National Audit Office

Financial Management in the Foreign and Commonwealth Office

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 289 Session 2008-2009 | 3 June 2009

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Comptroller and Auditor General
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27 May 2009

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SUMMARY

1 The role of the Foreign and Commonwealth Office (the Department) is to run a global network for the whole of the British government, deliver services to British citizens and pursue foreign policy priorities. The Department manages a budget of nearly £2 billion. Alongside its UK presence, the Department runs a network of 278 overseas posts, provides substantial funding to the British Council and the BBC World Service, and works closely with a range of other UK Government Departments.

2 Effective financial management helps an organisation manage its budgets, allocate resources, and make decisions supported by an understanding of the relationships between costs and performance. When the resources of an organisation's business are directed and controlled to support the organisation's goals, it is better able to deliver its services cost-effectively. In the same way, good corporate governance relies on sound financial management to underpin service quality and improvement, and to provide the information to account to stakeholders for its stewardship of assets and use of resources.

3 This report presents the findings and recommendations from our examination of financial management within the Foreign and Commonwealth Office (FCO). It examines:

- the management of the Foreign and Commonwealth Office's financial performance (Part 1); and
- how far the FCO uses five widely accepted aspects of financial management to manage its business (Part 2).

Main Findings

On the progress made in improving financial management

4 We have found that the FCO has made significant progress in developing its financial management capability. The focus of this effort has been a change project – 'Five Star Finance' – setting out a suite of milestones to be achieved in order for the Department to establish itself as one of the best in Whitehall. The Department currently rates itself at 'three and a half stars', which we consider to be a reasonable and soundly based assessment against the targets set within the original project plan. There is, however, still much to do to reach the five star standard, as the Department recognises.

5 The Department takes financial management seriously. In its review conducted in the final six months of 2008, the Institute of Public Finance Ltd (IPF) concluded that the building blocks of financial management are largely in place, to secure effective stewardship of resources. It identified that the FCO still has work to do to ensure that core financial competencies are present throughout the organisation to support performance and enable transformation. The FCO is establishing an Action Plan to respond to the main issues raised by the IPF review.

Financial Governance and Leadership

6 There is a strong financial management culture in place at the top of the Foreign and Commonwealth Office. The Accounting Officer and the Board have provided a strong lead to the mission to improve the standards of financial management throughout the Department. The external recruitment of a qualified Finance Director, and his promotion to the Board as Director General, Finance, provides a strong signal of the corporate importance of finance. The Board is also supported by a Non-executive director who is a senior member of the accountancy profession and the Chair of the Department's Audit and Risk Committee.

7 In terms of financial management skills, the proportion of qualified staff within the Finance function is below the average for central government. As at October 2008, eight per cent of staff working in Finance were professionally qualified, against a central government average of 14 per cent. The Department has launched a professional finance training programme to build its numbers of professionally qualified staff. It has also introduced training programmes to improve skills for non-finance staff, but needs to do more to ensure widespread take-up of these programmes.

Financial Planning

8 The Department has well-developed resource allocation procedures, but there is scope for better linkages to business planning processes. Business plans, developed to outline how Departmental Strategic Objectives are to be achieved, are lacking in detailed financial information. The Department aims, through enhanced staff activity recording, to map resource utilisation more effectively in to business plans and to inform future resource allocation decisions.

Finance for Decision Making

9 There is a structure of sub-committees of the Board (particularly the Finance Committee and Investment Committee) in place to manage decisions on resourcing commitments and future investments. Monthly meetings of both Committees are informed increasingly by financial analyses, though there is scope to develop additional sensitivity analysis in options papers.

Financial Monitoring and Forecasting

10 The Department underspent significantly against its 2007-08 budget, in spite of requesting additional funds part way through the financial year. The underspend of £128 million (resource and capital) was attributable to both operational underspends and accounting entries relating to asset impairments, but it was not anticipated during the financial year and hence the Department was not able to re-prioritise activity in a planned way.

11 There is more to do to achieve reliable in-year financial information, as a basis for holding budget holders to account for their financial management. The Department is working to enhance its financial systems and staff skills so that reliable and timely financial information is available to budget holders. Staff are increasingly held accountable for their own financial management performance in performance appraisals and consideration of forward posting discussions.

12 Going forward, the Department has taken action to avoid future unanticipated underspends. The Department has introduced additional challenges to in-year financial forecasting with detailed scrutiny of quarterly financial forecasts at Director General level. Evidence of budget re-forecasts in the early part of the year indicates that this scrutiny has proved effective. Financial forecasting for 2008-09 has been made more challenging by significant exchange rate fluctuations. The Accounting Officer has set a target for expenditure to fall within one per cent of the budget. In working to meet this target, the Department will also need to guard against the risk of inappropriate or poorly conceived expenditure towards the year end.

Financial and Operational Reporting

13 The Department has improved the accuracy, reliability and timeliness of financial information reported both externally and internally. The Department's 2007-08 Resource Accounts were laid in Parliament on 30 June 2008, the earliest date yet achieved after the 31 March year-end, and amongst the first of the major Whitehall departments. Internal management information (in the form of the "Key Performance Report" produced for the Board each month) has improved significantly over time. The Department aims to speed up the production of the report to within seven working days of the month-end. In so doing, the Department should balance the need for timely information with the demands of accuracy and quality of accompanying commentary.

14 The Department is working to align financial and operational reporting. Enhanced staff activity recording should provide a basis for inclusion of a financial element in operational reporting against Departmental Strategic Objectives. This is an important step in order for the Department to be able to identify the true cost of seeking to meet its various objectives, requiring the understanding and buy-in of operational staff so that information is soundly-based.

Conclusion on Financial Management

15 The Department has shown strong leadership in raising the profile of good financial management across the organisation. Its main driver for improvement is a change programme, called Five Star Finance, established in July 2007 to improve processes, IT systems, collection of monthly management information and financial skills for staff. Some early successes have been achieved, the programme is ongoing, and the Department has established a sound financial management framework, but against a background of consistent underspending against budget in recent years. The Department is working to strengthen the link between its business planning and resource allocation, and has introduced a system of staff activity recording as a basis for providing a clearer picture of the real cost of pursuing each of its Departmental Strategic Objectives.

Recommendations

16 Against this background, we recommend as follows:

a **The Department's Five Star Finance project will have run its course by July 2010, and the Department is currently considering how to consolidate the project's achievements.** In managing within increasingly constrained resources, the Department will need to use the capability created through the project to budget more rigorously and utilise all available resources to best effect.

b **The Department is working to extend Financial Skills training across the broader Department, but data on take-up of training is not complete, and there is scope to develop further tailored training for particular roles.** The Department should develop comprehensive data on the take-up of the training, use it to maximise participation, and develop further tailored finance training for Directors and for Senior Management Officers.

c **Historically, the Department has employed a large number of consultants and contractors in the Finance Directorate.** Progress on recruiting and training additional professionally qualified accountants should reduce the extent to which the Department needs to employ contractors or consultants in Finance roles. The Department should set targets for the reduction in use of contractors and consultants and monitor progress against them.

d **We noted some evidence of delays in delegating budgets to budget holders.** Directors General should delegate budgets at the beginning of the financial year to encourage accountability for the use of resources for the entirety of the financial year.

e The system of staff activity recording introduced in 2008-09 is beginning to provide a better picture of the real cost of pursuing each of its Departmental Strategic Objectives. **The Department recognises that it has more to do to obtain regular and accurate activity data, as a basis for longer term resource allocation to DSOs**. It should operate a proportionate system of staff activity recording as a routine management tool, taking care to ensure the buy-in and understanding of staff of the process so that information is soundly-based.

f The Finance Committee is increasingly drawing upon financial information to take decisions on financial risks arising from operational activities, and also for investment decisions. **The Committee has yet to make full use of sensitivity analysis in reaching its decisions**. The Department should review the form and content of submissions to the Committee so that adequate sensitivity analyses are included.

g The Investment Committee considers business cases in support of capital investment decisions, and monitors capital expenditure and project progress through the year. **The Committee does not, however, have a role either in the scrutiny of longer term capital expenditure strategies or in post-project appraisal**. The Department should assess the scope for the Committee to take on a role in the scrutiny of longer term capital expenditure strategies. It should also consider whether existing arrangements for scrutiny of major projects and post-project appraisal best meet its needs.

h **Some major projects which the Department has undertaken report in to a number of different Boards**. The Department should rationalise project scrutiny arrangements to minimise duplication of effort.

i From 2008-09 onwards, the Department has taken over from the Treasury the responsibility for managing the impact on its budgets of movements in exchange rates. **Large recent shifts in exchange rates pose significant challenges to the Department's ability to manage its resources**. The Department should ensure that it has the technical skills in place within the Finance Team to deal with forward exchange rate fluctuations in order to manage this complex issue.

j The Department has improved the accuracy and timeliness of the production of its Key Performance Report (KPR) for the Board. **It aims to build upon this improvement by producing the report within seven working days of the month end, but needs to manage the risk that the quality both of the core data and accompanying commentary could be reduced**. The Department should seek feedback from the Board on the KPR on an ongoing basis, to ensure that it balances the need for presenting management information on a timely basis with ensuring the accuracy of information and commentary provided.

k **Programme teams report progress and performance to a number of different stakeholders in the Department (e.g. Programme Boards, Financial Management Group, Directorate Resource Management Units)**. The Department should rationalise reporting arrangements to minimise unnecessary duplication.

PART ONE

Managing Financial Performance

Aims and Objectives

1.1 The Department's stated purpose is to run a global network for the whole of the British government; deliver services to British citizens such as consular support overseas; and pursue foreign policy priorities.

1.2 The FCO's strategic framework: *Better World, Better Britain*, published in February 2008 set out eight Departmental Strategic Objectives, which were put in place from April 2008. The DSOs are the basis on which the FCO receives its funding and against which its performance is judged. **Figure 1** lists the DSOs. A fuller description of the DSOs is set out in Annex 2.

1 Departmental Strategic Objectives for the FCO (2008-2011)

DSO 1 – A flexible **Global Network** serving the whole of the British Government.

Three **Essential Services** that are delivered through UK Trade and Investment (UKTI), UK Borders Agency and consular teams:

DSO 2 – Support the British economy

DSO 3 – Support British nationals abroad

DSO 4 – Support managed migration for Britain

Four new **Policy Goals** to:

DSO 5 – Counter terrorism, weapons proliferation and their causes

DSO 6 – Prevent and resolve conflict

DSO 7 – Promote a low carbon, high growth, global economy

DSO 8 – Develop effective international institutions, above all the UN and EU

Source: FCO website

1.3 The strategic framework that was introduced in April 2008 places more emphasis on the Department's global network and its role in delivering for the Government as a whole. So, in addition to delivering the new policy priorities and providing public services (such as assisting British nationals overseas), overseas Posts provide a platform for other Government Departments to deliver their own international priorities.

