

Audit Report No. 21, 2004-05

ANAO Inability-to-form-an-Opinion on the Department of Defence financial statements 2003-04

Introduction

- 9.1 At the close of each financial year the Government prepares two key financial reports: the Consolidated Financial Statements of the Australian Government (CFS); and the Final Budget Outcome Report (FBO Report) – required by the *Charter of Budget Honesty Act 1998*.
- 9.2 Under the *Financial Management and Accountability Act 1997* (FMA Act), the Auditor-General is required to report each year to the relevant Minister(s) whether government entities' financial statements give a true and fair view of the matters required by applicable legislation, Accounting Standards and other mandatory financial reporting requirements in Australia.
- 9.3 Audit Report no. 21 , 2004/05 provides a summary of the results of the ANAO's audits of the financial statements of all Australian government reporting entities, including the Consolidated Financial Statements for the Australian Government.

- 9.4 Audit Report no. 21 is the second report on these audits for the financial year ended 30 June 2004, and complements Audit Report No.58 2003/2004. The latter outlined audit findings relating to government departments' control structures, including governance arrangements, information systems and control procedures, which supported the reporting of public sector financial performance and accountability, through to March 2004.
- 9.5 As outlined above, the ANAO is responsible for the audit of the financial statements of 245 Australian Government entities. For the 2003/04 financial year, the ANAO issued:
- 217 unmodified audit opinions (clear opinions);
 - 12 'qualified' audit opinions (pp. 45 – 50 of Audit Report);
 - 7 audit opinions containing an 'emphasis of matter' (pp. 51 – 53 of Audit Report); and
 - 7 opinions, some qualified and others unmodified, containing an 'other statutory matter' (pp. 53 – 54 of Audit Report).

Defence Financial Statements

- 9.6 One of the 12 'qualified' audit opinions was for the Department of Defence. The qualification was expressed as an Inability-to-form-an-Opinion. Notably, the accompanying letter from the Secretary of Defence stated that he was unable to conclude that the financial statements were 'true and fair'.
- 9.7 This was the first time that the ANAO had expressed an Inability-to-form-an-Opinion on a government entity's financial statements.
- 9.8 The ANAO stated that
- in short, Defence management practices and systems are not robust enough for both Defence and the ANAO to conclude that the Defence financial statements were both 'true-and-fair' in 2003-04. These issues go well beyond accrual accounting matters.
- 9.9 The ANAO's inability to form an opinion arose from a series of significant 'audit scope limitations' on key financial systems within Defence. Due to these limitations, the ANAO could not validate \$7.12 billion of Defence assets and \$1.23 billion of Defence liabilities, including:
- General Stores Inventory totalling \$2.03 billion – due to weaknesses in the stocktaking, record-keeping systems and pricing data (including the SDSS v 4 system);

- \$845 million of Explosive Ordnance Inventory – due to lack of documentation to support the prices used to value that portion of the recorded balance;
- \$2.86 billion reported written-down value of Repairable Items – due to weaknesses in stocktaking and recording keeping as for General Stores Inventory;
- \$1.39 billion of the Land and Buildings Infrastructure, Plant and Equipment balances – due to some assets being excluded from revaluation processes, and other deficiencies in record-keeping; and
- \$1.23 billion for the Australian Defence Force leave provision – due to lack of supporting documentation for leave entitlements.

9.10 These problems are further elaborated below. The above scope limitations affected five line items on the Defence Statement of Financial Position: Inventories; SME (Specialist Military Equipment); Land and Buildings; Infrastructure; Plant and Equipment; and Employee Provisions.

Quantities for General Stores Inventory and Repairable Items

9.11 The ANAO identified material weaknesses in Defence's stocktaking system, recording of physical asset quantities, and accuracy of data. These systems are managed on the SDSS system, which as outlined in Audit Report No. 5, was found to have key weaknesses. Significant failures included:

- inability to identify owners, and subsequently the failure to manage and account for Repairable Items. Defence needs to have significant amounts of equipment repaired each year. These items are classed as Supply Customer Accounts (SCAs). These SCAs include assets that may be held by the ADF, external contractors or repair agents. The SDSS cannot accurately record the assets held in the SCAs;
- material discrepancies identified through the counting of physical stock at key Defence establishments; and
- poor management reporting and review of stocktake results.

9.12 These findings resulted in uncertainty around the General Stores Inventory balance and the Repairable Item balance (which is a component of SME).

Pricing for General Stores Inventory and Explosive Ordnance

9.13 This problem was largely linked to the problems with the SDSS program. Under financial accounting standards, inventory items must be given a

valuation. Within the SDSS system, many items are priced at zero or a notional price (eg one cent).

- 9.14 The ANAO reported that the allocation of incorrect or notional prices to transactions results in the misstatement of the General Stores Inventory balance. The ANAO also found a lack of evidentiary documentation to support the prices used to value \$845 million of Explosive Ordnance Inventory.
- 9.15 Defence is undertaking a price remediation and verification project aimed at correcting recorded values. Defence told Senate Estimates this year that it wants to use an American military catalogue (FEDLOG) to price its inventory equipment, but that ANAO does not approve of this method.

Military and Civilian Leave Processes and Systems

- 9.16 This problem was identified by the ANAO in its 2002-03 audit, resulting in a defence remediation program. As the program was still underway in 2003-04, Defence self-qualified its Military leave provision in 2003-04.
- 9.17 The problems with PMKEYS (civilian payroll, and leave for both civilian and military personnel) and ADFPAY (military pay system) included insufficient supporting documentation to verify leave provisions, and significant rates of error where documentation did exist.

Land and Buildings, Infrastructure, Plant and Equipment

- 9.18 The ANAO found significant uncertainty surrounding the value of Land and Buildings and Infrastructure, Plant and Equipment, due to 'inadequate management direction, analysis and review'. Some assets were excluded from revaluation processes, or the results of valuations were incorrectly reflected in Defence's asset register and financial statements.

