

6

FINANCIAL OVERVIEW

This chapter describes the DMO business and accounting model, and provides an assessment of the DMO financial performance in 2005–06 against budget projections.

6.1 FINANCIAL OVERVIEW

95

DMO BUSINESS MODEL

ACCOUNTING MODEL

2005–06 SUMMARY

DMO'S OPERATING PERFORMANCE

DMO'S FINANCIAL POSITION

DMO'S CASH POSITION

FINANCIAL OVERVIEW

The DMO was established as a prescribed agency under the *Financial Management and Accountability Act 1997* on 1 July 2005. The new agency was underpinned by a business model and associated funding arrangements agreed by the Government. These arrangements in turn defined the accounting approach to be applied to the DMO, including the allocation of assets and liabilities between Defence and the DMO.

This chapter gives a high-level description of the DMO business and accounting model, and provides an assessment of financial performance in 2005–06 against budget projections. The audited financial statements for the DMO are included in Chapter Seven to this report.

DMO BUSINESS MODEL

The DMO has three main areas of business:

- **Acquisition.** Arranging for purchase, construction or modification of equipment and systems for the Australian Defence Force.
- **Sustainment.** Arranging maintenance support for existing Defence Force equipment and systems.
- **Policy.** Providing policy advice to the Government in areas like contracting and Defence industry development.

These three business areas align with the DMO Outputs defined in Chapter 2.

The third area of business—policy—represents less than \$60m per annum in

expenditure, mainly for staff, and is largely funded as a direct appropriation by the Parliament to the DMO.

In the first two areas of business, which together comprise over 99 percent of the DMO's annual expenditure, funding comes not as a direct appropriation but as a payment from Defence (with some small supplementary amounts obtained from the sale of goods and services to other government agencies, and to foreign governments—associated with collaborative activity). The DMO acquisition business is akin to a construction contractor in the private sector, who receives cash from a client to construct a product to the client's specifications. The sustainment business is akin to the 'local garage' in the private sector, with payments received for servicing a customer's assets to achieve an agreed level of performance.

The funding from Defence for acquisition and sustainment is provided in two parts—a 'contracted' component and a 'service fee' component. The former represents the cost of the goods (construction and procurement activity) and services the DMO will deliver to Defence. The service fee represents the cost of DMO operations—staff costs, business systems, office requisites, travel and training. The Chief Executive Officer has full discretion over allocation of the service fee, but the contracted component must be spent in accordance with the outcomes agreed with Defence in signed agency agreements. The service fee covers the cost of both civilian and military staff, but the military staff are

considered to be 'owned' by Defence. The DMO pays a fee (reported in the DMO accounts as suppliers expenses) for those military staff that Defence provides—akin to the funding arrangements for contractor staff from the private sector. Defence, not the DMO, is liable for the payment of employee entitlements to military staff.

The DMO receives funding from Defence as a cash advance (mainly at the start of the financial year, but topped up periodically as Defence raises new or amended requirements and as the Government approves new projects from the Defence Capability Plan). The cash is initially held on the DMO balance sheet, but with an offsetting liability—unearned revenue—which reflects that the DMO has an obligation to provide Defence with goods and services in accordance with agreed outcomes. The DMO financial statements will include a combination of cash held at bank and an appropriation receivable, representing the undrawn component of the cash advance from Defence, offset by an unearned revenue liability. Through the year, both amounts will decline as the DMO delivers goods and services to Defence, thereby 'earning' the cash advance. By the end of the financial year, as reflected in the accounts in this report, the DMO will normally hold only a small level of cash, in accordance with the Government's requirement for just-in-time appropriation drawdown, and a small 'unearned revenue', representing any residual work yet to be delivered or performed that will carry over to the next financial year.

The DMO enters into contracts with industry to deliver the goods and services sought by Defence under the agency agreements signed between Defence and the DMO. Many of these DMO contracts with industry are large in value and long term in duration—up to a decade or two, or more in some cases. In many instances, the DMO will agree in the contracts to make cash advance payments to a company at certain defined milestones—commonly at contract signature. These cash payments are reported in the DMO financial accounts as

'prepayments'. This is akin to the deposit people commonly pay in the retail world when ordering goods. Such payments are agreed in DMO contracts only where they are judged to represent value for money for the Commonwealth in net present value terms—for example, where it results in a net reduction in contract price because industry does not need to borrow capital at rates higher than are available to the Government. These prepayments to industry are reflected on the DMO balance sheet as an asset—recognising the fact that they are underpinned by a contractual obligation from industry to deliver goods and services to the DMO of that value. When work associated with a prepayment is completed, the DMO will recognise that it has earned revenue, and will advise of the recognition of any assets to Defence and reduce both the DMO prepayment and unearned revenue liability accordingly.

