CHAPTER 4
GOVERNANCE AND ACCOUNTABILITY

DMO CORPORATE GOVERNANCE AND RISK MANAGEMENT

Ministerial Directive
During 2010-11, there was no change to the Ministerial Directive which establishes the Chief Executive Officer (CEO) Defence Materiel Organisation’s (DMO) direct obligations to the Minister for Defence, and the overarching responsibilities and management priorities in relation to DMO business outcomes.

Accountability and Financial Management
Under the Financial Management and Accountability Act 1997, the CEO DMO is directly responsible to the Portfolio Minister for managing the affairs of the DMO in a way that promotes proper use of the Commonwealth of Australia resources for which the DMO is responsible.

The 2010-11 Financial Statements are included at Appendix 1 of this volume. The Acting CEO DMO and the Chief Finance Officer (CFO) DMO have concluded that the financial statements are true and fairly stated.

Figure 4.1 The DMO’s customers as at 30 June 2011 (Ministerial appointments shown effective June 2011)
Relationship with Defence

Defence and the DMO are working together to deliver the operational capability required by the Australian Defence Force (ADF). From a governance perspective this business relationship operates under a Memorandum of Arrangements (MoA) signed by the Secretary of Defence, the Chief of the Defence Force and CEO DMO on 15 July 2005. The MoA contains a framework of five types of agreements between Defence and the DMO that formalise the provision of products, services and resources between Defence and the DMO.

The agreements have continued to evolve since the DMO’s prescription to provide greater clarity of requirements and to delineate responsibilities and accountabilities. The current focus is to provide agreements with clear service standards, expectations and understanding as the basis for the DMO and Defence to understand the cost of doing business and to foster cost conscious, business-like behaviours. For example, the Supplier Service Agreement/Customer Services Agreement signed between the DMO and Defence Support Group at the end of June 2011 introduced key performance indicators based on local contract specifications as well as national and industry standards and legislative requirements.

Customer - Supplier Arrangements

The categories of customer - supplier agreements between Defence and the DMO are:

- Materiel Acquisition Agreements (MAA)
- Materiel Sustainment Agreements
- Shared Services Agreements
- Defence Service Agreements
- Military Workforce Agreements.

These agreements cover major and minor materiel acquisition projects, sustainment of ADF fleets, services provided to facilitate these activities, and the military personnel posted to the DMO in support of these activities.

During 2010-11 significant improvements have been made in improving the clarity of Defence customer requirements and to move from input management to output delivery. A more robust partnership is evidenced by the inclusion of the designated Lead Capability Manager as a signatory and partner to the MAA.

A revised MAA template was introduced in January 2010 to include signature by the designated Lead Capability Manager, as well as Capability Development Group and the CEO DMO. The new template contains greater detail on project deliverables in terms of capabilities, specifications, cost, schedule and customer furnished supplies. It also introduces the Initial Materiel Release and Final Materiel Release milestones, which more accurately define the DMO’s contribution to, and accountability for, materiel elements of the achievement of initial operational capability and final operational capability.
Figure 4.2 Relationship between the DMO and key stakeholders within the Defence portfolio

Governance

Early Indicators and Warnings

Early Indicators and Warnings (El&W) is aimed at identifying problems with projects ‘early’ in order to allow for remediation of issues before they impact on delivery. El&W uses a set of defined triggers to allow projects to be measured against schedule, cost capability, industry or risk thresholds.

Each project’s performance is compared against defined project characteristics from the Government approved baselines at the key milestones of Project Initiation, First Pass and Second Pass. A project triggering a breach on mandated thresholds will immediately be notified to line management to determine remedial actions which include notifying Government and may then include a Gate Review.

Gate Reviews

Gate Reviews are an important part of the DMO’s assurance process. Gate Reviews are designed to improve overall project outcomes and ensure DMO is able to provide high quality and reliable advice to Defence and Government regarding the health and outlook of major capital acquisition projects at key stages (or gates) of a project’s development. A combination of senior DMO executives and external board members provide an assessment of project maturity, performance and plans against the Government approved business case, normally in the lead up to key project decision
CHAPTER 4 GOVERNANCE AND ACCOUNTABILITY

points. Based on the findings of the board, assistance and direction are provided to the project. The Chair of each Gate Review makes a recommendation to the CEO DMO regarding the readiness of the project to progress to the next stage in the project life cycle.

In 2010-11, the program focused on: conducting reviews for 50 high-value and high-risk projects; maturing the methodology; and increasing the number of external Board members. In June 2011, the Ministers for Defence and Defence Materiel announced the creation of the Independent Project Performance Office (IPPO) in the DMO. One element of the IPPO’s charter is to further expand the Gate Review program to include at least an annual review of every DMO major capital acquisition project.

