

Report of the Comptroller and Auditor General on the 2010-11 Accounts of the Ministry of Defence

Introduction

1. The Ministry of Defence (the Department) Annual Accounts for 2010-11 report a net operating cost of some £47.1 billion and assets of some £127.9 billion mainly consisting of land, buildings, fighting equipment and stores together with gross liabilities of some £21.3 billion.
2. Since my last report the Department has announced the results of the Strategic Defence and Security Review (SDSR) and its Comprehensive Spending Review (CSR) settlement. These announcements have led to decisions about the future of major defence platforms, including the cessation of the Nimrod project and the retirement of the Harrier fleet. As presented in the financial statements, these decisions have had a significant impact on the Department's financial performance and position. The Department has recognised in the Statement on Internal Control that a significant gap remains between the anticipated cost of the Defence Programme, and the likely available funding; prior to the SDSR the funding gap through to 2020 was quantified as £38bn. The Department is undertaking exercises to significantly reduce the scale of the deficit, but recognises the uncertainty and challenge of addressing this gap.
3. In this context, decisions may be required which give rise to further significant cancellations of capital projects or withdrawal from service of existing asset platforms. The financial statements have been prepared using the historic cost convention modified for the revaluation of non-current assets, this presumes that the value of assets will be realised through continuing use. While I consider this to remain an appropriate basis for the Statement of Financial Position at 31 March 2011, the valuation of these assets could be significantly lower if the Department was unable to fund its continued use of assets or the existing equipment programmes to completion.
4. While the Department has made some progress in addressing the issues raised in my previous reports on the accounts much of this progress has been the result of labour intensive manual processes. Following the SDSR, the Department has commenced a programme of redundancies for both civilian and military personnel, without substantial improvement in existing systems progress might not be sustainable.

The purpose of my report

5. This Report explains the basis for the qualification of my audit opinion on the 2010-11 Annual Accounts and provides an update on the actions taken by the Department to address the issues identified in my Report on the 2009-10 Annual Accounts¹.

My obligations as Auditor

6. Under the Government, Resources and Accounts Act 2000 (the Act) I am required to examine and certify the financial statements of all central government Departments. 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 Annual Accounts have been applied to the purposes intended by Parliament and conform to the authorities that govern them.
7. 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 35 to the accounts discloses the number voted by Parliament and the maximum numbers maintained during

¹ HC 258 2009-10 Ministry of Defence Annual Report and Accounts 2009-10

2010-11 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 as adapted or interpreted for the public sector context by the Government Financial Reporting Manual (FReM), and a limitation of scope due to the inadequacy of evidence to support certain expenditure and balances in the financial statements.

Accounting for lease-type arrangements

Qualified audit opinion

8. I have qualified my opinion for a second year 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 (FReM). Since 2009-10 the FReM has required the adoption of International Financial Reporting Standards (IFRS) by UK central government bodies. IFRS² requires preparers of accounts to establish whether lease-type contracts are in substance a lease, and then to consider whether these contracts have the characteristics of either a finance or operating lease. These decisions have a significant impact on the financial statements because if the contract is classified as a finance lease then, rather than simply recording contract expenditure as it is incurred in year in the Statement of Comprehensive Net Expenditure (SoCNE), the valuation of assets used to deliver the service would be recognised in the Statement of Financial Position (SoFP) alongside a liability for the minimum lease payments due under the contract.
10. While these considerations have not had a material impact in many other areas of the public sector they are of particular relevance to the Ministry of Defence. It necessarily enters into strategic arrangements with key contractors to procure specialist defence platforms on a non-competitive basis, for example in relation to surface ships, submarines and aircraft. These arrangements may provide for the exclusive, or near exclusive use of industrial assets and capability which have only limited utility to other customers. Consequently, the contractual terms, which are covered by the Government Profit Formula and its Associated Arrangements (GPFAA)³, may give rise to the Department controlling the significant majority of the outputs of the supplier's assets involved in the arrangement. For example, where shipyards are used exclusively on defence contracts and the pricing of the contract recognises this by allowing recovery of fixed costs other than through market rate or unit cost pricing. As such, these arrangements may be considered to contain a lease under IFRS, and may have the characteristics of a finance lease.

