

**MINISTRY OF DEFENCE:
DEPARTMENTAL RESOURCE
ACCOUNTS 2001-2002**

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



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Section 1: Summary

- 1 Since 1999-2000 the Ministry of Defence (the Department) has been required in accordance with Directions issued by the Treasury to prepare annual Resource Accounts. The Resource Accounts, drawn up on an accruals basis, should be prepared in accordance with the Treasury's *Resource Accounting Manual* and should give a true and fair view of the state of affairs of the Department and of its net operating costs, recognised gains and losses and cashflows for the year.
- 2 In producing its Resource Accounts the Department faces a number of challenges. It undertakes a wide range of complex functions and holds a vast range of assets. Some of these assets are held by contractors for manufacture and repair purposes. It has many old information systems which although adequate for the purposes they were designed for, are not suited in all respects to the production of accurate and timely accruals based information. The Department has therefore had to invest considerable efforts in implementing resource accounting and budgeting, both in IT and staffing.
- 3 At the introduction of the resource accounting and budgeting initiative the Department had little information on the value or extent of its asset base, and it struggled, initially to complete acceptable accounts. The Department recognised that much needed to be done and made significant efforts to improve the standard of its financial accounting information. These measures led to progressive improvements over the last three years. I qualified my audit opinion on the 2000-2001 resource accounts in respect of an uncertainty over the value of stock obsolescent provisions, the value of Departmental stock and certain fixed assets held by contractors and stock consumption charges to the operating cost statement. I also disagreed with the accounting treatment of the costs of major refits and overhauls. The Department has continued over this last year to make strenuous efforts to secure further improvements to the extent that I have been able to remove fully my qualification in respect of stock provisions and accounting for the cost of major refits and overhauls. In Section 2 of my Report I consider whether the Department is continuing to take appropriate steps to implement resource accounting effectively.
- 4 In Section 3 of my Report I explain why I do not yet consider the Department's resource accounts are robust enough to support a true and fair opinion. I conclude that although major improvements have been achieved in the accuracy and reliability of its stock management information, further progress is required. Because of

continuing problems in this information I am unable to confirm the completeness or values of charges to the operating costs statement in respect certain stock and fixed assets and accordingly I have qualified my audit opinion.

- 5 For 2001-2002 and future years the Department along with the rest of central Government must contain both resource consumption and cash expenditure within the limits approved by Parliament and within a control framework set by HM Treasury. This year the Department's resource consumption for 'Provision of Defence Capability' has exceeded the estimate approved by Parliament and requires an excess Vote to regularise this resource consumption. In Section 4 of my Report I consider the reasons for this and the action the Department is taking to prevent this occurring in the future.
- 6 In Section 5 of my Report I confirm that according to Departmental records the maximum numbers of military personnel maintained during 2001-2002 for the Naval, Army and Air Force Services in all active and reserve categories were within the numbers voted by Parliament.
- 7 The Department is continuing to demonstrate a strong and effective grip on the accounts production process. For 2001-02, it has again submitted Resource Accounts for audit in line with the timetable agreed with my staff and the Treasury. And it has accelerated their finalisation and publication. When compared with the quality of the Department's Resource Accounts for 1999-2000, on which I placed a disclaimer covering a range of accounting deficiencies, the Department has consistently made good progress in improving the quality of its accounts. During 2001-02 the Department has successfully cleared two of the four substantive issues which were the basis for the qualification of my audit opinion last year and it assures me it is fully aware of what remains to be done and is committed to securing the necessary improvements. My staff will continue to work closely with the Department in this task.

Section 2: Is the Department still making good progress to implement Resource Accounting effectively?

8 In my Report on the 2000-2001 Accounts¹ I explained my reasons for qualifying my audit opinion. These included the quality of data supporting the write down of stock values; the completeness and valuation of Departmental assets held by contractors and whether stock accounting transactions were complete or correctly recorded. I also identified other areas on which the Department would need to continue to make progress. These included ownership of financial accounting data and underlying audit trails; the completeness of creditor and accrual estimates and accounting for asset transfers, re-classifications and disposals.