Projects of Concern

The Projects of Concern (PoC) regime is closely linked to both the Early Indicators and Warnings (EI&W) framework and the Gate Review process. Once troubled projects have been identified through triggering one or more of the EI&W thresholds, and have undergone a diagnostic Gate Review to identify specific and measurable remediation objectives, a recommendation may be made to Government to add a project to the formal list of PoC. Once listed, the primary objective of the PoC regime is to remediate these projects through the implementation of an agreed remediation plan to resolve significant commercial technical, cost and/or schedule difficulties. PoC receive targeted senior management attention and are required to report more regularly to Government.

Since its introduction in early 2008, the DMO has been working closely with industry, Defence and the Government to successfully remediate these projects with the goal of returning them to the standard management regime.

Significant outcomes during 2010-11 included the following:

- the inaugural PoC summits between Government, Minister for Defence Materiel, Defence and CEOs from industry with responsibility for projects on the list
- the successful remediation of High Frequency Modernisation - JP 2043 Phase 3A and Air Defence Command and Control - AIR 5333 and subsequent removal from the list of Projects of Concern
- the removal of JP 2048 Ph 1A (LPA Watercraft) from the list through the Government’s decision to cancel the project.

Recent ministerial reforms to EI&W and the introduction of incentives to focus industry’s attention on PoCs, in addition to biannual summits, have further strengthened the PoC regime.
### Table 4.1 Current Projects of Concern as at 30 June 2011

<table>
<thead>
<tr>
<th>Project Name</th>
<th>Project Number/Phase</th>
<th>Date Added</th>
</tr>
</thead>
<tbody>
<tr>
<td>Airborne Early Warning and Control Aircraft</td>
<td>AIR 5077 Phase 3</td>
<td>January 2008</td>
</tr>
<tr>
<td>Anzac Ship Anti-Ship Missile Defence</td>
<td>SEA 1448 Phase 2B</td>
<td>January 2008</td>
</tr>
<tr>
<td>Lightweight Torpedo Replacement</td>
<td>JP 2070 Phases 2 &amp; 3</td>
<td>January 2008</td>
</tr>
<tr>
<td>Field Vehicles and Trailers</td>
<td>LAND 121 Phase 3</td>
<td>January 2008</td>
</tr>
<tr>
<td>Airborne Surveillance for Land Operations</td>
<td>JP 129 Phase 2</td>
<td>September 2008</td>
</tr>
<tr>
<td>Collins Class Submarine</td>
<td>CN 10</td>
<td>November 2008</td>
</tr>
<tr>
<td>Air to Air Refuelling Capability</td>
<td>AIR 5402</td>
<td>October 2010</td>
</tr>
<tr>
<td>P-3 Electronic Support Measure Upgrade</td>
<td>AIR 5276 Phase 8B</td>
<td>October 2010</td>
</tr>
<tr>
<td>Follow-on Stand Off Weapon</td>
<td>AIR 5418 Phase 1</td>
<td>November 2010</td>
</tr>
</tbody>
</table>

### Table 4.2 Former Projects of Concern

<table>
<thead>
<tr>
<th>Project Name</th>
<th>Project Number/Phase</th>
<th>Date Removed</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Landing Platform Amphibious Watercraft</td>
<td>JP 2048 Phase 1A</td>
<td>February 2011</td>
<td>Cancelled</td>
</tr>
<tr>
<td>Upgrade of M113 Armoured Vehicle</td>
<td>LAND 106</td>
<td>May 2008</td>
<td>Remediated</td>
</tr>
<tr>
<td>Armed Reconnaissance Helicopter</td>
<td>AIR 87</td>
<td>April 2008</td>
<td>Remediated</td>
</tr>
<tr>
<td>Sea Sprite Helicopter</td>
<td>SEA 1411</td>
<td>March 2008</td>
<td>Cancelled</td>
</tr>
<tr>
<td>Special Forces Inflatable Boat Trailers</td>
<td>JP 2088 Phase 1A</td>
<td>September 2008</td>
<td>Remediated</td>
</tr>
<tr>
<td>Guided Missile FFG Upgrade</td>
<td>SEA 1390 Phase 2.1</td>
<td>January 2010</td>
<td>Remediated</td>
</tr>
<tr>
<td>Rotary Wing EW Self Protection</td>
<td>AIR 5416 Phase 2</td>
<td>July 2010</td>
<td>Scope reduced</td>
</tr>
<tr>
<td>High Frequency Modernisation</td>
<td>JP 2043 Phase 3A</td>
<td>June 2011</td>
<td>Remediated</td>
</tr>
<tr>
<td>Air Defence Command and Control</td>
<td>AIR 5333</td>
<td>June 2011</td>
<td>Remediated</td>
</tr>
</tbody>
</table>
CHAPTER 4 GOVERNANCE AND ACCOUNTABILITY

Internal Governance

In October 2010, the CEO DMO approved a Defence Materiel Instruction which outlines the DMO's governance policy. The policy clarifies the principles of governance in the DMO and articulates 'the way we do business'.

