

**Report of the Comptroller and Auditor General on the 2009-10 Resource
Accounts of the Ministry of Defence.**

Report of the Comptroller and Auditor General to the House of Commons

Introduction

1. The Ministry of Defence (the Department) Resource Accounts for 2009-10 report net expenditure of some £41.5 billion. This includes payroll costs for the Armed Forces of £9.5 billion, which are reported under Requests for Resources 1 and 2¹. The financial statements also report assets of some £130.7 billion mainly consisting of land, buildings, fighting equipment and stores together with gross liabilities of some £19.5 billion consisting of, for example, creditors and provisions.

The purpose of my report

2. This Report explains the basis for the qualification of my audit opinion on the 2009-10 Resource Accounts and provides an update on the actions taken by the Department to address the issues identified in my Report on the 2008-09 Resource Accounts².

My obligations as Auditor

3. Under the Government, Resources and Accounts Act 2000 (the Act) I am required to examine and certify all Departmental Resource Accounts. International Standards on Auditing (UK and Ireland) require me to obtain evidence to give reasonable assurance that the Department's financial statements are free from material misstatement. In forming my opinion I examine, on a test basis, evidence supporting the disclosures in the financial statements and assess the significant estimates and judgements made in preparing them. I also consider whether the accounting policies are appropriate, consistently applied and adequately disclosed. I am also required to satisfy myself that, in all material respects, the expenditure and income shown in the Resource Accounts have been applied to the purposes intended by Parliament and conform to the authorities that govern them.
4. Votes A for the Ministry of Defence is presented annually to Parliament to seek statutory authority for the maximum numbers of personnel to be maintained by the Armed Forces. Note 36 to the accounts discloses the number voted by Parliament and the maximum numbers maintained during 2009-10 for the Royal Navy, Army and Royal Air Force in all active and reserve categories. My role is to inform Parliament whether or not the approved Estimates (Votes A) have been exceeded.

Qualified opinion due to material error arising from adopting accounting policies which do not fully comply with International Financial Reporting Standards and a limitation of scope due to the inadequacy of evidence to support certain income, expenditure and balances in the financial statements.

5. I have qualified my opinion on the Department's 2009-10 financial statements because the Department's accounting policies are not fully compliant with the requirements of International Financial Reporting Standards (IFRS) (paragraphs 8 to 15 below) and, in my opinion, this non-compliance has a material effect on the financial statements.
6. I have limited the scope of my opinion on the Department's 2009-10 financial statements, as I did in 2008-09, because the Department was unable to provide me with evidence to support the:
 - i. existence and value of certain assets and inventory balances reported within the financial statements (paragraphs 16 to 38 below); and
 - ii. completeness of income recognised for recovering the costs of certain accommodation and food charges from the pay of service personnel (paragraphs 39 to 51 below).

¹ A further Request for Resources, RfR 3: war pensions payments, is not the subject of this report.

² HC 467 2008-09 Ministry of Defence Annual Report and Accounts 2008-09

7. I was also unable to obtain sufficient evidence to support the accuracy of service personnel numbers in relation to some categories of reserves for the Royal Navy and the Army and therefore I am unable to report to Parliament whether or not the approved Estimates (Votes A) have been exceeded (paragraphs 52 to 53 below).

Accounting for lease-type arrangements

Qualified audit opinion

8. I have qualified my opinion because the Department has not complied with the accounting requirements for determining whether a contract contains a lease and has therefore omitted a material value of assets and liabilities from its Statement of Financial Position. I cannot quantify the impact of this on the accounts with certainty because, as a result of its accounting policies, the Department has not maintained the records, or obtained the information required to do so.

Accounting requirements

9. In preparing its accounts, the Department must comply with the requirements of the Government Financial Reporting Manual which for the first time from 2009-10, is based on International Financial Reporting Standards (IFRS). Previously the Manual was based on the requirements of UK Generally Accepted Accounting Practice (UKGAAP). IFRS³ require preparers of accounts to establish initially whether a lease-type contract is in substance a lease and then if it has the characteristics of either a finance or operating lease. The main impact of this requirement is that if the contract is classified as a finance lease then, rather than simply recording expenditure as it is incurred in year, the assets used to deliver the service should be recognised as assets in the Statement of Financial Position alongside a liability for the minimum lease payments due under the contract.

