

Remediation of Defence's Financial Statements

Background

- 5.1 In recent years Defence has come under increasing criticism for its financial management practices. The 2003 Australian Strategic Policy Institute (ASPI) policy report *Sinews of War* charted the recent history of financial management in Defence. The report advised that there have been significant improvements to Defence fiscal discipline and budgeting since a serious breakdown in 2000 and 2001, however the 2004-05 Statement by the Chief Executive and Chief Finance Officer for Defence remained qualified.
- 5.2 Defence concluded again, as they had in 2003-04, that they could not attest that the overall statements were true and fairly stated. However, they went on to note that 'while the overall result remains disappointing, it does reflect improvement on the 2003-04 statements'.¹
- 5.3 The Australian National Audit Office (ANAO) continued to monitor defence management performance closely. In order to address ANAO identified deficiencies, and improve reporting to Government, Defence reported the following initiatives:
- implementation of 16 remediation strategies;
 - establishment of program offices in the Chief Finance Officer Group and the Defence Materiel Organisation to drive audit remediation strategies and to provide independent advice to the Secretary and the

1 Department of Defence, *Defence Annual Report 2004-05*, p. 5

Financial Statements Project Board on achievement of remediation outcomes;

- rigorous monitoring of remediation strategies by the Financial Statements Project Board, augmented by a representative from the Department of Finance and Administration and a private sector accounting specialist; and
- development of a financial controls framework that will standardise financial transactions and management processes across the portfolio to improve the integrity of defence financial data, budgeting and financial statements.

- 5.4 Defence continued to progress a range of improvements to its financial management and business systems and processes. As of 31 January 2006, Defence was working through 95 ANAO 2003-04 audit findings, and 47 ANAO 2004-05 audit findings, some of which were the subject of consultation between Defence and the Australian National Audit Office. While some audit findings have been resolved, 'enduring improvements will take some years'².
- 5.5 Defence believed that a significant step had been taken towards transforming their financial management situation with the establishment of the Defence Financial Controls Framework Project. The project intends to 'draw together in a structured and integrated fashion all of the components necessary to build a best practice financial management environment'³ that 'standardise and document the way Defence financial business is undertaken ...'⁴
- 5.6 The ANAO remained critical of Defence's internal control environment 'which is designed to prevent and detect errors in accounting and financial reporting,' and which 'contains significant deficiencies due to weaknesses in internal controls pertaining to financial management and operational systems, inadequate accounting records and poor inventory and asset recording. The deficiencies in controls and accounting records have resulted in significant uncertainties in relation to the material balances described above.'⁵
- 5.7 This Chapter examined two broad areas in relation to the Department of Defence's financial statements: the audit and financial reporting

2 Department of Defence, *Defence Portfolio Additional Estimates Statements 2005-06*, p. 119

3 Department of Defence, *Defence Annual Report 2004-05*, p. 40.

4 Department of Defence, *Defence Annual Report 2004-05*, p. 40.

5 Australian National Audit Office, *Independent Audit Report*, 4 November 2005.

environment; and the progress with regard to remediation of the ANAO audit findings.

Accounting and Audit Standards

- 5.8 The Committee re-stated a position from the Review of the Defence Annual Report 2003-04 with regard to the appropriateness of the rigid application of business accounting standards to Defence. The Secretary of Defence accepted that there had been difficulties, and that the next stage of accounting reform would be more of a challenge with regard to conforming to international financial reporting standards, nonetheless, he believed that Defence should aspire to those standards.⁶
- 5.9 The Secretary of Defence also observed that he believed Defence was under-prepared in terms of management and training for the audit standards now in place. He advised the Committee that this under-preparation was linked to the lack of training for personnel across the spectrum of requirements. There were deficiencies:
- right from the level of awareness of the issues and how important they are through to the actual implementation of the sorts of controls we want.⁷
- 5.10 While considering the matter of conforming to business accounting and audit standards, the Committee sought information in relation to certain recommendations made as part of the review of the *Defence Annual Report 2003-04*. The detail sought was with regard to accepting the unique nature of Defence's financial situation and adapting business accounting procedures to accommodate this uniqueness. In particular, the matter of inventory reporting was considered an area where a solution could be found that acknowledged the unusual requirements of Defence and adapt financial accounting practices accordingly.
- 5.11 The Secretary advised that Defence had 'established some boundaries for stratification and reduced the area of uncertainty'⁸ with regard to explosive ordnance and were proceeding in a similar direction with the general inventory. The question of where to draw the line, and when and how to stratify, was being examined by Defence with specific consideration being given to the nature of inventory.