The business model provides for symmetry between the Defence and the DMO financial statements. Cash payments between agencies can be seen on both sides. Unearned revenue to the DMO will be recognised by Defence as a prepayment asset.

ACCOUNTING MODEL

In accordance with the *Financial Management and Accountability Act 1997*, the DMO is required to present financial statements prepared in accordance with Australian Accounting Standards and the requirements of the Finance Minister's Orders.

INCOME STATEMENT

The DMO receives an agreed level of funding for its service fee and its Output 1.3 policy work—about \$640m in total value for the 2005–06 financial year. Consistent with Government policy, the DMO prepares its budget on the basis that it expects to achieve neither a profit nor a loss against its budget. Any variation between the budget and actual expenses across the year will result in an

unplanned operating loss or profit. The contracted component of the payment to the DMO is funded on a no-win, no-loss basis, with revenue recognised as expenses occur, so that revenue and expenses will always be equal for the contracted part of the business. In light of this, the DMO operating result will be determined solely by performance against the service fee and Output 1.3.

While the contracted part of the DMO's business—representing approximately 90 per cent of total expenditure—will not provide any operating profit or loss, a comparison between budget and actual expenditure for those categories will give a guide to the DMO's performance. If expenditure is below budget expectations, it is indicative of slower than planned deliverables, with any unspent cash funding being held at the end of the year on the DMO balance sheet as cash plus appropriation receivable, offset by 'unearned revenue'. A comparison of the DMO budget and actual result for 2005–06 indicates that the DMO has achieved overall slightly ahead of the budget plan (for which Defence provided additional funds late in the year, some of which remained as cash at bank, appropriation receivable and unearned revenue in the final position).

It is to be expected that some level of cash and 'unearned revenue' will reside at year end, and indeed is necessary in the DMO. It is not uncommon for companies to hold up to a month of payments as 'cash at bank', and for the DMO this would represent well over \$600m. The DMO accounts included in this annual report have just under \$200m in cash and appropriation receivable—equating to about a week and a half of DMO expenses.

It should be noted that the business model for the DMO, established by the Government, does not involve the DMO receiving any profit margin on activity or paying dividends. The measure of success for the DMO is not, therefore, obtaining a large profit, but rather management of agreed activity delivery commensurate with funding provided and the

unearned revenue liability balance. This will translate ideally to a zero operating result. For 2005–06, the DMO operating result represented 0.1 per cent of total revenue. Both cash and expenses exceeded the revised estimate by about 2 per cent—which reflected a Government direction to seek to progress early the purchase of C17 Globemaster III aircraft. This is indicative of the DMO more than meeting in net terms the overall milestones and deliverables targeted in the budget (being slightly behind on sustainment, due to operations not requiring all available sustainment funding, but well ahead on acquisition).

The DMO receives many services from Defence free-of-charge. This includes things like communications and information systems, accommodation, and human resources services. Under the Australian Accounting Standards the DMO is required to report the value of these services in its financial statements. This reporting does not appear in the cash flow statement or balance sheet, but is shown as both an expense and revenue item on the income statement—and as these are equal it has no impact on the net operating result.

BALANCE SHEET

As Defence provides the cash for the DMO to construct or purchase the equipment and other assets under the agency agreements, Defence will subsequently own the assets as progressively delivered. These assets in use or under construction will appear on the Defence balance sheet. At the time the 2005–06 budget was prepared, it was assumed that the existing stocks of spare parts and other inventory would be owned by the DMO, and this is evident in the large value of assets on the DMO balance sheet predicted in the *Portfolio Budget Statements 2005–06*. It was subsequently agreed that ownership of inventory should reside with Defence, and this was reflected in the balance sheets for Defence and the DMO in the *Portfolio*

Additional Estimates Statements 2005–06. At this time 'Assets Under Construction' (elements of a materiel construction product delivered to date but not yet forming the final complete product) were expected to be held on the DMO balance sheet. It was subsequently agreed that these assets should reside on the Defence balance sheet, consistent with the notion of 'control' under the accounting standards. The balance sheet for the DMO included in this report reflects the fact that virtually all physical assets, including 'Assets Under Construction', reside with Defence. Those assets held by the DMO include some business systems and minor plant and equipment specific to the DMO's management.

The changes in balance sheet assumptions through the year are reflected in the comparisons in the tables throughout this chapter. Some apparently large variations (visible in the tables) simply reflect a refinement of the accounting treatment through the first year of operation of the DMO as a prescribed agency.

