

**Defence 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*

The Inquiry's Terms of Reference

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

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

PREFACE

Key Judgements

Defence has put a major effort into reforming our financial reporting and equipment procurement. We are starting to see the positive benefits of this work.

We have 16 remediation plans in place on financial matters and these are eliminating many long-standing problems. Defence procurement reforms are improving the timeliness and cost efficiency of our acquisitions.

Defence continues to maintain a very high standard of cash management practices. None of the financial or procurement issues that have required reform have had a negative impact on the operational competence of the Australian Defence Force.

Defence believes it is doing everything it can to improve our management of financial and procurement issues. Notwithstanding the substantial reform agenda already well underway, we are open to proposals and suggestions for new ideas and practices which might improve our overall accounting performance.

Based on a comparison with counterpart Defence agencies overseas we assess that Defence's efforts to implement financial management reform and improve acquisitions are well ahead of those in countries like the US, UK, New Zealand and Canada.

Notwithstanding our progress, financial and acquisition reforms are some of the most complex areas of modern governance. It will take some time for Defence to work its way through all the issues, but we are committed to the task and are well on track to achieve a high quality outcome.

Defence is keen to work with the Parliament, the ANAO and all other agencies in continuing to look for best practise methods for improving our financial management and procurement systems.

This submission is intended to support the inquiry by the Joint Committee of Public Accounts and Audit into progress on implementing systematic reforms in the areas of financial management and equipment acquisition at the Department of Defence and the Defence Materiel Organisation (DMO).

The submission is presented in two parts:

- Part one addresses financial remediation and reforms,
- Part two addresses equipment acquisition.

This preface provides an explanatory note on Defence's governance structure.

Under the *Financial Management and Accountability Act 1997*, the Secretary of the Department of Defence and the Chief Executive Officer of the DMO are responsible for the financial management of the Department of Defence and DMO respectively. The separation of the accounts of the two entities, and the attribution of responsibility for the accounts, follows from the DMO's listing as a prescribed agency under the *Financial Management and Accountability Act 1997* with effect from 1 July 2005.

The Secretary of the Department is the principal civilian adviser to the Minister, and exercises statutory responsibilities under the *Public Service Act 1999* for the whole of Defence, including the DMO.

The Chief of the Defence Force commands the ADF and is the principal military adviser to the Minister. The Chief of the Defence Force has no responsibilities under the *Financial Management and Accountability Act 1997*.

The **financial management remediation** and reform work, which is one of the elements of the Committee's inquiry, applies to both Defence and DMO. This is reflected in this submission. The work is being undertaken by an integrated workforce of ADF members, Defence civilians, consultants and contractors.

The **equipment acquisition** processes which are also specified by the inquiry, separate from the issues of financial management, also embrace both Defence and the DMO. In short, Defence advises Government on capability development matters, that is, on the equipment and other needs of the Defence Force and the Department; and the DMO acquires and sustains the equipment on which the government decides. The CEO DMO is accountable to the Minister for DMO's performance.

While a "prescribed agency", DMO remains part of the Defence portfolio, and – as noted – the Secretary and CDF retain some responsibilities for it. As a reflection of this, and of the necessary closeness of the business relationship between Defence and the DMO, the Secretary and CDF are members of the Defence Procurement Advisory Board, while the CEO DMO is a member of senior Defence committees, in particular the Defence Committee, to which he reports in detail, each month, on procurement projects and sustainment activities.

This submission has been prepared jointly by Defence and DMO under the direction of the Secretary and the CEO DMO. It is forward looking. It focuses on remedial and reform work in relation to financial management issues rather than on the history of this area of Defence's management. It addresses the post-Kinnaird review changes in the acquisition process rather than casting back to the pre 2000 approach or the first stage of reform from 2000 to 2003.

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PART ONE:

**DEFENCE FINANCIAL REMEDIATION
AND REFORM**

PART ONE

DEFENCE FINANCIAL REMEDIATION AND REFORM

OVERVIEW

The business of Defence is unique in Australia.¹ Its scale and complexity demands financial management that is rigorous, yet understandable and transparent. At 30 June 2005, Defence had in excess of 90,000 ADF members, including reservists, and civilians who are subject to the *Financial Management and Accountability Act 1997*. There are over 27,000 cadets who, while not members or employees, are also officials under the Act, as well as a number of private sector service providers on contract for such functions as garrison support.

Defence manages a budget framework that extends ten years into the future involving an annual spend in the order of \$20 billion. It has responsibility for in excess of \$30 billion of specialised military equipment, over 35,000 active structures (building, infrastructure and property assets), including many of heritage and cultural significance, including 350 major establishments in Australia and over 40 overseas locations, including operational areas valued at over \$17 billion. There are also in excess of 200 major equipment and 17 major facilities projects.

In managing its business Defence, like other large Australian organisations, has been subject to significant changes in financial reporting requirements. These reforms have been initiated by both Defence and the Government in response to Defence's evolving business requirements, the imposition of progressively higher standards of governance, and to remediate specific problems. Across the spectrum of reforms, Defence has achieved a great deal. Sound budgeting, improved performance reporting and managerial accountability, a strong independent audit committee, a focus on risk management and significant market testing are all hallmarks of those financial achievements.

While much has been achieved, the challenges Defence still faces have been highlighted by recent audit reports which point to three main areas requiring further improvement – better records management including maintenance of inventory pricing records, documentary evidence of operating financial controls, and improved financial systems. Since 2003, a concerted program of work to reform Defence's financial management and remediate these findings has been progressed.

Defence has also sought to further refine its remediation activity in the context of a new financial reporting framework, that is, the introduction of Australian Equivalents to International Financial Reporting Standards (AIFRS). This has been realised in the development of a series of conceptual '**position papers**' which explore the key accounting issues for Defence in depth and, in particular, describe the positions which Defence intends to adopt in relation to these issues for the 2005-06 financial statements. Remediation activity will be guided by and, to some extent, prioritised through the accounting positions adopted.

¹ Throughout Part One, references to 'Defence' may be taken to include DMO. Remediation and reform applies to both accounting entities.

When Defence critically reviewed the outcomes from the 2004-05 financial statements audit, it became apparent that a significant number of findings still result from differing technical interpretations of accounting standards by the ANAO and Defence.

With the introduction of the Australian equivalent of International Financial Reporting Standards (AIFRS), and to maximise the ability to form an opinion for the 2005-06 financial statements, Defence has worked to form a conceptual view of appropriate accounting practices and to implement these changes prior to the end of the financial year. This requires Defence discussions with the ANAO on the validity of the accounting treatments in the papers.

The position papers form a major component of Defence's financial reforms, will clearly articulate Defence's approach to Generally Accepted Accounting Practices (GAAP) and will guide the changes required by the adoption of AIFRS. The development of the position papers has already resulted in modification of some remediation plans and may subsequently warrant the development of remediation plans additional to those already in the program.

The centre piece of the remediation program is the implementation of a well documented and clearly articulated **financial controls framework**, which is underpinned by extensive financial training and comprehensive system upgrades.

The financial controls framework project is well underway. It is modelled on the internationally recognised Committee of Sponsoring Organisations internal control framework and will:

- document the key financial management risks;
- identify, document and categorise controls to manage the risks;
- assign traceable accountabilities for the controls, and
- establish a single system of monitoring and maintenance to ensure that the controls framework retains its relevance and integrity.

In total, the framework will contain in the order of 1,000 key controls documented in a single central register. The register already contains 161 key risks and 346 key controls with the remainder to be documented by 30 June 2006.

In recent times we have received audit qualifications in relation to the management of some of our assets, including general stores inventory, explosive ordinance inventory, repairable items, infrastructure, plant and equipment and intangibles. Additionally we have been qualified in relation to the management of military and civilian leave liabilities. At the core of each of these qualifications has been poor records management.

A comprehensive **program of 16 remediation plans**, including the implementation of a structured financial controls framework which will be the centrepiece for financial management in Defence going forward, has been instituted and are now well underway. These plans will rectify all audit qualifications and the 141 Category A, B and C audit recommendations identified by the Australian National Audit Office (ANAO) over the past 2 years. As a direct result of the 16 remediation plans to 6 April 2006, 40 audit recommendations had been signed off by the ANAO, a further

31 were with the ANAO for review and a further 35 were planned for completion by 30 June 2006.

The framework is underpinned by an extensive but evolving **financial training regime** to ensure all relevant personnel are able to adequately participate in the management of Defence's finances. For the year ended June 2005, some 7,300 staff attended training through the program with over 10,000 expected in 2005-06.

Financial management information technology systems are being reviewed and upgraded to ensure that all system-related controls are functioning appropriately. The upgrades will reduce maintenance costs and improve compliance with AIFRS, update financial controls, provide significantly improved financial management information and better match systems performance to business rules. During 2005-06, significant improvements have been made to the logistics management control environment. Defence and the DMO have identified and implemented 508 inventory management controls during the year comprising 186 system-based controls within the Standard Defence Supply System (SDSS) and 322 non-system, business process-based controls.

The remediation program is significant, and in many cases at the forefront of Defence agency reform internationally, but the introduction of **international accounting standards** places further financial reporting requirements on Defence's financial management agenda. Although the Australian Accounting Standards Board has provided some significant relief from the unintended consequences of international standard introduction, there still remain major challenges with the new standards on inventory and reportable embedded derivatives².

Although the accounting and audit standards were designed for organisations very different to Defence, they will continue to be used to drive necessary reform and to achieve essential compliance requirements. But if we judge that this compliance is not material, and can only be achieved at undue cost then we will not devote large amounts of resources to it and may have to bear some ongoing outstanding remediation.

As to **international comparisons**, Defence's financial statements issues are not unique. Defence bodies in the United States, the United Kingdom, Canada and New Zealand have also faced many of these issues. The United States Department of Defense has been unable to produce auditable financial statements and has a series of remediation plans in place to address financial statement 'challenges'. The United Kingdom Ministry of Defence now has audit certified accounts, but does not have long service records to maintain, does not apply the reporting of embedded derivatives and does not fair value or depreciate heritage and cultural infrastructure assets. The Canadian Department of National Defence has not yet adopted full accrual accounting and will be confronted with its first audit as a stand alone entity in 2009. The New Zealand Defence Force, where the Chief of Defence Force is also the Chief Accountant, has produced audit endorsed financial statements, but will not confront international accounting standards until 30 June 2008 when it will be expected to report on embedded derivatives and the difficulty of measuring inventory on a lower of cost or market value basis.

² Embedded derivatives are explained on p

It must be emphasised that, while attending to the remediation program, Defence maintains sound cash management practices and continues to deliver on its operational requirements. As the program is worked through Defence will continue to:

- maintain its responsiveness to Government requirements;
- carefully maintain and diligently monitor its funds and budgeting processes;
- manage its specialised military equipment well; and
- meet its financial obligations as and when they fall due.

1. PROGRESS IN IMPLEMENTING SYSTEMATIC REFORMS

This section provides an overview of Defence's progress in relation to implementing systematic reforms and covers:

- The Blueprint for Reform: Why are we reforming our systems?
- The Financial Controls Framework: An overview of Defence's Financial Controls Framework project.
- Financial Skilling Renewal: The way in which we equip our people with key skills.
- Enterprise Resource Planning Systems Reform: The current state and future plans for our key information systems.

1.1 THE BLUEPRINT FOR REFORM

The Secretary, the Chief of Defence Force and the Chief Executive Officer of the Defence Materiel Organisation (DMO) are committed to having Defence (and the DMO) recognised by Government as highly competent, professional and business-like financial managers within the next five years. Achievement of the vision encompasses the establishment of a culture of economy within Defence in which waste is eliminated, overheads reduced, productivity improved and resources applied where most needed. This vision cannot be achieved without a significant investment in the development of an enduring **financial management framework**, the concomitant improvement of the **skills and knowledge** base of the people working in financial management, and improvements in the performance and utility of the financial and business management elements of the **Defence Enterprise Resource Planning systems** (i.e. information technology systems).

A five-year time frame is appropriate given the fundamental nature of the changes to be put in place across the particularly large complex organisation and business that is Defence, as is indicated, for example, by in excess of:

- approximately 90,000 people subject to the *Financial Management and Accountability Act 1997* spread over 350 major establishments in Australia and over 40 overseas locations, including operational areas;
- \$30 billion in specialised military equipment;
- 47,000 individual land, building and infrastructure assets, including those of heritage and cultural significance, valued at over \$17 billion, and
- 160,000 line items with a stock turn covering many millions of diverse individual items ranging from O rings to complex weapon components, and a further 600,000 line items kept in reserve.

The adoption of a comprehensive financial management framework for Defence will drive significant cultural and behavioural change for all staff working in Defence. Effective, efficient and competent financial management requires standardisation across the organisation and is not solely the preserve of finance experts. Essential to the realisation of the vision is the recognition that this work relates to the nation's Defence capability and military effectiveness. Further improvements in the way Defence embeds financial management as core business, and manages its people, resources, property, information and materiel will allow Defence to respond in a more effective manner to contingencies as directed by Government. As one of the biggest organisations in Australia, the Government and the community rightly expect that our financial management will achieve best practice.

1.2 FINANCIAL CONTROLS FRAMEWORK

“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).” **Section 5.177 Australian National Audit Office Report No.21 2005-2006**

Defence has recognised the importance of a robust, documented internal control framework as the foundation for its future financial management. The Secretary and the Chief of the Defence Force established a Financial Controls Framework Project to establish a best practice framework in Defence (and the DMO), which they officially launched on 29 June 2005. It applies equally to Defence and the DMO.

Implementation of the framework is now well underway and is modelled on the Committee of Sponsoring Organisations (COSO) integrated internal control framework, which is internationally recognised as best practice. It is not the only recognised financial controls framework but it is the framework of choice for private sector companies in the United States, and Australia, seeking compliance with the reporting requirements on internal controls under Section 404 of the *US Sarbanes-Oxley Act 2001*. Establishing a framework that is based on the COSO model allows Defence to benchmark its framework against large, complex Australian companies such as BHP-Billiton and Telstra which are also adopting the COSO framework. Adoption of this model will place Defence at the forefront of financial management among Commonwealth agencies.

The financial controls framework will provide a formalised structure within which Defence can effectively manage its financial risks. Financial risks in Defence include the risk of non-compliance with the *Financial Management and Accountability Act 1997* and risks like procurement fraud and incorrect salary payments to staff. ‘Controls’ are specific actions or activities that are implemented to mitigate the likelihood of these occurring and can be either automated within financial management systems or manually applied.

The framework is the cornerstone of all remediation activities underway in Defence. It is more than just another remediation project. It is a major change management program that standardises and fully documents the way Defence meets its financial management obligations.

At its core, the framework is based on the identification of the controls required to manage the compliance risks associated with both external (for example, legislation, Accounting Standards) and internal (for example, Chief Executive Instructions, Defence Instructions) financial management obligations. To identify the risks, these obligations are further subdivided along functional lines (for example employee provisions, inventory, land and buildings, infrastructure plant and equipment and specialist military equipment). For each risk there will be one or more controls

developed that aim to either prevent the risk from occurring, or indicate when an undesirable event has occurred. These preventive and detective controls will be clearly recognisable within the framework and will be easily understood by staff. The framework will also provide staff with clear linkages between the policies, processes, skilling, risk assessments, controls and procedures that are used to manage each of the functional areas.

The requirements for the automated financial management system based controls will be included in the requirements for the enterprise resource planning systems upgrades planned over the next five years. The framework aims to have up to 50 per cent of controls embedded within the systems by 2011.

Benchmarking against similar large, complex private sector organisations indicates that the framework will contain up to 5,000 internal controls of in the order of 1,000 would be considered as key financial management controls. Each control will be documented and have an assigned control owner responsible for managing its effectiveness.

It is likely that most of these controls will be implicit. The framework project team is in the process of uncovering and explicitly documenting them. The framework, and its associated training regime, will provide Defence staff with a controls focus to their daily financial management activities. The framework project is implementing a change management program to raise the awareness of controls and embed the framework across all officers in Defence who fall under the *Financial Management and Accountability Act 1997*.

A controls framework will itself be insufficient to achieve best practice financial management. The controls framework will be monitored and maintained to keep pace with changing obligations, and efficiency and effectiveness improvements. In conjunction with the implementation of the controls framework, both the level of conformance with the framework, and the financial management performance of Defence, will need to be continuously analysed and monitored. To achieve this, conformance and performance monitoring regimes are being developed.

The introduction of certification for finance domain staff will complement the financial controls framework. Certification will initially be introduced for the key transactional and supervisory positions and will be based on competency criteria developed around the framework. This introduction of certification will involve consultation with staff and unions. Financial business skilling will be re-engineered to provide staff with the knowledge they require to achieve certification (see 1.3). It is expected that certification will be introduced in 2008-09.

Significant progress has been made in the identification of controls in the areas of:

- inventory management;
- employee provisions, and
- financial management information systems.

Improving inventory management controls, especially the system based controls within the SDSS, has been a high priority for Defence and the DMO over the past two years. This work has resulted in the identification of 508 inventory management controls; 186 system based controls within SDSS and 322 non-system, business

process based controls. All these controls have been documented and implemented. In June 2006, a third party audit of SDSS will be undertaken to determine the effectiveness of these controls.

In recent months significant progress has been made in relation to the identification of controls surrounding the management of employee provisions. To date, 30 key controls have been identified for the management of long service and annual leave for both military members and civilians. Additional controls will be identified during the leave balance substantiation process being undertaken for the 2005-06 financial statements.

In 1999-2000, Defence implemented a SAP financial management system (ROMAN) that included 451 controls, 105 of which are considered key. Each of these controls are documented and will be updated to include any additional controls that are in the latest release of the software.

1.3 FINANCIAL SKILLS TRAINING

“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 program 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.” **Section 5.178 Australian National Audit Office Report No.21 2005-2006**

Defence and the DMO are pursuing a program of skilling development and delivery to meet its financial and business needs. Training was delivered to some 7,300 staff in 2004-05. A further 9,400 staff have been trained to March 2006. Civilian and military personnel whose jobs entail financial operations or management have been targeted. The training falls into the following broad groups:

Financial Management Training - A significant recent development has been the introduction of financial management training support for the Senior Leadership Group and senior officers at the Executive Level 2/Colonel (equivalent) level. The first of the Senior Leadership Group courses was held in June 2005, and the first senior officer course in September 2005. To date, the courses have been attended by 91 Senior Leadership Group staff and the senior officer courses by 82 staff.

Financial Information Systems Training – In the period 1 June 2004 to 31 March 2006, Defence and the DMO provided training to 8,893 staff on the corporate financial management system covering ROMAN (principal transactional system), and BORIS (high level budgeting and reporting tool). The ROMAN system accounted for the largest training component, with 8,072 staff.

Finance and Business Training - A variety of other finance and business-related training courses were delivered in the period to 2,045 staff. This training included ten-day accrual accounting courses, as well as basic training in financial induction, budget development and resource management.

Tertiary Financial Training – Defence and DMO staff are able to access two tertiary training courses. Since 1 June 2004, 97 staff have studied under the *Diploma in Government (Financial Management)* and 73 staff have studied the *Graduate Certificate in Professional Management (Finance)*. The graduate certificate provides Defence and DMO staff with an entry way into postgraduate financial management studies.

e-Learning - Four finance-related e-Learning courses, *Defence Purchasing Card; Manage Official Bank Accounts; Travel Budget Calculators; Card Management System*, were introduced during 2004-05 and completed by 4,276 staff to 31 March 2006. A further 345 staff completed the ROMAN Procurement Awareness course and some 900 completed Introduction to ROMAN via e-Learning.

A more detailed summary of the financial training undertaken in 2004-05 and year to date in 2005-06 is at appendix A.

Finance in Defence

Defence is a complex environment where many people may operate without being aware of their impact on the financial performance of the organisation. In some way every member has the potential to impact on Defence's financial statements, for example, through the management of leave balances, the acquittal of business travel or the efficient and effective use of the Defence suppliers' budget. It can therefore be said that all Defence staff undertake financial activities. While some will clearly identify themselves as having a financial management function, others currently do not recognise themselves as having a financial role or responsibility.

The Approach to Finance Skilling

Defence's previous approach to finance skilling has focused heavily on systems training and provision of basic accounting, budgeting and planning related training. Generally this training did not lead to the award of qualifications or publicly recognised competencies. While there was provision for formal training courses through provision of tertiary programs, access was restricted by the nature of its delivery and the need for participants to be enrolled for the whole of the program.

Defence is now building on that approach to produce both the necessary technical skills and underpinning knowledge for Defence people to effectively carry out their financial management functions in the Defence environment. The new training will recognise the fact that all people in Defence enter the finance domain from time to time and need financial skilling of some dimension. We are also addressing the provision of training for middle and higher level managers, the ongoing development of professional level officers, getting all staff in Defence to recognise their financial responsibilities, and achieving an understanding across the organisation that good financial management is core business.

New training courses will be developed as learning outcome requirements emerge from the work of the Financial Controls Framework project (see 1.2), particularly in relation to certification of people to undertake financial duties.

Overall, Defence has established reforms in the following areas:

- training for senior and middle management in financial responsibilities and accountabilities;
- broader access to relevant, Defence tailored, tertiary level training;
- formal competency/skill testing and certification;
- professional development of staff linked to a clear career development pathway to allow managers and staff to meet immediate skilling needs as well as plan for their future in Defence, and
- incorporation of both Defence context and an understanding of the 'why' (why I need to do this, and why this way) into training.

The Broader Business Community's Approach to Business/Finance Skilling

Research by the Corporate Leadership Council³ indicates that in order to gain a competitive advantage in world-class leadership and organisational performance, leading organisations:

- develop middle management and senior leadership competency models;
- provide access to relevant higher education programs; and
- deliver job related training programs (including coaching, mentoring and on the job assistance)

According to the Council's competency based approaches, organisations should:

- enable the standardisation of recruiting, performance management, and development processes across an organisation; and
- allow consistent, organisation wide leadership development and process integration.

A frequently cited limitation to the use of competency models is their failure to anticipate future organisational needs, perceived lack of relevance to the organisation, and inability to reflect leaders' perceptions.

The Council's case studies of Royal Dutch, IBM, Unilever and PepsiCo have shown this need not be the case. These companies successfully linked their leadership competency requirements to a future oriented view. Similarly studies have demonstrated that well performing companies are able to link their competencies to the perceived uniqueness of the organisation.

The Corporate Leadership Council's studies have shown that in respect to leadership skills the top ten frequently cited competencies are found in over two-thirds of organisations' competency models. Given there appears to be broad agreement on the underlying skills/traits required 'uniqueness' may be more a perceptual issue than an actual one.

In respect to other defence organisations, both the United States and the United Kingdom's Defence organisations have adopted competency based financial management training approaches. In the United States, this is conducted through the Defense Finance and Administration Service and in the United Kingdom through the Ministry of Defence's Resource Management and Finance Competency Framework.

The use of competency based training aligns with the Australian Government's reforms in relation to vocational and technical Education which encourage the use of nationally recognised competency frameworks and aligned courses of study.

The Council's report of March 2006 notes that a study of United States corporations revealed at least 30 per cent of those surveyed provided funded higher education programs for staff. Benefits attributed to this practice included a more knowledgeable workforce, and improved recruitment and retention of staff.

³ The Corporate Leadership Council is an international research group that undertakes benchmarking and best practice studies against world class (recognised best practice organisations). Defence is a member of the council and is provided with their broad range of studies.

This approach is not unique to either the United States or the private sector. Within the Australian public service, for example, there are sponsored higher education programs through:

- the Australian Public Service Commission's public sector training packages which can lead to a variety of formal qualification;
- the Australian and New Zealand School of Government's Executive Master in Public Administration program;
- the Department of Finance's recent collaboration with the University of Canberra for a Diploma level public sector financial management program, and
- the Canberra Institute of Technology's public sector financial management Diploma level programs (of which the Department of Health and Ageing and the Department of Defence partake).

CFO Magazine (a leading commercial financial management magazine) in February 2006 reported on a survey of about 250 senior private sector finance executives on their organisation's approach to training and loss of skills within their organisations. The survey revealed that in order to meet the financial skilling needs 60 per cent of organisations undertook formal training, 39 per cent employed mentoring programs, 34 per cent used recruitment of permanent staff and 19 per cent used temporary staff or outsourcing. Seventy-eight per cent of the organisations provided training in accounting and financial practices for finance staff, while 46 per cent provided those staff with leadership and business skilling training.

These studies indicate that a broad approach to skilling finance staff is required in respect to the methodologies employed as well as the nature of the type of training being undertaken. In particular the CFO Magazine article makes it clear that both initial and ongoing financial management training is a key skilling activity across financial organisations

The competency model approach being used by Defence for finance skilling recognises the lessons from these case studies. The competencies and courses built around these are designed to provide leaders and staff with skill sets and knowledge appropriate to Defence's business needs today and into the future. This is reflected in the increasing use of scenario play and open ended exercise activities to drive staff to adopting a more pro-active management 'results' focused approach to their work with staff having a clear understanding of the 'why' of the tasks they are required to perform (not merely the how).

Defence's use of finance competency based skilling aligns with the broader community based competency framework/standards administered by the Australian National Training authority and widely adopted by industry. Defence's identified financial training requirements are mapped to these nationally recognised units of competency which have been defined by industry (including the Financial Services Industry and the Public Services) to meet industry identified requirements and provide industry benchmarks for performance. In most cases the mapping of Defence requirements to industry standards, as represented by units of competency, has been easily achieved. This suggests that Defence is not alone in identifying these areas as core business and areas of concern requiring benchmarking and skilling.

In addition, a key ingredient of the training approach is the incorporation of senior leader change management messages and strategic visions for Defence:

- respected financial managers;
- culture of economy, and
- effective, responsible and accountable administration and management.

Achievements to Date

Defence has commenced a financial training and career 'Pathways' approach which informs people in the various parts of the finance domain about the training most appropriate to their career and development needs. This approach enables people to undertake modules of training that can ultimately be built into more formal qualifications should individuals wish to pursue them.

Immediate attention is being given to the following areas:

- Senior Officer Training – four training courses have been introduced to provide senior managers with an understanding of Defence financial and budget management obligations and an awareness of technical accounting processes. These courses are aimed at general manager roles as well as senior officers more directly involved in financial management functions. The majority of the Senior Leadership Group will complete their course by early 2006-07.
- Financial Management Training – a significant effort is being placed on the development of financial management training which has application across much of the 'Pathways'. In particular:
 - Three new induction courses have been introduced and have been rapidly taken up by staff. The courses cover introduction to financial management, accounting and asset management in Defence.
 - A contract has been let for the development of eight competency assessed courses at the Certificate IV level. These courses are aimed at those with a significant role in financial management and who require formal accounting qualifications, and for middle level general managers who require or desire a more detailed level of knowledge than that provide at induction course level. These courses, which will become available in the second half of 2006, are:
 - Managing money in accordance with the rules;
 - Planning and budgeting for success;
 - Monitoring and reporting on financial achievement;
 - Managing assets and inventory;
 - Ensuring data quality;
 - Preparing financial reports;
 - Costing activities and outcomes, and
 - Managing budgets and forecasts.
 - Role-specific training is under development for those undertaking particular job-related duties with significant or particular financial management content. This work is limited at present (for example, training for Defence attaches, Executive Assistants, and in strategic

policy-related financials) but is expected to grow as the Financial Controls Framework identifies key financial management functions and processes.

- Financial delegate training has been incorporated into existing courses and an e-Learning module will be available from July 2006.
- Financial Enterprise Resource Planning Training – Financial systems training is being redeveloped to allow people to become job ready more quickly and provide the necessary levels of assurance that participants have gained the required skills to the required performance level. Work in this area includes:
 - a review and update of all course material to ensure up to date policy and process content;
 - use of a modular approach to re-design courses ensure participants receive the training they need and are not required to undertake unnecessary training;
 - moving more from instructor led to student driven self paced training;
 - integrated skills testing so that managers and supervisors can have greater assurance that staff undertaking training can perform the required functions properly on return to the work place, and
 - initial scoping of the training requirements for the move to the upgrade of the ROMAN (corporate accounting) system.

Thirteen revised training modules have been implemented with the balance of 22 modules to be completed through 2006-07.

Resourcing Financial Training

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

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

These funds will provide for: the re-development and updating of existing financial training packages; new training packages to meet identified skilling improvements; improved regional skilling delivery; the broader professional development of finance staff; support to audit remediation; the establishment of skilling to underpin the Financial Controls Framework in particular the Certification Framework, and the evaluation of the skilling delivery and the overall effectiveness of Defence's financial skilling approach. Critically the funds recognise the 'through-life' cost of skilling – analysis, development, delivery, assessment and review, ongoing delivery and maintenance, and costs associated with competency and certification frameworks.

1.4 INFORMATION MANAGEMENT SYSTEMS REFORM

Defence has three information management systems that support:

- financial management – financial system;
- personnel management – PMKeyS, and
- logistics management – SDSS.

The operational effectiveness of these systems is dependent upon successful performance of all their key elements - the information architecture and supporting hardware (such as servers and bandwidth); the core software; supporting business processes (both their design and compliance with them); data on the system (both its input and its quality); user training and competence; and reporting, compliance monitoring, investigation and audit processes. Shortcomings in any of these elements may impact on the systems and their capacity to support both the management and operational needs of Defence. Equally, the ongoing refinement and future development of the systems requires attention to all of these elements.

The Financial System – ROMAN and BORIS

The system deploys a commercial off-the-shelf SAP Environment. It is a robust effective system for the capture, manipulation and reporting of Defence financial information. This is evidenced by the relatively low number and level of audit findings with this system, which have been resolved, or are awaiting ANAO sign-off.

The principal transactional system, known as ROMAN, is based on the SAP R/3 application. It encompasses corporate accounting and reporting and is in operation throughout Australia as well as in Washington and London.

The primary budgeting and financial reporting tool is known as BORIS and is based on the SAP Strategic Enterprise Management and Business Warehousing applications and enables the input of budget data by Group and the development of consolidated budgets for the whole of Defence. BORIS is the principle financial reporting tool for output, financial statement, monthly variance and expenditure aggregation.

While ROMAN is an effective system, the current version is now eight years old and will become more difficult to support without increasing costs to develop responses to emerging business needs. A limited upgrade of ROMAN will be undertaken. This upgrade will be funded through Project JP 2080 Phase 2B which also includes funding for the major upgrade of the personnel management system, PMKeyS.

