

BAE SYSTEMS

Submission No. *2*

HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON
21 APR 2006

21st April 2006

Mr Russell Chafer
Secretary
Joint Committee of Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Russell,

Please find enclosed a submission by BAE Systems Australia to the inquiry into financial reporting and equipment acquisition at the Department of Defence and the Defence Materiel Organisation. We have addressed each of the four particular items cited in the terms of reference of the inquiry in our submission. However, the submission is necessarily brief in order to highlight areas in Defence procurement. We would be pleased to expand upon each of our remarks in more detailed written form or in testimony to the committee if required.

Sincerely,

Peter Nicholson

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Government Relations Director

BAE SYSTEMS

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**BAE Systems Australia
Submission to the Inquiry into
Defence Procurement and Financial
Administration
by the
Joint Committee of Public Accounts and Audit**

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1 INTRODUCTION

- 1.1 This submission by BAE Systems Australia addresses each of the four particular items cited in the terms of reference of the inquiry. The submission is necessarily brief in order to highlight areas in Defence procurement and financial administration that warrant further examination and improvement.
- 1.2 BAE Systems Australia would be pleased to expand upon each of our remarks in more detailed written form or in testimony to the committee if required.

2 TERMS OF REFERENCE ITEM 1 – PROGRESS IN IMPLEMENTING DEFENCE'S FINANCIAL REMEDIATION PLANS, RELATIVE TO INTERNATIONAL BEST PRACTICE IN THESE AREAS

- 2.1 It is evident that the same issues have been a recurring problem in annual accounts each year in recent years *eg* fixed assets. The suggestion is that materiality thresholds be agreed between the Australian National Audit Office and Defence to focus efforts on the major items. Also a standardised approach should be adopted by Defence in tracking, in conjunction with industry, Government Furnished Equipment (GFE).
- 2.2 We note that Defence appears to be organised around “stovepipes” *eg* each of the Services, DMO, *etc.* The suggestion is that senior Finance representatives of each stovepipe should have a clear and unambiguous functional reporting line to the CFO Defence for the implementation/results of the Financial Remediation Project (in addition to their primary reporting lines within their respective stovepipe). The creation of the DMO as a prescribed agency in July 2005 may be an obstacle to this proposal. Nevertheless, central coordination is vital in order to resolve these long standing Pan-Defence problems and to build a robust financial framework for the future.
- 2.3 Defence has clearly recognised that its Financial Remediation Project (FRP) is in fact a major change management project that will take a number of years to achieve. This is both necessary and realistic if significant change is to be made and implemented. The FRP correctly seeks to address the root causes of the problems (*i.e.* people/training, systems, policies & procedures) rather than reactively addressing quick fixes (which are not sustainable unless embedded in the culture and processes of the organisation).
- 2.4 The FRP therefore requires clear objectives, a detailed implementation plan, assigned ownership for all actions and a detailed, ongoing, reporting, monitoring and control process to ensure FRP objectives are met.
- 2.5 It may be helpful to involve CFO from some of the major defence companies in Australia to assist Defence in reviewing/challenging its remediation plans, in monitoring progress against plans and generally providing an independent sanity check/sounding board. We would be happy to be involved if requested and have in fact made this offer to the last two CFO – Lloyd Bennett and Ken Moore (acting CFO).

3 TERMS OF REFERENCE ITEM 2 – PROGRESS IN IMPLEMENTING THE KINNAIRD REFORMS, RELATIVE TO INTERNATIONAL BEST PRACTICE IN THESE AREAS

3.1 The Kinnaird reforms dealt primarily with the capability development to acquisition phase of the capability acquisition process (see paragraph 4.1 below). Progress in this phase has been substantial with highlights including:

- a. The creation of the position of Chief of Capability Development Group (CCDG) at three star rank has strengthened consideration of joint and other interoperability aspects with a 'purple' advocate and champion to balance the single Service points-of-view.
- b. A direct consequence of establishing CCDG has been the documentation of systematic processes and procedures for the capability development process in the Defence Capability Development Manual.
- c. The two pass system has introduced rigour to the process of acquiring capability and provided the opportunity for early Government scrutiny of proposals.
- d. The Defence Capability Development Manual and other documents provide clear guidance on the information required for the initial business case, first pass cost estimates and other important planning milestones.