The Department has made good progress on two specific issues so that they no longer contribute to an audit qualification

The Department has developed more robust data models to improve the quality of stock provisions

9 The Department maintains 13 principal logistics management systems, collectively known as Supply Systems. Together these systems hold details of over 3 million different types of items. As well as consumable stock, the Supply Systems hold fixed asset items including fighting equipment; capital spares (such as aircraft engines) and certain items of plant and machinery.

10 The Department has identified that many of the items held on the supply systems are in excess of requirements, or obsolete because the equipment they support is no longer in use. I have previously reported on the progress the Department is making to reduce these stock holdings². The Department must reflect these factors in its Resource Accounts by reducing stock values appropriately. In my Report on the 2000-2001 Accounts I noted that although the Department had introduced a consistent policy across all three Services for writing down stock values it had been unable to calculate this value accurately. Not all the information required was held in a readily accessible form.

¹ MOD: Departmental Resource Accounts 2000-2001 HC 443 Session 2001-2002: 18 December 2001

² Progress in Reducing Stocks HC 898 Session 2001-2002: 20 June 2002

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- 11 The Defence Logistics Organisation has provided £3,513 million for stock-write-down in its balance sheet and charged £405 million to the operating cost statement in 2001-2002. I am pleased to note that the Defence Logistics Organisation has refined its data collection and analysis techniques to more accurately determine the appropriate level of provision. These techniques include an analysis of future demand by individual stock items. As a result I have been able to remove my qualification in this regard.

The Department has complied with the requirements of FRS15 to account for the costs of major refits and overhauls

- 12 In my Report on the 2000-2001 Accounts I noted that the Department had not complied with key aspects of Financial Reporting Standard 15. This sets out the principles of accounting for the initial measurement, valuation and depreciation of tangible fixed assets. Certain fixed assets such as ships, submarines and aircraft wear out at a substantially quicker rate than might be assumed from their planned out of service date. To maintain planned capability, these assets have to undergo periodically major refits or overhauls, the cost of which can be very significant when compared with the net book value of the asset. The Department had not reflected the costs of these refits in the value of these assets.
- 13 Following consultation with my staff the Department undertook extensive analysis of costs incurred in the major overhaul and refits of ships, submarines and aircraft. The Department concluded that for aircraft, there was no significant distortion to the operating cost statement year on year by expensing the costs of refits and overhauls as they were incurred. These annual charges reflected fairly the consumption charges that would have been incurred had the costs been capitalised. However for ships and submarines the Department has determined that it is appropriate to capitalise the costs of major refits and overhauls for larger vessels and has capitalised some £779 million in respect of past refits and overhauls and £273 million for current repairs. The costs will be depreciated and charged to the operating cost statement over time until the next major overhaul or refit. In this way the Department is correctly recognising in its Accounts by way of depreciation the gradual wearing out of these major assets until the next refit or overhaul takes place. I have been able to remove my qualification in this regard.

The Department has made good progress on other issues during the year

Creditors and accruals are now more robust

- 14 The proper identification of creditors and accruals relies on the ability to match data on the delivery of goods or services, to the receipt of an invoice and to its eventual payment. The current Departmental systems do not have automated interfaces and most processes for matching the transactions are manual. The Department is currently implementing a new purchase order system. I reported last year that there was a significant level of correction of these balances in preparing the final account. The Department has made good progress and far fewer adjustments were required to the creditor and accrual balances.

The Department can account more accurately for asset transfers and re-classifications

- 15 I noted in my Report on last year's accounts that the Department had problems supporting fully the £1,178 million net balance shown on the 'other movements' line in Note 7 (Intangible Fixed Assets) and Note 8 (Tangible Fixed Assets) of the Resource Account. The 2001-2002 Resource Account reports the overall net balance on the 'other movements/transfers' line of Notes 7 and 8 as £118 million, a significant reduction. The Department attributes the balance to reclassifications between tangible fixed asset categories, intangible fixed assets, stock and transfers to operating costs. In light of my concerns last year, the Department has provided my staff with explanations for all of this balance and I am satisfied that it is fairly stated.