6 Mr Ric Smith, Secretary, Department of Defence, Transcript, p. 53.

7 Mr Ric Smith, Secretary, Department of Defence, Transcript, p. 52.

8 Mr Ric Smith, Secretary, Department of Defence, Transcript, p. 53.

We are having some discussion with the auditors about the nature of it [inventory], so we may be thinking more about whether it is a consumable rather than inventory and therefore there is a different accounting treatment.⁹

- 5.12 The inventory stratification process was made all the more difficult because original pricing records and data could not be found. Accordingly, the Australian Accounting Standards Board (AASB) has advised Defence that a 'best estimate' approach is acceptable where the original data cannot be found. The cost of this 'best estimate' approach for general stores inventory could be substantial, noting that up to 600,000 line items of inventory would have to be priced. Defence is currently considering how best to pursue this option cognisant of the fact that the need for accountability must be balanced with a cost effective approach.¹⁰

Recommendation 5

- 5.13 **The Committee recommends that Defence advise the course of action taken in relation to establishing the general inventory 'best estimate' and the results of the assessment/review.**
- 5.14 The Chief Finance Officer for Defence made the following comments in relation to the application of, and adherence to, accrual accounting practices and audit requirements:

Some of it might be more technical than we need, but I will readily say ... that there are also standards that we ought to be meeting, just as a reasonable matter of doing business efficiently, that we are not. Where I can find highly technical issues that we would spend money on that are not worth pursuing, I will take that up with the Australian Accounting Standards Board ...¹¹

Recommendation 6

- 5.15 **The Committee recommends that Defence report on the 'highly technical issues' that have been presented to the Australian Accounting**

9 Mr Philip Prior, Chief Financial Officer, Department of Defence, Transcript, p. 53.

10 Government response to the Joint Standing Committee on Foreign Affairs, Defence & Trade, *Review of the Defence Annual Report 2003-04*, 6 March 2006.

11 Mr Philip Prior, Chief Financial Officer, Department of Defence, Transcript, p. 54.

Standards Board for consideration.

- 5.16 While Defence acknowledged that transitioning to a full accrual accounting and audit framework had been challenging, and would continue to be so, the Secretary of Defence advised the Committee that he:

would like to think we can continue to aspire to corporate sector standards, but getting there from here will be very challenging. In part because the investment that it will take will not deliver the benefit to our business that it might to a private sector company.¹²

Australian National Audit Office Findings – Remediation Update

- 5.17 The Australian National Audit Office (ANAO) audit of the Department of Defence financial statements for the year 2003-04 identified 95 findings that required resolution.
- 5.18 The remediation plan implemented to address these audit findings identified accountable officers to progress remediation in their particular areas of responsibility. The 57 audit findings that were not allocated to a General or Specific Remediation Plan were grouped together as Remediation Plan S9.
- 5.19 Defence noted that an important part of the remediation process was to ensure timely resolution of the ANAO issues to prevent escalation from Categories B and C to the most serious category, Category A.^{13 14}

12 Mr Ric Smith, Secretary, Department of Defence, Transcript, p.58.

13 Department of Defence, *Defence Annual Report 2004-05*, p. 52.

14 The issues arising from the ANAO audit activity are rated in accordance with the seriousness of the particular matter identified. The rating indicates to the audited entity the priority it needs to give to remedial action. ANAO define their category ratings as follows:

A	Those matters which pose significant business or financial risk to the entity and must be addressed as a matter of urgency: this assessment should take account of both the likelihood and consequences of the risk eventuating.
B	Control weaknesses which pose moderate business or financial risk to the entity or matters referred to management in the past which have not been addressed satisfactorily: these would include matters where the consequences of the control weaknesses might be significant; however there is little likelihood of the consequences eventuating.

- 5.20 In a submission to the Review of the *Defence Annual Report 2004-05*, an analysis conducted by The Firm Consultancy Group into the ANAO Category A and Category B risks identified for Defence, and other government departments, noted that Defence exceeded all others in terms of risk factors, and that the number of these risk factors was increasing. Indeed, it was suggested that the Category A and Category B 'risks' identified by the ANAO's audit could in fact be understated from an overall business risk perspective. The submission contended that this understatement and consequent conservative assessment by ANAO was the result of Defence excluding assessment of certain major capability acquisition projects or major capability development projects.¹⁵
- 5.21 Defence advised the Committee that accounting standards required the measurement of impairment of physical projects ie a capability degradation or a cost increase which goes into the valuation of assets under construction or the value of assets when they are handed over from DMO to Defence. The two types of audit conducted by the ANAO, financial and performance, are distinct and separate. The performance audits, rather than the financial statements audits as reported in the Annual Report, were the focus for DMO projects. The performance audits evaluated projects one by one to determine risk and appropriateness of management. CEO DMO summed up his position in relation to the elements of the submission by The Firm Consultancy Group as follows:
- I am not aware of any accounting methodology where you would put contingent liabilities onto your balance sheet for something that potentially might happen. When you know there is a reasonable probability it will happen, that is when you take a contingent liability onto your balance sheet ... I certainly do not have the concerns that are expressed in this letter.¹⁶
- 5.22 Defence advised the Committee that 37 of the 95 audit findings had been completed and forwarded to ANAO for clearance, with the remainder of the 2003-04 findings still to be finalised. Furthermore, a strategy for remediation of the 53 additional issues identified by ANAO in relation to