1.4 The FCO delivers against its objectives and implements its policies in a variety of ways: subscriptions to international bodies such as the United Nations and Council of Europe; the provision of funding and capital grants to the BBC World Service and the British Council; contributions to the Strategic Programme Fund (previously the Global Opportunities Fund); partnership arrangements with the Department for Business Enterprise and Regulatory Reform (BERR) and with the Home Office to support the running of UK Trade and Investment (UKTI) and the UK Border Agency (UKBA) respectively; scholarships to young international postgraduates to study in the UK; and the FCO's own direct programme expenditure, which includes funding the operations of the global network.

Leadership and structure of the FCO

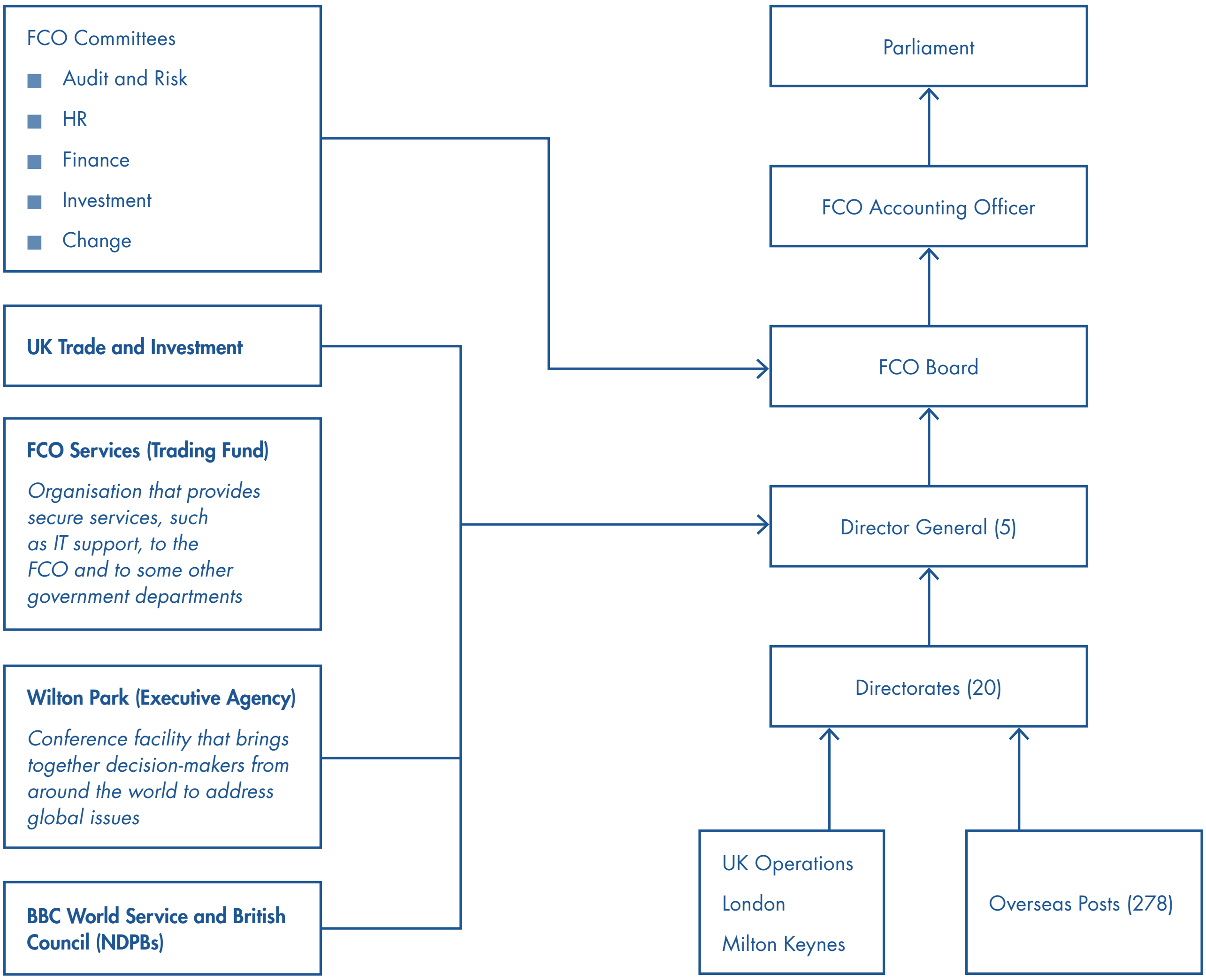
1.5 Sir Peter Ricketts is the Permanent Under Secretary (PUS) of the FCO and the Head of the Diplomatic Service. He is responsible for advising the Foreign Secretary and the Ministerial team on foreign policy, and for managing the FCO. He chairs the FCO Board.

1.6 The FCO Board consists of: the Permanent Under Secretary (PUS), the Chief Executive for UK Trade & Investment, the five Directors General, the Chief Information Officer, the Director for Human Resources and two non-executive members. The PUS and the five Directors General, who are responsible for Change and Delivery, Defence and Intelligence, Finance, Europe and Globalisation, and Political Units, supervise and coordinate the work of the Department's 20 Directorates as shown in **Figure 2**.

1.7 The FCO shares responsibility with the Department for Business, Enterprise and Regulatory Reform for UK Trade & Investment (UKTI). UKTI works to help UK companies do business overseas, and to attract inward investment to the UK.

1.8 Up to the end of March 2008, the Department jointly managed UKVisas with the Home Office. UKVisas is the body responsible for managing travel and migration work for Britain. From 1 April 2008, UKVisas merged with the Borders and Immigration Agency to become part of the UK Border Agency, an agency of the Home Office. The Department and UKBA are closely intertwined. UKBA operates around the world in almost all the places the FCO operates, employing some 3,000 staff from or recruited via the FCO, and occupying a significant proportion of the Department's total overseas floorspace.

2 Accountability Diagram of the FCO Group



Source: National Audit Office

1.9 The diplomatic network stretches across 145 countries and covers 140 Embassies and High Commissions in capital cities, 100 Consulates or Deputy High Commissions outside capital cities, 10 Missions to international organisations, and conferences such as the UN, the EU and NATO. There are also 38 Posts staffed entirely by local staff, 229 Honorary Consuls and nine resident Governors in the UK Overseas Territories.

Funding and efficiency targets

1.10 The net funding provided by Parliament to the FCO was some £2 billion in 2007-08. Funding has remained broadly consistent for the past few years. The FCO collects fees from the public in respect of services it provides directly or on behalf of others, principally from UKBA for visas and from the Identity and Passport Service. Consular and visa income in 2007-08 was £370 million. The majority of this income can be used to fund expenditure.

1.11 **Figure 3** shows resource flows in and out of the Department in 2007-08. Some of these are complex, as where FCO both makes payments to another Department to support funding of certain activities, and receives funding from that Department in support of certain of its own activities.

1.12 In response to the 2007 Comprehensive Spending Review, the Department is to embark on a value-for-money programme to generate annual net cash-releasing savings of over £144 million by 2010-11 (including savings achieved by British Council and BBC World Service).

The Department's assets

1.13 The Department has an extensive estate which accounts for over 80 per cent of both its Fixed and Net Assets. The current overseas estate consists of some 4,850 properties, including embassy buildings, accommodation and other facilities. The overseas estate accommodates not only FCO staff, but also staff from other Government Departments and other public sector organisations. **Figure 4 on page 12** shows the types and value of assets held by the FCO as at 31 March 2008. Total fixed assets for 2007-08 for FCO were £1.8 billion.

1.14 Management of this sizeable asset base presents a significant financial management challenge to the Department. The NAO is carrying out a value for money study on the Department's management of its overseas estate, the results of which are due to be published in late 2009. We have therefore limited our work on assets in this report to reviewing the work of the Department's Investment Committee.

1.15 The FCO's network of IT systems supports global communication, real time transaction processing via Prism (the Department's accounting system, which is an Oracle Enterprise Resource Planning system), and effective operation of the resource planning system and management information system. The global IT network is also used by several Government Departments which work with the FCO, such as the Home Office.

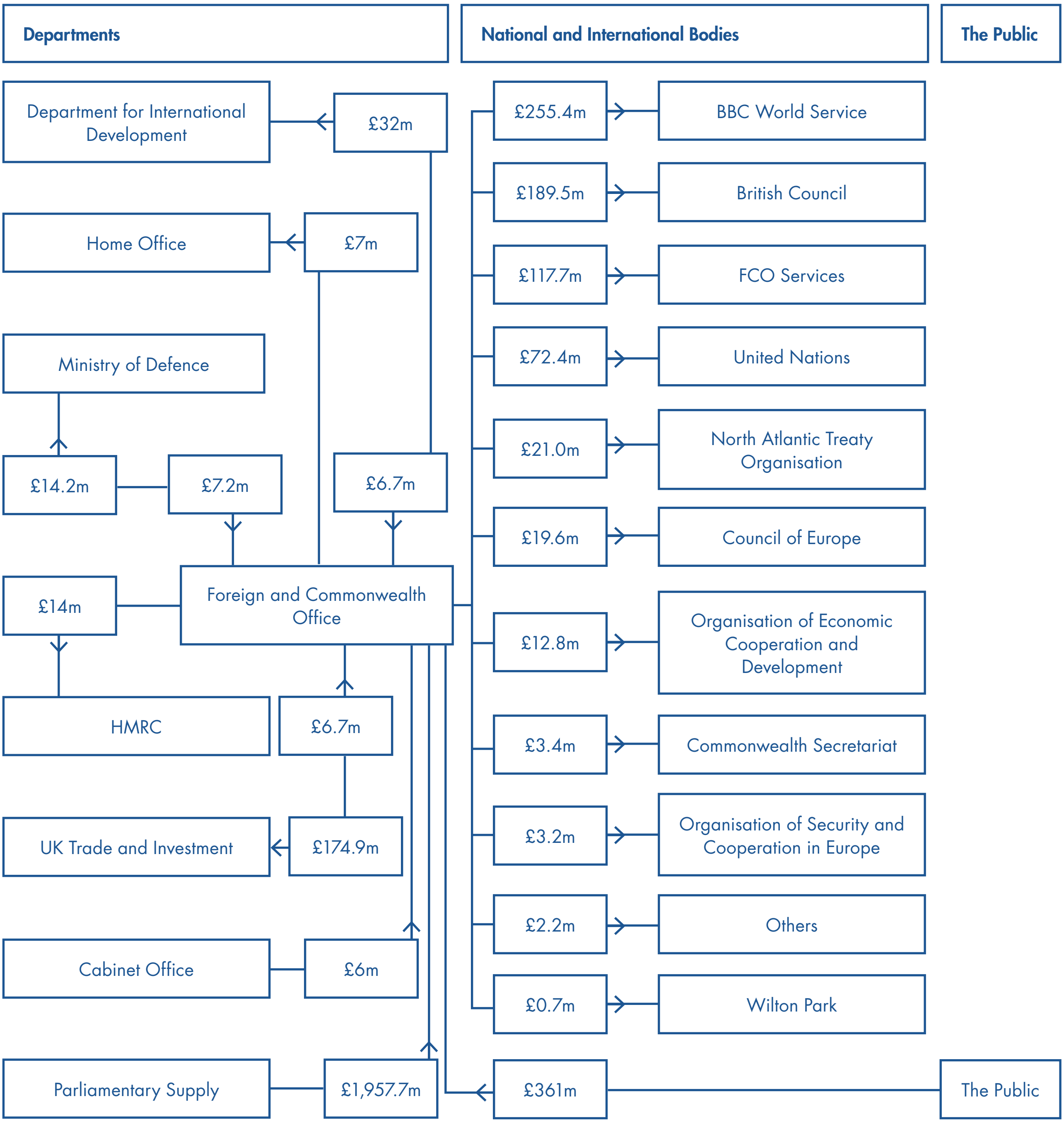
1.16 In 2007-08, the FCO had a total permanent staff of around 16,000, of whom 6,000 were UK-recruited and 10,000 recruited overseas.

