NATIONAL AUDIT OFFICE

REPORT OF THE COMPTROLLER AND AUDITOR GENERAL

MINISTRY OF DEFENCE:

DEPARTMENTAL RESOURCE ACCOUNTS 2000-2001

This report is issued on the strict understanding that it is not for publication or broadcast before:

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Contents

Section 1: Summary

1. Since 1999-2000, the Ministry of Defence (the Department) has been required in accordance with a Direction issued by the Treasury to prepare annual Resource Accounts. The Resource Accounts, drawn up on an accruals basis, should be prepared in accordance with the Treasury's *Resource Accounting Manual* and should give a true and fair view of the state of affairs of the Department and of its net operating cost, recognised gains and losses and cashflows for the year.

2. In producing its Resource Accounts the Department faces a number of challenges. It undertakes a wide range of complex functions, and holds a vast range of assets. It has many old information systems, which although adequate for the purposes they were designed for, are not suited in all respects to the production of accurate and timely accruals based information. The Department has therefore had to invest considerable efforts in implementing resource accounting and budgeting, both in IT and staffing. But at the same time as it has been introducing accruals accounts, the accounting and financial reporting standards have become more demanding both in the application of accounting policies and in the disclosure of information in the Accounts.

3. At the introduction of the Resource Accounting and Budgeting initiative the Department had little information on the value or extent of its asset base, and it struggled, initially, to compile acceptable Accounts. The Department recognised that much needed to be done and made significant efforts to improve the standard of its financial accounting information. These measures led to progressive improvement during 1999-2000 in the quality of its accounting records. However, despite these improvements the combined effects of uncertainty and error in the Accounts for that year were sufficiently widespread to prevent me forming an audit opinion.

4. The Department has continued over this last year to make strenuous efforts to secure further improvements, particularly in the quality of financial data produced by its stock management system. In Section 2 of my Report I consider whether sufficient improvement has yet been achieved and whether the Department's 2000-2001 Resource Accounts are robust enough to support a true and fair opinion. I conclude that although major improvements have been achieved in the accuracy and reliability of its stock management information, further progress is required. Because of continuing problems in this information I am unable to confirm the values for certain stock and fixed assets, or

confirm stock consumption and depreciation charges, and accordingly have qualified my audit opinion on the 2000-2001 Accounts.

5. As explained above, those Accounts have to comply with the Treasury's Resource Accounting Manual, which in turn draws upon Financial Reporting Standards issued by the Accounting Standards Board. Financial Reporting Standard 15 requires the Department to account for its tangible fixed assets on a consistent basis and for its operating costs to reflect the use of these assets in the reporting period in which they were consumed. However, in my judgement, the 2000-2001 Accounts do not comply fully with these requirements and I have therefore qualified my opinion on these grounds also.

6. Against the background of my qualified opinion, I consider in Section 3 of my Report whether the Department is continuing to take appropriate steps to implement resource accounting effectively. Over the last year the Department has improved further its management validation and audit trails, and Schedule 5 of the Resource Accounts now complies with Treasury requirements. However the completeness of creditor and accrual balances is uncertain, and asset transfer classifications cannot be wholly supported. And the Department continues to have problems in accounting accurately for properties identified for disposal. Although all of these matters are significant I do not consider them sufficiently material to lead me to extend my qualified audit opinion. The Department is fully aware of what needs to be done to remedy the deficiencies I have outlined, and is committed to securing improvements.

7. The Treasury's *Resource Accounting Manual* requires that losses and special payments be reported in departments' Resource Accounts. The Ministry of Defence has faced significant changes in its expenditure programmes over recent years because of a variety of factors, including changes in threat (particularly since the end of the Cold War) and advances in weapons technology. These factors have led to many of the losses and special payments reported in Note 27 to the 2000-2001 Resource Accounts.

8. In Section 4 of my Report I consider whether the Department is taking measures to limit the level of such cases. Given the size and lead-time for many military projects it will inevitably take time for all lessons learned to be incorporated into the Department's procurement procedures. The introduction of Smart Acquisition by the Department aims to reduce project risk by committing more resources at the assessment phase prior to full project authorisation. This should result in an overall reduction in funds incurred on procurement failure but may lead to more individual losses being reported in future accounts, albeit at a lower overall cost to the taxpayer.

9. In Section 5 of my Report I confirm that according to Departmental records the maximum numbers of military personnel maintained during 2000-2001 for the Naval, Army and Air Force Services in all active and reserve categories were within the numbers voted by Parliament.

