Report of the Comptroller and Auditor General on the 2012-13 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 2012-13 the Departmental Group was responsible for £37.7 billion of net operating costs and assets of some £133.0 billion mainly consisting of land, buildings, fighting equipment and stores, together with gross liabilities of some £21.6 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 2012-13 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 2011-12 Annual Report and Accounts[1].

Accounting for the impairment to the value of the Germany Estate

4. I have qualified my opinion on the financial statements as I disagree with the accounting treatment adopted in respect of the part of the impairment to the Department's German Estate which has been charged against the revaluation reserve. Applying the accounting treatment which I consider to be appropriate and consistent with the Government Financial Reporting Manual (the FReM) would have resulted in an increase in net operating costs of £907m for 2012-13.

Background

5. In March 2013, the Defence Secretary made a Statement to Parliament announcing the Regular Army Basing Plan which set out plans for the Army's move back to the UK from Germany. Part of the Department's overseas estate includes garrisons and training facilities in Germany which, following the announcement, the Department will hand back on a phased basis. Therefore, the Department has impaired the value of land by £638 million to £170 million and buildings by £866 million to £313 million, a total impairment of £1,504 million. This reflects the fact that the previous valuation was based on the continued use of the estate beyond the drawdown timetable announced to Parliament.

Accounting requirements

6. The Department is required to prepare its accounts in accordance with the Financial Reporting Manual (the FReM). The FReM requires that the impairment of assets arising from a loss of service potential or economic value is recorded in net operating costs. The Department considers that the impairment is not the result of a loss of service potential as the policy announcement has not affected the asset values or their future capability because the assets could be used beyond 2019 if considered necessary. Consequently the Department has charged £907 million of the impairment to the revaluation reserve, which was the full balance on this reserve, with no impact on net operating costs. The remaining impairment of £597 million has been charged to net operating cost. The Department sought the view of and received

[1] HC 62 2012-13 Ministry of Defence Annual Report and Accounts 2011-12

endorsement from HM Treasury's Group Financial Reporting Team in reaching its conclusion over the accounting treatment applied.

7. I have considered the Department's views and the advice provided by HM Treasury's Group Financial Reporting Team. However, in my opinion there has been a loss of service potential in respect of these assets. The Department plans to use these assets for a substantially shorter period than anticipated in its most recent revaluation. While the assets could be used for a period beyond 2019 if necessary, I consider it reasonable to assume that the policy announced to Parliament will be implemented and that the consequent loss of service potential should be reflected in the accounting treatment.

8. Consequently, I am of the opinion that the full value of the impairment should be charged to net operating costs, with a transfer of £907 million from the revaluation to the general reserve. If this treatment were adopted, the Department's net operating costs for 2012-13 would increase by £907 million to £38,611 million.

Implications on Statement on Parliamentary Supply

9. The expenditure of government departments is authorised by Acts of Parliament, which set annual limits on the net expenditure which the Department may not exceed. Departments have separate limits for expenditure recorded as Annually Managed Expenditure (AME) and Departmental Expenditure Limits (DEL). Had this impairment been treated in the manner I consider appropriate the £907million increase in net operating cost would have resulted in an increase in Net Resource Outturn of the same amount.

10. Under the Consolidated Budgeting Guidance impairments are charged against either Resource DEL or AME based on certain criteria and by agreement with HM Treasury. As disclosed in the financial statements, the Department has charged £597 million to net operating costs as a result of the impairment, and these costs have been recorded under AME in the Statement of Parliamentary Supply.

11. The Department considers it is appropriate to charge £907 million to the revaluation reserve. Consequently it has not indicated the budgeting treatment that would have been adopted if the full impairment was charged to net operating costs. Were the Department to charge the full amount to net operating costs, as I consider it is required to do under the FReM, and if the expenditure charged to the revaluation reserve was treated in a consistent manner with the elements charged to AME, the Department would have exceeded the AME limit set by Parliament by £395 million. I have therefore qualified my opinion on regularity as I consider the Department would have exceeded the resources voted to it by Parliament if this transaction had been accounted for correctly.