Recent history of financial management development in the Department

1.17 Ultimate responsibility for financial management rests with the Accounting Officer, supported at the top level by the Board. In practice, there are four key strands of activity which, taken together, form the Department's financial management capability.

- The Finance Directorate – reporting via the Director of Finance through to the Director General, Finance on the Departmental Board, the Finance Directorate has core responsibility for management of the Department's resources, covering budgeting, planning, monitoring, reporting, financial systems and financial skills development.
- Directors General and Directors – each Board-level Director General is supported by a number of Directors who take the lead in specific policy and operational areas and have budget-holder responsibilities. Budgetary responsibility for specific areas of programme expenditure may be delegated further to staff at UK and overseas Posts. The Department has recently introduced a requirement for Director Generals to conduct quarterly reviews of budgets and forecasts with their Directors.
- Resource Management Units (RMUs) – each Director General is assisted by a UK based RMU, which provides support in financial planning, budgeting, forecasting and monitoring. They also act as a liaison point for overseas Posts and will challenge and collect the monthly figures and budgets from the Posts.
- Overseas Posts – led by the Head of Mission (HoM), each overseas Post has budgetary responsibility for administration of the post and for financial management of consular and visa activities. Whilst ultimate responsibility for financial management at a Post rests with the HoM, day-to-day responsibility may be delegated to a Senior Management Officer (SMO). SMOs will generally also work closely with the relevant RMU covering their geographical area.

3 Resource flows for the Department (based on 2007-08 figures)



Source: National Audit Office analysis of FCO figures

NOTE

This diagram shows how resources flow in and out of the FCO. Further details of the expenditure and income of the FCO can be found in its Resource Accounts for 2007-08. HC 614.

1.18 The Department recognises the importance of good financial management and has developed a programme called 'Five Star Finance', to develop its financial management capability and financial management information processes. The FCO Board strongly endorsed the programme which was introduced on 11 September 2007 with the vision:

- to be recognised as the best in Whitehall;
- to use simplified, standardised and streamlined processes and tools to ensure that the Department gets things right first time, and makes best use of limited resources;
- to become a beacon organisation – learning from and sharing best practice with other Departments; and
- for the whole finance community to actively strive for excellence, delivering an efficient and effective service to customers, and developing their own skills in doing so.

1.19 Each star represents a key milestone, with five stars being the ultimate objective. To achieve each star there are a number of projects, processes and level of competencies that the Department aims to put in place.

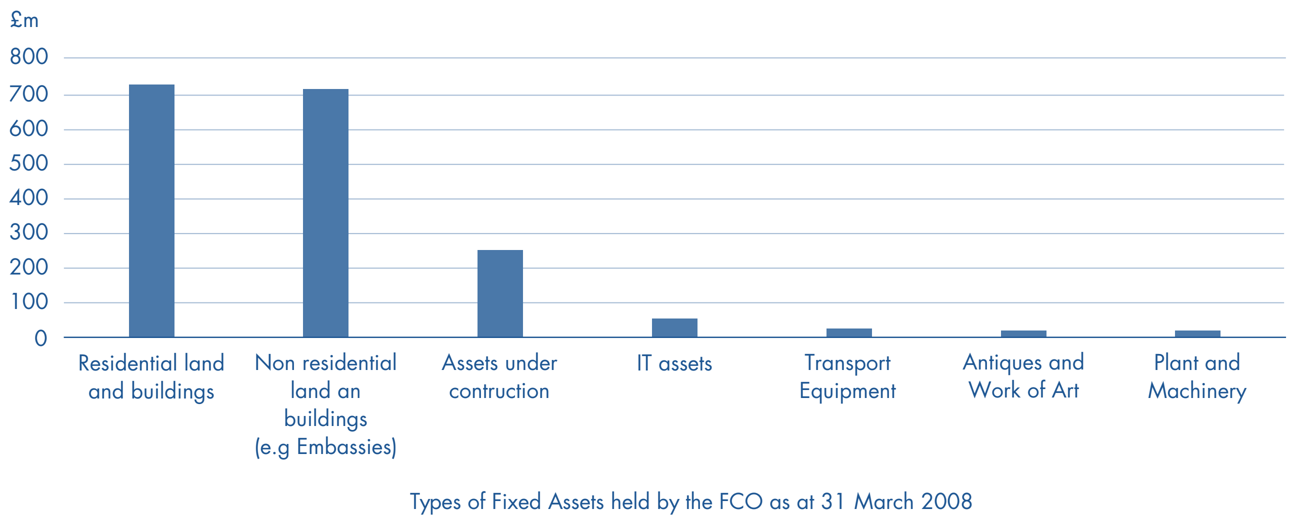
1.20 The Five Star Finance programme comprises some 24 individual projects covering a wide range of issues, including the selection and implementation of a new management information reporting tool, the development of a Professional Finance Training Programme, and the simplification of systems and processes, all of which need to be addressed if the objectives of the programme are to be met.

1.21 **Figure 5** sets out FCO's milestones against which it is measuring progress of the Five Star Finance project. The definition of each milestone was derived in part from the National Audit Office report, *Managing resources to deliver better public services*[1]. The original timeframe for achieving each star has slipped as the programme has progressed. The Department currently rates itself at three and a half stars (achieved August 2008). We consider that this is a reasonable and soundly based assessment against the targets set within the original project plan. The delay in achieving milestones can be attributed to:

- an ambitious timetable in completing the more challenging tasks to reach 4 and 5 stars; and
- additional tasks added once 3 stars had been achieved, such as increased efforts in purchase to pay compliance.

1.22 The Five Star Finance Programme has helped the Department make significant progress in improving financial management. As we explore in this report, however, more needs to be done across a range of areas in order to embed strong financial management across the Department and build upon the progress already made.

4 Types and values of assets held by the FCO as at 31 March 2008



Source: FCO Resource Accounts 2007-08

1 Managing resources to deliver better public services, National Audit Office, HC 61-I, December 2003.

1.23 In managing actively the Five Star Finance Project, the Department is in the process of updating the measurable achievements against which achieving the full 'Five Stars' will be judged, and extending the timetable for achieving them. These milestones are evidence that the Department is challenging and enhancing its own interpretation of what excellent financial management looks like, as thinking more generally across Government has also evolved. The future challenge for the Department is to build on the Project when completed, to embed a culture of continuous improvement in financial management.

1.24 The Department has itself recognised the need for a degree of independent assurance over its progress in this area. In May 2008, it commissioned the Institute of Public Finance Ltd (IPF) to carry out a review of progress made to date and the scope for further improvements. The review concluded that the building blocks of financial management are largely in place, to secure effective stewardship of resources. It found that the FCO still has work to do to ensure that core financial competencies are present throughout the organisation to support performance and enable transformation. FCO is establishing an action plan to respond to the main issues raised by the IPF review.

Financial Performance in the FCO

FCO expenditure against budget

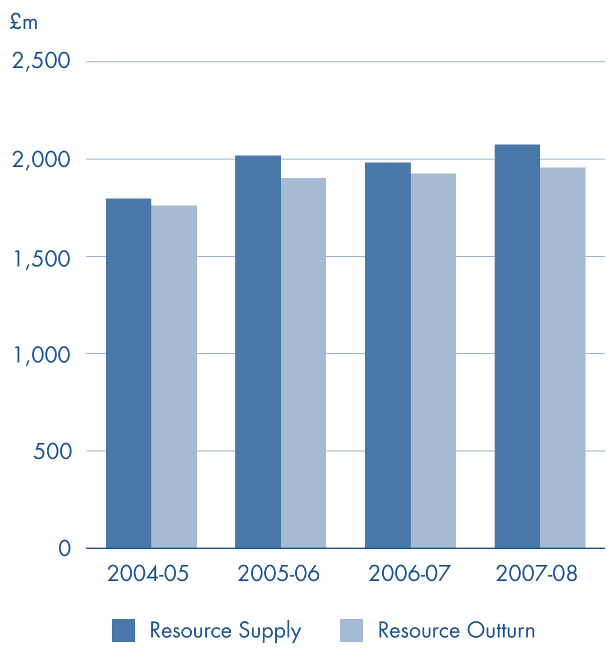
1.25 The Department manages its resources within the budgetary control totals set by the Treasury and, if successful in doing so, will keep its use of resources within the limits voted by Parliament. **Figures 6 and 7 overleaf** show the Department's actual expenditure against Estimates voted by Parliament for Resource and Capital expenditure since 2004-05. There is a consistent pattern of underspending within resource expenditure, with the underspend representing two per cent, six per cent, three per cent and six per cent for each of the years 2004-05 to 2007-08, respectively.