Section 2: Are the Department's Resource Accounts for 2000-2001 true and fair?

10. My Certificate on pages 11 and 12 explains that I am required to report my opinion as to whether the financial statements give a true and fair view. The 1999-2000 Accounts did not support such a view, but I note that during the last year the Department has made major progress in addressing the weaknesses identified. It has worked hard at resolving many of the difficulties posed by the elderly Supply Systems, particularly in validating the prices of items held in its inventory. As a consequence, it is now able to place much greater reliance on the accuracy of those records and is beginning to have in place more accurate information on its consumption. This information will be invaluable to enable the Department to manage its affairs professionally.

11. Similarly, it has taken steps to account more accurately for its fixed assets in line with the requirements recently introduced by the Accounting Standards Board in their Financial Reporting Standard 15 (FRS 15).

12. But there is still more that the Department is required to do in order to be in a position to produce Accounts which could be considered 'true and fair'. In the context of its 2000-2001 Resource Accounts I have no option but to qualify my audit opinion because I am unable to confirm values in the Balance Sheet for certain stock and fixed assets, and consumption and depreciation charges in the Operating Cost Statement. In addition, I have qualified my opinion because of the Department's failure to comply fully with accounting requirements for fixed assets in accordance with FRS 15.

I am unable to confirm figures in the Department's Resource Accounts for 2000-2001 for certain stock and fixed asset balances, and associated charges to the Operating Cost Statement.

13. The Department maintains 13 principal logistics management systems, collectively known as Supply Systems. Seven of these systems cover the Sea environment and are predominately for the Navy, five cover the Land environment and are predominately for the Army and one covers the Air environment. Together these systems hold details of over three million different types of items. As well as consumable stock, the Supply Systems hold fixed asset items, including fighting equipment, capital spares (such as aircraft engines) and certain items of plant and machinery. The reported value of the

inventory, which is reflected in the fixed and current asset headings of the Balance Sheet totalled before depreciation some £30 billion at 31 March 2001.

14. The Defence Logistics Organisation is responsible for managing the Supply Systems on which this vast inventory is held. Many of the individual Supply Systems are many years old. Although, in general, they are adequate for the purpose for which they were designed, namely to track the location, number and movement of items, they are not well equipped to provide accurate financial information. For resource accounting purposes the Department developed stock collation systems to process data from several different sources on the price of items held and stock movements in order to generate financial accounting data.

15. Last year I reported my concerns over the reliability of financial data produced by the Supply Systems for the 1999-2000 Resource Accounts[1]. These concerns focused upon: uncertainties over whether the value of inventory items held on the Supply Systems were appropriate and supported by adequate documentation; whether stock and assets held by contractors were completely and correctly recorded; whether stock consumption charges were completely and correctly recorded; and whether depreciation charges calculated by the Navy's stock collation system were correct.

The values for assets and stock recorded on the Supply Systems are now more robust

16. The Defence Logistics Organisation has undertaken a substantial amount of work to ensure that pricing records fairly reflect the values of items held on the Supply Systems. Over a two year period it has validated the prices for all items in the top 80 per cent (by value) of the inventory, including those prices that had not been updated for 5 years or more. Those less than 5 years old were considered more likely to be accurate.

17. Progress in validating prices for the top 80 per cent was such that at the time of my audit of the 1999-2000 Resource Accounts, prices in this category within the Air environment, and many of the prices over five years old in the Land environment, had been validated. During the 2000-2001 financial year validation work on the remaining items in this range, principally those held by the Sea environment, was completed.

18. My staff examined the price validation work carried out by the Defence Logistics Organisation as part of their audit of the 2000-01 Accounts and found that, in general, it had been undertaken diligently and carefully. The Department estimates that its validation

[1] Ministry of Defence: Consolidated Departmental Resource Accounts 1999-2000. HC50.

work led to adjustments downwards of some £125 million in respect of certain inventory items, and upwards by £123 million in respect of other items.

19. Not all of the prices could be adjusted during the year. In the Land environment the prices of certain capital spares items have been validated and revised downwards on the Supply System, but the accounting systems could not be updated with these values in time for the 2000-01 Accounts. My staff estimate that the net book value of capital spares is overstated in the Balance Sheet as at 31 March 2001 by some £58 million as a consequence.