CASH FLOWS

The DMO's business is predominantly cash based, as the agency has few physical assets. In view of this, the cash flow and expenses in any year will be similar, but differences will result from:

- The DMO is fully refunded (a month in arrears) for GST payments made to industry. These payments and receipts—over a half a billion dollars annually—are recorded in the cash flow statement but are neither revenue nor expense for the DMO, so they do not appear on the income statement. The end of year DMO balance sheet holds a receivable asset for the GST payment associated with the June period, which will be refunded in July.
- The DMO will make cash prepayments, as outlined above, and these appear in the cash flow statement but not in the income statement (until work associated with the

prepayment is completed) at which point the DMO will recognise the expense and earn revenue. Cash and expenses will vary depending on how prepayments made in-year compare with expenses reported in-year for acquittal of prior period prepayments. Amounts will net out over the long term, but will produce variations from year to year.

- The DMO will record some depreciation expenses associated with its small holding of business systems assets, and will also have some variations to accrued employee expenses. These accrual adjustments will be reflected in the income statement but not the cash flow.

In summary, the DMO is predominantly a cash based organisation. It has a small balance sheet—with equity of around \$100m (compared with Defence holdings of many tens of billions of dollars). The DMO has a very large income statement, with annual revenue and expenses that represent over 40 per cent of Defence expenditure, and a much larger proportion of expenditure when employees costs are removed.

2005–06 SUMMARY

Including all supplementary funding, the projected level of resourcing available to the DMO in 2005–06 was \$7,430.7m, comprising direct appropriation of \$44.3m. At the time of its establishment it received an equity contribution of \$308.1m.

The DMO's total resourcing for 2005–06 was \$170.2m higher than the projected result comprising \$205.2m in additional departmental funding provided by Defence. Table 6.1 summarises the total DMO resourcing in 2005–06 compared to the revised additional estimate.

TABLE 6.1 TOTAL DMO REVENUE RECOGNISED 2005–06

2005–06				
	Budget ⁽¹⁾ Estimate \$'000	Revised Estimate \$'000	Actual Result \$'000	Variance \$'000
REVENUE				
Revenue from Government	44,211	44,257	44,257	–
Revenue from Defence	6,887,680	7,223,227	7,428,433	205,206
Funds from Foreign Government ⁽³⁾	–	125,910	76,585	–49,325
Own-Source Revenue ⁽²⁾	192,018	35,777	9,222	–26,555
Total Revenue	7,123,909	7,429,171	7,558,497	129,326–
Other gains	1,500	1,500	42,383	40,883
Total gains	1,500	1,500	42,383	40,883
Purchase of Assets—Capital from Defence	121,197	122,043	–	–122,043
Total DMO Resourcing	7,246,606	7,552,714	7,600,880	48,166

Notes:

1. The Budget Estimate shows the full year budget in the *Portfolio Budget Statements 2005–06*. The Revised Estimate is the revised budget published in the *Portfolio Additional Estimates Statements 2005–06*.
2. Own-source Revenue includes sales of goods and services, interest, net foreign exchange gains, other revenues and resources received free of charge.
3. Funds from foreign Governments are funds for goods and services provided to them.

EXPLANATION OF MAJOR VARIATIONS

The main variations in the DMO’s total revenue were:

- **Revenue from Defence (+\$205.2m)**—the variation was due to the early progression of the purchase of the C-17 heavy airlift project (+\$271.0m), a net decrease in spending for other Approved Major Capital Equipment Projects (–\$97.7m) due to timing issues; and an increase in commissioned work required by Defence (+\$31.9m).
- **Funds from Foreign Governments (–\$49.3m)**—a decrease of anticipated funding from foreign governments for collaborative projects.
- **Own-Source Revenue (–\$26.6m)**— is due predominantly to the return of revenue to Defence from the sale of commercial vehicles (–\$33.6m) and \$7m more than the anticipated revenue from other sources.

DMO’S OPERATING PERFORMANCE

The purpose of the Income Statement is to measure and report the result of the DMO’s activities over the financial year period. It also highlights whether the DMO is operating at a sustainable level in the short-term.

At the time of the Additional Estimates, the DMO expected Income and Expenses to equal each other. This assumption was because the DMO is funded for the activity it performs.

The DMO has reported an operating surplus of \$8.8m in 2005–06 (which, in a budget set for zero operating result, indicates that expenses and revenue differed by only around 0.03 per cent). Table 6.2 provides a full comparative Income Statement. Explanations of the variation between actual and planned allocation follow Table 6.2.