Action by the Department

11. As part of the work undertaken in 2009-10 when it first adopted IFRS, the Department assessed its Private Finance Initiatives and Public Private Partnership contracts against the revised accounting requirements but it did not carry out this assessment for other contractual arrangements. Based on the results of its work, the Department believes that there may be a number of its contracts which would require disclosure as leases, including as finance leases (notes 1.49-1.50). Given the potential

²The 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)*

³ The GPFAA, also commonly referred to as the Yellow Book, is agreed by Government and industry, as represented by the CBI, and is subject to periodic review by an independent review board.

number and size of the contracts involved, there is likely to be material understatement of the assets and liabilities recognised in its financial statements.

12. Last year the Department undertook to account for new contracts, entered into from 2010-11, with a view to achieving full compliance with accounting requirements over time. Following the announcements in the SDSR and the potential impact on existing contracts and the supplier base, the Department has now put on hold further work to achieve compliance until contract renegotiations have been completed.
13. The Department does not currently have the information to measure the value of the assets and liabilities associated with these arrangements in order to comply with reporting requirements. In my opinion if this information were available and presented in the financial statements the consequences of a potential decision to exit or scale back a finance lease type arrangement would be more transparent to the reader of the accounts, for example the loss of asset utility would be disclosed as an impairment cost.

Recommendations for further action

14. I continue to 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. This work should be undertaken as contract renegotiations complete.

Non-current assets and inventory

Limitation on the scope of my opinion

15. I have limited the scope of my opinion in relation to certain non-current and inventory assets recorded within the Statement of Financial Position. The limitation arises due to the Department being unable to provide me with sufficient evidence to support:
 - the accounting for military equipment in the form of BOWMAN radios (£0.1bn);
 - the accounting for certain inventory and capital spares⁴ (£5.2bn); and
 - the valuation of a further unquantifiable amount of inventory and capital spares, where the associated asset platforms have been taken out of service, and for which inadequate assessment of impairment has been made.
16. The scope of my opinion on the 2009-10 and 2008-09 accounts was also limited in relation to weaknesses in the controls over inventory and the evidence to support the valuation and existence of assets. However, due to improvements in the Department's asset verification exercises, I am no longer limiting the scope of my opinion in respect of certain grouped military equipment assets (£0.6bn).

Bowman radios

17. Bowman is a tactical communications system, with an overall net book value of £1.52bn. Locating Bowman communication equipment represents a challenge for the Department. This is due to the different tracking systems used at different locations where radios are used, and as a consequence of the underlying tracking data relying on manual processes and inputs. Furthermore, the individual assets move around more rapidly, for example between military units, the repair loop and operations.
18. My audit found that of the 50,893 radio sets recorded on the system (an increase of 5,961 on 2009-10), the Department could only provide supporting evidence in the form of serial numbers and location data for 37,645. The Department uses estimates based on other alternative forms of evidence to support the existence of the remaining radios, and due to improvements in the quality of

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

some of these estimates I have been able to review evidence to support a further 9,155 radios. However, the department was unable to provide any suitable evidence to support the existence of 4,093 radios. Currently only 74 per cent of radios are recorded by serial number, the Department does not therefore have sufficient processes in place to monitor and control these assets.

19. In forming my opinion I have excluded the value of those radios where there was either insufficient evidence to support existence, or where I considered the estimates used to support the probable existence to be inadequate for the purposes of my opinion. I estimate that there is inadequate evidence to support around £125 million (2009-10 £184m) of Bowman radios held on the SoFP, and I have therefore excluded these from the scope of my audit opinion.