Other significant Audit findings

- 9.19 The ANAO found other problems with the Defence depreciation calculation, ROMAN (General Ledger) financial system; commitments and receivables.

- 9.20 The ANAO commented that

...A major contributor to the number of audit findings and the associated delay in finalising the 2003-04 financial statements was an apparent lack of adequate management review of the administrative and accounting processes and records within Defence....the production of reliable financial statements is fundamentally a by-

product of good governance arrangements, reliable information systems and an effective internal control environment.¹

9.21 The ANAO stated that if Defence were to meet the Government reporting deadline in future years, remediation processes will need to be brought forward.

ANAO audit ratings

9.22 The ANAO rates its audit findings according to a risk scale. Audit findings which pose a significant business or financial risk to the entity and which must be addressed as a matter of urgency, are rated as 'A'. Issues that pose a moderate business or financial risk are rated as 'B'. Issues that are procedural in nature, or reflect relatively minor administrative shortcomings are rated as 'C'.

9.23 The following table outlines the ANAO's ratings for Defence throughout 2004 .

Table 9.1 Status of Category A and B issues, Department of Defence to November 2004

Rating	Issues outstanding at August 2004	Issues resolved prior to November 2004	New issues to November 2004	Closing position, November 2004
A	14	0	7	27
B	45	10	15	48
Total	59	10	22	75

Source ANAO Audit Report no. 56, 2004-05, *Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2005*; p. 106.

9.24 In its Interim Report on Defence's Financial Statements, the ANAO illustrated that most of the category A and B audit findings were related to management oversight and control, rather than technical accounting issues:

1 ANAO Audit Report no. 21, 2004-05, *Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2004*, Commonwealth of Australia, January 2005, p. 112.

Table 9.2 Summary: source of Category A and B audit findings, Department of Defence

Balance Sheet Audit Issues	Technical Issues		Management/Control Issues		
	<i>Differences in accounting estimates</i>	<i>Non- compliance with legislation</i>	<i>Management controls and oversight</i>	<i>IT Controls</i>	<i>Business Process Controls</i>
General Stores Inventory			X	X	X
Explosive Ordnance Inventory			X		X
Repairable Items			X	X	X
Military Provisions			X	X	X
Land and Buildings, Infrastructure, Plant and Equipment			X	X	X
Executive Remuneration			X		X
Special Accounts		X	X		X

Source ANAO Audit Report no. 56, 2004-05; p. 107.

How did the situation occur

- 9.25 The Committee questioned the ANAO and Defence about what had happened in the 2003-04 year to send the Defence financial statements 'over the edge' into a state where the ANAO was unable to verify the accounts. Both agencies replied:

ANAO:

For a couple of years prior to 2004, we had what we call an 'exception qualification' on the Defence accounts in some areas. But what actually happened in 2004 is that the collective exceptions crossed a line or jumped over a hurdle. For auditing standards that means that we had to come to an inability to form an opinion on the accounts, so 2004 was just a particularly bad culmination of a lot of problems that we had had previously.²

Defence:

Some of that was the accumulated effect of the issues that had been the subject of exception for a number of years, some of it was the greater depth and more rigorous assessment, I believe, on behalf of our own auditors and ANAO and, frankly, some of it probably

2 ANAO, *Transcript of Evidence*, 27 June 2005, p. 14.

resulted from some deterioration in that year in some areas due to a higher operational tempo against inadequate systems.³

- 9.26 Defence also argued that the introduction of accrual accounting in 1999-2000 for government agencies had placed additional strains on its financial systems:

By any standards, [Defence is] one of Australia's biggest corporations. Unlike all the other corporations anything like this size, though, Defence does not exist to make a profit; it exists for quite different reasons. Nevertheless, we are being asked to achieve exactly the same accounting standards as other corporations. We accept that challenge. We also accept that, at present, we are quite some way from achieving those standards.⁴

- 9.27 The ANAO conceded that the requirements of accrual accounting, introduced in 1999-2000, had placed an additional load on the SDSS system, for which it was not originally designed:

It was not built as a financial system. There was no requirement to produce a financial opinion. So immediately that that requirement changed, it became an issue. We are using a system that was not designed as a modern financial management system.⁵

Defence remediation programs

- 9.28 In response to the problems highlighted in Audit Report 21, Defence has established a number of remediation programs aimed at resolving the problems identified in its various financial management systems.
- 9.29 A Financial Statements Project Board has been established, comprising the Secretary of Defence, the CEO of the Defence Materiel Organisation, the Vice Chief of the Defence Force and the three service chiefs, the Defence Chief

3 Defence, *Transcript of Evidence*, 27 June 2005, p. 14.

4 Defence, evidence to Joint Standing Committee on Foreign Affairs and Trade, *Transcript of Evidence*, 11 March 2005, p. 44.

5 ANAO, *Transcript of Evidence*, 27 June 2005, p. 17.

Financial Officer and a representative from the Department of Finance and Administration.

- 9.30 There are three General remediation plans aimed at fixing the problems in Defence financial management and reporting framework and systems; and 12 Specialised remediation plans aimed at specific line responsibilities. The plans, G 1 - 3 and S1 - S12 were outlined in the 2005-06 Portfolio Budget Statements, along with expected outcomes for 2004-5 and 2005-06. The PBS table is reproduced below.