The Department has improved again its management validation and audit trails

- 16 The Department's Resource Accounts are a consolidation of accounts prepared by the eleven top level budget holders across the Department. The accounts of these top level budget holders are in turn a consolidation of accounts produced by 84 management groupings. It is fundamental to the production of an account as complex as this that figures should be fully supported by good and clear documentation and be subjected to thorough scrutiny by management - prior to being submitted to my staff for external examination.
- 17 My staff found that the Department has made further improvements in this area since last year. In particular the Department changed the way it consolidated its accounts. This allowed the 84 management groupings a single opportunity to produce validated and supportable accounts. The second and final consolidated account incorporates audit adjustments only. Consequently the Department undertook a more thorough validation at an earlier stage compared to last year. As a result, this year the

Department has made far fewer adjustments between the first and final version of the Resource Accounts. In summary these amounted to £297 million decrease in net assets and £152 million increase in net operating costs.

Other developments in Resource Accounting and the disclosure of financial information

The Department has revised its objectives for Schedule 5

18 The Department has revised its objectives to align with those set out in its Public Service Agreement with HM Treasury³. In order to achieve consistency from year to year HM Treasury's *Resource Accounting Manual* requires Departments to restate the prior year according to the new objectives and explain the changes in a note to the accounts. The notes to the accounts should disclose current and prior year figures on the basis of the previous aim and objectives. Alternatively where this can be achieved only at disproportionate cost, the current year figures may be restated against the previous objectives. The Department has adopted this latter approach.

The Department is undertaking a quinquennial review of its asset valuations

19 Note 8 to the 2001-2002 Resource Accounts summarises the Department's holdings of tangible fixed assets. HM Treasury's *Resource Accounting Manual* requires that tangible fixed assets are professionally revalued at least once every 5 years. In December 2001 the Department started such a quinquennial review to determine up to date professional valuations of its assets at 1 April 2002. Because of the vast range of assets it holds, this has been a complex task for the Department and some valuation work is still being undertaken.

Section 3: Are the Department's Resource Accounts for 2001-2002 true and fair?

20 My certificate on pages x to y explains that I am required to report my opinion as to whether the financial statements give a true and fair view. I noted in Section 2 of my Report the Department has made significant progress in addressing some of these issues that led me to qualify my opinion on the 2000-2001 Resource Accounts. But

³ Spending Review 2000: Public Service Agreements 2001-04 Cm4808 July 2000

there is still more that the Department is required to do in order to be in a position to produce Accounts which could be considered to be free from material mis-statement. In the context of the 2001-2002 Resource Accounts I have qualified my audit opinion because I am unable to confirm the completeness of charges to the operating cost statement in respect of consumption of certain stock and fixed assets.

I am unable to confirm some figures in the Department's Operating Cost Statement in respect of consumption charges for certain stock and fixed assets

- 21 In my Report on the 2000-2001 accounts I noted the problems the Department had in accounting correctly for stock consumption. In particular, systems were not in place to capture data on the consumption of Departmental stock by contractors. And existing stock inventory systems were not designed to provide stock accounting data for accruals based financial accounts. While progress has been and continues to be made, these issues are unlikely to be fully resolved until current systems are replaced with an integrated stock management and accounting system.

There are incomplete charges to the operating costs statement for the use of stock and capital spares by contractors

- 22 Assets belonging to the Department may be held by contractors for a number of reasons. For example spare parts may be supplied to contractors to carry out repairs on major components or items may be supplied for incorporation into new builds or modifications. The contractor has responsibility for maintaining information on the items held. The degree of detail to be recorded by the contractor varies according to the contract type. The value of these stock and capital spares items should be reflected in the Department's Balance Sheet. And the use of these assets by contractors should be reflected as charges for consumption of stock items or depreciation for the use of capital spares.
- 23 In my Report on the 2000-2001 Accounts I noted the progress made by the Defence Logistics Organisation to capture data on these assets more accurately and maintain a record of their movement. Incomplete records and unvalidated asset valuations meant that I was uncertain whether the values were complete or fairly stated and I qualified my opinion in this regard. At the time the Defence Logistics Organisation was aiming to provide accurate figures for the 2001-02 Account.
- 24 The gross value of these stock and fixed assets in the Department's Resource Accounts amount to some £1,057 million. After provisions for obsolescence and