First-pass approval for the upgrade was granted on 12 July 2005. A Request for Tender for the upgrade of ROMAN was released to industry on 27 August 2005. Tender evaluation was completed in December 2005 and second-pass approval and project commencement is expected in the third quarter of 2006.

Broadly, the upgrade will:

- perform a technical upgrade of the SAP software and associated configuration;
- introduce some functional improvements;
- meet the requirements of the AIFRS and ensure the upgraded system addresses audit concerns, and
- base ROMAN on the latest supported software version.

More specifically, the upgrade will deliver the following system improvements:

- A sound software platform ensuring Defence receives better value from using commercial-off-the-shelf software through access to developing industry technological improvements and support of commonly accepted standards in financial management and reporting.
- The provision of a better, more efficient user interface across the accounting modules.
- Technology improvements, such as a greater capacity for Web enablement.
- Improved functionality for the reconciliation of Funds Management records with the General Ledger, saving time and providing more reliable reports.
- Expenditure limits being applied using endorsed budgets, adding a significant automated control to the financial system.
- A Flexible Ledger facility that will better capture costs against outputs, programs and other relevant parameters, largely replacing the current cumbersome and imprecise cost attribution approach.
- The replacement of a Defence developed module for cash management reporting which is complex and costly to maintain.

Personnel Management - PMKeyS

PMKeyS is the principal personnel management information and payroll system for Defence. It is based on the PeopleSoft (now part of Oracle) Software Version 7.5 application, a commercial off-the-shelf personnel information system.

PMKeyS went live in October 1999 for personnel administration and payroll for approximately 18,000 civilian employees in Defence including the DMO. Since July 2002, PMKeyS has catered for the more complex personnel management of the ADF and Reservists (some 75,000 members) with an interface to two legacy ADF payroll systems.

PMKeyS is now well established and incorporates an expanding intranet-based employee self-service and workflow technology. Self-service allows staff to view and edit their personal data and to apply for, and have approved, leave. It has commenced the streamlining of business processes, the empowerment of users and the improvement of data quality.

The ANAO was critical of the planning and approval processes and contract and project management conducted for the original PMKeyS implementation project during the period 1997-2002. Defence accepted the Audit Office recommendations and the lessons learned have been embedded in the conduct of the forthcoming

PMKeyS upgrade project. This is being managed consistent with the Kinnaird reforms to procurement projects.

The PMKeyS system is subject to audit each year by the ANAO as part of the information technology audit controls program for the annual financial statements. Over the past three years, Defence has worked closely with the Audit Office to improve and enhance system controls and processes.

PMKeyS is an ageing system and as the level of support for the software falls the cost of its support and upkeep will increase. Many PeopleSoft customers have either commenced or completed upgrading their systems to the current Version 8 release. JP 2080 Phase 2B will upgrade PMKeyS (and ROMAN) to current software releases to improve supportability and reliability, avoid substantial increases in support costs, and provide improved flexibility to respond to emerging business requirements such as financial reform.

The PMKeyS upgrade will also transfer ADF payroll transactions and management to PMKeyS, thereby bringing all Defence personnel and payroll functions together on a single system.

Logistics Management - The Standard Defence Supply System (SDSS)

The SDSS is an inventory management system that controls items of supply that support the ADF and its operational capability. It commenced operation in 1993. The core software is MIMS (provided by MINCOM Ltd) and is complemented by interfaced applications that include Defence-built CENCAT (NATO cataloguing and codification), NAVALLOW (Navy allowance management), CVS (cargo visibility) and commercial systems - AIMS (inventory optimisation software) and SLIMS/AMPS (shipboard inventory management).

As an integrated system, SDSS manages identification, procurement, requirements determination, warehousing, requisitioning and demand fulfilment, entitlement management and cargo tracking. This functionality enables the management of Defence's end to end supply chain from supplier through Defence warehousing down to unit level holdings within the three Services logistics operations. It supports operational platforms and the units that use them when on operations.

There are increasing demands on the logistics information system - arising from the increased operational tempo and deployment of the ADF; the increased number and dispersal of users; the introduction of accruals-based accounting; and advances in computing technology. There are acknowledged shortcomings in the performance of SDSS, related primarily to system controls, business process compliance and data quality. SDSS has also been subject to both assurance and performance audit by the ANAO. A performance audit of the SDSS Upgrade project, concluded in 2003, found deficiencies in project management and approvals that were acknowledged and addressed. Recent assurance audits, as part of the annual audits of Defence financial statements, have found continuing problems with the quality of the data held on SDSS. In addition, a 2005 assurance audit found that there was an insufficient level of controls reliance across SDSS and associated business processes.

The future development of SDSS (at a total cost of \$245m, including contingencies and subject to approvals) is focussed, therefore, on:

- a) Addressing identified shortfalls in current performance, particularly the introduction of an enhanced information technology controls framework; enhanced business processes; improved reporting capabilities; greater compliance monitoring and testing; validation of data; and remediation of a date processing problem (the Julian date issue). These measures will improve the way in which the system is utilised by Defence and the compliance of users with the mandated business processes which SDSS is designed to support.
- b) Continuing the future development path and introducing greater functionality through Project JP2077 (Improved Logistics Information Systems), the next phases of which will deliver new core software, increased financial functionality, improved in-transit visibility, an improved deployable capability and a radio frequency identification capability.
- c) Continuing refinement of current applications and improvement of functionality, business processes, training and assistance to users to be achieved through normal sustainment and business activities. Specific measures include the introduction of a local site administrator network, the establishment of specialist advisory teams that provide training and process and systems expertise to assist local units with their particular needs, an enhanced Help Desk function, and an increased training effort.
- d) Project JP2077 includes several phases which are at varying stages of approval and completion. Phases 1 and 2A that define the capability requirements and set the strategic direction for development and implementation have been completed. Phase 2B attained first pass approval from the Government in June 2005. Second pass approval for Phase 2B.1 and Phase 2B.2 will be sought late in 2006. Phase 2C gained second pass approval from the Government on 1 July 2005 and is planned for completion by the end of 2006. Phase 2D follows on from the core upgrade to consolidate/rationalise other legacy logistics systems and first pass approval is planned for the end of 2006.

“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.” **Section 5.190 Australian National Audit Office Report No.21 2005-2006**

2. PROGRESS IN IMPLEMENTING DEFENCE'S FINANCIAL REMEDIATION PLANS

This section provides details in relation to Defence's progress in implementing financial remediation plans, comparison with international best practice and further measures:

- What the Auditors Have Found
- Progress in Implementing Audit Remediation Plans: An overview of progress and summary of our general and specific remediation plans.
- Future Management of Audit Remediation Plans: How we will manage audit remediation plans going forward.
- Overseas Remediation: An overview of audit remediation being undertaken by international defence organisations.
- Further Challenges: An overview of the adoption of International Financial Reporting Standards.
- Further Measures: Comment on whether there are further measures that can be adopted.

2.1 WHAT THE AUDITORS HAVE FOUND

The ANAO has issued a disclaimer opinion in respect of Defence's financial statements for the past two financial years, i.e. 2003-04 and 2004-05. On those occasions the Secretary and the Chief Financial Officer were unable to form an opinion as to whether the financial statements provide a true and fair view of the financial position of Defence, its performance, or related cash flows. Consistent with this, the ANAO issued qualified audit opinions. The qualified audit opinions stated that certain uncertainties relating to the financial statements were pervasive and therefore prevent the ANAO from forming a view on the financial statements as a whole.

The findings of Defence management and the ANAO for 30 June 2005 can be found in the *Defence Annual Report 2004-05*.

2.2 PROGRESS IN IMPLEMENTING REMEDIATION PLANS

“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 programs to address, inter alia, the various matters raised in this and previous ANAO reports.” **Section 5.225 Australian National Audit Office Report No.21 2005-2006**

Defence is currently working through 141 ANAO audit findings comprising 95 from 2003-04 (including 38 brought forward from previous years) and 46 from 2004-05. Of the 141 findings, 40 have been signed off by ANAO as completed, a further 31 are with ANAO for review and another 35 will be referred for sign off by 30 June 2006. Accordingly, we expect to have remediated 106 of the audit findings by 30 June 2006. The majority are expected to be finalised during 2006-07.

Different Categories

The 141 findings comprise 46 Category A, 65 Category B and 30 Category C findings. The categories of findings refer to:

Category A

Those matters, which pose business or financial risk to Defence and must be addressed as a matter of urgency. A category A assessment takes account of both the likelihood and consequences of the risk eventuating.

Category B

Those matters, which pose moderate business or financial risk to Defence, or matters referred to management in the past and which have not been addressed satisfactorily. These are matters where the consequences of the weakness might be significant but there is little likelihood of the consequences eventuating.

Category C

Those matters, which are procedural in nature or minor administrative failings, including relatively isolated control breakdowns, which have been brought to the attention of management.

While the findings impact on our capacity to deliver clear financial statements, some do so more directly. Of the findings, 29 Category A, 17 Category B and 5 Category C findings relate directly to the financial statements qualifications which cover inventory; intangibles, infrastructure, plant and equipment; and employee leave provisions. The breakdown of audit findings by category against these areas of qualification is:

Inventories: 24A, 14B, and 5C.

Infrastructure, Plant and Equipment and Intangibles: 2A and 2B.

Employee leave provisions: 3A and 1B.

An overall summary of, and progress against, the audit findings is below.

Progress against the Audit Findings

Category	Outstanding Findings			Findings with ANAO		
	Findings	Packages Sent	Balance Outstanding	Packages Sent	ANAO Closed	ANAO Reviewing
Pre 2003-04						
A	17	(8)	9	8	(0)	8
B	19	(15)	4	15	(11)	4
C	2	(2)	0	2	(1)	1
Total	38	(25)	13	25	(12)	13
2003-04						
A	10	(6)	4	6	(1)	5
B	29	(22)	7	22	(13)	9
C	18	(13)	5	13	(10)	3
Total	57	(41)	16	41	(24)	17
	95	(66)	29	66	(36)	30
2004-05						
A	19	(0)	19	0	(0)	0
B	17	(3)	14	3	(3)	0
C	10	(2)	8	2	(1)	1
Total	46	(5)	41	5	(4)	1
Total	141	(71)	70	71	(40)	31

What is remediation?

Remediation in this context is about correcting adverse financial issues highlighted through audit or monitoring activity. Financial remediation is also about preventing the escalation and future occurrence of financial problems by improving the financial management environment and activities, including financial systems, processes and procedures. Defence has applied this approach in managing its audit findings.

All 141 findings have addressed by one of 16 remediation plans, each of which is providing a project management approach to remediating audit findings that have a similar focus. The plans ensure that synergies, integrated issues and solutions and cost effective opportunities are not overlooked. By working through the findings in this way, we will be able to remove financial statements qualifications and improve our financial management. The plans are:

Defence Remediation Plans

General Remediation Plans

- G1 Financial Reporting Framework
- G2 Managing the ANAO Annual Audit Process
- G3 Financial Management and Systems Training – Financial Business Management

Specific Remediation Plans

Inventory

- S1 Stores Record Accuracy
- S2 General Stores Inventory Pricing and Accounting
- S3 Supply Customer Accounts
- S4 Explosive Ordnance
- S10 Stock Holding Controls
- S11 SDSS Items “Not-In-Catalogue

Leave

- S5 Military Leave Records
- S6 Civilian Leave Records
- S7 Executive Remuneration

Property

- S8 Property Valuations
- S12 Provisions for Contaminated or Potentially Contaminated Land, Buildings and Infrastructure
- S13 Commitments and Accounting for Leases

Other

- S9 Preventing the Escalation of Category A & B Findings

A summary of the status of each remediation plan, projected through 2005-06, follows.

G1: Financial Reporting Framework

The G1 Plan contains five Category A and three Category B audit findings covering issues relating to the Financial Reporting Framework through to Goods Received/Invoice Received Accrual.

The Defence financial management system has been subject to ANAO findings over a period of years. The aim of this remediation activity is to provide a best practice financial management framework for Defence. For each of the key Balance Sheet elements the framework will comprise the key policies, processes, skilling requirements, risk assessments, controls identification and procedures against which ongoing conformance monitoring and performance assessment will be undertaken. An ongoing maintenance and monitoring regime will be instituted to ensure that the framework remains current into the future.

More detail on the financial controls framework is at section 1.2.

Under this framework in 2005-06, Defence has:

- identified gaps in existing financial management policies, processes, controls and procedures;
- identified 508 inventory controls, 186 system based controls within SDSS, and 322 non-system business process controls;
- developed and introduced financial training courses for:
 - the Senior Leadership Group,
 - Senior Officers,
 - induction training, and
 - modularised enterprise systems training, and.
- aligned financial management modules to Certificate and Diploma qualifications and developed e-learning module for financial delegations training.

In 2006-07, Defence will:

- identify and document the key financial controls required in each of the key Balance Sheet areas;
- develop a financial risk management system across Defence;
- deliver financial management modules aligned to Certificate and Diploma qualifications;
- complete modernisation of enterprise systems training;
- expand financial management induction training; and
- remediate remaining financial reporting framework audit findings.

Preparation for the 2005-06 Financial Statements. In addition to its remediation work, Defence has initiated a series of actions geared to more timely and compliant development and production of its financial statements. The initiatives relate mainly to developing better understanding within Defence of financial statements obligations, and achieving more consistency between areas of the parameters and sources of the data and information that inform the statements. In particular:

- With the assistance of professional advisers, and closer engagement with the Department of Finance and Administration and the ANAO, Defence has documented its approach to reporting balance sheet items in the 2005-06 financial statements.
- The role and reporting requirements placed on Group Finance Officers and Group Heads has been strengthened, including bi-annual compliance sign offs.
- A series of accounting position papers have been developed on each of the key accounting areas which, under the AIFRS, create significant overheads for Defence. The papers seek agreement on the way forward with the application of the standard particularly in respect of the removal of unintended consequences of standards application. The position papers cover the following topics: AASB1 Transition, Inventory Accounting Policy, Asset Recognition and Depreciation, Decommissioning Provisions for Specialist Military Equipment, Leave Entitlements, Restoration Provision, Embedded Derivatives, and Heritage and Cultural assets. Discussion on the implications of the adoption of AIFRS is at section 2.5.

- The Group Finance Officer Forum has been re-focused to address budget and financial reporting issues.
- Enhanced project management practices such as time tabling and standardised processes, have been applied to Defence's annual financial reporting processes.
- A hard close (dress rehearsal for year end) has been reintroduced for the end of February each year.
- Defence has worked closely with the Australian Accounting Standards Board (AASB) on the AIFRS transition issues and other reporting matters of interest to Defence such as inventory.
- A model work paper pack that encourages preparers to analyse and structure their working papers has been introduced to assist management review and audit scrutiny.
- Several new external quality assurance activities over specific aspects of Defence's 2005-06 financial reports have been introduced, including work paper production, compliance with the AIFRS, and the reliability of the DMO's accounting entries raised in Defence financial records.
- External expert financial and accounting assistance has been engaged on valuations, technical accounting advice, and a range of process improvement and remediation activities.

G2: Managing the Australian National Audit Office Annual Audit Process

It is crucial for Defence to have clear agreement with the ANAO on timelines, methodologies and both parties' expectations of deliverables in order to finalise annual financial statements. To facilitate this Defence has appointed an accountable officer to manage audit activities between Defence and the ANAO. The primary tasks in this role are to:

- Manage the ANAO relationship;
- establish and maintain a network of Defence Audit Liaison Officers to facilitate the efficient and effective management of the audit remediation plans;
- produce position papers on audit issues, and
- establish comprehensive procedures for quality assurance and clearance of audit findings.

Defence is committed to improving its relationship with the ANAO and will maintain these efforts throughout 2006-07 and the future.

G3: Financial Management and Systems Training – Financial and Business Management

A consistent theme in ANAO audit findings is the requirement for Defence to enhance skills in the execution of financial management procedures and the level of adherence to approved procedures in the use of Defence corporate information technology systems. The ANAO has made some targeted recommendations with regard to enhanced training to address knowledge and skills in the enterprise resource planning systems of ROMAN (financial), PMKeyS (personnel) and the SDSS (supply).

In order to address these issues Defence is developing and delivering training courses designed to improve financial and business knowledge and skills.

In 2005-06, Defence has developed stronger links between training and systems access, including a PMKeyS Assessment Strategy introduced on 30 December 2005. Key achievements include:

- stronger links between training and PMKeyS access;
- an initial evaluation of ROMAN courses leading to the modularisation of 13 ROMAN training courses to better target the needs of individual job roles;
- improved PMKeyS training;
- the development of Key Performance Indicators and metrics for measuring and analysing training effectiveness;
- a three year rolling evaluation program of PMKeyS courses;
- two financial management training courses for Executive Level 2 officers and military equivalents to follow up last financial year's introduction of a Senior Leadership course;
- 3 induction level financial courses; and
- development of 8 Certificate IV level financial management courses.

Detail on Defence's financial training effort is at section 1.3 and appendix A, and shows that to date 2005-06 training has been attended by 9,400 staff.

S1: Stores Record Accuracy

The S1 Plan includes nine Category A and three Category B audit findings, ranging across issues such as SDSS Warehouse Transaction Monitoring and Exception Reporting to Explosive Ordinance Quantities.

Defence 'self-qualified' stock quantities relating to general stores inventory and repairable items in 2003-04 and again in 2004-05 following adverse stocktake results. The ANAO noted material weaknesses in internal controls over stocktaking, failure to accurately record and report physical asset quantities, and inadequate system controls to safeguard the accuracy of data. This resulted in a significant range of uncertainty around general stores inventory and repairable items balances.

During the 2003-04 systems audit of SDSS, the ANAO indicated that the control and compliance mechanisms were not adequate and therefore did not provide assurance about the data in the system.

Defence has undertaken to remediate the general stores inventory and repairable items qualification by:

- correcting errors in stores record quantities in SDSS;
- promulgating and ensuring compliance with stocktaking policy to improve stocktaking practices and reporting;
- implementing stronger controls in SDSS, and
- establishing a sustainable compliance and assurance framework across Defence.

In 2005-06, Defence has:

- completed 100 per cent of stocktakes at the major warehouse sites at DNSDC Moorebank and Bandiana;
- implemented an enduring cyclic stocktake program across Defence;
- improved reporting to the Defence Audit Committee;
- identified requirements to enhance stocktaking capability in SDSS;
- agreement on a compliance and assurance framework across Defence;
- increased accuracy around repairable items and general stores inventory, and
- progressive implementation of stronger information technology controls, such as in the SDSS Information Technology Controls Framework.

In 2006-07, Defence will:

- implement the agreed Compliance and Assurance framework across Defence;
- sustain and improve information technology controls and process compliance;
- establish a Director General Logistics Assurance capability;
- achieve further improvements in data recording and accuracy, and
- prepare a S1 Remediation Plan closure plan, expected to be completed by June 2008.

S2: General Stores Inventory Pricing and Accounting

The S2 Plan contains ten Category A and three Category B audit findings ranging across issues such as SDSS General Stores Inventory Pricing to SDSS Classification Corrections.

The 2003-04 financial statements had a limitation of scope qualification of approximately \$2.026 billion with regard to uncertainty around the general stores inventory balance. The reported uncertainty was reduced to \$1.294 billion in 2004-05 as a result of an increased obsolescence provision.

At issue was Defence's ability to produce, in a timely manner, invoice and contract documentation to validate the recorded prices in SDSS. The concerns of the ANAO included the need for accounting policy to ensure the correct treatment of general stores inventory.

Inventory pricing issues have been assessed in light of the AIFRS. Under AIFRS, Defence is required to record inventory at the lower of cost or replacement cost. This provides Defence with some significant challenges in regard to the reporting of inventory balances. Defence has a significant amount of older inventories that have been held for many years. As a consequence, it is difficult to determine the replacement cost of certain items in its inventory holdings. By way of example, Defence holds approximately 160,000 lines of inventory which are turned over on a regular basis, and an additional 600,000 lines of static inventory. This represents tens of millions of individual inventory items. Compliance with AIFRS would require Defence to revisit the value of cost, and replacement cost, of all inventory items on a monthly basis. Any such activity would require a significant administrative effort, with limited incremental value. Defence has written to the Australian Accounting Standards Board to seek further clarification in regard to the valuation of inventory

and relief from what we believe are unintended consequences in this area of the standards.

In response to this finding, Defence nevertheless will proceed to remediate the general stores inventory pricing and accounting qualification by:

- developing a statistical model to validate legacy (pre-1997) priced items;
- implementing an exception reporting regime to provide quality assurance;
- establishing policies and procedures for inventory pricing controls on SDSS, and
- establishing policy to ensure the correct treatment of general stores inventory.

In 2005-06, Defence has completed a major price stratification task. This resulted in the identification of a range of legacy pricing issues where adequate confidence levels were not achieved across certain prices. The stratification work has also determined that reliable pricing surrogates are not available to validate or error correct existing legacy prices. Further options have been canvassed but have been deemed highly resource intensive with no assurance of an auditable outcome being achieved.

In 2005-06, Defence has also:

- completed a review of the AIFRS to determine system and data retention impacts for multiple pricing records;
- commenced development of financial framework requirements for inclusion in the replacement logistics system;
- initiated action to improve internal controls over new priced information within SDSS, and
- refined the detective and management reporting regime introduced to provide a basis for quality assurance reviews of in-year inventory prices.

In 2006-07, Defence will continue to progress the overarching objectives and activities for this Plan. This will enable the confirmation of a number of fundamental aspects for inventory accounting including what items are classified as inventory, and how AIFRS accounting will be implemented. Defence will also complete the inventory controls framework and introduce an AIFRS compliant replacement logistics system beyond 2006-07. Business process compliance and system control programs, including pricing aspects, will be monitored and improved as part of normal ongoing business processes.

“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.” **Section 5.188 Australian National Audit Office Report No.21 2005-2006**

S3: Supply Customer Accounts

The S3 Plan contains one Category A audit finding dealing with SDSS Supply Customer Accounts.

A supply customer account is a location indicator within SDSS used to track and manage assets and accountable inventory moving through the supply chain, predominantly outside a warehouse structure.

The 2003-04 financial statements had a limitation of scope qualification with regard to the uncertainty around the repairable items balance, of which supply customer accounts are a subset of \$2.857 billion which was reduced to \$2.722 billion in 2004-05. The ANAO were concerned with the controls and management of supply customer accounts, including repairable items, and adherence to stocktake procedures.

Defence is remediating the supply customer account element of the repairable item quantities qualification by:

- allocating all supply customer accounts an accountable owner;
- ensuring all supply customer account balances on SDSS are correct, and
- improving business processes and controls for supply customer accounts.

This has involved making improvements to data creation, maintenance and reporting to ensure accurate quantity. Ownership and location details are entered and maintained for all supply customer accounts on SDSS.

In 2005-06, Defence has identified accountable owners for all supply customer accounts. An enduring cyclic stocktake program has been put in place across Defence, and repair vendor supply customer accounts arrangements have been revised to improve management and control between repair vendors and system program offices. In addition to these activities, Defence has:

- completed stocktaking at the key warehouse locations of DNSDC Moorebank and Bandiana;
- reviewed the 33,000 Supply Customer Accounts and increased the controls and compliance resulting in 15,000 accounts being closed, and
- established an agreed process for verification of items in Supply Customer Accounts held by contractors.

Defence plans to close this Remediation Plan in 2006-07. The ANAO agreement to a closure package will be sought and improvements to business processes, information technology controls and compliance around Supply Customer Accounts will be sustained.

S4: Explosive Ordnance

The S4 Plan contains two Category A, eight Category B and five Category C audit findings, ranging across issues such as explosive ordinance pricing, UNIX vulnerabilities and security access management of the computer environment.

The 2003-04 financial statements had a limitation of scope qualification of \$845m relating to uncertainty around explosive ordnance pricing. This was reduced in 2004-05 to \$309m. At issue was Defence's ability to produce, in a timely manner, invoice and contract documentation to validate \$162m of the explosive ordnance inventory prices recorded in the explosive ordnance procurement management system, Computer System Armaments (COMSARM); and a further \$147m the ANAO requested to be written down but which was contrary to Defence's accounting treatment of inventories as at 30 June 2005.

The ANAO and Defence are discussing the accounting treatment of the \$162m which does not have documentation, and are considering options to finalise this matter.

The remainder of the qualification predominantly relates to direct purchase items and items acquired as part of asset under construction contracts between 1982 and 2000.

Defence is continuing to source (where possible) original documentation to substantiate explosive ordnance inventory prices. Tools are being developed to substantiate explosive ordnance inventory values when appropriate supporting documentation cannot be located. Defence is working to improve and integrate explosive ordnance inventory accounting and systems management processes. These changes are designed to confirm the accuracy of asset values and enable adherence to financial management standards.

In 2005-06, Defence has:

- upgraded and validated the COMSARM Explosive Ordnance management system graphical user interface;
- commenced development of policies and methodologies related to the new explosive ordnance provision for obsolescence qualification;
- produced audit closure packages for nine of the remaining twelve findings including all outstanding COMSARM system findings; and
- commenced development of methodologies and implementation strategies to ensure COMSARM system compliance with AIFRS.

In 2006-07 Defence will continue remediation action on explosive ordnance unsupported pricing. In particular, explosive ordnance inventory processing and reconciliation policies and procedures will continue to be improved.

S5: Military Leave Records

The S5 Plan contains one Category A audit finding addressing military employee leave provisions.

The 2003-04 financial statements had a limitation of scope for military leave provisions because insufficient supporting documentation was available for leave records.

While military long service leave was unqualified in 2004-05, Defence 'self-qualified' all other components of military leave for 2004-05.

Defence is addressing this limitation of scope by substantiating the military leave balances through controls that will validate balances, and by undertaking substantive testing (involving sampling of individual leave balances) and analysis of long term personnel and leave balance trends.

Throughout 2006-07 Defence will continue to refine and implement military leave remediation plans drawing on the outcomes from a sampling and controls review. This will allow Defence to achieve fully unqualified military leave balances on an enduring basis.

In order for Defence to remediate the military leave balance, the following activities are being executed over the next four months to eliminate the uncertainty on the reported leave balances in the 2005-06 financial statements.

- Review of Leave Controls
The review will identify key controls for leave entitlements and undertake limited walkthrough tests to validate the operation of the key controls. The review will enable management to assess the effectiveness of controls in place and determine the extent of reliance management can place on controls in asserting the accuracy of the balance of leave entitlements.
- Testing of Leave Transactions
A sample of leave transactions will be tested to determine whether the leave records for the sample agree with supporting documentation in regard to Defence's obligations to employees. A preliminary sample of 297 transactions across military and civilian annual and long service leave has been selected for testing. The testing of leave transactions will provide a level of substantiation of the recorded leave balance as at 28 February 2006.
- Analytical Estimation
Analytical procedures will be undertaken to estimate the balance of leave entitlements as at 30 June 2006, and potentially 2005. This analytical estimation will provide a level of substantiation of recorded leave balances. The analytical procedures will include analytical review of the roll-forward of leave entitlement as at 28 February 2006, the date of sample testing of leave transactions, to 30 June 2006. This roll-forward will enable management to ensure that the assurance obtained over leave entitlements as at 28 February 2006, as a result of the sample testing of leave transactions, can be extended to leave entitlements as at 30 June 2006.

S6: Civilian Leave Records

Plan S6 has one Category A and one Category B audit finding covering civilian leave provisions and leave plans in PMKeyS.

Civilian leave records in the 2003-04 financial statements reflected the same problems experienced with military leave and attracted the same limitation of scope. Sufficient supporting documentation was often not available.

Defence 'self-qualified' civilian annual and long service leave for 2004-05. In addressing this issue, Defence is working to substantiate the civilian leave balances by

relying on controls to validate balances; and undertaking substantive testing involving sampling of individual leave balances and analysis of long term personnel and leave balance trends.

Defence is aiming to eliminate the uncertainty on the reported leave balances in the 2005-06 financial statements. Refer to S5: Military Leave Records above for details of specific actions being carried out by Defence in order to remediate the civilian leave balance for the 2005-06 financial statements.

In 2006-07 Defence will continue to implement civilian leave remediation plans, which will be refined through outcomes from sampling and controls review, again leading to fully unqualified civilian leave balances on an enduring basis.

S7: Executive Remuneration

The S7 Plan contains one Category A audit finding addressing limitations of scope in executive remuneration.

Executive Remuneration could not be reliably certified because of the concerns over military and civilian leave provisions.

Defence is conducting a 100 per cent audit of all Senior Executive Service and military equivalents leave records for 2005-06 and will continue to implement reporting requirements for Executive Remuneration that include:

- applying quality assurance to business processes;
- record keeping strategies;
- reporting structures;
- relevant policy foundations and training initiatives, and
- a controls framework.

The 100 per cent audit of all Senior Executive Service and military equivalents leave records will be completed in 2005-06, with audit findings to be finalised in 2006-07.

The ANAO has received the proposed remediation approach and have stated in their letter of 1 February 2006 that “the approach outlined is appropriate on the basis that nothing significant arises from our assessment of current year controls and processes and the relevant substantiation”.

S8: Property Valuations

The S8 Plan contains one Category A audit finding addressing property valuations.

In 2003-04, the ANAO issued a 'limitation of scope' for land, buildings and infrastructure and other plant and equipment as shortcomings were identified in associated project management, reporting practices and management review functions. The requirements to be met by the Australian Valuation Office were not fully and adequately documented and Defence was considered to have misinterpreted the results of revaluations and incorrectly applied depreciation. A particular consequence was the misapplication of remaining useful life data provided by the independent valuer. This affected both the valuation adopted by Defence and the

reported depreciation expense. This was rectified for \$1.228 billion in 2004-05 with the remaining uncertainty being measurement of certain assets with a reported book value of \$103m.

Defence revised the Australian Valuation Office engagement letter to clarify valuation policy, procedures and outcomes. The Australian Valuation Office is contracted to revalue all land, buildings and infrastructure and other plant and equipment assets (this represents approximately 47,000 separate identifiable assets spread over 1,600 Defence sites) to fair value in accordance with policy guidance. Other measures being implemented include:

- undertaking a quality assurance on Australian Valuation Office site reports to ensure completeness;
- entering revaluation data into the ROMAN financial system and completing revised depreciation calculations;
- engaging a valuation contractor, and
- fully documenting the revaluation process in the Corporate Services Asset Management and Accounting Manual.