The supporting framework is structured around three overarching and two enabling elements. The overarching elements are:

- Directing — sets out how the DMO contributes to the Government, Defence and the DMO strategic priorities and objectives. At the foundation of Directing is accountability and control.
- Reporting — ensures that the DMO decision makers are informed about performance against both the DMO's and individual key result areas.
- Assuring — includes verifying to decision makers that key result areas are being met and the DMO is following the appropriate policies, processes and procedures.

The two key enabling elements are:

- Risk Management: builds resilience into all aspects of work by managing risks that might prevent achievement of objectives while also providing flexibility to respond to unexpected threats and exploit opportunities. Good risk management enables a continuous improvement cycle.
- Communicate: enables effective feedback for improvements within the three overarching elements of Directing, Reporting and Assurance.
Figure 4.3 DMO governance framework
ASSURANCE AND RISK MANAGEMENT

Materiel Audit and Risk Committee

The Materiel Audit and Risk Committee (MARC) is the DMO’s external independent governance and assurance body. The Committee comprises three independent members. The Chief Audit Executive (CAE) DMO and the Chief Finance Officer (CFO) DMO attend as advisers.

In 2010-11, the MARC met to discuss emerging risks and current issues including:

• progress with financial controls and assurance framework
• assurances on DMO achievements relating to Military Integration Logistics Information System, Smart Sustainment and Mortimer activities
• Certificate of Compliance.

The MARC works in conjunction with the Defence Audit and Risk Committee to oversee matters of shared importance to the DMO and Defence.

Internal Audit and Risk Management Arrangements

DMO internal audit activity was conducted by two audit entities: Defence Audit Division (to be reported by Defence Audit Division) and two External Service Providers (Ernst & Young Australia and Protiviti Pty Ltd) under the direction of the CAE DMO.

Four audits from the 2010-11 DMO Internal Audit Work Program were completed. The audits have provided recommendations for business improvements in the areas of risk management, governance, control frameworks and compliance with procedural guidelines.

DMO Assurance Rationalisation Program

The DMO Assurance Rationalisation Program is an ongoing effort to ensure maximum benefit is derived from audit and assurance activities. It identifies areas of risk for greater assurance attention and contributes to the maturing of the associated control frameworks. In 2010-11, the Assurance Rationalisation Program continued to ensure greater rigour and discipline is applied in managing DMO’s assurance obligations.

At 30 June 2011, the following outcomes were achieved:

• further reduction in the level of assurance activities, with no reduction in business outcomes
• further de-conflicting assurance activities by providing visibility over all assurance
• development of the consolidated 2011-12 DMO Assurance Program and mapping mandatory assurance activities.
DMO Financial Assurance Arrangements

The Directorate of Assurance and Compliance (DAC) is responsible for the development, implementation and promulgation of DMO’s Financial Assurance Framework, and the coordination of the certificate of compliance process for the whole of the DMO. The directorate also has responsibility for managing the Australian National Audit Office (ANAO) testing program, DMO Commitment assurance, internal testing program and remediation of AusTender data. These activities are primarily performed to increase the accuracy of DMO financial and compliance reporting and in doing so assist the CEO DMO and the CFO DMO in meeting their reporting and compliance obligations. In particular:

- Finance Ministers Orders (FMO) Section 14.3 (a) and 14.3 (b) which mandate that reporting entities (including the DMO) are required to prepare Financial Statements that must include a statement signed by the CEO DMO and the CFO DMO stating:

  14 (a) - whether the financial statements, in their opinion, give a true and fair view of the matters required by this schedule; and

  14 (b) - whether the financial statements, in their opinion, have been prepared based on properly maintained financial records.


Chief Executives are required to provide a completed Certificate of Compliance (Certificate) to their portfolio minister and copied to the Minister for Finance and Deregulation (Finance Minister), by 15 October each year.

- The DMO Financial Controls Reporting Framework:

  - The DMO has redesigned its Financial Controls Reporting Framework to better manage financial reporting and the respective compliance assurance risks. The redesign keeps concepts simple, limits complexities, reduces the volume of current assurance activities and promotes proficient and reliable financial management.

  - The activity frameworks have been mapped against the Certificate of Compliance questionnaire and the DMO financial risks, creating an end-to-end certification and assurance model for the agency.

  - The Assurance Model provides for the implementation and management of a comprehensive testing program to provide internal assurance to the CEO DMO and the CFO DMO that the financial statements are materially correct.

- The DMO Certificate of Compliance:

  - The Certificate of Compliance provides a comprehensive overview of the DMO reporting compliance with the Australian Government’s financial management framework. In 2010-11, a Compliance Requirements questionnaire containing 215 questions was completed by each of the 229 Systems Program Offices/Business Units in the DMO.