Action by the Department

10. The Department assessed its relevant PFI and PPP contracts against the revised accounting requirements but did not carry out this assessment for other contractual arrangements. Based on the results of its preliminary work, the Department believes that there may be a number of its contracts which would now require disclosure as leases, including as finance leases. Given the number and size of the contracts involved, the Department accepts that there is likely to be material understatement of the assets and liabilities recognised in its financial statements. This is disclosed in Note 1.30 to the financial statements.
11. In order to comply with financial reporting standards, the Department would need to review all of its relevant contracts in order to assess whether they contain a lease. Any leases identified would need to be classified as finance leases or operating leases and the relevant accounting requirements applied.
12. Although the Department has assessed that the impact on its financial statements is likely to be material, it has decided not to carry out the further work described at paragraph 11. It believes that the cost of the work exceeds the benefits of compliance. In particular, it believes that the number and complexity of its contracts, together with likely difficulties in obtaining information required from third parties, would make compliance costly and time-consuming.
13. The Department has however indicated that it intends to account for new contracts, entered into from 2010-11, in accordance with the new requirements, with a view to achieving full compliance with accounting requirements over time.

Recommendations for further action

³The key relevant accounting standards and interpretations are: International Financial Reporting Issues Committee Interpretation 4: *Determining whether an arrangement contains a lease (IFRIC 4)* and International Accounting Standard 17 *Leases* (IAS 17)

14. While it may be logistically unavoidable for the Department not to comply with accounting standards in the short term, a serious and concerted effort needs to be made to become compliant. I note the Department's commitment to applying the accounting requirements to new contracts from 2010-11 onwards. However, the long term nature of many of the Department's existing contracts means that it is likely to be a number of years before this approach results in financial statements that are materially compliant with accounting standards.
15. I recommend that the Department carries out further work to identify contracts where the risk of inappropriate accounting treatment is highest and targets further efforts on higher value, higher risk contracts. I understand the Department has already begun to engage with its contractors to discuss its information requirements. This is a welcome start which the Department should use to develop a programme of work with a clear timetable to achieve compliance with accounting standards.

Assets and inventory

Limitation on the scope of my opinion

16. I have limited the scope of my opinion in relation to around £6.3 billion (2008-09: £6.6 billion) of assets, reported within non-current assets and inventory on the Statement of Financial Position (previously called Balance Sheet) of the Department valued at £44.7 billion. The limitation arises due to insufficient evidence available to me to support my opinion on:

- capital spares and inventory⁴ recorded at £5.5 billion;
- around £752 million of military equipment including around £568 million of grouped assets such as firearms and around £184 million of BOWMAN radios.

The scope of my opinion on the 2008-09 accounts was also limited in relation to weaknesses in the controls over inventory and the evidence to support the existence and valuation of assets included in the accounts.

The Department's management and accounting processes for capital spares and inventory

17. I reported last year that certain key controls over inventory, operated by the Defence Storage and Distribution Agency (DSDA), were not effective and that the accuracy of the inventory systems was deteriorating. Following my report last year, the Department established the Materiel and Financial Accounting Project Board to review processes for all areas of asset management and accounting. This Board brings together stakeholders in logistics capability, finance and storage and distribution and has overseen a number of important initiatives.
18. The end-to-end process for the management of inventory is complex and stretches across the Department, including 28 countries overseas and deployed forces. Within the end-to-end process, DSDA is responsible for storage and for distributing items in accordance with instructions received from across the Department. Others, principally Project Teams, are responsible for the through-life stewardship of such assets from their initial procurement through to eventual disposal.
19. Despite the action by the Department, the significant issues I have identified are systemic and deep-rooted and have again led me to limit the scope of my opinion on the 2009-10 Resource Accounts. The main areas of weakness identified relate to:
 - discrepancies between inventory counts and warehouse management records which mean that the warehouse management systems at DSDA depots do not form a reliable basis for inventory records;
 - inadequate assessment for impairment of inventory resulting in my being unable to confirm the appropriateness of the values at which assets are reported in the accounts; and

⁴ Capital spares are major spares for military equipment which are capitalised in the accounts. They are managed however through the same processes and systems as inventory

- an inability to fully reconcile warehouse system records with accounting systems that leaves me unable to conclude whether the data from the warehouse systems has been accurately reflected in the financial statements.