In 2005-06, Defence has:

- completed the depreciation calculations;
- completed the valuations of other plant and equipment for the Chief Information Officer environment;
- undertaken a quality assurance process of valuation data and loaded the data into the financial system (ROMAN), and
- finalised tender evaluation and engaged valuation contractor for the next three year cycle from 2005-06 to 2007-08.

Defence will continue the revaluation program throughout 2006-07 to ensure an enduring solution, with completion of the Remediation Plan by June 2006.

“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.” **Section 5.227**
Australian National Audit Office Report No.21 2005-2006

S9: Preventing the Escalation of Audit Findings

The S9 Plan contains those audit findings not allocated to a General or Specific Remediation Plan to ensure each finding is remediated.

Defence also has recognised the clear need to improve the outcome, focus and management of the implementation of solutions to ANAO findings.

To prevent the escalation of audit findings Defence has assigned responsibility for remediation of audit findings not already allocated to a remediation plan, and

established a project-based management system for tracking and managing their resolution. Both progressive and final quality assurance of the remediation outcomes will be conducted. Monthly detailed reports on the progress of the remediation activities are provided to the Financial Statements Project Board and the Defence Audit Committee.

S10: Stock Holding Controls

The S10 Plan contains one Category A audit finding concerning SDSS to ROMAN reconciliation.

Items 'first found' are items of either asset or inventory that do not have a corresponding record on an authorised Defence asset register. Where a check of stock holdings shows that the Defence register record varies from the physical quantity, an investigation into the discrepancy is required and the outcome may be an adjustment to the Defence Register record, and/or a corresponding financial adjustment.

While it is accepted that the normal stock management processes will require a certain level of adjustment activity, current levels of adjustment are considered too high and indicate poor adherence to currently approved business processes.

Defence is improving stock holding controls by preventing or reducing the instances of items 'first found' and 'write-offs', and is accounting for and monitoring those instances of 'first found' and 'write-offs' considered to be legitimate or expected. The remediation activities focus on preventing errant transactions on SDSS through improvements in policy, procedure and system process, and the introduction of investigative reporting to measure compliance.

In 2005-06, Defence has:

- completed all S10 remediation activities;
- revised and promulgated supply chain policy and procedures relating to lost or damaged items and item tracking;
- strengthened segregation of duties and other controls relating to stock adjustments, and
- enhanced controls, monitoring and reporting relating to item tracking, repairable items and receipting discrepancies.

The Remediation Plan will be closed out in 2006-07.

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

The S11 Plan contains one Category A audit finding addressing Not-In-Catalogue items.

Defence is investigating the extent to which items may have been incorrectly accounted for in the Statement of Financial Position. This may occur when an item is purchased via the ROMAN financial system or through the Defence Purchasing Card and then not recorded and managed on SDSS. Such items are managed and tracked locally with no central visibility and this may lead to the incorrect recording and treatment of an item's value.

Defence is addressing the problem by putting measures in place to prevent and remediate Not-In-Catalogue items. This involves clarifying and simplifying policy directives to better support effective item identification, reviewing purchasing and management processes, and driving revised processes and procedures to prevent the future incidence of Not-In-Catalogue.

A 'self-remediation' methodology is being developed for use by units across Defence to ensure financial reconciliation of Not-In-Catalogue items and to transition them into SDSS. The 'self-remediation' methodology incorporates remediation processes, tools and SDSS functionality enhancements. The remediation includes development and implementation of an enhanced compliance monitoring and reporting regime to assist with adherence to new policy and processes pertaining to appropriate item identification in SDSS. A change management structure is also incorporated into the methodology to introduce the changes to processes and procedures across Defence, including coordination of training, compliance monitoring and communications.

In 2005-06, in relation to prevention of Not-In-Catalogue items, Defence has:

- published new and revised policies supporting this Remediation Plan;
- developed processes and procedures to support updated policies, including the process for assignment of ADF logistics managers;
- trained users in prevention and remediation processes and remediation tools, and
- developed and implemented a compliance monitoring framework to support the appropriate level of item identification in SDSS and to tie in with the SDSS compliance monitoring framework.

In relation to remediation of existing Not-In-Catalogue items Defence has:

- enabled groups to establish their Not-In-Catalogue remediation priorities;
- developed and implemented a Not-In-Catalogue remediation methodology for use across all sites;
- developed remediation tools to assist Units to conduct their Not-In-Catalogue remediation, and
- established a progress reporting regime.

In 2006-07, Defence will achieve:

- financial reconciliation of all Not-In-Catalogue items;
- significant progress in bringing all Not-In-Catalogue items into the logistics management system, and
- continuing communications, training of users, reporting and compliance monitoring, in order to prevent any new Not-In-Catalogue items.

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

The S12 Plan contains one Category B audit finding addressing provisions for land decontamination.

Under AIFRS Defence is required to identify and determine the cost of restoring contaminated sites (some 1,600 sites require review) and decommissioning assets

such as specialist military equipment. Defence will include a provision in its financial statements.

The ANAO was unable to verify the adequacy of current procedures of the reported provisions for land decontamination.

Implementation of the Plan is dependent upon the ANAO accepting expert third party recommendations on the methodology proposed to estimate decontamination costs.

Defence is implementing a number of measures to remediate the provision for land decontamination qualification. Accounting policies will be reviewed to ensure they reflect current reporting requirements. Sufficient and appropriate policies, procedures and practices for the identification of contaminated land are being formalised and implemented. A valuation of required decontamination and a review of procedures will also be undertaken and assessments made of the outcomes. Defence will establish, through consultation with the Australian Valuation Office, a clear understanding of matters included in valuation assessments.

During 2005-06, Defence has:

- undertaken an assessment of outcomes of an Australian Capital Territory /Southern New South Wales pilot study;
- summarised costs and created provisions in the financial statements for Australian Capital Territory /Southern New South Wales Defence owned and operated sites;
- developed a final remediation plan including an implementation timetable,
- completed assessments of legal and/or constructive obligations across the Contaminated Sites Register, and
- commenced site assessments for costings.

In 2006-07, Defence will summarise costs and create provisions in the financial statements for Australian Capital Territory /Southern New South Wales leased properties. The Remediation Plan will continue beyond 2006-07 with assessment of the entire Defence estate planned for completion by 2009-10.

S13: Commitments and Accounting for Leases

The S13 Plan contains two Category A, one Category B and one Category C audit findings ranging across issues such as a proposed finance lease on a munitions facility to the master lease register.

Defence and the ANAO are working to resolve the methodology to be used by Defence to recognise and record leases and commitments.

Defence is defining the criteria for recording commitments and establishing a lease register that identifies cash flows, revenues, expenses, liabilities, receivables and commitments. A closure package for the one Category A audit finding of 2002-03 has been submitted and the complete remediation of 2004-05 findings in relation to leases is planned for 2006-07.

2.3 FUTURE MANAGEMENT OF REMEDIATION PLANS

Defence and the DMO are developing an enduring and robust financial management system through its financial controls framework, the renewal of financial skilling and wide-spread improvements to its systems.

Notwithstanding our integrated approach to improving our financial management, Defence will continue to drive its remediation plans. This is evidenced by the resources directed to the remediation work, not simply to achieve closure of findings but more importantly to secure enduring solutions to the matters being raised in the findings.

In 2005-06, \$80m (\$51m in employee expenses and \$29m in suppliers expenses) will be redirected to the remediation work, with a further \$59m (\$47m employees, \$12m suppliers) committed in 2006-07 forecasts. An estimated 422 staff years in 2005-06 and 366 staff years in 2006-07 will be redirected to remediation work.

Importantly though the effort is not focussed solely on execution of the plans themselves. As indicated elsewhere in this submission, in particular in section 1, the lessons learned from audit findings are informing the way in which we are building the policies, processes, skilling, risk management, controls and procedures which will make up our future enduring financial management framework.

Defence will continue to oversee resolution of audit findings through its Financial Statements Project Board which is chaired by the Secretary, comprises members of the Defence Executive (including the CEO DMO) and includes a representative of the Department of Finance and Administration and an external accounting expert. Monthly updates of remediation progress are also provided to the Defence Audit Committee.

Any further audit findings will be managed within appropriate remediation plans encompassing detailed project plans and the appointment of senior level responsible and accountable officers to oversight action officers. The remediation plans will address the cause as well as the effect of an issue identified for remediation with planning for the resolution of both.

Audit liaison officers will continue to operate in each Defence Group to oversight progress with plans at the working level and to keep their responsible and accountable officers apprised. The liaison officers regularly report progress to the remediation program offices in the Chief Finance Officer Group and the DMO. The program offices are the primary point of contact for the ANAO.

“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 on-going assessment of both the timeliness and prioritisation of these remediation activities.” **Section 5.176**
Australian National Audit Office Report No.21 2005-2006

2.4 THE 2005-06 FINANCIAL STATEMENTS POSITION PAPERS

As Defence critically reviewed the outcomes from the 2004-05 financial statements audit, it became apparent that a significant number of findings resulted from differing technical interpretations of accounting standards by the ANAO and Defence.

With the introduction of AIFRS, and to maximise the ability to form an opinion for the 2005-06 financial statements, Defence has worked to form a conceptual view of appropriate accounting practices and to implement these changes prior to the end of the financial year. This requires agreement between Defence, our professional accounting advisers and the Defence Audit Committee. This has enabled initiation of discussion with the ANAO on the validity of the accounting treatments in the papers.

As Defence has progressed this task, it has become evident that some issues cannot be resolved by 30 June 2006 due to the amount of complex work required (eg on inventory). The position papers highlight why the difficulties exist and explain what Defence is doing to achieve compliance. This process will also aid Defence in meeting disclosure requirements.

The development of the position papers has already resulted in modification of some remediation plans and may subsequently warrant the development of remediation plans additional to those already in the program.

The following position papers are in preparation for the development of the 2005-06 financial statements:

1. AASB 1 and Transition to AIFRS. The Australian Accounting Standards Board has recently amended AASB 1⁴ and Defence has reviewed the proposed amendments to ensure that Defence can be a first time adopter for AIFRS as at 1 July 2006.
2. Assertion Validation Framework and Substantiation Methodologies. Defence has missing records that have affected the validation of leave entitlements, and the valuation of inventory. The paper looks at what other methods Defence can use to be able to satisfy itself that the balances on the Statement of Financial Position at year end can be asserted with confidence.
3. Materiality Framework. A materiality threshold of \$350m was applied to the Defence financial statements in 2004-05. This paper considers what the threshold should be in line with the Accounting Standards and the Finance Minister's Orders.
4. Assets Under Construction. This paper reviews the funding models for the Defence/DMO split and discusses the ownership and accounting treatments for Assets Under Construction that arise from the funding models.
5. General Stores Inventory (Accounting Policy). This paper considers the appropriateness of the existing inventory classification. If the inventory

⁴ AASB 1 *First Time Adoption of Australian Equivalents to International Financial Reporting Standards* is the standard that provides agencies with a suitable starting point for accounting under the Australian equivalents to IFRSs by dealing with a number of transition issues.

classification is retained, Defence will have difficulty in valuation when an assessment must be made between cost and current replacement cost at each year end. If it is determined that Defence has a mix of consumables (to be expensed), inventory and depreciable equipment, then the valuation and depreciation of the equipment will have to be assessed.

6. General Stores Inventory (Controls/Quantities). Defence must determine the stocktaking procedures and schedules going forward to address the uncertainty around quantities in SDSS. As appropriate systems and process controls will not be in place this financial year a 100 per cent stocktake to identify a baseline would not achieve that objective in 2005-06.
7. General Stores Inventory (Price/valuation). There is uncertainty due to unreportable values in SDSS. This paper explores the way ahead for arriving at reportable values for that element of General Stores Inventory.
8. Tangible Asset Capitalisation Threshold. Defence was qualified over its assets in 2004-05 due to the use of Asset Capitalisation thresholds. Defence is now considering an approach where tangible assets under the current \$10,000 threshold are pooled by asset type and depreciated as a pool.
9. Repairable Items. This paper will set out a strategy for validating the quantity of Repairable Items reported in the balance sheet.
10. Recognition and Depreciation of Specialist Military Equipment. Defence is reviewing the future economic life of specialist military equipment, how it is valued and the method for measuring its consumption if there is proven future economic value.
11. Leave Balances for Civilian and Military Annual and Long Service Leave. This paper will review the methodology options for substantiating the Military Long Service Leave, Military Annual Leave, Civilian Long Service Leave, and Civilian Annual Leave. In 2004-05 Military Long Service Leave was validated by the ANAO. Management will test the internal controls for the four types of leave liability. If the internal control framework is assessed as not being reliable then Management will adopt a substantive approach to validation of the balances. This approach will be sampling to verify data quality combined with actuarial assessment.
12. Site Restoration Provisions. Provisions for Contaminated land. The distinction between what is capital and what is an expense when decommissioning or restoring an asset in relation to land and buildings will be discussed in this paper.
13. Specialist Military Equipment Decommissioning. This paper will look at what Defence does when retiring an asset or fleet and how this is treated within the face statements in accordance with the requirements under AIFRS.
14. Embedded Derivatives. This paper confirms our approach that we do not have reportable embedded derivatives. A small sample of contracts will be reviewed to confirm our assertion.

15. Cashflow Statement (other than derived). Defence has been qualified on its Statement of Cashflows in the past two financial years because it has been derived from the other two qualified financial statements. This paper considers adjusting our approach whereby the Statement of Cashflows is constructed using the cash management module within the financial management system ROMAN.
16. Free of Charge Agreements between Defence and the DMO. Defence and DMO are determining a position, based on principles which define the scope of what services between the two entities need to be reported as Free of Charge and what is the appropriate method of estimating fair value.
17. Heritage and Cultural Assets. The issue of recognition and depreciation of these assets in Defence is addressed in this paper.
18. Reporting Entity – Consolidation of DMO. The question of whether consolidated financial statements are required for the reporting entity Defence/DMO is considered here. The issue has arisen due to the degree of control that Defence appears to have over DMO's activities.
19. Disclosure and Validation of Executive Remuneration Note. The issue to be addressed in this paper is which entity should disclose military star ranked officers posted to DMO. The basis of disclosure is the Finance Minister's Orders but there is some ambiguity as to whether the basis of reporting is the agency responsible for paying individuals or the agency where they are currently employed.
20. Not-in-Catalogue. This paper sets out the financial statement issues associated with Not-in-Catalogue, as distinct from the logistics management issues, and sets out an approach for 2005-06.
21. Assets Now Recognised/Written-Off/Written-Down. This paper will highlight the changed treatment for these items under AIFRS, in particular, the circumstances when these items go straight to equity.

2.5 FURTHER CHALLENGES: ADOPTION OF INTERNATIONAL FINANCIAL REPORTING REQUIREMENTS

This section provides an overview of Defence's progress, along with the challenges it faces, in respect to the implementation of international financial accounting standards.

In the preparation of its financial statements for 2005-06, Defence (and the DMO) will be subject to the AIFRS (the Australian equivalents to International Financial Reporting Standards). The implementation of AIFRS is a significant change in the financial reporting regime to be applied and results in a number of key changes in the accounting principles to be applied by Australian organisations compared the previous financial reporting regime. The adoption of AIFRS is especially significant to Defence because of its size and nature.

Some of the key impacts to be experienced by Defence can be summarised as follows:

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

Following a number of significant changes in the accounting practices required under AIFRS, Defence has been required to undertake considerable re-engineering in order to establish financial reporting processes to capture data, process transactions and record reportable transactions that would not have been required to be reported under the previous Australian Generally Accepted Accounting Principles (AGAAP) regime. Much of this re-engineering is in progress and is due to be completed, where possible, as part of the preparation of the 2005-06 financial statements.

The following table provides an overview of material differences between AGAAP and AIFRS:

Differences between AGAAP and AIFRS

	AGAAP	AIFRS
Embedded Derivatives	No need to recognise embedded derivatives	Requirement to identify and value embedded derivatives within financial statements
Site Restoration Provision	Restoration costs for properties listed for disposal are taken in to account in the valuation of the property.	Provision required where there is a legal or constructive obligation.

SME Decommissioning Provision	Decommissioning costs not provided for.	Decommissioning costs determined and capitalised in asset cost base.
SME	SME, like all assets, valued at deemed cost	Valued at cost or fair value
Inventory	Recorded at lower of cost or net realisable value.	Record at lower of cost or replacement cost

As stated above, the adoption AIFRS is especially significant for Defence because of its size and nature. In recognition of challenges that would arise as a result the adoption of IFRS, the International Accounting Standards Board issued a Standard entitled 'IFRS 1: First-Time Adoption of International Financial Reporting Standards' that was intended to provide some transitional relief to organisations adopting IFRS for the first time.

The transitional relief provides exemptions for retrospective application in a number of accounting areas including the measurement of property, plant and equipment, restoration provisions and decommissioning provisions. Notably, the conditions required to obtain the transitional relief could not initially be met by Defence due to the qualification of its prior year financial statements and therefore it appeared that Defence would not be entitled to the transitional relief.

Defence wrote to the Australian Accounting Standards Board in late 2005 to seek clarification as to whether the organisation could avail itself of the transitional relief provisions. In response to Defence's submission, and in recognition of difficulties it faced, in February 2006 the Board issued the Proposed Amendment AIFRS 1 which proposes allowing organisations in Defence's position to obtain access to the transitional relief available under AIFRS 1: First-Time Adoption of International Financial Reporting Standards. As a consequence of this, Defence will be able to elect to avail itself of the following relevant relief provisions on transitioning to AIFRS:

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

While this may ensure that Defence is not at an unreasonable disadvantage to other organisations in its efforts to adopt AIFRS for the first time, Defence still faces significant challenges in a number of areas including the establishment of financial reporting processes to capture data, process transactions and record reportable transactions that would not have been required under the previous Australian Generally Accepted Accounting Principles regime.

The key challenges and overheads faced by Defence upon adoption of AIFRS are as follows:

- **Embedded Derivatives** –Defence will be required to identify, value and recognise in its financial statements reportable embedded derivatives. Defence has determined that the likelihood of having any embedded derivatives

requiring separate recognition is remote, however it has established procedures to determine whether any embedded derivatives exist within its approximately 17,000 current contracts. These procedures include review of standard contracting templates, review of policies on the development of contracts, and examination of a sample of contracts to determine whether the standard template is consistently applied and whether any variations create separately reportable embedded derivatives. In addition, processes are in place to further minimise the likelihood of embedded derivatives arising going forward.

(The United Kingdom Ministry of Defence acknowledges that embedded derivatives may exist, but comments in its Annual Report that “because of the largely non-trading nature of its activities and the way in which government Departments are financed, the Department is not exposed to the degree of financial risk faced by business entities” and that such “financial instruments play a much more limited role in creating or changing risk than would be typical of the listed companies”, they are therefore not reported.)⁵

- **Site Restoration and Specialist Military Equipment Decommissioning Provisions** – Defence will be required to identify and determine the cost of restoring contaminated sites and decommissioning assets such as specialist military equipment. In order to demonstrate the magnitude of the effort required to identify and determine the cost of restoring contaminated sites, Defence has some 1,600 geographically diverse sites which will need to be reviewed for contamination. In addition, Defence has specialist military equipment with a written down value of \$30.804 billion, comprising of items such as aircraft, armoured personnel carriers and ships, which will need to be examined to identify decommissioning costs. While Defence has programs in place to manage the decontamination of sites together with planned restoration and decommissioning activities, AIRFS requires the development of a detailed program of identifying reportable obligations and the costs associated with restoration and decommissioning.
- **Measurement of Inventory** – Defence is required to record inventory at the lower of cost or net replacement cost. This provides Defence with some significant challenges in regard to the reporting of inventory balances. Defence has a significant amount of older inventories that have not been replaced, for many years. As a consequence, it is difficult for Defence to determine the replacement cost of certain of its inventory holdings. By way of example, Defence hold approximately 160,000 lines of inventory which are turned over on a regular basis, and an additional 600,000 lines of static inventory. This represents tens of million individual inventory items. As Defence produce monthly General Purpose Financial Statements which are required to be AIRFS compliant, such compliance would require Defence to maintain and revisit the value of cost and replacement cost of all inventory items on a monthly basis as part of its financial statement preparation. Any such activity would require a significant administrative effort, with limited incremental value derived. It is believed that this is an unintended consequence of the standard. Defence has written to the Australian

⁵ Ministry of Defence, Annual report and accounts 2004-05, Section 2, Departmental Resource Accounts, Note 28. p 189

Accounting Standards Board in order to seek agreement on a more practical approach to the measurement of inventory.

- **Heritage & Cultural Assets** – AIFRS requires further clarification on whether heritage and cultural assets should be recognised as assets and, if they should be recognised as assets, whether they should be depreciated. The concept of future economic benefits as the potential for an asset to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity does not recognise the difficulties in valuing heritage and cultural assets. Defence's heritage and cultural items include over one million artefacts, memorabilia and heritage land and buildings that are of national historical or cultural significance. Defence has written to the Australian Accounting Standards Board proposing that heritage and cultural assets not be depreciated due to Defence's conservation, restoration and preservation activities over such assets.

In the United Kingdom, the Financial Reporting Standard (FRS 15) and IPSASB Consultation Paper suggests that heritage and cultural assets might be disclosed, rather than recognised on the balance sheet, in circumstances where obtaining a valuation of such assets may outweigh the benefit to users of the financial statements. The treatment of heritage and cultural assets in this way has not yet been considered in Australia.

As part of its initiatives to prepare for the implementation of AIFRS, Defence has developed a series of accounting position papers on each of the key accounting areas which create significant challenges for Defence.

2.6 FURTHER MEASURES THAT CAN BE ADOPTED

Notwithstanding the extensive activity on its remediation plans, the veracity of those plans in dealing with audit recommendations, and the extent of the systematic financial management reforms to which Defence is committed, Defence continues to look for further reforms it could adopt.

Based on the experiences and practices of defence organisations overseas, we conclude that the practices and policies being developed in Australia are at least the equal, and in many respects better than what is happening overseas. Notwithstanding, Defence continues to survey the experiences of international defence organisations and emerging best practice and will take up any new measures that are appropriate for our organisation.

This view recognises that for a corporate entity the size and complexity of Defence to move from its current audit status to a full ‘true and fair’ opinion on all three financial statements will take time. It is also underscored by the facts that our cash and budget management have not been called into question and that our paramount role of military operations have not been affected by the remediation challenges.

“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.” **Section 5.227 Australian National Audit Office Report No.21 2005-2006**

“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).” **Section 5.177 Australian National Audit Office Report No.21 2005-2006**

“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 program 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.” **Section 5.178 Australian National Audit Office Report No.21 2005-2006**

3. ACHIEVEMENTS IN FINANCIAL REFORM

This section provides an overview of Defence's achievements in relation to financial reform and provides a comparison with international best practice:

- Defence Financial Reforms Since 2003: Our progress against recent Government financial reforms.
- How The Reforms Have Impacted Defence Activities

3.1 WHAT WE HAVE SET OUT TO ACHIEVE: DEFENCE FINANCIAL REFORMS

Financial Reform in the Australian Public Sector

In a public sector context financial reform includes budgetary and financial management initiatives which aim at improving public sector performance and achieving better resource management. Internationally, public sectors face a challenge in the identification and implementation of better practice.

Financial reforms have been the focus of successive governments over many years. Significant reforms impacting upon Defence have had their origins in major government wide initiatives. Whilst financial reforms embrace budgeting, financial management and financial reporting, the most profound impact upon Defence originated from the *Report of the National Commission of Audit* (June 1996) which made a number of recommendations including:

- achieving greater efficiencies through benchmarking, purchaser/provider arrangements, contestability, contracting out services, risk management, introduction of new technology and cost recovery mechanisms;
- accrual principles as the basis for an integrated budgeting, resource management and financial reporting framework, and
- accrual budgets forming the basis of financial performance targets to be reported in annual reports and ownership of accrual resource management within agencies.

The Government subsequently introduced an accruals based management framework focused on outputs and outcomes, including devolved cash management and an incentives regime.

The legislative framework was also changed through the introduction of the *Financial Management and Accountability Act 1997* and Regulations which support the financial reform agenda through the following essential elements:

- establishment and role of audit committees;
- promotion of the efficient, effective and ethical use of Commonwealth resources;
- Fraud Control Guidelines;
- annual financial statements requirement for audit and in accordance with Finance Minister's Orders;
- Commonwealth Procurement Guidelines, and
- special responsibilities of Chief Executives of Agencies – for example, Chief Executive Instructions.

The Management Advisory Board's *Beyond Bean Counting-Effective Management in the APS -1998 & beyond*, described the impact of the financial reforms in 'best practice features' based on proven private sector practice.

These included:

- the application of accrual accounting, budgeting, financial management and reporting;
- the provision of professional financial input to strategic and operational business planning;
- a focus on results rather than the process and rules (in an environment that displays the existence of an appropriate control framework and risk management);
- ex-post accountability replacing ex-ante control;
- financial management as the responsibility of management;
- financial advice as the responsibility of finance staff;
- the establishment of excellence in information and advice, and
- the employment of professional finance staff, where the Chief Finance Officer is professionally qualified.

The ANAO Better Practice Guides are relevant to understanding and interpreting the financial reform required of Defence. The guides include:

- *Building a Better Financial Management Framework (1999)* which addresses the process of developing and presenting a suite of financial information to support decision making more accountable management.
- *Building Better Financial Management Support (1999)* which addresses the supporting functions, systems and processes required to deliver relevant, timely and useful financial information for managers.
- *Internal Budgeting (February 2003)* which provides assistance on establishing efficient and effective internal budget processes. The Guide aims to ensure that organisations have established an effective control framework including a sound financial environment to support internal budget processes, are implementing better practice, and managers understand their role in the internal budget process. This guide also sets out that better practice elements for a sound financial environment include establishing organisational commitment, integrating budgeting with business planning, integrating accrual principles into internal budgets and aligning responsibility, authority and accountability.
- *Annual Performance Reporting* which was developed in response to the Joint Committee of Public Accounts and Audit Report No 388 *Review of Accrual Budget Documentation* and relates to measuring, assessing and reporting agency performance.
- *Public Sector Audit Committees (2005)* which outlines better practice principles and practices, in establishing better practice public sector audit committees.

Financial Reform in Defence

Defence has worked to achieve the implementation of all these financial reform elements. It is clear that some areas require further improvement, including in the quality of information and internal controls. This said, the following outlines some of the key Defence achievements in relation to financial reforms.

Defence has undertaken significant reform of its procurement and financial processes to improve the delivery of capability and the cost effectiveness of its activities. Defence recognises that it must constantly seek to achieve best practice to ensure it is recognised by the Government and stakeholders for its management performance. In terms of enhancing its policy standing and developing excellence in management, Defence recognises that, while some problems can be addressed quickly, others are more deep-seated and will take some years to resolve. To address these problems, Defence has undertaken a number of specific reform initiatives for improvement of procurement and financial management processes.

Other reforms have included fundamental changes to the organisational structure to improve efficiency, improvements to the budgeting processes, improvements to financial management practices, and reforms to workforce planning, preparedness management and the management of the Defence Information Environment to improve the quality of its outputs and to achieve greater cost effectiveness.

These reforms follow on the extensive program of micro-economic reform which Defence has undertaken since the 1980s, particularly through the Force Structure Review, Commercial Support Program and the Defence Reform Program. This has resulted in a substantial reduction in the workforce, both military and civilian, over the last 16 years, and implementation of significant efficiency measures. The savings from these initiatives have been used to fund higher per capita cost of personnel and have been redirected to the sharp end.

Planning and Budgeting Reform

Defence introduced a number of important reforms in the 1990s flowing from the Force Structure Review, the Commercial Support Program and the Defence Reform Program. These, along with the introduction of the *Financial Management and Accountability Act 1997*, provided the catalyst for improving financial administration in Defence. The new legislation provided for less centralised control with departmental secretaries becoming responsible for managing the affairs of their agencies in a way that promotes the efficient, effective and ethical use of the Commonwealth's resources.

In 1999, Defence moved to an accruals-based output-budgeting system and, in doing so, met one of the key reforms required by Government. The Government's budget framework is based on agencies delivering outputs to enable the Government to achieve its intended outcomes through a performance culture within the public sector that is more responsive to the needs of Government and the community. Receiving appropriations for outcomes provides a better framework for allocating resources to Defence outputs and assessing how well those outputs are delivered and how they contribute to the Government's planned outcomes.

Subsequently, as part of the Budget and Estimates Framework Review in 2003, Defence moved to a new **outcome and output structure**. While Defence continues to develop and manage budgets along organisational entity lines (ie Defence Group), it reports by outcome both in a financial and capability performance sense. As part of Defence's Portfolio Budget Statements, it displays the capability performance and financial metrics by outcome and the Group contribution to these outcomes. Accountability for results is shared by the Capability Managers, who are responsible for the delivery of capability, and the Group Heads who provide support to those Capability Managers.

The financial management framework that Defence has implemented, and continues to adapt and improve, has regard for the whole-of-Government budgeting and reporting framework and the requirements of the *Financial Management and Accountability Act 1997* and the *Public Service Act 1999*. These Acts require the Secretary, among other things, to:

- assist the Minister to fulfil the Minister's accountability obligations to the Parliament to provide factual information, as required by the Parliament, in relation to the operation and administration of the Department;
- at the end of each financial year, provide a report to the Minister, for presentation to the Parliament, on the Department's activities during the year;
- prepare that report in accordance with guidelines approved on behalf of the Parliament by the Joint Committee of Public Accounts and Audit; and
- provide the Minister with monthly, annual and *ad-hoc* performance reports that highlight the achievement or non-achievement of planned financial and non-financial performance of Defence. This includes the Defence Annual Report, which is required to be tabled in Parliament by 31 October each year.

Defence Governance Structure

Defence is managed under a joint 'diarchy' leadership model. Under the model, the Secretary and the Chief of the Defence Force have separate and joint powers. The Chief of the Defence Force commands the ADF and is the principal military adviser to the Minister. The Secretary is the principal civilian adviser to the Minister and has certain statutory obligations under the *Public Service Act 1999* and the *Financial Management and Accountability Act 1997*. Jointly, they are responsible for the administration of the Australian Defence Organisation.

For further information on the Defence governance structure and the budgeting framework refer to appendix B.

