

**2005/06 FINANCIAL STATEMENTS POSITION PAPER No. 16**  
**FREE OF CHARGE – DEFENCE/DMO**

- Defence and Defence Materiel Organisation (DMO) have developed a set of principles to guide the scope of Free of Charge (FoC) services to be reported respectively in each set of financial statements.
- A key principle is that of excluding any services provided by Defence in support of DMO Outputs 1.1 and 1.2 for FoC disclosure purposes under AAS 29. As a result, only services Defence provides in support of DMO Output 3 would be recognised by DMO.
- Similarly, only services, not otherwise excluded, that are provided by DMO to Defence through DMO's Output 1.3 would be reportable by Defence as all other services (Outputs 1.1 and 1.2) are paid for.

*Implementation:*

- Agreement by ANAO to this approach will be a significant determinant of the size of the costing task.
- The detailed costing methodologies applying to the agreed set of reportable services are under consideration for implementation during May-June.

## 2005/06 FINANCIAL STATEMENTS

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#### Defence Position

- Australian Accounting Standard 29 requires Defence and Defence Materiel Organisation (DMO) to present the fair value of resources received free of charge (FoC).
- The existing Free of Charge Agreements (FCAs) between Defence and DMO identify the range of possible services that may be provided between either organisation without charge.
- The FCAs are to be rewritten and retitled “Shared Services Agreements” to more accurately reflect that not all services identified in these agreements constitute FoC services for disclosure purposes under AAS 29.
- A set of principles has been developed to guide the reporting of FoC services provided between Defence and the DMO and vice versa.
- A significant principle is that services consumed by DMO in direct support of materiel acquisition and support functions will be excluded from FoC reporting.
- A separate implementation paper detailing the methodology will be issued.

#### Issue

This paper considers:

- the accounting standards relevant to FoC disclosure;
- the difficulties in determining fair value where no known market exists;
- the scope of reportable FoC services; and
- cost attribution.

#### Background

AAS 29 paragraph 10.1 states:

*A revenue of a government department must be recognised in the operating statement when and only when:*

- (a) *it is probable that the inflow or other enhancement or saving in outflows of future economic benefits has occurred*

- (b) *the inflow or other enhancement or saving in outflows of future economic benefits can be measured reliably.*

AAS 29 paragraph 10.12.1 requires:

*... contributions, other than contributions by owners, to be recognised as revenues when the government department obtains control over them, irrespective of whether conditions are imposed on the government department's use of the contributions.*

Further, AAS 29 paragraph 10.12.1 notes that contributions include “goods and services provided free of charge or for nominal consideration”.

Accounting Standard (AASB) 118 stipulates that “revenue shall be measured at the fair value of the consideration received or receivable” (paragraph 9) and that “revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity” (paragraph 22).

Under AAS 29 paragraph 12.2, the following must be disclosed in the general purpose financial report of a government department:

- (d) the fair value of goods and services received free of charge, or for nominal consideration, during the reporting period.*

Fair value is defined by AAS 29 paragraph 17.1 as:

*The amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's length transaction*

In terms of the issue of reliable measurement neither AAS 29 nor the Finance Minister's Orders define the word ‘reliable’. However, the quality of reliability is discussed in paragraph 31 of the AASB “Framework for the Preparation and Presentation of Financial Statements”:

*Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.*

Paragraph 33 and 34 of AASB “Framework for the Preparation and Presentation of Financial Statements” further explains the concept of faithful representation:

*To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent... Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognise them in the financial statements; for example, although*

*most entities generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.*

The FCAs were established under the new Defence-DMO business model to capture services supplied by Defence to DMO, and vice versa, where no exchange of funds occurred.

## **Analysis**

### Principles

The review of FoC services will be guided by a set of principles. These principles scope the extent of FoC costing for reporting purposes and were developed cognisant of the accounting standards. The principles are at Attachment A.

### Scope

Some of the more significant FoC services defined to be in scope and costed include computing services, training services, personnel systems and financial systems. This is subject to the application of the principles at Attachment A, in particular, principle 1 regarding support to the acquisition and sustainment functions.

## **Full cost**

It is proposed that actual full cost, that is the total of direct and indirect costs, be used as a surrogate for fair value of the services provided. The decision to use full costs as a proxy for fair value is based on the following:

- there is no direct market readily available to establish fair value for a number of FoC services;
- the size and nature of both agencies are such that significant agency structures would be leveraged in the provision of services by the market, which would distort the true cost of providing the service;
- no reliable benchmark exists for costing FoC services;
- both agencies are not-for-profit organisations and therefore the use of a market based value would not represent the true cost of the service; and
- value-for-money considerations having regard to the cost of obtaining fair value prices.

Defence has elected to calculate both direct and indirect costs to formulate a full cost, as direct costs alone would not satisfy the definition of fair value. Further, fair value implies a market or commercial rate, which would normally include indirect/overhead costs.

While the actual full cost may not necessarily reflect the market rate, it is considered inappropriate to disclose a nominal profit mark up, consistent with commercial practice, for services provided between agencies.

It should also be noted that the recognition of FoC services has no impact on the net operating result of Defence or DMO, as the revenue recorded will be exactly offset by an expense.