Accounting for lease-type arrangements

12. I have qualified my opinion for a fourth year because the Department has not complied with the required accounting treatment for leases in International Financial Reporting Standards (IFRS) and is therefore likely to have omitted a material value of lease 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

13. 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. IFRS[2] requires preparers of accounts to establish whether lease-type contracts are in substance either a finance or operating lease. These decisions could have a significant impact on the financial statements because if the contract is classified as a finance lease then, rather than recording contract spend as capital or revenue expenditure as it is incurred, the value 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.

14. 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, 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

15. 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 the assessments performed at the time of IFRS adoption the Department believed that there may be a number of its contracts which would require disclosure as leases. Given the potential number and size of the contracts identified from the Department's initial review, I concluded that the impact of the non-compliance would be likely to give rise to material omissions in its financial statements.

16. Since I last reported the Department has conducted a review of its contracts to identify those which have characteristics indicating that they contain lease type arrangements not currently recognised as leases. Through that review the Department has identified 27 contracts which they consider require a detailed assessment against the standards. The Department has committed to completing an assessment of all of these contracts, and for a small sample of these contracts, obtaining the necessary information and calculating the accounting entries required to comply with accounting standards by September 2013. Based on the results of this exercise, including the cost and time involved, the Department will consider whether to extend compliance to all relevant contracts.

17. Although progress is being made to address this issue the Department did not have the necessary information at 31 March 2013 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.

[2]The 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.

Non-current assets and inventory

Limitation on the scope of my opinion

18. I have limited the scope of my opinion in relation to certain non-current assets recorded within the SoFP, in the form of non-current asset capital spares (£7.2 billion) and inventory (£3.3 billion). The limitation arises as a result of the Department having an insufficiently robust and systematic process to assess impairment and the consequent impact on the valuation of these assets. 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 and the associated accounting entries which have been made in the accounts.

19. I have qualified my opinion for the past four years over the valuation of inventory. In June 2012 I also published a Value for Money Report 'Managing the Defence Inventory' in which I set out some of the wider issues and difficulties the Department was facing in managing its inventory and rationalising its holdings. In its responses to the House of Commons Defence Select Committee the Department has stated that it considered the problems to be deep rooted and complex and that it would require significant changes to business processes and the upgrade and replacement of many legacy systems over several years to enable it to provide a full resolution to the issues which give rise to my qualification.

20. My audit of these financial statements, again, 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.

21. During the year the Department established an exercise to systematically review stock-lines which represented the most significant elements of the Capital Spares and Inventory balances. The exercise required a review of each stock line for impairment against criteria set out in centrally issued guidance. The Department estimated that by covering the top 1% of stock-lines they would cover around 75% of their total reported inventory balance of £15bn and that a portion of other balances would also be assessed to provide a suitable analysis on which management could draw conclusions over the remainder. The exercise represented a significant commitment by the Department to address my previous recommendations and to write down the relevant assets to their fair value.

22. The results of my audit have led me to conclude that the process is not yet sufficiently robust to provide management with the necessary assurance over the valuation of capital spares and inventory because:

    - The impairment review was not systematically performed in line with the Department's plans and did not evidence the coverage of the top 1 per cent of stock-lines. From my audit of a sample of assessments I found that not all aspects of impairment had been adequately considered. In addition, a large number of stock-lines within the scope of the exercise had not been reviewed.
    - There was an insufficiently robust management review of the work performed by project teams which meant that the process was applied inconsistently. Consequently I was unable to confirm the coverage or that all aspects of impairment had been sufficiently considered; and
    - I was unable to determine the total level of impairment action that has been reflected in the accounting records as a result of the exercise. This was a result of inadequate central collation of the exercise; and a lack of clarity in the accounting guidance and account code structures to record the impairment activity.

23. Some Project Teams carried out separate reviews of elements of their holdings and posted adjustments. I audited impairments made during 2012-13 as a result of the 1 per cent exercise and ad hoc adjustments that contributed to a reduction of over £355m to the year-end balances. Unfortunately the accounting entries were not consistently posted and have highlighted that the need for clearer guidance and an improved account code structure. For example, the information presented for impairments in Note 11 records a net value of £85m.

24. I am therefore unable to conclude on the appropriateness of the valuation of capital spares and inventory, nor on the completeness of impairment charges recorded in the 2012-13 financial statements.

Recommendations for further action

25. As a result of work in 2012-13 the Department is in a stronger position than previous years. Firstly, the Department has made strides in disposing of much of the inventory previously identified as obsolete or surplus. Secondly, the Department can learn lessons from the 1% exercise and to facilitate a more consistent application in 2013-14 supported by improved guidance and training.