5 Five Star Finance project milestones

Star	Finance Directorate Definition	Original target	Actual or Forecast Achievement (as at February 2009)
1	Accounts and budgetary systems remain cash-based. A separate process exists to draw up financial statements for Parliament and for external publication.	Already achieved before initiating programme	Already achieved before initiating programme
2	Systems are moving towards accruals reporting but in-year financial information on this basis is produced only periodically and budgetary control is hybrid of cash and accruals.	Already achieved before initiating programme	Already achieved before initiating programme
3	Monthly accruals based in-year financial information and annual financial statements are produced by the same process. The focus of control is shifting to accruals based budgets and targets and there is good use of financial and performance data in decision making.	December 2007	February 2008
4	Accrual based and cash flow information are fully integrated both for internal management and external reporting. Separate reports on department's operational activity are reliable, regularly produced and underpin decision making and future investment strategy.	September/ October 2008	July 2009
5	The Board is able to challenge competing business proposals, has a clear view of the likely year-end financial position, and can produce robust medium-term business and investment strategies. Clear accurate and reliable in-year financial information, produced by the same process as annual financial statements and fully integrated with operational performance data, is reported to the Board monthly, enabling the Board to build financial considerations into its key operational and strategic decision making processes.	March/April 2009	May 2010

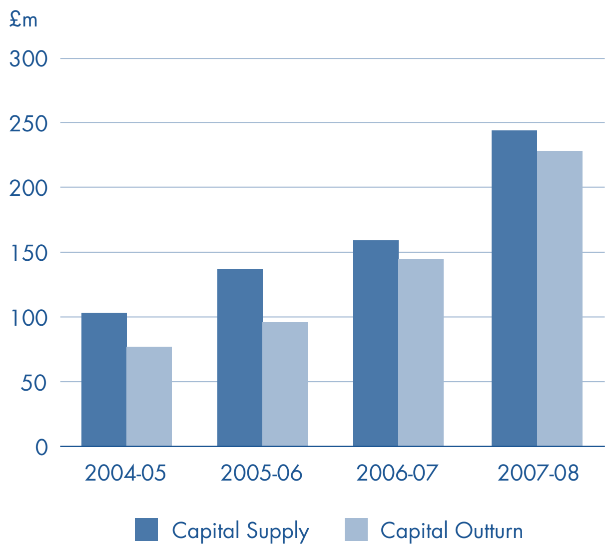
Source: FCO Five Star Programme

6 The Department has consistently underspent against its resource budget



Source: FCO Resource Accounts

7 The Department has consistently underspent against its capital budget



Source: Provisional Expenditure Outturn White Papers 2004-08, HMTreasury

NOTE

Capital Supply 2007-08 includes £66.3 million transferred from prior year's EYF (see Figure 8).

1.26 On capital expenditure, the underspending has been more pronounced though it has improved over time, with the underspend representing 25 per cent, 30 per cent, nine per cent and seven per cent for each of the years 2004-05 to 2007-08, respectively.

1.27 Government Departments may, with the permission of HM Treasury, carry forward unspent funds into future years through the system of End Year Flexibility (EYF). EYF was introduced by HM Treasury to encourage good financial management, and to discourage Departments from purchasing non-essential items in the last months of the financial year. **Figure 8** shows the build-up of the Department's EYF since 2003-04. It currently stands at around eight per cent (£170 million) of the Department's yearly resource allocation.

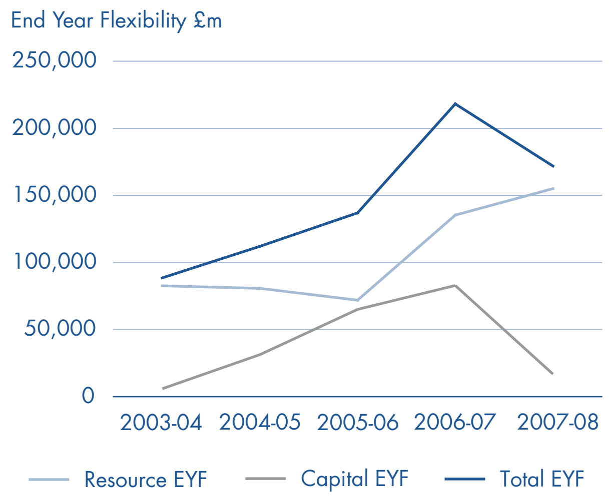
1.28 Consistent build-up of EYF over a long period flows from the analysis of Resource and Capital expenditure set out in Figures 6 and 7. Figure 8 illustrates how the Department has built up reserves of EYF in recent years. As part of broader public expenditure controls, and in a context of tightening resource availability more generally, the Treasury has tightened controls over use of accumulated EYF. In practice, this means that the Department may have limited access to these amounts going forwards to fund service delivery. The Department therefore needs effective in-year monitoring to spot underspends early so that it can move resources around the organisation effectively.

Paying suppliers on time

1.29 In the past five years, central government departments have been measured against a target of paying supplier invoices within 30 days. In October 2008, the Prime Minister issued a challenge for public bodies to pay small businesses within 10 days. Since 2005-06, the Department has been able to pay 93 per cent of all UK generated invoices within 30 days **(see Figure 9)**, but only 77 per cent within 10 days since the Prime Minister's announcement (as at December 2008). The Department is aiming to achieve further improvements in payment times through centralising UK invoice processing.

1.30 Prompt payment relies on the Department using its accounting system efficiently while maintaining appropriate authorisation controls and segregation of duties. Improving purchasing processes forms an important element of the Department's Five Star Finance project, since it will allow for prompt identification of expenditure commitments and hence act as a basis for improved in-year financial management. The Department has introduced purchasing performance indicators, whereby it can identify areas of the business where improvements are yet to be realised, so that it can focus efforts and hold teams accountable.

8 End Year Flexibility 2003-04 to 2007-08 (cumulative)

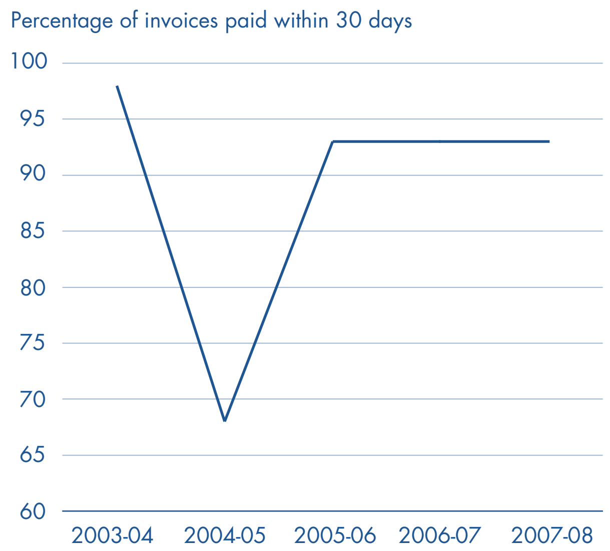


Source: HM Treasury's Public Expenditure Outturn White Papers 2003-04 to 2007-08

NOTE

The decrease in Capital EYF 2007-08 represents £66.3 million transferred to Capital Supply (see Figure 7).

9 FCO prompt payment performance



Source: Foreign and Commonwealth Office Resource Accounts 2003-04 to 2007-08

NOTE

The low payment performance in 2004-05 was in part due to the implementation of a new accounting system, which lead to difficulties in recording and paying invoices.

PART TWO

Financial Management Capacity

2.1 Good financial management should enable a Department: to allocate resources by objective and priority to achieve maximum overall performance; achieve value for money; manage resource consumption within the limits approved by Parliament and budgets agreed with HM Treasury; and effectively manage the financial risks to the organisation. The National Audit Office developed its own toolkit for reviewing financial management from published methodologies, which was used when undertaking this review. The approach followed the principles set out in the Audit Commission Discussion Paper World Class Financial Management published in 2005, and broadly accepted by the Treasury and other commentators. This part of the report assesses the financial management capacity of the Department against the following five criteria identified in the toolkit:

- Financial governance and leadership.
- Financial planning.
- Finance for decision-making.
- Financial monitoring and forecasting.
- Financial and operational reporting.

i) Financial Governance and Leadership

2.2 The quality of financial governance and leadership within an organisation, "the tone from the top", is fundamental to staff taking financial management seriously. Sound financial governance also depends on well-developed internal control and risk management, and staff having appropriate financial management skills and expertise.

Leadership

2.3 The Board and Permanent Under Secretary have demonstrated strong and consistent leadership over the last two years to improve financial management within the FCO, as evidenced by their promotion of the Five Star Finance project.

2.4 Survey work carried out by IPF in support of its review scored the Department strongly on the lead given from the top in establishing the importance of strong financial management through the organisation. This assessment is consistent with the NAO's own experience in auditing the Department's accounts, and in interviewing a selection of staff across the Department in support of this review.

Governance structures

2.5 Accountability and governance arrangements are set down for the Board and its sub-committees in published Terms of Reference. The Board has five sub-committees which support it in the delivery of its objectives: The Audit and Risk Committee, the Finance Committee, the Investment Committee, the Change Committee and the Human Resource Committee. While each has an important role in the governance of the Department, the first three play a direct role in the Department's financial management.

2.6 The Audit and Risk Committee (ARC) is chaired by a Non Executive Director, currently a senior partner with one of the "Big Four" accountancy firms. ARC's role includes:

- the oversight and monitoring of the plans and outputs from the Internal Audit Department and the Financial Compliance Unit;
- review of the process for updating the Operational Risk Register, and the annual Statement on Internal Control and the process supporting its preparation;
- reviewing the Department's annual Financial Statements; and
- the monitoring and oversight of the External Auditor's plans and outputs.

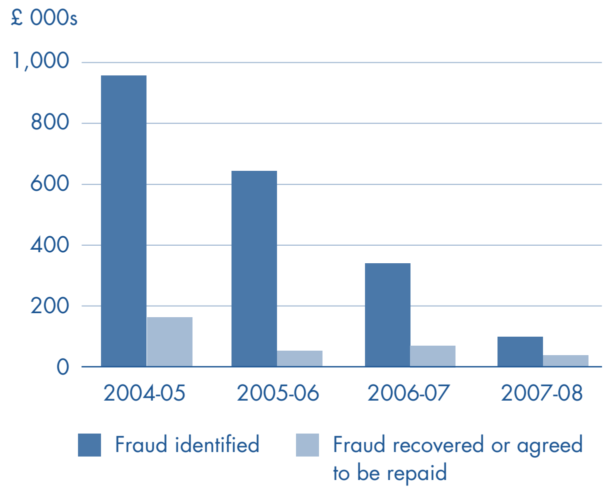
2.7 ARC has proved effective in providing a robust challenge to the Department's management on both governance and financial matters. It has played a key role in driving forward Five Star Finance and the associated development of improvements in financial reporting. Such a challenge has helped provide a clear message from the top of the Department that timely, accurate and complete financial information is essential.

2.8 The Accounting Officer and ARC are supported by an effective internal audit function. Internal audit presents annual reports to the Permanent Under Secretary and to ARC. Internal audit plans its work by reference to assessed risk. Its programme of work covers a wide range of audits both in the UK and at overseas posts.