3.2 Some problems remain with implementation of the Kinnaird reforms:

- a. The two pass process is not always appropriate, particularly to C4ISREW projects that are more amenable to incremental spiral development and continuous improvement.
- b. Less upstream resourcing from project funds to develop and test operational and system architectures and operational concepts before first pass has been evident than envisaged by the Kinnaird review. The Defence Capability Development Manual refers to the Project Development Fund (PDF) but the amounts pulled forward do not approach the accepted private sector value of up to 15% of project funds.
- c. Furthermore, the expertise for the analysis required is generally not available in the uniformed or public service personnel posted in CDG. The lack of human resource in CDG means, *inter alia*, that CDG must internally subcontract to DMO to perform much of the pre first pass and second pass tasks that should be carried out in CDG. This is contrary to the spirit of Kinnaird and has a serious effect on the colour of this work.
- d. The allocation of a technical assessment role to DSTO has slowed the process between first and second pass, and from second pass to contact award with little demonstrable reduction in risk. It also diverts DSTO from its core capability of applied research and development.
- e. The DMO continues to act as the prime system integrator in many large and complex projects when this work would be better performed by industry. Our observation is that the skills and experience necessary to successfully accomplish the PSI role do not reside in the DMO.
- f. In its concentration on using competition to achieve best value for money, the DMO has not comprehended the cost to companies of bidding. Competition is not the only or even the best method of achieving value for money.

- 3.3 Defence has introduced several measures to address these problems including the establishment of the Rapid Prototyping, Development and Evaluation (RPD&E) capability to accelerate networking the force and the Rapid Acquisition process to satisfy urgent operational requirements. Our contention is that these initiatives should be part of the normal process of capability development and acquisition rather than additions to a somewhat cumbersome and rigid procedure. In particular, RPD&E is demonstrating the value of more detailed analysis of both the perceived problem and possible solutions earlier in the cycle than is common at present.

4 TERMS OF REFERENCE ITEM 3 – REVIEW AUSTRALIA’S RELATIVE ACHIEVEMENTS IN PROCUREMENT AND FINANCIAL REFORM RELATIVE TO INTERNATIONAL BEST PRACTICE IN THESE AREAS OF DEFENCE ADMINISTRATION

4.1 In relation to Australia’s relative achievements in procurement reform, three phases in the process of acquiring capability can be identified:

- a. The Strategy to Capability Development Phase that sets the framework for the translation of strategic guidance from the Government to military strategy and operational concepts.
- b. The Capability Development to Acquisition Phase that is largely the purview of the Kinnaird reforms discussed in paragraph 3.1.
- c. The Acquisition to Sustainment Phase that is the responsibility of the System Program Offices (SPO) that form the through life support management structure. This is not the subject of review but is considered a viable and sustainable model for through life support of military systems.

4.2 The problem area is undoubtedly the first stage of translating strategic guidance into operational requirements. The reason for this is twofold:

- a. The future joint operational concept for employment of the ADF has not yet been developed from the military strategy. Instead single Service operational concepts have been, or are being, developed in the absence of the framework of an overarching operational architecture.
- b. The interaction and integration of different capabilities is not considered as a system-of-systems. A high-level operational (warfighting) architecture should be developed for different capabilities (*eg* strike, maritime warfare, *etc*).

4.3 There are other problems in the procurement process, not necessarily identified in the Kinnaird review that should also be addressed. Chief among these are:

- a. The premise that competition is the only method of achieving best value for money is contestable particularly in relation to renewal of sole source contracts for sustainment activity. We contend that developing a capability partnership relationship with longer term performance based contracts will represent best value for money in many cases. We suggest that care should also be taken to ensure that ‘best value for money’ is not equated to ‘cheapest’ in competitive evaluations.
- b. Failure to adhere to the sector strategic plans has introduced uncertainty in the bidding process. These plans should be either followed or discarded because in their absence, the type and degree of industrial capability required in the long term is not obvious to industry. Furthermore recent source selections have sent contradictory messages about the importance of the sector plans and inhibited industry plans for investment.
- c. The defence industry policy from which the sector plans are derived was issued in 1998 and warrants review and amendment. In particular, defence industry policy must take account of the effects of very large procurement on the industrial base. Decisions made even at the System Design and Development (SDD) phase of very large projects have the potential to skew the industrial base. The UK Defence Industry Strategy issued in 2005 would serve as a good model for an Australian industry policy.
- d. Despite the existence of the robust and well documented processes for capability development and acquisition, several recent major equipment acquisition projects have not

complied with these processes. This short-circuiting of the system leads to uncertainty and confusion and a reluctance by industry to invest in capability.