C	Matters which are procedural in nature or minor administrative failings: these could include relatively isolated control breakdowns which need to be brought to the attention of management.
---	--

15 Mr Peter Goon, The Firm Consultancy Group, Submission No 1 – Review of the Defence Annual Report 2004-05, 2 March 2006.

16 Dr Stephen Gumley, CEO Defence Materiel Organisation, Department of Defence, Transcript, p.63.

the 2004-05 report was being implemented.¹⁷ Accordingly, the Committee sought an update from Defence in relation to remediation of these ANAO issues and the status of those findings not yet resolved.

- 5.23 Defence advised that 71 findings were still outstanding : 32 Category A, 26 Category B and 13 Category C, but stressed that not all of those findings related to matters in connection with the financial statements. For example, one of the Category As was in relation to Reserve Force remuneration.¹⁸ Overall, the number of Category A, B and C findings were reduced with more progress being made in 2004-05 than in any previous year, particularly with regard to reducing the uncertainty on inventory and explosive ordnance. However, the Secretary of Defence expressed his personal disappointment that the remediation of leave records remained incomplete.¹⁹

Leave Provisions Remediation

- 5.24 As reported in the *Defence Annual Report 2004-05*, activity undertaken during 2004-05 in relation to remediation of the military leave provisions qualification included:

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

- 5.25 Major outcomes achieved were the remediation of military long service leave and completion of a sample of military annual leave. During the 2005-06 reporting period Defence planned to complete the military annual leave sample and review leave processing controls including cessation audits.²⁰

- 5.26 The activities undertaken during 2004-05 in relation to the remediation of the civilian leave provisions qualification included risk stratification and sampling, PMKeyS integrity, and quality assurance processes as per the

17 Department of Defence, *Defence Annual Report 2004-05*, p. 52.

18 Mr Ric Smith, Secretary, Department of Defence, Transcript, p. 55.

19 Mr Ric Smith, Secretary, Department of Defence, Transcript, p. 56.

20 Department of Defence, *Defence Annual Report 2004-05*, p. 49.

military leave considerations above. A major outcome achieved was undertaking the pilot phase of leave stratification, with completion of further sampling and verification of leave balances planned for 2005-06.²¹

5.27 In order to more fully understand the issues that were preventing the completion of the remediation of leave records, the Committee sought details from Defence as to the obstacles they believed they were facing.

5.28 Defence advised that essentially, it came down to the validation of the \$1.7 billion provision on the balance sheet for employee entitlements. Simply put, the matching of computerised records with documentary records, and verifying them, was the core of the problem. Defence further explained:

Auditors ordinarily would rely on internal control processes within an organisation to allow them to come to a view that the number the system generates is reliable ... When they come to the view, as they did some two years ago, that the controls are no longer reliable ... and therefore, to form their opinion, they must refer to a different substantiation approach, which is to substantiate the actual transaction ...²²

5.29 To physically check the actual records (including sign-offs and balances) of approximately 80,000 people is where the problem arises. Given the volume of records to be checked, and the fact that some records, eg long service leave, have accumulated over many years, the scope of the task is significant. The remediation activity therefore requires examination of records going back many years and finding the documentary evidence to substantiate a balance.

5.30 Defence admitted that until the internal controls were fully functioning again, the auditors would be unable to confirm the financial records, and would have to continue to rely on the substantiation approach.²³ Nonetheless, Defence advised that the remediation plans were progressing.

Asset Valuations Remediation

5.31 The Committee examined the remediation activity undertaken by Defence in relation to the ANAO reported qualifications of Defence land and buildings, and infrastructure, plant and equipment. The remediation

21 Department of Defence, Defence Annual Report 2004-05, p. 49.

22 Mr Philip Prior, Chief Financial Officer, Department of Defence, Transcript, p. 56.

23 Mr Philip Prior, Chief Financial Officer, Department of Defence, Transcript, p. 56.

activities associated with these qualifications are covered under Defence Remediation Plans S8 and S12.