Recommendations for further action

20. In order to address the weaknesses highlighted by my audit the Department should ensure that sufficient focused effort is given to addressing the underlying problems, in particular the Department should:
- improve the robustness of the quarterly Bowman reconciliations, focusing on the quality of data input to inventory management systems by users; and
 - ensure that any future IT solutions are matched with appropriate processes to accurately record all radios by serial number.

Inventory and Capital Spares

21. I reported last year that certain key controls over inventory were ineffective and that discrepancies between inventory counts and warehouse management records at the main Joint Support Chain Services (JSCS) non explosives depots did not form a reliable basis for quantifying the value of inventory held on the SoFP.
22. Following my reports, the Department's Materiel and Financial Accounting Project Board and JSCS agreed a strategy to address inventory control weaknesses; the Department is only two years into the implementation of this strategy which has included:
- focusing effort towards higher value warehouses and inventory items;
 - initiating an additional programme of location checks, with the aim of significantly reducing the levels of inventory omitted from warehouse system records; and
 - approved new IT solutions which will aim to reduce the risk of error and improve the efficiency of stock management.

The Department considers that from 2014 these new systems will begin to impact on the underlying inventory system weaknesses.

23. While some progress has been made a number of significant issues will remain until the strategy is fully implemented. Consequently the Department remains unable to provide sufficient evidence to adequately support inventory and capital spares balances within the financial statements, giving rise to my scope limitation. The main areas of weaknesses relate to:
- discrepancies between inventory counts and warehouse management records;
 - inadequate impairment of inventory and capital spares; and
 - unreconciled differences between the warehouse system records and the accounting system.

Discrepancies between inventory counts and warehouse management records

Completeness of inventory

24. The sample testing carried out by my staff to verify warehouse records against inventory on the shelf identified significant levels of inventory that were not recorded on the warehouse system. Due to the level and 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, or to assess the consequent impact on the SoFP and the SoCNE.

25. Following my previous recommendation that the Department should improve its completeness checks an enhanced process of location checks was undertaken during the year, covering the three main non-explosives depots. Following this exercise error levels of this type have reduced slightly when compared with 2009-10. However my audit testing identified an average of 7 per cent of items tested which were not recorded in warehouse systems. Where items are not recorded on warehouse systems their value cannot be captured in the financial records, and this error rate continues to lead me to limit the scope of my audit opinion.

Existence of inventory

26. The testing carried out by my staff to verify warehouse records to physical inventory holdings has identified a reduction in existence error rates when compared to last year. Higher value inventory items were significantly more accurate, reflecting the focus of JSCS's efforts. Although the level of inaccuracy remains high by location (16%) the results of my testing indicate that the level of inaccuracy by value is in the region of £17 million, and I consider that this level of net error is sufficient to support evidence of existence.

Inadequate assessment of impairment of inventory and capital spares

27. My audit considered how the Department assesses its inventory and capital spares holdings to ensure that the appropriate value is reflected in its accounts and that adequate assessment of impairment has been made. 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 for operational reasons 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 also important in reducing storage costs.
28. I have previously reported limitations in management information and a lack of clarity in Departmental guidance for assessing impairment. Following my recommendations the Department has undertaken a number of initiatives to improve the processes it operates to assess impairment. The Department conducted a centralised sample review of slow-moving inventory lines, representing some 25 per cent of total non-explosive inventory, resulting in a net write down of £325m. The Department plans to undertake further work in future years, recognising that impairment assessment is not systematically or routinely undertaken.
29. Information held in the warehouse data systems indicates that there are significant levels of inventory held at JSCS depots that are unlikely to be used. For example, the warehouse management systems showed that, at the year end, some 44 per cent by value of non-explosive inventory at depots was recorded in a condition which prevented immediate issue. This has led me to limit the scope of my opinion over the valuation of the £5.2bn of inventory and capital spares held in these depots (2009-10: £5.4bn).
30. Following decisions taken in the SDSR to take certain asset platforms out of service, the Department has not fully assessed the impact, through impairment review, on the utility of the associated inventory and capital spares. A review of these assets may have given rise to the impairment of assets currently valued in the SoFP. This has led me to further limit the scope of my opinion, but due to the lack of information I am unable to quantify the value of inventory and capital spares that might be affected.

