Defence. RLM is now responsible for JORN's maintenance and support, through the 46-month initial maintenance and support provisions within the JORN Contract.

The JORN Project has successfully transitioned from its acquisition to in-service support phase, and experience to-date indicates the Project has achieved its major objectives, namely: to provide the Australian Defence Force (ADF) with broad-area surveillance of aircraft and sea-going vessels in Australia's northern approaches; and to develop Australian industry capability to support over-the-horizon radar operations, maintenance and evolutionary development.

ANAO observations of JORN's performance diagnostics and performance monitors, and operational availability records indicate both JORN radars are effectively maintained and are operating within their design parameters.

Attachment B2

Inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation

Current Performance Audits

Management of the Tiger armed reconnaissance Helicopter Project Air 87: Scheduled to table in Parliament in May 2006

The Tiger Armed Reconnaissance Helicopter (ARH) Project Air 87 (the Project) was approved to provide for a new, and significant all-weather reconnaissance and fire support capability for the Australian Defence Force (ADF). The Project has contracted for delivery of 22 aircraft, with supporting stores, facilities, ammunition and training equipment. The first four aircraft are being manufactured in, and delivered from France; the remaining 18 aircraft are being manufactured in France, and assembled in Brisbane. Australianisation of the weapons and communications systems is a differentiating characteristic of the Australian Tiger ARH, compared to the French Tiger Variant.

The objective of the audit is to assess the effectiveness of the management of the procurement of a major, new capability for the ADF by the DMO, and Defence. The audit will review the initial capability requirements and approval process; the contract negotiation process; and the management of the Acquisition and Through-Life-Support Contracts. The coverage of the audit will include the development of the concept for the requirement through to the acceptance of deliverables in the period prior to the award of the Australian Military Type Certificate.

Procurement of Explosive Ordnance for the Australian Defence Force (Army): Scheduled to table in Parliament in May 2006

An important element of an effective Army capability is the availability of ammunition for the conduct of training exercises and operations. Issues affecting ammunition availability include acquisition processes, logistics supply, inventory management and technical integrity. The audit is examining arrangements within Army and between the Army, the Guided Weapons and Explosive Ordnance System Program Office and Joint Logistics Command.

The audit objective is to assess Army's ordnance management system, with particular reference to the stock management and holding policy, ordnance age and deterioration and replacement management, delivery and storage management and procurement processes.

Management of Army Minor Capital Equipment Procurement Contracts: Scheduled to table in Parliament in Spring 2006

Minor capital procurement projects in Army include new equipment, upgrades to existing equipment and enhancements to new equipment. Defence defines minor projects as projects costing some $20 million or less, and individual items generally costing less than $1 million or having no significant Defence policy or joint service implications. Army minor capital procurement projects are diverse in nature and include machinery, ammunition, electronic equipment, software and items purchased to support or update components of existing military equipment. Since 1999-2000 Army has spent $326 million under the Five Year Minor Capital Procurement Plan. In 2004-05, Defence budgeted to spend $163 million on these projects, a significant proportion of which relates to Army capability.

The audit is examining DMO's management of a range of Army minor capital equipment projects in order to provide Parliament with assurance concerning their effective management.

The Purchase of a Replacement Fleet Oiler (SEA 1654 Ph 2A): Scheduled to table in Parliament in Spring 2006

The Project will replace the fleet oiler, HMAS WESTRALIA, with a commercial Auxiliary Oiler, which will be modified in Australia. The acquisition and modification will be undertaken at an estimated cost of $150 million. The fleet oiler will be replaced through the acquisition of an operational and environmentally sustainable ship of commercial origin. In 2004, Defence purchased a double hulled, environmentally compliant, commercial tanker for approximately $50 million, and subsequently chartered it out for 14 months. The ship is being modified in Australia to provide the fleet with underway replenishment of fuel (diesel and aviation) and water. The replacement oiler is expected to be in service in late 2006. The objective of the audit is limited to an assessment of the procurement of the commercial oil tanker and associated upgrade.

The SDSS Remediation Program: Scheduled to table in Parliament in Autumn 2007

The 2004-05 ANAO audit of the Standard Defence Supply System (SDSS) Upgrade found that the Project has not delivered value for money to Defence. The Project exhibited extensive scope reduction and, based on scheduled final deliverables being accepted in June 2004, operated with an extended schedule in excess of 200 per cent of the planned schedule. SDSS version 4 was to provide Defence with improved finance functions, tighter controls over data integrity and transaction processing, and improved reconciliation and reporting. The Project had not delivered many of the outcomes for which it was funded, at a reported cost of $49.9 million. Defence subsequently advised that the SDSS version 4 Get Well Program was been proposed with a completion date of December 2005. The Get Well Program is expected to attend to infrastructure performance improvements, business process improvements, software defects and financial reporting shortfalls from the existing operating budget.

The objective of the audit is to review the effectiveness of remediation activities put in place to improve the performance of SDSS following the delivery in July 2003 of the SDSS Upgrade Project. The period of the intended coverage for the audit will encompass work undertaken to improve the operability and effectiveness of SDSS from the completion of the SDSS Upgrade Project in July 2003, until the completion of fieldwork for this audit, currently programmed for late June 2006.