depreciation are taken into account the net book value is some £591 million. Over the last year the Defence Logistics Organisation has made significant improvements to the accuracy of the data. The existence of some 96 per cent of the assets has been confirmed by reference to updated returns from contractors. This has been supplemented with compliance visits to selected contractors to confirm their stock management systems record accurately their holding of Departmental assets. Some 64 per cent of values have been derived from existing validated pricing records held by the Department; while the remaining items have been valued using estimating techniques based on the type of asset and an average price. The ownership of some 84 per cent of items has been attributed to specific Integrated Project Teams within the Defence Logistics Organisation which will further improve future validation and control.

- 25 In order to create the 31 March 2002 closing balances, the Department removed the opening balances at 1 April 2001 and substituted new values for the closing position. The more usual business process would be to record stock issued to contractors and stock usage by contractors during the year to determine the closing stock balance held by contractors. However there are no specific values for these transactions in the resource account. As a result, the only charges in respect of assets held by contractors that have been posted to the Operating Cost Statement reflect the change in stock provision for obsolescence and the change in the accumulated depreciation. Currently contractors are unable to provide transaction data without incurring additional cost to support the detail of their operations during the year.
- 26 I have concluded that the balance sheet values for these stock and fixed assets held by industry are essentially complete and correct. However because of the absence of a full audit trail I have been unable to determine the completeness of stock consumption and depreciation charges to the operating cost statement regarding the usage of these assets by contractors and I have qualified my opinion in this regard. The Defence Logistics Organisation recognises there are further improvements to be made and is developing data capture processes and estimating techniques to remedy this in the 2002-2003 accounts. And it will seek transaction data from contractors as new contracts are awarded.

Certain stock accounting transactions are not completely or correctly recorded.

- 27 The supply system for the Defence Logistics Organisation's Air environment continues to generate data that cannot be wholly supported. Each month the stock

accounting system compares opening and closing values with the movements generated by the stock inventory system. Where there is a difference a reconciling balance is automatically created. This ensures that the accounts reflect the stock inventory system, however there is no supporting audit trail as the procedure is embedded within the software programme. In the 2001-2002 accounts this "autobalance" procedure generated a net credit to the operating cost statement of some £340 million. In the previous year it had generated a charge of £440 million. During 2001-2002 the gross monthly postings varied between a £45 million credit and £25 million charge for consumable stock and a £261 million credit and a £177 million charge for capital spares.

- 28 The Defence Logistics Organisation has reviewed the larger autobalance transactions to determine possible causes. For example, spurious transactions are generated when the stock management system recorded a stock issue against a zero stock holding. This software programme error has now been rectified. In previous years a large part of the autobalance was caused by the inability of the stock inventory system to differentiate whether an item received from a contractor was a new or repaired item. For financial accounting purposes this distinction is important as a repaired item will already be held on the Balance Sheet. The Defence Logistics Organisation has improved the transaction mapping from the inventory system through the accounting system in this regard. A further area of concern is where the stock inventory system records items on repair as negative stockholdings. However when these balances are corrected the autobalance mechanism assumes the movement represents additions of new items. Items on repair tend to be capital spares and the value of these can be considerable.
- 29 Because of the lack of audit trail I have been unable to determine whether stock write-off and permanent diminution of capital spares charges to the operating cost statement generated by the autobalance mechanism are correct and I have qualified my opinion in this regard. The Defence Logistics Organisation recognises there are further improvements to be made. Additional resources have been tasked to review the autobalance activity to develop refinements to the Air environment stock inventory and accounting systems.

Section 4: Is the Department's resource outturn within the limits approved by Parliament?

30 In April 2001, the Government moved to a new resource based financial management system following agreement of Parliamentary Committees and Royal Assent to the Government Resources and Accounts Act 2000. This move to full resource accounting and budgeting is in accordance with the original timetable set out in the 1995 White Paper "Better Accounting for the Tax Payer's Money"⁴ and comprises:

- Completion of the first resource based public expenditure survey in the 2000 Spending Review⁵;
- Presentation of the first full set of resource based Estimates for 2001-02 in March 2001; and
- Resource Accounts replacing cash based Appropriation Accounts in respect of 2001-02.

