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Report 411

**Progress on equipment acquisition and financial reporting in
Defence**

Joint Committee of Public Accounts and Audit

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Foreword

The Defence portfolio has been the subject of a great deal of Parliamentary scrutiny over many years. There has been good reason for this. At the same time as the Department of Defence has been the beneficiary of generous funding it has suffered from deficiencies in its financial reporting and its capacity to acquire major equipment on time and on budget.

In fulfilling its statutory obligation to review all of the reports of the Auditor-General tabled in Parliament, the Committee has become well apprised of the challenges that Defence faces. Over and again, the Committee, and indeed the Australian public, have heard about major Defence acquisition projects that have gone wrong. Similarly, Defence's inability to attest to the accuracy of its financial statements for the years 2003-04 and 2004-05 is well known. In 2003, as a result of two major reviews and the uncertain financial position in which it found itself, Defence was under intense pressure to make changes. The primary purpose of this inquiry was to determine the extent to which Defence has made progress on its reform agenda since 2003.

There is little doubt that a considerable amount of work has been undertaken by the Department to remediate and reform its financial management practices. Similarly, Defence and the Defence Materiel Organisation (DMO) have worked hard to implement the recommendations of the *Defence Procurement Review 2003* (the Kinnaird Review). The Committee commends Defence's senior leadership team and their commitment to driving these reforms through the Department. However, the job is not yet complete. Three key areas have emerged from this inquiry. First, Defence must now undertake a comprehensive assessment of the effectiveness of the Kinnaird reforms including whether the full intent of the Kinnaird Review (i.e., to make the DMO a more business-like, outcomes-focussed organisation) has been realised. And, to that end, the Committee welcomes the Defence Procurement and Sustainment Review which is currently underway.

Second, the Department must demonstrate a greater commitment to measuring and monitoring outcomes. This involves developing techniques to evaluate the outcomes of its reform agenda. Third, the Department must make full use of the

Major Projects Report as a vehicle which can improve transparency and accountability. This Report, which will be reviewed by this Committee and other relevant committees of the Parliament on a regular basis, provides a unique opportunity to continuously scrutinize how Defence dollars are being spent and whether value for money is being achieved on behalf of the Australian public.


This was a long inquiry. It began in March 2006 and traversed two parliaments. I am therefore grateful for the work of the Members of the Defence Sectional Committees of both the 41st Parliament and the 42nd Parliament.

I would also like to thank the individuals and organisations who gave up their time to provide written submissions and oral evidence to the Committee.

It has been claimed in the past that deficiencies with the Department of Defence have impacted little on the Australian Defence Force's operational activities. However, more recently the Secretary of the Department of Defence, Mr Nick Warner conveyed the following caution "...unless the underlying weaknesses of Defence are fixed, over time our ability to deploy successfully will slowly but surely diminish".¹ The Committee takes this warning very seriously. The Committee will therefore continue to devote time to ensuring that Defence maintain its commitment to a robust and efficient financial management framework and achieving best practice in the procurement of Defence equipment.

Sharon Grierson MP
Committee Chair

1 Mr Nick Warner, *256,800 Paper hand towels: Mending Defence's Broken Backbone*. Speech to the Lowy Institute for International Policy, 10 June 2008, p 2.



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Terms of reference

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

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.

List of abbreviations

AASB	Australian Accounting Standards Board
ADF	Australian Defence Force
AEIFRS	Australian Equivalents to International Financial Reporting Standards (see also IFRS and AIFRS)
AIFRS	Australian Equivalents to International Financial Reporting Standards (see also AEIFRS and IFRS)
AGAAP	Australian Generally Accepted Accounting Principles
AIC	Australian Industry Capability
AII	Australian Industry Involvement
ANAO	Australian National Audit Office
APS	Australian Public Service
AVO	Australian Valuation Office
CCDG	Chief Capability Development Group
CDAF	Capability Development Advisory Forum
CDF	Chief of the Defence Force
CDG	Capability Development Group
CEO	Chief Executive Officer
CFO	Chief Finance Officer
CJOPS	Chief of Joint Operations