2.9 During 2008, the FCO commissioned an external peer review of its internal audit function. The review, which also took account of the team's own self-assessment, concluded that the FCO's Internal Audit Unit complies with Government Internal Audit Standards, and is professional and well-managed. Whilst the review team made some recommendations, it did not highlight any serious weaknesses in the team.

2.10 The risk of fraud at the FCO is policed actively by both Internal Audit and by the Department's Financial Compliance Unit (FCU). The FCU's main role is to investigate actual or suspected irregularity, fraud or corruption and to carry out surprise visits to test counter-fraud controls at overseas posts. The total amount of fraud identified and recovered or agreed to be repaid between 2004-05 and 2007-08 is summarised in **Figure 10**. The highest amount of fraud identified during this period was £1 million in 2004-05, representing 0.05 per cent of total resources granted in that year.

10 Total amount of fraud identified and recovered between 2004-05 and 2007-08



Source: FCO Audit and Risk Committee papers 2007-08

2.11 The apparent low level of recoveries reflects a small number of large cases where either the beneficiary of the fraud cannot be traced or where the legal process is still ongoing. The downward trend of fraud may be partly attributable to a tighter control framework and the introduction of Prism – the global accounting system. It could also be a product of a reduction in the number of whistleblowers (the main source of identifying fraud).

Professionalisation of finance staff

2.12 One measure of financial capability is the professionalisation of finance staff in the Department. The Director General Finance, a qualified accountant, joined the Departmental Board in April 2007, having joined the FCO in January 2007. He is supported in turn, by a Finance Director who is also professionally qualified.

2.13 As at October 2008, the Department had 32 qualified accountants across the whole organisation, including the DG Finance and Finance Director. Ten of these accountants were based outside the finance function – an important move as it helps bring financial capability to the wider organisation. Overall, however, the proportion of qualified staff within the Department's finance function is eight per cent, which is below central government's average of 14 per cent in 2007[2].

2 Managing financial resources to deliver better public services, National Audit Office, HC 240, February 2008.

2.14 Generalist staff within the Department tend to move roles approximately every three to five years. Training and guidance is available to staff who move into a role requiring particular financial skills (e.g. project management), but the evidence from our interviews with a range of staff is that the effectiveness of this training could be improved.

2.15 The Department has recognised that it needs to do more to build financial skills, both inside and outside the Finance Department. In response it launched its Financial Skills Project in July 2007, a strand of the Five Star Finance Programme. The Project, which was scheduled initially to run for 18 months but has now been extended, has two main strands: professionalising the financial community, and improving financial management skills across the broader Department.

2.16 As part of the former strand of the project, the Department completed a financial skills framework document in September 2008, based on a similar exercise carried out the by the Ministry of Defence. Managers will use the framework to define the skills required for every job in the finance community. Job-holders should compare their own skills with the finance skills required for the job, and undertake training or development to fill any gaps in their skills matrix. The Department has identified seven skills areas **(see Figure 11)** and for each has highlighted in detail what would be expected at an awareness level (aimed at all staff including non-finance), at a practitioner level and at an expert level. It also highlights the training that should be carried out for each skill area. A practical future challenge will be testing that staff meet the required level of competence, and linking it in turn to the assessment of individuals' performance.

11 The skill areas included in the financial skills framework

- Management accounting
- Capital expenditure
- Treasury management
- Financial accounting
- Business planning and performance management
- Governance and risk management
- Financial systems

Source: FCO Financial Skills Framework

2.17 To address the shortfall of professionally qualified staff, the Department has launched a professional finance training programme that offers a range of external options, ranging from bookkeeping and accounting technician qualifications through to full professional accountancy training. Over a three-year training period, trainees will gain experience of different areas of the business and will complete a two year role in finance at the end of their training.

2.18 In September 2007 eight people joined the programme out of a possible 10 places available. The Department has subsequently introduced an internal entry route for accountancy training to provide further developmental opportunities for FCO staff. 11 applications have been received, and the selection process is ongoing.

2.19 The Department is also responding to known areas of weakness by piloting training programmes to improve skills of non finance staff. From January 2009, two courses will be on offer to all members of the Department: one for improving general awareness of finance in the FCO and the other targeted at budgeting, monitoring and forecasting.

2.20 The Department had set itself a target for 85 per cent of senior staff to complete the Professional Skills for Government Financial Management e-learning course by 31st December 2008. At the time of our review, however, the Department had concluded that the available data were not sufficiently reliable to confirm who had actually completed the course and how well staff had actually performed. The Department was considering conducting a survey of senior staff to collate more accurate data on completion rates.

2.21 Where the Department has more certainty is on the numbers of senior staff attending the two-day Professional Skills for Government Financial Management course. As at 10 December 2008, the figure was 70 per cent, set against a 75 per cent completion target by 30 September 2008.

2.22 There is scope to offer additional tailored finance training for the following important roles:

- **Senior Management Officers (SMOs)**. SMOs have day-to-day financial responsibilities at FCO overseas posts. Whilst there is good training in place for SMOs prior to taking up post, evidence from our visits to FCO posts indicates that SMOs would also benefit from focused refresher training when some months into their posting.
- **Directors**. Our discussions with a number of Directors across the Department indicated scope for further focused training in relation to budget-holder responsibilities.

2.23 In previous years, we have noted during our audits that the Department employs a large number of contractors and consultants working in the Finance Directorate to assist in the production of the accounts. A reduction in numbers might indicate that the Department's own finance community was increasingly able to handle professional tasks, but the Department was unable to provide details to us of the trend over time in the number of contractors and consultants thus employed.

ii) Financial planning

2.24 The FCO faces inherent challenges in planning its allocation of resources, in that it needs to be flexible in moving resources around the world to meet emerging events or challenges, but at the same time it needs to keep a strong awareness of how these re-allocations impact on the longer term financial plans.

2.25 Departmental funding linked to Public Service Agreements and Departmental Strategic Objectives is agreed with the Treasury for three year periods (see Appendix 2 for a full list of the FCO DSOs). The latest allocation of resources for three years was determined in the Comprehensive Spending Review (CSR) 2007. It provides the Department with baseline resource figures for April 2008 through to March 2011, and therefore largely dictates the medium term financial planning envelope. Formal approval for the Department's budget each year is provided by Parliamentary approval of the Department's Estimate.

2.26 Following the CSR settlement, the Department carried out its Resource Allocation Round process, which involved initially dividing its allocation across each Director General command for the three year period. DGs bid for resources, with resultant allocations firm for Year 1 and indicative for Years 2 and 3.

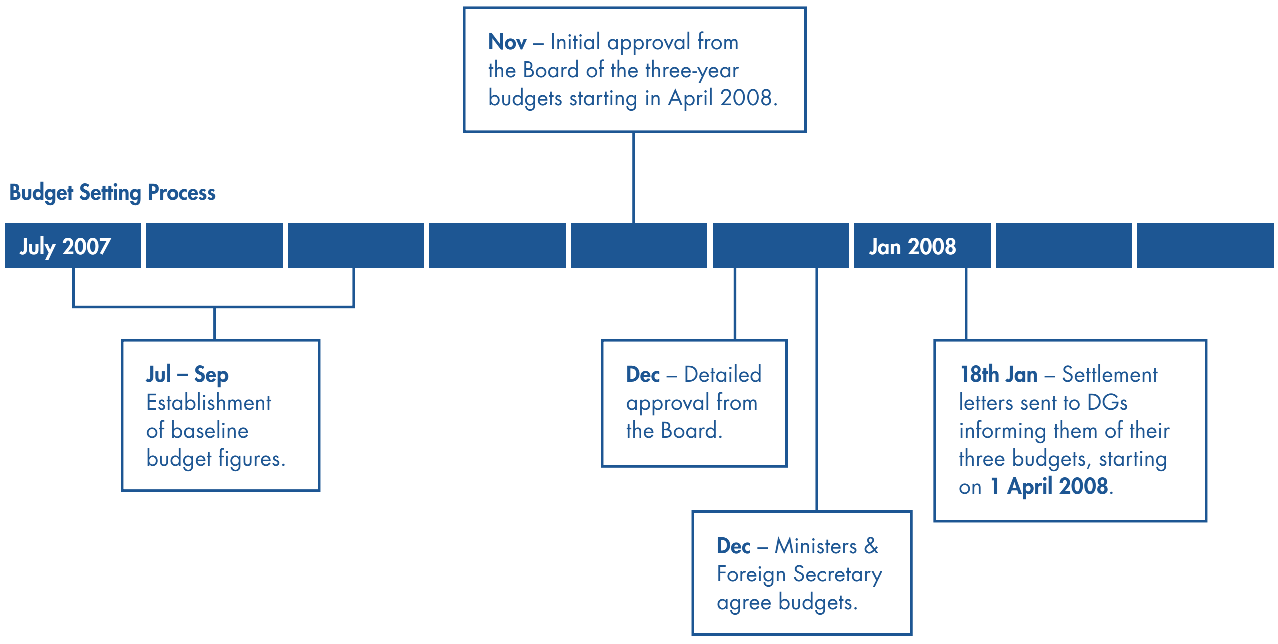
2.27 Between July and September 2007, The Financial Management Group (FMG) carried out a review of the budgets for 2007-08 to establish a fresh 'baseline' figure. This figure was used as a guideline for assessing the resourcing bids from the different DGs across the organisation for the next three years. In establishing the baseline, the Department included both exchange rate adjustments and transfers between DG commands where activity had moved. It uplifted the baseline budgets for inflation (2.7 per cent generally and 2 per cent for pay) before deducting target efficiency savings of 5 per cent in administration costs. **Figure 12 overleaf** depicts the time line for budget approval.

2.28 Once the DG has been informed of their allocation, budgets will be delegated to individual budgets holders e.g. Directors and Heads of Mission at overseas Posts. We noted some evidence, based on our interviews, of delays in delegating budgets to budget holders within DG commands.

Business Planning Process

2.29 In parallel to the process for allocating financial budgets, the Department has a separate business planning framework, which it is in the process of developing. Taking account of feedback from its Capability review, which identified the Department's ability to "plan, resource and prioritise" as an urgent development area, a revised Business Planning Framework was introduced in 2007-08. The Framework sought to reconcile what the Department describes as the "inherent tension" at the heart of its operational planning process, namely that its activities and objectives are defined thematically, through Departmental Strategic Objectives (DSOs), but the main delivery mechanism is geographic (through the overseas network). This tension is addressed through DSO plans developed through DSO owners at a corporate level, with Geographical Directorate Business Plans setting out how resources will be allocated to support DSOs in their regions, supported in turn by Country Business Plans produced and owned by Heads of Mission. **Figure 13 overleaf** sets out how the three types of business plan fit together.