Table 9.3 Defence Remediation Strategies – Portfolio Budget Statement 2005-06

REMEDIATION PLAN	ACTIVITY	MAJOR OUTCOMES
<p>G3: Financial Management and Systems Training – Financial and Business Management</p> <p>A consistent theme in the Australian National Audit Office audit findings is the requirement for enhanced skills in the execution of financial management procedures and adherence to approved procedures in the use of Defence corporate information technology systems. The Australian National Audit Office makes some targeted recommendations with regard to enhanced training to address the lack of knowledge in accounting, financial and business management (ROMAN), transactor knowledge (PMKeyS), and the supply system (Standard Defence Supply System). These are complemented by a number of other observations about failures in the application of policy and procedures.</p> <p>Accountable officers: Chief Finance Officer and Director-General Defence Education and Training Development</p>	<p>Develop the following courses to improve officers' underpinning knowledge and skills:</p> <ol style="list-style-type: none"> business capability workshops; accrual accounting; Diploma of Government (Financial Management); Graduate Certificate in Professional Management (Finance); and financial management processes for Senior Executive Service and Executive Level 1 and 2 officers. 	<p>2004-05:</p> <p>Conduct:</p> <ol style="list-style-type: none"> business capability workshops; course evaluations; Senior Executive Service and Executive Level courses; and training and competency assessments. <p>2005-06:</p> <ol style="list-style-type: none"> implement training as prerequisite for systems access; and modularise training delivery.
<p>S1: Stores Record Accuracy</p> <p>Defence 'self-qualified' stock quantities relating to general stores inventory and repairable items in 2003-04, following adverse stocktake results.</p> <p>The Australian National Audit Office noted material weaknesses in the internal controls over stocktaking, failure to accurately record and report physical asset quantities, and inadequate system controls to safeguard the accuracy of data. This resulted in a significant range of uncertainty around general stores inventory and repairable items balances.</p> <p>Accountable officer: Commander Joint Logistics</p>	<p>Remediate the general stores inventory and repairable items qualification by:</p> <ol style="list-style-type: none"> conducting 100 per cent stocktakes at Joint Logistics Command warehouses; correcting errors in stores record quantities in the Standard Defence Supply System; and promulgating and ensuring compliance with stocktaking policy to improve stocktaking practices and reporting. 	<p>2004-05:</p> <ol style="list-style-type: none"> implement compliance and assurance audit methodology; and complete 100 per cent stocktake of Defence National Storage and Distribution Centre (Moorebank). <p>2005-06:</p> <ol style="list-style-type: none"> complete 100 per cent stocktake of Joint Logistics Unit (Victoria); and finalise audit findings (subject to extent of additional work from S10 and S11).

REMEDIATION PLAN	ACTIVITY	MAJOR OUTCOMES
<p>S2: General Stores Inventory Pricing and Accounting</p> <p>The 2003-04 Financial Statement had a limitation of scope qualification of approximately \$2,026m with regard to uncertainty around the general stores inventory balance, of which \$600m relates to uncertainty around general stores inventory pricing.</p> <p>At issue was Defence's inability to produce, in a timely manner, invoice and contract documentation to validate the prices in the Standard Defence Supply System. The concerns of the Australian National Audit Office also included the lack of accounting policy in place to ensure the correct treatment of general stores inventory.</p> <p>Inventory pricing issues will need to be assessed in light of the pending Australian Equivalent to International Financial Reporting Standards. The implementation of an even more onerous reporting requirement places greater long-term uncertainty across inventory pricing issues.</p> <p>Accountable officer: Chief Finance Officer, Defence Materiel Organisation</p>	<p>Remediate the general stores inventory pricing and accounting qualification by:</p> <ol style="list-style-type: none"> developing a statistical model to validate legacy (pre-1997) priced items; implementing an exception reporting regime to provide quality assurance; establishing policies and procedures for inventory pricing controls on the Standard Defence Supply System; and establishing policy to ensure the correct treatment of general stores inventory. 	<p>2004-05:</p> <ol style="list-style-type: none"> remediate audit issues relating to Provision for Obsolescence, Asset Purchase Accounts, Defence Materiel Organisation Clearing Accounts, Reclassification Corrections, and Standard Defence Supply System Version 4 Upgrade; ascertain the level of inventory pricing uncertainty to be quarantined; establish an exception reporting regime to provide quality assurance of in-year inventory prices; and establish financial accounting general stores inventory policy. <p>2005-06:</p> <ol style="list-style-type: none"> remediate the audit issue relating to Limitation of Scope – Inventory pricing carried forward to 1999-00; complete an option study for a single financial and asset management system; and review Australian Equivalent to International Financial Reporting Standards implementation to determine system and data retention impacts for multiple pricing records.

REMEDIATION PLAN	ACTIVITY	MAJOR OUTCOMES
<p>S3: Supply Customer Accounts</p> <p>A Supply Customer Account is a location indicator within the Standard Defence Supply System to track and manage assets and accountable inventory moving through the supply chain, predominantly outside a warehouse structure.</p> <p>The 2003-04 financial statements had a limitation of scope qualification of \$2,857m with regard to the uncertainty around the repairable items balance, of which Supply Customer Accounts are a subset (\$1,000m). The Australian National Audit Office concerns rested with the controls and management of Supply Customer Accounts, including repairable items, and adherence to stocktake procedures.</p> <p>Accountable officer: Chief Operating Officer, Defence Materiel Organisation</p>	<p>Remediate the Supply Customer Account element of the repairable item quantities qualification by:</p> <ol style="list-style-type: none"> allocating all Supply Customer Accounts an accountable owner; ensuring all Supply Customer Account balances on the Standard Defence Supply System are correct; and improving business processes and controls for Supply Customer Accounts. <p>Note: these include improvements to data creation, maintenance and reporting to ensure accurate quantity, ownership and location details are entered and maintained for all Supply Customer Accounts on the Standard Defence Supply System.</p>	<p>2004-05:</p> <ol style="list-style-type: none"> allocate an accountable owner to all Supply Customer Accounts; start stocktaking of Supply Customer Accounts and record correct balances on Standard Defence Supply System for those stocktaked. <p>2005-06:</p> <ol style="list-style-type: none"> stocktake all Supply Customer Accounts and correct balances recorded on the Standard Defence Supply System; and improve business processes and transition controls into standard corporate governance activities of all Groups.