COTS	Commercial-off-the-shelf
DBIB	Defence Business Improvement Board
DMO	Defence Materiel Organisation
DMR	Defence Management Review
DOD	Department of Defense (US)
DPR	Defence Procurement Review
EO	Explosive ordnance
ESM	Electronic surveillance measures
EVMS	Earned Value Management System
FRP	Financial Remediation Project
FSPB	Financial Statements Project Board
IFRS	International Financial Reporting Standards (see also AEIFRS and AIFRS)
JCPAA	Joint Committee of Public Accounts and Audit
JSCFADT	Joint Standing Committee on Foreign Affairs, Defence and Trade
MOD	Ministry of Defence (UK)
MOTS	Military-off-the-shelf
SADI	Skilling Australia's Defence Industry
SCAs	Supply Customer Accounts
SDSS	Standard Defence Supply System
TLS	Through-life-support
UK NAO	United Kingdom National Audit Office
US GAO	United States Government Accountability Office



List of findings and recommendation

Since the commencement of this inquiry a substantial amount of work has been conducted by the Department of Defence to address major concerns identified in the 2003 Senate Foreign Affairs, Defence and Trade References Committee report into *Matériel acquisition and management in Defence*, the *Defence Procurement Review 2003* and financial and performance audits of the Australian National Audit Office. Significant progress has been made in a number of areas, most notably in remediating its financial statements position, and in implementing the Kinnaird recommendations. However, concerns remain in a number of areas. These concerns are set out in the Committee findings listed below in the following categories: *The Kinnaird Reforms; Measuring Outcomes; and Transparency and Accountability – the Major Projects Report*.

Committee findings

The Kinnaird Reforms

- **Implementation of the Kinnaird Review recommendations is all but complete, however, a process for determining the effectiveness of the Kinnaird reforms is in its infancy.**
- **The early phases of the capability development and acquisition cycle remain a critical area for the Department of Defence and the DMO. The clear articulation and communication of requirements is vital to that process. Defence must retain a strong focus on the leadership of the Capability Development Group and resource the area appropriately.**
- **Progress on the implementation of Recommendation 4 of the Kinnaird Review remains deficient and should be attended to as a matter of priority.**

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- Ongoing monitoring of the Kinnaird reforms by a body such as the Defence Procurement Advisory Board or its equivalent is critical to determining the ultimate success of the implementation of the Review's recommendations.

Measuring Outcomes

- Insufficient attention has been paid to developing techniques by which the status of the reform agenda can be measured.
- Priority should be given to developing metrics to gauge the impact of the Kinnaird reforms in terms of initiating and maintaining cultural change across the Department. In particular, these metrics should assess the degree to which the DMO has become a more business-like and outcomes-focussed organisation.
- The Department's large investment in financial training should be accompanied by the development of metrics to evaluate and monitor the effectiveness of this investment. This evaluation should go beyond simply reporting the number of personnel who have undergone financial skills training and should also assess attitudes to financial management across the Department.
- A definitive statement on the status of each individual remediation plan should be made publicly available.

Transparency and Accountability – Major Projects Report

- Oversight of the reforms undertaken by Defence is not a straightforward process. While the Major Projects Report represents a significant step forward in this respect, the Committee believes that more can be done to improve transparency and accountability across the Defence portfolio.
- Procedures and processes for documenting lessons learnt on all major projects are patchy and inconsistent. Lessons learnt should be accessible, consistent in their format, and communicated effectively.
- Inconsistent and ambiguous use of important terms including but not limited to 'off-the-shelf', 'cost blow out', 'lead customer', 'legacy project', 'pricing', 'pre-Kinnaird', 'post-Kinnaird' as well as terms denoting 'stages of acceptance' and 'release' continue to cause problems. The Committee urges Defence to standardise its procurement-related terminology.

- Any project deemed appropriate to be included in the Major Projects Report should continue to be reported on until full operating capability is achieved.
- It is critical that the Major Projects Report be publicly scrutinized by the relevant Committees of Parliament on an annual basis to ensure that the true intent of the report (i.e., to identify and remedy problems expeditiously) is preserved.

Recommendation

The Department of Defence address the Committee's findings above and provide an update to the Committee at a public hearing to be held 12 months from the tabling of this report.



Executive summary

Introduction

In March 2006, the Joint Committee of Public Accounts and Audit (JCPAA) resolved to conduct an inquiry into financial reporting and equipment acquisition at the Department of Defence and the Defence Materiel Organisation (DMO).