Support Arrangements and Business Rules

To support this planning and budgeting framework, Defence has implemented a portfolio-wide budgeting system, BORIS, which contains all the Services and Groups' budgets for an eleven-year period. This system is capable of building budgets at Group level and converting these budgets into an outcomes view through a sophisticated cost attribution model. This process ensures that Defence runs 'live' budgets with budget holders having certainty over their budget allocations well in

advance. Group budgets are allocated by 1 June each year. The annual Defence Management and Financial Plan provides the basis of the budget allocations and also serve as a planning base for the next cycle.

Group Heads are accountable for managing their Group Budgets to achieve the performance standards contained in their Organisational Performance Agreements. A set of business rules has been mandated for managing Group budget allocations and accuracy indicators have been set to allow Defence to meet the Government's mandated accuracy indicators which are applied at the Portfolio level. Monthly reports are prepared for Defence Committee consideration. The business rules provide both incentives (carryovers) and sanctions (repayment of overspends). Group budgets are refined throughout the year and all changes are tracked by the Chief Finance Officer Group.

Cash management reforms

In line with the outcomes of the Budget and Estimates Framework Review, in 2004, Defence was the first agency in the Commonwealth to move to a just-in-time cash management system. Under these arrangements, Defence is no longer required to maintain large cash balances in its bank account and can draw down from the Official Public Account on a daily basis to pay claims as they become due and payable. Unused appropriations, at the time, were held in the Appropriation Receivable which the Government subsequently agreed could be used to meet employee entitlements as they fall due.

Benchmarking Against ANAO Better Practice Guide

Defence continues to benchmark itself against the Australian National Audit Office's Better Practice Guidelines for internal budgeting.⁶ To illustrate, appendix C provides an assessment of the level of maturity Defence has reached in meeting the CEO's checklist in better practice. The model described above meets most of the key requirements of the ANAO guide.

Conclusion

In summary, Defence has implemented a number of improvements to its financial management framework, particularly in planning and budgeting, as part of the wider financial management reforms. Defence has established a good record of managing the cash side of its business and this has drawn favourable comment from the Government. Defence will continue to strive to meet the better practice benchmarks and currently has two proposals with Government that are designed to improve the accrual budgeting framework and the Defence outcome and output structure. It is expected that these proposals will be considered later in the year.

⁶ Internal Budgeting: Better Practice Guide, Australian National Audit Office, February 2003

3.2 HOW THE REFORMS HAVE IMPACTED DEFENCE ACTIVITIES

While many accounting issues have been noted by the ANAO in the conduct of their audits, these issues have had no negative impact on Defence's ability to make decisions in relation to its operations.

By way of example, the ADF has successfully initiated and executed more than 20 military and humanitarian operations since 1999. This includes deployments to East Timor, Iraq, Afghanistan and the Solomon Islands and subsequently to tsunami affected areas of Southeast Asia in December 2004, and then Far North Queensland in March 2006. These operations indicate that the ability of Defence to execute military and humanitarian operations has not been impacted by the uncertainties it faces in regard to financial and administrative processes and the preparation of financial statements.

Further, decisions relating to the funding of Defence are not linked to its Statement of Financial Position, or operating result. These decisions are linked to the Defence Financial Management Plan and the Capability Plan, both of which are not impacted by the uncertainties that impact the presentation of Defence's Financial Statements. Indeed, such budgeting performance has been best practice.

The remediation work has had no negative impact on Defence's ability to manage its cash budget and to make decisions in relation to its operations and investment in new or enhanced capability, nor to provide advice to Government on these matters. Indeed, Defence has established a good record in managing the cash side of its business, building on a range of improvements in its financial management framework, particularly in planning and budgeting.

It should be noted that Australia is an internationally acknowledged leader in the development of public expenditure management (Posner & Gordon 1999) and is positively reported in international literature such as the OECD Journal of Budgeting.

Australia compares very favourably with selected OECD countries including Canada, France, Japan, Netherlands, New Zealand, Sweden, United Kingdom and the United States in the Overseas Development Institute's 2003 Working Paper 209 *Results-Orientated Budget Practice in OECD Countries*. Interestingly, all selected countries reported that the move to results orientated budgeting was unfinished business including linking outputs to outcomes and appropriate accounting systems.

4. FINANCIAL STATEMENT ISSUES IN OTHER DEFENCE ORGANISATIONS

This section provides a description of the financial management challenges faced by defence organisations in four countries with comparable forms of government, that is, New Zealand, the United Kingdom, the United States and Canada. This section includes:

- Overview: a broad analysis of the different financial management challenges faced by Australia and the above four countries.
- International Comparisons: Financial Reporting Requirements: covering the above financial reporting requirements of the above four countries.

4.1 OVERVIEW

The following paragraphs provide an overview of the financial management challenges faced by other defence organisation. We have provided an analysis of financial reporting requirements on, and audit experiences of, defence organisations Australia and four other countries in order to provide a broad indication of international practice in these areas.

The following table provides a high level overview of financial management challenges facing selected international defence organisations:

Financial Reporting Challenges Facing Selected International Defence Organisations

	Required to prepare financial statements as a Stand Alone agency	Required to implement IFRS	Specific Accounting Challenges				Required to recognise and value Heritage and Cultural assets
			Challenges maintaining records of Inventory	Required to maintain Employee Leave Entitlements records for long term	Required to report Embedded Derivatives	Required to provide for Restoration and Decontamination	
Australia	Yes	Yes 30 June 2006	Yes	Yes	Yes	Yes	Yes
New Zealand	Yes	Yes 30 June 2008	No	No	No	Yes	No
United Kingdom	Yes	No	Yes	No*	No	No	No
United States	No**	No	Yes	Unknown	Unknown	Yes	Unknown
Canada	No	No	Yes	Unknown	No	Yes	No

* The United Kingdom does not have entitlements similar to Australia. As a consequence it does not recognise a provision for employee long service leave in its financial statements.

** The United States Department of Defense did not produce published financial statements due to the Department's continuing self qualification of accounts.

Our analysis indicates that the financial reporting requirements for Defence are at least as significant as those in other comparable countries and, in many cases, rather more significant. Further, the analysis indicates that Defence is making solid progress, when compared to overseas defence organisations, in the areas of financial reform. This is demonstrated by:

- To date, only Australia and New Zealand have decided to implement IFRS in the public sector. While the public sector will be required to implement the requirements in New Zealand, this compliance will not be required until 30 June 2008. Australia is required to implement AIFRS (the Australian equivalents to the International Financial Reporting Standards) in 2005-06.
- In the United States, the Department of Defense has self-disclaimed its own financial statements for many years, and in response the Comptroller General has decided not to audit the Department due to continued Department-wide control weaknesses across significant financial and administrative areas. It is unclear when the Department of Defense will produce auditable financial statements.
- The Ministry of Defence in the United Kingdom has undertaken a number of initiatives to improve its financial management and reporting. These initiatives were undertaken with a view to improve the reliability of financial statements and to remove audit qualifications it had received in previous years. The Ministry of Defence has been successful in improving its financial management and reporting, and has subsequently obtained an unqualified audit opinion from the Comptroller and Auditor General. Defence currently has programs in place that are consistent with those the Ministry of Defence has undertaken over the last few financial years.
- The Department of National Defence in Canada prepares financial statements on a stand alone basis but financial statements are audited by the Auditor General of Canada on a whole-of-government level. The Department of National Defence is not required to apply full accrual accounting or implement IFRS. It is not clear when full accrual accounting will be applied or when IFRS will be implemented.
- The maintenance of appropriate financial and administrative records in respect of inventory is a key challenge for each defence organisation and is indicative of the complex nature and extent of the operations of defence organisations.

4.2 INTERNATIONAL COMPARISONS: FINANCIAL REPORTING REQUIREMENTS

New Zealand: New Zealand Defence Force

The following paragraphs discuss financial statement challenges faced by the New Zealand Defence Force. Each of the items listed in the following table are further discussed below.

Stand Alone Financial Statements	Audited Financial Statements	IFRS Adoption Timing	Accrual Accounting	Audit Qualifications Experienced			Financial Statement Remediation
				2002-03	2003-04	2004-05	
Yes	Yes	30 June 08	Yes	No	No	No	Limited

Stand Alone Financial Statements

The New Zealand Defence Force is separate from the New Zealand Ministry of Defence.⁷ The New Zealand Defence Force prepares financial statements as a stand alone agency, with these financial statements subject to annual independent audit by Audit New Zealand.

Audited Financial Statements

The New Zealand Defence Force financial statements are independently audited by Audit New Zealand. The New Zealand Defence Force have what appears to be an open and cordial relationship with Audit New Zealand, with accounting positions agreed with the auditors on an ongoing basis throughout the financial year. Such agreements have, for example, covered the treatment of derivative instruments and methodology for valuing inventory.

IFRS Adoption Timing

The New Zealand Defence Force's financial statements will be prepared in accordance with New Zealand Generally Accepted Accounting Principles until 30 June 2007, and as such, will not comply with IFRS until 30 June 2008. Issues faced by Defence as part of its AIFRS compliance program, for example, in relation to embedded derivatives and restoration provisions, are yet to arise for the New Zealand Defence Force.

Accrual Accounting

The New Zealand Defence Force has adopted accrual accounting in accordance with New Zealand Generally Accepted Accounting Principles.

⁷ The New Zealand Ministry of Defence is responsible for providing the New Zealand Defence Force with policy advice, procurement of major items of equipment, and audit and assessment. The New Zealand Ministry of Defence prepares its own financial statements. The New Zealand Defence Force and the Ministry of Defence financial statements are consolidated at the whole of Government (Crown) level. The financial statements of the New Zealand Ministry of Defence are not discussed further here.

Audit Qualifications Experienced

The New Zealand Defence Force received a clean audit opinion from Audit New Zealand for the year ended 30 June 2005⁸, and has done for the past decade. Discussions with New Zealand Defence Force finance staff indicated no adverse findings were raised by Audit New Zealand within their 30 June 2005 management letter.

Financial Statement Remediation

As a result of these clean audit opinions, the New Zealand Defence Force has experienced limited need for financial statement reform or remediation activities. Our discussions with the New Zealand Defence Force have indicated that minor financial statement remediation is conducted on an ongoing basis. This involves, for example, forming a position in relation to the accounting treatment of a transaction, and agreeing the said position with New Zealand Audit. As noted above, issues faced by Defence as part of its AIFRS compliance program, for example, in relation to embedded derivatives and restoration provisions, are yet to arise for the New Zealand Defence Force. It is likely that financial statement remediation activities will need to be carried out by them upon the adoption of IFRS.

Specific Accounting Challenges

The points below highlight the New Zealand Defence Force's position in relation to a number of challenges faced by Defence:

- *Inventory*: The New Zealand Defence Force value inventories at weighted average cost less a provision for obsolescence.
- *Embedded Derivatives*: The New Zealand Defence Force is unaware of the existence of material embedded derivatives and does not at present report on any such items.
- *Employee Leave*: The New Zealand Defence Force has not been required by Audit New Zealand to provide detailed employee leave source documentation. As an alternative, the auditors have relied on employee records maintained within Personnel systems and annual actuarial estimate of the employee leave liability.
- *Heritage and Cultural Assets*: The New Zealand Defence Force does not hold any heritage or cultural assets. They are instead held, without value, by museums, which fall under a separate government organisation.

⁸ Report of the New Zealand Defence Force for the year ended 30 June 2005, p 150.

United Kingdom: Ministry of Defence

The following paragraphs discuss financial statement challenges faced by the United Kingdom Ministry of Defence. Each of the items listed in the following table are further discussed below.

Stand Alone Financial Statements	Audited Financial Statements	IFRS Adoption Timing	Accrual Accounting	Audit Qualifications Experienced			Financial Statement Remediation
				2002-03	2003-04	2004-05	
Yes	Yes	Unknown	Yes	Yes	No	No	Major – Complete

Stand Alone Financial Statements

The Ministry of Defence prepares financial statements as a stand alone agency.

Audited Financial Statements

Financial statements prepared by the Ministry of Defence are subject to annual independent audit by the United Kingdom Comptroller and Auditor General.

IFRS Adoption Timing

The Ministry of Defence does not produce IFRS compliant financial statements, and the timing of IFRS implementation is unclear.⁹ As a result of this, issues faced by Defence as part of its AIFRS compliance program, for example, in relation to embedded derivatives and restoration provisions, are yet to arise for the Ministry of Defence.

Accrual Accounting

The Ministry of Defence implemented accrual accounting in 1999-2000. Serious issues were experienced by the Ministry of Defence upon adoption of accrual accounting especially in relation to asset holdings.¹⁰ These issues contributed significantly to the qualified audit opinions experienced between 2000-01 and 2002-03.

Audit Qualifications Experienced

The United Kingdom Comptroller and Auditor General disclaimed his audit opinion on the financial statements of the Ministry of Defence for the years ending 31 March 2000 through to the year ending 31 March 2003. The qualifications for each of the three years extended from the following:

⁹ Delivering the benefits of accruals accounting for the whole public sector, December 2005, HM Treasury, Page 11, Paragraphs 2.32 to 2.36.

¹⁰ Ministry of Defence, Consolidated Departmental Resource Accounts 2001-02, p 15

2000-01

The financial statements for 2000–01 were qualified in relation to information held on its supply systems and compliance with Financial Reporting Standard 15 - Accounting for Fixed Assets.¹¹

2001-02

The financial statements were qualified due to the following limitations of scope relating to the appropriate recording of inventory and fixed assets held by third parties:

- The inability to capture data on the usage of stock and fixed assets held by industry. As a result, the Comptroller and Auditor General was unable to confirm the completeness of charges to the Operating Cost Statement in respect of consumption of stock and depreciation of fixed assets held by industry.
- Many of the Ministry of Defence's stock management systems were designed primarily for logistics purposes and have not lent themselves to providing the data required to account for financial transactions on an accruals basis. Consequently, accounting transactions may not be correctly recorded. The evidence available to the Comptroller and Auditor General was limited in respect of a £340 million credit to the Operating Cost Statement relating to stocks written off and impairment of fixed assets.¹²

2002-03

The financial statements were qualified due to the following limitation of scope relating to the appropriate recording of inventory:

- Many of the Ministry of Defence's stock management systems were designed primarily for logistics purposes and have not lent themselves to providing the data required to account for financial transactions on an accruals basis. Consequently accounting transactions may not be correctly recorded. The evidence available to the Comptroller and Auditor General was limited in respect of a £1,128 million net credit to the Operating Cost Statement relating to movements in consumable stock and capital spares¹³.

The Ministry of Defence financial statements for the years ending 31 March 2004¹⁴ and 31 March 2005¹⁵ received unqualified audit opinions.

¹¹ Ministry of Defence, Consolidated Departmental Resource Accounts 2001–02, p 8.

¹² Ministry of Defence, Consolidated Departmental Resource Accounts 2001–02, p 13.

¹³ Ministry of Defence, Annual report and accounts 2002-03, Section 2, p 76.

¹⁴ Ministry of Defence, Annual report and accounts 2003-04, Section 2, Consolidated Departmental Resource Accounts 2003-04, pp 104-105.

¹⁵ Ministry of Defence, Annual report and accounts 2004-05, Section 2, Departmental Resource Accounts, pp 137-138.

Financial Statement Remediation

In order to achieve an unqualified audit opinion for the year ending 31 March 2004¹⁶, the Ministry of Defence undertook significant financial statement remediation activities. These activities addressed the following financial statement issues:

- provision for items in excess of requirements, or obsolete because the equipment they support is no longer in use;
- accounting for the initial measurement, valuation and depreciation of tangible fixed assets;
- proper identification of creditors and accruals;
- asset transfers and re-classifications;
- management validation and audit trails;
- review of asset valuations;
- accounting for stock consumption;
- assets belonging to the Ministry of Defence held by contractors, and
- stock movement controls.

In addition to remediation activities, the Ministry of Defence have implemented a sound internal control framework¹⁷. The following are the key processes in operation within the Ministry of Defence to maintain an effective system of internal control:

- “A Defence Management Board that meets approximately monthly to manage the plans, performance and strategic direction of the Department, comprising the senior members of the Department and two external independent members.
- A Defence Audit Committee, chaired by an external independent member of the Defence Management Board, which has adopted a risk-based approach to internal control and is placed at the heart of the assurance process, co-ordinating the activities of internal audit, and drawing on reports from specialist assurance sources, including:
 - the Defence Environment and Safety Board;
 - the Departmental Security Officer;
 - Defence Internal Audit, including the Defence Fraud Analysis Unit;
 - the Director General Financial Management;
 - the Director of Operational Capability;
 - the Science and Technology Director, and
 - the National Audit Office
- A Departmental risk register, supported by operational-level risk registers, which complements the Defence Balanced Scorecard. The Departmental risk register has been reviewed and endorsed by both the Defence Audit Committee and the Defence Management Board.
- Through top level budget holders, a cascaded system for ensuring compliance with legal and statutory regulations. Each top level budget holder is supported

¹⁶ Ministry of Defence, Annual report and accounts 2003-04, Section 2, Consolidated Departmental Resource Accounts 2003-04, pp 104-105.

¹⁷ Ministry of Defence, Annual report and accounts 2004-05, Section 2, Departmental Resource Accounts 2004-05, p 135.

by an Audit Committee, in all but one case, chaired by non-executive directors and at which representatives from the internal and external auditors are present. Like the Defence Audit Committee these committees focus their activities to provide advice on wider-business risk and assurance processes.

- A developing business management system through which responsibility for the effective and efficient operation of the key pan-Departmental processes, such as Planning and Human Resources (military and civilian), including the identification of risks within these processes and the maintenance of effective controls to manage them, is assigned to functional heads or process owners. Process Owners report directly to the Defence Management Board.
- Through top level budget holders, a cascaded system for ensuring that business continuity plans are in place, and that these plans are tested on a regular basis. Following a revamp of the Department's business continuity management policy, an in-year review by the Directorate General of Safety and Security was undertaken to ascertain how the policy is being adopted across the Department, what improvements are planned, the identification of specific areas of risk and the measures being taken to mitigate those risks. The review revealed that all business continuity plans currently in place had been at minimum desktop tested and that there are no significant internal control problems.
- An annual risk-based program of internal audit provided by Defence Internal Audit, who is the primary source of independent assurance. They are complemented by the activity of the Directorate of Operational Capability, which provides independent operational audit and assurance to the Secretary of State and the Chief of Defence Staff. On the basis of the audit work conducted during the year, Defence Internal Audit offered substantial assurance that the systems of internal control, risk management and governance reviewed were operating effectively.
- Annual Reports providing measurable performance indicators and more subjective assessments on the health of financial systems from all top level budget holders and key functional specialists. Improvements have continued to be made to financial controls. The Ministry of Defence has delivered its outputs within the resources voted by Parliament and the Treasury's expenditure limits despite the additional workload generated by Operation TELIC and the migration to a new accounting system.
- Centres of Excellence in key areas – including Change, Equipment and Estates, integrating Office of Government Commerce processes, tools and structures into existing management and control processes – to ensure that high-risk mission-critical projects and programs do not suffer from any of the common causes of failure identified by the Office of Government Commerce and the National Audit Office.¹⁸

¹⁸ Ministry of Defence, Annual report and accounts 2004-05, Section 2, Departmental Resource Accounts 2004-05, Pages 135-136.

Section 1 describes the systemic reform of initiatives currently underway in Defence. These initiatives are broadly consistent with the initiatives undertaken by the United Kingdom Ministry of Defence, which contributed to their ability to obtain an unqualified audit opinion from the Comptroller and Auditor General.

Specific Accounting Challenges

The points below highlight the Ministry of Defence's position in relation to a number of challenges faced by Defence:

- *Inventory*: The Ministry of Defence experienced difficulty in recording inventory up until 31 March 2003.¹⁹
- *Embedded Derivatives*: The position that Her Majesty's Treasury will take in relation to embedded derivatives in the public sector upon the adoption of IFRS is unclear.²⁰ In a note to the accounts, the Ministry of Defence acknowledge that embedded derivatives may exist, however comments that "because of the largely non-trading nature of its activities and the way in which government Departments are financed, the Department is not exposed to the degree of financial risk faced by business entities" and that such "financial instruments play a much more limited role in creating or changing risk than would be typical of the listed companies", embedded derivatives are not reported.²¹ Further, in its 2004-05 Resource Accounts, the Ministry of Defence stated that the "Department does not trade or enter into any speculative transactions in foreign currencies".²²
- *Employee Leave*: The Ministry of Defence does not recognise a liability for employee leave entitlements as either there are no such entitlements available to employees (long service leave) or they are not vesting (annual leave).
- *Heritage and Cultural Assets*: The Ministry of Defence owns a range of non-operational heritage assets from historically significant defence equipment through archive information, to museum and art collections. No non-operational heritage assets, except land, were valued at the year-end as either:
 - the cost of the valuation outweighed the benefits that the knowledge of the valuation would deliver; or
 - it was not possible to establish a sufficiently reliable valuation.²³

Further FRS15, Tangible Fixed Assets, notes that "for some assets that were not capitalised in the past and for some donated inalienable, historic and similar assets, the cost of obtaining a valuation (if indeed a reliable valuation is available) may outweigh the benefit to users of the accounts. In such cases, appropriate disclosures should be made in the notes to the accounts instead."²⁴

¹⁹ Ministry of Defence, Annual report and accounts 2002-03, Section 2, p 76.

²⁰ Her Majesty's Treasury, Financial reporting advisory board paper, FRAB (71)02, 28 January 2005, [http://www.hm-treasury.gov.uk/media/CAC/16/FRAB\(71\)_FRS_25_FRS26.pdf](http://www.hm-treasury.gov.uk/media/CAC/16/FRAB(71)_FRS_25_FRS26.pdf)

²¹ Ministry of Defence, Annual report and accounts 2004-05, Section 2, Departmental Resource Accounts, Note 28. p 189

²² Ministry of Defence, Annual report and accounts 2004-05, Section 2, Departmental Resource Accounts. p 129

²³ Ministry of Defence, Annual report and accounts 2004-05, Section 2, Departmental Resource Accounts, p 196

²⁴ FRS 15, Tangible Fixed Assets, Appendix IV, Paragraph 9.

United States: Department of Defense

The following paragraphs discuss financial statement challenges faced by the US Department of Defense. Each of the items listed in the following table are further discussed below.

Stand Alone Financial Statements	Audited Financial Statements	IFRS Adoption Timing	Accrual Accounting	Audit Qualifications Experienced			Financial Statement Remediation
				FY 2003	FY 2004	FY 2005	
Yes	No	Unknown	Unknown	Yes	Yes	Yes	Major – In Progress

Stand Alone Financial Statements

The Department of Defense is required to prepare financial statements on a stand alone basis. These financial statements, however, were self disclaimed by Defense.

Audited Financial Statements

In his Independent Auditor’s Report on the Principal Statements, the Assistant Inspector General, Department of Defense stated: “We are unable to give an opinion on the Fiscal Year 2005 DoD financial statements because of limitations on the scope of our work. Thus, the financial statements may be unreliable.”²⁵ As a result of this, the Comptroller General of the United States **did not audit**, and **did not express an opinion** on the Department of Defense’s financial statements.²⁶

IFRS Adoption Timing

It is unclear as to when, or if, IFRS is to be adopted by the Department of Defense. As a result of this, issues faced by Defence as part of its compliance program, for example, in relation to embedded derivatives and restoration provisions, are yet to arise for the Department of Defense.

Accrual Accounting

The Department of Defense position in relation to accrual accounting is not clear.

Audit Qualifications Experienced

As noted above, the Comptroller General of the United States did not audit, and did not express an opinion on the Department of Defense financial statements.

“Serious financial management problems at Department of Defense”²⁷ were a significant contributor to the Comptroller General’s inability to express an opinion on the United States federal government’s consolidated financial statements. These serious problems include material internal control weaknesses in relation to the following areas:

²⁵ Department of Defense Performance and Accountability Report FY2005. Part 3: Financial Information. Independent Auditor’s Report on the Principal Statements, p 136.

²⁶ Government Accountability Office Statement, p 143.

²⁷ Government Accountability Office Statement, p 28.

- financial management systems;
- fund balance with treasury;
- inventory;
- operating materials and supplies;
- property, plant and equipment;
- government-furnished material and contractor-acquired material;
- environmental liabilities;
- intergovernmental eliminations;
- accounting entries;
- statement of net cost;
- statement of financing;
- accounts payable;
- accounts receivable, and
- contingent legal liabilities²⁸

It is unknown when the United States Department of Defense will be in a position to produce auditable financial statements.

Financial Statement Remediation

The United States Department of Defense is formally undertaking financial statement remediation, referred to as ‘initiatives’, in order to address specific challenges identified by the Government Accountability Office and the Department of Defense Inspector General. These initiatives form part of the Department of Defense Financial Improvement and Audit Readiness Plan, a plan which seeks to chart “a course to sound financial management by improving internal controls, resolving material weaknesses, and advancing the Department’s financial stewardship”²⁹.

Specifically, the Department of Defense has developed remedial initiatives in the following areas³⁰:

- military equipment;
- real property;
- internal use software;
- fund balance with treasury;
- inventory and operating materials and supplies;
- other assets;
- accounts receivable;
- cash and other monetary assets;
- loans receivable and loan guarantee;
- Medicare-eligible retiree Health Care Fund;
- other military retiree health care;
- environmental liabilities;
- accounts payable;

²⁸Department of Defense Performance and Accountability Report FY2005. Part 3: Financial Information. Independent Auditor’s Report on the Principal Statements. p 136.

²⁹ Defense Financial Improvement and Audit Readiness Plan, Supporting the warfighter through trust and confidence in financial data, p 1.

³⁰ Defense Financial Improvement and Audit Readiness Plan, Supporting the warfighter through trust and confidence in financial data, pp 28-58.

- debt;
- statement of net cost;
- statement of budgetary resources;
- statement of finance, and
- statement of custodial activities.

While broader, these initiatives appear to be not dissimilar to Defence's specific remediation plans discussed in section 2.

The United States Department of Defense is also currently in the process of implementing significant financial statement reform, also through its Financial Improvement and Audit Readiness plan. It recognises that timely, reliable and accurate information is required in order to facilitate financial management decision making, and initiatives within the plan are geared towards the generation of such information.

The Department of Defense has defined five steps in order to drive financial management improvements³¹:

1. *Discovery and Correction*: Review of policy, processes, controls and systems to identify deficiencies which impede accuracy, reliability, or timeliness of financial information. Identification and implementation of appropriate corrective action.
2. *Validation*: Validation that corrective actions have successfully resolved the identified impediment. This is performed to provide management with confidence that implemented controls are operating as intended.
3. *Assertion*: Management has the ability to assert the reliability of financial information.
4. *Assessment*: Auditors perform a limited review of controls and procedures in order to determine whether financial information is credible enough to warrant a full audit.
5. *Audit*: Performance of full audit of financial statements.

The approach adopted by the Department of Defense in order to improve the accuracy, reliability and timeliness of financial information is broadly in line with that taken by Defence (see section 1).

The timing for the execution of the Financial Improvement and Audit Readiness plan is not explicitly clear, however, a number of initiatives identified within the plan will not be complete, for example, until 2016. This implies that the Department of Defense accepts that it will not achieve an unqualified audit opinion for at least another ten years.

Specific Accounting Challenges

The points below highlight the Department of Defense's position in relation to a number of challenges faced by Defence:

³¹ Defense Financial Improvement and Audit Readiness Plan, Supporting the warfighter through trust and confidence in financial data, p 11.

- *Inventory*: The Department of Defense has experienced difficulty in recording inventory. In particular, the Department of Defense did not maintain adequate systems or have sufficient records to provide reliable information in relation to, amongst other assets, inventories.³² In addition, the Department of Defense “acknowledged that the existing inventory valuation at most activities does not approximate historical cost”³³ as required.
- *Embedded Derivatives*: Information in relation to the Department of Defense’s reporting of embedded derivatives is not available.
- *Employee Leave*: Information in relation to the Department of Defense’s employee leave provision is not available
- *Heritage and Cultural Assets*: Information in relation to the Department of Defense’s valuation of heritage and cultural assets is not available.

Canada: Department of National Defence

The following paragraphs discuss financial statement challenges faced by the Canadian Department of National Defence. Each of the items listed in the following table are further discussed below.

Stand Alone Financial Statements	Audited Financial Statements	IFRS Adoption Timing	Accrual Accounting	Audit Qualifications Experienced			Financial Statement Remediation
				2002-03	2003-04	2004-05	
Yes	No	Unknown	No	No	No	No	Unknown, but likely

Stand Alone Financial Statements

The Department of National Defence prepares financial statements for internal purposes and to facilitate the preparation of consolidated financial statements at a whole-of-Government level.

Audited Financial Statements

The Department of National Defence is not subject to an stand alone audit by the Auditor General of Canada. The audit is undertaken in respect of the consolidated financial statements at the whole of Government level. We have been advised by the Department of National Defence that Departmental financial statements will be individually audited by the year 2009.

IFRS Adoption Timing

It is unclear as to when, or if, IFRS is to be adopted by the Department of National Defence. As a result of this, issues faced by Defence as part of its compliance program, for example, in relation to embedded derivatives and restoration provisions, are yet to arise for the Department of National Defence.

³² Government Accountability Office Statement, p 145.

³³ Department of Defense Performance and Accountability Report FY2005. Part 3: Financial Information. Independent Auditor’s Report on the Principal Statements,. Attachment: Report on Internal Controls and Compliance with Laws and Regulations.

Accrual Accounting

The Department of National Defence is yet to implement full accrual accounting. In her review of the public accounts of Canada for 2004-05, the Auditor General expressed concern about challenges in the transition to full accrual accounting at the Department of National Defence.³⁴

Audit Qualifications Experienced

In her audit of the Public Accounts of Canada for 2004-05, the Auditor General opined that the financial statements were materially correct. While the Auditor General of Canada did not note any “matters of concern”, however the Department of National Defence has historically experienced difficulty in the maintenance of information in relation the pricing of inventory. These difficulties are discussed below.

Our discussions with representatives from the Department of National Defence finance team indicated that; in its management letter, the Office of the Auditor General identified areas for improvement relating to the following:

- Pricing of inventory / repairable items;
- Accounting for ‘contractor held’ material, and
- Accounting for environmental liabilities and contingencies.