  - Following completion of the third reporting period, the Certificate of Compliance is provided by the CEO DMO to report on legislative compliance and due diligence for the Minister for Defence and the Finance Minister to be tabled in Parliament. This submission is considered by the Materiel Audit and Risk Committee who provide advice to the CEO DMO to allow him to sign the Certificate. The DMO reported 513 instances of non-compliances for 2010-11. These instances were assessed as having non-financial impact on the 2010-11 Financial Statements.
CHAPTER 4 GOVERNANCE AND ACCOUNTABILITY

Cash Management Risk

The DMO manages the cash flow risk associated with Program 1.1 Management of Capability Acquisition by applying a program-level slippage model to the estimates developed by the approximately 300 acquisition projects in the program. The inherent uncertainty in managing a program with a large number of complex and long lead time projects means that there is a high probability that unknown project events will occur which will necessitate a variation to the cash requirement for many projects. Drawing on the principles of Portfolio Management Theory, the DMO mitigates this risk by managing the cash requirements for projects holistically. The DMO uses a range of quantitative estimating tools, such as the Basic and Extended Probability Assessment, Three Point Estimates, and the Project Estimates Risk Model Version 2. These are used in conjunction with qualitative information from projects to inform the slippage model and the resulting management margin to be applied to aggregated project estimates.

Cost Estimate Risk

In 2010-11, the Cost Estimation and Assurance Unit strengthened its assurance processes, providing detailed advice and assistance to projects on improving cost estimates. Assistance is now provided from Gate Review through to the internal clearance of Government submissions. The team provided initial assistance to several projects and identified data sources for cost estimation. An advanced cost estimating workshop was developed to support the early development of cost estimates.

Foreign Exchange Risk

The DMO has limited financial risks to international acquisitions as it operates in a no-win no-loss foreign exchange environment where the Government manages foreign exchange fluctuations centrally. General Government sector entities that participate in the reporting requirements of the Government Foreign Exchange Risk Management Policy have their departmental appropriation adjusted on a no-win no-loss basis to offset realised foreign exchange losses or gains.

Apart from the DMO’s direct appropriation for Program 1.3 Provision of Policy Advice and Management Services, all exchange adjustments are managed in Defence’s appropriations. This ensures the DMO adjustments are captured in Defence’s budget estimates, and ensures all capital approvals are fully adjusted for exchange movements according to the formula supplied by the Government.

There was significant movement in exchange rates post Additional Estimates for the major foreign currencies that the DMO operates in. Noting that the activity involving foreign currency transactions relates to funding by Defence through the prepayment mechanism, the majority of the impact of the movement was managed by transfer of funds between the DMO and Defence with any final settlement required being adjusted as part of the 2010-11 Additional Estimates process with Defence.
Procurement Matters

Contracts - Australian National Audit Office Access Clauses

The Australian Defence Contracting templates contain standard clauses providing for Auditor-General access to contractor and major subcontractor premises, records and accounts. The DMO has identified contracts which do not comply with the requirement to provide Auditor-General access, which can be found in Appendix 7 of Volume 1.

Contracts - Exempt from AusTender

In 2010-11, DMO reported a total of 158 contracts (including deeds of standing offer and contract variations) with a total value of $63,514,945.93, which were not published on AusTender because they were subject to an exemption under the Freedom of Information Act 1982.

Legal Expenses

Expenditure on external and internal legal services is set out in the tables located in Appendix 7 of Volume 1. Internal expenses include salaries and operating costs. External expenses include professional fees and disbursements.
CHAPTER 5 EXTERNAL SCRUTINY

PARLIAMENTARY COMMITTEES

This section reports on Defence’s activities in relation to parliamentary committee inquiries and activities from 1 July 2010 to 30 June 2011. Further information on the parliamentary reports, inquiries and hearings detailed below can be accessed through the Australian Parliament House website, <www.aph.gov.au>.

Joint Standing Committee of Public Accounts and Audit

Endorsed in September 2007 by the Joint Committee of Public Accounts and Audit (JCPAA), the Defence Materiel Organisation Major Projects Report (MPR) contains performance data on selected projects and reviewed by the Australian National Audit Office.

The 2009-10 DMO MPR included 22 projects and was tabled 30 November 2010. The 2010-11 DMO MPR will report on 28 projects with tabling in Parliament expected mid November 2011. The six additional projects to be reported in the 2010-11 DMO MPR, are:

1. AIR 6000 Phase 2A/2B - New Air Combat Capability
2. SEA 1390 Phase 4B - SM-1 Missile Replacement Project
3. AIR 9000 Phase 5C - Additional Chinook Helicopter
4. JP 2008 Phase 5A - UHF SATCOM
5. LAND 17 Phase 1A - Artillery Replacement Project
6. LAND 75 Phase 3.4 - Battlefield Management System.