REMEDIATION PLAN	ACTIVITY	MAJOR OUTCOMES
<p>S4: Explosive Ordnance</p> <p>The 2003-04 financial statements had a limitation of scope qualification of \$845m relating to uncertainty around Explosive Ordnance pricing. At issue was Defence's inability to produce, in a timely manner, invoice and contract documentation to validate the Explosive Ordnance inventory prices recorded in the Explosive Ordnance procurement management system, COMSARM.</p> <p>The qualification represented approximately 38 per cent of Explosive Ordnance inventory and relates to all items acquired before 1996 and items acquired as part of asset under construction contracts between 1997-2000.</p> <p>Accountable Officer: Head Electronic and Weapon Systems Division, Defence Materiel Organisation</p>	<p>Remediate the Explosive Ordnance inventory pricing qualification by:</p> <ol style="list-style-type: none"> sourcing (where possible) original documentation to substantiate Explosive Ordnance inventory prices; developing tools to substantiate Explosive Ordnance inventory values when appropriate supporting documentation cannot be located to support prices; and improving Explosive Ordnance inventory pricing policies and procedures to address reconfigurable items, to value identical items and to establish the link between COMSARM and Defence's financial management system, ROMAN. 	<p>2004-05:</p> <ol style="list-style-type: none"> remediate approximately \$440m of the \$845m Explosive Ordnance pricing qualification; and improve Explosive Ordnance inventory processing and reconciliation policies and procedures. <p>2005-06:</p> <ol style="list-style-type: none"> continue remediation of the remainder of the \$845m Explosive Ordnance inventory pricing qualification; and complete implementation of Explosive Ordnance inventory processing and reconciliation policies and procedures to ensure Defence's ongoing ability to accurately price Explosive Ordnance inventory items.

REMEDIATION PLAN**S5: Military Leave Records**

The 2002-03 financial statements had a limitation of scope for military leave provisions because insufficient supporting documentation was available for leave records and, where documentation was available, unacceptable error rates existed in the recording of leave transactions. These shortcomings were mainly attributed to inadequate controls and processes within the military personnel systems and the inability to locate source documentation.

The prior year limitation had resulted in a wide-ranging military leave remediation program but Defence did not expect to resolve the problems before 2005. Defence again 'self-qualified' the military leave provision in 2003-04.

Accountable officer: Head Defence Personnel Executive

ACTIVITY

Remediate the military leave provisions qualification by:

- a. implementing a risk stratification and sampling methodology to quantify the risk to Defence accounts;
- b. providing an accurate representation of the military leave liability by ensuring the integrity of military leave data captured and recorded in PMKeyS; and
- c. applying quality assurance to business processes, record keeping strategies, reporting structures, relevant policy foundations, training initiatives and a controls framework.

MAJOR OUTCOMES**2004-05:**

- a. obtain in-principle support from the Australian National Audit Office to the variable sampling methodology; and
- b. complete the pilot phase of leave stratification, i.e. set 7 strata with 30 individuals in each and undertake variable sampling.

2005-06:

- a. to be advised – as determined by outcomes from variable sampling.

S6: Civilian Leave Records

In 2003-04, the the Australian National Audit Office noted problems with civilian leave and payroll processing. The systems issues identified in the management of military leave provisions also affect civilian leave balances.

Accountable officer: First Assistant Secretary Personnel, Defence Personnel Executive

Remediate the civilian leave provisions qualification by:

- a. implementing a risk stratification and sampling methodology to quantify the risk to Defence accounts;
- b. providing an accurate representation of the civilian leave liability by ensuring the integrity of civilian leave data captured and recorded in PMKeyS; and
- c. applying quality assurance to business processes, record keeping strategies, reporting structures, relevant policy foundations, training initiatives and a controls framework.

2004-05:

- a. obtain in-principle support from the Australian National Audit Office to the variable sampling methodology; and
- b. complete the pilot phase of leave stratification, i.e. set 7 strata with 30 individuals in each and undertake variable sampling.

2005-06:

- a. to be advised – as determined by outcomes from variable sampling.

REMEDIATION PLAN	ACTIVITY	MAJOR OUTCOMES
<p>S7: Executive Remuneration</p> <p>The Executive Remuneration Note (containing information pertaining to civilian and military leave provisions) is 'material-by-nature', as required by the Finance Minister's Orders, and could not be reliably certified because of the limitation of scope within the Australian National Audit Office 2002-03 audit report regarding military leave provisions.</p> <p>A separate limitation of scope was applied to the Executive Remuneration Note in respect of any accrual effects arising from the military leave balances. During the 2003-04 period, Defence focused on improving the accuracy of leave records for the Senior Executive Service and military equivalents by reviewing source documentation.</p> <p>As a significant amount of supporting documentation remained outstanding, the note was again qualified for the same reason as in 2002-03.</p> <p>Accountable officer: First Assistant Secretary Personnel, Defence Personnel Executive</p>	<p>Remediate the Executive Remuneration Note qualification by:</p> <ol style="list-style-type: none"> completing the 2004-05 Senior Executive Service and military equivalents leave audit; and implementing a new system for reporting Executive Remuneration that includes applying quality assurance to business processes, record keeping strategies, reporting structures, relevant policy foundations and training initiatives, and a controls framework. <p>Note: the leave audit for executive leave is under way and is programmed for completion early in 2005-06. The Executive Remuneration Note audit qualification may continue if the starting balances of both military and civilian leave provisions are not accepted as accurate.</p>	<p>2004-05:</p> <ol style="list-style-type: none"> start review of leave for Senior Executive Service and military equivalents; and start implementation of revised Executive Remuneration Note management system. <p>2005-06:</p> <ol style="list-style-type: none"> finalise audit finding; and finalise implementation of revised Executive Remuneration Note management system.