12 Time Line of Budget Approval for the beginning of a CSR 07



Source: NAO (based on review of documents and interviews)

13 The Business Planning Process in the FCO

DSO Plans

The **DSO Plans** are produced and owned by the DSO Owners nominated by the FCO Board. The DSO Plans should identify the main objectives and the priority countries for each DSO, building on the FCO's **Strategy Refresh**. The objectives should be prioritised, limited in number, focussed on outcomes and performance indicators. They should cover the full range of work under each DSO. They should feed into Strategic Programme Fund (SPF) Strategies. DSO Owners should consult Geographic Directors, HoMs, and other stakeholders – Partners Across Government (PAGs) and Non-Governmental Organisations (NGOs) – in drawing up the Plans and identifying priority countries.

↓

Directorate Business Plans

Geographic Directorate Business Plans, produced and owned by Geographic Directors.

These plans should detail how resources will be allocated to support the DSOs in their region, and identify where resources may be most effectively deployed at the regional level. They should be signed-off by DGs.

↓

Country Business Plans

Country Business Plans (CBPs), produced and owned by Heads of Mission. HoMs should identify the key FCO objectives across the DSOs for each country that has been identified in the DSO Plan as a priority, which may be all eight DSOs for some Posts and perhaps one or two for others. The CBPs should be agreed with the respective DSO Owners, and signed off by Geographic Directors. They need to show how resources (both staff and programme) will be deployed to achieve maximum impact, including at sub-ordinate Posts. The plans need to be sufficiently detailed with clear targets and milestones to monitor against.

Source: FCO

2.30 Whilst the new framework helps address the tension noted above, the business planning process remains complicated and, perhaps most significantly from the point of view of financial management, it is difficult to see the linkage between outcomes/outputs and the allocation of resources. What remains to be established is a firm link between this business planning process and final resource allocation decisions.

2.31 The Department has acknowledged the unclear linkages between business planning and resource allocations, and it has also acknowledged the lack of financial information in the business planning process. Its starting point for improvement is to develop better management information, in particular through an improved system of activity recording, given that staff are the key resource to be deployed in pursuit of the various Departmental Strategic Objectives.

2.32 The new system aims to provide reports (at organisation, DG/directorate and overseas post level) on the deployment of staff and the activities they are engaged in with the aim of mapping resource utilisation more effectively on to business plans and informing forward decision-making. For 2008-09, activity data is being collected on a quarterly basis. In spite of initial data quality problems, activity data for Quarter 2 of 2008-09 was substantially complete, allowing the Board to conclude that a further shift from management and support to frontline activities was required.

2.33 The Department now has the challenge of implementing a more permanent solution and striving to obtain regular accurate activity data so that the Board has enough confidence to make firm decisions based on the information. Improvements in activity recording should provide the basis for budgets for DSOs, and will assist in longer term resource allocation. Only by making clear progress in this area will the Department develop a complete picture of the full cost of all its various activities. An important element of this work will be ensuring the understanding and buy-in of operational staff, so that the information collected is soundly based.

iii) Finance for decision making

2.34 The Board and its Committees need to consider the value for money achieved by allocating resources to different activities. They also need to have a thorough understanding of the financial implications of policies, programmes and activities.

2.35 The Department manages decisions on future investments and resourcing commitments through two sub-committees of the Board, the Finance Committee and the Investment Committee.

2.36 The Finance Committee, which meets monthly, is chaired by the Director General Finance. The Committee's role includes:

- overseeing the way that the FCO spends its money;
- guiding the budget process;
- monitoring FCO's performance and its efficiency plan; and
- managing exchange rate risk.

2.37 The Committee is increasingly using financial information to make decisions on financial risks arising from operating activities and investment decisions. It is supported in this role by the Strategic Planning Team, which presents options papers for proposed changes to the agreed programmes to the Finance Committee asking them for approval. The Finance Committee is authorised to agree budgetary changes valued up to £10 million. If the shift in priorities is greater than £10 million, the options paper will go to the Board for comment and decision.

2.38 A recent example of detailed financial analysis in support of a significant operational shift was the Board's decision to close the Department's Shared Services Programme, and replace it with a re-focused Corporate Services Change Programme. Net present value calculations and other analysis indicated that the initial project would not deliver the benefits that were originally proposed.

2.39 Since early 2008, the Finance Committee has taken on the role of reviewing the "Key Performance Report", the main management information pack prepared for Board meetings, before it is presented to the Board. This review has enabled the Finance Committee to develop its assessment of areas of high expenditure or variation from budget so that better commentary can be provided to the Board.

2.40 Our review of a sample of Finance Committee submissions indicated that there is scope for more scenario and sensitivity analysis to help assist in decision making.

2.41 The Investment Committee is chaired by Director General Defence and Intelligence and meets monthly. Its role includes:

- consideration of business cases in order to make capital investment decisions;
- monitoring of forecast capital expenditure against budget; and
- monitoring capital project progress and developments on an ad-hoc basis.

2.42 The Committee uses a process for investment appraisal based on OGC Gateway principles. The Committee recently undertook a self-assessment exercise which indicated that whilst members and participants were generally satisfied with its operation, there were a number of areas where its effectiveness could be enhanced. They included seeking financially qualified staff to join the Committee, and improving the clarity of investment decision papers to allow effective decision making.

2.43 An area where there may be scope for improvement lies in the ongoing scrutiny of major capital projects requiring a mix of funding (capital and resource) once the initial investment decision has been approved. Some projects fall under the scrutiny of three committees, such as the "Firecrest" project to replace the Department's ICT systems. This project is scrutinised by the Finance Committee, the Investment Committee, and the Change Committee, which monitors major Departmental change projects. This project also has its own project board, as for every major capital project. There is a risk of duplication of scrutiny of such projects and unclear reporting lines to the Board.

2.44 Estate matters will continue to be a particularly challenging area, as the Department shares and develops its overseas estate with a broad range of other active Government departments. In discussion with staff, we found an appetite to develop the role of the Investment Committee to have a greater influence over the longer term strategies of the major capital spending groups in the Department such as Estates and IT, rather than simply focusing on individual projects.

Post Project Reviews

2.45 Each project has a senior director assigned to it. The Project Director has overall responsibility for the project and for reporting on its progress to a central programme monitoring team. At the end of each project, managers are required to communicate to the same team any lessons to be learned. A project evaluation is also completed one year after project completion to assess whether the expected benefits are being realised. It was not clear to us whether this information is shared with an appropriate body such as the Investment Committee, even in summarised form to assess whether projects are realising the expected benefits, and to identify lessons more broadly for the Department.

iv) Financial monitoring and forecasting

2.46 The Department needs to have good quality financial monitoring systems in place to verify that its resources are being spent as intended and so that it understands its financial position at any time. It should monitor and review the costs of its key activities and assure itself that financial performance to date and forecast financial outturn for the year are in line with its plans and consistent with operational performance.

Monthly reporting teams

2.47 The Department's in-year financial monitoring is carried out by the Finance Management Group (FMG). This team keeps an overall check on all the delegated budgets, movements across budgets and challenge forecasts with a view to reallocating any variation in spending. In addition to the FMG, each Director General is assisted by a Resource Management Unit (RMUs) which provides support in financial planning, budgeting, forecasting and monitoring.

2.48 From discussions with each of the RMUs, there is scope for the Department to be clearer about the core elements of its role to ensure that accountability and reporting is consistent across the Department. Staff from some RMUs expressed concern to us that there is not a clear definition of their role. The Department has acknowledged this concern, and is considering the future shape and size of RMUs as part of the Five Star Finance project.

History of Underspending

2.49 Robust management information systems and processes are essential to effective monitoring and accurate forecasting of expenditure. With sound forecasts of potential underspends or overspends at budget holder level, the Department has the opportunity to re-allocate budgets between holders, or to set budgets at a more realistic level going forward if funds are not required. The Department's history of underspends (as depicted in Figures 6 and 7) suggests that previous arrangements to embed accurate financial forecasting, a fundamental element of good financial management, have not had the required effect.

2.50 There have been several contributory factors in previous years' underspends:

- Lack of financial skills to monitor budgets effectively.
- Lack of trust in the accounting systems to provide accurate monthly actual figures.
- Budget holder prudence to minimise the risk of overspending.
- Lack of ownership of budgets.
- Lack of personal accountability for significant underspending.

Monthly accounting systems

2.51 One of the items in the list above is the "lack of trust" in the monthly accounting system and its complex structure, which has in turn helped contribute to a lack of ownership of budgets.

2.52 The principal financial management information tool available to budget holders in the FCO is OFA (Oracle Financial Analyzer). One of the main criticisms of OFA expressed to us was that the management information system did not allow budget holders access to the information they needed to manage and monitor their budgets. Information on spending against budgets was only available two weeks after the month-end.

2.53 The lack of real time information has meant some budget holders maintain their own spreadsheets, creating the risk of there being "several versions of the truth". Furthermore, timing difference between figures recorded on the general ledger and the figures reported in OFA reports make it difficult for budget holders to reconcile their month end position with figures in the Department's core General Ledger. The more manipulation that is done, the more likely will be inaccuracies in the reported figures.

2.54 The Department has recognised that there are weaknesses with the current management information system, and is in the process of introducing a new Planning and Budgeting tool called Hyperion together with a replacement management information system OBIEE+. There is a sense of anticipation about their introduction, whereby Hyperion is seen as a panacea for the previous problems of inaccurate figures, for not having budgets on the general ledger and for timing differences. For these new management information tools to truly make a difference, however, the Department will need to ensure that it delivers an effective training programme, with refresher training once the system has become established.

Unexpected expenditure charged to budget holders

2.55 It is not always clear to budget holders where all the accounting entries relating to the expenditure against their budget have come from. The principal contributory factor is that the accounting system is set up so that it is possible, if correct purchase to pay procedures are not followed, for anyone to post items to any budget codes increasing the risk of erroneous entries. For example, some 24 per cent of purchase orders at the beginning of January 2009 were charged to budget holders outside the Directorate which had raised them.

2.56 Year-end postings are made to budget holders codes to reflect assets and liabilities such as prepayments and accruals, and in-year adjustments are made to budgets in respect of re-allocation of the costs of bulk purchased items such as laptops and mobile phones. Both types of adjustments should reflect actual budget holder activity, but the Finance Team has recognised the need for better communication with RMUs so that confidence in underlying finance data is improved. This improved visibility should help improve accountability, facilitate more successful forecasting and budgeting and improve central finance's position as an enabler for the broader business.