20. In some cases, the Defence Logistics Organisation was able to rollback the price adjustments for the top 80 per cent of items to the beginning of the financial year. As a result, the Defence Logistics Organisation has been able to improve the accuracy of the opening balances for the 2000-2001 year. But, with regard to the Sea and Land environments, in particular, prices could not be corrected for those items already consumed in the year. Consumption of such items during 2000-01 has therefore been recorded at the old price, and this has distorted the consumption figures reported in the Operating Cost Statement. Because of the real time, high volume nature of the systems it is not possible for the Defence Logistics Organisation or my staff to quantify the level of this error.

21. The bottom 20 per cent by value of the inventory comprises several million line items, many of which, individually, are of low value. The cost of validating the prices of such a large number of items would be prohibitive. As an alternative, the Department analysed this sub-population of the inventory in order to estimate the impact of inaccurate price records. It estimated that at 31 March 2001 the gross value of capital spares was understated by some £29 million, and the gross value of consumable stock also understated by £99 million. The Department believes that over a period of time the prices of items in the bottom 20 per cent of the inventory will become more accurate as new items are introduced or existing line items replenished.

22. The Defence Logistics Organisation recognises that it will need to keep its price database up to date. It has already taken steps to maintain a rolling programme for validating each year those prices which have become more than five years old, and it will continue for some time to monitor the estimated level of error in the bottom 20 per cent of the inventory.

The Department has now introduced a consistent policy across all three Services for writing down stock values

23. The Department's price validation work has confirmed that many of the items held on the Supply Systems are in excess of requirements, or obsolete because the equipment they support is no longer in use. In such circumstances, the Department needs to reflect these factors in its annual Resource Accounts by reducing stock values appropriately. During 2000-2001, the Department introduced a consistent policy across all three Services for determining the amount by which the value of consumable stock should be written down. This policy takes into consideration past usage, along with estimates of future requirements based on the lives of the asset the stock items are intended to support. I am content with this policy.

24. The Department has provided £3,755 million for stock write-down in its Balance Sheet, and charged £929 million to the Operating Cost Statement in 2000-01. The Department has not been able to calculate the write-down of stock accurately as not all the information required is at present held in a readily accessible form, and it has yet to resolve the feasibility of gathering this data. It is not possible therefore to calculate accurately the value of the stock write-down necessary for the 2000-01 Accounts and the Defence Logistics Organisation estimates that the stock balance could be overstated by as much as £145 million.

It is not clear that the Department's records of its assets held by industry are complete and that the assets are correctly valued

25. Assets belonging to the Department may be held by contractors for a number of reasons. For example, items may be with contractors awaiting repair; or spare parts may be supplied to contractors to enable them to carry out repairs on major components; or items may be supplied for incorporation into new builds or modifications. In addition, the Department’s test equipment, jigs and tools may also be with contractors. In all cases, the contractor has responsibility for maintaining information on the items held. The degree of detail to be recorded by the contractor varies according to the contract type or version. Historically, the quality of the Department’s data on items held on its behalf by industry has been poor.

26. For the purposes of the 1999-2000 Accounts the Department could not verify the existence or value of items held by industry and had to estimate these at £780 million. The Defence Logistics Organisation instigated a project some two years ago to capture asset data on these items more accurately and to maintain a record of their movement. The project is still ongoing and has already brought about improvements in the accuracy

of the data. Nevertheless incomplete records and unvalidated asset valuations remain problems for the 2000-2001 Accounts. The Department has estimated that the gross value of its assets held by industry was £1,400 million at 31 March 2001. But it considers that deficiencies in its records could have resulted in the Balance Sheet at 31 March 2001 being over or understated by as much as £150 million and the Operating Cost Statement understated by £65 million.

27. The Defence Logistics Organisation is aiming to provide accurate figures on the value of items held by industry in time for the 2001-02 Resource Accounts, but accurate data on consumption will not be available until 2002-03. In my judgement, doubts over the existence of these assets is reducing steadily in line with progress in the Defence Logistics Organisation's work. Concerns will remain for some time over whether the Department's asset records are complete and, in particular, over the valuation of these assets.

Stock accounting transactions are not completely or correctly recorded

28. As noted above, the Department's Supply Systems were designed primarily as logistics systems and have not lent themselves to providing the data required to account for financial transactions on an accruals basis. This has led to problems in a number of areas including the following:

(i) The supply system covering the Air environment is unable to differentiate whether an item received from a contractor is a new or a repaired item. For financial accounting purposes this distinction is important, as a repaired item will already be held on the Balance Sheet. Although the Department has been able to ensure that the double counting of repaired items is no longer reported in the Balance Sheet, a misclassification of £639 million between the depreciation of fixed assets and the surplus/deficit on asset disposals has arisen.