- e. The Defence Industry base in Australia is overwhelmingly geared to sustainment (including support and technology insertion) and therefore the need for adequate and widespread mechanisms for sole source contracting that will safeguard value for money is vital if the ADF is to garner the benefits from long term support partnering and contracting.
- 4.4 Generally, we welcome current DMO procurement reforms and look forward to the release of the revised ASDEFCON templates. We believe that proposals for developing a Strategic or Head Agreement between DMO and major individual prime contractors such as BAE Systems, to address corporate positions on headline terms and conditions such as (*inter alia*) insurance and limitation of liability, will assist in reducing the time to contract in future.
- 4.5 BAE Systems Australia's comments on the procurement process derive from our experience principally in relation to major capital acquisitions and follow-on support programs. We expect that input from appropriate industry members and/or associations in relation to procurement of goods and services from SME would provide additional commentary more targeted to such procurement activities.
- 4.6 Concerning Australia's relative achievements in financial reform, our observation is that there is a need to establish clear outcomes and measures in relation to financial reforms and monitor progress regularly. The process within Defence could benefit from independent CFO peer review from defence industry. Given the recent history of qualified audit opinions/no opinions being expressed by ANAO it would be sensible for Defence to agree with ANAO upfront what the goals, priorities and expected outcomes of the Financial Remediation Project (FRP) should be and the interim milestones for achievement. Regular interim audits should also be conducted, so that any corrective action deemed necessary can be undertaken prior to the "big bang" annual audit.
- 4.7 It would also be sensible to agree upfront the applicability (and areas of non applicability) of the various elements of the Accounting Standards on a pragmatic/fit for purpose basis recognising that Defence are quite different in many respects from the commercial and the not for profit sector for which the standards are primarily aimed (see item 5 below).

5 TERMS OF REFERENCE ITEM 4 - ASSESS PROGRESS IN DEFENCE'S ADOPTION OF INTERNATIONAL ACCOUNTING STANDARDS RELATIVE TO INTERNATIONAL BEST PRACTICE IN THIS AREA OF DEFENCE ADMINISTRATION

- 5.1 The suggestion is that Defence liaise with counterparts elsewhere (*eg* NZ, UK, Canada and USA.) to share lessons learned and best practice approaches in this complex area.
- 5.2 It is inevitable that Defence departments in all these countries will have different views on the applicability of the various elements of the Accounting Standards and will be at different stages of adoption. Much of this may well depend upon how suitable are their existing financial systems in capturing and regularly updating the information required by the standards (*eg* cost/replacement value of assets and impairment). This could well be an issue for Defence given that much of the "history" may not exist on legacy systems given cash accounting prior to 2000 and systems geared toward operational logistics support rather than financial reporting in some cases.
- 5.3 Arguably there has to be a cost/benefit analysis applied if the aim is a rigid application of the Accounting Standards. Also an agreed prioritisation of what can/cannot be accomplished realistically over a given period with finite resources much of which is already committed to the abovementioned Financial Remediation Project (FRP).
- 5.4 There are some areas of the standards that Defence should be able to readily comply with (*eg* fixed assets comprising buildings) but others where the replacement value (or impairment) of certain fixed assets is highly judgemental at best (*eg* F111 aircraft or obsolete stock when an asset is required to be supported for "life of type").
- 5.5 As previously mentioned it would be sensible for ANAO and Defence to agree applicability upfront in all key areas and then a roll-out programme leading to compliance to the "agreed standard". Perhaps the ASB, or Department of Finance and Administration, will need to arbitrate if agreement cannot be reached. This recognises the unique nature of Defence and is not "exemption" from the Accounting Standards *per se*.