Defence is an immense and complex portfolio. Departmental funding for Defence in 2008-09 represents 1.8 per cent of GDP and the DMO currently manages 236 major projects (valued at over \$20 million each) and 180 minor projects. While few would argue that operationally, the effectiveness of the Australian Defence Force is second-to-none, the Department of Defence has had a problematic history around financial reporting and equipment acquisition. Problems with financial reporting within Defence culminated in the Australian National Audit Office (ANAO) expressing an inability to form an opinion on Defence's financial statements for the years 2003-04 and 2004-05. Additionally, protracted problems with a number of major acquisition projects at the DMO are well documented and widely known as a result of a series of critical ANAO performance audits. The Department of Defence has been under intense pressure to make improvements as a result of these difficulties.

In 2003, two significant Defence-related reports were published: the *Senate Foreign Affairs, Defence and Trade References Committee Report into Materiel Acquisition and Management in Defence*; and the *Defence Procurement Review* (the Kinnaird Review). The objective of the Senate inquiry was to take a snapshot of progress since the restructure of the DMO that came about as a result of the 2000 White Paper. The purpose of the Kinnaird Review was to examine the processes around developing and maintaining capability. The Kinnaird Review set out a number of recommendations addressing each stage of the capability acquisition cycle, making explicit the imperative for the DMO to become a more outcomes-focussed organisation. In 2003, the Department of Defence also instituted a comprehensive financial remediation program to address issues related to financial management.

Significant resources have been expended to address financial management issues and to implement the recommendations of the Kinnaird Review. The primary

objective of this inquiry was to examine progress made since the publication of the Senate report and the Kinnaird Review and to identify remaining challenges.

The inquiry has seen a change of Government and subsequent announcements about a new Defence White Paper and a series of companion reviews. The Government is also currently undertaking a Defence Procurement and Sustainment Review chaired by Mr David Mortimer AO.

History advises that the Parliament must be vigilant in monitoring the business-end of Defence - this inquiry is part of that process.

Financial reform

A considerable amount of work has been undertaken by the Department in the form of a comprehensive remediation program to address the audit findings from the 2003-04 and 2004-05 financial years. Sixteen remediation plans put in place as part of that program are largely complete, an effective financial management framework is in place and the relationship between the ANAO and Defence on financial issues appears to be open and proactive.

The Committee was impressed with the progress that has been made on remediating the Department's financial management issues. The Department of Defence is working hard to remove uncertainty around the reported balance of Inventories - General. The Committee makes two findings on the basis of the evidence reported on in this Chapter. The first is in response to a lack of consistency in reporting progress on and/or completion of its remediation activities. The second is related to how the Department will be able to determine the ultimate effectiveness of its investment in financial skills training.

The Kinnaird reforms

The authors of the Kinnaird Review stressed the need for change. More specifically, they advocated rapid and fundamental change to reshape systems, structures and organisational culture. There are two key elements to consider when examining the changes that have taken place as a result of the Kinnaird Review. The first is the implementation of the recommendations *per se*. The second is whether the true intent of the reforms is being realised as a result of the implementation of those recommendations.

The evidence gathered during the inquiry demonstrates that the Kinnaird Review recommendations, where agreed, have been largely implemented to reshape systems and structures. One important outcome of the Kinnaird Review was the establishment of a single point of accountability for capability definition and assessment, and the work of the Capability Development Group (CDG) is central

to the success of the capability development and acquisition process. The importance of clearly defined and articulated requirements and effectively managing high levels of technical risk cannot be overstated. In recognition of this, the Committee reiterates in its findings the significance of retaining strong leadership of the CDG as envisaged in the Kinnaird Review and the need for appropriate resourcing.

Determining progress of the implementation of the Kinnaird Review recommendations is relatively straightforward. However, measuring the effectiveness of the resulting reforms is a somewhat more difficult and ongoing task. The Kinnaird Review recommended that a body be set up to advise and support the DMO and report progress of the implementation of the recommendations. To that end, the Defence Procurement Advisory Board was established. From evidence presented to the Committee it appears while the Board has overseen implementation of the recommendations, the job of measuring the effectiveness of the reforms has not yet begun in earnest. Of particular interest is the impact of the reforms not only on actual outcomes (i.e., improvements in cost overruns, schedule and delivery) which the Committee will monitor through its routine reviews of ANAO performance audits but also on the organisational culture of the DMO (i.e., is the DMO a more business-like, outcomes-focused organisation?). The Committee makes one finding related to an outstanding aspect of the implementation of the Kinnaird recommendations. The others are related to determining the ultimate effectiveness of the Kinnaird reforms.