(ii) A reconciliation at 31 March 2001 between the Supply Systems covering the Land environment and the accounting systems identified an unexplained discrepancy of £77 million. The Department was unable to determine the cause of the error and had to write-off the amount to the Operating Cost Statement.

(iii) Stock movements and balances in the individual Navy Supply Systems are processed by a single stock collation system. This system, correctly, ignores stock movements that do not constitute accounting transactions, such as movements of stock from one part of a store to another part. However, some movements that ought to be reflected in the accounting records have been erroneously rejected by the system. Various problems and limitations with the stock collation system in its development phase contributed to the Department having to make manual adjustments of some £500 million to the ledgers at 31 March 2001. A revised version of the collation system introduced during 2000-01 should help overcome this problem in future years.

29. Given the age and structure of the Supply Systems, the Department considers that to make wholesale changes to provide accurate financial information would incur both undue expense and risk to the effective operation of the systems. Minor changes are being made when considered to be justified on cost and risk grounds. The Defence Logistics Organisation is, therefore, largely reliant on the replacement of the existing systems by a commercial off the shelf stores management system. This is expected to provide sound financial data, as both the logistics and financial requirements should be fully integrated. The new system will link to the current Defence Financial Management System and to a new Purchase Order system. It will not be introduced within the Defence Logistics Organisation until the autumn of 2003. Therefore for the 2001-02, and 2002-03 Accounts, and indeed until the system is rolled out fully, the existing supply systems will be unable to ensure that the accounting transactions are completely and correctly recorded.

The Department has been unable to comply fully with fixed asset accounting requirements introduced by the Accounting Standards Board in 1999

30. Financial Reporting Standard 15 (FRS 15) issued by the Accounting Standards Board in 1999 details the accounting requirements for tangible fixed assets. It sets out the principles of accounting for the initial measurement, valuation and depreciation of all tangible fixed assets, with the exception of investment properties. Its objective is to ensure that tangible fixed assets are accounted for on a consistent basis and, where a policy of revaluation is adopted, that revaluations are kept up-to-date. The Standard codified much of the accounting practice that existed prior to its introduction, but also introduced some significant new requirements.

31. The Treasury's Accounts Direction requires all government departments to comply with the *Resource Accounting Manual* which draws upon accounting and reporting standards issued by the Accounting Standards Board. Financial Reporting Standard 15 applies to all financial statements that are intended to give a true and fair view and took effect from accounting periods ending on or after 23 March 2000.

The Department is meeting many of the requirements of FRS 15

32. In auditing the 1999-2000 Resource Accounts, my staff concluded that many of the requirements of the Financial Reporting Standard were already being complied with, for example, for initial measurement and valuation, and, to a limited extent, for subsequent expenditure and depreciation. They noted, however, that for major fixed assets the Department's Resource Accounts failed to comply with key aspects of the Financial Reporting Standard, particularly in ensuring that the costs of consuming economic benefits were expensed in the reporting periods in which the consumption took place. This non-compliance was reflected in my Report on last year's Resource Accounts.

33. The Department has begun to address these deficiencies. It issued to its Management Groups in November 2000 a technical bulletin setting out its policies on the application of the Financial Reporting Standard. These policies were intended to ensure that its annual operating costs reflect the use of components of tangible fixed assets in the reporting period in which the economic benefits are consumed. My staff noted, however, that not all of the Department’s Management Groups implemented these policies during the 2000-01 financial year. And those that did, did so in a way that failed to achieve full compliance with the FRS 15 requirement, namely that depreciation charges within operating costs reflect the economic benefits consumed. The need for these policies is particularly relevant for certain fixed assets such as ships, submarines and aircraft that wear-out at a substantially quicker rate than might be assumed from simply considering the date that the assets are due to be withdrawn from service. The Department spent £2,700 million during 2000-01 on equipment support, which included the costs of major refits or overhauls of ships, submarines and aircraft.

Major refits, or their equivalents, for ships, submarines and aircraft are not being accounted for correctly

34. For ships and submarines, the costs of routine maintenance and repairs have been properly expensed when incurred. In addition to routine maintenance and repair, ships and submarines require complete refits every eight to ten years. The total costs of refits and repairs, amounting to some £800 million in 2000-2001, have been charged to the Operating Cost Statement. Refits, though, involve a major strip-down, inspection and overhaul. Fundamentally, these refits are intended to reinstate the condition of worn-out elements, and to refurbish the vessel so that it is fit for service until the next scheduled refit, or until the vessel is due to be taken out of service. Obsolete or near-obsolete components are replaced and new components installed to enhance the ship’s capability. Consequently, the cost of the refits can be very significant when compared with the net

book value of the vessel. Yet the Department has not reflected the costs of these refits in the value of these assets, nor reflected the way in which benefits are consumed over the vessels' lives, in line with FRS 15.