Financial Statement Remediation

The Department of National Defence has not published information in relation to financial statement remediation activities, but, in her observations over the public accounts of Canada for 2005, the Auditor General of Canada noted that the Department of National Defence experienced difficulty in relation to the valuation of inventory and had made limited progress in efforts to determine the extent of inventory that is incomplete.³⁵ In addition, discussions with representatives from the Department of National Defence finance team indicate that the management letter from the Office of the Auditor General raised issues in relation to accounting for ‘contractor held’ material and accounting for environmental liabilities and contingencies.

This being the case, it is likely that the Department of National Defence are in the process of executing remedial activities in respect of inventories and accounting for environmental liabilities and contingencies.

³⁴ PACP (38-1) : Twenty-First Report: Public Accounts of Canada 2005 : Standing Committee on Public Accounts:
http://www.parl.gc.ca/InfocomDoc/38/1/parlbus/commbus/house/PACP/report/RP2071380/PACP_Rpt21/PACP_Rpt21_Pg01-e.htm

³⁵ Observations of the Auditor General on the Financial Statements of the Government of Canada for the year ended March 31, 2004. Public Accounts of Canada, 2003-2004 – Supplementary Information. http://www.oag-bvg.gc.ca/domino/other.nsf/html/200410agobs_e.html

Specific Accounting Challenges

The points below highlight the Department of National Defence's position in relation to a number of challenges faced by Defence:

- *Inventory*: In her observations over the public accounts of Canada for 2004-05, the Auditor General of Canada did not note any "matters of concern", however the Department of National Defence has historically experienced difficulty in the maintenance of information in relation the pricing of inventory.

For example, in her report on the public accounts of Canada for 2003-04, the Auditor General stated, "...the Department maintained inventory systems focused primarily on keeping track of quantities; as a result, cost accuracy was not emphasized and errors were made in the recording of costs... Unfortunately, errors continued to be made in the valuation of inventory. These largely relate to whether the costing of inventory was properly supported and whether the current-year transactions (purchases, usage, and obsolescence) were properly reflected in the summary financial statements. Most of these errors were corrected by National Defence staff but predominantly as part of their year-end effort to close the accounts..."³⁶,

- *Embedded Derivatives*: Formal information in relation to the recording of embedded derivatives is not available.
- *Employee Leave*: The Department of National Defence records a provision for accrued employee leave which has been 'banked' by military and civilian staff – currently valued in the order of \$200m.
- *Heritage and Cultural Assets*: Formal information in relation to the recording of heritage and cultural assets is not available. It is understood that Heritage and cultural assets, such as artwork, are not reflected within the financial statements of the Canadian Federal Public Sector, and therefore the financial statements of the Department of National Defence.

³⁶ Observations of the Auditor General on the Financial Statements of the Government of Canada for the year ended March 31, 2004. Public Accounts of Canada, 2003-2004 – Supplementary Information. http://www.oag-bvg.gc.ca/domino/other.nsf/html/200410agobs_e.html

PART TWO:
DEFENCE EQUIPMENT ACQUISITION

PART TWO DEFENCE EQUIPMENT ACQUISITION

OVERVIEW OF DEFENCE PROCUREMENT AND SUSTAINMENT: THE DEFENCE MATERIEL ORGANISATION

Introduction

There are two stages to the Defence procurement process. The first is to identify and define capability needs. This is done on the basis of strategic guidance approved by the Government. Within Defence, this activity is oversighted by the Defence Capability and Investment Committee chaired by Secretary and supported by the Strategy and Capability Development Groups. Acquisition proposals arising from this work are then approved by Cabinet if the value exceeds \$50m or through the Minister for Defence and the Minister of Finance and Administration if the amount is in the range \$8m to \$50m. Acquisitions below this amount can be approved by the Minister for Defence.

The second stage is capability delivery. It begins once approval decisions are made on acquisitions. The projects are passed to the Defence Materiel Organisation (DMO) which manages acquisition and sustainment activity.

Having regard to the terms of reference for this inquiry, this section focuses mainly on the DMO's role in the acquisition process.

The Defence Materiel Organisation

The DMO is engaged in the complex, high-risk enterprise of acquiring, modifying and sustaining high technology capability for the war fighter. In many cases this involves innovative, leading-edge technology, and highly complex systems integration.

The DMO currently manages approximately 210 major projects and acquisition and sustainment contracts worth \$7.9 billion annually. The table on page 82 lists the DMO's top 30 projects by expenditure in 2005-06.

The DMO is one of the biggest contracting organisations in Australia with a forecast expenditure of over \$50 billion dollars on equipment acquisition over the next ten years. Almost as much again will be spent on sustaining Defence equipment. If the DMO were a private business, it would be among the largest on the Australian Stock Exchange.

The DMO operates in numerous locations, both within and outside Australia, and provides worldwide direct support to ADF operations. Operating in numerous international jurisdictions, its business is impacted by the actions and decisions of domestic and international companies and governments. The DMO is therefore subject to a wide variety of external factors outside of its control that may impact on its performance.

The DMO is a service delivery agency. Its business is driven by the policies and objectives set by the Government and the Department of Defence, as well as the operational requirements of the ADF.

In order to maximise the effectiveness and efficiency of its investment in Defence, the Government expects the DMO to deliver and sustain required capability at an optimum cost and to tight schedules. To provide our warfighters with the best advantage the delivered capability must be leading-edge. This requires the acceptance and management of a high level of technological, cost, and schedule risk.

The Government and Defence expect the DMO to be able to manage a high level of risk prudently. In all cases risk is to be carefully monitored and intensively managed. Risk should be accepted only after calculated and sensible assessments, and mitigated where practicable.

It would not be acceptable for the DMO to remove risk by significantly increasing project cost and schedule. While this would ensure that the DMO nearly always met its deliverables, it would have a major impact on the overall Defence capability program and our warfighting capability. This approach would also lead to significant opportunity costs associated with additional contingency funds, delayed starts for new projects, and unnecessary overlaps in the retirement of old platforms and systems and the introduction of new ones.

It is also not feasible for Defence to acquire only tested technology and platforms. This approach would be more risky and would not meet the Government's requirement of maintaining a technological edge for the ADF. It could also impact negatively on Australia's national security and the defence of Australia.

In some circumstances, the DMO may not fully meet all the outputs required of it. Only an overly cautious and expensive approach that accepted long schedule delays could remove all chance of shortfalls in projects. The DMO's task is to minimise shortfalls, identify problems early and effectively manage risk related issues as they arise.

The Defence Materiel Organisation's Role and Vision

The DMO is responsible for equipping and sustaining the ADF through the acquisition and sustainment of capital equipment assets.

The DMO's vision is to be Australia's premier program management and engineering services organisation, delivering projects and materiel support on time, on budget, and to the required quality, capability and safety.

Major Aims of the Defence Materiel Organisation in 2006-07

In 2006-07 the DMO aims to:

- continue improving the delivery of acquisition and sustainment requirements, to meet the operational demands of the ADF;
- continue implementation of a major change program, to make DMO more outcome-focused and business-like;

- strengthen partnerships with Australian industry, enhance the national skills base and build industry's capacity to support Defence through a careful mix of competitive tendering and appropriately negotiated and sound contracting;
- enhance the depth and breadth of skills and expertise in the DMO workforce, and
- substantially lift outputs with a minimal increase in resources.

The Defence Materiel Organisation's Outcome and Outputs

The DMO has a single outcome and three outputs. As an enabling organisation to Defence, the DMO continues to contribute to a number of Defence outcomes and outputs. A table outlining the DMO's outcome and outputs is below.

DMO's outcome and outputs

Outcome	Description	Outputs
<p><i>Outcome One</i></p> <p>Defence capabilities are supported through efficient and effective acquisition and through-life support of materiel</p>	<p>This Outcome encapsulates the entire business of the DMO: the activities it undertakes for Defence in acquisition and sustainment of materiel; the advice it provides on contracting policy and industry policy; and the work it performs to meet the Government's reporting and governance requirements.</p>	<p><i>Output 1.1</i></p> <p>Management of Capability Acquisition</p> <p><i>Output 1.2</i></p> <p>Management of Capability Sustainment</p> <p><i>Output 1.3</i></p> <p>Provision of Policy Advice and Management Services</p>

The Purchaser-Provider Arrangements

A Memorandum of Arrangements was signed by the Secretary, the Chief of the Defence Force and the Chief Executive Officer of the Defence Materiel Organisation on 15 June 2005. These arrangements document the relationship between Defence and the DMO. Under this document sits a large number of detailed agreements covering major and minor acquisition projects, sustainment of ADF fleets, and services provided to facilitate these activities.

Two principal purchaser-provider arrangements have been established to support equipment acquisition and sustainment in the new relationship with Defence: Materiel Acquisition Agreements and Materiel Sustainment Agreements.

Materiel Acquisition Agreements cover the DMO's acquisition services to Defence for both major and minor capital equipment. Agreements are between the Chief of the Capability Development Group, on behalf of Defence, and the CEO DMO for major capital equipment. For Minor Capital Equipment projects, these are between the relevant Capability Managers, on behalf of Defence, and the CEO DMO.

Material Sustainment Agreements cover the sustainment of current capability, including services such as repairs, maintenance, and the provision of fuel and explosive ordnance. These agreements are between the Capability Managers and the CEO DMO.

DMO reports monthly to the Defence Committee and the Minister on its performance in relation to these agreements.

Other purchaser-provider arrangements between the DMO and Defence are the Shared Services Agreements. Shared Services Agreements cover a broad range of services provided by each agency to the other. Services covered by these agreements include payroll, accommodation and banking services provided by Defence, and contracting policy and advice provided by the DMO.

Top 30 Projects by 2005-06 Expenditure*

	Project Number
<hr/>	
Aerospace	
Armed Reconnaissance Helicopter	AIR 87 Ph2
F/A-18 Hornet Upgrade	AIR 5376 Ph2
Additional Trooplift Helicopter	AIR 9000 Ph2
ADF Air Refuelling Capability	AIR 5402
Anzac Ship Helicopter	SEA 1411 Ph1
Strategic Airlift Capability	AIR 5216 Ph1
Airborne Early Warning and Control	
Airborne Early Warning and Control	AIR 5077 Ph3
Maritime	
Armidale-class Patrol Boat	SEA 1444 Ph1
Anzac Ship Project	SEA 1348 Ph2
FFG Upgrade Implementation	SEA 1390 Ph2
Collins Replacement Combat System	SEA 1439 Ph4A
SM-1 Missile Replacement	SEA 1390 Ph4B
New Heavyweight Torpedo	SEA 1429 Ph2
Anti-Ship Missile Defence	SEA 1448 Ph2A
Collins-class Reliability and Sustainability Improvements	SEA 1439 Ph3
Electronic and Weapons Systems	
Electronic Warfare Self Protection for Selected ADF Aircraft	AIR 5416 Ph2
New Air Defence Command and Control Systems for 2CRU/3CRU	AIR 5333
Jindalee Operational Radar Network	JP 2025 Ph3/4
Explosive Ordnance Reserve Stocks	JP 2085 Ph1B
Lightweight Torpedo Replacement	JP 2070 Ph3
Lightweight Torpedo Replacement	JP 2070 Ph2
Milsatcom Ground Infrastructure	JP 2008 Ph3E
High Frequency Modernisation – Remainder of the network	JP 2043 Ph3A
Land	
Bushranger Infantry Mobility Vehicles	LAND 116 Ph3
Tank Replacement Project	LAND 907 Ph1
Upgrade of M113 Armoured Vehicles	LAND 106
Australian Light Armoured Vehicles	LAND 112 Ph3
General Service Field Vehicles - Overlander	LAND 121 Ph2
Amphibious Vessels	
Maritime Operations Support Capability	SEA 1654 Ph2A
New Air Combat Capability	
New Air Combat Capability	AIR 6000 JSF SDD
<hr/>	
TOTAL TOP 30 PROJECTS	

* This information is updated in the Portfolio Budget Statements and the Portfolio Additional Estimates Statements each year.

1. THE DEFENCE PROCUREMENT REVIEW

In December 2002, the Government commissioned Mr Malcolm Kinnaird AO to chair a review of a range of issues associated with major Defence acquisitions. Other members of the review were Dr Bill Schofield and Mr Len Early. The purpose of the review was to ensure Defence continued to spend taxpayer's money wisely and to maintain public confidence in the procurement process.

THE DEFENCE PROCUREMENT REVIEW

In August 2003, Mr Kinnaird presented the report of the Defence Procurement Review. The report noted that the management of large, costly and technically complex defence acquisitions is challenging and that Australia had not been alone in experiencing problems. The report concluded that cost over-runs, schedule delays and reduced capability of delivered platforms and systems were often the result of poor analysis and planning before tenders were sought from industry. The conclusion was that improvements were needed to the defence capability management process as a whole.

The Review's findings related to the whole defence capability cycle, from initial strategic assessment through to retirement of capability from service. They included a number of organisational changes to identify points of accountability, the strengthening of the 'two pass' system for new acquisitions, the creation of an Advisory Board and ensuring that project managers have appropriate remuneration and tenure.

In September 2003, the Government announced that it had broadly accepted the findings. The one exception was that the DMO would be established as a prescribed agency rather than an executive agency. The key results required by the Government's adoption of the recommendations included:

- Strengthening the capability development and assessment process before projects are passed to the DMO by forming a new Capability Development Group within Defence, solely responsible for capability development and ensuring that project proposals put to Government have reliable cost and schedule estimates.
- Strengthening the current 'two pass' approval system to facilitate early engagement with industry and provide a better basis for project scope and cost estimates. Additional funding was to be allocated at first-pass approval to allow Defence to undertake detailed studies of capability options. The early involvement of Defence Science and Technology Organisation and the Department of Finance and Administration was mandated to provide external evaluation and verification of project proposals.
- Establishing costing centres in Defence and the Department of Finance and Administration, which build on Defence's earlier decision to establish a cost assessment group, strengthen the review of project costs and risks and provide a quality assurance role for the Government.
- Establishing the DMO as a prescribed agency under the *Financial Management and Accountability Act 1997* to facilitate its evolution towards a more business like identity. As a prescribed agency, the DMO is financially autonomous from Defence and is required to prepare separate and auditable financial statements. This was intended to improve the financial transparency and accountability of the DMO.
- Establishing an eight-member Advisory Board to provide advice to CEO DMO on strategic issues and to report to the Ministers for Defence and Finance and Administration at regular intervals on the implementation of the review's recommendations.

- Giving CEO DMO an expanded range of powers to make improvements to the delivery of Defence projects and the management of the DMO. This includes empowering CEO DMO to revise DMO staffing and remuneration policies in order to attract and retain high quality project managers from the military, industry or public service on the basis of merit and for extended tenures.
- Extending the role of Project Governance Boards to advising CEO DMO on through-life support issues in order to provide greater recognition of the importance of managing the whole-of-life of a particular capability.

Significant progress has been made to date in implementing the Defence Procurement Review recommendations. Major achievements arising from the implementation of the recommendations have included the:

- release of the Defence Update 2005, which re-evaluated the strategic environment and its impact on Defence capability;
- appointment of Lieutenant General Hurley as Chief of the new Capability Development Group in December 2003, and Dr Stephen Gumley as the CEO DMO in February 2004;
- strengthening of the ‘two pass’ process and the amendment of the Cabinet Handbook in relation to Defence capability decisions;
- Defence Committee reviewing monthly DMO progress on approved acquisition projects and sustainment activities;
- development of a standardised project maturity score that is used to benchmark the performance of all DMO acquisition projects;
- establishment of the Defence Procurement Advisory Board in March 2004;
- DMO becoming a prescribed agency under the *Financial Management and Accountability Act 1997* on 1 July 2005;
- development of purchaser-provider agreements between Defence and the DMO;
- selection of project managers, both military and civilian, on merit. A certification system has been established for project directors and managers to gain accreditation from the Australian Institute of Project Management;
- signing of the Military Workforce Agreements between the CEO DMO and the respective Service Chiefs;
- establishment of the Materiel Assurance Boards to provide whole-of-life assurance on acquisition projects and sustainment activities; and
- Progression of Defence financial systems reform to provide a “transparent view of the whole-of-life budget”.

2. PROGRESS IN IMPLEMENTING REFORMS RECOMMENDED BY THE DEFENCE PROCUREMENT REVIEW

The Defence Procurement Review made ten major recommendations framed around four themes, and twelve recommendations of a minor nature.

The ten major recommendations were framed around the themes of

- Communicating with government: matching capability to strategy.
- Defining and assessing capability.
- Managing capability.
- Procuring and supporting Defence equipment.

This section contains information on the progress of the major and minor recommendations.

It also provides details in relation to Defence's progress in implementing number of initiatives and activities to ensure Defence develops and sustains strategic industry capability.

2.1 THE MAJOR RECOMMENDATIONS OF THE DEFENCE PROCUREMENT REVIEW

Communicating with government: matching capability to strategy

The determination of strategic priorities for the defence and security of the nation has obvious implications for the development of defence capability.

Judgements need to be made concerning what mix of capability and what trade offs between new and existing equipment are in the nation's interests. This is quite properly the prerogative of the elected government. But for Government to remain confident that it is controlling this decision-making process the Australian Defence Organisation (Defence) must provide greater clarity in setting out the options available to develop and sustain ADF capabilities within a defined budget. (Report p.iii)

Recommendation 1 - Defence should present to government the following information in a succinct form on an annual basis:

- *an assessment of the types of contingencies Australia might face in carrying out the strategic tasks endorsed by government in Defence White Papers;*
- *advice on the military force required in each contingency and the capacity of the ADF to apply this force now and in the future; and*
- *advice on capability to be sustained, acquired or retired to ensure this can be achieved at acceptable cost.*

Desired Outcomes (to be achieved by December 2006):

- Annual information that allows Government to assess the consequences of strategic decisions for Defence capability.
- Inclusion of relevant strategic information in the annual Defence Management and Finance Plan.

Progress:

Defence provides this type of information to Government in many different ways as part of the information supporting the decision making process. In December 2005, the Minister for Defence released *Australia's National Security – A Defence Update 2005*. In releasing the update, the Minister noted the Government's recognition that the development of strategy is a dynamic process and that there is a need to constantly revisit strategic circumstances and adjust strategic posture.

Defining and assessing capability

A strengthened capability definition and assessment function

Government has often been asked to sign off on acquisition proposals at a point where there has not been sufficient analysis within Defence to give confidence that financially and technically robust decisions are being made. Too often, poorly defined and inaccurately costed projects have been put to government and passed to the DMO to acquire. This gives rise to unrealistic expectations regarding the delivery of defence capabilities.

Accountability for managing the process of defining and assessing capability and achieving robust outcomes is diffused and overlaid by a complex system of committees. The position of Vice Chief of the Defence Force (VDCF) was intended to bring some focus to the management of developing ADF capabilities. However, given the numerous functions encompassed by the VDCF role, it has been difficult for any incumbent to give close and sustained attention to the vital task of capability definition and assessment.

A single point of accountability is needed to provide better integration of the capability definition and assessment process and to ensure that it maintains a joint warfare focus. (Report p.iv)

Recommendation 2 – A three star officer, military or civilian, should be responsible and accountable for managing capability definition and assessment. This appointment should be on a full-time basis, with a defined tenure (minimum five years) to ensure a coherent, cohesive, holistic and disciplined approach.

Desired Outcomes by March 2005:

- A strengthened capability definition and assessment function.
- The establishment of a single point of accountability for all aspects of capability definition and assessment.
- The single point of accountability would be responsible for maintaining a joint warfare focus, and managing the Defence Capability Plan.

Progress:

Implementation of this recommendation is complete. Lieutenant General Hurley was appointed as Chief of the new Capability Development Group in December 2003. He has a clear mandate and responsibility for managing the capability development process, including the *Defence Capability Plan*.

Since Lieutenant General Hurley's appointment he has established his new organisation and is progressing projects through the new two-pass approval process. Within the Capability Development Group, key developments have included:

- Production of *Defence Capability Development Manual*, with the first edition issued in February 2005;
- Completion in 2005 of the first version of the Defence Capability Strategy;
- Improved cost estimation, through new systems development;

- Integration during 2005 of simulation and testing and evaluation in pre-second pass activities;
- Development of Materiel Acquisition Agreements with DMO in time for prescription of DMO on 1 July 2005;
- Establishment with Industry of the Rapid Prototyping, Development and Evaluation Program, and
- Assuming responsibility for implementation of the Network Centric Warfare Roadmap.

A strengthened two-pass system

The process of capability definition and assessment notionally follows a two-pass system. However, as it is currently practiced, the system lacks rigour and discipline. It is also not based on mandatory endorsement of key decisions by relevant stakeholders, nor is external scrutiny applied to significant aspects of the proposals being forwarded to government.

A strong mandatory two-pass system should provide a precise and understandable process for the procurement of defence capabilities, which ensures that government will be presented with robust proposals.

It should be characterised by a higher proportion of project funds being spent on early analysis to provide better and more relevant information to government and to ensure that projects are less likely to develop problems during the acquisition phase. This would include rigorous analysis of technology, and cost and schedule risks, including external scrutiny and verification.

Most importantly, to provide a strong underpinning for the process, the two-pass system should be incorporated into the Cabinet Handbook, thus ensuring all proposals are considered using the same disciplined approach. (Report p.v)

Recommendation 3 – Government should mandate, and enforce via revised Cabinet rules, a rigorous two-pass system for new acquisitions with government considerations dependent on comprehensive analyses of technology, cost (prime and whole-of-life) and schedule risks subjected to external verification.

Desired Outcomes by June 2004:

- A strengthened two-pass process (by June 2004);
- The major processes be embodied in formal Cabinet arrangements (by June 2004);
- continued development of reasoned and fully investigated sets of options on which Government can make informed investment decisions; and
- A higher proportion of project funds should be spent on early analysis to provide more robust and relevant information to government and to ensure that projects are less likely to develop problems during the acquisition stage.

Progress:

The two-pass process has been embodied in formal Cabinet arrangements with fully investigated and well argued sets of options being presented to Government since March 2004.

In addition, a higher proportion of project funds is now being spent on early analysis to provide more robust information aimed at minimising the likelihood of projects developing problems during acquisition.

More rigorous analysis is being undertaken on capability submission costings, including the fundamental inputs to capability and through life cost aspects to prevent capability being delivered without full consideration of staff or infrastructure.

The *Defence Capability Development Manual* was published in February 2005, and revised in February 2006. The manual provides authoritative guidance for Defence staff on the development of capability proposals and the role of the Capability Managers. Capability Development Group and the DMO establish emerging project teams before 'first pass' in order to provide project management support and discipline during requirements development.

A standardised project maturity score was developed in 2004 to provide an indicator of project maturity at various points throughout the capability development process.

There were seven minor suggestions related to Recommendation 3. The progress is discussed below.

The Report states (page 17) that, “government needs to be assured that adequate scrutiny is undertaken

- a. by Finance, the CFO (now CDG) and DMO on costings;**
- b. by the DMO on acquisition strategy, risk mitigation and schedule;**
- c. by Defence’s Corporate Support and Infrastructure Group (CSIG) on facilities issues; and**
- d. by DSTO on technology feasibility, maturity, and overall technical risk...”**

The enhanced level of scrutiny being proposed might also require allocating new staff, with new skill-sets within Defence, particularly in relation to the assessment and definition of capability.

Desired Outcome by June 2006:

- More rigorous analysis and scrutiny applied to the capability development process.

Progress:

In 2004 the Department of Finance and Administration established a new branch to review project costs. It works closely with the DMO and Capability Development Group to provide Government with greater confidence in cost information. The Defence Science and Technology Organisation now provides technical readiness

assessments for all projects, and the DMO has developed an overall project maturity score that is being applied to acquisition projects and sustainment activity.

The Capability Development Group and the DMO have established emerging project teams to improve the teaming arrangements for projects pre-First Pass. Integrated Project Teams are being formed for all individual capability development projects, with a core membership of the supplier (DMO), the sponsor (Capability Development Group) and the Capability Manager. The Corporate Services and Infrastructure Group, the Defence Science and Technology Organisation and other Defence stakeholders participate in the integrated project teams as required. Processes and checklists have been developed to assist with cost estimation and assurance, including arrangements for CEO DMO sign-off of the acquisition strategy, cost, schedule and risks at both First and Second Pass.

It is difficult to predict with confidence the exact cost of a project planned for development in the future. This is exacerbated by changes in technology, real increases in the cost of military equipment over time, and evolving strategic priorities and military strategies. To combat this significantly more scrutiny is being applied and more reliable information is being provided for decision making. The appointment of appropriately skilled staff remains difficult in a very tight labour market. Available staff are currently being upskilled to cover any staffing deficiencies within the DMO.

In addressing the two-pass approval process the Report noted (page 13) that procedures might be developed “to handle the clearance of less complex proposals by the Minister for Defence”.

Progress:

Implementation of this recommendation is completed and the desired outcome has been achieved. Increased delegations were determined by Government in March 2004. Delegations are reviewed periodically to ensure that they remain at an appropriate level.

The Report suggests (page 19) that “an off-the-shelf alternative must be part of any set of options put to government”.

Desired Outcome:

- Establish a benchmark against which the costs, military effects and schedule of all proposals can be assessed.

Progress:

The requirement to include an off-the-shelf alternative in any set of options put to Government has been incorporated into the Cabinet Handbook and the *Defence Capability Development Manual*.

Initial business cases and acquisition business cases being presented now include specific advice about the level of military and/or commercial-off-the-shelf being proposed.

The report notes the importance of test and evaluation in acquisition projects and concludes (page 20) that “greater resources need to be allocated to conduct comprehensive and rigorous T&E programs as part of project funding”.

Desired Outcome by March 2007:

- To apply a more comprehensive and rigorous test and evaluation program to the capability life cycle.

Progress:

Defence is continuing to refine processes and data for costing of testing and evaluation.

Processes are now in place to ensure that comprehensive and rigorous test and evaluation programs are developed and funded as part of the project. The Capability Development Documents) guide has been developed to include more comprehensive information and processes for testing and evaluation. The 2006 revision of the *Defence Capability Development Manual* contains comprehensive information and processes for testing and evaluation.

All new projects progressing through the revised two-pass process have testing and evaluation concept documents for review. The consistency of the process and quality of these documents is steadily improving. Testing and evaluation is also being considered more comprehensively across the capability life cycle.

Work has commenced to identify the shortfalls with consideration and application of testing and evaluation for projects requiring accelerated or rapid acquisition processes.

The report observes in relation to capability development in Defence (page 10) that “the committee framework appears overly complex with a series of committees reporting to committees”. It concludes that, “the complex committee system should ... be reviewed”.

Desired Outcome:

- A more streamlined committee process.

Progress:

A review of committee arrangements has led to the abolition of the Defence Capability Sub-Committee. The responsibilities of this committee are now shared by the Defence Capability Investment Committee and the Defence Capability Committee. The number and role of capability-related committees is regularly reviewed.

The Report argues (page 17) that for DoFA to meet its responsibility to Cabinet on the review of costings in submissions, it needs additional resources.

Desired Outcome:

- Department of Finance and Administration provides government with independent evaluation and verification of proposals.

Progress:

The Department of Finance and Administration has established the Defence Capability Assessment Branch to fulfil this role. The Branch's interaction with Defence has matured and it now works closely with the Capability Development Group and the DMO and to provide Government with greater confidence in cost information.

The Report proposes (page 18) that “standardised technology readiness levels (TRLs) should be used to assess the technology maturity of equipment.**Progress:**

Implementation of this recommendation is completed and the desired outcome has been achieved. The Defence Science and Technology Organisation, in consultation with the Capability Development Group and the DMO, has developed policy and instructions for assessment of a project's technological maturity and its technical risk at appropriate decision points in the Capability Systems Life Cycle.

This policy is reflected in the DMO's project maturity score methodology, the *Defence Capability Development Manual* and its on-line process support tools. The revised policy, procedures and processes have been used in the conduct and certification of technical risk assessments for all new projects presented to Government for first and second-pass since July 2004 and, when appropriate, are being adopted by legacy projects being presented to Government for 2nd pass approval.

Submissions to Government now contain for each option a statement of technical risk developed by the Defence Science and Technology Organisation and certified by the Chief Defence Scientist. This statement includes an estimate of the technology readiness levels of the option.

In addition, the DMO provides in each submission a project maturity score, which includes assessments of technical understanding and difficulty. The Defence Science and Technology Organisation's technology readiness levels are used to inform this score. Technical understanding is an assessment of Defence's understanding of the technical solution and arrangements to operate and support the capability, while technical difficulty assesses progress in design and design validation.

Five other attributes are assessed in determining a project's maturity score:

- Schedule, in terms of whether progress is on track to meet the planned in- service date;
- Cost, in terms of how well the costs are tracking project approval;
- Requirement, in terms of how well the requirement is being realised;
- Commercial, which assesses the contractor's management performance and customer relationships; and

- Operations and support, which assesses a project's preparedness to deliver an operating system.

The attributes developed for the DMO sustainment maturity scores are:

- Obsolescence;
- Intended use;
- External supplier capability;
- Defence capability (non DMO);
- The DMO systems program offices capability;
- Cost estimation; and
- Schedule.

Theme 3: Managing capability

Defence, and ultimately government, must be confident that they receive an accurate and comprehensive report on all aspects of capability development at each stage in the capability cycle.

Capability managers, the most prominent being the Service Chiefs, should be made responsible and accountable for monitoring and reporting to government on all aspects of approved defence capabilities. However, capability managers would not assume management responsibility in other functional areas in Defence or exercise control over budgets or funding in these areas.

To properly perform their role, the capability managers will require sound and reliable financial and budget systems within Defence. However, taking into account the present state of Defence's financial systems, transition to improved arrangements will take time, perhaps two to three years. (Report p.v-vi)

Recommendation 4 – *Following second pass approval, the capability managers should have the authority and responsibility to report, and be accountable for reporting, on the development of defence capability. To undertake this role they should have access to all information necessary to enable them to fully inform government on all aspects of capability.*

(Note: Recommendation 4 is also linked to Recommendation 9).

Desired Outcome: Ongoing

- To provide accurate and comprehensive reporting on all aspects of capability development at each stage in the capability cycle.

Progress:

Processes to implement this recommendation are in place but the outcomes are still to be fully demonstrated. Lieutenant General Hurley, acting on behalf of Capability Managers, presents monthly reports to the Defence Committee on the progress of approved acquisition projects in the capability Development Group. Similarly, Dr Gumley presents monthly reports to the Defence Committee and the Minister on acquisition projects and sustainment activities managed by the DMO.