Forecasting

2.57 A further problem in the past has been that budget holders have consistently forecast their expenditure to meet their assigned budget by re-profiling the balance unspent across the remaining months of the year rather than surrendering back amounts unlikely to be spent. By the time budget holders declare underspending in February/March of the financial year there is insufficient time to secure best value by applying resources elsewhere and underspending for the Department becomes inevitable.

The 2007-08 underspending

2.58 All the weaknesses described above helped contribute to a large underspend in 2007-08. **Figure 14** shows that the majority of the 2007-08 underspending fell within the Department's administration and programme allocation totalling £118 million (representing six per cent of the resource budget). A further £10 million capital allocation was not spent.

2.59 Part way through the year, a projected overspend led to a request from the Department to the Treasury for additional resources drawing upon End Year Flexibility. As the financial year-end approached, however, forecast resource and capital expenditure outturn reduced to an eventual underspending of £128 million.

2.60 The underspending of the resource allocation was made up of a mixture of near cash underspend (£64 million) and unanticipated accounting entries relating to impairments in the value of assets (£54 million). The £64 million underspend was in part due to higher than expected efficiencies in reducing expenditure on staff, security in the Middle East and travel costs. Another element was attributable to international subscriptions being paid in January 2008 in US dollars at a time when sterling was strong. The sterling estimate for these subscriptions was some £8 million higher than actual expenditure, owing to the strength of Sterling.

14 The Department's underspend in 2007-08

Budget expenditure type	Budget (£m)	Actual (£m)	Underspend (£m)
Resource	2,076	1,958	118
Capital	202	192	10
Less depreciation	(72)	(72)	–
Total	2,206	2,078	128

Source: FCO Resource Accounts 2007-08

NOTES

1 Resource budget includes administration and programme expenditure.

2 Figures relating to Capital exclude capital grants, which are included within Resource expenditure.

3 Depreciation, which forms part of Resource budget, is excluded from the total budget, to avoid double-counting.

2.61 The net underspend would have been even higher had it not been for a net loss, amounting to £18.6 million, in delivering its consular and visa activities, mainly through a shortfall in visa receipts. Though visa income is inherently difficult to predict, the FCO knew in August 2007 that visa receipts were likely to be lower than anticipated. The budget was not updated to reflect the fall in anticipated receipts.

2008-09 Financial Year

2.62 The Accounting Officer is resolved to take strong action to avoid late and unexpected shifts in forecast expenditure going forward. For 2008-09, he has set a target for overall underspending of no more than one per cent. This is a stern challenge considering how difficult the Department has found budgeting its income and expenditure in the past. Overseas property prices, changing levels of international conflict and recent very significant fluctuations in foreign exchange all contribute to the difficulty of establishing and working to accurate and realistic budgets.

2.63 An important new element of in-year financial monitoring for 2008-09, arising from the Five Star Finance Programme, is the introduction of quarterly reviews of the budgets and forecasts at Director General level. In the first quarter review for 2008-09, £24m of budget was given up by budget holders when challenged by the Finance Director and Director Generals. The second quarter review highlighted that budget holders had not spent their half-yearly budget, and had instead re-profiled their expenditure to show greater forecasted spending in the second half of the year. A further £10.7 million of budget was "returned" to the corporate centre.

2.64 The quarterly DG reviews help to challenge forecasts and provide scope, and time, to re-allocate resources to areas under cost pressure. Different DGs have taken different approaches to improving financial management in their commands. One DG we interviewed had "overcommitted" the budget intentionally based on his experience of consistent under-spending. It is still too soon, though, to tell whether the involvement of DGs in improving in year monitoring will have had the desired effect for the full 2008-09 financial year.

Accountability

2.65 Embedding financial management throughout the Department requires that budget holders are held accountable for financial management. A pre-condition is that budget holders are in possession of robust, reliable and timely financial information to allow them to manage their budgets, and we have noted that the Department is working to that end.

2.66 The Department aims to give due prominence to matters of financial management both in performance appraisals and in considerations of future postings for senior staff, seeing this emphasis as necessary if the importance of strong financial management is to be embedded successfully across the Department.

2.67 The Board at its November 2008 meeting agreed that those Directorates not achieving a fully spent budget during 2008/09 will have their allocations for 2009-10 reduced by an amount similar to any underspending. We understand the reasoning behind taking this step, but the Department will also need to guard against the risk of inappropriate or poorly conceived expenditure by budget holders towards the year end in the light of this decision.

Foreign Exchange Pressures

2.68 One of the biggest challenges the Department is now facing in terms of forecasting expenditure levels is significant fluctuation in foreign exchange valuations. The Department's global operations mean that it handles several different currencies, and has the potential to be exposed to significant foreign currency risk. Historically, the Department's budgets have been protected from exchange rates and differential inflationary pressures by the Treasury, but with effect from CSR 07 this protection has been withdrawn.

2.69 The Department has introduced alternative methods to manage its exposure, particularly through the forward purchase of foreign currency, but foreign exchange movements will continue to present significant challenges to FCO in managing its budget. For example, in the Department's recent Quarter 3 2008-09 finance review, it identified an additional call on resources from foreign exchange movements totalling £43 million.

2.70 Foreign exchange is new territory for the Department. Thus far it has taken appropriate action to seek to manage this risk, and it will need to ensure that it has the appropriate skills in place in the Finance Team going forward.

v) Financial and operational reporting

2.71 The Department needs to demonstrate to its stakeholders how it is spending its resources and what it is achieving. Internally, it is important that reports support management to make timely and sound decisions on the allocation of resources, and they should therefore integrate financial and operational reporting.

External Financial Reporting

2.72 The Comptroller and Auditor General signed his opinion on the Department's Resource Accounts for 2007-08 on 27 June 2008, and they were laid in the House of Commons on 30 June. This was an improvement of more than three weeks on the previous year, and was among the earliest of the main Whitehall Departments. It represented substantial progress for the Department, and was one of the main planks for achieving three and a half stars under the Five Star Finance Programme. Progressively over time, the NAO's audit of the Department's accounts has produced fewer adjustments to the figures, so that the final published accounts resemble increasingly the internal management accounts against which in-year financial performance has been monitored.

Reports to the Board

2.73 The main source of in-year financial information for the Board is the Key Performance Report (KPR). The structure and content of the KPR has improved significantly in the last few years, allowing the Board a detailed view of the Department's financial performance. It is more detailed than similar documents seen across government, a direct response to a Board desire for information at a level which enables members to drill down below the aggregate figures. **Figure 15 overleaf** summarises the different sections making up the KPR for November 2008.

2.74 The desire to improve the Key Performance Report from the one or two page report that it used to be is testament to the Board's desire to improve financial and operational management within the FCO. Until the Board has absolute confidence in how the high level figures are derived, it is likely that the Report will remain a lengthy document.

2.75 Since October 2008, Director Generals have been required to physically sign off their element of the KPR. Directors General and Directors engage actively in ensuring that the data is accurate, with a refusal to sign-off providing a strong impetus to bottom out data quality issues, which perhaps previously have not been dealt with so proactively.

2.76 The KPR is provided to the Board 11-12 days after the financial ledgers close at each month-end. The Department aims to reduce this to within seven working days after month-end by January 2010. The Treasury's recommended standard is for Departments to produce its in-year financial reports and forward them to their Boards within 10 days[3]. The seven day target may impact on the robustness of commentary provided, which informs the Board of any significant financial risks. The Department should balance the need for presenting management information on a timely basis with ensuring the quality of information and commentary provided.

15 Summary of information included in the November 2008 KPR

Item in KPR	Description
Key Performance Summary	High level forecasts and variances accompanied with commentary
Detailed financial analysis	Showing forecasts and variances for each Director General
Reconciliation Sheet	Reconciliation of expenditure figures to Treasury control totals
Budget monitoring by Directorate	Tables showing budget, year-to-date spending and percentage spending to-date
Human Resources	Head counts Sickness days by Directorate Quarter 2 activity report – showing UK based staff time spent on each DSO
Workforce Dynamics	Unfulfilled home jobs by grade Unfulfilled overseas jobs by grade Inward and outward loans by grade Commentary
High level change programme and other major programmes	Red, Amber, Green assessment of each major project for each of the last three months, accompanied with Commentary
Service Level Agreements with Partners Across Government (PAG)	Central costs recovered against the budget (cost recoveries are largely in respect of the PAGs paying FCO for using the facilities at their overseas Posts)
Programme Costs	Forecast against budget including commentary
Treasury Management	New item for November – three pages explaining the forward purchasing of foreign currency
Annex A	PRISM Performance Measures (PRISM is the FCO's financial management and accounting system) Progress against efficiency targets for CSR 07 (forecast savings against target) Performance against DSOS (red, amber, green rating)
Annex B – Finance Annexes	Operating cost statement Balance Sheet (with commentary) Operating costs in detail Programme Costs
Annex C – Capital Expenditure	Actual capital expenditure against budget including commentary

Source: FCO KPR

3 NAO Cross Government VfM report *Managing Financial Resources*, Feb 2008.

Reporting on Programme Spend

2.77 Spending teams, particularly programme teams, report internally in a number of ways. **Figure 16** shows that programme teams have to supply very similar commentary on the use of financial resources on a regular basis to a number of different stakeholders (e.g. Programme Boards, the Financial Management group and Directorate Resource Management Units). Whilst helping challenge spending teams' use of resources, this could lead to over reporting, decreasing the time available for spending teams to carry out their principal activities and increasing administration costs through duplication of review. It also risks having several reports that use slightly different figures from different data sources.

