

REPORT OF COMPTROLLER AND AUDITOR GENERAL ON THE 2013-14 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 2013-14 the Departmental Group incurred £37.5 billion of net operating costs and held assets of £129.7 billion and gross liabilities of £ 20.7 billion.
2. The Department is required to prepare its financial statements in accordance with the Government Financial Reporting Manual (FReM) issued by HM Treasury. 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 2013-14 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 2012-13 Annual Report and Accounts¹ and follow up on the previous recommendations made in this area in earlier years.

Accounting for lease type arrangements

Basis of my qualification

4. I have qualified my opinion for a fifth year because the Department is likely to have omitted a material value of leased assets and associated 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. The FReM requires preparers of accounts to comply with International Accounting Standard (IAS) 17, Leases, to establish whether contracts contain lease-type arrangements and whether those are, in substance, either a finance or operating lease. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. An operating lease is any other type of lease. The classification made by preparers of accounts could have a significant impact on the financial statements.
6. If the contract is classified as a finance lease then the value of assets used to deliver the service would be recognised in the Statement of Financial Position alongside a liability for the minimum lease payments due under the contract. As an operating lease, no assets would be recognised and the payments made under the lease would be reflected in the Statement of Comprehensive Net Expenditure as spend is incurred.
7. I regard the accounting requirements for lease type arrangements as particularly relevant to the Department. The Department necessarily enters into strategic arrangements with certain contractors to procure specialist defence platforms on a non-competitive basis. These arrangements

¹ HC 38 2013-14 Ministry of Defence Annual Report and Accounts 2012-13

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)², 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. These arrangements may be considered to contain a lease under IAS 17, Leases, and may have the characteristics of a finance lease.

Action by the Department

8. The Department undertook an assessment of a number of contracts when IAS 17, Leases, was first adopted by the FReM in 2009-10. Based on the results of this assessment, the Department believed that there may be a number of contracts which would require accounting for and disclosure as leases. This review has continued and, to date, the Department has identified 25 contracts which demonstrate characteristics of a lease under IAS 17, Leases. Eight of these contracts were subsequently assessed as being finance leases, which, if recognised would lead to assets with an estimated initial net book value (for seven of the eight contracts) of some £860 million being recognised in the Department's Statement of Financial Position, the exercise also identified a number of sites where multiple MoD platforms or contracts were being supplied. The analysis undertaken by the Department confirms the material impact of IFRIC 4 although the quality of evidence is still insufficient for the purposes of my opinion.
9. In 2013-14, the Department has concluded that, in order to complete its review and conclude on whether the contracts it currently holds meet the criteria of a lease under IAS 17, Leases, further management information and supplier engagement would be required. As disclosed in its Annual Report and Accounts, the Department has, in agreement with HM Treasury, decided not to obtain more detailed information on the grounds that obtaining this would not represent value for money. Consequently, no conclusion can be drawn as to whether the existing contracts held represent leases and the financial impact of the omission of potential assets and liabilities cannot be determined with sufficient accuracy. This decision will have an ongoing impact on the audit opinion I am able to provide on the financial statements for the foreseeable future.
10. The Department is now considering further work in respect of the application of IAS 17, Leases, to new contracts; although no formal decision has yet been taken on this matter.

Qualifications arising in 2013-14 relating to prior year comparative figures

Inventory and non-current asset capital spares: basis of my qualification

11. I have qualified my opinion in relation to two aspects of inventory and non-current asset capital spares which stem from my previous qualifications in 2012-13. The Department has made a significant effort to provide sufficient evidence to support the year-end balance in respect of non-current asset capital spares and current asset inventories as at 31 March 2014, however I have limited the scope of my audit opinion in respect of:
 - **2012-13 comparative balances:** I qualified my opinion on the 2012-13 balances of non-current asset capital spares (£7.2billion) and inventory (£3.3billion) and on the consequential charges made to the Statement of Comprehensive Net Expenditure in respect of inventory. In 2013-14,

² 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.

there was insufficient information to enable the Department to make a sufficiently robust prior period adjustment to restate these figures. Therefore, the comparative figures in respect of these balances and the related movements remain unsupported;

- **2013-14 inventory and capital spares impairment charges:** On circa £860million of the charges made to the Statement of Comprehensive Net Expenditure for 2013-14 in respect of in year impairment on inventory and capital spares. This is due to a lack of evidence to attribute the charge to the Statement of Comprehensive Net Expenditure for impairments genuinely arising from activity in year, and those impairments arising from an impairment event which should have been accounted for in prior years. The impairment review conducted by the Department in 2013-14 could not sufficiently evidence the period to which an impairment event might be attributed.