35. My staff noted that aircraft, similarly, must have a complete inspection and overhaul once they have flown a predetermined number of hours, before they can be allowed to continue flying. Again the work typically involves a major strip-down and provides an opportunity for carrying out modifications. The costs of this work can be substantial in relation to the carrying value of the aircraft and some £900 million in 2000-2001 has been charged to operating costs rather than capitalised in line with FRS 15.

36. At present the Department is not recognising in its Accounts the gradual wearing-out of these major assets until the refit or overhaul takes place, and such costs are then being expensed rather than capitalised. This failure to charge the costs of consumption of the economic benefits to operating accounts, by way of depreciation, in the periods that the consumption takes place can lead to distortions in the Operating Cost Statement and to incorrect carrying values for fixed assets in the Balance Sheet. The value of ships, submarines and aircraft between scheduled refits and overhauls does not reflect their real condition at that time, since significant costs will need to be incurred progressively to bring their condition back to a standard that will ensure they continue to provide the planned economic benefits over the full projected lives of the assets.

The costs of major refurbishment of property may be reported incorrectly

37. The Department is committed to maintaining the defence estate at an acceptable standard and spent some £1,173 million on this in 2000-2001. Departmental policy is not to capitalise major refurbishment costs on property unless they provide a significant enhancement to the property, for example, by providing greater capacity or significant change of use. Consequently, there is a risk that individual properties are valued incorrectly in the Balance Sheet, and that the depreciation charge to the Operating Cost Statement is understated.

38. However, the Department judges in the context of the 2000-2001 Accounts that although the value of refurbished properties might, as a result of that refurbishment work, be higher than their book value, the value of properties not refurbished in the period since last professionally valued would be lower than their book value as components wear out. It believes that the effects of this - within a level of expenditure that is not fluctuating significantly year on year - will balance out, overall, when considered in the context of the whole estate.

39. The Department updates its property values annually using indices, and every 5 years undertakes a full property revaluation exercise. The next 5-yearly property valuation exercise is due to be undertaken by April 2002. Once completed, it is likely that Balance Sheet values will increase for those properties having been substantially refurbished. At that stage they will attract higher depreciation charges, and this as a consequence will result in the Operating Cost Statement incurring costs twice - once from the original refurbishment expenditure and subsequently from additional depreciation on the resultant increase in the property's value.

40. Although there may be a technical breach of FRS 15 in respect of the accounting treatment for refurbishment costs, it is not likely to be material in the context of the Department's Resource Accounts as a whole and I have not qualified my opinion on this count. The results of the first 5-yearly review of property values, when available, will determine whether there is a distortion in the Accounts because of this matter. The Department has recognised the need to determine the most appropriate accounting treatment once that 5 yearly revaluation is completed, and will do this in conjunction with my staff.

41. In addition to questions over the Department's accounting policy, my staff found there is some inconsistency across the Management Groups in their application of the policy with regard to the treatment of major refurbishment costs incurred on property. Most of the Management Groups do not capitalise such costs except for the RAF budget holders who often capitalise the cost of refurbishment work carried out on their property - for example, the refurbishment of barrack blocks. Consequently, the costs of major property refurbishments may be reported incorrectly in the Department's Accounts.

Some departmental systems do not account for depreciation in line with the requirements of the Financial Reporting Standard

42. Financial Reporting Standard 15 clarified accounting requirements for depreciation. When the useful economic life of an asset is revised, the carrying amount of the tangible fixed asset at the date of revision should be depreciated prospectively over the revised remaining useful economic life.

43. However, during 2000-2001 some of the Department's fixed asset systems were unable to calculate depreciation correctly in these circumstances. For example, the Department operates a single fixed asset register to account for the majority of the Army's fighting equipment and vehicles. When an asset life was changed the register calculated what the depreciation charge should have been over the whole of the new life of the asset and

compared this to depreciation charges already made. The difference was posted to the current period's Operating Cost Statement. This has resulted in depreciation of some £180 million being understated in the Operating Cost Statement during 2000-2001. Although, the Department has introduced a new software program in this area to calculate depreciation in accordance with FRS 15, other major systems within the Department remain to be corrected to ensure full compliance in all circumstances.