Australian Light Armoured Vehicle (ASLAV) Enhancement (LAND 112): Scheduled to table in Parliament in Winter 2006

LAND 112 is a multi phased project to provide Light Armoured Vehicles for the Australian Army. Phase 1, 2 and 3 was approved at a total cost of $666 million (December 2004 prices). Phase 1, now completed, acquired 15 vehicles from the US for evaluation. Phase 2, also completed, procured 111 vehicles and Phase 3 was approved in 1997 with a contract signature date in 2000. Phase 3 includes the acquisition of up to 144 additional vehicles and support equipment and began in service delivery in 2003. The audit is covering the major phases of the project and subsequent introduction into service.

Air Combat Fleet Sustainment: Scheduled to table in Parliament in Spring 2006

The audit scope covers key issues related to the in-service support of the ADF's F-111, F/A-18 and Hawk fleets. The audit objective is to assess the effectiveness of the fleet's maintenance and support arrangements. The audit will seek to identify any weaknesses and recommend improvements to Air Combat Fleet in-service management practices. The audit will also seek to identify better practice used by the Air Combat Fleet support organisations which may be generalised to DMO's other ADF fleet support organisations.

High Frequency Modernisation Project (JP 2043): Scheduled to table in Parliament in Autumn 2007

The High Frequency Modernisation project will replace naval high-frequency radio stations in Canberra, Darwin, Exmouth, Sydney, Cairns and Perth and the Air Force high-frequency radio stations in Sydney, Townsville, Darwin and Perth. The new network proposes to provide enhanced high-frequency radio communications capabilities and is to provide compatible high-frequency equipment in selected ADF mobile platforms. The Project is planned to be delivered in two stages. The first stage is to replace existing facilities. The second stage is to provide the upgraded capability and enhanced security and serviceability features. The objective of the audit is to provide Parliament with assurance regarding the cost effective delivery of the specified capability to Defence end users.

Attachment B3

Inquiry into financial reporting and equipment acquisition at the Department of Defence and Defence Materiel Organisation

Potential Acquisition Related Performance Audits 2006-07

Fast Frigate Guided Upgrade Project (Sea 1390)

The SEA 1390 - Fast Frigate Guided (FFG) Upgrade Project has an approved budget of $2.2 billion. The project seeks to regain the original relative capability of the FFGs, and to ensure they remain effective and supportable through to the end of their life in 2013-2021. The upgrade includes improvements to the FFG's self defence and offensive capabilities, and other modifications to improve equipment reliability, and crew living quarters at an approved cost of $1.46 billion. The other major element is integration of SM-2 missiles into four FFG's at a cost of $558 million. The missiles are being acquired under a Foreign Military Sales Agreement.

The objective of the proposed audit would provide an update to Parliament on the progress of the FFG Project and assess the adequacy of systems and processes put in place by Defence to ensure that project outcomes are achieved.

Lightweight Torpedo Replacement Project (JP 2070 Phases 2 and 3)

The Lightweight Torpedo Replacement Project has an approved budget of $588 million. The Project will acquire for the ADF EuroTorp MU90 lightweight torpedos, replacing the Mk 46 version. It will be integrated into the Anzac and Adelaide-class guided missile frigates, the Super Seasprite and Seahawk helicopters and the P-3 Orion maritime patrol aircraft. Phase 2 will include the acquisition of initial stock and will provide integration into all platforms. Integration is scheduled to occur in 2006. Phase 3 will acquire additional weapons to meet stock holding requirements.

The objective of the proposed audit would be to provide Parliament with assurance regarding the schedule, cost and performance parameters of the Project.

ANZAC Ship Helicopter Project (SEA 1411 Phase 1)

The ANZAC Ship Helicopter Project has an approved budget of $1 billion. The Project involves acquiring 11 maritime combat helicopters for the Anzac-class frigates, providing an enhanced capability for surface surveillance, anti-submarine warfare, contact investigation and maritime utility tasks. The scope of the proposed audit will include the acquisition and through-life support contracts for the sustainment of this Navy capability. The acquisition includes a full mission flight simulator and software support centre.

The objective of the proposed audit would examine the identification and development of the requirements, tendering, acquisition and in-service support phases of the Project and to assure compliance with relevant procurement processes.

Planning and Approval of Major Capital Acquisition Projects

Defence and the DMO are required to seek funding approval for Major Capital Equipment projects through a strengthened Two Pass System that was adopted in 2003. The Department of Finance and Administration is undertaking an enhanced role in the evaluation and quality assurance of cost and financial risks associated with Major Capital Equipment proposals. At the First Pass stage the Government considers alternatives and approves capability development options. These options then proceed to more detailed analysis and costing with a view to subsequent approval of a specific capability. At the Second Pass stage Government agrees to fund the acquisition of a specified capability system which has a well-defined budget and schedule. A sample of Major Capital Equipment projects will be examined to review key business processes associated with the planning and approval processes for First and Second Pass Government approval.

The objective of the proposed audit is to provide assurance to Parliament on the effectiveness with which the strengthened Two Pass System is being implemented for new Major Capital Equipment Acquisition Projects.

Management of Foreign Currency Payment Claims

The acquisition of weapons platforms involves considerable payments in a mixture of foreign currencies. The DMO accounts for nearly half of all the Australian Governments foreign exchange payments excluding debt management activities. The majority of DMO foreign exchange payments are in United States Dollars representing payments for United States Foreign Military Sales (FMS) and for commercial transactions. The audit would examine a selection of foreign exchange payments for the top 30 capital acquisition projects which have a combined cost of $25.89 billion and for a sample of FMS agreements.

The proposed audit will provide assurance to Parliament on the effectiveness of the management and reporting of material foreign exchange payments.