26. The Department remains hampered by legacy warehouse and inventory systems which necessitate a high level of manual intervention to ensure data integrity, both within the inventory systems and the general ledger; this is data that Project Teams require to effectively manage their inventory holdings. The roll-out of new systems in 2012-13 is allowing some greater visibility of deployed stockholdings, although a number of issues related to this roll-out required significant manual intervention to address data transfer issues. I understand that the Department is reflecting on these issues in the context of the planned inventory solutions.

27. I support the Department's commitment to improve its processes for adequately assessing the valuation of its non-current asset Capital Spares and Inventory balances through the establishment of a systematic impairment review process to meet the requirements of IAS 36[4] and IAS 2[5]. This will evidence that impairment actions are systematically considered and applied and; that appropriate accounting entries and disclosures are supported by an adequate audit trail. In order for the Department to achieve this it should:

    - Revise its internal guidance and accounting policy, building on the feedback from my review of its application in 2012-13. It should ensure that the process is consistently and systematically applied and that inventory managers and finance staff involved with the management of non-current assets are sufficiently skilled to identify and account for impairment to meet the requirements of the policy;
    - Ensure all significant non-current assets and inventory balances come within the scope of the review process, including assets held in industry and off-system;
    - Amend the resource account code structure to ensure that impairment actions can be properly reflected in the accounting record in a way which will provide the necessary level of information to support accounting disclosures and the associated SoCNE and SoFP impacts;
    - Strengthen the process to provide central oversight and to collate the outcomes from the impairment reviews across the non-current asset balances, to enable management to assess the adequacy of the level of coverage and the accuracy and support for the associated adjustments; and
    - Establish a process to provide assurance to management on the implementation and application of these processes in advance of my audit in 2013-14.

Qualified Opinion on Votes A – Excess Vote on Royal Navy Special Reserves Category

28. Votes A provides the formal mechanism by which Parliament sets limits for the maximum numbers of personnel retained for service in the Armed Forces. They are presented to the House for approval shortly before the start of each financial year (late February), and form part of the Parliamentary Supply process.

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[4] International Accounting Standard 36: *Impairment of Assets* (IAS 36)
[5] International Accounting Standard 2: *Inventories* (IAS 2)

29. The Special Members of the Reserve Naval Forces category should include personnel who have sponsored reserve status i.e. civilians who are temporarily classed as military to enable them to carry out their duties. Some Royal Fleet Auxiliary personnel fall into this category but the Department identified that the actual figures reported have not previously included them. Their inclusion results in the voted maxima for Officers in this category being exceeded by 50, and in aggregate the total for these reserves was exceeded by 10 in respect of the month of April 2012. The maximum numbers retained within the Reserve was 1,950 against a voted limit of 1,940 (as shown in Annex G). The Department has identified that similar breaches have occurred since 2007-08 as a result of the omission of Royal Fleet Auxiliary personnel.

30. The failure to include all eligible reserve personnel in the calculation of maximum numbers represents a weakness in the monitoring controls in respect of Votes A, although the small number of personnel exceeded represents only a very small proportion of the overall number of military personnel maintained.

31. My opinion is limited to providing a statement to certify whether the approvals for military personnel have been exceeded. I have therefore qualified my opinion to reflect that the number of Royal Navy Special Reserve Personnel approved in the Estimates has been exceeded.

Recommendations for further action

32. The Department should consider the level at which Parliament requires Votes A categories to be reported in the audited Annual Reports and Accounts, and whether there is scope for reporting at a higher aggregate level.

Progress on previous areas of qualification

Cabinet Office approval for Board member remuneration

33. For 2011-12 I qualified my regularity opinion on the grounds that the Department had not obtained the required approval for the overall remuneration and benefits for the Chief of Defence Materiel (CDM). As noted in the Remuneration Report (Page 76), the Department has now withdrawn its request for the approval of the accommodation allowance element of the remuneration package and CDM has agreed to repay the allowance received since 1 April 2012. The Department has not sought to recover the allowance paid prior to that date (£10k net of tax); the gross amount has been written off as a loss.

34. I have confirmed that the Department has now obtained the required approvals for the full remuneration package of the Chief of Defence Materiel for 2012-13.

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