Theme 4: Procuring and supporting Defence equipment

Driving change from the top down

The creation of the DMO provided a single point of accountability for the acquisition and through-life-support of Defence equipment and gave rise to a number of important reforms in the management of the acquisition process. But, despite what has been achieved, the task of transforming the DMO into a performance driven organisation is far from complete.

In performing its project management role the DMO operates in a commercial environment but has yet to fully develop a culture to match the tasks it is required to perform.

Establishing an Advisory Board that is independent of operational processes and able to provide advice and support to the head of the DMO will assist the pace and quality of change. The Board should include private sector members to enable the head of the DMO to draw upon appropriate business skills and experience to inject a stronger commercial focus into the DMO. Public sector representatives, who would be external to the DMO, would ensure government oversight of the DMO to help drive the change process. (Report p.vi)

Recommendation 5 - An Advisory Board should be appointed with immediate effect, to provide advice and support to the head of the DMO and report to the National Security Committee of Cabinet on the implementation of all Defence Procurement Review recommendations.

Desired Outcomes:

- A broad base of experience is available to provide advice and support to the CEO DMO on strategic issues.
- Government receives regular reporting on the implementation of the DPR.

Progress:

The Defence Procurement Advisory Board was established in March 2004 to advise and support CEO DMO in improving the DMO. The Board generally meets monthly and provides advice to CEO DMO and reports to the Ministers for Defence and Finance and Administration on the implementation of the Defence Procurement Review's recommendations. The Advisory Board is chaired by Mr David Mortimer and consists of both private and public sector members. More detailed information on the role of the Advisory Board and its membership is at appendix D.

A separate identity for the DMO

The transformation of the DMO into a more business-like organisation will require it to have a clear and separate identity from the Defence Department. This will bring clarity to the commercial task of delivering and maintaining defence equipment separate from broader Defence tasks.

A number of options for bringing about this separation were considered. However, on balance the most effective way is likely to be through establishing the DMO as an executive agency within the Defence portfolio.

This would establish clear separation between capability development and delivery and maintenance of equipment. It would provide the DMO with a clear separate role and identity from the department, and reinforce the need for distinct responsibilities and accountabilities. It would provide the DMO with more flexibility in determining staff remuneration, and provide a clear signal to staff that there will be cultural change.

The Advisory Board would advise on implementation of the executive agency. (Report p.vii)

Recommendation 6 - The DMO should become an executive agency [Government decided that DMO be created as a prescribed agency].

Desired Outcomes:

- The DMO becoming a prescribed agency by 1 July 2005.
- Develop DMO to be a more performance and outcomes driven, business-like organisation.
- Establish a more transparent relationship between DMO and Defence that ensures alignment of accountabilities, responsibilities and authority.
- Flexibility to adjust financial and staffing resources to meet workload – within Government regulatory framework.
- Introduce self-discipline into the DMO that obviates the need for externally imposed controls.

Progress:

Implementation of this recommendation is on track.

Since his arrival the new CEO DMO, Dr Gumley, has established a new organisational structure for the DMO and filled key executive positions. He has established his key objectives for the organisation, these being:

- Professionalising staff and practices;
- Standardisation of processes and systems;
- Reprioritising DMO activities;
- Benchmarking DMO against relevant best practice elsewhere;
- Managing relationships with industry; and
- Setting the standard for change more widely in Defence.

The DMO became a prescribed agency under the *Financial Management and Accountability Act 1997* on 1 July 2005. Instructions and delegations have been issued by the CEO DMO as the Chief Executive of the agency. The Secretary of Defence has provided the CEO DMO with appropriate delegations under the *Public Service Act 1999*.

A more transparent relationship was established between DMO and Defence through agency agreements. These have been established for the vast majority of approved acquisition projects and all the platforms and products currently in service. These continue to be refined with clearer enunciation of the key result areas and performance measures. Reporting to Defence on the outcomes requires improvement but is constrained by the limited availability of flexible management reporting systems.

DMO continues to become more outcomes focussed and business-like in its operations but its still has to operate within the government's financial and governance frameworks. This imposes some constraints on the extent to which it can become fully business like.

Related to Recommendation 6 is a suggestion, the progress is discussed below.

The Report suggests (page 35) that the Head of DMO should have several 'powers', including

- **to be able to recommend against project proposals that do not have adequate risk analysis or are not fully costed;**
- **delegated powers to provide remuneration flexibility to attract highly skilled and experienced staff; and**
- **to concentrate solely on developing and managing the organisation without distractions such as the need to deputise for the Secretary of Defence.**

Desired Outcome by July 2005:

- To adequately empower the Head of DMO to enable achievement of Government outcomes.

Progress:

Implementation of this recommendation is completed and the desired outcome has been achieved. A new DMO structure was implemented on 1 July 2004. The changes gave effect to the Defence Procurement Review recommendations as well as other DMO priority areas. The CEO DMO reports to each board meeting and provides an update on structure and staffing.

The Secretary of Defence has provided CEO DMO with the appropriate delegations, which are applied to appointments of senior staff.

Project management

Successful project management requires well-qualified and highly skilled project managers backed by project and financial systems that provide immediate access to reliable and accurate information on project costs, schedule and performance.

Project managers play the principal role in the acquisition of defence equipment and provide a direct interface with industry. Project management needs to be better recognised and developed as a major resource in the DMO, requiring high quality people with the requisite skills and experience.

Currently, most projects are managed by military staff posted into the DMO by the Service Chiefs and usually cycled through the position for no longer than the duration of a military posting. The head of the DMO has limited power to influence these appointments.

The DMO is applying significant effort in improving its project management systems and processes. However, further work remains to be done to ensure the timely rollout of these new systems and their consistent take up across the DMO. (Report p.vii-viii)

Recommendation 7 – Project managers should be selected on merit by the head of the DMO particularly for their project management skills. Managers could be drawn from the military, industry or the public service and they should be accountable to the head of the DMO and have minimum tenures, usually of five years. Remuneration levels should be set at the relevant level to attract and retain project management specialists.

Desired Outcomes by December 2006:

- DMO staff have the requisite skills, qualifications and experience to ensure effective and efficient delivery of DMO projects.
- Establish a transparent connection between complexity of work, performance and reward, in order to attract and retain quality staff and encourage a greater focus on outcomes and accountability.

Progress:

While the processes are largely in place, further work is required to ensure that all required outcomes are achieved. Project managers (both military and civilian) are selected on merit, with tenures and remuneration determined as appropriate. Under the acquisition project categorisation framework (ACAT), an interim certification system was established for project directors and managers to gain accreditation from the Australian Institute of Project Management. The interim certification system ran until December 2005 with 79 per cent of the target group taking part. The ACAT policy will be upgraded to include the requirements for ACAT I level project managers and to introduce an ACAT IV for small projects. A full certification framework is on track for introduction in December 2006.

Appointment of other staff to the DMO

Military personnel play an important role in the DMO. Their involvement in the organisation is confirmation of the DMO's central purpose to bring together acquisition of capital equipment and systems and through-life-support of equipment for the ADF.

The DMO should be able to continue to utilise ADF staff in a wide variety of roles, but this should be based on requirements that would apply to all DMO staff. In particular, they would commit to a minimum tenure for their DMO role, and would be accountable to the DMO for their performance. (Report p.viii)

Recommendation 8 – *The head of the DMO should be consulted on military postings to the DMO and should have the authority to accept only those ADF personnel who possess the requisite skills and experience.*

Desired Outcome by July 2005:

- Military staff within the DMO have the requisite skills and experience to meet the needs of the organisation, are committed to a minimum tenure and are accountable to the DMO for performance. A staffing policy was in place by July 2005.

Progress:

Implementation of this recommendation is progressing without risk. CEO DMO and each of the Service Chiefs have signed Military Workforce Agreements for 2005-06 which address workforce allocation and management of military staff assigned to DMO. The CEO DMO is consulted on military postings to DMO, and has the authority to accept only those personnel who possess the requisite skills and experience.

Representing capability managers in the DMO

The Service Chiefs, in their role as capability managers, should retain the right to place military staff in the DMO to monitor acquisition and logistics management on their behalf.

This would be similar to the role of the operator's representative within the project management team on major private sector projects.

These appointments should be on the basis that these staff are not acting as project managers or engaged in any other direct role that is part of the project management process. (Report p.ix)

Recommendation 9 – *Capability managers should have the option to locate their representatives in the DMO to monitor the acquisition and logistics management of approved capabilities.*

Progress:

Implementation of this recommendation is completed and the desired outcome has been achieved. Capability Managers were provided with this option in March 2004. They elected to pursue improvements in the current reporting process before taking up the option to provide representation. They consider that they receive sufficient information from their staff in the DMO and do not require separate representatives.

Project governance boards

Project governance boards were introduced to advise the head of the DMO on issues surrounding capital acquisition projects and have received wide support throughout Defence. Expanding their focus to incorporate through-life-support would recognise the importance of ongoing support for the operational availability and effectiveness of defence equipment. (Report p.ix).

Recommendation 10 – *The role of the project governance boards should be extended to include through-life-support of ADF equipment and report to the head of the DMO on potential difficulties.*

Desired Outcome by July 2005:

- Availability of independent advice on the management of sustainment activities.

Progress:

Implementation of this recommendation is completed and the desired outcome has been achieved. The role of the Project Governance Boards has been extended to cover the through-life-support function and have accordingly been renamed Materiel Assurance Boards. In addition, a number of private sector members have been appointed, including members nominated from Engineers Australia and from the Law Society of NSW. The boards provide independent advice to the CEO DMO.

2.2 PROGRESS ON MINOR RECOMMENDATIONS MADE IN THE REPORT OF THE DEFENCE PROCUREMENT REVIEW

In addition to the ten major recommendations, a suite of other suggestions was made. Most of these related to the defence capability cycle, and have accordingly been addressed above. Those others are addressed below.

The Report expresses the opinion (page 46) that “the location of many JLC functions needs to be revisited by the Secretary and the CDF in conjunction with the head of the DMO”.

Desired Outcome:

- Organisational structures are aligned to the core businesses of DMO and Defence.

Progress:

The location of the Joint Logistics functions has been reviewed and the organisational structure realigned. The Joint Logistics Command, which was formerly part of the DMO, was transferred to Defence in mid 2004. Most the functions have been integrated into Defence. The Defence and the DMO financial statements have been adjusted to reflect the asset control that results from the changed organisational structures. For the most part, inventory is now held on Defence’s accounts. Adjustments continue to be made to ensure that responsibility and accountability for functions reside together.

The Report expresses the view (page 45) that “it is difficult to see that a Defence industry policy function is appropriately retained in the DMO”.

Progress:

Implementation of this suggestion is completed following consideration of the issue by the Government. The policy function remains in the DMO, with the exception of the export compliance function, which has been relocated to the Strategic Policy Group within Defence.

There have been significant developments in the relationship with industry. The CEO has regular meetings with the CEOs of major defence industry companies, and agreement has been reached on contracting reforms that will improve schedule management. The engagement of small to medium enterprises in wider industry discussions is helping these companies to work with Defence. Finally, the initiative to assist industry to upskill and develop its workforce to meet future demands is being progressed as a priority. Further detail of industry-related initiatives and activities following the DPE are set out in section 2.3.

The Report suggests (page 27) that Defence financial systems “are not structured in a way that provides capability managers with a transparent view of the whole-of-life budget”.

Desired Outcome:

- Systems provide reliable information in terms of cost, schedule and performance to enable managers to monitor and report on capabilities from a whole-of-life perspective.

Progress:

Defence and the DMO both recognise the importance of having fully functional systems which provide accurate and timely information for managers to make business decisions. This is a high priority for both Defence and DMO.

Defence’s personnel (PMKeyS), financial (ROMAN) and logistics (SDSS) management information systems have been modified to accommodate the separation of the DMO. The full functionality of the DMO’s project management system (IPSSR) for planning, scheduling and control has been rolled out. IPSSR has been linked to the DMO’s monthly reporting system to report key performance indicators. The DMO part of the outputs reporting system (BORIS), which is designed to produce financial statements and progress reports on sustainment products, is not yet fully functional. The ADF requirements development information system and its interface to other systems are not yet fully functional.

The Report suggests (page 46) that “greater consideration should be given to alternative methodologies in strategic procurements, such as incentive contracts and alliance contracts”.

Desired Outcome:

- To have available a range of contracting options to enable mutually beneficial and enforceable contracts.

Progress:

As part of the Procurement Improvement Program the DMO is reviewing alliance contracting, incentive based contracting and relationship based contracting to determine their applicability within the Defence procurement environment.

All projects contemplating using an alliance structure are now required to seek advice from General Counsel Division within the DMO.

In October 2005, Invitation to Register Interest and Request for Proposal templates were released by DMO to ensure Defence is better informed, including with regard to contracting methodologies, before committing to strategic procurements.

DMO is using an incentivised gain-share/pain-share contracting structure for the new ship projects. Early indications are that the provision of ethics letters from companies’ senior management is an effective tool to focus the companies’ efforts. In his ethics letter, the CEO DMO seeks commitment from fellow CEOs that they personally are committed to ensuring their company’s satisfactory performance

against the contract. Similarly, the inclusion of a contract philosophy/objectives section seeks to clearly articulate the parties' aims in entering the contract.

2.3 INDUSTRY-RELATED INITIATIVES AND ACTIVITIES

Australia requires a diverse and dynamic defence industry sector to support current and future ADF platforms and equipment locally. Defence and the DMO have introduced a number of initiatives and activities to help ensure we can develop and sustain strategic industry capabilities in-country that are needed by the ADF. These initiatives are detailed below.

Skilling Australia's Defence Industry (SADI) Program

SADI is a policy initiative announced by the Government in 2004 to address a significant shortfall in the quantity and quality of skills available to defence industry. It is designed to ensure that the ADF has the capabilities it needs to defend Australia and its interests. Shortfalls have been identified as a result of a projected 30 per cent increase in expenditure in the *Defence Capability Plan*. The initiative will provide a total of approximately \$215m over ten years from 2005. The initial focus will be on entering into arrangements with larger companies in the defence sector who hold major contracts for either acquisition of new capability or support of existing capability. These companies are being asked to commit to the creation of new skilled positions and the retraining and up-skilling of existing positions in areas where shortages have been identified. Recognising that this requires major investment by industry, funding from the SADI Program provides financial assistance to help reduce these additional training costs.

Defence Small Business Access

Companies, particularly small to medium enterprises, often find it difficult to do business with Defence, to meet the requirements of our procurement plans and to identify the correct contacts. To facilitate easier access to Defence and to act as a first point of contact, we have established Defence Small Business Access that is contactable through the Defence website, via email or via a national toll-free phone number. Responses to enquiries are handled through a team in Canberra and through the DMO Regional Offices, who research and provide the information requested and/or refer the enquiry to the appropriate area in Defence.

Small to medium enterprises can also add details of their products and capabilities to a database that prime contractors use to locate local suppliers.

Defence Small Business Access also handles the Defence Unsolicited Proposals Gateway that provides a formal assessment process for the large number of unsolicited proposals that Defence receives from industry. Unsolicited proposals can range from company brochures, which are forwarded to appropriate defence areas, to innovative proposals warranting further investigation, including under other defence programs such as the Defence and Science Technology Organisation's capability technology demonstrator program.

Defence and Industry Conference

On behalf of the Defence organisation, Industry Division organises the annual Defence and Industry Conference, held over two to three days in June. It is the major public forum for Ministers and senior officers from Defence and industry to discuss the range of issues affecting the Defence-industry relationship including the *Defence*

Capability Plan, other procurement plans, industry capabilities, technology, and industry policy. The conference is often the venue for major procurement announcements and policy initiatives. About twelve hundred delegates from industry and Defence attend the conference. The primary messages from the conference are disseminated to regional industry through a regional briefing program organised by the DMO's regional offices in the months following the conference.

Defence and Industry Study Course

The Defence and Industry Study Course is an annual national program that attracts approximately 70 future leaders at the level of senior manager from industry, Defence, the ADF and other Commonwealth and State governments and agencies. It gives an insight into the roles and interdependencies of government, the ADF and industry in the defence of Australia and its interests. The course consists of three week-long study modules spread over a year, covering national policy and strategy, the ADF, and industrial support for Defence. The modules provide access to appropriate Ministers, senior officials and industry leaders, and include visits to Defence bases and industry facilities around Australia. Participants, sponsored and paid for by their respective organisations, are selected to provide an optimum mix of industry/agency and defence experience. Graduates from the course take back to their home organisations a first-hand appreciation of how Defence and industry operate, the government processes involved in capability development and acquisition, and the capabilities of the ADF and industry.

Publications for Defence Industry

In close consultation with the Capability Development Group, the DMO prepares and publishes the public version of the *Defence Capability Plan*. This is aimed at providing industry with information on Defence's future procurement plans over the next ten years and beyond including project/equipment/capability details, decision timing and phase information, an indication of the likely funding, and the strategic industry capabilities that will be required. This allows industry to plan future investments in plant, technology, facilities and resources. The DMO also produces other publications to assist industry such as the *Doing Business with Defence* booklet, and a monthly on-line magazine *On Target*.

Defence Materiel Advocate

In June 2004, the Government announced a new Defence export initiative to help facilitate access by Australian defence exporters to foreign buyers. This initiative had two key elements. Firstly, it sought the establishment of a new "Team Australia" international marketing package that showcases innovative Australian Defence technology. This was launched at Avalon in March this year

Secondly, the Defence export initiative sought the establishment of a dedicated military officer of star-rank to help promote Australian defence industry exports and provide the linkage to operational experience. This initiative recognises the need to provide more continuity in "service oriented" military user support to Australian defence industry export efforts.

Major General Jim Molan has been appointed to this new position and took up that appointment from 8 August 2005.

Major General Molan is well suited to this appointment and comes with a wealth of experience including appointments to Army Headquarters and Headquarters Australian Defence Force in the fields of Combat Development and Industrial Relations. In 1998 and 1999 he was Head of the Australian Defence Staff – Jakarta and recently returned from a twelve month appointment in the Middle East as Deputy Chief of Staff for Strategic Operations, Multinational Force - Iraq at the Coalition headquarters in Baghdad.

The Defence Materiel Advocate position provides assistance to Australian defence industry by having a dedicated military leader to present, and promote their capabilities. Major General Molan reports to CEO DMO and works closely with the Head of Industry Division in developing strategies and tactics for global engagement of Australian defence industry.

The Defence Materiel Advocate is tasked with escorting, or engaging other military officers to escort, Australian companies and potential export customers, both in country and overseas, to provide the operator's perspective of the defence technology to support export opportunities. It is expected that the Defence Materiel Advocate will lead targeted trade missions, involving Australian industry, to potential customers, both Government and industry.

The Defence Materiel Advocate's primary role is to implement the DMO's global engagement initiatives and work with the DMO's Systems Divisions and Industry Division to project industry capability into the market place. It also works in partnership with industry and with Austrade and other government agencies to win sales overseas.

Rapid Prototyping, Development and Evaluation

The Rapid prototyping, development and evaluation program is administered through the Capability Development Group. The aim of the program is to enhance ADF warfighting capacity through accelerated capability change in the Network Centric Warfare environment. Where critical shortfalls in the force-in-being are identified, the program allows rapid evaluation of the potential benefits and risks associated with new technologies and changes in procedures. This is achieved through a program with industry, recognising that neither Defence nor individual companies necessarily have all the answers. Following rapid prototyping, development and evaluation new technologies and/or processes can be rapidly adopted and integrated into ADF capability.

Rapid prototyping, development and evaluation has a budget of up to \$20m per year, with actual expenditure depending upon the number of approved tasks. As of March 2006 there were ten tasks currently underway, ranging from initial analysis to technology being prototyped for trial and implementation by ADF warfighters.

Eighty-three companies are presently engaged in the program ranging from global multi-nationals such as IBM and Boeing, to Australian small to medium enterprises like Cirrus Real Time Processing, Accacia and RLM Pty Ltd. Briefings on the program are held regularly and provide opportunities for companies to join.

Capability and Technology Demonstrator Program

The capability and technology demonstrator program aims to show ADF users how leading-edge technology can be integrated quickly into existing, new, enhanced or replacement high priority capabilities. The program is managed by the Defence Science and Technology Organisation. The program had initial funding of approximately \$20m annually, but this increased to approximately \$26m in 2004 and the following three years.

The program is not a grants program, but a collaborative activity conducted under contract arrangements between Defence and industry to deliver a demonstration of the capability potential of new technology. The program's emphasis is on technology in Australian industry that will provide capability advantages to the ADF and allow Australian industry to position itself to provide in-service capabilities and through-life support to the ADF. Proposals are sought annually.

In order to initiate a successful proposal, a company will need to have an appreciation of Defence's capability priorities, gained through prior discussions with both program and Capability Development Group staff and through publications such as the public version of the Defence Capability Plan. Industry briefings are also provided around Australia by the program office. Examples of areas of current capability interest include, but are not limited to:

- Battlespace energy generation and storage;
- Sensors and non-lethal weapons applicable to urban operations;
- Simulation systems support to ADF operations;
- Military platform hybrid drive systems;
- Countermine technologies and unmanned countermine vehicles for sea and land; and
- Ship/aircraft/vehicle signature management technology.

In 2004, the Government announced enhancements to the program, mainly to improve small to medium enterprise participation and access to the program. The enhancements included:

- Seed funding for detailed proposals – normally in the range of \$10,000 to \$20,000 to help companies further develop, modify or enhance proposals to better meet Defence's needs.
- Project viability funding – normally in the range of \$50,000 to \$100,000 to help companies maintain staff and infrastructure while their proposals await approval. The viability funding covers specific activities and is not dependent upon the ultimate decision regarding the proposal.
- Concept definition funding – normally in the range of \$10,000 to \$100,000 for seed funding of systems definition proposals with a view to developing the proposals for the program. These proposals, which have varying levels of maturity from systems definition through to demonstration, can be accepted at any time.

The program was established in 1997. As at May 2005, the program had invested about \$116 million in 38 projects.

3. THE DEFENCE MATERIEL ORGANISATION AND INTERNATIONAL BEST PRACTICE

Australian Defence capability planning processes are now at, or near, world best practice. Rigorous and intensive processes are used to identify defence capability needs, establish priorities, examine options and manage an on-going investment program within financial guidance and with a high level of accountability.

3.1 THE DEFENCE MATERIEL ORGANISATION AND INTERNATIONAL BEST PRACTICE

In 2005-06, DMO's performance showed significant improvement. Performance to date indicates that the slippage reduction will move closer to the construction sector's benchmark of 10 per cent. An earlier comparison of the Top 20 acquisition projects also showed schedule slippage has improved, reducing from 20 per cent in 2003-04 to 12 per cent in 2004-05.

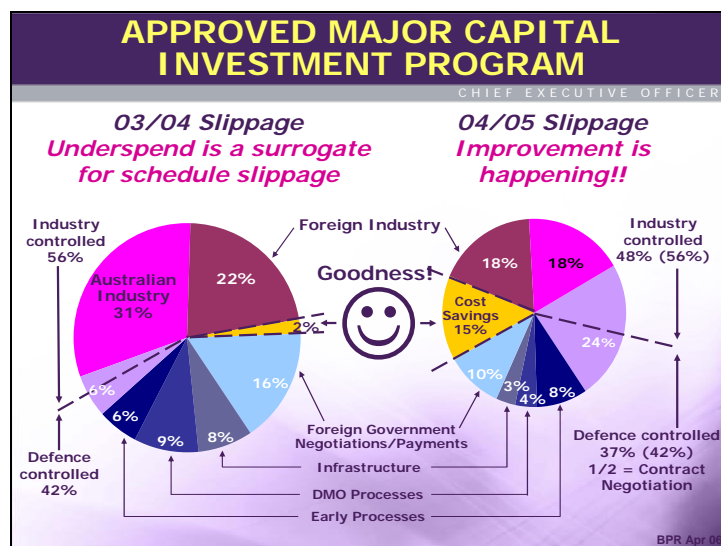
The DMO's analysis of international procurement agencies suggests that its performance compares more than favourably with the performance of its US and UK counterparts. For further information on their organisations the Committee may wish to refer directly to the documents at:

- www.gao.gov/cgi-bin/getrpt?GAO-06-391.
- http://www.nao.org.uk/publications/nao_reports/05-06/0506595_I.pdf

Australia's performance in this regard was noted at the Royal United Services Institute's Defence Acquisition Symposium held in London on 29-30 March this year. During the Symposium, favourable reference was made to changes in acquisition management being implemented within the DMO.

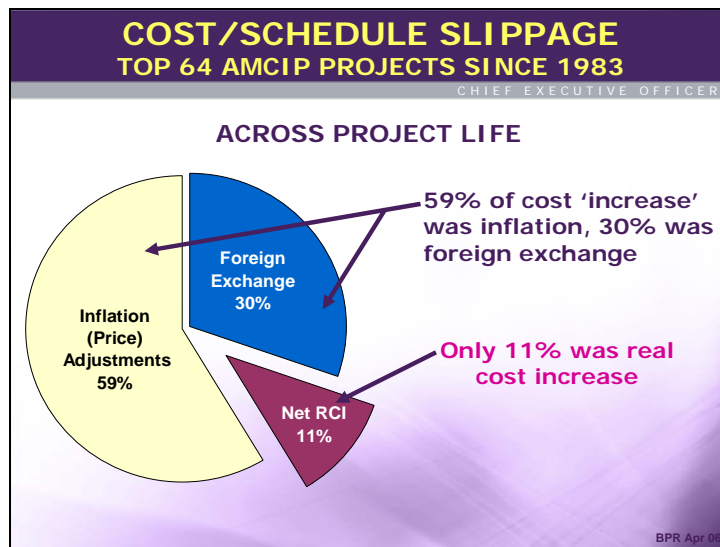
Further information can be provided if required.

The DMO's performance has shown significant improvement since 2003-04 as shown in the diagram below.



Using under-spend as a surrogate for slippage the above diagram shows performance in 2003-04 compared with 2004-05. Performance in 2004-05 shows substantial improvements in most sectors. The DMO has improved in the areas of foreign government negotiations improving from 16 per cent to ten per cent. The DMO's processes, contributing to schedule slippage, has also dropped from nine per cent to four per cent.

Looking at the data from a cost increase perspective, of a total of 64 of the major equipment projects since 1983, real cost increases only amounted for 11 per cent with the rest being attributable to foreign exchange and inflation adjustments.



Since July 2003, the DMO has completed and closed 26 projects worth about \$5 billion. The DMO has approximately \$53 billion worth of projects at different stages at any point in time. Of these projects, eight required real budget increases of \$127m and 18 managed to achieve real budget decreases of \$90m. This equates to a net variation of \$37m which is equivalent to only 0.7 per cent of the total.

The DMO and industry are together focussed on the need to improve schedule performance.

4. FUTURE IMPLEMENTATION OF PROCUREMENT REFORM

This section provides details in relation to the DMO's progress in:

- Contributing to future procurement reform through governance and accountability arrangements
- DMO's Continuing Improvement Program

4.1 CONTRIBUTING TO FUTURE PROCUREMENT REFORM THROUGH GOVERNANCE AND ACCOUNTABILITY ARRANGEMENTS

The DMO has in place a number of structures and processes that will allow it to implement future procurement reform within DMO, and across Defence more broadly.

- The DMO will continue to be very closely involved in Defence's strategic and business planning. The CEO DMO is a member of the Defence Committee and participates in its monthly meetings. The DMO is represented on all Defence senior committees.
- The DMO and the Capability Development Group continue to work closely and cooperatively to strengthen and improve the capability development and assessment process that takes place prior to projects being progressed to the DMO.
- The DMO's governance arrangements are focused on the key areas of planning, stewardship, performance management, assurance, and reporting and audit activities.
- The DMO will continue to use the Business Plan Review to communicate vital performance information to DMO staff around Australia. The review presents key corporate, acquisition and sustainment performance information.
- Performance Management is a key DMO leadership activity. The DMO will continue to monitor executive and staff performance through Employee Performance Agreements.

Reporting on Acquisition Projects and Sustainment Activities

The DMO provides monthly acquisition overview reports to the Minister and the Defence Committee for 74 projects, which includes the DMO top 30 projects by spend and an additional 44 projects that are of interest or concern to the Defence Committee and Government. These reports are key tools in reporting DMO's progress in the delivery of Defence capability.

The acquisition report provides its audience with an overview of improved or declined performance from one month to the next, focusing on technical aspects, project management, schedule, cost and contractual issues.

A main feature of the acquisition overview report is the project maturity score that quantifies, in a simple and communicable manner, the maturity/risk in capital investment projects as they progress through the capability development and acquisition lifecycle.

The DMO provides 94 Sustainment Overview Reports to the Defence Committee monthly. The reports provide an overview on improved or declined performance from

one month to the next, including technical, business management, operational support, price performance and main support provider issues.

The sustainment maturity score, similarly, is a strategic level representation of lag indicators for the sustainment of a capability through to its planned withdrawal date.

The Acquisition and Sustainment Overview Report is a classified document. Mock-ups of a typical Acquisition and Sustainment Overview Report can be found at appendix E.

The Materiel Audit Committee

Since becoming a prescribed agency, the DMO has appointed its own audit committee. The Materiel Audit Committee has an important place within the DMO's governance framework. The committee has focused on the practical arrangements that recognise the DMO's new accountability under the *Financial Management and Accountability Act 1997* and the essential links that must be maintained between the DMO and Defence. It has an annual workplan to meet its assurance obligation to the CEO DMO while allowing sufficient flexibility to pursue issues of concern that may arise.

Risk Management

Enterprise Risk Assessment and Fraud Control provide an essential element of the DMO's governance framework. Further development is underway to strengthen the risk management system at the enterprise, division and project levels, and to embed appropriate risk management culture in the DMO.

4.2 THE DEFENCE MATERIEL ORGANISATION'S CONTINUING IMPROVEMENT PROGRAM

The DMO is continuing to pursue and implement organisational change under six key themes. These are:

- professionalise our workforce;
- reprioritise our work;
- standardise our corporate systems and work practices;
- benchmark ourselves against best practice;
- improve industry relationships, and
- lead reform in Defence and embrace change.

Professionalise our workforce

The DMO Professionalisation Program provides the framework for up-skilling and professionalising the DMO workforce and is a key instrument for driving cultural change and transforming the DMO into a more business-like, accountable and outcome driven organisation. The program involves the implementation of an integrated, consistent and disciplined approach with activities based on industry standards and closely aligned to the DMO's business practices.