The case studies

The inquiry's two case studies, the Fast Frigate Guided (FFG) Upgrade Project and ARH Project Air 87 ('the Tigers') illustrate the type of issues that have previously been identified by ANAO performance audits and other critical Defence reviews. Poor project management and inventory management practices, non-enforcement of contract provisions, risk allocation, training and retaining personnel, documenting lessons learnt, and the need for cultural change were all again identified as key concerns.

Defence is well-acquainted with the issues that were raised over the course of this inquiry. It is now well known that careless inventory management impacts significantly on the financial reporting of the Department, project management practices are firmly in the spotlight, and the appropriate allocation of risk between industry and Government is a priority. The Committee will be vigilant in keeping these matters under review as performance audits of post-Kinnaird projects start to emerge.

The need for cultural change across the Department of Defence has been expressed *ad nauseam* over a number of years in a number of contexts. Yet, to date

no systematic and explicit attempt to measure and monitor Defence culture has been put in place. The Committee's findings reflect the need for Defence to pay significantly more attention to monitoring such change.

Despite its intensive campaign to professionalise its workforce, finding and keeping appropriately-trained staff remains a major challenge for the DMO. Challenges around the recruitment and retention of appropriately trained personnel make the collection and communication of corporate knowledge all the more critical. In its findings, the Committee reasserts the need for Defence to commit to developing a comprehensive formal process for documenting the lessons learnt on acquisition projects.

Major Projects Report

The absence of clear, consistent information from which to assess the progress of major acquisition projects has been a major concern for a number of years. This deficiency led the Committee to unanimously recommend during the course of the inquiry that the Auditor-General receive funding to produce an annual report on the progress of major acquisition projects.

The Major Projects Report, for which the ANAO has been allocated \$1.5 million from 2009-10 onwards, follows similar reporting models to those in the United States but more particularly, the United Kingdom. The DMO will prepare base material on the status of each included project and the ANAO will conduct an overview of that material.

The Major Projects Report provides an opportunity to increase the transparency of Defence projects. The Committee's findings reflect the importance of maintaining a holistic approach where projects are monitored from beginning to end (i.e., from contract signature to the achievement of capability). The Committee is confident this should, over time, contribute to a comprehensive and timely understanding of where projects succeed and where they fail. The Committee also believes that in articulating its concern about the use of ambiguous and inconsistent terminology such as 'military-off-the-shelf' and 'cost blow out', this will motivate the Department to carefully reconsider how these terms are to be understood consistently by the Australian public, the Parliament, industry and across the Department of Defence itself.

The Committee reasserts its steadfast commitment to its ongoing role, and that of other Parliamentary committees, in monitoring and reviewing Defence acquisition practices. The Committee will be alert to any attempts made to diminish the scope and depth of the Major Projects Report.

Conclusion

Since 2003, Defence has made significant progress toward improving the framework and processes underpinning the administration of its financial affairs. Similarly, the recommendations of the Kinnaird Review have been largely implemented. The Committee is pleased with this progress but warns Defence against complacency.

Over a number of years, this and other Parliamentary committees have expressed a great deal of frustration about the less than positive outcomes on a number of significant Defence acquisition projects and about the lack of disclosure around what went wrong with those projects, who was responsible and what has been learned to avoid problems in the future.

The Committee hopes that the Kinnaird reforms once realised will reduce the likelihood of cost overruns and schedule slippages. Similarly, the Committee is hopeful that the continuous, comprehensive and transparent monitoring that underpins the Major Projects Report in conjunction with the routine performance audits conducted by the ANAO, will strengthen the Parliament's capacity to identify problems early. This should also lessen the likelihood of future inquiries being referred to Parliamentary committees.

That said, the Major Projects Report is not a panacea. Given the magnitude and significance of the Department of Defence to the security of all Australians, the Committee is anxious to ensure that the Department of Defence does not 'drop the ball' either in terms of its financial reporting obligations or the management of equipment acquisitions.