Section 3: Is the Department continuing to take appropriate steps to implement Resource Accounting effectively?

44. Despite qualifying my audit opinion on the 2000-01 Accounts, I recognise that the Department has made very considerable efforts to implement Resource Accounting, and that those efforts have already resulted in improvements in the way it manages its resources. The qualified audit opinion on the 2000-2001 Resource Accounts is, in itself, an improvement on last year when I was unable to form any audit opinion.

45. The Department has demonstrated an effective grip on the accounts production process and again for 2000-2001 has produced Resource Accounts in line with deadlines agreed with my staff and the Treasury. Also, I am content that the Department is currently taking the right steps to remedy the remaining deficiencies in its Resource Accounts, and is progressing the remaining issues as fast as it can, given the constraints and other important priorities facing staff. The Department is fully aware of what needs to be done, and is committed to securing improvements. My staff will continue to work closely with the Department in this task.

46. In this Section I consider specific areas where the Department has made further improvements during this last year and consider those issues on which the Department will need to continue to take action. Although all of these matters are significant and need to be addressed by the Department, I do not consider them sufficiently material to lead me to extend my qualified audit opinion.

The Department has further improved its management validation and audit trails

47. The Department's Resource Accounts are a consolidation of accounts prepared by eleven top level budget holders across the Department. The accounts of these top level budget holders are in turn a consolidation of accounts produced by 93 management groupings. It is fundamental to the production of any Account, but particularly one as complex as this, that the figures in the Account should be fully supported by good and clear documentation. It is also important that the Account production process should be subjected to robust quality control arrangements and that the Accounts, and figures in the Accounts, be subjected to thorough management review prior to being submitted to my staff for external audit scrutiny.

48. My staff found that the Department has made improvements in this area since last year. The improvements, though, were not consistent across the Department, nor in some cases within top level budget areas. My staff again noted cases where there was inadequate trails from the Accounts figures back to supporting documents and records. For example, in one newly created budget area my staff faced major difficulties in confirming asset transfers due to poor records of movements and adjustments.

49. The very many organisational changes that continually take place within the Department also presented risks to the integrity of the Accounts. In some budget areas my audit was hampered by finance staff moving posts before or during the course of the audit without leaving sufficiently robust trails from the Accounts to the supporting documentation.

50. Overall, the Department had to make a large number of amendments between their first and final version of the Resource Accounts. These amounted in total to a £566 million decrease in fixed assets, £221 million decrease in working capital and £1,181 million increase in net operating costs. A significant proportion of these changes was the result of continuing work inside the Defence Logistics Organisation to improve the reliability of data produced by the supply systems (paragraphs 13 to 29 above), and other post year-end results. But some were the results of late management review. Although management validation was much better in 2000-01 than in previous years, and can be expected to improve further with the introduction from 1 April 2001 of in-year management on a resource basis, the fact that so many adjustments had to be made after the first Accounts had been submitted for audit highlights the need for further improvement in this area.

Schedule 5 now complies with Treasury requirements

51. Schedule 5 of the Department' s Resource Accounts is intended to show how the resources allocated by Parliament have been spent on each Departmental objective. I reported in the context of the 1999-2000 Resource Accounts that the Department had inadequate procedures in place to meet the reporting requirements demanded of them, and that the Treasury expected the Department to develop systems which would enable it to disclose resources by objective.

52. For the third year running the Department has refined one or more of its objectives in order to produce a more meaningful Schedule 5. Although, this precludes useful analysis of trends, I note that the Schedule for 2000-2001 complies with the Treasury’s requirements although its supporting systems and procedures continue to be based on an interim solution. It expects that it will take several years to develop fully integrated

costing systems which demonstrate clearly how resources have been applied against each Departmental objective. In the meantime, it will focus on improving the quality of the underlying figures.

It is uncertain whether the figures for creditors and accruals in the 2000-01 Accounts are complete

53. The proper identification of creditors and accruals relies on the ability to match data on the delivery or the provision of a service, to the receipt of an invoice and to its eventual payment. The current Departmental systems are unable to capture or match these three sources of data successfully. The top level budget holders are provided with creditor figures by the Department’s Bill Paying Agency, and are required to supplement these listings with accrual balances generated by local systems. In most cases the process is manual and subject to error. The extent of this error was revealed by the need to increase the figures for short-term creditors between the draft and final versions of the Accounts by £135 million. My staff estimate that there remains net understatements in the creditors balances at 31 March 2001 of some £45 million.