5.32 In relation to Remediation Plan S8, Property Valuations, the major outcomes achieved in 2004-05 included:

- Completion of all land, buildings and infrastructure valuations by 30 June 2005;
- completion of other plan and equipment valuations, except for Chief Information Officer, by 30 June 2005;
- undertook quality assurance of valuation data and load the data into the financial system;
- released request for tender for the next three year cycle ie 2005-06 to 2007-08; and
- documented the revaluation process in the Asset Management and Accounting Manual.²⁴

5.33 In relation to Remediation Plan S12, Provisions for Contaminated or Potentially Contaminated Land, Buildings and Infrastructure, the major outcomes achieved in 2004-05 included:

- conducted a detailed review of all extant policies to ensure current reporting requirements were met;
- provided clear guidance in the 2004-05 valuations instructions to the Australian Valuation Office;
- implemented the Contamination Priority Sites Investigation Program; and
- pilot review completed for the ACT/Southern NSW region.²⁵

5.34 The Committee specifically sought information in relation to 'major variations' as reflected in the *Defence Annual Report 2004-05* which related to land, buildings and infrastructure. Defence advised that variations were likely to be the result of assets, eg buildings and facilities, not previously having been brought to book or as a consequence of having been revalued.²⁶ With regard to equipment and items of inventory, variations could occur as a result of having been recorded incorrectly and

24 Department of Defence, *Defence Annual Report 2004-05*, p. 51.

25 Department of Defence, *Defence Annual Report 2004-05*, p. 55.

26 Dr Ian Williams, Chief Finance Officer, Defence Materiel Organisation, Department of Defence, Transcript, p. 61.

subsequently corrected, or having been recorded in the wrong location, and subsequently moved to the correct location on the balance sheet.

- 5.35 By way of explanation with regard to the land and buildings valuation process, Defence advised that there had been a complete valuation done by the Australian Valuation Office. For some valuations they may have applied a more detailed valuation process, or identified particular buildings or elements that had not previously been identified separately, or identified the commercial value which could have increased. The variations as reported therefore reflected the sum of all such possible effects.²⁷
- 5.36 In summarising the Defence position in relation to Remediation Strategies S8 and S12, the Secretary noted:

In 2003-04 we had a full qualification on our lands and buildings valuations and records. That was a very bad situation and reflected something that had been carried forward. We put in a lot of effort and spent a lot of money with the Australian Valuation Office in getting it all brought up to date ...²⁸

Cost of Remediation

- 5.37 As previously noted, Defence advised that the remediation plans were progressing and generating gains for the Department. In terms of 'gains for the Department', the Committee sought further information with regard to the actual cost of the remediation plans, in terms of both implementation costs and subsequent savings as remediation occurs.
- 5.38 Defence advised that the extent of the dollar value of the problem, that is, the quantum of the qualifications, continued to decline and as this occurred 'it becomes easier to deal with the problems, as we can get [them] under control.'²⁹ With regard to the costs associated with implementing the remediation strategies, Defence advised that for 2004-05 the cost was \$65.1 million. This figure comprised \$30.5 in employee costs, and \$34.6 million for supplier costs (private contractors and other outgoings).³⁰

27 Dr Ian Williams, Chief Finance Officer, Defence Materiel Organisation, Department of Defence, Transcript, p. 62.

28 Mr Ric Smith, Secretary, Department of Defence, Transcript, p.62.

29 Mr Philip Prior, Chief Financial Officer, Department of Defence, Transcript, p. 59.

30 Mr Philip Prior, Chief Financial Officer, Department of Defence, Transcript, p. 65.

Conclusion

5.39 Defence acknowledged that there remains work to be done, however emphasised that good progress was being made. The Secretary of Defence made the point that a lot of people, a lot of money and a lot of time and effort were being directed towards the remediation plan. He noted that generally the successes were not publicly recognised and this could have an impact on morale. He therefore believed that the ANAO shift to adding positive references in its reports, was encouraging.³¹ Indeed, the relationship between ANAO and Defence had matured as both worked towards achieving resolution of the areas of concern.

We do believe we are making headway. We have regular discussions with ANAO. I am heartened by the strong beneficial relationship that exists between us and the ANAO and the indication that we are getting from them is that they are also seeing the progress. So it is not just a self-assessment, we are also getting the feedback from the Audit Office.³²

31 Mr Ric Smith, Secretary, Department of Defence, Transcript, p. 59.

32 Mr Philip Prior, Chief Financial Officer, Department of Defence, Transcript, p. 59.