These issues are more extensive than those included in my Report on the 2008-09 financial statements, because the Department's actions to address my prior year findings and the audit work of my staff have brought a wider range of issues to light.

Discrepancies between inventory counts and warehouse management records

20. The Department has improved its procedures in a number of ways during 2009-10. The routine inventory checks which are carried out by DSDA now comply with the requirements mandated by the Department, which was not the case in 2008-09. However, these checks indicated that inventory recorded on the system did not match the stock-count at 29% of locations tested over the year, still well above Departmental targets.
21. The testing carried out by my staff to verify warehouse records against stock on the shelf identified significant levels both of stock that was recorded on the system but could not be located and also of stock on the shelf that was not recorded on the warehouse system. Due to the nature of these errors, it is not possible to estimate with sufficient accuracy the change in value which would result if all such discrepancies had been identified and corrected.

Inadequate assessment of impairment of inventory

22. My audit also considered how the Department assesses its inventory holdings to ensure that the appropriate value is reflected in its accounts. Assets can become impaired, most usually due to deterioration of their physical condition or because of obsolescence. Being able to identify and record the condition of inventory is critical in enabling the repair, replenishment and disposal of inventory, as well as ensuring that only functional inventory is distributed for use. Identifying obsolete inventory is important to enable prompt disposal leading to reduced storage costs and, potentially, revenue generation. However, limitations in management information and a lack of clarity in Departmental guidance have led to significant weaknesses in the processes for assessing for impairment.
23. The information held in the warehouse data systems suggests that there are significant levels of inventory held at DSDA depots that are unlikely to be used. For example, the warehouse management systems showed that, at the year end, some 47% of non-explosive inventory at depots, was recorded in a condition which prevented the immediate issue of the item. This can occur, for example, for items which have been returned by units and are awaiting assessment of its condition. Concern over levels of inventory and its condition has already led to the setting up of one project (Project Hercules) which is reviewing the potential to rationalise holdings of Tornado spares. The Department is also looking to improve monitoring of inventory condition through the development of Inventory Plans for Project Teams.

Inability to fully reconcile warehouse system records with accounting systems

24. The Department's stock systems are highly complex because of the number of different lines of stock and locations at which they are held. There are a number of different systems and applications ranging from complex applications to spreadsheet tools. Over recent years, the Department has reduced the number of applications and separate systems and it sees more rationalisation as important to achieve greater coherence.
25. There are a number of processes for reconciling inventory recorded on warehouse systems through "accounting systems" to the financial statements and the Department has made some improvements to the procedures in 2009-10. However, significant weaknesses remain. For instance, some reconciliations were not completed in 2009-10 and others were replaced by "comparison exercises" that result in only limited detection and correction of error. For two key systems this comparison work showed there were significant discrepancies between systems.

Recommendations for further action

26. I welcome the way in which the Department has responded to my previous recommendations, but the new processes will take some time to result in the changes necessary to support accurate data for inclusion within the financial statements. Since I am required to audit the accounts as presented for my audit in 2009-10 the Department cannot at this time provide me with sufficient information to prevent a limitation in the scope of my audit.
27. Further improvements are therefore required and I make the following recommendations:
- increased standardisation of processes and systems across DSDA sites and between individual warehouses to spread best practice;
 - DSDA should review its checking and monitoring procedures (including checks for completeness) with a view to making them more robust;
 - better management information and clearer instructions should be provided to ensure inventory is assessed for impairment; and
 - improving the reconciliation process between the various systems to support properly the financial statements.