One of the key aspects of the Professionalisation Program has been the introduction of certification programs within the DMO. These programs are focused on the professionalisation of project directors, project managers, engineering and technical officers, lawyers, accountants, commercial and business managers, procurement and contracting and logistics.

The following provides an indication of certification to date across the various professional groups:

Project Managers

Total target group: 300

Total certified pre-March 2005: 10

Total enrolled since March 2005: 473

Total certified since March 2005: 287

Total certified in interim certification program (July – December 2005): 238

Total certified: 297

Engineers

Total degree qualified group: 933

Total chartered pre-May 2004: 125

Total enrolled since May 2004: 374

Total chartered since May 2004: 90

Total engineers chartered: 215

Accountants

Total degree qualified group: 106

Total chartered pre-January 2005: 18

Total enrolled since January 2005: 55

Total chartered since January 2005: 18

Total accountants chartered: 36

Lawyers

Total target group: 24

Total enrolled for practicing certificate since April 2005: 13

Total practicing certificate issued: 10

Other measures undertaken to professionalise the DMO workforce are:

- The launching of a Corporate Institute. The DMO Institute was launched on 13 February 2006 with the signing of a Partnering Agreement between the CEO DMO and the CEO of DeakinPrime. The Institute provides strategic education and training, including project management, logistics and post graduate programs. The first suite of training programs (project management and business communications) commenced in February 2006.
- By promoting greater business acumen among staff. The DMO provides training to staff in private sector business and commercial skills. In total the DMO intends to train 3000 staff in business practices over the next three years. To date in 2006, 410 staff have already received training, with a further 600 due to receive training this year.
- By providing leadership programs. Courses have been designed for specific target groups; with the *Catalyst* course for EL1 and EL2 and the *Gateway* course for APS 5 6 level staff and their military equivalents. All training is based on the DMO Leadership Capability Framework. Since February 2006, two programs per month are being held in key DMO locations with twenty participants per program. To date 140 DMO staff have participated in the *Catalyst* and *Gateway* programs.
- The introduction in November of the DMO Project Management Training and Project Management Coaching program to assist project managers in the development of acquisition and sustainment activity. Currently five coaches are assisting clients across all divisions. Project Management Coaching provides:
 - quality and timely advice and practical problem solving activities;
 - independent short-term reviews;
 - development of reports profiling the current 'health' of projects;
 - induction advice to assist emerging project teams in 'first and second-pass approval'; and
 - the management of 'Communities of Practice' – social networks of subject matter experts for an environment (project management; systems engineering; software engineering).

Re-prioritise our work

The DMO is taking a holistic approach to managing our workforce through the military workforce agreement; managing APS staff by budget as opposed to absolute staff numbers; and by reducing the number of professional service providers.

By managing personnel, including military staff, APS staff and Professional Service Providers as integrated workforce it is expected that staff numbers will increase, but total costs will be reduced with a reduction in the level of Professional Service Providers used.

Australian Workplace Agreements have been applied to new recruitments and to existing staff in critical skilling categories including project managers, system program directors, engineers and commercial and business staff.

Current standing offer panels have been rationalised into a single DMO Support Services Panel. The panel provides engineering and other project support services.

Standardise our corporate systems and practices

Corporate systems are being standardised across the DMO. This has included the implementation of:

- a standardised corporate reporting system in 2005 that is being used to generate monthly acquisition and sustainment overview reports, and
- a corporate brand to build consistency in all our communications. A style guide has been released for DMO staff reference and a revamp of the DMO internet site is underway.

Currently, the Australian Defence Contracting (ASDEFCON) suite provides a set of proforma documents for use by Defence and DMO Procurement Officers for the acquisition of goods and services by Defence and DMO. The ASDEFCON Suite of tendering and contracting templates were introduced to:

- support Defence and DMO Contracting activities by facilitating tender and contract development and management;
- standardise and benchmark Defence and the DMO's business practices and procedures by providing tools to support Commonwealth and departmental policies; and
- provide a framework for obtaining value for money and ensuring accountability.

Current procurement policy provides that where an appropriate standard ASDEFCON contracting template exists for the type of procurement being undertaken, such as a complex procurement, it is mandatory for Defence and DMO staff to use that template as a starting point, with some tailoring allowed.

In recognition of the need to ensure that Defence's standard contracting procedures and templates reflect commercial 'best practice', and the global nature of Defence procurement, a Procurement Improvement Program (PIP) was commenced in late July 2005 by the DMO as business process owner for procurement and contracting policy and practices across the Defence portfolio.

The PIP is a key change initiative which will benefit both Defence and the DMO through the delivery of the following key outcomes:

- the reduction of unnecessary process and volume of documentation;
- placing Defence procurement and contracting on a commercial footing whilst remaining consistent with Government accountability frameworks; and
- providing increased attention to Defence and Defence Industry concerns to ensure a full understanding of Defence's capability requirements and of Defence Industry offers before entering into a contract.

The PIP consists of three phases. Phase one was announced at the Defence and Industry Conference in June 2005. This phase involves a strategic review and revision of all procurement and contracting policies, practices, templates, guidance and associated training material. Consultation with Defence Industry on the PIP has focused broadly on contracting reform initiatives that occurred in July and August 2005. This first round of consultation sought feedback on the existing ASDEFCON templates; inefficient processes that could be simplified; industry's preferences for contract structures and suggested improvements to reduce the time and cost of bidding. A broad range of industry members' responses and feedback is being considered as part of the development of the new contracting documentation. Further consultation with Industry occurred in February and March 2006.

The DMO will be consulting further with Defence Industry on key contracting templates prior to the release of the final version of phase one of the program at the Defence and Industry Conference in June 2006. This will assist with product refinement and development of enhanced industry relationships.

Phase one of the PIP has identified further work streams and products to ensure a strategic and consistent approach across the Defence procurement and contracting lifecycle. This work will continue into 2006-07.

The second phase comprises an intensive training and awareness program for key Defence personnel and Defence Industry, to be delivered as part of the launch of the new procurement and contacting templates and guidance material. This phase is expected to commence in July 2006 and may run through to September 2006.

A third phase of the program involves the consideration of an automated assembly tool for tendering and contracting documentation. The DMO will soon conduct a feasibility study into a whole-of-life Defence Contract Lifecycle Management System which will automate and track the processes of acquiring and sustaining a procurement from needs analysis, tendering, award and management of that contract through to disposal of assets at the end of the procurement lifecycle. No timeframe has been specified for this phase as it is subject to the results of a feasibility study.

By automating procurement documentation the DMO aims to provide users with a centralised information store ensuring contract managers have the most up to date versions of templates. This will lead to a consistency of approach in all documentation; an auditable, documented trail of the commercial thinking underpinning the draft contract; and appropriate guidance and policies attached to the contract clauses by way of a 'link'.

Defence and the DMO's new tendering and contracting documentation will:

- be more user friendly;
- improve business outcomes for Defence and the DMO from procurement processes, including more robust competitive tender processes;
- contemporise contractual risk allocations and their drafting –by modernising and standardising contracts reflecting the DMO's business requirements and by current best national and international procurement and contracting practice;
- improve risk management and quality assurance; and
- improve efficiency in contract delivery and management for Defence and the DMO.

Defence and DMO's new approach to contracting includes a broad range of options for structuring payment, control of cost, incentives, improved schedule performance and other changes that reflect best practice for Government.

Benchmark ourselves against best practice

The DMO is benchmarking itself against commercial and industry best practice by:

- implementing corporate performance reporting using strategic critical success factors, and
- monitoring its cost and schedule performance against industry.

Improve Industry relationships

The DMO continues to develop skills in industry through the Skilling Australian Defence Industry (SADI) program. Through the program a total of \$215m over ten years is being invested in industry. Thirty-four companies have received invitations to join the program. Nine companies have indicated the intention to develop and/or were making progress on their respective SADI proposals. The SADI program has already established agreements to contract with ASC, BAE, Saab, Tenix, and Thales.

The DMO continues to monitor the utility of, and access to, the Defence Small Business Access facility. The facility (an internet portal and a national toll-free number) assists small to medium enterprises to obtain information on opportunities in Defence and working with our prime contractors. An interactive database has been launched to enable small businesses to input advice on their capabilities to Defence and prime contractors.

The DMO's contractor performance management systems will be developed further to enhance the accuracy of Company ScoreCards on the performance of contractors and 360 degree Scorecards on the performance of the organisation. Scores have been weighted to reflect the primacy of schedule, cost, technical quality, project management and contract value over other performance measures.

Lead reform and embrace change

The DMO has established Project Management positions within the Capability Development Group. Teams from the DMO's Aerospace, Maritime and Electronic

Weapon Systems, and the Chief Operating Officer Divisions are working with the Capability Development Group.

Within DMO, senior military officer positions are open to filling by ADF, public servant, or external applicants. The successful applicant is the one with the strongest claims against the selection criteria. This recruitment strategy is being adopted in other areas of Defence.

The DMO is working with Defence to develop an innovative and flexible Defence Collective Agreement that supports the DMO's strategic direction.

APPENDICES

A – Financial and Resource Management Systems Training.

B – Defence’s Governance Structure and Budgeting Framework.

**C – Assessment of Defence’s Budget Management System against
ANAO Better Practice Guidelines.**

D – Defence Procurement Advisory Board.

E – Sample DMO Acquisition and Sustainment Overview Reports.

Appendix A – Financial and Resource Management Systems Training

2004-05	Financial & Resource Management Systems Training	
Training Courses	Number of Students	
<i>Financial Management Training</i>		
Senior Leadership Group Financial Management Courses		14
Total		14
<i>Financial Information Systems Training</i>		
Resource and Output Management and Accounting Network (ROMAN)		4,355
Budget and Output Reporting Information System (BORIS)		482
Force Element Product Costing (FEPC)		120
Total		4,957
<i>Financial and Business Training</i>		
Accrual Accounting (current enrolments in external courses)		80
Understanding Accounting Processes		464
Introduction to Resource Management		376
Cost Centre Management		216
Total		1,136
<i>Tertiary Financial Training</i>		
Diploma in Government		42
Graduate Certificate in Professional Management (Finance)		59
Total current enrolments in external courses		101
<i>E-Learning</i>		
Defence Purchasing Card		375
Manage Official Bank Accounts		64
Travel Budget Calculators		172
Card Management System		205
ROMAN Procurement Awareness		345
Total		1,161
Total Financial Management and Business Training		7,369

Appendix A – Financial and Resource Management Systems Training (cont)

YTD 2005-06	Financial & Resource Management Systems Training	
Training Courses	Number of Students	
<i>Financial Management Training</i>		
Senior Leadership Group Financial Management Courses		77
Senior Officer Financial Management Courses		68
Total		145
<i>Financial Information Systems Training</i>		
Resource and Output Management and Accounting Network (ROMAN)		3,717
Budget and Output Reporting Information System (BORIS)		176
Force Element Product Costing (FEPC)		43
Total		3,936
<i>Financial and Business Training</i>		
Accrual Accounting (current enrolments in external courses)		23
Understanding Accounting Processes		217
Introduction to Resource Management		274
Cost Centre Management		117
Introduction to Financial Management in Defence		125
Introduction to Accounting in Defence		44
Introduction to Asset Management in Defence		33
Defence Attache Finance Course		25
Developing a Business Case		51
Total		909
<i>Tertiary Financial Training</i>		
Diploma in Government		55
Graduate Certificate in Professional Management (Finance)		14
Total current enrolments in external courses		69
<i>E-Learning</i>		
Defence Purchasing Card		619
Manage Official Bank Accounts		19
Travel Budget Calculators		1,121
Card Management System		1,701
ROMAN Procurement Awareness		3,460
Total		8,519
Total Financial Management and Business Training		

Appendix B – Defence’s Governance Structure and Budgeting Framework.

Defence is managed under a joint ‘diarchy’ leadership model. Under the model, the Secretary and the Chief of the Defence Force have separate and joint powers. The Chief of the Defence Force commands the ADF and is the principal military adviser to the Minister. The Secretary is the principal civilian adviser to the Minister and has certain statutory obligations under the *Public Service Act 1999* and the *Financial Management and Accountability Act 1997*. Jointly, they are responsible for the administration of the Australian Defence Organisation.

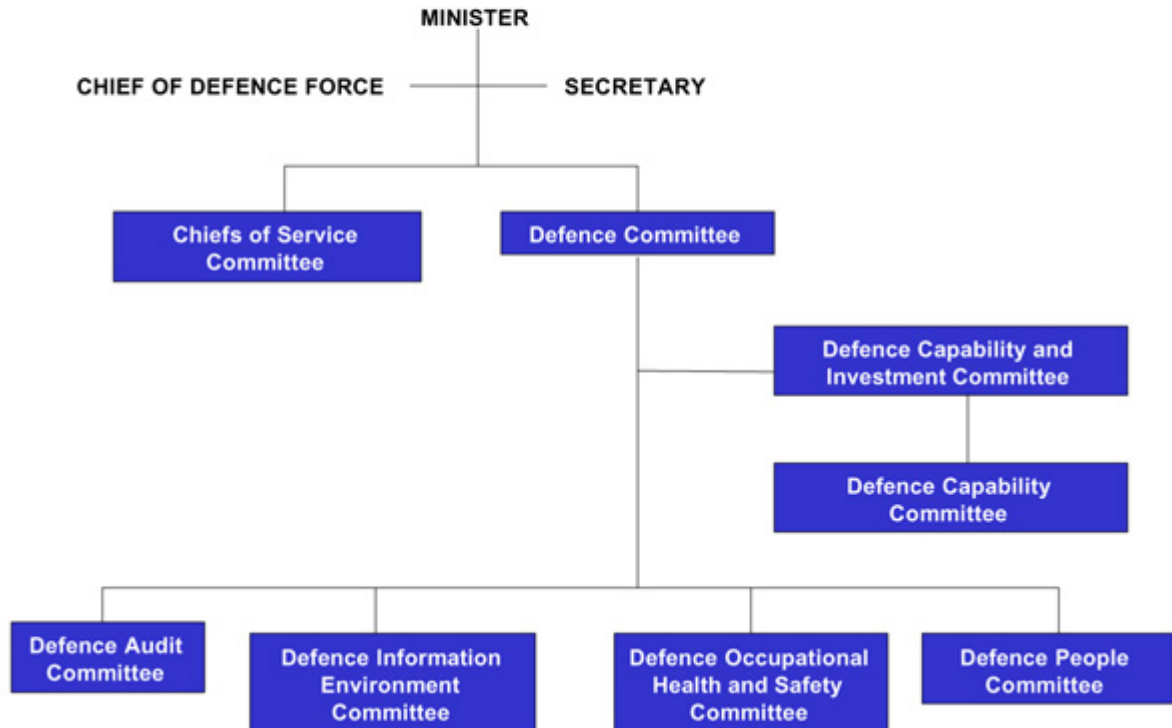
With effect from 1 July 2005, the DMO was established as a Prescribed Agency under the *Financial Management and Accountability Act 1997*. As a result, the CEO DMO is responsible for the efficient and effective acquisition and through-life support of materiel for Defence capabilities.

The Committee System

To facilitate the diarchy management arrangements, the Secretary and the Chief of the Defence Force have established a committee system to inform their decision making and to provide advice to Government. The committee system is depicted below.

Chart 1. The Defence Committee System

DEFENCE GOVERNANCE STRUCTURE



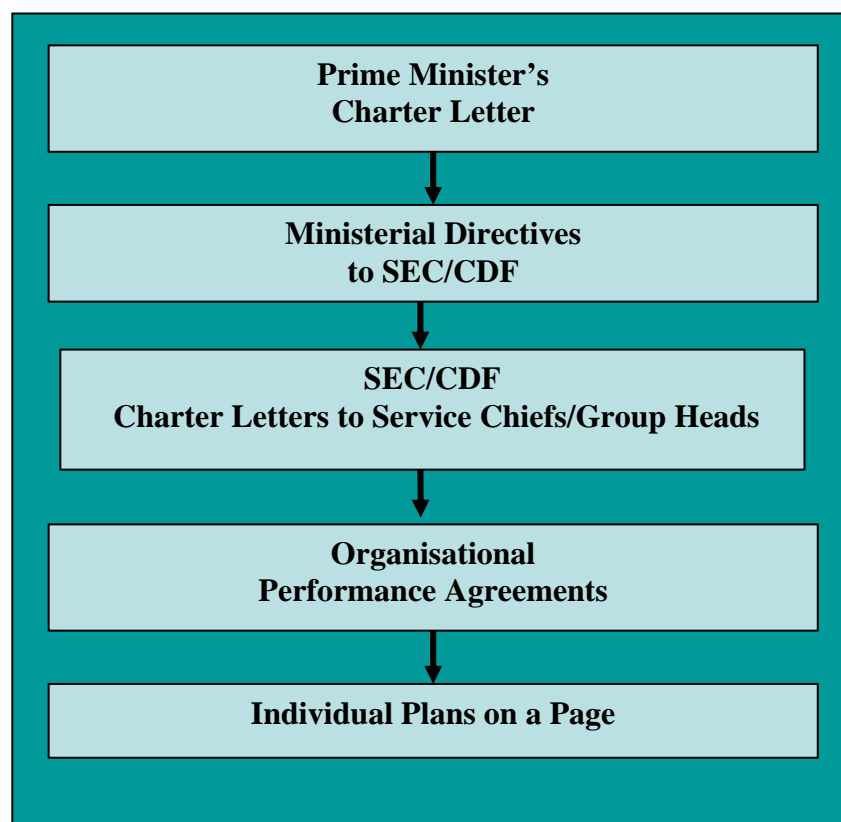
The key committees and their roles as they relate to resource allocation and financial administration are:

- a. **The Defence Committee** is the senior decision making body and governance board. It is chaired by the Secretary. It makes all the key decisions relating to Defence's ten-year management and finance plan, the annual budget and the administration of the organisation. It reviews non-financial and financial performance on a monthly basis.
- b. **The Defence Capability and Investment Committee** is chaired by the Secretary and is responsible for all significant capability decisions including the balance between the force-in-being and the future-force. It allocates priorities for the investment program and endorses all significant projects prior to Government approval.
- c. **The Defence Capability Committee** considers options for future capability, and considers and endorses all projects prior to Government approval. The Defence Capability Committee manages and reviews the Defence Capability Plan.
- d. **The Defence People Committee** provides a strategic focus on, and is an advocate for, the important place of people in supporting Defence capability. It establishes the size and distribution of the Defence workforce and the

priorities for the personnel budget subject to agreement by the Defence Committee.

At the heart of Defence’s financial management framework is the requirement to meet the directions it receives from the Government of the day. The 2000 White Paper, and the two Defence Updates, outlines the strategic objectives and tasks that shape the future development of the Defence Force and the priorities for allocating resources. Election commitments and other ministerial directives also provide high level policy guidance. Defence’s new governance framework and business model that supports it ensures that Defence complies with these directions through a strong focus on performance and accountability, underpinned by a culture of economy and continuous improvement. At the heart of the framework is a cascading set of directives and agreements as depicted below.

Chart 2. Defence’s Cascading Set of Directives and Agreements



Prime Minister’s Charter Letter

The Prime Minister has provided the Minister for Defence with a Charter Letter which sets the priorities for the Defence Minister for the fourth term of the Howard Government.

Ministerial Directive

The Minister for Defence provides direction to the Chief of the Defence Force, the Secretary and the CEO DMO through Ministerial Directives that outlines the requirements they are expected to deliver in achieving the Defence mission including:

- successful joint conduct of military operations, with the Chief of the Defence Force retaining sole command authority;
- provision of capability to enable our armed forces to defend Australia and its national interests;
- timely and responsive defence advice;
- proper stewardship of people and of financial and other resources, including achievement or bettering, of budgeted operating results, and
- the Defence Management and Finance Plan incorporating the above.

The Minister for Defence provides direction to the CEO DMO to deliver:

- timely and responsive advice on the outputs for the DMO; and
- proper stewardship of the people and of financial and other resources.

Secretary/Chief of the Defence Force Charter Letters

The Secretary and the Chief of the Defence Force provide each of the Service Chiefs and Group Heads with Charter Letters detailing the results expected of them from the resources allocated. These letters also outline their accountability obligations, including achieving or bettering their budgets.

Organisational Performance Agreements

All Service Chiefs and Group Heads have Organisational Performance Agreements with the Secretary and the Chief of the Defence Force. These agreements, which are reviewed each budget year, set out the performance to be provided for the allocated resources in support of the delivery of outcomes to the Government. They also identify any shortfall in performance and the remediation plans that are either funded or proposed. While the agreement focuses on the year that it is formed, it has a ten-year planning horizon to forecast performance, strategic initiatives, and the identifiable limitations and risks to performance.

Agency agreements between Defence and the DMO establish performance measures for the DMO.

Performance Agreements

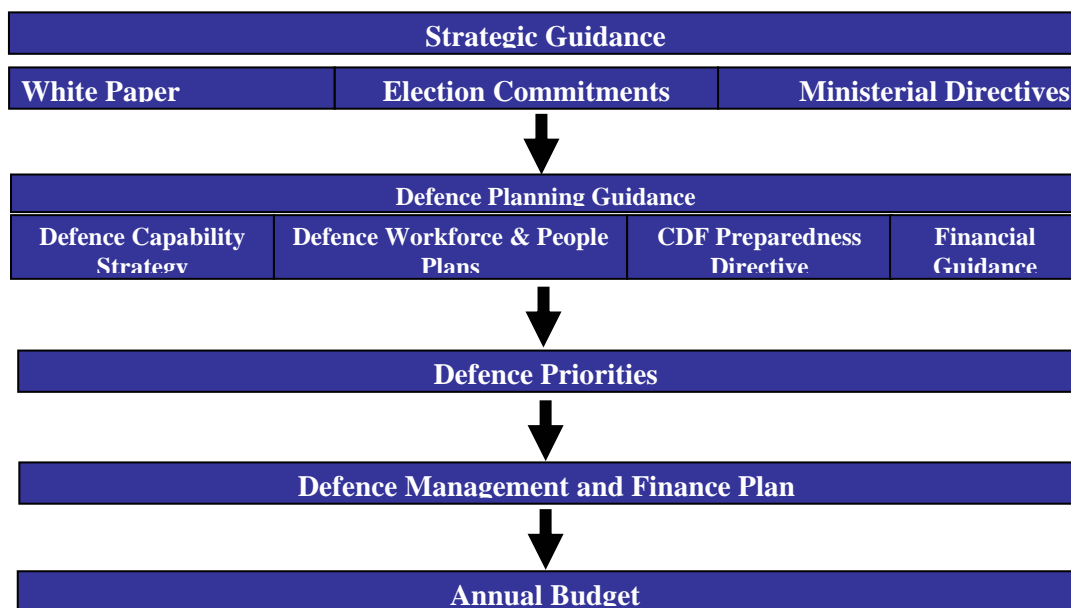
Individuals are accountable to the Secretary and the Chief of the Defence Force for their performance in meeting corporate goals and performance targets. Performance Agreements for Senior Executive Service officers are aligned with the Charter Letters and Organisational Performance Agreements. CEO DMO also has Performance Agreements with his SES Officers. Performance exchanges are conducted twice per year and performance is linked to salary progression.

Defence's Budgeting Framework

In 2000, following a joint review involving the Department of Finance and Administration and the Department of Defence, the Government agreed that Defence should move to a ten-year planning horizon. This required preparing an annual ten-year Defence Management and Financial Plan for Government consideration during the budget cycle. The introduction of the annual as part of each process coincided with the 2000 Defence White Paper which provided a ten-year funding projection for Defence of approximately three per cent real growth per annum to 2010-11. The provision of long term financial guidance is essential for effective long-term Defence planning. The ten-year planning horizon and funding projection provided a framework to introduce a number of improvements to Defence's financial management processes.

Chart 3 depicts Defence's long-term planning and budgeting framework and how this is brought together on an annual basis in the Defence Management and Financial Plan and the annual budget for consideration by Government.

Chart 3: Defence's Budgeting Process



Through periodic updates on the White Paper, election commitments and strategic updates the Government provides strategic direction to inform the resource allocation process. This guidance is used to inform lower level planning, capability, workforce, preparedness and financial guidance that sets the parameters for the development of the annual Defence Management and Financial Plan. The most recent review was *Defence Update 2005*.

The Defence Planning Guidance articulates the strategic priorities (near, medium and long term) that guide further planning and action within Defence. Based on a strategic risk assessment of the types of contingencies likely to face Defence in carrying out its Government-endorsed roles, the Defence Planning Guidance provides overarching guidance to subordinate plans that shape decision making on the

fundamental inputs to capability and their enablers (such as capability development and management, force disposition and workforce planning, international engagement, science and technology and industry positions).

The Defence Capability Strategy is one of the key subordinate plans and is a description of the Defence vision for capability transformation. It provides a picture of where the organisation is headed in capability terms over the next 20 years. It reflects the agreed directions from the Government, such as the 2000 Defence White Paper and the 2005 Defence Update, and addresses the resultant capability goals holistically.

Other key documents include the Defence Workforce and People Plans, the Chief of the Defence Force's Preparedness Directive and financial guidance from the Chief Finance Officer.

The Defence Management and Financial Plan Process

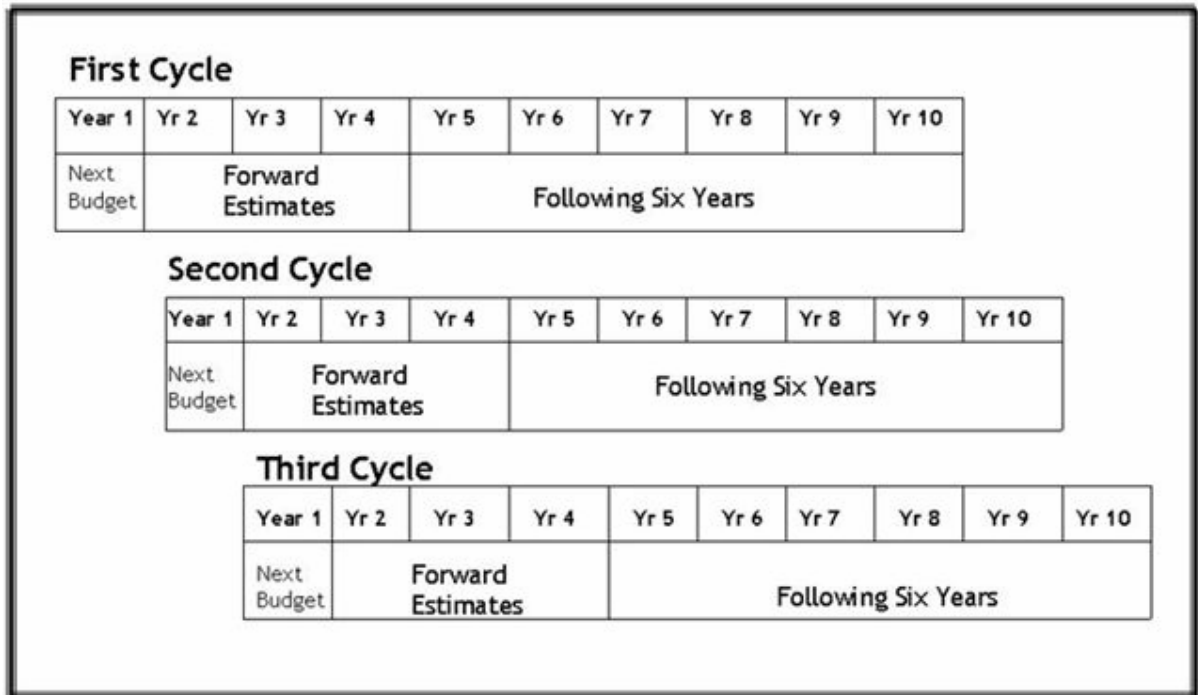
The Defence Management and Financial Plan is a decision support document, accompanying the Defence Portfolio Budget Submission. The Defence Portfolio Budget Submission remains the primary vehicle for Expenditure Review Committee consideration of the Defence budget. The requirement arose from the Government's consideration of the Joint Defence/Finance review of financial management in Defence undertaken in 2000. The requirement for the Defence Management and Financial Plan was reinforced publicly in the 2000 Defence White Paper.

As an integral part of the Budget process, the draft Defence Management and Financial Plan supports the Minister's submission to the Prime Minister for the Senior Ministers' Review each year. The Senior Ministers' Review, usually undertaken in late November or early December, incorporates the perspectives of the Prime Minister, Treasurer, and the Minister for Finance to establish the commitments of the next financial year. The outcome of this review committee helps determine Defence's budget submission. The Expenditure Review Committee meets in March and makes the decisions about which proposals will receive funding and at what level the funding will be provided. Once these are established, Defence budget documentation may begin.

The Defence Management and Financial Plan provides a mechanism for Ministers to have a clear oversight of Defence planning and financing strategies, and the means for delivering strategies agreed through the White Paper and subsequent strategic updates. The plan also enables Ministers to make informed budgetary and strategic decisions on Defence by bringing into one document the expected financial position of the portfolio, taking into account existing commitments and proposed new investments. The level of resources Defence is seeking and the outcomes to be delivered are set out in the document and include the cost of maintaining existing investments and the cost of proposed new investments. The Government is therefore able to assess whether its investment in Defence is both affordable and sustainable.

The annual budget is derived from the ten-year rolling Defence Management and Financial Plan. Year 1 becomes the budget and a new Year 10 is added. In this way, Defence's rolling program aligns with its longer-term plans as depicted below.

Chart 4: Cyclical Nature of the DMFP



Having moved to a ten-year planning and budgeting process, it was then important to introduce more effective arrangements for managing the key elements of the budget (ie investment, workforce and operating costs). The Defence procurement reforms, in 2005, provided a catalyst to further improve Defence’s management arrangements, particularly in relation to the Defence Management and Financial Plan, the Defence capability and investment programs and the Defence Capability Plan.

Investment Budget

Defence’s investment program accounts for about 25 per cent of Defence expenditure and is composed of four elements:

- the *Defence Capability Plan* (new projects not yet approved by Government);
- the approved Major Capital Equipment program (projects approved by Government including those *Defence Capability Plan* projects approved since its release);
- the Capital Facilities program (both unapproved and approved), and
- Minor Capital Equipment projects and other Capital items including Minor Capital programs, purchase of Repairable Items and Other Plant and Equipment.