REMEDIATION PLAN	ACTIVITY	MAJOR OUTCOMES
<p>S8: Property Valuations</p> <p>The Australian National Audit Office issued a 'limitation of scope' for Land, Buildings and Infrastructure and Other Plant and Equipment as significant flaws were identified in associated project management, reporting practices and management review functions. The requirements to be met by the Australian Valuation Office were not fully and adequately documented and Defence was considered to have misinterpreted the results of revaluations and incorrectly applied depreciation. A particular consequence has been the misapplication of remaining useful life data provided by the independent valuer. This affected both the valuation adopted by Defence and the reported depreciation expense.</p> <p>Accountable officer: Deputy Secretary Corporate Services</p>	<p>Remediate the Land, Buildings and Infrastructure and Other Plant and Equipment qualification by:</p> <ol style="list-style-type: none"> revising the Australian Valuation Office engagement letter to clarify valuation policy, procedures and outcomes; contracting the Australian Valuation Office to revalue all Land, Buildings and Infrastructure and Other Plant and Equipment assets to fair value in accordance with policy guidance; undertaking quality assurance on Australian Valuation Office site reports to ensure completeness; entering revaluation data into the financial system (ROMAN) and completing revised depreciation calculations; and 	<p>2004-05:</p> <ol style="list-style-type: none"> complete all Land, Buildings and Infrastructure valuations by 30 June 2005; complete Other Plant and Equipment valuations by 30 June 2005; undertake quality assurance of valuation data and progressively load the data into the financial system (ROMAN); and engage the valuation contractor for the next three year cycle, ie 2005-06 to 2007-08, and issue letter of engagement detailing data requirements. <p>2005-06:</p> <ol style="list-style-type: none"> complete the loading of valuation data into the financial system (ROMAN); and

REMEDIATION PLAN	ACTIVITY	MAJOR OUTCOMES
	e. engaging a valuation contractor for the next 3 year cycle, i.e. 2005-06 to 2007-08.	b. complete the depreciation calculations.
S9: Preventing the Escalation of Category A and B Findings		
<p>The 2003-04 Financial Statement Audit Closing Audit Report identified 95 findings that required resolution. The 67 audit findings not allocated to a General or Specific Remediation Plan were grouped under Remediation Plan S9 to ensure each finding is remediated. Any audit findings that are not resolved could escalate from Categories B and C to the most serious category, Category A. Defence has recognised the clear need to improve the outcome, focus and management of the implementation of solutions to Australian National Audit Office findings.</p> <p>Accountable officer: Chief Finance Officer</p>	<p>Prevent the escalation of Category A and B findings by:</p> <p>a. assigning responsibility across Defence for remediation of each of the 67 audit findings not already allocated to a Remediation Plan;</p> <p>b. establishing a project-based management system for tracking and managing resolution of these Australian National Audit Office audit findings; and</p> <p>c. undertaking progressive and final quality assurance of the remediation outcomes.</p>	<p>2004-05:</p> <p>a. master task list completed; and</p> <p>b. 14 audit findings completed and forwarded to Australian National Audit Office.</p> <p>2005-06:</p> <p>a. finalise 52 audit findings.</p> <p>2006-07:</p> <p>a. finalise one audit finding.</p>
REMEDIATION PLAN	ACTIVITY	MAJOR OUTCOMES
S10: Stock Holding Controls		
<p>Items first found are items of either asset or inventory that do not have a corresponding Defence register record on any Defence register. Where a check of stock holdings shows that the Defence register record varies from the physical quantity, an investigation into the discrepancy will be required and the outcome may be an adjustment to the Defence Register record, and/or a corresponding financial adjustment.</p> <p>While it is accepted that the normal stock adjustment process will require a certain level of adjustment activity, current levels of adjustment are considered too high and indicate poor adherence to currently approved business processes.</p> <p>Accountable officer: Chief Operating Officer, Defence Materiel Organisation</p>	<p>Improve stock holding controls by:</p> <p>a. preventing or reducing the instance of items first found and write-offs; and</p> <p>b. accounting for and monitoring those instances first found and write-offs considered legitimate or expected.</p> <p>Note: The remediation activities will focus on preventing errant transactions on the Standard Defence Supply System through improvements in policy, procedure, system process, and the introduction of investigative reporting to measure compliance.</p>	<p>2004-05:</p> <p>a. project schedule under development.</p> <p>2005-06:</p> <p>a. to be advised.</p>

REMEDIATION PLAN	ACTIVITY	MAJOR OUTCOMES
S11: Standard Defence Supply System Items Not-in-Catalogue	<p>Address the potential Not-in-Catalogue issues as they may affect the financial statements by:</p> <ul style="list-style-type: none"> a. addressing policy issues to better support an effective purchasing process; b. developing improved processes in conjunction with units, the Supply Chain Systems Program Office, the National Codification Bureau and the Directorate of Logistics and Processes; c. undertaking systems-based investigations, coupled with targeted site visits, to determine the value breakdown of Items Not-in-Catalogue; d. agreeing a methodology to transition Not-in-Catalogue items into the Standard Defence Supply System and the standard financial management regime, including development of a value proposition for the management of legacy items; e. coordinating Group activity to identify and transition Not-in-Catalogue items at Defence locations across Australia; and f. developing an ongoing compliance monitoring and reporting regime. 	<p>2004-05:</p> <ul style="list-style-type: none"> a. define and promulgate items that will be subject to codification and assigned a NATO Stock Number (i.e. procurement routing rules); b. clarify catalogue and codification policy and procedures; c. undertake systems investigation and data mining to obtain a value breakdown and establish a materiality index; d. undertake and complete investigative site visits to verify value breakdown; and e. finalise ADF Logistics Manager roles and responsibilities, including resourcing issues and the process for ADF Logistics Manager assignment. <p>2005-06:</p> <ul style="list-style-type: none"> a. to be advised – outcomes not available until 2004-05 activities completed and project schedule finalised.
<p>Defence is investigating the extent to which items may have been incorrectly accounted for in the Statement of Financial Position. This may occur when an item is purchased via the ROMAN financial system and then not recorded and managed on the Standard Defence Supply System. Such items are managed and tracked locally with no central visibility. It may lead to the incorrect recording and treatment of an item's value.</p>		
<p>Accountable officer: Chief Operating Officer, Defence Materiel Organisation</p>		