Inability to fully reconcile warehouse system records with accounting systems

31. The Department remains unable to perform a full reconciliation between the financial accounting and warehouse systems, although some progress has been made. The Department continues to run a large number of legacy warehousing systems which are difficult to integrate due to age and incompatibility. The Department plans a long-term solution of fewer host systems, coupled with improved processes. The investment in the new Base Inventory Management Systems (BIMS) is

underway and the Department expects it to be delivered in 2014, and that this will rationalise the reconciliation process.

32. Despite progress there remains a high level of unexplained discrepancy, particularly in respect of two key system interfaces where I am unable to obtain assurance that information passes with sufficient accuracy from warehouse to accounting systems. Had I not already limited the scope of my opinion these reconciliation deficiencies would represent a significant limitation in the evidence available to me. It should remain a key focus for the Department to reconcile the financial systems to the underlying accounting records held on inventory systems.

Recommendations for further action

33. I welcome the way in which the Department has responded to my previous recommendations and acknowledge that it has adopted a strategy to address these issues over a number of years. However, further improvements are required:
- JSCS should revisit and improve its procedures for shelf to system checks to drive down the level of stocks not recorded;
 - further develop and escalate the initiatives to ensure inventory is assessed for impairment, particularly in light of the SDSR impacts;
 - continue to develop the present initiatives to improve the reconciliation process between the various inventory systems to support the financial statements; and
 - as the current process weaknesses are addressed in the short-term it is important that the Department designs more efficient and effective processes to operate with the planned new IT systems.

Progress on previous areas of qualification

Grouped military equipment assets

34. Last year I reported on the challenges facing the Department in maintaining adequate records for grouped military equipment assets, MAESTRO, with a value of £0.6bn. For the last two years I have reported weaknesses in the MAESTRO census, which verifies existence and condition of these assets. Last year this exercise delivered low return rates of around 83 per cent and identified high levels of discrepancies, resulting in limitation in the scope of my opinion. Following my previous report the Department has sought to improve the MAESTRO census results by raising the profile of the census exercise; completing it earlier; and putting a greater premium in resolving discrepancies identified through the census.
35. The census return levels for 2010-11 have improved to over 92 per cent and the Department identified fewer discrepancies; resulting in only £55m of assets having insufficient evidence to support existence. The results of this exercise are now sufficient to provide me with evidence for the purposes of providing an opinion on these balances.

Single living accommodation and food charges income from service personnel

36. In 2009-10, I 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.
37. During 2010-11 more detailed analysis has been carried out by the Department which provides sufficient assurance that the income from charges made to personnel is complete in all material respects. I have, therefore, not limited the scope of my opinion in this regard this year. The Department plans to introduce monthly checks at unit level, this will enhance the assurance which the Department has to ensure the completeness of charges made to personnel. However, the Department will need to ensure that it establishes mechanisms to collate the results of these reviews.

Votes A - approved maximum numbers of personnel

38. In 2008-09 and 2009-10, I was unable to obtain sufficient evidence to support the accuracy of certain categories of service personnel numbers reported to Parliament; I was therefore unable to report whether or not the approved estimates (Votes A) had been exceeded in respect of the Reserve Land Forces and the Royal Naval Reserve List 7.
39. During 2010-11 the Department has undertaken a data cleansing exercise on the Joint Personnel Administration system used to collate this information. My audit procedures have confirmed that this now provides a reliable basis to support service personnel numbers reported to Parliament in respect of all categories. I have, therefore, not qualified my audit opinion in this regard this year.

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