Military equipment

28. Last year, I also reported on the challenges facing the Department in maintaining adequate records for military equipment such as vehicles, grouped assets and Bowman radios. Since my prior year Report, the Department has made a number of improvements to its processes. In particular vehicle numbers reported by the MERLIN census are better supported so that I have removed my limitation of scope in this area. However, the level of control exercised by the Department is not yet sufficient to enable me to provide an opinion on assets reported via the MAESTRO census or a significant number of Bowman radios.

Vehicles and grouped assets

29. Information on managed equipment assets is input to the fixed asset registers using data fed from a number of subsidiary systems, including the MERLIN system for wheeled and tracked vehicles and MAESTRO for grouped assets such as firearms.
30. The Department performs a census each year for each major category of assets to provide assurance that the assets recorded on MERLIN and MAESTRO can be physically verified and that assets held at Units are captured on the systems. The Department conducts the census by issuing returns to asset “custodians” who check the location and condition of the assets.
31. Last year I reported that the census exercises had delivered lower return rates than previous years. Additionally, the returns that had been received had revealed high levels of discrepancies. Since last year’s report, the Department has sought to improve the census results by, for instance, raising the profile of the census exercises and completing them earlier.
32. On the MERLIN census, my staff found that the census return levels have improved and there are fewer unresolved discrepancies. I am able to conclude that assets recorded on the Merlin system are adequately reflected within the financial statements.
33. On the MAESTRO census my audit found that the census return levels have declined further with only 81 per cent of the census forms being returned. Of the census forms returned almost 38% of line items showed an error. Therefore, the MAESTRO census does not provide adequate assurance over the existence or completeness of the £568 million balance recorded in the fixed asset register and the financial statements.

Bowman communications equipment

34. Bowman is a tactical communications system. I reported last year that the accounting records of Bowman communication equipment were not fully supported, that the 35,800 radio sets then recorded could not be adequately verified and that the number of Bowman assets in service was

uncertain. The net book value of Bowman radio assets recorded in this year's Resource Accounts is £1.4 billion.

35. Locating Bowman communication equipment is always going to be difficult for example due to operational demands, but the weaknesses in the system are not confined to deployed assets. Since last year's report, the Department has continued to address the weaknesses in its systems. It has developed a Bowman Asset Management Improvement Plan (BAMIP) which supports key stakeholders to tackle issues in a co-ordinated manner.
36. By the end of March 2010 the Department had completed the first full Bowman reconciliation. This showed some 44,940 Bowman radios in existence. The Department now has serial number records for the majority of radios, a significant increase on the previous year. A further number of radios are considered 'visible' by the Department based on management estimates though serial number information is not available. The quality of the information supporting the estimates is variable and I consider it to be insufficient for 2,561 radios. There are a further 3,400 radios for which no visibility data is available.
37. As a result of the above, the Department is unable to demonstrate satisfactorily the existence and location of 5,961 (13 per cent) of Bowman radios. At this level some £184 million of assets reported in the Departmental Financial Statements could not be accounted for.

Recommendations for further action

38. Building on the improvements noted above, I make the following recommendations:
 - unless the quality of the MAESTRO census exercise can be improved, the Department should seek to establish an alternative source of assurance. I understand that the Department is currently reviewing how this can best be achieved;
 - in addition to Bowman radios, the Department has other pooled assets and should consider how best to manage and account for these; and
 - the Department should consider whether its current plans will achieve its minimum management information requirements for Bowman assets.

Allowances and expenses paid to service personnel

Limitation on the scope of my opinion

39. I have limited the scope of my opinion in relation to the income from charges for accommodation and food costs. Last year, I also limited the scope of my opinion in this area.
40. In 2007-08, I limited the scope of my opinion due to the inadequacies of the evidence available to support allowances paid to military staff. I qualified my opinion on the 2008-09 accounts due to material error in the calculation of basic pay, allowances and expenses made via the JPA system. The level of error detected in the payment of allowances and expenses in 2009-10, while still significant, is not material and I have therefore not qualified my audit opinion in this regard this year.