Defence Capability Plan

The *Defence Capability Plan* is a costed, detailed development plan for Australia’s military capabilities over a ten-year period. The plan is reviewed regularly by Government to take account of changing strategic circumstances, new technologies and changed priorities, in the context of the overall Defence budget. The plan sets out

the proposed investment in new equipment under the five capability goals set out in the 2000 White Paper as adjusted by subsequent updates. The *Defence Capability Plan* is managed through the Defence Capability Committee. Defence Capability Committee consideration is required prior to each project going forward to Government for first or second pass approval. Following implementation of the new 'two pass' approval process as part of the Defence Procurement Review, the Cabinet approval threshold has been increased to \$50m. Projects costing between \$8m and \$50m are approved jointly by the Ministers for Defence and Finance and Administration.

Approved Major Capital Investment Program

The Approved Major Capital Equipment Program is comprised of those projects which generally cost in excess of \$20m and which, following approval, are transferred from the *Defence Capability Plan* to the DMO for the acquisition phase. The Approved Major Capital Equipment Program is managed by CEO DMO and following the implementation of the acquisition reforms, each project is managed under Materiel Acquisition Agreements between CEO DMO and the Chief of the Capability Development Group. The ten-year program is reviewed annually as part of the annual Defence Management and Financial Plan process, and key projects are reviewed monthly by the Defence Committee.

Capital Facilities Program

The Capital Facilities Program comprises approved and unapproved major and medium projects. Major capital facilities have expenditure over \$6m and are subject to Government approval and review by the Joint Standing Committee on Public Works. Medium facilities projects have expenditure between \$500,000 and \$6m. Projects between \$5m and \$6m are subject to Government approval but are not reviewed by the Joint Standing Committee on Public Works. Projects under \$5m are approved by departmental delegates. The Capital Facilities Program is managed by the Deputy Secretary Corporate Services with individual projects considered by the Defence Infrastructure Sub-Committee. The Capital Facilities Program is also reviewed each year by the Defence Capability Committee as part of the Defence Management and Financial Plan.

To improve the management of the Capital Facilities Program, and align the approved program with the 'two pass' approval process now used for major capital equipment projects, Defence has implemented two key changes:

1. the establishment of the Defence Infrastructure Sub-Committee in 2002 to enable systematic whole-of-Defence consultation and prioritisation of the capital facilities program, and
2. the introduction of a new two-stage infrastructure asset development model in 2003-04 to provide a higher level of transparency, accountability and cost certainty to Government. The new two-stage process, which is consistent with the 'two pass' system, involves greater design and development work prior to seeking Government approval. This early work aims to refine costs to a greater level of certainty and develop a feasible construction schedule. The time and resources required for the early project design and development work slowed the number of large major projects that were approved over 2003 and 2004.

Other Capital Purchases

Other capital purchases consist of Minor Capital Equipment projects, purchase of repairable items and other plant and Equipment which exceed the asset capitalisation threshold of \$10,000 (\$50,000 for grouped assets) but are not designated minor capital projects. Minor capital projects cover new equipment, and are generally valued at between \$250,000 and \$20m. Minor projects costing between \$8m and \$20m are approved jointly by the Ministers for Defence and Finance and Administration. Projects costing below \$5m are approved by the Service Chiefs and Group Heads, or their nominated delegates. Minor Capital programs and other capital purchase budgets are reviewed annually as part of the Defence Management and Financial Plan.

Clearance of project cost estimates

Emanating out of the procurement reforms was a desire by Government to improve the cost estimates for investment proposals including their whole-of-life costs. New project and through-life-support costing techniques have been implemented, and the Chief Finance Officer is required to sign-off on the estimates (including the through-life-support costs) and agree that the cost estimates are affordable and within the forward allocations provided by Government. To complement this process, all Ministerial and Cabinet submissions, which have resource implications, are required to be cleared by the Chief Finance Officer, in terms of the accuracy of the costs and funding strategy proposed, as a pre-requisite for Ministerial consideration.

Workforce and People Plans

Following a review of Defence's strategic workforce planning processes in 2003, Defence adopted a new workforce and people planning process and this has been instrumental in managing a workforce of over 90,000 people with an annual budget of over \$6 billion or 40 per cent of the Defence budget.

The Defence Workforce Plan

The Defence Workforce Plan sets out the total workforce requirements for the Defence over a ten-year period. As well as detailing the allocation of permanent and reserve forces, it allocates civilian staffing and external service provider numbers for the same period. It contains agreed workforce distributions by the Defence Groups (including for military personnel working in the non-Service Groups). It takes account of Government decisions, changing capabilities and changes in force disposition. Under a total workforce concept, Group Heads are permitted to trade between their ADF, civilian and professional service provider workforces provided they stay within the approved total workforce.

The Defence Workforce Plan has regard for:

- the current workforces numbers as influenced by current and historical separation data;
- planned recruiting intakes;
- throughput in the training system, including officer training, ab initio training and operational training;
- changes in the Defence Capability Plan;

- changes in the mix and skills of the workforce;
- management efficiencies and reforms, and
- new policies and measures agreed by the Government (eg the Hardened Networked Army).

The Workforce Plan also has regard for wider labour market conditions such as an aging population and the need to change the mix and composition in line with a changing skills base, technology and other factors.

The Defence People Plan

The Defence People Plan has three key purposes. They are:

- identifying the key workforce pressures and risks confronting the organisation in terms of populating the Workforce Plan;
- establishing a workforce funding strategy for the ten year period, and
- proscribing a range of new policy measures and new conditions of service enhancements such as recruitment and retention measures and pay levels in order to attract and retain sufficient skilled personnel to meet the Workforce Plan targets.

The Defence Workforce Plan and the Defence People Plan together provide the framework and discipline for managing the Defence workforce and its associated budgets.

Operating Budget

Defence continues to improve its preparedness management system and this has been instrumental in providing key information for decision making on the preparedness levels of all force elements and the operating budget that supports them. The operating budget amounts to over \$6 billion per year or 35 per cent of the Defence budget. Effective management arrangements are critical to maximise the delivery of capability to Government.

The preparedness levels required by Government are derived through a cascading planning process starting from the 2000 Defence White Paper, which forms the basis for developing Australia's military strategy. This provides further amplification, with particular reference to the four Defence tasks: Defending Australia; Contribution to the Security of the Immediate Neighbourhood; Supporting Wider Interest; and Peacetime National Tasks. Within each of the four Defence tasks, the Military Strategic Objective, Military Strategic Effect and Military Response Options are described.

The performance levels for each force element group are developed having regard to this planning process. This involves an annual assessment of the targets against available resourcing levels, known deficiencies, and the constraints of effective workforce management. Funding decisions have regard for critical gaps between the required levels of preparedness and the funds allocated. The Organisational Performance Agreements between Secretary and the Chief of the Defence Force and each Group Head are the vehicle for setting out the preparedness levels that can be maintained at current funding levels and the shortfalls for which additional funding is needed. Changes in preparedness levels are a key cost driver for the operating budget,

especially for the logistics sustainment budget. Following the Defence Procurement Review, the logistics budget is managed by CEO DMO under Materiel Sustainment Agreements with the Capability Managers. The logistics budget is reviewed as part of the Defence Management and Financial Plan, along with other operating budget items.

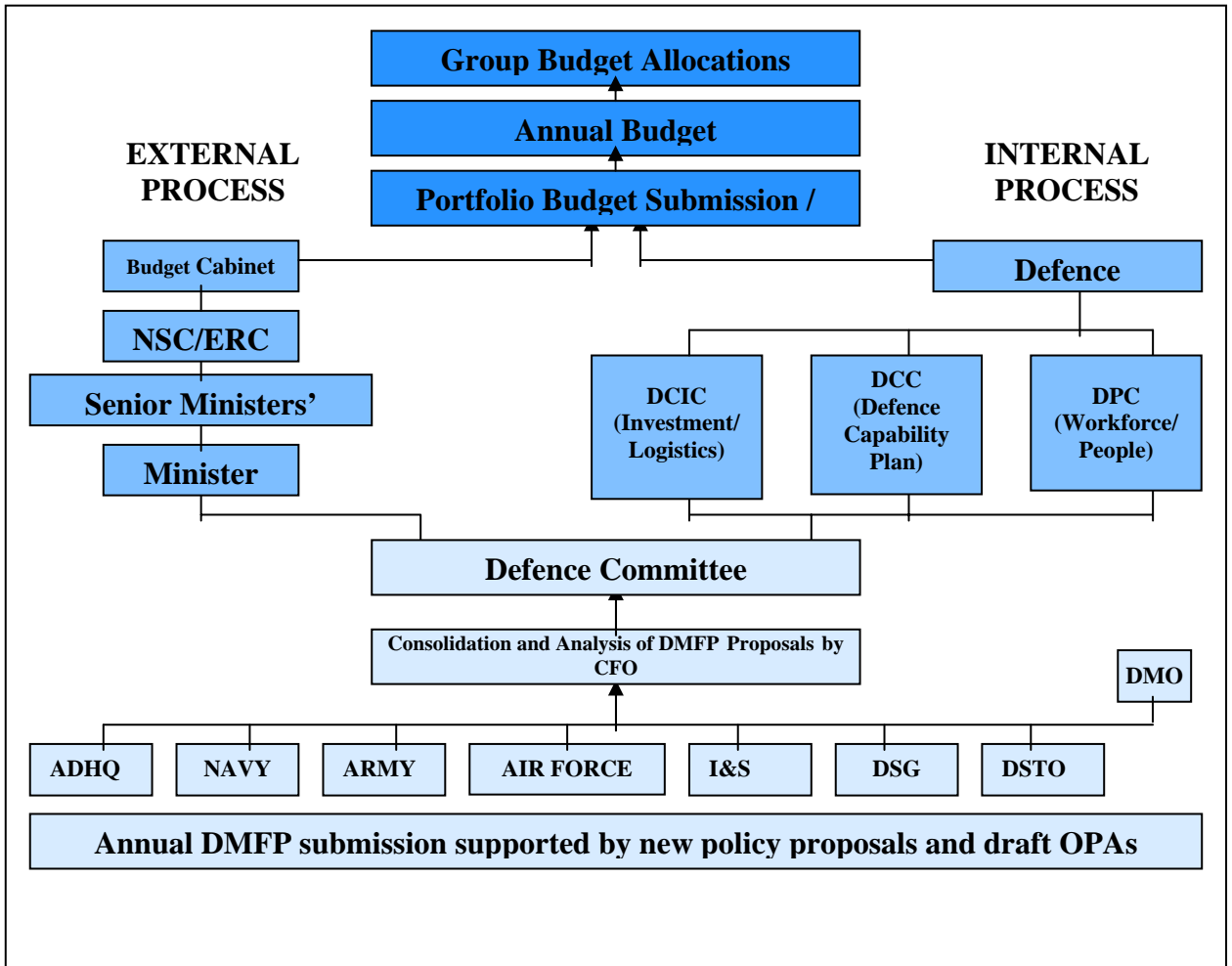
At the same time, Defence's commitments to meeting the Government's efficiency dividend and other savings required of the organisation are also reviewed to ensure that savings are being achieved in the areas intended.

Oversight of the Defence Budgeting Process by the Defence Committee

The Defence Committee plays a pivotal role in setting budget parameters and making key decisions on budget priorities in Defence. This committee is Defence's most senior committee and is chaired by the Secretary with members comprising the Chief of the Defence Force, the Service Chiefs and Group Heads. As well as overseeing the development of the ten-year Defence Management and Financial Plan, it reviews the current budget on a monthly basis and this provides a framework for a continuous review and adjustment to the Defence budget. Through this process, Defence is able to maintain eleven years of live budgets within the long term financial planning parameters provided by the Government.

The Defence Committee is required to make important judgements about the balance of investment between the current force and the future force, on the one hand, and between investment, personnel and operating on the other. This work is complemented by that undertaken by the Defence Capability and Investment Committee, which considers all key capability and investment decisions, and by the Defence People Committee which oversees all key workforce and people issues. This process is depicted below.

Chart 5: Defence's Bottom-Up Budget Process



Appendix C – Assessment of Defence’s Budget Management System against ANAO Better Practice Guidelines.³⁷

BETTER PRACTICE ATTRIBUTES CEO’S ASSESSMENT	MATURITY			COMMENTS
	Established	Developing	Absent	
Financial management environment				
Has the organisation established a budget committee to oversight the internal budget process?	x			Yes. The Defence Committee, which is Defence’s senior management committee, oversees the development of Defence’s budgets and revisions thereof. It sets the parameters and key priorities for the development of Defence’s ten year Defence Management and Finance Plan (DMFP). It also considers new proposals for inclusion in the DMFP and budget. The DMFP is considered by the Committee about four times in each year. The current budget is reviewed by the Defence Committee on a monthly basis and this provides a basis for continual review and adjustment to the current year budget and the DMFP.
Do you (the Secretary) actively participate in the budget development process and do you authorise the budget for the year?	x			Yes. The Secretary chairs the Defence Committee and, in this role, has responsibility, drawing on advice from the Chief of the Defence Force (CDF), the Service Chiefs and Group Heads, for preparing for Government consideration all key decisions in relation to Defence’s budget. As the Chair of the

³⁷ *Internal Budgeting: Better Practice Guide*, Australian National Audit Office, February 2003

				Committee, the Secretary authorises the annual budget allocations and key revisions to those allocations.
Do corporate and business plans include budgets and financial targets? Are internal budget and business plans developed and approved at the same time?	x			Yes. All Service Chiefs and Group Heads have charters with the Secretary and the CDF. They are also required to have Organisational Performance Agreements with the Secretary and the CDF which are based on high level business plans and the DMFP. These documents set out the performance targets (both financial and non-financial) to be achieved for the resources allocated to them.
Are all internal budgets developed on the same basis used to prepare the financial statements?	x			Yes. Budgets are developed on a consistent basis and are maintained in Defence's portfolio budgeting system (BORIS) in the same basis that Defence prepares its financial statements. Estimates are maintained at the reporting note level.
Have managers' financial responsibilities been clearly articulated and incorporated into their performance agreements?	x			Yes. All Group Heads annually sign a Charter with the Secretary and the CDF. The Charter specifies the personal responsibilities and expectations of the Group Head including the Group Head's responsibilities for resource management.
Building an efficient and effective budget development process				
Is the internal budget process benchmarked against other organisations to ensure that better practices are being adopted?		x		Developing. Defence has commenced benchmarking its performance against other organisations. For example, Defence currently has a proposal with Government which proposes the adoption of some of the features of the UK system which it believes will improve the Commonwealth

			<p>budgeting framework, particularly as it applies to Defence.</p> <p>The Chief Finance Officer has an out-posted officer in Washington who is able to observe US practices and who is able to share with US officials, Australian Defence Organisation experiences and practices. This is a most beneficial arrangement.</p> <p>Defence shares experiences and methods with other defence organisations. For example, the Secretary programmed discussions with the US Under Secretary of Defense (Comptroller) in his visit program in September 2005; the Canadian Assistant Deputy Minister (Finance and Corporate Services) will be visiting Canberra in April 2006 to discuss financial management matters relevant to both countries' defence organisations; and a delegation from Singapore is to visit Australia in April 2006 to discuss Defence's experience in implementing accrual budgeting. In addition, Defence conducts training programs for the Philippines on project management, planning and budgeting.</p>
Do senior executives challenge budget submissions and assumptions for consistency with organisational priorities?	x		<p>Yes. Defence uses various methodologies to assess the relative priority of competing proposals. As an initial step, the CFO assesses all proposals for their policy basis, their contribution to capability and from a risk management point of view. Competing priorities are ranked for committee consideration and these are tested against organisational priorities by the Defence Committee before proposals are agreed and implemented. The six strategic themes flowing from the Defence 2000 White Paper provide a sound basis for making</p>

				<p>these decisions.</p> <p>The six strategic themes are:</p> <ul style="list-style-type: none"> • Developing the capability to win today and tomorrow. • Creating the climate where people do their best. • Promoting quality advice and decision making. • Getting best value from the Defence dollar. • Strengthening international relationships for Australia's security. • Making best use of science and technology and Australian industry.
Have different budget and reporting systems/tools been assessed to see if they would improve the efficiency or effectiveness of the process?		x		<p>Developing. Defence has an organic budget development and reporting information system – BORIS. BORIS is used throughout Defence to develop and report budgets. BORIS is undergoing further development to better automate the budget development process and to provide greater reporting flexibility.</p>
Is the organisation project driven and does it use a bottom up approach to budgeting or is it process driven and using a top down approach?	x			<p>Yes. Defence uses a combination of top-down and bottom-up budgeting. The Defence Committee sets the parameters and priorities for the development of future budgets drawing on the Defence White Paper, Defence Planning Guidance, the Defence Capability Strategy, the CDF's Preparedness Directive and the Defence Workforce Plan. Financial guidance is provided to Groups to provide them a sound basis for planning their future budgets.</p>

			At subordinate levels within Groups, budgets are generally developed using a bottom-up method. Where Groups experience cost pressures within allocated funds, they can bring forward budget proposals which are assessed and considered for funding by the Defence Committee.
Does the organisation drive its budget development from the outputs required to be delivered but still recognise the need to hold various parts of the organisation responsible for contributions to outputs?	x		<p>Yes. Long term capability goals are specified in the White Paper, the Defence Planning Guidance and the Defence Capability Strategy. In turn, these goals are resourced through the DMFP including the Defence Capability Plan</p> <p>Defence budgets by Group but presents its budget by Outcome and Output. The rationale is that the Capability Managers (Outcome Managers) do not have to own resources to direct their usage. Under this model, service providers (the Defence Personnel Executive, Defence Materiel Organisation (DMO), Corporate Services and Infrastructure Group and the Chief Information Officer's Group) provide services to the Capability Managers under DMO-Defence agreements or Customer-Supplier Agreements. Group Heads are held accountable for the services they deliver to the Capability Managers and, in turn, the Capability Managers are held accountable for the delivery of their Outcomes and Outputs.</p>
Are operational managers equipped to contribute to an accrual-based budget and are they supported by the finance area in making decisions?		x	Developing. All Service Chiefs and Group Heads have a Group Finance Officer who provides business advice, coordinates financial planning and budgeting activities, and who reports and accounts for actuals. While responsible to the Group Heads, they are responsive to the CFO who provides

				<p>technical oversight and direction for the finance domain.</p> <p>All members of the Defence Senior Leadership Group (APS SES officers and military star-ranked officers) are required to undertake financial management training conducted by the CFO's Group. The training includes accrual accounting concepts and the Defence budget management and planning process. Similar training is being implemented for Defence middle-managers (APS executive level officers and the military equivalent). More effort is being devoted to training in accrual-based budget and financial reporting at all levels.</p>
Reviewing and managing financial performance				
Does the organisation have effective processes to enable budget revisions for changes in environment and/or organisational priorities during the financial year?	x			Yes. The Defence Committee monitors changes in the environment and organisational priorities on a monthly basis. Budgets are continually reviewed and adjusted to meet the directions of the Government, changes in circumstances and priorities and other factors.
Is financial performance on the agenda at least monthly at executive meetings and does the discussion focus on the impact of the results rather than on the accuracy of the results presented?	x			Yes. The Defence Committee considers a monthly financial report which is prepared by the CFO. Through this process of review and adjustment, action is taken to manage the current year's budget and to adjust the future year budgets, as appropriate.
Are forecasts included in the management reports?	x			Yes. As part of Defence's whole-of-Government report to the Department of Finance, Defence provides detailed

				<p>explanations of variation relating to last year's budget, pro-rata in the current year, and phasings in the current year. Internally, Defence augments these measures for the monthly report with both financial and non-financial forecasts. Examples include changes in project schedules and project risks, changes in capability and preparedness levels, variation in workforce numbers including separation and recruitment forecasts, and end-of-financial-year forecasts. Through this process, budget adjustments are made in order to optimise capability delivery.</p>
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<p>Is the financial information presented with operational information so that a balanced view of performance is obtained?</p>	<p>x</p>		<p>Yes. Operational performance is also considered by the Defence Committee on a monthly basis. Through the monthly preparedness reports, all outcome and force element groups are assessed for the operational performance, based on performance targets set out in the budget and the Organisational Performance Agreements. Where appropriate, resource adjustments are made as part of the review process. All key projects, the workforce and other key inputs to capability are also reviewed and management action taken as appropriate.</p>
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Appendix D – Defence Procurement Advisory Board

Role of the Defence Procurement Advisory Board

The role of the Defence Procurement Advisory Board is to:

- Monitor the implementation of the Defence Procurement Review recommendations as agreed by Government and report to the Ministers for Defence and Finance and Administration on progress.
- Provide advice and support to the Chief Executive Officer of the Defence Materiel Organisation on strategic issues related to the direction and focus, objectives, planning, management and structure of the Defence Materiel Organisation, including how best to achieve cultural change.
- The Advisory Board does not advise on day-to-day management issues or the management of individual projects.
- Membership of the Defence Procurement Advisory Board is:

Chair:

Mr David Mortimer AO

Private Sector Members:

Mr Malcolm Kinnaird AO

Dr John White

Mr Kevin McCann AM

Public Sector Members:

Air Chief Marshal Angus Houston, AO, AFC (the Chief of the Defence Force)

Mr R.C. Smith, AO, PSM (Secretary of Defence)

Dr Ian Watt (Secretary of Finance and Administration)

Dr Ken Henry (Secretary of the Treasury).

The Chief Executive Officer of the Defence Materiel Organisation, Dr Stephen Gumley is an ex officio member of the Board. A senior representative from the Department of Prime Minister and Cabinet also attends as an observer.

Sample DMO Acquisition Overview Report

AOR Overall Performance – Traffic Lights are the comparison of the Cost, Schedule and Capability indicators as follows:

Any one Red = Two or more Amber = Other combinations =

Trend Arrows show difference between This Month and Last Month's

traffic lights: Any Decrease = No Change = Any Increase =

Decision by Branch and Division Heads to override this indicator requires them to provide comments to justify changes.

facility, ground mission system, full scale fatigue test program, logistics, engineering and a comprehensive training system. Includes the initial period for Through Life Support and Deeper Maintenance.

PRIME CONTRACTOR: SquirrelMake Australia

PROJECT TRENDS:

Cost		SPI	Schedule		Capability	
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PROJECT DELIVERY STATES:

Cost Traffic Light is calculated from 'Latest Approved Plan Total' divided by 'Latest Cost Estimate'

< 0.95 =

< 1 and ≥ 0.95 =

≥ 1 =

Trend Arrow is the comparison with Last Month's Cost indicator.

Technical Aspects – Continued use of delivery of supplies to contractor. A testing program has been submitted previous months at 37kW, will now be significant increase and the resulting repair in the platform's later life.

Project Management – Quality of contractor has again failed to meet a strategic view of mitigation strategies further mitigation action continuing, t

Schedule – Availability of skilled trade company's deficiency in workforce (resignation) including the contractor's has been completed and submitted,

Contractor Commitment – Squirrel effect support to our project. The im concerns have increased since last r the tender evaluation for project ADF

CONTACT OFFICERS:

Project Manager:	WGCDR John Citizen : 0123 456 789
Director-General	Dr Mary Shepherd : 0321 654 987
Signed Off By:	GPCAPT W. Wood

Div Head Comments – The remediation plan to resolve the technical problems has achieved results. The current tests are in progress and confirming that the major problems identified last year are solved. Other minor problems are being identified, such as the manual handbrake will not yet hold on the required incline (60 degrees). These are being addressed and will probably not affect schedule. The technical data, cataloguing and training packages are slow and to some extent rely on finalisation of the design.

Brief Cleared By: AIRCDRE B. Lightyear

	Aug 05	Jan 06	Feb 06
	MAA (\$m)		CATEGORY
	455		ACAT 1
	REPORTING REQUIREMENT		
	Top 30 by \$		
	CO	TYPE	Top 30 by PBS
	Total project value		

Schedule Traffic Light is a comparison between milestone (MAA) schedule and OPP (system) schedule. It is calculated by comparing Forecast Finish date with the Actual Finish date for all open and single schedule events, unless another milestone is manually selected.

For Milestones with Set Date:

Forecast > 14 days late =

Forecast > 7 and < 14 days late =

< 7 days late =

For Milestones with a given year or date ranges:

Forecast > 20% (max 14 elapsed days) after Baseline Late date =

Forecast is earlier than Baseline Early date or falls within 20% (max 14 elapsed days) after Baseline Late date =

Forecast is between the Baseline Early and Baseline Late dates =

Schedule Performance Roll Up

Once an Actual Finish date has been set, the milestone is no longer used in roll up calculations.

Any indicator set to Red =

< 80% are Green =

>= 80% are Green =

Capability Traffic Light is a "roll-up" of the subjective health assessment of MAA measures of Supportability and Effectiveness.

Any red =

< 80% are Green =

>= 80% are Green =

Trend Arrow is the comparison with Last Month's indicator.

nal facilities for the integrated y for Heat Distribution, reported in dditional compression. This is a ber of units requiring fatigue related

Supporting text must support the logic expressed in Traffic Lights and Trend Arrows. Accountability rests with Sign-Off officer!



management changes continue to o be determined; however g term viability will be affected by the next month.

Sample DMO Sustainment Overview Report

SOR Overall Performance – *Traffic Lights* are produced automatically by comparing Price and MSA Performance indicators as follows:

Any one RED = Two or more Amber = Else =

Trend Arrows show difference between This Month and Last Month's

indicators: Any Decrease = No Change = Any Increase =

These can be overridden by Branch and Division Heads.

Aug 05	Jan 06	Feb 06
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MSA (\$m)

2,500

REPORTING REQUIREMENT

Operational Of In

CONTRACT TY

MSA contracted price

and training units, and includes a Full Flight and an Operational Mission Simulator, Aircraft Maintenance Training Aid, a scaled part task trainer and a Simulated Unit Maintenance Trainer.

MAIN SUPPORT PROVIDER:

SquirrelMake Australia

PRODUCT TRENDS:

Price

Availability

DSR

Other Measures

DELIVERY DATES:

Introduction into Service

Planned

2000

REF

The Maintenance Contractor provided technical specialist support for air weapons systems on Operations Here Assist and The Re-certification and successful Contractor provided technical specialist support for air weapons systems on Operations Here Assist and The

Price Performance Traffic Light and Trend Arrow are not currently used as Sustainment financial data not currently available.

MSA Performance within a product group must first be categorised as 'Availability', Demand Satisfaction Rate ('DSR') or 'Other'. Each performance measure is independently scored in accordance with criteria within the MSA schedule and converted into a traffic light.

Any measures are red =

2 or more measures are Amber =

Any other combination of colours =

Trend Arrow is the comparison with Last Month's indicator.

SUPPORT CONCEPT:

Light and medium repairs are carried out by operational Contractors provide a mix of organic and contracted support repair is contracted by DMO to several companies. Supply support is primarily provided by DMO.

ISSUES OF INTEREST:

Technical Aspects – Two radars failed during testing of the radio fit-out, and were returned to the engineering agency for advance completion of electro-magnetic testing. Program Office perceives some key management turnover with contractor may impact schedule and delivery of Replaceable Items. Significant number of Contract Change Proposals provided claiming prolongation. Program Office is investigating contractor's use of resources during that time. Funding for DMFP relating to the shortfall requires further investigation.

Business Management – The sign-off year seems to not have carried into this project as it has in other projects in vacant positions has had little trouble filling positions so far. An IP dispute identified cost and schedule is yet to be determined. However the effect this will have on cost continues to be sought.

Operational Support - Support relating to availability of aircraft, the 31J has caused it to fall behind on requirement. There was one significant issue relating to corrosion inside wing struts of aircraft A29- inspection of other aircraft is still concluding, however no further collection of the data all aircraft remain on DM schedule.

Supporting text must support the logic expressed in Traffic Lights and Trend Arrows. Accountability rests with Sign-Off officer!



Price Performance – Following previous issues with supplier, skills shortages and IP, prices have improved and are now within budget. Fleet is on track to achieve forecast expenditure and performance targets this financial year in accordance with the Materiel Sustainment Agreements. Large levels of Inventory and Specialist Military Equipment Items are expected in the next month and will require further support than currently provided.

Main Support Provider Commitment – SquirrelMake anticipates that its long term viability will be affected by the tender evaluation for project ADF007Ph1, with an announcement expected in the next month. (Having invested heavily in the tender) Deeper Maintenance and support services continue unaffected at this stage; however meetings have been arranged in light of the tendering outcome to balance this against maintenance and work to provide Government Furnished Equipment and support for the aircraft upgrade project.

CONTACT OFFICERS:

SPO Director: Wing Commander Smith : 0123 456 789

Director-General: Brigadier Bloggs: 0321 654 987

Signed Off By: AndrewSmith

Div Head Comments – Current MSA availability levels have been met and so the overall traffic light has been set to Green Improving.

Brief Cleared By: AIRCDRE B. Lightyear

SUSTAINMENT MATURITY SCORE:							
Maturity Score	Obsolescence	Intended Use	External Supplier Capability	Defence Capability (non DMO)	DMO/SPO Capability	Cost Estimation	Schedule
48	8	8	4	6	8	8	6
Fleet Roll Up?		NO					
FLEET OR PRODUCTS ROLLED UP:					NUMBER IN FLEET: 54		
Secret Squirrel (B Model) Operational and Training variants				Secret Squirrel (C Model)			
PREVIOUS MATURITY SCORE: 47							
MATURITY SCORE COMMENTS:							
<p>(Some obsolescence issues resolved since last assessment)</p> <p>External Supplier Capability – Concerns with the ability to meet changing DMO requirements is a priority for the DMO.</p> <p>Defence Capability (non DMO) – DMO is finding it difficult to find resources whose skills are required for the project. The DMO has shown that extra workloads imposed from the acquisition of further units has impacted response to Project Office requirements.</p> <p>Schedule Issues – Concerns exist about Main Support Provider's resources to be able to provide technical expertise for the entirety of the project, which could cause some delays in meeting deliverable dates.</p>							
CSIG SUPPORT REQUIREMENTS:							
Yes							
Requirement	DMO comment on facilities and infrastructure requirements for the ADF001 Ph3 Project.						
Satisfactory	CSIG performance requirement.						
Comment	provide staffing resource to undertake the CSIG tasks of development and delivery. CSIG-ID is currently providing adequate support to DMO in the development of the ADF001 Ph3 infrastructure requirement.						