Source *Portfolio Budget Statements 2005-06, Defence Portfolio, pp. 198-207.*

Committee comment

- 9.31 The Committee notes the ANAO's comment that the effectiveness of the remediation plans will not be known for some time. Most of the plans were approved in February 2005, however their implementation is a work-in-progress. The ANAO noted that some of the plans have not progressed enough to have a major impact on the 2004-05 financial statements, however it did expect to see improvements over time. The ANAO has undertaken to closely monitor the progress of the Defence remediation plans over the next few years.⁶
- 9.32 In June 2005 the ANAO found that, at the end of the 2004-05 financial year, there had been limited completed remediation or agreement on key audit issues. However, ANAO acknowledged that considerable work by Defence was progressing. The ANAO stated:
- The current momentum, which has been supported by the Secretary and the CFO, individually and via the Financial Statements Project Board, is essential in progressing and realising the remediation, cultural and structural changes necessary to sustain the required Defence outputs in the current financial reporting environment.⁷
- 9.33 The Committee welcomes the detailed remediation plans outlined by Defence in response to its financial reporting problems. We recognise that this problem will not be completely resolved in the short-term, and that cultural change within Defence is one of the major challenges of this reform process.
- 9.34 Given the past problem with projects slipping past their deadlines, and being delivered over-budget, the Committee is keen to ensure that the remediation plans are implemented efficiently and effectively, taking into account the lessons learned through the SDSS upgrade and other projects over recent years. The Committee welcomes the ANAO's commitment to auditing Defence over coming years on the implementation of a new financial reporting regime. The Committee also intends to closely monitor Defence's work in this area.

6 ANAO Audit Report no. 56, 2004-05, p. 111.

7 ANAO Audit Report no. 56, 2004-05, p. 125.

Recommendation 27

- 9.35 **The Committee recommends that the Department of Defence report to this Committee every six months against the milestones of the 14 remediation plans outlined in the 2005-06 Portfolio Budget Statements. These reports are to continue until the end of the 41st Parliament.**

More recent ANAO findings

- 9.36 As the Committee's inquiry progressed, the ANAO tabled in Parliament another of its regular financial audits which detailed further challenges for Defence financial management. This report, *ANAO Audit Report no. 56, 2004-05: Interim phase of the audit of financial statements of general government sector entities for the year ending 30 June 2005*, includes a chapter on the Department of Defence. The Committee resolved to include this new report in its review of the Department of Defence financial management.

Julian Date

- 9.37 Audit Report no. 56, 2004-05 highlighted a problem within SDSS similar to the Y2K issue confronted by many companies leading up to the year 2000. SDSS had a start date of 1 January 1980, and a boundary date of 9,999 days from then on. This date will be 17 May 2007. There is a danger that when the system hits 17 May 2007, the date will revert to 0000, potentially causing a system failure.
- 9.38 Defence told the Committee that it had been aware of the problem for a number of years, but initially believed that JP 2077 project would come into effect before May 2007. However, given that JP 2077 will not be implemented by then, Defence has now asked MINCOM to correct the problem. Defence acknowledged that the Julian Date "...it is a catastrophic effect on version 4 of the MIMS software which we are currently running on SDSS."⁸
- 9.39 Defence advised that they are in the initial stages of planning a technical fix for the Julian Date problem, and that MINCOM had agreed to fix the software at their own expense. The ANAO stated that a problem with the Julian Date issue is that the extent of the problem is largely unknown. The ANAO also noted that SDSS v. 4 is a highly customised system, and

8 Defence, *Transcript of Evidence*, 27 June 2005, p. 2.

therefore any technical fix is going to be more complicated than running a 'patch' for an off-the-shelf system.⁹

- 9.40 The Committee only became aware of this problem at its final public hearing for this inquiry. The Committee notes the ANAO's concern that the problem is largely unknown at this stage, and the danger is that the entire SDSS system could collapse in May 2007, without the replacement JP2077 ready to take over logistics management.

Recommendation 28

- 9.41 **The Committee recommends that Defence outline to the Committee its plan to ensure that the Julian date problem associated with the SDSS program will be fixed prior to May 2007. Defence's report to the Committee should include a project plan, costings, milestones, and details of the project management team.**

Security of SDSS

- 9.42 Audit Report no. 56, 2004-05 also raised concerns about the security of access to the SDSS system. The ANAO found that the Get-Well program did not appear to be addressing concerns such as:
- the use of generic user ID's;
 - a high number of users with access to all system functions – that is, with full administrative access to the system;
 - users being able to perform incompatible activities (assignment of duties/activities that are incompatible with the principle of segregation of duties);
 - weaknesses over the user access management process, in particular the authorisation of user access to the system;
 - user access is often not commensurate with the officer's duties;
 - no formal review mechanisms to review user access related issues; and
 - issues around the method by which access is gained to SDSS – that is, whether the graphical user interface is used or not.
- 9.43 The ANAO commented:

9 ANAO, *Transcript of Evidence*, 27 June 2005, p. 3.

...even in a fluid operational environment, the current management process surrounding the security environment in SDSS, in the ANAO's view, was deficient.¹⁰

- 9.44 Defence conceded that the ANAO had not been able to get the necessary level of controls reliance on SDSS in order to trust its data. Regarding security and access controls, Defence commented:

...we acknowledge that we have not been careful enough in understanding, cataloguing and recording the levels of access that different users of the system have had. That has in part been due to things that the operation imperative – of simply needing to get things done and giving people in deployed forces the levels of access they need to do the job without asking the types of 'segregation of duties' questions that we might have asked.

One point I would make is that up to now we have not had a standard against which to be audited, and one of the things we are discussing with the Audit Office is an agreed standard for a controls framework so that in future we know the measure that we need to achieve to be able to determine for ourselves whether we have met it or not.¹¹

- 9.45 Defence stated that its aim was to achieve controls compliance within SDSS by 2005-06, so that rather than Defence and the ANAO needing to undertake intensive stocktake activity every six months to confirm the accuracy of the system, there will only be a requirement to test the controls environment once a year in order to confirm the system's accuracy.¹²
- 9.46 The Committee was most concerned to hear about the apparent lack of controls over access to the SDSS system.