### Cost Attribution

The cost attribution rules developed must be robust. Individual Defence Groups will be responsible for their attribution rules in accordance with overarching policies. Groups have been made aware that their rules must withstand audit scrutiny and, therefore, the rationale for the rules will be adequately documented.

Attribution measures may vary across FoC services. Common attribution measures include per capita headcount, square meterage, user log ons, user registers, course attendance lists, and applicants.

Where system generated or pro rata figures are intended for reporting use, critical analysis of these figures will be performed before use to ensure they are reasonable and reliable.

### Implementation

A selection of Defence Groups has been asked to conduct a sample FoC costing exercise which will be reviewed by both agencies. Once the costings have been provided and analysed, management will be able to determine a preliminary estimate for some key FoC services.

A separate implementation paper will be prepared on the scope of services considered FoC for reporting purposes and the methodology to be adopted.

### **Principles for Determining Reportable Free of Charge Services**

The following principles will be used to exclude FoC services for reporting purposes:

- Principle 1 - Support of materiel acquisition and sustainment

Services that Defence provides directly to DMO in support of the acquisition and sustainment functions are ultimately for Defence's benefit. Defence has an obvious interest in contributing to the acquisition and sustainment functions and provides input to these as Defence ultimately benefits from these services. Further, these services are often provided without DMO having much discretion over receipt of these functions.

DMO's sole role in relation to the provision of acquisition and sustainment services to Defence is one of project management. DMO does not undertake acquisition or sustainment activities directly. This work is undertaken by a third party in accordance with the contractual arrangements between DMO and the third party. As part of the contractual arrangements, Defence makes its facilities available to the third party, an arrangement that is currently in place.

In order to ensure that the contract is managed properly in accordance with Defence requirements, DMO staff will be required to use Defence facilities. This collocation arrangement is an efficient and effective use of resources and necessary if Defence capability requirements are to be met. These resources are made available to meet Defence capability requirements and not the needs of DMO.

Materiel Acquisition Agreements (MAAs) specify Project Deliverables, Price, Project Event and Delivery Schedule and Customer Furnished Supplies, while Materiel Sustainment Agreements (MSAs) identify the management and provision of the services and products needed to meet the capability, preparedness and performance requirements of a Materiel System. Put simply, the MAA/MSAs stipulate what specifications are to be built and maintained.

The MAAs and MSAs operate within a framework which makes the customer (Defence) responsible for understanding and specifying their requirements. The framework is articulated in the Memorandum of Arrangements (MOA) which, inter alia, establishes the principles governing agreement development and management for the acquisition and sustainment agreements. The MOA affirms DMO's role as an integral part of Defence and the importance of close collaboration as a critical ingredient in effective business outcomes. This underlying principle of the MOA acknowledges that Defence will provide some technical assistance to DMO in support of the MAAs/MSAs

- Principle 2 - Military personnel capability

Under the existing military workforce agreements between Defence and DMO, DMO pays a fee to Defence for military personnel provided to DMO. By

definition, the provision of services that are funded on a ‘fee for service’ basis, such as those identified under the Military Workforce Agreements (MWAs)/MOA between Defence and DMO, are not FoC.

The cost to DMO is less than the full cost of the military personnel, which would include housing, health and allowance costs, some of which is subsidised by Defence. The delta between what DMO is paying and the full cost for these military personnel is incurred for capability and operational reasons, and not for DMO requirements.

An analysis of the MWAs indicates that the majority of staff supplied by Defence are for a period of fewer than 3 years. Therefore, it is considered that the subsidies paid by Defence are being provided because the individuals are primarily members of the Australian Defence Force who have been “temporarily” made available to DMO and can, in certain circumstances, be “withdrawn” from DMO.

As the military workforce is not provided FoC, all facilities and services provided to military personnel would be excluded from FoC reporting. For example, office accommodation, communication facilities and security clearances would not be recognised as a FoC service.

- Principle 3 - Shared responsibilities

Certain portfolio responsibilities are being shared or allocated between Defence and DMO, where the other organisation may be an unintended customer. In order to avoid duplication of services, delivery for a range of services is shared between Defence and DMO. For example, DMO provides industry policy while Defence provides policy advice on strategic and international planning. These services do not represent FoC services from one agency to the other, but rather an allocation of shared responsibilities within the Defence portfolio.

- Principle 4 – Non-discretionary government and other compliance requirements

Defence and DMO provide policy and advice to each other to meet government and other compliance requirements. This has a parallel with Department of Finance and Administration and other central agencies providing similar policy and advice to agencies in the government – a ‘service’ not recognised by recipient agencies for financial reporting purposes.

- Principle 5 - Services which would not otherwise be purchased

Services provided by Defence or DMO that are not commercially available, and for which the receiving agency would otherwise not pay for, will not be considered FoC services. Where it can be established that either agency would not purchase a service in the event that the service was not provided FoC, this service will not be reported as FoC.

The following principle will be used to include services for FoC reporting for services provided by DMO to Defence:

- Principle 6 – DMO Output 1.3 funded and not excluded under other principles

Services that DMO provides to Defence that are funded by DMO Output 1.3 and are not provided as *Shared responsibilities, Non-discretionary Government or other compliance requirements*, or *Services which would not otherwise be purchased*, are reportable FoC services.