Operational performance

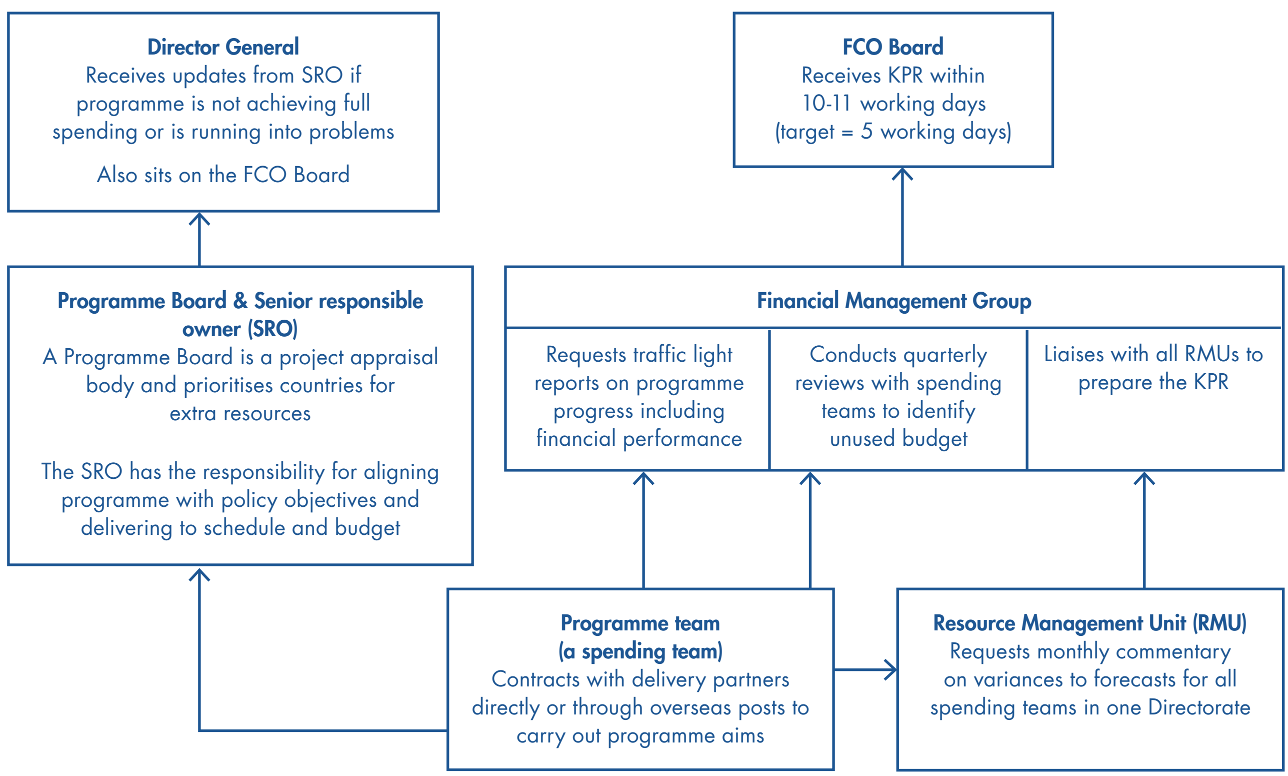
2.78 The Department reported against 9 Public Service Agreement (PSA) targets during the 2005-06 to 2007-08 Spending Review period. Performance against the Department's targets can be difficult to measure, and in many cases is dependent upon subjective judgement. For the 2008-09 to 2010-11 CSR period, the Department will report against one PSA target (PSA 30 – Reduce the impact of conflict) and eight Departmental Strategic Objectives (see Annex 2 for more detail on the DSOs).

2.79 For the 2005-06 to 2007-08 Spending Review period, the Department completed financial analysis after the year-end in order to be able to report the cost of activity across its different PSAs. Resources were not allocated across PSAs for the purposes of financial planning and in-year financial monitoring.

2.80 For the current Spending Review period, the Department prepares non-financial progress reports on a quarterly basis, providing the Board with a high level view of its performance against their PSAs and DSOs. Plans are in place to enhance this reporting to include a financial element on how much the Department spent against each DSO, using developments in activity recording across the organisation already noted elsewhere in this report.

2.81 Activity recording has been discussed in detail as part of the Financial Planning section of this report. The Department has some way to go towards linking operational reporting and financial reporting, with robust real-time financial information being routinely available, disaggregated between DSOs, as a basis for decision-making.

16 Reporting programme expenditure across the organisation



Source: National Audit Office

APPENDIX ONE

Methodology

1 This report is based on our assessment of financial management in the Foreign and Commonwealth Office against the five criteria detailed in the Audit Commission's paper on World Class Financial Management. These criteria are: financial governance and leadership; financial planning; financial decision making; financial monitoring and forecasting; and financial and operational reporting.

2 In developing our assessment we used the following methods:

- Semi-structured interviews with staff across the Department.
- Analysis of HM Treasury and FCO financial data, annual budgets and expenditure since 2003-04, along with other published financial information.
- Analysis of Board papers and minutes, internal FCO guidance and the results of previous NAO work with the Department.
- Review of the findings of the study by the Institute of Public Finance Ltd.
- Assessment of the Department against an NAO-developed Financial Management toolkit.

3 Interviews were conducted with several members of the Board within the Department, along with a number of Directors from across the Department, Finance Department staff, Resource Management Unit staff, Internal Audit, and UK and overseas budget managers, including visits to overseas posts. The interviews took place between September 2008 and January 2009.

4 We reviewed publicly available documents and documents held by the Department, including:

- HM Treasury Supply Estimates.
- Departmental Reports.
- Internal audit reports, self-audit returns and NAO management letters.
- Other papers held by staff and documents posted on the Department's intranet.
- We also drew information from the NAO's Value for Money Report: Managing Financial Resources (published February 2008 HC 240 2007-08).

5 In May 2008, the Department commissioned the Institute of Public Finance Ltd to undertake a review of its financial management. The aim was to provide a comparison with other organisations and prioritise financial management improvements. The IPF's work included a staff survey. Its review used the CIPFA Financial Management Model as a framework for the review. IPF's conclusions have informed our work, but the conclusions and recommendations included within the report are the responsibility of the NAO alone.

6 The National Audit Office developed its own Financial Management toolkit for reviewing financial management using published methodologies and these were used when undertaking this review. As evidence from all sources was gathered, it was logged against the relevant good practice statements. This was then used as a basis for assessment of the Department.

APPENDIX TWO

Departmental Strategic Objectives

DSO 1 – A flexible, global network, serving the whole of the British Government

1 The network delivers the key priorities of Whitehall partners.

2 The network is realigned by March 2009 as agreed by FCO Ministers/Board; and regularly reviewed as necessary:

– e.g. shifting resources from Europe and Americas.

3 The network remains flexible.

4 The network remains global.

5 The network delivers change and manages its resources well.

DSO 2 – Support the British economy

1 Attract high value foreign direct investment to the UK.

2 Improve the performance of UK business by helping them internationalise.

3 Increase the quantity of Research and Development (R&D) activity in the UK through business internationalisation.

4 Improve the UK's reputation as the international business partner of choice.

5 Improve UKTI's operational performance.

DSO 3 – Support British Nationals Abroad

1 Quality of Service – with a focus on customers being responsive to customers e.g. issuing passports within 10 working days.

2 Professionalism of staff – trained staff and well managed staff.

3 Consistent service delivery – compliant with internal procedures and prepared for the unexpected.

4 Efficient working – maximise fee income. Reliable systems and efficient use of resources.

DSO 4 – Support managed migration for Britain

1 Establish and develop sustainable arrangements with foreign governments for the return of immigration offenders, including Foreign National Prisoners (FNPs) and Failed Asylum Seekers (FAS) in order to meet the PSA 3 indicators on ensuring and enforcing compliance with UK immigration laws, removing the most harmful people first and denying the privileges of the UK to those here illegally.

2 Through the cross-departmental (FCO, DFID, Ministry of Justice, UKBA) Returns and Reintegration Fund, the FCO will significantly increase the number of Foreign National Prisoners (FNP) and Failed Asylum Seekers (FAS) returned to countries of origin, and tackle intake.

3 Support the PSA Indicators on strengthening UK borders and boosting Britain's economy to help to deliver a successful merger of UKVisas into UKBA and launch of the new Agency. The FCO will act as UKBA's strategic partner in the development of HMG's migration and visa policy and will work with bilateral partners, especially France and Belgium, to strengthen borders (juxtaposed controls).

4 Through FCO country and multilateral expertise provide timely and informed contributions to Country of Origin Information (COI) Reports, and to country assessments for designation of countries for Non-Suspensive Appeals.

5 Ensure that international and EU co-operation, including the Global Forum on Migration and Development and UN developments on asylum protection meets UK objectives.

DSO 5 – Counter-terrorism, weapons proliferation and their causes

1 Focus our international counter-terrorist (CT) work on creating real effect across the four strands of the Government's CONTEST CT strategy, namely:

- **Prevent:** Reduce the threat posed by violent extremism to the UK and its interests overseas by undermining extremist ideology, supporting mainstream voices and increasing individual and community resilience in priority countries as part of a coordinated cross-Whitehall response.
- **Pursue:** Enhance the detection and disruption of terrorists and terrorist networks that pose a threat to the UK and its overseas interests.
- **Protect:** Reduce the vulnerability of UK interests and people overseas. Raising public awareness of the terrorist threat overseas is done predominantly through **FCO Travel Advice**. Stakeholder feedback remains positive and readership is high – there have been over 2.5 million visits to the Travel Advice website since it was re-launched on 31 March 2008.
- **Prepare:** Set baseline standards for response to terrorist incidents, ensure the FCO global network meets and exceeds them, and that sufficient staff in London have the appropriate training.

2 Address the threat from Weapons of Mass Destruction (WMD) by preventing States from acquiring or developing WMD capabilities (including their delivery) and by reinvigorating the global commitment to nuclear disarmament.

3 Prevent terrorists or criminals from acquiring chemical, biological, radiological, and nuclear materials.

4 Tackle the threat posed by conventional weapons to humanitarian, UK, regional, and global stability.

DSO 6 – Prevent and resolve conflict

1 Better early warning and early action, to prevent conflict and its resources.

2 Better-integrated national and international approach to Peace Support Operations, stabilisation and sustained post-conflict peace building.

3 Increased national and international capabilities to tackle conflict, including conflict mediation and resolution.

4 Improved capability to tackle the long-term and structural causes of conflict, e.g. political inequality, human rights abuses, weak governance, and natural resources.

5 Reduced impact of conflict and acceleration towards resolution, primarily through political and diplomatic efforts, in Afghanistan, Iraq, Kosovo, Middle East, and Sudan, and progress in addressing long-term, "frozen" or intractable conflicts.

DSO 7 – Promote a low carbon, high growth, global economy

1 A visible and accelerated shift in investment initiated in the major economies towards low carbon.

2 Political conditions created for an equitable post-2012 agreement of sufficient ambition to avoid dangerous climate change.

3 Risks to UK and EU energy security managed through more diverse and reliable external sources of supply and more efficient global consumption.

4 Increased international commitment for an open and equitable low carbon global economy.

5 Increased international commitment to achieve the Millennium Development Goals.

DSO 8 – Develop effective international institutions, above all the UN and the EU

1 Stronger capacity in international institutions to address effectively the challenges and opportunities of the 21st Century: terrorism, weapons proliferation, climate change, sustainable growth, conflict, and migration.

2 International institutions that are more representative of the modern world, more effective, efficient, responsive, and coherent.

3 Greater international institutional effectiveness in promoting respect for human rights, justice, rule of law, democracy, open markets and the reduction of poverty and inequality.

4 An EU that responds effectively to the global challenges of prosperity, environmental security and climate change, and stability by:

- delivering an open and competitive European economy;
- promoting stability and growth in its neighbourhood; and
- working for sustainability, openness and security in the wider world.

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