Accounting for the impairment for the value of the Germany Estate: basis of my qualification

12. In 2012-13 I disagreed with the Department's accounting treatment to apply impairment in respect of the Germany Estate through the revaluation reserve, rather than as a charge to the Statement of Comprehensive Net Expenditure. Consequently in 2012-13, I considered the expenditure of the Department to be understated. I have therefore qualified my opinion to reflect the understatement of net operating expenditure by £907million in the comparative information for 2012-13. This qualification has no impact on the opinion given in respect of the charges made to the 2013-14 Statement of Comprehensive Net Expenditure.

Progress on previous areas of qualification

Valuation of Non-Current Assets and Inventory

13. I am satisfied the Department has provided a materially correct valuation of non-current asset capital spares and current asset inventory as at 31 March 2014. This is the first time the Department has had an unqualified audit opinion on its inventory and capital spares holdings since 31 March 2008.
14. The FReM requires that the Department adopts IAS 36, Impairment of Assets. Impairment reflects a permanent diminution in the value of an asset as a result of a clear consumption of economic benefits or service potential. In my opinion, in previous years the Department did not have a sufficiently robust and systematic process to assess impairment and the consequent impact on the valuation of certain non-current asset capital spares and inventory. The Department was therefore unable to provide me with sufficient evidence to support the valuation of these balances, resulting in a limitation of scope qualification in previous years.
15. In response to my previous reports, the Department implemented a systematic impairment review process. This included the introduction of a centrally co-ordinated impairment review. The Department's central review exercise covered a significant proportion of the assets held on its inventory systems, at over 60 per cent by value of inventory and capital spares previously subject to my qualification. In addition, Project Teams accounting for more significant values evaluated their remaining holdings, providing a further level of coverage, allowing my team to conclude that in year impairment charges were materially complete. As a result of the exercise and other impairment action taken in year, £860 million of net impairments were charged to the Statement of Comprehensive Net Expenditure in year. In addition, the Department continued to classify assets for

disposal, resulting in further write-downs of £1.3 billion in 2013-14 as part of its ongoing rationalisation. A significant proportion of these asset disposals arise from the Department's improved focus on the principles underpinning the assessment of impairment and are a consequence of this work.

16. This centrally managed process meant that local reviews of inventory by project teams in the Defence Equipment and Support division were consistent, comprehensive and that the results were effectively collated. The Department commissioned its Defence Internal Audit function to perform an audit of the impairment exercise. Together with the results of my own testing and observations and review of the work of the Department's internal auditors to the extent necessary, I have obtained sufficient and appropriate audit evidence regarding the year end valuations. I have consequently removed my qualification of the value of these balances held on the Statement of Financial Position at 31 March 2014.

Progress made against previous inventory qualifications

17. The removal of the qualification relating to the valuation of non-current assets and inventory is the last of a series of longstanding qualifications in this area. The Department has had a history of qualifications covering various aspects of the £15 billion of current and non-current assets held on its inventory systems covering, existence, completeness and valuations. As the final qualification is removed, I consider it an opportune time to consider the Department's progress and current position in respect of inventory.
18. Over the past five years, I have seen sustained improvements in accounting for assets held on inventory systems. In 2008-09, I limited the scope of my opinion due to significant inaccuracies in the recording of inventory on the warehouse management systems at the Department's non-explosives storage depots, which impacted on existence and completeness. In 2011-12, this qualification was lifted after the Department made substantial improvements in its inventory checking and recording procedures at the depots. This year, my audit found that the gross book value of assets recorded on the warehouse systems at non-explosive depots was overstated by a most likely error of £108 million in gross book value terms, on a total gross book balance of £8.7 billion. The Department's own internal processes to validate stock holdings showed an error rate of 0.32 percent against its stock records. This level of potential error in inventory systems demonstrates that the Department has sustained its efforts in establishing improved inventory control.
19. In 2009-10, I limited the scope of my opinion due to material unexplained discrepancies between the depot warehousing systems and the main accounting systems. The Department deployed significant resource to undertake quarterly reconciliations across the systems. This allowed me to conclude in 2011-12 that there were no further material discrepancies. This year, the reconciliation between the systems that caused the qualification in 2009-10, gave rise to a maximum estimated net overstatement of £12 million of reported non-current asset capital spares and inventory. Given the complexity of these systems the reconciliation difference demonstrates the Department's continued attention on this key control to ensure that warehouse systems reconcile to the accounting records.
20. My value for money report, 'Managing the defence inventory' (HC 190 in 2012-13) also made recommendations aimed at helping the Department achieve value for money from its inventory management. These included the Department developing a coherent and comprehensive strategy for the size, value and composition of the inventory that it needs to retain; expanding its financial information and using it to improve cost-effective decision making; reducing the amount it spends each year on inventory where it already holds sufficient stocks; and setting up management and accountability structures that incentivise good inventory management. These developments are