31 Resource budgeting uses resource accounting information as the basis for planning and controlling public expenditure. It distinguishes between resource consumption and capital investment and requires departments to match their costs to the time of service delivery.

32 Supply Estimates are the means by which Government seeks authority from Parliament for its spending each year. The Main Estimates are presented to Parliament at the start of the financial year and Supplementary Estimates may be presented during the course of the year if the Government decides to ask Parliament for additional provision. Parliament's vote on the annual Appropriation Act approves the Main Estimates and retrospectively approves any changes advised in the Supplementary Estimates. The Appropriation Act sets out for each Request for Resource the ambit or scope of the expenditure, net resources, resource appropriations in aid (current income) and non operating appropriations in aid (income from the sale of capital assets and from repayment of loans). Parliament also

⁴ Better Accounting for the Taxpayer's Money: Resource Accounting and Budgeting in Government July 1995 Cm 2929

⁵ Spending Review 2000, New public spending plans 2001-2004 July 2000 Cm 4807

approves the net cash requirement for each Estimate (but not for each Request for Resource).

- 33 Through its in year monitoring procedures the Department identified during the course of 2001-2002 that additional provision was required and presented Supplementary Estimates to Parliament as summarised below.

£000	Main Estimate	Winter Supplementary	Spring Supplementary	Total	Outturn
Gross Resource provision RfR 1	30,665,167	121,463	1,671,759	32,458,389	33,060,206
* A in A RfR 1	1,255,800	50,482	2,325	1,308,607	1,351,417
* Net Resource provision RfR 1	29,409,367	70,981	1,669,434	31,149,782	31,751,599
Gross Resource provision RfR 2	184,259	0	388,918	573,177	530,016
* A in A RfR 2	0	0	0	0	0
* Net Resource provision RfR 2	184,259	0	388,918	573,177	530,016
Capital	5,573,181	300	515,208	6,088,689	6,306,572
* Non operating A in A	173,413	300	162,820	336,533	359,090
* Net Cash Requirement	24,205,998	71,481	1,636,556	25,914,035	24,873,679

* Subject to Parliamentary control

- 34 Schedule 1 of the Departmental Resource Accounts summarises the Department's expenditure and net cash requirement against these revised budgets authorised by Parliament. In respect of key elements of Parliamentary control the Department has:

- exceeded its target for appropriations in aid on Request for Resource 1 by some £43 million;
- underspent its budget for Request for Resource 2 "Conflict Prevention" by some £43 million;

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- exceeded its target for non operating cost appropriations in aid by approximately £23 million; and
 - underspent its overall net cash requirement by about £1,040 million.

The net cash requirement underspend arises from several causes including an underspend on relevant cash operating costs, smaller than forecast working capital movements, including the deferment of a payment into court pending an appeal against adjudication and a lower than expected cash draw-down for the loans made to Trading Funds.

The Department has exceeded its voted net resources for RfR 1

35 However, under Request for Resource 1 "Provision for Defence Capability" the Department has incurred resource consumption of £31,752 million against voted provision of £31,150 million and exceeded the net resource provision authorised by Parliament by £601.8 million or 1.9 per cent of its Estimate. It is proposed to ask Parliament to provide for the excess by voting a further supply grant for resource of £601,816,500.45.

The main cause of the excess vote is unforecast charges arising from the impairment of fixed assets

36 The Joint Force Harrier was formed on 1 April 2000 and currently operates two aircraft types - the Sea Harrier FA2 air defence aircraft flown by RN personnel and the RAF Harrier GR7 a ground attack/reconnaissance aircraft flown by RAF personnel. The Department intended that both the Sea Harrier FA2 and the Harrier GR7 would be replaced by a common aircraft type by 2012.

37 On 28 February 2002 the Minister of State for the Armed Forces announced to Parliament⁶ that Joint Force Harrier would migrate to an all Harrier GR force maximising investment in one aircraft type. The Department plans to upgrade the GR7 to GR9 standard - aircraft systems will be enhanced to extend lives and give Harrier the capability to operate with smart weapons. To that end the Sea Harrier FA2 will be withdrawn from service earlier than planned, by 31 March 2006.

