

Report of the Comptroller and Auditor General on the 2011-12 Accounts of the Ministry of Defence

Introduction

1. The principal activity of the Ministry of Defence (the Department) is to deliver security for the people of the United Kingdom and the Overseas Territories by defending them, including against terrorism, and to act as a force for good by strengthening international peace and stability. In 2011-12 the Departmental Group was responsible for £38.9 billion of net operating costs and assets of some £132.6 billion mainly consisting of land, buildings, fighting equipment and stores, together with gross liabilities of some £21.8 billion.
2. The Department is required to prepare its financial statements in accordance with the Government Financial Reporting Manual (FReM). Under the FReM, the Department is required to apply International Financial Reporting Standards (IFRS) as adapted or interpreted for the public sector.

The purpose of my report

3. This Report explains the basis for the qualification of my audit opinion on the Department's 2011-12 financial statements. This report also provides an update on the actions taken by the Department to address the issues identified in my Report on the 2010-11 Annual Report and Accounts¹.

Accounting for lease-type arrangements

4. I have qualified my opinion for a third year because the Department has not complied with the required accounting treatment for leases in International Financial Reporting Standards (IFRS) 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

5. 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 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.
6. The accounting requirements for lease type arrangements are particularly relevant to the Department. It necessarily enters into strategic arrangements with certain contractors to procure specialist defence platforms on a non-competitive basis, for example in relation to surface ships,

¹ HC 992 2010-11 Ministry of Defence Annual Report and Accounts 2010-11

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 \(IAS 17\)](#)

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

7. 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 22-23). Given the potential number and size of the contracts involved, there is likely to be material understatement of the assets and liabilities recognised in its financial statements.
8. Since the Strategic Defence Review in 2010, the Department has been in the process of renegotiating its contracts with its principal industrial suppliers. The Department has put on hold any further work necessary to comply with the accounting requirements for lease type arrangements until those renegotiations are complete. As noted in the management commentary of the 2011-12 Annual Report and Accounts, the Department has now committed to completing an initial review by September 2013, by supplier and contract, of the industrial facilities to which IFRIC 4 is likely to apply. This review will consider the potential resources and timescales required to achieve compliance.
9. 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 the financial reporting requirements. In my view, if this information were available and presented in the financial statements the consequences of any 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.

Non-current assets and inventory

Limitation on the scope of my opinion

10. I have limited the scope of my opinion in relation to certain non-current assets recorded within the SoFP, in the form of capital spares (£7 billion) and inventory (£3 billion). The limitation arises as a result of the Department having inadequate processes to assess the impact of impairment of non-current asset capital spares and the valuation of current asset inventories in the form of raw materials and consumables. Due to the lack of a systematic assessment the Department has been unable to provide me with sufficient evidence to support the valuation of these balances.

Accounting requirements

11. Both current and non-current assets can become impaired, most usually due to deterioration of their physical condition, because of obsolescence or simply because they have no further use. This

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.

can also include holding stock which is surplus to future business requirements and which no longer has value to the business.

12. IFRS requires that assets are reviewed on an annual basis to consider the impact of impairment on the valuations held on the Statement of Financial Position. Under IAS 36 '*Impairment of an Asset*' any non-current asset which is held at an amount in excess of its fair value or use to the business must be subject to an impairment assessment with the loss in value charged to the SoCNE. IAS 2 requires current assets in the form of raw materials and consumables to be valued at the lower of cost and net realisable value. Consequently the Department needs to assess the level of stock held and its on-going value to its business. Without such assessment there is the potential for asset values to be overstated, and for an understatement of expenditure in the SoCNE.
13. A systematic impairment assessment will also enable the Department to identify spares and inventory for disposal or repair; this will serve to reduce stock holding costs and critically to help to better inform operational decision making in respect of items available for immediate use.
14. My audit considered how the Department currently 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. As highlighted in my previous Reports on Account 2008-09 to 2010-11 the Department has not undertaken a systematic review of impairment in respect of capital spares and inventory.
15. I have previously reported limitations in management information and a lack of clarity in Departmental guidance for assessing impairment over the last four years. As part of my audit I have noted that the Department's continues to rely on the review of asset holdings undertaken by project teams within Defence Equipment and Support and documented in Annual Inventory Plans. Project teams are responsible for producing and delivering the appropriate actions following review of these plans, which require consideration of inventory and capital spares held in respect of their condition, levels of holding and future business need.
16. As a result of visits to these teams to review Annual Impairment Plans, wider discussions within the Department and the results of my own audit testing I am not satisfied that there has been sufficient consideration of impairment. I do not therefore have a suitable basis on which to consider the impact of impairment in respect of inventory and capital spares. Consequently I am unable to form an opinion on the valuation of these balances or to assess the potential impact which a systematic consideration of impairment might have on the financial statements. There were no alternative audit procedures I could adopt to assess the valuation of these balances.