The Joint Personnel Administration System

41. The framework of service personnel HR policies, regulation and administration is collectively known as Joint Personnel Administration (JPA). JPA depends on a software package that provides a wide range of processes including the payroll function, centralised records of service and the management of assignments and training. During 2009-10, the JPA payroll system was used to administer around £9.5 billion of staff costs for Service personnel.
42. In my Report on the Department's Resource Accounts for 2008-09, I detailed a number of significant weaknesses in the JPA system, which were undermining its effectiveness in delivering the capability which had been originally intended.

43. In response to my Report, the Department has taken a number of important steps including the establishment of an Assurance and Controls Working Group (ACWG). This Group brings together each of the main parties involved in the military pay process to monitor the Department's progress on recommendations from previous reviews of JPA including my 2008-09 Report.
44. A number of important initiatives have also been introduced during the year, including the correction of data in service personnel records, extended checking of expense claims and improvements in management information.

Basic salaries, specialist pay, allowances and expenses

45. A fundamental aspect of the JPA system is that input is carried out mainly by self-service users and HR clerks both in Units and Manning Branches and is subject to only very limited further checks before payment is made. In addition, Service personnel are able to submit their own expenses claims and payment is normally made without further checks. The Department has a range of detective controls in place but these will not prevent error occurring or detect all errors that have been made.
46. In the absence of adequate input controls over the processing of payments made via the JPA process, my staff carried out testing of a sample of basic salaries, other pay, allowances and expenses. I found no significant error in relation to basic and specialist pay for service personnel. On allowances and expenses, however, I continued to find a significant number of errors relating primarily to incorrect input of data and failure to provide supporting documentation to validate the payment of expense claims as required by Departmental regulations.
47. For allowances and expenses, 11 percent of the transactions tested contained an error in the payment. These errors amounted to some 5.2 per cent by value of the sample. I have therefore concluded that this does not represent material error in the population as a whole. The reduction in the level of likely error from some £145m last year represents a welcome improvement.

Income from charges for accommodation and food costs

48. I have limited the scope of my opinion due to the inadequacy of evidence to support the completeness of income recorded in the accounts at £87 million relating to charges made to personnel.
49. Particular areas were deductions from pay for occupying single service accommodation and for food. Deductions are made from pay based on input into JPA by Units who are also responsible for ensuring credit is given for periods when personnel are not due to make payment, for example if they are away on exercise or deployment. The Department has no means by which it can assess whether the income due is complete and, although work has started to address this weakness going forward, no additional controls have been put in place during 2009-10.

Recommendations for further action

50. The Department is addressing the issues identified in this and my previous Report and has made some good progress. Most significantly, the actions already taken by the Department have reduced the level of error in pay, allowances and expenses due to lack of sufficient evidence sufficiently for me to remove the qualification of my audit opinion in this regard. However the level of error due to misunderstanding or deliberate action remains about the same with 7.5 percent of allowances and 1 in 5 expenses claims being wrong.
51. There remains significant further work to be done to ensure that a robust control environment is established and that processes are sound. In particular:
 - the Department should continue to work to increase the quality of the data being input into the JPA system;
 - management information should continue to be improved; and
 - the Department should consider how JPA will be used and updated going forward.

Votes A -approved maximum numbers of personnel

52. Votes A for the Ministry of Defence is presented annually to Parliament to seek statutory authority for the maximum numbers of personnel to be maintained by the Armed Forces. Note 36 to these accounts discloses the numbers authorised by a vote by Parliament and the maximum numbers maintained during 2009-10 for the Army, Royal Navy and Royal Air Force in all active and reserve categories.

Qualified audit opinion

53. As was also the case in 2008-09, I was unable to obtain sufficient evidence to support the accuracy of certain categories of Service personnel numbers reported to Parliament to enable me to report to Parliament whether or not the approved Estimates (Votes A) have been exceeded. The Army has been unable to provide the maximum number of Service Reserves. Whilst the Royal Navy has been able to provide maximum numbers for the Royal Fleet Reserve (Navy and Marines), the Royal Naval Reserve and the Royal Marines Reserve, it has been unable to provide evidence to support the maximum number of the Royal Naval Reserve "List 7".