TABLE 6.2

INCOME STATEMENT FOR THE YEAR ENDED 30 JUNE 2006

	2005-06			
	Budget Estimate \$'000	Revised Estimate \$'000	Actual Result \$'000	Variance ⁽¹⁾ \$'000
INCOME				
Revenue				
Revenues from Government	44,211	44,257	44,257	
Goods and Services	6,976,161	7,223,227	7,432,989	209,762
Other revenue	70,000	128,115	81,251	-46,864
Total revenue	7,090,372	7,395,599	7,558,497	162,898
Gains				
Net Gains from Sale of Assets	33,537	33,572	-	-33,572
Other gains ⁽²⁾	1,500	1,500	42,383	40,883
Total Gains	35,037	35,072	42,383	7,311
Total Income	7,125,409	7,430,671	7,600,880	170,209
EXPENSE				
Employees	358,296	354,654	353,892	-762
Suppliers	6,590,587	6,969,456	7,221,709	252,253
Depreciation and amortisation	72,989	72,989	6,374	-66,615
Write-down of assets	70,000	-	304	304
Net losses from sale of assets	33,537	33,572	-	-33,572
Net foreign exchange losses	-	-	8,365	8,365
Other expenses	-	-	1,458	1,458
Total Expenses	7,430,671	7,430,671	7,592,102	161,431

Notes

1. The variation is between actual result as disclosed in the 2005-06 audited financial statements and the revised budget published in the *Portfolio Additional Estimates Statements 2005-06*.
2. Other gains include resources received free of charge.

EXPLANATION OF MAJOR VARIATIONS

The variation in the DMO's overall operating performance of \$8.8m comprises a \$170.2m increase in income and an increase in expenses of \$161.4m.

Income received was \$170.2m more than the estimate of \$7,430.7m.

Expenses were \$161.4m higher than budget. The main elements were:

- **Supplier expenses (+\$252.3m)**—variation due to an increase in commissioned work required by Defence.
- **Depreciation (-\$66.6m)**—the transfer back from the DMO to Defence of commercial vehicles, resulting in a decreased depreciation expense on the DMO's books.
- **Net losses from sale of assets (-\$33.6m)**—the lower than planned expenses were due to the transfer back of commercial vehicles from the DMO to Defence.

- **Net Foreign Exchange Losses (+\$8.4m)**— the net variation was due to the timing difference between when invoices for transactions in foreign currencies are entered in the financial system for payment and the date they are paid.

– Assets Under Construction Payable (-\$8,314.2m) – as the asset ‘Specialist Military Equipment’ is transferred back to Defence, this corresponding liability, which was to recognise the DMO’s obligation to provide completed assets to Defence, has been removed from the Balance Sheet.

DMO’S FINANCIAL POSITION

The Balance Sheet sets out the DMO’s assets, liabilities and equity as at 30 June 2006. Its purpose is to provide a snapshot of the long-term sustainability of the organisation. Table 6.3 provides details.

EXPLANATION OF MAJOR VARIATIONS

The reduction in equity is due primarily to asset ownership changes associated with the transfer of commercial vehicles from the DMO back to Defence (-\$216.8m).

Other movements in the Balance Sheet include:

- **Assets**

- Receivables (\$116.1m) – the increase is a measure of the work to be performed for Defence and other government agencies as at 30 June 2006.

- **Non-financial Assets**

- Specialist Military Equipment (-\$8,314.2m) – a transfer of the asset ‘Specialist Military Equipment’ (assets under construction) to Defence for existing approved projects.
- Infrastructure, plant and equipment (-\$229.5m) – variation is due primarily to the transfer of commercial vehicles from DMO back to Defence (-\$216.8m).
- Intangibles (-\$69.6m) – due to their transfer back to Defence.

- **Payables**

- Suppliers (\$115.8m) and other Payables (\$175.6m) – these are associated with activities yet to be performed for Defence and other government agencies, and outstanding payments as at 30 June 2006.