Action by the Department

17. I have recently published my report on 'Managing the Defence Inventory'⁴ which looks extensively at how the Department might improve its management of inventory and capital spares. In this report I have identified a number of recommendations as to how the Department should adopt a more systematic approach to the rationalisation of its holdings. Delivery against these recommendations would provide a better basis for the Department to consider the impact of impairment.
18. The Department, through the Chief of Defence of Materiel, is finalising an Inventory Strategy to improve the Department's arrangements for managing its inventory. As part of this strategy the Department will establish a systematic impairment review of inventory and capital spares by focusing review activity on specific high value inventory and capital spares, together with a statistical sampling approach for all other holdings. My audit in 2012-13 will review the Department's progress in implementing these arrangements.

⁴ HC 190 2012-13 Managing the Defence Inventory

Recommendations for further action

19. I continue to recommend that the Department delivers against its planned approach to undertake a systematic review of inventory and capital spares against the requirements of IAS 36 and IAS 2, in order to assess the impact of impairment.

Cabinet Office approval for Board member remuneration

Qualification of my regularity opinion

20. Since May 2010 the Cabinet Office in its *Guidance for approval of senior pay*⁵ has required approval of all pay packages for newly appointed Civil Servants who receive remuneration packages in excess of £142,500. In July 2010 the Department obtained outline approval for the basic salary package of the future Chief of Defence Materiel (CDM), on the basis that it would seek approval on finalisation of the package following appointment.
21. As the Department has noted in the Remuneration Report (Page 84) the Department has not yet obtained the required approval for the overall remuneration and benefits package. Consequently I am unable to give an opinion on whether the remuneration of the CDM has exceeded the Department's delegated authorities. As a consequence I have qualified my opinion on regularity in respect of these payments, which I consider to be material in the context of the Remuneration Report.
22. I will review the outcome of the approval process and in respect of the taxable allowances as part of my 2012-13 audit of the Department's Annual Report and Accounts.

Progress on previous areas of qualification

23. I have reported in each of the last three years that certain key controls over inventory were ineffective and that discrepancies between inventory counts and warehouse management records at the main Logistic and Commodity Services (LCS, formerly Joint Support Chain Services) non explosives depots did not form a reliable basis for quantifying the value of inventory held on the SoFP. In response to my previous reports the Department's Materiel and Financial Accounting Programme Board and LCS agreed a strategy to address inventory control weaknesses; the Department is now in the third year of 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 aim to reduce the risk of error and improve the efficiency of stock management.
24. As a result of these efforts I have been able to remove the limitation of scope in respect of my audit opinion in relation to the completeness of non-current asset capital spares, and current asset inventories in respect of their completeness. I have also been able to remove the limitation of scope in respect of BOWMAN radio equipment for which the Department has been able to provide me with sufficient assurance to support the valuation of these items within the Statement of Financial Position.

Completeness of inventory and capital spares

25. Last year I reported that around 7 per cent of items I tested in LCS warehouses were not recorded on the warehouse stock-recording systems, and were not recorded on the SoFP. In advance of the

⁵ Cabinet office - Guidance for approval of senior pay Version 2 - applicable from June 2010

introduction of new systems the Department has made substantial improvements in its stock-checking and recording procedures. Following my previous report the Department has undertaken a major exercise to ensure all stock locations are visited by July 2012 and that all stock is recorded on the warehouse systems. As a consequence of this on-going work my staff have evidenced reductions in error rates between items held on the shelf and warehouse records. The results of my audit work this year have shown that the error rate has now dropped significantly. Together with analysis of the Department's own results, I have now been able to conclude that the inventory system records are materially complete. My opinion is no longer qualified in this respect.