54. The Department is reliant on new systems to resolve the underlying problem. The Defence Logistics Organisation is introducing a new purchase order system which will allow commitment, receipt logging and bill payment to be joined-up, and thereby provide reliable accrual and creditor data. The new system will be rolled out progressively across the Department from April 2002.

The Department continues to have problems in accounting accurately for asset transfers, re-classifications and disposals

55. The Department was unable for its 1999-2000 Resource Accounts to support fully the balances shown on the 'other movements' line in Note 7 (Intangible Assets) and Note 8 (Tangible Fixed Assets). The unsupported net balances were £21 million and £61 million respectively. These residual balances were presented as reclassifications between tangible fixed assets, intangible assets and stock, and as consequence of adjustments made to improve the Supply Systems financial data. The Department concluded last year that the residual unsupported balances related largely to prior years, but was unable to provide evidence for this. This gave rise to uncertainties about the fixed asset balances, and figures in the Operating Costs Statement and Cash Flow Statement for that year.

56. The final 2000-2001 Resource Accounts reports balances on the 'other movements' lines as £40 million (Note 7 Intangible Assets) and £1,218 million (Note 8 Tangible Fixed

Assets). The Department has provided my staff with explanations for the majority of these balances. However it cannot support some £32 million (of the £40 million) disclosed in Note 7 Intangible Assets, and £57 million (of the £1,218 million) disclosed in Note 8 Tangible Fixed Assets. The Department attributes the cause of these residual elements as imbalances arising from misclassifications in the transfers of fixed assets within the Department.

57. The Department has also had difficulties in accounting accurately for property sales. All property disposals are handled by the Department's Defence Estates Agency. When top level budget holders wish to dispose of land and buildings, they transfer the existing use value to the Agency. After transfer an open market valuation is obtained and all valuation adjustments and proceeds from the sale are accounted for by the Agency. I reported last year on problems faced by the Department in accounting correctly for transfers of land and buildings prior to disposal by the Agency.

58. Some of these problems continued to have an impact on the 2000-01 Accounts. For example, the Defence Estates Agency disposed of 203 sites during 1999-2000 but in three cases the sites remained in the accounts of the top level budget holder concerned. The total value of these properties at an existing use value, namely £44 million, has been written-off in 2000-01, overstating the Department's net expenditure for the year.

59. These accounting problems give rise to uncertainties about the fixed asset balances and figures in the Operating Cost Statement and Cash Flow Statement for the year 2000-01. Fixed assets comprise a major part of the Department's Balance sheet. It is therefore important that continuing care is maintained, including in the management of fixed asset transfers, to ensure that fixed asset balances and figures in the Operating Cost Statement and Cash Flow Statement are correct.

Section 4: Is the Department taking measures to limit the level of losses and special payments?

60. The Department's expenditure programmes are subject to many changes in requirements because of advances in weapons technology; changes in threat (particularly since the end of the Cold War); and the scale of changes in organisational structures, for example arising from the Strategic Defence Review. These changes can result in the Department having to abandon procurement or development projects before the items are introduced into service. And in some instances, because of changes in specifications demanded by the Department, the equipment delivered may not meet the Department's requirements.

61. The Treasury gives departments delegated authority to write-off such expenditure as a loss or special payment after careful appraisal of all the facts, but requires departments to bring them to Parliament's attention at the earliest opportunity. Nevertheless, investigation of the circumstances can take some time. Where final details cannot be reported this is noted as an advisory loss.

62. There are important lessons for the Department to learn on equipment failures and changing requirements from these reported losses. Given the size and lead-time for many military projects it will inevitably take time for all lessons learned to be incorporated into the Department's procurement procedures. It is also clear that not all circumstances lie within the Department's control.

63. The introduction of Smart Acquisition[2] by the Department aims to reduce project risk by committing more resources at the assessment phase prior to full project authorisation. This should result in an overall reduction in the funds incurred on procurement failures. However, the commitment of more funding to the assessment phase may lead to more individual losses being reported in future accounts, albeit at a lower overall cost to the taxpayer.

64. Note 27 of the Department's Resource Accounts for 2000-2001 discloses losses, special payments, gifts and loans. I highlight below some of the more significant examples recorded in the Note.

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[2] Major Projects Report 2001 (HC330 of 2001-2002).