TABLE 6.3

BALANCE SHEET AS AT 30 JUNE 2006

	2005-06			
	Budget Estimate \$'000	Revised Estimate \$'000	Actual Result \$'000	Variance ⁽¹⁾ \$'000
ASSETS				
Financial Assets				
Cash	50,270	30,176	23,581	-6,595
Receivables	84,404	137,874	253,948	116,074
Total Financial Assets	134,674	168,050	277,529	109,474
Non-Financial Assets				
Infrastructure, Plant & Equipment	242,727	240,525	11,018	-229,507
Intangibles	81,211	77,562	7,999	-69,563
Inventories	4,750,511		-	-
Special Military Equipment	-	8,314,212	-	8,314,212
Other Non-financial Assets	595,000	602,663	898,794	296,131
Total non-financial assets	5,669,449	9,234,962	917,811	-8,317,151
Total Assets	5,804,123	9,403,012	1,195,340	-8,207,672
LIABILITIES				
Provisions				
Employees	121,390	117,214	125,804	8,590
Total Provisions	121,390	117,214	125,804	8,590
Payables				
Suppliers	591,704	624,703	740,526	115,823
Other Payables	269,369	38,816	214,465	175,649
Assets under construction Payable	-	8,314,212	-	-8,314,212
Total Payables	861,073	8,977,731	954,991	-8,022,740
Total Liabilities	982,463	9,094,945	1,080,795	-8,014,150
NET ASSETS	4,821,660	308,067	114,545	-193,522
EQUITY				
Contributed Equity	4,821,660	308,067	105,767	-202,300
Retained Surplus or Accumulated Deficits			8,778	8,778
TOTAL EQUITY	4,821,660	308,067	114,545	-193,522

Notes

1. The variation is between actual result as disclosed in the 2005-06 audited financial statements and the revised budget published in the *Portfolio Additional Estimates Statements 2005-06*.

DMO'S CASH POSITION

The DMO receives the majority of its cash from Defence in payments for goods and services provided by the DMO. The DMO also receives cash from the appropriation for its outcome and from own-source revenue receipts and cash reserves. The allocations are subject to Government approval as part of the annual budget process. Once funds are paid by Defence, received from other sources or appropriated by the Government, they remain in the DMO's special account even if not fully used in the budget year. They are held as an appropriation receivable in the Official Public Account and are available to meet liabilities as they fall due, including employee liabilities.

TABLE 6.4 USE OF CASH BY THE DMO IN 2005–06

	2005–06 Actual Result \$'000
SOURCES OF CASH	
Section 32 (transfer of appropriation from Defence)	50,270
Direct Appropriation	44,257
Funding Provided by Defence	7,543,211
Net GST received	498,771
Other Cash Receipts	192,980
Sub Total Cash Available	8,329,489
USE OF CASH	
Employees	343,499
Suppliers	7,443,726
GST paid to Suppliers	506,150
Other Operating Activities	4,144
Purchase of Plant and Equipment	6,492
Purchase of Software and Intangibles	1,897
Purchase of Inventory	–
Borrowing Costs	–
Sub Total: Cash Used	8,305,908
2005–06 Closing Cash at Bank	23,581

USE OF CASH IN 2005–06

At 30 June 2006, the DMO had a cash at bank balance of \$23.6m. During the course of the financial year, the DMO used \$8,306m. Table 6.4 provides details of cash sources and cash usage and shows the actual movement of cash in 2005–06.

DMO'S SPECIAL ACCOUNTS

As part of the funding model adopted for the DMO, two Special Accounts were established:

- Defence Materiel Special Account; and
- Other Trust Monies Special Account.

The Defence Materiel Special Account is the main operating account from which most business activities are conducted. The Other Trust Monies Special Account holds any other public money on trust.

DEFENCE MATERIEL ORGANISATION SPECIAL ACCOUNT

The main purposes for which the funds in the Special Account can be used are:

- supporting the ADF's capability through development, acquisition, sustainment, disposal, and provision of goods and/or services;
- developing, acquiring, sustaining and providing goods and/or services for foreign governments and other bodies;
- managing and marketing the Agency whose chief executive has been allocated responsibility for this Special Account; and
- developing and implementing policies for, and providing advice to, the Government on defence, defence industry and other matters related to the provision of goods and/or services.

Movements to flows in the DMO's special accounts are in Table 6.5.

105

TABLE 6.5**ACTUAL SPECIAL ACCOUNT FLOWS AND BALANCES ⁽¹⁾**

		Opening Balance 2005–06	Credits 2005–06	Debits 2005–06	Adjustments 2005–06	Closing Balance 2005–06
Outcome						
		\$'000	\$'000	\$'000	\$'000	\$'000
DMO Special Account ⁽¹⁾	1	–	8,496,693	8,305,908	–	190,785
DMO Other Trust Monies Special Account ⁽²⁾	1	–	375	–	–	375
Total special accounts		–	8,497,068	8,305,908	–	191,160

Notes:

1. The DMO Special Account is established under Section 20 of the *Financial Management and Accountability Act 1997*.
2. The DMO Other Trust Monies Special Account is established under Section 20 of the *Financial Management and Accountability Act 1997*.