being taken forward in the Department's Materiel Strategy. The impairment exercise is an important part of the process for improving management information; however, there are some significant challenges which remain for the Department.

Challenges ahead

21. **Systems:** Despite the significant improvements made by the Department over the last few years it still faces significant challenges in its management of and accounting for assets held on its inventory systems. The Department remains constrained by aging 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. The data held on these systems is critical to Project Teams who require it to effectively manage the Department's inventory holdings. The Department is continuing to focus significant resources on understanding the relationships and data flows within its inventory systems and consequential risks to data integrity. A new deployed warehouse management system has been rolled out across a significant proportion of deployed units and is improving visibility of inventory holdings. However, investment in the new Base Inventory Warehouse Management systems (BIWMS), which was to replace the remaining legacy systems, has been suspended while the Department re-assesses its user requirements. The full implementation of BIWMS was to be a significant step in enhancing the Department's ability to efficiently manage and control its inventory.
22. **Inventory checking procedures:** The results of my audit this year have identified isolated warehouse locations where there are significant inventory discrepancies under investigation by the Department. My findings were consistent with those identified by the Department's own stocktaking procedures. While these results were not material to my opinion it underlines the continued importance of controlling deployed inventory. This can be actioned most efficiently by focusing on checking of the highest value inventory items.
23. **Inventories held off system:** The Department's internal auditors noted that improvements are still required to the impairment consideration of off-system non-current asset capital spares and inventory holdings including assets in industry. Greater attention and focus needs to be given to off-system inventory and the assets the Department holds within industry. These represent areas where the Department can further enhance its processes and ensure that it invokes contract clauses more regularly to inspect and hold its contractors to account more actively.
24. **Changes to the business:** As announced by the Minister for Defence Equipment, Support and Technology on 5 June 2014, the Department plans to close the Dülmen depot in Germany in 2015. This will require disposal or transfer back to the UK of £0.8billion gross book value of non-current asset capital spares and inventory. The Ministry of Defence closed a depot in Stafford in 2007 and I identified inaccuracies in the depot record which had a significant impact on the qualification of my 2008-09 audit opinion. The Department will need to ensure that it applies the lessons from the Stafford drawdown to the Dülmen transfer processes.
25. The Department is progressing the transformation of its Logistics and Commodities Services. It will need to ensure that, whatever arrangements are established, adequate controls are maintained in the depots to ensure accurate records are kept. Robust performance measures should be established for outsourced providers. In addition, the contracting mechanisms for outsourced providers should ensure that adequate management information is available and processes are in

place to enable the Department to obtain the necessary assurance and evidence to support the balances in its statements.

26. **Embedding good practice:** The Department needs to ensure that it embeds the good practice in assessing the fair value of inventory items and that these principals become part of the normal course of business. Effective inventory planning and management are fundamental to this, allowing the Department to retain control and knowledge of inventory purchasing, usage, repair and disposal. The Department will need to ensure that, whatever arrangements are established in respect of the transformation of Defence Equipment and Support (DE&S), appropriate accountability, assurance and inventory management structures are maintained during the transition.
27. Notwithstanding these observations, the Department has made significant improvement to its processes. My audit will continue to monitor the Department's inventory systems and balances together with the implementation of the recommendations within my value for money report 'Managing the Defence Inventory'.

**Sir Amyas C E Morse
Comptroller and Auditor General
National Audit Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP**

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