Equipment delivered into service may not always meet the Department's requirement

ALR 66 Radar Warning equipment

65. The ALR 66 Radar Warning equipment was intended for installation in the Royal Air Force Hercules fleet. The need for this particular equipment was identified following the Falklands Conflict. The project started in 1982 but took until 1993 before initial installation had occurred. The RAF identified numerous software faults with the system that led to it being rendered inoperable. The Department and the contractor worked on remedying these faults, but advances in military technology were constantly eroding the usefulness of the project. By 1997 both the Royal Air Force and the Defence Evaluation and Research Agency concluded that the project would never work at a satisfactory level and the project was terminated. Since then, the Department has held discussions with the contractor, and has recovered £0.6 million. The Department has estimated that the beneficial use it has gained from testing the equipment amounted to £1.4 million, and has therefore written off the balance, some £12 million.

Upkeep stores and engineering system

66. Upkeep was to be an integrated stores and engineering information technology system. The Department intended to implement Upkeep across the Fleet and Naval Shore establishments, thereby replacing around 20 major and many minor existing systems. This project involved not only software replacement but also costs associated with hardware, training and user licenses.

67. Despite efforts by both the contractor and the Department since 1995 when the project was approved, it became apparent that there was no clear indication of how long it would take before the project could be made operationally effective, nor an indication of the associated costs. In view of cost escalations and difficulties with implementing the project it was terminated in June 1999 and the Defence Logistics Organisation decided to adopt a new commercial off the shelf package to control its inventory management. The Department has now written-off £30.7 million as nugatory expenditure.

The cancellation and modification of defence contracts because of changed requirements has resulted in waste

Long Range and Medium Range Trigat

68. The Department has reported an advisory loss of £205 million arising from a decision not to procure variants of the Long Range Trigat - an anti-tank guided weapons system.

Subsequent to placing a contract to purchase the weapons systems the Department decided to procure Apache helicopters, complete with their own weapon systems, which rendered the procurement of Long Range Trigat unnecessary. The Department will report on this project in more detail once the full extent of the loss has been established.

69. The Department has also reported an advisory loss of £109 million arising from a decision not to proceed with an international collaborative programme for the production of the Medium Range Trigat - a portable anti-tank guided weapon system for use by the infantry and Royal Marines. The Department decided to withdraw from this project in the face of significant uncertainty surrounding the future of the collaborative programme. It was not convinced that the weapons systems offered an appropriate solution to current and future needs in an acceptable time-scale. I have reported already on this project in some detail in my Major Projects Report 2000 (HC 970 of 1999-2000).

The Department has reported significant accounting losses

Suspense accounts

70. My report on the 1996-97 Defence Appropriation Accounts (HC 251-I of 1997-98) noted that the overall management and control of suspense accounts throughout the Department needed to be improved, particularly in view of the introduction of Resource Accounting. I continued to have concerns on these matters, and reported on both the 1997-98 and 1998-99 Appropriation Accounts. The Department, as a consequence, directed its Senior Finance Officers to resolve problem suspense accounts, ensure that the posting of transactions was both controlled and auditable and develop more effective reporting processes to enable rigorous management review. To assist progress, the Department also established teams specifically tasked with reconciling problem suspense accounts, and improved the guidance available to staff on the operation of suspense accounts.

71. Since 1996-1997 my staff have continued to monitor the Department's improvements over the control of these accounts and concluded that progress has been steady. As part of my examination of the Resource Accounts for 2000-2001 my staff reviewed a number of suspense accounts. My staff concluded that in most instances, the controls and management procedures are now working satisfactorily - regular monitoring is undertaken to ensure the accounts are being used correctly and are fully reconciled. In the case of unreconcilable suspense account balances, the Department had made exhaustive examinations of the underlying problems and concluded that there was no satisfactory alternative to write-off action. Note 27 to the Resource Account records

some £27 million written off as a result of these processes. There is no evidence that the amounts written off represented actual cash losses.

72. The Department's investigation of a few unreconciled balances, some £11 million debit and £11 million credit balances, is still ongoing, and the outcome of those investigations if leading to write-off action will be reported in the Resource Accounts for 2001-02. Apart from these remaining balances I am satisfied the Department has made progress in addressing the legacy of problem suspense accounts.

Section 5: Ministry of Defence - Votes A

73. The Ministry of Defence's Votes A is presented annually to Parliament to seek statutory authority for the maximum numbers of personnel to be maintained for service with the armed forces. Note 31 to the Accounts shows that the maximum numbers maintained during 2000-2001 for the Naval, Army and Air Force Services in all active and reserve categories were within the numbers voted by Parliament. My staff have been provided with strength returns to support this Note to the financial statements.