Recommendation 29

- 9.47 **The Committee recommends that Defence urgently review the security controls for the SDSS program to ensure that user access is set at the appropriate levels. Defence should report back to the Committee about its implementation of this recommendation by February 2006.**

10 ANAO Audit Report no. 56, 2004-05, p. 116.

11 Defence, *Transcript of Evidence*, 27 June 2005, p. 7.

12 Defence, *Transcript of Evidence*, 27 June 2005, p. 31.

Pricing issues

- 9.48 The ANAO also found ongoing problems with pricing in the SDSS. The ANAO found that zero price and notional prices are continuing to be entered into SDSS, despite this being identified as a major concern in the 2003/04 audit of financial statements.
- 9.49 The ANAO advised that because of the problems it found with SDSS, both in terms of security of the system and pricing issues, it had to conduct a significant stocktake at year-end 2004/05, to ensure the accuracy of financial reports generated by the system. At the public hearing on 27 June 2005 the Audit Office told the Committee it had ten per cent of its total staff in the field doing stocktakes in Defence warehouses, in order to verify the SDSS figures.¹³
- 9.50 Defence replied that it was also very concerned about the pricing issue:
...people who do not enter correct prices are taking the system too lightly. This is important to us.¹⁴
- 9.51 Defence told the Committee that they are now modifying the SDSS system to ensure that users must enter an accurate price for inventory.¹⁵

Future challenges

Defence Materiel Organisation

- 9.52 The Defence Materiel Organisation (DMO) was established as a prescribed agency with effect from 1 July 2005. As part of this process, DMO is required to establish its own books and records and prepare separate financial statements for audit. Consequently, the issues pertaining to Defence accounts, including the ANAO's inability to form an opinion, will impact on the transfer of balances and information to the new entity. Defence outlined some of the complications involved in the demerger:

To ensure the complete separation of the financial transactions and accounts for the two organisations, we should not have agents who are able to operate with the accounts of both Defence and DMO...we need to be very careful with the access that people have, the delegations they use and the cost codes that they are able to use to

13 ANAO, *Transcript of Evidence*, 27 June 2005, p. 4.

14 Defence, *Transcript of Evidence*, 27 June 2005, p. 11.

15 Defence, *Transcript of Evidence*, 27 June 2005, p. 10.

make sure that every individual is operating very carefully inside either the Defence organisation or the DMO.¹⁶

- 9.53 In order to manage this problem, Defence advised that at 30 June 2005 all dual access to both the Defence and DMO financial management systems was removed, and new applications were made with justification of why dual access was required. At 15 July 2005, 44 DMO personnel had access to the Defence ROMAN financial system, and some 190 Defence personnel had access to the DMO accounts. Defence stated that the access approvals were managed at Branch Head level, and would be regularly reviewed.¹⁷

International Financial Reporting Standards

- 9.54 The Australian Accounting Standards (AAS) have been revised to include the International Financial Reporting Standards issued by the International Accounting Standards Board (IASB). Australian Government entities, which are required to comply with AAS by the Finance Minister's Orders, will need to plan for the changes resulting from this process.
- 9.55 Government entities will first apply the International Financial Reporting Standards (IFRS) in their 2005-06 statutory financial reports. Because the standards require retrospective restatement of comparative information, this will require entities to:
- prepare a balance sheet as at 1 July 2004 based on IFRS;
 - restate their 2004-05 comparative figures as if IFRS had applied in that year;
 - prepare, as part of the 2005-06 financial report, an additional financial statement, the Statement of Changes in Equity; and
 - include, in the notes to the 2005-06 financial statements, a reconciliation of the changes resulting from the application of IFRS to the 2004-05 operating result and to equity as at 1 July 2004 and 1 July 2005.

Agreement between Defence and the ANAO

- 9.56 Over a number of hearings the Committee detected a tension between the standards imposed by the ANAO and what Defence believes it can actually achieve. The Secretary of Defence told the Committee:

16 Department of Defence, *Transcript of Evidence*, 27 June 2005, p. 9.

17 Correspondence from Dr Stephen Gumly, DMO, to Committee Secretary, dated 15 July 2005.

I accept that the ANAO is the champion of the ultimate...that is something that we should aspire to. I think that with the best of systems and the best of training, given our activity levels, the continuing focus on effectiveness, and frankly, the absence of the sort of incentive that the private sector has, it is going to be quite difficult to achieve at the best of times. But it remains the aspiration.¹⁸

- 9.57 The Secretary of Defence also foreshadowed that the Department (with Ministerial approval) may eventually decide that it cannot fulfil all the requirements being placed on its financial record-keeping by the ANAO. The Secretary told the Committee:

There will come a point when we will say 'this is an issue of importance to accountants but it does not seem to affect our operations and therefore not worth \$100 million to fix'. That might have to be a management decision. I am not isolating any particular project or proposal in that regard, but if that is the kind of decision we have to take as a management decision – do we spend \$100 million or do we bear a scar on our accounts – then the good management decision might be the second one.¹⁹

- 9.58 Defence acknowledged that it faces a cultural problem in encouraging many of its staff to recognise the seriousness of the financial reporting problems current facing Defence, and the need to be vigilant in accurate record-keeping and financial management. Defence stated that while many of its members were remarkably adaptable when it came to taking on new ways of war fighting and new equipment, financial management issues are not seen by many as the core business of the organisation.²⁰

Committee comment

- 9.59 The Committee believes it is most important that the international accounting standards adopted by the Australian Government are applied to all government agencies, without exception. However, the Committee recognises that Defence faces some particular difficulties in meeting all the financial reporting requirements imposed by these standards, and audited by the ANAO. These difficulties include the size of the organisation and the fact that financial systems designed up to two decades ago do not have the technical capacity to provide the level of financial reporting required. The Committee believes that the problem of pricing within the SDSS, particularly the ongoing use of zero or notional pricing, must be resolved as a matter of

18 Defence, *Transcript of Evidence*, 27 June 2005, p. 33.

19 Defence, *Transcript of Evidence*, 16 March 2005, p. 6.

20 Defence, *Transcript of Evidence*, 12 May 2005, p. 4.

urgency. The Committee urges Defence and ANAO to agree on a resolution for this matter as soon as possible:

Recommendation 30

- 9.60 **The Committee recommends that Defence and the ANAO conduct ongoing consultations to discuss areas of disagreement such as pricing within the SDSS system. Defence should aim to resolve the issue of pricing of items within SDSS by June 2006.**

Project JP 2077

- 9.61 Project JP 2077 is identified as a major capital equipment purchase in the *Defence Capability Plan 2004-2014*. Under the project outline in the Capability Plan, Project JP 2077 Phase 2B is for the acquisition and roll-out of the Improved Logistics Information System. In other words, JP 2077 will be a comprehensive upgrade of the SDSS system.
- 9.62 Australian technology company MINCOM was identified in the Capability Plan as a Defence Alliance partner to develop the new logistics management system. The project is due for delivery from 2007-2009. The Capability Plan outlines a budget of between \$100 - \$150 million.²¹
- 9.63 In June 2005 the Government announced that Cabinet had granted First Pass approval for project JP 2077 Phase 2B. Initial expenditure is to be \$13.4 million, to develop and refine options and costs for the project. The Defence Minister announced that the project will include:
- an upgrade of the core transaction system of SDSS, which currently uses a MINCOM application;
 - development of an enhanced deployable logistics capability;
 - an improved financials package; and

21 Department of Defence, *Defence Capability Plan 2004-2014 Public Version*, Defence Materiel Organisation, Defence Publishing Service, 2004, p. 101.

- an integrated In-transit Visibility System, which will allow Defence to track the movement of stores and components across the country and at overseas locations.²²
- 9.64 Expenditure to date on JP 2077 has included \$37.1 million on Phase 1, approved July 2001; and \$15.9 million approval for Phase 2A.²³ The project is due to go before Cabinet for 'Second Pass' approval – authorising the go-ahead for the project – by the end of 2005.
- 9.65 The Committee questioned Defence on project management for JP 2077, given the ANAO's past findings about the problems of past IT projects such as the SDSS upgrade. In particular, the Committee was concerned that Defence does not out-source project management for future IT projects. Defence stated that a DMO employee will be the JP 2077 project manager.²⁴ Defence advised that there were 11 full-time and 54 part-time Defence personnel, and seven contract personnel, engaged with JP2077 who had prior involvement with SDSS and inventory management.²⁵
- 9.66 Defence provided the following information regarding JP2077 Phase 2B (the current phase of the project):

Table 8.4 Defence JP2077, Phase 2B

Project Phase	Deliverables	Timeframes
2B.1	○ Core software upgrade to implement the next generation of Mincom software, Ellipse.	Second Pass approval 1 st Quarter 2006
	○ Enhanced financial functionality, to enable interface with ROMAN, and to meet financial reporting and auditing requirements.	Implementation 2 nd Quarter 2007
	○ Military off-the-shelf enhancements will incorporate defence modifications into the standard COTS product, enabling significantly reduced maintenance and support costs.	
2B.2	○ Integrated in-transit visibility, to provide SDSS users with accurate information on the location of equipment in transit within the supply system.	Second Pass approval 2 nd /3 rd Quarter 2006
	○ Enhanced deployability capability to allow SDSS to operate independently of a fixed communications link – particularly relevant for reliable logistics support to operational units overseas.	Implementation 4 th Quarter 2009

Source Department of Defence, submission no. X, p. 2.

22 Senator the Hon. Robert Hill, Minister for Defence, *Plan to upgrade Defence logistics system*, Press Release 24 June 2005, available at:

<http://www.minister.defence.gov.au/Hilltpl.cfm?CurrentId=4952>, accessed July 2005.

23 Defence, *Transcript of Evidence*, 27 June 2005, p. 39.

24 Defence, *Transcript of Evidence*, 27 June 2005, p. 44.

25 Defence, submission no. 11.1, p. 1.

9.67 The Committee questioned Defence about any involvement of Tenix Toll Defence, the contracted warehouse management organisation, in development of the JP 2077 project. Defence replied that to date, Tenix Toll had not had any involvement with the project. However, Defence advised that the Integrated Project Team would seek defence industry input, including from Tenix Toll, prior to seeking second pass approval from Cabinet.²⁶

Recommendation 31

9.68 **The Committee recommends that for Project JP 2077:**

- **the project must be managed from within the Defence Materiel Organisation;**
- **all appropriate cabinet-level, ministerial-level and departmental approvals must be sought prior to implementation of various phases of the project;**
- **the project must include defined project milestones;**
- **no project management bonus payments are to be made to any DMO personnel if the project milestones are not met on-time, and on-budget;**
- **there must be continued input from on-the-ground users of the logistics system; and**
- **the project must include sufficient upgrades to the technological hardware supporting the new logistics system to ensure that it will run efficiently.**

Final comments

9.69 The finding by the ANAO, and concurrently the Secretary of the Department of Defence, that they had an inability to form an opinion on the status of the Defence Financial Statements, was unprecedented. It was the culmination of a number of years of poor record-keeping, information systems failure, and a failure to fully recognise the impact of accrual accounting.

26 Defence, submission no. 11.2, p. 3.

- 9.70 Given the move to International Financial Reporting Standards, and the scale of problems that Defence needs to overcome, it is likely to be several years before Defence moves from an 'inability' to a 'qualified' audit opinion in the Financial Statements.
- 9.71 The Committee recognises the significant work begun by Defence to address these problems. A major cultural change is required at Defence, from the lowest to most senior levels, to place an appropriate emphasis on financial management and reporting requirements.
- 9.72 The Committee would also like to recognise the significant resources provided by the ANAO dedicated to auditing the Defence financial statements. The Committee understands that at one stage this year, most of the ANAO's financial auditing staff were on the ground at Defence undertaking stocktaking activities.
- 9.73 The Committee intends to closely monitor Defence's remediation plans and the Department's progress in improving its financial reporting status. This may include a more detailed Committee inquiry on Defence financial management during 2006.