⁶ Hansard 28 Feb 2002 Column 1453W

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- 38 Of the 56 Sea Harriers, the Department has identified 15 for immediate disposal. The carrying value of £262 million of these aircraft and their associated development cost has been written off to the operating cost statement. The Department has drawn up a schedule for taking the remaining Sea Harriers out of service over the next 4 years. This has required an increase in their depreciation rate to reduce their carrying value to a disposal value by the out of service date. As a result an additional charge of £24 million has been incurred to the operating cost statement for 2001-02.
- 39 The Department had not considered at an early stage the financial consequences of the decision to withdraw the Sea Harrier. This prevented the Department from seeking additional resource provision from Parliament through the Spring Supplementary Request for Supply procedure in February 2002.
- 40 In addition to the decision to withdraw the Sea Harrier, the Department identified after review other fixed and rotary winged aircraft which no longer met their planned capability. But it did not do so until the end of the financial year after the Department's Supplementary Estimates had been agreed. These reviews resulted in decisions to dispose of or scrap three Tornado aircraft and 14 Lynx and Gazelle helicopters deemed to be damaged beyond repair. This generated further writes-off of asset carrying values to the operating cost statement amounting to some £76 million. The Department also identified at a late stage a reduction to the carrying values for a class of submarine, amounting to some £59 million. A series of smaller changes to the carrying values of a range of fighting equipment and capital spares holdings resulted in further charges to the operating cost statement of some £175 million.
- 41 The Department approached my staff in March 2002 to discuss a potential impairment to the operational capability of Skynet satellites. These support a secure communications system across much of the world; but some satellites have not functioned fully as planned since their launch. The Department undertook a review of the operational capability of the satellites and this was completed in May 2002. The review concluded that there was indeed an impairment and that it was appropriate to adjust the carrying value to reflect this. In total some £106 million has been written off to the operating cost statement to reduce the carrying value of these assets.
- 42 Because the impairment was identified at the end of the financial year this prevented the Department from seeking additional resource budget from Parliament through the

Spring Supplementary Request for Supply procedure in February 2002. The impairment has contributed to the Department's excess net resource expenditure.

The Department is improving its financial forecasting

- 43 For Treasury control purposes, departments' budgets comprise three-year Departmental Expenditure Limits (DEL) consisting of both resource and capital elements. In addition, departments are authorised to incur other expenditure which does not fall within DEL and is termed Annually Managed Expenditure (AME). Under a transitional regime introduced in the 2000 Spending Review, the non-cash costs introduced by resource accounting and budgeting (cost of capital charges, depreciation and provisions for future expenditure) are included in AME rather than DEL. This was to allow departments time to gain more experience in monitoring and forecasting these items. They become part of the three year expenditure limits from 1 April 2003.
- 44 In the first year of managing under Resource Budgeting the Department focused efforts on meeting Treasury control totals and tried to manage centrally against Parliamentary control totals. Top Level Budget Holders were required to monitor and forecast but not to control resource consumption classified as AME. Because of the Department's large and diverse asset base, AME makes up a significant part of the overall resource consumption. This meant there were no automatic checks on the affordability of decisions taken to withdraw assets early, generating impairments and writes-off, and forecasts were not sufficiently reliable due to the lack of prior experience of managing such resource consumption.
- 45 To mitigate an excess of resource consumption during 2002-2003, the Department has implemented a more robust system for monitoring all consumption during the year. In particular, the Department will check thoroughly that Top Level Budget Holders' estimates for Annually Managed Expenditure items are complete before submission of the Spring Supplementary Estimates to Parliament in 2003.

Section 5: Ministry of Defence - Votes A

- 46 The Ministry of Defence's Votes A is presented annually to Parliament to seek statutory authority for the maximum numbers of personnel to be maintained for service with the armed forces. Note 29 to the Accounts shows that the maximum numbers maintained during 2001-2002 for the Naval, Army and Air Force Services in

all active and reserve categories were within the numbers voted by Parliament. My staff have been provided with strength returns to support this Note to the financial statements.

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