Stock reconciliations

26. In previous years I reported on the difficulties the Department has encountered in reconciling its numerous and aged warehousing systems to its accounting systems. In previous years this has resulted in material discrepancies which the Department has been unable to explain or reconcile. During 2011-12 the Department has deployed significant resource to undertake a quarterly reconciliation across its major warehousing systems. Consequently the Department has significantly reduced the level of discrepancy and gained a better understanding of the underlying reasons for remaining differences. Although work remains to reduce these levels still further, the discrepancy is now low enough to enable me to conclude that there are no material discrepancies between the inventory systems and the financial systems.
27. The Department plans a long-term solution of fewer inventory systems, coupled with improved processes. The investment in the new Base Inventory Warehouse Management Systems (BIWMS) is underway and the Department expects it to begin operating in March 2014 with the replacement of the Air Inventory System. The aspiration is for subsequent roll-out into Land, Maritime and Explosives in 2015 subject to scoping and detailed planning. This will provide a basis for improved stock account management and rationalisation of the reconciliation processes. In the interim, the Department has undertaken to continue the quarterly comparisons with a view to further understanding and reducing any differences between these interfaces. These processes are labour intensive and will require continued resource input to ensure that balances are suitably controlled.

BOWMAN radios

28. I have reported in each of the last three years that the Department was unable to provide sufficient information to enable me to provide an opinion on the account balances relating to BOWMAN radio equipment. The main weakness was that the Department's systems did not effectively track the existence, location and condition of a material proportion of BOWMAN radios, consequently I was unable to verify the value of assets recorded on the Statement of Financial Position.
29. Over the past two years the Department has been upgrading its BOWMAN radios to enhance capability such that all radios operate to the new 'level 5.4' build standard. Any radios not upgraded to this standard will no longer be operational. This upgrade process has provided an opportunity for the Department to cleanse the tracking data held for its BOWMAN radio assets and establish a definitive baseline against which to track and monitor the existence and condition of its radio assets. The upgrade progress was due to complete after the year-end.
30. The Department's balance of £1.343bn is based on 49,730 functioning and verifiable radio sets. This compares with 50,893 radios used as the basis for the Department's valuation of its BOWMAN assets in 2010-11. Having considered the results of the upgrade, and other data available to it the Department has written off 1,163 radio sets this year at a value of £33m (see Note 25.1 to the accounts). The Department has taken this write-off action where it has been unable to verify these radios to the required standard of evidence.

31. My audit found that the Department now has sufficiently reliable data to support the existence of 49,730 functional radios through a mix of direct verification and supportable management estimates. The value includes 41,884 upgraded radios identified by individual serial number at 31 March 2012. My audit directly verified a sample of these serially tracked assets and has undertaken verification procedures to assess the reasonableness of other supporting data in respect of estimates. I am satisfied that the evidence provided now enables me to form an opinion on these balances.
32. In response to my observations the Department has developed a plan to ensure all BOWMAN radios will be tracked individually within the future logistic systems and to depart from the use of management estimates to support these balances in the accounts. This should provide more robust data to track the location of specific radio assets for both accounting and operational purposes.
33. However, the Department remains some way from achieving its stated aim of tracking all radios electronically via their serial number. Around 84 per cent of assets were serially tracked and recorded on electronic systems at the time of my audit. Further effort will be required to improve this rate of capture on data systems. Should management be unable to achieve its aims in gathering this data electronically it will need to ensure that it is able to maintain the current level of support for its estimates, without which the Department would lack the necessary evidence on which I can form an opinion.

Other matters

34. In my last report I noted that the Department was continuing to work to reduce the gap between the anticipated cost of the Defence Programme, and the likely available future funding which had previously been quantified as £38bn. Since then the Secretary of State has announced that, and as referenced in the Introduction by the Chief of Defence Staff and Permanent Secretary (Page 7), this gap has been closed. I have been invited by the Department to provide my view on the affordability of the Department's Equipment Plan, and I plan to publish this in the winter.
35. The Department has also made progress in addressing the qualification issues raised in my previous Reports on the Accounts. Much of this progress continues to be the result of labour intensive manual processes. With the impact of staff redundancies now being felt it is important that the longer term investment in systems and controls is delivered to allow the sustainment of these improvements.

Amyas C E Morse
Comptroller and Auditor General

3 December 2012

National Audit Office
157-197 Buckingham Palace Road
Victoria
London SW1W 9SP